

UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF NEW JERSEY

WINDELS MARX LANE & MITTENDORF, LLP  
William C. Cagney (WCC-6025)  
120 Albany Street Plaza  
New Brunswick, New Jersey 08901  
(732) 846-7600  
[wcagney@windelsmarx.com](mailto:wcagney@windelsmarx.com)

Attorneys for Plaintiff Herbert Mankofsky

IN RE HOVNANIAN ENTERPRISES, INC.  
SECURITIES LITIGATION

**Civil Action No. 2:08-cv-00999  
SRC-MAS**

**SECOND AMENDED COMPLAINT  
FOR VIOLATION OF THE  
SECURITIES EXCHANGE ACT OF  
1934**

**JURY TRIAL DEMANDED**

Plaintiff, by undersigned counsel, for his Class Action Complaint, alleges the following upon personal knowledge as to plaintiff and plaintiff's own acts, and upon information and belief based upon the investigation of plaintiff's attorneys as to all other matters. The investigation includes a thorough review and analysis of public statements, publicly-filed documents including those of Hovnanian Enterprises, Inc. ("Hovnanian" or the "Company"), press releases, news articles and statements of former employees of Hovnanian and its business partners. Plaintiff believes that further substantial evidentiary support will exist for the allegations set forth below after a reasonable opportunity for discovery.

### **SUMMARY**

1. This is a securities fraud class action brought on behalf of all purchasers of common stock and preferred shares<sup>1</sup> of Hovnanian Enterprises, Inc. (the "Company" or "Hovnanian") between June 30, 2005 and December 19, 2007 (the "Class Period"). Hovnanian is engaged in the homebuilding and financial service businesses in the United States. It designs, constructs, markets, and sells single-family detached homes, attached townhomes and condominiums and mid-rise and high-rise condominiums. The Company sells homes in communities in nine states, including Florida, which represented the Company's largest market during the Class Period. Based on revenues, Hovnanian is one of the 10 largest homebuilders in the United States. Its stock trades on the New York Stock Exchange ("NYSE"). The defendants are Hovnanian, two of its top insiders, Ara Hovnanian (Chief Executive Officer), J. Larry Sorsby (Chief Financial Officer) and the Chief Operating Officer of First Home Builders of Florida, Bruce Robb.

---

<sup>1</sup>The preferred shares relate to Hovnanian's 7.625% Non-cumulative Preferred Depository Shares issued in or around June 2005.

2. The crux of this lawsuit involves Hovnanian's acquisition of the assets of First Home Builders of Florida ("FHB")<sup>2</sup> in August, 2005 and subsequent events occurring throughout the Class Period related to that acquisition. At the time of the acquisition, FHB was the leading home builder in western Florida, ranked first in the greater Ft. Myers-Cape Coral market. Following the acquisition, Hovnanian repeatedly touted FHB's "strong" sales backlog as it evolved throughout the Class Period, and led investors to believe it would strongly contribute to the Company's revenues.<sup>3</sup> As detailed herein, the FHB backlog was plagued by a series of major problems throughout the Class Period which Hovnanian at first did not disclose, and later only partially disclosed at the end of the Class Period, all of which negatively affected the Company's financial performance.

3. Unbeknownst to the investing public, the FHB backlog consisted of highly speculative and legally questionable contracts that were prone to buyer cancellation. Consequently, a significant portion of Hovnanian's backlog during the Class Period was effectively illusory and fictitious, as it was permeated with speculators/investors who purchased multiple homes and who were prone to cancel their contracts at the slightest turn of the market. Nevertheless, rather than disclose the problems and significant risks that defendants knew or were reckless in not knowing existed with the FHB backlog, which would negatively impact revenues, Defendants refused to admit that the FHB acquisition was a costly mistake (Hovnanian

---

<sup>2</sup>After the acquisition of FHB, Hovnanian operated FHB under the name K. Hovnanian First Homes, LLC, a New Jersey limited liability company.

<sup>3</sup>Once a customer signs a home sale contract, it is placed in the Company's inventory or "backlog" of other executed sales contracts. Once the home that is subject to the contract is built, and the buyer obtains a permanent mortgage, the sales contract is taken out of the backlog and recognized as revenue for the Company. Backlog is a key metric which is closely examined by securities analysts to analyze homebuilders' current operating performance. During the Class Period, the number of contracts in the FHB backlog was constantly changing as new contracts were added and existing contracts were removed from the backlog for various reasons.

touted its acquisition strategy as one of its “core strengths”). Instead, Defendants insisted that its backlog of FHB homes as it evolved throughout the Class Period was based on solid and sound sales contracts. Toward the end of the Class Period, Hovnanian began slowly leaking information to the public concerning its problems with its FHB operation, and ultimately suffered massive losses directly attributable to its FHB backlog.

4. Hovnanian’s backlog was artificially bloated as a result of a scheme which was in effect during the Class Period wherein high risk home buyers/speculators put minimum down payments on multiple homes with FHB’s promise that the homes would be occupied by renters who would ultimately buy the home and thus turn a profit for the original buyer. In some cases, buyers with questionable credit would make a down payment of only a few thousand dollars for several homes with a total value exceeding \$1 million. Notwithstanding these material omissions, Hovnanian publicly stated that FHB sales contracts were “probably the best contracts” the Company had, representing “the strongest and most solid backlogs.”

5. In order to present the illusion that it had a “strong” backlog and that homebuyers were unlikely to cancel their home purchase, Hovnanian publicly touted FHB’s “unique” two-step business model in which homebuyers purportedly purchased the lot first and then entered into a construction loan to build the home. However, Defendants failed to disclose that Hovnanian merely conveyed the land to the prospective home buyer for a nominal price, typically \$10.00, and that the construction loan, on which the home buyer was not obligated to make interest payments, included the cost of the land. Further, Hovnanian did not publicly disclose that the home buyers were not responsible for making interest payments on those loans and were not responsible for paying the property insurance. Defendants further failed to disclose that in the event FHB buyers were unable to obtain permanent mortgage financing, the sales contract provided that the buyer could re-convey the real property back to Hovnanian.

6. In connection with its scheme to pump its sales backlog, Hovnanian and FHB personnel allowed buyers to enter into sales contracts despite the fact that the buyers were making less than the minimum down payment required by Hovnanian and FHB's own sales contract. Further, Hovnanian and FHB recklessly permitted unqualified buyers to enter into FHB sales contracts and "coached" investors and falsified buyer financial data in order to push sales contracts through and increase the Company's backlog.

7. In order to present the fiction that FHB home sales provided little financial risk to Hovnanian, defendants falsely led the investing public to believe that the Company did not maintain a large inventory of home lots in Florida, but rather utilized a "just-in-time" approach to lot acquisition, meaning that Hovnanian would not purchase a lot until it had a home buyer in place. This was proven false when Defendants eventually revealed that Hovnanian had purchased more than a hundred million dollars worth of lots in the Ft. Myers area at the beginning of the Class Period, and was attempting to sell that property at a substantial loss toward the end of the Class Period.

8. The materiality of the FHB acquisition, specifically its sales backlog, is clear. Hovnanian's sales backlog increased approximately 35% as a result of the FHB acquisition. Most conference calls during the Class Period included a discussion of Hovnanian's current FHB operations. During these conference calls, Hovnanian's management - specifically Ara Hovnanian and Larry Sorsby - were peppered with questions about FHB by analysts. Defendants responded with misleading representations concerning Hovnanian's FHB operation, creating confusion and prompting further questions by analysts during the Class Period and thereafter.

9. Defendants admitted in a series of disclosures ending in December 2007, that the Company would be taking substantial write-downs of its FHB assets and that it was experiencing

an alarming rate of cancellations on sales contracts in its FHB backlog. Hovnanian's stock fell from its Class Period high of \$61.68 per share to as low as \$8.40 per share on December 17, 2007 – an 86.4% decline.

10. Defendants' fraudulent conduct throughout the Class Period, which centered on Hovnanian's activities in Lee County Florida, was certainly a contributing factor to the characterization of that area of the country by commentators as ground-zero of the sub-prime mortgage meltdown. *See e.g. "The Ponzi State" The New Yorker* 16 Feb. 2009, 81-93 ("By last year, the highest [foreclosure] rate in the country could be found in Fort Myers and Cape Coral, where twelve per cent of the area's residences were in foreclosure").

#### **JURISDICTION AND VENUE**

11. Jurisdiction is conferred by §27 of the Securities Exchange Act of 1934 ("1934 Act"). The claims asserted herein arise under §§10(b) and 20(a) of the 1934 Act and SEC Rule 10b-5.

12. Venue is proper in this District pursuant to §27 of the 1934 Act. Many of the false and misleading statements affected persons in this District.

#### **PARTIES**

13. Lead Plaintiff Herbert Mankofsky purchased Hovnanian common stock at an artificially inflated price as described in the certification attached to the initial complaint in this action, and was damaged thereby.

14. Plaintiff Jeffrey S. Buffoni Revocable Trust purchased Hovnanian's 7.625% Non-cumulative Preferred Depository Shares on June 30, 2005.

15. Defendant Hovnanian Enterprises, Inc. is a Delaware Corporation with its principal place of business in Red Bank, New Jersey. Hovnanian Enterprises, Inc. engages in homebuilding and financial services businesses in the United States.

16. Defendant Ara Hovnanian is, and was at all relevant times hereto, Hovnanian's Chief Executive Officer.

17. Defendant J. Larry Sorsby ("Sorsby") is, and was at all relevant times hereto, Hovnanian's Chief Financial Officer.

18. Defendant Bruce Robb ("Robb") was at all relevant times hereto, Chief Operating Officer of First Home Builders of Florida, a position he held both prior, and subsequent to, FHB's acquisition by Hovnanian.

19. Defendants Ara Hovnanian, Sorsby and Robb are sometimes collectively referred to herein as the "Individual Defendants."

20. Because of their positions with the Company, the Individual Defendants possessed the power and authority to control the contents of Hovnanian's quarterly reports, press releases and presentations to securities analysts, money and portfolio managers and institutional investors – *i.e.*, the market. The Individual Defendants were provided copies of the Company's reports and press releases alleged herein to be misleading prior to or shortly after their issuance, and had the ability and opportunity to prevent their issuance or cause them to be corrected. Because of their positions with the Company, and access to material non-public information available to them but not to the public, the Individual Defendants knew that the adverse facts specified herein had not been disclosed to and were being concealed from the public and that the positive representations being made were then materially false and misleading.

21. According to a confidential witness (CW1), who was a former FHB/Hovnanian controller based in Florida from May 2002 through August 2006, the Company's controllers prepared weekly "CSD" (contracts, starts, and deliveries) reports which contained the number of sales contracts signed, the number of contract cancellations, the number of housing starts (*e.g.*, pouring the slab), the purchase price of the homes (per the contract), and the number of homes

delivered. These reports would be sent to a staff accountant at Hovnanian's corporate office who would consolidate the CSDs, and once a month, distribute a consolidated CSD report to all senior management including Larry Sorsby and Ara Hovnanian. CW1 stated that Sorsby and Hovnanian "lived and died by" these reports which related to Hovnanian's backlog.

22. Another confidential witness (CW 2) was a former Treasury Manager and Forward Planning & Development Manager for FHB/Hovnanian from February 2004 to February 2007. One aspect of his job was forecasting daily, weekly and monthly cash requirements including determining the bulk interest payments to be paid by FHB/Hovnanian to the construction lenders which amounted to millions of dollars per month. According to CW2, FHB/Hovnanian would require a small down payment of about \$1,000.00 per home and then FHB/Hovnanian would qualify the buyer for a construction loan which included the cost of construction and cost of the lot. FHB/Hovnanian would then transfer title of the lot to the buyer which CW2 described as "transfer of risk" because the buyer was purportedly contractually responsible for the land. CW 2 stated that FHB/Hovnanian would make the interest payments of those construction loans as well as pay the property insurance, and in some cases the property taxes.

### **BACKGROUND TO THE FRAUD**

23. Defendant Hovnanian engages in building residential homes in the United States. The Company designs, constructs, markets, and sells single-family detached homes, attached townhomes and condominiums, and mid-rise and high-rise condominiums. The Company purportedly markets and builds homes primarily for first-time buyers, first-time and second-time move-up buyers, luxury buyers, adult buyers, and empty nesters. Hovnanian also engages in the sale of land, and also offers mortgage loans and title insurance products and services.

24. During 2002, 2003, and the first half of 2004, home builders in the United States were enjoying the fruits of a multi-year housing boom fueled in large part by some of the lowest interest rates in history. Hovnanian was a beneficiary of this boom, seeing its revenues increase from \$1.7 billion in fiscal 2001 (“F01”) to \$2.5 billion in fiscal 2002 (“F02”), then to \$3.1 billion in fiscal 2003 (“F03”) and to \$4 billion in fiscal 2004 (“F04”), while its earnings per share (“EPS”) increased from \$2.28 to \$5.35 in the same periods.

25. In addition, Hovnanian fueled its growth with an aggressive acquisition strategy. Between 2000 and 2007, Hovnanian completed 14 acquisitions, including FHB in August 2005. In discussing acquisitions during the Company’s Q2 2005 earnings call, Ara Hovnanian stated:

We remain extremely disciplined in our approach to acquisition. We're actually very pleased with them, obviously. And we'll move forward once we are comfortable with the company's track record, the management team, operating culture, market position, and financial returns based on a reasonable price. As I've mentioned in the past, integration of acquisitions is a core strength in our Company. We have been acquiring companies for many years and think our track record speaks for itself.

**A. Hovnanian Acquires FHB in 2005 and Touts its Backlog**

26. At the time Hovnanian was conducting its due diligence on FHB, in or around June, 2005, Hovnanian issued a prospectus which detailed its offering to sell 7.625% Non-cumulative Preferred Depository Shares. Absent from the prospectus materials was any mention of FHB or its unusually risky business model as detailed herein.

