

THIS IS THE TEXT OF A SPEECH PRESENTED AT A THOMPSON/WEST MEETING FOR COUNSEL FOR BANKS IN CHARLOTTE, N.C., APRIL 17, 2008, ON SUBPRIME LITIGATION

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LET ME FIRST DEFINE MY SUBJECT.

I AM GOING TO ADDRESS THE LESSONS WE CAN LEARN FROM PRIOR FINANCIAL AND LITIGATION "CRISES" THAT COULD INFORM US ABOUT WHAT WE MIGHT EXPECT IN THE NEXT 5-8 YEARS OF SUBPRIME AND RELATED LITIGATION THAT APPEARS TO BE UPON US.

BY THE PRIOR CRISES, I REFER TO THE SAVINGS & LOAN CRISIS OF THE 1980'S AND THE FIRST HALF OF THE 1990'S.

I WILL ALSO ADDRESS BRIEFLY THE LESSONS FROM THE LITIGATION THAT FOLLOWED THE COLLAPSE OF ENRON IN 2001.

EVERY SPEAKER APPROACHES A SUBJECT THROUGH THE LENS OF HIS/HER OWN EXPERIENCES. I APPROACH FROM THE PERSPECTIVE OF ONE WHO SPENT APPROXIMATELY 80% OF MY TIME FROM 1982 TO 1998 LITIGATING AND TRYING CASES ARISING OUT OF THE BANKING AND SAVINGS AND LOAN CRISES. THIS INCLUDES CIVIL CASES, ADMINISTRATIVE SANCTIONS ACTIONS, AND CRIMINAL CASES.

I WAS DIRECTLY INVOLVED IN PROBABLY 40 MAJOR BANKING AND SAVINGS & LOAN FAILURES INCLUDING VIRTUALLY EVERY ONE OF THE TEN LARGEST FAILURES.

I TYPICALLY REPRESENTED LAWYERS, DIRECTORS AND OFFICERS OR OWNERS, BUT I HAVE REPRESENTED VIRTUALLY EVERY PLAYER IN THE S&L AND BANKING PROCESS.

TURNING BRIEFLY TO ENRON, I REPRESENTED A GREAT HOUSTON LAW FIRM FOR FIVE AND ONE-HALF YEARS -- FROM NOVEMBER OF 2001 TO EARLY 2007 -- UNTIL ALL THE CASES AGAINST THE FIRM WERE DROPPED.

I WANT TO EXPLORE THE SUBPRIME CRISES FROM BOTH A MACRO LEVEL --WHAT ARE THE SCOPE OF THE LOSSES, WHERE WILL THEY OCCUR AND HOW -- A TOPIC PROBABLY BEST LEFT TO ECONOMISTS. AND ALSO FROM A MICRO LEVEL --PRECISELY WHAT TYPE OF CLAIMS WILL RESULT, WHO

WILL ASSERT THE CLAIMS, WHERE WILL THEY BE ASSERTED AND WHAT WILL BE THE DEFENSES?

MY TIME IN THE S&L CRISIS HOPEFULLY MAKES ME QUALIFIED TO TALK ABOUT THE LATTER ISSUE WITH SOME AUTHORITY.

MACRO ANALYSIS

IN THE PAST SEVERAL MONTHS, THERE HAVE BEEN A NUMBER OF ACADEMIC AND ECONOMIC STUDIES COMPARING THE SUBPRIME LITIGATION TO THE S&L CRISIS.

THE MOST RECENT ESTIMATES OF THE EXTENT OF THE LOSSES ARE BREATHTAKING.

FOR EXAMPLE, LAST MONTH'S *FINANCIAL TIMES* REFERRED TO TWO ESTIMATES OF THE LOSSES FROM THE SUBPRIMES.

THE INTERNATIONAL MONETARY FUND ESTIMATED THAT THE LOSSES WOULD BE IN THE RANGE OF \$945 BILLION.

THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD, ESTIMATED THE LOSSES AT BETWEEN \$320 BILLION AND \$420 BILLION.

THIS NUMBER IS MULTIPLES OF THE LOSSES IN THE S&L CRISIS, WHICH WAS ESTIMATED AT AROUND \$175 BILLION FOR THE PERIOD 1982-1995.

THE OECD REPORT CONCLUDES THAT THE RESIDENTIAL MBS HELD BY U.S. COMMERCIAL BANKS TOTAL ABOUT \$345 BILLION.

AND THE MOST LIKELY DIRECT LOSSES TO U.S. COMMERCIAL BANKS IS \$60 BILLION, AND THAT IS NOT ADOPTING THE PESSIMISTIC ASSUMPTIONS.

