Westlaw Journal

# BANK & LENDER LIABILITY

Litigation News and Analysis • Legislation • Regulation • Expert Commentary

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## WHAT'S INSIDE



MORTGAGE-BACKED SECURITIES

## Trustee sues Deutsche Bank over $113 million MBS losses

HSBC, the acting trustee for a $323 million mortgage-backed securities offering, is suing a Deutsche Bank subsidiary for allegedly failing to buy back defective loans the bank sold bundled together as securities.

***ACE Securities Corp. v. DB Structured Products Inc., No. 651936/2013, complaint filed (N.Y. Sup. Ct., N.Y. County May 30, 2013).***

HSBC, which serves as securitization trustee for the offering, filed the complaint in the New York County Supreme Court, alleging the Deutsche Bank subsidiary, DB Structured Products, sold the loans knowing they were overvalued and would cause investor losses.

The suit says the original $323 million principal amount of the offering ended up losing some $113 million because of the defendant's failure to make sure the loans were not in default or foreclosure.

A mortgage-backed security is a financial instrument backed by pools of mortgage loans whose principal and interest payments are distributed to investors with varying maturity dates, cash flows and default risks.

As trustee, HSBC has the right under the agreements between DB Structured Products and ACE Securities Corp. to sue on behalf of investors in the securities to enforce DB Structured Products' alleged promises about the underlying mortgage loans.


REUTERS/Mike Segar

***HSBC, which serves as securitization trustee for a $323 million mortgage-backed securities offering, alleges Deutsche Bank subsidiary DB Structured Products sold about 3,000 "defective" mortgage loans while knowing they would cause investor losses.***

The suit says DB sold about 3,000 mortgage loans to ACE Securities to be pooled and

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COMMENTARY

## Risks and rewards of commercial and industrial lending for community banks

James Walter and Corey Ross, the founders of loan automation technology provider BBC Easy, discuss how community banks can take advantage of the increasing popularity of commercial and industrial loans.

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# Risks and rewards of commercial and industrial lending for community banks

**By James Walter and Corey Ross**
***BBC Easy***

In their earnings reports for the first quarter, many of the biggest banks, such as Citigroup and U.S. Bancorp, reported marked growth in earnings, buoyed by significant increases in commercial and industrial loan portfolios. This parallels what the Federal Reserve observed in its January 2013 survey of senior loan officers: "[L]ending standards on commercial and industrial loans had been eased over the past three months. ... In addition, moderate net fractions of domestic banks reported that demand for C&I loans from firms had increased over the survey period."[1]

SNL Financial also reported "from 2010 to 2011, C&I loans rose to 17 percent from 15 percent of total loans."[2]

This slight loosening of lending standards and the increase in C&I lending is a welcome change for both lenders and businesses, given current low net-interest margins and the pressure to reduce mortgage lending exposure.

So, why are banks across the board increasing C&I loans now? The increase in C&I lending can be attributed to banks' response to the risk involved with commercial real estate portfolios during the financial crisis. Overleveraged CRE portfolios in the last few years resulted in bank failures. C&I loans, on the other hand, have become increasingly popular because they offer relatively higher margins while reducing concentration risk.


Banks also came under significant pressure to increase lending during the credit crunch, during which formally qualified applicants were increasingly turned down. The pressure from above and the slightly improved economic conditions on the ground are now converging to make a marked difference in the commercial lending space.

Since mortgage rates were and have remained at record lows throughout the recession and into the recovery, the needs of bankers and community businesses became further aligned. Mortgage loans made at low, fixed rates over a 15- or 30-year period are considerably less attractive than a commercial loan tied to the variable prime rate over a significantly shorter time period. Commercial loans, especially alternative types like asset-based loans, provide a buffer against razor-thin net interest margins on consumer and real estate loans.

> The increase in C&I lending can be attributed to banks' response to the risk involved with commercial real estate portfolios during the financial crisis.

The picture on the demand side of things is less clear. In the face of an uncertain economic environment, many small businesses are maintaining a wait-and-see position with regard to expansion. The National Federation of Independent Business revealed in its April small business optimism report that loan demand by surveyed small businesses had decreased, while the credit markets remained weak, with only 29 percent of those surveyed saying "all capital needs were met."[3]

It is likely that decreased demand for loans is directly linked to increased pessimism with regard to future market conditions. Therefore, bankers hoping to issue more commercial loans in order to adjust portfolio risk across the board have to compete with a smaller pool of eligible businesses.