27. Hovnanian announced the acquisition of FHB on August 8, 2005. FHB was a leading home builder in western Florida and ranked first in the greater Ft. Myers-Cape Coral market. At the time of the acquisition, FHB had approximately 4,350 homes in contract backlog with a sales value of \$925 million. As a result, Florida became Hovnanian’s largest market and a substantial source of the Company’s projected revenues. Hovnanian issued a press release via

the PR Newswire highlighting Hovnanian's acquisition of FHB:

Hovnanian Enterprises, Inc. (NYSE:HOV), a leading national homebuilder, announced today that it acquired the assets of First Home Builders of Florida, a privately held homebuilder and provider of related financial services headquartered in Cape Coral, Florida, for an undisclosed purchase price paid in cash. First Home Builders is a leading builder in Western Florida and ranked 1st in the greater Fort Myers-Cape Coral market and 51st nationally based on 2004 permit activity as tracked by Builder Magazine. Thus the acquisition provides Hovnanian with the number one market position in the high growth Fort Myers-Cape Coral market, which is the 18th largest housing market in the U.S. as ranked by Builder Magazine based on 2004 permits.

First Home Builders of Florida designs, markets and sells single family homes, with a focus on the first-time home buying segment. The company also provides mortgage financing, title and settlement services to its homebuyers. In 2004, First Home Builders delivered 1,819 homes with revenues of \$308 million. As of July 31, 2005, First Home Builders had approximately 4,350 homes in contract backlog with a sales value of \$925 million.

"We are excited about the addition of Fred Hermann, Bruce Robb and their team to our Company," commented Ara Hovnanian, President and Chief Executive Officer of Hovnanian Enterprises, Inc. "First Home Builders has an excellent reputation as a high-quality homebuilder and a strong track record of financial performance. With several initiatives in vertical integration underway, Fred and Bruce share our focus on becoming more efficient as a homebuilder to gain competitive advantages."

"Earlier in 2005, we increased our presence in Florida through two acquisitions. The addition of First Home Builders further solidifies our footprint in this strategically important state," Mr. Hovnanian said. "We have targeted further investment in Florida because the regulatory process in the state is lengthening, which is constricting the supply of land available for homebuilding. At the same time, population growth and job growth in Florida are creating sustained demand for new homes. The confluence of these factors make Florida an attractive market for the foreseeable future," Mr. Hovnanian concluded.

Fred Hermann, President, and Bruce Robb, Chief Operating Officer of First Home Builders of Florida, will remain with Hovnanian following the acquisition. JMP Securities LLC represented First Home Builders of Florida in the transaction.

Hovnanian expects the addition of First Home Builders will be accretive by approximately \$0.05 to earnings per fully diluted share in its 2006 fiscal year. In future years, Hovnanian expects First Home Builders' contribution to earnings to increase through growth of the operations and a reduction in the amount of stepped up inventory and intangibles amortized. Hovnanian does not anticipate booking any goodwill in conjunction with the transaction. Further, after taking into account the effects of the acquisition, the Company expects to be within its targeted ratio of 50% net debt to capitalization at its fiscal year end, October 31, 2005.

**B. FHB's Purported Backlog was Misleading as it Consisted of Speculators Attracted by FHB's Leased-Up Home Scheme**

28. FHB's backlog consisted of speculators due to its unique business relationships as detailed in a local Southwest Florida commercial real estate magazine. The article described a business venture between FHB and two realtors, Frank D'Alessandro and Tom Woodyard. As described in the 2003 edition of Suite Life Magazine<sup>4</sup>:

The concept involves selling leased-up, new houses to investors eager for double-digit returns, which D'Alessandro says could exceed 16 percent annually. Here's how it works: Each year, First Home gets tens of thousands of potential homebuyers leads through its model centers, of which several thousand cannot qualify for a mortgage. Those applicants will be recruited to rent homes built by First Homes and sold to investors through the D'Alessandro & Woodyard team. With prices of the turn-key homes starting at around \$120,000, investors may opt to buy homes in packages of 5, 10 or 15. "Most investors will put down 20% and mortgage the rest," said D'Alessandro, noting that most returns will be tax-free because of IRS-allowed depreciation. "That makes it a very nice investment for them."

29. The above-described "leased-up" home scheme, which continued during part of the Class Period, began with the recruitment of potential home buyers. D'Alessandro and Woodward ("D&W") along with various associates, including Samir Cabrera, would scour the eastern seaboard looking for prospects. The prospective investors were typically low-to-middle-

---

<sup>4</sup>At the time this article was published, Suite Life Magazine's circulation was less than 10,000.

income persons. The typical sales pitch made by D&W and/or Cabrera was that a “ready-made” tenant would occupy the house built by FHB immediately upon its completion, and would ultimately purchase it outright from the investor, resulting in a promised 14% rate of return. The investor would only be required to make a small down payment of approximately \$1,000, and enter into a construction loan/mortgage agreement wherein FHB would pay the interest on the construction loan until such time as the house was completed. Once the house was completed, the investor would be required to convert the interim construction financing to permanent financing. The investor was assured that a tenant would be in place by the time the house was built and that other than the minimal down payment for each home, he or she would not incur other costs or expenses. A prospectus prepared by D&W and Cabrera entitled, “First Home Lease Purchase Investment Opportunity,” which detailed the guaranteed rate of return and the procurement of tenants by D&W and its affiliates, was provided to the prospective home buyer.

30. All communications with the lender regarding the specifics of the construction loan were typically handled solely by FHB and its representatives and affiliates.

31. Although the above construction loans were ostensibly to be for the cost of construction, the actual principal amount of the loan also included the cost of the land). As a result, the appraised value of each property securing the loan was artificially inflated.

32. Speculators/investors were permitted to put down payments on multiple properties substantially below what was required by the terms of the sales contract. The minimal down payments made under this scheme expressly violated the standard sales contract “Purchase Agreement” provision entered into between the investor and FHB, which provided in part:

Buyer acquiring the property as Buyer’s primary residence is required to make a minimum deposit of \$500.00 to initiate this transaction. Buyer will be required to make a \$2,500 earnest money deposit if this property will be Buyer’s secondary residence. Buyer will be required to make a \$5,000 earnest money deposit if the property will not be occupied by the buyer.

33. The fact that investors were putting less than the required down payment (sometimes as low as \$500.00) was confirmed by CW1, who stated that information concerning down payments could be derived from weekly reports that Hovnanian controllers published on a community-by- community basis.

34. FHB was fully aware that many of these investors were not credit-worthy and represented a high risk of failure to obtain permanent financing. Consequently, FHB would coach these investors on how to improve their credit-worthiness so that they could potentially obtain permanent financing after the completion of the home. In connection with this scheme, FHB typically sent the following letter which strongly advised the following:

1. INCOME - You and/or your co-borrower must keep your wages and hours at or above what they were when you applied for your mortgage.
2. EMPLOYMENT - There can be no changes in your employment.
3. CREDIT - Do not take on any additional debt. Do not make any purchases for anything on credit
4. FINANCIAL INFORMATION - Do not open any new credit accounts or get any new credit cards.

35. The next step in the scheme was the procurement of tenants for the FHB homes sold to the home buyer. Toward that end, FHB would receive tens of thousands of potential home buyer leads through its model centers, of which several thousand could not qualify for a mortgage due to insufficient income and/or poor credit histories. The names of these unqualified applicants would be referred by FHB to D&W and their affiliates, who would then recruit these individuals to rent new homes being built by FHB.

36. The final step in the scheme, as described in the section of the prospectus entitled, "Exit Strategy," was when the "ready-made" tenant "buys" the home buyer out of the deal. This "buy-out" was purportedly made possible through the tenant's successful procurement of

refinancing in the “Sub-prime” lending market, and they would be “coached” in this process by D&W and their affiliates. As described in the prospectus:

The 14% is paid once the tenant refinances the home in their name, buying the investor out of the deal. The refinance is possible because Sub-prime lenders will allow a refinance on a property with 12 cancelled monthly checks for a lease payment. Tenants are preliminarily screened for credit, income, and debt analysis. They are coached on the process of the refinance and how to qualify in the upcoming year.

37. Not surprisingly, during the Class Period, the “ready-made tenants” never materialized, resulting in many of the investors walking away from the speculative deals.

38. The above scheme was clearly directed toward speculators wanting to purchase multiple homes with virtually no down payment, who, if the market turned, were certain to walk away.

39. On June 18, 2008, United States prosecutors filed a four count fraud indictment against Samir Cabrera, one of the principal orchestrators in the above-described leased-up home scheme, in the U.S. District Court for the Middle District of Florida in connection with his participation in an illegal land-flipping scheme. On August 27, 2008, a Superseding Indictment was filed against Cabrera, adding eight additional fraud counts. On June 14, 2009, Cabrera was found guilty on those fraud counts.

**C. FHB’s Backlog was Replete with Rampant Speculator-Driven Investing**

40. Documents obtained from litigation records filed with the United States District Court for the Middle District of Florida, and Lee County Florida’s Department of Public Records establishes the extent of speculator/investor contracts in Hovnanian’s FHB backlog. This information provides a glimpse into the flagrant speculation which fueled FHB’s backlog before and during the Class Period. The records reveal that mostly out-of-state-investors, who typically possessed only marginal credit and made less than the required down payment on multiple

homes, in most instances were ultimately unable to obtain permanent financing.

41. In connection with these court filings, a review of the underlying loan documents revealed FHB's extreme internal control deficiencies which continued during part of the Class Period. The existence of these deficiencies made it wholly improper to include such loans in Hovnanian's backlog. These deficiencies include but are not limited to:

1. Unsigned purchase agreements and other loan documents;
2. Undated purchase agreements and other loan documents;
3. Unwitnessed and/or un-notarized loan documents;
4. Forged loan documents;
5. Backdated loan documents; and
6. Failure to have buyer initial each page of loan documents.

42. The speculator/investors described above depict the types of investors who were the primary cause of FHB's bloated sales backlog at the time it was acquired, and were also the cause of the dramatic increase in contract cancellations that Hovnanian began to experience during the Class Period. Toward the end of the Class Period, it became apparent to Hovnanian that the speculators were unable or unwilling to qualify and/or obtain permanent financing after Hovnanian obtained a certificate of occupancy.

#### **D. The FHB Contract Backlog Begins to Collapse**

43. When investors began experiencing trouble obtaining financing, they frequently attempted to walk away from their "investment." Since these investors made only a minimal financial investment, it dramatically increased the likelihood that they would walk away from their contracts, resulting in massive cancellations in Hovnanian's backlog.

44. In an attempt to dissuade investors from abandoning their real estate investments, Bruce Robb, FHB's Chief Operating Officer, would typically send a letter to these investors

trying to pressure them to enter into permanent financing. The letter presented a skewed view of the current Florida real estate market by stating that “the real estate market in SW Florida is based on solid economic fundamentals. The in-migration of new residents is still very strong. The need for rental housing is strong and growing, job growth has been very good, ...” The letter ended with a warning that failure to obtain permanent financing would place them in default, which was “clearly inadvisable.”

45. Despite Robb’s warning, the standard purchase agreement entered into between FHB and the investors unambiguously provided that the investor could re-convey the property back to FHB in the event that the investor could not obtain financing. The “Miscellaneous Provisions,” section of the agreement provided in relevant part:

In the event that Buyer obtains and initially closes using a construction loan and is thereafter unable to obtain or qualify for the financing that would result in the end-closing, Buyer agrees to convey, via statutory deed to Builder/Seller the home and real property, at which time, Builder/Seller shall pay and satisfy the construction loan.

**E. FHB’s Backlog was Fueled by its Unusual Financing Arrangement with First American Mortgage, Inc., Norlarco Credit Union and a Series of Other Credit Unions**

**1. The collapse of the Participating Credit Unions**

46. Thousands of speculative loans were funded by credit unions that eventually suffered severe losses relating to these Ft. Myers’ FHB construction loans. Three of these credit unions ultimately collapsed and were taken over by the National Credit Union Administration.

47. An August 25, 2007 article published in Ft. Myers’ *The News-Press*, provided details concerning the collapse of these credit unions resulting from the questionable loans

generated from FHB. The article provided in part:

### **Michigan Credit Union Collapses from Loans like Norlarco's**

**Editor's note:** Norlarco Credit Union is the second credit union in the country this year to be taken into conservatorship by the National Credit Union Administration because of massive loan delinquencies tied to construction loans in Lee County, Fla. This story, published April 10 in the Fort Myers News-Press, details the problems of an Ann Arbor, Mich., credit union. Norlarco is now a co-defendant in at least seven lawsuits in Florida involving the developers who also worked with the Michigan credit union.

A Michigan credit union has collapsed following hundreds of questionable loans to people buying First Home Builder houses in Lee County. Meanwhile, some buyers have filed suit against First Home, the credit union and others - alleging fraud and conspiracy in the marketing, sale and financing of the homes.

The National Credit Union Administration on Feb. 16 assumed control of the Ann Arbor-based Huron River Area Credit Union, which has 39,000 members and \$348 million in assets.

The credit union also made loans for building houses that might not be worth the full amount of the loan after the housing market collapsed last year, say those involved.

"We aren't going to comment on the extensions of credit by the credit union," said John McKechnie, director of public and congressional affairs for the credit union administration.

But Fort Myers-based attorney Richard Ingalls said he has five clients with contracts to buy First Home houses that are worth far less than the amounts of the construction loans.

Often they have no way to close on their houses because they can't get permanent financing for the full loan and can't make up the difference, he said.

"These are people who initially got into these investments with good credit scores but not many assets," Ingalls said.

The credit union administration has an ongoing investigation into the circumstances of Huron's financial problems, McKechnie said, but he declined to elaborate.

Chief Assistant U.S. Attorney Doug Molloy said he never comments when "things are at this stage."

He said he is "aware of that set of facts" surrounding Huron's problems.

48. A September 18, 2007 article by The Coloradoan.com further provided details of the problems facing Norlarco and its relationship with FHB. The article provided in part:

**Federal Regulators Negotiating with Home Builder in Norlarco Case**

Norlarco Credit Union, the largest in Larimer County and eighth-largest in the state, was taken over by the NCUA [National Credit Union Administration] earlier this year because of a rapidly mounting portfolio of delinquent real estate loans in Lee County, Fla. The credit union's July financial report indicated its delinquent loans totaled nearly \$70 million, up from \$56 million a month earlier and just more than \$2 million in March.

The loans were made in the Lehigh Acres and Cape Coral communities near Fort Myers, Fla., on homes built by First Home Builders. First Home was later acquired by K. Hovnanian, the nation's sixth-largest homebuilder.

Hovnanian officials couldn't be reached for comment.

Norlarco has loans totaling \$238.4 million on 1,035 homes in Lee County, McKechnie said. Some of that loan risk is shared with other credit unions that joined in a participatory program, he said.

