

## **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 the U.S. Department of Justice (DOJ) intent to bring criminal charges against banks and individuals with regard to mortgage-backed securities; the dismissal of Merrill Lynch from an auction rate securities action; settlement of the New York Mets' Madoff case; the conviction of R. Allen Stanford; the result of the latest Federal Reserve stress tests; and resistance to the current funding proposal for the Office of Financial Research.

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## **Litigation and Regulatory Investigations**

### **Bank of America Challenges MBIA Discovery Tactics**

In a closely watched lawsuit over packaged mortgage loans, Bank of America (BoFA) has accused MBIA Inc. of harassment in connection with its efforts to depose BoFA Chief Executive Officer Brian Moynihan. In seeking a protective order from the New York State Supreme Court, BoFA has characterized MBIA's efforts to depose its CEO as an "unnecessary burden" and disruptive to its business. In 2008, MBIA previously sued BoFA's Countrywide Financial unit over its obligation to guarantee payments to investors that bought securities comprising of loans packaged by Countrywide Financial. MBIA alleged that the pooled products did not match the quality represented by the BoFA division. MBIA has responded, calling the BoFA's request for a protective order "frivolous" and asserting that BoFA's current CEO has knowledge relevant to its claims against the bank. ("[BoFA Accuses MBIA of Harassment in Fight Over CEO Deposition](#)," *Bloomberg*, March 9, 2012)

### **Department of Justice Signals Uptick in Financial Crisis Criminal Actions**

On March 6, 2012, the DOJ announced that it intends to promptly bring criminal cases against both banks and individuals for their roles in selling risky mortgage-backed securities and for committing other crimes that deepened the financial crisis. In a speech to a national association of states' attorney generals, Attorney General Eric Holder stated that the DOJ has recently subpoenaed at least 11 financial institutions related to their issuance of mortgage-backed securities and expects to bring prosecutions in coming months.

Recently, Citigroup acknowledged receipt of a DOJ subpoena by way of regulatory filings. While BoFA also indicated that it had received subpoenas from unidentified regulators and government agencies, it did not mention the DOJ by name.

The DOJ is expected to rely on its Financial Fraud Enforcement Task Force and a newly created subgroup led by state attorneys general from New York, Delaware and Illinois, to investigate and

prosecute such offenses. The larger group includes 55 DOJ attorneys as well as numerous members from other federal agencies. In addition, the DOJ has recently sought a substantial budgetary increase to investigate and prosecute financial crime for the 2013 fiscal year. ([“DOJ Warns of Coming Criminal Cases Over Financial Crisis,” \*Law360.com\*, March 6, 2012.](#))

### **Federal Judge Finds ARS Disclosures Adequate; Dismisses Claims Against Merrill Lynch and Investment Adviser**

Merrill Lynch & Co. has successfully convinced a U.S District Court in New York to dismiss federal securities and California state law claims brought against it by Louisiana Pacific Corp. (LPC) relating to Merrill’s disclosures in connection with its sale of auction rate securities (ARS). The District Court held that Merrill’s disclosure of the risks were adequate, finding that Merrill’s warnings on its website that “auction failures” were possible was sufficient to apprise plaintiffs of the risks associated with the products. The District Court noted that LPC was a sophisticated investor that had more than \$300 million in similar investments and should have been aware of the associated risks.

In connection with this ruling, the District Court also dismissed federal market manipulation fraud and related claims against Money Market 1 Institutional Investment Dealer (MM1), a San Francisco investment adviser that served as LPC’s broker-dealer. The District Court, however, refused to dismiss California state law claims for breach of fiduciary duty against MM1 based on the plaintiff’s allegations that: 1) MM1 breached its duty in recommending unsuitable investments with subprime exposure in light of LPC’s investment criteria; 2) the market for these securities failed as a result of their subprime exposure; and 3) MM1 failed to adequately respond to LPC’s inquiries into the ARS when LPC could still have sold some portion of the securities in a then-functioning ARS market. ([“Merrill’s ARS Disclosures to La. Pacific Were Adequate: Judge,” \*Law360.com\*, February 17, 2012](#))

## Fraud and Ponzi Schemes

### **Game Over – Mets Strike a Deal with Picard for \$162 Million**

After a recent ruling whereby Judge Jed Rakoff of the U.S. District Court for the Southern District of New York determined the ground rules for the trial, Mets owners and Madoff Trustee Irving Picard reached a \$162 million settlement on March 16, 2012. The settlement put to rest the civil lawsuit styled *Picard v. Katz, et al.*, U.S. District Court, Southern District of New York, No. 11-03605. Picard had accused Mets owners Fred Wilpon and Saul Katz of ignoring warning signs of a Ponzi scheme during their investment tenure with Madoff because the investments were so profitable. The owners maintained, however, that they had no knowledge of Madoff's fraud. On March 5, Judge Rakoff ruled that the owners must repay as much as \$83.3 million of fictitious profit from Madoff's firm and at trial the jury was expected to consider whether they should return an additional \$303 million. The settlement agreement included a statement by Picard "that he has reviewed the evidence and will no longer pursue the willful blindness claim against the defendants." Outside the courthouse, Wilpon stated that "...[w]e are not willfully blind, we never was, we acted in good faith...."

