WHITE COLLAR PROSECUTIONS FROM SUBPRIME MORTGAGE PROBLEMS

WAYNE GROSS
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The Sleeping Giant Awakens

Surviving Law Enforcement's Response to the Subprime Hurricane

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TORA! TORA! TORA!

- I fear all we have done is to awaken a sleeping giant and fill him with a terrible resolve.

- Admiral Isoroku Yamamoto

Enron Example

- In early 2001, Enron seventh largest company in US with stock selling at $83 per share
- In Dec 01, declares bankruptcy (debt exceeds $13 billion) with stock trading at 28 cents
- 4000 employees who were prevented from trading stock in 2001 were laid off, losing both retirement funds and savings.
- Billions lost by investing public.

Law Enforcement Response

- Corporate Fraud Task Force created, resulting in federal criminal cases being filed against not only Enron defendants but more than 1000 defendants, including corporate executives, attorneys, accountants, stock brokers, and investment advisors.
- 600 convicted, including top executives at Enron, Worldcom, and Adelphia

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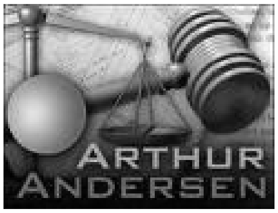
Demise of a Venerable Institution



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History Repeating Itself?

- In 2006, subprime mortgage business was a $672 billion market.
- Substantial number of borrowers defaulted, creating record number of foreclosures and decreasing home values.
- Ripple effects: Hedge funds involved in subprime mortgage-backed securities lose billions (Bear Stearns); Subprime companies file for bankruptcy (New Century and American Home Mortgage Investment Corp) or suffer dramatic decrease in value (Countrywide); Corporate write-downs exceed $230 billion.

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Task Force?

- April 11, 2008: WSJ reports that pressure grows on the Justice Dept to create a task force similar to the Enron Task Force to centralize probes of the mortgage industry.
- AG Mukasey has resisted making such a move.
- Some inside DOJ fear it risks appearing to be doing too little, despite more than 1300 ongoing FBI mortgage-fraud probes.

AG Comments

- DOJ lawyers are "still working to determine a unifying theme to the probes under way, which run the gamut from loan scams to more sophisticated explorations of how mortgages are turned to securities."
- "We're trying to see a couple of things. No. 1 is what prosecutions are being, and can be, brought. And then figuring out whether there's some larger story out there."
- U.S. Attorney General Michael Mukasey
- April 2008

What this means

- Senior Justice Dept officials are letting local U.S. attorneys offices run investigations.
- FBI has created 36 local mortgage-fraud task forces and working groups, which include state and federal agents focusing on mortgage fraud.
- Only recently have federal investigators and regulators begun probes into exotic financial instruments that bankers used to slice mortgages into securities. Investigators said such cases will focus on public disclosures by companies and insider trading by principals in the companies being investigated.

FBI Disclosures

- Jan 2008: Opened criminal inquiries into 14 companies, focusing on accounting fraud, securitization of loans, insider trading, among other things. (Blog: Gucci-loafer wearing Wall Street bankers who made millions selling CDOs are no doubt ringing up their lawyers as we speak)
- March 2008: Criminal investigations launched against 17 companies, including Countrywide. Officials declined to comment on recent troubles at Bear Stearns, but one said: “Common sense would indicates that we would look at something that big.”

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Likely Targets

- Mortgage Brokers: Loan-initiation practices – both getting the loan and disclosing risks of subprime loans to borrowers.
- Lenders: Relationships with brokers and appraisers. Willful collaboration?
- Banks: Relationships with mortgage affiliates and subsidiaries. Failure to exercise sufficient oversight?
- Issuers and Underwriters: Adequacy of disclosures of risks associated with mortgage-backed securities to investors and credit-rating agencies.
- Executives: Insider trading by principals in the companies being investigated.

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New Century Example

- Once the nation’s second largest subprime mortgage bank, New Century filed for bankruptcy in April 2007.

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Bankruptcy Report

- Senior management blamed for creating a "ticking time bomb" of risky loans and improper accounting.
- Example: Loan-production dept trained mortgage brokers in sessions it referred to as "CloseMore University."

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What about Auditor?

- Report also blamed accounting firm, which served as outside auditor for 10 years, for allowing improper accounting practices to continue.
- Partner castigated subordinate who questioned accounting practices in an email: "I am very disappointed we are still discussing this. As far as I am concerned, we are done. The client thinks we are done. All we are going to do is p- everybody off."
- WSJ reports that local USAO looking at individuals at accounting firm, though they're not currently a target.

