Westlaw Journal
BANK & LENDER LIABILITY
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 18, ISSUE 4 / JULY 2, 2012

WHAT'S INSIDE

COMMENTARY

A primer on mezzanine finance

Benjamin W. Baldwin of Robinson, Bradshaw & Hinson in Charlotte discusses mezzanine financing and offers advice on how businesses can use this method to raise capital.

SEE PAGE 3

CRIMINAL LAW

ING Bank pays $619 million to end illegal-transactions case

Amsterdam-based ING Bank has agreed to pay $619 million to federal and state authorities to resolve criminal charges that it knowingly evaded U.S. laws to process financial transactions for customers in Cuba and Iran.

United States v. ING Bank N.V., No. 12-CR-136, settlement announced (D.D.C. June 12, 2012).

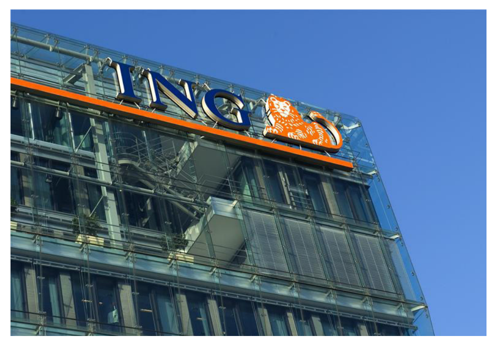
The payment ends allegations that ING illegally moved more than $2 billion through the U.S. financial system for entities that are subject to U.S. economic sanctions, the Justice Department said in a June 12 statement.

"The fine announced today is the largest ever against a bank in connection with an investigation into U.S. sanctions violations," Lisa Monaco, assistant attorney general for national security, said in a statement.

The Justice Department said the $619 million will be equally split between the United States and the New York County district attorney's office, which claimed the bank's Cuban and Iranian funds transfers violated New York state law.

ING Bank also reached a non-monetary settlement with the Treasury Department's Office of Foreign Assets Control regarding the same series of illegal transactions.

Under the terms of that settlement, the bank must review its policies and procedures to ensure compliance with U.S. sanctions laws.



REUTERS/United Photos

The Justice Department raised its allegations against the bank in a criminal information filed in tandem with a deferred prosecution agreement in the U.S. District Court for the District of Columbia.

The government claimed that by handling financial deals for customers in Cuba and Iran, ING violated the International Emergency Economic Powers Act, 50 U.S.C. § 1701, and the Trading with the Enemy Act, 50 U.S.C. app. § 1

The laws bar U.S. citizens from doing business with Iran and from participating in financial and commercial deals with Cuba, respectively.

CONTINUED ON PAGE 12

41246891

Westlaw Journal
Bank & Lender Liability

Published since September 1997

Publisher: Mary Ellen Fox

Executive Editor: Donna Higgins

Production Coordinator: Tricia Gorman

Managing Editor: Phyllis Lipka Skupien, Esq.

Editor: Catherine A. Tomasko
Cath.Tomasko@thomsonreuters.com

Managing Desk Editor: Robert W. McSherry

Senior Desk Editor: Jennifer McCreary

Desk Editor: Sydney Pendleton

Westlaw Journal Bank & Lender Liability (ISSN 2155-0700) is published biweekly by Thomson Reuters.

Thomson Reuters
175 Strafford Avenue
Building 4, Suite 140
Wayne, PA 19087
877-595-0449
Fax: 800-220-1640
www.westlaw.com
Customer service: 800-328-4880

For more information, or to subscribe, please call 800-328-9352 or visit west.thomson.com.

How to Find Documents on Westlaw
The Westlaw number of any opinion or trial filing is listed at the bottom of each article available. The numbers are configured like this: 2011 WL 000000. Sign in to Westlaw and on the "Welcome to Westlaw" page, type the Westlaw number into the box at the top left that says "Find this document by citation" and click on "Go."

Westlaw.

TABLE OF CONTENTS

A primer on mezzanine finance

By Benjamin W. Baldwin, Esq.
Robinson, Bradshaw & Hinson

INTRODUCTION

Although the financial markets have loosened up significantly since the trough of the "Great Recession," senior lenders are still none too eager to part with their cash in making commercial loans. If a senior lender is willing to extend financing, it is still willing to loan only so much, and all too often, the borrower is left looking for other sources of cash. Thus, mezzanine finance, which has been around in various contexts for decades, is an increasingly popular means by which business owners, including private equity groups, may raise additional capital for acquisitions and to accomplish recapitalizations and the like. The purpose of this commentary is to provide an overview of this type of financing. (Note that this commentary addresses something different from high-yield debt, which involves subordinated debt occupying a similar spot in a company's capital structure, but which is typically available only to large businesses and is relatively expensive and difficult to obtain.)

WHAT IS MEZZANINE FINANCE?

As a building's mezzanine is an intermediate level between two of its main floors, in finance a mezzanine layer of a company's capital structure is what comes between the senior debt and the common equity. The equity owner, or buyer in the case of an acquisition, is usually eager to invest only so much of its cash in a transaction, and its first step in seeking financing will be the senior lender. Naturally, the senior lender will have its own reasons for lending less than is necessary to fund the entire transaction (the reasons might be a function, for example, of a still jittery lending climate and heightened credit standards, or for a particular borrower, an overabundance of goodwill or intangibles on the company's balance sheet). The mezzanine layer helps the equity owner or buyer fill the gap created by the senior lender's limited appetite for the deal.

This type of financing, though more expensive than senior debt (as described below), is often easier to obtain, offers more certainty of closing, and is less expensive and more efficient to obtain than additional equity. Furthermore, a mezzanine investment acts to increase the equity owner's ultimate return on investment, since, assuming the transaction is ultimately a success, the equity owner will have achieved its financial goal with a smaller upfront outlay.

