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Subprime Scriveners

Milan Markovic

ABSTRACT

Although mortgage-backed securities ("MBS") and other financial products that nearly caused the collapse of the global financial system could not have been issued without attorneys, the legal profession's role in the financial crisis has received relatively little scrutiny.

This Article focuses on lawyers' preparation of MBS offering documents that misrepresented the lending practices of mortgage loan originators. While attorneys may not have known that many MBS would become toxic, they lacked incentives to inquire into the shoddy lending practices of prominent originators, such as Washington Mutual Bank ("WaMu"), when they and their clients were reaping considerable profits from MBS offerings.

The subprime era illustrates that attorneys are unreliable gatekeepers of the financial markets because they will not necessarily acquire sufficient information to assess the legality of the transactions they are facilitating. The Article concludes by proposing that the Securities and Exchange Commission impose heightened investigative duties on attorneys who work on public offerings of securities.

1 Associate Professor of Law, Texas A&M University School of Law. J.D., Georgetown University Law Center (2006); M.A., New York University (2003); B.A., Columbia University (2001). I would like to thank Wayne Barnes, Donald Langevoort, Kevin Michels, Huyen Pham, Marc Steinberg, and Brad Wendel for their invaluable comments on this article.
Although lawyers have played an integral role in the most high profile cases of corporate fraud of the last forty years, the conduct of attorneys in connection with the recent financial crisis has received relatively little attention. Attorneys, many of them members of prestigious law firms, represented financial institutions engaged in the purchase and sale of mortgage-backed securities ("MBS"), collateralized debt obligations ("CDOs"), and other financial products that nearly caused a collapse of the global financial system, but few of these attorneys have been implicated in any misconduct. Lawyers, like many of their clients, may not have appreciated the risks associated with these investments.

However, lawyers did not need to be especially knowledgeable about financial products to understand the consequences of securitizing mortgages originated by irresponsible lenders. Financial institutions issued $3.1 trillion in MBS in 2003,

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2 See Donald C. Langevoort, Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud, 46 VAND. L. REV. 75, 76-77 (1993); W. Bradley Wendel, Professionalism as Interpretation, 99 NW. U. L. REV. 1167, 1167 (2005) (suggesting that attorneys were a "but-for cause" of accounting scandals of the early 2000s). The role of lawyers in Enron's bankruptcy has received particular scrutiny and served as the impetus for significant changes in professional discipline.

3 See Dustin A. Zacks, Robo-Litigation, 60 CLEV. ST. L. REV. 867, 867 (2013) (discussing the legal system's failure to discipline attorney misconduct attributable to the financial crisis). Courts have criticized some attorneys for failing to ensure that mortgage notes were properly transferred prior to being marketed and sold to investors. See U.S. Nat'l Bank Ass'n. v. Ibanez, 941 N.E.2d 40, 55-56 (Mass. 2011) (Cordy, J., concurring) (noting the "utter carelessness" with which banks documented their ownership of mortgages); Robo-Singing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing: Hearing Before the Subcomm. on Hous. & Cnty. Opportunity of the H. Comm. on Fin. Serv., 111th Cong. 267 (2010) (statement of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center), available at http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg63124/pdf/CHRG-111hhrg63124.pdf (criticizing bank attorneys for cutting corners and engendering confusion with respect to mortgaged properties); Zacks supra (criticizing attorneys for failing to vet their clients' documentary evidence in foreclosure proceedings).


5 The Model Rules of Professional Conduct ("Model Rules") require lawyers to present "unpleasant facts and alternatives that a client may be disinclined to confront." MODEL RULES OF PROF'L CONDUCT R. 2.1 cmt. 1 (2013); see also Aaron Unterman, Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt, 4 HASTINGS BUS. L.J. 77, 98 (2008) ("Where liability is found based on knowledge of fraudulent lending practices it follows that the complacent party should have also been aware of the risks associated with these assets. If securitizers knew that sub-prime lenders were making bad loans, they must have known that the securities created from these loans were not stable investments.")
$1.8 trillion in 2004, and $2 trillion in each of 2005, 2006, and 2007,\(^6\) while mortgage loan originators were often issuing home loans without assessing the ability of borrowers to repay.\(^7\) Even after prominent loan originators began to file for bankruptcy in late 2006, financial institutions continued to conduct MBS offerings.\(^8\)

Some institutions, like Washington Mutual Bank, Inc. ("WaMu"), once one of the largest banks in the United States, issued MBS and also originated many of the problematic mortgages.\(^9\) WaMu misrepresented its loan underwriting standards to MBS investors as well as its own stockholders.\(^10\) When the real estate market crashed, many of the mortgages issued by WaMu became toxic because borrowers could not make payments on the underlying mortgages.\(^11\) Misleading statements about WaMu’s loan underwriting standards were incorporated into registration statements and prospectuses (collectively "offering documents") for WaMu’s MBS offerings as well as those of other financial institutions that securitized WaMu mortgages.\(^12\)

This Article will seek to explain why attorneys continued to assist with MBS offerings even as originators were increasingly extending loans to borrowers who did not have the capacity to repay them. Financial institutions were highly motivated to sell lucrative MBS, which made it difficult for in-house attorneys at WaMu and other financial institutions to forestall the lax lending practices that enabled the issuance of more mortgage loans. The role of outside counsel consisted predominately of preparing boilerplate Securities and Exchange Commission ("SEC") filings for the issuance of MBS and other securities, which were, in large part, "a scissors and paste-pot job"\(^13\) of originators' claims about their own lending practices.