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Criticism of Law Firm

- Bankruptcy Examiner also singled out law firm for discovery delays and for meeting with one former New Century officer "and likely more" before the examiner could interview them.
- "The examiner informed counsel for the Company in October 2007 that he did not consider it appropriate for them to give witnesses they did not represent a preview of the examiner's interviews as it could harm the integrity of the investigation."

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Surviving Law Enforcement's Response to the Subprime Hurricane

By

Wayne Gross and Chris Pinzon[1]

In an economic development of mind-numbing complexity, sub-prime mortgage loans, many of which were generated in Orange County, generated economic hurricanes world-wide. This article explains how this happened, what law enforcement's likely reaction will be, and, finally, what companies that face potential criminal prosecution can do to minimize exposure.

The Bubble Inflates

The birth of today's crisis emerged from the solution to our last crisis: the dot-com bubble burst. From 2000 to 2003, the Federal Reserve Board lowered the federal funds rate from 6.5% to 1.0% in an attempt to stimulate a reeling economy.[1] Consequently, money was cheap and lending was an attractive business—even if it meant providing loans to sub-prime borrowers who under normal circumstances would never have been considered sufficiently creditworthy for such loans.[2]

The resulting rash of home-loan lending left banks with a large portfolio of mortgages—some good, some bad—but without sufficient capital to continue issuing lucrative loans. So the banks decided to sell the mortgages to raise funds for more loans.[3] The good mortgages were easily marketable, but how could the banks sell the high-risk mortgages profitably?

Enter the investment banks. The investment bankers saw that the high risk mortgages, commensurate with their increased risk, promised high returns and were secured by property whose value was rising. A win-win! So the investment banks pooled the risky mortgages and issued Collateralized Debt Obligations (CDOs). A CDO is a bond whose periodic payments are guaranteed by, in this case, the pool of risky mortgages grouped together. The CDOs were subdivided into various risk levels: low-risk CDOs were entitled to the highest priority in receiving payments, while high risk CDOs were promised higher yields.[4] The low-risk CDOs—even though made up of risky, sub-prime mortgages—received high credit ratings because of their payment priority, thereby allowing regulated institutional investors to purchase them, such as pension funds and foreign governments.[5] After the slicing and dicing was complete, the bankers had discovered a way to tap into the lucrative market of AAA rated bonds with *junk mortgages*. But this was only the beginning.

The higher risk CDOs were snapped up by hedge funds that were hungry for high performing investments. And as property values continued to rise, the fund managers looked like stars. So these rising stars did what any good hedge fund manager would do—they not only bought them, but *leveraged* them. In other words, they bought on borrowed money. So—to take one of the Bear Stearns hedge funds that crashed as an example—for every 1 high risk CDO that the fund actually bought, it purchased 15 more on borrowed funds. Consequently, these already risky investments now had their risk (and potential profit) magnified by a factor of 15.[6] The hedge funds then spread some of that risk to banks by purchasing Credit Default Swaps—essentially, insurance policies in the event that the CDOs defaulted.

This cycle was lucrative so long as home prices continued rising—and the cycle itself contributed to the rising home prices. The market demanded more CDOs, giving further

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incentive for lending institutions to lend to sub-prime borrowers. More buyers resulted in greater demand for homes, and, therefore, rising home prices, which further fueled the demand for lucrative CDOs. And so long as loan originators were no longer holding the risk associated with the subprime loans, they were happy to ease their lending standards to oblige the CDO market by offering the now-infamous Adjustable Rate Mortgages (ARMs) and "Liar Loans."[7]

The Bubble Bursts

Having described the bubble, it's easy to see how it burst. The entire mortgage-backed CDO market had a single stone for its foundation: steadily increasing property values. This "market euphoria," as Alan Greenspan described it,[8] would soon become market misery as the easing credit standards that fed the CDO market led to significantly increased defaults. This led in turn to tighter credit standards, which led to fewer home buyers, which led to softening home prices. Additionally, home owners found it harder to refinance their ARMs, resulting in even more defaults.[9] At that point the writing was on the wall for mortgage-based CDOs, and a mad rush for the exit ensued.[10] The market for CDOs collapsed, sellers of Credit Default Swaps lost, and suddenly the market realized that it had not fully understood the risks involved, nor how pervasive CDOs had become in the global economy.[11] This uncertainty led investors to pull back, and lenders to severely restrict lending activities, landing us in today's credit crunch.[12] And that, in a nutshell, is how imprudent home loans led to a global financial crisis.

The Feds Take Aim.

