Sedgwick LLP

Credit Crunch Digest

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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 reported cases of financial fraud. This issue focuses on the Securities and Exchange Commission's revised policy regarding civil settlements; developments in the MF Global bankruptcy; MBIA's mortgage-related lawsuit against Countrywide; Picard's lawsuit filed against the California Attorney General; a District Court ruling against investors in Madoff feeder funds; Allen Stanford's current trial schedule; and the status of Dodd-Frank reforms.

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Litigation and Regulatory Investigations

SEC Changes "Neither Admit, nor Deny" Policy in Some Civil Cases

On January 6, 2012, the Securities and Exchange Commission (SEC) announced significant changes to the way it settles certain securities fraud cases. Under the new policy, companies will no longer be able to take the position that they neither admit nor deny the SEC's civil or insider trading charges when they have admitted to or have been convicted of criminal violations. The policy will similarly apply to cases where a company and individual agree to defer prosecution or not to prosecute in accordance with a settlement. Notably, the "neither admit, nor deny" settlement process will continue to be used in cases where the SEC reaches a settlement with a company for civil securities law violations and no other agencies are involved. According to the SEC, these matters make up the great majority of its cases.

The SEC has recently been under scrutiny by both federal legislators and the courts for allowing companies to settle cases without admitting or denying the charges against them, even when a company has acknowledged the misconduct to another governmental agency. The SEC's new policy will require the civil settlement to cite the admission in any related criminal case.

The new policy will not apply to the SEC's recently rejected settlement with Citigroup over its sale of mortgage-related securities because there is no concurrent criminal charge. The SEC-Citigroup settlement was rejected in November by U.S. District Court Judge Jed Rakoff in the Southern District of New York, based on the grounds that the "neither admit, nor deny" settlement left the court with insufficient information to ascertain if the settlement was adequate. ("S.E.C. Changes Policy on Firms' Admission of Guilt," *The New York Times*, January 6, 2012).

Federal Authorities Question MF Global Regulator

Federal regulators have broadened their inquiry into the massive collapse of MF Global and are now reviewing the actions of the CME Group, which acts as the operator of the commodities exchange where the fallen company did its business. CME is facing extensive scrutiny from authorities following the disappearance of more than $1.2 billion in customer money from MF Global accounts.

The conduct of CME, which served as MF Global's primary private regulator, is being probed by the Commodity Futures Trading Commission (CFTC). In large part, the CFTC is said to be focused on CME's actions in the days prior to the MF Global bankruptcy filing on October 31, 2011, and is analyzing CME's efforts to confirm the sufficiency of MF Global's internal controls. CME officials reportedly reviewed MF Global documents indicating that customer accounts were sound less than four days prior to its collapse. Federal regulators could take action against CME if it is determined that it did not meet the standards of a self-regulatory organization. It is possible that the CME could face censure, but it is unlikely that its status as a self-regulator could be revoked. The government has also engaged in other initial reviews relating to the collapse at MF Global, including reviews of divisions at JP Morgan Chase and Goldman Sachs. The preliminary results of such findings are expected to be released soon. ("MF Global Inquiry Turns to Its Primary Regulator," *The New York Times Deal Book*, January 5, 2012).

Bank of America Loses Key Ruling in Suit by MBIA Against Countrywide

Bank of America (BofA) is potentially facing further losses related to its 2008 acquisition of Countrywide following a New York Supreme Court's decision in favor of bond insurer, MBIA. MBIA sued Countrywide over its alleged misrepresentations and fraud relating to loans that were a part of mortgage-securitizations insured by MBIA. MBIA is seeking damages of approximately $1.4 billion for its losses in connection with the three-year-old lawsuit.

BofA argued that MBIA needed to meet a higher standard to establish Countrywide's wrongdoing; in particular, it argued that MBIA was required to establish a direct link between the misrepresentation regarding the mortgages and MBIA's insurance payout. The Supreme Court rejected such an approach, holding that MBIA "was not required to establish a direct causal link."

BofA previously noted in SEC filings that it faced losses related to mortgage representations of up to $5 billion, but warned that figure could be higher if courts adopted similar interpretations to those espoused by MBIA. ("BofA suffers setback in Countrywide case," *The Financial Times*, January 3, 2012).

Fraud and Ponzi Schemes

Picard Seeks Injunction Against California Attorney General

On January 4, 2012, Madoff trustee Irving Picard filed a lawsuit in the U.S. Bankruptcy Court in Manhattan to stop California Attorney General Kamala Harris and four other defendants from pursuing lawsuits against the estate of Stanley Chais, a Beverly Hills money manager. In 2009, Picard and the SEC, in separate lawsuits, brought claims against Chais alleging that he invested his clients' money with Madoff despite obvious red flags associated with Madoff's investment firm. Chais died in September 2010 at age 84, and the Attorney General's lawsuit seeks to recover from Chais' estate, related entities and family members the $270 million Chais collected in fees for investing his clients' money with Madoff. Picard's lawsuit alleges that the California claims attempt to "side-step the trustee's exclusive right to seek recovery of fraudulently transferred property," and could therefore reduce the amount Picard seeks to recoup for former Madoff investors. Counsel for the Attorney General's office has stated that its client's claims are independent from the Madoff bankruptcy case, and are "based on conduct that Stanley Chais did in connection with investments by California residents." Picard is seeking an injunction to stop these and any future similar lawsuits. ("Madoff trustee sues Calif AG, gets feeder fund win," *Reuters*, January 5, 2012).

