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# *LEGAL ABANDON*:

## *HOW LIMITING LAWSUITS LED TO THE FINANCIAL COLLAPSE AND WHAT TO DO ABOUT IT*

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*"Fighting to protect the right to jury trial and an independent judiciary for all Americans."*



> *Sellers rip off buyers: This is a fundamental downside of capitalism. Governments have three ways to deal with it. They can do nothing and trust (or hope) that financial and reputation concerns will keep securities-selling executives on the straight and narrow. (How quaint.) Second, they can establish a regime of private enforcement [litigation] through which wronged investors can try to recoup losses. The third approach is more explicitly statist: public enforcement … like the Securities and Exchange Commission —independent regulators with the power to investigate, prosecute, and fine.*[1]

So wrote Professor André Douglas Pond Cummings in a 2005 law review article entitled, "'Ain't No Glory in Pain': How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets." At the time, Cummings was addressing the reasons behind the 2001-2002 stock market crash and major well-known frauds like Enron and WorldCom. Even he was unlikely to predict what would come next.

The 2008 financial collapse, led by the subprime mortgage crisis the year before, brought the country to the brink of economic catastrophe. Former financial regulator and financial market expert William Black recently explained, "The FBI has been warning of an 'epidemic' of mortgage fraud since September 2004," noting that "lenders initiated 80% of these frauds."[1] Yet plenty of people are still scratching their heads about how we got to such a precarious position.

Many have focused on deregulation of the financial industry, which took place with great determination in the 1990s when

Congress weakened laws and regulations passed after the Great Depression that had established accountability and transparency in the financial markets. Clearly, regulatory agencies also failed massively, even botching efforts that would have detected gigantic Ponzi schemes like that of Bernie Madoff.

But greatly compounding the problem was the deliberate weakening of investors' private legal rights of action. Beginning in the 1990s and into the early part of the next decade, the legal rights of defrauded shareholders were greatly restricted. Combined with Congress's failure to fix new litigation obstacles primarily created by the U.S. Supreme Court, it seems everywhere one turned there were roadblocks to legal accountability, leaving "private enforcement of the federal securities laws in near terminal condition."[2]

The impact has been clear. As former federal judge, Congressman and White House counsel Abner J. Mikva wrote in 2002 (insight that is just as applicable today):

> By inhibiting the rights of individuals to seek damages, we lowered the risks for securities fraud, eliminated deterrence and fostered a culture of laxity. Arthur Levitt, [former] chairman of the [Securities and Exchange Commission] … has observed that what used to be unthinkable is now commonplace in the marketplace.[3]

A closer look at each of these components helps illuminate exactly how certain political, legislative and judicial decisions led to the current situation and made it extremely hard for shareholders to hold companies accountable for fraudulent behavior. While each of these legislative and judicial pronouncements may seem fairly archaic in their own stead, taken together, and especially in light of the political forces encouraging such pronouncements, a clear policy emerges: That of constraining the rights of shareholders and borrowers to hold corporate entities accountable for financial fraud.

## SUMMARY

Private civil lawsuits are as important as strong regulation and enforcement to properly manage any national capital market. Greatly compounding recent trends toward deregulation and lax regulatory enforcement has been the weakening of investors' and borrowers' private legal rights of action.

Beginning in the 1990s and into the early part of the next decade, the legal rights of defrauded shareholders were greatly restricted by Congress and the U.S. Supreme Court. The rights of mortgage borrowers are extremely limited, as well.

- Corporate fraud immediately increased after passage of the Private Securities Litigation Reform Act (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA), and investor cases have been thrown out of court — cases that could have brought fraud to the attention of regulators and the public.

    - PSLRA bars investors from bringing fraud claims against a corporate entity without a very large amount of evidence in hand and stops all discovery until after a judge decides whether the case can go forward. As one legal scholar put it, "You can't get discovery unless you have a strong evidence of fraud, and you can't get strong evidence of fraud without discovery."

    - SLUSA says that federal courts are the exclusive jurisdiction for class actions based on state law fraud in relation to the purchase or sale of stock.

- The Class Action Fairness Act of 2005 (CAFA), which limited the rights of all class action plaintiffs, has resulted in a 24 percent decline in class action securities filings as of December 2009 compared to the same period in 2008.

Congress has balked at reversing or modifying U.S. Supreme Court decisions that substantially weakened consumer protections in the financial markets. These include:

- *Central Bank of Denver, N.A. v. Interstate Bank of Denver, N.A.* (1994), where the Court ruled that shareholders could not sue aiders and abettors to corporate fraud.