Yet, for their benefits, C&I loans have their risks. Because of their complexity, C&I loans require the greatest commitment from bank management to monitor and control risks. Few community banks and credit unions have risk management policies in place, which could result in relaxed loan covenants, overly thin loan spreads, or excessive concessions to attract new and retain existing clients. Additionally, banks have generally higher loss rates on C&I loans than on secured

**James Walter** (R) is CEO and **Corey Ross** (L) is vice president of sales at **BBC Easy** in Seattle. They founded the loan automation technology provider to help financial institutions and borrowers reduce costs and increase efficiency by streamlining the expensive and highly inefficient Borrowing Base Certificate process. They can be reached at info@bbceasy.com.

commercial real estate loans, so a portfolio shift has the potential to increase, rather than decrease, banks' expected losses.

To increase C&I lending substantially, banks must have the operational capacity and the technology to efficiently facilitate loan review and approval. Frequently, the lending and credit departments within financial institutions have varying objectives. Community banks have an advantage as far as forming long-lasting relationships with business owners in their areas, but if there are no clear directives and procedures across the involved departments, stagnation may result.

Bank management should facilitate communication between the lending and credit departments, which can be furthered by simply having the same information available across its network, reducing the possibility for human error and miscommunication. Efficiency gains achieved by implementing such programs can help the entire organization expand processing capacity. Automating the commercial lending process will also help in customer retention by reducing the business owner's time to input financial, inventory and tax information.

While there are positive signs of a strengthening real estate market in many regions of the United States, mortgage rates remain at historic lows, leading both community and large banks to look at ways to shift capital to higher-yielding assets. Commercial lending has received a boost because of these shifting priorities, but community and regional banks in particular need to streamline processes, implement customer-facing technology to improve retention and provide clear directives in order to benefit from the shifting tide in the capital markets. WJ

> Since mortgage rates were and have remained at record lows throughout the recession and into the recovery, the needs of bankers and community businesses became further aligned.

## NOTES

[1] Bd. of Governors of the Fed. Reserve Sys., "The January 2013 Senior Loan Officer Opinion Survey on Bank Lending Practices" (Feb. 4, 2013), *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/201302/fullreport.pdf.

[2] Sageworks, "Changes in bank portfolios and worried examiners" (Feb. 4, 2013), *available at* http://www.sageworks.com/blog/post/2013/02/04/Changes-in-bank-portfolios-worried-examiners.aspx.

[3] Nat'l Fed'n of Indep. Bus., "April Report: Small Business Optimism Down in March," *available at* http://www.nfib.com/research-foundation/research-foundation-article?cmsid=62528.

## Deutsche Bank

**CONTINUED FROM PAGE 1**

securitized in 2007. The loans were placed in a trust and packaged into mortgage-backed securities to be sold to investors.

The parties entered into a pooling and servicing agreement and a mortgage loan purchase agreement to govern the transfer of the loans from DB to ACE, according to the complaint.

The documents allegedly said the underlying mortgage loans met certain requirements, such as credit quality and marketability, that made them smart investments that would retain their value.

The complaint says that out of 1,254 mortgage loans inspected, at least 95, or 8 percent, were delinquent or in bankruptcy or foreclosure when the securities were issued.

> Out of 1,254 mortgage loans inspected, at least 8 percent were delinquent or in bankruptcy or foreclosure when the securities were issued, the complaint says.

According to the pooling and servicing agreement, the defendant allegedly agreed to cure any breach of its promises or repurchase any defective mortgage loans, HSBC says.

Upon learning the loans were defective, HSBC informed DB in May that the loans were losing money and requested that DB cure its breaches.

The suit says DB has not repurchased the defective mortgage loans or cured the breaches in the agreements.

HSBC is asking the court for specific performance of the agreements so that DB is forced to buy back the loans in default or foreclosure or, in the alternative, to pay HSBC $113 million. WJ

**Attorneys:**
*Plaintiff:* Michael S. Shuster, Brendon DeMay and Eileen DeLucia, Holwell Shuster & Goldberg, New York

**Related Court Document:**
Complaint: 2013 WL 2367236

***See Document Section A (P. 15) for the complaint.***

# AIG drops a suit vs. N.Y. Fed related to bailout

(Reuters) – American International Group Inc. has agreed to end litigation against the Federal Reserve Bank of New York over whether the insurer retained the right after its 2008 taxpayer-funded bailout to sue over losses on residential mortgage-backed securities.

***American International Group Inc. et al. v. Maiden Lane II LLC, No. 13-cv-00951, stipulation of dismissal filed (S.D.N.Y. May 28, 2013).***

In a May 28 order made public May 30 in U.S. District Court in Manhattan, AIG and Maiden Lane II, an entity created by the New York Fed in December 2008 to buy troubled mortgage debt from the insurer, agreed to dismiss their case without prejudice.

