

Bulletin

A Quarterly
Newsletter for
Institutional Investors
by Barroway Topaz
Kessler Meltzer & Check, LLP

CAUGHT OFF-GUARD BY LOSSES IN SECURITIES LENDING PROGRAMS: How Supposedly Conservative Investments Have Turned into Unexpected Losses for Pension Funds

Sharan Nirmul, Esquire

In the days and weeks following the Lehman Brothers bankruptcy on September 15, 2008, fiduciaries of private employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (“ERISA”) — as well as public employee benefit plans and other institutional investors — that participate in securities lending programs, were informed, virtually across the board, that the funds in which the cash collateral from their securities lending activities was invested had “broken the buck.” As such, the fiduciaries and boards were told that they were liable for the deficiencies in the cash collateral in these funds under the terms of their securities lending agreements. To say the least, these collateral deficiencies — and resulting losses — were

an unpleasant shock given that the securities lending programs, by contract and supposed design, were intended to be conservative investment pools with the principal objective of enhancing an institution’s investment returns from its portfolio of securities. As it turns out, the Lehman bankruptcy served as a catalyst for exposing that the securities lending programs held highly risky investments in the purportedly risk averse commingled funds. These risky investments exacerbated losses suffered by institutions in the market downturn.

BTKMC has taken the lead in representing institutional investors suffering losses from securities lending programs. On behalf of two institutional clients, the firm has commenced

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LEHMAN BROTHERS UPDATE: Recent Developments in the Downfall of a Wall Street Giant

Benjamin Hinerfeld, Esquire and John A. Kehoe, Esquire

On September 15, 2008, the venerable 158-year-old Wall Street giant Lehman Brothers Holdings Corporation (“Lehman”) petitioned for protection under Chapter 11 of the United States Bankruptcy Code, shocking the financial world and by some accounts leading the way to a global financial meltdown. Barroway Topaz Kessler Meltzer & Check, LLP is serving as court-appointed Co-Lead Counsel on behalf of a group of institutional investors, including Alameda County Employees’ Retirement Association, Government of Guam Retirement Fund, Northern Ireland Local Government Officers’ Superannuation Committee, City of Edinburgh Council as Administering Authority of the Lothian Pension Fund, and Operating Engineers Local 3 Trust Fund (the “Pension Fund Group”) in a securities class action styled *In re Lehman Brothers Equity/Debt Securities Litigation*, No. 1:08-CV-05523 (LAK), pending in

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COURT DENIES MOTION TO DISMISS IN COUNTRYWIDE PREDATORY LENDING CASE

Edward W. Ciolko, Esquire

As each day's news features the latest billion dollar government plan for bailing out Wall Street and the nation's biggest banks alongside heart-wrenching stories of everyday folks losing their homes in an unprecedented wave of foreclosures, Barroway Topaz has actively sought to attack the predatory mortgage lending practices that played such a central role in bringing the nation's housing market — and the economy in general — to a screeching halt. On February 5, 2009, the Honorable Dana A. Sabraw of the United States District Court for the Southern District of California, in a detailed and thoughtful opinion, denied a motion to dismiss a lawsuit filed by consumer-residential loan borrowers ("Private Plaintiffs") represented by Barroway Topaz, along with Co-Lead Interim Class Counsel, against Countrywide Financial Corporation, its corporate "successor," Bank of America Corp., and certain of its brokers and subsidiaries ("Countrywide"). The suit accused Countrywide of violating federal anti-racketeering law, state consumer protection laws and the common law of unjust enrichment. Judge Sabraw dashed Defendants' hopes for quick disposal of the numerous predatory lending claims asserted against them in the consolidated proposed class action entitled *In Re: Countrywide Financial Corporation*, Case No. 3:08-md-01988-DMS-LSP. The Consolidated Class Action Complaint ("Complaint") addressed in the February 5, 2009 decision is part of Multi-District Litigation No. 1988 ("MDL"), which also includes claims asserted against Countrywide by numerous state attorneys general.

In their Complaint, the Private Plaintiffs charge that Countrywide and others, including a nationwide network of mortgage brokers, developed and executed an unlawful and unscrupulous scheme to maximize profits by steering borrowers into costly, unsuitable subprime loans through a myriad of misrepresentations, deceptions, non-disclosures and false promises. The Private Plaintiffs allege that this over-arching scheme to steer borrowers into inappropriate mortgage loans, without regard to their suitability for the borrowers, violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961, et seq., and California consumer protection laws, including the California Unfair Competition Law, Cal. Bus. & Prof. Code § 17200, et seq. ("UCL"), and the False Advertising Law, Cal. Bus. & Prof. Code § 17500, et seq. ("FAL"), as well as the common law of unjust enrichment.

For years, the alleged scheme produced great profits for Countrywide. At the height of its success, Countrywide was the largest residential mortgage lender in the United States, with hundreds of billions of new loan fundings each year and a

loan servicing portfolio that exceeded \$1 trillion. Countrywide allegedly developed the scheme to push consumers into costly subprime loans because, by doing so, it made higher profits on unnecessarily high interest rates, origination fees and other related fees, and from packaging the loans as mortgage-backed securities. Historically, lenders who made mortgage loans kept the loans and, thus, were concerned about the borrowers' ability to repay. However, throughout the boom of the housing and mortgage markets, mortgage loans were frequently no longer held by the original lenders but routinely bundled, securitized and sold to Wall Street investors on the secondary market.

Therefore, the Private Plaintiffs contend that Countrywide's enormous growth was fueled by a blind focus on originating, packaging and then selling as many subprime mortgage loans on the secondary market as possible. Indeed, according to the Complaint, during 2006 alone, Countrywide securitized \$47.7 billion in subprime and prime home equity loans. The Complaint alleges that these astronomical volumes were achieved because Countrywide actively encouraged its sales associates, loan officers and third party brokers to steer borrowers into high-priced subprime loans with incentives such as increased commissions and all-expense-paid trips to Las Vegas, NV. This was not because the loans were actually suitable for the borrowers, but, rather, because such loans were hugely profitable for Countrywide — on their terms at origination and upon being securitized and sold into the secondary market.