Mezzanine financing was once confined to real estate transactions and growth capital situations, but as a consequence of the recent disruption in the credit markets, there have been increased needs and opportunities for this kind of financing in a variety of other contexts. Thus, it is now customary to see middle-market or much smaller companies fund acquisitions and recapitalizations, and even new product line initiatives, with proceeds of mezzanine transactions. The providers of these products include specialty mezzanine funds, private equity groups and others, including banks with niche mezzanine operations.

One may occasionally encounter a lender that will market a "unitranche" facility, which is essentially a single, larger, senior loan occupying capital structure space that would otherwise be allotted to both the senior loan and the mezzanine financing. These loans are generally fully secured (as would be the case with the senior loan) and involve full senior-style covenants and pricing that is blended (that is, they are priced higher than typical senior loans, to compensate the lender for the added exposure). Unitranche transactions are rare, especially given the current state of the economy, but as conditions improve, one may see them more frequently.

> Mezzanine finance is an increasingly popular means by which business owners, including private equity groups, may raise additional capital for acquisitions.

CHARACTERISTICS OF A MEZZANINE FINANCING

Mezzanine transactions involve considerably more risk to the investor than do senior loans since the investor's rights are subordinate to the rights of the senior lender. The obligor's obligations are usually unsecured (and if they are secured, the collateral is usually going to be "under water" relative to the senior lender's collateral position). All things considered, the mezzanine investor's prospects of repayment are substantially less certain than those of the senior lender, and consequently, the mezzanine investor will require various protections to enhance its interest.

Accordingly, the general characteristics of a mezzanine investment are as follows:

Structure

Mezzanine transactions are most often structured as subordinated, unsecured loans. There are two exceptions to this broad proposition, however.

First, as loans, although they will always be subordinated, mezzanine financings may

Benjamin W. Baldwin practices with **Robinson**, **Bradshaw & Hinson** in Charlotte, N.C. His practice covers a broad range of corporate finance and commercial transactions, with an emphasis on mergers and acquisitions, and senior and mezzanine lending. He can be reached at BBaldwin@rbh.com.

occasionally be secured (on a second-lien basis relative to the senior loan). A senior lender will usually insist that there be no liens junior to its liens, but if the mezzanine provider has an abundance of negotiating leverage (for example, if it is entering the picture in a workout or a restructuring context in which it is reducing the senior lender's exposure), the mezzanine provider may be able to obtain security, albeit junior and subordinate, for the borrower's mezzanine obligations. Of course, this security would give the mezzanine investor various advantages in bankruptcy and a preferred place in the distribution waterfall as compared to the trade or any other unsecured creditors.

Second, mezzanine financings sometimes take the form of preferred equity or some other hybrid investment, such as a convertible investment. A preferred equity security will, like a subordinated loan, provide the layer between the senior debt and the common equity in the company's capital structure. Preferred stock would be structurally, as opposed to contractually, subordinated to the senior debt, since as equity it would automatically come behind the senior debt in a liquidation scenario. The economics of a preferred investment (and the other contractual provisions related thereto) can mimic those of a mezzanine debt investment as the parties may desire. Often tax considerations drive the decision whether to structure the instrument as a preferred equity investment as opposed to one for debt.

Term/maturity

As is consistent with the notion of subordination, the term of a mezzanine investment (as will be dictated by the senior lender) will be longer than the term of the senior loan. A senior lender may require a gap of six months to a year between the maturity of the senior debt and that of the mezzanine investment so as to permit the senior lender and the company to work out a senior lender exit without the presence of the mezzanine investor "at the table" in the event the company is not able to repay or refinance the senior loan by its agreed upon maturity date.

In addition, mezzanine financings usually do not amortize significantly, if they amortize at all, during their term, and thus are typically most often due and payable with balloon payments at final maturity. Again, this structure is often dictated by the senior lender, that will insist on leaving maximum cash in the business and as few impediments as possible to its easy exit from the transaction by the date of maturity of its loan.

Pricing

Mezzanine debt usually bears interest at a fixed rate, and similarly a preferred instrument will come with a fixed coupon. Again, because the investment entails more risk for the investor, the rate will be substantially higher than the rate applicable to the senior debt and may even range, for example, from 10 percent to 14 percent, depending on the credit quality of the borrower and the other circumstances surrounding the transaction.

This increased interest cost (which is further magnified by customary quarterly compounding) can result in too heavy a burden for some borrowers. In such cases, the obligation may be structured to provide for some combination of payment in cash and payment-in-kind (or "PIK" interest.) In a typical scenario, where the interest accrues at 14 percent per annum, the borrower would have the option to elect to have up to 4 percent of the interest be payable on a PIK basis, so that such amount is essentially added back to the principal and then collected in cash by the investor at maturity.

Where the maturity of the obligation is five years or more (which again, is frequently the case for a mezzanine investment) the parties should be aware of the original issue discount and applicable high-yield discount obligation issues posed by such deferral of interest. If the borrower is a corporation, failure to consider these rules can have serious borrower tax consequences, including loss of an interest deduction. A solution to the issue is payment of "catch up" cash interest at year five, and accordingly, loan agreements for transactions with PIK interest components and maturities beyond five years will often permit the borrower to make this payment.

> The mezzanine layer helps the equity owner or buyer fill the gap created by the senior lender's limited appetite for the deal.

Fees

Apart from the rate of interest, mezzanine investors usually collect sizable upfront fees at closing, as enhanced compensation for the investor's added risk. An upfront fee (which might be called a closing fee, structuring fee or some other fee, depending on the investor's accounting, tax or regulatory requirements) might typically fall in the range of 1 percent to 3 percent of the size of the financing.

These fees, combined with the interest rate (discussed above) and the equity rights (discussed below), enable the investor to achieve the desired overall rate of return over the life of the investment, which is usually in the range of 20 percent to 25 percent, assuming things go as planned.

