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FINANCIAL FRAUD
Cleaning Up the Financial Crisis of 2008: Prosecutorial Discretion or Prosecutorial Abdication?

By Bradley T. Borden & David J. Reiss

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When finance professionals play fast and loose, big problems result. Indeed, the 2008 Financial Crisis resulted from people in the real estate finance industry ignoring underwriting criteria for mortgages and structural finance products. That malfeasance filled the financial markets with mortgage-backed securities (MBS) that were worth a small fraction of the amount issuers represented to investors. It also loaded borrowers with liabilities that they never had a chance to satisfy.

Despite all the wrongdoing that caused the financial crisis, prosecutors have been slow to bring charges against individuals who originated bad loans, pooled bad mortgages, and sold bad MBS. Unfortunately, the lack of individual prosecutions signals to participants of the financial industry that wrongdoing not only will go unpunished but will likely even be rewarded financially. Without criminal liability, we risk a repeat of the type of conduct that brought us to the edge of financial ruin.

The Bill of Particulars Is Mounting

There is ample evidence of Wall Street's extensive and critically damaging wrongdoing. Documents such as *The Financial Crisis Inquiry Report* have documented wrongdoing in the aggregate.[1] Recently filed civil lawsuits against financial institutions highlight wrongdoing by the organizations themselves, but they also provide glimpses of wrongdoing by individuals that was illegal and warrants prosecution. REFinblog.com, a website edited by the authors and written by Brooklyn Law School students and the authors, is tracking these cases.

One of the settlements relating to the robo-signing scandal provides some of the clearest evidence of wrongdoing by individuals. While the defendant, LPS, did not admit "any violation of law," there are some interesting admissions.[2] They include the fact that some mortgage loan documents executed by employees of LPS subsidiaries contain "unauthorized signatures, improper notarizations, or attestations of facts not personally known to or verified by the affiant" and some may contain "inaccurate information relating to the identity, location, or legal authority of the signatory, assignee, or beneficiary or to the effective date of the assignment."[3] LPS subsidiaries also "recorded or caused to be recorded Mortgage Loan Documents with these defects in local land records offices or executed or facilitated execution on behalf of the Servicers knowing some of these Mortgage Loan Documents would be filed in state courts or used to comply with statutory, non-judicial foreclosure processes."[4] And employees of LPS subsidiaries signed mortgage loan documents in the name of other employees. Sounds like "violations of law" to us. Only one person pleaded guilty for her role in this racket.

Lawsuits against rating agencies provide some of the most colorful evidence of wrongdoing by individuals. The litigation in this area is international. For example, the Federal Court in Australia has held Standard & Poor's liable for

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[1] Available at http://fcic.law.stanford.edu/report.

[2] Executed Consent Final Judgment between Michigan and various Lender Processing Services entities, at p. 2, available at https://docs.google.com/file/d/0BxUYhg0cYUOTbUUwd0Z 6ekVDWnc/edit.

[3] Id. at p. 5.

[4] Id.

misrepresentations it made in ratings of structured financial products.[5] Similar litigation will likely spread to other countries.[6] Domestically, the Department of Justice and the state of California (among others) have filed lawsuits against Standard & Poor's, claiming it made material misrepresentations about its rating processes for MBS.[7] Some of the allegations in these complaints are shocking.

According to the Department of Justice's complaint, S&P executives "suppressed development of new, more accurate rating models that would have produced fewer AAA ratings—and therefore lower profits and market share."[8] A senior managing director at S&P later said, "I knew it was wrong at the time."[9] Senior S&P executives allegedly stated that its rating models were "massaged" using "magic numbers" and "guesses."[10] Why would S&P do this? According to one executive quoted in the complaint, "The revenue potential was too large."[11]

Because investor cases are just wending their way through the courts, there have not yet been many findings of fact about wrongdoing arising from the Housing Boom of the early 2000s. But they are beginning to appear. In a denial of a motion to dismiss, Judge Jed S. Rakoff (S.D.N.Y.) wrote, "The confidential witness statements incorporated into the Amended Complaint, combined with the documentary sources, support a strong inference that the [Bear Stearns] defendants knew that the mortgages included within the loan pools were not of the quality represented in the offering documents."[12] These are the same types of claims that New York Attorney General Eric T. Schneiderman makes in lawsuits filed against JPMorgan Securities and Credit Suisse Securities for wrongdoing related to securitizing mortgages.[13]

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[5] See *Bathurst Regional Council v. Local Government Financial Services Pty Ltd*, (No. 5) [2012] FCA 1200 (Nov. 5, 2012).