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\(^7\) From 2001 to 2006, the number of no-document loans (i.e. loans obtained without the borrower submitting any documentation to verify employment or stated assets on his/her loan application) rose from 28.5% of the subprime mortgages in 2001 to 50.8% in 2006. John C. Coffee, Jr., What Went Wrong? A Tragedy in Three Acts, 6 U. St. Thomas L.J. 403, 406 tbl.1 (2009); see also Unterman, supra note 5, at 84 (arguing that originators accepted loans "indiscriminately").

\(^8\) See Robert S. Friedman & Eric R. Wilson, The Legal Fallout from the Subprime Crisis, 124 Banking L.J. 420, 425 (2007) (noting that the bankruptcy of Ownit Mortgage was followed by the bankruptcy of several other prominent loan originators); Jonathan C. Lipson, Re: Defining Securitization, 85 S. Cal. L. Rev. 1229, 1255 (2012) (noting that "new securitization transactions were being originated" after 2007).


\(^10\) Id. at 11-12.

\(^11\) See id. at 10.

\(^12\) See infra Part II.B.1.

Since financial institutions did not retain attorneys to investigate the soundness of the mortgage market, attorneys had little incentive to question the quality of the mortgages they were securitizing.\textsuperscript{14} Federal securities laws do not allow for private actions for aiding and abetting securities fraud,\textsuperscript{15} and lawyers lack the requisite state of mind to aid and abet securities fraud in actions brought by the SEC, or under the securities laws of most states, when they fail to inform themselves about their clients' businesses.\textsuperscript{16} Moreover, financial institutions are unlikely to sue their attorneys for malpractice for failing to detect violations of the securities laws,\textsuperscript{17} and attorneys generally do not owe duties to non-clients.\textsuperscript{18}

Scholars have long debated whether attorneys should act as their clients' gatekeepers,\textsuperscript{19} but these debates presuppose that attorneys will have sufficient

\textsuperscript{14} See Susan P. Koniak, \textit{When the Hurlyburly's Done: The Bar's Struggle with the SEC}, 103 COLUM. L. REV. 1236, 1271-72 (2003) (suggesting lawyers are deterred from investigating client misconduct by current SEC regulations).


\textsuperscript{16} See generally Marc I. Steinberg, \textit{Lawyer Liability After Sarbanes-Oxley - Has the Landscape Changed?}, 3 WYO. L. REV. 371, 378, 380 (2003) (noting that attorneys must knowingly make material misstatements to incur liability for aiding and abetting under federal law whereas some states require only a showing of recklessness). As Professor Steinberg notes, the impact of state securities laws has been significantly lessened by Congress' enactment of the Securities Litigation Uniform Standards Act of 1998 such that state securities law actions are generally preempted with respect to nationally traded securities. See id. at 381.

\textsuperscript{17} See Roger C. Cramton et al., \textit{Legal and Ethical Duties of Lawyers After Sarbanes-Oxley}, 49 VILL. L. REV. 725, 746 (2004) ("Until and unless a corporation is forced into bankruptcy and a trustee has been appointed, experience teaches that corporations are unlikely to bring malpractice actions against their lawyers."). Such suits would also usually be barred by the doctrine of \textit{in pari delicto}. See Gen. Car & Truck Leasing Sys., Inc. v. Lane & Waterman, 557 N.W.2d 274, 283 (Iowa 1996); Whiteheart v. Waller, 681 S.E.2d 419, 422 (N.C. Ct. App. 2009). Some courts do not apply the doctrine where the malpractice suit is brought by a receiver. See Jones v. Wells Fargo Bank, 666 F.3d 955, 967 (5th Cir. 2012); FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995).

\textsuperscript{18} See \textit{RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS: DUTY OF CARE TO CERTAIN NONCLIENTS} § 51 (2000) (setting out the limited circumstances in which lawyers may owe duties to non-clients); Ultramares Corp. v. Touche, 174 N.E. 441, 448 (N.Y. 1931) ("[I]f there has been neither reckless misstatement nor insincere profession of opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made.").

information to function as gatekeepers. During the subprime era, attorneys failed to inform themselves about the transactions that they were facilitating and thus were in no position to advise their clients to comply with the securities laws. If, as some scholars have theorized, legal services are transitioning from a bespoke model to a more commoditized one whereby attorneys are retained to perform only certain discrete and narrow tasks, attorneys will increasingly be able to facilitate securities fraud without possessing the requisite knowledge to run afoul of ethical rules or trigger liability under the securities laws. This problem will persist even if the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") helps to ensure that asset-backed securities ("ABS") are far less risky in the future.

To better protect the integrity of the capital markets and ensure that lawyers do not function as mere scriveners for public securities offerings, this Article will propose that the SEC impose investigative duties on attorneys akin to those found in Rule 11 of the Federal Rules of Civil Procedure and Rule 3.1 of the Model Rules of Professional Conduct ("Model Rules"). The SEC has the statutory authority pursuant to Sarbanes-Oxley to promulgate professional standards for in-house and outside counsel who appear before it and should exercise this authority to ensure that attorneys do not abdicate their duties to exercise "independent professional judgment" by failing to inform themselves of inconvenient facts when preparing public offering documents for securities.