Orange County—unceremoniously dubbed the subprime lending capital of the world[13]—featured an array of home mortgage lenders steeped in the subprime market, including former heavyweight New Century Finance Corp., which is now bankrupt and, according to news accounts, under criminal investigation.[14] The FBI's recent announcement that it has opened 14 criminal investigations arising from the subprime mortgage crisis may have some Orange County businesses wondering whether they face potential criminal liability.[15] As a general matter, if a company's employees participate in illegal activity—such as accounting fraud, improper securitization of loans, or insider trading—and act within the scope of their employment, the company may very well be criminally liable.[16]

Remedial Action

Companies, however, need not sit idly by wondering whether they will soon face the prospect of being on the wrong end of a law enforcement or regulatory investigation. More and more companies engaged in conduct of potential interest to law enforcement and/or regulators are undertaking their own internal investigations, which constitute the single most-effective management tool for uncovering potential wrongdoing and instituting remedial relief. By providing outside counsel with the mandate to investigate conduct, fashion remedies, and, if appropriate, communicate findings – good or bad – to enforcement authorities, companies may be able to significantly decrease the likelihood of being criminally charged. Indeed, federal prosecutors are under specific instruction by the Department of Justice to take such measures into account in determining whether to criminally charge a particular company.[17] Accordingly, companies in the subprime market should consider the many benefits that can be derived from retaining independent counsel to conduct an internal investigation.

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[13] Daniel Gross, *Subprime Suspect*, The Washington Post, July 29, 2007, at http://www.washingtonpost.com/wp-dyn/content/article/2007/07/27/AR2007072701693.html
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[16] *See United States v. Beusch*, 596 F.2d 871, 877 (9th Cir. 1979).
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New Century Report Likely Reading for Prosecutors

REAL ESTATE: Report details mismanagement, finance errors

By Jessica C. Lee

Missal: "New Century had brazen obsession with increasing loan origination, without due regard to the risks"

A recently unsealed bankruptcy court report on accounting issues at Irvine's New Century Financial Corp. could become part of a criminal probe into the bankrupt subprime mortgage lender.

In the report, court-appointed examiner Michael Missal blamed New Century's senior management and auditor KPMG LLC for creating a "ticking time bomb" of risky loans and improper accounting.

Missal's preliminary report was issued in November with a final version submitted and made public late last month.

New Century, once the nation's second largest subprime mortgage lender, spiraled in early 2007 when executives warned of a quarterly loss, projected a big drop in 2007 loans and said some results would need to be restated to fix accounting errors.

The company filed for bankruptcy in April 2007.

New Century, the poster child for the mortgage boom and subsequent meltdown, is under investigation by the U.S. Attorney's Office in Santa Ana.

The probe includes once top executives, including former chief executives Brad Morrice and Robert Cole.

The U.S. Attorney's Office declined to comment for this story, as did many representatives of local law firms due to work they have related to the New Century case or because of the sensitivity of the matter.

Other white-collar crime lawyers offered input on how an investigation into a company like New Century could play out.

Companies that do their own internal probes into accounting issues and that share information with federal regulators can end up avoiding indictments or harsh penalties, according to legal sources.

That's been the case with scores of companies that did their own probes into stock options backdating. Out of some 150 that have been investigated by the government, only a handful has seen indictments, including Irvine's Broadcom Corp.

But there won't be any company probe into accounting issues at New Century, which is liquidating assets and winding down operations in bankruptcy court. The company didn't even restate past results amid its rapid unwinding.

The demise of New Century as a company makes its former executives the likely focus of federal investigators, sources said.

The company's senior management team could face criminal charges if prosecutors conclude they knowingly and willingly committed wrongdoing, they said.

In his report, Missal, a partner with Kirkpatrick & Lockhart Preston Gates Ellis LLP's office in Washington, D.C., accuses New Century executives of mismanagement and raises the specter of possible fraud at the company.

In an interview last week, Missal declined to comment on whether he's working with federal prosecutors looking into New Century. He was appointed as examiner in the case by Delaware's bankruptcy court last year to look into allegations of mismanagement and possible wrongdoing.

Bad Risk Management

New Century executives failed to take steps to manage rising risks in making loans to borrowers with imperfect credit, Missal said in his report.

Instead of focusing on whether borrowers could pay their mortgages, members of New Century's board and senior management team told Missal that their standard for loan quality was whether the loans could be packaged and sold as bonds to Wall Street, according to the report.

"New Century had a brazen obsession with increasing loan origination, without due regard to the risks associated with that business strategy," Missal said.

The failed company was aware of an "alarming and steady increase in early payment defaults" on its loans done no later than mid-2004, he said.

Yet "senior management turned a blind eye to the increasing risks of New Century's loan originations and did not take appropriate steps to manage those risks," Missal said.

The company opted to "feed eagerly the wave of investor demands without anticipating the inevitable requirement to repurchase an increasing number of bad loans," he said.

New Century went bankrupt after Wall Street buyers of loans packaged as bonds forced them back on the company as defaults started rising.

Missal's report accuses New Century of at least seven wide-ranging improper accounting practices in 2005 and 2006 that resulted in misstatements of financial results for 2005 and the first three quarters of 2006.

