Sedgwick LLP

Credit Crunch Digest

March 2011

By: Jennifer Broda, Jennifer Hamilton, Thomas Orofino, Eric Scheiner

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

Litigation and Regulatory Investigations

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Litigation and Regulatory Investigations

FDIC Sues Former CEO of Washington Mutual

On March 17, 2011, the Federal Deposit Insurance Corporation (FDIC) sued Kerry Killinger, the former chief executive of Washington Mutual (WaMu). The suit alleges that Killinger and his top two executives, David Schneider and Stephen J. Rotella, engaged in reckless lending before the economic downturn of 2008. According to the FDIC, the three executives pushed for expansion of WaMu's risky lending even though they knew or should have known that its loan standards and controls were inadequate.

WaMu, a Seattle-based bank with $307 billion in assets, collapsed in September 2008 at the height of the financial crisis and was sold for $1.9 billion to JPMorgan Chase & Co. in a deal brokered by the FDIC. In addition, the complaint states that Killinger and Rotella used estate planning techniques to keep their respective homes out of the reach of bank creditors. The FDIC has asked the court to freeze those assets, which it says were fraudulently transferred.

Killinger and Rotella dispute the FDIC's allegations. In a statement on Killinger's behalf, his attorneys called the suit "baseless and unworthy of the government" and "political theater." According to a statement issued by Rotella, “This action runs counter to the facts about my relatively short time at the company.” He also called it “unfair and an abuse of power.” (“FDIC Sues Ex-Chief of Big Bank That Failed,” *The New York Times*, March 17, 2001.)

Credit Suisse Subprime Securities Suit Settled for $70 Million

Credit Suisse Group agreed to pay $70 million to settle a securities class-action lawsuit filed by investors alleging that the bank misled investors about its mortgage exposure during a

roughly one-year period that began in 2007. The plaintiffs filed their initial complaint in April 2008 alleging that the Swiss bank materially misrepresented the company's asset valuation system, its internal controls and its exposure to subprime-mortgage related losses.

In a settlement agreement filed on March 10, 2011, in U.S. District Court for the Southern District of New York, the bank agreed to settle with investors who purchased American depositary shares of the company's stock on the New York Exchange between February 15, 2007, and April 14, 2008. The settlement, which must be approved by the court, also includes U.S. residents who purchased Credit Suisse stock on the Swiss stock exchange during the same period. ("Credit Suisse Subprime Securities Suit Settled for $70 Million." *The D&O Diary*, March 14, 2011.)

IndyMac Strikes Deal Over Executives' Sweetheart Loans

IndyMac Bancorp Inc. reached several agreements with former mid-level executives who received "sweetheart" home loans to come to work for the company.

The California-based bank was assisting senior officers who relocated to the Pasadena area by offering them special loans. In essence, the mortgage loans (for up to $500,000) would allow the executive to pay no interest or principal due unless the executive was terminated. In addition, the loans would be forgiven after a four- or five-year period.

IndyMac Bancorp filed for Chapter 7 protection in July 2008 to liquidate its assets after the bank was seized by federal regulators. At the time of its takeover by the FDIC, it was the third-largest bank failure in U.S. history. ("IndyMac Strikes Deal Over Executives' Sweetheart Loans," *The Wall Street Journal*, February 25, 2011.)

Fraud and Ponzi Schemes

Kenneth Starr Sentenced to Seven and a Half Years

On March 2, 2011, Kenneth Starr, the celebrity accountant arrested and charged with running a $33 million Ponzi scheme, was sentenced to seven and a half years of a potential 12-year sentence. Starr, whose clientele included celebrities such as Uma Thurman, Sylvester Stallone, Carly Simon and Wesley Snipes, pleaded guilty to wire fraud, money laundering and adviser fraud and was ordered to pay $29 million in restitution.

In sentencing, Judge Shira Scheindlin of the Southern District of New York stated that the fraud "is not an astronomical figure" but that Starr had "lost his moral compass . . . partly as a result of his infatuation with his young fourth wife." During the hearing, Starr was quoted as saying "I stand before you a contrite, humiliated and ashamed man." ("New York Celebrity Money Man Handed 7.5-Year Prison Term," *Reuters*, March 2, 2011.)

Picard Targets Ruth Madoff

On March 10, 2011 the Bank of New York Mellon, Corp. agreed to release Ruth and Bernard Madoff's monthly bank statements, canceled checks and other records from January 2002 through December 2008. In his continued effort to recapture investors' losses, Irving Picard, the trustee in liquidation of Madoff's businesses, contends that at least $14 million in the couple's joint account represents fraudulent transfers misidentified as interest payments on loans made by Madoff companies. Picard alleges that many of these funds, including a $2.3 million deposit used for the purchase of a yacht, rightfully belong to the investors. To date, Ruth Madoff has forfeited houses, jewels and various bank accounts. She is scheduled to respond by March 31, 2011. ("Ruth Madoff Account Got $14 Million From Fraud," *Bloomberg*, March 16, 2011.)

