

1 UNITED STATES DISTRICT COURT
2 EASTERN DISTRICT OF WASHINGTON

3
4 No. CV-04-0025-FVS

5 IN RE METROPOLITAN SECURITIES
6 LITIGATION

7 ORDER GRANTING IN PART AND
8 DENYING IN PART DEFENDANTS'
9 MOTIONS TO DISMISS

10 **THIS MATTER** is before the Court on four motions to dismiss
11 brought by the various Defendants. In view of this procedural
12 posture, the Court must accept all factual allegations set forth in
13 the complaint as true for the purposes of the present order. *Epstein*
14 *v. Wash. Energy Co.*, 83 F.3d 1136, 1140 (9th Cir. 1996). The
15 following statement of facts is accordingly drawn from the pleadings.

16 **BACKGROUND**

17 This is a class action brought by investors against
18 the former accountants, the Qualified Independent Underwriter, and
19 certain officers and directors of Metropolitan Mortgage & Securities
20 Company ("Metropolitan"), Summit Securities ("Summit"), and their
21 subsidiaries. The Plaintiffs allege that Metropolitan and Summit were
22 affiliated securities companies. Both owned a number of subsidiaries,
23 collectively referred to as the "Met Group." After the collapse of
24 Metropolitan and Summit in 2004, their securities became virtually
25 worthless. SCAC ¶ 12. This suit followed.

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DISMISS- 1

1 **Procedural History**

2 The present action is a consolidation of two previously filed
3 actions, *Hall et al. v. Metropolitan Mortgage & Securities Co. Inc.,*
4 *et al*, CV-04-28-FVS and *Cauvel et al. v. Metropolitan Investment*
5 *Securities Company, Inc. et al*, CV-04-25-FVS. When the Court
6 consolidated the cases on August 11, 2004, it appointed Keith Cauvel,
7 Arthur Becker, Venus Hafford Weber, Eva Drauhn, George Saylor, Becklyn
8 Wilkey, and Floyd Bodner (collectively, "the Saylor Group") as Lead
9 Plaintiffs for the proposed class pursuant to 15 U.S.C. § 78u-
10 4(a)(3)(B). (Ct. Rec. 121.) By the same order, the Court appointed
11 Hagens Berman LLP and Gordon Thomas Honeywell Malanca Peterson &
12 Daheim LP as Co-Lead Counsel. *Id.*

13 The First Amended Complaint¹ ("FAC") in *Cauvel*, Ct. Rec. 11,
14 named as Defendants Metropolitan, Summit, Metropolitan Investment
15 Securities, Inc. ("MIS"), Ernst & Young, LLP, and a number of former
16 Metropolitan and Summit officers and directors. It alleged claims
17 under Section 10(b) of the Securities and Exchange Act of 1934 ("the
18 Exchange Act" or "the 1934 Act") and Sections 11, 12, 15, and 20 of
19 the Securities Act of 1933 ("the Securities Act" or "the 1933 Act").
20 (Ct. Rec. 11.) Following the consolidation of *Cauvel* with *Hall*, on
21 December 17, 2004, the Plaintiffs moved to file an amended complaint.
22 (Ct. Rec. 150.) The Plaintiffs attached their proposed Consolidated
23 and Amended Class Action Complaint ("CAC") to the motion to amend.
24 The Court granted the motion on January 20, 2005, Ct. Rec. 178, and

25 _____
26 ¹The original Complaint, Ct. Rec. 1, in *Cauvel* was amended
prior to the filing of the Defendants' Answer.

1 the Plaintiffs filed the CAC on March 11, 2005. (Ct. Rec. 209.) The
2 CAC named Pricewaterhousecoopers, LLP and Roth Capital Partners, LLC
3 as Defendants for the first time. The CAC dropped the claim
4 previously asserted under the 1934 Act, and instead alleged a claim
5 under Washington State's Securities Act ("WSSA").