At issue was whether AIG, as part of its since-repaid $182.3 billion federal bailout, had transferred $18 billion of litigation claims to Maiden Lane, preventing the New York-based insurer from recouping losses from banks.

The dismissal follows a May 6 decision by U.S. District Judge Mariana Pfaelzer in Los Angeles that AIG did not assign $7.3 billion of those claims, which are part of a fraud lawsuit by the insurer against Bank of America Corp and its Countrywide unit. *In re Countrywide Fin. Corp. Mortgage-Backed Sec. Litig.*, No. 2:11–ML–02265; *AIG Inc. et al. v. Bank of Am. Corp et al.*, No. 11-cv-10549, 2013 WL 1881567 (C.D. Cal. May 6, 2013).

"In light of the recent ruling that AIG did not assign its fraud claims to ML II, we have agreed to dismiss our declaratory judgment action, without prejudice to our right to reinstitute it if necessary," AIG spokesman James Ankner said, referring to the New York case.

Jack Gutt, a spokesman for the New York Fed, declined to comment.

The case before Judge Pfaelzer is part of a $10 billion lawsuit in which AIG accused Bank of America, Countrywide and the bank's Merrill Lynch unit of misrepresenting the quality of more than $28 billion of residential mortgage-backed securities it bought.

Lawrence Grayson, a spokesman for Bank of America, on May 30 said the Charlotte, N.C.-based bank retains the right under Judge Pfaelzer's ruling to obtain more evidence to suggest that AIG assigned its litigation claims to Maiden Lane.

AIG won a federal appeals court ruling in April to move the entire case against Bank of America to the New York state court where it began. The bank has since taken steps to keep the case in federal court. *AIG Inc. et al. v. Bank of Am. Corp. et al.*, No. 12-1640, 712 F.3d 775 (2d Cir. Apr. 19, 2013).

U.S. District Judge Lewis Kaplan, who signed the May 28 order, had put the case before him on hold in February, saying it was best to let the California case take its course.

At issue was whether AIG, as part of its since-repaid $182.3 billion federal bailout, had transferred $18 billion of litigation claims to Maiden Lane, preventing the New York-based insurer from recouping losses from banks.


REUTERS/Brendan McDermid

He also admonished the New York Fed, saying that "on the face of it" some of its actions "perhaps are unattractive and, indeed, wrongful."

AIG separately opposes an $8.5 billion settlement between Bank of America and Countrywide investors over other mortgage debt. A hearing on that accord before Justice Barbara Kapnick of the New York State Supreme Court began June 3. WJ

*(Reporting by Bernard Vaughan and Tom Polansek; additional reporting by David Sheppard and Joshua Schneyer; editing by Leslie Gevirtz)*

**Related Court Document:**
Stipulation of dismissal: 2013 WL 2408215

# Mortgage lender says former employee stole clients

A New York-based mortgage lender alleges in a lawsuit that a former employee breached a noncompetition agreement by setting up a rival loan origination firm and diverting away business from his former employer.

***Greystone Funding Corp. v. Kutner et al., No. 651926/2013, complaint filed (N.Y. Sup. Ct., N.Y. County May 30, 2013).***

Manhattan-based Greystone Funding Corp., which specializes in multifamily property loans, says Ephraim Kutner is barred by contract from competing against it in the lending business until April 15, 2015.

Greystone says Kutner, with the help of his brother Jonathan has stolen clients, employees and trade secrets for the benefit of Harborview Capital Partners LLC — the mortgage banking firm he started.

Jonathan and Harborview are co-defendants in the suit.

The plaintiff lender is asking the New York County Supreme Court to order the defendants to stop all conduct that is in violation of their duties to Greystone and to pay unspecified damages.

> Greystone Funding Corp. says former employee Ephraim Kutner stole its clients, employees and trade secrets.

In the, complaint, Greystone says it employed Ephraim as a loan originator at its office in Lawrence, N.Y., where he supervised a group of employees, including Jonathan.

Ephraim signed an agreement stating he would not compete with the company in the lending business while working there or for two years after his employment ended, the suit says.

The plaintiff says that in the agreement, Ephraim also promised to maintain the confidentiality of Greystone's trade secrets and proprietary business information.


Greystone says both brothers left their positions April 15.

Under his contract, Ephraim cannot engage in a competing business until 2015, when his two-year post-employment period ends, Greystone says.

Despite this agreement, Ephraim and Jonathan set up Harborview, which has an office in Lawrence, at some point in April, the complaint says.

