# *Lawyers are Needed to Clean up Wall Street's Mess and Rebuild the Economy*

*by Wayne Klein*

**Introduction**

Wall Street "quants," employing sophisticated (but flawed) algorithms, joined with shortsighted bankers to cause a near-collapse of our financial system. This meltdown precipitated severe investment losses, destroyed long-standing business relationships, and pushed companies into crisis mode. The impact is being felt in law offices as firms implode, close offices, and lay off attorneys.

Bankruptcies are rising. The government has assumed roles in the financial sector unseen in seventy-five years. News stories regularly expose excesses and abuses on Wall Street and by the inventors of incomprehensively-complex derivatives such as credit default swaps, collateralized debt obligations, and structured notes.

In the midst of this turmoil, lawyers must constantly give current and accurate advice. What changes should attorneys expect following the market crash? What new legislation might be needed to rebuild the financial system? What new challenges will attorneys and their clients face? What skills make lawyers better prepared than the masterminds of financial destruction to clean up this mess and help rebuild the economy? To answer these questions, it is useful to review briefly the events leading up to the current crisis.

**How to Ruin the Economy in Four Easy Steps**

Financial crises are not new; they seem to recur about every twenty years. *See* John Steel Gordon, *A Short Banking History of the United States,* Wall St. J., Oct. 10, 2008, at A17. The most recent in 1987 involved savings and loan associations that failed following a deregulatory push that unwisely granted expanded powers to financial firms.

The causes of the current financial crisis are similar to those of prior crises, suggesting that policy makers, business executives, and investors have not learned important lessons. There were four basic stages of this financial Armageddon.

**1. Credit Surpluses:** A confluence of several global events created huge surpluses of available credit. In 1997, the economies of several "Asian Tigers" collapsed. The restructurings of their economies induced high savings rates in those countries. In the meantime, the U.S. economy was booming, fueled by sales of consumer goods purchased from other countries. Companies outsourced services to India and Ireland. Ever-increasing amounts of oil were imported into the U.S. and countries receiving these dollars invested much of their trade surpluses in the U.S.

Following the bursting of the tech stock bubble in early 2000 and the terrorist attacks in 2001, the Federal Reserve dropped interest rates to stimulate the economy. Home loan rates fell to historic lows. Homeowners reacted by buying more expensive homes or refinancing their homes, often serially. When refinancing, many homeowners withdrew equity from their homes, treating the homes as personal ATMs from which money could be withdrawn to purchase new cars, take vacations, or invest.

Hedge funds borrowed massive amounts of this low-interest money to leverage profits for their investors. These funds used trading algorithms, computerized trading, and complex derivatives, to hedge risk and earn huge profits. Wall Street compensation plans encouraged speculative risk taking. Capital reserves were lowered for banks around the globe, freeing up more money for investing and subprime lending.

The result? Trillions of additional dollars flowed into U.S. financial markets from banks, hedge funds, pension plans, private equity funds, businesses, investors, and homeowners. All this money was looking for high returns.

**2. Speculative Bubbles:** Most of this money became concentrated in three areas: the stock market, real estate, and commodities. All rose to spectacular heights, as investors ignored Alan Greenspan's famous warning of "irrational exuberance." The 2000 tech crash caused a brief interlude in an otherwise inexorable rise. Lofty stock valuations facilitated a wave of friendly mergers, private-equity buyouts, and hostile takeovers, all funded by easy

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credit. Ominously, many of the large mergers occurred in the oil industry (concentrating market power in a few companies) and in the financial industry (making them too large to fail?).

The initially untrammeled rise in real estate values became self-reinforcing. The more home prices rose, the more buyers wanted to purchase costlier homes and engage in real estate speculation (home flipping). More credit became available as Wall Street investment banks securitized mortgages, pooling thousands of mortgages and selling interests in the mortgage pools to investors. The initial successes of these investments generated explosive demand for more. Soon, subprime mortgages were being pooled and sold to investors. Mortgage brokers began pitching unconventional loans: "liar" loans (no income documentation), "no income, no job, no assets" loans (NINJA loans), stretch loans (payments greater than 50% of net income), adjustable-rate loans with low "teaser" rates, and interest-only loans. Fannie Mae and Freddie Mac owned or guaranteed half of all these mortgages, a result of Congressional pressure to increase mortgages to minorities and the poor.

