Sedgwick LLP

Credit Crunch Digest

September 2010

By: Jennifer Broda, Thomas Orofino, Eric Scheiner

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.

Litigation & Regulatory Investigations

New Century Settles Shareholder Class Action Suit
On August 10, 2010, U.S. District Judge Dean Pregerson granted preliminary approval of a settlement between the former directors and officers of New Century Financial Corp. and investors who bought New Century common stock, preferred stock or call options, or sold put options between May 2005 and March 2007. Investors alleged that the former officers and directors of New Century, which was one of the largest originators of subprime mortgages in the U.S., deceptively concealed its financial condition prior to filing for bankruptcy in April 2007. Pursuant to the settlement agreement, the former directors and officers of New Century will pay $65.1 million. Additionally, KPMG LLP, which served as New Century's auditor, will pay $44.75 million, and several underwriters for the securities at issue will collectively pay $15 million. The U.S. District Court for the Southern District of California will hold a hearing on November 8, 2010 to consider final approval of the settlement. ("Judge OKs $125 Mln New Century Lawsuit Settlement," *Reuters*, August 10, 2010)

BankAtlantic Bancorp Subprime Securities Suit Will Proceed
On August 18, 2010, U.S. District Judge Ursula Ungaro granted in part and denied in part cross-motions for summary judgment in a lawsuit pending in the U.S. District Court for the Southern District of Florida against BankAtlantic Bancorp and certain of its officers and directors. The lawsuit alleges that the defendants made misleading statements regarding the credit quality of certain loans in its commercial real estate portfolio, its underwriting guidelines and the adequacy of its loan loss reserves. Judge Ungaro granted summary judgment in favor of the defendants with respect to the alleged misstatements regarding BankAtlantic's loan loss reserves and all claims for the period prior to October 18, 2006. Additionally, Judge Ungaro granted significant portions of the defendants' motion to exclude the plaintiffs' expert testimony on loss causation and materiality. The defendants were denied summary judgment

on the issues of scienter, loss causation and alleged misleading statements beginning in April 2007 with respect to certain loans held in BankAtlantic's portfolio. Judge Ungaro found that there were no issues of material fact regarding the falsity of statements made by BankAtlantic's former chair and CEO during a July 2007 analyst conference call regarding the performance of the bank's loan portfolio, and as such granted summary judgment in the plaintiffs' favor on these claims. A trial is scheduled to begin on October 6, 2010. ("Subprime Securities Suit Headed to Trial Following Summary Judgment Rulings," *D&O Diary*, August 20, 2010; *In re BankAtlantic Bancorp, Inc. Securities Litigation*, Case No. 07-61542-Civ-Ungaro (S.D. Fl. August 18, 2010))

SunTrust Subprime Securities Suit Dismissed
On August 19, 2010, Judge Thomas Thrash of the U.S. District Court of the Northern District of Georgia granted the defendants' motion to dismiss a lawsuit against SunTrust Inc. and certain of its officers and directors alleging that the defendants concealed its nonperforming loans during the second and third quarters of 2008 by classifying those loans as "in-process" loans. The plaintiffs alleged that on the day that SunTrust reclassified those loans as nonperforming in the fourth quarter of 2008, SunTrust's share price decreased by 11 percent. However, Judge Thrash found that the plaintiffs failed to allege sufficient facts to support their claim that the defendants misclassified a half-billion dollars worth of loans. Judge Thrash also found that the plaintiffs did not sufficiently allege scienter or loss causation, noting that SunTrust's share price had already lost two-thirds of its value prior to the alleged corrective disclosure during the fourth quarter of 2008. The court's opinion concluded that the plaintiffs' allegations did not support the inference that the defendants' misstatements, as opposed to "general market conditions," caused the plaintiffs' alleged losses. ("SunTrust Subprime Securities Suit Dismissed," *D&O Diary*, August 24, 2010; *Waterford Township General Employees Retirement System v. SunTrust Banks, Inc., et al.*, NO. 1:09-CV-617-TWT (N.D. Ga. August 19, 2010))

