

2010

Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown

Charles W. Murdock

Loyola University Chicago, School of Law, cmurdoc@luc.edu

Follow this and additional works at: <http://lawcommons.luc.edu/lucj>



Part of the [Banking and Finance Law Commons](#)

Recommended Citation

Charles W. Murdock, *Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown*, 41 Loy. U. Chi. L. J. 801 (2010).
Available at: <http://lawcommons.luc.edu/lucj/vol41/iss4/5>

This Article is brought to you for free and open access by LAW eCommons. It has been accepted for inclusion in Loyola University Chicago Law Journal by an authorized administrator of LAW eCommons. For more information, please contact law-library@luc.edu.

Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown

Charles W. Murdock*

“Beware of Geeks Bearing Formulas.”¹

“[For] too long there’s been a culture of anything goes.”²

“What is required of us now is a new era of responsibility.”³

I. INTRODUCTION

The above statements, one by a distinguished businessman and the others by our new president and his chief of staff, bear directly on the subject of this Article. Today we are witnessing a crisis caused by economic formulae developed without a responsible exercise of judgment and, in many instances, with a shocking disregard for the truth. The virtue of truthfulness is not just some abstract moral principle. Rather, it is a critical component of a well functioning society. As the current situation demonstrates, the lack of regard for truthfulness can have disastrous consequences, not just for our own country, but around the world.

The crisis of truthfulness, or rather the lack thereof, permeates our society. We might ask: what’s wrong with a little puffing in advertising? The problem with this ideology is that it steels us against critical thinking and creates a mindset that there is nothing wrong with

*Professor of Law, Loyola University Chicago School of Law.

1. Letter from Warren Buffet, Chairman of the Board, Berkshire Hathaway, to Shareholders, Berkshire Hathaway 15 (Feb. 27, 2009), *available at* <http://www.berkshirehathaway.com/letters/2008ltr.pdf>; *see also* Posting of Peter Klein, *Beware of Geeks Bearing Formulas*, to Organizations and Markets, <http://organizationsandmarkets.com/2008/11/03/beware-of-geeks-bearing-formulas> (Nov. 3, 2008) (noting that the recent collapse of AIG will likely fuel skepticism about the use of computer models to gauge risk assessment).

2. *See* Interview by David Gregory, Meet the Press, with Rahm Emanuel, White House Chief of Staff, on Meet the Press (Jan. 18, 2009), *available at* <http://www.msnbc.msn.com/id/28719411/> (statement by Rahm Emanuel in response to questions regarding President Barack Obama’s inaugural address in which he notes that President Obama’s speech will focus on a return to an era of responsibility in both business and government).

3. Barack Obama, President of the United States, Inaugural Address 3 (Jan. 20, 2009), *available at* <http://www.gpo.gov/fdsys/pkg/DCPD-200900001/pdf/DCPD-200900001.pdf>.

stretching the truth. While “little white lies” may cause little harm, when business embarks on massive deception—which the government enables instead of holding to account—the seeds are planted for massive problems. We are now experiencing these seeds of deceitfulness coming to fruition in connection with the subprime mortgage crisis and the government bailouts.

In this decade, we have had both the corporate corruption scandals of the early 2000s and the current subprime mortgage crisis. We have also witnessed an administration that has little regard for truthfulness. While these problems occurred on the Bush “watch,” or lack thereof, some of the responsibility clearly relates back to the Clinton administration. In fact, the symbiotic relationship between business and government stretches back decades. President Eisenhower warned of the military-industrial complex.⁴ President Reagan scuttled antitrust enforcement⁵ and undercut the unions.⁶ President Clinton opened up free trade with China,⁷ which has led to a massive trade deficit⁸ and the loss of working-class jobs.⁹ Additionally, President Clinton encouraged deregulation and thwarted attempts to engender increased transparency for hedge funds.¹⁰

While the Bush administration raised deception to an art form, Democrats have had their own issues with truthfulness: witness the scandalous circumstances surrounding Governor Blagojevich filling President Obama’s vacant Senate seat and Senator Burris’ alleged perjury in connection with it.¹¹ And, of course, President Clinton had

4. Dwight D. Eisenhower, President of the United States, Farewell Radio and Television Address to the American People (Jan. 17, 1961), in 1960–1961 PUB. PAPERS 1035, 1037–39.

5. Mark E. Roszkowski, *The True Reagan Antitrust Legacy: The End of Intra-brand Competition*, THE ANTITRUST SOURCE, Mar. 2005, at 1, available at <http://www.abanet.org/antitrust/at-source/05/03/05-mar05-roszkowski323.pdf>.

6. Stacey Hirsh, *Reagan Presidency Pivotal for Unions*, BALT. SUN, June 8, 2004, at 1C, available at <http://www.baltimoresun.com/business/bal-bz.unions08jun08,0,1761456.story?call=bal-business-headlines>.

7. David Armstrong, *U.S. Racks Up Record Trade Deficit in '05*, S.F. CHRON., Feb. 11, 2006, at C1, available at <http://www.sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2006/02/11/BUGSMHGKGD1.DTL&type=business?>.

8. Alan Tonelson, *China Deficit Keeps Rising As U.S. Exports Tank*, AM. ECON. ALERT, Nov. 13, 2008, available at http://www.americaneconomicalert.org/view_art.asp?Prod_ID=3081.

9. See *id.* (noting that America’s trade policies have “weakened the nation’s economy and productive base”); Armstrong, *supra* note 7 (noting that the trade deficit and corresponding flood of cheap imported goods hurts blue-collar workers by forcing them into lower-paying service jobs).

10. Editorial, *Bill v. Barack on Banks*, WALL ST. J., Oct. 1, 2008, at A24.

11. See David Stout, *Illinois Governor Calls for Burris to Step Down*, N.Y. TIMES, Feb. 20, 2009, <http://thecaucus.blogs.nytimes.com/2009/02/20/illinois-governor-calls-for-burris-to-step->

his own personal issue with truthfulness.¹²

This Article will examine in Part II how broadly truth is devalued throughout our society. This Part will focus on the lack of truthfulness in politics and government.¹³ Then, in Part III the Article will analyze the deception that led to the corporate corruption scandal at the turn-of-the-century. It will also discuss United States Supreme Court decisions involving Illinois-based companies, which dealt with hyping stock prices and deception in manufacturing earnings instead of products.¹⁴

Next, in Part IV, the Article will consider the deceitfulness that has triggered the current crisis, namely, the toxic mortgages created by unscrupulous mortgage brokers and lenders, which were packaged into securities by investment bankers and rated AAA by the credit rating agencies.¹⁵ Litigation brought by Lisa Madigan, the Illinois Attorney General, exposed many of these abusive lending practices which culminated in an \$8.6 billion settlement with Bank of America over Countrywide Financial's widespread illegal activity. The Attorney General then took the lead when Illinois enacted amendments to the Residential Mortgage Licensing Act, which required brokers and lenders to verify the borrower's ability to repay and imposed a fiduciary obligation on mortgage brokers.¹⁶ Had legislation of this type been in place earlier, the subprime crisis might not have occurred.

The Article will conclude by analyzing the real causes of the crisis¹⁷ and suggest at least a partial solution to the problem of toxic assets which have precipitated the crisis.¹⁸ In particular, the Article advocates for the reform of TARP, to increase bank risk in the sale of troubled assets and encourage honesty in dealing with the government. The Article further advocates for a change in the bankruptcy laws to allow bankruptcy courts to lower the amount of mortgages and to induce fair dealing between banks and borrowers regarding mortgages.

own/?hp; see also *infra* text accompanying notes 92–102 (detailing the scandal surrounding Governor Blagojevich's attempts to sell President Barack Obama's former Senate seat).

12. See Bill Clinton, Statement Concerning his Relationship with Monica Lewinsky (Jan. 26, 1998) (transcript available at http://www.pbs.org/newshour/bb/white_house/jan-june98/historians_1-26.html) (stating that he never had sexual relations with White House intern Monica Lewinsky).

13. See *infra* text accompanying notes 39–107.

14. See *infra* text accompanying notes 134–206.

15. See *infra* text accompanying notes 206–45.

16. See *infra* text accompanying notes 276–318.

17. See *infra* text accompanying notes 267–349.

18. See *infra* text accompanying notes 364–72.

II. THE PROBLEM OF TRUTHFULNESS IN GENERAL

A. *The Lack of Truthfulness in Advertising, Research, and Journalism*

The basic ethic of securities law is that it is a sin, not just to lie, but to tell a half-truth.¹⁹ Accordingly, a student of securities law cannot be unaware of the issue of truthfulness. However, any time one is focused upon a particular area, it is easy to be myopic in other areas. For me personally, it was an article in the Wall Street Journal a couple of decades ago that highlighted how widespread our society devalues truthfulness.

The lead for the article stated: “[a]dvertising executives are still shaking their heads in amazement at North American Volvo’s blatant rigging of its ‘monster truck’ commercial.”²⁰ The ad in question depicted a pick-up truck driving over the top of a row of cars, crushing the roofs of all the cars except the Volvo.²¹ However, what the ad did not reveal was that the roof of the Volvo was reinforced with lumber and steel, whereas the roof support pillars of the other cars had been severed or weakened.²²

Does this ad seem problematic from the perspective of truthfulness? Not to a University of Michigan marketing professor who said: “I don’t find these commercials morally repugnant, or have any legal concerns about them . . . [even though] every day the consumer is getting deceived.”²³ It has been observed that, if Christ can speak in parables, what prevents business from speaking in metaphors? But there is a fundamental difference in motivation. A parable is often purposefully unclear to force someone to think through to the truth. On the other hand, the purpose of much advertising, as the professor observed, is to deceive the public.

It is not just business that engages in deception. The scientific,

19. See Rule 10b-5 of the Securities Exchange Act of 1934:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

17 C.F.R. § 240.10b-5 (2009).

20. Krystal Miller & Jacqueline Mitchell, *Car Marketers Test Gray Area of Truth in Advertising*, WALL ST. J., Nov. 19, 1990, at B1.

21. *Id.*

22. *Id.*

23. *Id.*

academic, and journalism worlds, among others, have had serious issues with truthfulness. One of the shocking areas involves that of research. There is a general perception that research is data-oriented and therefore reliable. Thus, the world was shocked when it was reported that a Korean scientist, Hwang Woo Suk, had faked the research in which he claimed to have created stem cell colonies from eleven patients.²⁴ This created a major embarrassment, not just for him and the stem cell industry, but also for the Korean government that had issued a postage stamp as a tribute to his work.²⁵

Other research has also been called into question. About the same time as the incident with Hwang Woo Suk was unfolding, the New England Journal of Medicine disclosed its concern about studies it had published dealing with the blockbuster drug Vioxx (“Drug Profits Article”).²⁶ The studies in question reported only selective data on heart attacks and strokes without mentioning the cardiovascular or overall dangers of Vioxx.²⁷ Conversely, Merck’s own study had showed that Vioxx was more dangerous than Naproxen, an over-the-counter drug.²⁸

Along with other articles, the Drug Profits Article induced medical practitioners to prescribe Vioxx, rather than having their patients use cheaper, and safer, over-the-counter medicine.²⁹ At the time, it was estimated that Vioxx probably caused between 88,000 and 144,000 cases of serious heart disease.³⁰ The Drug Profits Article suggested that academic journals change their policy from “trust” to “trust, but verify,”³¹ a phrase popularized by President Reagan.³²

More recently, the Sunday Times of London reported that scientists manipulated a 1998 study linking the mumps, measles, and rubella (MMR) vaccine to autism.³³ At this point, the physician who conducted

24. Choe Sang-Hun & Nicholas Wade, *Korean Cloning Scientist Quits over Report He Faked Research*, N.Y. TIMES, Dec. 24, 2005, at 20.

25. Editorial, *Stem Cell Disgrace*, CHI. TRIB., Jan. 20, 2006, at 20.

26. John Abramson, Commentary, *Drug Profits Infect Medical Studies*, L.A. TIMES, Jan. 7, 2006, Commentary.

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. Ronald Reagan, President of the United States, Farewell Address to the Nation (Jan. 11, 1989), in 1988–1989 – BOOK II PUB. PAPERS 1718, 1721, available at http://www.reaganfoundation.org/pdf/Farewell_Address_011189.pdf.

33. See John Gever, *Father of Vaccine-Autism Link Said to Have Fudged Data*, MED PAGE TODAY, Feb. 11, 2009, <http://www.medpagetoday.com/Pediatrics/Autism/12850>; see also

the study, Dr. Wakefield, has denied the allegations. However, in 2004 it was disclosed that his research had been partially funded by plaintiffs' lawyers involved in suits against the vaccine makers. The current bombshell asserts that the children's hospital records differ from the descriptions in Dr. Wakefield's paper. The matter is a serious one since the study has induced many parents to forgo the vaccine, with a corresponding rise in the number of measles cases. In early February 2010, the *Lancet*, the British medical journal that published Dr. Wakefield's study, retracted the study following an investigation that found significant inconsistencies with Dr. Wakefield's research.³⁴ In addition, a British medical panel found that "Dr. Wakefield had been dishonest, violated basic research ethics rules and showed a 'callous disregard' for the suffering of children involved in his research."³⁵

In journalism, there have been numerous instances of plagiarism.³⁶ One that garnered much media attention was that of Jayson Blair, the New York Times reporter who fabricated about forty stories in less than a year.³⁷ However, one of the more interesting instances of plagiarism involved Fox Butterfield of the New York Times who plagiarized a story about someone else plagiarizing.³⁸

Closer to the main theme of this Article are editorial comments that raise the question of when bias also constitutes lying. For example, consider the Wall Street Journal editorial that dismissed as not stimulative "\$252 billion [] for income transfer payments," and concluded that only \$.12 out of every dollar could be considered a stimulus.³⁹ Transfer payments include such things as an extension of food stamps and unemployment insurance benefits. There is a

Posting of Dana Blankenhorn, *Was the vaccine-autism link a fraud?*, to ZDNet.com, <http://healthcare.zdnet.com/?p=1794> (Feb. 10, 2009).

34. Gardiner Harris, *Journal Retracts 1998 Paper Linking Autism to Vaccine*, N.Y. TIMES, Feb. 3, 2010, at 9.

35. *Id.*

36. See MediaMythbusters.com for a list of twenty-three instances of plagiarism by prominent journalists and public figures. MediaMythbusters.com, Plagiarism, <http://mediamythbusters.com/index.php?title=Plagiarism> (last visited Apr. 22, 2010).

37. Dan Barry et. al., *Correcting the Record—Times Reporter Who Resigned Leaves Long Trail of Deception*, N.Y. TIMES, May 11, 2003, at 1.

38. See Fox Butterfield, *Pulitzer-Winning 'New York Times' Reporter, Accepts Buyout*, ALLBUSINESS.COM, Aug. 2, 2005, <http://www.allbusiness.com/services/business-services-miscellaneous-business/4680334-1.html> (noting that in 1991, Butterfield faced accusations of plagiarism when he lifted text from a Boston Globe story about a plagiarism scandal involving a Boston University Dean).

39. Editorial, *A 40-Year Wish List: You Won't Believe What's in the Stimulus Bill*, WALL ST. J., Jan. 28, 2009, at A14.

conservative bias against such transfer payments and a liberal bias in favor of them. Whether the concept of transfer payments is good or bad policy is not the issue. Rather, it is the statement that they are not stimulative. As an example of the inherent falsity of this claim, Mark Zandi, the chief economist and cofounder of Moodyseconomy.com and an adviser to Senator McCain's presidential campaign, has stated that such payments would provide a greater impact than any other potential stimulus provision he analyzed, including temporary and permanent tax cuts.⁴⁰ When biased statements are patently false, they represent a lack of truthfulness and cannot be excused as mere opinion.

Editorial distortions in the print media are often picked up with hyperbole in the talk radio medium.⁴¹ Does this activity move us toward truth or toward being responsible citizens? Or rather, do distortions of this sort feed our biases and inhibit rational decision-making? Is it mere opinion or is it a lie?

Each of the foregoing examples illustrates the culture of deception that has helped spur the subprime crisis. This crisis has placed our economy in substantial economic straits, and led the government to enact the subprime bank bailout and pass a federal stimulus package to stem the downward spiral. This is a subject of concern to all and, hopefully, the media will shed some light on the strengths and weaknesses of the various alternatives. Unfortunately, the media often provides more heat than light. While the foregoing is clearly cause for concern, these examples pale in comparison to the lies and distortions in the political and business worlds.

40. See Mark Zandi, *The Economic Impact of the American Recovery and Reinvestment Act*, MOODY'S ECONOMY.COM, Jan. 21, 2009, at 2, available at http://www.economy.com/mark-zandi/documents/Economic_Stimulus_House_Plan_012109.pdf. In terms of "bang for the buck," his analysis indicates that a dollar of permanent tax cuts returns only \$.30–\$.49, and that a lump sum tax rebate would return only \$1.01. *Id.* at 9. On the other hand, general aid to state governments returned \$1.41, increased infrastructure spending returns \$1.57, extending unemployment insurance benefits returns \$1.61, and a temporary increase in food stamps returns \$1.74. *Id.*

41. For example, in their Fox News radio program, Keith Weinman and Gail Fallen engaged in the following exchange:

WEINMAN: Yeah. And just go to the point where twelve cents out of every dollar can be defined as money that will actually stimulate the economy, which is what the whole thing is supposed to do. That's what came out of your U.S. House of Representatives.

FALLEN: And doesn't it tick you off, to some extent? The arrogance—that they're trying to push more pork, arguably, than they have in recent history[.]

See Keith & Gail: *Hour 4* (KCOL radio broadcast Feb. 2, 2009), available at http://www.600kcol.com/cc-common/podcast/single_podcast.html?podcast=keith_and_gail.xml.

B. Truthfulness in Politics

Not only has the media itself been untruthful, but it has done a poor job of holding others to account for their untruthfulness. With respect to print media, there is a general agreement that opinion belongs on the editorial pages and facts belong on page one. But what is fact and what is newsworthy? The political sphere has a serious problem with distortion and outright lies. When a politician makes a false statement and the media reports it as “fact,” then lies become facts and are relied upon by the electorate.

Also problematic are media attempts to be “balanced.” While all lies should be identified and rejected, there is a distinction, sometimes nebulous, between lies and political puffing. To me, a statement by a candidate that he will balance the budget in four years⁴² is puffing rather than lying, even though it may strain credibility. On the other hand, to mischaracterize a candidate’s position on taxes,⁴³ for example, falls on the side of lying. Both the public and the media need to make these types of distinctions.

A superficial attempt to be “balanced” can itself be a distortion if it means that every time one candidate is guilty of a misrepresentation, a report about this person’s misrepresentation must also include a report that the other candidate has also made some misrepresentation. There has been a pattern of reporting that goes something like this: A lied about X and also B lied about Y. However, the reporting often does not distinguish between the fact that X may be a critical issue and repeated frequently, whereas Y may be a less significant issue and its repetition less pervasive. This is not to excuse any lie, but merely to suggest that despite “balanced” reporting, one candidate may, in fact, be more culpable in authoring deception than another.

While President Clinton’s various affairs brought disgrace upon him, and led to an impeachment proceeding, in part predicated upon perjury, his lies related essentially to his private life. From the public’s perspective, he lost his integrity when he went on national television to proclaim that “I did not have sex with that woman.”⁴⁴ At that point, it was no longer a private issue but a public lie. As a result of these actions, President George W. Bush campaigned on a pledge “to restore

42. See Mike Allen, *McCain Promises to Balance Budget*, POLITICO, July 6, 2008, <http://www.politico.com/news/stories/0708/11553.html>.

43. See David Espo, *In Swing States, McCain And Obama Spar Over Taxes*, ASSOC. PRESS, Oct. 18, 2008 (noting that McCain, in the weeks leading up to the November, 2008 election, likened Barack Obama’s fiscal policies to socialism).

44. See Clinton, *supra* note 12.

honor and dignity” to the White House.⁴⁵ However, the distortions that unfolded during President Bush’s tenure extended well beyond the “personal” arena.

1. Pollster Frank Luntz’s Advice on How to Be Deceptive

The past eight years have witnessed an incredible disregard for the truth by the Bush administration on domestic and foreign policy issues of importance. It is rare for a political party to document its intention to play with the truth, but that is exactly what occurred when Frank Luntz’s “Straight Talk” memo was leaked to the public.⁴⁶

Frank Luntz, a Republican pollster, advised his political constituency that they were losing an important segment of the public because of their stance on the environment.⁴⁷ He counseled that they needed to change their language, not necessarily their positions.⁴⁸ In his “Straight Talk” memo, he advised that, in dealing with environmental issues, Republicans should use words such as “safer,” “cleaner,” and “healthier.”⁴⁹ He stated that: “[a] compelling story, even if factually inaccurate, can be more emotionally compelling than a dry recitation of the truth.”⁵⁰

Following this advice, President Bush announced his “Healthy Forests Initiative”⁵¹ after a series of forest fires created anxiety in the Western states. This initiative authorized the logging of healthy, commercially-valuable trees miles away from at-risk communities and the source of forest fires.⁵² In effect, the “Healthy Forests Initiative”

45. Frank Bruni, *The 2000 Campaign: The Texas Governor—Bush Calls on Gore to Denounce Clinton Affair*, N.Y. TIMES, Aug. 12, 2000, at 11.

46. See Memorandum from Frank Luntz to the Bush White House (2002) [hereinafter *Straight Talk*], partially available at http://www.aspenlawschool.com/books/plater_environmentallaw/updates/02.6.pdf.

47. *Id.* at 132.

48. *Id.*

49. *Id.* at 131.

50. *Id.* at 132.

51. See *Fact Sheet: Progress Reported On Implementing President Bush’s Healthy Forests Initiative*, U.S. DEP’T OF AGRIC., Jan. 2004, <http://www.usda.gov/Newsroom/fs0044.04.pdf>; Press Release, White House, President Signs Healthy Forests Restoration Act into Law (Dec. 3, 2003), available at <http://georgewbush-whitehouse.archives.gov/infocus/healthyforests>; see also *Healthy Forests Initiative: A Campaign of Severe Forest Policy Rollbacks* (2003), available at <http://www.wildcalifornia.org/publications/article-57>.

52. See Healthy Forests Restoration Act of 2003, Pub. L. No. 108-148, tit. I, § 102, 117 Stat. 1888 (codified at 16 U.S.C. § 6512 (2003)); see also Healthy Forests Restoration Act of 2003, Pub. L. No. 108-148, 16 U.S.C. 6512 (2003); Douglas Jehl, *Bush, Citing Fires, Will Seek to Ease Laws on Logging*, N.Y. TIMES, Aug. 22, 2002, at 1, available at <http://query.nytimes.com/gst/fullpage.html?res=950CE1DD173CF931A1575BC0A9649C8B63>.

was designed to eliminate healthy forests, not preserve them.

Bush accompanied his "Healthy Forests Initiative" with his "Clear Skies" policy. While the "Clear Skies" policy awaited congressional approval,⁵³ President Bush rolled back the "new source review" rules, which meant that old power plants could make improvements and boost production without automatically adding expensive pollution-control equipment.⁵⁴ At a photo op at the Detroit Edison plant in Monroe, Michigan, in connection with suspending the new source rules, Bush told the workers and executives, "You're good stewards of the quality of the air."⁵⁵ Critics countered by citing a 2000 study by Abt Associates, a group that the Environmental Protection Agency (EPA) has used to gauge the health effects of pollution, that indicated "the plant is responsible for 293 premature deaths, 5,740 asthma attacks and 50,298 lost workdays each year," as well as producing 45,900 tons of nitrogen oxide and 810 pounds of mercury.⁵⁶

With respect to global warming, Luntz recognized that "[t]he scientific debate is closing [against us] but not yet closed."⁵⁷ Accordingly, he recommended:

Voters believe that there is *no consensus* about global warming within the scientific community. Should the public come to believe that scientific issues are settled, their views about global warming will change accordingly. Therefore, *you need to continue to make the lack of scientific certainty a primary issue in the debate.*⁵⁸

This exemplified one aspect of the Bush administration's strategy: not just emphasizing the lack of consensus when, in fact, there is near consensus,⁵⁹ but also stifling administration officials who sought to be

53. For additional information, see the Environmental Protection Agency's summary of the provisions of the Healthy Forests Restoration Act of 2003 at Press Release, Environmental Protection Agency, Summary of the Clear Skies Act (Feb. 27, 2003), available at http://www.epa.gov/air/clearskies/CSA2003shortsummary2_27_03_final.pdf, and a history of this legislation at Environmental Protection Agency, Legislative History of the Clear Skies Act, <http://www.epa.gov/air/clearskies/legis.html>. See also Javier Sierra, *Illegal Misleads*, SIERRA CLUB, <http://www.sierraclub.org/ecocentro/ingles/pinocchio.asp>; Tom Valtin, *Bush Chips Away at Clean Air Act*, SIERRA CLUB, http://www.sierraclub.org/planet/200302/clean_air_act.asp.

54. Dana Milbank, *Bush Lauds Mich. Power Plant As a Model of Clean Air Policy—But Opponents Say It's a Polluter Excused by 'Clear Skies' Plan*, WASH. POST, Sep. 16, 2003, at A3.

55. *Id.*

56. *Id.*

57. Straight Talk, *supra* note 46, at 138.

58. *Id.* at 137.