Even before real estate prices peaked nationally in 2005, money started to move to commodities, on the assumption they represented a hedge against rising inflation (inflation that was being driven by real estate speculation and the excessive availability of credit). Oil, metals, and agricultural commodities saw dramatic increases. Oil rose from $50 a barrel in early 2007 to $145.29 in July 2008. Gold went from $300 per ounce in 2002 to $1000 in March 2008. Wheat, corn, soybean, and rice prices doubled or tripled during the past two years.

**3. Excesses and Fraud:** The meteoric rises in the values of stocks, real estate, and commodities could not continue. Even without manipulation, oil can only rise so far before demand becomes elastic. Home prices rapidly became unaffordable for many Americans. Higher commodity prices translated into higher costs for finished goods and lower demand for those goods.

The bursting of these bubbles were accelerated by exposure of fraudulent and abusive conduct. New Century Mortgage, one of the largest mortgage originators in the country, set aside $14 million in reserves to repurchase loans that went bad within a year. By September 2006, the company had $400 million in repurchase requests – 28 times the total of its reserves. Bankruptcy followed seven months later.

Two-thirds of commodities trading was conducted off-exchange, through the use of unregulated swaps and derivatives. Oil trades were split between the U.S. and London, to prevent regulators from observing both sides of transactions. Swaps dealers were exempted from limits on the size of positions they could hold. Commodities regulators lacked authority to oversee trading on electronic networks. The resulting lack of transparency invited abuses: a trading company executive has been accused of earning $1 million manipulating oil futures in July 2007. Amaranth Trading sought to corner the natural gas futures market in 2005, at one point controlling 100,000 positions in natural gas, valued at $7 billion. The market collapsed and Amaranth lost $5 billion of investor money – in one week.

A venture capital company filed for bankruptcy after its founder was charged with wire fraud in October 2008 for running a $3 billion fraud scheme. Two Bear Stearns hedge fund managers were criminally charged for insider trading. UBS Securities' general counsel settled civil allegations of insider trading in auction-rate securities.

The ubiquity and variety of derivatives allowed investors to speculate on all types of market developments. The large volume of credit default swaps written by Lehman Brothers, Bear Stearns, AIG, Fannie Mae, and Freddie Mac caused their failures. Two offshore hedge funds illegally used synthetic securities to influence developments at CSX Corporation. The judge noted:

> Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law.
>
> This is such a case.

*CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP,* 562 F. Supp. 2d 511, 516 (S.D.N.Y. 2008), *aff'd,* 2008 U.S. App. LEXIS 19788 (2D Cir. N.Y. Sept. 15, 2008).

**4. Gravity:** As the old adage teaches, "the bigger they are,. . . ." The fall has been devastating. As a result of an extraordinary decline in home values, almost one in every six homeowners nationally is "under water," owing more on their homes than they are worth. The stock market swooned from over 14,000 in October 2007 to less than 8000 in October 2008. Gold is more than 25% off its high. The spot price of crude oil fell by half in a little more than three months. Even the $14 billion seaweed bubble has burst. Prices more than tripled to 18,000 Indonesian rupiah in a period of a few months, then fell 45% in two months. Fortunately, the collapse of commodities prices is resulting in lower consumer prices.

The collateral effects have been immediate and widespread.

Trillions of dollars in value have been lost as the stock market fell and real estate values plummeted. Home foreclosures are at record levels. Blue chip companies have gone bankrupt or merged into healthier institutions. Credit has become hard to find, even for profitable companies. The U.S. government has socialized, at least temporarily, large segments of the financial markets taking over Fannie Mae and Freddie Mac, taking effective control over AIG, converting Goldman Sachs and Morgan Stanley into bank holding companies, and investing directly in the largest money-center banks.