The suit also claims that before leaving Greystone, Ephraim began asking some of the company's employees to work with him at his own lending firm. The plaintiff says three of its employees resigned their positions April 17 and began working for Harborview.

The suit alleges that since leaving his employment, Ephraim has breached the contract by engaging in direct competition with Greystone by pursuing lending business for Harborview. He also has contacted Greystone's clients to cancel business meetings without its knowledge, the complaint says.

Ephraim also wrapped up lending deals he previously had pursued for Greystone, the plaintiff claims.

The suit also claims that Jonathan and Harborview tortiously interfered with the contract between Greystone and Ephraim because Jonathan knew of the non-competition contract but helped Ephraim breach the agreement for the financial benefit of himself and Harborview, the suit says.

In addition to an order preventing the defendants from competing in the lending business, the plaintiff has asked the court to impose a constructive trust on any profits the defendants received from the deals they diverted away from Greystone. WJ

**Attorney:**
*Plaintiff:* Jonathan L. Israel, Foley & Lardner, New York

**Related Court Document:**
Complaint: 2013 WL 2356262

***See Document Section B (P. 18) for the complaint.***

# Mortgage services firm rushed to ink $2.9 billion merger, suit says

A Lender Processing Services investor claims the mortgage services giant's directors disloyally accepted a fire-sale-priced $2.9 billion merger before LPS' stock price could recover from disclosures about its role in the improper robo-signing of foreclosure documents.

***Orlando Police Pension Fund v. Kennedy et al., No. 2013-005607, complaint filed (Fla. Cir. Ct., Duval County May 31, 2013).***

A municipal pension fund filed suit in Florida's Duval County Circuit Court, alleging that by hurriedly accepting Fidelity National Financial Inc.'s $33.25-per-share offer, the LPS directors breached their fiduciary duty to get the best price for the nation's largest mortgage processing and services provider.

LPS and FNF (which is America's largest title insurance services provider and is located next door to LPS in Jacksonville) were once one company, and FNF continues to hold a major interest in LPS, according to the lawsuit filed by the Orlando Police Pension Fund, which seeks to block the deal.

> The suit says investors would get a "modest" 10.7 percent over the price of their stock on the day before the deal was made public.

The suit claims that LPS CEO Lee A. Kennedy and numerous other directors and officers have conflicts of interest because they are or were officers or directors of FNF or the companies' former parent, Fidelity National Information Services Inc.

The two companies announced the merger May 28, claiming the price offered LPS shareholders a generous premium for their stock, but the suit says investors would get a "modest" 10.7 percent over the price of their stock on the day before the deal was made public.

The merger announcement followed a $127 million settlement of charges that LPS routinely used improper foreclosure procedures in which mortgage foreclosure papers were "robo-signed" by unauthorized bank employees who did not give them the required review.

The pension fund claims that if the LPS directors cared about their duty to maximize the stock price for shareholders, they would have rejected FNF's opportunistic offer and waited for the LPS stock price to rise in reaction to increasing profits and diminishing foreclosure scandal publicity.

Instead, the directors agreed to the FNF deal while LPS share prices were still weak after it agreed to the latest in a series of settlements over its purportedly improper foreclosure practices, the complaint alleges.

The foreclosure practices, which were widespread during the meltdown of the banking and financial services industry over subprime mortgage lending, made LPS the target of fraud suits by 47 state attorneys general and numerous shareholder securities fraud suits, the pension fund says.

LPS has settled most of those actions and is expected to report rapid revenue growth in the near future as the pace of foreclosures (which are part of the company's mortgage servicing business) continues to be brisk, according to the complaint.

Nevertheless, the LPS directors rushed into the deal with FNF without checking the market to properly determine what the company was worth and then disloyally agreed to deal-protection measures that would deter competing bids, the suit says.

Chief among those preclusive provisions are a short, restricted "go-shop" period to talk to other prospective suitors and a $74 million termination fee that any successful competing bidder would have to pay FNF as the new owner of LPS, the complaint says.

The pension fund asks the court to enjoin the merger and order the defendant directors to shop for a better price. It further seeks to hold the defendants personally liable for any damage to the company's value caused by the proposed deal.

No one at LPS immediately responded to a request for comment on the suit. WJ

**Attorneys:**
*Plaintiffs:* Jonathan M. Stein and Joseph E. White, Saxena White PA, Boca Raton, Fla.

**Related Court Document:**
Complaint: 2013 WL 2391697

# Bondholders look to refile complaint in Libor antitrust case

Following the dismissal of their antitrust claims against the world's biggest banks for allegedly manipulating Libor, bondholders have asked a federal judge for permission to refile their complaint.

