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The 2008 Bankruptcy of Literacy – A Legal Analysis of the Subprime Mortgage Fiasco (Part 2)

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D. Securitization Implications[1]

Mortgage securitization provided the cash that started lending to subprime borrowers, and subprime lending provided the cash that kept mortgage securitization going. By transferring default risks to Wall Street and then to the financial markets, mortgage securitization also changed the industry's business model. When loans transferred into pools were diversified not only by geography but also by creditworthiness of the borrowers, such transfers became even harder to parse. Structuring risk through securitization was supposed to make risk more manageable, by using senior/subordinate shifting of interest and excess spread/overcollateralization structures in one transaction, however, additional complexity was created.[2] For the person not directly involved in the respective transaction, the risks securitized became easily overlooked; a false sense of security was created.[3]

1. Self Interest

Mortgage securitization supported a decline in lending standards. By shifting the industry's business model,[4] securitization 'atomized' the loan process.[5] It created a chain of intermediaries,[6] running from broker, via mortgage lender and Wall Street, to investors.[7]

a. Loss of Responsibility

The effect was that (i) the chain-link making the credit decision was not connected to the chain-link bearing the default risk, and (ii) each intermediary-link could deny responsibility for the actions of the others.[8] Just as much as the desire for higher commissions,[9] this aspect of securitization explains why home loans to low-income borrowers became attractive to the industry.[10] Gary Gorton came to the following conclusion:[11]

"The design of subprime mortgages is unique in that they are linked to house price appreciation. The securitization of subprime mortgages is also unique. Because subprime mortgages are financed through a chain of securities and structures, investors could not easily determine the location and extent of the risk. Information was lost. The house price declines led to a fear of losses that could not be measured because the subprime risk had been spread around the globe opaquely. The available information was on the side of the market that produced the chain of structures; outside investors knew much less. The problem is that the magnitude of the structures, and their impenetrability by outsiders, was not completely understood; it was not common knowledge."

b. Originate-to-Distribute

Another aspect of mortgage securitization is its transformation of non-liquid assets into exchange traded securities. While in 1990, US$ 380 billion, in 1995, US$ 348 billion, and in 2000, US$ 684 billion of mortgage-backed securities were issued, such numbers skyrocketed to US$ 3.1 trillion in 2003, US$ 1.8 trillion in 2004, and US$ 2.0 trillion in 2005, 2006, and 2007, respectively.[12] Because mortgage-backed securities became so popular, at one point, home loans were not originated to provide financing to borrowers, they were originated to induce borrowers into financing (or refinancing) in order to create fees and assets for securitization pools.

From chain-link to chain-link, however, the pictorial, 'real' problems of the respective financed property, such as location and character of the home or creditworthiness of the borrower, disappeared behind a veil of letteral abstractions. Some therefore hold that this "originate-to-distribute" approach offers the best explanation for the subprime mortgage crisis:[13]

"The originate-to-distribute model . . . created some severe incentive problems, which are referred to as . . . agency problems, in which the agent (the originator of the loans) did not have the incentives to act fully in the interest of the principal (the ultimate holder of the loan). Originators had every incentive to maintain origination volume, because that would allow them to earn substantial fees, but they had weak incentives to maintain loan quality."[14]

c. Only Pieces of the Puzzle

The above listed reasons, however, should not be overstated. Home loan originators suffered from the subprime mortgage crisis along with the rest of the industry, as losses were suf-

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1 Eggert, *supra* note 36, at 534. *See also* Richard C. Jordan, *Will the Bubble Burst? Some Subprime Lessons for Mexico, Latin America's Leader in Asset Securitizations*, 42 INT'L LAW. 1179 (2008).

2 Gorton, *supra* note 33, at 24.

3 Some financial institutions had been trying to assess the fall out of the subprime mortgage crisis for over one year. *Cf. Riding out the subprime crisis*, THE ECONOMIST, Nov. 4, 2007.

4 See section above titled "Pyramid Scheme."

5 Kurt Eggert, referring to: *Subprime Mortgage Market Turmoil: Examining the Role of Securitzation Before the Subcomm. on Securities, Insurance, and Investments*, at 8 (Apr. 17, 2007) (statement of Michael Jacobides) *available at* http://banking.senate.gov/public/_files/eggert.pdf

6 *See generally* PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME, HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS (2008).