Prepayment penalties/call protection

Senior debt terms rarely, if ever, prohibit or penalize early repayment. This contrasts with the typical mezzanine scenario in which the agreement might either prohibit repayment in the early years, or otherwise impose prepayment penalties or "make-whole" obligations. It is common to see provisions contemplating that during the first year of the agreement, amounts prepaid shall be accompanied by a 3 percent prepayment premium; during the second year, 2 percent; during the third year, 1 percent; and thereafter, payments of principal may be made with no premium.

Certain exit rights

Mezzanine investments almost always contemplate exit rights for investors in the event of certain fundamental transactions. These include changes in control, sales of all or substantially all the company's assets, and initial public offerings. This is also the case, of course, with most any senior loan.

In addition, in certain highly negotiated transactions, the investment documentation might provide that while certain significant transactions (such as acquisitions — see in this regard "covenants" below) may not be prohibited, the investors would be entitled to partial prepayment, or put rights, of a pre-negotiated amount if such triggering transactions exceed an agreed-upon threshold.

Again, the mezzanine environment is one of flexibility, and unlike the high-yield domain, which is rigid by comparison, there is ample room for creativity and negotiation.

Covenants

Conventional wisdom holds that mezzanine covenants are generally less restrictive those for senior debt. If that is the rule, it is fraught with exceptions.

First, with respect to the form of the covenants, responsible counsel for a sophisticated company will often want to base the mezzanine agreement on the form used by the senior lender so that it will be easier for the company to ensure compliance with the ongoing terms of the two different transactions. Typically, the mezzanine investor, understanding that its next business opportunity may depend on how flexible and user-friendly it is perceived as being in the current deal, will often accede to the sponsor or company's wish in this regard. Thus, the senior covenants will frequently be the starting point for the mezzanine covenants.

It is of course in the company's and the senior lender's best interests for the mezzanine covenants to be looser, consistent with the norm described above. The company would prefer the added flexibility, and in a senior default scenario, the senior lender would want the mezzanine investor to be absent from the negotiating table. Thus, the mezzanine lender can expect to be asked to live with financial-covenant ratios and negative-covenant baskets that are 10 percent to 25 percent looser than what applies in the senior agreement.

Since the underlying transaction probably cannot be accomplished without the mezzanine money, and because the company is going to be eager to have the transaction closed as soon as possible, the parties will often agree that the senior and the mezzanine agreements will contain the same covenants (in which case the senior lender would rely on the protections afforded to it under its intercreditor agreement).

What about events of default that result from breached covenants? Again, in most cases, the senior and mezzanine events of default will resemble one another to a great degree (if they are not in fact identical), except in one key respect. In a properly negotiated transaction, there would be an event of default under the senior agreement arising from any event of default under the mezzanine agreement, but only an *acceleration* of the senior debt would trigger an event of default under the mezzanine agreement. This is a facet of subordination that is central to the relationship between the senior and mezzanine debt.

Equity rights

As noted above, a typical mezzanine investor will try to attain an overall rate of return over the life of the transaction of 20 percent to 25 percent. One means of enabling the investor to attain that goal is equity in the business. The purchase price for the mezzanine investor's subordinated notes may include consideration for the issuance to the investor of stock or other interests in the company's common equity. Or the investor may receive a warrant for the purchase of shares at a later date, usually with a payment of a nominal exercise or "strike" price.

This equity may be subject to put rights on the part of the investor (say, at a date certain or upon the occurrence of certain fundamental transactions) or call rights on the part of the company. In any event, if the company and the investment are a success, the mezzanine investor will walk away at the conclusion of the transaction with significant added income (and based on rights that might have been fairly regarded as just "gravy" when the transaction was originally conceived).

SUBORDINATION

Fundamental to the nature of mezzanine investment is that it be subordinate (in terms of right of payment and, in the event it is secured, as to lien priority) to the senior debt. The subject of subordination deserves its own article, so many are the issues for discussion and negotiation. The principal issues for negotiation include:

- Limits on the amount of the senior debt.
- Circumstances under which the mezzanine investor may receive payments.
- Details concerning payment blockages that may be imposed by the senior lender.
- Remedy standstill provisions binding on the subordinated investor.
- Limits on the parties' ability to amend their respective loan documents and the exceptions to those limits.

Many a transaction has hit a snag at the eleventh hour as a consequence of disagreement over subordination issues. Thus, counsel would be wise to put subordination at or near the top of the agenda early in the process. This would allow any hurdles to be cleared before the parties spend significant time and money working toward the closing of a transaction. The language in a subordination agreement and the related points can be highly complex, and it is best to avoid wrestling with such difficult issues the night before, or even worse, the morning of, closing.

CONCLUSION

Although the financial markets have largely stabilized since the recent recession, senior lenders are still relatively conservative in applying their credit standards, and companies and their equity sponsors are thus left looking for additional sources of financing. In this environment, mezzanine finance is a readily available, ever more popular and efficient source of capital for the right borrower. WJ

Abacus Bank indicted for alleged mortgage fraud

Abacus Federal Savings Bank along with 11 current and former employees have been indicted in New York state court for allegedly operating a mortgage fraud similar to schemes that caused the 2008 financial crisis, prosecutors said May 31.

REUTERS/Andrew Burton

People v. Abacus Federal Savings Bank et al., No. 2480/2012, indictment issued (N.Y. Sup. Ct., N.Y. County May 31, 2012).

Between May 2005 and February 2010, the defendants were allegedly responsible for a residential mortgage fraud scheme that resulted in the sale of millions of dollars in fraudulent loans to the Federal National Mortgage Association, also known as Fannie Mae, New York County District Attorney Cyrus Vance Jr. said in a statement.

