Credit Crunch Digest

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This issue focuses on recent significant developments in the New York Attorney General's challenge to the Bank of America/Countrywide settlement; the Wachovia Bondholders settlement; AIG's lawsuit against Bank of America for mortgage securities losses; updates on recovery efforts in the Madoff Ponzi scheme; and the status of financial regulatory reform implementation in response to the subprime crisis and credit crunch.

Litigation and Regulatory Investigations

New York Attorney General Targets $8.5 Billion Bank of America/Countrywide Settlement

In June 2011, a proposed $8.5 billion settlement between Bank of America and Bank of New York Mellon (Bank of New York) was announced regarding loan pools issued by Countrywide. This proposed settlement is now coming under fire by the New York Attorney General (NYAG) in a lawsuit recently filed in New York state court. The NYAG alleges fraud by Bank of New York in connection with its role as trustee, in which it oversaw the packaged loans for investors. The lawsuit further alleges Bank of New York misled investors about its supervisory role and breached its duties in agreeing to the deal with Bank of America since it is conflicted and stands to gain from the agreement. The NYAG contends that the deal could also potentially compromise investors' claims, resulting in payments for a fraction of claimed losses. A Bank of New York spokesman said the company disputed the allegations and intends to fight the matter in court.

Investors left out of the discussions culminating in the June announcement have asserted that the terms were insufficient, the negotiations were conducted in private, and Bank of New York was conflicted since Bank of America agreed to cover Bank of New York's costs and liability associated with the deal.

According to reports, the NYAG uncovered court records indicating that Bank of New York failed to deliver complete and sufficient mortgage files for each of the loans in the pools, as was required by the trust documents. The NYAG alleges that Bank of New York misled investors since it claimed to review loan documents for deficiencies, but failed to do so. ("Mortgage Settlement Challenged," *New York Times*, August 4, 2011.)

Wachovia Bondholders Agree to Massive Subprime Settlement

Parties to the Wachovia Preferred Securities Litigation and Bond/Note Litigation have agreed to settle both actions for a combined total of $629 million. According to reports, the Bond/Note plaintiffs alleged that Wachovia's bond and note offering materials misrepresented the soundness of Wachovia's mortgage loan portfolios and made misstatements about Golden West's residential loan portfolio. Wachovia acquired Golden West in 2006. The District Court previously granted defendants' motions to dismiss the equity securities plaintiffs' claims under the Securities Exchange Act of 1934 for the failure to adequately allege scienter.

The settlement is comprised of a $590 million payment by the former Wachovia directors and officers, as well as the underwriters of Wachovia's bond offering from 2006 to 2008. Wachovia's auditor, KPMG, is contributing $37 million. The proposed settlement is currently before the court for approval. The settlement reportedly represents a recovery to the bond/note holders of approximately 30 percent to 50 percent of their total damages. If approved, this settlement would be the 14th largest securities class action settlement in history. Notably, the settlement does not include attorneys' fees, but settlement papers suggest that plaintiffs' counsel will seek approximately $110 million of the settlement amount as fees. ($627 Million Wachovia Bondholders' Settlement: Largest Subprime Securities Suit Settlement Yet," *D&O Diary.com*, August 8, 2011.)

AIG Sues Bank of America Over Mortgage Securities Losses

American International Group (AIG) filed a lawsuit against Bank of America seeking damages for $10 billion in mortgage-backed securities losses as a result of alleged misrepresentations by Bank of America and its Merrill Lynch and Countrywide Financial units regarding the underlying quality of the packaged mortgages it sold to investors. The

$10 billion in claimed losses on AIG's $28 billion investments would reportedly be the largest mortgage-related securities action by a single investor.

Prior to the formal filing of the lawsuit, a Bank of America spokesman vehemently denied the allegations, asserting that AIG epitomized a sophisticated investor and that it "recklessly chased high yields and profits" in the "mortgage and structured finance markets." The spokesman attributed AIG's losses directly to its excessive risk taking and errors in investing.

According to the article, sources indicate that AIG also intends to intervene in the proposed $8.5 billion settlement between Bank of America and Bank of New York. AIG believes that the settlement amount is insufficient and that Bank of New York was conflicted in its negotiations given Bank of America's promise to cover its costs and liability. ("A.I.G. Sues Bank of America Over Mortgage Bonds," *New York Times,* August 8, 2011.)