The loans were made just before the western Florida real estate market went into a tailspin in 2006. Three credit unions that made large numbers of construction loans and mortgages in the development - Norlarco, New Horizons of Denver and Huron River Area Credit Union in Michigan - were placed into conservatorship by federal regulators as their delinquent loan portfolios threatened their viability.

New Horizons has since been sold, but Norlarco and Huron River remain in federal conservatorship. That means the NCUA is running operations of the credit unions while attempting to restore them to health.

McKechnie said the NCUA is holding \$438 million in loans tied to the Florida developments, with most of that from Norlarco.

49. To make matters worse, in July 2007, Hovnanian dropped its insurance coverage on the Norlarco loans originated from FHB, forcing federal regulators to insure the properties to eliminate financial risk during the hurricane season.

50. As part of his investigation into the high failure rate within Defendants' FHB home sales backlog, Plaintiff served a FOIA request on the NCUA seeking documents relating to southwest Florida homes whose construction loans were financed by the three out-of-state credit unions noted above. On February 2, 2009, the NCUA responded by providing a list of approximately 300 property addresses in southwest Florida which were financed by the three out-of-state credit unions and now owned by the NCUA. However, as more time passes and more homes become NCUA owned, the truth concerning the speculation-infused FHB backlog, which Defendants concealed from the investing public, will become even more obvious. This list provides a glimpse into the high-risk, speculative loans within the FHB backlog and provides additional support for Plaintiff's allegations that investors in the FHB backlog were neither "solid" nor "strong" as publicly touted by Defendants.

51. On November 26, 2008, the NCUA issued a report on its website entitled "Material Loss Review of Huron River Area Credit Union."<sup>5</sup> In the report, the NCUA concluded that Huron was insolvent as a result of Huron's participation in providing construction loans in Florida. The Material Loss Review contains information substantiating Plaintiff's allegations that the FHB backlog contained high-risk construction loans. For example, the NCUA determined that the a majority of Huron River's loan portfolio involved a "speculative Florida real estate construction project" and "investment properties in Florida." These findings by the NCUA also support Plaintiff's allegations that Defendants were aware, or were reckless in not

---

<sup>5</sup>A Material Loss Review is triggered if the credit union's losses exceed \$10 million. A Material Loss Review for Norlarco is currently underway.

being aware, that a significant percentage of Hovnanian's prospective home buyers were investors, rather than "strong" and "solid" first-time buyers of homes to be used as their primary residences as Defendants falsely portrayed to the public. The report also supports Plaintiff's allegations that FHB's extreme internal control deficiencies concerning the construction loans made it wholly improper to include such loans in Hovnanian's backlog. For example, the report noted deficiencies in the construction loans including "poor loan quality and inadequate loan documentation."<sup>6</sup>

## **2. The Funding Arrangement with First American Mortgage, Inc.**

52. Back in 2003, Norlarco entered into a funding agreement with First American Mortgage wherein Norlarco agreed to purchase construction loans obtained by home buyers from First American Mortgage. On or about October, 2004, FHB entered into a construction loan agreement with First American Mortgage in which **FHB agreed to guarantee and make interest payments on the construction loans** obtained by FHB home buyers up to the time when the home buyer secured permanent financing. The loan agreement provided in relevant part:

Whereas the Construction Lenders are willing to provide interim construction financing (the "Construction Loan" or collectively the "Construction Loans") under certain terms to qualified buyers that are customers of FHB (the "Buyer" or collectively the "Buyers") for the construction of single family homes and improvements to real property (the "home" or collectively the "Homes"), and;

Whereas, FHB has agreed to guarantee and make the interest payments due and payable for each Construction Loan on behalf of the Buyers during the period of the Construction Loan and up to the time when the Buyer's permanent financing has closed and/or the Construction Loan has been satisfied or modified, and;

---

<sup>6</sup>The report also reveals that Florida construction loan applicants were not legal members of Huron.

It is the intent of FHB that neither FHB nor FAM nor the Construction Lenders realize a loss on a Home or Construction Loan as the result of a breach, default or failure by a Buyer. In this regard, FHB guarantees to FAM and the Construction Lenders the prompt, timely and complete payment of all debts and liabilities, present and future, direct or indirect, matured or not, at any time owing by a Buyer pursuant to a Construction Loan, until the end-loan satisfies the construction loan.

53. Armed with this guarantee, FHB was able to magnify its backlog of home sale contracts because First American Mortgage was more likely to approve any FHB home buyer construction loan application guaranteed by FHB. Similarly, the existence of the FHB guarantee created little risk for Norlarco purchasing the loans.

54. Just two months prior to Hovnanian's announcing its acquisition of FHB, in or about June, 2005, FHB and First American Mortgage entered into an Addendum No. 1 to the loan agreement which completely contradicted and eliminated the FHB guarantee. The Addendum stated in relevant part:

It is not and was not the intention of the Parties that the (Construction Loan) Agreement be construed as containing a guaranteed buy back or other guarantee provision which would oblige FHB to purchase or pay off a Construction Loan in the event a Buyer should default.

55. However Addendum No. 1 did confirm that FHB, rather than home buyer, was advancing the interest payments on the home buyers' construction loans:

The parties recognize and agree that these Construction Loans to consumers (Buyers of homes from FHB) are obligations of those individuals and are not guaranteed obligations of FHB. The fact that FHB has agreed to make and advance the interest payable on the Construction Loans until the Construction Loan is satisfied does not alter that conclusion and redounds to the benefit of both Parties.

56. Plaintiff alleges on information and belief, that the close proximity of time between the inclusion of Addendum No. 1 and Hovnanian's acquisition of FHB is explained by the fact that Hovnanian's due diligence concerning FHB revealed this contract provision between

FHB and First American Mortgage, and Hovnanian insisted that the guarantee provision be expunged.

57. According to a February 23, 2009 article published by the Credit Union Journal entitled “How Did a Credit Union Manage to Lose so Much Money Here? The Now-Defunct Norlarco CU Bet Big On Florida Real Estate, And Became The First Domino To Fall When It Went Bust. What Happened, And Where Were The Regulators? A Credit Union Journal Special Report,” Norlarco was able to persuade at least sixteen credit unions and two banks to take participating loan interests beginning in 2005. These loan participation interests totaled about \$170 million.

58. According to a complaint filed by Superior Choice Credit Union against Norlarco Credit Union, Case No. 08-cv-02400-CMA-MEH (D.C. Col.), in October 2005, Norlarco solicited Superior Choice to purchase an interest in a portion of the First American Mortgage construction loans and the underlying debt obligations. On December 1, 2005, Norlarco and Superior Choice entered into a Master Loan Participation Agreement memorializing Superior Choice’s participation in the First American Mortgage construction loans. In its complaint, Superior Choice alleges that hundreds – if not thousands – of these speculative Florida loans ultimately defaulted.

59. According to a March 16, 2009 article published by the Credit Union Journal entitled “NCUA Sued Over Norlarco CU Loan Participations,” in a deal with the NCUA, Hovnanian has paid nineteen credit unions that bought participation interests from Norlarco a total of about \$12 million, less than 10% of the book value of the loans.<sup>7</sup> In fact, a document filed in the Superior Choice lawsuit against Norlarco reveals that Hovnanian agreed to pay

---

<sup>7</sup>Among other reasons, these payments are surprising in light of the fact that Hovnanian had purportedly no prior direct dealings with the majority of these credit unions and Hovnanian had repeatedly touted to its shareholders how “solid” these construction loan contracts were.

Superior Choice \$696,583.31 as part of a Settlement Agreement in connection with Superior Choice's participation interest in construction loans from Norlarco.

**F. Hovnanian's Demise in the Ft. Myers Market**

60. The rampant speculation and high risk loans that helped Hovnanian's FHB backlog soar were also the primary factors which caused Hovnanian's financials to suffer such a dramatic decline. An article appearing in the November 17, 2007 edition of *The News-Press* noted that:

. . .just more than two years after buying First Home for an undisclosed amount, Hovnanian is largely out of business in Lee County.

It has a skeleton crew of about 50 employees, down from nearly 1,200 during the boom. The company's inventory of hundreds of lots is for sale. Two of the main lenders for First Homes construction loans are also in financial trouble: Colorado-based Norlarco Credit Union and Michigan-based Huron River Area Credit Union were taken over by the National Credit Union Administration because of bad debt due in part to their construction loans for First Home customers.

61. Since the conclusion of briefing on Defendants' first Motion to Dismiss, numerous articles have been published relating to the intense speculation-driven real estate market in Lee County, Florida. These articles confirm Plaintiff's allegations that home buying in Southwest Florida during the Class Period was fueled by speculators and land-flippers. For example, in a February 16, 2009 *New Yorker* article entitled "The Ponzi State," one Florida realtor stated: "I wish I could say the market [in Ft. Myers] was driven by end users and retirees, but it wasn't. Two-thirds were speculators. You could flip 'em before you had to close on 'em." In a February 7, 2009 *New York Times* article entitled "In Florida, Despair and Foreclosures," another Florida realtor stated: "Sometimes houses would sell three or four times in a few months, and no one would move in." In a February 17, 2009 *Wall Street Journal* article entitled "A Florida Court's 'Rocket Docket' Blasts Through Foreclosure Cases," a Lee County clerk of the

circuit courts stated: “Many [foreclosure] defendants in Fort Myers are speculators who never lived in the houses.” The article further stated that “[M]odern-day treasure seekers invaded [Lee County, Florida] during the recent housing boom, snapping up houses and parcels of land, hoping to flip them to retirees and working families. Millionaire University, an unaccredited program in nearby Cape Coral, taught speculators from around the country how to buy and sell properties for huge profits.” These statements stand in stark contrast to Defendants’ statements during the Class Period that Hovnanian focused on the first-time home buying segment and discouraged speculators and also that investors had left the southwest Florida marketplace.

62. The *Wall Street Journal* article noted above, which focuses on the backlog of court foreclosure proceedings in Florida, also supports Plaintiff’s contention that the list of NCUA owned properties discussed herein understates the number of homes that have been, or will be, foreclosed and transferred to the NCUA. As reported by the *Wall Street Journal*: “To clear a huge backlog of foreclosures, judges are hearing ‘rocket dockets’ of nearly 1,000 cases a day and calling retired colleagues back to the bench to help ease the workload.”

#### **False and Misleading Statements Issued During the Class Period**

63. The Class Period begins on June 30, 2005 when Hovnanian was conducting its due diligence on FHB. In or around June, 2005, Hovnanian issued a prospectus which detailed its offering to sell 7.625% Non-cumulative Preferred Depository Shares (the “Prospectus”).

64. The Prospectus was false and misleading in that it did not disclose that Hovnanian was considering acquiring FHB or provide any details regarding FHB’s unusually risky business model as detailed herein.

65. On August 8, 2005, Hovnanian publicly announced its acquisition of FHB. Hovnanian reported that the FHB acquisition substantially increased Hovnanian’s backlog by approximately 4,350 homes with a sales value of \$925 million, and would add \$0.05 to earnings

per share in 2006. Hovnanian issued a press release via the PR Newswire detailing the benefits of the FHB acquisition:

Hovnanian Enterprises, Inc. (NYSE:HOV), a leading national homebuilder, announced today that it acquired the assets of First Home Builders of Florida, a privately held homebuilder and provider of related financial services headquartered in Cape Coral, Florida, for an undisclosed purchase price paid in cash. First Home Builders is a leading builder in Western Florida and ranked 1st in the greater Fort Myers-Cape Coral market and 51st nationally based on 2004 permit activity as tracked by Builder Magazine. Thus the acquisition provides Hovnanian with the number one market position in the high growth Fort Myers-Cape Coral market, which is the 18th largest housing market in the U.S. as ranked by Builder Magazine based on 2004 permits.

First Home Builders of Florida designs, markets and sells single family homes, with a focus on the first-time home buying segment. The company also provides mortgage financing, title and settlement services to its homebuyers. In 2004, First Home Builders delivered 1,819 homes with revenues of \$308 million. As of July 31, 2005, First Home Builders had approximately 4,350 homes in contract backlog with a sales value of \$925 million.

"We are excited about the addition of Fred Hermann, Bruce Robb and their team to our Company," commented Ara Hovnanian, President and Chief Executive Officer of Hovnanian Enterprises, Inc. "First Home Builders has an excellent reputation as a high-quality homebuilder and a strong track record of financial performance. With several initiatives in vertical integration underway, Fred and Bruce share our focus on becoming more efficient as a homebuilder to gain competitive advantages."

"Earlier in 2005, we increased our presence in Florida through two acquisitions. The addition of First Home Builders further solidifies our footprint in this strategically important state," Mr. Hovnanian said. "We have targeted further investment in Florida because the regulatory process in the state is lengthening, which is constricting the supply of land available for homebuilding. At the same time, population growth and job growth in Florida are creating sustained demand for new homes. The confluence of these factors make Florida an attractive market for the foreseeable future," Mr. Hovnanian concluded.

Fred Hermann, President, and Bruce Robb, Chief Operating Officer of First Home Builders of Florida, will remain with Hovnanian following the acquisition. JMP Securities LLC

represented First Home Builders of Florida in the transaction. Hovnanian expects the addition of First Home Builders will be accretive by approximately \$0.05 to earnings per fully diluted share in its 2006 fiscal year. In future years, Hovnanian expects First Home Builders' contribution to earnings to increase through growth of the operations and a reduction in the amount of stepped up inventory and intangibles amortized. Hovnanian does not anticipate booking any goodwill in conjunction with the transaction. Further, after taking into account the effects of the acquisition, the Company expects to be within its targeted ratio of 50% net debt to capitalization at its fiscal year end, October 31, 2005.

66. The foregoing statements regarding the positive contribution of the FHB acquisition to Hovnanian's financial position were false and misleading. In fact, the backlog of sales contracts Hovnanian acquired from FHB consisted largely of transactions with speculators that were highly susceptible to cancellation. Specifically, the FHB backlog was built upon contracts with real estate investors with marginal credit who made minimal down payments. The contracts were especially risky because a single investor was often responsible for multiple real estate investment properties.