7 Eggert, *supra* note 118, at 8.

8 Eggert, *supra* note 36, at 552.

9 See section above titled "Pyramid Scheme."

10 Karl Gelles, *Why banks are Squeezing Credit Card Holders*, USA TODAY, Nov. 10, 2008, at A1.

11 Gorton, *supra* note 33, at 76.

12 U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009, TABLE 1159.

13 Gorton, *supra* note 33, at 68.

14 Frederic Mishkin, Speech at the U.S. Policy Forum in New York City: Leveraged Losses: Lessons from the Mortgage Meltdown (Feb. 29, 2008) *available at* http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm.

fered up and down the chain.[15] House price depreciation was the single most important factor that hit all links. The decline in lending standards is therefore "only a piece of the puzzle."[16] The widespread irrationality of subprime lending was based on the belief that the prices for houses would not fall.[17]

2. Accounting

At the same time, U.S. generally accepted accounting principles (GAAP) did not only enhance the letteral appearance of ABS issues, they did not expose the consequences of subprime lending either. And when the subprime mortgage crisis began, GAAP contributed to its acceleration.

a. Special Purpose Vehicles

Wall Street pools home loans in special purpose vehicles. FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, revised December 2003 (FIN 46R)[18] and Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Services of Financial Assets and Extinguishments of Liabilities*, issued September 2000 (FAS 140)[19] govern the accounting for such special purpose vehicles. FIN 46 was originally issued in January 2003 to govern the kind of off-balance-sheet vehicles whose sudden return to the group accounts wreaked havoc on Enron Corp. FIN 46R measures seventy-nine pages, FAS 140 is 142 pages long; both are of frightening complexity.[20] Their bottom line, however, is scarily simple: Special purpose vehicles used for securitization may still not have to be consolidated.

That is why certain risks did not exist for outsiders. A need for more funding and more capital was not apparent. Pooling subprime mortgage loans created a considerable cluster risk, a warning signal for the markets. Such signal did, however, not readily appear in the group accounts of Wall Street, as value changes of assets in the securitized pools were absorbed by the special purpose vehicles and not by the group. If assets are controlled by the special purpose vehicle and risks are regarded as being dispersed effectively[21] such variable interest entities will not be consolidated and do not appear in the financial statements of the group.[22] Special purpose vehicles used in connection with securitizations therefore continued to make a 'mockery' of the disclosure rules for public companies.[23]

FIN 46R and FAS 140 have since come under public scrutiny. The Financial Accounting Standards Board has proposed amendments:[24] on September 15, 2008, it issued two exposure drafts – *Amendments to FASB Interpretation No. 46 (R)*[25] and *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*.[26]

b. Fair Value Accounting

GAAP did not, however, only affect the origination side of securitization. Wall Street was unable to move all of its ABS issues into the markets. It and other financial institutions hold ABS as part of their portfolio. A new accounting technique named 'mark-to-market' accounting, introduced during the onset of the subprime mortgage crisis, caught the industry off guard and exacerbated the problems.

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, issued September 2006 (FAS 157)[27] became effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. FAS 157 changed the way companies have to report the value of most of their assets. According to FAS 157, the reported values must reflect the prices a company would receive if such assets were sold "in an orderly transaction between market participants at the measurement date." Because reports are due each quarter, the measurement is performed every three months. By requiring regular evaluations, FAS 157 shifted important power from management to accounting firms.[28] But FAS 157 did more than putting accountants at the fore of decision making about the valuation of a company's assets. Because marking-to-market is also applied to hard-to-value assets for which there is no readily observable market, when liquidity dries out, no market prices occur and such asset must be written down substantially.

As ABS are typically held for long term investment, even when traded on an exchange, their market is not very broad. The liquidity drought caused by subprime mortgage crisis therefore destroyed their fungibility and eliminated their value. Mortgage-backed securities were priced not in terms of probability of default, but in terms of what such securities would fetch if they had to be sold at the measurement date. Over the course of the subprime mortgage crisis, ABS prices plummeted below any value determined by the risk of default. In April 2008, for example, the Bank of England estimated that, based on actuarial methods, the credit losses in connection with this crisis would eventually reach US$ 170 billion,[29] whereas, following mark-to-market valuation, mortgage-backed securities had already lost around US$ 380 billion of their value.[30]

Section 132 of the Emergency Economic Stabilization Act of 2008 (EES Act)[31] restated the Securities and Exchange Commission's authority to suspend the application of fair value accounting rules "if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors." Section 133 of the EES Act requires the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, to conduct a study