6 On October 6, 2006, the Court approved a partial settlement that
7 dismissed a number of Defendants. (Ct. Rec. 406.) The Court also
8 granted the Plaintiffs permission to file a second consolidated and
9 amended complaint. (Ct. Rec. 404). The Plaintiffs filed their Second
10 Consolidated and Amended Class Action Complaint ("SCAC") on October
11 10, 2006.

12 The SCAC asserts a total of thirteen claims. Pursuant to Section
13 11 of the 1933 Act, the Plaintiffs allege that, as a result of the
14 Defendants' negligence, certain registration statements issued by
15 Metropolitan and Summit contained material misrepresentations and
16 omissions. The Plaintiffs bring an additional Section 11 claim
17 against Metropolitan and Summit's former auditors and underwriter,
18 alleging that the misrepresentations in the registration statements
19 amounted to fraud. SCAC ¶¶ 758-782. Pursuant to Section 12 of the
20 1933 Act, the Plaintiffs allege that the Met Group's former officers
21 and directors sold securities using prospectuses that contained
22 misrepresentations. Pursuant to Section 15 of the 1933 Act, the
23 Plaintiffs allege that the Met Group's former officers and directors
24 exercised control over the parties responsible for the Section 11 and
25 Section 12 violations. Finally, pursuant to Washington State's
26 Securities Act, the Plaintiffs allege that all of the Defendants made

1 false statements in connection with the sale of securities.

2 The Plaintiffs propose to certify two different classes. The
3 Federal Claims Class would bring only federal claims and consist of
4 all persons who purchased investment debentures and preferred stock
5 from Metropolitan and investment certificates and preferred stock from
6 Summit pursuant to nine registration statements (the "Registration
7 Statements") that became or were effective from February 13, 2001 to
8 December 15, 2003 ("the Class Period"). SCAC ¶ 40. The State Claims
9 Class would bring only state law claims and consist of all persons who
10 purchased investment debentures and preferred stock from Metropolitan
11 and investment certificates and preferred stock from Summit pursuant
12 to the Registration Statements that became or were effective during
13 the Class Period *but which were not listed or authorized for listing*
14 *on the National Market System of the NASDAQ market system."* SCAC ¶ 40
15 (emphasis added). Class certification is not before the Court at this
16 time.

17 **The Met Group's Business Practices**

18 The Plaintiffs allege that Metropolitan focused on buying high
19 risk home mortgages after its founding in 1953. SCAC ¶ 43. In 1973,
20 Metropolitan Investment Securities, Inc. ("MIS"), a broker-dealer, was
21 formed as a wholly owned subsidiary of Metropolitan. SCAC ¶ 46.
22 Metropolitan later expanded into other areas of business, including
23 insurance. SCAC ¶ 48. Summit was created as another wholly owned
24 subsidiary in 1990. SCAC ¶ 49. Summit became a "near mirror image"
25 of Metropolitan after it was acquired by National Summit Corporation
26 in 1994. SCAC ¶ 50.

1 Metropolitan and Summit originally focused on different business
2 activities. Metropolitan was primarily involved in residential
3 mortgage loans and selling various kinds of receivables, while
4 Summit's primary areas of business were commercial lending and
5 property development. SCAC ¶ 55. Metropolitan's earnings in the mid-
6 1990s could not keep pace with its rapid growth, however, and
7 Metropolitan became "very thinly capitalized." SCAC ¶ 85. As a
8 result, Metropolitan changed its practices to reflect those of Summit
9 in 2000. SCAC ¶ 56.

10 Functioning as "a single enterprise focused on commercial
11 lending," Metropolitan and Summit aggressively pursued commercial
12 lending, writing \$20-\$30 million dollars in commercial loans every
13 month during much of 2001 and 2002. SCAC ¶¶ 86-87. In an effort to
14 increase this amount to \$100 million a month, the companies engaged in
15 increasingly risky ventures. SCAC ¶¶ 88-90. The SCAC describes
16 sixteen "representative transactions" to illustrate the Met Group's
17 practices. ¶¶ SCAC 455-619.

