Daily Journal Newswire Articles
www.dailyjournal.com
© 2008 The Daily Journal Corporation. All rights reserved.

• select Print from the File menu above

FOCUS & FORUM • Jun. 10, 2008

Lessons Learned?

FORUM COLUMN

By Mark Labaton
This article appears on Page 6

Home foreclosures. Bailouts. Lawsuits.

As the mortgage crisis grows worse, we see these words plastered across headlines with increased frequency. Sound familiar? It should. Similar headlines described the savings and loan crisis two decades ago.

History repeats. Or does it? Well, yes and no. That's my perspective, colored by experience. As an assistant U.S. attorney in the 1990s, I prosecuted fraud cases stemming from the savings and loan industry collapse; today, as liaison counsel, I represent investors in a securities fraud class action who purchased stock in Countrywide Financial, the country's largest home-mortgage lender.

Then as now, systematic deregulation was a root cause of a financial mess; greed and a real estate boom encouraged imprudent real estate loans, lax underwriting and sharp business practices; and, to paraphrase Warren Buffett, when the tide went out we discovered who had been swimming naked.

In the 1980s, Congress deregulated the savings and loan industry. Not surprisingly, many savings and loans began investing heavily in high-risk real estate and other ventures. Some even used their federally insured funds to buy millions of dollars of "junk bonds," one of the rages of the time.

The result: Savings and loans went bankrupt, investors lost life savings and the government - that is, taxpayers - inherited these savings and loans-impaired assets and even greater liabilities, including their federally insured deposits.

Before this happened, though, a real estate bubble hid the consequences of poor business judgments and fraudulent conduct.

If there had been better oversight, much of this conduct might have been discovered earlier with far less harm to the victims. As a result of auditors being derelict, between 1992 and 1994, the Big Six (now Big Four) accounting firms paid about $1 billion to settle claims by federal agencies.

Here, in sum, is a partial explanation of what happened. With real estate values spiraling upward, unqualified borrowers lied on loan applications, bought property with funds fraudulently procured, made mortgage payments for a short time, and then sold their property at a profit. But when real estates markets faltered, everything unraveled: Mortgages went unpaid, and lenders often were forced to foreclose on property that lost much of its value forcing many lenders to go bankrupt.

Today's mortgage crisis also follows a real estate boom, this time fueled by low interest rates and liquid capital markets.

Flush with cash, lenders made home loans with little regard to the risks. By late 2006, close to half of these loans were "stated income loans" - loans not requiring proof of income, such as copies of tax returns or W2s. These "no documentation loans," now appropriately called "liars' loans," invited false representations.

Lenders also made loans, often adjustable-rate ones, that did not require borrowers to put down a deposit, giving borrowers little incentive to make payments when the interest rates shot upward and their property's value plummeted.

Because of the conversion of piles of risky loans into securities, the current crisis is likely to have a deeper and wider impact than the savings and loan one.

Converting loans into securities enabled lenders who made shoddy loans to pass on their risks. Like hot potatoes, the risks passed from borrowers to lenders to investment banking firms to investors - with many hands profiting handsomely along the way.

So far, companies buying these mortgage-backed securities have lost more than $300 billion, and analysts think the losses could eventually exceed $1 trillion.

What does this mean for lawyers? Here are some observations.

The fallout will include hundreds of lawsuits - presumably, more than in the aftermath of the savings and loan crisis.

The current crisis has already generated a wide variety of lawsuits, and law firms have formed litigation groups and geared up to handle criminal prosecutions and administrative proceedings in which governmental entities seek civil money penalties and injunctive relief; predatory lending and other consumer cases; securities class actions; ERISA cases; and cases brought against mortgage brokers and other professionals.

Criminal cases and administrative proceedings are likely to resemble those that followed the savings and loan crisis. The FBI is investigating 1,300 referrals based on conduct by borrowers, loan brokers, appraisers, other professionals and banks. And the SEC and many state attorneys general have started investigations of securities frauds, predatory lending and other unlawful conduct - investigations likely to lead to criminal and administrative proceedings and civil lawsuits similar to those following the savings and loan crisis. California is likely to be a hotbed for such actions.

It is unclear how much litigation there will be relating to the bank failures. Between 1986 and 1995, approximately 1,600 of 3,200 savings and loans failed, and federal receivers brought lawsuits to recoup funds owed to the government after it assumed the assets and liabilities of these institutions.

This time, several huge investment banks - many times the size of the savings and loans that failed earlier - face serious economic challenges because of their investments in mortgage-backed securities and/or their sales of such securities. One investment bank, Bear Stearns, has already failed.

The current crisis will continue to generate predatory lending lawsuits based on aggressive, hard-sell lending practices aimed at borrowers not qualified by objective measures for the loans they became saddled with.

Some cases will be individual lawsuits, but groups bringing consumer class actions will need to show company-wide illegal practices, rather than random acts committed by rogue employees and contractors. Moreover, some state actions could be limited because of the recent implementation of federal regulations that arguably preempt state lending laws designed to reign in lenders.

Within the last eight months, investors have filed dozens of securities class actions against lenders, investment banks and others, a trend likely to continue along with related ERISA and employee stock option class actions.

Although securities lawsuits followed the savings and loan crisis, the current crisis has already generated more such lawsuits and larger ones as a result of having bad loans converted to securities that were sold to investors. Defendants include subprime lenders and issuers, holders and sellers of other types of mortgage-backed securities, auditors and other facilitators of fraud.

These cases are based partly on misrepresentations of the value of mortgage-backed securities and the adequacy of the reserves set aside to cover problematic loans, and on insider trading by officers and directors.

Defendants typically argue they did nothing wrong, but were blindsided by the credit crunch and collapse of the real estate market.

On a case-by-case basis, investors must prove that the defendants knew, or should have known, they were violating securities laws or acted with sufficient recklessness to be held accountable.

An additional challenge to investors' counsels will be proceeding in appropriate cases against certain "gatekeepers," parties such as investment bankers, accountants, lawyers and other professionals whose conduct sometimes facilitates fraud.

This year, the Supreme Court gave the gatekeepers a gift in *Stoneridge Investment Partners v. Scientific-Atlantic*, which circumscribed the liability of many gatekeepers.

This decision, however, has only limited impact on securities claims brought against accounting firms, who prepare false financial statements that investors relied upon and does not apply to claims asserted in state courts.

It is too soon to predict the outcome of the new litigation or whether politicians, bankers, business executives and lawyers will learn more from the current crisis than they learned from the earlier savings and loan one.

Mark Labaton is a partner at Kreindler & Kreindler in Los Angeles, where he represents plaintiffs in securities, corporate governance, consumer and whistle-blower actions. He can be reached at mlabaton@kreindler.com.

****

© 2008 Daily Journal Corporation. All rights reserved.