15 Gorton, *supra* note 33, at 69.
16 Gorton, *supra* note 33, at 75.
17 *Id.*
18 Financial Accounting Standards Board [FASB], FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised Dec. 2003), *available at*, http://www.fasb.org/fin46r.pdf [hereinafter FIN 46R].
19 FASB, Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Services of Financial Assets and Extinguishments of Liabilities*, (issued Sept, 2000), *available at* http://www.fasb.org/pdf/fas140.pdf [hereinafter FAS 140].
20 *Cf.* Bily v. Arthur Young & Co., 834 P.2d 745, 750-752 (Cal. 1992); Bernhard Großfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards?*, 28 N. C. J. INT'L L. & COM. REG. 847, 853 (2003).
21 And no single party holds an interest or combination of interests that effectively recombines such risks.
22 Gary Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization* (FRB Philadelphia, Working Paper No. 05-21, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=713782; Jalal Soroosh & Jack Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46 (R)*, CPA JOURNAL, July 2004.
23 Stephen Schwarzman, *Some Lessons of the Financial Crisis*, WALL ST. J., Nov. 4, 2008, at A19.
24 *See* FASB Board Minutes for May & June 2008, *available at* http://www.fasb.org/board_meeting_minutes/board_meeting_minutes.shtml.
25 FASB, Amendments to FASB Interpretation No. 46 (R) (Sept 14, 2008), *available at* http://www.fasb.org/draft/ed_amend_fin46r.pdf.
26 FASB, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (Sept 14, 2008), *available at* http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf.
27 FASB, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, issued September 2006 (FAS 157)(effective Nov. 15, 2007)http://www.fasb.org/pdf/aop_FAS157.pdf.
28 Gorton, *supra* note 33, at 64.
29 Bank of England, *Financial Stability Report*, 18 (Apr. 2008), *available at* http://www.bankofengland.co.uk/publications/fsr/2008/fsrfull0804.pdf.
30 *Id.* at 19.
31 12 U.S.C. § 5201 (2008).

on mark-to-market accounting, including, but not limited to, its (i) effects on a financial institution's balance sheet, and (ii) impact on the quality of financial information available to investors. On December 30, 2008, the Commission published a study recommending improvements to the existing practice but not suspending mark-to-market accounting.[32]

3. Positive Ratings

The letteral appeal of ABS, accounted for under GAAP, was complimented by an easily understandable rating system. Mortgage-backed security issues are typically divided into different tranches with different seniority. Losses inside a pool are generally applied to the tranches in reverse order of seniority. To compensate for the added default risk, junior tranches offer higher interest rates than senior tranches. Rating agencies followed this approach: (i) the senior tranche is generally rated AAA, (ii) the one or more mezzanine tranches, they rate AA to BB, and (iii) the equity tranches are typically left unrated. As ABS issues became more and more complicated – senior/subordinate shifting of interest and excess spread/overcollateralization structures were combined in one transaction – because mortgages are not priced on an open market, such ratings were based on little tested models. Rating different mortgage-backed security tranches became extremely difficult.[33] Stephen Joynt of Fitch Ratings remarked: [34] "We weren't able to project forward."

But what is rating about if not projecting forward? The purported blindness of the rating agencies is even more surprising, as the cluster risks created by the pooling of subprime mortgage loans were visible from the beginning.

4. Pretend Insurance[35]

In an effort to provide against these cluster risks, financial institutions started engaging in Credit Default Swaps (CDS). A CDS is a credit 'derivative' contract in which the buyer of the CDS makes a series of payments to the seller and, in exchange, receives a payoff if a specified credit event occurs. Such credit event is typically the default of a bond or a loan.[36] It is, however, not necessary for the buyer to be affected by such credit event. But the lack of an insurable interest is not the only difference that distinguishes the CDS business from the insurance business. Unlike an insurance company, the seller of a CDS does not need to be a regulated entity[37] (for example, AIG Financial Products Corp.), and, unlike an insurance contract, CDS are generally subject to mark-to-market accounting.[38]

During the dawn of the subprime mortgage crisis, however, betting on the materialization of certain default risks, or other credit events, became so popular that the notional amounts of outstanding CDS increased to about US$ 58 trillion (US$ 58,000,000,000,000).[39] At the same time, for example, the volume of all debt securities issued and outstanding in the United States was US$ 29.7 trillion.[40] "To put into [yet another] context this US$ 58 trillion of value that credit default swaps insure: US$ 58 trillion is more than the gross domestic product of every country on earth, combined."[41]

But the sheer magnitude of the CDS market is not the only circumstance that became breathtaking. In April 2008, AIG Financial Products Corp. committed to pay certain employees retention bonuses in the amount of US$ 450 million to stay on board.[42] AIG needed such employees to unwind its CDS business, as they were deemed to be the only ones who understood the business and were capable of unwinding it.[43] By March 2009, its parent company, American International Group, Inc., is considered to have received at least US$ 170 billion in U.S. bailout money since September 2008,[44] and AIG Financial Products Corp. is deemed to have destroyed AIG.[45]

The combination of mortgage-backed securities and CDS worked as paper built Archimedean lever. Unfortunately it failed to pass the real-world test.[46]