The turmoil is also having tangible effects on law firms. Some, such as the 650-lawyer Heller Ehrman firm, have dissolved. Other firms are retrenching by withdrawing offers to new hires, closing offices, cutting back on support staff, laying off attorneys, and, in some cases, asking partners to leave. Clients are imposing tighter controls on the expenses and expectations of outside counsel.

**How the Legal Profession Can Respond**

What role will lawyers play in the aftermath of this economic crisis?

In crucial ways, lawyers are uniquely positioned to chart a course forward and clean up the wreckage. Our critical-thinking skills and professional training to identify "what can go wrong," enable us to guide future decisions. Our problem-solving expertise will be indispensible in dispute resolution and business reorganization. Areas where specialized services will be provided by lawyers include:

**Legislation:** The federal government has aggressively responded to the financial crisis, exercising power in unprecedented ways such as using sparsely-written laws. Litigation can be expected to test the constitutionality of some of these laws. There has been only one case since the Great Depression in which Congress was found to have exceeded its power under the Constitution's Commerce Clause, *see United States v. Lopez,* 514 U.S. 549 (1995) (limiting Congressional power to regulate possession of a handgun near a school). Will courts again find limits to Congress's authority?

State and federal policy makers will enact new legislation as they craft new regulatory structures for the financial sector. Lawyers need to advise legislators and lobbyists on the consequences of alternative proposals. Clients will need advice on how to implement these new laws.

**Takeovers:** The government seized control or forced the mergers of a wide variety of firms. The closures and forced mergers upset many of the longstanding relationships these firms had with clients, business partners, and suppliers. Substantial litigation may result regarding the extent to which the new owners honor existing contracts.

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Jilted merger partners are suing. After the federal government seized Wachovia and sold it to Citigroup, Wells Fargo offered a higher price to Wachovia's management – a price that would not require government financial assistance. Citigroup lost Wachovia, but filed a $60 billion lawsuit against Wells Fargo. Utah-based Huntsman Chemical won a September court ruling that private-equity group Hexion breached its obligations when it refused to complete its negotiated agreement to buy Huntsman. *See Hexion Specialty Chems., Inc. v. Huntsman Corp.,* 2008 Del. Ch. LEXIS 143 (Del. Ch., Sept. 29, 2008).

**Bankruptcy, Turnaround Experts:** The Lehman Brothers bankruptcy was the largest in history. Business bankruptcy filings are rising quickly, increasing from 5811 in the first quarter of 2006 to 15,471 in 2008's second quarter. Bankruptcies of large companies require extensive legal assistance. Examiners (usually attorneys) increasingly are being appointed to investigate cash transfers in the days just preceding or just following bankruptcies. Creditors and counterparties of failed financial firms are engaging lawyers to protect their interests. Bankruptcy attorneys can expect to remain swamped with work for the foreseeable future.

Other companies, seeking to avoid bankruptcy, are hiring turnaround experts – many of whom are attorneys. The skills needed for successful turnarounds and restructurings will result in lawyers continuing to succeed in this field.

**Seeking Credit:** As a result of the financial meltdown restricting the availability of credit, many businesses have had to delay expansion plans or seek other sources of capital – often at high rates. Attorneys need to warn their clients of the risks involved in alternative financing options, such as factoring or peer-to-peer lending. Attorneys also should review carefully any changes to the terms of their clients' financing agreements and evaluate whether traditional loan terms need revision.

Denials of credit may also spawn lender-liability litigation. As creditors revoke lines of credit, reduce the size of loans being offered, impose more stringent conditions on borrowers, or refuse to make loans, businesses may file suit.

**Receivership Manual for the Utah Judiciary**

For those who were unable to attend the Litigation Section CLE program on receivers, held December 9, 2008, complimentary copies of the Receivership manual are available by sending a request to wklein@lbfglobal.com.

**Banking:** The Treasury Department is implementing plans to infuse $250 billion of capital in banks. Attorneys need to counsel banking clients on how accepting such an investment might affect dilution of existing shareholders, the rights of other debt holders, and compensation to bank executives, and whether the company's charter and bylaws would have to be amended.