The report contends that New Century calculated its buyback reserve incorrectly by not accounting for the growing backlog of claims related to older loan sales. In the company's calculations, it also excluded interest that needed to be paid to investors when loans were repurchased.

"These critical omissions and changes were a violation of (generally accepted accounting principals)," Missal said.

KPMG, which served as New Century's outside auditor since the company went public in 1997 to early 2007, allowed some of the improper accounting practices to continue, according to Missal.

Several people who Missal interviewed claimed that KPMG recommended the improper changes to New Century's repurchase reserve calculation for its second and third quarters of 2006.

"New Century is ultimately responsible for the accuracy of its financial statements but KPMG bears responsibility at a minimum," Missal said.

KPMG refutes Missal's report.

"We strongly disagree with the report's allegations concerning KPMG and we believe that an objective review of the facts and circumstances will affirm our position," spokesman Dan Ginsburg said.

New Century's accounting irregularities almost always resulted in increased earnings, according to Missal. But he said his investigation didn't find evidence to conclude that New Century executives manipulated results.

"Law enforcement, regulators and even bankruptcy examiners are focusing like a laser on perceived misconduct."
-Wayne Gross
Snell & Wilmer

Fraud?

Whether New Century's accounting practices broke the law is up to prosecutors to determine. Missal's report stops short of alleging fraud by New Century and KPMG.

Wayne Gross, head of the U.S. Attorney's Office in Santa Ana until last year, declined to comment on New Century but weighed in on criminal probes into subprime mortgage companies. He now heads a white-collar criminal defense practice for the Costa Mesa office of Snell & Wilmer LLP.

The FBI's announcement earlier this year that it opened 14 criminal investigations stemming from the subprime mortgage crisis may have some in OC wondering if they could face potential criminal liability, according to Gross.

"Orange County companies and professional service providers that have been involved in the subprime crisis need to be particularly careful in an environment where law enforcement, regulators and even bankruptcy examiners are focusing like a laser on perceived misconduct," Gross said.

Missal, the lead counsel to the examiner in the 2002 WorldCom bankruptcy proceeding, said he hopes the media buzz surrounding New Century sends a message.

"Hopefully lessons can be learned from the New Century situation," he said.

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Wayne R. Gross is a litigation partner at Snell & Wilmer, where he focuses on trial practice, corporate crisis management, internal investigations, complex civil litigation, intellectual property litigation, and white collar criminal defense. The Orange County Register recently described Mr. Gross as a "dream team" defense lawyer.

Before joining Snell & Wilmer, Mr. Gross served as Chief of the Southern Division of the U.S. Attorney's Office for the Central District of California and prosecuted cases of national and international significance, including the UCI Fertility case, the Katarina Witt stalker case, and one of the first criminal trademark infringement cases brought to trial in Southern California. In addition to serving as a federal prosecutor in the Criminal Division of the U.S. Attorney's Office, Mr. Gross also served as a civil litigator in the Affirmative Civil Enforcement Section, a specialized unit of the Civil Division. Mr. Gross successfully pursued multi-million dollar civil litigation, including a False Claims Act lawsuit against a global engineering and construction firm, and obtained one of the largest civil fraud recoveries in the history of the Central District. Mr. Gross' primary area of emphasis in both the Criminal and Civil Divisions was complex fraud work, for which he was presented with awards by two U.S. Attorneys General and the Director of the F.B.I.

Mr. Gross has lectured at law schools and colleges throughout Southern California. He served as a law clerk for Central District Judge Laughlin E. Waters. Mr. Gross received his law degree, magna cum laude, from Hastings College of the Law, where he served as a Notes Editor for The Hastings Law Journal.

Mr. Gross serves on the Board of Directors of the Orange County Bar Association, the Federal Bar Association of Orange County, and the Constitutional Rights Foundation. He also served as chair of the Professionalism and Ethics Committee of the Orange County Bar Association.

Education

University of California, Hastings College of Law (J.D., *Magna Cum Laude*, honors, 1988)
Order of the Coif
Thurston Honor Society
Note Editor, HASTINGS LAW JOURNAL
University of San Francisco (B.S., Cum Laude, 1985)

Memberships & Activities

Orange County Bar Association
- Board of Directors (2006-Present)
- Education Committee (2007-Present)
-Chair, Professionalism & Ethics Committee (2005-2006)
-Resolutions Committee & Conference of Delegates (2006)
-Administration of Justice Committee (2006-Present)
-Founder of College of Federal Advocacy (2006)

Federal Bar Association, Orange County Chapter
-Board of Directors (2007-Present)

Constitutional Rights Foundation, Orange County Chapter
-Board of Directors (2007-Present)

Association of Business Trial Lawyers, Orange County Chapter