[6] See, e.g., Bridgette Haar, *Civil Liability of Credit Rating Agencies—Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence*, University of Oslo Faculty of Law Research Paper No. 2013-02, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2198293 (Jan. 9, 2013) (discussing the liability exposure of rating agencies in other countries).

[7] See Complaint for Treble Damages, Civil Penalties and Permanent Injunction for Violation of the California False Claims Act, Unfair Competition Law, and False Advertising Law, *California v. The McGraw-Hill Companies Inc.*, No. CGC-13-528491 (San Francisco County Feb. 5, 2013); Complaint for Civil Money Penalties and Demand for Jury Trial, *United States v. McGraw-Hill Companies Inc.*, No. CV13-00779 (C.D. Cal. Feb. 4, 2013).

[8] Complaint, *United States v. McGraw-Hill Companies Inc. and Standard & Poor's Financial Services LLC*, at p. 3, available at http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Notizie/2013/02/ricorso-Standard-Poor.pdf?uuid=eb65cbca-6fb0-11e2-b836-41317ffddf4b.

[9] Id.

[10] Id.

[11] Id. at 4.

[12] Memorandum, *Dexia SA/NV et al. v. Bear Stearns & Co. Inc. et al.*, at p. 17 (1:12-cv-04761) (S.D.N.Y. Feb. 27, 2013).

[13] See Complaint, *New York v. J.P. Morgan Securities LLC*, No. 451556/2012 (County of New York Oct. 10, 2012). The claims in this case relate to actions by Bear Stearns entities that JPMorgan acquired in 2008. Mr. Schneiderman has brought a similar suit against Credit Suisse. See Complaint, *New York v. Credit Suisse Securities (USA) LLC*, No. 451802/2012 (County of New York Nov. 20, 2012).

Recently filed suits by investors also allege disturbing actions that may have criminal implications. Labaton Sucharow, a leading securities fraud firm, has filed dozens of lawsuits on behalf of MBS investors against MBS sponsors.[14] Those lawsuits claim that the MBS sponsors made material misrepresentations. For instance, the alleged misrepresentations include claims about the occupancy rates of homes secured by mortgages held by MBS trusts. Despite representations in the MBS offering materials regarding owner-occupancy rates, the complaint reviews studies showing that owner-occupancy was much lower than represented. Studies also show that in the overwhelming majority of cases, the originator and MBS sponsor did not properly transfer mortgage notes to the MBS trust. Furthermore, despite many uncertainties regarding the tax status of the MBS trusts, the offering materials provided that trusts "will" qualify for REMIC tax status—"will" is the highest level of tax certainty available for tax opinions, suggesting a 90-95 percent certainty of the position.[15] If these misrepresentations are proved, they could have implications for various criminal fraud statutes.

Greed Is Legal, But …

Statutes of limitations will soon bar nearly all remaining claims arising from the MBS mess. We, along with many others, wonder why so few of the individuals who profited from packaging and selling horrible MBS have faced criminal charges.

Prosecutors have various reasons to exercise their discretion not to prosecute. The evidence resulting from the criminal investigation may not be enough to support the charges. Or the evidence may be sufficient to indict but unlikely to result in a conviction. Or the prosecutor may not have the resources to conduct a thorough investigation nor the resources to effectively prosecute the case. While the first two reasons are legitimate reasons to abstain from prosecuting a case, the last one may, in certain circumstances, amount to an abdication of the prosecutor's role in the criminal justice system. We review below some of the reasons that prosecutors may not have pursued cases arising from the Financial Crisis in particular.