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20 See Koniak, supra note 14, at 1280 ("Lawyers don’t need to discover what the client is up to; they know, because they are drifting the scripts, structuring the transactions.").
21 See, e.g., William D. Henderson, A Blueprint for Change, 40 PEPP. L. REV. 461, 479 & n. 94 (2013) (discussing Richard Susskind’s theory on the paradigm shift within the legal industry as presented in his 2008 book The End of lawyers?).
23 The SEC has adopted a rule that requires issuers to undertake a review of the underlying assets in an ABS offering that "must be designed and effected to provide reasonable assurance that the disclosure . . . regarding the assets is accurate in all material respects." Issuer Review of Assets In Offerings of Asset-Backed Securities, Securities Act Release No. 9176, Exchange Act Release Nos. 33-9,176 & 34-63,742, 76 Fed. Reg 4231, 4234 (Jan. 25, 2011) (codified at 17 C.F.R. pts. 229 & 230). The issuer, however, is able to rely on a third party to undertake this review. Id. at 4235-37.
26 Kevin H. Michels, Lawyer Independence: From Ideal to Viable Standard, 61 CASE W. RES. L. REV. 85, 139 (2010) (arguing that lawyer cannot form professional judgment under Model Rule 2.1 unless he or she "gain[s] the information necessary to form a judgment about the matter in question, which requires inquiry into the facts and circumstances as well as research into the law implicated by the facts."); see MODEL RULES OF PROF’L CONDUCT R. 2.1 (2013). As this author has observed previously, however, very few authorities address the meaning of Model Rules of Professional Conduct R. 2.1. See generally Milan Markovic, Advising Clients After Critical Legal Studies and the Torture Memos, 114 W. VA. L. REV. 109, 119 (2011) (noting the paucity of authorities and scholarship on Rule 2.1).
Part I of this Article will briefly explain the nature of the securitization process and how MBS were created. It will also describe the role of attorneys in this process. Attorneys for originators, depositors, and underwriters would have reviewed representations regarding mortgage origination before these representations were included in MBS offering documents. In theory, the involvement of attorneys should have ensured that offering documents accurately reflected originators' lending practices. In actuality, lawyers had few incentives to inquire into lending practices if their clients did not expect them to do so.

Part II will use the example of WaMu to illustrate the disparity between loan originators' actual lending standards and what was disclosed to investors. WaMu's in-house lawyers and risk management personnel were largely marginalized as WaMu loosened its lending standards, and internal concerns about irresponsible loan origination were not shared with the attorneys who worked on MBS and other securities offerings on WaMu's behalf. Indeed, misleading statements about WaMu's underwriting standards were incorporated not only in offering documents for WaMu securities, but also those of Citigroup, Goldman Sachs, and other institutions that securitized mortgage loans from WaMu and its affiliates. Without a realistic sense of how mortgages were being originated, investors could not accurately gauge the riskiness of MBS and related investments.

Part III examines the possibility of requiring attorneys involved in the preparation of public offering documents to conduct a reasonable inquiry to ensure that the documents do not contain material misrepresentations and omissions. The SEC is able to impose such a requirement as part of its mandate to regulate attorneys who appear before it. Attorneys who prepare public offering documents without seeking to corroborate any of the claims therein should be sanctioned and potentially prohibited from practicing before the SEC. This proposal would increase the likelihood that material misrepresentations are detected and corrected prior to an offering taking place and would ensure that lawyers take greater responsibility for the documents that they file with the SEC.

Attorneys who represented issuers of MBS and related financial products failed to investigate whether the mortgages they were securitizing were originated responsibly. This was not an oversight on the part of a small number of attorneys but a collective abdication to effectuate compliance with the securities laws.

27 This does not mean, of course, that attorneys alone bear responsibility for the content of offering documents. Underwriters, for example, obtain significant profits from securities offerings and are expected to "pass on the soundness of the security and the correctness of the registration statement and prospectus." Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973).
29 See 17 C.F.R. § 205.6 (2014).
I. SECURITIZATION AND THE PREPARATION OF MBS OFFERING DOCUMENTS

A. The Securitization Process

Securitization has been one of the primary means of capital formation in the United States since the 1990s. Virtually any asset that generates cash flow can be securitized. Despite the importance of securitization to the economy, there is little consensus regarding its definition. For example, Dodd-Frank regulates securitization without attempting to define it.

Securitization consists of the transfer of payment rights from income-producing financial assets to a special-purpose vehicle ("SPV"), which issues securities to investors. The SPV funds itself from the sale of these securities and investors are paid from the income generated from the securitized assets. Since the assets (and the income generated therefrom) are separated from the credit risk of the originator, securitization allows the originator to raise capital more inexpensively than it otherwise might and permits it to have access to the capital markets that it might otherwise lack.

In the case of MBS, a financial institution, known as a sponsor, assembles mortgage loans that it or a third party originated. The sponsor then sells the pool of loans to a subsidiary known as a depositor. The depositor proceeds to sell the loans to an SPV that is usually in the form of a trust. The trust sells the certificates to investors, which entitle the investors to payments from the mortgages

30 See Lipson, supra note 8, at 1231–32.
31 See Unterman, supra note 5, at 79.
33 See Lipson, supra note 8, at 1232; see also Joseph C. Shenker & Anthony J. Colletta, Asset Securitization: Evolution, Current Issues and New Frontiers, 69 TEX. L. REV. 1369, 1374 (1991) ("The difficulty in constructing a satisfactory definition of securitization is that the term is used to describe a wide variety of financial transactions, from the most basic mortgage-backed security to a complex offering of multiple layers of debt and equity interests in a single asset or pool of assets.").
35 See William W. Bratton & Adam J. Levitin, A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs, 86 S. CAL. L. REV. 783, 800 (2013); Schwarcz, supra note 34.
36 See Lipson, supra note 8, at 1239 (suggesting that in most securitizations, investors will be afforded payment rights); Schwarcz, supra note 34.
37 See Lipson, supra note 8, at 1239.
38 See id. at 1243–44.
39 Adam J. Levitin & Tara Twomey, Mortgage Servicing, 28 YALE J. ON REG. 1, 13 (2011).
40 Id. This step is not strictly necessary for the securitization but is done for accounting reasons. See id. at 13 & n.34.
41 Id. at 13–14.
pools that form the trust, while using the proceeds to pay for the mortgage loans.\textsuperscript{42} Often the SPV will not sell the securities directly but through the depositor and an underwriting syndicate.\textsuperscript{43} By the end of 2007, of the approximately $9.7 trillion held in ABS, $7.2 trillion were held in MBS.\textsuperscript{44} The vast majority of MBS and other ABS were publicly issued.\textsuperscript{45}

