Credit Crunch Digest

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This issue focuses on recent significant decisions in civil litigation regarding subprime and other high-risk mortgages, the status of the Madoff Ponzi scheme and related litigation, and the status of financial regulatory reform implementation in response to the subprime crisis and credit crunch.

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Litigation & Regulatory Investigations

NY Attorney General Sues Ernst & Young, Alleging Lehman Accounting Fraud

On December 21, 2010, New York Attorney General Andrew Cuomo sued the accounting firm Ernst & Young, alleging that for seven years it helped Lehman Brothers deceive investors about its true health. The complaint, filed in New York State Supreme Court, seeks the repayment of at least $150 million in fees the audit firm collected between 2001, when Lehman's aggressive accounting began, and 2008, when the bank collapsed, precipitating a global bank run. "Our lawsuit seeks to recover the fees collected by Ernst & Young while it was supposed to be using accountable, honest measures to protect the public," said Cuomo.

The suit centers on Ernst & Young's failure to confront Lehman about its practice of reducing the size of its balance sheet through routine securities repurchase agreements that it improperly accounted for as sales. That practice was known as Repo 105. By going along with this conduct, the attorney general charges, Ernst & Young encouraged investors to continue pouring their funds into Lehman long after a properly compiled set of books would have alerted them to the investment bank's increasing instability.

The attorney general's suit is noteworthy because it raises questions about the involvement of auditors in fueling the global investment bubble that ended in mid-2007, and because actions against auditors would normally seem to be the province of the Securities and Exchange Commission. ("Cuomo Sues Ernst & Young Over Lehman," *The New York Times*, December 21, 2010)

Citigroup Subprime Securities Suit Survives Motion to Dismiss

On November 9, 2010, Judge Sidney Stein of the U.S. District Court for the Southern District of New York issued a ruling on the defendants' motion to dismiss a class action securities complaint originally filed in November 2007 and amended in February 2009 by Citigroup shareholders. The lawsuit alleges that Citigroup and certain of its officers and directors made misleading statements regarding Citigroup's financial condition during 2007. Specifically, the plaintiffs allege that when the defendants disclosed Citigroup's exposure to super-senior collateralized debt obligation (CDO) tranches in November 2007, the defendants failed to disclose $10.5 billion worth of Citigroup's CDO holdings, which were hedged in swap transactions.

Judge Stein granted the defendants' motion to dismiss the amended complaint with respect to the allegations regarding statements about financial instruments other than CDOs. Judge Stein also dismissed the claims against seven of the individual defendants, finding that the plaintiffs did not sufficiently allege scienter for those seven officers and directors. However, Judge Stein denied the defendants' motion to dismiss with respect to the plaintiffs' claims regarding Citigroup's CDO exposure. Judge Stein found that the allegations that the defendants minimized or denied Citigroup's CDO exposure while simultaneously "taking significant steps internally to address increasing risk in CDO exposure" were sufficient to allege that the defendants acted with scienter. ("Citigroup Subprime Securities Suit Narrowed, 'Principal' CDO Claims Survive," *D&O Diary*, November 10, 2010; *In re Citigroup Inc. Securities Litigation*, 09-md-2010 (SHS) (November 9, 2010))

Toll Brothers Settles Investor Suit

Toll Brothers Inc. agreed on November 4, 2010, to pay $25 million to settle a lawsuit brought by investors alleging that Toll Brothers misled them regarding the company's ability to manage the downturn in the U.S. residential real estate market. According to the lawsuit, the directors and officers of Toll Brothers, which is the largest builder of luxury homes in the U.S., made misleading statements regarding the demand for new homes and the company's ability to maintain "historically strong" earnings growth after 2005. However, the company did not post any profits between 2007 and August 2010. The plaintiffs also alleged that the company falsely stated that its "niche market of high-end buyers" was not affected by rising interest rates and other factors that were adversely affecting the general residential real estate market. The settlement agreement states that the law firms representing the plaintiffs will seek legal fees totaling $6.25 million and costs of as much as $750,000. ("Toll Brothers Settles Investor Lawsuit for $25 Mln," *International Business Times*, November 4, 2010)

Sedgwick LLP

SEC Investigating JPMorgan's Disclosures Regarding CDO

On November 1, 2010, it was reported that the Securities and Exchange Commission (SEC) has commenced an investigation into the disclosures that J.P. Morgan Chase made with respect to a 2007 transaction called "Squared." Squared was a CDO comprised of pieces of other CDOs, which were backed by subprime mortgages. Magnetar, a hedge fund that helped select assets for the CDO, allegedly bought the riskiest portion of the CDO and hedged the purchase in a bet against the mortgage market. The SEC is reportedly investigating whether J.P. Morgan adequately disclosed Magnetar's involvement in packaging the CDO and its subsequent purchase and hedging activity. The SEC's investigation into J.P. Morgan's disclosures is part of a wider SEC investigation into the CDO market. ("SEC Investigating JPMorgan CDO Disclosure-Report," *Reuters*, November 1, 2010)

