

Carlyle Group's mortgage jam

New class cases filed against Carlyle Group

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More than three years after an arm of The Carlyle Group L.P. collapsed, taking nearly \$1 billion with it, the Washington-based investment firm continues to fend off allegations that it deliberately misled investors.

Created in 2006, Carlyle Capital Corp. Ltd. put its money on residential mortgage-backed securities. When the mortgage market began to crumble the following year, Carlyle Capital found it increasingly difficult to pay back its lenders and was placed in liquidation in March 2008.

In a slew of lawsuits filed since then, Carlyle Group executives are accused of mismanaging Carlyle Capital and presenting a misleadingly rosy picture of its health to potential investors, both in the private market and during Carlyle Capital's initial public offering in July 2007.

The first round of litigation has been snagged over where the cases could be heard. One of those lawsuits, filed by Michael Huffington, a former Republican congressman from California, is just now getting to the merits, while others are still pending an appeal on the forum issue. Three new class actions were filed this summer in Washington and New York.

Unlike lawsuits filed against banks over how they marketed the risk of mortgage-backed securities to buyers — like the cases filed in early September by the Federal Housing Finance Agency against financial institutions — these cases come down to whether Carlyle withheld or fudged information to avoid telling investors that Carlyle Capital was in trouble.

"It's not about that, 'This might be a risky investment' — the complaint alleges that Carlyle Capital already was failing," said Matthew Miller of Washington's Cuneo Gilbert & LaDuca, which filed two of the class actions this summer. "There were tremendous unrealized losses before the [initial public offering] that were not disclosed to investors."

Carlyle Group spokesman Christopher Ullman said the company does not comment on pending litigation.

Carlyle Capital was launched in August 2006 under the laws of Guernsey in the Channel Islands, a British dependency. The fund, which was managed by an affiliate of The Carlyle Group, made an initial public offering in July 2007, only to enter court-ordered liquidation less than a year later in March 2008.

According to Carlyle Capital records, the company bought the mortgage-backed securities through repurchasing agreements, selling the assets to other financial institutions with the understanding that Carlyle Capital would buy them back later.

The problem, according to the lawsuits filed to date, is that when the value of the securities went down, the banks holding them would ask Carlyle Capital for more money as collateral. The fund had a cushion, but the lawsuits accuse Carlyle officers of dipping into those stores and allowing the cushion to drop too low.

In early 2007, defaults across the country on subprime mortgages led to a drop in the securities' value. Banks that had bought Carlyle Capital's securities under repurchasing agreements began making margin calls for more collateral.

By June 2007, according to the complaints, Carlyle Capital had been hit with millions of dollars in unrealized losses. The initial public offering went ahead in July 2007, netting \$345 million, on top of the \$600 million in shares sold privately. By February, however, the complaints claim that Carlyle was defaulting as banks asked for more collateral. On March 17, 2008, the fund went into liquidation.

FULL DISCLOSURE

In July 2009, Huffington, an investor and the former husband of media mogul Arianna Huffington, made headlines when he sued The Carlyle Group in U.S. District Court for the District of Massachusetts. Huffington lost \$20 million with Carlyle Capital and claimed Carlyle Group executives misrepresented that it was a conservative fund and then failed to disclose that it was struggling.

The following summer, Carlyle Capital's Guernsey-based liquidators filed nearly identical lawsuits in Washington, New York and Delaware state courts and the Royal Court of Guernsey against Carlyle Group executives. In that suit, the liquidators alleged that "the entirety of CCC's capital was spectacularly lost under the reckless and grossly negligent direction, supervision, management and advice of the Defendants."

Carlyle Group fought both sets of cases on forum issues, arguing that Huffington and the liquidators had agreed to litigate any disputes in Delaware. In Huffington's case, the district court and U.S. Court of Appeals for the 1st Circuit agreed with Carlyle. Huffington is now pursuing his case in Delaware Superior Court, where a judge heard oral arguments on Carlyle's motion to dismiss last month.

"Over the past couple of years Carlyle has done everything possible both in the courts of Massachusetts and Delaware to deny me a full-blown trial which would be based upon the merits of this case after discovery," Huffington said in an e-mail. "Nevertheless, I'm still looking forward to ultimately presenting my case to a jury."

The Carlyle Group, in filings in both cases, has maintained that it fully disclosed how the fund was set up to potential investors and denied making any misrepresentations. "Rather than any untoward action by Defendants, [Carlyle Capital], like so many other financial institutions, fell victim to the unprecedented crisis that enveloped the financial markets in 2007 and 2008," the company argued in a motion to dismiss.

In Huffington's case, the company said that, regardless of any broad "puffery" Carlyle representatives might have used to sell Huffington the fund, he was provided with written materials that included detailed disclosures and information.

Huffington's attorney in the Delaware case, Adler Pollock & Sheehan shareholder John Tarantino, declined to comment. Williams & Connolly partner Robert Van Kirk, lead counsel for the Carlyle Group in both the Huffington and liquidators' cases, also declined to comment.

The liquidators attempted to pursue their lawsuit in Guernsey instead of in the United States, but similarly lost on the forum issue in a July ruling from the Guernsey court. An appeal is pending. Lead counsel for the liquidators, Jason Karas of Lipman Karas in Hong Kong, declined to comment.

Carlyle is now facing three new class actions, two in U.S. District Court for the District of Columbia and one in New York County, N.Y., Supreme Court, a state trial-level court. Cuneo Gilbert's Miller and partner Jonathan Cuneo filed the New York case on Sept. 1 and one of the cases in Washington in June, while plaintiffs' firm Robbins Geller Rudman & Dowd is behind the other Washington case filed in August.

There are already hints that the new cases could get caught up in issues aside from the merits, too. Miller and Cuneo want to merge the Washington cases, but Robbins Geller partner Darren Robbins said he doesn't think that would be "appropriate." Cuneo's lawsuit is alleging violations of U.S. law, while Robbins Geller makes claims under English law.

Miller and Cuneo filed a motion to combine the cases Sept. 8. "It's the same set of facts, same circumstances," Miller said. "It's appropriate to be consolidated."

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