***In re Libor-Based Financial Instruments Antitrust Litigation; Gelboim et al. v. Credit Suisse Group et al., No. 2011 MD 02262, plaintiffs' memorandum in support of motion for leave to amend filed (S.D.N.Y. May 17, 2013).***

The motion for leave to file an amended complaint, filed May 17 in the U.S. District Court for the Southern District of New York, argues that the defendant banks' alleged manipulation and suppression of Libor harmed competition and violated federal antitrust laws.

Libor, the London Interbank Offered Rate, is the published rate that international banks would charge each other for short-term loans.

The bondholder plaintiffs filed their original complaint in the District Court on Feb. 8, 2012, claiming that the defendant banks' alleged manipulation of Libor reduced the value of debt securities they owned.

According to the plaintiffs, the interest rates of the debt securities they owned were calculated using Libor.

Defendants named in the original complaint are Credit Suisse Group AG, Bank of America Corp., JPMorgan Chase & Co., HSBC Holdings, Barclays Bank, Lloyds Banking Group, WestLB AG, UBS AG, Royal Bank of Scotland, Deutsche Bank, Citibank, Rabobank Group, Norinchukin Bank, Bank of Tokyo-Mitsubishi UFJ, Societe Generale and Royal Bank of Canada.

The complaint alleged that the defendant banks' manipulation of Libor violated the Sherman Act, 15 U.S.C. § 1.

Relying on news reports about pending investigations by the U.S. Securities and Exchange Commission, U.S. Justice Department, British regulatory authorities and the Japanese Financial Supervisory Agency, the plaintiffs alleged the defendant banks conspired to suppress and manipulate Libor to their benefit and to the detriment of the plaintiffs.

> Injury as a result of misrepresentation can also be an injury from anti-competitive conduct, the plaintiffs argue.

The complaint alleged that the defendants' suppression of Libor caused the plaintiffs to receive a lower payout on their debt securities because the overall interest rate payment was lower due to a lower Libor.

U.S. District Judge Naomi Reice Buchwald dismissed all antitrust claims against the defendant banks March 29, saying the plaintiffs failed to allege they suffered an antitrust injury through reduced competition. *In re Libor-Based Fin. Instruments Antitrust Litig.,* No. 2011 MD 02262, 2013 WL 1285338 (S.D.N.Y. Mar. 29, 2013).

The plaintiffs' injury did not require a conspiracy between the banks and could have occurred if the banks individually decided to report a false interbank lending rate, she said. The plaintiffs' alleged harm came from the defendant banks' misrepresentation, not reduced competition, Judge Buchwald concluded.

She admitted that her ruling might be "unexpected," given that the defendant banks had been fined and entered into settlements totaling billions of dollars with various government agencies.

Judge Buchwald on May 3 allowed the plaintiffs to file a motion for leave to file an amended complaint. *In re Libor-Based Fin. Instruments Antitrust Litig.,* No. 2011 MD 02262, 2013 WL 1947367 (S.D.N.Y. May 3, 2013).

In their motion, the bondholder plaintiffs argue they did in fact suffer an antitrust injury.

They say the Libor setting process was previously competitive and became anti-competitive when the banks agreed to conspire and fix the Libor.

Injury as a result of misrepresentation can also be an injury from anti-competitive conduct, the plaintiffs say.

According to the motion, the defendants conspired to create a lower Libor that otherwise would have been higher and would have resulted in higher interest rate payments on the plaintiffs' bonds. WJ

**Related Court Document:**
Motion for leave to file amended complaint: 2013 WL 2155656

***See Document Section C (P. 25) for the motion.***

# Florida federal judge uses lower liability standard for failed bank's officers

Most of the directors of a failed Florida bank only face charges of gross negligence but the board member who also served as CEO is liable in that capacity for ordinary negligence as well, a federal judge in Panama City has ruled.

***Federal Deposit Insurance Corp. v. Brudnicki et al., No. 12-398, 2013 WL 2145720 (N.D. Fla. May 15, 2013).***

In his May 15 ruling on motions to dismiss by former directors of the Peoples First Community Bank, U.S. District Judge Richard Smoak of the Northern District of Florida let government regulators pursue only those state and federal law charges that involve the more serious offense of gross negligence.