Although prominent figures have blamed securitization for the financial crisis,\textsuperscript{46} the securitization of MBS and CDOs, in particular, was largely responsible.\textsuperscript{47} MBS and CDOs are both backed by mortgage loans.\textsuperscript{48} However, whereas MBS entitle the holder to primary payment rights from a pool of mortgages, CDOs entitle the holder only to partial payments from a pool of assets that include MBS and other securities as well, such as bonds and derivatives.\textsuperscript{49} Many of the riskiest MBS were packaged into CDOs.\textsuperscript{50} Financial institutions also issued so-called “synthetic CDOs,” which essentially represented bets via credit default swaps on the performance of certain MBS.\textsuperscript{51} After assigning stellar ratings to MBS and CDOs for years, credit agencies downgraded most of these investments to junk status by the end of 2008.\textsuperscript{52}

The legal industry profited handsomely from structuring MBS and CDO

\textsuperscript{42} Id. at 14; see also Schwarz, supra note 34. The trustee would be responsible for either servicing the loans or contracting with an entity to service the loans. See Levitin & Twomey, supra note 39, at 15–16.

\textsuperscript{43} See Levitin & Twomey, supra note 39, at 14.

\textsuperscript{44} Grossfeld & Heppe, supra note 6, at 718.

\textsuperscript{45} See Sandra L. Thompson, Acting Director, Div. of Supervision and Consumer Prot., Fed. Deposit Ins. Corp. (FDIC), Addressing the Subcomm. on Hous. & Transp. and the Subcomm. on Econ. Pol’y of the S. Comm. on Banking, Hous., & Urban Affairs (Sept. 20, 2006), available at https://www.fdic.gov/news/news/speeches/archives/2006/chairman/spsep2006.html. It is nevertheless the case that more and more ABS were being sold through the private markets. See id. (noting that the share of U.S. mortgage debt financed through private ABS trusts more than doubled between 2003–2005, from 8.6% to 17.4% of all U.S. mortgage debt financed through ABS trusts).

\textsuperscript{46} See Lipson, supra note 8, at 1248-49 (noting criticisms of securitization by former Treasury Secretaries Timothy Geithner and Henry Paulson, among others).

\textsuperscript{47} See id. at 1250 tbl.

\textsuperscript{48} See Schwarz, supra note 34, at 1111–12.

\textsuperscript{49} Lipson, supra note 8, at 1251.

\textsuperscript{50} Unterman, supra note 5, at 91.

\textsuperscript{51} Bratton & Levitin, supra note 35, at 791; see also Michael Simkovic, Competition and Crisis in Mortgage Securitization, 88 IND. L.J. 213, 262 (2013) (“Rather than purchase MBS and thereby fund mortgages, synthetic CDOs used credit default swaps to enable investors to make side bets on the performance of existing MBS or CDOs.”). In a credit default swap, a party enters into a contract with a counterparty and pays the counterparty a periodic fee in exchange for the counterparty agreeing to purchase assets such as MBS if certain events occur. Kristin N. Johnson, Governing Financial Markets: Regulating Conflicts, 88 WASH. L. REV. 185, 209 (2013).

\textsuperscript{52} FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 221-24 (2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf. For example, Moody’s downgraded to junk status seventy-six percent of all MBS it had initially rated as investment grade in 2006 and eighty-nine percent in 2007. Id. at 222-23. By the end of 2008, Moody’s downgraded more than eighty percent of Aaa CDOs and ninety percent of Baa CDOs to junk status. Id. at 224.
transactions. Attorneys worked with sponsors and depositors to document the purchase, sale, and service of mortgage loans and prepared offering documents that would be filed with the SEC and disseminated to investors. The SPV comes into existence immediately prior to the time of the offering and is generally not represented by counsel.

With respect to the issuance of MBS and other asset-backed securities, the securities laws specifically require the disclosure of certain information regarding the underlying assets, including the presentation of historical delinquency and loss data. Much of this information will be obtained from the originator of the mortgage loans, and to the extent that loans do not conform to the originator's