In order to maximize the breadth of its scheme, Countrywide heavily marketed a variety of subprime loan products, including high-rate adjustable rate mortgages ("ARMs"), to hundreds of thousands, if not millions, of borrowers nationwide. Perhaps the most notorious such product described in the Complaint's allegations was the pay option-ARM mortgage, a loan product that was very difficult for borrowers to understand and that all but guaranteed negative amortization and eventual default. In 2006, Countrywide originated \$70 billion in such loans — nearly double that of its closest competitor! The Complaint alleges that, often, when concerned borrowers inquired as to the suitability of the loans that Countrywide offered to them, they were purposefully led astray, directed to focus on the deceptively low initial monthly payments rather than the true long term loan terms or assured that Countrywide would refinance their loans at a later date. As a result, Plaintiffs allege, borrowers were often unaware of the true terms of their mortgages, including such key facts as substantial increases

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BARROWAY TOPAZ LEADS FIGHT FOR INDYMAC SHAREHOLDERS

Christopher L. Nelson, Esquire

Though certainly the most publicized, investment banks like Lehman Brothers and Merrill Lynch were not the only institutions whose reckless dealings in sub-prime and non-prime loans led to their demise in 2008 and cost shareholders billions of dollars. A handful of retail/thrift banks failed in 2008 as well; few larger than Pasadena, California-based IndyMac Bancorp, Inc. (“IndyMac”) which had, not long before, been one of the country’s largest home lenders.

By the time the Federal Deposit Insurance Company (“FDIC”) raided IndyMac’s offices on the afternoon of July 11, 2008 and took over the operations of the bank, Barroway Topaz Kessler Meltzer & Check, LLP was already a year into its investigation and suit against IndyMac and its then CEO, Michael Perry, on behalf of its shareholders for the very activities that ultimately brought down the bank. Since being appointed as lead counsel in June 2007, Barroway Topaz’s investigation — which

included dozens of interviews with former employees — has led to shocking revelations about IndyMac and Perry, particularly with regard to the bank’s ever-more reckless underwriting policies which focused on loan volume at the expense of quality, purportedly protected by hedging strategies.

Background to the Fraud at IndyMac

From 2001 until 2006, the United States experienced a “bubble” in the housing market resulting in inflated home valuations, and a related refinancing boom. During this period, IndyMac experienced unprecedented growth by focusing on writing, purchasing, and reselling as packaged securities, high risk “Alt-A loans.” Alt-A loans are loans that borrowers can obtain with little (or at times no) documentation. Originally

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IS NOW THE TIME FOR “SAY ON PAY”?

J. Daniel Albert, Esquire

The current economic climate has given greater voice to non-binding shareholder advisory votes on executive compensation known as “say on pay” provisions. These measures had already begun to gain popularity among shareholders and politicians alike who have grown weary of excessive pay bestowed on executives at many public companies, especially companies that are struggling to provide investment returns to shareholders.

For example, on April 20, 2007, Rep. Barney Frank, D-Mass, introduced the Shareholder Vote on Executive Compensation Act in the U.S. House of Representatives, designed to provide shareholders with a non-binding advisory vote on companies’ executive compensation, essentially mandating “say on pay” at all public companies. President Barack Obama, while still in the Senate, introduced a companion bill to the Committee on Banking, Housing and Urban Affairs. Also, in 2008, Aflac, Inc. became the first publicly traded company to actually adopt a non-binding “say on pay” provision at the behest of the company’s shareholders.

The preceding events occurred in advance of the passage on October 3, 2008 of the landmark Emergency Economic Stabilization Act of 2008 (“EESA”) and the first phase of its Troubled Asset Relief Program (“TARP I”), which imposed substantial restrictions on executive compensation for

companies that received federal bailout money. For example, TARP I limited golden parachute payments to certain senior executive officers at companies during the period in which the federal government holds any debt or equity position in the company.

In spite of this initial crackdown on executive compensation, some executives did not appear to get the message, as demonstrated by former Merrill Lynch CEO John Thain’s million dollar remodel of his office following Merrill’s merger with Bank of America. As a result, President Obama and Congress imposed even tighter restrictions on executive compensation with the passage of the American Recovery and Reinvestment Act of 2009 (“ARRA”) on February 17, 2009.

The ARRA amends and expands the compensation restrictions set forth under the EESA for all companies which received federal funds under TARP I, and applies going forward to all companies that will receive federal funds from the second half of the \$700 billion TARP fund (“TARP II”). Notably, the ARRA imposes a non-binding “say on pay” upon all companies that receive TARP funding. ARRA provides that “[a]ny proxy or consent or authorization for an annual or other meeting of the shareholders of any TARP recipient during the period in which any obligation arising from financial assistance pro-

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CAUGHT OFF-GUARD BY LOSSES IN SECURITIES LENDING PROGRAMS *(continued from page 1)*

two class actions involving securities lending programs managed by BNY Mellon and JP Morgan, *Board of Trustees of the AFTRA Retirement Fund v. JP Morgan Chase Bank, N.A.*, 09-civ-00686 (S.D.N.Y.) and *Compsource Oklahoma v. BNY Mellon, N.A.*, 08-civ-469 (E. D. Okla). These suits seek to recover losses resulting from these custodians' breaches of their fiduciary duties to investors in their securities lending programs and for negligence. This article outlines the framework by which the largest asset custodians operate their securities lending programs, the duties of care of custodians who operate the lending programs, the reasons for the large collateral deficiencies in these programs and resulting losses to institutional investors, and potential avenues for recovery for some of the realized losses.