Feeder Fund Investors Ought Not to Look to Trustee, Judge Rules

A January 5, 2012 ruling by U.S. District Court Judge Denise Cote held that investors that indirectly invested into Bernard Madoff's Ponzi scheme through feeder funds do not qualify as "customers" and accordingly are not among the Madoff victims eligible to recoup money recovered through the Madoff trustee's efforts. This recent ruling upholds a former June 2011 ruling by U.S. Bankruptcy Judge Burtand Lifland, who is responsible for overseeing the liquidation of Madoff's former investment firm, Bernard L. Madoff Investment Securities, LLC. Madoff Trustee Irving Picard had previously rejected these third-party claims. In her January 5 ruling, Judge Cote held that these particular investors were aware that they purchased "ownership shares" in the feeder funds themselves and therefore had no property interest in the assets that were subsequently issued to Madoff. ("Madoff feeder fund investors cannot recover: judge," *Reuters*, January 5, 2012).

Despite Defense Efforts, Stanford Trial Set to Begin January 23, 2012

On December 28, 2011, U.S. District Judge David Hittner issued a ruling that directs Allen Stanford's defense team to prepare for trial currently scheduled for January 23, 2012. Stanford's trial date was originally scheduled for January 2011. However, Judge Hittner delayed the trial after finding that Stanford was incompetent to understand the proceedings and effectively assist in his defense. Hittner ruled on December 22, 2011 that Stanford had adequately recovered from an anxiety medication addiction, as well as a head injury incurred in a previous jailhouse assault. In his eight-page December 28 ruling denying Stanford's extension request, Hittner stated that "[t]his trial will decide not just whether Stanford is guilty of the criminal charges, but also whether hundreds of millions dollars of investor funds currently frozen may be forfeited and returned to his alleged victims." Stanford's attorneys attempted to delay the trial until late April arguing that this time was needed to review the multitude of corporate documents with Stanford while he was clear-headed. Stanford's criminal case stems from a June 2009 indictment alleging he defrauded investors of more than $7 billion and is styled *U.S. v. Stanford,* 09-cr-342, U.S. District Court, Southern District of Texas (Houston). ("Allen Stanford Loses Bid to Delay His Fraud Trial in January," *Bloomberg Businessweek*, January 4, 2012).

Government and Regulatory Intervention

Most Dodd-Frank Rules Not Yet Implemented

According to a recent study, since the Dodd-Frank Wall Street Reform and Consumer Protection Act passed in July 2010, only 21 percent of the act's 400 rulemaking requirements have been finalized. Almost 75 percent of the rulemaking deadlines imposed under Dodd-Frank have been missed. Additionally, experts expect efforts to implement the so-called "Volcker Rule," which proposes new regulations on core banks, to increase public and political discourse in 2012. Further, proposed rules regarding minimum bank capital holding requirements are expected to firm up in 2012, with increased debate regarding the conflux of international standards on capital requirements, such as Basel III, and proposed U.S. standards. In any event, it appears that final implementation of the

Dodd-Frank rules may be years away, because once a rule is finalized, it could take up to two years to phase in all the rule requirements. ("Tracking the Pace of Dodd-Frank Rulemaking for 2012," *Corporate Counsel*, January 5, 2012).

Consumer Financial Protection Bureau Ready for Action With New Appointment

On January 4, 2012, President Obama made a recess appointment, installing Richard Cordray as director of the Consumer Financial Protection Bureau (CFB). The CFB was created under the Dodd-Frank financial regulation overhaul and is tasked with preventing fraud, deception and unfair business practices in the market. According to Cordray, oversight of non-bank financial firms is a "top priority" for the CFB. "With a director finally in place and no question about its powers, the Consumer Protection Bureau can start scrutinizing unfair practices by debt collectors, mortgage brokers, credit reporting agencies, and predatory payday lenders," said Lauren Sanders, of the National Consumer Law Center. Cordray said his top priority will be the oversight on non-bank financial entities.

Cordray is the former Ohio Attorney General. His recess appointment has angered many Congressional Republicans who oppose the CFB and had blocked efforts to nominate the CFB head until changes were made to the agency's funding and structure. ("Cordray's Ascent Expands U.S. Consumer Bureau's Reach to Non-Bank Firms," *Bloomberg*, January 4, 2012).

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