THERE IS ANOTHER \$30 BILLION OR SO IN LOSSES AT PRIME BROKERS SUCH AS BEAR STEARNS.

THE FLY IN THE OINTMENT IS HEDGE FUNDS.

THEY ARE EXPOSED TO ROUGHLY \$84 BILLION IN LOSSES.

THE PROBLEM WITH HEDGE FUNDS IS THAT THEY ARE EXTREMELY HIGHLY LEVERAGED, SO THAT IF THEY FAIL, THEIR LENDERS LOSE A

TON OF MONEY – PUTTING INCREASING LOSSES ON COMMERCIAL BANKS.

THE OECD ESTIMATES THE HEDGE FUND COUNTERPARTY EXPOSURE TO BE \$1.3 TRILLION.

IF THE HEDGE FUNDS BEGIN COLLAPSING, ALL THE DOMINOES FALL.

“IT IS HARD TO ESTIMATE HOW MUCH OF THIS \$1.3 TRILLION WOULD BE AT RISK IN THE EVENT OF RMBS HEDGE FUND LOSSES CAUSING FAILURES OF FUNDS – GIVEN THE INTERCONNECTEDNESS – AND IT IS PROBABLY BETTER NOT TO ASK” (P.20).

AS TO THE SCOPE OF THE CURRENT PROBLEMS, THERE WAS AN UNUSUALLY THOUGHTFUL ANALYSIS ON PAGE 9 OF FEBRUARY 24TH FINANCIAL *TIMES* ENTITLED “ALMOST OUT OF POWER.”

THE AUTHORS EXAMINE POTENTIAL CHAIN REACTIONS THROUGHOUT THE FINANCIAL SYSTEM OF CURRENT PROBLEMS -- INCLUDING MUNICIPAL BONDS, AUCTION RATE SECURITIES, AND CREDIT DEFAULT SWAPS AND BEYOND.

THE DOWNSTREAM LOSSES ARE MIND-BOGGLING.

LET’S DO THE COMPARISON BETWEEN THE S&L CRISIS AND THE SUBPRIME CRISIS.

BECAUSE OF THE INGENUITY OF THE INVESTMENT BANKS IN CUTTING UP THE SUBPRIME LOANS INTO TRANCHES THAT GAVE BUYERS A BROAD ARRAY OF RISK CHOICES, THE MARKET AND APPETITE FOR SUBPRIME LOANS EXPLODED.

NOW, EVERY TYPE OF INSTITUTIONAL BUYER COULD FIND SOME PORTION OF A RMBS THAT FIT ITS INVESTMENT NEEDS.

AND AS THE BUYING MARKET GOT LARGER, MORE MONEY FLOWED BACK INTO EVER MORE MORTGAGES.

THE RMBS HAD BEEN SPREAD AROUND TO A FAR BROADER ARRAY OF BUYERS THAN WE HAD EVER SEEN FOR ANY OTHER ASSET.

SUBPRIME RELATED ASSETS, INCLUDING CDO’S, DERIVATIVES AND RELATED ASSETS ARE DISPERSED MUCH MORE BROADLY THROUGHOUT

THE WORLD FINANCIAL SYSTEM TODAY THAN THE TROUBLED REAL ESTATE ASSETS OF THE 1980'S.

IF YOU EXAMINED CAREFULLY THE LOAN LOSSES FROM THE S&L CASES, A VERY HIGH PERCENTAGE OF THE LOSSES WERE CENTERED IN THE SUN BELT -- IN AN ARC FROM FLORIDA TO ARIZONA.

THERE WERE FAILURES IN MOST OTHER STATES. BUT MANY OF THOSE PROBLEMS RELATED TO THE DRAMATIC INCREASE IN INTEREST RATES THAT DOOMED MANY OF THE TRADITIONAL S&L'S THAT BORROWED SHORT AND LENT LONG.

OUTSIDE OF THE SOUTHWEST, THE WHOLESALE COMMERCIAL BANKING INDUSTRY -- LARGE REGIONAL OR NATIONAL BANKS -- WAS IMPACTED BY THE S&L CRISIS PRIMARILY THROUGH THE PURCHASE OF SYNDICATIONS FROM THE SOUTHWEST. THE BEST EXAMPLE WAS THE FAILURE OF CONTINENTAL ILLINOIS AND SEAFIRST FROM SYNDICATIONS PURCHASED FROM PENN SQUARE IN OKLAHOMA.

INDEED, THE MASSIVE DAMAGE TO THE REGIONAL BANKS IN THE SOUTHWEST IN THE S&L CRISIS WAS THE ENTRÉE THROUGH WHICH NEW YORK AND NORTH CAROLINA BANKS BECAME MAJOR PLAYERS IN TEXAS.