"The lessons of the financial crisis are still being learned," Vance said. "The public must have confidence that when a bank issues a loan that it later re-sells to Fannie Mae, and by extension the nation's investors, it will engage in honest and ethical practices and follow the rules set by regulators."

The 184-count indictment, filed in the New York County Supreme Court, comes after a two-and-a-half-year investigation. It charges Abacus and 11 current and former employees with conspiracy, grand larceny, falsifying business records, residential mortgage fraud and other related offenses.

The indictment says Yiu Wah Wong, who was the bank's chief credit officer, vice president and underwriting supervisor, and Wai Hung Tam, the bank's loan origination supervisor, trained and supervised the Abacus employees who processed the fraudulent loan applications.

Eight other former Abacus employees have already pleaded guilty to charges related to the fraudulent scheme, Vance said.

Abacus is a federally chartered lending institution based in New York that provides banking services primarily to the Chinese-American community. According to the indictment, the bank participated in a systematic mortgage fraud scheme by falsifying and fabricating loan application documents that allowed unqualified borrowers to obtain mortgages backed by Fannie Mae.

The indictment says Abacus loan officers and loan originators helped borrowers prepare fraudulent loan applications that qualified them for mortgages they could not financially support. Abacus then sold the bad loans to Fannie Mae, which bundled them into mortgage-backed securities and sold them to investors, who lost millions of dollars when the borrowers defaulted on their mortgages, the charges say.

Abacus' goal in this process was to generate fees, commissions and other funds for itself by issuing and selling as many mortgages as possible to Fannie Mae, Vance said.

Fannie Mae has mandatory standards and procedures in place to ensure loans are made at an appropriate risk level so as to minimize the possibility of financial harm. Abacus' actions were an attempt to avoid the protocols and commit fraud by selling mortgages with false information, according to the indictment.

"Loan schemes based on fraud inevitably will unravel as this one did," Vance said, adding that his office would continue to enforce laws aimed at "transparency and fair dealing in the financial markets." WJ

Attorney:

Plaintiff: New York County District Attorney Cyrus R. Vance Jr.

Straw buyer gets jail time in $41 million mortgage scheme

A New Jersey man who helped bilk mortgage companies out of nearly $41 million in loans on high-end properties was sentenced to 18 months in federal prison and ordered to repay $40,000 he earned as a "straw purchaser."

REUTERS/Fred Prouser

REUTERS/Brendan McDermid

The scammed lenders include Wells Fargo and Bank of America.

United States v. Siuszko*, *No. 11-CR-00509-JEI, defendant sentenced (D.N.J. June 5, 2012).

According to a 2011 criminal information filed in the U.S. District Court for the District of New Jersey, John Siuszko, 56, was a straw buyer who participated in a scheme to obtain fraudulent mortgages on condominiums and vacation properties in New Jersey, Georgia and South Carolina.

A straw buyer makes purchases secretly to hide the true buyer's identity from a seller.

Siuszko pleaded guilty to a single count of conspiracy to commit wire fraud for his role in obtaining a $980,000 mortgage on a Wildwood Crest, N.J. property.

Prosecutors said Siuszko's co-conspirators would seek out properties owned by financially distressed developers or homeowners. They would then find people like Siuszko, who had a good credit rating, and recruit them to act as straw buyers.

According to the information, the buyer's financial worth would be inflated on loan applications through phony documents like W-2 forms, income tax returns and investment statements in order to make them appear more creditworthy to lending institutions.

After the loans were approved, the conspirators would use some of the proceeds to pay off the buyer in a lump sum and then divvy up the rest among themselves, according to the information.

Prosecutors say the scheme ran from September 2006 to September 2008, during which the lenders released almost $41 million based on the fraudulent applications. The scammed lenders are major U.S. financial institutions, including Century 21, JPMorgan Chase, Wells Fargo and Bank of America, the charges say.

In addition to jail time, U.S. District Judge Joseph E. Irenas ordered Siuszko to repay the $40,000 he received in the scheme and pay a $5,000 fine. Siuszko will also serve two years of supervised release.

Co-conspirator Charles Harvath, 34, of Lodi, N.J., pleaded guilty last year to conspiracy charges for wire fraud and money laundering, the New Jersey U.S. attorney's office said in a June 5 statement.

He is expected to be sentenced in December. WJ

Related Court Document:
Criminal information: 2011 WL 8088438

See Document Section B (P. 24) for the criminal information.

Indian tribes accuse U.S. of allowing improper funds transfer

Two Indian tribes say in a lawsuit that the government allowed more than $760,000 to be removed from a federal trust account maintained for their benefit and transferred into an unknown individual's bank.

Cheyenne & Arapaho Tribes v. United States, No. 12-CV-357, complaint filed (Fed. Cl. June 6, 2012).

The Oklahoma-based Cheyenne and Arapaho tribes claim that the Bureau of Indian Affairs made the funds transfer after being contacted by someone purporting to act on their behalf.

The tribes say the BIA breached its fiduciary duty by allowing the money to be moved from the trust account without their permission.

> Two Indian tribes say the federal government breached its fiduciary duty by allowing money to be moved from their trust account without permission.

In the complaint pending in the U.S. Court of Federal Claims, the tribes say the Department of the Interior holds their land in trust. The United States leases the land for oil and gas exploration and collects the royalties owed to the tribes by the lessees, according to the suit.

The government collects revenue from agricultural activities and livestock grazing on the land. The BIA then puts the oil and gas royalties and agricultural revenue into trust accounts maintained for the tribes by the Treasury Department, the complaint says.

The tribes allege that an unidentified person contacted the BIA's El Reno, Okla., office Nov. 10, 2011, and asked for a transfer of funds from one of the trust accounts to a private account at nonparty Citizens Bank.

REUTERS/Jason Reed

The suit involves the Oklahoma-based Cheyenne and Arapaho tribes, shown here at a 2004 procession in Washington. The tribes claim the Bureau of Indian Affairs transferred funds from a trust account in their name without properly obtaining permission.