67. Speculators/investors comprising the FHB backlog had been misled to believe that: (a) tenants would be placed in all properties purchased by investors; (b) the rental income generated from these tenants would cover all of the investors' mortgage expenses; and (c) investors would receive a guaranteed 14% return on their investment after the first year. These assurances were not met, resulting in a morass of litigation against Hovnanian relating to its FHB operation. Speculators/investors comprising the purported FHB backlog were responsible for a record number of cancellations.

68. The FHB backlog included buyers with limited incomes who made down payments of a few thousand dollars for multiple homes with a total value close to or exceeding \$1 million. These minimal down payments violated the sales contract's "Purchase Agreement" provision entered into between the buyer and FHB which provided that a buyer would be

required to make a \$2,500 deposit if the property would be a buyer's secondary residence or a \$5,000 deposit if the property would not be occupied by the buyer.

69. On August 9, 2005, during the Company's Q3 2005 Earnings Call, Ara Hovnanian echoed the positive statements regarding Hovnanian's acquisition of FHB and its sales backlog:

As of July 31, First Home Builders had a contract backlog of approximately 4,000 homes with a sales value of \$888 million. As a result of First Homes' unique operating model, this backlog represents about 18 months of deliveries, which is longer than our traditional home building operations, but obviously gives us great visibility, going forward.

We're extremely excited about adding this unique and profitable operation to our Company

. . . there will be minimal accretion from this acquisition during the initial time frame, despite the large number of deliveries and revenues. However, we expect our returns and our profits to improve dramatically once we get beyond this initial period.

70. During that call, defendants Ara Hovnanian and Sorsby were also asked a series of questions by analysts regarding Hovnanian's acquisition of FHB, and provided additional details regarding FHB's underlying operations. Notably, defendants represented that the FHB backlog was especially "solid" because buyers had purchased the lots in question and were paying on construction loans. Defendants used the phrase "just-in-time" to describe this purportedly advantageous arrangement whereby Hovnanian did not have the burden of carrying real estate in inventory:

**Hovnanian:** First Home Builders owns and controls scattered lots predominantly located in the Cape Coral and Lee High Acres, two large tracts of land that were substantially developed with infrastructure but never fully built out in the 1950's and 1960's. Today, there are still about 190,000 vacant buildable lots, mostly owned by individuals or their heirs that purchased them many years ago. First Home Builders are able to control these lots through contracts and utilize a just-in-time approach to lot acquisition.

**Hovnanian:** In the case of First Home Builders, they have typically maintained a much shorter land supply because they haven't needed to do it. They manage it more on a just-in-time basis because it's just an unique market there with the scattered lots.

**Hovnanian:** It's probably the best contract we have. Because what we have is a lot more than a deposit. The buyers, in that case, actually purchase the lot from us first. And then effectively, we have a contract to build a house from them. That lot purchase typically happens within a few months of the contract. I'm sorry, Larry. Were you elaborating on that?

**Sorsby:** I'm just thinking. I think that 80% of the backlog has already closed on the lot with them. So it's not 100% of the backlog at first, but roughly 80% of that backlog has already closed on the lot, **so it's very solid.** (Emphasis added).

**Hovnanian:** And then, many of our buyers, the overwhelming majority of our buyers, use construction loans. Which basically means that as a contractor for somebody that already -- who has already purchased a lot from us, we receive periodic payments as the house progresses in construction. **So the backlog at First Home Builders is probably one of the strongest and most solid backlogs from many perspectives, not only in our Company, but in the industry, because of those peculiarities.** (Emphasis added).

71. Ara Hovnanian also stated that the construction loans similar to those discussed in

¶ 25 were non-recourse loans to the Company.

**Analyst:** Okay. They (the buyer) put down the land. And then they are getting the loan -- the construction loan themselves?

**Hovnanian:** We help arrange that for the [buyer].

**Analyst:** The construction loan is non-recourse to you?

**Hovnanian:** That's correct.

72. Defendants' description of a two-step process whereby the home buyer purchases the lot and then finances a construction loan was false and misleading. At the time these statements were made, defendants failed to disclose and misrepresented the following adverse facts, among others: (1) as revealed in the Public Records in Lee County Florida, rather than the

home buyers “actually purchasing” the home lots, Hovnanian was merely deeding the lots to home buyers for \$10.00; (2) pursuant to Hovnanian’s standard construction loan contract with home buyers and the agreement between FAM and FHB (see ¶53), Hovnanian, rather than the home buyer, was required to make interest payments on the construction loans and typically paid for property insurance. This fact is also confirmed by CW1 and another confidential witness who was a sales representative employed by FHB from 1998 through March 2007 (CW3); (3) the “Agreement to Purchase” contract gave the buyer the option of conveying the property back to Hovnanian if the buyer was unable to obtain or qualify for permanent financing; (4) as evidenced by the executed “Agreement to Purchase” contracts, Hovnanian typically accepted less than the required minimum deposit and ignored or falsified home buyer’s financial data; (5) the preceding non-disclosures had the effect of manipulating the backlog; and (6) the Public Records in Lee County Florida reveal that Hovnanian did not utilize a just-in-time approach to lot acquisition, but rather purchased approximately 3,000 scattered lots in Florida valued at \$139,409,990 on August 8, 2005.

73. In an October article published by a homebuilding trade publication, FHB’s Chief Operating Officer, Bruce Robb (who continued to work for Hovnanian after the acquisition), further emphasized the benefits of the FHB acquisition. As reported in the October 1, 2005 edition of “Builder”:

Investors account for about a third of its (FHB’s) 3,000 annual sales. But there's a twist: The builder, which was bought in August by Hovnanian Enterprises, has partnered with investors to help serve its first-time home buyer market, says COO Bruce Robb. All its investor buyers take out a construction loan and go to closing. **"With us, there's no such thing as cancellation, because they own the lot," Robb says.** (Emphasis added).

As part of the effort, First Home Builders teamed up with a local real estate office to create an updated version of a lease-to-own program. Under the arrangement, the builder's investor clients have a buyer who will purchase the home 12 or 24 months after closing,

at a predetermined price. Or the investor can put the unit in a rental pool for customers who want to buy but aren't quite ready because of credit issues. Every month buyers make their rental payment on time, they get a \$150 credit to use for options and upgrades if they buy a house from First Home Builders.

"All in all, it's a fabulous opportunity," says Robb. "It's a good business strategy that **protects our risk** and differentiates us in the marketplace." (Emphasis added).

74. Unbeknownst to the investing public, however, Robb's statements in the preceding paragraph were materially false and misleading when they were made because the FHB investors' ownership of the land was merely a result of Hovnanian deeding the lot to the investor for \$10.00 who thereafter took out a construction loan which frequently included the price of the lot. Moreover, Hovnanian, rather than the investor was required to pay the interest on the construction loan and typically paid for property insurance. Consequently, there was a high risk that investors would walk away from their marginal financial investment given the slightest downturn in the housing market. This fact further illustrates the falsity that the "leased-up" home scheme could in any way protect the Company's risk as alleged by Robb.

75. On December 7, 2005, Hovnanian issued a press release announcing the Company's fiscal year 2005 financial results. The press release stated in part:

#### Comments from Management

"...we completed four strategic acquisitions in 2005. The integration of these companies is well underway and has become a core competency of our Company. However, for the full fiscal 2005 year, 91% of our earnings per share growth came from our organic operations. While our acquisitions typically provide healthy cash returns from the outset, the amount of GAAP earnings they contribute grows in later years as we reduce, and eventually eliminate, additional expenses from premium amortization and earnouts relating to the acquisitions," Mr. Hovnanian continued.

Overall, we are delighted with our performance in 2005, and more importantly we are excited with our land positions and market-leading powers of scale which position us for additional growth in 2006 and beyond," Mr. Hovnanian concluded.

"As we enter fiscal 2006, our backlog of almost 15,000 homes with a sales value in excess of \$5 billion provides us with excellent visibility for earnings and deliveries during fiscal 2006," Mr. Sorsby said. "We are maintaining our earnings per share projections for 2006 in the range of \$8.05 to \$8.40 per fully diluted common share. These projections for fiscal 2006 are inclusive of a full year of preferred dividends, and are after amortizing more than \$95 million of non-cash pre-tax expenses related to company acquisition premiums. In addition, based on the new GAAP rules, we estimate recognizing for the first time in fiscal 2006 \$11.5 million in non-cash employee stock option expense."

"While our backlog is strong, a variety of issues are causing a greater back-end weighting of our fiscal 2006 results. Due primarily to the adverse impact of Hurricane Wilma, regulatory delays in California and construction delays caused by labor and material shortages in Arizona and Florida, we project first quarter earnings to be 13% to 16% of our full-year 2006 earnings projection, in the range of \$1.10 to \$1.25 per fully diluted common share. In fiscal 2005, our first quarter earnings were approximately 17% of our full year earnings," Mr. Sorsby continued.

#### In Closing

"While our 2005 results benefitted from strong housing markets, in many of our more regulated markets in particular, we believe that we are well-positioned with a sound business model that will allow us to continue to thrive even in a less robust housing market," Mr. Hovnanian said. "We are maintaining our discipline when acquiring land for future communities with an emphasis on achieving strong returns, without the benefit of any price increases and with sales paces that are in line with market norms. While the pace of housing demand and price increases may moderate over the short term, we believe that the long-term fundamentals of the housing industry will provide for a healthy environment to profitably grow in 2006 and further into the future," Mr. Hovnanian concluded.

76. The following day during the Company's Q4 2005 Earnings Call, Ara Hovnanian commented on the Company's backlog and the FHB operations:

**Hovnanian:** "We are well-positioned as we enter '06 as the number of homes in backlog and dollar volume of backlog are both all time records for any quarter in our history. We have actually begun to build a significant backlog for '07, particularly with our first homes operation in Fort Myers which already has a backlog of more than 1,600 homes for deliveries in '07. In addition we have

presold some mid rise homes in other parts of the country with significant down payments for '07 deliveries. On the basis of our sales backlog and current market conditions we are reaffirming our EPS projection for fiscal '06 of between \$8.05, and \$8.40, per fully diluted share.

Some of you may not realize this but Florida is now expected to be about 20% of our '06 projected deliveries, making it our largest state. Hence our aggregate delivery projections for the first half of the year are subject to a greater amount of uncertainty than would normally be the case. Assuming no further home price increases as we continue to sell out communities where we have higher margins from past price increases we expect that our gross margin will decline over the next few years back to a level that represents a more normalized level but still very healthy. Even with these lower margins we believe we can generate a level of returns and net profit performance that most industries would relish on a long-term basis. For the full fiscal '06 year we are projecting our home building gross margins to be in a range of 24.5 to 25%, 140 to 190 basis points lower than the 26.4% home building gross margin we achieved in fiscal '05. Remember, this assumes no further price increases as is always the case with our projections and budgets.

77. During the same Earnings Call, both defendants put a further positive spin on the

FHB operations:

**Sorsby:** First Homebuilders has an operating model that is quite different from most other operations. They are a scattered site homebuilder and our first home operations, home buyers come to our sales centers which include nine model homes. They choose a home and select a homesite from a wide choice of locations. First Homebuilders owns and controls scattered lots predominantly located in two large tracks of land that are already substantially developed with infrastructure built decades ago. The buyer then typically closes on the purchase of the homesite and obtains a construction loan for the construction of the house under a standard construction contract with First Homes as the homebuilder.

Although we receive the cash for the lot and a reimbursement of construction expenses as we build the home the sale of the house is not recorded for accounting purposes until it is completed and delivered to the home buyer. And the lead time from the signing of sales contracts through the completion of construction and delivery of the home tends to be longer than our company-wide average. Thus contract backlog conversion rates are slower than our historical averages. As of July 31, 2005, at the time of the acquisition First Homebuilders had a strong contract backlog of

approximately 4,000 homes with a sales value of about \$888 million. As a result First Homes -- as a result of First Homes unique operating model this backlog represented at least 18 months of future deliveries which is longer than our traditional home building operation. In fact, First Homes has more than 1600 homes currently in backlog that are projected to be delivered in fiscal 2007 and thus will not be converted at all in fiscal 2006.

**Hovnanian:** But what really drives a phenomenal return on investment there is a very unique selling approach there. And that is a scenario where they sell the lot first very early in the process. And then effectively have a contract to build a house for the customer and receive contract payments along the way. So our investment levels are very low relative to the income. And that combination, even though the margins are a little lower when you compare them to the investment we make, the returns on investment are excellent in that marketplace.

78. Ara Hovnanian also boasted that the Company's return on assets as a result of FHB home buyers obtaining construction loans was "phenomenal," and stated that it was the home buyer who was financing the construction loan for the Company.

**Analyst:** Okay. Now the way you are getting the buyers to take the construction loan your return on assets have to be astronomical.

**Hovnanian:** It is phenomenal, yes.

\*\*\*

**Analyst:** There aren't many assets, if the [buyer] is taking the construction loan and he is basically financing it for you.

**Hovnanian:** That is generally true.

79. The foregoing statements regarding the details of Hovnanian's FHB operation were false and misleading. Both Sorsby's and Ara Hovnanian's representations that a homebuyer typically purchased the homesite was grossly misleading because in fact Hovnanian was merely conveying the homesite to the buyer for \$10.00. Also, the home buyer was **not** financing the construction loan for Hovnanian but rather Hovnanian was paying the interest on those construction loans as well as paying the property insurance. Thus, effectively, Hovnanian was securing the loan for itself. The contract backlog acquired from FHB, far from "strong,"

consisted largely of investors who made nominal down payments on multiple properties, and who depended upon non-existent tenants to cover mortgage expenses.

80. The misrepresentation that construction loans were carried by buyers was materially misleading in multiple ways. It led the market to believe that Hovnavian's financial performance – *i.e.*, the “return on its assets” – would benefit from buyers having taken what normally would be a builder's responsibility. It also created the false impression that cancellations would be less frequent as a consequence of buyers having become financially and otherwise committed to the properties in the course of making loan payments during the pre-construction period.

81. As a result of the Company's positive statements regarding its financial prospects, Hovnanian's stock increased over the next month from \$48.73 to a high of \$54.29 on January 6, 2006.

82. On January 11, 2006, Hovnanian filed with the SEC its Form 10-K for the period ended October 31, 2005. Defendants Ara Hovnanian and Sorsby signed the 10-K. The 10-K contained the following language:

In markets with significant investor demand, our Company's policy states that sales contracts include an investor restriction on resale of homes for a stipulated time period, if the home is not occupied by the purchaser.