FROM 1984 -- 1992, MAJOR CORPORATIONS THROUGHOUT THE UNITED STATES AND ABROAD CONTINUED TO GET ACCESS TO CREDIT.

AND -- OTHER THAN LOSSES OF BANK AND THRIFT SHAREHOLDERS, MUCH OF THE LOSSES WERE TO DEPOSITORS AND THE U.S. TAXPAYERS PAID FOR THOSE LOSSES THROUGH RECAPITALIZING THE FDIC, FSLIC, RTC, ETC.

THE COMING LOSSES ARE BOTH QUALITATIVELY AND QUANTITATIVELY DIFFERENT FROM WHAT WE SAW IN THE S&L CRISIS.

THEY WILL IMPACT THE CAPITAL AND THUS THE LENDING CAPACITY OF THE GREAT FINANCIAL INSTITUTIONS WHICH HAVE BEEN THE SOURCE OF LIQUIDITY FOR CAPITAL EXPANSION.

MICRO LEVEL

MOVING AWAY FROM THE 100,000 FOOT LEVEL, WHAT IS THE PARADIGM FOR THE LOSSES IN THE BANKING SECTOR?

THERE ARE SEVERAL WAYS THAT ARE APPARENT AND PROBABLY MANY THAT I HAVE NOT YET CONSIDERED.

MANY OF THE SUBPRIME LOANS WERE ORIGINATED BY MORTGAGE COMPANIES AND BROKERS AND SOLD TO BANKS, WHO PACKAGED THEM AND THEN SOLD THEM OUT INTO THE MARKET.

THE BANKS AND OTHER FINANCIAL INSTITUTIONS MAY HAVE RETAINED RESIDUAL INTERESTS IN THE MORTGAGES THAT ARE VALUED FOR CAPITAL PURPOSES.

UNDER MANY OF THE AGREEMENTS BETWEEN THE MORTGAGE BROKERS AND THE BANKS, FOR A PERIOD OF 90 DAYS, THE BANKS HAVE THE ABILITY TO PUT BACK TO THE BROKERS/ORIGINATORS THOSE LOANS THAT DO NOT CONFORM TO THE UNDERWRITING GUIDELINES.

ASSUME NOW THAT A HIGH PERCENTAGE OF THE SUBPRIME LOANS DEFAULT AND THE VALUE OF THE POOL DROPS PRECIPITOUSLY.

THE HOLDERS WILL SEEK RECOURSE UPSTREAM AGAINST THE INTERMEDIARIES, THE BANKS AND FINALLY THE MORTGAGE BROKERS/ORIGINATORS.

UNFORTUNATELY, THE NUMBER OF MORTGAGE ORIGINATORS WHO SURVIVE IS DWINDLING RAPIDLY AND THOSE THAT DO EXIST HARDLY HAVE THE CAPITAL TO MAKE GOOD EVEN A FRACTION OF THE LOSSES.

THUS, AS A PRACTICAL MATTER, THE BANKS OR THRIFTS WHO BOUGHT FROM THE ORIGINATORS WILL BE THE LAST STOP FOR LIABILITY.

THE NEXT QUESTION IS WHAT WOULD BE THE BASIS FOR LIABILITY?

WELL, FOR EXAMPLE, THERE WILL BE CLAIMS THAT THE BANKS DID NOT PRUDENTLY UNDERWRITE THE LOAN PORTFOLIOS THEY BOUGHT.

THE FIRST LINE OF ATTACK WILL BE ON THE BASIC UNDERWRITING OF THE PORTFOLIOS. MUCH OF THE UNDERWRITING IS NOW DONE BY COMPUTER PROGRAMS, SO PERHAPS THE PURCHASING BANKS CAN EMPLOY THE DEFENSE THAT IN RELYING ON THESE PROGRAMS THEY MEET THE STANDARD OF CARE WITHIN THE INDUSTRY.

HERE THE BANKING AND S&L CRISIS OF THE 80'S AND 90'S DOES GIVE US SOME GUIDANCE.

IN THAT PERIOD, MANY BANKS MADE THE ARGUMENT THAT THE HIGH LTV LOANS WERE NECESSARY TO MEET COMPETITION, OR WERE TYPICAL WITHIN THE INDUSTRY.

IN GENERAL, THIS FELL ON DEAF EARS.

I CAN TELL YOU THAT BANKERS WHO WERE TOLD TO LEND ONLY IN THEIR LOCAL AREAS WERE SUED WHEN THEIR LOANS WENT BAD, BUT ALL OF THE LOANS WENT BAD IN REGIONS OF TEXAS, FLORIDA, LOUISIANA, OKLAHOMA ETC.