- *Stoneridge Investment Partners v. Scientific-Atlanta, Inc. et al*. (2007), where the Court ruled that investment banks, lawyers, accountants, credit rating bureaus or other so-called "secondary actors" who knowingly help a public company deceive investors cannot be liable for the fraud if they did not make a material misrepresentation to shareholders. This decision broke with SEC precedent, members of Congress from both parties and the views of 33 state attorneys general.

When it comes to Wall Street's accountability, victims of predatory mortgage loans that led to the subprime mortgage crisis have been largely left out in the cold due to certain decisions about "assignee liability" by Congress, the Clinton and Bush Administrations and the U.S. Supreme Court. Had the law been different from the start, victims could have held Wall Street firms accountable and many believe the subprime mortgage crisis would have been avoided.

Scholars and economists have loudly called for re-regulation of the capital markets. Many of their solutions emphasize the importance of being able to hold corrupt CEOs and underwriters legally responsible for fraudulent actions. Top priorities are addressing the roadblocks posed by federal legislation and by the Supreme Court decisions in *Central Bank* and *Stoneridge*.

## FINANCIAL DEREGULATION AND THE CRITICAL NEED FOR CIVIL LAWSUITS

After the Depression, a regulatory system was put into place which "drew bright lines between different kinds of financial activity and protected regulated commercial banking from investment bank-style risk taking," forced transparency of financial information and established many additional rules to protect consumers.[4] Congress created the Securities and Exchange Commission (SEC) to regulate markets and protect investors. In the 1940s, the SEC promulgated Rule 10b(5)[5] to prevent fraud in the purchase or sale of any security, with the courts establishing a private right of action for investors who have suffered losses to enforce this critical rule.

While perhaps not a perfect system, the structure was in line with what some have recommended for "most efficient and productive" capital markets. For example, one study of the 49 largest stock markets in the world, conducted by "a troika of Ivy League economists — Dartmouth's Rafael La Porta, Yale's Florencio Lopez De Silanes, and Harvard's Andrei Shleifer," found that "private lawsuits, combined with common-sense regulation and governmental control, is by far the most effective method to manage a national capital market." Indeed, they discovered that "markets develop better when civil — not criminal — law is strong."[6]

But in the mid-1990s, a "deregulation hysteria" gripped the country with the election of the 1994 Congress and the advent of the "Contract with America."[7] Investors and pensioners were at a clear disadvantage trying to fight back. Financial regulation is an immensely complex area, and organized business interests have a political and institutional advantage over the average shareholder in both lobbying for their interests and perpetrating frauds. As a result, during this decade, many securities protections were rolled back. Among the more problematic:

- Final repeal of laws that had prohibited commercial banks and investment banks from operating as one entity. This allowed "the infusion of an investment bank culture into commercial banking," so that "[c]ommercial banks sought high returns in risky ventures and exotic financial instruments, with disastrous results."[8]

- A law to formally exempt derivatives (*i.e.*, financial products that derive their value from something else) from regulation, even though many lawmakers strongly argued for regulation.[9]

After the Enron disaster, Congress did take steps to implement some accounting reforms with the passage of the Sarbanes-Oxley Act, which included stronger criminal penalties for fraudulent behavior by publicly traded companies, stronger protections for whistleblowers and more reporting regulations.[10] Since Sarbanes-Oxley, the Department of Justice has obtained nearly 1,300 convictions of corporate fraud and those fraudulent actions have translated into an average cost of nearly $60,000 per U.S. household.[11] Yet very few of these fraud cases will result in civil judgments.

Much has been written on the immense lobbying effort lodged by the insurance industry and banking institutions to push for deregulation.[12] According to one analysis, the financial sector spent over $5 billion on reported federal campaign contributions and lobbying in the U.S. from 1998-2008 and employed almost 3,000 separate lobbyists.[13] In fact, since 1998, the U.S. Chamber of Commerce spent over $380 million on lobbying efforts for large corporations like AIG, Enron and Qwest.[14] The U.S. Chamber also lobbied furiously against Sarbanes-Oxley with its campaign that "an accounting error should never be seen as a crime."[15] According to U.S. Chamber CEO Tom Donahue, the regulations imposed by Sarbanes-Oxley were unnecessary and "[b]usiness should stop apologizing for being the one institution in America that really works."[16] This was said after Enron imploded. And although the Chamber failed to stop Sarbanes-Oxley, the law that eventually passed was considered by many as a "watered-down compromise"[17]; it certainly did nothing to prevent the financial collapse yet to come.

