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Credit Crunch Digest

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July 27, 2011

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 developments in the Bank of America settlement; an attempt for eight major mortgage servicers to remediate their foreclosure protocols; an $800 million lawsuit initiated against JPMorgan and Royal Bank of Scotland; the guilty plea of a former Rothstein employee; dismissal of a Madoff-related lawsuit brought against JPMorgan; and the status of financial regulatory reform implementation in response to the subprime crisis and credit crunch.

Litigation and Regulatory Investigations

- Bank of America Settles Countrywide Mortgage-Backed Securities Claims for $8.5 Billion
- Major Mortgage Servicers Race to Meet OCC Deadline for Remedial Foreclosure Plans; $20 Billion Settlement May Be in the Works
- Credit Union Regulators Sue JPMorgan and RBS for $800 Million Over Mortgage-Backed Securities Losses

Fraud and Ponzi Schemes

- Mets May Have Scored Potentially Sympathetic Judge to Preside Over District Court Case
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Litigation and Regulatory Investigations

Bank of America Settles Countrywide Mortgage-Backed Securities Claims for $8.5 Billion

On June 28, 2010 in New York state court, Bank of America Corp. (BofA) reached an $8.5 billion agreement to settle claims brought by a number of high-profile institutional investors in Countrywide Financial Corp.'s subprime mortgage-backed securities that bottomed out following the housing bubble. BofA, which purchased Countrywide in January 2008, resolved the nine-month dispute with the trustee on behalf of 530 trusts, including 22 institutional investors, who held a combined balance of $424 billion in subprime mortgage-backed securities. As a part of the agreement, BofA also resolved to improve its mortgage servicing operations, and further clarify its loss

mitigation standards for its investors. The settlement is subject to approval by the New York Supreme Court. The $8.5 billion Countrywide bondholder settlement comes on the heels of BofA's recent mortgage-related $2.8 billion settlement with Freddie Mac and Fannie Mae, and an additional $1.6 billion settlement with Assured Guaranty. ("BofA Agrees to $8.5B Settlement Over Soured Mortgages," *Law360*, June 29, 2011.)

Major Mortgage Servicers Race to Meet OCC Deadline for Remedial Foreclosure Plans; $20 Billion Settlement May Be in the Works

A group of eight major mortgage servicers, including Bank of America Corp. (BofA), JPMorgan Chase & Co., and Citigroup Inc., had until July 13 to submit corrective plans to the Office of the Comptroller of the Currency to improve their foreclosure practices. The Department of Justice is also working in a coordinated process with other regulators, including U.S. housing officials and all 50 state attorney generals, to come to a broad settlement agreement with the banks regarding their foreclosure practices. As part of the proposed agreements, banks would be required to establish a fund to address civil mortgage complaints and federal accounts to provide mortgage relief to distressed borrowers. A combined settlement with the banks regarding these practices may total more than $20 billion. The proposed standards for loan servicing and foreclosure processing may also serve as a corrective model for others in the industry. ("BofA, JPMorgan to Submit Foreclosure Plans Next Week," *Bloomberg.com*, July 8, 2011)

Credit Union Regulators Sue JPMorgan and RBS for $800 Million Over Mortgage-Backed Securities Losses

Units of JPMorgan and Royal Bank of Scotland PLC (RBS) were named as defendants in lawsuits brought by the National Credit Union Administration (NCUA) and the U.S. credit union regulator in federal district court in Kansas surrounding those defendants' sales of mortgage-backed securities to now-failed credit unions. The NCUA alleges that defendants misrepresented the safety and soundness of the mortgage-backed securities while knowing that the underlying instruments were on the verge of delinquency, or would be in default shortly after origination. The NCUA alleges that at least five defunct credit unions were sold triple-A rated securities in senior tranches of debt, which were supposed to be safe and substantially protected from risks of default. According to the complaints, RBS and JPMorgan misrepresented the risks in these investments. In a related statement in connection with the lawsuits, the NCUA announced that it intends to file additional lawsuits seeking damages in the billions against other unidentified parties. ("JPMorgan, RBS Units Sued Over $800M in Risky MBS," *Law360*, June 20, 2011.)

