The US credit crisis will affect personal and corporate liability for years to come

BY WILLIAM SHAWN
partner, ShawnCoulson
E-mail: wshawn@shawncoulson.com

WHETHER OR NOT CONGRESS FASHIONS a legislative fix for the US Treasury Department to solve the current, unprecedented credit crisis, a maelstrom of civil and criminal liability issues will surely arise for perpetrators and victims to confront and resolve.

Mounting defaults and insolvencies, even when rescued by private or Treasury Department efforts, will spawn criminal inquiries and resultant prosecutions or civil actions by state and federal authorities. Private parties will likely pursue corporate and individual malefactors with time-honoured derivative and class action suits. Only congressionally legislated limits of liability, a doubtful prospect in the current election year and climate of voter outrage, will likely forestall a new wave of such legal activity.

Although current liability concerns involve banks and other financial institutions, US and foreign, potential liability and exposure issues will likely extend beyond such immediate targets to corporate and individual parties, including pension plan and other fiduciaries, which purchased now-worthless financial instruments, including exotic collateralised debt issues, or otherwise invested in investment banks and other failed entities.

Unlike past credit crises, current circumstances involve a much greater degree of interconnectivity. Through credit default swaps [CDSs] and similar financial instruments, seemingly unrelated entities may collapse in days or hours under a financial domino effect. Required 'fair value' accounting methods effectively accelerate that domino effect by forcing sudden write-downs of assets held as collateral, even when such assets are not subject to current sales or exchanges.

Purchasers, especially fiduciaries, of financial instruments, borrowers of bank debt, and even portfolio managers must now consider means to recover losses created by seemingly unrelated bank and other entities' insolvencies. Such purchasers, borrowers, and portfolio managers may also be under affirmative duties to seek recovery of their principals' losses. Enterprising plaintiffs' class action counsel may already contemplate derivative class action suits against solvent companies that fail to move quickly to contain the financial contagion.

Despite the unprecedented scope of the current credit crisis, there is precedent to be found in government involvement in earlier crises. Understanding that precedent may help individual and corporate interests to protect their legitimate interests.

BACKGROUND

Financial crises are nothing new to the US. Bank failures, recessions, and depressions were a common occurrence in the 19th and early 20th centuries. In 1907, for example, financier JP Morgan single-handedly rescued the US banking system in a negotiating *tour de force* that Treasury Secretary Henry M Paulson Jr might envy for its simplicity and efficiency.

The most calamitous 20th-century financial crisis, the Great Depression, prompted the enactment of comprehensive financial regulation. Among others, the New Deal's National Banking Act, the Securities Act 1933, the Securities Exchange Act 1934 and the Glass-Steagall Act separating commercial and investment banking functions, created a relatively stable financial environment lasting over 75 years, with a few discrete intervening crises, including the savings and loan [S&L] bailout of the 1980s and the long-term capital collapse of the early 1990s.

The S&L bailout provides a possible template for liability and recovery issues in the latest credit crisis. After S&Ls – originally specialised community and local depository and mortgage lending entities – expanded risky real estate lending in the early 1980s (when a wave of insolvencies arose in a real estate recession) Congress passed the Financial Institutions Reform Recovery and Enforcement Act (FIRREA). FIRREA created the Resolution Trust Corporation (RTC) to acquire failed S&Ls' lending and asset portfolios, and to sell or merge failed S&Ls with other financial institutions.

Like legislative proposals in the latest crisis, the RTC had authority to buy and sell such assets in an attempt to recoup the cost of that taxpayer-financed bailout. The RTC ultimately disposed of nearly $400bn in assets, and generated a substantial return to the US Treasury by participating in the upside of acquired assets later sold well above their foreclosed or seized price levels.

The S&L bailout exposed rampant malfeasance and criminality. It also generated significant criminal and civil litigation. For example, while the RTC worked to cleanse the financial system of seized assets, the US Department of Justice obtained the conviction of numerous S&L principals and others behind the S&L crisis, including Charles Keating of Arizona, whose influence even extended to the US Senate. Civil litigation also flourished when investors and others sought to recover their investments in failed S&Ls or other consequential damages.

