

Complex Derivatives Litigation—How Experts Can Help

BY HOWARD SCHNEIDER¹

The demise of Bear Stearns and Lehman Brothers in 2008 made the world acutely aware of the potential toxic nature of certain complex derivatives. Whatever could go wrong with subprime mortgage loans, their securitization by financial institutions and their sale to even the most sophisticated investors did go wrong in that period. Many fingers pointed at OTC derivatives as a cause of the financial meltdown. The inevitable result has been significant litigation which has, at its core, the complex derivative products sold by major financial institutions in the period prior to the Lehman bankruptcy.²

These litigations have involved mortgage brokers, property appraisers, mortgage originators, securitization companies, mortgage servicing companies, asset management companies, financial advisory companies, wealth management companies, financial consultants, insurance companies, insurance agents, hedge funds, regional and national banks and security and commodity brokers, to name a few of the targets of these litigations. Among others, these litigations can take the form of class action complaints, Governmental investigations, individual financial and non-financial institutions pitted against each other because of failed transactions, improper investment advice, bankruptcy claims, im-

proper valuation and diligence claims, as well as insurance coverage claims.

While every litigation is different and has its own fact pattern (which will often govern the outcome), in the case of complex derivatives, an early use of consulting experts will produce best results for the client at risk in the litigation. What follows is a common sense approach to complex derivatives litigation. The concept is to use experts initially in a consulting capacity, as knowledge enhancers for client and counsel, and then as a resource to help plan overall case strategy and to assist in the pretrial phases of the litigation (document discovery, interrogatories, depositions, preparation for trial, etc.) The more traditional use of experts as testifiers can come later in the process, as the case develops. The testifying experts can be from the same firm as the consulting experts, or from another consulting firm or from academia, as the situation warrants.

Complexity of Certain Derivative Products

Needless to say, many derivative products are innately complex and, while designed to achieve a specific result, can often go amiss when unforeseen external events intrude on the original design intent. Many

of these instruments were designed by quants with mathematical precision, but without taking into account all possible risks. The period of 2007-2008 created the perfect storm of unforeseen risks, including the bursting of the housing market bubble in the United States.

After design, these complex instruments were brought to sales and organizational managers in the financial institutions who may have had, in many instances, little or no understanding of what the quants were telling them about the instruments they had engineered. These managers accepted, without much question, that the desired end result would be achieved by the instrument that was devised for that purpose. Yet, even these extraordinary bright and accomplished people may have failed to grasp the risk consequences because they may not have fully understood the instruments they were about to sell into the marketplace.

In the debacle that followed, a significant fallout was, and continues to be, litigations with these complex derivative instruments at their center.

How Can Experts Help?

A number of consulting firms have either hired or have access to the industry professionals who structured, were instrumental in establishing the underlying asset (or creating a synthetic for such assets), issued and marketed the instruments and/or worked to get them through the rating agencies. They have worked with and know how to utilize industry databases and valuation tools. These professionals supplemented already existing expertise in financial services, accounting and derivative transactions at the consulting firms.

That knowledge base enables the experts to reverse engineer the derivative transactions at issue, understand the fundamentals, replicate the practical operations involved, and, most importantly, place the transactions in their historical context.

An early-on and good working relationship between experts and counsel can help to enhance the value of the client's own understanding of the facts and can serve to make the litigators a great deal

more knowledgeable on the specifics of the particular instruments at issue, how they were structured, how they were sold, the nature of the collateral involved, what role the rating agencies performed and similar basics of the transactions so as to neutralize the 20/20 hindsight position usually taken by regulators and/or class action plaintiffs.

With that knowledge in hand, the experts can help litigators:

- Formulate an overall case strategy – a complete mastery of the subject matter will allow for a much more nuanced plan for how to take the case forward.
- Get what's needed in document discovery – experts can help pinpoint key documents that might otherwise have been overlooked and can identify the industry databases and tools that were utilized to conceive of the derivatives involved.
- Ask the right questions when formulating interrogatory requests – experts will be able to get beyond the superficial questions and can get to the key issues so as to surface the major points of contention at any early stage in the dispute.
- Assist in the preparation of deposition questioning of the other side - experts should be able to work with counsel to help frame questions in depositions which can get to the heart of the dispute.
- Assist in the defense of deposition questioning by the other side - likewise, experts may be able to work with counsel to help the client's side answer questions put to them in a way which best advances the client's position.
- Assist in preparation for trial — as in the deposition phase, experts can work with counsel to frame questions for both direct examination and cross-examination.
- Identify expert witnesses — expert witnesses can cover any number of topics where it is felt that an expert would bolster the case. The experts used in the pre-trial phase can be strictly consulting experts or could act as both consulting

and testifying experts, depending on the facts and best utilization concepts involved in the case at hand.

Early Preparation

The intelligent use of consulting experts in the complex derivatives litigation field would argue for an early engagement of such experts. Obviously, the earlier the experts are called in, the more helpful they can be in –

- Imparting solid background knowledge to client and counsel about the facts and circumstances of the particular instruments in question and related questions about their issuance, sale, protocols, and similar matters.
- Help formulate overall case strategy. This is more easily accomplished if experts are in the mix at the beginning of the case, rather than at mid point or at the end of the case.
- Assistance in document discovery, interrogatories, depositions and in trial preparation is clearly enhanced if experts are on hand when those pretrial phases are on the horizon rather than when it's too late because those phases have been completed. The position to avoid is having everyone say, "I wish I'd thought of that," when the point can no longer effectively be raised.

Ancillary Help

A common use of experts is in connection with damage and valuation issues in a litigation. This function would apply in complex derivatives litigations as well. Thus, once experts are on board, counsel should begin to think of the uses to which

his or her experts can be put. Will there be damage issues? Will the valuation of the derivative instrument currently be a factor in the damages calculation? If the answer is "yes", counsel will need to think about lining up those issues. Again, those experts can be part of the consulting expert's team or can come from a separate outside source.

Conclusion

Derivative instruments, in most cases, are highly complex and difficult to understand for even highly sophisticated and intelligent investors. When litigation involving those instruments arrives at counsel's doorstep, a good place to start would be to hire experts early on in the case. Experts expand the knowledge base quickly and effectively. And, they can be invaluable in providing assistance in all phases of the discovery and pre-trial process.

The establishment of a working relationship with experts as soon as feasible in the litigation process will inure to the client's benefit.

NOTES

- 1 Mr. Schneider is a Managing Director at Navigant Economics. Mr. Schneider was the first General Counsel of the Commodity Futures Trading Commission. He can be reached at (646) 227-4450 or at howard.schneider@naviganteconomics.com.
- 2 An additional consequence was passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act which seeks to remedy perceived deficiencies in, among other things, the OTC derivatives markets.