V. Complexity

The structural overview shows that the instruments invented to minimize the risks involved in mortgage lending led to unprecedented levels of complexity. The chain of transactions and the securities involved make it almost impossible to determine the location and extent of the risk:[47] "[I]t is not possible to penetrate the chain backwards and value the chain based on the underlying mortgages. . . . There are (at least) two layers of structured products in CDOs. Information is lost because of the difficulty of penetrating to the core assets."[48]

Law therefore became an instrument of complexity, reducing transparency from beginning to end.[49]

32 *See* Securities and Exchange Commission, Congressionally-Mandated Study Says Improve, Do Note Suspend, Fair Value Accounting Standards (Dec. 30, 2008) *available at* http://sec.gov/news/press/2008/2008-307.htm.

33 Aaron Lucchetti & Judith Burns, *Moody's CEO Warned Profit Push Posed a Risk to Quality of Ratings*, WALL ST. J., Oct. 23, 2008, at A4, *available at* http://online.wsj.com/article/SB122471995644960797.html#.

34 Pallavi Gogoi, *Credit Rater's Judgment Questioned*, USA TODAY, Oct. 23, 2008, at 3B, *available at* http://abcnews.go.com/Business/story?id=6090528&page=1.

35 *See generally* Judy J. Kim, *Credit Default Swaps Get Attention of U.S Regulators*, BLOOMBERG LAW REPORTS, RISK & COMPLIANCE (Nov. 2008); Claus Luttermann, *Kreditversicherung (Credit Default Swaps): Vertrag, Restrukturierung und Regulierung (Hedge-Fonds, Rating, Schattenbanken)*, RECHT DER INTERNATIONALEN WIRTSCHAFT at 737 (Nov. 2008).

36 Less commonly, the credit event that triggers the payoff can be a company's credit rating being downgraded or a company undergoing restructuring or bankruptcy.

37 Eggert, *supra* note 36, at 550. (Eggert therefore describes them as "completely lacking in transparency and completely unregulated.")

38 See above section titled "Fair Value Accounting."

39 Bank for Economic Development, Monetary and Economic Department, *OTC derivatives market activity in the second half of 2007*, May 2008, at 1, *available at* http://www.bis.org/publ/otc_hy0805.pdf?noframes=1.

40 U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009, TABLE 1159, *available at* http://www.census.gov/prod/2006pubs/07statab/banking.pdf.

41 Christopher Cox, SEC Chairman, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), *available at* http://www.sec.gov/news/speech/2008/spch100808cc.htm.

42 Edmund Andrews and Peter Baker, *Bonus Money at Troubled A.I.G. Draws Heavy Criticism*, THE N.Y. TIMES, Mar. 15, 2009, at 1, *available at* http://www.nytimes.com/2009/03/16/business/16aig.html.

43 *See* Jim Zarroli, *Obama, Cuomo Target AIG Bonuses*, NPR, Mar. 16, 2009, *available at* http://www.npr.org/templates/story/story.php?storyId=101963181.

44 *See* Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, at A1, *available at* http://online.wsj.com/article/SB122156561931242905.html.

45 Monica Langley, Deborah Solomon & Matthew Karnitschnig, *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J., Sept. 18, 2008, at A1, *available at* http://online.wsj.com/article/SB122169421247449935.html. *Cf.* Mollenkamp et al., , *supra* note 56, at A1; *AIG names recipients of its bailout money*, CNN, Mar. 16, 2009, http://www.cnn.com/2009/US/03/15/AIG.banks.list/index.html.

46 *Financial WMD*, USA TODAY, Oct. 22, 2008, at 8A (and became "financial weapons of mass destruction") (quoting Warren Buffet).

47 Gorton, *supra* note 33, at 45.

48 Gorton, *supra* note 33, at 61.

49 *Cf.* Bernhard Grossfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards*, 28 N.C. J. INT'L L. & COM. REG. 847, 853 (2003).

A. At the Bottom

The complexity started with selling ARM loans to borrowers. An ARM loan does not look too complicated to the expert, but it seems that borrowers who actually submitted to 2/28-ARMs did not understand their economic consequences. This is due to the fact, that in matters of interest we meet imperfect information. The "ignorant borrower"[50] is typically not familiar with the power of interest and compound interest.[51] He is not aware of the "Rule of 72"–72 divided by the annual interest rate provides the number of years it takes for the amount to be actually repaid on a debt to double.[52] At the bottom we find information asymmetry.

