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5 Attorneys for Claimant The New Century
6 Liquidating Trust and Reorganized New
7 Century Warehouse Corporation, by and
through Alan M. Jacobs, as Liquidating
8 Trustee and Plan Administrator

9
10 **SUPERIOR COURT OF THE STATE OF CALIFORNIA**
11 **IN THE COUNTY OF LOS ANGELES**

13 The New Century Liquidating Trust and)
Reorganized New Century Warehouse)
14 Corporation, by and through Alan M.)
Jacobs, as Liquidating Trustee and Plan)
15 Administrator,)
16 Plaintiff,)
17 v.)
18 KPMG LLP, a Delaware Limited Liability)
19 Partnership)
20 Defendant.)
21)

Case No. _____

**COMPLAINT FOR DECLARATORY
RELIEF; NEGLIGENCE AND AIDING
AND ABETTING BREACH OF
FIDUCIARY DUTY**

22
23
24 1. This is an action for declaratory relief, negligence and aiding and
25 abetting breach of fiduciary duty against KPMG LLP (“KPMG”). By the allegations
26 herein, Plaintiff The New Century Liquidating Trust and Reorganized New Century
27 Warehouse Corporation, by and through Alan M. Jacobs, as Liquidating Trustee and Plan
28 Administrator (the “Trustee” or “Plaintiff”) (together, “New Century”), seeks a

1 declaration that the arbitration agreement between the parties is void because Defendant
2 KPMG intentionally included a prohibition on punitive damages in the parties' arbitration
3 agreement it knew was illegal, against public policy and unenforceable. Plaintiff also
4 asserts claims for negligence and aiding and abetting breach of fiduciary duty against
5 KPMG as the auditor of New Century for its reckless and grossly negligent audits of New
6 Century and its knowledge of and substantial assistance with the breaches of fiduciary
7 duty by New Century's officers and directors.

8 INTRODUCTION

9 2. Audits of financial statements can only be done by independent,
10 certified *public* accountants. Audits of public companies like New Century are required
11 by law to protect creditors, the investing public, the Company's employees and other
12 stakeholders, and the Company itself. Because of this special responsibility the United
13 States Supreme Court holds auditors like Respondent KPMG to be the "public
14 watchdog."

15 3. KPMG failed its public watchdog duty. The result was catastrophic.

16 4. Founded in 1995, New Century was a mortgage finance company
17 that both originated and purchased residential mortgage loans, the majority of which were
18 subprime loans. As the subprime mortgage market grew, so did New Century — New
19 Century's reported assets grew from \$300,000 in 1996 to \$26 billion in 2005.

20 5. With the backdrop of New Century's rapid growth, New Century's
21 Board of Directors and Audit Committee questioned management's incentives to manage
22 earnings and therefore engage in aggressive accounting — precisely the type of risks an
23 independent auditor is there to watch for and respond to. New Century and the users of
24 its financial statements depended on its gatekeeper, KPMG, to ensure that those financial
25 statements were fairly presented in accordance with GAAP and free of material
26 misstatement due to error or fraud.

1 **KPMG Was Not Independent**

2 6. KPMG did not act like a watchdog. Instead, KPMG assisted in the
3 misstatements and certified the materially misstated financial statements.

4 7. When specialists within KPMG tried to point out misstatements in
5 the financial statements, they were silenced by the KPMG partner in charge of the New
6 Century audits to protect KPMG's business relationship with, and fees from, New
7 Century. When a KPMG specialist, John Klinge, continued to raise questions about an
8 incorrect accounting practice on the eve of the Company's 2005 Form 10-K filing, John
9 Donovan, the lead KPMG audit partner told him: "I am very disappointed we are still
10 discussing this. As far as I am concerned we are done. The client thinks we are done.
11 All we are going to do is piss everybody off."

12 8. KPMG then did the unthinkable for a public auditor — it issued its
13 audit report before its audit was complete, falsely enabling New Century to file its Form
14 10-K.

15 9. KPMG acted as a cheerleader for management, not the public
16 interest. KPMG lacked the independence required by the ethical and SEC rules that
17 govern it. Because KPMG lacked independence, KPMG could not even issue its audit
18 opinions, perform reviews, or audit the internal control of New Century. KPMG's audits
19 and reviews thus failed as a matter of law and ethics.