At the same time, SEC oversight continued to weaken. Even after Enron, "the same lack of oversight that existed in December 2001 when Enron failed" continued, with both funding and personnel shortages; the number of enforcement personnel declined even while the financial collapse was underway and even after clear enforcement disasters like the Bernie Madoff Ponzi scheme.[18] Moreover, in 2004, the SEC abolished critical bank regulations in favor of "voluntary" oversight systems. As reported in the *Multinational Monitor*, "On September 26, 2008, as the crisis became a financial meltdown of epic proportions, SEC Chair Cox, who spent his entire public career as a deregulator, conceded 'the last six months have made it abundantly clear that voluntary regulation does not work.'"[19]

It is against this backdrop that the simultaneous diminishing of victims' legal rights over the last 15 years, for which both Congress and the U.S. Supreme Court are responsible, must be understood.

## THE ATTACK ON SHAREHOLDERS' RIGHTS

### Private Security Litigation Reform Act (PSLRA)

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA) over President Clinton's veto. The PSLRA "dramatically changed the landscape of federal securities law regulation by amending the Securities Act of 1933 and the Securities Exchange Act of 1934 to essentially, as many argue, 'shield corporations and accountants from shareholder lawsuits.'"[20] As Abner Mikva wrote in 2002, with the PSLRA, "[s]imply put, Congress reduced the incentives against committing fraud."[21]

Before 1995, federal law required investors suing companies for fraud to include allegations of fraud in their initial pleadings but they were allowed to wait until the discovery phase of the case to develop specific evidence of a defendant's "intent" to defraud (which allowed plaintiffs to later uncover more specific facts to support their claims). That all changed with the enactment of the PSLRA.

Basically, the PSLRA bars investors from bringing fraud claims against a corporate entity without a very large amount of evidence in hand. This heightened pleading standard requires that a plaintiff show, at the time of filing the complaint, that a defendant's fraudulent statements were made knowingly and with intent to defraud. The law also stops all discovery until after a judge decides whether the case can go forward (*i.e.*, after the "motion to dismiss" is decided). The impact is obvious. As one legal scholar put it, "You can't get discovery unless you have a strong evidence of fraud, and you can't get strong evidence of fraud without discovery."[22]

The PSLRA was widely opposed. Judge Mikva wrote, "Consumer groups, senior citizen groups, labor unions, pension funds and state and local government regulators warned that the PSLRA … overreached and … relieved wrongdoers from accountability."[23] President Clinton vetoed the bill, stating that he did not support "legislation that will have the effect of closing the courthouse door on investors who have legitimate claims. Those are the victims of fraud that should have recourse in our courts."[24] Unfortunately, although Clinton vetoed the bill, his tepid opposition failed to arouse enough votes to sustain the veto, and it was overridden for the only time in his eight-year presidency.

The impact of the PSLRA was swift. For example, in 2002, a federal court dismissed civil claims of securities fraud against WorldCom's CEO Bernard Ebbers and CFO Scott Sullivan because the complaint "failed to support a strong inference of fraud" as required under the PSLRA.[25] Scott Sullivan and MCI WorldCom Director of General Accounting Buford Yates, Jr. were later indicted for securities fraud, along with other WorldCom executives.[26] The indictment alleged similar activity covering some of the same time periods as the civil complaint previously dismissed. The indictment also alleged that in the two years after the civil lawsuit had been filed, defendants had continued their fraudulent behavior. Two defendants pled guilty to those charges and, while some executives have been punished through the criminal justice system, defrauded investors will not get their money back as they would through civil litigation.

Fortunately, in the case of WorldCom, a subsequent securities class action eventually settled and plaintiffs were awarded some of their losses from the personal accounts of those responsible.[27] But as Professor Cummings wrote in 2005,

> Excruciating monthly reports detail the efforts of shareholders and employees seeking to sue Enron, WorldCom, Global Crossing, Tyco, and Adelphia for retribution, only to have most efforts stonewalled by the PSLRA. Not only has the PSLRA prohibited many shareholders from conducting preemptive suits against malfeasant companies, but also the PSLRA has blocked aggrieved shareholders and employees from finding a deserved remedy from the criminally-charged and admittedly-guilty corporate executives.[28]

According to a study done after the passage of the PSLRA, "[M]ost companies have less than a 2 percent chance of getting hit with a shareholder suit in any given year. Even if a company does get sued, odds are also slim that it will ever have to pay out in a verdict or settlement. NERA [an economic consulting firm] reports that nearly 40 percent of all shareholder class actions filed between 1999 and 2004 were dismissed. Dismissal rates have doubled since passage of the 1995 Private Securities Litigation Reform Act."[29] In other words, lawsuits that could have uncovered risky business practices were either never brought or dismissed before the merits of the lawsuit were examined because of the PSLRA. Currently a motion to dismiss is pending in a consolidated class action against AIG for their credit default swaps.[30] Discovery has been stopped while the motion is pending, discovery that could enlighten regulators who are now trying to uncover what went so wrong.

