Sedgwick LLP

Credit Crunch Digest

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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, the status of the Madoff Ponzi scheme and the status of financial regulatory reform implementation in response to the subprime crisis and credit crunch.

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Litigation and Regulatory Investigations

Barclays' Subprime Related Securities Suit Dismissed

On January 5, 2011, Judge Paul Crotty of the Southern District of New York granted the defendants' motions to dismiss the consolidated Barclays Bank subprime-related securities class action lawsuit. In March 2009, investors filed the first of several securities class action lawsuits against the company, some of its directors and officers, and its offering underwriters. The plaintiffs alleged that they purchased approximately $5.45 billion of American depository shares that Barclays issued between April 2006 and April 2008. Furthermore, the plaintiffs alleged that the company failed to

timely and adequately disclose its exposure to risky credit assets; failed to comply with applicable accounting standards and Securities and Exchange Commission (SEC) requirements; and misleadingly assured investors that Barclays' risk management practices helped the company avoid the worst credit market risks. The lawsuit is one of many by investors accusing major banks of inflating their share prices by hiding or being too slow to report credit deterioration on their balance sheets. The investors stated that the shares lost 73 percent to 78 percent of their value by the time the lawsuit was filed in March 2009, and that Barclays should compensate them for losses they suffered. In his ruling, Judge Crotty said the plaintiffs failed to show how Barclays violated accounting and regulatory reporting rules or misled them about its risk management practices, and that the plaintiffs waited too long to bring some of their claims. ("Barclays Wins Dismissal of U.S. Suit Over Risky Debt," *Reuters*, January 5, 2011)

Charles Schwab to Pay $119 Million for Misleading Investors

Charles Schwab Corp. has agreed to pay $119 million to settle a government criminal probe over misleading investors about their Schwab YieldPlus Funds. The SEC filed fraud and securities law violation charges against Schwab on January 11, 2011, and the YieldPlus Fund settlement was announced the same day. Schwab did not admit or deny liability as part of the settlement. The agreement comes more than a year after the SEC issued a "Wells notice" advising that the company was under investigation for fraud.

Schwab YieldPlus funds are ultra-short bond funds, which were heavily promoted as conservative investment alternatives to money market funds or cash. Despite being advertised to generate income with minimal changes in share price, the fund lost more than 30 percent of its value between June 2007 and June 2008 due to heavy investments in risky subprime mortgage securities, which allegedly violated the prospectus. The SEC charged the company with making misleading statements, failing to establish, maintain and enforce policies that prevent the misuse of material, nonpublic information, and also accused the company of deviating from the YieldPlus Fund's concentration policy without first obtaining shareholder approval. ("Schwab Settles SEC Case Over Troubled YieldPlus Fund for $119 Million," *The Los Angeles Times*, January 11, 2011)

Citigroup Subprime Securities Suit Narrowed

On November 9, 2010, the Southern District of New York dismissed several allegations and several individual defendants in the Citigroup subprime-related securities suit, *In re Citigroup, Inc. Securities Litigation.* However, the court allowed the plaintiffs' claims involving Citigroup's alleged misrepresentations concerning its collateralized debt obligation (CDO) portfolio to go forward against seven individuals, including Charles Prince, Citigroup's former CEO, and former treasury secretary, Robert Ruben, who served on Citigroup's board during the relevant period.

This action was initially brought against Citigroup and its directors and officers in November 2007 by a class of Citigroup shareholders alleging, *inter alia*, misrepresentation regarding the nature of Citigroup's investments and financial condition. Specifically, plaintiffs contend that Citigroup made material misstatements or omissions in Citigroup's disclosures regarding the company's holdings in, and exposures to, the subprime-related assets that made up its CDOs. The crux of plaintiffs' CDO-related allegations (that remain) is that Citigroup did not disclose to its investors that the CDOs that

Citigroup had underwritten were not purchased but were retained by Citigroup, thereby increasing Citigroup's potential loss exposure.

In allowing the plaintiff's CDO related claims to go forward, the Southern District found that the plaintiffs had adequately alleged that Citigroup's CDO valuations were false between February 2007 and October 2007, and held that the company's disclosures in November 2007 were materially misleading because they omitted to disclose the additional $10.5 million of CDO exposure that the company had hedged through the use of swap transactions. ("Citigroup Subprime Securities Suit Narrowed, Principal CDO Claims Survive," *The D&O Diary*, November 10, 2010)

SEC Looking Into Deals With Sovereign Funds

The SEC is investigating whether American financial firms may have violated bribery laws in their dealings with sovereign wealth funds. Specifically, the SEC is examining if certain companies violated the Foreign Corrupt Practices Act in their efforts to secure investments from foreign governments' investment funds. Included in the companies being investigated are banks as well as private equity firms.

The focus of the SEC's investigations appears to be on the significant investments made by sovereign wealth funds in American financial firms. For instance, foreign sovereign wealth funds are reported to have made capital injections worth billions of dollars for purposes of propping up the balance sheets of Citigroup, Morgan Stanley and Merrill Lynch. Further, private equity firms have been apparently seeking out partnerships with sovereign wealth funds rather than as investors. The types of deals being investigated include the China Investment Corporation's purchase of a large stake in the Blackstone Group before that firm's initial public offering in 2007, and the Carlyle Group and Apollo Global Management's sale of stakes to funds run by Abu Dhabi. Violations of the antibribery act can take the form of cash payments by companies in exchange for business from foreign government officials, as well as benefits such as entertainment or trips.