83. The above language was false and misleading because as revealed in the standard sales contracts used for the FHB “leased-up” sales program during the Class Period, no such provision restricting the resale of a home existed. Actually, FHB representatives were actively signing up speculators to its “leased-up” sales program, which clearly contradicted the restriction Hovnanian claimed was in place. At this time, Florida was one of the hottest speculation-driven markets with significant investor demand.

84. On March 1, 2006, Hovnanian issued a press release announcing the Company's first quarter 2006 financial results. The press release stated in part:

#### Comments from Management

"We expect to post earnings growth and continued strong performance in 2006 and in future years, but at a more measured pace than the extraordinary rate of growth we achieved over the past few years. This expectation of a healthy but slower pace of growth is reflected in our projections for fiscal 2006 earnings, which we are maintaining in the range of \$8.05 to \$8.40 per fully diluted common share. This range of earnings would represent a 12% to 17% increase over our 2005 earnings and a return on beginning equity above 30%. Our 2006 projections reflect the slower market conditions that we are experiencing currently, as evidenced by a 140 to 190 basis point projected decline in our consolidated homebuilding gross margin and a lower projected number of deliveries from California than we achieved in fiscal 2005."

"While our contract backlog is very strong, regulatory and production delays are contributing to a significant weighting of our fiscal 2006 deliveries toward the second half of the year, with an especially large number of deliveries projected for our fourth quarter," Mr. Sorsby continued. "Our first quarter earnings were only about 15% of our projected earnings for the year, and we are expecting 2006 second quarter earnings to be in the range of \$1.55 to \$1.80 per fully diluted common share, representing only 19% to 22% of our projected earnings for the full year," stated Mr. Sorsby.

#### In Closing

We are also well positioned for earnings growth during the remainder of 2006, with a \$4.9 billion contract backlog as we start the second quarter. The major challenges for achieving our 2006 projections relate primarily to construction of the homes that are in our contract backlog, particularly in Florida, where in spite of the production delays that we are currently experiencing, we expect to deliver approximately 20% of our total home closings in 2006. We are also focused on continuing to generate sales that will lead to 2007 deliveries. While we expect margins on new sales to be lower as many markets return to a normal, healthy sales environment, without the positive effects of pent-up price increases that have benefitted our margins over the past several years, we see no evidence of a "bubble bursting" . . . Mr. Hovnanian concluded.

85. On March 2, 2006, during the Company's Q1 2006 Earnings Call, Ara Hovnanian continued to tout Hovnanian's recent Florida acquisition as "highly profitable," that "we continue to be astounded at the strength of that marketplace" and that "our acquisitions there [Florida] have been excellent and we are very pleased."

86. During that call, Ara Hovnanian misleadingly stated that buyers in the FHB backlog had already purchased the land and would therefore be unlikely to cancel their construction loans:

**Hovnanian:** "It's kind of a simultaneous contract for the land and the house, but they close on the land parcel early, which is a beautiful thing. I think about, I don't know, 70% or 80% off the top of my head, of their backlog, the customers have already bought the land from us, and by the way, it's at a profit, but we do not book that profit. We don't recognize that profit until the home delivers. So it is about the most solid backlog you can imagine. Since they've already bought the land, they're not very apt to try and cancel at that point. (Emphasis added).

87. The foregoing statement was false and misleading. Specifically, as disclosed at the end of the Class Period, home buyers did not actually own the land but merely took out a construction loan which included with it the price of the lot. Moreover, the home buyer was not even required to make interest payments on the construction loan and did not pay for property insurance. In fact, because the FHB backlog consisted of property flippers who were purchasing multiple homes they were most apt to cancel.

88. During that same call, Ara Hovnanian claimed that the Company was "tempering" its FHB sales due to the large existing backlog:

**Hovnanian:** When we acquired them [FHB], they had a huge backlog, about a year-and-a-half-plus's worth of backlog. We don't like to manage with quite as much of a backlog. We are absolutely still selling homes there every week, and we continue to be astounded at the strength of that marketplace, but we are tempering their sales. That's one of the few markets where I can honestly say we're trying to temper sales. In most markets, we are trying to boost them up. There, we've just got such a big market, such a big

backlog, that we're not overly anxious to sell too many homes too far in advance.

89. Ara Hovnanian's statement in the preceding paragraph was false and misleading because, at the time it was made, FHB representatives were actively signing up speculators to its "leased-up" sales program. Ara Hovnanian's statements are further belied by the fact that Samir Cabrera, one of the leased-up home scheme orchestrators, purchased two FHB properties in approximately January 2006, and his wife, Jessica Stilwell, purchased an additional four homes in approximately March 2006. In addition, Donald Stilwell, Jessica Stilwell's father, purchased an additional three properties. A number of these homes subsequently went into foreclosure.

90. On March 7, 2006, during Citigroup's Global Industrial Manufacturing Conference, Ara Hovnanian made further positive representations regarding the FHB operation:

**Hovnanian:** I will add that we have a couple of interesting lines of business, that have probably the strongest backlog out there. One is our recent acquisition of First Homebuilders, in Fort Myers, Florida, we will be delivering a couple of thousands homes there. It's a recent acquisition and in that market place, our buyers close on the lot. First, pay us with a significant profit, and then, we build the house for them. We do not recognize the profit incidentally, even though they pay us 100% for the improved lot, but those are very strong buyers, they have already closed on the lot they own it. So, they are not to be going anywhere. (Emphasis added).

91. Ara Hovnanian's statements in the foregoing paragraph were false and misleading. According to CW3, FHB was signing sales contracts during this time despite the fact that many of the home buyers were not qualified. In truth, since Hovnanian shouldered most of the financial risk, FHB home buyers were **more** likely to walk from their contracts.

92. On May 31, 2006, Hovnanian issued a press release announcing the Company's second quarter 2006 financial results. The press release stated in part:

Comments from Management

"Our performance in the first half of fiscal 2006 was just behind

last year's record-setting performance, and our current sales pace, along with our strong contract backlog, positions us to conclude another solid year of deliveries, revenues and earnings, despite the current environment of slowing housing markets," said Ara K. Hovnanian, President and Chief Executive Officer of the Company. "Our return on beginning common equity for fiscal 2006 is projected to be nearly 30%, significantly higher than the average ROE among companies comprising the S&P 500."

"In the near term, we continue to experience a more challenging sales environment in most of our markets, when compared with conditions over the past few years," Mr. Hovnanian continued. "However, we believe the slowdown has been affected primarily by a sharp increase in investor resale inventory in some of our markets and community locations, combined with much more cautious buyer sentiment. Fortunately, economic and demographic fundamentals remain strong. Thus, we expect our more regulated markets, including New Jersey, California, Florida and metropolitan Washington, D.C., will return to a stronger level of sales contracts as the market overhang is absorbed and buyer sentiment improves. In the interim, we are managing our company and our land position cautiously, as we have done in past downturns during our 47-year history," Mr. Hovnanian stated. "And we have taken steps to prepare our sales associates and our communities to meet the more competitive environment that we are currently experiencing."

"We expect earnings for the fiscal year ending October 31, 2006 to be in the range of \$7.20 to \$7.40 per fully diluted common share, slightly higher than what we achieved in 2005," said J. Larry Sorsby, Executive Vice President and Chief Financial Officer. "Given our current \$4.8 billion sales backlog and our recent sales pace, we are well positioned to deliver on these expectations. More than 85% of our projected deliveries are either in sales backlog or delivered as of April 30th. We expect earnings for the third quarter to be in a range of \$1.40 to \$1.50 per fully diluted common share," Mr. Sorsby continued. "We expect to continue to manage the Company's average ratio of net recourse debt-to-capitalization below 50% for fiscal 2006. The ratio at April 30, 2006, which is typically near a seasonal peak for the year, was 50.6%."

#### In Closing

"Sales contracts have slowed from the white-hot pace we enjoyed the past couple of years, but they continue at sound historical levels. Our resolve and long-term focus to become a better, more efficient homebuilder has not changed. As we move ahead, we expect to be able to continue generating strong returns," Mr.

Hovnanian concluded.

93. In the Q2 2006 Earnings Call that occurred the following day, defendants were not as effusive about the Company's FHB acquisition. Defendant Sorsby only commented that Hovnanian's Florida sales activity "really didn't help us much at all for the quarter."

94. On September 6, 2006, Hovnanian issued a press release announcing the Company's third quarter 2006 financial results. The press release stated in part:

#### Comments From Management

"Since the end of last summer, we have experienced a deteriorating environment for new home sales in many of our more regulated markets," said Ara K. Hovnanian, President and Chief Executive Officer of the Company. "This current market slowdown is unique, because the economy is relatively strong - jobs are being created and interest rates remain at levels that are low on a historical basis. Under similar economic circumstances, the homebuilding market historically performed well. We believe the current slower housing market has resulted from the sudden and substantial increase in the inventory of homes offered for resale, combined with mounting negative sentiment among homebuyers that has caused many to postpone their purchase decisions."

"We do not know how long the elevated levels of resale listings will persist and it is equally difficult to predict what events might cause a reversal in buyers' sentiment. Thus, we are making decisions today with the assumption that current conditions will persist for the foreseeable future. We remain focused on competitively pricing our homes on a community-by-community basis to balance our margins and sales pace at an optimal level relative to market conditions," Mr. Hovnanian continued.

"Our profits have been negatively impacted by the increased use of incentives and concessions, as well as expenses related to walking away from option deposits," said J. Larry Sorsby, Executive Vice President and Chief Financial Officer. "We incurred \$11.4 million of charge-offs associated with walk-away costs and an additional \$0.8 million in land write-downs in the third quarter. We continue to renegotiate a significant number of our land contracts, and are likely to incur additional walk-away costs in conjunction with some of these situations. Although a certain number of such costs are factored into our guidance for the fourth quarter, we cannot quantify the exact amount or reserve for them until each contract renegotiation is finalized, thus creating an additional variable in

our forecast. Based on current market conditions, we anticipate fully diluted earnings per common share in a range of \$1.05 to \$1.80 in our fourth quarter," Mr. Sorsby continued. "Our balance sheet remains strong. We expect to achieve an average ratio of net recourse debt to capital at or below 50% for fiscal 2006."

#### In Closing

"Despite the current slowdown, including deliveries from unconsolidated joint ventures, we still expect to deliver more than 20,000 homes and generate pretax income in the range of \$535 million to \$610 million, and net income in a range of \$325 million to \$375 million on revenues of greater than \$6 billion in fiscal 2006" . . . Mr. Hovnanian concluded.

95. During the Q3 2006 Earnings Call on the following day, Ara Hovnanian initially noted that sales activity in Southwest Florida was down and cancellation rates there had increased. However, he went on to explain that cancellation rates had "definitely flattened" and blamed the current cancellations on "older investors."

96. Trying to alleviate analysts' concerns regarding cancellation rates and their impact on projected revenues, the Individual Defendants made the following statements regarding the buyers' security deposits during the Q3 conference call:

**Hovnanian:** Well obviously, in certain markets we have a sizable deposit. And once they get through the mortgage qualification, their deposit is at risk. There aren't a lot of buyers that are buying today that aren't serious buyers. There aren't many investors at all in the marketplace today. So, I'd say the new buyers that are coming in are pretty serious buyers. A good indication, by the way, is once they sign a contract, then they go to our design home gallery. And if they go to that step, and they're recent buyers, they're probably pretty serious. And we're seeing pretty good trends in that regard. (Emphasis added).

**Hovnanian:** They [the deposits] vary all over, from a high of 10% in the Northeast, to 3% in California. It really varies market by market.

**Sorsby:** . . . it's easier in California for someone to walk away, than it is in a D.C., or a Florida, or New Jersey, because we have more meaningful deposits.

**Sorsby:** About 6% in Florida for deposits.

97. Ara Hovnanian's statement regarding the fact that "there aren't many investors at all in the marketplace today" is false and misleading. In fact, Hovnanian was orchestrating an investor/speculator driven "leased-up" scheme that permitted investors with questionable credit to make minimal down payments for multiple homes. Mr. Hovnanian's statements regarding sizable security deposits were false and misleading because he knew or was reckless in not knowing that the Company routinely accepted less than minimum required security deposits in the Florida market. Finally, the fact that the home buyers were not required to make the interest payments on the construction loans, or pay for property insurance, combined with buyers' contractual right to re-convey the property, belied Sorsby's statement that Florida home buyers were less likely than buyers in other states to walk away from sales contracts. In truth, since Hovnanian shouldered most of the financial risk, FHB home buyers were **more** likely to abandon their contracts.

98. On December 18, 2006, Hovnanian issued a press release announcing the Company's fiscal year 2006 financial results. Notably, the release and subsequent earnings call revealed that, despite management's claims made as recently as last quarter that it did not expect to take significant impairment charges in the coming quarters, Hovnanian incurred \$141 million of "option abandonment" charges and \$174 million of "inventory impairment" charges during the quarter, totaling \$315 million, or roughly 11% of tangible equity on an after-tax basis. The press release stated in part:

#### Comments From Management

"Although we are concerned with the uncertainty currently evident in housing markets, we are providing initial guidance for fiscal 2007, based on our standard practice of assuming that our sales pace and pricing in each of our communities remains as it is today and that market conditions do not deteriorate further," Mr. Sorsby

continued. "On that basis, assuming that the economy remains reasonably healthy and mortgage rates remain stable, we are projecting fiscal 2007 earnings between \$1.50 to \$2.00 per fully diluted common share on 16,000 to 18,000 home deliveries, including 1,000 to 1,500 deliveries from unconsolidated joint ventures. For the first quarter of fiscal 2007 we anticipate modest earnings of between \$0.05 and \$0.10 per fully diluted share with earnings significantly weighted to the second half of the year. We believe that the overall U.S. housing market may hit the bottom in the first half of 2007. However, the housing market is likely to bounce along the bottom for several quarters before pricing and sales pace improves."

"As we go forward, we will continue to exercise discipline with regard to our balance sheet. . . . While our inventories are expected to grow through the first two quarters of fiscal 2007, for the full year we expect the net change in inventories to be close to zero. We anticipate that our average ratio of net recourse debt to capitalization will average close to our target of 50% during fiscal 2007," Mr. Sorsby concluded.

