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.

This issue focuses on recent significant decisions in civil litigation, the status of the Madoff and Rothstein Ponzi schemes, 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

$109 Billion Shareholder Suit Against Wells Fargo Dismissed; Bondholder Action Lives On

On March 31, 2011, Judge Richard Sullivan of the U.S. District Court for the Southern District of New York dismissed a $109 billion suit on behalf of shareholders of Wachovia Bank, accusing Wachovia Corp. – and its current owner Wells Fargo – of misrepresenting the bank's exposure to risky subprime mortgage loans.

The lawyers representing Wachovia shareholders cited 50 former employees as "confidential witnesses" to support claims that executives knew or should have known that they were providing false information to investors. Judge Sullivan concluded that the absence of communications between the confidential witnesses and the directors and officers failed to support a finding that Wachovia executives recklessly disregarded the truth about Wachovia's mortgage portfolio.

However, Judge Sullivan denied the defendants' motion to dismiss the complaint brought by holders of Wachovia bonds, notes and preferred securities, in the case titled *In re Wachovia Corp. Preferred Securities and Bond/Notes Litigation*. In that case, the bondholder plaintiffs brought claims under Section 11 of the Securities Act of 1933 against Wachovia, Wachovia's directors and officers, certain underwriters and auditor KPMG. Judge Sullivan concluded that the bondholders adequately pled material misrepresentations in their

complaint relating to Wachovia's lending practices, including how the bank reported its loan-to-value ratios in certain offering documents.

The purchase of Wachovia by Wells Fargo and Company was completed on December 31, 2008 after a government-forced sale to avoid a failure of Wachovia. The Wachovia brand was being absorbed into the Wells Fargo brand in a process that was estimated to take three years to complete, starting in 2009. ("Fried Frank Gets $109 Billion Shareholder Suit Dismissed for Wells Fargo," *The AmLaw Daily*, April 4, 2011.)

Wells Fargo Settles With the SEC for $11.2 Million

Wells Fargo Securities settled with the Securities and Exchange Commission (SEC) for $11.2 million over its sale of toxic mortgage derivatives. The SEC had accused Wells Fargo of misleading investors in a collateralized debt obligation (CDO), a derivative based on mortgage assets that the bank secretly transferred at above-market prices. The SEC's order found that Wachovia violated securities laws by allegedly charging "undisclosed excessive markups" in shares of CDOs to the Zuni Indian Tribe and to an individual investor. The SEC's inquiry is part of a broader probe into Wall Street sales of $1 trillion worth of CDOs. Last year, the SEC and Goldman Sachs Group Inc. agreed to a $550 million settlement over CDOs. ("Wells Fargo Agrees to Pay $11.2 Million in SEC Case," *Business Record*, April 6, 2011.)

Washington Mutual Investors Reach Accord in Lending Lawsuit

Investors in Washington Mutual Inc. (WaMu) reached a tentative settlement in a lawsuit concerning the bank's lending practices. The contemplated settlement, which must still be approved by U.S. District Judge Marsha Pechman, is in excess of $200 million. Judge

Pechman, after being advised of the pending settlement, issued an order canceling a trial scheduled for 2012 and suspending other action in the case.

The lawsuit consolidated more than 20 cases that alleged the bank encouraged questionable lending practices, artificially inflated home-price appraisals, made misleading statements about its financial condition and failed to disclose its deteriorating financial condition when the loans began to fail. Furthermore, the suit alleges that WaMu's auditor, Deloitte & Touche, failed to audit WaMu properly and that underwriters who prepared stock offerings did not accurately disclose the company's true condition and risky business practices.

WaMu, a Seattle-based bank that had $307 billion in assets at the time of its collapse in September 2008, was sold for $1.9 billion to JPMorgan Chase & Co. in a deal brokered by the Federal Deposit Insurance Corporation (FDIC). WaMu was the largest bank in U.S. history to fail, with more than 2,200 branches and $188 billion in deposits. ("Washington Mutual Investors Reach Accord in Lending Lawsuit," *Bloomberg*, April 7, 2011.)