18 With its commercial real estate investments generating little
19 return, the Met Group was unable to pay the significant annual rates
20 of return on its securities, leading it to issue yet more securities
21 as a source of cash. SCAC ¶ 148. The Met Group thus became wholly
22 dependant on cash acquired from the sale of securities. SCAC ¶ 130.
23 Its practices required both unqualified financial statements from the
24 Met Group's auditors and continual regulatory approval. SCAC ¶ 130.
25 During the time period identified by the proposed class, the Met Group
26 made nine securities offerings. MIS acted as the sales brokerage for

1 all of these sales.

2 **Efforts to Evade State Regulation**

3 In 1995, the Securities Division of the Washington State
4 Department of Financial Institutions ("DFI") conducted an audit and
5 examination of the Met Group that disclosed numerous regulatory
6 violations, unsound business practices, and conflicts of interest.
7 SCAC ¶ 62. DFI and the Met Group subsequently entered into a
8 Memorandum of Understanding ("MOU") that imposed special requirements
9 on the Met Group. By 1998, the Met Group was disregarding the terms
10 of the MOU. SCAC ¶ 63.

11 In late 1999, Metropolitan "sought to escape the supervision of
12 the Washington State regulators" by "listing its debentures on a
13 national securities exchange for the express purpose of achieving
14 preemption as a 'covered security' under federal law." SCAC ¶¶ 64-65.
15 Metropolitan accordingly listed its debentures on Tier I of the
16 Pacific Stock Exchange. SCAC ¶ 66. In January 2002, Metropolitan
17 listed its preferred stock, Series E-7, on the American Stock
18 Exchange. SCAC ¶ 72. "Thus Metropolitan was able to achieve complete
19 preemption of regulation by the DFI." SCAC ¶ 73.

20 **The Collapse**

21 On December 31, 2002, Metropolitan filed its Annual Report (Form
22 10-K) with the SEC. The report explained that the IRS intended to
23 disallow certain tax benefits Metropolitan had claimed based on its
24 involvement in the Foreign Leverage Investment Program ("FLIP"). The
25 report further indicated that Metropolitan could lose up to \$28
26 million if, following an audit, the IRS ultimately disallowed the FLIP

1 transaction's tax benefits. The report also stated that a complete
2 review had not taken place at the time of the report and Metropolitan
3 could not "reasonably estimate a loss, if any, associated with this
4 transaction." Metro. Mortgage & Sec. Co., Annual Report (Form 10-K),
5 at 28 (December 31, 2002).

6 In October 2002 and March 2003, the Met Group sought SEC approval
7 for two new securities offerings, one for Metropolitan and the other
8 for Summit. SCAC ¶¶ 131-132. In investigating the registration
9 statements underlying the securities, the SEC observed a number of
10 concerning practices, SCAC ¶ 134, and denied approval for both
11 proposed offerings. SCAC ¶ 133. Following the SEC's lead, the Met
12 Group's qualified independent underwriter, as well as its auditor,
13 also took a closer look at the Met Group's practices. SCAC ¶ 135.
14 The underwriter withdrew its approval of pricing and yield
15 determinations for all currently offered Met Group Securities on July
16 17, 2003. SCAC ¶ 136.

17 Around the same time, the National Association of Securities
18 Dealers ("NASD") began investigating MIS, eventually resulting in a
19 \$500,000 fine and a prohibition on further marketing of securities.
20 SCAC ¶¶ 137, 139. On July 7, 2003, Metropolitan filed a Current
21 Report, Form 8-K, with the SEC, revealing that MIS, "the sole broker
22 dealer responsible for the offer and sale of [Metropolitan's]
23 preferred stock and debt securities," had received a "Wells letter"
24 from NASD. The Wells letter notified MIS that NASD had made a
25 preliminary determination to recommend sanctions against it. The July
26 7 report explained that MIS would be given an opportunity to respond

1 to NASD's allegations and that MIS was cooperating with NASD in an
2 attempt to resolve the matter. The report further explained that
3 sanctions, if ultimately imposed, could have an adverse effect on
4 MIS's ability to sell Metropolitan's securities, which could, in turn,
5 have an adverse effect on Metropolitan. Metro. Mortgage & Sec. Co.,
6 Current Report (Form 8-K), Item 5 (July 7, 2003).