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54 See Ronald S. Borod & Andrew M. Sroka, Securitization Reform Halftime Report, 32 BANKING & FIN. SERVICES POL’Y REP., Apr. 2013, at 3; Brian E. Berger, Recent Development, The Professional Responsibility of Lawyers and the Financial Crisis, 31 REV. BANKING & FIN. L. 3, 6 (2011) (“Issuers of MBS customarily retain securities lawyers to help prepare disclosure documents for MBS offerings.”). Another key function of attorneys was to provide “true sale” opinions that assure investors that the assets in question had actually been sold to the SPV so that creditors of either the depositor or sponsor could not reach the assets. See David R. Keyes, Bankruptcy-Remote Special Purpose Entities: A Case and Trial to Watch, 44 TEX. J. BUS. L. 205, 206 (2012); Lipson, supra note 8, at 1239–40. The true sale opinion has been described as the “holy grail” of securitization.” Id. at 1240 & n.39 (citing Peter V. Pantaleo et al., Rethinking the Role of Recourse in the Sale of Financial Assets, 52 BUS. LAW. 159, 161 (1996)). For a discussion of the legal ethics of true sale opinions, see Steven L. Schwarz, The Limits of Lawyering: Legal Opinions in Structured Finance, 84 TEX. L. REV. 1, 42 (2005) (suggesting that lawyers should have the right to issue legal opinions that facilitate lawful structured finance transactions). The issuance of true sale opinions proved controversial in connection with Enron's use of SPVs. See William H. Simon, The Market for Bad Legal Advice: Academic Professional Responsibility Consulting as an Example, 60 STAN. L. REV. 1555, 1556 (2008) (“Lawyers from Andrews Kurth and from Vinson & Elkins gave opinions to Enron that various asset transfers represented ‘true sales’ or involved a ‘true issuance’ of securities even though the opinions were either plainly wrong or plainly irrelevant to the circumstances they addressed.”) (internal citations omitted); Dov Solomon, The Rise of a Giant: Securitization and the Global Financial Crisis, 49 AM. BUS. L.J. 859, 868 (2012). Most of the litigation arising out of the financial crisis has focused on the adequacy of disclosures regarding the mortgage loans that were securitized into MBS. See Berger, supra, at 6 (noting private litigation involving disclosures made with respect to MBS and CDOs). See generally SEC Enforcement Actions, Addressing Misconduct That Led to or Arose From the Financial Crisis, SEC, http://www.sec.gov/spotlight/enf-actions-fc.shtml (last updated Sept. 18, 2014) (setting out a complete list of enforcement actions arising out of the financial crisis and status thereof).

55 See Levitin & Twomey, supra note 39, at 13–14; see also Bratton & Levitin, supra note 35, at 787.


57 See 17 C.F.R. § 229.1100(b) (2014).
representations, the originator may be contractually required to replace them.\textsuperscript{58} By the time offering documents are made available to investors, the lawyers for the originator, the depositor, and the underwriter would have all had the opportunity to scrutinize the representations therein.

Although few attorneys likely set out to facilitate violations of the securities laws during the subprime era, attorneys did have strong incentives to avoid inquiring into originators' lending practices. Indeed, the high demand for MBS and related investments made it unlikely that attorneys would seek to inquire into, let alone challenge, lax lending standards.

B. Lawyers as Production Managers or Scriveners?

In a traditional securities offering, the role of issuer's counsel has been equated to that of a "production manager for the entire disclosure process."\textsuperscript{59} Because of the pro-disclosure regime of the federal securities laws,\textsuperscript{60} and the possibility of liability under securities laws for both the client and attorney, lawyers should seek to ensure that all material facts are disclosed to prospective investors.\textsuperscript{61} This is consistent with the Model Rules' requirement that attorneys "exercise independent professional judgment and render candid advice"\textsuperscript{62} even if the advice is "unpalatable to the

\textsuperscript{58} See Henry T. C. Hu, Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm, 90 TEX. L. REV. 1601, 1708 (2012); Helen Mason, No One Saw It Coming – Again Systemic Risk and State Foreclosure Proceedings: Why A National Uniform Foreclosure Law Is Necessary, 67 U. MIAMI L. REV. 41, 72 (2012); Simkovic, supra note 51, at 232–33 (noting that Freddie Mac and Fannie Mae have been more aggressive than private financial institutions in enforcing repurchase agreements with loan originators). The SEC now requires issuers to review the assets in an ABS offering. See 17 C.F.R. § 230.193 (2014). This review should provide reasonable assurance to the representations about the underlying assets are accurate in all material aspects. Id. While an analysis of this and other SEC rules promulgated pursuant to Dodd-Frank is beyond the scope of this Article, MBS offering documents were largely misleading because they omitted information necessary for investors to understand how mortgage loans were actually being originated. See infra Part II.B.2. By omitting key information, a disclosure can be technically accurate, while still providing a misleading account of the assets that are being securitized.


\textsuperscript{60} Affiliated Ute Citizens of UT v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)) (noting that the "fundamental purpose [of the federal securities laws was] to substitute a philosophy of full disclosure for the philosophy of caveat emptor"). For example, Sections 11 and 12 of the Securities Act prohibit material misstatements or omissions in public offering documents. See 15 U.S.C. §§ 77k(a), (e) (2013) (noting that Section 11 only applies to public offerings); 15 U.S.C. § 77k(a)(2) (2013); Gustafson v. Alloyd Co., 513 U.S. 561, 571–72 (1995) (holding that Section 12 only implicates public offerings of securities). Plaintiffs are not required to plead that the defendants acted with scienter in such actions. See In re Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 (2d Cir. 2010) (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983)) ("Issuers are subject to 'virtually absolute' liability under Section 11, while the remaining potential defendants under Sections 11 and 12(a)(2) may be held liable for mere negligence.").

\textsuperscript{61} See Warren, supra note 59, at 388.

\textsuperscript{62} MODEL RULES OF PROF'L CONDUCT R. 2.1 (2013).
At times, counsel may even be forced to assume an adversarial posture with the client if the client is reluctant to disclose information that might negatively affect the marketability of the securities being offered. When a particular offering is underwritten, the underwriters' counsel will also review the offering documents to ensure that the necessary disclosures have been made. Under Sections 11 and 12 of the Securities Act, underwriters are able to escape liability for any material misrepresentations and omissions contained in an issuer's offering document if they are able to demonstrate that they, or their attorneys, reasonably investigated the claims.