A. The Framework of Securities Lending Agreements by the Major Custodians

Securities lending was developed by some of the largest custodial banks — BNY Mellon, Northern Trust, State Street and JP Morgan, among others — into a product for their institutional clients to augment investment income on securities held in the institution's investment portfolios. Under these securities lending programs, the custodial bank lends its clients' securities to borrowers looking, for the most part, to short sell these securities, and in return receives collateral from the borrower in an amount greater than the current market value of the securities being lent. Typically, this collateral is in the form of cash — in an amount that is 102% to 105% of the value of the securities lent. The cash collateral received on behalf of the lending client is then commingled with cash collateral received on behalf of other lending clients and the pooled money is reinvested in fixed income securities, and other debt instruments, through a commingled investment fund. Any income generated from the investment of the cash collateral is shared between the lender and the custodian, after a rebate is first paid to the borrower. Custodians may receive up to 70% of the net fees after rebates are paid, depending on how much bargaining power the institution can exert.

Key terms in the agreements governing the securities lending programs — other than the fees that the custodian receives — include the investment guidelines for investment of cash collateral, the standard of care assumed by the custodian in the investment and management of the cash collateral and terms governing the indemnification for losses. Securities lending programs are advertised by custodians as a relatively risk-free way to augment income. For example, JP Morgan's securities lending website advertises that "Our objective is to help you obtain an attractive return while minimizing risk." This risk-averseness is necessarily a component of the securities lending

programs because the typical participants in the commingled funds in which the cash collateral is invested — ERISA funds and public pension funds — are not seeking to substantially increase the risk profile of their investments beyond what they would expect from the index funds or diversified benchmark portfolios' from which securities are lent. In addition to these fairly conservative investment guidelines, the agreements may specify the types of debt or other fixed income instruments, by issuer and ratings, in which cash collateral may be invested. For the most part, appropriate debt instruments, with respect to commingled funds in which ERISA and public pension plans are invested, are limited to highly rated debt instruments with fairly short maturity dates.

Under the typical securities lending agreement, any loss to the principal of the cash collateral is borne solely by the lender of the securities and in the event of a collateral deficiency, arising for instance from the default of an issuer of the debt instrument purchased by the commingled fund. Agreements, however, especially with respect to ERISA and public pension plans, contain provisions indemnifying these institutions from losses in the event that the lender breaches the investment guidelines for the investment of cash collateral, or for acts of bad faith, negligence or willful misconduct on the part of the lender. In addition to these contractual obligations, custodians are also, likely, subject to statutory and common law duties of care attendant to their role as investment advisors, discussed below.

B. The Recent Losses Suffered by Participants in Securities Lending Agreements

In September 2008, some of the largest custodians that operate securities lending programs — including BNY Mellon, JP Morgan and Northern Trust — notified their clients that the commingled cash collateral accounts in which they were invested had suffered collateral deficiencies causing these accounts to "break the buck." The collateral deficiency, according to the custodians, occurred as a consequence of the bankruptcy of Lehman Brothers and the market disruptions that followed.

For example, as of September 18, 2008, in Northern Trust's "Core USA" collateral pool, which was one of several cash collateral pools in which Northern Trust invested its clients' cash collateral and which held \$74 billion in fixed income assets, the collateral deficiency amounted to \$886 million. \$100 million of this deficiency was due to permanent impairment of the Lehman Brothers bonds held in this account while the rest of the collateral deficiency was due to mark-to-market losses. Northern Trust's direct lending clients were informed that, under contract, they bore the loss of the cash collateral deficiency in the commingled account. In theory, these clients

would need to fund the loss or collateral deficiency by way of a cash injection into the cash collateral pools. As such, a “payable” was posted in the accounts of these direct lending clients in the amount of their pro-rata share of the cash collateral in the commingled accounts.

In addition to the realized losses, the unrealized “mark-to-market” losses in the cash collateral pools have effectively prevented lending clients from extricating themselves from the securities lending programs and avoiding potential future losses because withdrawal now will result in assets held in the cash collateral pools being liquidated at depressed prices and the lender having to make up any shortfall in cash collateral owed to the borrower of the securities. The realized losses on these accounts have, for many securities lending participants, reversed years of income they received from these programs, practically overnight.

C. How Did It Come to This? Sigma Finance as a Case Study

Participants in the securities lending agreements have been left wondering why they have suffered losses in supposedly conservative investments in highly rated fixed income assets that were intended to simply augment returns on even safer investments in passive or enhanced index funds. The answer, we believe, lies in the conflicts of interest built in the securities lending programs and the lack of diligence by custodians to monitor the supposedly “safe” investments in which the cash collateral was intended to be invested. Our investigation into these losses has revealed that one major component of the realized losses suffered by clients in the JP Morgan and BNY Mellon cash collateral pools were investments in a structured investment vehicle (“SIV”) called Sigma Finance, which went bankrupt in October 2008.

Less than a year before its collapse, Sigma was the world’s largest SIV, among the thirty or so SIVs that existed. SIVs issue short term debt, typically in the form of medium term notes (“MTNs”) and commercial paper, to finance the acquisition of long term high yielding assets, such as mortgage backed securities. SIVs’ revenues are generally based on the difference in yield between the debt it issues to investors and the investment assets they own. Investors in SIVs are typically the equity investors, who enjoy whatever spillover profits the SIV generates through its investments, but who stand last in the line of seniority as creditors to the SIV, and those who lend money to the SIV i.e. purchasers of the SIV’s short term debt. The short term debt purchasers may be further divided into those who purchase commercial paper — usually instruments that are repaid in a few months to a year and are the most senior creditors of the SIV, and MTN purchasers, who are the next most senior creditors in the SIV hierarchy. Commercial paper and MTN purchasers buy SIV debt because these instruments

promise a better yield than similarly rated corporate debt instruments. Rating agencies rate the instruments issued by SIVs based on their perception of the value of the SIV’s underlying assets relative to the SIV’s debt burden.