Over the past few years, the Justice Department has continued to increase investigations into possible violations of the act. For example, in February of last year, BAE Systems of Britain, Europe's largest military contractor, agreed to pay a $400 million fine to the U.S. government after it allegedly made payments to gain contracts in several countries. ("SEC Looking Into Deals With Sovereign Funds," *The New York Times*, January 13, 2011)

Fraud and Ponzi Schemes

Madoff Victims Win $7.2 Billion From Picower Estate

On January 13, 2011, Judge Burton Lifland of the U.S. Bankruptcy Court for the Southern District of New York approved a $7.2 billion settlement to pay former customers of disgraced financier Bernard L. Madoff. Judge Lifland ruled that Irving Picard, the court-appointed trustee in the recovery of assets stolen by Madoff, should free up cash to compensate victims. On December 17, 2010, Picard and Jeffry Picower's widow, Barbara, reached an agreement by which she agreed to hand over the money her husband received from the Madoff scheme so it could be used to compensate the victims.

Jeffry Picower is alleged to have been one of the greatest beneficiaries to Madoff's scheme, having withdrawn $7.8 billion from Madoff's firm since the 1970s (compared to a total investment of $619 million). The trustee argued that Picower should have realized that he was profiting from a fraud because of the implausible high rates of return he was receiving.

While several victims have already received compensation through the Securities Investor Protection Corp., which insured $783 million of the damages to investors, this is the first time that victims will receive money from seized assets. To date, the trustee has confirmed about $6 billion worth of claims from 2,372 victims. ("Madoff Victims Win $7.2 Billion From Picower Estate," *CNNMoney*, January 13, 2011)

Receiver of Merkin Fund Tied to Madoff Fraud to Distribute $167 Million

A New York State Supreme Court has approved the first interim payment to Ariel Fund Limited investors, which was formerly managed by J. Ezra Merkin and has been tied to Bernard Madoff's Ponzi scheme. New York Attorney General Andrew Cuomo sued Merkin in 2009 for allegedly steering $2.4 billion to Madoff for which Merkin received millions of dollars in fees. On December 17, 2010, Bart M. Schwartz, the receiver for the fund, won approval from New York Supreme Court Justice Richard Lowe to make the first interim cash distribution to investors in the fund, which totaled $16 million.

The Merkin fund was alleged to have secretly invested more than one-fourth of its assets with Madoff's investment-securities operation. Schwartz stated he intends to continue his efforts to maximize overall returns for investors, and pursue additional recovery from other culpable parties. ("Receiver of Merkin Fund Tied to Madoff Fraud to Distribute $167 Million," *Bloomberg News*, January 3, 2011)

Government and Regulatory Intervention

FDIC Board to Act on Dodd-Frank Resolution Rule

The board of the Federal Deposit Insurance Corporation (FDIC) was set to meet in January to review provisions of the Dodd-Frank Act relating to executive compensation and liquidation of failed financial institutions. Specifically, the FDIC is concerned with executive compensation structures that might provide incentives for executives to take inappropriate risks, as well as implementing regulations that give the government the power to seize and dismantle large, troubled financial firms (also referred to as liquidation authority).

According to the Dodd-Frank legislation, the FDIC, Federal Reserve, S EC and a few other agencies are required to complete these rules by April. The FDIC had already approved interim guidelines in October to help clarify its procedures for liquidating complex financial firms when they collapse, including permitting better treatment for some creditors when it benefits the estate or the broader economy. An implementation of new rules relating to incentive-based compensation schemes and liquidation authority is likely to have a significant impact for financial institutions. ("FDIC Board to Weigh Dodd-Frank Pay Resolution Authority Rules," *Bloomberg News*, January 12, 2011)

FDIC Seeks $2.5 Billion From Failed Bank Executives

On January 4, 2011, the FDIC announced that it authorized lawsuits against 109 directors and officers of failed financial institutions in an effort to recover nearly $2.5 billion. The FDIC retains the authority to sue directors, officers and other officials after seizing failed banks in order to replenish its deposit insurance fund, which absorbs the cost of bank failures. In 2010, the FDIC grappled with 157 bank failures, the most since the savings-and-loan crisis of 1992.

The FDIC has filed two civil lawsuits as a result of the surge in bank failures. The agency is seeking $300 million in damages from four former executives of IndyMac Bancorp, the Pasadena, Calif., lender that failed in 2008. In addition, the FDIC is suing 11 former directors and officers of Glenwood, Ill.-based Heritage Community Bank for $20 million in damages. According to the agency's disclosure, more lawsuits are forthcoming. ("FDIC Seeks $2.5 Billion From Executives of Failed Banks," *The New York Times*, January 5, 2011)

The First Bank Closures of 2011

After taking control of 322 banks between January 1, 2008 and December 31, 2010, the FDIC completed the first two bank closures in 2011 when it took control of the First Commercial Bank of Florida (Orlando) and Legacy Bank (Scottsdale, Ariz.) on January 7, 2011. The First Commercial Bank of Florida was acquired by First Southern Bank and Legacy Bank was acquired by Enterprise Bank and Trust. Additionally, on January 14, 2011, the FDIC closed Oglethorpe Bank located in Brunswick, Ga., which was subsequently acquired by the Bank of the Ozarks. For a complete list of FDIC receivership for banks that have failed since October 1, 2000, please follow this link to the FDIC's website.