Attorneys, whether they represent the issuer or underwriter, may nevertheless avoid functioning as independent "production managers" and ensuring that all requisite disclosures are made. This is because, as scholars have observed in a wide variety of contexts, attorneys may assist their clients with actions of dubious legality by choosing to not pursue information that would indicate that their clients are engaged in fraud or other misconduct. Willful ignorance may not only consist of deliberately ignoring clear signs of a client's wrongdoing, but also of arguably less blameworthy conduct such as failing to conduct a sufficient inquiry in order to determine whether the client is engaged in wrongdoing. States have disciplined attorneys for deliberately ignoring clear signs of wrongdoing in the course of providing legal assistance to their clients, but,

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63 Id. cmt. 1.
64 See Warren, supra note 59, at 390; see also Marc I. Steinberg, The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas, 46 WASHBURN L.J. 1, 2 (2006) ("The portrayal of the attorney as 'gatekeeper' is now a fixture in the attorney responsibility landscape.").
65 See, e.g., Poonam Puri, Taking Stock of Taking Stock, 87 CORNELL L. REV. 99, 153 (2001) ("[E]ven if the issuer's counsel is ... not performing its gatekeeping role, counsel for the underwriter will continue to have unaltered incentives to perform its gatekeeping function."); Eric Seitz, Comment, Underwriter Due Diligence: It's [Not] a Whole New Ballgame, 61 SMU L. REV. 1633, 1653 (2008) ("[T]he underwriter's counsel assumes the due diligence function of ensuring the veracity and completeness of all registration material.").
67 See, e.g., Monroe H. Freedman, Professional Responsibility of the Criminal Defense Lawyer: The Three Hardest Questions, 64 MICH. L. REV. 1469, 1472 (1966); David Luban, Contrived Ignorance, 87 GEO. L.J. 957, 976-77 (1999); Simon, supra note 19, at 34-35 ("Deliberate ignorance and calculated ambiguity are key themes in major scandals from Watergate to Enron. . . . The legal community has historically embraced this path of deliberate ignorance and calculated ambiguity . . . ."). Professor Koniak had made this point explicitly with respect to the reporting obligations of SEC attorneys. Koniak, supra note 14, at 1271 ("Lawyers never 'know' that their client is committing a crime or fraud, not before a court has ruled conclusively, and sometimes not even then.").
68 See Luban, supra note 67, at 969-70.
69 See In re Dobson, 427 S.E.2d 166, 168 (S.C. 1993); Conn. Bar Ass'n Comm. on Ethics & Prof'l Responsibility, Informal Op. 91-22 (1991); see also MODEL RULES PROF'L CONDUCT R. 1.0(f) (2013) (suggesting that "actual knowledge" can be "inferred from the circumstances"); CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 696 (1986) ("As a lawyer, one may not avoid the bright light of a clear fact simply by averting one's eyes or turning one's back."); Roiphe, supra note 4, at 198 ("There is
the impropriety of failing to conduct enough of a meaningful inquiry to assess a client's conduct is far less clear.\textsuperscript{70}

The main reason that attorneys may choose not to inform themselves about the representations in offering documents is that they are ethically required to terminate their involvement with an offering if they become aware of material misrepresentations and omissions that will not be corrected.\textsuperscript{71} Attorneys may even be required to take further steps such as reporting misconduct to the issuer's boards of directors.\textsuperscript{72} To avoid potential friction with a corporate client and having to decide whether to terminate a potentially lucrative representation, attorneys can simply fail to inquire into their clients' claims.\textsuperscript{73}

There is little prospect of civil liability for attorneys who fail to inform themselves of the specifics of an offering. Attorneys generally cannot be held liable for material misrepresentations and omissions contained in offering documents under Section 11 of the Securities Act.\textsuperscript{74} Moreover, the Supreme Court has greatly restricted the breadth of private securities fraud actions under Section 10(b) of the Exchange Act such that private actions can only be brought against secondary actors such as attorneys in unusual circumstances.\textsuperscript{75} The SEC is able to bring aiding and abetting securities fraud actions against attorneys;\textsuperscript{76} but, in these actions, the SEC would have to demonstrate, at a minimum, that the attorneys knew of their clients' securities fraud.\textsuperscript{77} An attorney who does not inform himself or herself about the claims made in offering documents is unlikely to have the requisite state of mind for fraud.\textsuperscript{78} Furthermore, state securities laws are inapplicable to class actions at least some argument that even with the actual knowledge standard, by willfully blindin himself to important facts, a lawyer violates other substantive rules of professional conduct.

\textsuperscript{70} Cf. Markovic, supra note 26, at 118–19 (noting that lawyers duties qua advisors are underexplored and under-enforced).

\textsuperscript{71} See MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2013); Warren, supra note 59, at 390.

\textsuperscript{72} See MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2013); 17 C.F.R. § 205.3(b)(1), (b)(3) (2014).

\textsuperscript{73} See Koniak, supra note 14, at 1271–72.

\textsuperscript{74} Section 11 of the Securities Act prohibits misrepresentations in registration statements and other offering documents and allows for liability only against a narrow range of actors. See 15 U.S.C. § 77k(a) (2013). These actors include the issuer, directors thereof, and the underwriter. See id.

\textsuperscript{75} See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. 552 U.S. 148, 165–66 (2008) (holding that private causes of actions for securities fraud are available only against primary violators); see also Gary M. Bishop, A Framework for Analyzing Attorney Liability Under Section 10(b) and Rule 10b-5, 10 U. N.H. L. REV. 193, 210-11 (2012) (suggesting that post-Stoneridge, attorneys can only be sued by defrauded investors if they went beyond advising their corporate clients and working on offering documents by making public statements about the offerings at issue); Marc I. Steinberg & Chris Claassen, Attorney Liability Under the State Securities Laws: Landscapes and Minefields, 3 BERKELEY BUS. L.J. 1, 3-4 (2005) (noting that the Supreme Court has consistently circumscribed liability for attorneys under the securities laws since the 1980s).

