Sedgwick LLP

Credit Crunch Digest

November 2010

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In the October 2010 Edition:

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 regarding subprime and other high-risk mortgages, the status of the Madoff and Stanford Ponzi schemes 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

Subprime Lawsuit Against ING Substantially Dismissed

On September 14, 2010, Judge Lewis Kaplan of the U.S. District Court for the Southern District of New York issued an opinion substantially dismissing a lawsuit brought by bondholders who had purchased securities in three ING Group offerings in June 2007, September 2007 and June 2008. The lawsuit, which was filed in February 2009, alleges that the defendants, including ING, two ING affiliates, certain ING officers and directors and the offering underwriters, made material misrepresentations in the offering documents regarding ING's own investments in Alt-A and subprime mortgage-backed securities. Judge Kaplan addressed the allegations regarding each offering separately and dismissed all of the plaintiffs' allegations except certain allegations regarding the June 2008 offering. With respect to the June 2007 offering, Judge Kaplan found that the plaintiffs' claims failed because the offering materials contained sufficient "storm warnings," and the claims were untimely filed. Judge Kaplan found that the plaintiffs failed to allege any facts "suggesting that ING assets had been impacted by the general market conditions" at the time that allegedly misleading statements were made in the offering materials for the September 2007 offering. Judge Kaplan did not dismiss the plaintiffs' claims based on allegations that the June 2008 offering materials misleadingly stated that ING's mortgage-backed assets were "near prime and of high quality." Judge Kaplan rejected the defendants' argument that, as a matter of law, those statements were immaterial. ("Dismissal Motion in ING Bondholders Subprime Suit Granted – Except for One Part," *D&O Diary*, September 15, 2010; *Freidus v. ING Groep, N.V.*, No. 09-cv-1049 (September 14, 2010))

Bank of America Sued for Losses Related to Countrywide Bonds

On September 28, 2010, Ambac Assurance Corp. filed suit in New York state court against Bank of America Corp. (BofA) alleging that Countrywide Financial Corp., which was acquired by BofA in 2008, fraudulently induced Ambac to insure bonds backed by loans that did not conform to Countrywide's underwriting guidelines. Ambac alleges that it has paid $466 million in claims arising from more than 35,000 Countrywide home-equity loans. The complaint identifies 12 pools of home loans that were created between 2004 and 2006, and alleges that many of the loans in those pools were made to borrowers who had "limited or no ability to meet their payment obligations." Ambac seeks damages "sufficient to place [it] in the same position it would have been in had it never insured the transactions." During the past four quarters, BofA has reported losses of $7.6 billion from home-equity loans and expects to continue to experience losses related to Countrywide loans through mid-2012. ("Ambac Sues Bank of America Over Countrywide Bonds," *Bloomberg.com*, September 29, 2010)

Goldman Faces Lawsuit Over Sale of CDO to German Bank

On October 4, 2010, Landesbank Baden-Wuerttemberg (LBBW), a German state-owned bank, filed suit in the U.S. District Court for the Southern District of New York against Goldman Sachs Group Inc. and TCW Group, Inc., a subsidiary of Societe Generale SA, alleging that the defendants committed fraud and/or were negligent in marketing and selling certain notes that were part of a collateralized debt obligation (CDO) to an affiliate of LBBW in March 2006. Goldman served as the placement agent for the CDO, and TCW was the investment advisor on the CDO. According to the complaint, the defendants represented that the securities underlying the CDO were "safe, secure, and nearly risk free," when in fact, the CDO was 95 percent comprised of residential mortgage-backed securities, of which 33 percent were subprime and 46 percent were "midprime." LBBW contends that at the same time that the defendants were marketing the CDO, Goldman senior executives knew that the subprime mortgage market was in distress and were reducing Goldman's exposure to the subprime mortgage market. Additionally, the complaint alleges that at that time, Goldman was purchasing credit fault default swaps on the CDO to insure against its failure. LBBW asserts that it lost approximately $37 million on its investment. ("Goldman Sachs Sued Over German Bank's $37 Million Loss on CDO," *Bloomberg.com*, October 5, 2010)

Countrywide Granted Dismissal of MBS Case

On October 13, 2010, New York Supreme Court Justice Barbara Kapnick issued an opinion dismissing a lawsuit brought by two investment funds against Countrywide. The lawsuit sought to force Countrywide to buy back mortgages that it agreed to modify in 2008 pursuant to an agreement between Countrywide and 11 state attorneys general. The investment funds, which purchased securities backed by those loans, alleged that they suffered lower returns on the securities as a result of the loan modifications, which reduced borrower obligations. Justice Kapnick ruled, however, that the plaintiff investment funds had not complied with certain prerequisites for bringing a lawsuit regarding the securities. Specifically, Judge Kapnick found that the plaintiffs failed to demonstrate that they had gathered the support of 25 percent of the investors in the securities. ("BofA's Countrywide Wins Dismissal of Mortgage Case," *Reuters*, October 13, 2010)

Fraud & Ponzi Schemes

Madoff Family Members Ask Court to Halt Suit Against Them

On October 6, 2010, family members who were executives at Bernard Madoff's firm asked a New York Bankruptcy Court judge to halt a bid to sue them for nearly $200 million. The family members insist they did not know about the Ponzi scheme and were simply executives for the firm's legitimate market-making and proprietary trading units, not the investment arm at the center of the multibillion-dollar fraud. Defendants include Bernard Madoff's two sons, his brother and his niece. On October 2, 2009, Irving Picard, the bankruptcy trustee appointed to wind down Bernard Madoff Investment Securities, sued the four Madoffs in a lawsuit seeking $198.7 million. The suit accuses Madoff's relatives of being negligent in their duties as executives and enriching themselves with money that belonged to customers. Judge Burton Lifland has not indicated when he will rule, but during the hearing noted that "this is not Merrill Lynch where you might have rogue activity. This is a real close family and any rogue activity that took place over time would be easily discernible, one would think." ("Madoff Clan Denies Fraud Role, Seek Suit Dismissal," *ABC News*, October 6, 2010)