B. Along the Links

The complexity of ABS continued along the links. A good example is Structured Asset Securities Corporation's last registration statement on Form S-3 (Amendment No. 3) that it filed with the Securities and Exchange Commission (SEC) on June 29, 2007.[53] The Structured Asset Securities Corporation was a special purpose vehicle of Lehman Brothers Holdings Inc. for the issue of ABS.

The first sample base prospectus contained in this registration statement measures 187 pages plus Index of Principal Terms, Annex A Book-Entry Procedures, and Annex B Global Clearance, Settlement and Tax Documentation Procedures. Its Table of Contents is three pages long, referring to twenty-six chapters. They start with Risk Factors, Description of the Securities, and The Trust Funds, deal with Servicing of Loans, Credit Support and Derivatives, and conclude with Additional Information, Incorporation of Certain Documents by Reference (i.e. more documents to be aware of) and Reports to Security Holders.

The Index of Principal Terms alone covers four and one-half pages. Risk Factors are explained on thirty-three pages. They discuss, among others matters, typical weaknesses of subprime mortgage loans such as Higher Expected Delinquencies, the effects of Changes in the U.S.-Economic Conditions as well as Prepayment Premiums, Negative Amortization and Geographic Concentration. As characteristic we quote the explanation of prepayment penalties in connection with home loans:

"Many residential mortgage loans, particularly adjustable rate mortgage loans, negative amortization mortgage loans and subprime mortgage loans, require the payment of a prepayment premium in connection with voluntary prepayments of the mortgage loan made during the period specified in the related mortgage note. These prepayment premiums may discourage borrowers from refinancing their mortgage loans, and in many cases, may discourage borrowers from selling the related mortgage property, during the applicable period. Borrowers who wish to refinance their properties to take advantage of lower interest rates, or who want to sell their mortgaged property, may not be able to afford the prepayment premium and may be more likely to default. You should consider the effect of these prepayment premiums on borrowers and the resulting effect on the yields of your securities."[54]

The risk factors end with a global warning:

"The Securities May Not Be Suitable Investments. The securities may not be a suitable investment if you require a regular or predictable schedule of payment, or payment on any specific date. . . . An investment in these types of securities involves significant risks and uncertainties and should only be considered by sophisticated investors who, either alone or with their financial, tax and legal advisors, have carefully analyzed the mortgage loans and the securities and understand the risks."[55]

After the risk factors, the ABS to be issued by the Structured Asset Securities Corporation are explained on six and one-half pages. Over twenty-two pages are spent on the home loans that may be included in a trust fund; another three and one-half pages describe the underwriting procedures and standards for such loans. The next part presents on fourteen and one-half pages the sponsor (Lehman Brothers Holdings Inc.), the depositor (Structured Asses Securities Corporation), and the master servicer of the loans in the trust fund (Aurora Loan Services LLC), including an eleven page section on Servicing before 'the' Servicing of Loans is explained on another twelve pages.

Altogether, an impressive legal document. We learned, however, the hard way that subprime mortgage lending created opaque legal constructions and produced securities that did not deliver on one of their core functions – a manageable allocation of risk. Because the markets were not provided with efficient information that allowed effective pricing, the markets became self-destructive.

C. An Avalanche of Letters[56]

"All the ills we face...can be traced back to illiteracy."[57]

As we look at the legal documents along the risk chain, we are buried by an avalanche of letters. Certainly, this is a not uncommon feature of Western civilization since the invention of the printing press by Johannes Gutenberg around 1450. Based on the idea "of the 'autonomy' of law"[58] it, however, washed away pictures and reached gigantic proportions with Martin Luther's "*sola scriptura*,"[59] when it was extended far beyond its religious meaning:

"[T]he fact that looking at law as a constant element may easily induce a distorted and limited vision of the external world. . . . Starting from rules may lead to select perceptions, and therefore events themselves, according to a predefined model which

50 Rashmi Dyal-Chand, From Status to Contract: Evolving Paradigms for Regulating Consumer Credit, The Future of Consumer Credit Regulations 49, 59 (Michelle Kelly-Louw, James P. Nehf & Peter Rott eds., 2008).

51 *See generally* Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DePaul L. Rev. 961 (2008); Steven M. Graves & Christopher L. Peterson, *Usury Laws and the Christian Right: Faith-Based Political Power and the Geography of American Payday Loan Regulation*, 57 Cath. U. L. Rev. 637 (2008); Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 Minn. L. Rev. 1110 (2008).

52 *See The Rule of 72, Better Explained*, Jan. 25, 2007, *available at* http://www.betterexplained.com/articles/the-rule-of-72/.

