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Attorneys at Law

Princeton Update

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message from partners in charge

With summer upon us, we often find ourselves looking for diversions. We hope you'll take some time out of your day and divert your attention to our latest *Princeton Update*.

We are pleased to announce that **Gregory A. Paw**, former director of the New Jersey Division of Criminal Justice and a former Deputy U.S. Attorney, will join the firm as a partner on June 30, 2008. He will practice with the firm's White Collar and Corporate Investigations Practice Group and the Commercial Litigation Practice Group, and divide his time between the Princeton and Philadelphia offices.

Mr. Paw's former colleagues from the U.S. Attorney's Office, Pepper partners Thomas Gallagher and Michael Schwartz, along with associate Travis Nelson, co-authored an article which details the formation of joint task forces in several U.S. cities that will examine violations related to the subprime lending meltdown.

As always, thank you for reading and please let us know if you have any comments or suggestions.

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Federal Authorities Launch Investigations into the Subprime Meltdown

Recently, federal and state law enforcement authorities announced that joint task forces in several U.S. cities, including Philadelphia, New York, Los Angeles, Dallas, and Atlanta, will examine possible criminal and regulatory violations related to the subprime lending meltdown.

The task forces will determine, among other things, whether lenders and banks securitized fraudulent loans in the creation of subprime mortgage packages, and whether the securitizers of the packaged loans accurately disclosed the risks of the underlying subprime loans supporting the investment bundles.

Federal prosecutors, federal and state law enforcement agencies (including the FBI, postal inspectors and the HUD Inspector General), and regulatory examiners form the task forces. They are investigating mortgage lenders, loan brokers, title companies, real estate developers and investment banks.

Among other issues, prosecutors and regulators are attempting to determine whether the securitizations disclosed that the underlying mortgages were made to some borrowers without proper underwriting documentation, whether lenders approved loans based on inappropriate loan-to-value ratios, and whether lenders and borrowers submitted or knowingly relied on fraudulent appraisals, financial statements, tax returns and other supporting documents.

The tasks forces also are investigating other potential schemes, such as industry insiders in New York who allegedly sold their personal stakes before the collapse of the hedge funds they managed, individuals in South Florida who allegedly used fraudulent borrower qualifying information to obtain mortgage loans, individuals in Virginia who allegedly fraudulently obtained loans from federally insured institutions through furnishing false

documents, and individuals in New York who allegedly received excessive mortgage loans through fraudulent loan applications and settlement statements.

Mortgage lenders, mortgage brokers, title companies, investment banks, real estate developers and other related businesses must beware of the potentially highly disruptive investigations that are being conducted by prosecutors (the Justice Department, state attorneys general and local district attorneys) and regulators (Securities and Exchange Commission, Office of the Comptroller of Currency, Federal Reserve Board, U.S. Treasury Department and state regulators). These investigations could be the result of alleged fraud, insider misconduct or the actions of third parties.

How federal prosecutors, law enforcement agents and regulatory examiners come upon suspected misconduct varies. Frequently, a disgruntled employee, attempting to invoke whistleblower status, comes forward with information. In other cases, routine regulatory examinations may uncover irregularities that lead to further investigation. Sometimes a prosecutor, agent or regulator opens the morning newspaper and decides to take a closer look at a company's activities.

Regardless of how the investigation begins, companies must take a proactive approach to mitigate the risk of intrusive investigations and potential bet-the-company prosecutions. When a prosecutor or regulator launches an investigation, the investigator will typically interview current and former employees, customers and vendors, generally showing up unannounced at these individuals' homes. However, even before conducting interviews, investigators will use grand jury subpoenas or regulatory civil investigative demands to gather documentary and testimonial evidence, often obtaining this information from third parties and asking those third parties not to disclose the existence of the subpoenas. In cases where the investigation follows more egregious conduct, federal prosecutors may seek wiretaps and use other types of electronic surveillance to obtain evidence. Finally, a company (or its insiders) may be served with search warrants permitting investigators to seize computer hardware and software, as well as other company records.

To help prevent and effectively respond to probes by law enforcement and regulatory authorities, consider the following tips:

- **Implement a Compliance Program:** To avoid and/or mitigate allegations of fraud and other misconduct, corporations must implement comprehensive compliance programs designed to detect wrongdoing perpetrated from within and outside of the company and effectively implement remedial measures.

- **Assign Responsibilities:** From the board of directors and executives to rank-and-file employees, each member of a company must know what his or her role is in compliance oversight. The tone for implementing and maintaining an effective compliance program must begin with the board of directors, the CEO and the chief compliance officer. Given the paramount role of compliance in the life of a highly regulated company, the chief compliance officer should not be the general counsel.

- **Know the Rules:** You cannot effectively defend your company against an investigation if you wait until a subpoena or search warrant arrives and then learn the rules of the game. Guidance from prosecutorial and regulatory authorities, such as the Justice Department's McNulty Memorandum, the SEC's Seaboard Factors, and the bank regulators' civil money penalty matrix, set forth the government's approach for dealing with corporate targets, addressing a variety of issues, including waiver of privilege, indemnification of officers/employees, consideration of past violations, and the effect of misconduct on third parties. General counsel and chief compliance officers must understand the government's policies before federal agents arrive at the door.

- **Involve Counsel Immediately:** As soon as anyone becomes aware of a subpoena relating to the company or interviews of former or current employees, vendors, or customers, immediately notify corporate counsel and retain experienced outside counsel. Counsel can then begin a dialogue with the investigators and attempt to minimize the intrusiveness of the government investigation. Counsel also can begin an internal investigation to assess the risk and collect evidence favorable to the company.