59. *Climatologists Agree: Earth's Surface Warming Beyond Dispute*, POLLUTION ONLINE.COM, March 14, 2000, <http://www.pollutiononline.com/article.mvc/Climatologists-Agree-Earths-Surface-Warming-B-0001?VNETCOOKIE=NO>.

truthful on the issue of global warming.⁶⁰

2. The More Egregious Lies Dealing with National Security

Arguably, more serious than the distortions on the environment were those relating to national security issues: (1) that Saddam Hussein was responsible for 9/11; (2) that Iraq possessed nuclear weapons; (3) that we do not torture; and (4) that we do not spy on American citizens.

The first distortion, that Saddam Hussein was responsible for 9/11, is an interesting "lie." The Bush administration never explicitly made this statement. Yet, it continually linked Saddam Hussein with 9/11 through proximity in statements, over and over again. The net result was that, in a 2003 poll, seventy percent of Americans believed that Saddam was responsible for 9/11.⁶¹ In 2007, forty-one percent of Americans still believed that Saddam Hussein was responsible for 9/11.⁶² Deliberately coupling two unrelated statements to suggest a causal connection is a form of lying.

With respect to whether Iraq possessed nuclear weapons, the Bush administration tried to give itself some wiggle room by generally referring to weapons of mass destruction.⁶³ While this could include

60. Andrew Revkin, *NASA Expert Criticizes Bush on Global Warming*, N.Y. TIMES, Oct. 26, 2004, at 22.

61. *See Poll Suggests 70 Percent Believe Saddam, 9-11 Link*, ASSOC. PRESS, Sept. 6, 2003, available at http://www.usatoday.com/news/washington/2003-09-06-poll-iraq_x.htm.

62. Josh Catone, *Number of Americans Who Believe Saddam-9/11 Ties Rises to 41 Percent*, THE RAW STORY.COM, June 24, 2007, http://rawstory.com/news/2007/Poll_41_of_Americans_believe_Saddam_0624.html.

63. For an example, see the Center for Public Integrity's website at <http://projects.publicintegrity.org/WarCard/>. This website sets forth the following:

President Bush, for example, made 232 false statements about weapons of mass destruction in Iraq and another 28 false statements about Iraq's links to Al Qaeda. Secretary of State Powell had the second-highest total in the two-year period, with 244 false statements about weapons of mass destruction in Iraq and 10 about Iraq's links to Al Qaeda. Rumsfeld and Fleischer each made 109 false statements, followed by Wolfowitz (with 85), Rice (with 56), Cheney (with 48), and McClellan (with 14).

Charles Lewis & Mark Reading-Smith, *False Pretenses*, CTR. FOR PUB. INTEGRITY, Jan. 23, 2008, <http://projects.publicintegrity.org/WarCard>. The website supported its charge of deception with respect to the statements as follows:

It is now beyond dispute that Iraq *did not* possess any weapons of mass destruction or have meaningful ties to Al Qaeda. This was the conclusion of numerous bipartisan government investigations, including those by the Senate Select Committee on Intelligence (2004 and 2006), the 9/11 Commission, and the multinational Iraq Survey Group, whose "Duelfer Report" established that Saddam Hussein had terminated Iraq's nuclear program in 1991 and made little effort to restart it.

Id. See also Study: *Bush, Aides Made 935 False Statements in Run-Up to War*, CNN, Jan. 23, 2008, <http://www.cnn.com/2008/POLITICS/01/23/bush.iraq/> (reporting on the study conducted by the Center for Public Integrity).

such matters as chemical and biological weaponry, in the public's mind this generally meant nuclear weapons. This was reinforced by President Bush, Condoleezza Rice, and members of the administration, as they repeatedly made references to a smoking gun in the form of a "mushroom cloud."⁶⁴ No such weapons have been uncovered in Iraq.

With respect to torture, President Bush⁶⁵ and Vice President Cheney⁶⁶ have asserted that the United States does not torture. However, this is reminiscent of Humpty Dumpty who said, "When I use a word . . . it means just what I choose it to mean—neither more nor less."⁶⁷ It is hard to look at what occurred at the Abu Ghraib prison in Iraq as anything other than torture. Vice President Cheney has even asserted that a "dunk in the water" might be helpful in getting terrorists to talk.⁶⁸ This was an obvious reference to waterboarding, a long-recognized form of torture.

However, despite Vice President Cheney's own admissions, other Bush Administration officials have claimed ignorance as to what the process of waterboarding even entails. Attorney General Mukasey's statement in his confirmation hearings that he did not know what was involved in waterboarding strains credibility.⁶⁹ The use of waterboarding has been replete throughout history.⁷⁰

64. See Derrick Jackson, Op-Ed: *Questions for Condoleezza*, BOSTON GLOBE, Aug. 13, 2003, at A23, available at <http://www.commondreams.org/views/03/0813-02.htm>; see also John Harris et al., *Cheney Warns of New Attacks*, POLITICO, Feb. 4, 2009, <http://www.politico.com/news/stories/0209/18390.html>; Editorial, *Remember That Mushroom Cloud?*, N.Y. TIMES, Nov. 2, 2005, at 28.

65. *Bush: 'We Do Not Torture' Terror Suspects*, MSNBC, Nov. 7, 2005, <http://www.msnbc.msn.com/id/9956644>.

66. Interview by Terry Moran with Dick Cheney, Former Vice President of the United States, in Iraq (Dec. 18, 2005), available at <http://abcnews.go.com/Nightline/IraqCoverage/story?id=1419206>.

67. LEWIS CARROLL, *ALICE IN WONDERLAND, AND THROUGH THE LOOKING GLASS* 164 (Lothrop Publ'g Co. 1898).

68. Terence Hunt, *White House Denies Cheney Endorsed 'Water Boarding'*, ASSOC. PRESS, Oct. 28, 2006; see also Barton Gellman & Jo Becker, *Pushing the Envelope on Presidential Power*, WASH. POST, June 25, 2007, available at http://voices.washingtonpost.com/cheney/chapters/pushing_the_envelope_on_presi/.

69. *Confirmation Hearing on the Nomination of Michael B. Mukasey to be Attorney General of the United States: Hearing Before the Committee on the Judiciary, United States Senate*, 110th Cong. 145 (2007) (transcript), available at http://www.fas.org/irp/congress/2007_hr/mukasey.html.

70. Its origin dates back to the Inquisition; the United States charged Japanese soldiers with war crimes because they waterboarded our soldiers during World War II. Eric Weiner, *Waterboarding: A Tortured History*, NPR, Nov. 3, 2007, available at <http://www.npr.org/templates/story/story.php?storyId=15886834>. Federal prosecutors have convicted a sheriff and three of his deputies for violating prisoner civil rights based on

The CIA has now acknowledged that it has used waterboarding.⁷¹ However, the question is whether torture occurred, not just waterboarding. Susan Crawford, the top Bush administration official in charge of deciding whether to bring Guantánamo detainees to trial, recently determined that a suspect could not be referred to prosecution because he had been tortured. In this case, the detainee had been subjected to “sustained isolation, sleep deprivation, nudity and prolonged exposure to cold, leaving him in a ‘life-threatening condition.’”⁷² That being said, the United States has certainly tortured prisoners, notwithstanding the deceptive statements of Bush and Cheney.

When politicians mislead the public, bad policy may result. And bad policy does have consequences. Our actions, in initiating the war in Iraq, killing innocent civilians, and torturing prisoners at Abu Ghraib, have undercut America’s reputation around the world. Recall that, just prior to the turn of the previous century, England had a worldwide empire and was the undisputed world leader. Just a few short years later, as result of the Boer wars, England was in financial straits and its reputation had deteriorated as a result of how it conducted the war and treated civilians.⁷³ Let us hope that the lies that led us to the Iraq war, and which surrounded issues such as torture, do not lead America to a similar fate.

Another area in which the Bush Administration has engaged in deceitfulness involves surveilling American civilians. With respect to the NSA spying program, President Bush, on January 1, 2006, stated that the NSA spying program was a limited program, limited to calls coming from outside the United States into the United States, and limited to known numbers of known al-Qaeda members.⁷⁴

waterboarding. See Evan Wallach, *Waterboarding Used to Be a Crime*, WASH. POST, Nov. 4, 2007.

71. Randall Mikkelsen, *CIA Says Used Waterboarding on Three Suspects*, REUTERS, Feb. 5, 2008, available at <http://www.reuters.com/article/topNews/idUSN0517815120080205?feedType=RSS&feedName=topNews>.

72. Bob Woodward, *Detainee Tortured, Says U.S. Official*, WASH. POST, Jan. 14, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/13/AR2009011303372.html?hpid=topnews>.

73. See FAREED ZAKARIA, *THE POST-AMERICAN WORLD* 170–71 (Simon and Schuster 2008).

74. Interview by Amy Goodwin of Democracy Now with Russell Tice, Former NSA Intelligence Agent (Jan. 3, 2006), available at http://www.democracynow.org/2006/1/3/exclusive_national_security_agency_whistleblower_warns.

While there is still much to be learned about this program, since those who choose to discuss it have been labeled traitors,⁷⁵ we do know today that the program was not a limited one,⁷⁶ that it was not limited to calls from outside the United States,⁷⁷ that the calls intercepted are not just from members of Al Qaeda but from United States servicemen and members of the press,⁷⁸ that Justice Department officials have had reservations about the legality of the program,⁷⁹ and that, not only has Congress not been adequately briefed, but that members of the intelligence committee have not been fully informed.⁸⁰

Russell Tice, the original whistleblower who brought many of these discrepancies to light, is now suggesting that communications involving journalists may have been particularly targeted.⁸¹ This would be especially distressing since it would involve violations, not just of the

If somebody from al-Qaeda is calling you, we'd like to know why. In the meantime, this program is conscious of people's civil liberties as am I. This is a limited program designed to prevent attacks on the United States of America—and I repeat limited.

Bush Defends NSA Spying Program (Jan. 1, 2006), available at <http://www.cnn.com/2006/POLITICS/01/01/nsa.spying/index.html>.

[The program] is limited to calls from outside the United States to calls within the United States. But, they are of known numbers of known al Qaeda members or affiliates. I think most Americans understand the need to find out what the enemy is thinking. And that's what we are doing. We're at war with a bunch of cold blooded killers who will kill in a moment's notice. I have a responsibility to act within the law which I am doing. The program has been reviewed constantly by Justice Department officials. A program to which the Congress has been briefed. A program that is in my judgment necessary to win this war and to protect the American people.

President George W. Bush, Press Conference at Brooke Army Medical Center (Jan. 2, 2009).

75. *Tamm the Traitor* (Dec. 17, 2008), available at http://www.rightwingnews.com/mt331/2008/12/tamm_the_traitor.php.

76. James Risen & Eric Lichtblau, *Bush Lets U.S. Spy on Callers Without Courts*, N.Y. TIMES, Dec. 16, 2005, at A1, available at <http://www.nytimes.com/2005/12/16/politics/16program.html>.

77. *See id.*

78. David Edwards & Muriel Kane, *Whistleblower: NSA Spied on Everyone, Targeted Journalists*, RAW STORY, Jan. 21, 2009, available at http://rawstory.com/news/2008/Whistleblower_Bushs_NSA_targeted_reporters_0121.html.

79. Jason Leopold & Matt Renner, *Former Deputy on Wiretapping: "White House Tried to Coerce Ashcroft,"* TRUTHOUT, May 15, 2007, available at <http://www.truthout.org/article/jason-leopold-and-matt-renner-former-deputy-ag-wiretapping-white-house-tried-coerce-ashcroft>.

80. Senate Select Committee on Intelligence Oversight, Cong. Rec. (Sept. 13, 2006) (statement of Senator Russ Feingold). Here again, lies can lead to bad policy. Senator Frank Church of Idaho, in 1975, warned of the dangers inherent in NSA intercepting communications: "The danger lies in the ability of the NSA to turn its awesome technology against domestic communications." 1975 Hearing: The NSA and 4th Amendment Rights, Select Committee to Study Governmental Operations with Respect to Intelligence Activities, available at <http://cryptome.org/nsa-4th.htm> This danger is currently being realized in our country.

81. *See* Edwards & Kane, *supra* note 78.

Fourth Amendment, but the First Amendment as well. Overall, it is clear that our government has not been truthful with the American people about domestic spying.

3. The Swift Boating of Senator John Kerry in the 2004 Election

Pundits have many theories as to what factors, other than the merits of the respective candidates' positions,⁸² turned the 2004 election. One factor, which deflated Senator John Kerry's momentum and became a substantial distraction, was the book, commercials, and television appearances by the group called "Swift Boat Veterans for Truth."⁸³ While the group's commercials were not widely played, the story flooded the media, particularly Fox News, without sufficient vetting to see if the stories were accurate.

In effect, the group asserted that Senator Kerry had not earned his medals in Vietnam, his injuries were self-inflicted, he was not under fire when he rescued a soldier who had been knocked overboard when a mine detonated, his attack on a Vietcong ambush displayed "stupidity not courage," and he was a coward who fabricated events because of his "insatiable appetite for medals."⁸⁴ While then President Bush basically stayed out of the fray, his father stated that the claims against Senator Kerry were "rather compelling."⁸⁵

But in reality, the charges of the Swift boat veterans were essentially a pack of lies.⁸⁶

82. Everyone remembers the charges of Senator Kerry's "flip-flops." In addition, in Ohio, which decided the 2004 election, Bush won by slightly more than 100,000 votes, but the gay marriage prohibition carried by 1.5 million votes. Some have argued that Karl Rove's strategy of putting constitutional amendments to forbid gay marriage on the ballot was determinative. See Posting of Johanna Neuman to Countdown to Crawford, <http://latimesblogs.latimes.com/presidentbush/2008/10/bush-to-connect.html> (Oct. 11, 2008, 06:55 PT). And then there were the Catholic bishops who, in 2004, published a terse statement, focusing on the Catholic Church position on abortion and raising the question of whether politicians who support *Roe v. Wade* can receive communion. See William P. Fay, *Catholics in Political Life*, UNITED STATES CONFERENCE ON CATHOLIC BISHOPS, available at <http://www.usccb.org/bishops/catholicsinpoliticallylife.shtml>. The same issue was raised in sermons throughout the country and 53% of Catholics voted for Bush in the 2004 election.

83. JOHN E. O'NEILL & JEROME R. CORSI, UNFIT FOR COMMAND: SWIFT BOAT VETERANS SPEAK OUT AGAINST KERRY (Regnery Publ'g 2004).

84. See Tim Jones, *Swift Boat Skipper: Kerry Critics Wrong*, CHI. TRIB., Aug. 22, 2004, at 1; see also Kae Zernike & Jim Rutenberg, *Friendly Fire: The Birth of an Anti-Kerry Ad*, N.Y. TIMES, Aug. 20, 2004, <http://www.nytimes.com/2004/08/20/politics/campaign/20swift.html?pagewanted=1>.

85. James Bennet, *The Republicans: The Convention in New York—The Veterans; Ex-President Bush Calls Charges of Swift Boat Group Compelling*, N.Y. TIMES, Aug. 31, 2004, at 6.

86. On March 13, 1969, five boats were on a mission when one boat was blown up and a special services officer, Jim Rassmann, was knocked out of Kerry's boat. Kerry turned his boat

These allegations not only conflicted with the written records at the time of the Vietnam War, but also with the veterans' own prior statements. Most importantly, with respect to the charge that Senator Kerry did not lead the counter-attack against the Vietcong ambush, the Swift Boat Veterans' claims conflict with the testimony of members of Kerry's crew and the captains of the other two boats who were involved in the attack.⁸⁷

In retrospect, it appears that the leaders of the Swift boat group had substantial animus against Senator Kerry because of his post-conflict opposition to the Vietnam War and his disclosure of various atrocities that occurred during the war.⁸⁸ Whatever the reason for their hostility, it is one thing for Vietnam veterans to challenge Senator Kerry's stance on the War; it is quite another for the media to repeat scurrilous and untrue accusations without properly vetting them. Indeed, probably

to pick up Rassmann and leaned over the bow to help Rassmann out of the water. Rassmann says he expected that he and Kerry would be killed by enemy fire while they were vulnerable on the bow of the boat.

Despite this account, Larry Thurlow, a commander of another boat, claimed 35 years later that there was no enemy fire. However, both Kerry and Thurlow received the Bronze Star for their heroism and Thurlow's own citation refers to "constant enemy small arms fire." In addition, the after-action report refers to heavy enemy fire from both banks of the river and Thurlow's own boat had bullet holes in it. Recently, one of Thurlow's own crew has come forward to confirm that bullets were flying at the time.

On February 28, 1969, Kerry received the Silver Star when he ordered three ambushed swift boats to turn and attack the enemy instead of continuing down the river. Admiral Hoffman now says Kerry was impetuous and lacked leadership in taking this action. However, William Rood, now a *Chicago Tribune* editor, commanded one of the other boats and reported that Kerry discussed this strategy the day before with the other commanders and they agreed to attack, rather than be sitting ducks. Moreover, Admiral Hoffman sent a congratulatory message when he heard of the operation, stating it was "a shining example of completely overwhelming the enemy," and the Navy gave Kerry the Silver Medal.

During the same excursion, Kerry again attacked an ambush and chased and shot a Viet Cong. O'Neill, in his cable TV presentations, says Kerry shot a "lone teenager," wearing "a loin cloth," "in the back." However, O'Neill was not there, but Rood, the *Tribune* editor was. Rood and another crewman state that it was a "grown" man, dressed in "VC garb," armed with "a loaded B-40 rocket launcher," and that there were other ambushers, as well as "firing from the tree line" and "from the opposite river bank." See Jones, *supra* note 84; see also Zernike & Rutenberg, *supra* note 84.

87. See Judith Keyes, *The View From the Boat*, N.Y. TIMES, Aug. 27, 2004, at 21 (written by the widow of the driver of the third boat); William Rood, *Feb. 28, 1969: On the Dong Cung River - 'This is what I saw that day,'* CHI. TRIB., Aug. 22, 2004, at 1 (the story of William Rood, the skipper of one of the boats).

88. Stanley Kutler, *Why Have We Landed in Vietnam Again?*, CHI. TRIB., Aug. 27, 2004, at 21 (the author, Stanley Kutler, is the editor of *ENCYCLOPEDIA OF THE VIETNAM WAR* (MacMillan Publishing 1997)); see also Ralph Blumenthal & Robert Worth, *The 2004 Campaign: The Veterans; For Kerry's Chief Accuser, a Flashback to a Political Battle from 1971*, N.Y. TIMES, Aug. 28, 2004, at 10.

never before have so few individuals spread so much distortion so widely with so little vetting to fulfill their goal of toppling a perhaps would-be President.

4. The 2008 Campaign

For many, the 2008 election held promise for an election without lies, distortions, and dirty tricks, since both candidates had spoken against the divisiveness in Washington. Yet, optimists were soon disappointed, and it did not take long before the public and the media were once again taking the position that “they all lie.” This is a tragic attitude since it undermines trust in government, which in turn led to the outcries against health care reform at the so-called “town hall” meetings last year.⁸⁹ Today, trust in government is critical in view of the extraordinary situation in which we find ourselves.

When Senator McCain introduced Sarah Palin as his Vice Presidential nominee, her most important sound bite was the statement: “I told the Congress ‘thanks but no thanks’ for that Bridge to Nowhere.” *The Anchorage Daily News* immediately rebutted this claim, pointing out that she had, in fact, supported this project.⁹⁰ She made the same claim that she had said “no thanks” in her speech at the Republican National Convention.⁹¹ Several days later, she was still making the same discredited claim.⁹² Senator McCain also parroted her claim.⁹³

The Columbia Journalism Review raised the issue: “Is it naïve to think that if a candidate for national office is caught lying by the press, she might be forced, at a minimum, to stop repeating the lie? Or to

89. See, e.g., *Health Care Town Halls Turn Violent in Tampa and St. Louis*, FOXNEWS.COM, Aug. 7, 2009, <http://www.foxnews.com/politics/2009/08/07/health-care-town-halls-turn-violent-tampa-st-louis/>.

90. Tom Kizzia, *Palin Touts Stance on ‘Bridge to Nowhere,’ Doesn’t Note Flip-Flop*, ANCHORAGE DAILY NEWS, Aug. 31, 2008, available at <http://www.adn.com/sarahpalin/story/511471.html>.

91. Sarah Palin, Vice-Presidential Candidate, Speech at the Republican National Convention (Sept. 3, 2008), available at http://elections.nytimes.com/2008/president/conventions/videos/transcripts/20080903_PALIN_SPEECH.html.

92. See Peter Nicholas & Michael Muskal, *Obama, McCain Lay Claim to ‘Change,’* L.A. TIMES, Sept. 9, 2008, available at <http://timesunion.com/ASPStories/story.asp?StoryID=718928>. A search of “sarah w/l palin & “bridge to nowhere” & da(aft 8/30/2008) & da(bef 9/10/2008)” produces 656 results.

93. *Lend Me Your Earmarks*, THE HOTLINE, Sept. 9, 2008, http://www.nationaljournal.com/hotline/hl_20080909_6517.php; see also Hardball with Chris Matthews (MSNBC television broadcast on Sept. 9, 2008) (mocking the ridiculousness of the claim during Hardball’s “Big Number” segment, when Chris Matthews played seven video clips of the statement made at different times).

explain herself? Or to apologize?"⁹⁴ The article questioned why a retraction was never given and suggested that the McCain camp decided there was no benefit to admitting fault, bearing in mind that 40 million people watched Palin's speech to the Republican National Convention.⁹⁵

This approach may be pragmatic in terms of getting elected, but it hardly fulfills the purpose of public discourse, that is, to deal with issues in a manner that will inform, and not mislead, the public.

To try to analyze all the lies and distortions in a political campaign would require a book, not part of an article. However, to offer a perspective, the appendix to this article provides, in tabular form, a comparison of some of the distortions and lies by the two candidates. The list was compiled from the *FactCheck.org* list of "The Whoppers of 2008," which ran in two parts this year.⁹⁶

The problem with lies is that, as they are repeated over and over again, they began to gain acceptance by many as the truth. Recall Senator McCain's town hall in which a woman said that Obama was an Arab and Senator McCain immediately corrected her.⁹⁷ Nevertheless, a study by Kathleen Hall Jamieson, the Director of the University of Pennsylvania's Annenberg Public Policy Center, and Brooks Jackson, of *Factcheck.org*, reported that nearly one in five Americans believe that President Obama is a Muslim or half Arab.⁹⁸ The study revealed that Republicans were more than twice as likely to believe these charges as were Democrats, reflecting the fact that we are more likely to accept

94. Clint Hendler, *Bridge Fact Checks Go Nowhere: The Press Tries, Palin Still Lies*, COLUM. JOURNALISM REV., Sept. 11, 2008, available at http://www.cjr.org/campaign_desk/bridge_fact_checks_go_nowhere_1.php.

95. *Id.* The article stated:

Tactically, the McCain camp seems to have decided that there's no benefit to admitting fault or to cutting the claim. Palin's speech to the Republican National Convention, which again included the line, was watched by close to 40 million people. As *The New Republic's* Michael Crowley pointed out, how many of those do you think have seen or read a fact check of the claim?

Id.

96. Joe Miller, *The Whoppers of 2008*, FACTCHECK.ORG, http://www.factcheck.org/elections-2008/the_whoppers_of_2008.html; Viveca Novak, *The Whoppers of 2008—The Sequel*, FACTCHECK.ORG, http://www.factcheck.org/elections-2008/the_whoppers_of_2008_the_sequel.html.

97. Jonathan Martin & Amie Parnes, *McCain: Obama Not an Arab, Crowd Boos*, POLITICO, Nov. 10, 2008, <http://www.politico.com/news/stories/1008/14479.html>.

98. Kathleen Jamieson & Brooks Jackson, *Our Disinformed Electorate*, FACTCHECK.ORG, Dec. 12, 2008, available at http://www.factcheck.org/specialreports/our_disinformed_electorate.html. And, even though this claim is untrue, should it make a difference if President Obama actually was a Muslim or Arab?

information that is in line with our own biases.⁹⁹

The study also reported that 52% of Americans believed that Senator Obama's tax plan would raise taxes on most small businesses and 42% believed that Senator McCain planned to cut \$800 billion in Medicare payments, notwithstanding that these claims had been rebutted by *Factcheck.org*. But it is far more difficult for *Factcheck.org* to get out the truth than it is for a politician to distort the truth. The authors point out that Senator Obama's ad claiming that McCain planned to cut Medicare benefits cost several times more than *Factcheck.org*'s annual budget.¹⁰⁰

5. The Aftermath of the 2008 Campaign: The Alleged Selling of a Senate Seat and the Impeachment of Governor Blagojevich

The election of President Obama resulted in a vacant Senate seat in Illinois, which would be filled by the governor's appointment. Stunningly, before Governor Blagojevich could act, he was arrested on federal corruption charges on December 9, 2008. The charges involved conspiracy to commit wire and mail fraud and solicitation of bribes. At a press briefing by Patrick Fitzgerald, the United States Attorney for the Northern District of Illinois, Governor Blagojevich's checkered career and questionable activities were extensively summarized. However, according to the U.S. Attorney, the "most cynical behavior" of all was his attempt to sell the appointment to the Senate seat vacated by President-elect Obama; such conduct "would make Lincoln roll over in his grave."¹⁰¹ According to Governor Blagojevich's own words, "It's a bleeping valuable thing-thing. You just don't give it away for nothing."¹⁰² Arguably, the risk that the Senate seat could be filled under circumstances involving corruption motivated the U.S. Attorney to act when he did. Governor Blagojevich, of course, denied that he had put the seat up for sale. Ultimately, the Illinois Senate removed

99. See Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path from Central Bank to Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 6 BERKELEY BUS. L. J. 131 (2009) (in part, discussing a study in which persons who identified themselves as either in favor or opposed to the death penalty were given a balanced article to read. The researchers expected that each group would moderate its views; instead the opposite occurred. People selectively focused upon information that would reinforce their pre-existing biases).