The BIA transferred more than $760,000 from a tribal trust account into the Citizens Bank account Nov. 18, 2011, according to the suit.

The Cheyenne and Arapaho say the government never contacted them to check on the legitimacy of the funds transfer request. They say did not authorize the transfer and had no knowledge of it.

The complaint says the BIA had a duty to properly manage the trust accounts and to protect the tribes from the loss, theft and unauthorized transfers of the money. The government did not fulfill this duty and breached its obligations.

The Cheyenne and Arapaho are asking the Claims Court to award more than $760,000 in damages, plus interest, costs and attorney fees.

The tribes are also requesting a court order directing the government to provide an accounting of the trust accounts.

At press time, the government had not filed a response to the suit. WJ

Attorney:
Plaintiff: Charles B. Morris, Concho, Okla.

Related Court Document:
Complaint: 2012 WL 2317385

See Document Section C (P. 34) for the complaint.

Citigroup exec loses bid to dismiss SEC fraud charges

A Manhattan federal judge has rejected a Citigroup executive's bid to dismiss Securities and Exchange Commission charges that he defrauded investors in complex transactions involving subprime mortgages while the firm "shorted" the deals.

Securities and Exchange Commission v. Stoker, No. 11-cv-7388, 2012 WL 2017736 (S.D.N.Y. June 6, 2012).

"Shorting" refers to an investment strategy consisting of a bet that a security will fall in value.

In a June 6 ruling U.S. District Judge Jed S. Rakoff of the Southern District of New York said the SEC's allegation that Brian Stoker fraudulently obtained money or property for his employer while acting as its agent was enough to state a violation of the Securities Act of 1933, 15 U.S.C. § 77q(a).

The judge also rejected Stoker's argument that he does not qualify as "speaker" of a fraudulent statement as the term is defined by the U.S. Supreme Court in *Janus Capital Group Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

Stoker had argued that he did not actually make any of the alleged misstatements in the offering materials, but Judge Rakoff held *Janus'* narrow definition of "speaker" applied only in private fraud lawsuits under the Securities Exchange Act of 1934, not in SEC enforcement actions under the Securities Act.

The SEC's charges arise from the same allegedly fraudulent conduct that led the agency and Citigroup to propose a $285 million settlement in October 2011. Judge Rakoff angrily rejected the settlement a month later, finding the accord too lenient with a fine amounting to "pocket change." That ruling is currently on appeal to the 2nd U.S. Circuit Court of Appeals.

The SEC's complaint against Stoker accuses him of misrepresenting the risk of investing in Citigroup's collateralized debt obligations.

A CDO is a security backed by pools of bonds and loans. A synthetic CDO is backed by a pool of credit default swaps that mimic the value of a so-called "reference portfolio" of bonds and loans. A credit default swap is a financial contract that functions like insurance against investment risk.

As a result of the fees the bank collected from the sale of the toxic CDOs to investors and its short position on the deals, Citigroup allegedly realized net profits of about $160 million.

The enforcement action alleges Citigroup and Stoker marketed numerous synthetic CDOs while knowing the securities were doomed and failed to disclose to investors that the bank bought separate credit default swaps to stake a $500 million short position on the shaky swap collateral it used for CDOs.

The SEC also alleges Stoker misled investors about the bank's "significant influence" over the selection of the collateral, which consisted mostly of subprime-mortgage-related securities.

The offering materials for the CDOs did not disclose Citigroup's short position or its influence over collateral selection, Judge Rakoff's opinion says.

As a result of the fees the bank collected from the sale of the toxic CDOs to investors and its short position on the deals, Citigroup collected net profits of about $160 million, the opinion says.

Stoker received total compensation of about $2.4 million in 2007, exceeding his 2006 pay by more than $1 million, the opinion says.

He moved for dismissal of the suit, arguing the SEC failed to allege he obtained money or property by means of the alleged misrepresentations in the CDO offering materials. Stoker contended the SEC was unable to connect his 2007 raise to his work on the CDOs.

Further, Stoker asserted he did not make any of the alleged misstatements in the faulty offering materials for the CDOs and thus was not a "speaker" under *Janus*.

Judge Rakoff disagreed, reasoning that it is sufficient for the SEC to allege Stoker "obtained money for his employer while acting as its agent."

Alternatively, the judge said the SEC could maintain its fraud suit by virtue of its allegation that Stoker personally obtained money indirectly from the conduct.

"The [Securities Act], on its face, does not state that a defendant must obtain the funds personally or directly," the judge said, noting that the law provides for liability "directly or indirectly."

"It would be contrary to this language, and to the very purpose of…[the law], to allow a corporate employee who facilitated a fraud that netted his company millions of dollars to escape liability for the fraud by reading into the statute a narrowing requirement," he said.

Further, he explained, the Supreme Court's decision in *Janus* to limit fraud claims to "speakers" of misstatements only applied to claims under the Exchange Act.

The inclusion of the words "by means of" in the Securities Act's language is an important difference, Judge Rakoff said, meaning Stoker can be liable for fraud "if he obtains money or property by *use* of a false statement, whether prepared by himself or by another." WJ

Attorneys:
Plaintiff: Andrew H. Feller, SEC, Washington

Defendant: Brook Dooley, Keker & Van Nest, San Francisco

Related Court Document:
Opinion: 2012 WL 2017736

See Document Section D (P. 39) for the opinion.

European banking laws slow SEC insider-trading suit

European banking and privacy laws are impeding an insider-trading suit the Securities and Exchange Commission filed last year against a pair Swiss investment firms, leading a federal judge to close the case at the agency's request.

REUTERS/Arnd Wiegmann

Stefan Borgas, CEO of Swiss drug industry supplier Lonza, at a news conference in Zurich July 11, 2011, announcing that the company will buy Arch Chemicals for $1.2 billion in cash. The deal was at the center of an insider-trading lawsuit recently dropped by the SEC.