SEC Defends Settlement With Citigroup
In a September 8, 2010 filing with the U.S. District Court for the District of Columbia on the Securities and Exchange Commission (SEC) defended the $75 million penalty that Citigroup Inc. agreed to pay to settle civil charges brought by the SEC alleging that Citigroup misled investors regarding potential losses from its subprime mortgage portfolio. The SEC described the settlement, which was announced in July 2010, as "fair, adequate, reasonable and in the public interest." In its lawsuit against Citigroup and certain of its officers, the SEC alleged that the defendants repeatedly made misleading statements regarding its portfolio of high-risk mortgages. At a hearing regarding the settlement, U.S. District Judge Ellen Segal Huvelle criticized the settlement and questioned why Citigroup's shareholders should be punished for the alleged wrongful acts of Citigroup's executives. ("SEC Defends $75 Million Deal With Citigroup," *Associated Press*, September 8, 2010)

Fraud & Ponzi Schemes

Court Allows Suit Against Fairfield Greenwich Group to Proceed
On August 18, 2010, U.S. District Judge Victor Marrero denied the defendants' motion to dismiss most of the claims in a lawsuit filed against Fairfield Greenwich Group and several firms that provided administrative and accounting services to Fairfield, alleging that the defendants assisted Madoff in orchestrating his massive Ponzi scheme. The class action lawsuit brought by investors asserts that Fairfield funneled money into Madoff's fraudulent investment scheme while willfully ignoring the signs of Madoff's fraud. According to Judge Marrero's opinion denying the defendants' motion to dismiss, Fairfield was "an intricate tangle of entities" that "all apparently existed to accomplish the same task" of managing funds invested almost exclusively with Madoff. However, Judge Marrero did dismiss many claims pending against individually named defendants. In a separate lawsuit naming Fairfield, Irving Picard, the U.S. trustee appointed to recover assets for investors in Bernard L. Madoff Investment Securities, alleges that Fairfield earned approximately $1 billion in fees from Madoff for, among other things, serving as a feeder fund. ("Fairfield Must Face Investor Suit, U.S. Judge Rules," *Bloomberg*, August 18, 2010; "With Ruling, Madoff Feeder Fund Faces Fewer Claims," *The New York Times*, August 19, 2010)

Fairfield Sentry Sues Former Shareholders
On August 17, 2010, Fairfield Sentry Ltd. (Fairfield Sentry), an investment fund affiliated with Fairfield Greenwich Group (that invested $3.2 billion into Madoff's Ponzi scheme), filed a lawsuit in U.S. Bankruptcy Court in New York against 17 of its former shareholders to recover approximately $160 million that those shareholders allegedly received since 2004. According to the lawsuit, the shareholders, including Banco Bilbao Vizcaya Argentaria SA, Merrill Lynch Pierce Fenner & Smith Inc. and RBC Dominion Securities Sub A/C, were unjustly enriched by returns that Fairfield Sentry paid out from Madoff's fraudulent investment scheme. Fairfield Sentry asserts that it transferred funds to Madoff without knowledge that he was operating a Ponzi scheme. Fairfield Sentry is currently being liquidated under the supervision of the Commercial Division of the High Courts of Justice in the British Virgin Islands. ("Bernard Madoff Feeder Fund, Fairfield Sentry, Sues 17 Former Shareholders," *Bloomberg*, August 17, 2010)