\textsuperscript{76} See Stoneridge, 552 U.S. at 162–63.

\textsuperscript{77} "Knowledge may be shown by circumstantial evidence, or by reckless conduct, but the proof must demonstrate actual awareness of the party's role in the fraudulent scheme." Woodward v. Metro Bank of Dallas, 522 F.2d 84, 96 (5th Cir. 1975).

\textsuperscript{78} See Schlifke v. SeaFirst Corp., 866 F.2d 935, 948 (7th Cir. 1989) (quoting Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496-97 (7th Cir. 1986)) ("A plaintiff's case against an aider,
involving nationally traded securities\(^7\) and do not generally allow for aiding and abetting liability when attorneys should have known that the claims in the offering documents were false.\(^8\)

To be sure, attorneys' failure to inquire into the veracity of offering documents can constitute legal malpractice.\(^6\) For example, the Ninth Circuit has held that "[p]art and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors."\(^2\)

Although malpractice liability is a theoretical possibility, a client is unlikely to sue its attorneys for failing to detect its securities fraud in the course of preparing securities offering documents.\(^3\) Such a suit is also likely to be barred by the doctrine of *in pari delicto*.\(^4\) Courts have dismissed malpractice cases against law firms in numerous cases on the basis that their clients bore more responsibility for the fraud.\(^5\) Most states recognize this equitable defense even when the action is brought not by the wrongdoer but by a trustee.\(^6\)

Of course, many issuers and underwriters will wish to be appraised of material misrepresentations and omissions in offering documents. But the higher the demand for the securities, the more pressure there will likely be on attorneys to merely facilitate the offerings. As Professor Hill has noted:

> Once a new instrument [such as MBS] becomes "vetted" and distribution networks are established, the speed at which the "assembly line" moves can make focusing on anything other than the immediate term difficult. All participants in the distribution, including . . . lawyers . . . have strong incentives to keep the

\[^{7}\text{See Steinberg, supra note 16, at 381 (noting the effect of the Securities Litigation Uniform Standards Act of 1998 on state securities law actions).}\]

\[^{8}\text{See id. at 380. A full discussion of aiding and abetting securities fraud under state securities laws is beyond the scope of this Article. For a useful introduction, see Steinberg, supra note 75, at 5-41.}\]

\[^{9}\text{See FDIC v. Clark, 978 F.2d 1541, 1549–51 (10th Cir. 1992); FDIC v. O'Melveny & Myers, 969 F.2d 744, 748–49 (9th Cir. 1992), rev'd on other grounds, 512 U.S. 79 (1994).}\]

\[^{10}\text{O'Melveny, 969 F.2d at 749.}\]

\[^{11}\text{See Crampton, supra note 17, at 746.}\]

\[^{12}\text{"The Latin phrase *in pari delicto potior est conditio defendentis[,]" means}\}

> "[i]n a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one." Bateman Eichler, Hills Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985) (citing BLACK'S LAW DICTIONARY 711 (5th ed. 1979)). This equitable defense is used to dismiss suits where the plaintiff bears substantially equal responsibility for his or her injury.\(^8\)

\[^{13}\text{See id. at 307.}\]


assembly line going. They and others on the assembly line are highly paid “cogs in the wheel.” Succeeding at churning out securities requires not questioning the task or product; stopping the line would risk diminishing one’s earnings and perhaps even losing one’s job.87

The conception of lawyers and legal services as part of an “assembly line” in the creation of MBS stands in stark contrast to how the profession often conceives of itself and its work.88 Nevertheless, this is an accurate description of much of the legal work that was conducted in connection with the issuance of MBS and CDOs.

The next Part of this Article uses the example of WaMu to illustrate the extent to which attorneys failed to provide an adequate picture of the mortgages that they were being paid to securitize.

II. LAWYERS AND WAMU

WaMu was founded in 1889 and issued its first home loan in 1890.89 At the time of its collapse, WaMu was the sixth largest bank in the United States with over $300 billion in assets, $188 billion in deposits, and over 43,000 employees.90 Regulators seized the bank on September 25, 2008 after WaMu encountered a severe liquidity crisis because of a precipitous drop in the value of its mortgage assets.91 JP Morgan Chase ultimately acquired WaMu for $1.9 billion.92

WaMu’s collapse was predominately caused by its lax underwriting of mortgage loans.93 It was by no means the only institution that engaged in irresponsible lending prior to the financial crisis, but the existence of thorough accounts of its collapse allow for an in-depth analysis of the disconnect between its

88 See MODEL RULES OF PROF’L CONDUCT R. 1.6 cmt. 2 (2013) (“Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct.”). The attorney is also described as “a public citizen having special responsibility for the quality of justice.” Id. pmbl. He or she is also one who will reference not only the law, but “other considerations such as moral, economic, social and political factors, that may be relevant to the client’s situation.” Id. R. 2.1.
91 Id.
92 Id.
93 See id. at 56; Goodman & Morgenson, supra note 89, at 22 (“It was the Wild West. . . . [i]f you were alive, [WaMu] would give you a loan. Actually, I think if you were dead, [WaMu] would still give you a loan.”) (quoting Steven M. Knobel, the founder of an appraisal company that frequently worked with WaMu).
lending practices and what was disclosed to investors. As the Senate Subcommittee on Investigations concluded in its report on the financial crisis:

[WaMu's] strategy for growth and profit led to the origination and securitization of hundreds of billions of dollars in poor quality mortgages that undermined the U.S. financial system. WaMu had held itself out as a prudent lender, but in reality, the bank turned increasingly to higher risk loans. . . . [It] was emblematic of a host of financial institutions that knowingly originated, sold, and securitized billions of dollars in high risk, poor quality home loans. . . . [T]he high risk loans they issued became the fuel that ignited the financial crisis.