Securities and Exchange Commission v. Compania Internacional Financiera S.A. et al., No. 11-CV-4904, 2012 WL 1856491 (S.D.N.Y. May 22, 2012).

"The commission is unable to predict if and when it will receive … information from overseas parties, and thus seeks a dismissal … rather than an order extending the current discovery schedule," the SEC said in court motion papers.

In a May 22 decision, U.S. District Judge J. Paul Oetken of the Southern District of New York granted the motion "without prejudice," meaning the agency may refile the suit.

"The commission has made clear that it intends to proceed with this case should its motion to dismiss without prejudice be denied," the judge said.

The parties had agreed to an expedited discovery deadline that expired in January, he noted.

"Were the court to deny this motion, the court would be inclined to grant the commission's alternative request and reopen discovery," Judge Oetken said.

The SEC's complaint alleged Compania Internacional Financiera S.A. and Coudree Capital Gestion S.A. violated U.S. securities laws by using confidential information to buy hundreds of thousands of shares of Connecticut-based Arch Chemicals Inc. just days before a merger announcement.

Switzerland-based disinfectant maker Lonza Group Ltd. announced last July it would acquire Arch for $1.2 billion in cash.

Arch's share price rose 12 percent after the deal was announced, according to the complaint.

The judge ordered the release of almost $15 million the defendants deposited in a court escrow account.

The defendants subsequently sold their Arch shares for millions of dollars in profits, the SEC said.

"Although the commission has submitted dozens of requests to foreign regulators in five countries and has interviewed or deposed numerous foreign witnesses overseas, it has been unable to speak with insiders at Lonza or at Swiss investment banks, or to obtain documents … due to European banking, data protection and privacy laws," Judge Oetken said in the decision.

The judge also ordered the release of almost $15 million the defendants deposited last year in a court escrow account.

"The expedited discovery schedule was apparently part of the quid pro quo for their temporary surrender of that money," he said. "Defendants understandably want their money back."

The complaint alleged the defendants violated Section 10(b) of the Securities Exchange Act of 1934.

The court in February dismissed a third defendant, Chartwell Asset Management Services, from the case without prejudice based on a stipulation by the parties. WJ

Related Court Documents:
SEC motion: 2012 WL 432383
Opposition memo: 2012 WL 1611380
Reply memo: 2012 WL 1611382
Opinion: 2012 WL 1856491

Lender must 'put back' deficient mortgages, trust servicer says

A mortgage servicing firm has sued Sand Canyon Corp. in New York state court to force the lender to repurchase bad loans that were pooled into a trust in 2006 as part of a $1.5 billion mortgage-backed securities offering.

Homeward Residential Inc. ex rel. Option One Mortgage Loan Trust 2006-2 v. Sand Canyon Corp. f/k/a Option One Mortgage Corp., No. 651885/2012, complaint filed (N.Y. Sup. Ct., N.Y. County May 31, 2012).

Homeward Residential Inc., the trust's mortgage servicer, says Sand Canyon, once known as Option One Mortgage Corp., has breached its agreement to repurchase the mortgage loans.

Homeward Residential, formerly known as American Home Mortgage Servicing Inc., says in its New York County Supreme Court suit that the trust and its investors have suffered losses of over $325 million from the securities because of the underlying loans' high default rates and widespread foreclosures.

The securities pay dividends drawn from principal and interest payments made by borrowers whose loans were pooled into the trust.

The suit states claims for breach of contract, anticipatory breach and indemnification. Homeward seeks a declaratory judgment stating that Sand Canyon must honor its obligation to repurchase the faulty loans.

It is the second lawsuit between the parties this year.

Four months ago, Sand Canyon sued the servicer for allowing the trustees and the insurers of the mortgage-backed securities to access loan files. The suit is pending in New York state court before Judge Melvin L. Schweitzer. *Sand Canyon Corp. v. Am. Home Mortgage Servicing*, No. 65050412012, *complaint filed* (N.Y. Sup. Ct., N.Y. County Feb. 22, 2012).

The trust has lost 22 percent of its original value since it issued the mortgage-backed securities, the suit says.

Homeward Residential's suit concerns more than 7,500 residential mortgage loans that Sand Canyon allegedly represented as conforming to specified underwriting standards.

The defendant sold the loans to depositor Option One Mortgage Acceptance Corp. in June 2006 to be pooled and securitized, the complaint says.

The Option One Mortgage Loan Trust 2006-2 issued the mortgage-backed securities, with Homeward Residential acting as the servicer and Wells Fargo as the trustee, the suit says.

The trust has lost 22 percent of its original value since it issued the MBS, the suit says.

According to the complaint, a series of agreements governing the MBS authorized Homeward Residential to enforce Sand Canyon's representations and warranties concerning its underwriting practices.

The servicer undertook a forensic investigation of 1,600 of the loans in the trust and discovered Sand Canyon allegedly had violated its representations by:

- Inflating the true market value of properties.
- Understating loan-to-value and combined-loan-to-value ratios.
- Falsely representing that not a single mortgage was "underwater" at origination.
- Understating the number of non-owner-occupied properties.

Homeward Residential allegedly notified Sand Canyon that it had breached various representations and warranties, and it demanded that the defendant repurchase hundreds of the defective loans within 120 days.

Sand Canyon failed to repurchase a single loan, the complaint says.

In addition to a court order requiring Sand Canyon to perform its obligations to cure or repurchase the defective loans from the mortgage pool, Homeward Residential seeks damages, attorney fees, expert fees and costs. WJ

Attorney:
Plaintiff: Brian V. Otero, Hunton & Williams, New York

Related Court Document:
Complaint: 2012 WL 2003908

ING

CONTINUED FROM PAGE 1

ING Bank willfully made more than 20,000 illegal transactions on behalf of Cuban and Iranian customers between the 1990s and 2007, the charges said.

