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Managing Risks Arising From the Credit Crisis

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The current crisis in the credit markets is beginning to give rise to numerous regulatory investigations and private lawsuits involving issues similar to what we saw in the wake of Enron in December 2001. At the core of many of these investigations and disputes will be whether certain thinly traded securities, such as certain types of CDOs, were fairly valued, described, marketed and disclosed. Among other things, structured investment funds (or SIVs) and their counter-parties may be subjected to intense scrutiny both with respect to their past dealings and with respect to any future bail-outs. Four main areas of significant litigation and regulatory risk are summarized below.

(1) One set of legal disputes relate to how these thinly traded securities were valued, *i.e.*, whether the marks to market were justified. Valuation of securities by marking to market is a bit of a misnomer when it comes to thinly traded securities. In the absence of an active market, the marks are often derived by extrapolating the value of the security being valued from the price of a similar, more liquid security. The security being valued may be unique or illiquid, meaning that there is no useful market information for determining its value; in such cases the valuation must be derived from a mathematical model based on certain assumptions about the security's characteristics. Since valuation of many of these securities may be subjective and the transactions involving these securities tend to be negotiated, there may be significant room for litigation.

We expect both regulators and litigants to challenge valuations by, among other things, challenging:

- the extrapolation techniques by, for example, claiming that the reference securities were improperly selected;
- modeling, especially for models that are heavily reliant on the credit rating of the security issuer, rather than the unique characteristics of the security itself; and
- certain market transactions on which valuations are based, on the theory that these transactions were shams entered into for the sole purpose of creating support for a valuation.

(2) A second set of legal disputes relate to the timing of the valuations, focusing on whether portfolio managers and others delayed recognizing losses by, for instance, failing to change their valuations in light of adverse market information. Among other things, litigants and investigators may focus on whether portfolio managers and others:

- changed their valuation in response to favorable market news more quickly than in the face of unfavorable news;
- changed the model or the reference securities to avoid recognizing a loss; and
- substituted subjective judgment for objective market information because the market did not reflect a "longer view" or the like.

(3) A third set of issues will arise from the relationships between traders or portfolio managers and their customers. Among other

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things, the focus here will be on whether:

- customers were fully informed about the nature and the risks of individual securities or securities portfolios;
- customers had in fact agreed to purchase the securities in their accounts;
- traders parked troubled securities with customers by agreeing to re-purchase them at a guaranteed price to avoid taking a loss;
- traders re-purchased securities from favored clients at inflated prices in order to help clients avoid losses; and
- market participants engaged in transactions for the sole purpose of creating the appearance of an active market to support their marks.

(4) Finally, all of these issues impact earnings disclosures by public companies, such as banks and other large financial institutions, as well as earnings and valuation disclosures to investors of hedge funds or mutual funds. In this regard, it is safe to expect a panoply of securities fraud, books and records, and other related claims and investigations focusing on the timing and nature of disclosures of losses or expected losses. Significant attention will be on:

- whether earnings reported in past periods were inflated because the mark to market (or mark to model) valuations were too high historically; and
- how public companies and funds reacted to current market conditions, *i.e.*, whether public disclosure of losses was timely and comprehensive, given what management knew or should have known at the time.

To be prepared, financial institutions – and those who have dealt with them – must take a sober, comprehensive look at their portfolios, business practices and reporting procedures. Understanding the scope and nature of any potential problem, of course, puts one in the best position to address any litigation, governmental investigations, or to pursue claims.

The authors have significant experience with the issues identified in this Alert. Mr. Weissmann is the former Director of DOJ's Enron Task Force. Mr. Newkirk is the former Associate Director of the SEC's Division of Enforcement. Mr. Ziegler recently joined Jenner & Block from the 3M Company in St. Paul, Minnesota, where he served from 2003 – 2007 as Senior Vice President, Legal Affairs and General Counsel. Mr. Lipman worked on the Enron matter as a Branch Chief at the SEC's Division of Enforcement.

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