Securities Litigation on Track to Set New Record

Although the credit crisis has eased, securities litigation is poised for another increase. According to Advisen's 2011 first quarterly report, securities litigation is on track to set an all-time high in suit filings. The report noted that during the first quarter of 2011, 362 securities suits were filed, marking a 47 percent increase in similar suits from the first quarter in 2010. Approximately 35 percent of the suits filed during this time involved new securities fraud suits filed by regulators and law enforcement officials. Breach of fiduciary duty suits accounted for 33 percent of suits in the first quarter, up from 32 percent in 2010 and 24 percent in 2009.

According to John Molka III, the author of the report, "The easing of the credit crisis […] has not resulted in fewer securities suits being filed. To the contrary, the number continues to grow. The elevated level of filings in 2010 and 2011 may represent a 'new normal.'" ("Securities Litigation on Track to Set New Record in 2011," *Insurance Journal*, April 29, 2011.) ("Securities Litigation Reaches a Crescendo: An Advisen Quarterly Report-Q1 2011," *Advisen*, April 2011.)

Fraud and Ponzi Schemes

JPMorgan Chase Employees Allegedly 'In The Know' Revealed

On April 14, 2011, a second redacted version of the complaint initially filed by Madoff Trustee Irving Picard on December 12, 2010 against JPMorgan Chase was filed. The newly redacted version revealed previously redacted information including the names of several individual JPMorgan Chase employees. The JPMorgan Chase persons revealed include Matt Zames, head of, *inter alia*, public finance and global fixed income for JPMorgan Chase. Another individual revealed is John Hogan, the bank's chief risk officer, whom Picard quotes in the complaint as saying at one time, "For whatever it's worth, I am sitting at lunch with Matt Zames who just told me that there is a well known cloud over the head of Madoff and that his returns are speculated to be part of a Ponzi scheme." Although not named as defendants in the suit, the second redacted version of the complaint also identifies 21 other JPMorgan Chase employees including: Head of Global Equities Carlos Hernandez; Chief Credit Officer Brian Sankey; and Chief Investment Officer of J.P. Morgan Global Wealth Management Michael Cembalest.

Picard alleges that the above quoted conversation between Hogan and Zames was reported to JPMorgan Chase's Hedge Fund Underwriting Committee at a June 2007 meeting to consider investing additional assets into Madoff feeder funds. Picard contends that after Madoff's arrest in December 2008, Sankey referred to the agenda for the Underwriting

Committee meeting, stating: "Perhaps best this never sees the light of day again!!" JPMorgan Chase is one of 1,000 banks, individuals, feeder funds and others that Picard alleges profited from Madoff's fraud. To date, Picard has recouped approximately $10 billion of approximately $20 billion in principal that is estimated to have been lost in the Madoff Ponzi scheme. ("Madoff Trustee's Filing Alleges JPMorgan 'Thoroughly Complicit' in Fraud," *Bloomberg*, April 14, 2011.)

Ex-Rothstein COO Takes the Fifth

Debra Villegas, the former chief operating officer of the now-bankrupt South Florida law firm Rothstein Rosenfeldt Adler, LLP, refused to testify under oath during a recent civil deposition by attorneys for Florida's private bank and wealth management firm Gibraltar Private Bank & Trust. Gibraltar is currently being sued for $60 million in the bankruptcy of Rothstein Rosenfeldt Adler, LLP, whereby the trustee has asserted that Gibraltar aided and abetted the perpetrators of the fraud and was involved in preferential transfers and fraudulent conveyances. The alleged Ponzi scheme involved purchases of certain structured settlements in exchange for one-time payments, but the structured settlements were allegedly fabricated by Rothstein. The trustee seeks to recover losses suffered by numerous large investors in the Rothstein Ponzi scheme. Villegas asserted her Fifth Amendment rights in response to more than 250 questions, which is notable because she has pled criminally guilty to her involvement in the Rothstein Ponzi scheme. However, the start of her jail sentence has been delayed so that she may cooperate with federal officials. ("Ex-Rothstein Law Firm COO 'Totally Stonewalls' Gibraltar in Deposition," *South Florida Business Journal*, April 15, 2011.)