The lawsuit has taken a significant financial toll on the Mets requiring them to cut payroll and attempt to raise money through new investors. While the Mets and Picard are currently working out the details of the prospective settlement with former New York Gov. Mario Cuomo, who has been mediating the dispute, as the settlement now stands, the Mets owners are not required to make a payment toward the settlement for three years. Instead, they will forfeit potential recoveries related to their claims of more than \$178 million they have made against the Madoff estate. After three years, the Mets agreed to pay any amount not resolved by the \$178 million in claim recoveries, with Wilpon and Katz personally guaranteeing up to \$29 million of the settlement amount. (["New York Mets owners settle Madoff fraud lawsuit brightening team's grim financial picture," \*The Washington Post\*, March 19, 2012](#)).

### **Stanford Found Guilty on Charges of Fraud and Conspiracy**

On March 6, 2012, three years after R. Allen Stanford was indicted for fraud, a federal jury returned a verdict against Stanford with regard to a \$7 billion Ponzi scheme involving nearly 30,000 investors

worldwide. After a six-week trial, the jury found Stanford guilty on 13 of 14 counts of fraud related to the fraudulent high-interest certificates of deposit issued by Stanford International Bank, which was based on the Caribbean island of Antigua. According to prosecutors, Stanford defrauded his investors for more than two decades by promoting safe investments for money that was actually used to fund his luxurious lifestyle, a Swiss bank account and nonprofitable business deals.

The prosecution's case relied on testimony from James M. Davis, Stanford International Bank's former CFO. Davis testified that Stanford's business was fraudulent and that Stanford had once sent him to London with the sole purpose of sending a fax from a phony insurance company to a prospective client in order to convince the client that his investment would be safe. Davis also testified that Stanford "instilled intimidation and fear" and manipulated him to lie and cheat investors.

The defense, on the other hand, maintained that all was well with Stanford International Bank until the SEC began making accusations against it, which in turn destroyed the value of the business. Furthermore, Stanford's attorneys contended that Stanford himself was uninvolved in the financial details of the business and that those responsibilities were left to Davis, who pleaded guilty of fraud and conspiracy. Stanford's attorneys maintained that Davis often acted without Stanford's knowledge.

Stanford was ultimately convicted of several counts of wire fraud and counts of conspiracy to commit mail fraud, launder money and obstruct justice. While the defense has indicated that it intends to file an appeal, Stanford faces the potential of a life sentence. ("[Stanford Convicted by Jury in \\$7 Billion Ponzi Scheme](#)," *The New York Times*, March 6, 2012).

### **Government and Regulatory Intervention**

#### **Latest Stress Test on Big Banks Yields Mostly Positive Results**

On March 12, 2012, the Federal Reserve announced that 15 of the 19 largest banks in the country had passed stress tests designed to assess how the financial firms would fare under extremely weak economic conditions. This is the third round of stress tests, which came about as a result of the aftermath of the financial crisis. As part of these stress tests, the Federal Reserve looks at whether the

banks have sufficient capital to weather unemployment of up to 13 percent, a 21 percent drop in housing prices and severe market turbulence throughout the world. While many of the banks were determined to have sufficient capital to weather such conditions, a small number of large banks still remain in fragile condition. Under extreme conditions, the Federal Reserve said that Citigroup could lose 9.7 percent of its first mortgage loans, more than any other bank. On the flip side, positive results for JPMorgan Chase cleared the way for increased dividends and a large planned stock buyback of approximately \$15 billion through 2013. (“15 of 19 Big Banks Pass Fed’s Latest Stress Test,” *The New York Times*, March 13, 2012).

## **Banks Oppose Funding New Regulatory Agency**

In a letter dated March 2, 2012, a collection of industry groups representing financial firms sent a letter to the U.S. Treasury Department, urging the Treasury to defray the start-up costs of a new regulatory agency tasked with monitoring Wall Street. Under the Dodd-Frank financial reforms, a new agency, the Office of Financial Research, is scheduled to be financed with fees levied on banks starting this coming July. The Office of Financial Research is tasked with collecting and analyzing bank data in an effort to prevent a repeat of the liquidity problems faced during the financial crisis. In the March 2, 2012 letter, the groups stated that the financial firms should not have to provide the initial start-up costs for the agency. Rather, the industry groups stated that the new agency, which has taken two years to get partially staffed for its work, should get its initial funding from the Federal Reserve: “We believe that a corresponding adjustment should be made to the initial assessment basis to adjust for the delay,” the industry groups said. The letter also voiced complaints similar to those made by lawmakers in the past that the Treasury has been too slow getting the new agency up and running. However, the letter has received criticism from at least one group, the nonprofit Better Markets, which promotes the public interest in connection with the financial markets. Better Markets analyzed the bank’s proposal as a “request for a handout.” (“Wall Street Says New Oversight Agency Is Too Costly,” *The New York Times*, March 7, 2012).

### **Related Practices:**

[Insurance Practices](#)