Suit Against Madoff Feeder Fund Proceeds

On October 5, 2010, Judge Leonard Sand issued an opinion substantially denying motions to dismiss a class action securities lawsuit filed by investors against Ivy Asset Management LLC, a subsidiary of Bank of New York Mellon Corp., for losses arising from Madoff's Ponzi scheme. The lawsuit, which is pending in the U.S. District Court for the Southern District of New York, alleges that Ivy invested approximately $164 million of client money with Madoff through the Beacon Associates fund between 1995 and 2008, and that during that time, Ivy was aware of facts that suggested that Madoff was operating a Ponzi scheme. The plaintiffs contend that despite that knowledge, Ivy continued to invest client money with Madoff because it was collecting millions of dollars in fees on the investments from Beacon Associates. Judge Sand denied the defendants' motions to dismiss the securities fraud claims, but dismissed certain of the plaintiffs' claims, including those based on state law. ("Suit Against Madoff Feeder Fund Beacon Proceeds as Judge Cuts Some Claims," *Bloomberg.com*, October 5, 2010)

Allen Stanford Not Entitled to $100 Million of Directors and Officers Insurance

Allen Stanford is not entitled to use any of the $100 million of Lloyd's of London directors and officers insurance to pay lawyers to defend him in a criminal action alleging that he ran a $7 billion investment fraud scheme. In June 2009, Stanford and three former top executives at Houston-based Stanford Financial Group were indicted for allegedly swindling investors who bought certificates of deposit issued by Antigua-based Stanford International Bank Ltd. After initially agreeing to cover Stanford's defense costs, Lloyd's denied coverage after former Stanford Group chief financial officer, James Davis, pleaded guilty last year to mail fraud, obstructing the SEC proceeding and conspiracy to commit securities fraud. According to a federal judge in Houston presiding over the insurance dispute, it is more likely than not that Stanford "knowingly committed acts of money laundering" involving the use of corporate funds and that those actions should have been disclosed to investors and regulators. Those actions violated the terms of the insurance policies and voided coverage. While the judge involved in the insurance coverage dispute applied a more-likely-than-not threshold of proof, prosecutors at the criminal trial must prove Stanford's guilt beyond a reasonable doubt. ("Allen Stanford Loses Bid for $100 Million of Lloyd's Directors Insurance," *Bloomberg*, October 13, 2010)

Government & Regulatory Intervention

Obama Administration Rejects Nationwide Freeze on Home Foreclosures

According to David Axelrod, a senior advisor to President Barack Obama, the Obama Administration would not support a nationwide temporary freeze on home foreclosures. Attorneys general in about 40 states are expected to announce a joint investigation into potentially faulty foreclosures at the largest banks and mortgage firms. According to reports, the investigation may center on claims that employees at home lenders and loan servicers signed court documents without ensuring the information was accurate. Bank of America, JPMorgan Chase & Co., and Ally Financial Inc. froze foreclosures in 23 states where courts supervise home seizures because of allegations that employees used unverified or false data to speed the foreclosure process (but Bank of America has already lifted the freeze in some states). According to Axelrod, while faulty paperwork that prompted many banks to put foreclosures on hold has "thrown a lot of uncertainty into the housing market that is already fragile," the Obama administration would not support a nationwide moratorium. ("Obama Advisor Rejects Temporary Nationwide Freeze on All Home Foreclosures," *Bloomberg*, October 10, 2010)

FDIC Seeks to Recoup Losses by Going After Failed Bank Directors and Officers

The Federal Deposit Insurance Corporation (FDIC), which insures bank deposits, has lost more than $75 billion in almost 300 bank failures since 2008. According to reports, the FDIC has concluded that more than 50 bank officers and directors were negligent, committed fraud or otherwise breached their duties and are legally liable for their actions. Based upon this finding, the FDIC has authorized lawsuits against these directors and officers at failed banks across the country in an attempt to recover more than $1 billion of the agency's losses during the credit crisis. The agency has not yet revealed the names of the bank officials or said how many banks were involved. To date, the FDIC has filed only one lawsuit, against four former executives of failed IndyMac Bancorp, in which it seeks $300 million in damages. According to FDIC Chair Sheila C. Bair: "These investigations are now beginning to produce results, and we anticipate that many more will be authorized. As a matter of policy, the FDIC believes strongly in accountability for directors and officers whose personal misconduct led to a bank's failure." ("FDIC to Sue Bank Officials in Effort to Recoup $1 Billion in Losses," *The Washington Post*, October 9, 2010)

Treasury Department Calculates Expected Loss From Federal Bailouts

On October 5, 2010, the Treasury Department released a report examining the costs of various federal programs set in place after the financial crisis. According to the report, the Treasury Department expects to lose $29 billion on the federal bailouts, with most of the losses stemming from the housing finance program and the auto companies rescue. The figures, which include profits that offset some of the losses, come just as the Obama Administration tries to wind down the bailout program known as the Troubled Asset Relief Program, or TARP. According to the report, the Treasury has received back about $204 billion of the bailout funds, or a little more than half of the money given out. The report segregated the money given out under the Bush Administration—$294 billion—from the $94 billion awarded under the current administration. Treasury officials have declared the bailout a success, emphasizing that much of the program's money has been returned, and that losses are now likely to be less than once expected. The Congressional Budget Office originally estimated losses from the programs to be $350 billion, far higher than the now estimated $29 billion. ("Bailout Loss Estimated at $29 Billion," *The New York Times*, October 5, 2010)

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