- **Do Not Overreact:** Sometimes intrusive government investigations cannot be avoided. Sometimes when the government executes a search warrant, twice as many agents as needed may show up. This is due, at least in part, to the government's goal of overwhelming

the target into making admissions of guilt. When informed of a search warrant, notify corporate counsel and retain experienced outside counsel. It also is important that the company's personnel understand their legal rights and responsibilities.

For additional tips, you may read this article in its entirety at http://www.pepperlaw.com/pepper/publications_update.cfm?rid=1426.0.

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Peppercast: State of the Mortgage Markets

Recently, Pepper Hamilton co-hosted a conference with Ernst and Young entitled "The State of the Mortgage Markets in 2008." The conference focused on what the mortgage and capital market participants can expect next and what they might need to do if litigation occurs. Listen to a podcast with **Daniel G. Murray**, a partner in Pepper's Financial Services Practice Group in our Princeton office, as he talks about secondary market implications as well as likely litigation and other controversies for loan modifications under the American Securitization Forum and Treasury Plan.

Listen today by visiting the Financial Services section of Pepper's podcenter at www.pepperpodcasts.com.

Of Note

Recently, New Jersey's Attorney General announced the filing of mortgage fraud lawsuits against 36 defendants. The lawsuits charge consumer fraud and civil racketeering by mortgage brokers, real estate entities and others throughout the state.

Three unrelated complaints accuse defendants - which include mortgage brokers, real estate appraisers, title companies, straw buyers and sellers, and promoters - of inducing consumers to purchase property under false pretenses, and of taking out mortgage loans on the basis of grossly inflated property values. The complaints, involving 25 properties and more than $5 million in fraudulent loans, allege violations of both New Jersey's Consumer Fraud Act and the RICO Act.

The separate lawsuits, which name as defendant 15 corporations and 21 individuals, allege all defendants engaged in "inflated sale and crash," whereby investors are convinced to purchase property at grossly inflated values through mortgage loans obtained using false information. The defendants, allegedly knowing the properties will end up in foreclosure, then broker these loans.

For more information, visit www.nj.gov/oag/newsreleases08/pr20080617b.html.

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New Jersey Supreme Court Restricts Claims for 'Medical Monitoring'

On June 4, 2008, the New Jersey Supreme Court issued its opinion in *Sinclair v. Merck & Co., Inc.*, in which it refused to recognize claims for medical monitoring by persons who claimed no current, "manifest" injury.

The *Sinclair* plaintiffs had sought creation of a nationwide class of persons who had taken Vioxx for at least six consecutive weeks, but who had no diagnosed injury attributable to the drug. Plaintiffs alleged that because of their past use of Vioxx, they might have experienced an "unrecognized myocardial infarction (UMI)," and sought creation of a court-administered fund to pay for a diagnostic test to determine whether class members had sustained (or might sustain) UMIs.

Plaintiffs sought recovery in part under New Jersey's Consumer Fraud Act (CFA), claiming that Merck made misrepresentations regarding the safety of Vioxx and that the costs of diagnostic and related tests constitute an "ascertainable economic loss" covered by the Act. This decision is significant for two reasons: it limits the availability of "medical monitoring" claims to very limited factual contexts, and it affirms that plaintiffs seeking recovery for product-related harm are limited to their rights under New Jersey's Product Liability Act (PLA), and not the more expansive CFA. *Sinclair* appears to represent another example of the current Supreme Court's reluctance to expand the limits of products liability law, or to accept expansive interpretations of the PLA.

In the trial court, Merck successfully moved to dismiss the complaint, arguing that plaintiffs failed to state a claim in that they had not alleged the existence of any manifest injury, relying on the three Supreme Court opinions that had addressed medical monitoring claims to that point: *Ayers v. Township of Jackson*, 106 N.J. 557 (1987); *Mauro v. Raymark Industries, Inc.*, 116 N.J. 126 (1989) and *Theer v. Philip Carey Co.*, 133 N.J. 610 (1993).

The Appellate Division reversed, and undertook a re-analysis of the three Supreme Court decisions. Based on its review, the Appellate Division concluded that proof of "manifest injury" was not necessarily pre-conditioned to recovery of medical monitoring damages. Rather, the Appellate Division interpreted the Supreme Court's decisions to hold that, while medical monitoring damages are available only where there is a demonstrated legitimate need for surveillance following "direct" exposure to an injurious substance, "manifest injury" was but one way to establish that need. Expressing its reluctance to "adopt a bright-line test, I would make the availability of medical monitoring dependent on the existence of a manifested disease or condition, alone." The Appellate Division remanded the case for development of a more complete record.

Recently, the New Jersey Supreme Court reversed, and reinstated the trial court judgment in Merck's favor. In a 5-1 opinion authored by Justice Wallace, the Court reaffirmed earlier precedent that recognized the PLA as remedial legislation, intended to limit, not expand, manufacturer liability. Observing that the PLA governs claims for "harm caused by a product," the Court analyzed the proper construction of the statute's definition of "harm:" "personal physical illness, injury and death." N.J.S.A. 2A:58C-1(b)(2). Based on earlier precedent, the Court concluded that the PLA requires proof of **physical** injury to constitute a covered "harm." Since plaintiffs did not allege existence of a current personal physical injury, they could not satisfy the definition of harm, and their claim for medical monitoring damages failed.

The Court also rejected plaintiffs' argument that they could avoid the requirements of the PLA by pursuing their claims under the CFA. "The language of the PLA represents a clear legislative intent that, despite the broad reach we give to the CFA, the PLA is paramount when the underlying claim is one for harm caused by a product." Since the claim was "obviously a product liability claim," the CFA was not available to plaintiffs.

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