Interestingly, during the debates around the PSLRA, Congress also examined and considered regulating the derivatives market. U.S. Representative Ed Markey (D-MA) foresaw much of the current crisis and proposed an amendment that would ensure investors' abilities to sue for abuses related to the derivatives market. The amendment failed with the help of then-Federal Reserve chair Alan Greenspan and SEC chair Arthur Levitt. At the time of those debates, Greenspan argued that "singling out derivative instruments for special regulatory treatment" would be a "serious mistake."[31] Levitt agreed, warning that "[i]t would be a grave error to demonize derivatives."[32] Time, however, proved Representative Markey right, and unregulated derivatives drove much of the financial bubble that we are contending with today.

It should be noted that the U.S. Supreme Court's interpretation of the PSLRA and pleading requirements have added to plaintiffs' difficulties in filing a case.[33] In 2007, the Court ruled that in deciding whether there is fraudulent intent, it "must be more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[34] Two years earlier, the Court had ruled that pleading a stock purchase price was inflated, indeed a price inflated by fraudulent statements, was not showing enough of a causal relationship to a subsequent price drop to hold the company responsible for the monetary loss.[35] In other words, even though the pharmaceutical company had made misleading statements regarding its antibiotic sales and the pending FDA approval of one of its medical devices, causing stock prices to go up, the company was not liable to shareholders for the losses incurred when the stock price went back down. The economic consulting firm NERA has reported a higher percentage of dismissals of securities fraud cases since the Court's 2005 decision.[36]

The Supreme Court took many additional steps to weaken shareholder rights, as will be explained below.

### Securities Litigation Uniform Standards Act of 1998 (SLUSA)

Congress did not stop with the PSLRA to weaken the legal rights of defrauded investors. In 1998, businesses lobbied to have all securities class actions brought under state fraud laws thrown out of state courts. This legislation, the Securities Litigation Uniform Standards Act of 1998 (SLUSA), provides that class actions based on state law fraud in relation to the purchase or sale of stock may no longer be brought in state court.[37] By the time of the SLUSA, President Clinton, who had half-heartedly vetoed the PSLRA, changed his position altogether and signed the bill into law.

There is overwhelming evidence that corporate fraud immediately increased after passage of the PSLRA and SLUSA. On December 18, 2001, leading securities law professor John Coffee testified before the Senate Commerce Committee that the PSLRA and SLUSA created a climate where fraud could flourish.[38] And indeed it did, from the massive accounting frauds of the Enron era to the financial crisis of the last two years.

For example:

> ***In Re: 2007 Novastar Financial, Inc.***[39] The court in this case dismissed plaintiffs' securities fraud complaint against Novastar Financial, Inc. The opinion described a lengthy complaint detailing many bad business decisions, mismanagement and even a "minimal inference of fraudulent intent." However, the court found that mismanagement and poor business does not rise to the level of fraud and any gleaning of fraudulent behavior in the complaint is not sufficient to pass PSLRA's heightened pleading requirements. The court did not offer plaintiffs the opportunity to amend their complaint.
>
> ***Atlas v. Accredited Home Lenders Holding Co.***[40] This consolidated class action was brought by shareholders of the mortgage banking company Accredited and its subsidiary, REIT. Accredited specialized in subprime mortgages and plaintiffs charged that the company, its directors and subsidiaries made false and misleading statements meant to artificially inflate its stock price, which eventually plummeted. Some of the misleading statements implied that Accredited focused on credit quality and even performed more underwriting than its competitors and manipulated earnings and reserves statements.[41] The court found that plaintiffs stated a sufficient claim against Accredited and some of its officers but dismissed claims against the remaining officers and REIT.[42] Those claims were dismissed for failure to state with particularity the fraud, its materiality and the knowledge of the fraud on behalf of some officers and the subsidiary company.