The Justice Department said the bank, at its branches around the world, concealed information that would lead U.S. financial institutions to discover the transactions were being made for sanctioned entities.

The U.S. banks ended up moving funds and processing transactions that would have otherwise been rejected due to the government's prohibitions on dealings with Cuba and Iran, the agency alleged.

In addition ING Bank threatened to punish employees who did not remove the identifying data from the prohibited transactions, the charges said.

The Justice Department said the United States and New York County both agreed to defer prosecution because ING has taken responsibility for its illegal actions and agreed to the fine.

The agency said it will recommend that the District Court dismiss the charges in 18 months. WJ

Related Court Document:
Criminal information: 2012 WL 2320791

See Document Section A (P. 19) for the criminal information.

NEWS IN BRIEF

FDIC SENDS FAILED TENN. BANK'S ASSETS TO NEW INSTITUTION

The assets and deposits of the failedFarmers Bank of Lynchburg in Tennessee have been transferred to Clayton Bank & Trust in Knoxville, Tenn., according to a June 15 statement by the Federal Deposit Insurance Corp. The FDIC, acting in its capacity as Farmers Bank's receiver, arranged the transfer after state regulators acted on liquidity concerns and closed the bank. Farmers Bank had $163.9 million in assets and $156.4 million in deposits as of March 31, the agency said. The institution is the 31st bank in the nation to fail this year and the third in Tennessee.

CFPB SEEKS INFO ON FINANCIAL ABUSE OF THE ELDERLY

The Consumer Financial Protection Bureau is seeking information from the public about fraudulent and deceptive financial practices that victimize senior citizens. The agency said in a June 14 statement that it intends to use the information to help older Americans make responsible monetary decisions and avoid financial abuse. In particular, the CFPB said it is interested in learning what the public thinks is the best way to determine the legitimacy of a financial planner's credentials, as well as details about existing financial education programs tailored to the needs of seniors. The CFPB published its request for information in the June 19 issue of the Federal Register. The request is available at http://files.consumerfinance.gov/f/201206_cfpb_rfi_senior_financial_exploitation.pdf.

FDIC ENDS RECEIVERSHIP OVER CLOSED OHIO BANK

The Federal Deposit Insurance Corp. plans to end its receivership over Ohio's Bramble Savings Bank, according to a notice the agency published in the Federal Register June 13. State regulators closed Bramble Sept. 17, 2010, based on liquidity concerns, and appointed the FDIC as the institution's receiver. In that capacity, the agency transferred the majority of the failed bank's assets and deposits to Cincinnati-based Foundation Bank. The FDIC said it has finished liquidating Bramble's remaining assets and therefore has no reason to continue the receivership. The agency said it plans to terminate its receivership no later than July 12 and will make a final distribution to the bank's creditors if there are any available funds. The notice is available at http://www.gpo.gov/fdsys/pkg/FR-2012-06-13/pdf/2012-14279.pdf.

MONEY LAUNDERING

Commerzbank had anti-money-laundering lapses, Fed says

WASHINGTON, June 14 (Reuters) – The Federal Reserve said June 14 that the U.S. branch of Germany's Commerzbank AG had lapses in its anti-money-laundering systems that are supposed to prevent the flow of shadowy funds through the U.S. financial system.

The Fed and the bank entered into an agreement requiring the Commerzbank to take steps to clean up its anti-money-laundering programs. The Fed did not fine the bank for the shortcomings.

The Fed said the problems with the bank's anti-laundering programs occurred in the bulk-cash-transactions business run out of its New York branch. Customers can use this type of business line to move large amounts of cash through the banking system in a way that can be hard for the government to trace.

As part of the agreement with the Fed, Commerzbank will have to submit within 60 days a plan for how it will better comply with anti-money-laundering laws. This will include more staff training and improvements to how it performs its "due diligence" on customers.

The bank will also have to hire an independent consultant to review transactions made through its bulk-cash-transaction business from Sept. 1, 2010, to the present for any suspicious activity.

"Commerzbank has committed to take all necessary measures to comply with the additional compliance and reporting requirements agreed with U.S. regulators," Commerzbank said in an emailed statement. WJ

(Reporting by Mark Felsenthal and Dave Clarke; editing by Marguerita Choy and Tim Dobbyn)

JPMorgan, execs sued over $2 billion credit derivatives blunder

JPMorgan Chase's common stock sold at artificially inflated prices while the bank and top executives hid its massive exposure to risk-laden credit derivatives that resulted in a $2 billion loss, a shareholder alleges in a New York federal court lawsuit.

Pipefitters Local Union No. 537 Trust Funds v. JPMorgan Chase & Co., No. 12-cv-4552, complaint filed (S.D.N.Y. June 11, 2012).

The class-action suit, filed in the U.S. District Court for the Southern District of New York, says JPMorgan Chase & Co. falsely told shareholders that rumors of its losses from its credit-related derivatives portfolio amounted to "tempest in a teapot."

The suit also names as defendants JPMorgan CEO James Dimon, CFO Douglas Braunstein and former CIO Ina Drew.

The defendants allegedly violated the anti-fraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a).

The plaintiff, the Massachusetts-based Pipefitters Local Union #537 Trust Funds, says it relied on the defendants' misrepresentations and paid too much for JPMorgan shares.

It seeks compensation on behalf of all investors who bought the bank's common stock between Jan. 13 and May 10, when it revealed the $2 billion loss.

JPMorgan allegedly made several public statements during that time downplaying the extent of its exposure to the risk of loss on its CIO's investment positions.

In January the bank released 2011 annual and fourth-quarter financial results showing a stable and consistent risk management. It also reported 2012 first-quarter financial results in April showing stable and consistent risk exposure.