100. Jamieson & Jackson, *supra* note 98.

101. See *Transcript: Justice Department Briefing on Blagojevich Investigation*, N.Y. TIMES, Dec. 9, 2008, available at http://www.nytimes.com/2008/12/09/us/politics/09text-illinois.html?_r=1.

102. *Id.*

Governor Blagojevich from office.¹⁰³ After Governor Blagojevich's impassioned speech before the Senate, one senator observed that "[h]e reminded us today in real detail that he is an unusually good liar."¹⁰⁴

Prior to being removed from office, Governor Blagojevich appointed Roland Burris to the vacant Senate seat, despite warnings by Senate leaders that they would not seat someone that the arrested governor appointed.¹⁰⁵ This set off an inquiry into Burris' connections with the governor and whether he had made any contributions in connection with his appointment.

On January 5, 2009, Senator Burris gave an affidavit to the House impeachment committee in which he swore that, prior to a December 26, 2008 telephone call that was a prelude to being offered the Senate vacancy, "there was not any contact between myself or any of my representatives with Governor Blagojevich or any of his representatives regarding my appointment to the United States Senate."¹⁰⁶ Unfortunately, Burris was caught by an FBI wiretap recorded November 13, 2008, in which he told Rob Blagojevich, who was the governor's brother and the chairman of the reelection campaign, that he could not put on a fundraiser because it would have so many negative complications but that "I know I can give him a check myself. And my law partner, we were going to try to do something at the law firm."¹⁰⁷

When this information came out, it raised calls for Senator Burris to resign¹⁰⁸ and initiated an investigation into whether Burris had

103. A month later, the Illinois House of Representatives impeached Governor Blagojevich and, on January 14, 2009, the Illinois House brought an article of impeachment to the Illinois Senate and the Senate summoned the governor to respond. See FindLaw, *Blagojevich Impeachment Charges*, Jan. 14, 2009, <http://news.findlaw.com/wsj/docs/blago/blagojevich-impeachment-charges.html>. The lead charge was the governor's "plot to obtain a personal benefit in exchange for his appointments to fill the vacant [Senate] seat." On January 29, the Illinois Senate voted to remove Governor Blagojevich from office. See Ray Long & Rick Pearson, *Impeached Illinois Governor Rod Blagojevich has been Removed from Office*, CHI. TRIB., Jan. 30, 2009, available at <http://www.chicagotribune.com/news/local/chi-bлагоjevich-impeachment-removal,0,5791846.story>.

104. *Id.*

105. See Ray Long & Rick Pearson, *Roland Burris Appointed to the U.S. Senate by Rod Blagojevich*, CHI. TRIB., Dec. 30, 2008, available at <http://www.chicagotribune.com/news/politics/chi-roland-burris-081230-ht,0,4306105,print.story>.

106. Affidavit of Roland W. Burris, Jan. 5, 2009, available at <http://www.ilga.gov/house/committees/95Documents/January%205,%202009%20Affidavit%20of%20Roland%20Burris.pdf>.

107. See *Burris Denies New Allegations of Pay-to-Play* (NPR radio broadcast May 28, 2009), available at <http://www.npr.org/templates/story/story.php?storyId=104648072>.

108. See Editorial, *Roland Burris, Resign*, CHI. TRIB., Feb. 18, 2009, available at <http://www.chicagotribune.com/news/opinion/chi-0218edit1feb18,0,6946762.story> (noting that

committed perjury.¹⁰⁹ However, Burris rode out the storm and the perjury investigation was ultimately dropped.¹¹⁰ Nevertheless, Senator Burris has announced that he will not seek reelection in 2010,¹¹¹ a decision that was influenced at least in part over the furor about his lack of candor.

The only way to rein in political distortion is to express our displeasure to politicians, instead of becoming ensnared ourselves in their distortions because of our own biases. An example of this lack of indignation on our part is that, even though Governor Palin's lie concerned an issue that is an important value for Republicans (i.e., cutting out "pork" and restraining spending by the federal government), she is still one of the leading candidates at this time for the 2012 nomination.¹¹² The public cannot claim to value truth without holding persons who are not truthful to account.

III. THE CORPORATE CORRUPTION SCANDALS OF THE EARLY 2000S: THE CAUSES AND CONSEQUENCES

A. *Business Is Good; Government Is Bad*

The notion that government should be distrusted has dominated political and economic thinking for almost four decades. It essentially found its origin in President Reagan's first inaugural address where he stated that "government is not the solution to our problem; government is the problem."¹¹³ As will be developed in this Part, Reagan's statement birthed an anti-government, pro-business attitude that has spread throughout society and into our judicial system.

the Senate leaders told Burris "to go to the impeachment committee and testify fully and truthfully. And he did not").

109. See Mike Robinson, *Burris Perjury Case No "Slam Dunk": Former US Attorney*, HUFFINGTON POST, Feb. 21, 2009, available at http://www.huffingtonpost.com/2009/02/21/burris-perjury-case-no-sl_n_168847.html.

110. John Chase & Dan Blake, *Burris Won't Face Perjury Charge*, CHI. BREAKING NEWS CTR., June 19, 2009, available at <http://www.chicagobreakingnews.com/2009/06/burris-wont-face-perjury-charges.html> (quoting Patrick M. Collins, who prosecuted former Governor George Ryan).

111. See Rick Pearson, *Roland Burris Officially Bows out of 2010 Senate Election*, CHI. TRIB., July 9, 2009, available at <http://archives.chicagotribune.com/2009/jul/11/local/chi-burris-senate-11jul11>.

112. Mark Memmott & Jill Lawrence, *CNN Poll Gives Palin Slight Advantage over Others for 2012 GOP Nomination*, USA TODAY, Dec. 5, 2008, available at <http://content.usatoday.com/communities/onpolitics/post/2008/12/59559020/1>.

113. Ronald Reagan, *Inaugural Address* (Jan. 20, 1981), available at <http://www.reaganfoundation.org/reagan/speeches/first.asp>.

This attitude is the driving force behind deregulation and the notion that the market cures all ills. It confers upon corporate leaders a form of omniscience and deference. On the other hand, consider a recent blog by Tom Peters, the management guru: “[i]f you sent all F[ortune] 500 CEOs and their #2s to St. Elba, performance of their companies would not on average deteriorate. The ‘myth of the irreplaceable CEO’ is just that—myth.”¹¹⁴

Corporate executives follow a bell curve, not just in terms of competence, but also in terms of integrity. The previous Part spoke of plagiarism in journalism; the business world is replete with similar examples of dishonesty. For example, a counterpart to the aforementioned journalistic acts of plagiarism occurred in the business world when it was discovered that the CEO of Raytheon plagiarized many of the rules in his much acclaimed booklet, *Swanson’s Unwritten Rules of Management*, from a 1944 work, *The Unwritten Laws of Engineering*.¹¹⁵ In addition, RadioShack CEO David Edmondson resigned over a “tarted-up” resume.¹¹⁶ Moreover, in the criticism over Richard Grasso’s \$139.5 million compensation as CEO of the New York Stock Exchange, one of the executives testified that “she hid the columns with the bonus and total compensation information in documents that were provided to the compensation committee, but included that information in documents given to the finance department, which had to make the appropriate bookkeeping entries.”¹¹⁷

A major scandal involving lack of integrity occurred a few years ago in connection with backdating stock options by executives. *The Wall Street Journal* won a Pulitzer Prize for its reporting on this issue. At that time, nearly 140 companies were under investigation, seventy top executives had lost their jobs, and ten were subject to criminal investigation.¹¹⁸ The acting chief economist of the SEC said that backdating options so that executives can get a bigger paycheck is “an

114. Tom Peters, *Alas, Yes. But a Definite Yes*, TOMPETERS.COM, Feb. 4, 2009, <http://www.tompeters.com/dispatches/010851.php>; see also Nicholas D. Kristof, *Escaping the Bust Bowl*, N.Y. TIMES, Feb. 12, 2009, available at http://www.nytimes.com/2009/02/12/opinion/12kristof.html?_r=1&ref=opinion.

115. Lisa Takeuchi Cullen, *Rule No. 1: Don't Copy*, TIME, May 7, 2006, available at <http://www.time.com/time/magazine/article/0,9171,1191835,00.html>.

116. See Cullen, *supra* note 115.

117. Jenny Anderson, *N.Y.S.E. Executive Tells of Altering Documents to Hide Grasso's Full Payout*, N.Y. TIMES, Apr. 7, 2006, available at <http://www.nytimes.com/2006/04/07/business/07grasso.html?pagewanted=print>.

118. *Two Pulitzer Prizes for the Wall Street Journal*, WEBWIRE, Apr. 16, 2007, <http://www.webwire.com/ViewPressRel.asp?ald=32821>.

intentional lie.”¹¹⁹ One executive, Henry Samueli of Broadcom, a noted philanthropist, was convicted of lying to investigators in connection with backdating options so that employees would have a lower exercise price. He himself did not receive any of the questioned options.¹²⁰ Another executive, Jacob Alexander of Comverse Technology, was more greedy. He participated in the backdating scheme in order to obtain an additional \$6.4 million in option profits. His overall profits from options were about \$140 million.¹²¹ This scheme involves not just lying and greed, but stupidity. Why would he risk his name and future for comparatively so little profit?

Probably the most disgraceful and far-ranging example of systematic lying occurred in connection with analysts pumping up the dot com bubble with recommendations without a basis—recommendations that they privately ridiculed, but promulgated to help their employer gain business.¹²² The scandal came to light in spring 2002 when New York State Attorney General Eliot Spitzer announced litigation against Merrill Lynch.¹²³ Merrill Lynch at first denied the allegations but then settled for \$100 million and agreed to revise its practices with respect to analysts.¹²⁴

Spitzer uncovered a number of e-mails written by Merrill Lynch investment analysts, describing stock as “junk,” “crap,” and “a disaster,” but that they were publicly rating as a “buy.”¹²⁵ Analysts

119. *Backdating Woes Beg the Question of Auditors' Role*, WALL ST. J., June 23, 2006, at C1.

120. E. Scott Reckard & Christopher Goffard, *Broadcom Billionaire Admits Guilt*, L.A. TIMES, June 24, 2008, available at <http://articles.latimes.com/2008/jun/24/business/fi-samueli24>.

121. Julie Creswell, *At Comverse, Many Smart Business Moves and Maybe a Bad One*, N.Y. TIMES, Aug. 21, 2006, available at <http://query.nytimes.com/gst/fullpage.html?res=9400E0D6153EF932A1575BC0A9609C8B63&sec=&spon=&pagewanted=1>.

122. For an extensive summary of this activity and its impact on investors, see *The Dotcom and Technology Bubbles—Market Analysts and Fraud*, <http://www.uow.edu.au/arts/sts/bmartin/dissent/documents/health/citiansalysts.html>.

123. *Merrill Ordered to Reform Ratings: New York AG Wins Court Order Finding Brokerage Firm Issued 'Misleading Stock Ratings'*, CNNMONEY, Apr. 8, 2002, <http://money.cnn.com/2002/04/08/news/companies/merrill/index.htm>.

124. *The Merrill Lynch Settlement: Good for Merrill, Not for Investors*, June 5, 2002, <http://www.upenn.edu/pennnews/researchatpenn/article.php?44&bus>.

125. See www.lawyershop.com, *Merrill Lynch*, <http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/securities-fraud/lawsuits/merrill-lynch/> (last visited Apr. 6, 2010). Other examples include: “Internet Capital Group (ICGE): E-mail: October 5, 2000 – ‘Going to 5?’ (strong sell),” “October 6, 2000 – ‘No helpful news to relate, I’m afraid. This has been a disaster- there really is no floor to the stock,’” “Investor advice: October 5, 2000 – 2-1 rating (buy to strong buy),” “excite@home (ATHM): E-mail: June 3, 2000 – ‘ATHM is such a piece of crap!’” “Investor advice: June 3, 2000 – 2-1 rating (buy to strong buy),” “Lifeminders (LFMN) E-mail: December 4, 2000 – ‘I can’t believe what a POS that thing is,’” and “Investor advice: December 4, 2000 – 2-1 rating (buy to strong buy).” *Id.*

hyped their ratings, not just to obtain investment banking work for their firms, but sometimes for personal profit, such as getting their daughters into nursery school.¹²⁶

Within a year of Merrill Lynch being sued, ten top United States investment banking firms agreed to pay a total of \$875 million in penalties and disgorgement for similar practices.¹²⁷ While Wall Street promised to change its ways in connection with the above settlements, a couple of years later Rodman and Renshaw fired an analyst because he would not raise his price target for a particular stock. The analyst originally had an "outperform" recommendation with a price target of \$2.88. As the stock approached this price, he sought to downgrade his recommendation to "market perform," but instead, his director of research recommended that he increase his price target. The director sent an e-mail stating: "if you'd like some help regarding how to finesse the price target on HTI[,] your conversation should be had with me."¹²⁸ Since the analyst did not believe that there was information that would justify raising the price, he declined and risked his job.

The analyst scandals involved many players. But the Bernard Madoff Ponzi scheme that bilked investors out of \$50 billion is at this point basically still a one-man show.¹²⁹ Madoff was the former chairman of NASDAQ and supposedly a pillar in the investment community. Now the charities that held him in such high esteem are reeling from the losses they have incurred from unknowingly investing in his scheme.¹³⁰ Madoff provided little information to potential investors about what they were involved with and demanded a lot of

126. Jack Grubman, one of the leading analysts on Wall Street, sent an e-mail stating that his boss, Sanford Weill, the chairman of Citigroup and a member of the Board of Directors of AT&T, helped Grubman to get his twin daughters enrolled in an exclusive nursery school after Grubman began recommending AT&T stock. Mr. Weill has acknowledged that he asked Grubman to "take a fresh look at AT&T," which was code on Wall Street for changing your opinion. See Gretchen Morgenson & Patrick McGeehan, *Wall Street and the Nursery School: A New York Story*, N.Y. TIMES, Nov. 14, 2002, available at <http://query.nytimes.com/gst/fullpage.html?res=9C03E3D71630F937A25752C1A9649C8B63&fta=y>.

127. Press Release, U.S. Securities and Exchange Commission, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest between Research and Investment Banking (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm>.

128. See Gretchen Morgenson, *Did Wall Street Really Learn its Lesson?*, N.Y. TIMES, Apr. 9, 2006, at BU 12.

129. Sara Hansard, *Bernard Madoff Charged With \$50 Billion Fraud*, INVESTMENT NEWS, Dec. 12, 2008, available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20081212/REG/812129987>.

130. Stephanie Strom, *Wall St. Fraud Leaves Charities Reeling*, N.Y. TIMES, Dec. 15, 2008, available at <http://www.nytimes.com/2008/12/16/business/16charity.html>.

trust—a trust which many wealthy people offered and are now regretting. Allegedly, millions of dollars were invested on the basis of locker-room chats.¹³¹

Following Madoff's infamous arrest, it did not take long before the "mini-Madoffs" began to appear. The following month Nicholas Cosmo was arrested in connection with a \$380 million Ponzi scheme in New York; George Theodule bilked investors in Florida out of \$23 million; and another Florida money manager, Arthur Nadel, turned himself in to authorities in connection with a \$300 million investment fraud.¹³² The latest chapter in businessmen bilking investors came to light in February when, after the SEC filed a complaint, a caravan of cars and trucks carrying federal authorities pulled up to the headquarters of the Stanford Group, a company run by Robert Allen Stanford, to shut down what is estimated to be an \$8 billion fraud.¹³³

The foregoing should suggest that there is no reason for courts to indulge in a presumption that businessmen are acting above board when their conduct is challenged. Yet, that is in essence what federal courts have done with the help of Congress and the Republican "Contract with America." In order to understand how this dynamic was created, this Article will now analyze the events leading up to the corporate corruption scandals in the early 2000s.

B. Central Bank, N.A. v. First Interstate Bank: Eliminating Aiding and Abetting Liability in Securities Cases

Two factors in the mid-1990s combined to create an indifference to truthfulness in the securities markets. The first was the 1994 decision of the United States Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*¹³⁴ The second was the enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA) by

131. Christine Haughney, *Madoff Scandal Shaking Real Estate Industry*, N.Y. TIMES, Dec. 18, 2008, available at <http://www.nytimes.com/2008/12/18/business/18brokers.html>.

132. Leslie Wayne, *Troubled Times Bring Mini-Madoffs to Light*, N.Y. TIMES, Jan. 27, 2009, available at <http://www.nytimes.com/2009/01/28/business/28ponzi.html>.

133. Clifford Krauss et al., *Texas Firm Accused of \$8 Billion Fraud*, N.Y. TIMES, Feb. 18, 2009, available at http://www.nytimes.com/2009/02/18/business/18stanford.html?_r=1&th&emc=th. Mr. Stanford's scheme was similar to that of Bernard Madoff: he offered supposedly safe certificates of deposit that carried interest rates often twice as much as that offered by mainstream banks. If it is too good to be true, it probably isn't true. At present, the charges are basically based upon falsely advertising that the securities were liquid when in fact they were not.

134. *Cent. Bank of Denver, N.A., v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

Congress.¹³⁵

Central Bank eliminated aiding and abetting liability in actions based upon rule 10b-5.¹³⁶ The case was unsound, both on the law and as a matter of public policy. Prior to the Supreme Court decision, all eleven Courts of Appeals had recognized that a private cause of action against aiders and abettors existed under rule 10b-5.¹³⁷ Accordingly, the issue of whether such a cause of action existed had not even been briefed by the parties; the Supreme Court, on its own motion, sent the existence of such a cause of action back to the parties for briefing.¹³⁸

The Court supported its refusal to recognize a private cause of action by pointing out that the language of section 10(b) does not mention aiding and abetting liability.¹³⁹ However, liability under rule 10b-5 is an implied cause of action; it is not expressly set forth in the 1934 Securities Exchange Act. Since the statute does not explicitly provide for a cause of action for the primary violation, one would not expect that a cause of action for aiding and abetting liability, which is based upon the primary violation, would be found in the statute. Moreover, typically, aiding and abetting has been a common law doctrine generated by the courts.¹⁴⁰

The Court also sought to glean congressional intent by looking at the express private causes of action embodied in the securities laws. Since the express causes of action did not provide for aiding and abetting liability, the Court concluded that Congress did not intend that aiding and abetting liability should exist under rule 10b-5. However, most of the express causes of action sound in negligence, whereas a rule 10b-5 cause of action requires scienter. Historically, aiding and abetting

135. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 U.S.C. §§77z-1, z-2, 78u-4, u-5).

136. 17 C.F.R. §240.10b-5 (1951).

137. See, e.g., *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *Levine v. Diamantheset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991); *Schatz v. Rosenberg*, 943 F.2d 485, 496-97 (4th Cir. 1991); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799-800 (3d Cir. 1978).

138. *Cent. Bank*, 511 U.S. at 195. Justice Stevens dissented: "As I have said before, 'the adversary process functions most effectively when we rely on the initiative of lawyers, rather than the activism of judges, to fashion the questions for review.'" *Id.* at 959 n.4 (quoting *New Jersey v. T. L. O.*, 468 U.S. 1214 (1984) (Stevens, J., dissenting))

139. *Id.* at 175.

140. See generally RESTATEMENT (SECOND) OF TORTS § 876(b) (1979).

liability did not attach to liability predicated upon mere negligence.¹⁴¹ Therefore, the fact that Congress did not attach aiding and abetting to express causes of action based upon negligence is not persuasive with regard to an implied cause of action based upon recklessness.

Finally, the court ignored the fact that Congress had amended the securities laws several times subsequent to 1966 when courts began to apply aiding and abetting liability in conjunction with rule 10b-5 litigation. An earlier Supreme Court decision had held that “long-standing acceptance by the courts, coupled with Congress’ failure to reject” a judicial interpretation, argued in favor of leaving a judicial determination standing.¹⁴² However, in *Central Bank*, the Supreme Court simply discarded the fact that Congress knew that courts had conferred aiding and abetting liability via rule 10b-5 for multiple decades.

The *Central Bank* decision reflects outcome determinative judicial craftsmanship, the sole purpose of which is to protect the so-called watchdogs of corporate management, such as accountants, lawyers, boards of directors, bankers, and analysts, from responsibility. From a policy standpoint, the Court’s decision to eliminate aiding and abetting liability led to sleeping watchdogs. Corporate governance is predicated upon oversight by boards of directors and auditing by accounting professionals. Good advice from legal counsel is helpful as well. However, with the elimination of aiding and abetting liability, the watchdogs nodded off.

Situations like Enron and Hollinger involved trophy boards of directors who took their fees and did little else.¹⁴³ It is rare that we get the opportunity to look inside a corporation to find out how well the board of directors is doing its job. Often, it is only when the corporation fails miserably that, through congressional hearings or reports to the bankruptcy court, we get such an inside view. It was through a special investigation and congressional hearings that we learned that the audit committee of Enron considered the various special-purpose entities that were used to manipulate earnings, the conflicts of interest of management in such entities, the status of the current audit, the internal

141. *Id.*

142. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975).

143. The Enron board received compensation of \$350,000 per year and had numerous consulting arrangements with the company as well. See PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE SENATE. COMM. ON GOVERNMENTAL AFFAIRS, REPORT ON THE ROLE OF THE BOARD OF DIRECTOR’S IN ENRON’S COLLAPSE, S. REP. NO. 107-70, at 53–57 (2002), available at <http://f1.findlaw.com/news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf> [hereinafter REPORT].

audit control plan, a discussion of the current aggressive accounting approach, and other matters—all within a meeting that lasted less than an hour and a half.¹⁴⁴ These subjects could not have been adequately covered in a day and a half, let alone an hour and a half!

The deception in Enron was astonishing. The Senate Enron Board Report concluded:

Enron's Directors protest that they cannot be held accountable for misconduct that was concealed from them. But much that was wrong with Enron was known to the Board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-books activity and excessive executive compensation.

At the hearing, the subcommittee identified more than a dozen red flags that should have caused the Enron Board to ask hard questions, examine Enron policies, and consider changing course. Those red flags were not heeded. In too many instances, by going along with questionable practices and relying on management and auditor representations, the Enron Board failed to provide the prudent oversight and checks and balances that its fiduciary obligations required and a company like Enron needed. By failing to provide sufficient oversight and restraint to stop management excess, the Enron Board contributed to the company's collapse and bears a share of the responsibility for it.¹⁴⁵

The *Hollinger* case, involving the Chicago Sun-Times and other newspapers, is another example of a supine board of directors. Conrad Black, David Radler, and their management cronies took out hundreds of millions of dollars, supposedly as covenants not to compete and consulting fees to a controlled entity, Ravelston, while the board and its audit committee sat by idly.¹⁴⁶ The report of the special committee investigating this activity summarized the actions, or rather the failure to act, of the audit committee as follows:

Each of the Audit Committee members acknowledged that they never questioned the business rationale for, or fairness of, the Ravelston "outsourcing" arrangement. They also acknowledged that they did not develop or apply any comparisons or other metrics against which each

144. ENRON AUDIT COMMITTEE, MINUTES: MEETING OF THE AUDIT AND COMPLIANCE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 12, 2001), *available at* <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/audcomp021201min.pdf>.

145. *See* REPORT, *supra* note 143, at 61.

146. SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS OF HOLLINGER INTERNATIONAL, INC., REPORT OF INVESTIGATION 106, tbl. 3 (2004) [hereinafter HOLLINGER REPORT], *available at* <http://www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.htm>.

year's proposed fee could intelligently be measured. They never asked for any information about Ravelston: its size, scope of business, revenues/profitability, clientele, employee list, compensation schedules, or anything else. They never asked if the payment of the annual management fees to Ravelston was causing Hollinger to incur costs greater than it would incur if the Company simply hired Black, Radler and other needed Ravelston personnel directly. And they never sought to base the annual fee on a performance component, such as a percentage of Hollinger's EBITDA.¹⁴⁷

Former Governor Thompson of Illinois, as chairman of Hollinger's audit committee, acknowledged that he only "skimmed" the material he was given and conducted audit committee meetings over a cup of coffee.¹⁴⁸

As a Business Week article pointed out:

[D]espite a decade or more of boardroom reforms, many directors seem to have become either passive or conflicted players in this morality play unwilling to question or follow-up on even the most routine issues. If the governance of the modern corporation isn't completely broken, it is going through a severe crisis of confidence.¹⁴⁹

Apparently, eliminating aiding and abetting liability has created a "what, me worry" mentality. In the process, financial lying has become rampant.