7 On November 3, 2003, Metropolitan and Summit's boards of
8 directors suspended monthly payments on all preferred stock and
9 announced the penalties NASD had imposed upon MIS. SCAC ¶ 143. The
10 following day, Metropolitan filed a Current Report that revealed two
11 facts relevant to the motions presently before the Court. First, the
12 report revealed that MIS had settled the issues raised in NASD's Wells
13 letter by entering into a Letter of Acceptance, Waiver, and Consent
14 ("AWC") with NASD. Under the AWC, MIS agreed to pay a fine of
15 \$500,000, make restitution to certain investors, and "agreed not to
16 sell securities to its affiliates until it has revised its systems,
17 supervision, training, and written procedures with respect to those
18 sales." Metro. Mortgage & Sec. Co., Current Report (Form 8-K), Item 5
19 (November 4, 2003).

20 Second, the November 4 report disclosed that Metropolitan had
21 suspended dividend payments in order to "conserve liquidity." While
22 Metropolitan's projected cash needs for the next three months totaled
23 \$10 million, the company's available cash only amounted to \$7 million.
24 Most significantly, the report explained,

25 Because the company is currently unable to sell securities
26 publicly, which sales historically have been significant
sources of liquidity, the company is exploring other options

1 to improve its liquidity position. No assurance can be
2 given that these efforts will be successful.

3 *Id.*

4 Summit issued a similar Current Report on November 4, 2003. This
5 report revealed that Summit, like Metropolitan, was suspending
6 dividend payments on its preferred stock in order to "conserve
7 liquidity." It also contained identical language warning investors of
8 the historical importance of securities sales and the uncertainty of
9 Summit's cash flow position. Summit Sec. Inc., Current Report (Form
10 8-K), Item 5 (November 4, 2003).

11 On December 15, 2003, Metropolitan filed another Current Report,
12 Form 8-K, revealing that MIS had ceased operations. The report
13 stated, "MIS will no longer have the ability to sell [Metropolitan's]
14 securities which in the past have been a significant source of
15 revenue." Metro. Mortgage & Sec. Co., Current Report (Form 8-K), Item
16 5 (July 7, 2003).

17 Unable to sell additional securities, the Met Group's "liquidity
18 problems intensified" and it began considering the possibility of
19 bankruptcy. SCAC ¶¶ 139-140. On January 20, 2004, the Met Group's
20 independent auditor withdrew its 2001 and 2002 opinions on the Met
21 Group's financial statements. SCAC ¶ 144. Metropolitan and Summit
22 filed for bankruptcy on February 4, 2004. SCAC ¶ 147.

1 **The Accountant² Defendants**

2 Pricewaterhousecoopers, LLP ("PwC") served as the Met Group's
3 independent auditor and accountant from 1994 until June 12, 2001. In
4 this capacity, PwC prepared and certified Metropolitan and Summit's
5 financial statements for fiscal year 2000. PwC consented to being
6 named as the party that prepared and certified the financial
7 statements attached to the Registration Statements. SCAC ¶ 36.

8 Ernst & Young, LLP ("EY") served as Metropolitan and Summit's
9 independent auditor and accountant from June 12, 2001, until January
10 22, 2004. In this capacity, EY prepared and certified financial
11 statements for fiscal years 2001 and 2002, and quarterly statements
12 for fiscal year 2003. EY consented to being named as the party that
13 prepared and/or certified the financial statements attached to the
14 Registration Statements. SCAC ¶ 37.