53 Structured Asset Securities Corp., Securities and Exchange Commission [SEC], Amendment No. 3 to Registration Statement (S-3){(June 29, 2007), *available at* http://www.secinfo.com/d13f21.umb.htm#1stPage

54 *Id.* at "Risk Factors—Prepayment Premiums May Affect a Borrower's Ability to Sell a Mortgaged Property or Refinance a Mortgage Loan, and May Affect the Yields on Your Securities."

55 *Id.* at "Risk Factors—The Securities May Not Be Suitable Investments."

56 Leslie Eaton & Amir Efrati, *Lawyers Will Be Lawyers, Dumping More on Juries Than They Can Process*, Wall St. J., Nov. 6, 2008, at A16, *available at* http://online.wsj.com/article/SB122593285676003505.html.

57 Judy Keen, *After Hudson's Death, Chicago Vows to Fight Rising Murder Rate*, USA Today, Oct. 29, 2008, at 3A, *available at* http://www.usatoday.com/news/nation/2008-10-28-hudson_N.htm.

58 Vinzenzo Ferrari, Law and Society Studies and Legal Education, 55 J. Legal Educ. 495, 497 (2005).

59 *See generally* Diarmaid MacCulloch, The Reformation: A History (2004). For the power of the word in the Protestant legal culture *see* Bernard Hibbitts, *The Re-vision of Law: The Pictorial Turn in American Legal Culture*, http://faculty.law.pitt.edu/hibbitts/pictor.htm.

often happens to correspond to an individual's personal views about what rules mean. Factual interpretation, in short, may easily become normatively bound. As a result, lawyers often tend to have a preselected and simplified vision of the social landscape that surrounds them, all the more so because law, by its own inner logic, 'dychotomizes reality'. . .on the basis of the 'lawful-unlawful' (Recht-Unrecht) discrimination code."[60]

Letters became the most reliable instruments for ordering.[61] Certainly, law requires that we ignore certain complexities of life;[62] but in law, as always, the amount makes the poison: "*Iura scripta sunt vigilantibus.*"[63] ("The laws are written for the weary.") – But how watchful does one have to be to hold one's own? In addition, how are we keeping a statistical balance, when the line stretches further and further between parties with different social and educational experiences?

Before the onset of the subprime mortgage crisis, everything appeared to be well documented. But, in fact, the reality of risks had disappeared behind a veil of *precisely lettered* optimism. The sheer amount of detail oriented legal letters covered-up the complexity of the many transactions involved in the subprime mortgage fiasco, individually and cumulatively. Risks were not managed along the links, they hid behind walls of paper created by each link. Inexperienced, low income borrowers did not understand what they were getting into. At the same time, investors relied on more than the protection offered by legal disclosure; they relied on prudent under writing practices, backed by Wall Street's good will as financial adviser, not just seller. And, finally, it seems like Wall Street did not know what it was getting into either. The attempt to realize an American dream therefore turned full circle against those in whose favor it was made.

D. Up to Reality – Again

"Our duty is 'reality, reality, reality' however difficult to achieve."[64]

Recent decisions by Massachusetts courts[65] seem to indicate a return to reality when discussing home loans with four characteristics: (i) adjustable rates, (ii) teaser rates, (iii) debt-to-income ratios exceeding 50 percent, and (iv) loan-to-value ratios of 100 percent or certain prepayment penalties. The Commonwealth of Massachusetts Appeals Court saw the situation as follows:[66]

"[I]t is to be expected that the borrower will not be able to meet the scheduled payments once the 'teaser' rate expires at the close of the introductory period [i.e. the Initial Period], and the loan will be 'doomed to foreclosure' unless the borrower is able to refinance the loan at or around the close of the introductory period; and where loans also have the fourth characteristic [i.e. a loan-to-value ratios of 100% or prepayment penalty], the borrower has no realistic prospect of being able to refinance should housing prices decline."

The lower Commonwealth of Massachusetts Superior Court had concluded:[67]

"Given the fluctuations in the housing market and the inherent uncertainties as to how that market will fluctuate over time, this Court finds that it is unfair for a lender to issue a home mortgage loan secured by the borrower's principal dwelling that the lender reasonably expects will fall into default once the introductory period ends unless the fair market value of the home has increased at the close of the introductory period. To issue a home mortgage loan whose success relies on the hope that the fair market value of the home will increase during the introductory period is as unfair as issuing a home mortgage loan whose success depends on the hope that the borrower's income will increase during the same period."

The Washington *Summit on Financial Markets and the World Economy* in November 2008 added the following insight to the picture:[68]

"M]arket participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system."

The Leaders of the Group of Twenty therefore put "Strengthening Transparency and Accountability" on top of their "common principles for reform."[69] Immediate Actions to be taken by March 31, 2009 were to:[70]

- "... address weaknesses in accounting and disclosure standards for off-balance sheet vehicles[;]
- ... enhance the required disclosure of complex financial instruments by firms to market participants[;] and
- ... [enhance] the governance of the international accounting standard setting body."

