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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 increasing number of reported cases of financial fraud. This issue focuses on a U.S. District Court decision approving a large mortgage services settlement; a Florida jury finding Wells Fargo liable for breach of contract; a U.S. District Court seeking the deposition of a IndyMac's former CEO; trustees for the Madoff Ponzi scheme seeking recovery from Madoff's sons' wives; another person indicted in the Rothstein Ponzi scheme; the denial of R. Allen Stanford's motion for a new trial; the Dodd-Frank Act extending oversight on nonbank financial institutions; and regulatory agencies' proposals that Dodd-Frank's Volcker Rule have more clarity.

Litigation and Regulatory Investigations

Judge Approves $25 Billion Settlement in Mortgage Servicers Litigation

On April 4, 2012, a U.S. District Court signed off on a groundbreaking $25 billion settlement between the largest mortgage servicers, the federal government and 49 state attorneys general. The settlement was initially announced on February 9, 2012.

The recently disclosed agreements by Ally Financial Inc., Bank of America Corp., Citigroup Inc., JPMorgan Chase Bank NA and Wells Fargo Bank NA, will require the banks to adhere to federally monitored mortgage servicing standards. The banks will also be subject to potential penalties of $1 million for violations of the consent decrees or $5 million for repeat violations. The banks will also be required to enhance their supervision of third-party servicers, such as law firms, which often operate the banks' mortgage-servicing businesses. The agreements provide for at least $20 billion in assistance to homeowners that were subject to allegedly improper mortgage practices. The deal will also entail a cash payment of $5 billion to the federal government and 49 state attorneys general, of which approximately $1.5 billion will go to a separate fund to assist individuals who were foreclosed on between 2008 and 2011.

The banks also reached separate settlement agreements with certain U.S. states in mid-March, including a $25 million settlement with New York's attorney general, a $2.5 million settlement with Delaware's attorney general, as well as settlements by certain banks with the attorney generals of California, Florida and Massachusetts. ("Judge Finalizes Banks' Landmark $25B Mortgage Settlement," *Law360.com*, April 5, 2012).

Florida Jury Finds Wells Fargo Liable for Lehman Investments

A Florida federal jury found against Wells Fargo Bank NA in the amount of $10.4 million as a result of Wachovia Global Securities' breach of contract for its failure to notify its client of a deteriorating Lehman Brothers Holdings Inc. investment. Wachovia, which was bought by Wells Fargo in 2008, was found to have breached its contract by not informing the City of St. Petersburg of Lehman's impending collapse during the middle of 2008. The breach allegedly cost the City approximately $15 million.

The City, which initially filed the suit in March 2010, alleged that Wachovia selected and purchased $15 million in Lehman bonds for the municipality with maturity dates in 2009. The City alleged causes of action for negligence, breach of contract and breach of fiduciary duty in relation to bond investments that were allegedly "riskier than other alternatives." The City later raised questions about its participation in securities lending programs. In response, Wachovia allegedly agreed to not make further loans based on St. Petersburg securities, but advised the City not to sell its collateral investments, including the Lehman bonds, prior to maturity. St. Petersburg alleged that by spring 2008, the investment was too risky based on the City's "conservative investment strategy with respect to securities lending." Wachovia allegedly did not take action to insulate the City, such as informing it of the weakening of the Lehman bonds or advising it of credit ratings downgrades.

Well Fargo has expressed its disappointment with the decision and is considering an appeal. ("City of St. Petersburg Wins $10.4 million Verdict Against Big Bank," *Tampa Bay Times*, April 4, 2012).

Former IndyMac to Be Deposed, Judge Rejects Protective Order

A U.S. magistrate judge has denied a motion to postpone the deposition of the former president and CEO of IndyMac Bancorp Inc.'s homebuilder division. Defendant Scott Van Dellen was one of several former executives sued by the Federal Deposit Insurance Corp. (FDIC) for contributing to IndyMac's collapse by their approval of numerous poor loans.

Van Dellen sought a protective order delaying his deposition until IndyMac's successor, OneWest Bank FSB, produced documents relating the loans that are at issue in the FDIC's lawsuit. The court denied the request, holding that while the loan information would be relevant to the defense at trial, they would not necessarily be required to prepare for his deposition so as to make the deposition "unduly burdensome or prejudicial."

The FDIC's November 2010 complaint, filed in the U.S. District Court for the Central District of California, alleged that the former officers failed to follow sound banking practices during the height of the housing boom by providing loans to borrowers with weak credit history or without sufficient collateral. The FDIC also alleged that the bank's compensation structure rewarded a high volume of loan originations with no regard for underlying borrower quality. It is expected that the bank will incur losses in excess of $500 million for the homebuilder division's loan portfolio. ("Judge Won't Delay IndyMac Exec's Deposition On Bad Loans," *Law360.com*, April 6, 2012).

Fraud and Ponzi Schemes

Picard Seeks Recovery From Madoff Wives

Irving Picard, the trustee in charge of recovering approximately $20 billion from the Madoff Ponzi scheme, may now seek claims against the wives of Bernard Madoff's two sons according to a recent court order. Judge Burton Lifland of the U.S. Bankruptcy Court is allowing Picard to implead Deborah Madoff, wife to (and soon-to-be divorcee of) Andrew Madoff, as well as Stephanie Mack, widowed wife to Mark Madoff, who committed suicide in 2010. Picard is seeking to recover $43 million and $33 million from these women respectively, alleging that they illegally used funds from Bernard L. Madoff Investment Securities LLC for personal use.

Judge Lifland justified his decision to permit Picard to pursue the wives through a procedural rule that allows individuals to be added to a previous complaint for unjust enrichment and constructive trust. Because the current lawsuit already includes Andrew Madoff and the estate of Mark Madoff as defendants, their wives can be impleaded into the action. However, Picard will not be able to seek recovery from them under bankruptcy law claims because such laws require a trustee to include all defendants within the original complaint.