20 **KPMG Was Grossly Negligent**

21 10. Even apart from KPMG's lack of independence, KPMG still
22 performed grossly negligent audits and reviews. Because KPMG violated basic audit and
23 review requirements, KPMG failed to detect material errors in New Century's financial
24 statements, including New Century's residual interest asset in the loans it securitized and
25 in its loan repurchase liability.

26 11. KPMG's audit and review failures concerning New Century's
27 reserves highlights KPMG's gross negligence, and its calamitous effect — including the
28 bankruptcy of New Century. New Century engaged in admittedly high risk lending. Its

1 public filings contained pages of risk factors. A key component of New Century's
2 accounting was properly reserving against the various and substantial risks its business
3 model embraced.

4 12. New Century's calculations for required reserves were wrong and
5 violated GAAP. For example, if New Century sold a mortgage loan that did not meet
6 certain conditions, New Century was required to repurchase that loan. New Century's
7 loan repurchase reserve calculation assumed that all such repurchases occur within 90
8 days of when New Century sold the loan, when in fact that assumption was false. KPMG
9 applied auditing procedures to the repurchase reserve calculation, reviewed it quarterly
10 and advised New Century about it. KPMG knew or should have known that the 90 day
11 assumption was false, yet KPMG accepted the incorrect reserve calculation and reserves.

12 13. In 2005 New Century informed KPMG that the total outstanding
13 loan repurchase requests were \$188 million. If KPMG only considered the loans sold
14 within the prior 90 days, the potential liability shrank to \$70 million. Despite the fact that
15 KPMG knew the 90 day look-back period excluded over \$100 million in repurchase
16 requests, KPMG nonetheless still accepted the flawed \$70 million measure used by New
17 Century to calculate the repurchase reserve. The obvious result was that New Century
18 significantly under reserved for its risks.

19 14. Not only did KPMG fail in its gatekeeper role, it actually advised
20 New Century to alter the loan repurchase reserve calculation, which resulted in a
21 violation of GAAP. When a KPMG staff auditor raised her concerns with the client
22 about the decision to remove certain components from the reserve calculation, the KPMG
23 Senior Manager silenced the more junior auditor, instructing her to "not ask the client
24 regarding this anymore."

25 15. KPMG now admits that New Century did not satisfy GAAP
26 requirements pertaining to loan repurchase reserves. Had KPMG done its job the
27 fundamental mistakes in the calculation of the loan repurchase reserve been caught early.
28 Instead, the mistake grew to over \$300 million dollars, and when it was finally detected,

1 contract at issue was made with the KPMG office located in this county and Plaintiff is
2 informed and believes that Defendant KPMG conducts business continually in this
3 county.

4 **THE PARTIES**

5 21. Plaintiff is the New Century Liquidating Trust and Reorganized New
6 Century Warehouse Corporation, by and through Alan M. Jacobs, as Liquidating Trustee
7 and Plan Administrator (the “Trustee” or “Plaintiff”) (together, “New Century”).¹ New
8 Century was a publicly-traded mortgage lender with its headquarters in Irvine, California.

9 22. Defendant KPMG LLP is a Delaware limited liability partnership.
10 KPMG was the independent auditor for New Century and its subsidiaries for the years
11 1995 through 2006. KPMG’s Los Angeles, California office entered into the “Agreement
12 to Perform Services,” dated September 7, 2004, and as amended April 17, 2006
13 (“Agreement”) with New Century. A copy of the Agreement is attached to this
14 Complaint as Exhibit A. Pursuant to that Agreement, KPMG performed the audits of
15 New Century out of its Los Angeles, California office, including by staffing John
16