BUT EVEN IF THE COMPUTERIZED DUE DILIGENCE PROGRAM WAS EMPLOYED, AND IT WAS STATE-OF-THE-ART, IN MANY CASES THERE WILL UNDOUBTEDLY BE EVIDENCE OF NOTICE BY MANY BANKS THAT THE ACTUAL EXPERIENCE OF THE PORTFOLIOS DEVIATED SIGNIFICANTLY FROM THE EXPECTED PERFORMANCE, YET THE BANKS TURNED A BLIND EYE.

ONE NEEDS ONLY A FEW EMAILS OR DOCUMENTS FROM DISGRUNTLED EMPLOYEES TO SHOW THAT THERE WERE DOUBTS ABOUT THE VALUE OF THE PORTFOLIOS TO UNDERMINE THE RELIANCE-ON-COMPUTER-DUE-DILIGENCE DEFENSES.

ONCE THAT LINE OF DEFENSE FALLS, IT STARTS A SERIES OF DOMINOES.

THE BANK MAY BE LIABLE FOR MAKING FALSE STATEMENTS IN CONNECTION WITH THE SALES OF THE ASSETS OR SLICES OF THE ASSETS.

ANOTHER SOURCE OF LIABILITY RESULTS FROM THE ASSETS THAT REMAIN ON THE BOOKS OF THE BANKS.

OFTEN THE BANKS SECURITIZE AND SELL MUCH OF THE SUBPRIME LOANS INTO THE SECONDARY MARKET BUT KEEP THE MOST JUNIOR TRANCHE – OFTEN CALLED RESIDUALS.

THE RESIDUALS ARE NOT READILY MARKETABLE BUT HAVE A VALUE AND CAN ACCUMULATE ON THE BOOKS OF A SELLER OR ISSUER.

WHEN THE MARKET AS A WHOLE COLLAPSES, THE FIRST SECURITY TO FALL IN VALUE IS THE RESIDUAL, WHICH IS WIPED OUT.

I HAVE BEEN INVOLVED IN LARGE LITIGATION INVOLVING THE FAILURE OF A NUMBER OF LARGE FINANCIAL INSTITUTIONS BECAUSE OF THE COLLAPSE OF THE VALUE OF THEIR RESIDUALS.

THIS LEADS TO FAILURES, SUITS AGAINST THE DIRECTORS AND OFFICERS FOR, AND BREACH OF, FIDUCIARY DUTY AND RECKLESS CONDUCT.

THIRD, WHERE DO WE PREDICT THAT THE LITIGATION WILL OCCUR?

I EXPECT THAT LITIGATION WILL CLUSTER IN THREE BROAD GROUPS WITH OF COURSE DOZENS OF SMALLER AREAS OF LITIGATION.

FIRST, NO SURPRISE HERE: 10B 5 CLASS ACTIONS, AND DERIVATIVE SUITS, AND INVESTIGATIONS, AGAINST FINANCIAL INSTITUTIONS THAT SUSTAIN LARGE LOSSES AND DROPS IN ENTERPRISE VALUE.

AFTER THE SUPREME COURT'S RULING IN STONERIDGE, HOWEVER, THE SCOPE OF THE SUITS WILL BE NARROWER BUT THE CASES WILL BE SIGNIFICANT BECAUSE OF THE DEPTH OF THE LOSSES.

IT IS POSSIBLE, INDEED LIKELY, THAT THESE CLAIMS WILL INCLUDE CLAIMS AGAINST AUDITORS.

THE SECOND MAJOR FOCUS OF LITIGATION WILL BE CUSTOMER/INVESTOR ACTIONS AGAINST THE SELLERS, UNDERWRITERS, AND MARKETERS OF SOPHISTICATED FINANCIAL PRODUCTS THAT HAVE FALLEN IN VALUE, OR FAILED TO PERFORM AS PREDICTED.

THIS WOULD INCLUDE CLAIMS FROM CUSTOMERS WHO HAVE BOUGHT THESE ASSETS FROM FINANCIAL INSTITUTIONS, CUSTOMERS WHO FIND THAT THEIR PORTFOLIOS ARE DEPLETED, AND CLIENTS WHO FIND THAT THEIR COST OF BORROWING HAS SKYROCKETED.

THIS LITIGATION WILL NOT NECESSARILY BE BROUGHT IN NEW YORK BUT IN THE STATES IN WHICH THE BUYERS ARE LOCATED, AND IT WILL EXPLORE THE SUITABILITY OF THE PRODUCTS, THE ADEQUACY OF THE DISCLOSURES AND POSSIBLE CONFLICTS OF INTEREST BETWEEN THE SELLERS AND THE BUYERS IN THE MANNER IN WHICH ASSETS/PORTFOLIOS WERE STRUCTURED, MANAGED AND MARKETED.