**Real Estate:** Most real estate market sectors are being affected. What began as a subprime mortgage problem soon affected the entire residential market and is now impacting the commercial sector. There are more than 1.5 million homes either in foreclosure or owned by banks. This may affect litigators and judges. Access to some courts may become so clogged with foreclosures that other cases will get postponed. Even foreclosure proceedings may be in jeopardy if attorneys are unable to produce original loan documents from mortgages that were pooled and sold to investors, especially if the brokerage firm securitizing the mortgage or the financial institution servicing the debt has failed or merged. Nervous buyers of custom homes or condominiums may seek returns of deposits on planned construction or walk away from purchase commitments. Intrepid bargain hunters need counsel on buying foreclosed properties.

**Government Investigations:** Federal and state agencies are investigating misconduct in many corners of the economy. Hedge funds are being investigated for insider trading and manipulation. CEO's are being scrutinized to determine whether statements made in defense of their companies were false. A dozen brokerage firms reluctantly agreed to repurchase over $50 billion in auction-rate securities from investors. Short sellers are being investigated for selling securities they never owned and spreading false rumors to drive company stock prices lower. Brokers have been criminally charged for lying to investors. Commodities traders are accused of manipulating oil futures. Regulators are investigating whether "gamers" manipulated stock trading in "dark pools."

Utah enforcement agencies have aggressively prosecuted many types of real estate fraud. These will continue and could expand to include prosecutions of buyers who overstated income, used the credit of another, or falsely represented that a speculator would occupy the home. Regulatory actions against securities violators may increase. The targets of all these investigations need skilled representation.

**Liability of Companies and Executives:** Disappointed business creditors, bondholders, and investors are seeking to hold companies, their insurers, and their officers and directors responsible for pecuniary losses. In many cases, responsibility for losses might

lie in the executive suite. Lehman CEO Richard Fuld assured investors on September 10, 2008, that the firm needed no new capital – one day after company executives had calculated the firm needed $3 billion in new capital and four days before the company filed for bankruptcy.

**Private Securities Litigation Investors:** Investors whose losses were caused or magnified by the misconduct of others can seek recovery. This includes brokers recommending complex or risky investments to conservative investors, inadequate disclosure of risks, unsuitable investments, and improper margin sales. Courts overseeing litigation involving buyers and sellers of exotic derivative investments first will need to resolve whether these products are commodities, securities, insurance, or outside the coverage of any laws. Fraud schemes are predicted to become more prevalent. Investors burned by the stock market will be targeted by fraudsters guaranteeing high rates of return in "safe" investments or promoting schemes promising to recoup lost money.

**Professional Malpractice:** Appraisers, viewed by many as aiders and abettors of the real estate bubble, may be the subject of suits by unhappy buyers who believe they overpaid for property based on improper appraisals. Regulatory agencies are investigating appraisers' conduct in fueling the housing bubble. CPAs may face additional litigation as disappointed investors and lenders try to blame the accounting profession for inadequate warnings of company financial problems.

**Business Advice:** Companies of all types will need legal advice about complying with new legislation, responding to government inquiries, participating in rescue packages, incorporating new industry practices, and resolving disputes. The best-informed lawyers will be best positioned to serve their clients well.

**Conclusion**

Despite the financial market turmoil and expected recession, the economy will adjust and strengthen. But, this financial recovery will differ from past ones. Wall Street "geniuses" and shortsighted, irrational mortgage bankers caused this crisis, but cannot solve it themselves. Will Rogers's query is apt: "If stupidity got us into this mess, then why can't it get us out?"

Lawyers from many disciplines are needed to "get us out of this mess." Implementing critical-thinking and problem-solving skills, lawyers can: (1) craft legislation for recovery programs; (2) liquidate, reorganize, and restructure businesses; (3) litigate, mediate, arbitrate, and negotiate disputes among investors, businesses, and employees; and (4) advise clients how to thrive in the new economic and financial environment.

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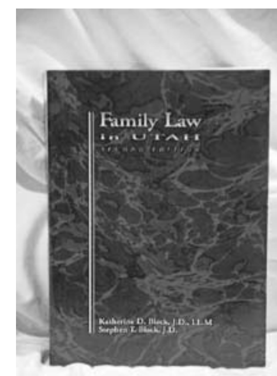


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