THE CURRENT CRISIS

The current crisis apparently rests upon similar confidence and liquidity concerns to earlier crises. However, these earlier crises involved largely stand-alone institutional failures. The unprecedented interrelationship created by CDSs and other exotic, unregulated financial instruments has, by contrast, fostered a financial contagion where healthy institutions may quickly succumb to the insolvency of others.

The interrelationship created by CDSs and other financial instruments is only one new development in the current crisis. Fair value accounting methods required by the Securities and Exchange Commission (SEC), originally developed to prevent banks and other institutions from carrying assets at unrealistically high prices (as Japan experienced in its decade of financial malaise), effectively jumped corporate and even national boundaries to other, unrelated entities. Accordingly, market-to-market and similar fair value accounting rules require massive write-downs of assets pledged as collateral or used as capital. Healthy banks or broker-dealers with adequate capital reserves can, within hours, face violation of their leverage or reserve requirements, and fail like Lehman Brothers or be acquired like Wachovia.

The rest may be psychology. Massive write-downs and institutional failures have created an atmosphere of distrust. Without substantial increases in depression-era federal deposit insurance programs, depositors withdraw and flee with their savings, banks can no longer lend, investors do not invest, and insurers like AIG or guarantors are forced to honor CDSs and other financial instruments many participants never fully understood.

TROUBLED ASSETS RELIEF PROGRAM (TARP)

The US Treasury Department's response to the crisis has been its Troubled Assets Relief Program (TARP) first outlined in a simple, four-page legislative proposal designed to give the Treasury Secretary unprecedented, sweeping powers to buy troubled assets from participating financial institutions. The original proposal envisioned banks, thrifts, credit unions, broker-dealers, and insurance companies as 'financial institutions' and contemplated foreign participation for those entities 'having significant operations in the United States.'

Despite its recent defeat in Congress, the core concepts of the program and its $700bn funding will likely be implemented in some form, and will likely include:

- the Treasury Department's ability to hire banks and other financial institutions to help buy troubled assets;
- the creation of financial instruments (eg bonds and other government obligations) to buy troubled assets;
- the ability to sell troubled assets, presumably through the financial instruments created; and
- the management of troubled assets or their portfolios, presumably also through financial institutions hired by the Treasury.

As originally proposed, actions of the Secretary of Treasury were not reviewable by any court or administrative agency, and completely discretionary. The Secretary was only obligated to submit periodic reports to Congress.

The absence of any court or other meaningful review, the unfettered discretion afforded to the Treasury Secretary, and the lack of any direct benefit to individual homeowners doomed the original proposal. Any successful version of TARP will thus likely include new bankruptcy provisions to reduce defaulting homeowners' mortgage debt, tax relief, expanded insurance limits for bank and money market deposits, reduced 'fair value' accounting requirements, and potential new SEC regulation of exotic debt swaps and other financial instruments, the defaults of which likely contributed to the current crisis.

Given pressing time constraints, the November election, and the need for meaningful government action, any successful version of TARP may require massive new implementing regulations, policy statements and interpretations. For example, the Treasury will need to determine the prices to be paid for troubled assets, and the price at which such assets can be sold. Participating financial institutions will understandably seek the highest prices for their troubled assets reduced in value by market-to-market accounting rules, and the Treasury will presumably seek the lowest cost to help fetch the highest profit on resale when the $700bn funding is ultimately repaid. As the RTC experience showed, however, proper management of the assets acquired with such monumental funding may ultimately reap a return on the US taxpayer's $700bn obligation.

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PRE-TARPS ENFORCEMENT DEVELOPMENTS

While Congress and other governments work to stabalise the financial system, some enforcement initiatives have already surfaced. For example, in August, the SEC settled claims involving deceptive sales practices of Citigroup involving auction-rate securities, another exotic financial instrument touted as a cash equivalent. In late August, New York Attorney General Andrew Cuomo reached agreement with Merrill Lynch, Goldman Sachs and Deutsche Bank Securities, among others, to return nearly $50bn to investors.