The more leveraged a SIV is, the better the return it enjoys, assuming that it can consistently and reliably revolve its short term debt. SIVs rely on the confidence of purchasers of its short term debt — particularly commercial paper — that the value of the SIV’s assets can generate sufficient income and have enough liquidation value to pay off the SIV’s short term debt. Because SIVs, more recently, invested heavily in mortgage backed securities and other asset backed instruments as their long term investments, when the subprime mortgage crisis began to unfold in the summer of 2007, causing a global credit crisis, SIVs were among the first casualties. As investors refused to lend money to SIVs, SIVs were unable to continue to finance their long term assets and had to sell these assets to pay their short term creditors. These forced sales drove down the price of these assets even more — and in the case of mortgage backed securities, exacerbated the existing price erosion of these securities — and caused a cascading failure of SIVs.

Participants in the securities lending agreements have been left wondering why they have suffered losses in supposedly conservative investments

For Sigma, the writing was on the wall in the fall of 2007. At that time, almost all peer SIVs were being saved only by being consolidated onto the balance sheets of the investment banks that had created them. Citigroup, for example, which managed seven of these thirty SIVs, absorbed each of its SIVs onto its balance sheet. Sigma, however, was an independent SIV and having an asset base of more than \$50 billion dollars, survived the liquidity crisis of the Fall of 2007 by selling off its assets to pay maturing MTNs that were coming due. By January 2008, Sigma had turned to repurchase “repo” transactions or to fund its operations. In a repo transaction, the SIV sells a portion of its assets to a “repo counterparty,” typically a bank with the highest possible short term rating. At the same time, the SIV

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LEHMAN BROTHERS UPDATE *(continued from page 1)*

the Southern District of New York. The Action is on behalf of all persons and entities who purchased Lehman common stock between June 12, 2007 and September 15, 2008, or who acquired certain Lehman debt offerings between February 13, 2007 and September 15, 2008, and arises from material misstatements and omissions about Lehman's financial condition and exposure to the residential and commercial real estate markets in the period leading to Lehman's unprecedented bankruptcy filing.

As reported in the Fall 2008 edition of the *Barroway Topaz Bulletin*, soon after Lehman's downfall the Federal Bureau of Investigation and the Securities and Exchange Commission ("SEC") commenced investigations, and Federal prosecutors from United States Attorneys' offices in Brooklyn, Manhattan and New Jersey reportedly issued grand jury subpoenas to twelve former Lehman executives, including former CEO Richard S. Fuld Jr., and former CFO Erin Callan. According to news accounts, the criminal investigations are focused on whether Mr. Fuld and other Lehman executives made misleading statements about the bank's financial condition to investors who took part in a \$6 billion infusion of capital announced by Lehman on June 9, 2008. *The New York Times* reported that the Brooklyn and Manhattan prosecutors are investigating, among other things, "comments Lehman executives made during a Sept. 10 conference call five days before the company filed for bankruptcy [and] . . . whether Lehman put proper values on its large commercial real estate holdings. . . ."

Barclay's Purchases Lehman Assets

Just two days after Lehman sought bankruptcy protection under Chapter 11, it negotiated a court-approved sale of its North American brokerage unit, Lehman Brothers Incorporated ("LBI"), to Barclays Capital Inc., the investment banking division of British bank, Barclays Bank PLC, for \$1.7 billion in cash and Barclays' assumption of approximately \$4 billion in liabilities. On September 20, 2008, United States Bankruptcy Judge James M. Peck approved the sale, stating:

LBI is a valuable, but highly sensitive, asset of [Lehman]. Its value is greatly dependent upon its ability to assure its clients and customers of its financial and operational integrity. In the circumstances of Lehman's instability, Lehman cannot instill that assurance in its clients and customers.

Overruling each objection to the sale, Judge Peck found that Lehman had full corporate authority to consummate the transaction with Barclays, that the sale was in the best interest of Lehman's estate, and was necessary to "maximize the value of [Lehman's] estates," that the sale was at arm's-length and that Barclays would acquire the assets "free and clear" of liens, claims, encumbrances, obligations, liabilities, etc. In short

order, Barclays extended job offers to approximately 10,000 former Lehman employees, and within days, Lehman's North American trading operations were up and running in Barclays' name. Among the assets Barclays acquired from Lehman on September 20, 2008 were Lehman's prime brokerage business and accounts and its landmark headquarters on New York City's Seventh Avenue.

SIPC Intervention

On September 26, 2008, fulfilling a condition of the sale of Lehman's assets to Barclays, James W. Giddens of Hughes Hubbard & Reed was appointed under the Securities Investor Protection Act of 1970 ("SIPA") as Trustee for the liquidation of LBI. Working with the Securities Investor Protection Corporation ("SIPC"), the Trustee enumerated five major tasks in the LBI liquidation: (1) transferring accounts; (2) processing claims; (3) marshalling assets; (4) administering the liquidation process; and (5) investigating the causes of LBI's collapse and potential legal actions arising from that collapse, and issuing a report on its findings. As of December 1, 2008, the Trustee reported that "over 135,000 accounts of securities customers containing more than \$140 billion in customers' property" had been transferred to other broker-dealers. The Trustee has no jurisdiction over accounts held by Lehman's foreign brokerage subsidiaries.

