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 increasing number of reported cases of financial fraud. This issue focuses on President Obama's appointment of the New York Attorney General to lead the Financial Fraud Enforcement Task Force; class certification in a mortgage-backed securities lawsuit against Goldman Sachs; the $26 billion foreclosure abuse settlement; the Madoff trustee's most recent lawsuit filed against Koch Industries; current status of the Madoff trustee's lawsuit against Mets owners Fred Wilpon and Saul Katz; the SEC's whistleblower program; and inquiries into the private equity industry.

Litigation and Regulatory Investigations

Fraud and Ponzi Schemes

Government and Regulatory Intervention

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Big Banks and States Agree to $26 Billion Deal With States Over Foreclosure Abuses

Five of the nation's biggest banks and authorities have reached a $26 billion settlement to provide relief to nearly 2 million current and former American homeowners. After many months of talks and withdrawals from the negotiations by New York and California's attorney generals, the deal is designed to aid homeowners harmed by the bursting of the housing bubble through either the lowering of mortgage debt or favorable refinancing options. An additional 750,000 former homeowners will receive approximately $2,000 each for the banks' alleged foreclosure abuses that occurred from September 2008 through the end of 2011. Federal officials participating in the negotiations were hopeful that the eventual value for homeowners would be in excess of $39 billion.

Banks and mortgage servicers participating in the settlement include JPMorgan Chase, Wells Fargo, Citigroup, Ally Financial and Bank of America, which is expected to make the largest payment. Notably, the deal will not include mortgages owned by the government's housing finance agencies, Fannie Mae and Freddie Mac. This will result in the exclusion of half of the nation's mortgages.

The attorney generals of New York and California signed on to the deal as a result of recent concessions from the banks. The New York Attorney General initially opposed the agreement on the basis that it provided too broad of a release for the banks' past transgressions, which potentially impeded future investigations. Releases are expected to be limited to the foreclosure process, but do not include the packaging of risky mortgages, insurance, tax fraud or any criminal wrongdoing. ("States Negotiate $26 Billion Agreement For Homeowners," *The New York Times*, February 8, 2012).

President Obama Names NYAG to Lead Expanded Financial Fraud Enforcement Task Force

During his January 24 State of the Union Address, President Obama announced the expansion of an existing federal task force to investigate and prosecute financial fraud, naming New York State Attorney General Eric T. Schneiderman as the leader of the new unit. The Financial Fraud

Enforcement Task Force, first created in late 2009, has not produced any major prosecutions following to date the onset of the housing crisis. However, the new unit is expected to focus on financial firms that improperly packaged home loans into securities for sale to investors.

Officials have indicated that the new agency will be more focused than previous interagency programs to address the mortgage crisis. Attorney General Schneiderman stated that state and federal investigations have been ongoing and "[w]e're now making a concerted effort to pull everything together and move forward aggressively to address these issues."

The unit is expected to focus on Wall Street firms, major banks and other entities that have so far avoided scrutiny for their role in the crisis. Given that President Obama's term is up at the end of the year, the task force will have a short amount of time in which to prove its value. ("New Housing Task Force Will Zero in on Wall Street," *The New York Times*, January 25, 2012).

Class Certification Granted in MBS Action Against Goldman Sachs

A 150-plus investor class has been certified by the U.S. District Court in the Southern District of New York in a lawsuit against Goldman Sachs surrounding its marketing of certain mortgage-backed securities. The investors participated in a $696 million March 2006 offering, in which Goldman Sachs allegedly misled plaintiffs into investing in mortgage pass-through certificates using false and misleading offering documents. These documents allegedly overrated the quality of home loans that were bundled into the securities.

The plaintiffs' complaint alleges that a Goldman Sachs subsidiary issued a registration statement and prospectus with various misrepresentations, namely, that the mortgages making up the securities were viewed as high grade. The plaintiffs allege that offering documents failed to disclose that lending guidelines were not followed, appraisals were artificially high, and that the ratings assigned to the securities were inaccurate.

Goldman Sachs opposed class certification on the grounds that the plaintiffs' claims were not common. Specifically, it asserts that the securities were sold through individually negotiated deals

and therefore, the plaintiffs had different information about the underlying loans. The District Court disagreed and held that the common elements of the plaintiffs' claims were based on the same allegedly misleading offering documents. The judge further found that although there is the potential for varying degrees of investor knowledge, he did not believe that such would predominate over common issues to all investors. ("Goldman Investors Win Class Cert. In Action Over Risky MBS," *Law360.com*, February 3, 2012).

Fraud and Ponzi Schemes

Potential Witness May Testify That Wilpon and Katz Knew of Madoff Concerns

Deposition testimony of Noreen Harrington, a potential witness for Madoff trustee Irving Picard in the lawsuit he has brought against the New York Mets owners, indicates that Mets owner Saul Katz may have known about several concerns surrounding investments with Bernard L. Madoff. Contained in a court pleading filed February 9, 2012, Harrington's deposition testimony indicates that she informed Katz that Madoff's investment performance may be pure "fiction." In the lawsuit, Mets owners Katz and Fred Wilpon are accused of ignoring the signs of Madoff's dubious investment performance and improperly benefiting from their investments with Madoff. Harrington appears to be a respected financial executive with more than 20 years experience working in hedge funds with a resume that includes positions within Goldman Sachs, Barclays Capital and the investment firm M.D. Sass.