C. The Private Securities Litigation Reform Act of 1995

The PSLRA was one of the few alleged "accomplishments" to come out of Newt Gingrich's "Contract with America."¹⁵⁰ There are three provisions in PSLRA that particularly bear on the lack of truthfulness in the financial information disseminated to the investing public. They are: (1) the provision requiring specificity in pleading misleading statements and scienter,¹⁵¹ (2) the requirement that discovery is stayed until a motion to dismiss attacking the pleading is heard,¹⁵² and (3) the safe harbor that the company and officials who disseminate projections

147. *Id.* at 133.

148. See Posting of Michael Miner to Chicago Reader Blog, CHI. READER, <http://blogs.chicagoreader.com/news-bites/2007/05/03/big-jim-testifies-conrad-black-trial/> (May 3, 2007, 16:20 CST).

149. John A. Byrne et al., *How to Fix Corporate Governance*, BUS. WK., May 6, 2002, available at http://www.businessweek.com/magazine/content/02_18/b3781701.htm.

150. See United States House of Representatives, Republican Contract with America <http://www.house.gov/house/Contract/CONTRACT.html> (last visited Feb. 20, 2010) (containing the "contract").

151. See Securities and Exchange Act of 1934, 15 U.S.C. § 78u-4(b)(1)(2) (1995).

152. *Id.* § 78u-4(b)(3)(B).

and other forward-looking material have no liability even if they know that there is no basis for their forward-looking statements.¹⁵³

1. The Interplay of Particularity and Lack of Discovery

As an abstract proposition, it does not seem overly burdensome to plead misrepresentations with particularity. The crux of the issue, however, is how much specificity is required to satisfy this requirement. Further, the plaintiff must attain the required level of specificity without the benefit of discovery. This is not an abstract matter. Let us consider two cases that are outstanding examples of strained judicial analysis.

In *In re Spectrum Brands, Inc. Securities Litigation*,¹⁵⁴ the plaintiffs alleged that the defendant company had engaged in channel stuffing¹⁵⁵ so as to accelerate sales recognition. One of the plaintiffs' many allegations set forth the following:

According to a former national account manager, K-mart stores had on average between 52 to 100 weeks of Rayovac batteries, with some stores holding 250 weeks of C and D batteries. This same witness stated that Wal-Mart had 30-50 weeks of product in inventory and even though everyone knew in January 2005 that Wal-Mart's inventory levels and weeks on hand were way up, SPC continued to offer Wal-Mart incentives to take additional product because "we needed to make the numbers." Wal-Mart's inflated inventory was confirmed by a former sales analyst, employed at SPC during the Class Period, who recalled at least "30 weeks on hand" and stated, "We all knew what was going on, we front loaded the stores in August and September 2004 for the Christmas holiday." This witness reiterated that executive-level management handled every aspect of the Wal-Mart account because the Company was so dependent on this relationship.¹⁵⁶

153. *Id.* § 78u-5(c)(1).

154. 461 F. Supp. 2d 1297 (N.D. Ga. 2006).

155. The Court stated:

Plaintiffs describe the alleged channel-stuffing as a course of conduct in which Defendants "induce customers to purchase larger volumes of [battery] product than ordinarily purchased, even though the customers do not need the larger volume." According to Plaintiffs, this practice "has the effect of pulling forward into the present quarter orders and revenue that otherwise would be properly placed and recognized in a future quarter." Plaintiffs allege that Defendants engaged in aggressive channel-stuffing during the fourth quarter of 2004 and the first quarter of 2005, which allowed Spectrum Brands's performance in the battery market to appear better than it should have and caused an artificial spike in the company's stock price. Plaintiffs claim that Defendants deliberately "mortgaged" future sales to inflate artificially present quarters, in part to facilitate Spectrum Brands's acquisition of United Industries, Inc.

Id. at 1301.

156. *Id.* at 1309-10.

The Court's response was almost a *non sequitur*. It held that these allegations did not meet the standard of particularity:

Plaintiffs' allegations as to Wal-Mart and K-Mart state that those stores had multiple weeks of battery inventory their shelves, but Plaintiffs fail to allege facts to show that this level of inventory was unusually high for that time of year, what special incentives, if any, were offered to the customers, that Wal-Mart or K-Mart accepted the incentives or bought additional batteries in response thereto, or to show any of the other circumstances of the transaction.¹⁵⁷

One cannot have even a modicum of awareness of business practices without being aware of "just-in-time" inventory control. Companies simply do not want to pay for inventory that is not needed. It strains credibility that a court could not understand that an accumulation of one year to five years of inventory supported a charge of channel stuffing. Recall that the degree of specificity expected by the court must be accomplished without the benefit of discovery.

Decisions such as this reflect a judicial stance that is oblivious to the fact that management is lying. Channel stuffing is a means to inflate earnings. When the truth came out, Spectrum's stock price dropped from over \$40 per share to about \$5 per share, demonstrating that the lying by management had a dramatic negative impact on the investing public.

Another decision, *In re Silicon Graphics Inc. Securities Litigation*,¹⁵⁸ was even more egregious. Specifically, not only did this decision take an unrealistic view of particularity in general, but it also held that, in order to satisfy particularity, the plaintiff must identify the informant who provided the information to him.¹⁵⁹ There are basically four ways for a plaintiff to acquire detailed information: (1) the board of directors commissions a special study, such as was done in *Hollinger*,¹⁶⁰ (2) the company goes into bankruptcy and the bankruptcy court orders a special study;¹⁶¹ (3) the accountants decide to restate the company's financials;¹⁶² or (4) the plaintiff locates an informant from within the

157. *Id.* at 1310.

158. 183 F.3d 970 (9th Cir. 1999), *overruled by* *South Ferry, LP, No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008). The Third Circuit's decision in *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999), was decided a couple of weeks before the Ninth Circuit's opinion was filed.

159. *In re Silicon Graphics, Inc.*, 183 F.3d at 985.

160. *See supra* note 146; *see also* REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), available at <http://www.broadbandc-span.org/downloads/powersreport.pdf>.

161. *See* REPORT OF THE EXAMINER IN THE CHAPTER 11 PROCEEDINGS OF LEHMAN BROTHERS HOLDINGS INC., <http://lehmanreport.jenner.com/>.

162. *See infra* note 189 and accompanying graph.

company who has knowledge of the relevant facts.¹⁶³

The fourth avenue is the most typical, since it does not involve the extraordinary events of the first three. However, a requirement that the plaintiff must name the informant begs the obvious question of whether informants will ever come forward if they know they will be identified at the outset of litigation. Indeed, publicity of the informant's identity could well result in being blackballed in the industry.

In *Silicon Graphics*, management had publicly stated that the product, Indigo2, was shipping in volume, that there were no supply problems, and that a 40% growth rate would be maintained.¹⁶⁴ Were the statements false and did management have scienter, i.e., were the officers aware of the untruthfulness? Plaintiff's allegations in *Silicon Graphics* went on for pages. Let us consider one allegation relating to the scienter of the officers:

Brody alleges that SGI's internal reports alerted the officers to serious production and sales problems. According to Brody, the Flash reports, Financial Statements/Packages and Stop Ship reports announced that: (1) SGI was not shipping the Indigo2 workstation in volume; (2) North American and European sales remained slow; and (3) SGI would not meet its revenue and growth targets for FY96. Brody contends that the reports notified the officers that SGI was suffering "weak North American sales due to continuing problems with its North American direct sales force" and "a very poor Oct[ober], with revenues, net income and earnings per share well below forecasted and budgeted levels."¹⁶⁵

The actual facts were:

Soon thereafter [December, 1995], SGI began to publicly confirm the negative rumors about its performance. On January 2, 1996, the company announced its disappointing second quarter results and acknowledged that revenue growth for the year would be much lower than expected. The next day, SGI's stock fell to \$21 1/8. On January 17, 1996, SGI's officers admitted to securities analysts that SGI had been unable to fill Indigo2 orders because of a shortage of ASIC chips and other primary components. They also acknowledged that OEM, North American, and European sales had all been down.¹⁶⁶

Looks like management had been lying! But, according to the court, the plaintiff's allegations were not particular enough:

163. See *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 335 (2007) (dissent of Justice Stevens discussing twenty-seven confidential informants).

164. *In re Silicon Graphics, Inc.*, 183 F.3d at 981.

165. *Id.* at 984-85.

166. *Id.* at 982.

This paragraph is an insufficient basis for fraud allegations because it fails to state “with particularity all facts on which [her] belief is formed.” This means that a plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief. It is not sufficient for a plaintiff’s pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim. In this case, Brody’s complaint does not include adequate corroborating details.

What were the corroborating details that the plaintiff should have alleged?

She does not mention, for instance, the sources of her information with respect to the reports, how she learned of the reports, who drafted them, or which officers received them. Nor does she include an adequate description of their contents which we believe—if they did exist—would include countless specifics regarding ASIC chip shortages, volume shortages, negative financial projections, and so on. We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability.¹⁶⁷

These are the kind of facts that would be introduced at trial—after full discovery—not in a pleading. Once again, the court protected blatant lies at the expense of the investing public. In this case, the stock dropped from \$45 a share to \$25 a share after the truth was disclosed.

2. The Safe Harbor for Projections

One of the subtler ways in which the PSLRA encourages lying is its provision with respect to forward-looking statements, or, in layman’s language, projections. The stock market lives in the future. Much of investment analysis is based upon estimates of next year’s earnings, which in turn, is based upon forward-looking information. However, even if management knows there is no basis for its projections and fashions them anyway, PSLRA imposes no liability. As amended by PSLRA, the 1934 Securities Exchange Act provides there is no liability for forward-looking statements if:

[T]he forward-looking statement is—

identified as a forward-looking statement, **and** is **accompanied** by meaningful **cautionary statements** identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
immaterial; or

167. *Id.* at 985 (internal citations omitted).

the plaintiff fails to prove that the forward-looking statement—
(ii) if made by a business entity; was—
made by or with the approval of an executive officer of that entity; and
made or approved by such officer with **actual knowledge** by that
officer that the statement was false or misleading.¹⁶⁸

The key word is “or.” Unless one is absorbed in wordsmithing, one could easily miss the significance of the foregoing provision. Paragraph (B) deals with the possibility of liability if the officer making the statement has actual knowledge that it was false or misleading. But, even if a plaintiff could prove such actual knowledge, there is no liability if the forward-looking statement is accompanied by “meaningful cautionary statements.”

Consider *Harris v. Ivax Corp.*, in which earlier positive statements, which included cautionary language, were followed by an announcement of a \$179 million loss for the quarter, based on a massive goodwill write-down.¹⁶⁹ The cautionary statements accompanying the prior positive statements did not mention the possibility of a goodwill write-down.¹⁷⁰ Despite this, the court rejected liability on the ground that the cautionary statement need not list “all factors” impacting future projections, but just “important factors.”¹⁷¹

The court essentially focused on whether the plaintiff had been appraised that there were substantial risks, rather than the particular risk that caused the problem. This is sophistry. It would be easy for management, in developing its almost boilerplate type cautionary statement to fantasize some large risk that the investment public would ignore as remote. Then, management would have no liability even if they knew of realistic risks that they declined to disclose because of the potential negative impact on the company’s stock price.

The *Ivax* court also stated that “if a statement is accompanied by ‘meaningful cautionary language,’ the defendants’ state of mind is irrelevant” and that “the first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement.”¹⁷²

168. See Securities and Exchange Act of 1934, 15 U.S.C. § 78u-5(c)(1)(A)-(B) (1995) (emphasis added).

169. *Harris v. Ivax Corp.*, 182 F.3d 799, 802 (11th Cir. 1999).

170. *Id.*

171. *Id.* at 807.

172. *Id.* at 803 (internal citation omitted). In a footnote, the court added:

The plaintiffs do make a wholly unpersuasive argument that the defendants’ knowledge of the need to reduce goodwill robs the projections of their forward-looking status.

With no liability for hyping forward-looking statements, it is no wonder that corporate management has adopted an “anything goes” attitude toward financial reporting. I suggest there is not just a correlation between *Central Bank* in 1994 and PSLRA in 1995, and the massive corporate corruption that came to light in the early 2000s, but, rather, there is a strong causal connection.

D. Enron and the Other Corporate Corruption Scandals in the Early 2000s

On October 16, 2001, Enron revealed a \$1.2 billion decrease in company value.¹⁷³ At the heart of Enron’s demise were a series of special purpose entities created by Enron’s management, many of whose names were inspired by Star Wars and Jurassic Park (e.g. Chewco, JEDI, and Raptors).¹⁷⁴ These entities were designed to get Enron’s liabilities off its books and to create income. Other scandals quickly followed, such as those involving Global Crossing, Adelphi, Tyco International, WorldCom, Xerox, and Health South.¹⁷⁵ Apparently, both the senior management of these companies and their boards of directors were unconcerned that the lies they promulgated could give rise to liability.

Many of these scandals involved the accounting firm of Arthur Andersen. While this firm was regarded as the paragon of virtue at the beginning of the 1990s,¹⁷⁶ by the mid-1990s it had lost its way¹⁷⁷ and ultimately was criminally convicted; this conviction was later

The statutory definition of “forward-looking statement” does not refer at all to the defendants’ knowledge of the truth or falsity of the statement, however; such knowledge is relevant only to liability in the safe harbor, and even there only when there is inadequate cautionary language.

Id. at 807–08 n.10; see also *Sandmire v. Alliant Energy Corp.*, 296 F. Supp. 2d 950, 958 (W.D. Wis. 2003) (holding that knowledge and state of mind of the defendant at the time a forward-looking statement is made is irrelevant).

173. See Independent Lens, *Enron: The Smartest Guys In The Room*, Enron Timeline, <http://www.pbs.org/independentlens/enron/timeline2001.html> (last visited Feb. 20, 2010).

174. SPECIAL INVESTIGATION COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP., REPORT OF INVESTIGATION 43, 87 (Feb. 1, 2002), available at <http://news.findlaw.com/hdocs/docs/enron/sicreport/>.

175. For a listing of more than twenty of the more spectacular examples of corporate corruption during this period, see HAROLD S. BLOOMENTHAL, *SARBANES-OXLEY ACT IN PERSPECTIVE* app. D (West Pub Co. 2006–07) (2003).

176. Paul Volcker called Arthur Andersen the “gold standard.” See *Lehrer News Hour* (PBS television broadcast Mar. 12, 2002), available at http://www.pbs.org/newshour/bb/business/jan-june02/volcker_3-12.html.

177. SUSAN E. SQUIRES ET AL., *INSIDE ARTHUR ANDERSEN: SHIFTING VALUES, UNEXPECTED CONSEQUENCES* 149 (Jim Boyd ed., 2003).

overturned by the United States Supreme Court on a technicality.¹⁷⁸ The uproar over these scandals led to the enactment of the Sarbanes-Oxley Act.

E. Sarbanes-Oxley and the Opposition of Management

The enactment of the Public Company Accounting Reform and Investor Protection Act of 2002 (which is popularly known as the "Sarbanes-Oxley Act," or simply "SOX") was a response to the financial scandals discussed above. The reaction of the business world to this legislation has been part rational and part irrational.

The two sections of the Sarbanes-Oxley Act most pertinent to this Article, because they are so closely tied to lying, are sections 302 and 404.¹⁷⁹ On its face, section 302 would not appear to be extraordinary. It requires that principal executive officers and principal financial officers certify the following: (1) they have reviewed quarterly and annual reports (filed under the securities laws); (2) based on the officers' knowledge, the report does not contain any false statements or omit material facts that would be necessary in order that the actual statements not be misleading; and (3) the statements present fairly the financial condition and results of the operations of the company.¹⁸⁰ Would anybody buy a company's stock if they knew its officers could not make such a statement?

The officers are also required to establish internal controls that ensure the availability of the material information necessary to give the above certification.¹⁸¹ The effectiveness of such controls and any deficiencies with the controls are required to be reported to company auditors and the company audit committee.¹⁸²

Section 404¹⁸³ is a very short provision that has turned into a nightmare. The section first requires that the internal control report and an assessment of its effectiveness be included in each annual report filed under the 1934 Act.¹⁸⁴ So far so good. However, it goes on to require that companies' auditors "shall attest to, and report on, the assessment made by the management" of the company.¹⁸⁵ The accounting world

178. Arthur Andersen LLP v. United States, 544 U.S. 696 (2005).

179. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, §§ 302, 404, 116 Stat. 745.

180. *Id.* § 302.

181. *Id.*

182. *Id.*

183. *Id.* § 404.

184. *Id.* § 404(a).

185. *Id.* § 404(b).

interpreted this provision as the “accountants’ full employment work act,” and ended up billing companies hundreds of millions of dollars in unnecessary auditing fees.¹⁸⁶

Concern about unnecessary auditing expense is a rational reaction; however, it should have been directed at the accounting industry, not at Sarbanes-Oxley itself. Sarbanes-Oxley did not require the type of auditing activity in which accounting firms had engaged.¹⁸⁷ Nevertheless, the business world has railed against Sarbanes-Oxley and the obligation of executives to stand behind the truthfulness of the financial statements they disseminate to the public because it costs too much. Consider the following:

A survey of global chief executives released by PricewaterhouseCoopers at the World Economic Forum found that 59 percent viewed overregulation as a significant risk or, worse, one of the biggest threats to the growth of their companies—far more than viewed global terrorism or currency fluctuations as posing major risks.¹⁸⁸

Sarbanes-Oxley is more of a threat to the growth of American companies than global terrorism or currency fluctuations?

Has there been a problem with truthfulness in financial statements? Arthur Levitt, the former chairman of the SEC, stated that “earnings management is on the rise and the quality of financial reporting is on the decline.”¹⁸⁹ The facts bear this out. Consider the rise in corporate

186. See Charles W. Murdock, *Sarbanes-Oxley Five Years Later: Hero or Villain*, 39 LOY. U. CHI. L.J. 525, 550–51 (2008) (stating the problems with § 404 of Sarbanes-Oxley).

187. *Id.* at 550.

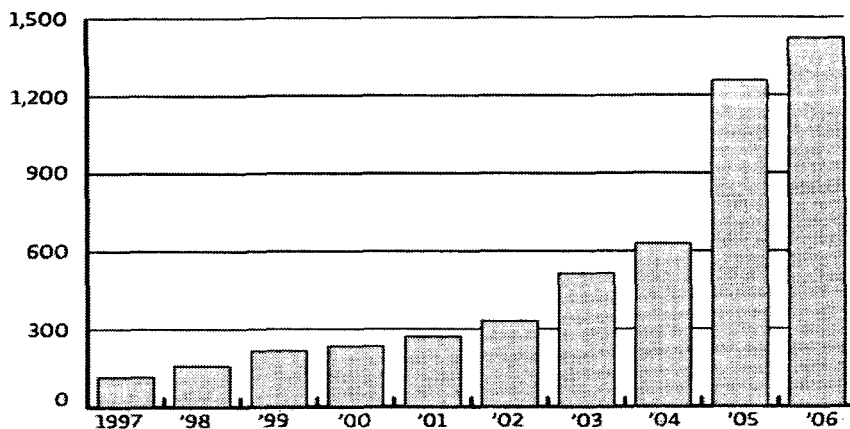
188. See Floyd Norris, *Too Much Regulation? Corporate Bosses Saying the Sarbanes-Oxley Blues*, N.Y. TIMES, Jan. 23, 2004, at C1.

189. Arthur Levitt, Chairman, Sec. and Exch. Comm’n, Remarks at the New York University Center for Law and Business: The Numbers Game (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>. The same theme was repeated a dozen times: Arthur Levitt, Chairman, Sec. and Exch. Comm’n, Remarks to the Financial Executive Institute, New York: A Financial Partnership (Nov. 16, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch227.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm’n, Remarks before the American Institute of Certified Public Accountants: A Partnership for Public Trust (Dec. 8, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch230.txt>; Arthur Levitt, Chairman, Sec. and Exch. Comm’n, Remarks at Stanford Law School (Mar. 22, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch261.txt>; Arthur Levitt, Chairman, Sec. and Exch. Comm’n, Remarks at the 1999 Annual Meeting of the Council of Institutional Investors: In the Best Interest of Beneficiaries (Mar. 30, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch263.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm’n, Remarks to Community for Economic Development (May 19, 1999), available at <http://www.sec.gov/news/speech/>

financial restatements subsequent to Sarbanes-Oxley:¹⁹⁰

(RE)STATING THE CASE

The rapid rise in filings by U.S. public companies



Source: Glass, Lewis & Co. (2003-6) and Huron Consulting (1997-2002)

Companies do not restate their financial statements unless there is a substantial issue. The volume of restatements reflected in the above

speecharchive/1999/spch278.htm; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks at the Audit Committee Symposium: An Essential Next Step in the Evolution of Corporate Governance (June 29, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch289.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks to the American Council of Germany: Corporate Governance in a Global Area (Oct. 7, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch302.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, at Economic Club of New York: Quality Information: the Lifeblood of our Markets (Oct. 18, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch304.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks at Economic Club of Washington (Apr. 6, 2000), *available at* <http://www.sec.gov/news/speech/spch362.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks at Fall Council of American Institute of Certified Public Accountants: The Public's Profession (Oct. 24, 2000), *available at* <http://www.sec.gov/news/speech/spch410.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks Before the Conference on the Rise and Effectiveness of New Corporate Governance Standards (Dec. 12, 2000), *available at* <http://www.sec.gov/news/speech/spch449.htm>; Arthur Levitt, Chairman, Sec. and Exch. Comm'n, at Investors Town Hall Meeting, Pennsylvania: The Future for America's Investors- Their Rights and Obligation (Jan. 16, 2001), *available at* <http://www.sec.gov/news/speech/spch457.htm>.

190. See Roy Harris, *Say Again?*, CFO MAG., Apr. 2007, *available at* <http://www.cfo.com/article.cfm/8885662?f=singlepage> (explaining the graph following this footnote).

graph reflects the lack of truthfulness in financial data upon which the investing public relies. One of the very positive results of Sarbanes-Oxley has been forcing some companies and auditors to understand that financial statements should reflect the truth.

F. The Deception in the Stoneridge and Tellabs Cases, and the Supreme Court's Tepid Response

Several Illinois-based companies, unfortunately, have been the subject of highly publicized judicial decisions involving deception of public investors. The *Hollinger/Chicago Sun-Times* criminal case has previously been discussed.¹⁹¹ In addition, the United States Supreme Court recently decided two cases, one involving Motorola and the other Tellabs, involving inexplicable corporate deception. In *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, otherwise known as the Motorola case,¹⁹² the Supreme Court found no violation of the securities laws when Motorola and Scientific-Atlanta conspired with the issuer to inflate its earnings and its stock price. In *Tellabs Inc. v. Makor Issues & Rights*,¹⁹³ Tellabs had lied to the public about its operations, and the Supreme Court reversed a sound decision of the Seventh Circuit¹⁹⁴ by engaging in wordsmithing as to how a plaintiff must plead a strong inference that management acted with scienter.

Stoneridge involved a blatant fabrication of revenues, and illustrated the disastrous impact of the *Central Bank* decision upon the investing public by eliminating aiding and abetting liability. The following is the Supreme Court's summary of the facts:

Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents \$20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met

191. See *supra* notes 146–49 and accompanying text.

192. 552 U.S. 148 (2008).

193. 551 U.S. 308 (2007).

194. *Makor Issues & Rights, Ltd. et al. v. Tellabs, Inc.*, 437 F.3d 588, 601 (7th Cir. 2006) *overruled by Tellabs*, 551 U.S. 308.

projected revenue and operating cash flow numbers. Respondents agreed to the arrangement.¹⁹⁵

This was clearly a scam to manufacture earnings. The financial statements that Charter issued were fabrications of income, based upon highly inflated revenues. Scientific-Atlanta and Motorola undoubtedly facilitated the fraud. They were aware that they were overcharging for their product and that they were sending a countervailing cash payment back to Charter to enable it to hype its earnings. They were complicit in a scheme to defraud the public by enabling Charter to lie about its earnings.

The plaintiffs sought to charge the defendants with primary liability predicated upon common participation in a scheme. Instead, the court determined that its decision was controlled by *Central Bank* and reaffirmed and expanded, rather than limited, that decision.¹⁹⁶ As such, the defendants were allowed to skirt civil liability for their clear malfeasance.

The reality was that the defendants were acting in concert with Charter's management to inflate Charter's earnings. The court sought to avoid this reality by stating that securities fraud "does not reach all commercial transactions that are fraudulent and affect the price of the security in some attenuated way."¹⁹⁷ However, the defendants' actions did not affect the price of the security in some "attenuated" way. Rather, they went to the heart of the company's earnings which, in turn, went to the heart of the market price of the company's securities. The court also stated that the defendants "were acting in concert with Charter in the ordinary course as suppliers."¹⁹⁸ But this was no ordinary course transaction. Buyers do not ordinarily pay twice as much as the supplier's product is worth.

The Supreme Court, in *Tellabs*,¹⁹⁹ dealt with the issue of pleading the requisite state of mind. The Court observed that "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required."²⁰⁰ The Court noted that whether and when recklessness satisfies the scienter requirement was not at issue in the

195. *Stoneridge*, 552 U.S. at 154.

196. *Id.* at 162–66.

197. *Id.* at 162.

198. *Id.* at 166.

199. 551 U.S. 308 (2007).