FOR EXAMPLE, THERE MAY BE SUITS CHARGING THAT SELLERS, PORTFOLIO MANAGERS OR INVESTMENT ADVISERS SOLD OR

RECOMMENDED ASSETS TO CUSTOMERS THAT THE INSTITUTIONS WERE THEMSELVES DUMPING FROM THEIR OWN PORTFOLIOS.

ALLEGATIONS OF CONFLICT OF INTEREST MAKE THESE CASES FAR MORE DIFFICULT TO DEFEND.

THE THIRD LITIGATION FOCUS WILL BE THE COLLAPSE OF LARGE, LIGHTLY REGULATED AND HIGHLY LEVERAGED PLAYERS SUCH AS HEDGE FUNDS.

IF HEDGE FUNDS FAIL, THE POST MORTEM MAY BRING MANY POTENTIAL CLAIMS TO THE LIGHT.

BANKRUPTCIES GENERATE LITIGATION BECAUSE THE DEBTOR, THE CREDITORS COMMITTEE, OR EVEN A BANKRUPTCY EXAMINER, HAS THE AUTHORITY, UNDER BANKRUPTCY RULE 2004, TO OBTAIN DISCOVERY AND DEVELOP CLAIMS PRE-LITIGATION!

AND, AS WE WILL DISCUSS LATER, THERE IS A POOL OF HUNGRY LAWYERS WHO WILL GLADLY JUMP INTO THESE CASES.

CLAIMS AND DEFENSES

DON'T UNDERESTIMATE THE PENCHANT FOR JUDGES, JURIES, REGULATORS AND PROSECUTORS TO IGNORE WHAT WERE THE PREVAILING BUSINESS PRACTICES AT THE TIME AND VIEW PAST CONDUCT WITH A JAUNDICED EYE.

WHAT WE SAW IN THE BANKING AND S&L CASES WAS THAT CIVIL LITIGANTS, REGULATORS AND EVEN PROSECUTORS WERE WILLING TO PARACHUTE IN AND CRITICIZE CONDUCT THAT WAS NOT AT THE TIME CONSIDERED EXCESSIVELY RISKY OR ABERRATIONAL.

DIRECTORS AND OFFICERS WERE SUED FOR MAKING ADC LOANS, FOR INVESTING IN VOLATILE MORTGAGE-BACKED SECURITIES AND FOR LENDING OUTSIDE OF THEIR GEOGRAPHIC REGION.

LAWYERS WERE SUED FOR CLOSING LOANS THAT WERE A PART OF A FRAUD AND ACCOUNTANTS WERE SUED FOR FAILING TO RECOGNIZE THE EXTENT OF THE COLLAPSING REAL ESTATE VALUES.

THE BASIC ARGUMENT WAS THAT THE BANK DIRECTORS AND OFFICERS WERE ENGAGED IN EXCESSIVELY RISKY BEHAVIOR -- AMOUNTING TO A

BREACH OF THEIR FIDUCIARY DUTIES -- AND YOU, AS LAWYERS, AIDED AND ABETTED IT.

THERE IS AN ANALOGY TO THE PRESENT DAY: IF YOU GO BACK AND LOOK AT THEORY BEHIND NO DOC LOANS, THE LEVELS OF RISK THAT MANAGERS WERE WILLING TO ACCEPT, THE FINANCIAL ASSUMPTIONS ANALYSTS BAKED INTO THEIR VALUATIONS, AND ASSUMPTIONS ABOUT CONTINUED INCREASE IN HOME PRICES, YOU JUST SHAKE YOUR HEAD.

TURNING BACK TO THE S&L CRISIS, MANY PEOPLE WHO WERE SUED, SANCTIONED BY REGULATORS OR EVEN PROSECUTED DID NOT SUBJECTIVELY BELIEVE WHAT THEY WERE DOING WAS A DEVIATION FROM THE NORM AT THE TIME.

THEIR PROBLEM WAS THE INABILITY TO PROVE NORMATIVE CONDUCT.

I WAS IN A NUMBER OF CASES IN WHICH WE HAD SUCCESS IN THE DEFENSES OF BANK DIRECTORS, OFFICERS, LAWYERS, OWNERS, HOLDING COMPANIES, ETC.

IN MANY OF THE SUCCESSFUL DEFENSES, THE KEY WAS GETTING THE CONTEMPORANEOUS BANK EXAMINATION REPORTS TO PROVE NORMATIVE CONDUCT.