Fraud and Ponzi Schemes

Mets May Have Scored Potentially Sympathetic Judge to Preside Over District Court Case

Counsel for the New York Mets owners Fred Wilpon and Saul Katz were successful in transferring the ongoing lawsuit filed by Madoff Trustee Irving Picard, styled *Picard v. Katz, et al.*, from the U.S. Bankruptcy Court to the U.S. District Court for the Southern District of New York. Federal District Court Judge Jed S. Rakoff is presiding over the matter and is a former federal prosecutor and defense attorney who is known as having an independent streak. As examples, in 2002, Judge Rakoff declared the death penalty unconstitutional, *sua sponte*, and in 2009, refused to approve a $33 million settlement of a Bank of America lawsuit involving shareholder bonuses, declaring the amount too little. In the instant matter, Judge Rakoff's questioning appears favorable for the defendants, at least preliminarily, as he has questioned why investors like Wilpon and Katz should not be judged by securities laws but by bankruptcy laws that came into being after Madoff's Ponzi scheme was exposed. Although an attorney working closely with Picard answered that it was the "nature of bankruptcy law," Judge Rakoff replied by stating "I'm not sure I agree with that." Currently, Rakoff is awaiting additional legal briefs before resuming oral arguments for defendants' motion to dismiss on August 17, 2011. In terms of Judge Rakoff's forthcoming decision, he can either dismiss the matter entirely or rule on some issues and return the matter to the

U.S. Bankruptcy Court for the Southern District of New York. ("Federal Judge Holds Financial Fate of Wilpon and Katz," *The New York Times*, July 6, 2011).

Rothstein Associate Pleads Guilty

William Corte pleaded guilty on June 22, 2011 to wire fraud conspiracy. Prosecutors alleged that Corte assisted in effectuating Scott Rothstein's Florida Ponzi scheme by creating bogus Internet pages in an effort to convince investors of the Ponzi scheme's legitimacy. The charge carries a maximum five-year prison sentence, and sentencing is currently set for September. Rothstein, former CEO of the now-defunct Rothstein Rosenfeldt Adler, LLP, is currently serving a 50-year prison sentence. ("Another Rothstein Associate Pleads in Ponzi Scam," *Bloomberg Businessweek*, June 22, 2011.)

Second Circuit Court of Appeals Affirms Dismissal of Madoff Suit Against JPMorgan

The U.S. Court of Appeals for the Second Circuit upheld the dismissal of a lawsuit brought by MLSMK Investment Co. against JPMorgan Chase & Co. alleging JPMorgan conspired with Bernard Madoff, aiding him in his Ponzi scheme while benefiting from the fees Madoff paid to the bank. Under both state and federal laws, MLSMK alleged that it lost its $12.8 million investment with Madoff's firm, in part because of JPMorgan's role as Madoff's banker. A Manhattan federal district judge previously dismissed the state court causes of action, finding that MLSMK failed to plead facts to adequately show aiding and abetting fraud, commercial bad faith and negligence. The Second Circuit upheld the district court's holding related to the state law claims last month. However, the Second Circuit's latest ruling affirms the dismissal of the federal racketeering claim that remained outstanding. JPMorgan continues to remain a party to the $19 million litigation brought by Madoff trustee Irving Picard. ("Dismissal of Madoff Suit Against JPMorgan Affirmed by U.S. Appeals Court," *Bloomberg,* July 7, 2011.)

Government and Regulatory Intervention

Final CFTC Vote Approves Rule Against Market Manipulation

On July 7, 2011, in a 5-0 vote, the commissioners of the U.S. Commodity Futures Trading Commission (CFTC) approved a final rule regarding derivatives and commodities market manipulation. The anti-manipulation rule is intended to make it easier for the CFTC to prove fraud and market manipulation by requiring that the agency need only show that traders in the markets acted recklessly. Currently, the CFTC must show under a four-part test that artificial prices were set and prove that traders intentionally manipulated markets. Under the Dodd-Frank financial reform legislation, more than 40 new rules regulating the derivatives and commodities markets are set for a vote at the CFTC. This rule is among the first to reach a final vote. "This closes a significant gap, as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers," said CFTC Chair Gary Gensler. According to David Meister, head of CFTC enforcement, the new rule will be a "priority" for the agency's enforcement lawyers: "We will look to bring cases and investigate under this new authority." ("CTFC Adopts Dodd-Frank Swap Rule Against Market Manipulation," *Bloomberg*, July 7, 2011.)

FDIC Finalizes Clawback Rule for Executive Compensation

Under the Dodd-Frank financial reform legislation, the Federal Deposit Insurance Corporation (FDIC) was given expanded authority to wind down failed banks, as well as order the affairs of non-banks that pose a systemic threat to the overall financial system. As part of this authority, the FDIC recently finalized and voted unanimously to approve a rule that would allow the FDIC to clawback some pay from top U.S. financial executives if their company were to be liquidated by the government. The FDIC is now authorized to recover pay for two years preceding its appointment as receiver for a failing institution. The rule is focused on allowing the FDIC to go after senior directors and executives who are deemed "substantially responsible" for a firm's failure. According to the final rule, the FDIC first evaluates an executive's role in causing shareholder loss and then determines the

appropriate clawback compensation amount. Large banking groups representing firms such as JP Morgan Chase & Co. and Goldman Sachs filed a comment letter with the FDIC, calling portions of the clawback rule "fundamentally unjustifiable and counterproductive." ("FDIC Adopts Pay Clawback Rule for Largest Bank Resolutions," *Bloomberg*, July 6, 2011.)