Former Countrywide CEO Reaches Settlement With the SEC

On October 15, 2010, former Countrywide Financial CEO and co-founder Angelo Mozilo agreed to pay $67.5 million to settle fraud charges brought by the SEC related to Countrywide's mortgage underwriting practices. Mozilo and two other former executives of Countrywide were charged in 2009 with defrauding investors by intentionally concealing the high risk of Countrywide's mortgage holdings. The SEC also charged Mozilo with insider trading, alleging that he sold millions of dollars worth of Countrywide stock after he was aware that Countrywide was failing financially. Mozilo will pay a $22.5 million penalty, which, according to the SEC, is the largest penalty ever paid by a senior executive of a public company. Additionally, Mozilo will pay back $45 million in "ill-gotten gains."("Countrywide's Mozilo to Pay $67.5 Million Settlement," *CNNMoney.com*, October 15, 2010)

Fraud & Ponzi Schemes

Barbara Picower Returns $7.2 billion for Madoff Fraud Victims

On December 17, 2010, Barbara Picower, the widow of deceased investor Jeffry Picower, one of the biggest beneficiaries of Madoff's scheme, agreed to return more than $7.2 billion to Madoff fraud victims. Preet Bharara, U.S. attorney for the Southern District of New York, said that Barbara Picower had agreed to return "proceeds" collected over a 35-year period. Bharara said it was the largest forfeiture in U.S. history. He said the $7.2 billion, combined with the $2.6 billion already recovered in stolen assets, is nearly half of the $20 billion lost to Madoff's scheme.

In 2009, Irving Picard, the trustee of seized Madoff assets, claimed in court filings that Jeffry Picower was a key beneficiary of Madoff's scheme. The trustee said Jeffry Picower had withdrawn $7.8 billion from Madoff's firm since the 1970s, even though he only deposited $619 million. Picard stated that Jeffry Picower "knew or should have known that [he] was profiting from fraud, because of the highly implausible high rates of return" on his accounts. Barbara Picower said, in a prepared statement, that "this settlement honors what Jeffry would have wanted, which is to return this money so that it can go directly to the victims of Madoff." ("Feds Nab $7.2 Billion for Madoff Victims," *CNNMoney.com*, December 17, 2010)

Picard Targets Madoff's Austrian 'Criminal Soulmate' in Most Recent String of Lawsuits

On December 11, 2010, Irving Picard filed a lawsuit against 2020 Medici, formerly known as Bank Medici, and its founder Sonja Kohn, seeking $58.8 billion. The lawsuit names Kohn, Bank Medici, Bank Austria, UniCredit and dozens of other parties and seeks $19.6 billion in damages, tripled to $58.8 billion as allowed for under the Racketeer Influenced and Corrupt Organizations Act. It's the biggest claim filed by Picard to date. In the lawsuit, Picard alleges that Kohn, 62, whom Picard called Madoff's "criminal soulmate," used her relationship with Madoff to help build the Vienna-based bank. Picard further accuses Kohn of supporting Madoff's fraud since the 1980s and alleges that she "masterminded a vast illegal scheme" and accepted more than $60 million in kickbacks from Madoff for soliciting investors into his scheme. On December 14, 2010, in a statement out of Vienna, 2020 Medici released a public statement asserting that Picard's claims are "completely unfounded and untrue" and that this action is part of Picard's "international witch hunt." ("Madoff's Trustee Sues Accountants for $900 Million," *ABC News*, December 11, 2010; "Austrian Bank Strikes Back at Madoff Trustee," *Wall Street Journal*, December 14, 2010)

J.P. Morgan Sued by Madoff Trustee

On December 2, 2010, Madoff Trustee Irving H. Picard sued J.P. Morgan Chase for $6.4 billion alleging that the bank aided and abetted Madoff's fraud. The lawsuit seeks $1 billion in fees and $5.4 billion in damages. J.P. Morgan Chase was Bernard Madoff's "primary banker" and is alleged to have been "willfully blind to the fraud, even after learning about numerous red flags surrounding Madoff." J.P. Morgan denies that it knew or assisted in the Madoff scheme. The lawsuit is the second-largest in terms of alleged damages filed by the Madoff trustee. ("Madoff Trustee Alleges J.P. Morgan Aided Fraud," *Washington Post*, December 3, 2010)

K1 Founder Charged With Fraud

As first reported in our November 2009 edition, German investigators have been examining possible fraud by Helmut Kiener, the founder of German hedge fund group K1. On November 16, 2010, the public prosecutors' office in Wuerzburg, Germany charged Kiener with fraud, forgery of documents and tax evasion more than a year after he was arrested in connection with a multimillion-dollar investigation. German prosecutors accuse Kiener of swindling investors out of approximately $482 million with an elaborate Ponzi scheme. According to the charges, investors were duped into investing in K1 Global Ltd. and K1 Invest Ltd. after the funds posted significant profits and promised to continue doing so, even though both funds had suffered massive losses. Although almost 5,000 individual investors entrusted money to K1, the largest losses come from Barclays and BNP Paribas, having invested a combined $301 million. Kiener has denied any fraudulent activities.("K1 Founder Charged With Fraud for Ponzi Scheme," *Reuters*, November 16, 2010)