Even financial institutions have sought relief in the current crisis. For example, Pricewaterhouse Coopers, an administrator for the European operations of Lehman Brothers, has sought, from a US bankruptcy court, the return of $8bn transferred from Lehman Brothers' London office to New York shortly before Lehman Brothers' bankruptcy filing in New York.

Shareholder class actions and other suits have already been filed against

defaulting institutions, their advisors, and others. Such litigation may, however, face unprecedented challenges based upon notions of Federal pre-emption and even damages' calculation issues. For example, despite the absence of specific pre-emption language in public versions of TARPs legislation, defendants may argue state litigation issues are necessarily pre-empted by the remedial nature of TARPs under US constitutional commerce clause principles similar to those applied to Federal pre-emption of state taxation. Defendants may also argue that sales of troubled assets through the TARPs program represent prudent management consistent with fiduciary duties and other standards imposed by state corporate laws.

POST-TARPS LIABILITY OUTLOOK

As noted, TARPS may provide some defenses against shareholder and other litigation. As the S&L crisis proved, however, federal and state prosecutors pursued more egregious behavior. While the culprits in the S&L scandals of the 1980s were S&L owners and operators, today's culprits may be the institutions that created, promoted, and sold exotic instruments few understood. Although current, public versions of the legislation may not include acquisition by the federal government of claims against participating institutions, a clear incentive for such institutions to participate in TARPs (even participating institutions selling their troubled assets in TARPs) may launch suits against defaulting parties in credit swaps and others involved in any collapse of asset values.

Owners of troubled assets, whether or not participating in TARPs, may be under significant pressure to sue other individuals and entities possibly responsible for significant losses of asset values. For example, management of institutional owners of collateralised mortgage obligations including fraudulent or suspect mortgages may be subject to a duty to pursue those responsible for such mortgages, or risk suits for violation of their duties as officers and directors. Management generally, and fiduciaries of pension funds, trusts, endowments, and charitable causes in particular, should examine:

- the terms and conditions of any CDSs or similar instruments bought or sold;
- outstanding loan covenants, guarantees, and other commitments, including disclosures made to third parties and shareholders;
- insurance coverage for third-party liability claims, including officers' and directors' coverage;
- corporate minutes, resolutions, and consents evidencing due diligence and other steps taken before CDSs or similar instruments were bought or sold; and
- any shareholder derivative demands to sue third parties, especially those who created, marketed, and sold CDSs or similar instruments to management.

POST-TARPS RECOVERY ISSUES

Given the duty of care imposed on corporate officers and directors under US state laws – especially in Delaware, where many US subsidiaries of foreign parents are incorporated – management must consider two implications of the current credit crisis. First, how to protect the entity against the vicissitudes of defaults by others, and secondly how to protect the entity against claims by others for CDS and other losses.

Protecting entities in the present crisis requires a thorough understanding of entities' credit obligations, investments, and transactional involvement. Among other matters, management should know:

- whether the entity has participated in any credit swaps or collateralised obligations of any kind, and, if so, the nature of the obligations, the parties involved, and the solvency of such arrangements;
- the nature, kind, and whereabouts of all deposits, investment funds, and other liquid assets subject to limited deposit insurance coverage;
- the nature, kind, and whereabouts of all borrowing, guarantor, and credit obligations of any kind, including renewal and covenant conditions for lines of credit;
- whether the entity is a party to any pending sale, merger, or acquisition agreement and whether any 'material change' provision of any such agreement should be invoked;
- the insurance coverage available to management, and any applicable claim notification periods and requirements, for claims relating to financial losses, and director and officers' liability coverage.

CONCLUSION

For most observers, the current credit crisis unfolded rapidly and unexpectedly. Consequently, not all the causes of the current credit crisis are apparent, and their solutions may be even further obscured. It is very likely, however, a TARPs-like solution may be enacted by Congress very soon, while individual and business interests must navigate through the liability and recovery issues that will inevitably affect their existence for years.

By William Coulson,
partner, ShawnCoulson.
E-mail: wshawn@shawncoulson.com.