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Wall Street beware: the lawyers are coming

By Frank Partnoy
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The US Congress will debate new financial legislation this week, but the real action in financial reform started last Friday with the fraud lawsuit filed by the Securities and Exchange Commission against Goldman, Sachs & Co. That case opens the litigation floodgates for more suits based on subprime mortgage fraud, and smart investors know it. Goldman's market value fell $12bn during trading on Friday, more than 10 times the losses alleged in the case. Shares of other major banks, such as Bank of America, Citigroup and Morgan Stanley, lost more than 5 per cent. JPMorgan Chase was also hammered last week and announced a $2.3bn increase in its reserve for litigation expenses.

These declines reflect two important consequences of the Goldman case. First, it shows how fraud allegations about complex subprime mortgage deals can be made simple. Although the SEC focused on an arcane synthetic collateralised debt obligation known as Abacus 2007-AC1, its complaint is a spare 22 pages. The heart of the document is one straightforward claim: that Goldman misrepresented the role played by Paulson & Co, a hedge fund. Goldman allegedly told investors that Paulson was investing in the deal, when instead Paulson bet against it. Goldman also allegedly hid from investors Paulson's significant role in selecting the subprime mortgage securities referenced in the trade. Thus, the SEC cast a supposedly incomprehensible derivatives trade as a morality tale: the investors were gingerbread boys who weren't told about the fox.

A trillion dollars or more of CDOs could face similar litigation. Goldman did two dozen deals under the Abacus label; the SEC's case involves just one. ProPublica, a non-profit news group, recently identified 26 CDOs sold by various banks in which Magnetar, a Chicago hedge fund, allegedly bet that portions would fail. Magnetar has denied any wrongdoing.

Many lawyers previously thought such deals were bulletproof. Now, simplified, they look vulnerable. The SEC, by blazing a trail, has shown plaintiffs' lawyers how they might frame private cases. (If you sue Goldman, they will come.) The potential damages are huge: on average, these CDOs lost more than a billion dollars each. This is why bank shares fell so sharply on Friday.

Goldman has denied the charges, which it said were unfounded "in law and in fact". It will argue that investors were sophisticated and assumed the risks in exchange for higher returns. It will wave a lengthy prospectus and a 66-page pitch book, which disclaimed liability and disclosed a Cayman Islands special purpose issuer, an exchange listing and centrally clearing.

These defences illustrate the second important point of the case: it shows how litigation can fill gaps regulation will miss. Regulators will never keep pace with financial innovation, and bankers run circles around even the best-intentioned rules,

especially in derivatives. More fundamentally, Wall Street interprets detailed rules as a shield from liability. If Congress requires only that derivatives be centrally cleared, and those in Abacus were, is that not sufficient to show Goldman complied with the law?

In contrast, the case demonstrates a more effective way to police bankers, because Wall Street cannot outrun a judge. That simple point has been part of Anglo-American common law jurisprudence for centuries. The US judge Oliver Wendell Holmes advised that the law was a prediction about what a judge would do. If bankers consider only whether they are complying with specific legal rules, they will create "alegal" transactions - deals that fit the letter of the law but violate its spirit. But they cannot be certain about how a judge might assess their conduct. That worry, not a rule, is what will make bankers tell clients about the presence of a fox.

More generally, the suit against Goldman gives Congress a way forward for financial reforms. For example, the credit rating agencies, which rated Abacus 2007-AC1 triple A, were not named as defendants. Nor was Paulson, which issued a statement denying wrongdoing. These are important omissions, especially that of the rating agencies, which should worry about what a judge may say. Congress could ensure that they will by eliminating the protections that have shielded them from liability.

Congress could also use the threat of litigation to reform derivatives and off-balance sheet transactions. As currently drafted, the new law would do nothing about recently publicised accounting abuses at Lehman Brothers and other banks. The banks' inaccurate financial statements have generated howls of protest but no successful litigation.

Lynn Turner, the former SEC chief accountant, and I have published a paper* explaining how Congress could reform this area with one simple paragraph requiring that financial statements reflect reality, and by empowering lawyers to enforce that requirement after the fact. Some politicians recoil at the idea of expanding liability, and lawyers have been unpopular among business people since at least Shakespeare's time. But 1930s financial reform worked for decades because it created a fear of liability.

Even if Congress chooses not to modernise litigation to include credit rating agencies and derivatives, much of the 1930s liability framework remains intact. Both government and private lawyers can be slow, as they were after scandals involving initial public offerings and stock option backdating, but the Goldman case is a signal that, even without reform, the lawyers are finally coming.

** 'Off-Balance Sheet', available at www.makemarketsbemarkets.org/modals/report_off.php*

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