Congressional Hearings

In the wake of Lehman's downfall, the United States House of Representatives Committee on Oversight and Government Reform held hearings on "The Causes and Effects of Lehman Brothers Bankruptcy." Appearing before the Committee on October 6, 2008, former Lehman CEO Richard Fuld testified that Lehman had been swept up in a "financial tsunami . . . much bigger than any one firm or industry." Mr. Fuld would not attribute Lehman's downfall to excessive leverage, reckless underwriting strategies of its mortgage origination subsidiaries, or the firm's buying spree in overvalued commercial real estate, but instead to a combination of naked short-selling, false rumors about Lehman's liquidity, threats of credit downgrades by ratings agencies, counterparties unwilling to enter into trades without Lehman posting increased collateral, the Federal Reserve's refusal to allow Lehman to convert into a bank holding company, and finally, to buyers unwilling to acquire Lehman without government backing. To the contrary, according to Committee Chairman Henry Waxman, ". . . documents obtained by the Committee undermine Mr. Fuld's contention that Lehman was overwhelmed by forces outside its control." One internal analysis reveals that Lehman "saw warning signs" but "did not move early/fast enough" and lacked "discipline about capital allocation." Chairman Waxman added that,

Mr. Fuld's actions during this crisis were questionable. In a January 2008 presentation, he and the Lehman board were warned that the company's "liquidity can disappear quite fast." Yet despite this warning, Mr. Fuld depleted Lehman's capital reserves by over \$10 billion through year-end bonuses, stock buybacks, and dividend payments.

Likewise, University of Chicago professor Luigi Zingales testified before the Committee that, "It is important to note that Lehman did not find itself in that situation by accident; it was the unlucky draw of a consciously-made gamble."

Appointment of a Bankruptcy Examiner

On January 16, 2009, following the requests of several Lehman creditors, Bankruptcy Judge Richard Peck ordered the United States Trustee overseeing Lehman's bankruptcy to appoint an independent Examiner with the power to investigate a wide range of issues, including asset transfers or breaches of fiduciary duty before and after the bankruptcy filing. Judge Peck ordered the Examiner to investigate, among other things, events that occurred from September 4, 2008 through September 15, 2008, or prior thereto, that may have resulted in commencement of the Lehman's chapter 11 case, and whether there are colorable claims for breach of fiduciary duties and/or aiding or abetting any such breaches against the former officers and directors of Lehman arising in connection with the financial condition of the Lehman enterprise prior to the commencement of the Chapter 11 bankruptcy.

On January 19, 2009, the U.S. Trustee appointed Anton R. Valukas, Chairman of Jenner & Block and former United States Attorney, to serve as the Lehman Bankruptcy Examiner. According to a Preliminary Work Plan filed with the Bankruptcy Court, the Examiner anticipates coordinating his investigation with the investigation of the SIPA Trustee, and to reach similar understandings with United States Attorneys for the Southern District of New York and the SEC. The Preliminary Work Plan also provides that the Examiner anticipates gaining access to "billions" of pages of documents, to interview 100 or more witnesses voluntarily, and to use subpoena power when necessary. The Preliminary Work Plan projects that, if there are no issues with respect to immediate access to documents and financial data, the Examiner believes that a final report summarizing his findings will be completed in 9 months.

Tidal Wave of Litigation

In the aftermath of Lehman's collapse, dozens of legal actions, in state and federal courts nationwide, were filed by institutional and individual investors who held Lehman debt securities. Actions were not only brought against Lehman, but also against the syndicates of banks that had collaborated with Lehman in issuing the notes. Actions were also filed on behalf of purchasers of hundreds of "structured notes," a hybrid debt/derivative

instrument that embeds seemingly profitable derivative formulas (based on the price of other non-Lehman issued instruments) within traditional, supposedly risk-free bonds backed by Lehman. Like Lehman's traditional bonds, the structured notes lost value when Lehman filed for bankruptcy protection and defaulted on its payments.

In addition to these lawsuits brought on behalf of purchasers of Lehman's equity and debt, former employees of Lehman have also filed actions under the Employee Retirement Income Security Act ("ERISA"), alleging that Lehman and members of its Board of Directors breached their fiduciary duties by mismanaging the Company's 401(k) plans. In addition to the equity/debt actions and the ERISA claims, still more actions were filed on behalf of investors who purchased the hundreds of mortgage-backed securities that Lehman or its affiliates had securitized and sold to the investing public.

On January 8, 2009, Judge Lewis A. Kaplan of the United States District Court for the Southern District of New York convened a conference of counsel to establish a plan of organization for the lawsuits then pending before Judge Kaplan. BTKMC and its Co-Lead Counsel presented Judge Kaplan with a comprehensive plan to manage the lawsuits on behalf of purchasers of Lehman's equity and debt securities, including the structured notes. In his January 9 initial case management order, Judge Kaplan ordered that all cases pending before Judge Kaplan that involved Lehman's issuance of equity or debt, including structured notes, would be consolidated under the name *In re Lehman Brothers Equity/Debt Securities Litigation*, and Judge Kaplan confirmed BTKMC as Co-Lead Counsel for the consolidated litigation. Judge Kaplan also established a Plaintiffs' Executive Committee consisting of BTKMC and its Co-Lead Counsel, as well as lead counsel in the ERISA and mortgage-backed securities cases against Lehman.

On February 23, 2009, the Pension Fund Group filed a Second Amended Consolidated Class Action Complaint for Violations of the Federal Securities Laws ("Complaint"). As defined in the Complaint, the action asserts claims on behalf of all persons and entities that purchased or acquired various securities of Lehman between February 13, 2007 and September 15, 2008 ("the Offerings Period"), and persons and entities that purchased Lehman common stock between June 12, 2007 and September 15, 2008. The Complaint asserts claims against several former Lehman officers (including Richard Fuld), several members of Lehman's Board of Directors, and underwriters for various Lehman debt and equity offerings during the Offerings Period. The Bankruptcy Code prevents Lehman from being a named defendant in this action.

For more information on the status of the litigation, and to access certain information and materials regarding the substantive allegations, including a copy of the Complaint, please visit the Lehman Securities Litigation Website at www.lehmansecuritieslitigation.com.

CAUGHT OFF-GUARD BY LOSSES IN SECURITIES LENDING PROGRAMS *(continued from page 5)*

agrees to repurchase the assets at a specific point in the future (the repo term) and pays interest to the repo counterparty over the term of the transaction. To protect itself from default by the SIV, the repo counterparty will insist on a “haircut” being applied to assets. This means that the SIV must post collateral over and above the SIV borrows from the repo counterparty. For investors in Sigma’s MTNs, these repo transactions were a red flag because they encumbered assets of Sigma that also secured the MTNs.