Third Named Partner in South Florida 'Ponzi Firm' Settles With Trustee

On April 7, 2011, Madoff Trustee Irving Picard filed a $216 million civil lawsuit in the U.S. District Court for the Southern District of New York against two Swiss private banks, Pictet &

Cie and Bankque J. Safra. Picard alleges that Pictet & Cie made $156 million and that Safra made $60 million in investments through Madoff-backed feeder funds, and that defendants knew or should have known that Madoff was engaged in fraud. ("Madoff Trustee Sues Pictet & Cie for $156 Million Over Knowledge of Fraud," *Bloomberg*, April 7, 2011.)

Government and Regulatory Intervention

Senate Panel Releases Report Detailing Causes of WaMu Failure

On April 12, 2011, a Senate panel released a lengthy report detailing the causes of the collapse of WaMu. More than 600 pages in length, the report is based on testimony and documents from WaMu executives and the regulators charged with overseeing the bank. According to the Senate panel, the Office of Thrift Supervision (OTC) (WaMu's primary regulator at the time) identified hundreds of failings within the bank. In addition, the OTC was found to impede the FDIC from ordering corrective action to help the bank. According to the report, WaMu rewarded bankers for overcharging customers on subprime mortgages and selling subprime loans to investors. Top loan officers were given free trips to tropical locales in return for increased mortgage origination, despite the fact that WaMu's loans were quickly deteriorating. According to one quality-assurance officer in California, when she tried to stop approval of loans that were not up to the banks stated standards, the loans would often be referred to upper-management and approved anyway. While many deficiencies within the bank were discovered by the OTC, the Senate report concluded that "it failed to take action to force the bank to improve its lending operations and even impeded oversight by the bank's backup regulator, the FDIC." ("WaMu Hawaii Trips for Bankers Drove Risks as Regulator Failed, Report Says," *Bloomberg*, April 13, 2011.)

FDIC Report Says Lehman Creditors Could Have Been Saved Under Dodd-Frank

In a recent report issued by the FDIC, the agency says that under the new Dodd-Frank bill, the FDIC could have enabled an unwinding of Lehman Brothers that would have resulted in higher payments to creditors and lower losses to taxpayers. According to the report, "if the FDIC had been able to initiate a prompt structured sale of Lehman in 2008, unsecured creditors could have recovered 97 cents on every $1 of claims, compared with the 21 cents estimated in the most recent bankruptcy reorganization plan." The new Dodd-Frank legislation allows the FDIC to wind down any entity it oversees if that entity is deemed a threat to the overall financial system. The conclusions in the FDIC report have been questioned by economists and industry experts. According to Gilbert Schwartz, a former Federal Reserve attorney, the FDIC may be too optimistic about its abilities to use the powers granted to it under the Dodd-Frank legislation: "It seems to me it would put a tremendous amount of pressure on the resources of the FDIC to deal with a situation they have never dealt with before. The expertise would have to be developed very quickly over time to deal with companies they are not used to dealing with, like securities firms and non-banking businesses." ("Dodd-Frank Would Have Rescued Lehman Creditors, FDIC Says," *Bloomberg*, April 18, 2011.)

Federal Reserve Loaned Money to More Than 100 Failed Banks During the Credit Crisis

During the financial crisis, the Federal Reserve loaned money to more than 100 banks that subsequently failed despite these loans. Such loans are often made to cash-strapped banks through what is called the "discount window," and typically used for banks that need short-term cash injections. However, during the financial crisis, the Federal Reserve issued loans to numerous banks that were in trouble, with these loans sometimes lasting for more than a year. Critics of the long-term lending by the Federal Reserve note that by propping

up banks in trouble, the taxpayers ultimately end up paying when the bank is only able to survive for a bit longer, incurring more debt, and then eventually collapsing, leaving the FDIC on the hook for the cleanup costs. According to Marvin Goodfriend, a professor of economics at Carnegie Mellon University: "I think the lesson from this is that Congress needs to clarify the boundaries of independent Fed credit policy. There should be a mechanism so that the Fed doesn't have to make these decisions on behalf of taxpayers." ("Fed Help Kept Banks Afloat, Until It Didn't," *The New York Times*, April 4, 2011.)

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