Settlement Reached With Brokerage Firm Tied to Madoff

On November 1, 2010, federal regulators reached a settlement with Cohmad Securities Corp., a New York brokerage firm, and its executives, resulting from ties to the Madoff Ponzi scheme. The firm and its executives neither admitted nor denied the SEC's accusations that they had made misrepresentations and omissions by referring hundreds of investors to Madoff. Earlier this year, a federal court dismissed civil fraud complaints that the SEC had brought against the defendants. The settlement puts an end to lesser charges still pending. The settlement requires the defendants to agree not to violate securities law and to pay yet-to-be decided civil fines and restitution. ("Settlement With Firm Tied to Madoff," *The New York Times*, November 1, 2010)

New York Attorney General Seeks Ruling in Fraud Suit Against Merkin

On October 18, 2010, New York Attorney General Andrew Cuomo filed a motion for summary judgment in a lawsuit filed against Ezra Merkin and Gabriel Capital Corp., a fund managed by Merkin. The lawsuit, which Cuomo filed in 2009 in New York state court, alleges that Merkin and Gabriel fraudulently placed $2.4 million worth of client funds with Bernard Madoff in exchange for millions of dollars in fees. The lawsuit seeks $729 million in restitution of fees, unspecified restitution for investor losses and an order prohibiting Merkin from acting as an investment manager in the future. In the motion for summary judgment, Cuomo argues that the "undisputed evidence" obtained during discovery in the case establishes that Merkin and Capital intentionally failed to disclose to clients that their funds were managed by Madoff. Cuomo asserts that the defendants' "deceitful practices" constitute violations of the Martin Act and Executive Law. Additionally, Cuomo asserts that Merkin and Capital breached their fiduciary duties to investors by failing to disclose that their funds were invested with Madoff and not investigating warning signs that Madoff was operating a Ponzi scheme. ("Cuomo Seeks Ruling Against Merkin Over Madoff Fraud," *Bloomberg*, October 20, 2010)

Government & Regulatory Intervention

FDIC Continues to Go After Failed Bank Officials

According to reports, the Federal Deposit Insurance Corporation (FDIC) has told dozens of former bank officers and directors that it has drafted complaints accusing them of misdeeds such as fraud and breach of fiduciary duty. The FDIC, seeking to help offset losses in the nation's deposit insurance fund, is reportedly warning officials that it is time to discuss settlement or face suit and have the courts decide the matter. According to one lawyer representing former officials of five banks targeted by the agency, the letters being sent by the FDIC are "very detailed" in describing purported misdeeds by bank officials. "We're only doing this after careful investigation. We don't bring suit every time a bank fails," said Richard Osterman, the FDIC's acting general counsel. Although the FDIC says it will try to settle the cases, officials reportedly expect to file a significant number of suits. Criminal charges are reportedly a possibility in a few of the cases. ("FDIC Prepares to Crack Down on Officials of Failed Banks," *Los Angeles Times*, November 10, 2010)

Largest Banks Set to See Higher FDIC Fees

Under a provision included in the Dodd-Frank financial reform law, large banks will pay much higher fees to the FDIC when the law goes into effect next year. Under the new law, the FDIC must base fees on a measure of a bank's assets. Currently, the FDIC calculates premiums solely on a bank's domestic deposits. The new formula is reported to favor smaller banks because they largely rely on deposits to provide money for lending, whereas larger banks have access to other sources of funding, such as commercial paper, which would count under the new formula. According to industry analysts, J.P Morgan Chase & Co., Bank of America and Citigroup alone will collectively pay an estimated $1 billion in additional FDIC fees each year. FDIC officials say that the large banks' share of deposit-insurance premiums would rise to 80 percent from 70 percent under the new system, and that most of the increase would be paid by the largest banks, with $100 billion of assets or more. ("Largest Banks to See Higher Fees for FDIC Deposit Fund," *Wall Street Journal*, November 9, 2010)

Wall Street Firms Attempt to Take Advantage of 'Volcker Rule' Provision

According to reports, the "Volcker rule," which bans banks from short-term trading of securities for their own account and limits investments in private equity and hedge fund groups, contains one provision that is attractive to U.S. financial firms. This provision allows banks to continue to make "principal investments, that is, the direct purchase of securities, companies and property assets. This allowance was put into law because these "principal assets" are regarded as longer-term commitments and carry higher capital charges. However, according to reports, unlike short-term "proprietary trading," which has traditionally had a modest impact on earnings, principal transactions were both an important driver of banks' profits in the run-up to the financial crisis and a big source of losses. Advocates for a broad curb on banks' investments believe a separate part of the financial reform legislation will stop banks from making dangerous risks with their own money, although the final implementation of the financial reform law by regulators is yet to be seen. ("Wall Street to Sidestep 'Volcker Rule,'" *Financial Times*, November 10, 2010)

Related Practices:

Insurance Practices