SEC v. Goldman Sachs: Political-Legal Risks and Economic Strategies for Litigators and Transaction Planners

Dino D. Falaschetti

The Securities and Exchange Commission (SEC) introduced a new source of uncertainty to the financial exchanges when it sued Goldman, Sachs & Co. for fraud in marketing a collateralized debt obligation (CDO). The suit not only questioned the integrity of one of the world's best-known financial services firms, it encouraged many to reconsider the political-legal risks that other such firms may be facing. These risks may be rising as policymakers turn their attention from concerns about financial system collapse to questions about who may have been responsible, and even liable, for losses incurred during the recent economic downturn.

Assessing responsibility for losses requires understanding who knew what, when they knew it, and how markets valued such information. These questions can be difficult to address in normal times, and may be even harder to address during economic fluctuations, where systemwide effects can mask true securities fraud or suggest fraud when none exists. Economic models of how financial disclosures relate to market performance frequently help lawyers as both transaction planners and litigators, and may be especially important for success if legal risks have indeed grown following this unusually volatile period of financial market activity.

Economic models enjoy a fundamental advantage in seeing through accounting information that doesn't always reflect financial realities and in working through complicated deal structures that can make it hard to identify who relied on financial disclosures and whether omissions caused material harm. This advantage comes from logically building, from the ground up, an empirically verifiable case for how corporate governance practices may have affected the content of disclosures or the decision to disclose, as well as quantitative assessments of the possible consequences (if any) for various stakeholders. Less formal methods, by comparison, provide relatively weak guidance for distinguishing between potentially important forces and do not measure any relevant effects in a manner that can withstand rigorous tests.

Applied to cases like Goldman, good models facilitate a careful consideration of how financial derivatives strengthen economic performance, as well as how their construction and marketing can go wrong. For example, by letting investors buy into pools of loans (e.g., credit card balances or home mortgages), asset-backed securities (ABS) offer a low-cost mechanism for diversifying away from risks that are specific to any particular loan. This cost reduction can ultimately pass through to initial borrowers.

Collateralized Debt Obligations (CDO) take this strategy a step further, giving investors an opportunity to select where they want to stand in line when receiving cash flows from an ABS. Those who buy into "senior tranches" participate first in these cash flows, followed by those who buy into "mezzanine tranches" and, finally, "equity tranches." By letting investors buy risks that best suit their appetites, a CDO can further the efficiencies that an ABS makes possible.

To produce these efficiency gains, however, the securities market must avoid becoming a market for "lemons." This problem is perhaps most familiar in the market for used cars. There, buyers' skepticism about the quality of cars for sale can reduce their willingness to pay for any car, even those that may truly be high quality. Similarly, when the quality of loans in an ABS is hard to measure, investors will curb their willingness to pay not only for the ABS, but for the derivative CDO.

To productively address this issue, corporate and securities laws must address the lemons problem at a lower cost than would market mechanisms (e.g., arms-length contracts). Corporate law works toward this goal by assigning directors and officers of financial service firms a duty to act as a fiduciary for shareholders (and, possibly, other stakeholders). Securities law tends to play an even more prominent role and, in both cases, important questions include whether a misrepresentation *materially* affected investor decisions and *caused* a loss.

Understanding the economics behind these terms creates opportunities for both transaction planners and litigators. For the planner, integrity of process matters, especially for establishing good faith of decision makers (and even the planner itself). How were decisions made about what to disclose? Did decision makers stand to benefit from a transaction as individuals, or only indirectly through stronger firm performance? When addressing such questions, it is useful to consider whether the process risks being seen (after the fact) as having set up a zero-sum game where decision makers benefit at the expense of those who are fooled into buying lemons, or whether it can more easily be characterized (even when decisions ultimately go wrong) as having involved decision makers who are interested in building and maintaining a positive reputation for themselves, for their products and services, and for their firm.

For litigators, a compelling theory about what counts as "material" and "causal" is crucial. Here, again, economic reasoning and methodology can be valuable. On the question of materiality, an economic analysis of what was known and disclosed at the time of an alleged misrepresentation can firmly establish whether, for example, investor expectations about the likelihood and magnitude of losses for a CDO tranche would have been significantly different. And for the question of causation, quantitative methods have become almost indispensable for evaluating what would have happened except for alleged misrepresentations. Economic models can be combined with statistical methods, for example, to quantify market responses to possible misrepresentations and calculate explicit bounds on how much confidence those estimates deserve.

Given the statute of limitations for private 10b-5 actions, many commentators see the Goldman case as the tip of a litigation iceberg that will more fully emerge during the next couple of years. The analytical tools described in this note can go far to strengthen or rebut the theories of participating litigants and better equip future transaction planners.

Dr. Falaschetti is a special consultant for Economists Incorporated, an associate professor of law and economics at the Florida State University College of Law, and the Gleed Chair of Business Administration at Seattle University's Albers School of Business and Economics. He previously served the White House as a senior economist for the Council of Economic Advisers, with responsibilities for regulation and financial services.