200. *Id.* at 319 n.3

case.²⁰¹ It then observed that:

[T]he "strong inference" standard "unequivocally raise[d] the bar for pleading scienter," and signaled Congress' purpose to promote greater uniformity among the Circuits. But "Congress did not . . . throw much light on what facts . . . suffice to create [a strong] inference," or on what "degree of imagination courts can use in divining whether" the requisite inference exists.²⁰²

According to twenty-seven different confidential informants, management engaged in channel stuffing²⁰³ and made a series of positive and specific statements with respect to two of Tellabs key products, the Titan 5500 and the Titan 6500. They reported the continuing growth of the 5500 and that the 6500 was ready to ship. But in reality, according to the complaint, demand for the 5500 was precipitously declining and the 6500 was not yet being produced.

The U.S. Court of Appeals for the Seventh Circuit had rejected the standard adopted by the Sixth Circuit that "plaintiffs are entitled only to the most plausible of competing inferences."²⁰⁴ The Seventh Circuit held "[i]nstead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable

201. *Id.*

202. *Id.* at 322–23 (citation omitted).

203. As Justice Stevens elaborated in a footnote:

The "channel stuffing" allegations in ¶¶ 62–72 of the amended complaint, App. 110–113, are particularly persuasive. Contrary to petitioners' arguments that respondents' allegations of channel stuffing "are too vague or ambiguous to contribute to a strong inference of scienter" *ante*, at 2511, this portion of the complaint clearly alleges that Notebaert himself had specific knowledge of illegitimate channel stuffing during the relevant time period. *See, e.g.*, App. 111, ¶ 67 ("Defendant Notebaert worked directly with Tellabs' sales personnel to channel stuff SBC"); *id.*, at 110–112 (alleging, in describing such channel stuffing, that Tellabs took "extraordinary" steps that amounted to "an abnormal practice in the industry"; that "distributors were upset and later returned the inventory" (and, in the case of Verizon's Chairman, called Tellabs to complain); that customers "did not want" products that Tellabs sent and that Tellabs employees wrote purchase orders for; that "returns were so heavy during January and February 2001 that Tellabs had to lease extra storage space to accommodate all the returns"; and that Tellabs "backdat[ed] sales" that actually took place in 2001 to appear as having occurred in 2000). If these allegations are actually taken as true and viewed in the collective, it is hard to imagine what competing inference could effectively counteract the inference that Notebaert and Tellabs "acted with the required state of mind."

Tellabs, 551 U.S. at 337 n.2 (Stevens, J., dissenting).

204. *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004) (quoting *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001)) *overruled by Tellabs*, 551 U.S. at 324.

person could infer that the defendant acted with the required intent.”²⁰⁵

The Supreme Court reversed the Seventh Circuit, concluding that “in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.”²⁰⁶ The court reasoned:

The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite “strong inference” of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.²⁰⁷

The Court determined that a strong inference is pleaded “only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”²⁰⁸

This drew the ire of Justice Scalia who opined that the inference of scienter must be *more plausible* than the other inferences, modestly suggesting that, of the various wordsmithing found in the different opinions, “only . . . mine is the natural reading of the statute.”²⁰⁹ Justice Scalia does not understand that there are three degrees of adjectives: positive, comparative, and superlative. In the present context, this would translate into strong, stronger, and strongest. While the majority is correct in arguing that a word like strong involves some degree of comparison, it is in the context of “strong” versus “weak.” Justice Scalia would rewrite the statute from requiring a “strong” inference of scienter to requiring the “strongest” inference. This would appear to be an example of judicial activism that Justice Scalia generally decries.

Justice Stevens would have used a “probable cause” standard that would have avoided the above wordsmithing. He observed that:

205. *Makor Issue & Rights, Ltd., et al v. Tellabs*, 437 F.3d 588, 602 (7th Cir. 2006). The Seventh Circuit reviewed the approaches of the other circuits with respect to what was necessary to plead a strong inference of scienter. The Second and Third Circuits have continued the Second Circuit’s standard of pleading either motive and opportunity or strong circumstantial evidence of recklessness or consciousness behavior. *Id.* at 601. The Ninth and Eleventh Circuits have basically rejected motive and opportunity and required the pleading a particular facts showing deliberate recklessness. *Id.* The other seven circuits have taken a middle ground that does not adopt or reject particular methods of pleading but instead require plaintiffs to plead facts that together establish a strong inference of scienter. *Id.*

206. *Tellabs*, 551 U.S. at 309.

207. *Id.* at 323–24.

208. *Id.* at 324.

209. *Id.* at 331 (Scalia, J., concurring).

if a known drug dealer exits a building immediately after a confirmed drug transaction, carrying a suspicious looking package, a judge could draw a strong inference that the individual was involved in the aforementioned drug transaction without debating whether the suspect might have been leaving the building at that exact time for another unrelated reason.²¹⁰

IV. THE SUBPRIME MORTGAGE CRISIS

A. The Lies and Deception in Connection with the Subprime Crisis

As previously illustrated, lying and deception are pervasive in society. Lying in government and business is particularly reprehensible because it can be tremendously costly. Let us now turn to the subprime crisis. What causes most financial crises? Typically, greed and deception, but lying was raised to an art form in the current subprime crisis.

1. Liar's Loans

The lack of truthfulness in business and society in general became institutionalized in the early 2000s in the mortgage industry with the development of a product called "liar's loans." Prior to this, a form of loan known as a "stated income" loan had been available, generally to professionals or small business owners who did not have a W-2 form to verify their income. However, in the early 2000s, stated income loans went mainstream, picking up a new nickname among mortgage-industry insiders: liar's loans.²¹¹

For anyone fascinated with acronyms, this current crisis provided a bonanza. Consider the following:

- VIVA: verified income, verified assets
- SIVA: stated income, verified assets
- SISA: stated income, stated assets
- NINA: no income, no assets

Most would assume that, when you sought a mortgage, you would need to prove that you had a certain income, some money in the bank, and maybe additional assets. Providing this information would put a borrower within the VIVA category. The liars loans, however, started with SIVA and moved to SISA. In these circumstances, there was no

210. *Id.* at 336–37 (Stevens, J., dissenting).

211. MARK ZANDI, FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS 17 (FT Press 2009) (2008).

verification of income. Frequently, the income stated on the mortgage application was grossly inflated so that the borrower could get a larger mortgage, often one that the borrower could not afford. It has been estimated that in some parts of the country during this decade, liar's loans made up as much as half of the new mortgages obtained.²¹² The ultimate move was to NINA—you don't even ask people to lie, you just give them a loan.

2. Who Lied on the Liar's Loans?

If stated income loans were categorized as liar's loans, then somebody must have been falsifying the borrower's income on the mortgage application. Three possibilities exist: (1) the borrower lied; (2) the borrower lied with the approval of the lender; and (3) the mortgage lender itself fabricated the borrower's income.

We can have little sympathy for borrowers who lie on their own. However, if the lender is complicit in the borrower's lies, then the lender—as the professional in the transaction—has an equal or greater responsibility than the borrower. In reality, the lender, or more likely the mortgage broker, will often tell the borrower that the income is not important, as it is the security afforded by the house that counts.²¹³ While this does not excuse any borrower's untruthfulness in obtaining mortgages, it demonstrates the need to regulate the industry representatives who are soliciting borrowers.

Often we find that it is the mortgage broker who fills out the application and inserts the borrower's income.²¹⁴ One study found that, of one hundred stated income loans that were checked against tax documents, 90% of them over-stated income by at least 5% and, in almost 60% of the cases, stated income exaggerated actual income by

212. Mark Gimein, *Inside the Liar's Loan: How the Mortgage Industry Nurtured Deceit*, SLATE, Apr. 24, 2008, <http://www.slate.com/id/2189576/>. A Google search of "liar's loans" produced 1,190,000 hits. Google, <http://google.com> (search "liar's loans").

213. See ZANDI, *supra* note 211, at 17 (stating that "many [borrowers] had overstated their incomes on the loan documents, often with their lenders' tacit approval."); see also Scott Pelley, *60 Minutes: World of Trouble*, CBS NEWS Feb. 15, 2009, available at <http://www.cbsnews.com/stories/2009/02/13/60minutes/main4801309.shtml> (quoting one lender who told the borrower "[s]o I don't really need to know what you make. I don't need proof. You tell me you make \$200,000 a year? You make \$200,000 a year." There was another example of a widow who was told that the lender would use her husband's payroll record, even though he was now dead.).

214. This is frequently the pattern when a client opens an account with a stock brokerage firm. I have testified as an expert witness in two cases in which the broker falsified the account opening documents.

more than 50%.²¹⁵ The Mortgage Asset Research Institute also found that twenty-six loans originated by one mortgage broker contained false Social Security numbers, inflated incomes, fabricated bank statements, and forged signatures for the borrowers. These were submitted by five different loan officers indicating that the fraud was not the result of just one “bad apple.”²¹⁶

The borrower should examine the document carefully before signing it. However, unsophisticated people are frequently very trusting and insecure about the mortgage process.²¹⁷ Additionally, how many of us thoroughly read and understand the waivers we execute when we are admitted to the emergency room of a hospital?

What would motivate a mortgage broker to falsify a borrower's income? One of the best overall perspectives on the subprime crisis and this particular issue was produced by National Public Radio.²¹⁸ One example involved a Marine back from Iraq who would have qualified for a VA loan at a reasonable rate. Instead, the mortgage broker induced him to get an adjustable rate mortgage that had just reset, increasing his payments by more than \$2,000 a month. The application was filled out by his broker and listed his income at \$16,250 a month, or almost \$200,000 a year. His actual income was \$37,000. Moreover, he had given the broker his tax return. Simply put, the income that the broker inserted was clearly fraudulent. The broker received a fee of \$18,500—apparently adequate motivation for him to lie.

The NPR program also discussed the situation of a mortgage broker from upstate New York, who was just out of college. He was making \$75,000-\$100,000 a month, or around \$1 million a year, had five cars, a \$1.5 million vacation house, and a rented penthouse in Manhattan. Mortgage brokers were paid a commission for each acceptable loan that they generated and were usually paid out of the points that the borrower paid at closing. The best brokers in the peak years of the subprime

215. E. Scott Reckard, *New Alarm: Option-ARM 'Liars Loans,'* CHI. TRIB., Jan. 21, 2008, at Bus. 1.

216. MORTGAGE ASSET RESEARCH INST., INC., PERIODIC MORTGAGE FRAUD CASE REPORT TO NATIONAL HOME EQUITY MORTGAGE ASSOCIATION 8 (May 2005), available at <http://www.marisolutions.com/pdfs/nhema/nhemacaserpt2.pdf>.

217. A publication by the Milken Institute, relying on Federal Trade Commission data, found that 87% of respondents could not identify the total up-front cost of the loan, 51% could not identify the loan amount from the documents, and 30% could not identify the presence and amount of a balloon payment. See MILKEN INST., DEMYSTIFYING THE MORTGAGE MELTDOWN: WHAT IT MEANS FOR MAIN STREET, WALL STREET AND THE U.S. FINANCIAL SYSTEM (Oct. 2, 2008).

218. *This American Life: The Giant Pool of Money* (Chi. Pub. Radio broadcast May 9, 2008), available at http://www.thislife.org/extras/radio/355_transcript.pdf.

boom could earn between \$1 million and \$3 million annually in commissions.²¹⁹ If you were materialistic, the mortgage business provided a nice incentive to produce liar's loans.

The foregoing does not even take into consideration the mortgage brokers who were out-and-out crooks. In Florida, more than 10,000 previously-convicted criminals worked in the mortgage business, thousands of whom were licensed brokers.²²⁰ Congresswoman Kathy Castor stated that "Florida was particularly lax when it c[ame] to mortgage regulation," and connected the lack of oversight with state politics and the political clout of developers.²²¹

While conservatives like to blame poor people and the Community Reinvestment Act for the crisis, some of the real estate activity was fueled by speculators who would buy a house and then flip it. A tattoo parlor owner, known as Sonny, made ninety sales in about four years, often using strawmen buyers who put no money down but received a small slice of the mortgage proceeds, and then disappeared without a trace.²²² He cleared \$4 million. Sonny's deals were financed by Wachovia, Wells Fargo, Washington Mutual, Bank of America, Lehman Brothers, Fannie Mae, and Freddie Mac, who obviously did little due diligence.

The environment surrounding liar's loans was replete with moral hazards. The originator of the loan had little incentive to do due diligence, since the bank planned to sell the loan to Fannie Mae or an investment bank that would package it with other loans, securitize it, and sell it. Additionally, the mortgage broker who found the customer would not only get paid from the proceeds of the loan but, if his compensation depended upon a percentage commission, the greater the loan, the more money he made. Thus, an incentive to lie existed.

3. Lying about Risk

Many who took out subprime mortgages were financially unsophisticated. These individuals were induced to buy by the availability of teaser interest rates—adjustable rate mortgages with a low initial interest rate. As an example of how these rates can

219. Judge Thomas L. Perkins, *The Origins of the Subprime Mortgage Crisis*, TRUSTED ADVISOR, Oct. 2008, available at <http://www.atgf.com/AllAttorneys/ATGNewslettersArchive/TheTrustedAdviser/tabid/459/Default.aspx>.

220. Matthew Haggman & Jack Dolan, *Probe of Broker Agency Is Sought*, MIAMI HERALD, July 29, 2008, at 1B, available at <http://www.miamiherald.com/1060/story/787362.html>; see also George Packer, *The Ponzi State*, NEW YORKER, Feb. 9 & 16, 2009, at 81, 84.

221. Packer, *supra* note 220, at 84–85.

222. *Id.* at 85.

negatively impact individuals, a teaser rate of 3%, which resets to 6%, will almost result in a doubling of the mortgage payment.

A Federal Reserve Bank study found that about 70% of subprime loans were what is known as “2/28” or “3/27” loans, meaning that they have a low teaser rate for two or three years, and then reset to a much higher interest rate which can double the mortgage payment.²²³ In addition, many subprime loans were option ARMs, or “pic-a-pay,” in which the borrower could choose a payment amount that was substantially below the accruing interest rate, with the deficiency in accrued interest added to the principal. When these loans reset, the mortgage payment could triple.²²⁴

This explains why so many people ended up defaulting on their mortgage payments. There should be an obligation on the mortgagee to disclose clearly both the initial payments and the potential for resetting. While this may be in writing, the documentation is seldom understood and the borrower often relies upon the oral assurances of the mortgage broker.²²⁵

Elizabeth Warren, a Harvard law professor who is overseeing the TARP program, has been involved in a field project examining a representative cross-section of individuals who have declared bankruptcy. One of those individuals was a 78-year-old widow whose husband died eighteen years ago and who bought a small house where she could look after her elderly sisters. Her Social Security check covered the mortgage payments.

Three years ago, a “nice lady” at a bank phoned this woman and persuaded her to take out a variable-rate mortgage on the understanding, or so she thought, that she could switch back to her fixed-rate mortgage if rates went up. Of course she could not switch back, and now she is facing foreclosure and the likelihood of living in her car. Warren said: “There’s nothing on the face of the story that makes this unlawful, but

223. See Kelly D. Edmiston & Roger Zalneraitis, *Rising Foreclosures in the United States: A Perfect Storm*, FED. RES. BANK OF KAN. CITY ECON. REV., 4th Quarter 2007, at 127, available at <http://www.kc.frb.org/publicat/econrev/PDF/4Q07Edmiston.pdf>.

224. *Id.* at 127–28.

225. See Alex J. Polack, *After the Subprime Lending Bust*, AEI ONLINE, May 15, 2007, http://www.aei.org/publications/pubID.26179/pub_detail.asp (“Most of us have experienced being overwhelmed and befuddled by the huge stack of documents full of confusing language in small print presented to us at a mortgage closing. . . . These documents are the result of legal and compliance requirements, including regulatory attempts to insure disclosure.”). Polack has developed a one-page mortgage summary sheet which, among other information, would give the borrower the current interest rate and mortgage payment and the maximum reset interest rate and corresponding monthly payment (available at http://www.aei.org/docLib/20070515_PollockPrototype.pdf). An outstanding suggestion!

"[i]f she had understood the deal the bank was offering, her answer would have been no, no, and a thousand times no. But it's the deal she took, not the deal she understood."²²⁶

Professor Warren has argued that "credit products aimed at both middle class and poor families are designed to trick them, trap them, and otherwise pick their pockets."²²⁷ Additionally, she has opined that "a principles-based federal regulator [is] needed to address the problem."²²⁸ She wants a federal regulator who will be interested in protecting consumers, as opposed to the mortgage industry. Such legislation has now been introduced in Congress.²²⁹

4. The Most Costly Lies of the Credit Agencies, and the Complicity of the Investment Bankers

Thousands of the mortgage loans discussed above are sold and then bundled into a security, commonly referred to as a "mortgage-backed security" (MBS),²³⁰ by Fannie Mae and the investment bankers. Slices, or tranches, of mortgage-backed securities can then be combined to

226. Posting of Felix Salmon to Market Movers, *Elizabeth Warren on Financial Sector Regulation*, <http://www.portfolio.com/views/blogs/market-movers/2007/06/22/elizabeth-warren-on-financial-sector-regulation> (June 22, 2007).

227. *Id.*

228. *Id.* Salmon notes:

If someone wants to make a speculative housing bet, Warren is happy to let them do so. If they tick a box saying that they're financing their house as a speculative investment, and they're clearly cognisant [sic] of the fact that if they can't refinance or sell in two years then they might not be able to make the mortgage payments when their ARM adjusts, then they should be free to take out that kind of mortgage. Warren just wants to make sure that products which make sense for housing speculators aren't being sold to normal families who have every intention of staying in their home for decades.

Id.

229. See Anne Flaherty, *Senate Dems Move to Curb Fed's Powers*, ABC NEWS, Nov. 10, 2009, <http://abcnews.go.com/Business/wirestory?id=9042662&page=1>. A summary of the discussion draft of the Senate bill is available at http://banking.senate.gov/public/_files/FinancialReformDiscussionDraftRevised111009.pdf.

230. The SEC has posted the following definition of the mortgage-backed security on its website:

Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

U.S. Sec. and Exch. Comm'n, *Mortgage-Backed Securities*, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Feb. 20, 2010).

create what is known as a “collateralized debt obligation” (CDO).²³¹ Michael Gibson, of the Federal Reserve Board’s Trade Risk Analysis Section, discussed the risks associated with CDOs in a 2004 working paper:

A defining feature of both cash and synthetic CDOs is the tranching of credit risk. The risk of loss on the reference portfolio is divided into tranches of increasing seniority. Losses will first affect the “equity” or “first loss” tranche, next the “mezzanine” tranche(s), and finally the “senior” and “super-senior” tranches. CDO “investors” take on exposure to a particular tranche, effectively selling credit protection to the CDO “issuer.” The CDO “issuer,” in turn, hedges its risk by selling credit protection on the reference portfolio in the form of single-name credit default swaps. Parties on the other side of these hedging transactions are the ultimate “sellers” of credit risk to the CDO “investor,” with the CDO “issuer” acting as intermediary.²³²

If this sounds complicated, it is. This is the danger of “geeks bearing formulas.” The SEC recently provided a clearer explanation of the tranching process:

For example, if a trust issued securities in 10 different tranches of securities, the first (or senior) tranche would have nine subordinate tranches, the next highest tranche would have eight subordinate tranches and so on down the capital structure. Losses of interest and principal experienced by the trust from delinquencies and defaults among loans in the pool are allocated first to the lowest tranche until its principal amount is exhausted and then to the next lowest tranche

231. A CDO has been defined as a “bond created from tranches of other bonds. A tranche represents cash flow from a pool of different mortgages. In attempts to diversify risk, a CDO might contain many different tranches of different asset-backed securities.” PAUL MUOLO, \$700 BILLION BAILOUT: THE EMERGENCY ECON. STABILIZATION ACT AND WHAT IT MEANS TO YOU, YOUR MONEY, YOUR MORTGAGE AND YOUR TAXES 178 (2008). The SEC has provided a more expansive explanation of CDOs:

The creation of a typical CDO is similar to that of an RMBS [residential mortgage-backed security]. A bankruptcy remote trust is created to hold the CDO’s assets and issue its securities. The underlying assets, however, are generally debt securities rather than mortgage loans. The CDO trust uses the interest and principal payments from the approximately 200 underlying debt securities to make interest and principal payments to investors in the securities issued by the trust. The trust is structured to provide differing levels of credit enhancement to the securities it issues. Similar to RMBS, credit enhancement is provided through subordination, over-collateralization, excess spread, and bond insurance. In addition to the underlying assets, one significant difference between a CDO and an RMBS is that the CDO may be actively managed such that its underlying assets change over time, whereas the mortgage loan pool underlying an RMBS remains static for the most part.

Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212, 36,214 (proposed June 25, 2008) (to be codified at 17 C.F.R. pts. 240 & 249b).

232. MICHAEL S. GIBSON, UNDERSTANDING THE RISK OF SYNTHETIC CDOs 1 (July 2004), available at <http://www.federalreserve.gov/Pubs/FEDS/2004/200436/200436pap.pdf>.

and so on up the capital structure. Consequently, the senior tranche would not incur any loss until the principal amounts from all the lower tranches have been exhausted through the absorption of losses from the underlying loans.²³³

This gives the impression that the top tranche would be AAA and supported by the lower rated tranches, which would be 90% of the offering. But this is not the pattern. In one mortgage backed security, five tranches totaling \$1.483 billion were rated AAA, and another seven tranches totaling \$251 million were rated A- or better. The last three tranches, rated BBB+ to BBB-, totaled only \$58 million. So, while there were twelve tranches below the AAA tranches, they totaled only 17% of the offering.²³⁴ According to the ratings agency Standard & Poor's, Lehman Brothers and American Insurance Group (AIG) were included in 2,634 tranches of 1,889 synthetic CDOs as of September 2008.²³⁵ The *Wall Street Journal* last year reported that there were \$516 trillion of derivatives outstanding.²³⁶ Compare this with United States gross annual domestic product or money supply, which are each about \$15 trillion.²³⁷ Once again, if this seems complicated, it is. Warren Buffett has characterized derivatives as "financial weapons of mass destruction."²³⁸

Investors around the world, including banks, insurance companies, state government funds, and pension funds, purchased MBSs and CDOs. However, since no investor could understand the risk involved in these complicated instruments, the credit rating agencies' evaluation of them was essential.²³⁹ Unfortunately, the rating agencies were

233. Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 36,214.

234. Ameriquest Mortgage Securities Inc/Asset Backed Pass-Through Certificates/Series 2005-R11, SEC Info., <http://www.secinfo.com/dr66r.z2F9.htm>, at 1, 88 (last visited Feb. 16, 2010) (the dollar amounts were rounded).

235. *S&P Likely to Cut Derivative Deals on Lehman, AIG*, REUTERS, Sept. 16, 2008, <http://www.reuters.com/article/idUSN1625304920080916>.

236. See Paul B. Farrell, *Derivatives the New 'Ticking Bomb'*, MKT.WATCH, Mar. 10, 2008, <http://www.marketwatch.com/story/derivatives-are-the-new-ticking-time-bomb?pagenumber=1> ("Data on the five-fold growth of derivatives to \$516 trillion in five years comes from the most recent survey by the Bank of International Settlements, the world's clearinghouse for central banks in Basel, Switzerland.").

237. *Id.*

238. Letter from Warren Buffet, Chairman of the Bd., Berkshire Hathaway, Inc., to Shareholders 15 (Feb. 21, 2003), available at <http://www.berkshirehathaway.com/letters/2002pdf.pdf>.

239. The SEC, in its Proposed Rules Release, noted:

Some investors use the credit ratings to assess the risk of the debt instruments. In part, this may be due to the large number of debt instruments in the market and their complexity. Other investors use credit ratings to satisfy client investment mandates

bought off by the investment bankers who were packaging and selling these instruments. According to former employees, after Moody's was spun off and went public,²⁴⁰ its focus changed from informing investors to responding to the demands of investment banking clients.²⁴¹ Joseph Stiglitz, a professor at Columbia University who won the Nobel prize in 2001 for his analysis of markets with asymmetric information, stated that Standard & Poor's and Moody's "were trying to please clients" and not only graded a company but also told it "how to get the grade it wants."²⁴²

In 2004, Moody's changed its rating model to accommodate more concentration in one type of asset and utilize a hypothetical investment pool.²⁴³ The overall effect was to create more AAA securities (the supposedly safest type). Standard & Poor's also relaxed its rating requirements to avoid losing deals.²⁴⁴ When the subject of tightening rating criteria came up, Standard & Poor's co-director of CDO ratings said: "Don't kill the golden goose."²⁴⁵ By August 2008, Moody's had downgraded 90% of all asset-backed CDO investments issued in 2006 and 2007, and Standard & Poor's had downgraded 84% of the CDO tranches it rated.²⁴⁶ Professor Stiglitz offered the following characterization of the activity of the credit agencies: "They cheated on their models. But even without the cheating, their models were bad."²⁴⁷ A recent SEC report questioned "the integrity of the ratings process as a whole" and quoted a December 2006 email from an analyst who stated,

regarding the types of securities they can invest in or to satisfy regulatory requirements based on certain levels of credit ratings, or a combination of these conditions. Moreover, investors typically only have looked to ratings issued by Fitch, Moody's, and S&P, which causes the arrangers of the subprime RMBS and CDOs to use these three NRSROs to obtain credit ratings for the tranche securities they brought to market.

Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 36,215.

240. Moody's stock went from about \$13 a share in 2001 to \$70 a share in 2006, before dropping down to about \$10 a share in 2008.

241. Elliot Blair Smith, *Bringing Down Wall Street as Ratings Let Loose Subprime Scourge*, BLOOMBERG, Sept. 24, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=ah839IWTL9s> [hereinafter *Bringing Down Wall Street*].

242. Elliot Blair Smith, *'Race to the Bottom' at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG, Sept. 25, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=ax3vfya_Vtdo&refer=home [hereinafter *Race to the Bottom*].

243. *Id.*

244. *Id.*

245. *Id.*

246. See *Bringing Down Wall Street*, *supra* note 241. The two agencies had downgraded 85% and 76% respectively of the AAAs they had rated. *Id.*

247. *Race to the Bottom*, *supra* note 242.

“[l]et’s hope we are all wealthy and retired by the time this house of cards falters.”²⁴⁸

Investors around the world put their trust in the rating agencies and their gold standard AAA rating. Unfortunately, the rating agencies were bought off by greed and their ratings were nothing more than complex lies.

5. The Deception Involved in the Subprime Bailout

By late summer of 2008, it was clear that the exotic instruments that banks and investors around the world had purchased were turning into “toxic” assets that threatened the entire banking system. Some of the instruments that banks held as assets on their balance sheet were worth only a few cents on the dollar.²⁴⁹ If the assets that a bank carries on its books are not worth the value at which they are carried, but must be written down, there is a corresponding charge to the bank’s capital. If a bank’s capital is impaired, it cannot lend.

In September 2008, Secretary Paulson called congressional leaders together and told them that it was imperative that they provide him with a \$700 billion bailout fund to purchase the toxic assets of the nation’s banks, or else there would be an economic meltdown. He presented them with a three-page bill that totally exculpated him from any responsibility.²⁵⁰ Section 2 of the bill granted the Secretary of the Treasury the authority to purchase mortgage-related assets.²⁵¹ In response to Paulson’s plea, Congress ultimately enacted a 451-page bill, The Emergency Economic Stabilization Act of 2008, which President Bush signed into law in early October 2008.²⁵² The focus of the bill was, once again, on the purchase of toxic assets as reflected in its

248. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 2, 12 n.8 (2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

249. On July 28, 2008, Merrill Lynch sold \$30 billion of CDOs for twenty-two cents on the dollar. Maria Bartiromo, *John Thain on the Fire Sale Of Toxic Assets at Merrill*, BUS. WEEK, Aug. 6, 2008, at 1, available at http://www.businessweek.com/magazine/content/08_33/b4096000464182.htm.

250. David M. Herszenhorn, *Administration is Seeking \$700 Billion for Wall Street*, N.Y. TIMES, Sept. 21, 2008, at A1, available at http://www.nytimes.com/2008/09/21/business/21cong.html?_r=1; *Text of Draft Proposal for Bailout Plan*, N.Y. TIMES, Sept. 20, 2008, available at <http://www.nytimes.com/2008/09/21/business/21draftcnd.html?ref=business>.

251. *Text of Draft Proposal for Bailout Plan*, *supra* note 250; see also *Bailout Bill: Full Text of Plan*, HUFFINGTON POST, Sept. 28, 2008, http://www.huffingtonpost.com/2008/09/28/bailout-legislation-full_n_130063.html.

252. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of the U.S.C.).

acronym, TARP, or the Troubled Asset Repurchase Program.

Nevertheless, Secretary Paulson's first action under the bill was to purchase preferred stock in major banks to shore up their capital base,²⁵³ something that was not contemplated in the discussions leading up to the bill. Apparently, Fed Chairman Bernanke had reservations about purchasing the troubled assets and instead favored investing directly in the banks.²⁵⁴ However, this was not disclosed to Congress or the public. The report of Neil M. Barofsky, the Special Inspector General for the TARP program, noted that the "Capital Purchase Program" implemented by Paulson "was widely seen as a shift in approach from the original understanding of purchasing troubled assets."²⁵⁵

Either Secretary Paulson lied to Congress when he asserted that he needed the money to buy toxic assets, or he did not know what he should do to solve this problem. Either alternative is unsettling. Moreover, Secretary Paulson has represented that, in return for its infusion of capital into the banks, the Treasury received full value.²⁵⁶ He assured that the "transactions were at par—that is, for every \$100 injected into the banks the taxpayer received stock and warrants from the banks worth about \$100."²⁵⁷ Nevertheless, Elizabeth Warren, Chair of the Congressional Oversight Panel for TARP, has testified that the Treasury paid \$254 billion for stock that her study only valued at \$176 billion. Thus, there was a shortfall of \$78 billion to the taxpayer.²⁵⁸ She also testified that many of Secretary Paulson's responses to her

253. *U.S. Will Buy Stock in Banks, Paulson Says*, MSNBC, Oct. 10, 2008, <http://www.msnbc.msn.com/id/27123491/>.

254. *Frontline: Inside the Meltdown* (PBS television broadcast Feb. 18, 2009), available at <http://www.pbs.org/wgbh/pages/frontline/meltdown/etc/script.html>.

255. OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, INITIAL REPORT TO THE CONGRESS 49 (Feb. 6, 2009), available at http://sigtarp.gov/reports/congress/2009/SIGTARP_Initial_Report_to_the_Congress.pdf; see also Joe Nocera, *Looking Back in Anger at the Crisis*, N.Y. TIMES, July 18, 2009, at B1, available at <http://www.nytimes.com/2009/07/18/business/18nocera.html?sq=Looking%20Back%20in%20Anger%20at%20the%20Crisis&st=cse&scp=1&pagewanted=all> (discussing Congressional frustration with TARP).

256. *Pulling Back the TARP: Oversight of the Financial Rescue Program*, Hearing before the S. Comm. on Banking, 111th Cong. 4 (2009) (statement of Elizabeth Warren, Chair, Cong. Oversight Panel, Troubled Asset Relief Program) [hereinafter *Pulling Back the TARP*].

257. *Id.*

258. *Id.*; see also *US Treasury Overpaid By Nearly \$80 Billion*, <http://www.eurotrib.com/comments/2009/1/30/112242/182/19> (last updated Feb. 5, 2009); Frank Ahrens, *Bailout Overseer: Treasury Overpaid by Nearly \$80 Billion*, WASH. POST, Feb. 5, 2009, http://voices.washingtonpost.com/economy-watch/2009/02/sen_warner_taxpayers_could_see.html?hpid=topnews.

questions were non-responsive or incomplete.²⁵⁹

One of the big complaints about the TARP bailout is that the banks that have received funds have not opened up the flow of credit.²⁶⁰ However, one factor that is not generally well known is that the TARP funds went to parent corporations and not their banking subsidiaries. Therefore, the parent was free to use the money either to acquire other banks or to shore up its capital position, without any obligation to increase the funds available for lending.²⁶¹

With hundreds of billions of dollars at stake, let us hope that the new administration will be more candid and transparent. Unfortunately, the record to date is not reassuring. President Obama's Treasury Department has not committed to provide valuation information on the TARP portfolio, except on the statutorily required annual basis, and has resisted disclosing all trading activity, holdings and valuation of assets of the Public-Private Investment Funds. This latter intransigence is hard to understand since disclosure would promote "price discovery" of the illiquid assets known as CDOs or MBSs.²⁶²

B. The Lies and Distortions in Connection with Identifying the Cause of the Subprime Crisis

As should now be clear, lying and deceit were significant factors in causing the subprime crisis. However, from a policy standpoint, there has also been a fair amount of lying and distortion by pundits and politicians trying to identify the cause of the crisis.

One of the biggest lies with respect to the subprime crisis is that the responsibility lies with the Community Reinvestment Act. An editorial in the *Investor's Business Daily* modestly asserted that the regulation "destroyed credit standards across the mortgage industry, created the subprime market, and caused the housing bubble that has now burst and left us with the worst housing and banking crisis since the Great

259. See *Pulling Back the TARP*, *supra* note 256, at 3.

260. Christopher S. Rugaber, *Largest Banks that Received Aid Cut Lending*, HUFFINGTON POST, Feb. 17, 2009, http://www.huffingtonpost.com/2009/02/17/largest-banks-that-receiv_n_167748.html.

261. See *As Senate Mulls Approval, Bank of America Stakes Claim to Bailout Funds*, FOX NEWS, Jan. 15, 2009, <http://www.foxnews.com/politics/2009/01/15/senate-mulls-approval-bank-america-stakes-claim-bailout-funds/> (discussing Congressional concern over bank "hoarding" of bailout funds and Bank of America's request for additional bailout funds in order to "integrate" its recent acquisition, Merrill Lynch).

262. OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 8 (July 21, 2009) [hereinafter SIGTARP JULY REPORT], available at http://www.sigtar.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

Depression.”²⁶³ The editorial acknowledged that over 60% of the subprime loans between 2004 and 2007 were made by banks that were not covered by the CRA.²⁶⁴ Nevertheless, it asserted the “exotic securitizations that have gotten so much of the blame were a symptom, not the cause, of the crisis” and that federal regulations “mandating that banks make high-risk loans based on race”²⁶⁵ were the real cause.

Similarly, Neil Cavuto of Fox News has opined that, if banks had not been forced to make loans to “minorities and risky folks,” the crisis would not have occurred.²⁶⁶ Another infamous conservative pundit, Ann Coulter, blamed the subprime crisis on “affirmative action lending policies.”²⁶⁷ Additionally, Representative Michele Bachmann earlier quoted an *Investor’s Business Daily* article that accused the CRA and President Bill Clinton of forcing banks to give out loans “on the basis of race and often little else.”²⁶⁸ Chairman Ben Bernanke of the Federal Reserve Board rebutted that assertion.

As another example, consider an advertisement published by The Washington Legal Foundation, a conservative observer of the subprime crisis:

Our heavily regulated credit markets were pushed to the brink of collapse in spite of hundreds of laws and rules enforced by numerous federal and state agencies. No amount of oversight could have stopped the wreckage that resulted when ideologically-motivated politicians socialized major aspects of mortgage lending. Congress and the Executive Branch compelled government-sponsored enterprises Fannie Mae and Freddie Mac to purchase toxic mortgages and take on massive risk.²⁶⁹

Similarly, the American Enterprise Institute, a conservative think

263. *Stop Covering Up and Kill the CRA*, INVESTOR’S BUS. DAILY, Nov. 28, 2008, <http://www.investors.com/NewsAndAnalysis/Article.aspx?id=497422>.

264. *Id.*

265. *Id.*

266. *Cavuto Suggests Congress Should Have Warned that “[L]oaning to Minorities and Risky Folks Is a Disaster,”* MEDIA MATTERS FOR AM., Sept. 19, 2008, <http://mediamatters.org/mmtv/200809190021>; Clarence Page, *A Lame Rap Aimed at Poor Folks*, CHI. TRIB., Oct. 8, 2008, at 49, available at <http://archives.chicagotribune.com/2008/oct/08/news/chi-oped1008pageoct08>.

267. Ann Coulter, *They Gave Your Mortgage to a Less Qualified Minority*, anncoulter.com, Sept. 24, 2008, http://www.anncoulter.com/cgi-local/printer_friendly.cgi?article=275.

268. See C-Span, *Predatory Mortgages and Foreclosures* (citing Testimony of Marc H. Morial, President & CEO, Nat’l Urban League, Oct. 16, 2008, and Letter from Chairman Ben Bernanke, Chairman, Federal Reserve, to Sen. Robert Menendez, U.S. Senate, Nov. 25, 2008), available at <http://www.c-spanvideo.org/congress/?q=node/77531&id=8963151>.

269. Advertisement, Washington Legal Foundation, *In All Fairness: The American Bad Dream*, N. Y. TIMES, Oct. 20, 2008, at A31.

tank, laid the blame for the subprime crisis solely on the shoulders of Fannie Mae and Freddie Mac.²⁷⁰

But these perspectives fail to capture the entire picture. They neglect the role that the investment banks played in creating and securitizing financial instruments that no one understood and that were not regulated, as well as the action of the regulators in reducing the capital that banks needed to maintain. Had the subprime crisis exploded in 2003, laying blame on Fannie Mae and Freddie Mac might have been defensible. However, after 2003, the investment banks became major players, both in securitizing subprime mortgages and financing the “non-banks” that originated most of these loans.²⁷¹ The following section will analyze the true causes of the subprime crisis.

C. What Were the Real Causes of the Subprime Crisis?

1. The Extraordinary Demand for Securities with a Better Return, Coupled with Extraordinary Profits on the Supply Side

The basic driving force behind the subprime crisis was the huge amount of assets under investment that were held by money managers looking for better returns than were available from the traditional safe investments. Traditional investments, such as treasury bills and certificates of deposit, had a return of only about 3% in the mid-2000s. Worldwide assets under investment were fairly stable from 1998 to 2002—averaging about \$37 trillion.²⁷² However, between 2002 and 2007, assets under investment doubled from \$36 trillion to \$73 trillion.²⁷³ This brought a tremendous surge to the demand side for investments with an attractive return that were supposedly safe. At the

270. PETER J. WALLISON & CHARLES W. CALOMIRIS, AM. ENTER. INST. FOR PUB. POLICY RESEARCH, *THE LAST TRILLION-DOLLAR COMMITMENT: THE DESTRUCTION OF FANNIE MAE AND FREDDIE MAC* 1 (Sept. 2008), available at http://www.aei.org/docLib/20080930_Binder1.pdf. Notably, the text provides:

This *Outlook* tells the disheartening story of how the GSEs [Fannie Mae and Freddie Mac] sold out the taxpayers by taking huge risks on substandard mortgages, primarily to retain congressional support for the weak regulation and special benefits that fueled their high profits and profligate executive compensation. As if that were not enough, in the process, the GSEs' operations promoted a risky subprime mortgage binge in the United States that has caused a worldwide financial crisis.

Id.

271. See *infra* Part III.C.3 (discussing investment banking culpability); see also CTR. FOR PUB. INTEGRITY, *WHO'S BEHIND THE FINANCIAL MELTDOWN?* 14 (2009), available at http://www.publicintegrity.org/investigations/economic_meltdown/.

272. See INT'L FIN. SERVS. LONDON, *FUND MANAGEMENT 2009* (Oct. 2009), available at http://www.ifsl.org.uk/upload/Fund_Management_2009.pdf.

273. *Id.*

same time, Federal Reserve Chairman Alan Greenspan was keeping interest rates low in the United States.²⁷⁴ This resulted in some conservative investments, such as treasury bonds and certificates of deposit, paying a fairly low interest rate, as indicated above.²⁷⁵ On the other hand, real estate mortgages were providing a better return and appeared relatively safe because of the low historical default rate.²⁷⁶

Furthermore, with increased volume of mortgages came additional profits and a spike in the price of bank stocks. Thus, the biggest “Alt. A”²⁷⁷ lender, IndyMac Bancorp., did \$70.2 billion of loans in 2006, up 48% from a year earlier. As a consequence, the shares shot up nearly 50%.²⁷⁸

On the investment banking side, Judge Perkins, in his development of the origins of the crisis, used Merrill Lynch as an example of the economic incentives pushing these products:

For example, from 1998 through 2002, the investment bank Merrill Lynch averaged \$2.1 billion in annual operating profits. From 2003 through 2006, which were the peak years of subprime mortgages, it averaged two and a half times that or \$5.2 billion in annual operating profits, almost all of which were paid out in bonuses to employees. In 2007, for example, the top five investment banks paid out \$36 billion in bonuses alone, a figure that does not include salaries. I would suggest to you that that kind of money is intoxicating—even addictive—and the pursuit of profits was really a siren song that was absolutely irresistible.²⁷⁹

Thus, there were strong incentives from both the demand and the supply side to keep the mortgage loans flowing. The problem was that the system was running out of qualified buyers.

274. Brad G., The Top 10 Reasons Its Easy to Make Mortgage Rates Predictions, TheTop10Reasons.com, <http://thetop10reasons.com/the-top-10-reasons-its-easy-to-make-mortgage-rates-predictions> (last visited Feb. 22, 2009).

275. Randy Strauss, P.E., *A Few Words on “The Conundrum”—The Flattening of the Yield Curve*, USA GOLD, Aug. 19, 2005, <http://www.usagold.com/analysis/strauss-20050819.html>.

276. Ronel Elul, *Residential Mortgage Default*, FED. RES. BANK OF PHILA. BUS. REV. 21 (Q3 2006), available at http://www.philadelphiafed.org/research-and-data/publications/business-review/2006/q3/br_q3-2006-3_residential_mortgage.pdf.

277. See Muolo, *supra* note 231, at 177. These loans are a nonconforming mortgage where the borrower has a higher than subprime credit score. “Alt. A” is short for “alternative A.” Typically, these loans may not be immediately eligible for purchase by Fannie Mae or Freddie Mac because they have underwriting anomalies that might include higher than normal debt-to-income ratios or irregular income. However, Fannie Mae and Freddie Mac have bought billions of dollars worth of bonds backed by some Alt. A loans.

278. Chris Isidore, *‘Liar Loans’: Mortgage Woes Beyond Subprime*, CNNMONEY.COM, Mar. 19, 2007, http://money.cnn.com/2007/03/19/news/economy/next_subprime/index.htm.

279. Perkins, *supra* note 219.

2. The Mortgage Brokers and Mortgage Bankers: Incentives to Deceive and Action by Illinois Regulators

There has been an unholy relationship between the mortgage brokers, mortgage bankers, and investment bankers that gave rise to the subprime crisis. The incentives that mortgage brokers had to produce borrowers have already been discussed.²⁸⁰ As brokers, they should have realized that they had a fiduciary duty to act in the best interest of their client, not in the best interest of themselves and the mortgage bankers. Unfortunately, the desire for compensation often led them to induce borrowers into mortgages that the borrower was not qualified for and could not afford. The mortgage banks, many of which were publicly traded, were obsessed with producing loans that translated into increased revenue and earnings and higher stock prices. Many of these loans were then sold to investment bankers who packaged them into securities and sold them to the investing public. Again, the investment bankers were focused on creating securities that translated into increased revenue, earnings, and higher stock prices.

Lisa Madigan, the Illinois Attorney General, working closely with California officials, took the lead in challenging the abusive lending practices by Countrywide Financial, the largest mortgage banker in the country.²⁸¹ The attorney general's complaint reads like a textbook in chronicling the scope of the abusive tactics employed and the lack of regard for the borrower and, ultimately, the investors who bought the mortgages.²⁸² The complaint ultimately resulted in a consent decree²⁸³ in which the attorney generals from ten other states also joined, and which has been characterized as an \$8.6 billion settlement.²⁸⁴ As a result of this investigation, Attorney General Madigan also took the lead in advancing legislation that, had it been passed earlier in the decade, might have prevented the crisis.²⁸⁵

The complaint nicely ties together the mortgage origination process by the mortgage bankers with a mortgage securitization process by the

280. See *supra* notes 218–24 and accompanying text.

281. See THE CTR. FOR PUB. INTEGRITY, *supra* note 271, at 14.

282. See Complaint for Injunction and Other Relief, *Illinois v. Countrywide Fin. Corp.*, No. 08 CH 22994 (Ill. Cir. Ct. June 25, 2008), available at http://www.illinoisattorneygeneral.gov/pressroom/2008_06/countrywide_complaint.pdf.

283. See Final Judgment and Consent Decree, *Illinois v. Countrywide Fin. Corp.*, No. 08 CH 40569 (Ill. Cir. Ct. Oct. 31, 2008), available at http://www.illinoisattorneygeneral.gov/consumers/countrywide_final_judgement.pdf.

284. See *BofA in \$8.6 Bln Settlement Over Countrywide Loans*, REUTERS, Oct. 6, 2008, <http://www.reuters.com/article/idUSBNG28749420081006>.

285. See *infra* text accompanying notes 319–22.

investment bankers. Investors would pay a premium for loans with high interest rates and with prepayment penalties:

Lenders, such as Countrywide, were aware of the types of loans and loan features for which investors would pay a premium. Investor demand and secondary market valuation, therefore, became the primary concern when determining what types of loans to market and sell at what price, rather than the consumers' ability to repay the loans.²⁸⁶

In order to keep churning out mortgages to be securitized, Countrywide changed its business plan. In 2002, it originated only \$9 billion in subprime loans, but this number increased to \$44 billion in 2005.²⁸⁷ In 2003, only 18% of the loans were adjustable interest rate loans, whereas a year later that number had grown to 49%.²⁸⁸ By 2005, Countrywide's growth in number of loans, revenue, earnings and stock price "was fueled by the company's origination of a menu of risky loan products, such as reduced documentation loans, option ARMs, and loans for 100% of a home's value."²⁸⁹

Countrywide advertised its "Expanded Criteria" loans—loans with reduced documentation, higher loan-to-value ratios, and other risky features—to mortgage brokers²⁹⁰ and pushed its employees to sell these products.²⁹¹ Employees were paid more to sell these types of products.²⁹² The company loosened its underwriting standards to the point that its guidelines would approve virtually any loan. Even though it had loose underwriting standards, Countrywide also had a system to grant exceptions, which was aggressively used.²⁹³

Countrywide was also charged with inflating the borrower's income, generally without the borrower's knowledge, in order to qualify a loan.²⁹⁴ If a borrower could not qualify for a loan based on his or her real income, the loan would sometimes be submitted as a stated-income loan with the borrower's income inflated to qualify the borrower for the loan.²⁹⁵ The attorney general's investigation disclosed that many borrowers were not aware that they were receiving a reduced

286. Complaint for Injunction and Other Relief, *supra* note 282, at 13.

287. *Id.*

288. *Id.*

289. *Id.* at 14.

290. *Id.* at 26.

291. *Id.* at 22.

292. *Id.*

293. *Id.* at 21–22.

294. *Id.* at 27.

295. *Id.*

documentation loan that they could not afford and were not qualified to receive.²⁹⁶

The risk of teaser rates and pay option loans has already been discussed.²⁹⁷ Yet, these were the types of loans that Countrywide was pushing at the height of the subprime crisis. In a pic-a-pay, or pay option loan, if the buyer does not pay the accruing interest, the interest is added to the principal. The negative amortization that resulted was carried by Countrywide on its books as uncollected income. In 2004, the accumulated negative amortization income was only \$29,000. Three years later, this accumulated negative amortization income had grown to \$1.215 billion.²⁹⁸ This reflected both borrowers' inability to afford a fully amortized loan and the extent to which Countrywide pushed such risky loans.

The Countrywide litigation was settled in October, 2008.²⁹⁹ The 38-page order is wide ranging but basically obligates Countrywide to embark on a loan modification program with respect to the pay option ARMs, hybrid ARMs, and other subprime loans it made to Illinois residents. As a result of the Countrywide settlement, as of the second quarter of 2009, Countrywide had made offers to modify 5,683 mortgages resulting in savings of \$88,154,716.³⁰⁰

While Countrywide has been hailed as the "mother of all predatory lending settlements,"³⁰¹ there have been numerous other regulatory actions challenging abusive lending practices. In 2002, Citigroup paid \$250 million to resolve Federal Trade Commission charges that a company it had acquired had engaged in "systemic and widespread deceptive and abusive lending practices."³⁰² Two years later, the Federal Reserve levied a \$70 million civil penalty against Citigroup's subprime lending unit.³⁰³ In 2007, AIG paid \$128 million in restitution after the Office of Thrift Supervision determined that it had failed to consider the credit worthiness of borrowers.³⁰⁴ Earlier, Household

296. *Id.*

297. *See supra* text accompanying notes 203–04.

298. Complaint for Injunction and Other Relief, *supra* note 282, at 44.

299. *See supra* note 283.

300. *See* Countrywide Report to the State of Illinois, *Summary Overview-Aggregate Non-Confidential Data-Q2 2009*. Because of the huge number of subprime loans made in states such as California, Texas and Florida, the overall modifications as of the second quarter were 143,867 loans resulting in expected savings of \$2,365,415,210.

301. *See* WHO'S BEHIND THE FINANCIAL MELTDOWN?, *supra* note 271, at 24.

302. *Id.* at 22.

303. *Id.*

304. *Id.* at 22–23.

Finance paid a \$484 million settlement for unfair and deceptive lending practices.³⁰⁵ Ameriquest paid \$325 million for misleading borrowers, falsifying documents and pressuring appraisers to inflate home value.³⁰⁶

Another distressing development that has been uncovered in the subprime crisis is that many borrowers, who would have qualified for a prime loan, were instead funneled into riskier and more expensive subprime loans because of the greater profitability to the mortgage brokers, mortgage lenders, and investment bankers. One study found that, in 2005 and 2006, 55% and 61%, respectively, of the subprime borrowers had credit scores generally high enough to qualify for conventional loans.³⁰⁷ While opinions vary as to what credit score is sufficient to get a prime loan—generally between 620 and 680—during the period 2004 to 2007 about one eighth of the subprime borrowers had credit scores over 700, clearly sufficient for conventional financing.³⁰⁸

Furthermore, a *Chicago Reporter* investigation disclosed that “African Americans earning more than \$300,000 were more likely to get high-cost loans than Asian, Latino and white borrowers earning less than \$40,000,” and that among big city lending markets, Chicago had the highest volume of high-cost loans.³⁰⁹ A high-cost loan is one that carries an interest rate 3% above the rate of a U.S. Treasury security of a comparable-maturity. Another study disclosed that Chicago had the worst disparity among lending groups since “African-American borrowers were fourteen times more likely to receive a higher-cost home purchase loan from Wells Fargo than were white borrowers.”³¹⁰ While it might be argued that African-Americans, as a group, have a higher risk profile than Caucasian Americans, the *Chicago Reporter* data rebuts this by showing that high income African-Americans were

305. *Id.*

306. *Id.*

307. See Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, at A1, available at <http://online.wsj.com/article/SB119662974358911035.html> (“On average, U.S. mortgage brokers collected 1.88% of the loan amount for originating a subprime loan, compared with 1.48% for conforming loans, according to Wholesale Access, a mortgage research firm.”).