17
18 ¹ The Liquidating Trustee stands in the shoes of the New Century debtors which are the
19 following entities: New Century TRS Holdings, Inc. (f/k/a New Century Financial Corporation),
20 a Delaware corporation; New Century Mortgage Corporation (f/k/a JBE Mortgage) (d/b/a
21 NCMC Mortgage Corporate, New Century Corporation, New Century Mortgage Ventures,
22 LLC), a California corporation; NC Capital Corporation, a California corporation; Home123
23 Corporation (f/k/a The Anyloan Corporation, 1800anyloan.com, Anyloan.com), a California
24 corporation; New Century Credit Corporation (f/k/a Worth Funding Incorporated), a California
25 corporation; NC Asset Holding, L.P. (f/k/a NC Residual II Corporation), a Delaware limited
26 partnership; NC Residual III Corporation, a Delaware corporation; NC Residual IV Corporation,
27 a Delaware corporation; New Century R.E.O. Corp., a California corporation; New Century
28 R.E.O. II Corp., a California corporation; New Century R.E.O. III Corp., a California
corporation; New Century Mortgage Ventures, LLC (d/b/a Summit Resort Lending, Total
Mortgage Resource, Select Mortgage Group, Monticello Mortgage Services, Ad Astra Mortgage,
Midwest Home Mortgage, TRATS Financial Services, Elite Financial Services, Buyers
Advantage Mortgage), a Delaware limited liability company; NC Deltex, LLC, a Delaware
limited liability company; NCoral, L.P., a Delaware limited partnership; and New Century
Warehouse Corporation (“NCW”), a California Corporation.

1 Donovan from KPMG’s Los Angeles office as the Lead Audit Partner for the New
2 Century audits.

3 **FACTUAL ALLEGATIONS**

4 **I. The Agreement Between New Century and KPMG**

5 23. The Agreement between New Century and KPMG set forth the audit
6 services KPMG would perform for New Century and includes a dispute resolution
7 process for all claims arising out of KPMG’s services to New Century:

8 Any dispute or claim arising out of or relating to the engagement letter
9 between the parties, the services provided thereunder, or any other services
10 provided by or behalf of KPMG . . . shall be resolved in accordance with
11 the dispute resolution procedures set forth in Appendix II.

12 Exh. A at A9.

13 24. Appendix II of the Agreement, entitled “Dispute Resolution
14 Procedures,” provides that mediation and arbitration are “sole methodologies to be used
15 to resolve any controversy or claim” between New Century and KPMG. *Id.*, App. II at
16 A17.

17 25. The Agreement prohibits any award of punitive damages in any
18 arbitration conducted pursuant to the Agreement: “Damages that are inconsistent with
19 any applicable agreement between the parties, **that are punitive in nature**, or that are
20 not measured by the prevailing party’s actual damages shall be unavailable in
21 arbitration.” *See id.* at A18 (emphasis added).

22 26. Years before KPMG attempted to exclude punitive damages against
23 it, the California Supreme Court held in *Armendariz v. Foundation Health Psychcare*
24 *Servs., Inc.*, 24 Cal. 4th 83 (2000), that an arbitration agreement that prohibited punitive
25 damages was “contrary to public policy and unlawful.” *Id.* at 104.

26 27. More specifically, in California, arbitration agreements between
27 accounting firms and audit clients, such as the Agreement between KPMG and New
28 Century, that prohibit punitive damage awards are unenforceable and contrary to public

1 policy. *NG v. BDO Seidman*, No. A109677, San Francisco Super. Ct. (April 5, 2006),
2 attached as Exhibit B; *Balwani v. BDO Seidman*, No. A108973, San Francisco Super. Ct.
3 (April 5, 2006), attached as Exhibit C and; *Cowan v. BDO Seidman*, No. A107681 (April
4 5, 2006), attached as Exhibit D. Pursuant to *Armendariz*, the Agreement’s prohibition on
5 punitive damage awards is unenforceable.

6 28. KPMG included the prohibition on punitive damages in the
7 Agreement knowing of its illegality and therefore acted in bad faith. KPMG drafted the
8 2004 Agreement after the Supreme Court’s 2000 *Armendariz* decision, applied it again in
9 2005 with no change, and then amended the Agreement – leaving in the illegal punitive
10 damage prohibition – even after bars on punitive damages in agreements between
11 auditors and their clients were declared illegal. Exhs. B-D. Because the law was
12 sufficiently clear that prohibitions on punitive damages were illegal under California law
13 at the time KPMG drafted the Agreement, KPMG acted in bad faith in including the
14 prohibition, rendering the arbitration provision in the Agreement unenforceable.

15 **II. New Century’s Collapse and KPMG’S Gross Negligence**

16 29. Pursuant to the Agreement signed each year, KPMG prepared audit
17 opinions of New Century’s financial statements each year from 1995 to 2006.

18 30. In each of these years, KPMG certified that New Century’s financial
19 statements “present[ed] fairly, in all material respects, the financial condition” of New
20 Century.