Accounting as a legal instrument finally got to the front page.[71]

VI. Macro-Justice[72]

The story told in this article offers a sad, but nevertheless great, story for legal edification. It shows, how we lawyers abandoned the legal analysis of economics, while not noticing how compartmentalized legal regulation became. The law disconnected from economic results, as we failed to consider the macro-economic consequences of individual acts. At the same time, the economic analysis of the law did not take notice of these concerning developments. For the mathematical models used to predict the markets proved insufficient,[73] when reality exposed their inherent weakness. They cannot "cope with illogical and uneconomic factors."[74]

60 Vinzenzo Ferrari, Law and Society Studies and Legal Education, 55 J. Legal Educ. 495, 497 (2005).

61 Naglee v. Ingersoll, 7 Pa. 185 (1847) ("The black letter of the law.").

62 Amnon Reichman, *Law, Literature, and Empathy: Between Withholding and Reserving Judgment*, 56 J. Legal Educ. 296, 307 (2006).

63 Cf. Corpus Iuris Civilis, Digesta 41. 10,24.

64 Bernhard Grossfeld, *Global Financial Statements/Local Enterprise Valuation*, J. Corp. L. 337, 362 (2004).

65 Commonwealth of Massachusetts v. Fremont Investment & Loan and Fremont General Corp., *supra* note 85; Massachusetts v. Fremont Investment & Loan & another, Mass. Appeals Ct., Civil Action No. 08-J-118 (May 2, 2008), *available at* http://www.goodwinprocter.com/~/media/F661C77BEC2E46A1BBE14B286BAE48DB.ashx.

66 Commonwealth of Massachusetts v. Fremont Investment & Loan & another, *supra* note 178, at 3.

67 Commonwealth of Massachusetts v. Fremont Investment & Loan and Fremont General Corp., *supra* note 85, at 18 *et seq.*

68 *See* Press Release, Office of the Press Secretary, Declaration of the Summit on Financial Markets and the World Economy 1 (Nov. 15, 2008), http://www.fsforum.org/press/pr_151108.pdf.

69 *Id.* at 3.

70 *Id.* at 6.

71 *See generally* Bernhard Grossfeld, *Global Accounting: A Challenge for Lawyers*, *supra* note 30, at 143; Bernhard Grossfeld, *International Financial Reporting Standards: European Corporate Governance* in O DIREITO DO BALANCO E AS NORMAS INTERNACIONALES DE RELATO FINANCEIRO 11 (J. L. Sadanha Sanchez ed., 2006).

72 Alfred Conard, *Macrojustice: A Systematic Approach to Conflict Resolution*, 5 Ga. L. Rev. 415, 420 (1971); *Cf.* H. Peyton Young, EQUITY–THEORY AND PRACTICE 6 *et seq.* (1995).

73 *See* White, *supra* note 16.

74 L. Gordon Crovitz, *The 1% Panic*, Wall St. J., Oct. 6, 2008, at 17A.

Securitization created investment products of international reach that separated financing from the location of the financed object – though "*location, location, location*" has always been the common and almost hackneyed phrase in real estate. It was able to do so, by giving ABS a *letteral* appearance through a series of complex, highly regulated transactions, accounted for under generally accepted principles. The persons involved in these transactions, however, did not apply the standards of statistical reasoning and were therefore unaware of their macro-economic impact. A legal analysis of economics would have detected this development, because it takes into account that markets depend on systems of law as it uses such systems as cognitive models. The legal analysis of economics thereby binds the language of economics to the grammar of a value system and limits the power of self-interest according to the moral order of a society. It sets pragmatic standards for economic interests that are typically not derailed by illogical economic factors.

We lawyers need to re-embrace this analysis. This does not mean that we need to conduct extended business studies,[75] we must simply be fact oriented and observe how our work influences economic reality. This is more than words, words, words. But it is not more difficult than it is for economists to analyze the law, and that could be an important lesson from the subprime mortgage crisis!

75 Roberta Romano, *After the Revolution in Corporate Law* (Yale Law & Economics Research Paper No. 323, 2005) available at http://ssrn.com/abstract=824050; *see also* Bernhard Grossfeld *Comparative Accounting*, 28 Tex. Int'l. L. J. 233 (1993).