But JPMorgan's May 10 announcement of the $2 billion blunder came with a warning of even higher losses on its portfolio of credit derivatives.

According to the complaint, CIO Drew undertook a strategy of selling credit default swaps at mark-to-market on the risk of default of investment-grade companies on an index known as the Markit CDX North America Investment Grade Series 9 10-Year Index, or IG.9.

A credit default swap is a financial contract that functions like insurance against investment risk.

In late 2011, a group of hedge funds led by Saba Capital Management's manager Boaz Weinstein noticed a divergence between the IG.9 rate and the CDS' value and took trading positions as JPMorgan's counterparty on the CDS, meaning the funds stood to profit if the value of the CDS on the IG.9 increased, the suit says.

By early 2012 the bank faced "massive" exposure to CDS on the IG.9, the value of, which increased significantly in May on poor economic news related to the European sovereign debt crisis, the suit says.

The full extent of JPMorgan's credit exposure to the index finally came to light with the May 10 report of the $2 billion loss, the suit says.

During the class period JPMorgan's share price fell 20 percent, from a March 27 high of about $46 to about $37 each May 11, the complaint says.

Had they known the truth, the plaintiff class members would not have bought JPMorgan stock or paid the "artificially inflated" share price, the suit says. WJ

Attorney:
Plaintiff: Christopher J. Keller, Labaton Sucharow LLP, New York

Related Court Document:
Complaint: 2012 WL 2087381

Business groups defend Citigroup subprime suit pact to 2nd Circuit

Two business interest advocacy groups have filed briefs urging a federal appeals panel to direct a lower court to approve Citigroup's $285 million settlement of Securities and Exchange Commission charges that the bank illegally sold toxic mortgage debt.

Securities and Exchange Commission v. Citigroup Global Markets Inc., Nos. 11-5227, 11-5242 and 11-5375, brief filed (2d Cir. May 22, 2012).

The Business Roundtable and the U.S. Chamber of Commerce are supporting the SEC and Citigroup's appeal of a 2011 order in which U.S. District Judge Jed Rakoff of the Southern District of New York rejected a proposed pact that required the bank to pay what he termed "pocket change." *SEC v. Citigroup Global Mkts.,* 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011).

A group associated with the Occupy Wall Street movement sought to intervene in the appeal on the side of Judge Rakoff, however, arguing that he rightly rejected the settlement because there was not enough information to know whether it served the public interest.

The proposed pact forces Citigroup to disgorge its subprime loan profits with $30 million in prejudgment interest and to pay a $95 million penalty in return for the release of SEC charges that it violated federal securities laws in marketing risky investments linked to shaky mortgages.

Judge Rakoff rejected the pact, noting that "Citigroup realized net profits of around $160 million [while] investors … lost more than $700 million," and the bank's officers and directors are not required to admit or deny guilt, so the public cannot decide whether the settlement is fair.

ADMIT-OR-DENY REQUIRED?

Both the SEC and Citigroup separately appealed that ruling, arguing that companies seeking to settle alleged securities law violations should not be required to admit or deny the charges.

The 2nd U.S. Circuit Court of Appeals in March stayed the lower court proceedings and agreed to review the petition. *SEC v. Citigroup Global Mkts.*, 673 F.3d 158 (2d Cir. 2012).

The SEC argued in its brief that "it is not the court's role to dictate how the commission should settle its cases."

In its separate brief, Citigroup said it faced shareholder suits based on allegations similar to those of the SEC, so it would not make sense to admit wrongdoing by officers and directors here.

RUNNING HEAD-LONG

In its *amicus* brief, the Chamber of Commerce, in conjunction with the Pharmaceutical Research and Manufacturers of America, says the decision on appeal is "far-reaching as regulatory agencies of all stripes regularly settle enforcement actions … through court-approved agreements that do not require admission of wrongdoing."

Judge Rakoff's settlement rejection is a sweeping decision that "runs head-long into decades of nearly uniform precedent" approving such pacts and, if affirmed, "would upset the long-settled expectations of the nation's business community," the brief says.

In a separate *amicus* brief, the Business Roundtable, an association of CEOs of the nation's leading companies, agreed that in many cases, "companies would be unwilling or unable to settle enforcement actions if required to admit or deny" each allegation.

"If district courts are allowed to second-guess negotiated resolutions … agencies will be severely hampered in their ability to bring and conclude enforcement actions, [and] respondents will be forced to litigate to judgment," the Business Roundtable said in the brief.

This will add to the work of an "already overburdened judiciary," the brief adds.

OCCUPY THE 2ND CIRCUIT?

A group identifying itself as "Occupy Wall Street — Alternative Banking Group" sought to be recognized as an *amicus* "in support of the public interest."

OWL claims that, contrary to the arguments of the parties and the other *amici*, "a full examination of the facts underlying this case … is necessary."

The other parties mischaracterize the case as being about whether an absolute admission of guilt is necessary for confirmation "in an attempt to destroy the hallowed practice of settlement-by-consent," OWL argues.

"In reality, this case is simply about whether a district court has the authority to demand the adequate production of facts to assess how a proposed consent order would serve the public interest," OWL says. "A district court does have that authority."

This case, like many others, requires a full examination of underlying facts, including "the broader impact of the actions of the parties on the financial crisis and the economy," OWL says. WJ

Attorneys:

Amicus (OWL): Ashat Tewary, Edison, N.J.

Amicus (Business Roundtable): Mark Perry, Gibson, Dunn & Crutcher, Washington

Amicus (Chamber of Commerce): Lori McGill, Latham & Watkins, Washington

Related Court Documents:

Chamber of Commerce *amicus* brief: 2012 WL 2131929

Business Roundtable *amicus* brief: 2012 WL 2166144

Occupy Wall Street *amicus* brief: 2012 WL 2131928

CASE AND DOCUMENT INDEX