## Class Action Fairness Act of 2005 (CAFA)

Securities class actions have dropped, especially since the 2005 enactment of the so-called Class Action Fairness Act of 2005 (CAFA), which limited the rights of all class action plaintiffs. Class actions allow citizens to aggregate small claims that otherwise might not warrant individual litigation. Consequently, plaintiffs often use class actions to gain access to the courts in cases where a defendant may have gained a substantial benefit through small injuries to a large number of people.[43]

According to a 2007 report by the Stanford Law School Securities Class Action Clearinghouse, a joint project between Stanford Law School and Cornerstone Research, "The number of securities fraud class actions filed in 2006 was the lowest ever recorded in a calendar year since the adoption of the Private Securities Litigation Reform Act (PSLRA) of 1995 … . The study reports securities fraud class actions decreased by 38 percent since 2005, plunging from 178 filings to just 110, making [2006] numbers nearly 43 percent lower than the ten-year historical average of 193."[44]

That trend continued, even in the midst of the financial collapse due to fraud within the industry. Some new litigation stems from the fact that financial institutions have recorded "massive losses" due to the subprime mortgage crisis. But some contend that litigation based on fraud may not survive, since "unlike the accounting scandals that dominated securities litigation earlier in this decade … the subprime crisis has not easily lent itself to allegation of fraud, mainly because the assets that are at the heart of these cases tend to be complex and difficult to value."[45] This also makes these cases vulnerable to dismissal under the PSLRA "for failure to allege facts sufficient to infer defendants' fraudulent intent or failure to allege causation" as required by that law.[46]

The most recent statistics on class action securities litigation show a 24 percent decline in class action securities filings as of December 2009 compared to the same period in 2008, with only Ponzi scheme litigation showing growth in 2009 due to the Madoff scandal.[47]

## Additional Supreme Court Rulings and Congress's Failure to Fix Them

When Congress was debating the PSLRA, it discussed reversing or modifying two U.S. Supreme Court decisions that had substantially weakened consumer protections in the financial markets. In both instances, Congress balked.

***Lampf, Pleva, Lipkind et al. v. Gilberson.***[48] In 1991, the Supreme Court drastically and retroactively limited the statute of limitations for securities cases. After *Lampf, Pleva*, a shareholder may only bring a fraud action within one year of learning of the fraud and within three years of the fraudulent action. If a shareholder learns of the fraudulent action after three years, the shareholder cannot bring a lawsuit.

Notably, the Court recently agreed to hear another case involving the statute of limitations in these types of lawsuits, revisiting its *Lampf, Pleva* ruling. In the pending case, *Merck & Co. Inc. v. Reynolds*, the question before the Court is whether the statute of limitations begins to run when the investor is alerted to the possibility of fraud or rather the probability of fraud.[49] This case was argued in November 2009 and a decision is expected in the 2009-2010 Term.

***Central Bank of Denver, N.A. v. Interstate Bank of Denver, N.A.***[50] Perhaps even more significantly, in 1994, the Court ruled that shareholders could not sue aiders and abettors to corporate fraud. In 2009, U.S. Senator Arlen Specter (D-PA) called *Central Bank* an "errant" decision.[51] Before that ruling, he noted, "[E]very circuit of the Federal Court of Appeals had concluded that Section 10(b)'s private right of action allowed recovery not only against the person who directly undertook a fraudulent act … but also anyone who aided and abetted him."[52] He explained that, during the PSLRA debate, "then-SEC chairman Arthur Levitt and others urged Congress to overturn *Central Bank*. Congress declined to do so." And massive frauds followed (Enron, Refco, Tyco, WorldCom, etc.), showing that "auditors, bankers, business affiliates, and lawyers … all too often actively participate in and enable the issuer's fraud." He also noted, "Enforcement actions by the SEC have proved to be no substitute for suits by private plaintiffs."[53]

The U.S. Supreme Court continued to make matters worse for investors. *Central Bank* "had at least held open the possibility that secondary actors who themselves undertake fraudulent activities prescribed by Section 10(b)" could be held liable.[54] That changed in the case of *Stoneridge Investment Partners v. Scientific-Atlanta, Inc. et al.*, decided in 2007.[55] *Stoneridge* examined whether investment banks, lawyers, accountants, credit rating bureaus or other so-called "secondary actors" who knowingly helped a public company deceive investors could be liable for the fraud if they had not made a material misrepresentations to shareholders. The Court held, in a 5-3 decision, that indeed they could not be held liable. The decision broke with SEC precedent, members of Congress from both parties and the views of 33 state attorneys general. In fact, a coalition of 27 state attorneys general had written a friend of the court brief in support of liability that said the following:

