Sedgwick LLP

Credit Crunch Digest

February 2011

By: Jennifer Broda, Jennifer Hamilton, Thomas Orofino, Eric Scheiner

The subprime lending crisis and ensuing credit crunch have resulted in significant losses and numerous lawsuits involving parties to the mortgage lending and securitization process. This digest collects and summarizes recent media reports regarding potential liability, government initiatives, litigation and regulatory actions arising from the subprime mortgage crisis and credit crunch, as well as the increasing number of reported cases of financial fraud.

This issue focuses on recent significant decisions in civil litigation, including the Federal Deposit Insurance Corporation's (FDIC) prosecution of claims against the directors and officers of failed banks, as well as the status of the Madoff Ponzi scheme, the alleged Stanford fraud, and the status of financial regulatory reform implementation in response to the subprime crisis and credit crunch.

Litigation and Regulatory Investigations

- SEC Files Fraud Suit Against IndyMac Executives
- FDIC Files Lawsuit against Former First Centennial Bank Directors and Officers
- Calpers Files Suit Against Former Lehman Executives and Underwriters

Fraud and Ponzi Schemes

- Mets Owners Face Suit by Madoff Trustee
- Outside Lawsuits Against Individual Madoff Relatives Barred
- Stanford Receiver Sues Miami Heat Basketball Franchise

Government and Regulatory Intervention

- Financial Crisis Inquiry Commission Releases Final Report
- U.S. Regulators Seek to Curb Excessive Risk Taking
- Credit Card Regulation Study Released

Litigation and Regulatory Investigations

SEC Files Fraud Suit Against IndyMac Executives

The U.S. Securities and Exchange Commission (SEC) filed two complaints on February 11, 2011 in the U.S. District Court for the Central District of California against former IndyMac CEO Michael W. Perry and former CFOs A. Scott Keys and S. Blair Abernathy. The SEC alleges that the former IndyMac executives participated in the filing of false disclosures about the company and misled investors about the mortgage lender's deteriorating condition while trying to sell IndyMac shares. Specifically, the SEC contends that Perry and Keys defrauded new and existing IndyMac shareholders by issuing false and misleading statements in IndyMac's 2007 annual report and marketing materials in order to sell $100 million in new stock to investors. The SEC further maintains that Perry knew that an April 2008 downgrading of bonds held by IndyMac Bank exacerbated its cash flow and liquidity problems, yet such information was not disclosed to investors in IndyMac's ongoing stock offerings.

The SEC reports that Abernathy (who replaced Keys as IndyMac's CFO in April 2008) was also alleged to have committed fraud. Specifically, while acting as IndyMac's executive vice president of specialty lending, the SEC alleged that Abernathy made false and misleading statements regarding the quality of certain mortgage-backed securities. Without admitting any wrongdoing, Abernathy agreed to a settlement with the SEC. As part of that settlement, he will pay a $100,000 civil penalty and $25,000 in disgorgement. The SEC said that Abernathy will also be suspended from practicing as an accountant, but will be allowed to apply for reinstatement in two years.

Perry and Keys are charged with knowingly violating the anti-fraud provisions of both the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as aiding and abetting IndyMac's violations of its periodic reporting requirements. The SEC's complaint against Perry and Keys seeks permanent injunctive relief, an officer and director bar, disgorgement of ill-gotten gains with pre-

judgment interest and a financial penalty. ("SEC Charges Former IndyMac CEO and CFO With Securities Fraud," *CNBC.com*, February 11, 2011.)

FDIC Files Lawsuit against Former First Centennial Bank Directors and Officers

The FDIC filed the first of what is believed to be many legal actions in California against former directors and officers of failed banks that are alleged to have been involved in high-risk commercial real estate loans. In *FDIC v. Appleton, et al.*, the FDIC alleges that 12 former directors and officers of First Centennial Bank in Redlands, Calif., committed gross negligence in the approval of real estate development loans that ultimately led to the 2009 failure of the bank. The bank collapsed in 2009 after losing money on several failed real estate development loans, particularly in the "Inland Empire" area of California, which was hit particularly hard by the real estate downturn. The FDIC contends that the former directors and officers of First Centennial were negligent in issuing loans for "non-diverse" projects in a concentrated geographical area. These loans left the bank particularly vulnerable once the real estate market began to decline.

