

Legal Tsunami Is Coming, Batten Down the Experts

By Robert Ambrogi

What did they know and when did they know it? That is the question likely to be asked of lenders, borrowers, investors and insurers in courtrooms across the country as lawyers and litigants try to untangle the roots of the financial crisis that has undermined the economy and unsettled the nation.

The times may be uncertain, but the forecast is clear: a tsunami of litigation is headed our way, and at its center will be the finance and economics experts who will prove critical to establishing liability or mounting a defense.

As James J. Angel, associate professor of finance at the McDonough School of Business at Georgetown University puts it: "When there's a trillion-dollar hole in the economy, there will be a lot of litigation."

Shareholder lawsuits are likely to make up much of the litigation, but there will be plenty of lawyering to go around. A major unknown is the possible extent of litigation over credit default swaps, an obscure but significant market estimated to be twice the size of the U.S. stock market. Also in the mix will be any number of cases implicating everything from employment law to bankruptcy.

Through it all, expert witnesses will play two key roles, says Angel, a financial expert whose work focuses on the operation of markets in the United States and abroad. One will be to explain the transactions in terms juries can understand. The other will be to study and dissect the transactions and the documents underlying them.

That latter role, he adds, could well involve equal parts professional analysis and detective work. As a simple example, he points to a hypothetical offering of mortgage-backed securities. Based on the prospectus, the offering probably looked solid. But as an expert drills down into the loan documents, it becomes apparent that these were all 80/20 mortgages with no equity to fall back on.

Going Back to the Future

While documents, alone, may provide the smoking gun in some cases, they may be insufficient to prove allegations of bad faith or misrepresentation. In these instances, the role of the economic expert might be to provide models that help explain the behavior of one party or another.

"Most people understood that subprime loans were risky," says Robert Van Order, adjunct professor of finance at the University of Michigan's Ross School of Business and former chief international economist at Freddie Mac. In the hindsight of litigation, the question may boil down to the parties' perception of the degree of risk as of the date of origination.

Consider it crystal-ball gazing in reverse. An economics expert would chart the economic data as it stood at some previous point in time and then model the risk as it could then be understood. "The question for the expert is, given the data that they

had going in, what would have been a sensible model of the credit risk," Van Order explains.

Another role for economic experts in subprime mortgage litigation is to chart patterns of behavior by individual lenders that might show a tendency for or against risky business. "One of the things you might want to look at is whether some lenders systematically were off in a way that suggested that someone there was improperly manipulating these loans," Van Order suggests.

Adding Focus to Hindsight

This question of who knew what when is likely to come up in any number of scenarios, as a recent employment case from California illustrates. It involved a subprime lender forced to layoff employees when its business came crashing down.

Under California law, an employer must provide its workers with 60 days notice before a major layoff. The law allows exemptions under certain circumstances, most notably if the cause of the layoff was unforeseen.

Anthony Yezer, a professor in the department of economics at George Washington University, served as an expert in the California case. His role was to provide an opinion on whether the business should have foreseen its sudden collapse.

"I think that, with various modifications, that will be an issue in a lot of litigation coming out of this crisis," Yezer says. "Who should have foreseen that a business model was no longer viable or that a set of securities would no longer perform as had been modeled?"

This will require economics experts to step backwards in time and then forecast forward from there, looking at various factors including securities pricing and pricing of credit guarantees. "Pricing is a good indicator of what informed participants thought the future value of the securities would be."

An economist might also look at what others in the industry were doing at the time and, given that information, assess whether the particular firm was behaving in a manner that was consistent with the norm.

"An economist would look for patterns of activity," Yezer says. "There are any number of practices that are consistent with a business that thinks its prospects are good or are not good."

In its simplest form, the expert's analysis is two-fold, says Yezer. "First, given what I would have known historically at any given date, what would I have forecast going forward? ... Second, look at overall behaviors. If I sell you something and retain it in my own portfolio, that's powerful evidence of whether I considered it sound."

A Range of Expertise

While economic and financial experts are likely to be most in demand for these cases, a broad range of expertise from various fields could eventually come into play. Consider the recent case of *Aon Financial Products Inc. v. Société Générale*, 476 F.3d 90 (2nd Cir. 2007).

This was an action to recover damages for breach of a \$10 million credit default swap agreement related to construction of a condominium complex in the Philippines. Aon asserted that a "credit event" requiring payment under the agreement occurred when an agency of the Philippines government defaulted on a surety bond it had issued to cover investments in the project.

Société Générale's defense hinged on its contention that the agency in question was legally distinct from the Philippines' sovereign government. To establish this, it presented the affidavit of an expert in Philippines law that the agency was considered a juridical entity distinct from the sovereign. In its decision siding with SG, the 2nd Circuit cited this expert evidence and noted that Aon did not contest it.

David M. Lindley, the lawyer who represented Société Générale, says that he considers the implications of foreign law as a matter of course in cases involving international agreements. But regardless of whether foreign law is implicated, his preparation almost always involves an expert in accounting or finance.

These are complicated cases, requiring experts who have skills in mathematics, computation and modeling and who can help prepare charts and other exhibits, says Lindley, a partner in the New York office of Pillsbury Winthrop Shaw Pittman LLP.

As this tsunami of new litigation crashes over us, and as lawyers and experts try to sort out the answers to the questions of who knew what and when they knew it, economics professor Yezer offers a note of caution about jumping to conclusions.

"We all make mistakes," he says. "Not everyone who is wrong is a crook or has committed fraud. If we take that position, no one will ever take risks."

*This article was originally published in **BullsEye**, a newsletter distributed by IMS ExpertServices, the premier [expert witness search](#) and services firm.*