#### In Closing

"We believe the quick reaction of the housing markets to set pricing for new homes at lower levels is a significant positive that should allow us to return to a more profitable business environment sooner," Mr. Hovnanian said. "We have been through downturns in the housing industry many times during our 47 years of operation. Each time, we have emerged as a stronger and better company, with an improved market share. We are confident that we will weather the current slowdown with a similar result. Despite incurring \$336 million of land-related charges in 2006, our common stockholders' equity grew by 9.1%."

99. During the Q4 2006 Earnings Call that occurred the following day, Defendants disclosed very little concerning FHB other than Sorsby's confirmation that a sizable portion of the Company's \$92 million Southeast impairment charge related to its FHB operations.

**Analyst:** The \$92 million in the southeast impairments, how much of that was related to First Home?

**Sorsby:** I don't think I want to get into the specifics of exactly where it occurred, but a substantial portion of it was.

100. Also, Ara Hovnanian stated that so long as incentives did not increase beyond 15% of sales price, the Company did not see any risk of further impairments in that market.

101. For Ara Hovnanian to state that further impairments in Florida were unlikely was false and misleading, since Mr. Hovnanian knew that the FHB backlog was plagued with fraud, leveraged investor transactions, and significant cancellation rates as detailed herein.

102. Following the Earnings Call, Credit Suisse issued an analyst report noting Hovnanian's impairment charges relating to FHB. The December 20, 2006 report provided in part:

**Negatives from the quarter and the call:** (1) Despite management's claims made as recently as last quarter that it did not expect to take significant impairment charges in the coming quarters, HOV incurred \$141 million of option abandonment charges and \$174 million of inventory impairment charges during the quarter, totaling \$315 million, or roughly 11% of tangible equity on an after-tax basis. Of the total impairment charges, \$92 million (53%) came from HOV's southeast region (FL, GA, NC, SC), with a "substantial portion" related to HOV's August 2005 acquisition of First Home Builders of Florida in Fort Myers.

103. On January 16, 2007, Hovnanian filed with the SEC its Form 10-K for the period ending October 31, 2006. The 10-K contained the following language:

In many of the markets with significant investor demand, our Company's policy states that sales contracts include an investor restriction on resale of homes for a stipulated time period, if the home is not occupied by the purchaser.

104. The above cited language from the Company's 10-K is subtly different from the 2005 10-K language in ¶82. Whereas the 2005 10-K stated that the resale restriction applied in markets with significant demand, the 2006 10-K is more limiting in that the resale restriction only applies in "many" of the markets with significant demand. Plaintiff alleges on information and belief that defendants made this change to carve out Florida, Hovnanian's largest market, where the Company wholly encouraged investor deals without requiring a restriction on the

resale of homes. The existence of this subtle change, combined with the fact that both of Hovnanian's 10-Ks were signed by defendants Ara Hovnanian and Sorsby, signify the fact that they were acutely aware of the FHB operations and the contracts being used.

105. In early 2007, Sorsby met with one or more of the Colorado credit unions who were funding the FHB construction loans to discuss Hovnanian's continued interest payments on the construction loans. This fact is confirmed by a former Vice President of Operations for Norlarco who attended the meeting with Sorsby.

106. On February 16, 2007, the NCUA assumed control of the Ann Arbor-based Huron River Area Credit Union which collapsed under the weight of the high-risk speculative FHB construction loans they were funding.

107. On March 8, 2007, Hovnanian issued a press release announcing the Company's first quarter 2007 financial results. The release and subsequent earnings call disclosed that Hovnanian would take an additional \$93 million of asset impairments related to FHB. Contract cancellations were so great at this point that defendants reported *negative* sales for the quarter in Florida. The press release stated in part:

The Company's contract cancellation rate, excluding unconsolidated joint ventures, for the first quarter of fiscal 2007 was 36%, close to the cancellation rate of 35% experienced in the fourth quarter of fiscal 2006. Excluding the results from the Company's Fort Myers- Cape Coral operations, the contract cancellation rate was 29% for the first quarter of 2007.

For the month of February 2007, the first month of the Company's second fiscal quarter, the dollar value and number of net contracts excluding unconsolidated joint ventures increased 4.3% and 2.6%, respectively, from February 2006. This marks the first positive monthly comparison since the market slowdown began.

#### Comments From Management

"Our contract pace in the first quarter held steady in most of our markets with the pace we achieved in the fourth quarter of last year, as adjusted for normal seasonal factors," commented Ara K.

Hovnanian, President and Chief Executive Officer of the Company. "However, we lowered prices in some of our community locations in the beginning of the first quarter through additional incentives and discounts in order to maintain the pace of sales that we were targeting for those locations. Pricing has generally stabilized since that time. In addition, conditions in our Fort Myers-Cape Coral market continued to deteriorate considerably during our first quarter, which led to further impairments in the first quarter and contributed to lower expectations for deliveries, gross margin and earnings for the full year," Mr. Hovnanian stated.

"Our first quarter is always the slowest seasonal period for new contracts, so it is difficult to get a good feel for the strength of the market and what absorption rate to project for the rest of the year in each of our communities. Most of our markets have begun to show signs of stabilization, but we are not yet confident that we have found the bottom of this housing slowdown," Mr. Hovnanian said.

"Assuming that our sales pace and pricing in each of our communities remain at current levels, we are projecting fiscal 2007 earnings, prior to the effect of the charges from our Fort Myers-Cape Coral operations, between \$1.10 and \$1.50 per fully diluted common share on 16,000 to 17,200 home deliveries, including 1,000 to 1,400 deliveries from unconsolidated joint ventures. For the second quarter of fiscal 2007, we are anticipating a net loss between \$0.05 and \$0.20 per fully diluted common share. Our fiscal 2007 earnings will thus be significantly weighted to the fourth quarter," Mr. Hovnanian said.

"Although our total lots controlled declined 3.7% in the first quarter, the number of open communities increased. Together with the normal seasonal construction of homes in backlog, this led to an increase of about 2% in the total book value of inventories during the three month period. For the full year we expect a modest increase in our investment in inventories, with positive cash flow from operations in the fourth quarter," said Mr. Sorsby. "At year end, we anticipate that our number of active selling communities will be approximately 465, compared to 427 at the end of fiscal 2006," Mr. Sorsby concluded.

#### In Closing

"Once the housing market bottoms out, we are not expecting a rapid recovery. Instead we expect sales to hold at a steady pace for several quarters. In the current environment, our contract pace is difficult to predict and it will likely vary based on individual market and community characteristics," said Mr. Hovnanian. "Although conditions in the housing market remain challenging,

we have been through many downturns in the housing industry during almost five decades of homebuilding, and we are confident we will emerge from the current slowdown with a solid financial footing and positioned to capitalize on strategic opportunities," Mr. Hovnanian concluded.

108. During the Q1 2007 Earnings Call that followed, defendants provided some sobering news regarding the FHB operation:

**Hovnanian:** During the quarter, we incurred \$93 million of pretax charges related to the Company's Fort Myers operations due to a continued substantial decline in sales pace and general market conditions as well as increasing cancellation rates during the quarter. The charges consisted of \$42 million in inventory impairments and a complete write-off of the remaining balance of intangibles associated with the acquisitions of Fort Myers, which occurred in August of 2005.

After these charges, we reported a net loss of \$57 million for the first quarter of fiscal 2007, or \$0.91 per fully diluted common share compared to earnings of \$81.4 million, or \$1.25 per fully diluted common share in last year's first quarter. In addition to the charges related to the Fort Myers operation, we incurred \$4.6 million of impairment charges on land owned and \$3 million in charges related to write-offs of predevelopment costs on option land during the first quarter.

Each month the cancellations continued to get worse and, in fact, for the quarter, we reported negative contracts for our Fort Myers operations. This led us to take further impairments. As I said, we took \$42 million of impairments on inventory in Fort Myers. As of January 31, we have about 2,600 lots owned and a remaining inventory balance on those lots after all impairment charges of \$47 million or \$18,000 per lot. In addition to the inventory impairment, we wrote off the remaining balance of the definite life intangibles that we carried on our balance sheet related to the acquisition. This balance was approximately \$51 million.

In terms of bad markets for us, Fort Myers market is definitely our worst market today.

**Sorsby:** . . . we are lowering our projections for gross margins for the year about 100 basis points from our prior guidance. This is partially due to the decline in our projected price and margins in Fort Myers going forward.

109. The Company also disclosed for the first time, the following cancellation data specific to the FHB operation:

	Gross Contracts	Cancellations	Net Contracts
September, 2006	38	10	28
October, 2006	50	35	15
November, 2006	45	44	1
December, 2006	22	103	(81)
January, 2007	22	165	(143)

110. Defendants' statements regarding problems with the Company's FHB operations only partially disclosed the extent of the infirmities which existed. For example, unbeknownst to the investing public at this time: (1) home buyers were not required to make interest payments on their construction loans or pay for property insurance; (2) Hovnanian effectively had granted home buyers the right to walk away from their homes; and (3) home buyers with limited incomes were allowed to put minimal down payments on multiple properties. The consequence of these undisclosed facts was the artificial inflation of the Company's backlog. Thus, the materialization of the risk had not been fully realized by the market at this time.

111. The market reacted to the negative news disclosed by Hovnanian, causing a 4% drop in the Company's stock price on March 9, 2007.

112. Following the earnings call, Credit Suisse issued an analyst report noting Hovnanian's impairment charges relating to FHB. The March 12, 2007 report provided in part:

**Negatives from the quarter and the call:** (1) HOV's Fort Myers acquisition in August 2005 continues to haunt results, with the company forced to take another \$93 million of asset impairments related to the deal, despite management's claims in September that those assets were "safe." In total, we estimate that the company has written off \$150 million related to First Home Builders, which would equate to the approximate \$175 million cash portion of the deal.

113. Prompted by the negative news concerning the FHB operations, Moody's Investors Service lowered its rating for Hovnanian. As reported by Bloomberg on April 10, 2007:

Hovnanian's Ratings Lowered by Moody's on Negative Cash Flow

Hovnanian Enterprises Inc., the sixth largest U.S. homebuilder by revenue, had its debt rating lowered and its outlook downgraded by Moody's Investors Service on the company's negative cash flow and unsold inventories.

Homebuilders including Hovnanian have inventories of unsold properties while speculators who propelled the five-year housing boom cancel contracts. Hovnanian took charges of \$93 million in the first quarter on cancelled contracts for homes in southwest Florida and to write off its 2005 purchase of a Florida homebuilder.

"The negative outlook reflects Moody's expectation of continuing weakening in Hovnanian's earnings-based metrics, including interest coverage, gross margins and return to assets," Moody's said.

114. On April 10, 2007, an article appeared in the *The News-Press* entitled "Collapse of Lender Taints Lee Builder" which revealed that on February 16, 2007, the NCUA assumed control of the Ann Arbor-based Huron River Area Credit Union which collapsed under the weight of the high-risk speculative FHB construction loans it was funding. Sorsby is quoted in the article stating: "up until two or three weeks ago we had no idea Huron even existed. We had no direct dealings with Huron; we were dealing with a local mortgage company that I guess made the loans and may have assigned them" to Huron. The article noted, however, that the company referenced by Sorsby, Construction Loan Company Inc., is based in Howell, Michigan, at the same address as a Huron branch.

115. Sorsby's statement in the preceding paragraph disavowing any knowledge of Huron River is inconsistent with documents filed with the Lee County Florida's Department of Public Records which reveal that a significant number of FHB home buyer construction loan

contracts were made either directly with Huron River Credit Union or an entity owned by Huron River.

116. On or around April 15, 2007, further problems concerning FHB surfaced when the first of many lawsuits filed by Hovnanian home buyers began to surface. Cedric and Sandra Walta sued FHB, Hovnanian and others, alleging fraud in connection with the offering and sale of real estate. The complaint alleged that the defendants altered information to enhance the home buyers' financing application without their knowledge, inflating the value of their residence and length of time Mr. Walta had been at his job.

117. A story regarding the Waltas' complaint appeared in the Florida newspaper, *The News-Press* on April 15, 2007. The article provided, in part:

Cedrick Walta and his wife Sandra Chen-Walta, tried three lenders but weren't able to find one that would finance the three Cape Coral houses they signed up to buy from First Home in July 2005 with a down payment of \$12,500 on loans totaling \$766,382.

Hovnanian faces an increasing number of people who, like the Waltas, say a clause in their contract gives them the right to deed back the house to the builder if the buyer can't close.

Richard Inglis, A Fort Myers-based attorney who represents some people with that clause said: "My phone's been ringing off the hook" with people trying to get out of their contracts on that basis.

Marc Savitt, vice president of the National Association of Realtors, said he's reviewed the documents for the Waltas' case.

"This is clearly abusive lending," he said.

118. Larry Sorsby is also quoted in the above article stating: "We've had the document in the entirety reviewed by three independent law firms and each of them agrees that First Home has the option to purchase the home but no obligation."

119. Sorsby's statement in the preceding paragraph is inconsistent with the standard FHB sales contract. The relevant section of FHB's "Agreement to Purchase" entitled

“Miscellaneous Provisions,” provides in relevant part:

In the event that Buyer obtains and initially closes using a construction loan and is thereafter unable to obtain or qualify for the financing that would result in the end-closing, Buyer agrees to convey, via statutory deed to Builder/Seller the home and real property, at which time, Builder/Seller shall pay and satisfy the construction loan.

Further, another provision in the agreement entitled, “Buyer’s Default,” provides that in the event the buyer defaults, buyer “shall immediately execute conveyance documents as needed to deed the property back to the Builder/Seller, or to such other parties, as the Builder/Seller shall direct.”

120. During a May 21, 2007 JMP Securities Research Conference, Sorsby was discussing Hovnanian’s efforts to curb sales to investors:

“Yes, I would say that we were stunned, that’s probably as good a word as any. Most of the public builders had put in anti flipping clauses into the contract, I mean legally you can’t not sell to some one but you can make it more onerous for them to buy by saying if you flip it within a year all the profits come back to us. We had that in place and virtually all of our markets other than maybe Texas. . .”

121. During that same conference, Sorsby discussed how surprised he was in the number of investors that were part of Hovnanian’s backlog. However, the October, 2005 edition of the trade publication “Builder” (*See* ¶69) described how Hovnanian was specifically targeting investors through the leased-up home scheme.