308. *Getting to ‘Yes,’* WALL ST. J., Dec. 3, 2007, available at http://online.wsj.com/public/resources/documents/retro_SubPrime1107.html.

309. Alden K. Lory, *More Loan for the Same Home*, CHI. REP., Sept. 2008, available at http://www.chicagoreporter.com/index.php/c/Web_Extras/d/More_Loan_For_The_Same_Home.

310. Celeste Busk, *Minorities Getting Lion’s Share of Subprime Loans*, THE WOODSTOCK INSTITUTE, Mar. 16, 2007, available at <http://www.woodstockinst.org/for-the-press/woodstock-in-the-news/minorities-getting-lions-share-of-subprime-loans-sun-times/>.

nonetheless shunted into high-cost loans.³¹¹

Addressing this problem, the Illinois Attorney General filed a lawsuit against Wells Fargo, charging it with reverse redlining, that is, “when lenders target minorities or residents of minority neighborhoods for abusive and unfair home mortgages.”³¹² The complaint asserted that Wells Fargo incentivized its employees to steer minority borrowers into subprime or high-cost loans by paying a higher commission on such loans.³¹³ The state’s investigation revealed that borrowers with credit scores in the 700s were placed in subprime loans.³¹⁴ In 2007, 43% of African-American borrowers and 23.5% of Latino borrowers making between \$120,000 and \$140,000 received high-cost mortgage loans from Wells Fargo, while only 12% of Caucasian borrowers in this income range received such mortgages.³¹⁵ Similarly, roughly 34% of African-Americans earning \$120,000 or more received high-cost mortgages in the Chicago metropolitan area, whereas less than 22% of the Caucasian borrowers who earned less than \$40,000 received high-cost mortgages.³¹⁶

After the Attorney General began her investigation, Wells Fargo Financial, which had operated in Illinois under a state license, informed the Attorney General that its operations had been taken over by Wells Fargo Bank, a national banking association, and that “any further attempts to obtain documents by the Attorney General would be an improper assertion of visitatorial power over Wells Fargo Bank.”³¹⁷ This appears to be a new ploy by lenders in response to the current aggressive action by the state attorneys general (as compared with the passivity that has existed at the federal level).³¹⁸ Lenders seek to avoid state enforcement proceedings by consolidating lending activities into a federally regulated entity.

The Attorney General also took the lead in introducing remedial

311. Loury, *supra* note 309.

312. Complaint for Injunctive and Other Relief at 2, *Illinois v. Wells Fargo & Co.*, No. 09 CH 26434 (Ill. Cir. Ct. July 31, 2009), available at http://www.illinoisattorneygeneral.gov/pressroom/2009_07/WELLS%20FARGO%20COMPLAINT_07-31-2009_13-44-30.pdf.

313. *Id.* at 17–18.

314. *Id.* at 29.

315. *Id.* at 37.

316. *Id.*

317. *Id.* at 5.

318. See David Streitfeld & John Collins Rudolf, *States Are Pondering Fraud Suits Against Banks*, N.Y. TIMES, Nov. 3, 2009, at B1, available at <http://www.nytimes.com/2009/11/03/business/03suits.html> (describing state efforts to sue major mortgage lenders under consumer fraud).

legislation in 2008 to avoid a replication of what occurred in the subprime crisis. Public Act 95-691 made several very significant changes to the Illinois Residential Mortgage License Act of 1987.³¹⁹ Three changes are among the most important. First, borrowers were given a private right of action.³²⁰ Second, all licensees were required to verify the borrower's reasonable ability to service the mortgage, that is, to pay the principal, interest, insurance, and real estate taxes.³²¹ Finally, the amendments made crystal clear that mortgage brokers have an agency relationship with the borrower and an obligation to act in the borrower's best interest and in good faith.³²² If these provisions were in place across the country at the start of this decade, the subprime crisis might never have unfurled. Unfortunately, at the federal level, similar provisions were taken out of pending legislation.³²³

3. The Investment Bankers

As stated in a previous section, conservative critics would like to lay the blame for the subprime crisis on Fannie Mae and Freddie Mac because of their purchase of subprime loans.³²⁴ However, while these two government-sponsored entities were the major players in the subprime loan market prior to 2003, after 2003 the investment banks dominated, both because of their securitization of subprime loans and their financing of subprime mortgage lenders. The graph below shows this pattern:

319. See Ill. Pub. Act. No. 095-0691, 2008 Ill. Laws ch. 24, par. 1611, available at <http://www.ilga.gov/legislation/publicacts/95/PDF/095-0691.pdf>.

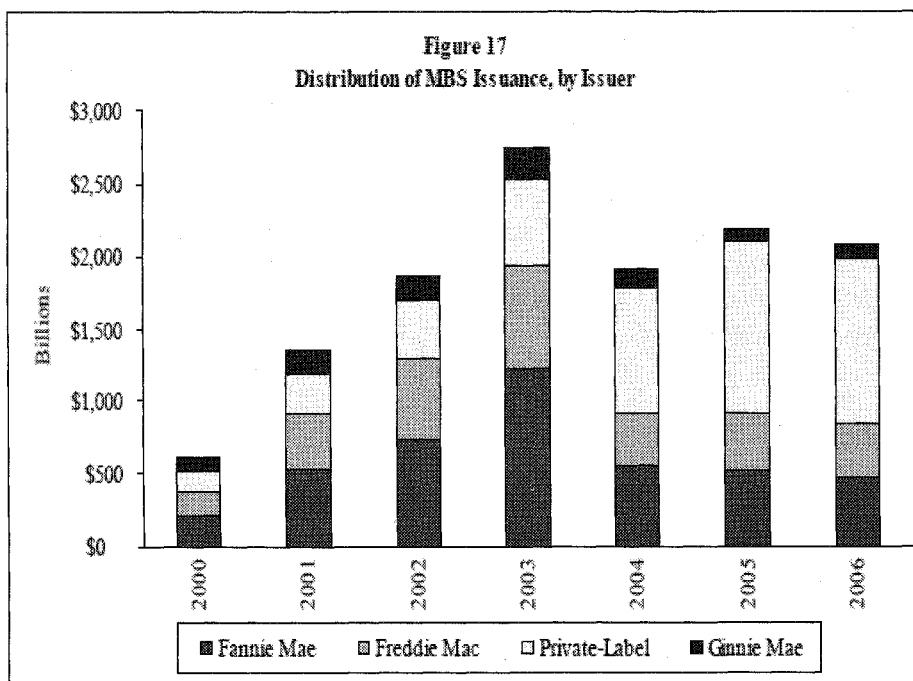
320. 205 ILL. COMP. STAT. 635/4-16 (2009).

321. 205 ILL. COMP. STAT. 635/5-6 (2009).

322. 205 ILL. COMP. STAT. 635/5-7 (2009).

323. See Joe Nocera, *Have Banks No Shame?* N.Y. TIMES, Oct. 10, 2009, at B1, available at <http://www.nytimes.com/2009/10/10/business/10nocera.html> (describing the banking industry's opposition to consumer protection reforms). See also Consumer Financial Protection Agency Act of 2009 (Discussion Draft, Sept. 25, 2009), available at http://www.house.gov/apps/list/press/financialsvcs_dem/discussion_draft_for_website_92509.pdf (last visited Mar. 7, 2010).

324. See *supra* notes 269–70 and accompanying text (laying out the conservative critique of Freddie Mac and Fannie Mae).



Sources: Fannie Mae, Freddie Mac, and Inside Mortgage Finance Publications

There existed a symbiotic relationship between the subprime lenders and the investment banks. A December 2007 report in the *New York Times* stated:

At the center of the boom in mortgages for borrowers with weak credit was Wall Street's once-lucrative partnership with subprime lenders. This relationship was a driving force behind the soaring home prices and the spread of exotic loans that are now defaulting in growing numbers. By buying and packaging mortgages, Wall Street enabled the lenders to extend credit even as the dangers grew in the housing market.³²⁵

As a result of the fierce competition to acquire loans that the investment banks could repackage into securities, they tried to establish exclusive or near exclusive relationships with some of the subprime lenders. For example, Morgan Stanley had such a relationship with New Century Financial and Merrill Lynch with First Franklin and Ownit Mortgage Solutions.³²⁶ These relationships were often

325. Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt*, N.Y. TIMES, Dec. 6, 2007, at A1, available at <http://www.nytimes.com/2007/12/06/business/06hedge.html>.

326. *Id.*

established by supplying a warehouse line of credit. Some of the investment banks even integrated vertically by owning and operating lenders. For example, Lehman Brothers operated Aurora Loan Services and Encore Credit Corporation and Bear Stearns operated EMC Mortgage.³²⁷ Merrill Lynch eventually acquired First Franklin. Judge Perkins summarized the situation as follows:

The profits (or “yield premiums,” as they are called) in the mortgage backed securities were so large that the investment banks got into hot competition with each other in the race to buy and securitize these subprime mortgages. It got to be so competitive that the investment banks offered to provide warehouse lines of credit to the largest non-bank lenders at a no-cost or on an interest-free basis if the lenders would agree to sell their mortgages to the banks that were providing the credit on an exclusive basis. So that is really what it came down to, that these were so lucrative that the investment banks were simply offering free money, free capital to finance the making of the loans as long as they got the opportunity to securitize these subprime mortgages and sell them on the secondary market.

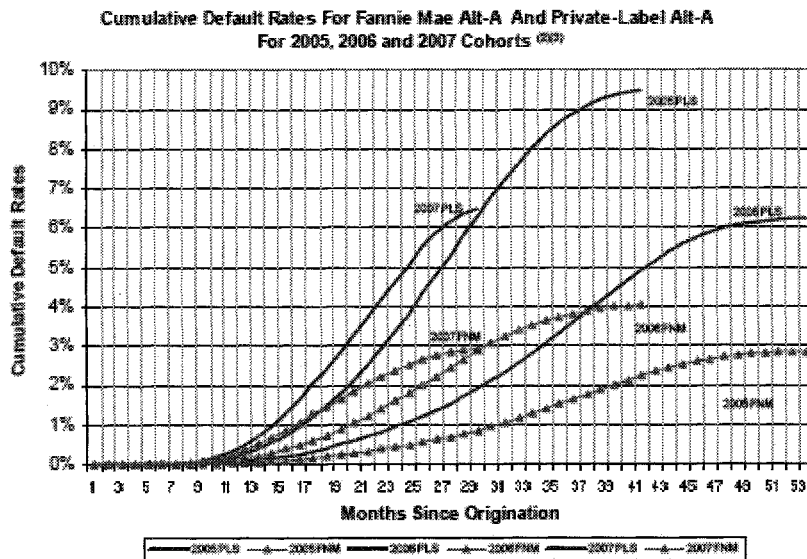
The investment banks all had marketing representatives who were out in the field who were really driving the lenders, mostly the non-bank lenders, to make the subprime loans to satisfy what had become an insatiable demand for mortgage backed securities. The subprimes were so profitable that Wall Street began to pay a premium.³²⁸

The data in the chart below demonstrates that the private-label securities packaged by the investment bankers had riskier loans than those packaged by Fannie Mae; in fact, they had more than twice the default rate.³²⁹

327. Perkins, *supra* note 219, at 4. *See also* WHO’S BEHIND THE FINANCIAL MELTDOWN?, *supra* note 271, at 14–15, 54–56, and 70–72.

328. *See* Perkins, *supra* note 219 (suggesting that warehouse lines of credit are akin to “free money”).

329. Fannie Mae, *2009 Second Quarter Credit Supplement*, Aug. 2, 2009, at 12, available at http://fanniemae.com/ir/pdf/sec/2009/q2credit_summary.pdf.



Source: Fannie Mae

Why would this be the case? Consider the types of loans packaged by the two constituencies. Fannie Mae essentially dealt in fixed rate loans whereas the private-label securities were heavily invested in adjustable rate loans. This is illustrated in the chart below:³³⁰

330. *Id.*

Fannie Mae Alt-A Versus Private-Label Security Conforming Alt-A		
	<u>Fannie Mae Alt-A</u>	<u>Private-Label Alt-A</u>
	Outstanding Alt-A loans in Fannie Mae's Single- Family Guaranty Book of Business as of May 2009	Outstanding loans backing non-agency conforming Alt-A MBS as of May 2009
FICO	718	710
Original Loan-to-Value Ratio	73%	75%
Combined Loan-to-Value Ratio at Origination ⁽¹⁾	77%	81%
Geography		
California	22%	27%
Florida	11%	13%
Product Type		
Fixed Rate	72%	50%
Adjustable-Rate	28%	50%
Interest-Only	20%	25%
Negative-Amortizing	3%	20%
Investor	18%	21%

Source: Fannie Mae

When the so-called 2/28 and 3/27 adjustable rate loans with initial teaser rates reset to higher interest rates, the scene was set for mortgage defaults. In addition, Fannie Mae rarely packaged loans with negative amortization, or, "pic-a-pay" loans, whereas the data set above indicates that about a quarter of the private-label loans had negative amortization.

While conservatives have claimed that Fannie Mae and Freddie Mac pressured the banks to make poor loans, the reality is just the opposite. By 2004, Fannie Mae was under siege from competitors. The previous year, it had lost 56% of its loan-reselling business to investment bankers and other competitors.³³¹ The company had had a longstanding and lucrative relationship with Countrywide Financial, which was the nation's largest mortgage lender and sold more loans to Fannie Mae than anyone else.

Consequently, shortly after he became CEO of Fannie Mae, Daniel Mudd traveled to California to meet with Angelo Mozilo, the head of Countrywide Financial.³³² At the meeting, Mozilo threatened to upend their partnership unless Fannie started buying Countrywide's riskier

331. Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1, available at <http://www.nytimes.com/2008/10/05/business/05fannie.html>.

332. *Id.*

loans. This was no idle threat since Countrywide had other options: in 2004, firms like Bear Stearns, Lehman Brothers and Goldman Sachs had started bundling home loans and selling them to investors—bypassing Fannie Mae and dealing with Countrywide directly. According to anonymous sources, Mozilo told Mudd, “you’re becoming irrelevant,” and added, if Fannie Mae did not take the loans that Mozilo was pushing, “you’ll find you can lose much more.”³³³

Accordingly, it should be clear that the private sector mortgage lenders and the Wall Street investment bankers have far more responsibility for the current financial turmoil than the minority community or the government sponsored entities.

4. The Credit Rating Agencies

As discussed above, few, if any, participants in the system understood the risk involved with mortgage-backed securities and collateral debt obligations.³³⁴ George Soros, a billionaire investor, has acknowledged that he did not know how these complex instruments worked.³³⁵

Many of the investors in mortgage-backed securities were fiduciaries subject to fiduciary standards as to the instruments in which they could invest. The only way these investments could be sold was to receive the imprimatur of the credit agencies. Without their stamp of approval, the whole game would have shut down.

The approach of the SEC in regulating credit agencies has been to focus upon disclosure of the conflicts of interest that credit rating agencies have as a result of being paid by the same people they are rating.³³⁶ At one time, the rating agencies obtained their income on a

333. *Id.* See Gretchen Morgenson, *Countrywide to Set Aside \$8.4 Billion in Loan Aid*, N.Y. TIMES, Oct. 6, 2008, at B1, available at <http://www.nytimes.com/2008/10/06/business/06countrywide.html>.

334. See *supra* notes 231–48 and accompanying text (analyzing the risk associated with collateralized debt obligations).

335. See Julia Finch, *Twenty-five People at the Heart of the Meltdown*, THE GUARDIAN, Jan. 26, 2009, available at <http://www.guardian.co.uk/business/2009/jan/26/road-ruin-recession-individuals-economy> (last visited Mar. 7, 2010).

336. See Proposed Rules Release, *supra* note 233, at 7 (outlining proposed new reporting requirements and other information exchanges); see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-57967 [File No. S7-13-08] at 2–3 (Feb. 2, 2009).

In particular, the requirements [the final amendments] are intended to increase the transparency of the NRSROs’ rating methodologies, strengthen the NRSROs’ disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs’ recordkeeping and reporting obligations to assist the Commission in performing its regulatory and

subscription basis. When they began charging a fee for the rating work they were doing, they came under tremendous pressure, from a competitive standpoint, to accommodate the investment banks bringing them the business. Once rating agencies went public, there was additional pressure to generate income in order to keep the price of their stock rising.³³⁷

Markets work on trust. Phony ratings by the rating agencies have destroyed trust in the securitized loan market. In 2006 and 2007, investors bought \$2.1 trillion and \$1.6 trillion, respectively, of securitized loans.³³⁸ In 2008, this figure dropped dramatically to \$314 billion.³³⁹ This is another reason that banks are not lending: they cannot get existing loans off their books by securitizing them.

5. The Lack of Regulation

While conservatives believe that the U.S. economy is overregulated, the current subprime crisis demonstrates that deregulation in some areas, and a lack of regulation in other areas, bear a very heavy responsibility for the present situation. But while this crisis occurred on George Bush's watch, the seeds were planted during Bill Clinton's presidency. While conservatives criticized Clinton's actions with respect to the Community Reinvestment Act,³⁴⁰ liberals objected to the repeal of the Glass-Steagall Act in 1999. The repeal of Glass-Steagall eliminated the separation of commercial banks and investment banks. This was part of a general move toward deregulation. The present subprime mortgage crisis shows that this separation was a disastrous move. There is a fundamental difference between the risk profile that commercial bankers have and the risk profile that investment bankers

oversight functions.

Id.

337. See generally Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59 (Yasuyuki Fuchita & Robert E. Litan, eds., 2006).

338. See Benjamin J. Keys, et al., *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans*, 125 Q. J. ECON. 307, 314–15 (2010), available at <http://www.mitpressjournals.org/doi/pdf/10.1162/qjec.2010.125.1.307>.

339. Vikas Bajaj, *U.S. Tries a Trillion-Dollar Key for Locked Lending*, N.Y. TIMES, Feb. 20, 2009, at A1, available at <http://www.nytimes.com/2009/02/20/business/20lend.html?partner=rss&emc=rss>.

340. See William A. Niskanen, *Repeal the Community Reinvestment Act*, Testimony before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, (March 8, 1995), available at <http://www.cato.org/testimony/ct-ni3-8.html> (advocating the repeal of the Community Reinvestment Act).

have: commercial banks want to minimize risk, whereas investment banks live off risk. It is the activity of the investment bankers in creating and securitizing MBSs and CDOs that has placed commercial banks in jeopardy and dried up their credit lending to even the most creditworthy businesses.

It was also the Clinton administration—in conjunction with Senator Phil Gramm and the Republican Congress—that resisted regulating derivatives. In 1997, Brooksley E. Born, a Republican lawyer, was the chair of the Commodity Futures Trading Commission (CFTC), a federal agency that regulates options and futures trading. She was concerned about the risks that derivatives posed to the financial system and the greater economy and began considering approaches to regulate derivatives.³⁴¹

Ms. Born was opposed by Robert Rubin, Secretary of the Treasury, Lawrence H. Summers, Mr. Rubin's deputy, and Alan Greenspan, the chairman of the Federal Reserve Board. Mr. Greenspan was essentially a libertarian who was opposed to government regulation and a firm believer that markets solve all problems. "Proposals to bring even minimalist regulation were basically rebuffed by Greenspan and various people in the Treasury," recalled Alan S. Blinder, a former Federal Reserve board member and an economist at Princeton University. "I think of him [Greenspan] as consistently cheerleading on derivatives."³⁴² His stance on keeping interest rates down during the 2000s did not lead to inflation generally, but rather to the housing bubble, a bubble about which he expressed little concern.³⁴³ Moreover, Greenspan encouraged innovative products in the mortgage market.³⁴⁴

Basically, Ms. Born wanted more transparency and the creation of reserves to cushion losses. Mr. Summers argued that Born's proposals would lead to a financial crisis,³⁴⁵ and Mr. Rubin and Mr. Greenspan urged her to back off from pushing for regulation. When she did not,

341. See *Brooksley Born & the Regulatory Limit of Democrats*, (Nov. 11, 2008), available at <http://cobb.typepad.com/cobb/2008/11/brooksley-born.html>; Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html>.

342. See Goodman, *supra* note 341.

343. See Alan S. Blinder, *Two Bubbles, Two Paths*, N.Y. TIMES, June 15, 2008, at BU6, available at <http://www.nytimes.com/2008/06/15/business/15view.html>.

344. See Alan Greenspan, Chairman of the Federal Reserve, Remarks before a Conference on Mortgage Markets and Economic Activity sponsored by America's Community Bankers (Nov. 2, 1999), available at <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/1999/19991102.htm>.

345. See Born, *supra* note 341; Goodman, *supra* note 341.

Mr. Greenspan, Mr. Rubin and Mr. Levitt, then the chairman of the Securities and Exchange Commission, called on Congress to prevent Ms. Born from acting until more senior regulators developed their own recommendations. Congress froze the regulatory authority of the CCTC, Ms. Born resigned, and the next year Senator Gramm attached a rider limiting the CFTC's authority to an 11,000-page appropriations bill. The Senate passed it. President Clinton signed it into law.³⁴⁶

Mr. Levitt now says that he regrets opposing regulation. Mr. Greenspan and Mr. Rubin were "joined at the hip on this," he said. "They were certainly very fiercely opposed to this [regulation] and persuaded me that this would cause chaos."³⁴⁷ Mr. Levitt also asserted that Mr. Greenspan's authority and grasp of global finance consistently persuaded less financially sophisticated lawmakers to follow his lead.³⁴⁸ What concerns many today is that President Obama has appointed Mr. Summers, an ally of Mr. Rubin and an apparent champion of deregulation, to be Chairman of the Council of Economic Advisers.³⁴⁹

The SEC's relaxed enforcement is also a major factor in the present crisis. In 2004, the SEC modified the net capital rules for brokers to enable firms to nearly double their leverage.³⁵⁰ The leverage ratios (which are measured by the ratio of total assets to shareholder equity or capital) for Merrill Lynch and Morgan Stanley went from 19:1 and 22:1, respectively, in 2000, to 32:1 and 33:1 in 2007.³⁵¹ Additionally, Bear Stearns's 2007 ratio was even higher at 34:1, while Lehman Brothers was 31:1.³⁵² When leverage ratios increase, it does not take a very substantial drop in the asset value to begin to wipe out capital. And when capital is reduced, the capacity of the bank to lend is likewise reduced.

Again, while conservatives believe that the financial industry is overregulated, many of the loans made during the early to mid 2000s were completed by state-chartered mortgage companies that were not

346. See Commodity Futures Modernization Act of 2000, <http://thomas.loc.gov/cgi-bin/bdquery/z?d106:hr05660>; see also Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

347. See Goodman, *supra* note 341.

348. *Id.*

349. See Jonathan Weisman, *Geithner, Summers to Take the Lead on New Economic Team*, WALL ST. J., Nov. 24, 2008, available at <http://online.wsj.com/article/SB122740604807650973.html>.

350. See Julie Satow, *Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers*, N.Y. SUN, Sept. 18, 2008, available at <http://www.nysun.com/business/ex-sec-official-blames-agency-for-blow-up/86130/> (discussing the SEC rule changes and their impact).

351. MILKEN INSTITUTE, *supra* note 217, at 74.

352. *Id.*

regulated by the FDIC, nor were they part of the Federal Reserve system. These companies have been referred to as nonbanks and, as Judge Perkins observed, “[S]tate regulation is really nonexistent with regard to the substance of the transactions in which they are engaged, so it really is a situation where these non-bank lenders are, for all intents and purposes, simply unregulated by any government regulatory agency.”³⁵³ Since they did not have deposits, they were dependent for their capital upon the warehouse lines of credit that they received from the investment banks. The nonbanks often used independent mortgage loan brokers to generate the loans; these entities also were either unregulated or inadequately regulated, depending upon the state.

D. Why the Paulson and Geithner Plans Are Not Working

At this time, it is clear that the first \$350 billion of the TARP bailout money has not rejuvenated the credit markets. The question is how effectively the second \$350 billion will be used and, at the time this Article is written, that is still in flux.³⁵⁴ What seems apparent is that merely putting additional capital into the banks did not restart lending.³⁵⁵ The reason is obvious: as long as we do not know what banks’ assets are worth, nobody knows how much capital is necessary to absorb the losses while retaining the requisite capital to begin lending.³⁵⁶

It looks as though Secretary Paulson may have had it right the first time around—buying the toxic assets rather than buying the stock of the banks, since buying stock did not resolve the underlying problem of toxic mortgages and led to banks defeating the underlying purpose of the program by arguably misusing TARP funds.³⁵⁷ The problem with

353. Perkins, *supra* note 219.

354. Tom Raum, *Banks Still in Distress, Geithner Tells Overseers*, A.P., Apr. 21, 2009, available at <http://abcnews.go.com/Politics/wirestory?id=7387195&page=1>.