During this period, Sigma’s MTNs were held in the commingled pools of a number of the large securities lending programs, including Northern Trust, BNY Mellon and JP Morgan. While these MTNs, at the time they were purchased, during the spring and summer of 2007, were highly rated by ratings agencies and likely fit the investment guidelines for the securities lending programs, by the fall of 2007, the increased risks of investing in these securities were apparent. By the spring of 2008, rating agencies — not the quickest to act — had downgraded the MTNs issued by Sigma. By the fall of 2008, when many analysts had predicted that Sigma would be unable to pay its debts that were coming due, the collapse of Lehman Brothers was merely a nail in the coffin of this SIV. On October 2, 2008, one of Sigma’s repo counterparties, JP Morgan — itself a manager of large securities lending program that was invested in Sigma — declared Sigma in default of its repo agreements and seized approximately \$25 billion of Sigma’s \$27 billion in assets, leaving only \$1.9 billion to secure approximately \$6.2 billion in outstanding senior secured liabilities (primarily MTNs).

So given these facts, why were so many of the largest commingled cash collateral funds holding Sigma MTNs when Sigma was forced into liquidation? One explanation is that lending agents do not share the risk of default of securities held in commingled funds and therefore, custodians have little incentive to carefully monitor the developing risks of default on principal after the debt instruments have been purchased. In Sigma’s case, large custodians, like JP Morgan, had their own financial interests in Sigma and so liquidating large volumes of MTNs into the market may have been contrary to these self-interests. Indeed, JP Morgan’s securities lending clients have suffered millions of dollars in losses due to the investment of their commingled cash collateral in the Sigma MTNs, in part as a consequence of JP Morgan seizing the collateral that securitized these MTNs. BNY Mellon’s clients, collectively, may have lost hundreds of millions of dollars as a consequence of Sigma’s collapse.

The unprecedented nature of Lehman bankruptcy provided both BNY Mellon and JP Morgan with a convenient excuse for the sudden and dramatic losses stemming from investments in debt instruments, without having to separately explain the

losses resulting from Sigma. As far as we can tell, JP Morgan, for instance, never directly informed its clients that the majority of the realized losses in its securities pending portfolio were due not to the default of Lehman, but to the Sigma MTNs held in the account. Northern Trust, which attempted to compensate its clients in part for losses relating to Lehman bonds held in clients’ accounts has all part ignored the more substantial losses relating to Sigma. The same holds true for BNY Mellon.

D. Pending Litigation and Avenues for Recovery

As mentioned above, the securities lending agreements typically place the risk of loss principally on the lending client, except in cases of negligence and willful misconduct. However, while securities lending programs are contractual in nature and these contracts may or may not define a duty of care by which the custodian is bound, a custodian and manager of a securities lending program may also have duties beyond the terms of the contract. Sources of these duties are ERISA, the governing statutes for public pension plans, and common law. These duties of care provide a potential avenue of recovery for some of the losses suffered by participants in the securities lending programs and is the basis under which the cases currently being prosecuted by BTKMC have been brought.

In the case of ERISA plans, an investment manager that contracts with the plan is automatically bestowed with the fiduciary duties and responsibilities of an ERISA fiduciary. Indeed, in securities lending agreements involving ERISA plans, such assumption of duties is likely spelled out clearly in the agreement. ERISA provides, in pertinent part, that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. See ERISA §§ 404(a)(1)(A) and (B), 29 U.S.C. § 1104(a)(1)(A) and (B); see also *In re Syncor ERISA Litig.*, 516 F.3d 1095, 1103 (9th Cir. 2008). A fiduciary found liable for the breach of these duties “shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plans any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.” ERISA § 409(a), 29 U.S.C. § 1109(a). Non-ERISA funds may also bargain for ERISA type fiduciary duty obligations under the terms of their lending agreements, requiring,

for instance, that their cash collateral only be invested in collateral pools that contain ERISA and public pension funds. Moreover, the enacting legislation for many state pension funds may create fiduciary obligations on those who have discretionary authority over the assets of public pension plans. In addition, there are common law fiduciary duties applicable to investment managers, as agents of their clients.

Turning back to the Sigma, ample market information existed from the fall of 2007 about the potential collapse of this SIV, which by the spring of 2008 had turned into a cacophony of warning signals and write downs. By October 2008, Sigma had collapsed and lending clients who had been invested in Sigma — who had believed that their assets were in safe, principal-conserving investments — lost the entirety of their collateral invested in Sigma. The central question for the cases that seek to recover the losses from investments in Sigma is how a fiduciary, under the obligation to act with “the care, skill, prudence, and diligence” in managing their investments, could have left their clients exposed to this known risk of loss absent a breach of their duties or through negligence.

E. Broader Considerations

Conflict of interests in securities lending agreements are inherent in the very terms of the agreement, where the custodian shares the majority of the income derived from lending out the clients’ securities and shares no downside risk from the loss of the collateral. These conflicts may account for the fact that in some instances we have observed, almost 99% of the securities beneficially owned by institutions were lent and the cash collateral reinvested in income producing, fixed income securities. Custodians are bound to not act in their self interest because of the fiduciary duties they owe to their clients. However, institutions may want to consider prophylactic measures to mitigate these conflicts of interests. For example, in reexamining the contracts under which they lend their securities, institutions may want to consider inserting risk-sharing clauses in their securities lending agreements, where the custodian shares the same percentage of loss as the percentage of income received. We anticipate that the securities lending litigation will lead to more transparency into what went wrong with these programs and how they may be fixed.

IS NOW THE TIME FOR “SAY ON PAY”? *(continued from page 3)*

vided under the TARP remains outstanding shall permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the [SEC]. . . .” However, it is relevant to note that this mandated “say on pay” provision for TARP recipients is not required until 2010 and is only required while the federal government maintains an investment in the company.