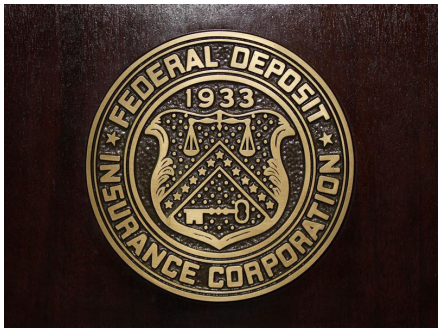
He denied the directors' motion to dismiss those charges but tossed out ordinary-negligence claims against most board members because Florida law insulates directors from such lower-level allegations based on their business decisions.

However, because defendant Raymond Powell also served as the president and CEO of Peoples First, state law does not shelter him against ordinary-negligence charges he faces in that capacity.

Judge Smoak said the Florida Legislature intended that directors be held liable for only "willful misconduct or conscious disregard for the best interests of the corporation," but officers can be liable for "something less than conscious disregard."

The charges are part of a 2012 lawsuit brought against eight ex-directors by the Federal Deposit Insurance Corp., which took over as Peoples First's receiver when the bank failed in December 2009.

The FDIC is trying to recover more than $40 million in damages from the defendants for their alleged malfeasance in approving 11 high-risk commercial real estate loans that purportedly violated bank policy.




REUTERS/Jason Reed

The directors moved for dismissal on various grounds.

They claimed that some of the charges alleged ordinary negligence disguised as gross negligence and therefore must be dismissed because directors' actions are protected by the business judgment rule. The rule immunizes directors and officers from liability in corporate transactions if they acted in good faith and with reasonable care.

However, Judge Smoak said the claims the defendants wanted thrown out are not protected by the business judgment rule because they involved high-risk, subprime loans that the directors had already been warned about and which violated the bank's own loan policy.

The directors argued that some of the charges based on Florida law allege only ordinary negligence and should be dismissed, but Judge Smoak said the complaint backs up those charges with examples of actions that indicate gross negligence, so those claims should not be dismissed.

> Defendant Raymond Powell also served as the president and CEO of the defunct lender, so Florida law does not shelter him against ordinary negligence charges, the judge said.

The judge also rejected the directors' argument that the FDIC didn't show that their actions directly damaged the bank.

He said the complaint alleges "that due to the deficient underwriting allowed by the defendants ... Peoples was fatally exposed to the inevitable cyclical decline in real estate values" that led to the bank's failure.

However, the judge said the complaint should be amended to include "a more definite statement ... as to causation." WJ

**Attorneys:**
*Plaintiff:* Andrew S. Kwan, Beasley Hauser Kramer & Galard, West Palm Beach, Fla.

*Defendants:* Charles A. Wachter, Holland & Knight, Tampa, Fla.

**Related Court Document:**
Order: 2013 WL 2145720

WESTLAW JOURNAL

**BANKRUPTCY**

This reporter offers comprehensive coverage of significant issues in both business and consumer bankruptcy proceedings. The editors track dockets, summarizing recent developments and their implications for the debtor, its creditors, officers and directors, employees, and other parties. This reporter covers a wide range of topics regarding business and consumer bankruptcies and includes analysis of the most noteworthy case law and legislation. Important litigation documents are also included.



PONZI SCHEME

# Wisconsin bank sued over Ponzi scheme profits

A Wisconsin bank is the target of a federal court lawsuit seeking to recover profits the bank made on alleged fraudulent transfers tied to an $80 million Ponzi scheme.

***Finn et al. v. Security Financial Bank, No. 13-cv-381, complaint filed (W.D. Wis. May 29, 2013).***

According to the complaint filed in the U.S. District Court for the Western District of Wisconsin, Security Financial Bank was one of many financial institutions that entered into loan participations with First United Funding LLC, a bank being used by Corey Johnston to operate a Ponzi scheme.

Johnston started the scheme in 2002 to support a lavish lifestyle by orchestrating loan participations that did not exist and ones he oversold between First United Funding and several other banks, the complaint says.

A loan participation is a loan made by multiple lenders to a single borrower.

> First United Funding Bank performed 17,000 cash transactions involving more than $2 billion with no system to track the transactions, the suit alleges.

Johnston used the proceeds from the loan participations to pay earlier participants, according to the complaint. He also allegedly used $29 million of the funds on himself and his family between 2002 and 2009.

The U.S. attorney's office charged Johnston in August 2010 with bank fraud resulting from his alleged Ponzi scheme through First United Funding.

The victims of the scheme have claims totaling more than $90 million, according to the complaint.

First United Funding allegedly engaged in over 17,000 cash transactions involving over $2 billion with no system to track the transactions, the suit says.


Johnston's scheme left First United Funding insolvent when it was discovered with 41 loans outstanding, the suit alleges. In addition Johnston allegedly manipulated bank statements, forged signatures and altered other financial documents in furtherance of the fraud.