TO SHOW THAT THE BUSINESS PLAN AND LOAN POLICIES THAT WENT AWRY WERE, AT THE TIME, CONSIDERED ADEQUATE AND ACCEPTABLE -- EVEN BY SKEPTICAL BANK AND THRIFT EXAMINERS.

PROVIDING THAT YOU COULD SHOW THAT NOTHING MATERIAL WAS WITHHELD FROM THE BANK EXAMINER WHEN THE EXAM REPORT WAS PREPARED, THE NEW-FOUND CRITICISMS RING HOLLOW.

I FAIL TO SEE WHERE WE ARE GOING TO FIND THE EQUIVALENT OF THE EXAMINATION REPORTS IN THE CURRENT CRISIS.

IRONICALLY, MANY OF THE LARGER FINANCIAL INSTITUTIONS ARE NOT EXAMINED IN THE DETAIL AND TO THE DEPTH THAT A REGIONAL OR LOCAL S&L WAS EXAMINED IN THE 1980'S -- WHERE ALL LARGE LOANS WERE INDIVIDUALLY REVIEWED.

OTHER MAJOR FINANCIAL PLAYERS -- LIKE HEDGE FUNDS -- ARE NOT REGULATED OR LIGHTLY REGULATED, AND THUS THERE ARE NO EXAMINATION REPORTS OR THEIR EQUIVALENT.

WILL THE HISTORICAL RATINGS FROM RATINGS AGENCIES FILL THAT ROLE?

I DON'T THINK SO. NOT IN THIS ENVIRONMENT.

WILL THE REPORTS OF INDEPENDENT AUDITORS SERVE THE SAME FUNCTION AS BANK EXAMINER'S REPORTS?

AGAIN, I DON'T THINK SO. THE BEAUTY OF THE BANK EXAMINERS' REPORT WAS THAT IT WAS NEARLY IMPOSSIBLE FOR THE GOVERNMENT PLAINTIFFS OR PROSECUTORS TO WALK AWAY FROM.

NO ONE BELIEVES THAT THE EXAMINERS WERE CORRUPT AND NO ONE WAS WILLING TO SAY THAT THEY WERE INCOMPETENT.

AUDITORS ARE A DIFFERENT MATTER.

A COMPANY IN TROUBLE WHO TRIES TO USE ITS AUDITOR AS A SHIELD MAY FIND THE AUDITOR SITTING NEXT TO IT IN THE DOCK, BEING ACCUSED OF INCOMPETENCE, COMPLICITY OR WORSE.

TAKE A LOOK AT THE REPORT OF THE EXAMINER IN THE NEW CENTURY FAILURE WRITTEN UP IN THE SUNDAY NYT BUSINESS SECTION.

THE AUDITOR IS ACCUSED OF BEING PART OF THE PROBLEM.

IN SHORT, THE RISK TAKING AGGRESSIVE BUSINESS PRACTICES AND FINANCIAL ASSUMPTIONS THAT ONCE SEEMED COMMONPLACE AND ACCEPTED WILL BE EXPOSED TO REVIEW WITH THE BENEFIT OF HINDSIGHT.

POINT 4: WE ARE LIVING IN THE MOST DANGEROUS PERIOD OF THE ENTIRE CRISIS.

IN THE SAVINGS AND LOAN CRISIS, IT WAS NOT THE INITIAL BUSINESS MISTAKES THAT LED TO THE WORST PROBLEMS BUT THE ATTEMPTS TO HIDE, DISGUISE, COVER UP OR DEFER THE LOSSES.

IF YOU GO BACK THROUGH THE BANKING AND S&L CASES, YOU WILL SEE SOME CASES PARTICULARLY EARLY IN THE CRISIS IN WHICH DIRECTORS, OFFICERS, AND OTHER FIDUCIARIES WERE SUED FOR MERELY MAKING LOANS THAT LOST A TON OF MONEY.

AS THE CRISIS SPREAD, HOWEVER, SUITS FOR SIMPLY MAKING BAD LOANS BECAME LESS PREVALENT, OR WOULD BE SETTLED BY THE FDIC WITHOUT DEMANDING LARGE PERSONAL FINANCIAL CONTRIBUTIONS BY THE CORPORATE FIDUCIARIES.

IN SOME SUCH CASES, EVEN THE FDIC MIGHT TAKE A PASS.

IN THE S&L CRISIS, THE CASES OF REGULATORY SANCTIONS, SUITS FOR FRAUD, AND THE CRIMINAL PROSECUTIONS PRIMARILY RESULTED EITHER FROM (1) ATTEMPTS TO COVER UP AND DEFER FINANCIAL LOSSES, OR (2) CONFLICT OF INTEREST/ PERSONAL GAIN TRANSACTIONS.