While the ARRA “say on pay” mandate is valuable in and of itself for shareholders of public corporations that have or will receive federal funding under TARP I or II, it also sends a strong signal of the propriety of “say on pay” generally. Commentators have suggested that “say on pay” provisions could follow in the footsteps of majority voting provisions, which while once attacked by management as an onerous burden and intrusion on public companies’ director election process have now become recognized as part of the mainstream of good corporate governance. While “say on pay” improves executive accountability directly through an advisory vote on compensation, majority voting improved director accountability by requiring a director to receive a majority of votes cast in each board election to be elected rather than simply a plurality of the votes cast.

The inclusion of “say on pay” provisions at several large publicly-traded companies, including Verizon Communications, Par Pharmaceutical Companies, Blockbuster, and Riskmetrics Group, empirically demonstrates that the tide is turning on

“say on pay” and many institutional investors are taking advantage of this situation by pressing this momentum.

In 2008, the American Federation of State, County and Municipal Employees pension fund (“AFSCME”) submitted “say on pay” proposals to be included on the ballot of approximately 90 public companies, garnering average support of 42% of the votes cast across those companies. Additionally, AFSCME is opposing the entire slate of directors proposed by Apple, Inc. for 2009, because the company failed to implement a “say on pay” provision after it received a majority of the shareholder vote last year. AFSCME has already submitted 100 “say on pay” proposals for public companies in 2009, and we anticipate that in light of the current economic crisis and the public backlash on exorbitant executive compensation that shareholder support for “say on pay” provisions put on the ballot in 2009 will increase.

Now is a golden opportunity for institutional investors to demand the adoption of “say on pay” provisions. Moreover, as it has now become increasingly clear that one of the causes of the economic meltdown was executive compensation policies that improperly valued and rewarded excessive risk-taking at the expense of prudent management aimed at maximizing shareholder value, we believe that public corporations will be forced to entertain greater shareholder activism in the arena of executive compensation generally.

BARROWAY TOPAZ LEADS FIGHT FOR INDYMAC SHAREHOLDERS *(continued from page 3)*

designed to accommodate well-qualified borrowers seeking mortgages on atypical properties, Alt-A loans have since come to be known as “liar’s loans” because of the pervasiveness of abuse associated with their underwriting. By 2006, IndyMac ranked among the top Alt-A lenders with over \$49 billion in Alt-A production, which represented 77.5% of IndyMac’s total origination volume. Unfortunately for IndyMac and its shareholders, the bubble in the housing industry began to burst in 2006, leaving the bank with a tremendous down-side exposure.

The effects of IndyMac’s cavalier behavior initially went largely unnoticed outside of the bank, mainly due to its ability to play “hot potato” with the loans.

IndyMac’s Fraud

The bank dealt with the downturn in the housing market by further loosening its underwriting standards (and concealing as much) — mainly by exploiting the Alt-A loan market and purchasing pools of loans from third-parties — in an effort to foster portfolio growth. Unfortunately for investors, in response to loosening underwriting standards, lending at IndyMac — at the direction of then-CEO Perry — deteriorated into a “free for all” where “anything went” to close a loan, and the bank appeared no longer to care whether it would ever collect on a loan. As a result, by mid-2006, the number of loans being reviewed for fraud had increased by approximately 1500%.

This increase in fraud and uncollectible loans could not have been surprising to Perry and other members of senior management at IndyMac, as these individuals directly pressured underwriters at the bank to “push loans through” regardless of whether the borrower satisfied underwriting guidelines. In fact, attempts to curtail the fraud at IndyMac were personally rebuffed by upper management as even the Fraud Investigation Department was directed by upper management not to report fraud. As a result, defaults were increasingly due to fraud in the loan origination documents or associated with poor underwriting and the approval of “borderline” loans — and not due to the industry-typical “straight defaults” or defaults due

to a borrower’s change in circumstance, such as job loss or divorce.

IndyMac was not much more selective in purchasing loans from third-parties. According to lawsuits that IndyMac itself filed against companies it bought loans from, borrowers in up to 97% of the loans IndyMac purchased from certain brokers went into “early payment default” — meaning that the borrowers either failed to make their very first payment or failed to make a timely payment in one of the first three months of the loan. In the industry, early payment defaults are some of the clearest signs that a loan is in trouble.

The effects of IndyMac’s cavalier behavior initially went largely unnoticed outside of the bank, mainly due to its ability to play “hot potato” with the loans. That is, IndyMac would immediately sell the loans off through the securitization market before the borrowers defaulted. Indeed, Perry himself touted this fact by stating that IndyMac had “the best quality control function of any thrift out there because we sell 95% of our production in the secondary market . . .” But IndyMac’s ability to pass off these loans began to dramatically decline during 2006 as the secondary market became less liquid and many of the companies that IndyMac sold its loans to promptly returned them to IndyMac pursuant to warranty provisions contained in the respective sale contracts. These returns or “kickbacks” as they were known at the bank, increased by 50% in 2006 compared to 2005. To deal with the situation, IndyMac initiated a “special project” on the weekends in 2006 during which IndyMac provided underwriters with a list of the kickbacks that the underwriters would have “make work” so that the loan could be bundled with other loans and sold again in the secondary market. The underwriters involved in the special project aggressively did what they could to make the loans work. For example, in instances where the loan had defaulted and been kicked back because of a lack of income verification, underwriters would obtain a more favorable “average national salary” for the borrower based on data for those positions found on websites provided by IndyMac such as Salary.com. These special projects were not always successful and IndyMac, unable to resell such loans to the secondary market, got stuck with a substantial portion of loans on its books that defaulted quickly.