Harrington was hired in 2002 to work for Sterling Stamos, a hedge fund founded by Wilpon, Katz and Peter Stamos. In 2003, Harrington met with J. Ezra Merkin, a hedge fund manager that steered much of his clients' money into Madoff accounts. Harrington testified that her efforts to inquire into Madoff's investment practices were met with scorn and that she was told by Merkin, "[y]ou don't get it, do you? . . . This is a privilege. You don't get to ask questions." Harrington further testified that she informed Katz of the meeting and accused Madoff of either "front-running" – a form of illegal insider trading – or that Madoff's investment practices were "fiction." After receiving an angry response from Katz, Harrington testified that she admitted that she had no proof that Madoff was a fraud and asked for the opportunity to meet with Madoff. However, that request was ignored. As

time went on, Harrington's faith in Madoff's investment practices was dwindling, and she testified that she told Katz and several other Sterling Stamos individuals that she did not "believe the numbers are worth the paper they're written on." Harrington testified that she resigned from Sterling Stamos after learning that her superiors were going to invest with Madoff despite her warnings, stating "[i]f you're going to make this investment, I'm gone."

When asked under oath, Katz testified that he had no memory of meeting with Harrington or of her warnings against Madoff. Trial for this matter is currently set for March 19, 2012. ("A Court Filing Says a Mets Owner Knew of Madoff Concerns," *The New York Times,* February 10, 2012).

Picard Targets Koch Industries in Latest Lawsuit

In a lawsuit filed in the U.S. Bankruptcy Court for the Southern District of New York against Koch Industries, Inc., Madoff trustee Irving Picard is seeking $21.5 million, representing a return of the profits Koch Industries earned through Madoff's Ponzi scheme. Specifically, the trustee alleges that a subsidiary of Koch Industries funneled a substantial amount of its clients' funds into Bernard L. Madoff Investment Securities and when that subsidiary later dissolved, the investment returns were then funneled to Koch Industries. Notably, and dissimilar to several of his other lawsuits, Picard does not allege that Koch Industries engaged in any wrongdoing. Nevertheless, he seeks the return of these funds on the grounds that they are fraudulent proceeds of a Ponzi scheme rather than legitimate investment returns. When asked for comment, Koch Industries spokeswoman said the lawsuit was meritless and stated that "[t]he Koch entity involved made an investment in an entirely separate fund. That Koch entity no longer exists and its investment was redeemed in 2005, long before anyone knew of Madoff's fraud." ("Madoff Trustee Sues Koch Industries to Claw Back Ponzi Proceeds," *The Wall Street Journal*, February 10, 2012).

Picard Seeks $386 Million From Mets Alleging Willful Blindness

Last year, U.S. District Judge Jed Rakoff dismissed the majority of Madoff trustee Irving Picard's $1 billion in claims against Saul Katz and Fred Wilpon, leaving Picard to seek roughly only $386 million. Judge Rakoff noted, however, that in order to receive more than $83 million of that amount,

Picard would need to make a showing of willful blindness on the part of Wilpon and Katz. In a February 9, 2012 filing, Picard alleged that Wilpon and Katz had motive to ignore indications of impropriety with Madoff's investments, namely that they were so "hooked" on the money they received from Madoff's investment scheme that they used it in place of disability insurance and to fund their deferred compensation plans. Picard alleged that "[t]he Mets relied on Madoff's returns as a predictable source of income for a business -- professional baseball -- with an otherwise unpredictable revenue stream." ("Madoff Trustee Seeks to Pursue $386 Million Mets Owners Suit," *The San Francisco Chronicle*, February 13, 2012).

Government and Regulatory Intervention

SEC Examining Private Equity Industry

According to reports, the Securities and Exchange Commission's (SEC) enforcement unit sent letters to several private equity firms seeking certain information as part of an "informal inquiry" into the industry. It appears the SEC is attempting to gather information from various private equity firms in an attempt to better understand how the firms value their investments and report performance to investors. Sources familiar with the inquiry say that the SEC is concerned that certain firms may exaggerate their portfolio valuations in order to attract future investors.

Several private equity firms are already under the purview of the SEC because they have gone public and are obliged to supply detailed financial information like other public companies. However, for those who are not, most private equity firms must register with the SEC by the end of March as part of the new Dodd-Frank financial reform act.

Speaking at a private equity conference in January, Robert B. Kaplan, co-chief of the SEC enforcement division's asset management unit, said that the private equity industry needed more scrutiny. Kaplan emphasized the current lack of oversight. According to reports, the SEC would like to focus on how the industry conducts portfolio evaluation. Private equity funds use complex methodologies to value their holdings and because there are no easily obtainable market prices for

many private companies, subjective judgment plays a large role in valuing a holding. ("Private Equity Industry Attracts S.E.C. Scrutiny," *The New York Times*, February 12, 2012).

Financial Incentives for Whistleblowing Drive Tips

The Dodd-Frank financial reform act put in place a whistleblower program at the SEC. Currently the False Claims Act is often used with regards to investigations in connection with whistleblowers, but the new SEC program will expand oversight. "The False Claims Act is a wildly successful program, and the SEC whistleblower program has the potential to surpass its success," said expert Jordan Thomas. "The False Claims Act is relatively narrow, whereas the breadth of securities violations is even greater."

According to the SEC whistleblower office's first annual report, in the seven weeks after the law went into effect in August 2011, the SEC received 334 whistleblower tips. The tips covered subject matter involving market manipulation, corporate disclosures, and offering fraud. Whistleblowers have huge financial incentives to report tips to the SEC. Should the SEC recover more than $1 million from a company after using a tip that provides unique information, the whistleblower can recover 10 percent to 30 percent of the government recovery. However, some groups, such as corporations and the Chamber of Commerce, are pushing back against the SEC's new whistleblower program. One complaint is that the rules of the program do not require the whistleblower to first report concerns or infractions internally to give a company a chance to address the issue first. In response, Republicans in the House are in the process of drafting the Whistleblower Improvement Act, which, if passed, would require whistleblowers to report concerns internally before contacting the SEC. ("More Financial Whistleblowing Is On the Way," *Business Week*, February 16, 2012).

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