HERE IS A LESSON OF DIRECT AND IMMEDIATE IMPORT: DECISIONS ARE BEING MADE EVERY DAY REGARDING THE DEPTH OF THE LOSSES WHICH HAVE THE PURPOSE OR EFFECT TO DEFER OR OBSCURE THE LOSSES "UNTIL THE MARKET BOUNCES BACK".

I UNDERSTAND THE MOTIVATION FOR THIS BUT WE MUST ALSO RECOGNIZE THAT THIS IS PERHAPS THE MOST DANGEROUS TIME FOR POTENTIAL ACCUSATIONS OF CRIMINAL MISCONDUCT AND FRAUD.

I THINK THAT THIS IS PARTICULARLY TRUE IN THE LIGHTLY REGULATED CULTURE THAT GREW UP AROUND THESE NEW INSTRUMENTS. RISK TAKING AND IMAGINATIVE APPROACHES WERE ENCOURAGED AND REWARDED.

COUPLE THAT WITH THE FACT THAT THE ASSETS INVOLVED ARE ILLIQUID AND DIFFICULT OR IMPOSSIBLE TO VALUE.

IT WILL BE EASY TO SECOND GUESS ANY JUDGMENT.

NOW TO THE SECOND HOT BUTTON: IS THERE EVIDENCE OF CONFLICT OF INTEREST/PERSONAL GAIN?

I DOUBT THERE WAS PILFERAGE OR EMBEZZLEMENT.

THE QUESTION IS WHETHER IT IS "PERSONAL BENEFIT" FOR FINANCIAL INSTITUTIONS OR HEDGE FUNDS TO RECOMMEND TO CUSTOMERS ASSETS/PRODUCTS THAT SELLER IS DUMPING FROM ITS PROPRIETARY PORTFOLIOS?

HOW WILL THAT PLAY?

NOT WELL I PREDICT.

WHERE WILL THE SUITS BE FILED?

BANKRUPTCIES WILL BE THE HOTSPOTS FOR LITIGATION.

IT BECAME AN ARTICLE OF FAITH THAT IF A BANK OR SAVINGS AND LOAN FAILED, LITIGATION AND CRIMINAL INVESTIGATIONS WOULD RESULT.

THE FAILED INSTITUTIONS' DOCUMENTS WOULD BE COMBED THROUGH BY INVESTIGATORS, FDIC/RTC LAWYERS, AND CREDITORS WITH UNFRIENDLY EYES.

THEY HAVE NO LOYALTY TO PRIOR MANAGEMENT AND THE INVESTIGATORS' RAISON D'ETRE WAS TO INITIATE AND PURSUE LITIGATION.

INDEED, MANY INVESTIGATORS WOULD FIND THEMSELVES OUT OF JOBS IF THEY COULDN'T FIND A LAWSUIT TO BRING.

THE SAME FORCES ARE AT WORK IN BANKRUPTCIES TODAY.

BANKRUPTCY TRUSTEES, BANKRUPTCY EXAMINERS, CREDITORS COMMITTEES AND LITIGATION TRUSTS, AND THEIR LAWYERS, ARE ON A ROLL.

THEY ARE PICKING UP RIGHT WHERE THE FDIC AND RTC LEFT OFF.

RULE 2004 OF THE BANKRUPTCY RULES GIVES THEM BROAD MEANS OF DISCOVERY -- PRE-LITIGATION -- TOTALLY INCONSISTENT WITH OUR LEGAL SYSTEM.

EXAMINER REPORTS LAY OUT A PRO-PLAINTIFF SPIN ON THE EVENTS.

THEY CAN PROVIDE THE FACTUAL BASIS FOR SUITS BY THE BANKRUPT ENTITY AND MANY OTHERS.

AND MAY MAKE LATER SUITS INSULATED FROM RULE 11 ATTACK.

MOST IMPORTANTLY, THESE REPORTS CAN DESCRIBE A COURSE OF CONDUCT THAT EXPOSES A POTENTIAL DEFENDANT TO SUITS FROM MANY OTHER PARTIES BESIDES THE DEBTOR.

MANY LARGE LAW FIRMS ARE CONCLUDING THAT THE PARTIAL CONTINGENCY ARRANGEMENTS THAT THEY CAN OBTAIN IN THESE CASES CAN GIVE THEM THE POTENTIAL FOR A JACKPOT RETURN.

SO THEY ARE BECOMING PLAINTIFFS' COUNSEL.

COUPLE THAT WITH THE EFFECT OF *STONERIDGE*, WHICH WILL LEAD TO STEEPER DECLINE IN THE NUMBER OF 10B-5 SUITS, AND ALSO DISPLACES A LARGE NUMBER OF PLAINTIFFS' LAWYERS, AND YOU SEE THE COMING BOOM.