> The view that those crafty enough to benefit from participating in a securities fraud while carefully avoiding the public attribution of a false statement to them can escape liability directly conflicts with the broad language and purposes of the antifraud provisions. Indeed one could argue that it is precisely with respect to such a scheme that the anti-fraud provisions are needed the most.[56]

The Court's opinion in *Stoneridge* was a direct blow to American investors, essentially confirming that banks, accountants, law firms and other institutions that intentionally commit fraud were not liable to investors. This seriously compromised the integrity of American markets and denied investors the opportunity to seek recovery from those who orchestrated the fraud. Victims of Enron's massive fraud were directly hurt by *Stoneridge*, which immunized investment banks complicit in the scheme.[57]

At least one federal judge has already criticized *Stoneridge* and called on Congress to overrule the Supreme Court's decision.[58] In a March 2009 ruling, Judge Gerald Lynch (S.D.N.Y.) said:

> It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. …This [law] may be ripe for legislative re-examination. …[A] bright line between principles and accomplices may not be appropriate."[59]

The fact remains that shareholders have very little recourse for their losses, losses that are the direct result of illegal behavior on the part of a corporation, its individual directors and other corporate partners.

## WALL STREET UNACCOUNTABLE FOR ENCOURAGING PREDATORY LENDING; HOMEBUYERS OUT IN THE COLD

Investors are not the only ones having a difficult time recovering losses due to massive Wall Street mismanagement and fraud. Victims of predatory mortgage loans that led to the subprime mortgage crisis have been largely left out in the cold due to certain decisions by Congress, the Clinton and Bush Administrations and the U.S. Supreme

Court. Moreover, had the law been different from the start, many believe the subprime mortgage crisis would have been avoided, leaving us in a very different situation from the one we face today.

The subprime mortgage crisis essentially occurred when banks and lenders lent hundreds of billions of dollars in home loans with terms that made them incredibly risky. Many of these loans would be characterized as predatory mortgage loans, when a lender or bank "takes advantage of unsophisticated borrowers and gives them bad loan rates or terms … such as high fees and charges associated with the loan; low teaser interest rates, which skyrocket after an initial grace period; and negative amortization loans, which require, for a time, monthly payments less than the interest due."[60] Wall Street bought up these loans, encouraging this reckless lending behavior. More specifically, "the rapid and extensive transfer of subprime loans, including abuse predatory loans … was central to the rapid proliferation of subprime lending."[61]

Where the transaction is found to involve illegal actions or abusive terms, borrowers should be able to pursue legal claims against anyone in possession of a piece of their loan — from the original lender who sold it to them to whatever Wall Street investment bank (*i.e.*, "assignee") purchased it. But while the commercial banks and original lenders can be on the hook for predatory lending, Wall Street firms that pressured lenders to make these risky loans are not and they knew it at the time. This fact "relieved them of any duty to investigate the terms of the loans."[62] Specifically, these Wall Street firms

> were often directly involved in enabling predatory lending by mortgage brokers and were well aware of the widespread abuses in the subprime market. "Brokers wouldn't even exist without wholesalers, and wholesalers wouldn't be able to fund loans unless Wall Street was buying," explain reporters Paul Muolo and Mathew Padilla, authors of *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis*. "It wasn't the loan broker's job to approve the customer's application and check all the financial information; that was the wholesaler's job, or at least it was supposed to be. Brokers didn't design the loans, either. The wholesalers and Wall Street did that. If Wall Street wouldn't buy, then there would be no loan to fund.[63]

In 1994, Congress passed the Home Ownership and Equity Protection Act to end certain predatory practices. While the law included an "assignee liability" provision, the law applied to just a tiny portion of high-priced loans and did not adequately address the myriad of deceptive strategies that loan originators would utilize in later years. In the meantime, Wall Street went on an unprecedented buying frenzy — increasing its acquisitions of subprime mortgages as much as eightfold from 2001 to 2006. These mortgage-backed securities grew significantly over the past decade, in part because it insulated investors from liability.[64]

In 2002, there was a movement in some states to pass anti-predatory lending laws that contained assignee liability provisions. Those provisions held financiers liable for the mortgages they were buying and selling, and consequently liable for any predatory or fraudulent actions associated with those mortgages. However, they were aggressively fought by the Clinton Administration and later by the Bush-controlled Office of the

Comptroller of the Currency, which insulated federally chartered banks from state anti-predatory laws as part of a larger Bush White House agenda to preempt state consumer protection laws.[65]