In stark contrast to what was going on behind the scenes in underwriting, Perry and other IndyMac executives gave glowing public reviews of IndyMac (even raising its earnings guidance for the year in April 2006) and actually touted the job that senior management was doing in managing the bank’s risk, including its “thorough sellers/3rd party approval and monitoring [systems]; pre-funding quality control reviews; sound underwriting guidelines; rigorous in-house appraisal reviews;

post-funding quality control audits; and loss mitigation/fraud recovery management.” In fact, in SEC filings, Perry certified that proper internal controls were in place to detect the very fraud witnesses say was rampant. The bank also assured the public that its allowance for loan losses (i.e. the amount it sets aside to cover loan-based losses) was adequate and factored in the “effects of any changes in risk selection and underwriting standards.” As investors would soon learn, none of this was true.

The Truth Comes Out

On January 25, 2007, IndyMac issued a press release in which it informed the market not only that the bank would not meet its forecasted results for the fourth quarter of 2006, but also that several of the previously touted business areas were, in actuality, profoundly weakened and impaired. Specifically, IndyMac revealed the bank’s quarterly earnings per share would be \$0.97, rather than the previously forecasted \$1.35, admitting that the bank “missed its earning forecasts” primarily because it had doubled its credit reserves from the previous quarter to cover the massive number of defaults on the loans it had underwritten, and due to the lack of hedging over areas that IndyMac and Perry previously reported were hedged. In a related conference call, Perry admitted “[w]e should be doing

a much more detailed bottom’s up forecasting in all our business units . . . and I take responsibility for that.” With regard to the previously touted internal controls, Perry admitted that, “[o]ur provision for loan losses is increasing . . . Credit quality generally is deteriorating so I would say that’s something we have to do a better job forecasting, and clearly we want to be a little more conservative as it relates to that . . . This is something we should have done a better job forecasting on. This is something that we probably could have seen better if we had more precise models . . .” In response to these disclosures the price of IndyMac’s stock immediately tumbled almost 10% and never recovered. Indeed, this disclosure was but the first of many issued by IndyMac along this vein. The culmination of IndyMac’s fraud, as is now well-known by the market, was the utter collapse of the bank, seizure by federal regulators in July of 2008, the dismissal of its senior executive team, and, finally, a bankruptcy filing for the bank.

Barroway Topaz represents a proposed class consisting of all purchasers of IndyMac stock between January 26, 2006 and January 25, 2007. The case, *Tripp v. IndyMac et al.*, is proceeding in the Central District of California, Docket Number 07-CV-1635-GW (VBK) before the Honorable George Wu.

COURT DENIES MOTION TO DISMISS IN COUNTRYWIDE PREDATORY LENDING CASE

(continued from page 2)

in monthly payments, crippling prepayment penalties and negative amortization. Ever increasing numbers of these duped borrowers have experienced serious problems keeping a roof over their heads as the original “teaser” or introductory terms ended and onerous interest rate and/or monthly payment increases set in — just as the housing market was collapsing.

Judge Sabraw’s February 5, 2009 order allowing the action to proceed requires Countrywide to now address the substance of the Complaint. More specifically, following argument by attorneys from Barroway Topaz and its Co-Lead Interim Class Counsel before Judge Sabraw on January 30, 2009, the Court rejected, *inter alia*, Countrywide’s contentions that the Complaint failed to adequately and properly allege an actionable RICO violation, and held that the plaintiffs’ allegations satisfied the pleading requirements for a RICO enterprise. The Court also refused to dismiss the Complaint for failure to allege actionable misrepresentations and non-disclosures with sufficient specificity. While the Court determined that several of the plaintiffs provided an insufficient level of specificity with regards to certain of their allegations, the Court

dismissed such claims with leave to amend so that such plaintiffs may have an opportunity to provide additional details regarding their specific transactions. Further, the Court refused to dismiss the Private Plaintiffs’ claim that Countrywide has been unjustly enriched as a result of its alleged malfeasance. Lastly, the Court ordered the parties to report for an Early Neutral Evaluation Conference before Magistrate Judge Leo S. Papas on March 25, 2009.

Barroway Topaz believes that this litigation can provide an effective vehicle for addressing the widespread harm — at a consumer-homeowner level — caused by Countrywide’s alleged illicit lending practices. Such consumer relief will hopefully augment and supplement the relief that has been obtained or may be obtained by state attorneys general or the federal government for certain subgroups within the proposed nationwide class of aggrieved borrowers, as the private plaintiffs seek relief that would exceed the measures anticipated by settlements reached or loan modification programs announced to date.

CALENDAR OF UPCOMING EVENTS

Council of Institutional Investors 2009 Spring Meeting • April 5-7, 2009

Mandarin Oriental Hotel – Washington, D.C.

Visit www.cii.org for more information.

NCPERS 2009 Annual Conference • May 3-7, 2009

Hyatt Regency Century Plaza – Beverley Hills, CA

Attendees benefit from the wide selection of superior educational programs and dynamic speakers, and the opportunity to network with money managers, investment service providers and public fund colleagues from across the nation.

Pennsylvania Pension Fund Conference on Shareholder Responsibility • May 13, 2009

Radnor Hotel – Radnor, PA

Join your colleagues from public and labor pension funds across Pennsylvania to learn more about shareholder rights and responsibilities and how you can protect and assert those rights. For more information please e-mail dcheck@btkmc.com.

2009 ICGN Annual Conference – The Route Map to Reform and Recovery • July 13-15, 2009

Hilton Hotel – Sydney, Australia

The three-day conference is hosted by the Australian Council of Superannuation Investors and the Australian Institute of Superannuation Trustees. ICGN is partnering with the World Economic Forum and the UN PRI to bring together leaders in corporate governance from around the world to consider how to rebuild sustainability and trust for the long term.

Visit www.icgn.org for more information.

Guns & Hoses 2009 • September 21-23, 2009

Hyatt Regency Mission Bay – San Diego, California

Trustees from across the country gather to exchange ideas about the rapidly changing economy, current issues facing trustees and new opportunities presented to Pensions by these changes. Focused on educating Trustees in their fiduciary responsibilities as well as provide a platform to address current challenges and threats to Public Pensions.

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