HOW LONG WILL THE LAWSUITS LAST?

THE BREADTH AND DURATION OF THE LITIGATION WILL BE DETERMINED IN PART BY THE EMERGENCE OF WELL-FUNDED PLAINTIFFS.

AS I HAVE ALLUDED TO BEFORE, THE FDIC, RTC, FSLIC, OTS AND OCC AMONG OTHER AGENCIES WERE THE MOVING FORCES IN THE BANKING AND S&L LITIGATION.

THAT PHENOMENON HAD A PROFOUND EFFECT ON THE LITIGATION AS IT GAVE THEIR THEORIES SOME PLAUSIBILITY, AND IT GAVE THE PLAINTIFFS' LAWYERS LIMITLESS WAR CHESTS TO DEVELOP THEIR CASES.

IT ALSO PERPETUATED THE LITIGATION BEYOND WHAT MOST PRIVATE PLAINTIFFS WOULD HAVE DONE.

PUT ANOTHER WAY, THE GOVERNMENT SPONSORSHIP OF THE PLAINTIFFS' SIDE RESULTED IN BRINGING MANY SUITS THAT PRIVATE PLAINTIFFS WOULD NOT HAVE BROUGHT, AND THOSE THAT WERE BROUGHT WERE MAINTAINED FOR MUCH LONGER THAN ONE WOULD EXPECT.

WITHOUT THAT GOVERNMENTAL SPONSORSHIP, IT IS UNLIKELY THAT THE S&L CASES WOULD HAVE GONE ON FOR NEARLY A DECADE.

IT REMAINS TO BE SEEN WHAT WILL HAPPEN IN THE IMPENDING LITIGATION.

WILL STATE ATTORNEYS' GENERAL FILL THE ROLE OF THE FDIC? WILL MAJOR STATE OR PRIVATE PENSION FUNDS LEAD THE PACK? IF THE ANSWER IS YES, THEN THE LITIGATION WILL BE BROADER AND LONGER.

FINALLY A FEW WORDS ABOUT THE ENRON-RELATED LITIGATION WHERE I DEVOTED FIVE AND ONE-HALF YEARS OF MY LIFE.

WHAT WE LEARNED FROM ENRON IN TWO MINUTES OR LESS?

I AM NOT SURE WHAT WE CAN LEARN FROM ENRON.

I HAVE SPOKEN TO INSURERS IN LONDON AND ELSEWHERE WHO CONFIRM WHAT I ALREADY KNEW -- WHICH IS THAT THE ENRON CASE WAS THE BIGGEST CASE EVER.

THE CASE WAS SO LARGE AND MULTI-FACETED, AND THUS SO UNIQUE THAT IT FOLLOWED NO PREDICTABLE PATH.

INDEED, SOMETIMES IT COULD ONLY BE EXPLAINED BY REFERENCE TO THE FAMOUS JACK NICHOLSON, FAYE DUNAWAY MOVIE -- CHINATOWN.

WHEN SOME EVENT IS SO UNPREDICTABLE AS TO CONFOUND REASON AND EXPERIENCE, THE ONLY ANSWER IS THAT "IT'S CHINATOWN."

THAT WAS ENRON.

IF THERE ARE ANY LESSONS THAT I TAKE FROM THE ENRON CASE, IT IS TO REINFORCE TWO OF THE POINTS I MADE REGARDING THE S&L CASES:

FIRST, ACCOUNTING AND BUSINESS PRACTICES WHICH WERE NOT VIEWED AS ILLEGAL AT THE TIME ARE SEEN IN A VERY DIFFERENT LIGHT WHEN VIEWED IN 20/20 HINDSIGHT.

SECOND, AND MORE IMPORTANTLY, THE FATAL MISTAKE OF MANY BUSINESS PEOPLE IS THAT THEY ASK IF SOME NOVEL CONDUCT, ADMITTEDLY IN THE GRAY ZONE, IS ILLEGAL? IF THE LAWYER CAN'T OPINE THAT IT'S ILLEGAL, THE BUSINESS PERSON ASSUMES THAT HE CAN ENGAGE IN IT AND THAT IT WILL BE ONLY A CIVIL ISSUE IF IT'S LATER CHALLENGED; HE ASSUMES THERE WILL BE NO CRIMINAL PROSECUTION.

NOT TRUE.

THE CRIMINAL LAW EVOLVES, FILLS IN GAPS AND PUNISHES NEW CONDUCT THAT NO ONE COULD SAY OR "KNEW" WAS ILLEGAL.