In 2007, the U.S. Supreme Court again made matters worse through its ruling in *Waters v. Wachovia Bank*.[66] The case involved Michigan regulators who wanted to continue overseeing a Wachovia-owned mortgage business that had recently become a wholly-owned subsidiary of the nationally chartered bank, Wachovia. The parent bank sued, arguing that "states are not at liberty to obstruct, impair, or condition the exercise of national bank powers, including those powers exercised through an operating subsidiary." The Court agreed. The effect of that decision, however, is that bank-owned mortgage lenders are no longer subject to the more rigorous state licensing and consumer protection laws in the mortgage provider arena. In his dissent, Justice John Paul Stevens lamented that it was "especially troubling that the court so blithely preempt[ed] Michigan laws designed to protect consumers."[67] Travis B. Plunkett, Legislative Director at the Consumer Federation of America, agreed, saying the decision "encourages national banks and their subsidiaries to ignore even the most reasonable of state consumer laws."[68]

Many experts agree that assignee liability, especially applied to mortgage-backed securities, would have gone far to weaken industry excess and the resulting damage now unfolding. In fact, a recent study by the UNC Center for Community Capital found that after the 2004 preemption of state anti-predatory lending laws, national banks swooped into those states and made riskier loans than the state banks were able to make since they remained constrained by state laws.[69] According to the Center for Responsible Lending, "There was a lot of legal talent hired by the industry to try to figure out ways to make sure that nobody along the chain (including Wall Street) had to suffer legal accountability."[70] In recent years, there has been a renewed push to create assignee liability for these financial markets, but even in the current climate the financial industry continues to lobby heavily against such liability.

## NECESSARY "RE-REGULATION"

Given the most recent financial collapse, scholars and economists have loudly called for re-regulation of the capital markets. Many of these solutions emphasize the importance of the ability to hold corrupt CEOs and underwriters legally responsible for their actions.[71] Top priorities are addressing the hindrances posed by the PSLRA and the Supreme Court decisions in *Central Bank* and *Stoneridge*. The Obama Administration responded with its proposal of the Consumer Financial Protection Agency.[72] U.S. Senator Christopher Dodd (D-CT) and other Senate Democrats have sponsored the Restoring American Financial Stability Act of 2009, which expands the Consumer Financial Protection Agency to include other reforms, like overruling the aiding and abetting loophole upheld by the Supreme Court in *Central Bank* and *Stoneridge*.[73]

The design and structure of the agency and any attendant overhauls are still being hammered out in Congress, but one promising addition is the ability of state attorneys general to enforce new federal laws, as well as the restoration of federal laws as a floor, with states free to legislate more consumer-friendly laws.[74] The proposed legislation also grants authority to a new agency to write and enforce new rules for the financial industry and its dealings with consumers. The authorizing statute explicitly gives the agency the power to restrict or abolish the use of mandatory arbitration clauses in consumer lending documents.[75] Also important is the legislation's whistleblower protection clause.

Consumer advocates support the creation of a new agency, but many advocates hope that it will go even further and clearly specify a consumer's ability to go to court when wronged by the financial industry.[76] According to David Arkush, Director of Public Citizen's Congress Watch, "If the president and Congress are serious about ensuring that the new laws are enforced, they should give consumers the ability to enforce their own rights in court — not depend on government regulators to protect them."[77]

The details of how the new agency will address liability and accountability have yet to be decided, but the change appears to be one in the right direction. As long as Congress follows through on creation of an agency with actual strength, this could be a very important step toward reigning in the rampant fraudulent and criminal behavior on Wall Street. Giving shareholders and borrowers access to court to be compensated for monetary losses that were the direct result of fraudulent acts by a corporation would serve as an important deterrent on such companies.[78]

# NOTES

[1] William Black, "The Two Documents Everyone Should Read to Better Understand the Crisis," *Huffington Post*, February 25, 2009, found at http://www.huffingtonpost.com/william-k-black/the-two-documents-everyon_b_169813.html.

[2] André Douglas Pond Cummings, "'Ain't No Glory in Pain': How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets," 83 *Neb. L. Rev*. 979, 1009 note 135 (2005)(quoting Steven A. Ramirez, "Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous," 40 *Wm. & Mary L. Rev*. 1055, 1059-60 (1999).

[3] Abner J. Mikva, "Share and Shares Alike: Now let's fix the 'reform' of securities laws," *Legal Times*, April 8, 2002.