122. Sorsby’s statement contained in the preceding paragraph was false and misleading because as revealed in the litigation records filed by FHB home buyers with the United States District Court for the Middle District of Florida which include mortgage related documents, no such “anti flipping clause” appears to exist.

123. On May 31, 2007, Hovnanian issued a press release announcing the Company’s second quarter 2007 financial results. The release and subsequent earnings call revealed that the Company’s Florida operation was performing at a negative gross margin (pre-impairments) and

approximately zero margins post-impairments. During the Company's earnings call, defendants also announced another \$8 million of impairment charges related to FHB. The press release stated in part:

#### Comments From Management

"We are frustrated to report that the housing market has continued to slip further in many locations in terms of both sales pace and sales prices," commented Ara K. Hovnanian, President and Chief Executive Officer of the Company. "The housing market weakened in the latter part of the second quarter and the slower conditions have continued into May. Lower prices offered to buyers to close homes during the quarter also led to a further reduction in margins and a net loss for the quarter."

"After a 3% increase in our February contracts over last year, the overall market fell off again, and our net contracts declined approximately 30% year over year through March and April," Mr. Hovnanian said. "We believe that much of this decline was a reaction to recent problems in the sub-prime mortgage market. While we have felt the sub-prime impact directly in the form of fewer potential homebuyers qualifying for a mortgage as lending standards have tightened, the more significant impact has been indirectly through a further pullback in home buyers' psychology toward making a purchase," Mr. Hovnanian stated.

"Given the increased uncertainty of housing market conditions, we have discontinued offering earnings guidance and we have increased our focus on improving our balance sheet and generating positive cash flow," Mr. Hovnanian said.

"An excess supply consisting primarily of existing homes remains in many of our markets," Mr. Hovnanian said. "Before the current housing market correction is over, the market needs to work through those inventories. Throughout our 48-year history, we have successfully navigated past down cycles, and we are confident that we will emerge from the current slowdown with a solid financial footing and positioned to capitalize on strategic opportunities in our markets," Mr. Hovnanian concluded.

124. During the Q2 2007 Earnings Call held the following day, Defendants announced that they were in the process of selling the Company's remaining lots in the Ft. Myers market:

**Hovnanian:** Part of the reason for the higher charges again related to Fort Myers which resulted in about \$8 million of the \$34 million

in pre-tax land charges for the quarter. We identified a buyer for half of our remaining lots in that market and have them under contract for sale. We're not abandoning the market, but there's not likely going to be the need for a lot of brand new houses in the near future, and we feel we can replenish the supply of land when we need to. We are recognizing the loss related to the bulk sale this quarter, even though the transaction is not anticipated to close until the fourth quarter. The sale price on the lots was moderately lower than the basis at which we were carrying these lots. In addition, we reported an impairment on the other half of the lots based on a recent offer to buy these lots in bulk. While we have not signed a contract for the second half of the lots, we did book the impairment as the sale or some sale is likely. When we earlier did the impairment, we hadn't anticipated a bulk sale.

125. During this conference call, Ara Hovnanian also stated that at the time the Company acquired FHB, it did not buy all of the subject land in one transaction, but was purchased in small increments on a regular basis.

**Hovnanian:** Oh, well, we didn't buy all of that land in one transaction. These are, if you remember, scattered lots in that area, so they were literally bought in small increments on a regular basis.

126. Ara Hovnanian's statement contained in the preceding paragraph was false and misleading because as revealed in the Public Records of Lee County Florida, Hovnanian purchased approximately \$140 million worth of scattered lots in Florida from FHB in August, 2005, just days prior to the acquisition announcement.

127. Further, Defendants' statements regarding problems concerning the Company's FHB operations only partially disclosed the extent of the infirmities which existed, as detailed herein.

128. The market reacted to the negative news disclosed by Hovnanian, resulting in a 4.5% drop in the Company's stock price on June 1, 2007.

129. Following the Earnings Call, Credit Suisse issued an analyst report noting that the FHB operation was continuing to ravage Hovnanian's financials. The June 4, 2007 report provided in part:

**Negatives from the quarter and the call:** (5) HOV's Fort Myers acquisition in 2005 continues to weigh on results, as it is operating at a negative gross margins (pre-impairments) and at roughly break-even post impairments. The company took another \$8 million of **unexpected charges** in this market pertaining to the potential sale of its remaining lots to two separate buyers (speculators). It emphasized it is not exiting the market, but will replenish lots once the market conditions warrants it. (Emphasis added).

130. Thereafter, on August 13, 2007, Hovnanian issued a press release announcing the Company's preliminary net contracts and deliveries for the quarter ended July 31, 2007. Among other things, the Company reported that "[c]ancellations for the fiscal 2007 third quarter were 35% of gross contracts, compared to the cancellation rate of 33% for the third quarter of 2006." The August 13 press release also reported that the Company "expects to incur approximately \$90 million to \$110 million of pretax charges related to land impairment and write-offs of pre-development costs and land deposits in the third quarter." The press release stated, in relevant part, as follows:

**Hovnanian Enterprises Reports Preliminary Net Contracts and Deliveries for the Third Quarter of Fiscal 2007**

RED BANK, N.J., Aug. 13 /PRNewswire-FirstCall/ – Hovnanian Enterprises, Inc. (NYSE: HOV) today announced preliminary net contracts and deliveries for the third quarter ended July 31, 2007. The Company delivered 3,179 homes during its third quarter, a decrease of 31% from the same quarter a year ago, excluding 329 homes in unconsolidated joint ventures.

Net contracts for the quarter were 2,539, a decrease of 24% from last year's third quarter, excluding 255 net contracts for unconsolidated joint ventures. Cancellations for the fiscal 2007 third quarter were 35% of gross contracts, compared to the cancellation rate of 33% for the third quarter of 2006. Contract backlog, as of July 31, 2007, excluding unconsolidated joint ventures, was 7,126 homes, a decrease of 31% from the same quarter a year ago.

As a result of continued deterioration in sales pace and pricing in certain communities since the end of the Company's second fiscal quarter, the Company also announced that it expects to incur

approximately \$90 million to \$110 million of pretax charges related to land impairment and write-offs of predevelopment costs and land deposits in the third quarter.

These results are preliminary and the Company is still completing its review of financial results and impairment charges.

The Company expects that it is in compliance with all of its debt covenants, as of July 31, 2007.

131. During the Q3 2007 Earnings Call the following day, Larry Sorsby provided additional statements regarding the FHB operation:

**Sorsby:** Our operations in this market are very different from what we see throughout most of our Company and we've commented that we view Fort Myers as likely the worst housing market in the country, so we think it is worth providing some additional clarity on the status of this sizable sales backlog, most of which is likely to close with much lower gross margins and profits than our consolidated averages.

Almost all of our home buyers in this market first buy a lot from us and then use construction financing from a third party lender to build the home. We typically receive between 75% and 90% of the purchase price from our Fort Myers customers via their construction loans. However, given that the market has deteriorated so significantly in Fort Myers, many buyers are now refusing to convert to permanent financing where we would receive the balance of our sales price.

They are effectively defaulting on their construction loan. Therefore it is likely that we will not receive the balance of the purchase price on many of these homes and will make minimal if any margin on these homes. We do not book any revenues or profits on any of the Fort Myers homes until either our customer secures permanent financing and pays off the construction loan or when the construction lender forecloses or takes a deed in lieu back from their customer. Additionally, we continue to work on sale in bulk of our remaining lots in this Fort Myers market which total approximately 2,500 lots with a book value of \$31.6 million after impairments taken in prior quarters. One small block of lots has already sold, another larger block comprised of nearly half the remaining lots is currently under contract, and we continue to market the remaining lots in bulk.

132. Mr. Sorsby's explanation in the preceding paragraph was false and misleading in that he misrepresented and omitted to disclose material information regarding the FHB operation as detailed in ¶ 94. Additionally, documents obtained from the Lee County Florida's Department of Public Records as well as documents attached to the Florida complaints filed by home buyers against Hovnanian reveal that home buyers were merely obtaining title to a lot from Hovnanian for a nominal amount, usually \$10.00, and then using construction financing which included the price of the lot. However, Hovnanian, rather than the home buyers, was required to pay the interest on the construction financing and typically paid for property insurance. Thus, the home buyers' only financial stake was the minimal down payment as reflected in the purchase agreements.

133. However, Mr. Sorsby's comments did partially reveal the extent of the problems Hovnanian was experiencing as a result of its "leased-up" sales program. Hovnanian was now feeling the effect of investors who, after putting minimal down payments on multiple homes, were walking away from their speculative investment properties.

134. The market reacted to the negative news disclosed by Hovnanian, resulting in a 7% drop in the Company's stock price on August 14, 2007.

135. On November 17, 2007, an article published in *The News-Press* entitled, "How Hovnanian Lost Big in Lee County," provided details of Hovnanian's problems in Florida. The article provided in part:

**Flush with Flippers:** Sure enough the honeymoon only lasted four months. By December the median price of an existing home in the county had peaked at \$322,300 and was poised for a steep slide. To make matters worse, much of First Home's supercharged growth in 2005 had come in the form of thousands of houses bought by people hoping to resell them quickly for a profit.

Helping people get financed had always been a strength of First Home's, and most of the buyers were borrowing close to 100 percent of the home's value.

Money flowed freely for construction, with much of the debt ending up with two small, out-of-state credit unions loaning to people who were nominally qualified to be members.

Meanwhile, a deal Logue [former owner of FHB] had made with real estate broker Frank D'Alessandro in March 2003 was bringing in even more investors - lured by the prospect of tenants already in place when the house was sold.

The bottom line: Huge numbers of homes being built by First Home ended up flooding the inexpensive-home market because so many buyers were investors who never intended to live there.

\*\*\*

A good part of the blame, experts say, should go toward the company's venture in Southwest Florida.

"It's really the First Home Builders Division that's hurt Hovnanian the most," said Jack McCabe, a real estate consultant based in Deerfield Beach. "Fort Myers/Cape Coral is the worst market in the country right now; it saw the most rapid inflation in prices and now it's seeing the most rapid deflation. It just doesn't have the industries that would attract new residents. People are either already here or retirees."

136. The above article confirmed the speculative nature of Hovnanian's backlog, which contradicted defendants' earlier public statements that the Company's FHB acquisition possessed the "strongest" and "most solid" backlog with "very strong" buyers.

137. Finally, on December 18, 2007, Hovnanian issued a press release announcing the Company's dismal fourth quarter 2007 financial results. Although the risk concerning the FHB operation had not fully materialized, it was now crystal clear that the FHB acquisition was a complete disaster which had wreaked havoc on Hovnanian's financial results. The press release stated in part:

Hovnanian Enterprises Reports Fiscal 2007 Results  
Tuesday December 18, 7:30 pm ET

RED BANK, N.J., Dec. 18 /PRNewswire-FirstCall/ – Hovnanian Enterprises, Inc. (NYSE: HOV - News), a leading national homebuilder, reported results for its fourth quarter and fiscal year ended October 31, 2007.

Results for the 3 months and 12 months ended October 31, 2007:

Excluding unconsolidated joint ventures, the Company delivered 13,564 homes with an aggregate sales value of \$4.6 billion in fiscal 2007, down 24.4% from 17,940 home deliveries with an aggregate sales value of \$5.9 billion in fiscal 2006. In the fourth quarter, the Company delivered 3,969 homes with an aggregate sales value of \$1.3 billion in fiscal 2007, a decline of 22.0% in sales value from the fourth quarter in fiscal 2006.

Total revenues were \$4.8 billion for fiscal 2007, a decrease of 21.9% compared to last year. Fourth quarter revenues were \$1.4 billion for fiscal 2007, down 20.3% from last year's fourth quarter.

The Company generated \$376 million of positive cash flow from operations during the fourth quarter of fiscal 2007 and reduced total debt outstanding by \$390 million.

Excluding land-related and intangible charges, the Company reported a pretax loss of \$21 million for the twelve month period. For the fourth quarter, the pretax loss excluding land-related and intangible charges was \$30 million. Including all land-related and intangible charges, the Company reported a pre-tax loss of \$647 million for the full year and \$413 million for the fourth quarter.

During the fourth quarter of fiscal 2007, the Company incurred a total of \$383 million of pretax charges including land impairments of \$168 million, intangible impairments of \$78 million and write-offs of predevelopment costs and land deposits of \$105 million, as well as \$32 million representing its equity portion of write-offs and impairment charges in unconsolidated joint ventures. Similar charges in the fourth quarter of fiscal 2006 totaled \$322 million.

For the full year, the Company recognized pre-tax charges totaling \$626 million, including \$332 million related to land impairments, \$135 million of charges associated with intangible impairments, write-off of predevelopment costs and land deposits of \$126 million and \$33 million representing its equity portion of write-offs and impairment charges in unconsolidated joint ventures. Similar charges in fiscal 2006 totaled \$343 million.

The Company reported an after tax loss of \$469 million or \$7.42 per common share for the final three months of fiscal 2007, compared with a net loss of \$118 million, or \$1.88 per common share, in the fourth quarter of fiscal 2006. For the full year, the Company reported an after tax loss of \$638 million or \$10.11 per common share in 2007, compared with net income of \$139 million,

or \$2.14 per fully diluted common share, in fiscal 2006.

The Company's contract cancellation rate, excluding unconsolidated joint ventures, for the fourth quarter of fiscal 2007 was 40%, compared with the rate of 35% reported in both the fourth quarter of 2006 and the third quarter of fiscal 2007.

138. During the Q4 2007 Earnings Call the following day, Sorsby reiterated his description of the FHB operation. He made the following additional comments regarding the dismal state of the operation:

**Sorsby:** . . .given that the market has deteriorated so significantly in Fort Myers, many buyers have chosen not to convert to permanent financing where we would normally receive the balance of our sales price.

Approximately 1400 of the 1652 homes in our Fort Myers backlog are expected to deliver during the first quarter of 2008, because construction is now completed and we no longer have any further continuing involvement. Since we will not be receiving the last 10% to 25% of our purchase price from the customers who have not closed on a permanent loan, we will report deliveries for these homes at a gross margin close to zero, and these closings will cause our first-quarter consolidated gross margin to be much lower than otherwise would have occurred.

As of October 31, 2007, our remaining investment in land and lots in Fort Myers is only \$20 million, so our exposure to this market is rather minimal going forward.