15 The SCAC alleges that PwC and EY negligently violated their
16 duties under Generally Accepted Auditing Standards ("GAAS") and
17 Generally Accepted Accounting Principles ("GAAP") by issuing
18 unqualified audit opinions that enabled Metropolitan and Summit to
19 sell securities. SCAC ¶ 150. The SCAC further alleges that the
20 Accountant Defendants certified Metropolitan and Summit's year-end
21 financial statements. These certifications were materially false.
22 SCAC ¶¶ 708, 716.

24
25 ²Both of the Defendants described in this section also
26 served as Metropolitan and Summit's independent auditor during
part of the Class Period. For the sake of simplicity, this order
refers to them as "the Accountant Defendants."

1 **Roth Capital Partners**

2 Roth Capital Partners ("Roth") is an investment banking
3 firm. Roth served as Metropolitan and Summit's Qualified Independent
4 Underwriter ("QIU") from 1998-2003. SCAC ¶ 630. As the QIU, Roth was
5 required to undertake the responsibilities and liabilities of an
6 underwriter prescribed by Section 11 of the Securities Act of 1933.
7 One such responsibility is to exercise due diligence by verifying the
8 accuracy of the Met Group's registration statements and prospectuses.
9 SCAC ¶ 632.

10 The SCAC alleges that Roth performed its due diligence
11 negligently. As a result, Roth failed to detect a number of
12 misrepresentations and omissions in the Met Group's registration
13 statements. Roth also negligently approved prices and dividend
14 schedules for the Met Group's securities that understated the risks of
15 the securities. SCAC ¶ 643.

16 **Koa Timber Transaction**

17 One of the representative transactions alleged in the SCAC of
18 particular import to the present motions is the "Koa Timber
19 Transaction." Pursuant to the "Timber Harvest Agreement,"
20 Metropolitan, Summit, and Old Standard Life Insurance, a Summit
21 subsidiary, loaned a total of \$11.85 million to one Kyle Dong to
22 enable him to acquire and begin logging 13,000 acres of forested land
23 in Hawaii known as the Hilo property. The Hilo property was worth
24 only \$9.1 million and most of it was located in a Conservation
25 District. Dong did not have the permit necessary to begin logging.
26 SCAC ¶¶ 456-493.

1 Pursuant to the Timber Harvest Agreement, Metropolitan purchased
2 the right to harvest the timber on the Hilo property from Dong for
3 \$2.5 million. The same day, Dong reacquired the right from
4 Metropolitan for \$18 million to be paid over five years. Metropolitan
5 then sold the Timber Harvest Agreement to Summit for \$13.2 million.
6 Dong defaulted on his second payment, to be made on November 1, 2000.
7 In August of 2001, Summit brought suit to recover the amounts due.
8 SCAC ¶ 627. Dong counterclaimed, alleging that the Timber Harvest
9 Agreement was void and unenforceable "as part and parcel of securities
10 fraud." Declaration of Brian D. Buckley, December 6, 2006, Ex. A ¶
11 201.

12 The SCAC alleges that, although PwC was aware of Dong's default
13 and his failure to obtain a permit, PwC's consolidated financial
14 statements for Metropolitan for 2000 did not disclose either of these
15 facts. The consolidated financial statements for Summit for 2000
16 indicated that the Timber Agreement was acquired for fair market
17 value. For these and other reasons, "Financial reporting for the Koa
18 Transaction violated numerous GAAP, GAAS and SEC provisions." SCAC ¶
19 493.

20 The SCAC further alleges that EY was familiar with the Met
21 Group's accounting in the Koa transaction, that EY negligently failed
22 to conduct an investigation of the transaction in connection with its
23 2001 audit, and that EY did not revise PwC's 2000 financial
24 statements. SCAC ¶ 491.

25 **FLIP Transaction**

26 In support of their argument that PwC was negligent in performing