[4] Robert Weissman and James Donahue, "Wall Street's Best Investment: Ten Deregulatory Steps to Financial Meltdown," *Multinational Monitor* (January/February 2009), found at http://www.multinationalmonitor.org/mm2009/012009/weissman.html.

[5] 17 C.F.R. § 240.10b-5.

[6] André Douglas Pond Cummings, "'Ain't No Glory in Pain': How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets," 83 *Neb. L. Rev*. 979, 1065-6, notes 407, 408, 409, citing Rafael La Porta et al., "What Works in Securities Laws?," National Bureau of Economics Research Working Papers Series, Working Paper No. 9882 (July 2003) ("We examine the effect of securities laws on stock market development in 49 countries. We find almost no evidence that public enforcement benefits stock markets, and strong evidence that laws facilitating private enforcement through disclosure and liability rules benefit stock markets."), found at http://www.nber.org/papers/w9882.

[7] André Douglas Pond Cummings, "'Ain't No Glory in Pain': How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets," 83 *Neb. L. Rev*. 979, 984 (2005).

[8] Robert Weissman and James Donahue, "Wall Street's Best Investment: Ten Deregulatory Steps to Financial Meltdown," *Multinational Monitor* (January/February 2009), found at http://www.multinationalmonitor.org/mm2009/012009/weissman.html.

[9] *Id*. ("As Warren Buffett warned in 2003, financial derivatives represent 'weapons of mass financial destruction' because 'large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers' so that 'the troubles of one could quickly infect the others' and 'trigger serious systemic problems.'")

[10] Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002.

[11] American Association for Justice, "Behind the Bailout: How U.S. Chamber Created the 2008 Financial Crisis" (2009).

[12] Brian Sommer, "The PSLRA Decade of Decadence: Improving Balance in the Private Securities Litigation Arena with a Screening Panel Approach," 44 *Washburn L. J.* 413, note 8 (2005) ("When asked about lobbyists' influence on Capital Hill, Former SEC Chairman Arthur Levitt stated, 'It's almost impossible to compete with the effect that money has on these congressmen.' Jane Mayer, 'The Accountants' War,' *The New Yorker*, Apr. 22, 2002, at 64.")

[13] Robert Weissman and James Donahue, "Wall Street's Best Investment: Ten Deregulatory Steps to Financial Meltdown," *Multinational Monitor* (January/February 2009) found at http://www.multinationalmonitor.org/mm2009/012009/weissman.html.

[14] American Association for Justice, "Behind the Bailout: How U.S. Chamber Created the 2008 Financial Crisis" (2009).

[15] *Id*.

[16] *Id*.

[17] Robert Weissman and James Donahue, "Wall Street's Best Investment: Ten Deregulatory Steps to Financial Meltdown," *Multinational Monitor* (January/February 2009), found at http://www.multinationalmonitor.org/mm2009/012009/weissman.html.

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[21] Abner J. Mikva, "Share and Shares Alike: Now let's fix the 'reform' of securities laws," *Legal Times*, April 8, 2002.

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[24] "Message to the House of Representatives Returning Without Approval the Private Securities Litigation Reform Act of 2005," December 19, 1995, found at http://ftp.resource.org/gpo.gov/papers/1995/1995_vol2_1912.pdf.

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[26] Kurt Eichenwald and Simon Romero, "Plea Deals Are Seen for 3 WorldCom Executives," *New York Times*, August 29, 2002, found at http://www.nytimes.com/2002/08/29/business/plea-deals-are-seen-for-3-worldcom-executives.html.

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[32] *Id*.

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[42] *Id*. at *15-16.

[43] Public Citizen Fact Sheets, found at http://www.citizen.org/congress/civjus/classaction/factshts/s353fact.htm.

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[45] James C. Dugan, "A Primer on Securities Litigation and Enforcement in an Economic Crisis," *Securities Litigation and the Economic Crisis Leading Lawyers on Understanding the Current Legal Environment, Developing Litigation Best Practices, and Helping Clients Respond to a Changing Marketplace (Inside the Minds)*, Thomson Reuters/Aspatore (2009).

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[49] *Merck & Co., et al., v. Reynolds, et al.* (08-905), *cert. granted* May 26, 2009.

[50] 511 U.S. 164 (1994).

[51] Statement by U.S. Senator Arlen Specter on Introduced Bills and Joint Resolutions, *Congressional Record*, July 30, 2009, p. S8564.

[52] *Id*.

[53] *Id*.

[54] *Id*. at S8565.

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[62] *Id*.

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