Patrick Finn and Lighthouse Management Group Inc. were appointed receiver for First United Funding in October 2009 to "investigate and pursue any and all claims that First United or the receiver may have against any third party, including, but not limited to, fraudulent transfer and illegal distribution claims."

The plaintiffs discovered that defendant Security Financial Bank purchased interest in a loan participation from Alliance Bank, the complaint says. Security Financial allegedly received $4.4 million from Alliance and realized profits of $706,000.

Any profits obtained from the scheme are fraudulent transfers and thus are redeemable by the receiver, the suit says.

A similar action was filed in Minnesota's Dakota County District Court, seeking to ensure the receiver's claims are preserved in both state and federal court. WJ

**Attorney:**
*Plaintiff:* Emily M. Feinstein, Quarles & Brady, Madison, Wis.

**Related Court Document:**
Complaint: 2013 WL 2444281

***See Document Section D (P. 38) for the complaint.***

# S&P credit ratings not 'mere puffery,' DOJ says in support of fraud suit

Standard & Poor's credit ratings were materially false statements meant to induce investors to buy overvalued financial instruments, the Department of Justice says in response to the company's attempt to dismiss the government's fraud suit against it.

***United States v. McGraw-Hill Cos. et al., No. 13-cv-00779, opposition brief filed (C.D. Cal. May 20, 2013).***

S&P said in its motion to dismiss that its representations were vague and generalized and therefore not actionable as fraud.

The Department of Justice disagrees and argues that S&P's statements are actionable as fraud because investors relied on the rating agency's representations when making investment decisions.

"It would no doubt come as some surprise to many ... that S&P's repeated assurances that its ratings were objective, independent and uninfluenced by any conflict of interest were 'mere puffery,'" the Justice Department says it its opposition brief.

The government's complaint, filed Feb. 4 in the U.S. District Court for the Central District of California, seeks $5 billion in damages under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73.

FIRREA permits the government to recover large civil penalties for fraud perpetrated upon federally insured financial institutions.

The claims in this case arise from S&P's credit ratings of mortgage-backed securities and collateralized debt obligations purchased by federally insured financial institutions, such as Citibank.

A mortgage backed security is backed by pools of mortgage loans whose principal and interest payments are distributed to investors with varying maturity dates, cash flows and default risks.

Collateralized debt obligations are securities backed by pools of other debt securities, sometimes MBS, credit derivatives and other structured debt securities.

S&P analyzes securities from issuers and rates them according to risk for investors.

According to the complaint, S&P worked with issuers to determine if its rating system would cause S&P to lose profits and market share. It worried, the complaint says, that if it rated securities lower than investment-grade, issuers would move their business to competing ratings services Moody's or Fitch.

As a result, S&P's ratings were artificially inflated to the benefit of issuers and to the detriment of investors, the complaint asserts.

S&P argued in its motion to dismiss that the suit could not proceed because it was based on non-actionable statements.

S&P said the company's aspirations to be independent and objective were vague and generalized statements that do not cover current activities. To be actionable, statements must be based on facts and not "how business should be conducted," S&P claimed.

Additionally, S&P argued that the complaint is contradictory. For instance, the government alleged that the skewed ratings also defrauded MBS and CDO issuers Citibank and Bank of America.

Following the government's logic, S&P argued, it would have intended to defraud the issuer banks "about the likely performance of their *own* products."

The Justice Department disputes S&P's arguments in its opposition brief.

The statements S&P made were not "simply aspirational," but were specific assertions about the company's current business practices, the government says.

According to the opposition brief, the allegations in the complaint pointed to statements that were specific and material such that investors relied on them when making investment decisions.

The Justice Department argues that the complaint sufficiently alleges a motive by S&P to defraud investors: The company inflated the ratings to continue to receive business from issuers and to increase its market share in credit ratings.


REUTERS/Brendan McDermid

S&P also knew the statements were false, the Justice Department says.

The company's internal projections showed that the collapse of the housing market was hurting financial instruments tied to the housing market, yet it continued to rate the instruments the same as it had when the market was robust, the government says.

Finally, the Justice Department argues that the complaint sufficiently alleges a motive by S&P to defraud investors: The company inflated the ratings to continue to receive business from issuers and to increase its market share in credit ratings. WJ

**Related Court Documents:**
Opposition brief: 2013 WL 2157828
Motion to dismiss: 2013 WL 1715640
Complaint: 2013 WL 416293

# Fraud suit over subprime investments was correctly dismissed, Freddie Mac says

Freddie Mac has told a federal appeals court that a securities fraud lawsuit filed over the subprime loans it acquired during the 2007-2008 financial crisis was properly dismissed and should not be revived.