139. Also during the Earnings Call, Sorsby finally revealed that FHB home buyers did not actually purchase the lot prior to signing purchase agreements as repeatedly touted throughout the Class Period:

**Analyst:** Good afternoon. Just a quick question, on this Fort Myers situation, I find it very intriguing -- I don't think in 40 years I've seen something like this. But am I to understand that the people bought the lots and paid you for that portion. You got that from a cash flow basis and now that that -- you got 80% of the construction loan but since they are keeping construction loans and not changing them to conventional loans, you lose the last 20%, is that correct?

**Sorsby:** You basically have it right. **They may have gotten a construction loan that paid us for the lot rather than the customer actually paying us for the lot.** But I think the rest of that you are pretty much on track, Tim. (Emphasis added).

140. The market reacted to the negative news disclosed by Hovnanian resulting in a 11% drop in the Company's stock price on December 19, 2007. As a direct result of the market learning of defendants' wrongdoing, the price of Hovnanian shares declined and plaintiff and the Class suffered a loss on their investment in Hovnanian.

### **THE AFTERMATH**

141. Following Hovnanian's Earnings Call, Bear Stearns issued an analyst report regarding the Company. In regards to the FHB operation, the December 19, 2007 report stated in part:

. . . many of the customers have chosen not to convert to permanent financing where the company would receive the normal balance of the sales price. Approximately 1400 of the 1652 homes in Fort Myers are expected to deliver during the first quarter of 2008, because construction is now completed and the company has no further involvement in the market. Since the company will not be receiving the last 10% to 25% of the purchase price from the customers, the company will report deliveries for these homes will be at a gross margin close to zero.

142. On December 26, 2007, the *Newark Star Ledger*, the leading newspaper from Hovnanian's home state, published an article discussing the Company's financial problems. The article provided in part:

Hovnanian also has a large exposure to the southwestern Florida housing market, where demand has plummeted. In the Fort Myers-Cape Coral area, the company has an unusual arrangement in which homeowners buy lots, then arrange for third-party financing to build their homes. In some cases, homeowners are backing out of the construction loans, and the defaults are eating into Hovnanian's profits, analysts said.

## **SCIENTER AND SCHEME ALLEGATIONS**

143. Defendants knew their public statements and representations were materially false and misleading; knew their false and misleading statements and representations would be issued or disseminated to the investing public; and knowingly and substantially participated or acquiesced in the issuance or dissemination of such statements or documents as primary violations of the federal securities laws. Defendants, by virtue of their receipt of information reflecting the true facts regarding Hovnanian, their control over, and receipt or modification of Hovnanian's materially misleading misstatements which made them privy to confidential proprietary information concerning Hovnanian, participated in the fraudulent scheme alleged herein.

144. Defendants had the motive and opportunity to commit fraud and had actual knowledge of the falsity of the statements they made, or acted in reckless disregard of the truth or falsity of those statements. In doing so, defendants participated in a scheme to defraud and committed acts, practices and participated in a course of business that operated as a fraud or deceit on purchasers of Hovnanian stock during the Class Period.

145. The Individual Defendants were Hovnanian's top executive officers charged with not only developing Hovnanian's business strategy, but also overseeing the implementation and execution of that strategy during the Class Period.

## **LOSS CAUSATION**

146. During the Class Period, defendants engaged in a scheme to deceive the market and a course of conduct that artificially inflated Hovnanian's securities and operated as a fraud or deceit on Class Period purchasers of Hovnanian securities by misrepresenting the Company's present and future operational and financial performance. Later however, when the truth concerning Hovnanian's present and future operational and financial performance entered the

market and became apparent to investors, Hovnanian's securities price fell as the prior artificial inflation came out of it. As a result of their purchases of Hovnanian securities during the Class Period at artificially inflated prices, and defendants' subsequent disclosures which removed the inflation from their securities, plaintiff and other members of the Class suffered economic loss – *i.e.*, damages under the federal securities laws.

147. By misrepresenting the strength of demand for Hovnanian's homes, failing to disclose the true extent of the decline in that demand and traffic to Hovnanian's largest market, failing to adequately disclose the actual level of difficulty that faced Hovnanian in attempting to close on its backlog of sales contracts at rates necessary to meet 2006 and 2007 projections, failing to disclose significant problems with FHB's backlog existing at the time it was acquired by Hovnanian and issuing false or misleading projections for Hovnanian's future financial performance, defendants presented a misleading picture of Hovnanian's business and prospects. Defendants' omissions and false and misleading statements caused Hovnanian's securities to trade at artificially inflated levels throughout the Class Period.

148. Partial revelations about the Company's declining health throughout the Class Period allowed some of the artificial inflation to come out of Hovnanian's stock. However, due to defendants' lack of full and complete disclosure, false assurances and continuing misrepresentations, Hovnanian's stock continued to trade at artificially inflated prices through the balance of the Class Period.

149. The timing and magnitude of Hovnanian's stock price decline negates any inference that the loss suffered by plaintiff and other Class members was caused by changed market conditions, macroeconomic or industry factors or Company-specific facts unrelated to the defendants' fraudulent conduct. The economic loss – *i.e.*, damages, suffered by plaintiff and other members of the Class was a direct and proximate result of defendants' fraudulent scheme

to artificially inflate Hovnanian's stock price and the subsequent significant decline in the value of Hovnanian's stock when the truth was revealed to the market.

**APPLICABILITY OF PRESUMPTION OF RELIANCE:  
FRAUD ON THE MARKET DOCTRINE**

150. The presumption of reliance established by the fraud-on-the-market doctrine applies to plaintiff's allegations because:

a. The common stock of Hovnanian met the requirements for listing, and was listed and traded on the New York Stock Exchange, a highly developed and efficient market, under the ticker symbol "HOV";

b. During the Class Period, Hovnanian stock was heavily traded, with average volume of at least hundreds of thousands of shares traded daily;

c. As a regulated issuer, Hovnanian filed periodic public reports with the SEC, and regularly communicated with public investors via established market communication mechanisms, including through regular disseminations of press releases;

d. Hovnanian was followed by securities analysts from several major brokerages, including Bear Sterns, Credit Suisse, Citigroup, Wachovia and Deutsche Bank, who wrote reports that were redistributed to certain customers of such firms and were available through various automated data retrieval services;

e. The misrepresentations and omissions alleged herein were material and would tend to induce a reasonable investor to misjudge the value of Hovnanian stock and notes; and

f. Plaintiff and the members of the Class purchased Hovnanian securities during the Class Period without knowledge of the omitted or misrepresented facts.

151. The market for Hovnanian's stock and notes was efficient at all relevant times in

that it promptly digested current information with respect to the Company from all publicly available sources and reflected such information in the price. Plaintiff and the other members of the Class are entitled to a presumption of reliance upon the integrity of the market for Hovnanian stock and notes for the purpose of class certification as well as for ultimate proof of their claims on the merits.

152. The statutory Safe Harbor provided for forward-looking statements under certain circumstances does not apply to any of the allegedly false statements pleaded in this Complaint. The specific statements pleaded in this Complaint were either not forward-looking or were not identified as “forward-looking statements” when made. To the extent that there were identified forward-looking statements when made, specific meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the purportedly forward-looking statements were not presented. The Safe Harbor warnings in Hovnanian’s SEC filings and releases as well as those made at the start of Hovnanian’s conference calls were boilerplate and did not materially change during the Class Period, even though the economic and business conditions in which Hovnanian operated and the risks facing its business did. Alternatively, to the extent that the statutory Safe Harbor does apply to any forward-looking statements pleaded in the Complaint, defendants are liable for those false forward-looking statements because at the time each of those forward-looking statements was made, the particular speaker knew that the particular forward-looking statement was false, and/or the forward-looking statement was authorized and/or approved by an executive officer of Hovnanian who knew that the statement was false when made.

153. Throughout the Class Period, defendants pursued a course of deceptive conduct in which they blamed the decline in the Company’s business on market factors, falsely representing

that the Company's business condition was declining due to market factors largely outside of their control. While general market conditions were affecting the business of all homebuilders during the Class Period, Hovnanian's business was fairing worse than its competitors due to its poor decision by management to purchase FHB. As the housing bubble began to deflate, defendants were aware of the position in which their misguided decision to acquire FHB left the Company, and in order to conceal the irreparable harm done, defendants blamed the slow business on market factors that all homebuilders were facing. It was not until near the end of the Class Period that the investing public began to learn the truth that Hovnanian was fairing much worse than defendants had previously claimed.

154. But for defendants' deceptive course of conduct, the market would have learned of the true financial health of the Company and immediately adjusted the trading price of the Company's publicly-traded securities accordingly. However, defendants' false and misleading statements as to the Company's financial health allowed for the gradual decline in Hovnanian's securities during the Class Period. The Company-specific adverse information that was withheld from the market throughout the Class Period allowed the Company's publicly-traded securities to continue to trade at artificially inflated levels, thereby harming the purchasers as the truth slowly removed the inflated value.

155. When the market began to compare the revealed truth to defendants' earlier misstatements, the difference between the prior statements and the truth was marked. The discovery of this fraud, by way of learning the true status of Hovnanian's financial health and future business prospects, proximately caused the drop in securities price, directly causing economic harm to all purchasers of the Company's publicly-traded securities during the Class Period.

156. To avoid a sudden collapse in stock price, which would have threatened the lucrative compensation the defendants were able to collect throughout the Class Period, defendants pursued a course of deception in which they attempted to slowly ease the bad news into the market. As the revelations of the true value of the Company were leaked out to the market over the course of the Class Period, defendants' fraud in concealing the poor financial status of the Company became known and proximately caused enormous damage to the investors who purchased the inflated Hovnanian securities during the Class Period.

### **CLASS ACTION ALLEGATIONS**

157. Plaintiff brings this action as a class action pursuant to Rule 23 of the Federal Rules of Civil Procedure on behalf of all persons who purchased or otherwise acquired Hovnanian common stock as well as purchasers of Hovnanian's 7.625% Non-cumulative Preferred Depository Shares, during the Class Period (the "Class"). Excluded from the Class are defendants, the officers and directors of the Company, as well as their families, and the families of the defendants, and any entity in which defendants have or had a controlling interest.

158. The members of the Class are so numerous that joinder of all members is impracticable. The disposition of their claims in a class action will provide substantial benefits to the parties and the Court. Hovnanian has more than 47.5 million shares of stock outstanding, owned by hundreds if not thousands of persons.

159. There is a well-defined community of interest in the questions of law and fact involved in this case. Questions of law and fact common to the members of the Class which predominate over questions which may affect individual Class members include:

- a. Whether the 1934 Act was violated by defendants;
- b. Whether defendants omitted and/or misrepresented material facts;

c. Whether defendants' statements omitted material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading;

d. Whether defendants knew or deliberately disregarded that their statements were false and misleading;

e. Whether the price of Hovnanian common and/or preferred stock was artificially inflated; and

f. The extent of damage sustained by Class members and the appropriate measure of damages.

160. Plaintiff's claims are typical of those of the Class because plaintiff and the Class sustained damages from defendants' wrongful conduct.

161. Plaintiff will adequately protect the interests of the Class and has retained counsel who are experienced in class action securities litigation. Plaintiff has no interests which conflict with those of the Class.

162. A class action is superior to other available methods for the fair and efficient adjudication of this controversy.

## **COUNT I**

### **Violations of §10(b) of the 1934 Act and Rule 10b-5 Promulgated Thereunder**

163. Plaintiff repeats and realleges each and every allegation described above as if fully set forth herein.

164. During the Class Period, defendants disseminated or approved the false statements specified above, which they knew or deliberately disregarded were misleading in that they contained misrepresentations and failed to disclose material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

165. Defendants violated §10(b) of the 1934 Act and Rule 10b-5 in that they:

- a. Employed devices, schemes and artifices to defraud;
- b. Made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- c. Engaged in acts, practices and a course of business that operated as a fraud or deceit upon plaintiff and others similarly situated in connection with their purchases of Hovnanian securities during the Class Period.

166. Plaintiff and the Class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for Hovnanian securities. Plaintiff and the Class would not have purchased Hovnanian securities at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' misleading statements.

## **COUNT II**

### **Violation of §20(a) of the 1934 Act**

167. Plaintiff repeats and realleges each and every allegation described above as if fully set forth herein.

168. The Individual Defendants acted as controlling persons of Hovnanian within the meaning of §20(a) of the 1934 Act. By reason of their positions with the Company, defendants had the power and authority to cause Hovnanian to engage in the wrongful conduct complained of herein. By reason of such conduct, defendants are liable pursuant to §20(a) of the 1934 Act.

## **PRAYER FOR RELIEF**

WHEREFORE, plaintiff prays for judgment as follows:

- A. Declaring this action to be a proper class action pursuant to Fed. R. Civ.P. 23; certifying plaintiff as class representative under Rule 23 of the Federal Rules of Civil Procedure and designating this Complaint as the operable complaint for class purposes;
- B. Awarding compensatory damages in favor of plaintiff and the other Class members against all defendants, jointly and severally, for all damages sustained as a result of defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;
- C. Awarding extraordinary, equitable and/or injunctive relief as permitted by law, equity and the federal statutory provisions sued hereunder, pursuant to Rules 64 and 65 to assure that the Class has an effective remedy;
- D. Awarding plaintiff reasonable costs and attorneys' fees; and
- E. Awarding such equitable/injunctive or other relief as the Court may deem just and proper.

## **JURY DEMAND**

Plaintiff demands a trial by jury.

Dated: Newark, New Jersey  
June 12, 2009

## **WINDELS MARX LANE & MITTENDORE, LLP**

By: \_\_\_\_\_  
William C. Cagney

wcagney@windelsmarx.com  
120 Albany Street Plaza  
New Brunswick, New Jersey 08901  
Telephone: (732) 846-7600  
Facsimile: (732) 846-8877

*Liaison Counsel*

**GLANCY BINKOW & GOLDBERG LLP**

Lionel Z. Glancy

Michael Goldberg

Marc L. Godino

1801 Avenue of the Stars, Suite 311

Los Angeles, California 90067

Telephone: (310) 201-9150

Facsimile: (310) 201-9160

*Lead Counsel*

**KIRBY MCINERNEY, LLP**

Ira M. Press

Randy Berger

830 Third Ave, 10<sup>th</sup> Floor

New York, NY 10022

Telephone: (212) 317-2300

Facsimile: (212) 751-2540

*Attorneys for Plaintiff*