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The Financial Crisis

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The unstable financial environment is fueling public and political demand for justice that, as in times past, will increase the number of investigations of institutions and individuals who may be suspected of wrongdoing in the financial crisis. As the credit meltdown causes pain on Main Street, the political world will demand villains to blame on Wall Street, provoking both very public congressional investigations and somewhat more private but also more perilous criminal grand jury investigations. At the same time, the 'new financial order,' whereby the government becomes far more involved in the largest financial institutions, brings with it a host of new potential liabilities for those companies and firms.

Individual executives of failed or troubled institutions are likely targets of congressional or grand jury investigations. In particular, especially well-compensated executives of troubled institutions may be inviting targets for congressional hearings. Executives who failed to timely disclose material information to investors, spoke publicly in contravention to the information or acted in their own financial self-interest on the information are potential targets for enforcement investigations. Companies and firms where there is suspected executive malfeasance are equally exposed on

legal theories of vicarious liability for acts of officers and employees.

Prospectively, financial institutions in which the government has become a shareholder or lender, or has greatly increased its regulatory role -- such as under the Bank Holding Company Act -- will, as a result of these new relationships and reporting requirements, obtain greatly increased exposure to federal criminal statutes of general jurisdiction. Such statutes include the False Statements statute, 18 U.S.C. 1001, a felony provision that proscribes any false oral or written statement to a federal agency that is material to that agency's jurisdiction and any concealment of material information from the agencies where there is a duty to disclose. Similarly, any agreement to defraud the United States is a felony under the conspiracy statute, 18 U.S.C. 371. The courts expansively apply the conspiracy statute to any agreement to engage in conduct that has the effect of impeding or impairing a US agency's statutory or regulatory functions. These two statutes are examples of the many statutes that provide prosecutors with expansive and powerful means to investigate and prosecute financial institutions for statements to, and dealings with, a much more involved federal regulatory establishment.

The Financial Crisis

Enforcement is advancing on all fronts

An overview of the investigative environment attendant to this crisis and suggestions for a proactive response follow.

The US Department of Justice (DOJ) and US Securities and Exchange Commission (SEC) are both devoting substantial resources to the investigation of the financial crisis. According to media reports, as of Sept. 24, the Federal Bureau of Investigation (FBI) was investigating 26 companies entangled in the suspected roots of the financial crisis. These investigations have reportedly further strained the FBI's resources, which have become substantially devoted to terrorism matters. The FBI is focusing on devoted to terrorism matters. The FBI is focusing on suspected accounting fraud, insider trading and failure to disclose the value of mortgage-related securities and other investments by these companies. Investigators are specifically trying to determine whether anyone in those companies, including senior leadership, had any responsibility for providing 'misinformation' to the investing public. In testimony before the House Judiciary Committee, FBI Director House Judiciary Committee, Robert Mueller vowed to pursue corporate executives if warranted in the current mortgage fraud investigations.

The SEC formed a subprime working group last spring and reportedly has more than 50 ongoing investigations that relate to the subprime market. According to congressional testimony by SEC Chairman Christopher Cox, the SEC is also working with criminal prosecutors to probe claims to probe claims of fraud, manipulative short selling, and spreading rumors about firms that are victims of the crisis. The SEC has already required hedge funds, brokers and institutional investors to file sworn statements on their trading in stocks and credit default swaps in these firms, and it maintains a database of the information to look for 'manipulative patterns' in stocks and derivatives.

The SEC's Division of Enforcement announced on Oct. 22 that it had reached preliminary settlements in principle with six of the largest firms in the

auction-rate securities market. Although these settlements are subject to final approval by the SEC, if approved, the division has stated that 'they would be the largest in the history of the SEC and would return more than \$50 billion to investors.'

Additionally, state authorities -- particularly the New York attorney general -- are also investigating the companies entangled in the financial crisis.

Following is a summary of reported investigations:

The Bear Stearns Cos.: Federal prosecutors in New York have charged two of Bear Stearns' former hedge fund managers with fraud for misleading investors about the condition of two now-defunct hedge funds heavy exposure to subprime now-defunct hedge funds that had heavy exposure to subprime mortgage-backed securities. These managers are the first executives to be criminally charged in the subprime market debacle. Federal prosecutors have expanded their probe to include the activities of banks and lenders with regard to the two funds. Investigators are also looking at private financial memoranda to see if the firm defrauded wealthy investors. The SEC and the US attorney's office in attorney's office in Brooklyn, N.Y., are also looking into allegations that certain Bear Stearns insiders pulled their personal money out of the investment vehicles at the same time the funds' managers urged other investors to stay put.

Freddie Mac & Fannie Mae: A federal grand jury in New York is investigating accounting, disclosure and corporate governance issues at Fannie Mae and Freddie Mac dating back to 2007. Fannie and Freddie received subpoenas from the US attorney's office in New York, and the SEC has requested that they preserve documents.

Lehman Brothers Holdings Inc.: New Jersey is considering a lawsuit against Lehman after losing more than half of the \$180 million it invested with the bank in June because state officials are questioning the accuracy of information Lehman provided.

The Financial Crisis

Washington Mutual Inc.: On Oct. 15, the FBI announced that it had been investigating Washington Mutual's operations for several months. Media reports indicate that the FBI is closely following the progress of several consolidated class actions against the bank. As with the other investigations, a critical question is whether the bank had knowledge about the quality of its investments that it should have disclosed but failed to do so.

American International Group Inc.: On Sept. 16, AIG accepted an \$85 billion loan from the federal government in exchange for an 80% government stake in the troubled insurance company. On Oct. 7, the House Committee on Oversight and Government Reform held a hearing on the causes and effects of the AIG bailout, after which the committee requested additional information to aid the committee's investigation. Separately, on Oct. 15, New York State Attorney General Andrew Cuomo informed AIG that it was under investigation for 'irresponsible and damaging' expenditures related to executive compensation packages.

IndyMac Bank FSB: The Federal Deposit Insurance Corp. seized IndyMac on July 11, after investors withdrew \$1.3 billion in funds. Five days later, federal investigators said that it would look into whether the bank engaged in fraud when it made home loans to high-risk borrowers. Investigators are reportedly interested in bad appraisals and underwriting that might have caused false statements to be made on loan applications.

Countrywide Financial Corp.: Countrywide was purchased by Bank of America on Jan. 11 for \$4 billion in stock. In March, investigators announced preliminary investigations into whether Countrywide officials misrepresented the company's financial position and the quality of its mortgage loans in securities filings.

Proactive responses to this enforcement environment

The current enforcement environment makes it essential that current management as well as boards

and their audit committees aggressively address any red flags that indicate circumstances that may give rise to allegations of wrongdoing and/or liability. Even without such indicators, financial players are well-advised to step up scrutiny of their dealings and communications with their federal partners or overseers because all such activity brings with it increased exposure to federal criminal provisions.

Both legal and reputational risks dictate a prudent, proactive response. The components of such a response would include a self-assessment of potential legal exposure and liabilities, the identification and undertaking of remedial measures, marshaling facts and legal arguments necessary to respond and defend against allegations, monitoring the progress of investigations and current events in order to continue to assess risk and respond accordingly, and preparing an action plan to address any government investigation on the first day the company learns of it.

A proactive response is a prudent risk management strategy for companies and firms in the financial industry that can address the substantial legal risks attendant to the financial crisis. Should such organizations become involved in congressional inquiries or the subject of nascent criminal investigations, they will be in a much better position to respond and defend if they have proactively obtained relevant facts and formulated a response. Failing to do so could easily turn a financial crisis into a legal one.

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