21 31. KPMG’s certification was false and KPMG was grossly negligent in
22 auditing New Century. KPMG was not independent in violation of auditing standards
23 and the ethical rules governing auditors, and therefore KPMG could not even audit or
24 review New Century’s financial statements or audit New Century’s internal control.
25 Even if KPMG had been independent, KPMG still was grossly negligent in its audits and
26 reviews of New Century’s financial statements and its audit of New Century’s internal
27 control. The details of at least some of KPMG’s gross negligence are set forth in the
28 Final Report of Michael J. Missal, Bankruptcy Court Examiner, dated February 29, 2008

1 as filed in the bankruptcy proceedings, *In re New Century TRS Holdings, Inc. et al.*, Case
2 No. 07-10416 (KJC), United States Bankruptcy Court for the District of Delaware (the
3 “Examiner’s Report”). A copy of the Examiner’s Report is attached as Exhibit E.

4 **III. KPMG Aided and Abetted New Century’s Directors’ and Officers’ Breaches**
5 **of Their Fiduciary Duties**

6 32. As New Century’s auditor, KPMG knew that New Century’s
7 officers and directors owed the company a fiduciary duty.

8 33. KPMG also knew that New Century’s officers and directors were in
9 breach of their fiduciary duties because KPMG knew that the directors and officers were

10 34. improperly reserving for the risks faced by the Company and failing
11 to implement an effective system of internal control over financial reporting that led to
12 the Company’s 2007 announcement of the need to restate its financial statements.

13 35. Despite KPMG’s certification that New Century’s financial
14 statements “present[ed] fairly, in all material respects, the financial condition” of New
15 Century, in 2007 New Century publicly acknowledged in 2007 that its financial
16 statements were not prepared in accordance with GAAP and were materially misstated.
17 New Century also publicly reported in 2007 that there were material weaknesses and
18 significant deficiencies in its system of internal control over financial reporting in at least
19 2005 and 2006.

20 36. Specifically, New Century advised, among other things, that the
21 financial statements audited and reviewed by KPMG:

- 22 i. failed to properly account and report the repurchase reserve in
23 accordance with GAAP;
- 24 ii. failed to properly account and report the lower of cost or market
(LOCOM) valuation adjustment for repurchased loans in accordance
25 with GAAP;
- 26 iii. failed to properly account and report the valuation of residual
27 interests in accordance with GAAP.
- 28 iv. materially understated the repurchase reserve, materially overstated
the value of repurchased loans and materially overstated the value of
residual interests;

- 1 v. materially over-stated pre-tax earnings; and
- 2 vi. should not be relied upon.

3 37. Moreover, KPMG also performed audits of the effectiveness of New
4 Century's internal control over financial reporting. In connection with these audits,
5 which were required by the 2002 Sarbanes-Oxley Act, KPMG was required to audit New
6 Century's assessment of the effectiveness of its internal control over financial reporting
7 and identify any significant deficiencies and material weaknesses in control.

8 38. KPMG therefore knew, and aided and abetted, New Century's
9 directors and officers in maintaining material weaknesses and significant deficiencies in
10 New Century's system of internal control over financial reporting during at least 2005
11 and 2006, which included, but were not limited to, the following:

- 12 i. a failure to develop and document effective policies and procedures
13 for performing estimates requiring the exercise of judgment,
14 including the repurchase reserve and the valuation of residual
15 interests;
- 16 ii. a failure to establish safeguards and controls to prevent the revision
17 of or deviation from accounting policies and related assumptions
18 without adequate supervision and review;
- 19 iii. a failure to establish safeguards and controls to insure the
20 remediation of identified internal control deficiencies;
- 21 iv. a failure to establish safeguards and controls to identify and process
22 efficiently repurchase requests; and
- 23 v. a failure to establish safeguards and controls to ensure that the
24 repurchase reserve estimation process accounted for all outstanding
25 repurchase requests.

26 39. Each of the above deficiencies was the result of KPMG's knowing
27 and substantial assistance and encouragement to the directors and officers in these
28 breaches of their fiduciary duties.

39. KPMG therefore aided and abetted the directors' and officers'
breaches of fiduciary duties. As a result, KPMG is jointly responsible with the directors
and officers for the damages resulting from those breaches.