355. See Scott Lanman & Edwin Chen, *Summers Urges Banks to Lend More, Says Growth Pace 'in Doubt'*, BLOOMBERG.COM, July 21, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=ae2ts7VZVTs8> (outlining Summers’ comments on the economy).

356. While several banks have now repaid their TARP borrowings, not only the presence of toxic assets, but also the specter of a substantial amount of short-term debt coming due for financial companies in the next year or two, continue to hang over the credit markets. See Gretchen Morgenson, *Debts Coming Due at Just the Wrong Time*, N.Y. TIMES, June 14, 2009, at BU1.

357. See SIGTARP JULY REPORT, *supra* note 262, at 186:

Moreover, the results show that institutions commonly have used TARP funds in ways that will not immediately or directly register on a bank’s lending report. In addition to activities that would directly lead to lending, for example, banks reported that TARP funds have been used in these ways:

- to increase capital cushions to absorb unexpected losses

buying the toxic assets is that, as stated above, no one knows what they are worth; moreover, it is a time-consuming process. If the government pays too much, the taxpayers take a bath. If the government pays too little, the capital problem of the banks is not resolved. Here again, there is a moral hazard problem. Banks want the highest possible sales price for their assets; on the other hand, the government must be careful not to negotiate too aggressively or else the price paid for the assets will not be sufficient to remedy the banks' capital problems. One research analyst has stated:

Ultimately, the taxpayer will pay one way or another, either through greatly diminished job prospects and/or significantly higher taxes down the line to pay for the massive debt issuance required to fund current and prospective fiscal spending initiatives. We think the government should do the following: estimate the highest price it can pay for the various toxic assets residing on financial institution balance sheets which would still return the principal to taxpayers.³⁵⁸

The problem, of course, is that no one knows what is the "highest price" that will "return the principal to the taxpayers." Consider a simple hypothetical balance sheet for a troubled bank:

<u>Assets</u>		<u>Liabilities</u>	
Mortgages	90	Debt	80
Cash	<u>10</u>	Capital	<u>20</u>
Total	100	Total	100

But what if those mortgages are only worth 70 instead of 90?

<u>Assets</u>		<u>Liabilities</u>	
Mortgages	70	Debt	80
Cash	<u>10</u>	Capital	<u>0</u>
Total	80	Total	80

-
- to purchase mortgage-backed securities, thus not resulting in lending by the bank itself, but supporting lending by other institutions in the MBS pipeline
 - to pay down debt, thus de-leveraging the bank's balance sheet and improving its ability to withstand further economic downturn
 - to acquire other banks

358. Joseph A. LaVorgna, *Falling Short: The Government Needs to Buy Toxic Assets* (Deutsche Bank A.G., New York, N.Y.), Feb. 11, 2009, at 1, available at <http://www.talkingpointsmemo.com/docs/toxicassets>.

At this point, the bank has no capital and cannot lend. So Secretary Paulson inserted capital into the banks:

<u>Assets</u>		<u>Liabilities</u>	
Mortgages	70	Debt	80
Cash	<u>20</u>	Capital	<u>10</u>
Total	90	Total	90

Now things look better, and maybe the banks will lend. But what if these mortgage assets are really only worth 60 or 50?³⁵⁹ If that is the case, the capital of the bank will still be impaired. This supports the first assertion above, namely, that if the value of the assets is unknown, it is impossible to know how much capital is necessary.

So was it foolish for Secretary Paulson to insert capital into the banks? Not at all. Urgent action was necessary and, as the last few months have demonstrated, getting buyers for the toxic assets—the original purpose of TARP—takes a long time. Why? Because nobody knows what the assets are worth.

Let's turn now to Secretary Geithner's plan. He begins by gilding the lily and calling the "toxic assets" by a less harsh sounding euphemism: "legacy assets." His Public-Private Investment Program (PIPP) has two elements: a "Legacy Loans Program," (LLP) and a "Legacy Securities Program," (LSP).³⁶⁰ The funds contributed by the government and a private investor would go into a Public-Private Investment Fund (PPIF), which would be managed by a fund manager. The Fact Sheet set forth the following example as to how the LLP would work:

Sample Investment Under the Legacy Loans Program

Step 1: If a bank has a pool of residential mortgages with \$100 face value that it is seeking to divest, the bank would approach the FDIC.

Step 2: The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.

Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the

359. It has been reported that the banks think the toxic assets are worth about \$0.60 on the dollar, whereas private investors want to pay about \$0.30 on the dollar. Edmund L. Andrews, et al., *Toxic Assets Plan Foresees Big Subsidies for Investors*, N.Y. TIMES, Mar. 21, 2009, at A1, available at <http://www.nytimes.com/2009/03/21/business/21bank.html>.

360. See U.S. DEP'T OF THE TREASURY, FACT SHEET: PUBLIC-PRIVATE INVESTMENT PROGRAM, Mar. 23, 2009, at 3–5, available at http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf.

private sector—in this example, \$84—would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages.

Step 4: Of this \$84 purchase price, the FDIC would provide guarantees for \$72 of financing, leaving \$12 of equity.

Step 5: The Treasury would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, the Treasury would invest approximately \$6, with the private investor contributing \$6.

Step 6: The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis—using asset managers approved and subject to oversight by the FDIC.³⁶¹

The LPP example assumes that the toxic assets are worth \$0.84 on the dollar, considerably above other reports which have indicated that the banks think they are worth about \$0.60 on the dollar, while private investors are only willing to pay about \$0.30 on the dollar.³⁶² The Treasury Department and Secretary Geithner seem to agree with the banks that the “legacy assets” are not as “toxic” as most are surmising. However, it may be that, if the legacy assets are realistically priced, many banks are really insolvent, a possibility that neither the banks nor Secretary Geithner are eager to acknowledge. At this point in time, there is great reluctance to have the government nationalize banks, as was done in Sweden.³⁶³

Let us once again use a simple accounting model for the banks to illustrate the consequences of Secretary Geithner’s approach to the taxpayer. While Secretary Paulson directly infused capital, Secretary Geithner would do this indirectly by taking toxic assets off the banks’ books and thereby preserving the bank’s apparent capital. He would also involve private investors so that it would not be taxpayer money that is solely at risk. In addition, by involving private investors, there would be a so-called “market” approach to valuing the assets.

Consider the first two simplified accounting approaches illustrated above in which the value of the assets is not the \$90 at which they are carried on the bank’s books, but rather \$70. Thus, they are only worth \$0.78 on the dollar, which is close to the example utilized in the Treasury’s Fact Sheet. The government has already infused \$10 of

361. *Id.* at 4.

362. See Andrews, *supra* note 359, at A1.

363. See Steve Perry, “We Just Don’t Nationalize Things Here”: Doug Henwood on the Banks and More, MINNPOST, Feb. 25, 2009, available at http://www.minnpost.com/steveperry/2009/02/25/6951/we_just_dont_nationalize_things_here_doug_henwood_on_the_banks_and_more (describing the United States’ reluctance to nationalize).

capital, so the balance sheet now looks something like this:³⁶⁴

<u>Assets</u>		<u>Liabilities</u>	
Mortgages	70	Debt	80
Cash	<u>20</u>	Capital	<u>10</u>
Total	90	Total	90

If these toxic assets are worth 30%, or even 60%, of the value at which they are carried on the bank's books (in this case, at 70), then there is no way the system will work. But since there are assets other than toxic mortgages on the banks' balance sheet, let's assume that the LPP finds a buyer who will pay 70. Using the percentages in the Treasury Department's Fact Sheet (7.5% government equity, 7.5% private equity, 85% government financing), the government and the private investor would each invest 5 and the government would lend 60. However, if it turns out that the assets are only worth 60, both the government and the private investor lose their equity investment, but the government will be repaid its loan.

Some critics of the program have claimed the private investors have "no skin in the game," and that the government bears all the risk.³⁶⁵ However, as the prior paragraph demonstrates, this is not true. The investor does have an economic interest in not overpaying for the assets. However, it is true that the greater risk is upon the government since, if the assets are only worth 50, the private investor will lose 5 but the government will lose 15 (equity of 5 and a loan loss of 10).

If Geithner is right and the assets are worth the price the banks are seeking, everybody wins. The bank gets rid of its toxic assets and preserves its capital—and shareholder equity. In addition, the government is paid back its investment, as are the private investors, and everybody is happy. Unfortunately, this is not the way the game is playing out because the game has yet to get underway. The FDIC announced that it was temporarily suspending the LPP program because the banks' ability to raise private capital has lessened their need to sell

364. This example is not only simplified, but somewhat misleading in that the banks' balance sheets are not composed solely of toxic mortgages, but reflect many other assets that are equal, or close, to their book value.

365. See, e.g., Paul Krugman, *Geithner Plan Arithmetic*, *The Conscience of a Liberal*, <http://krugman.blogs.nytimes.com/2009/03/23/geithner-plan-arithmetic/> (Mar. 23, 2009, 10:11 EST) (providing another simple arithmetic approach to understanding Geithner's plan).

the toxic assets.³⁶⁶ On the other hand, many others believe that the program was suspended because the government has had difficulty finding private investors to participate in the program. Who is telling the truth?

However, even if the program does get underway, a moral hazard issue remains. Since the private investors have “little [not no] skin in the game,” they could view this from the old junk bond perspective: if the return on some investments is high enough, you do not worry if a few of the investments go belly up. If that occurs, as illustrated above, the taxpayers will bear the brunt of the risk of a purchase at too high a price, whereas the shareholders of the banks will benefit because the banks, by unloading the toxic assets at a good price, will have preserved shareholder equity. However, the private investor could come out ahead if some investments paid off handsomely, since the government only receives half the profit, whereas, in a failing investment, the government bears the lion’s share of the risk. This is the junk-bond model.

In addition, if banks that employ the fund managers can participate in these purchases, there would be another moral hazard issue. For example, if Bank A overpaid for the toxic assets of Bank B, A would only lose 7.5% of the investment, but Bank B, and its shareholders, would receive the benefit of 100% of the overpayment. If the fund manager has a relationship with Bank B, the conflict of interest is readily discernible. If, in buying on behalf of A, he overpays for B’s assets, B scores at the expense of A, and the manager is indirectly rewarded because of his relationship with Bank B. Similarly, Bank B could purchase Bank A’s assets. This could invite mutual back scratching, if not collusion, in the process of setting the price.³⁶⁷

366. Posting of Sung Moss to TheStreet.com, *FDIC Suspends Toxic Asset Plan*, <http://www.thestreet.com/story/10509143/1/fdic-suspends-toxic-asset-plan.html> (June 3, 2009, 17:50 EDT).

367. See SIGTARP JULY REPORT, *supra* note 262, at 171–72:

Conflicts of Interest: PPIF managers might have a powerful incentive to make investment decisions that benefit themselves at the expense of the taxpayer. By their nature and design, including the availability of significant leverage, the PPIF transactions in these frozen markets will have a significant impact on how any particular asset is priced in the market. As a result, the increase in the price of such an asset will greatly benefit anyone who already owns or manages the same asset, potentially including the PPIF manager who is making the investment decisions.

Collusion: A closely related vulnerability is that PPIF managers might be persuaded, through kickbacks, *quid pro quo* transactions, or other collusive arrangements, to manage the PPIFs not for the benefit of the PPIF (and taxpayers), but rather for the benefit of themselves and their collusive partners. The significant non-recourse, Government-financed leverage presents a great incentive for collusion between the

In the example above, if a Public-Private partnership paid 70 for assets that are only worth 50, the selling bank and its shareholders would get the benefit of the overpayment, namely, 20, but the private investor would only lose 5. The government would lose the other 15.

E. A Solution

Consequently, one question arises. How do you protect the taxpayer and, at the same time, induce private investors to participate in the program? There is a two-pronged solution to this problem.

To protect the taxpayer and the private investor, it is desirable to have the banks guarantee the price that is paid for the banks' assets. However, the contingent liability resulting from such a guarantee would overhang the capital of the banks and stifle their ability to lend. A solution to this dilemma would be a guarantee by the banks of the price that is paid, with the proviso that the guarantee is to be funded and satisfied solely with authorized but unissued stock of the bank. The stock of the banks would be valued at the time the assets are sold, rather than some inflated pre-crisis price, which was apparently used by Secretary Paulson when he obtained warrants in the first go around. Thus, the price of the stock should impound the riskiness of the assets, since the larger the loss the investors incur, the greater amount of stock to be issued, with the attendant dilution of existing shareholder equity. This should insure that the market price for the stock continues to reflect the riskiness of the toxic assets that the government purchases and should avoid a windfall to the shareholders.³⁶⁸

If, upon the sale of the toxic assets, the assets are worth substantially less than the government and private investors had paid, then the government and the private investors would receive such a large amount of stock that it would dwarf the holdings of the existing shareholders. For those who fear nationalization, nationalization could be avoided if the assets are fairly priced; it would also be partially avoided if the assets are not fairly priced because half of the stock issued pursuant to the guarantee would go to private investors. On the other hand, if the economy recovers and the assets have a value approaching that which the public-private partnership paid, little if any stock would be issued to fund the guarantee. This is a way to keep the banks honest, avoid

buyer and seller of the asset, or the buyer and other buyers, whereby the taxpayer may be exposed to a significant loss while others profit.

368. Disclosure: I own shares in Citigroup; but if Citigroup truly is insolvent, my shares should be worthless.

shareholder windfalls, and induce private investment since, if the toxic assets are mispriced, the private investor could own half the bank. For example, the Citigroup franchise would have substantial value since overpaying for the assets maintains its solvency, and its employees, business plan, and book of business stay in place.

The second prong of a potential solution is one that the Senate has already undercut by failing to pass a bankruptcy bill³⁶⁹ that would have given bankruptcy judges the power to lower the amount owed on a home loan.³⁷⁰ This is a power that some bankruptcy judges exercised, and that four Circuits upheld, until the 1993 Supreme Court decision in *Nobleman v. American Savings Bank*,³⁷¹ which held that such power did not exist under the then-existing bankruptcy code.³⁷² Foreclosures are having a devastating effect on the value of property because, once the home is vacant, this depreciates the overall value of property in the neighborhood and, if the home is vandalized, the effect is even more drastic. Moreover, if the lender does foreclose, the lender will not recover any more than the existing value of the home. Moreover, the lender frequently receives even less when the purchase is by vulture bidders.³⁷³

Not only does foreclosure exacerbate a downward spiral in home prices, but the inability of homeowners to file for bankruptcy, with the possibility of having a judge lower the amount owed on the loan, has another unsettling effect on resolving the subprime crisis. While opportunities exist for the homeowner and the mortgage holder to renegotiate the terms,³⁷⁴ little use has been made of this opportunity

369. S. 61, 111th Cong. (2009). Senator Richard J. Durbin was the bill's sponsor.

370. See Stephen Labaton, *Ailing, Banks Still Field Strong Lobby at Capitol*, N.Y. TIMES, June 5, 2009, at A1, available at <http://www.nytimes.com/2009/06/05/business/economy/05bankrupt.html>.

371. *Nobleman v. Am. Sav. Bank*, 508 U.S. 324 (1993), *superseded by*, 11 U.S.C. § 1322(c)(2).

372. Many home owners had successfully argued that, when the balance on their loan was less than the value of the property, the loan was bifurcated such that the part of the mortgage represented by the existing value of the home was a security interest which could not be released in bankruptcy, but that the excess was unsecured and could be released.

373. See, e.g., Eric Lipton, *No Easy Workout*, N.Y. TIMES, Apr. 17, 2009, at B1, available at <http://www.nytimes.com/2009/04/17/business/smallbusiness/17debt.html>. The owners of the Fayetteville Athletic Club offered to pay \$6 million immediately and an additional \$1 million upon the future sale of the club, if the FDIC, which had taken over the bank that made the loan, would accept that in settlement of their \$10 million debt. Instead, it was sold to a "vulture investor" who paid \$0.34 on the dollar, a price far below what the owners were willing to pay.

374. See U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM UPDATE, Apr. 28, 2009, available at <http://www.financialstability.gov/docs/042809SecondLienFactSheet>.

because the banks are not interested in realizing a loss which could impair their capital.³⁷⁵ This is undoubtedly one reason why there is such a spread between the price the banks want for the toxic assets and the price the investors are willing to pay. Rather than taking an immediate hit by renegotiating a mortgage, banks would rather wait out the foreclosure process, which could take up to 18 months, in the hope of rising prices and to delay the day of reckoning. If homeowners could force the issue by going into bankruptcy, there would be an upsurge in negotiated settlements, which would bring some realism to the pricing process. But as it now stands, unless Senator Durbin reintroduces his bill, this opportunity to inject some truthfulness into the process of evaluating the toxic assets has been lost.

There is one other possible situation involving moral hazard in the process of forming the public-private partnerships. What has not yet been announced is the interest rate that would be charged under the government financing. Depending upon the spread between the interest rate the government charges on its loan to the public-private partnership and the net effective interest rate from the toxic assets purchased, there is an arbitrage opportunity for private investors that could eliminate the risk that the private investor bears. For example, the government is presently borrowing short-term at about 1%. If the government only charges the partnership 2% and the toxic assets yield a net of 3%,³⁷⁶ the interest spread in a short time will return the private investors' equity investment, leaving them in a riskless situation.

pdf (describing Treasury efforts to stabilize the housing market such as the "Second Lien Program").

375. Professor Alan M. White of Valparaiso University School of Law has analyzed data on 3.5 million subprime and Alt-A mortgages in securitization pools overseen by Wells Fargo. For the month ending March 25, 2009, there were 460,775 foreclosures but only 20,894 mortgage modifications. The average loss on a mortgage foreclosure was \$132,761, or 63% of value, while the average loss on a modification was \$25,968 or an average loss of just under 13%. Two conclusions flow from this data. One is that banks are willing to make only minor adjustments when modifying a loan, but incur substantial losses when going through the foreclosure process. Rationality would dictate that more effort should be employed in modifying loans, but the banks are hesitant to voluntarily recognize a loss. The second conclusion is that a loan loss of 63% of value reflects the fact that such mortgages are only worth \$0.37 on the dollar, which correlates with what investors are willing to pay and is a far cry from the valuation of subprime mortgages by the banks and Secretary Geithner. Alan White – Data Files, <http://www.valpo.edu/law/faculty/awhite/data/index.php>.

376. If the pool of mortgage assets average 6% interest and 50% are in default, there is still a net income yield of 3%.

V. CONCLUSION

The lack of regard for the truth permeates all facets of society—from advertising to talk radio. Our society “relativizes truth, often paying little heed to it and showing increasing reluctance to acknowledge its existence.”³⁷⁷ Those who raise concerns about the lack of truthfulness are usually dismissed as moralists. However, when it comes to government and business, lying and its permutations can have dramatic consequences. While the main focus of this Article is upon business, we have witnessed the effects of government’s lack of candor upon our environment, our national security, and our basic principles, such as privacy and the torture of prisoners. This lack of truthfulness impedes our ability to solve the current subprime crisis because ideology precludes us from focusing upon the real causes of the crisis.

With respect to business, corporate corruption at the turn-of-the-century involved financial lying. While the issues involved in governmental lying may be more abstract and the effects harder to quantify, individual investors, pension funds, and mutual funds lost hundreds of billions of dollars as a result of being duped by corporate managements in these scandals. The manner in which the federal courts have interpreted the PSLRA reflects a blasé attitude towards financial lying, instead of the outrage that should have been reflected in their opinions.

Moreover, the subprime crisis reflects the apogee of the consequences of lying. Losses are no longer measured in tens of billions of dollars, but rather hundreds of billions or trillions of dollars.³⁷⁸ Seldom has lying been so pervasive throughout a system. From customers, mortgage brokers, and banks, in creating the mortgages, to investment bankers and credit rating agencies in bundling, securitizing and selling mortgages and mortgage derivatives, to the government’s lack of candor to Congress and the American people about the nature of the problem and what is being done to solve it.

The present crisis requires a reappraisal of the notion that business is good and government is bad, as well as a reconsideration of the deregulatory mindset that led to this crisis. It is unacceptable that banks

377. Benedict XVI, Encyclical Letter, *Caritas in Veritate* [Charity in Truthfulness], June 29, 2009, available at http://www.vatican.va/holy_father/benedict_xvi/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate_en.html.

378. Prior to the bailout, Treasury Secretary Paulson met with members of Congress and Senator Chris Dodd reported that Paulson told them: “Unless you act, the financial system of this country and the world will melt down in a matter of days.” Senator Dodd added: “There was literally a pause in that room where the oxygen left.” *Frontline*, *supra* note 254.

and others can originate mortgages, sell them, and wash their hands of any responsibility for the credit worthiness of the buyer. As investment bankers like to say, the originators of the loans need to have some “skin in the game.”

Our regulatory bodies need to regulate. The excessive leverage that they have permitted has led to a shutting down of credit markets because banks’ capital is impaired, or at least moving in that direction. With respect to credit rating agencies, it is insufficient for the SEC to merely require disclosure of conflicts of interest; these conflicts should be eliminated altogether or the consequences of favoring investment banks over investors need be made very clear.³⁷⁹

Disclosure and transparency should be required of all significant participants in the market—particularly hedge funds and the market in derivatives. Databases must be publicly available. One of the problems in dealing with the present crisis is that there is still uncertainty as to the scope of the problem and the impact on the players affected.

Congress needs to separate commercial banking from investment banking—two sectors with entirely different risk profiles—and the Senate needs to revisit amending the bankruptcy laws to permit courts to modify mortgages and stop the upward surge in foreclosures and the resulting downward spiral in the economy. If banks are insolvent because of their investment in toxic assets, so be it. Until foreclosures, with their devastating effect upon neighborhoods and the real estate market in general, are curtailed, we are letting banks keep their heads in the sand, instead of facing up to the reality of their balance sheets.

379. The pervasive problem of conflicts of interest involving the rating agencies has again been highlighted in the recent TARP Inspector General’s Report, SIGTARP JULY REPORT, *supra* note 262, at 184–85:

Since SIGTARP’s April Quarterly Report, there have been several developments that raise additional concerns about TALF’s use of ratings agencies. Most ratings agencies, by the nature of their business model, have inherent conflicts of interest—they are paid by the issuers of the very securities that they are rating. As a result, the agency has an incentive to issue a high rating to attract future business from that issuer. As one commentator recently characterized the conflict, it would be as if Hollywood studios paid movie critics to review their films: any individual critic would have a strong incentive to give a particular film a good review, even if it was terrible, out of fear that the studio would not give the critic future business. This inherent conflict played out with disastrous consequences in the recent credit crisis in which AAA ratings for many MBS, in particular certain classes of RMBS, had little or no relation to the creditworthiness of the securities.

Over the last quarter, there has been reporting that these conflicts may be impacting TALF. For example, Moody’s Investors Services, one of the major agencies that has been qualified to rate all TALF securities, has complained of a “race to the bottom,” in which issuers are selecting other agencies to rate TALF securities because they are employing lower standards and therefore are more likely to give a potential TALF security the necessary AAA rating.

Congress should also follow the lead of Illinois in imposing an obligation upon lenders to have real data, which supports a reasonable likelihood that the borrower can service the mortgage on a fully indexed basis. This should end the era of “liar’s loans.” Illinois has also imposed fiduciary responsibilities on mortgage brokers so that their obligation is to act in the best interests of their client, rather than themselves and the mortgage lenders.

A crisis is too valuable to waste.³⁸⁰ Solutions are needed, not platitudes. The era of “anything goes” must be over.

380. See Phil Power, *A Crisis We Can't Afford To Waste*, CENTER FOR MICHIGAN, Jan. 21, 2009, <http://www.thecenterformichigan.net/blog/a-crisis-we-cant-afford-to-waste/> (discussing the transformative possibilities within an economic crisis).

APPENDIX

COMPARISON OF MCCAIN AND OBAMA DISTORTIONS

McCain Distortions

- Obama will raise your taxes³⁸¹
- Obama doesn't take Iran seriously
- Obama canceled a visit to troops in order to go to a gym
- Obama voted against funding troops
- Obama legislated comprehensive sex education to kindergartners
- Obama pals around with terrorists
- Obama's health care plan would rob 50 million employees of their health coverage

Obama Distortions

- McCain will cut your Social Security Benefits
- McCain wants to stay in Iraq for 100 years
- McCain voted against increasing health-care benefits for veterans (statement of Joe Biden)
- McCain voted to cut education spending
- McCain opposes stem cell research
- McCain's health care plan contains the largest middle-class tax increase in history

N. B. The reader should consult the above sources to make his or her own determination as to whether the foregoing are lies or distortions.

381. All of the statements in this chart come from the following two sources: *The Whoppers of 2008*, FACTCHECK.ORG, Sept. 25, 2008, http://www.factcheck.org/elections-2008/the_whoppers_of_2008.html; *The Whoppers of 2008—The Sequel*, FACTCHECK.ORG, Oct. 31, 2008, http://www.factcheck.org/elections-2008/the_whoppers_of_2008--the_sequel.html.