To date, Picard has already recovered about $9.1 billion on behalf of the trust for individuals who fell victim to Madoff's Ponzi scheme, but most of that money is not yet available because of the ongoing litigation proceedings. ("Madoff wives to face trustee claims in Ponzi case," *Reuters*, April 4, 2012).

Ninth Person Indicted in Rothstein Ponzi Scheme

Attorney Steven Lippman was indicted earlier this month for his role in the Rothstein Ponzi scheme occurring within the former law firm of Rothstein, Rosenfeldt and Adler. He is the ninth person charged in connection with this $1.2 billion Ponzi scheme. Lippman faces three charges: conspiracy to violate the Federal Election Campaign Act, bank fraud and tax fraud.

Lippman already pleaded guilty to being involved in the Ponzi scheme where the firm would invest in fake legal settlements. Allegedly, he also personally contributed to Sen. John McCain's presidential election campaign on behalf of the law firm only to be reimbursed by the firm for such actions. Prosecutors linked checks purported to be for a bonus with this reimbursement scheme, where the firm would fraudulently backdate the checks prior to Lippman making the political donations. It is believed that these political gifts helped Scott Rothstein gain political influence by being appointed a delegate during the 2008 Republican National Convention, as well as a member of the Florida Judicial Nominating Committee.

Additionally, Lippman is facing charges for a bank fraud scheme called "check kiting," where he would orchestrate transferring money between various law firm accounts to overstate their balances. Finally, prosecutors are also alleging that Lippman did not accurately report his income and the reimbursements he received from Rothstein, Rosenfeldt and Adler. If Lippman is found guilty, he may be sentenced to a maximum of five years in prison. ("Former Rothstein Associate Indicted in Ponzi Scheme," *CBS Miami*, April 9, 2012).

Judge Denies Stanford's Motion for a New Trial

Allen Stanford, former owner of Stanford International Bank, was convicted in early March on 13 counts in connection with his $7 billion Ponzi scheme, in which the bank sold fraudulent certificates of deposit. The jury also voted in favor of allowing the federal government to attempt to seize about $330 million of Stanford's money from funds frozen in 29 banks throughout the world. Stanford filed a motion for a new trial, but Judge David Hittner of the U.S. District Court for the Southern District of Texas denied the request. Inadequate time to prepare a defense, prejudicial pretrial publicity, and the possibility of some media Twitter messages influencing the jury's decision were some of the reasons mentioned in the request for a new trial. Stanford will likely appeal Judge Hittner's denial to the Court of Appeals.

Each count of fraud can include a prison sentence of up to 20 years. Stanford's sentencing is scheduled for June 14, 2012. ("Financier Allen Stanford loses bid for new trial," *Reuters*, March 23, 2012).

Government and Regulatory Intervention

Dodd-Frank Now Imposing Oversight on Nonbank Financial Institutions

"There will not be any more large, complex, systemically critical firms that have no oversight," according to Federal Reserve Chair Ben Bernanke. The Dodd-Frank Act is beginning to extend its scope of oversight to nonbank financial institutions. Pursuant to its responsibilities designated within this piece of legislation, the Financial Stability Oversight Council, a regulatory agency within the Department of Treasury, voted to supervise financial institutions it deems important, such as hedge funds, private equity firms and insurers. Any company that has a substantial impact on the national economy due to its source of credit or source of risk may be subject to the standards of transparency set forth in the Dodd-Frank Act.

The Council plans to implement a three-part method to determine which corporations should face additional regulatory scrutiny and be subject to stringent standards similar to the ones already placed upon banks that have more than $50 billion in assets. The Council will first assess nonbank financial institutions on an individual basis to determine whether they should be under additional scrutiny. As a general standard, any company that has more than $3.5 billion in derivative liabilities, $20 billion in debt, or has high leverage ratios will proceed to a second round of assessment. While the Council has not elaborated any further, other factors may also be considered.

If the company proceeds onto the second prong of this determination, the Council will then analyze financial data to determine if its level of financial risk should subject the firm to greater supervision. If so, the third stage of the process requires the Council to analyze the institution's financial records. Upon receiving a vote from two-thirds of the Council, any company at this level deemed to be "systematically important" to the nation's economy will then be regulated. All companies who would be subject to stringent regulatory standards do have an opportunity to appeal the Council's final determination. ("Regulators Move Closer to Oversight of Nonbanks," *The New York Times*, April 3, 2012).

Regulatory Agencies Seek Clarity in Dodd-Frank's Volcker Rule

The Volcker Rule is intended to restrict banks from making proprietary trades where a bank uses deposited money to trade on its personal account, because these speculative investments are potentially adverse to customers. This provision of the Dodd-Frank Act is scheduled to be operational by July 2012. Financial regulation agencies, including the Securities and Exchange Commission, the Federal Reserve, the Federal Deposit Insurance Corporation, as well as the Office of the Comptroller of the Currency, have submitted a joint request, re-proposing the institution of the rule, but requesting that it include more clarity.

This request from regulators is due to the proposed Volcker Rule's language granting exceptions that allow banks to engage in proprietary trading that is limited to "market-making activities or hedging risk." This language is being criticized because of its complexity and because it would make implementing the ban difficult for regulators. The Dodd-Frank Act currently sets a deadline to finalize the guidelines for proprietary trading by July 21, 2012. Currently pending within the Senate is a piece of legislation to postpone enacting the Volcker Rule until regulators revise and simplify the proprietary trading ban. ("Regulators Should Propose New Volcker Rule, Paredes Says," *Bloomberg*, April 2, 2012).

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