IV. Consequence of KPMG's Gross Negligence and Aiding and Abetting

1 between auditors and their clients, such as the Agreement between KPMG and New
2 Century, and the punitive damages prohibitions have been ruled void and unenforceable.
3 Exhibits B-D.

4 48. The prohibition on punitive damages set forth in the Agreement
5 illegally deprives Plaintiff of his right to seek punitive damages in arbitration.

6 49. KPMG acted in bad faith when it included the punitive damages
7 prohibition in the Agreement. The *Armendariz* rule was established by the California
8 Supreme Court four years before the Agreement was originally executed in 2004 and six
9 years before the Agreement was amended. Moreover, three court decisions finding
10 punitive damages prohibitions in auditor agreements, such as the Agreement for KPMG's
11 services between KPMG and New Century, were issued prior to the 2006 amendment to
12 the Agreement. KPMG's continued use of an illegal contract term constitutes bad faith.
13 Because the arbitration provision was included in the Agreement in bad faith, the
14 arbitration provision is unenforceable.

15 50. California has a substantial interest in this Agreement, including the
16 legality of the arbitration clause, because the Agreement was executed by New Century,
17 whose headquarters were in Irvine, California and the work was performed in KPMG's
18 Los Angeles and Orange County offices.

19 51. There exists a substantial controversy of sufficient immediacy and
20 reality to warrant the issuance of a declaratory judgment.

21 52. A judicial declaration pursuant to Cal. Civ. Proc. Code § 1060 is
22 necessary and appropriate at this time so that Plaintiff's rights under the Agreement may
23 be determined with certainty.

24 **SECOND CAUSE OF ACTION**

25 **(Negligence)**

26 53. New Century repeats and realleges paragraphs 1 through 51 of this
27 Complaint as though fully set forth herein.

1 54. Defendant KPMG owed New Century a duty of care in performing
2 their professional services. KPMG is required to perform within the scope of
3 professional auditing standards.

4 55. KPMG breached its duty to New Century when it was grossly
5 negligent in conducting its audits, quarterly reviews and Sarbanes-Oxley reviews of New
6 Century's financial statements and its internal control over financial reporting. In
7 violation of auditing standards, KPMG repeatedly failed to obtain sufficient audit
8 evidence and repeatedly failed to exercise due professional care in the performance of its
9 audits, quarterly reviews, and Sarbanes-Oxley reviews and in the preparation of its
10 reports. KPMG's failures were numerous and far-reaching.

11 56. KPMG failed to exercise due care by providing erroneous advice to
12 New Century that was inconsistent with GAAP regarding New Century's method for
13 calculating loan repurchase reserves and its method for calculating the lower of cost or
14 market adjustments for repurchased loans. New Century relied on this advice.

15 57. KPMG failed to plan its audits and reviews appropriately in light of
16 the inherent and control risks of the engagement, including, among other things, known
17 defects in the control environment and certain aggressive assumptions used as part of
18 New Century's accounting practices.

19 58. KPMG's audit procedures and review work on other financial
20 accounts at New Century, including the allowance for loan losses, mortgage servicing
21 rights, amortization of loan fees and costs, hedging and goodwill, exhibited a lack of due
22 care in that the engagement team frequently failed to consider seriously repeated
23 concerns expressed by KPMG specialists, failed to adequately question assumptions, and
24 failed to quantify magnitude of identified errors for prior periods.

25 59. In addition, KPMG lacked independence. KPMG's specialists had
26 little or no control over the conclusions reached by the engagement team and their
27 significant concerns were often dismissed by engagement team leaders.

28

1 a) A judgment stating that the punitive damage prohibition in the Agreement is
2 void, illegal and, because KPMG acted in bad faith, that the arbitration provision as a
3 whole is unenforceable;

4 b) actual compensatory and consequential damages not less than \$1 billion;

5 c) punitive damages;

6 d) rescission or rescissory damages;

7 e) attorney's fees and costs of this suit as allowed by law;

8 f) pre-judgment and post-judgment interest as allowed by law; and

9 g) such other and further legal and equitable relief as the Court deems just and
10 proper.
11

12 **DEMAND FOR JURY TRIAL**

13 Plaintiff hereby demands a trial by jury.

14 Dated: April 1, 2009

Respectfully submitted,

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18 _____
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