Money Manager to the Stars Pleads Guilty
Kenneth Starr, former money manager to many wealthy celebrities, pleaded guilty on September 10, 2010, to defrauding his clients out of as much as $50 million. Starr, who was arrested in May and charged with 23 criminal counts, pleaded guilty to one count each

of wire fraud, investment advisor fraud and money laundering. According to federal sentencing guidelines, Starr faces between 121 and 151 months in prison, although the judge may ignore those guidelines when Starr is sentenced on December 15, 2010. "From 2009 to 2010, instead of using my clients' money as I promised, I knowingly used a portion of the money for my own purposes," Starr told U.S. Magistrate Theodore Katz in federal court in New York. As part of his agreement with the government, Starr will forfeit his $7.5 million apartment on Manhattan's Upper East Side. ("Starr, Fund Manager to Celebrities, Pleads to Fraud," *Bloomberg*, September 10, 2010)

Government & Regulatory Intervention

Top Bank Regulators Back New Rules
On September 12, 2010, bank regulators from around the world agreed on new rules intended to make the global banking industry safer and more prepared to withstand future financial downturns. The bank regulators met in Basel, Switzerland, and agreed on new requirements that will more than triple the amount of capital that banks must hold in reserve. The purpose of the new requirements are to push banks into more conservative positions and force them to maintain a larger safety net against potential losses. Central to the new rules is an agreement that requires banks to raise the amount of common equity they hold to 7 percent of assets, up from the current 2 percent figure. While critics of the new regulations say that the new rules could reduce profits, strain weaker institutions and raise the cost of borrowing, the regulations are being touted by bank regulators as a way to make the system safer by ensuring banks can withstand a future financial crisis. The recommendations by the group, which includes Ben Bernanke, chair of the Federal Reserve, are subject to approval in November by the G-20 nations, and then enactment by individual nations before they become binding. The group set a deadline of January 1, 2013, for member nations to begin to phase in the rules, known as Basel III. ("Bank Regulators Back New Bank Rules to Avert Crises," *The New York Times*, September 12, 2010)

Former Lehman Brothers CEO Testifies to Financial Crisis Commission
On September 1, 2010, Richard Fuld, former chief executive officer of Lehman Brothers Holdings Inc., testified in front of the Financial Crisis Inquiry Commission. The 10-member bipartisan commission was created by Congress to study the causes of the recent financial crisis and report its findings to Congress and the president by December 2010. According to Fuld, "Lehman was forced into bankruptcy not because it neglected to act responsibly or seek solutions to the crisis, but because of a decision, based on flawed information, not to provide Lehman with the support given to each of its competitors and other nonfinancial firms in the ensuing days." Fuld said although Lehman Brothers sought permission to convert to a bank holding company, regulators turned down its request and then aided other firms with relief similar to what Lehman Brothers had requested. According to Federal Reserve General Counsel Scott Alvarez, Lehman never applied to become a bank holding company. He also stated that the Federal Reserve denied Lehman funding in the firm's final days because Lehman lacked sufficient collateral to guarantee repayment. ("Fuld Says U.S. Used 'Flawed Information' to Deny Aid," *Bloomberg*, September 1, 2010)

FDIC Report Shows Increase in Troubled Banks, But Hopeful Outlook
According to a quarterly report issued by the Federal Deposit Insurance Corporation (FDIC) on August 31, 2010, the banking industry is slowly starting to recover. The report listed the number of "problem banks" at 829, an increase of 54 lenders from the previous report. Most of these new troubled lenders are small community banks. While the increase is smaller than in previous quarters, the number of problem banks remains at its highest level in more than 16 years. However, bank earnings are beginning to rebound, with the banking industry posting a $21.6 billion profit in the second quarter as loan losses begin to stabilize. Additionally, the FDIC reports that fewer borrowers are falling behind on their loan payments. In every category, troubled loans started falling for the first time in more than four years, with the exception being commercial real estate loans, which continue to show weakness. Although the FDIC's deposit insurance fund has been severely depleted, FDIC chair Sheila Blair said that projections indicate that the fund is well-equipped to handle future bank failures. ("More Banks in Trouble, But Profits Are Rising," *The New York Times*, August 31, 2010)

Related Practices:

Insurance Practices