One depressing, but legitimate, reason for prosecutorial abstention is that a surprising amount of bad behavior is still legal. In the lead-up to the Financial Crisis, lenders, for instance, often took steps to ensure that their loans complied with relevant statutes such as the Truth in Lending Act. Unfortunately, the relevant consumer protection statutes and regulations were often out of date. As a result, lenders had wiggle room and could make loans that were clearly inappropriate for millions of people but that complied with the letter of the law. Going forward, at least, the newly created Consumer Financial Protection Bureau has begun to issue new rules to better regulate the consumer credit markets.

Another, almost counterintuitive, reason to choose not to prosecute is that the parties to these sophisticated contracts anticipated a lot of bad behavior. The litigation brought by mortgage insurers like Syncora against Wall Street firms such as Bear Stearns subsidiary EMC provides a great example.[16] Syncora claims that EMC enticed it to provide insurance on many fraudulent mortgages, but the agreement between the parties says Syncora's only remedy is to return the mortgages to EMC. EMC employees would argue that they did not commit fraud by entering into the insurance contract; they merely sought to allocate risk.

A third reason is that much of the bad behavior may have been driven by greed, not criminal intent. Michael Lewis's book *The Big Short* illustrates that greed in detail.[17] Some Wall Street executives and managers saw their bonuses go

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[14] See, for example, Consolidated Complaint, *HSH Nordbank AG v. Barclays Bank PLC*, No. 652678/2011 (N.Y. Sup. Ct. Apr. 2, 2012).

[15] See Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301, 327 (Winter 2011).

[16] See Gretchen Morgenson, *JPMorgan Unit Is Sued Over Mortgage Securities Pools*, N.Y. TIMES (Oct. 1, 2012), available at http://www.nytimes.com/2012/10/02/business/suit-accuses-jpmorgan-unit-of-broad-misconduct-on-mortgage-securities.html?_r=1&.

[17] See Michael Lewis, *The Big Short: Inside the Doomsday Machine* (2011).

from six figures to eight figures during the Boom because they took advantage of uninformed investors who relied upon rating agencies and offering documents to make investment decisions. Greed in itself is not criminal. Juries seem to have seen things this way too, at least with respect to two Bear Stearns MBS hedge fund managers whom the jury acquitted.[18] That acquittal may have been taken as a harbinger of prosecutions to come in document-heavy cases of financial wrongdoing, and it may be supporting evidence that prosecutors believe that they are unable to make a case against individuals. Indeed, the outgoing Assistant Attorney General in charge of the Criminal Division, Lanny Breuer, seemed to see it that way: "I understand and share the public's outrage about the financial crisis. Of course we want to make these cases. … If there had been a case to make, we would have brought it. I would have wanted nothing more, but it doesn't work that way."[19]

A fourth reason is that proving the guilt of individuals for their work within a corporation presents its own set of challenges. A corporation can be charged on the basis of its "collective knowledge" to keep companies from slicing and dicing a criminal enterprise into noncriminal components. An employee, on the other hand, cannot be criminally charged on the basis of the knowledge of his or her colleagues.[20] That is, an individual cannot be found guilty unless he or she had the requisite mens rea whereas the corporation can be found guilty if the requisite mens rea was found among all its employees, a bit here and a bit there. The end result is that there is effectively a much higher burden to prove the guilt of the individual employee than that of the corporation itself.

This leads to the final and perhaps most important potential reason for prosecutorial abstention. Large-scale financial crimes are very difficult to prove in the absence of a smoking gun or an informant. Each investigation requires extraordinary manpower to sift through hundreds of thousands of documents. Intent can be very hard to prove. For every email that describes a pool of mortgages as a "sack of shit"[21] there are another 50 that discuss how well the market had done historically and how the firms' complex computer models indicated that the pool would perform well, based upon the past performance of similar products. And most prosecutors, even those in the biggest and most elite offices, face technical and training challenges in putting together an effective investigation. A securities fraud case based on even a single mortgage-backed security can involve thousands of mortgages originated by many different lenders. Numerous hands touch those files at origination as well as during the securitization process. On top of that, many of the key documents are missing, or at least their chain of custody is uncertain. The net result is that building such a case can be exponentially harder than building even a complex insider trading case. This is particularly true because many prosecutor offices do not have the sophisticated software (Excel is not enough!) to track all the relevant data or the training (forensic accounting skills for instance) to do an effective job.