REUTERS/Jason Reed

***Central States, Southeast and Southwest Areas Pension Fund v. Federal Home Loan Mortgage Corp. et al., No. 12-4353, appellee's brief filed (2d Cir. May 13, 2013).***

In a brief filed in the 2nd Circuit U.S. Court of Appeals, the Federal Home Loan Mortgage Corp. said the lower court correctly concluded that the government-sponsored mortgage company did not make material misrepresentations about the decline in the housing market or cause investors' losses.

The current class-action suit filed by the Central States, Southeast and Southwest Areas Pension Fund asserts that investors did not know the full extent of the subprime loans in Freddie Mac's portfolio until the Securities and Exchange Commission filed charges against certain officers in late 2011.

In addition, the investors claim they learned additional facts about the alleged misclassification of loans when the agency announced its non-prosecution agreement with Freddie Mac. The investors sought to file a third amended complaint based on the new information.

However, Freddie Mac says, the SEC's charges were filed more than three years after the proposed class period and do not show it caused investors' losses.

On Nov. 20, 2007, Freddie Mac announced more than $2 billion in losses that caused its stock price to fall from $37.50 to $26.74 per share. Freddie Mac's financial performance worsened until Sept. 7, 2008, when it was put into conservatorship.

In September 2012 the U.S. District Court for the Southern District of New York dismissed the suit without leave to amend after finding that any alleged misrepresentations regarding the adequacy of Freddie Mac's capital and internal controls did not cause investors' losses.

Moreover, the court said, any statements made by Freddie Mac officials about the housing market were not material or made with intent to deceive, or *scienter*.

In this appeal of that ruling, the government-sponsored enterprise maintains it repeatedly warned investors about the risks associated with investments in nontraditional mortgages and securities backed by subprime loans.

Even if additional information was disclosed in the non-prosecution agreement about the classification of the loans, there was no universal definition of the term "subprime," Freddie Mac says, adding that it disclosed the riskier loan purchases it was making 2007 and 2008.

During the financial crisis, Freddie Mac "repeatedly and extensively warned investors that if real estate values declined or credit tightened or interest rates changed, it was likely to incur unavoidable losses," it says.

The appellant also fails to point to any "corrective disclosure" that caused a subsequent stock price drop, Freddie Mac asserts.

The suit was properly dismissed without leave to amend for failure to allege loss causation and failure to meet the heightened pleading standards for securities fraud actions, Freddie Mac says. WJ

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**Related Court Document:**
Defendants' memo in support of dismissal: 2013 WL 2149412

## NEWS IN BRIEF

### CLOSED TENNESSEE BASED BANK'S DEPOSITS GO TO NEW INSTITUTION

The Federal Deposit Insurance Corp. said in a June 7 statement that it has moved the assets and deposits of the failed Sevierville, Tenn.-based Mountain National Bank to First Tennessee Bank in Memphis. The Office of the Comptroller of the Currency acted on liquidity concerns, closed Mountain National and appointed the FDIC as the bank's receiver. The failed bank had $437.3 million in assets and $373.4 million in deposits as of March 31, the FDIC said. Mountain National is the 16th bank to fail this year and the first in Tennessee.

### CYBER THREATS POSE RISKS TO BANKS, OCC SAYS

National banks and federal savings associations are facing risks posed by sophisticated cyber threats and need increased awareness and resources to fight such threats, the Office of the Comptroller of the Currency said in a new report. The agency's spring 2013 Semiannual Risk Perspective, issued June 18, discusses cyber threats as well as risks arising from identity theft, theft of proprietary information and fraud targeting online banking services. The report also covers how competition in the commercial and industrial lending market may lead to poor loan underwriting practices, which affect an institution's safety and soundness. The report is available at http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2013.pdf.

### FDIC, CFPB SEEK TO PREVENT FINANCIAL ABUSE OF THE ELDERLY

The Consumer Financial Protection Bureau said in a June 12 statement that together with the Federal Deposit Insurance Corp., it is offering a free electronic guide to help seniors avoid becoming victims of financial abuse. The guide is designed for use by financial institutions, adult protective service agencies, senior advocacy groups and law enforcement. It provides instruction on preventing financial exploitation and making educated financial decisions. The materials discuss common types of elder financial abuse, identity theft and fraud schemes targeting veterans and homeowners. The guide, called Money Smart for Older Adults, is available at http://www.fdic.gov/consumers/consumer/moneysmart/OlderAdult.html.

# CASE AND DOCUMENT INDEX