Fraud and Ponzi Schemes

Judge Rakoff Throws Out Common-Law Claims Against HSBC and UniCredit

On July 28, 2011, U.S. District Judge Jed Rakoff dismissed Madoff Trustee Irving Picard's common-law claims against HSBC Holdings Plc in the lawsuit styled *Irving H. Picard v. HSBC Bank Plc., et al.*, filed in the U.S. District Court for the Southern District of New York. The dismissed claims alleged that HSBC violated a duty to Madoff's clients by failing to discover Madoff's fraud. Judge Rakoff's ruling effectively throws out approximately $6.6 billion worth of damages related to the common-law claims asserted against HSBC. Moreover, a footnote in Judge Rakoff's July 28, 2011 order states that it is "clear that these claims would also have to be dismissed against any other defendants who appeared and so moved." UniCredit Bank Austria AG soon thereafter accepted Judge Rakoff's offer and on August 8, 2011, Judge Rakoff extended his July 28, 2011 ruling to UniCredit, thereby dismissing Picard's common-law claims against UniCredit and UniCredit's parent company, UniCredit SpA. In his strongly worded August 8, 2011 opinion, Judge Rakoff wrote that "even though a bankruptcy trustee can seek to recover monies on behalf of the debtor's estate that will ultimately be used to help satisfy creditors' claims, it is settled law that the federal Bankruptcy Code . . . does not itself confer standing on a bankruptcy trustee to assert claims against third parties on behalf of the estate's creditors themselves, because the trustee stands in the shoes of the debtor, not the creditors." Despite Judge Rakoff's ruling, defendants' still face Picard's $2.3 billion fraudulent transfer claims that remain pending in bankruptcy court. Nevertheless, Judge Rakoff's ruling has increased the confidence of other banks that Picard has targeted. On August 1, 2011, UBS AG and JPMorgan Chase & Co. cited Judge Rakoff's ruling in seeking dismissal of Picard's claims against the banks. ("Bank Austria Wins Dismissal of Some Madoff Claims," *Law360*, August 9, 2011.)

UniCredit Seeks Dismissal of 'Hollow' Racketeering Claims

On July 25, 2011, in a case titled *Picard v. Kohn, et al.*, 11-cv-01181, and pending in the U.S. District Court for the Southern District of New York, UniCredit SpA filed a motion to dismiss claims brought against it by Madoff Trustee Irving Picard, pursuant to the Racketeer Influenced and Corrupt Organizations Act. The effect of such claims, if adjudicated in favor of the trustee, could allow for treble damages up to $59 billion, or three times the amount the Madoff investors lost. UniCredit SpA argued that Picard has not shown that defendants engaged in or had any motive to engage in Madoff's Ponzi scheme. The motion is pending before Judge Rakoff. ("UniCredit Seeks Tossing of 'Hollow' Madoff Trustee RICO Suit," *Bloomberg*, July 26, 2011.)

Tremont Settles Claims Brought by Picard for $1 Billion

On July 25, 2011, Tremont Group Holdings, Inc., settled the claims brought against it by Madoff Trustee Irving Picard for a little more than $1 billion. In his complaint against Tremont, Picard had alleged that Tremont was a feeder fund created in 1994 solely for purposes of opening an account in Madoff's investment business. Tremont, however, maintains that it followed the appropriate standards of due diligence and was wholly unaware of Madoff's Ponzi scheme. A spokesperson for Tremont stated that "Tremont is pleased to have negotiated an agreement with the Trustee that gives investors in our funds the potential to recover a substantial portion of their losses incurred as a result of Madoff's fraud. We concluded that bringing this matter to a close, with proofs of claim preserved, was the best outcome for investors in our funds." To date, Picard has recovered approximately $8.6 billion (inclusive of the $1 billion plus Tremont settlement) of the approximately $17.3 billion he has sought in connection with the liquidation proceedings. A hearing is set for September 13, 2011 for approval of the settlement. ("Tremont Strikes $1B Deal With Madoff Trustee," *Law 360*, July 28, 2011.)

Government and Regulatory Intervention

Implementation of Dodd-Frank Financial Reforms Behind Schedule

While the Dodd-Frank financial reform legislation was enacted by Congress on July 21, 2010, according to a recent study, nearly 90 percent of all the rules that are supposed to be implemented are still incomplete. The Dodd-Frank Act was enacted to address the derivatives market, lending standards, and other issues thought to contribute to the financial crisis. In order to address these issues, more than 300 new rules are to be implemented by regulators, including the Securities and Exchange Commission and the Commodity Futures Trading Commission. Although regulators were supposed to complete approximately 160 regulations by now, a year later nearly 80 percent of them remain unfinished.

The delay does not come as a surprise, as regulators are attempting to finalize rules while operating on an extremely tight budget. According to the Government Accountability Office, in the next two years it will cost regulators $1.25 billion to enforce the rules promulgated under Dodd-Frank. In addition, Republican lawmakers are currently threatening to cut regulatory spending, which could have the effect of delaying the implementation of the final rules even more. ("A Year Later, Dodd-Frank Delays Are Piling Up," *The New York Times*, July 22, 2011.)

Standard & Poor's Opposes SEC Proposal Requiring Disclosure of Rating Errors

By letter to the Securities & Exchange Commission (SEC) dated August 8, 2011, Standard & Poor's (S&P) raised concerns with proposed SEC rules that would require rating agencies to post on their websites when a "significant error" is identified in their methodology for a credit rating action. Currently, the SEC is analyzing new rules designed to improve the quality of credit ratings. Those proposed rules contain provisions requiring credit raters to disclose more about their internal controls to protect against conflict of interests, and to reveal more about their rating methodologies.

Currently the SEC is considering who should define the term "significant error." According to S&P President Deven Sharma, if the SEC were to define the term, "we believe it would effectively be substituting its judgment" for the credit rating agencies. Further, S&P's current error correction policy "has proven to be effective and, where errors have occurred, our practice of reacting swiftly and transparently has benefited the market," said Sharma. S&P's August 8, 2011 letter was issued just three days after the U.S. Treasury Department accused the company of miscalculating U.S. debt at the time S&P downgraded the U.S. credit rating to "AA-plus." ("S&P Balks at SEC Proposal to Reveal Rating Errors," *Reuters*, August 10, 2011.)

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