Experts in the industry anticipate the filing of similar lawsuits by the FDIC against former directors and officers of other failed banks in California. Banking consultant Gary Findley anticipates "a half-dozen" lawsuits in the area by the FDIC in its aim to recoup more than $1 billion in losses stemming from the credit crisis. The First Centennial defendants deny the FDIC's allegations, including the allegation that "defendants recklessly implemented an unsustainable business model pursuing rapid asset growth concentrated in high-risk loans in commercial real estate" without ensuring that the proper policies and procedures were in place to manage the risk. Attorneys for the defendants issued a statement that the bank's directors and officers "fulfilled their responsibilities faithfully and competently" and that the directors and officers intend to "vigorously oppose the FDIC's meritless allegations and expect to be fully exonerated." The case is pending before the U.S. District Court for the Central District of California. ("FDIC Lawsuit Targets Officers of Failed 1st Centennial Bank," *The Los Angeles Times*, February 3, 2011; "Former First Centennial Officers, Directors Sued by FDIC," *Bloomberg Businessweek*, January 26, 2011.)

Calpers Files Suit Against Former Lehman Executives and Underwriters

On February 7, 2011, the California Public Employees' Retirement System (Calpers) filed a lawsuit in the U.S. District Court for the Northern District of California against former executives of Lehman Brothers, including former Lehman Chief Executive Richard Fuld, Jr., as well as several investment banks that served as underwriters on Lehman bond offerings, including Citigroup Global Markets Inc. Calpers alleges numerous violations of the Securities Act of 1933 and Securities Exchange Act of 1934, and requests unspecified damages plus interest, attorneys' fees and rescission. Specifically, Calpers maintains that Fuld and his colleagues did not disclose Lehman's involvement in mortgage-related transactions and failed to mitigate the risks involved in such transactions. Calpers contends that it purchased more than $700 million in bonds and Lehman stock without knowing the true condition of the now-bankrupt financial company. ("Calpers Sues Ex-Lehman Execs Over Mortgage Risks," *Reuters*, February 8, 2011.)

Fraud and Ponzi Schemes

Mets Owners Face Suit by Madoff Trustee

Irving Picard, the bankruptcy trustee charged with recovering assets to compensate the victims of the Madoff Ponzi scheme, has sued Fred Wilpon and Saul Katz, the owners of the New York Mets. Picard seeks approximately $700 million from Wilpon, Katz and their various business entities. According to the suit, the defendants are accused of perpetuating the Ponzi scheme by continuing to invest with Madoff even though numerous "red flags" should have alerted them of Madoff's fraud. By choosing not to acknowledge these "red flags," Picard alleges that other investors with Madoff were allegedly harmed, as the fraud was allowed to continue and grow larger.

In the lawsuit, Picard details the apparent numerous warnings that should have alerted the defendants to the fraudulent nature of Madoff's scheme. According to the suit, although Wilpon and Katz "knew that Madoff's returns were almost statistically impossible and sharply at odds with his split-strike conversion strategy, they willfully disregarded any criticisms of Madoff and simply buried

their heads in the sand." Legal scholars say that the issue is novel, with Picard essentially attempting to hold the defendants responsible for losses suffered by other investors even though the defendants apparently never communicated with any other investors or even knew that a fraud was being perpetrated. Picard has brought claims against Katz and Wilpon for constructive fraud and fraudulent transfer, which allow the bankruptcy court flexibility to determine proper and improper transfers. With the possibility of an adverse judgment or large settlement payment looming, Katz and Wilpon have already prompted the owners to seek out investors interested in buying a portion of the Mets franchise. ("Mets Owners Face Novel Claim in Madoff Clawback," *The New York Times*, February 7, 2011.)

Outside Lawsuits Against Individual Madoff Relatives Barred

U.S. Bankruptcy Judge Burton Lifland has blocked several lawsuits that were brought against relatives of Bernard Madoff. In an effort to recoup their alleged losses from the Madoff Ponzi scheme, several individual plaintiffs sued several of Madoff's relatives, including his wife, Ruth, his children and a daughter-in-law. According to Judge Lifland, "there is simply no basis" to allow the individual lawsuits and, in any event, such litigation cannot be allowed to proceed until Irving Picard, the court-appointed trustee, finishes his own litigation against the Madoff relatives. The ruling is a win for Picard, who is currently overseeing the bankruptcy recovery efforts and trying to recover money for victims of the Madoff scheme. According to Judge Lifland, allowing the individuals to bring lawsuits before Picard is finished with his recovery efforts could allow some of Madoff's former clients to "receive more than their fair share." ("Outside Lawsuits Against Madoff Relatives Blocked," *Reuters*, February 9, 2011.)