*Dr. Peter Kasiske**

Oliver Wendell Holmes, Jr. und die empiristische Wende im amerikanischen Rechtsdenken

Um die Wende vom 19. zum 20. Jahrhundert war die amerikanische Rechtswissenschaft Schauplatz eines grundlegenden Paradigmenwechsels. Das bisher vorherrschende formalistische Rechtsdenken sah sich herausgefordert durch eine neue Jurisprudenz, die das Recht nicht mehr in erster Linie als ein abstraktes Gefüge von Begriffen und Institutionen verstand, sondern als einen historisch gewachsenen Teil der sozialen Wirklichkeit, der gezielt der Durchsetzung politischer Zwecksetzungen dienstbar gemacht werden konnte. Einer der zentralen Protagonisten dieses Wandels war Oliver Wendell Holmes, Jr. Sein Verständnis von „Law as Experience" bewirkte eine empiristische Wende im amerikanischen Rechtsdenken, die die moderne amerikanische Rechtstheorie bis heute maßgeblich geprägt hat. Der vorliegende Beitrag versucht, Holmes' Beitrag zu dieser Entwicklung nachzuzeichnen und die philosophischen Wurzeln seines Rechtsdenkens aufzuzeigen.

I. Zur Biographie von Holmes

Oliver Wendell Holmes ist eine der großen Gestalten der amerikanischen Rechtsgeschichte. Seine Bedeutung für die Entwicklung des Rechts in den Vereinigten Staaten kann mit dem Einfluss verglichen werden, den Friedrich Carl von Savigny auf das deutsche Recht ausübte. Obwohl sein intellektuelles Format von niemandem in Abrede gestellt wird, ist er dabei auch gleichzeitig immer einer der umstrittensten Juristen der USA geblieben. Die Urteile über ihn divergieren in erstaunlichem Maße: Die einen sahen in ihm einen progressiven Liberalen, während andere ihn als reaktionären Sozialdarwinisten, wenn nicht gar als verkappten Faschisten, geschmäht haben.[1] Die Vielfalt der Urteile mag ihren Grund darin haben, dass Holmes, abgesehen von seiner Studie „The Common Law", seine Ansichten nie in geschlossener und systematischer Form niedergelegt hat, sondern in einer Fülle von Urteilsvoten, Kurzbeiträgen, Anekdoten und Briefen.

Oliver Wendell Holmes Jr. wurde am 8. März 1841 als Sohn des Arztes und Schriftstellers Oliver Wendell Holmes Sr. in Boston geboren. Nach dem amerikanischen Bürgerkrieg, in dem er mehrfach schwer verwundet wird, studiert Holmes in Harvard Rechtswissenschaften. Im Jahr 1882 wird er dort zum Professor ernannt. Noch im selben Jahr nimmt er jedoch eine Berufung als Richter an den Supreme Court of Massachusetts an. 1902 beruft man ihn schließlich an den Obersten Gerichtshof der Vereinigten Staaten, wo er erst 1932 im Alter von neunzig Jahren aus dem Dienst ausscheiden wird. Holmes stirbt am 6. März 1935 kurz vor seinem vierundneunzigsten Geburtstag.

II. „Law as Experience"

„The Life of the law has not been logic. It has been experience."[2] Mit diesen Worten beginnt Holmes im Jahr 1881 sein Buch "The Common Law". In ihm ist das rechtstheoretische Programm zusammengefasst, das Holmes Zeit seines Lebens verfolgte: Die Abkehr von einer formalistischen Begriffsjurisprudenz und ihre Ersetzung durch ein empirisches Rechtsverständnis, das das Recht als Teil der sozialen Wirklichkeit und ein Instrument zu ihrer Gestaltung begreift.

1. Die Kritik am Formalismus

Als Holmes in der zweiten Hälfte des 19. Jahrhunderts seine juristische Karriere beginnt, dominiert an den Juristischen Fakultäten der Vereinigten Staaten eine Auffassung von Rechtswissenschaft, die von ihren Kritikern später mit der Bezeichnung "Formalism" oder "Mechanical Jurisprudence" bedacht wurde. Exemplarisch fand sie sich im Werk von Christopher Columbus Langdell verkörpert, einem langjährigen Dekan der Harvard

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1 Für die liberale Interpretation siehe etwa *Frankfurter*, Mr. Justice Holmes and the Supreme Court, 1938; z.w.N. bei *Rogat*, Stanford Law Review 15 (1962), 3 Fn. 1; für den Faschismusvorwurf vgl. *Palmer*, „Hobbes, Holmes and Hitler", 31 American Bar Association Journal (1945) S. 569 ff. *Richard Posner* bringt die Ambivalenz von Holmes besonders prägnant zum Ausdruck, wenn er ihn als „The American Nietzsche" apostrophiert, *Posner*, The Problems of Jurisprudence, 1990, S. 239 ff.

2 *Holmes*, The Common Law, Ausg. Cambridge MA, 1963, S. 5.