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

Russell Adler, one of the three named partners of the now-bankrupt South Florida law firm Rothstein Rosenfeldt Adler, LLP, (RRA), entered into a settlement with bankruptcy trustee Herbert Stettin for up to $500,000 in exchange for being released from ongoing litigation. The lawsuit stems from the December 2009 bankruptcy of RRA and the resulting arrest of Scott Rothstein on federal criminal charges tied to his Ponzi scheme involving fraudulent litigation settlements.

In response to RRA's bankruptcy, and investors' losses, Stettin is engaging in an ongoing effort to recoup funds believed to belong to Rothstein creditors. In February 2010, Stettin sued Adler and his wife for roughly $580,000 that Stettin alleged was overpaid to Adler over a two-year span. The settlement, which was approved in February 25, 2011 by Judge Raymond B. Ray of the U.S. Bankruptcy Court in Fort Lauderdale, Fla., will release Adler from the trustee's civil litigation. Under the terms of the settlement agreement, Adler must pay RRA's bankruptcy estate either $350,000 within the next 30 months or $500,000 after that. Terms of the settlement also preclude the Adlers from filing for personal bankruptcy to avoid paying. To date, no criminal charges have been filed against Adler in connection with his former partner's alleged $1.2 billion Ponzi scheme. ("Judge OKs Bankruptcy Settlement with Former Rothstein Partner," *The Wall Street Journal*, February 28, 2011.)

Government and Regulatory Intervention

'Too Big to Fail' Problem Addressed by New FDIC Rules

On March 15, 2011, the Federal Deposit Insurance Corporation (FDIC) voted unanimously to approve new rules designed to create a process to unwind large financial institutions. As part of the Dodd-Frank financial reform bill, the FDIC was given the authority to create rules to unwind

large financial institutions, if, in the future, those institutions appear to pose a systemic risk to the overall financial system. During the beginning of the financial crisis, the government was criticized for its handling of the Lehman Brothers crisis and subsequently the firm went bankrupt in the fall of 2008. The FDIC's proposed rules focus on how to deal with failing financial firms that pose a systemic risk to the financial system, and specifically address how creditors can file claims and how those claims are addressed. There is a 60-day public comment period, after which the FDIC will finalize the rules.

Notably, the proposed rules also deal with pay clawbacks. According to the proposed rules, the FDIC could recapture the compensation of "persons who are substantially responsible for the failed condition of a covered financial company." These rules are aimed at financial institution executives and directors. However, according to the proposed clawback rules, executives and directors "who perform their responsibilities with the requisite degree of skill and care will not be required to forfeit their compensation." ("FDIC Approves 'Too Big to Fail' Plan," *The New York Times*, March 15, 2011.)

Big Changes on the Way for Fannie Mae and Freddie Mac

The Treasury Department, the Department of Housing and Urban Development, and the White House have collectively drafted a proposal that aims to phase out Fannie Mae and Freddie Mac. Created after the Great Depression to help Americans buy homes, the government-sponsored entities have recently experienced problems caused by the financial crisis and have received more than $150 billion in taxpayer help. Currently, Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) buy or insure approximately 97 percent of residential mortgages.

The proposal, which was sent to Congress in February, proposes a number of options to lessen the role Fannie and Freddie play in the consumer mortgage market. In addition, the proposal calls for a more limited role for the FHA, which insures loans with low down payments, usually popular among first-time home buyers and those with weak credit or low income. According to the proposal, the minimum down payment would go up to 10 percent from the current 3.5 percent,

and a 10 percent minimum would be required for all Fannie and Freddie loans. According to industry experts, consumers could see higher borrowing costs as early as this year because some of the proposed changes do not require congressional approval and appear to be ready for implementation. Should Fannie and Freddie be phased out in any considerable way, industry observers think that the 30-year fixed-rate mortgage will likely become harder to find and more expensive, as banks will be less willing to extend credit at a fixed rate over such a long time without being able to sell these loans to Fannie and Freddie. ("A Plan to Phase Out Fannie Mae and Freddie Mac," *The New York Times*, March 3, 2011.)

Obama Administration Names Head of New Federal Insurance Office

Michael McRaith, currently the head of the Illinois Department of Insurance, will take the national stage as head of the newly created Federal Insurance Office (FIO). The FIO was created under the Dodd-Frank financial reform act and is tasked with monitoring insurers, but not regulating them directly. As mandated by the Dodd-Frank Act, the FIO will operate from within the U.S. Department of Treasury and will keep Congress up to date on insurance issues, with a focus on the potential systemic risk any particular insurer or group of insurers pose to the U.S. financial industry.

While the FIO will work closely with the Treasury, direct regulation of insurers will remain at the state level, and the FIO will not have direct regulatory power. Before his previous job as head of the Illinois Department of Insurance, McRaith worked for 15 years in private practice as an attorney in Chicago, representing financial institutions, including insurers. ("McRaith to Lead New Federal Insurance Office," *Insurance Journal*, March 18, 2011.)

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