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Lessons from the S&L crisis litigation for today

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The lessons of the savings and loan crisis and the junk bond markets resonate in the current financial crisis and the tsunami of litigation that looms ahead. Government agencies, investors, receivers, trustees and other stakeholders who hope to recover losses should look to the experience of the savings and loan crisis of the late 1980s and early 1990s for guidance -- and we in California certainly had our share of that experience. On the other hand, it would be folly to adopt the last war's tactics without due deference to today's terrain. Some of the important lessons learned in the savings and loan litigation trenches may guide today's plaintiffs' counsel.

The savings and loan crisis was provoked by the confluence of bad loan underwriting, fraud and greed, undercapitalization and sweeping changes in the regulatory regime. Newly allowed investments included junk bonds and real estate participations. The savings and loans encountered a financial "perfect storm" buffeted by an economic slowdown and aggravated by the misfeasance and malfeasance. Litigation focused on junk bonds and real estate.

The 1980s market for original issue junk bonds was dominated by the investment bank Drexel Burnham Lambert. Many of Drexel's clients and colleagues bought California savings and loans and loaded them up with junk bonds; a number of insurance companies, including some high-profile California insurers, did the same. This circle of the junk bond market was alleged as the "Drexel Daisy Chain" and many of its members used the same auditors. Junk bond buyers were told that a well-diversified portfolio of junk bonds minimized default risk and frequent refinancings, albeit with non-cash components, masked problems.

The market was thinly traded and ill-liquid and the mark-to-market rules were not well-enforced. When Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act in late 1989 and Drexel filed for bankruptcy under the weight of criminal investigations and litigation, the junk market cratered as institutions were forced to divest and mark to actual market value.

The new savings and loan rules also allowed participation in real estate development. In some cases, real estate was flipped from one straw buyer to another to manipulate valuations in order to forestall defaults and write downs. Charles Keating's Lincoln Savings was so contaminated that it was referred to as an "accounting factory" and discovery revealed that other institutions had engaged in similar accounting gimmicks.

The corollaries to the causes of today's crisis are obvious. In the wake of de facto market de-regulation, novel loan products were securitized and sold worldwide: mortgage-backed securities, residential and commercial, collateralized mortgage obligations, principal and interest strips and derivatives, ad infinitum. The loans supporting these instruments, and their inherent risks, were not fully understood.

Rating agencies and accountants did not adequately assess risks and analyze value to reflect true the mark-to-market values, and default rates were masked by easy money refinancings. Internal valuation and accounting rules appear to have been ignored, misapplied or manipulated, concealing the problems and, as a result, investors and taxpayers incurred huge losses when refinancing and a "rising tide" of home values could no longer sustain the bubble and default risks turn out not to be as represented.

What are the current litigation lessons available from this history? First, there will be litigation by investors in financial institutions who were forced to take writeoffs and writedowns after the music stopped in the mortgage-backed securities markets. Potential targets include directors and officers in mortgage banking institutions, rating agencies, and purchasing institutions; auditors and other professional service providers; and investment banks as broker-dealers and mortgage-backed securities issuers, and others. The institutions themselves may also sue investment banks and any remaining mortgage originators. Mortgage-backed securities issuers may sue institutions and loan servicers who re-structured mortgage pools, perpetuating the bubble. The FDIC may sue directors and officers, auditors, other professionals, brokers, mortgage-backed securities issuers, aggregators and others.

The Economic Stabilization Act of 2008 may complicate some litigation, since many of the potential targets of the FDIC's litigation are now subject to government ownership and control, although the FDIC has handled such conflicts deftly in the past. Further, the Department of Justice is currently investigating a number of firms and markets, not just mortgage-backed securities, perhaps leading to the reconstitution of the attorney general's Interagency Bank Fraud Working Group in one form or another.

Reaching past the savings and loan crisis, the Watergate investigations provided tools for claimants. What did they know and when did they know it? How and when did they conceal and cover up? What were the means and methods for insider enrichment? And, finally, in all events, "follow the money." Timelines that overlay insider actions on top of the prices of the mortgage-backed securities will be valuable tools for investigators. Undoubtedly there will be litigation over individual deals gone bad. Some litigants, however, such as the FDIC and large fiduciary investors with interests in multiple companies and securities, will need to consider a more systemic approach. Investigations into individual deals and cases should be coordinated, and a cross-case database of potential targets developed to assist in identifying trading and other patterns. Certain actors, both institutional and individual, will pop up repeatedly. Once a database is in place, any "hot money" will be reflected in the transactions between them.

Focus on the trading. This applies as much to the mortgage-backed securities and other securities as it does to real estate lending. If past is truly prologue, there will be an inside group -- the daisy chain -- and concentric circles of subsequent investors. Evidence may be developed showing that investors and institutions furthest from the center were expected to be left holding the bag when the music stopped. Conversely, the closer to the center one is, the more the issue of manipulative trading to establish values for mark-to-market purposes should be seriously investigated. In any event, systemic litigants will need a database that shows trading in the mortgage-backed securities market as a whole.

Litigants will need discovery into "what did they know and when did they know it?" and "how and when did they cover it up?" While the popular mantra is that "no one could have seen this coming," discovery is likely to yield a contrary result. In the savings and loan crisis, we found that the defendants knew about the problems early on, they usually tried something to at least mitigate the extent of the damage and, when that proved impossible, they tried to conceal the problems or their magnitude.

In these cases, the devil resides in the details and cover-ups are frequently hinted at in the footnotes of financial statements and in extraordinary transactions, ala Keating's "accounting factory." Fortunately for investigators, audit workpapers are usually revealing. And, these days, e-mail spiders and similar programs are available to trace e-mail chains.

Finally, in the early days of the savings and loan crisis litigation, systemic plaintiffs contended with significant judicial skepticism over their allegations concerning the junk bond market's effect on the savings and loans. While the current climate is markedly different from the early 1990s, counsel should be prepared for this possibility. The best strategies include drafting complaints that are well organized and allege detailed evidence and narrow claims, targeted and supportable document discovery and presenting a trial plan early on.

Those who don't heed history are doomed to repeat it. Thus the new financial crisis litigation will be déjà vu all over again, with some new twists.

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