Stanford Receiver Sues Miami Heat Basketball Franchise

The NBA's Miami Heat was sued by the court-appointed receiver for Stanford International Bank Ltd. According to the complaint, which was filed in Dallas federal court, the basketball team allegedly collected more than $1.3 million in ill-gotten gains from Stanford's alleged fraud. In the complaint, the receiver states that "the payments to the Miami Heat are related to Stanford's sponsorship, advertising and promotional activities." R. Allen Stanford, 60, is being held without bail awaiting trial, and has been accused of leading a $7 billion investment fraud centered on the sale of

certificates of deposit. Ralph Janvey, the court-appointed receiver, is tasked with liquidating Stanford's assets and recouping money to repay injured investors. ("Allen Stanford Receiver Sues Miami Heat NBA Franchise," *Bloomberg*, January 25, 2011.)

Government and Regulatory Intervention

Financial Crisis Inquiry Commission Releases Final Report

On January 27, 2011, the Financial Crisis Inquiry Commission, the federal group tasked with investigating the causes of the financial crisis, concluded that the 2008 financial crisis was an "avoidable" disaster caused by a combination of failures in government regulation, corporate mismanagement and excessive risk-taking by Wall Street. The commission interviewed more than 700 witnesses and held 19 days of hearings. Although the 10-member commission was bipartisan, only the six Democrats endorsed the findings of the final majority report, with three Republican members preparing a dissent focused on a more narrow set of causes. A fourth Republican wrote a separate dissent pointing to policies to promote homeownership as the major culprit.

The majority report criticized the two Federal Reserve chairs, Alan Greenspan and Ben Bernanke. According to the report, Greenspan erred in advocating deregulation, which resulted in a "pivotal failure to stem the flow of toxic mortgages." Additionally, the report cites the government's "inconsistent" response to the financial crisis as a main cause of uncertainty and panic in the financial markets. As an example, the commission points to the Bush administration's decision to allow Lehman Brothers to collapse in September 2008 after bailing out Bear Stearns. However, the commission also lays blame at the feet of some Democrats, citing the Clinton administration's decision in 2000 to shield financial instruments known as "over-the-counter derivatives" from regulation as "a key turning point in the march toward the financial crisis."

Turning to the excessive risk-taking by the nation's major financial institutions, the commission stated: "When the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans and the risky assets all came home to roost. What resulted was panic. We had reaped what we had sown." ("Financial Crisis Was Avoidable, Inquiry Finds," *The New York Times*, January 25, 2011.)

U.S. Regulators Seek to Curb Excessive Risk Taking

In response to directives contained in the Dodd-Frank financial reform legislation of 2010, both the FDIC and the Federal Reserve are working on rules to change the pay structures on Wall Street in an effort to avoid another financial crisis. The regulators are working on compensation standards that propose that banks should defer half of senior executives' bonuses for at least three years. After the withholding period, banks would evaluate the performance of executives and amend their pay accordingly. Regulators are seeking to use pay rules to discourage bankers and traders from taking the type of short-term risks that contributed to the financial crisis. Many U.S. banks already defer a portion of senior executives' bonuses. However, critics argue that such rules would not discourage traders (as opposed to executives) from taking short-term risks because banks typically do not withhold bonus money unless there is a case of gross misconduct and not in the case of a bad trade. ("U.S. Regulators Propose Deferral of Bank Bonuses," *The Financial Times*, February 7, 2011.)

Credit Card Regulation Study Released

According to a study released by the Boston Consulting Group, new credit card regulations could cost U.S. credit and debit card issuers as much as $25 billion per year in lost revenue. As part of the Dodd-Frank financial reform package, the amount issuers can charge retailers for every debit-card swipe are now capped. Additionally, a separate piece of the legislation requires customers' permission to charge overdraft fees. According to the study, the likely effect of such regulation will be a large loss of revenue to credit card issuers, with a likely response coming in the form of lower rewards and higher annual fees. Additionally, the study projects that free checking may be a thing of the past. Further, the report predicts that "delayed-debt" or charge cards where the customer pays off the balance monthly will become more useful. These cards would allow issuers a chance to charge a higher interchange fee while allowing customers to control spending more like a debit card. ("Regulations Will Cost Card Industry $25 Billion a Year—Study," *The Wall Street Journal*, February 8, 2011.)

Related Practices:

Insurance Practices