Prosecutors may realize that they can indict in such cases but may have a hard time convicting, as with the Bear Stearns hedge fund executives. Prosecutors may also be considering their other serious priorities in making these decisions (even though it is difficult to imagine many things more important than the world economy). They may believe that civil lawsuits, with their lower burden of proof, provide sufficient justice. They may also believe that regulators like the SEC and the IRS are in a better position to investigate and respond to these complex financial disasters. These all may appear to be good, measured reasons not to pursue criminal charges against individuals, but the lack of convictions still chafes. To the extent that a lack of resources is the reason for no meaningful prosecutions, prosecutors should consider reallocating resources to cover this complex field that is so fundamental to our country's economy and national security.

While the complexity of the transactions that led to the Financial Crisis is almost beyond comprehension, there is also a simplicity behind what went wrong that should guide investigations. A basic definition of fraud would appear to

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[18] See Tom Hays, *Ralph Cioffi, Matthew Tannin Verdict: Ex-Bear Stearns Hedge Fund Managers NOT GUILTY on All Fraud Charges*, THE HUFFINGTON POST (Nov. 10, 2009), available at http://www.huffingtonpost.com/2009/11/10/ralph-cioffi-matthew-tann_n_352720.html.

[19] Ben Protess, *Breuer Reflects on Prosecutions that Were, and Weren't*, N.Y. TIMES DEALBOOK (Feb. 28, 2013), available at http://dealbook.nytimes.com/2013/02/28/breuer-reflects-on-prosecutions-that-were-and-werent/.

[20] *United States v. Bank of New England*, 821 F.2d 844, 855 (1st Cir. 1987).

[21] See *New York v. J.P. Morgan Securities LLC*, supra note 13 at p. 11.

apply to much of the wrongful behavior. Some individuals had to know (if they did not have actual knowledge, their lack of knowledge would appear to be reckless) that the information in offering materials was inaccurate, that investors would rely upon the information, and that the investors would suffer harm. They presented the incorrect information, and harm resulted.

The Fight For Justice Is Not Easy

For every million underwater homeowners, there is also someone like Dick Fuld, Lehman Brothers' CEO during its worst excesses in the mortgage markets. He suffered to some extent from the failure of his firm, as he lost his equity when it went under. But he also earned a half-billion dollars in compensation during his time there.[22] That provides a troubling coda to our modern morality tale. There are many others who were well (if not *that* well) compensated during the Boom. The evidence is out there that some of them know that "it was wrong at the time."

> Prosecutors' lack of action against more of the individuals within the organizations that sold bad mortgage instruments and who oversaw the machinery that produced millions of terrible mortgages is discomfiting. Indeed, by exercising their discretion to abstain from prosecution, it appears as if federal prosecutors have abdicated each and every one of their stated roles as it relates to the Crisis: To enforce the law and defend the interests of the United States according to the law; to ensure public safety against threats foreign and domestic; to provide federal leadership in preventing and controlling crime; to seek just punishment for those guilty of unlawful behavior; and to ensure fair and impartial administration of justice for all Americans.[23]

The financial service industry almost sent the global economy into a death spiral. Its participants should account for their roles in that destructive pursuit. If prosecutors continue to refuse to proceed on general criminal charges, the IRS should move forward with criminal investigations for representations parties made with respect to arrangements that could not qualify for claimed tax treatment. Lawmakers should also consider changing laws, as needed, to facilitate prosecution of financial wrongdoers.

Our laws should encourage managers on Wall Street to scrutinize their decisions before acting and understand that the pursuit of short-term profits have long-term consequences for all of society. Successful prosecutions of individuals who created the Financial Crisis would help deter future wrongdoing, and prosecutors should allocate resources as needed to help with such deterrence. We applaud prosecutors for filing civil lawsuits against institutions, but if they do not take actions against individuals, individual actions will, no doubt, lead to another boom and bust when greed and bad behavior once again overwhelm a well-ordered market.

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[22] See *25 People to Blame for the Financial Crisis*, TIME LISTS, available at http://www.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877326,00.html.

[23] Department of Justice website, http://www.justice.gov/about/about.html.