Lawyers were unwilling or unable to stop WaMu from issuing, selling, or securitizing these "high risk, poor quality home loans." Even as WaMu's deteriorating lending standards were being contested within the Bank, WaMu's MBS offering documents did not convey that it was lending recklessly. Other financial institutions incorporated WaMu's material misrepresentations and omissions about its loan underwriting into its own securities offerings involving WaMu loans. The lawyers involved in all of the securities offerings may not have intended to further securities fraud, but they also did not seek to provide investors with a realistic sense of how WaMu mortgages were originated.

A. WaMu and the Power of Yes

Until the mid-1990s, WaMu had been a mid-sized bank that specialized in home mortgages. Then, in 1996, WaMu began six years of acquisitions, whereby it purchased more than a dozen financial institutions, including American Savings Bank, Great Western Bank, Fleet Mortgage Corporation, Dime Bancorp, PNC Mortgage, and Long Beach Mortgage ("Long Beach"). After these acquisitions, it became the sixth largest bank in the United States and one of the largest originators of home loans.

WaMu's business model depended on retaining only a small percentage of the mortgage loans that it originated. It either securitized its mortgages to sell to investors or sold them directly to Fannie Mae and Freddie Mac. To enable WaMu to continue to grow in a time of increasing competition in the home mortgage industry, WaMu's CEO, Kerry Killinger, aspired to transform home

96 Id. at 66.
97 Id. at 66.
98 Id. at 76.
99 Id.
100 See id. at 66–67.
101 Id.
lending in much the same way that Wal-Mart had transformed retail sales.\textsuperscript{102} This meant making mortgage loans available to middle and lower income Americans who did not qualify for traditional mortgages.\textsuperscript{103}

WaMu's commitment to this goal was best captured by its popular advertising campaign dubbed "The Power of Yes."\textsuperscript{104} Television commercials boasted of WaMu's "flexible lending rules," "quick approval," and also intimated that WaMu would approve loans without requiring basic documents such as pay stubs.\textsuperscript{105} From January 2005 until its collapse, WaMu implemented a "High Risk Lending Strategy" that focused on originating higher risk loans such as subprime loans, Option ARMs, and home equity loans as opposed to low-risk, fixed-rate mortgage loans, in order to claim an even greater share of the mortgage market.\textsuperscript{106} These loans were more profitable for WaMu because borrowers generally had to pay higher interest rates and origination fees, and investors consequently assigned greater value to them.\textsuperscript{107} In the period from 2003 to 2006, WaMu's mortgage originations that were fixed rate loans fell from sixty-four percent to twenty-five percent, while originations from subprime loans, Option ARMs, or home equity loans increased from nineteen percent to fifty-five percent.\textsuperscript{108}

As WaMu was increasing the risk of its mortgage loan portfolio, it was simultaneously easing its lending rules. One significant change was to originate more "stated income loans," whereby the Bank would not require proof of a lender's income.\textsuperscript{109} By the end of 2007, stated income loans made up fifty percent of subprime loans, seventy-three percent of Option ARMs, and ninety percent of home equity loans issued by WaMu.\textsuperscript{110} An increasing percentage of WaMu's residential mortgage loans were also coming from third-party lenders and independent brokers.\textsuperscript{111} These loans were approximately sixty-six percent less

\textsuperscript{102} See Goodman & Morgenson, supra note 89, at A1.


\textsuperscript{104} See Grind, supra note 94, at 68.

\textsuperscript{105} Id. At the height of the real estate bubble, WaMu extended a second loan on a home to O.J. Simpson. Id. at 179.

\textsuperscript{106} See Staff of S. Permanent Subcomm. on investigations, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Collapse 66, 79 (Comm. Print 2011). Subprime loans were loans that were issued to borrowers who lacked the credit to qualify for traditional fix rate mortgages. See id. at 84. Under WaMu's High Risk Lending Strategy, one could qualify for a home loan with a FICO score of 620. Id. at 83. Option ARMs have an interest rate that is pegged to prevailing interest rates, but the borrower pays an initial "teaser" rate and is qualified for the loan via the initial rate. See id. at 85, 133.

\textsuperscript{107} See id. at 85. WaMu would earn eight times as much from securitizing subprime loans than fixed rate loans, for example. Id. at 86.

\textsuperscript{108} Id. at 91.

\textsuperscript{109} See id. at 117–19; Grind, supra note 94, at 123 (noting that risk management personnel could not limit the number of stated income loans being issued).

\textsuperscript{110} Staff of S. Permanent Subcomm. on investigations, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Collapse 117 (Comm. Print 2011).

\textsuperscript{111} See id. at 114.
expensive for WaMu to originate and were subject to minimal oversight from WaMu.112

Another significant change came in the form of issuing home loans with high loan-to-value ("LTV") ratios.113 Banking regulators advise banks to avoid LTV ratios over eighty percent, but a significant percentage of WaMu's home loan portfolio consisted of loans with a LTV ratio of eighty percent, and the High Risk Lending Strategy, initiated by WaMu's management and discussed below, called for loans with LTV ratios of ninety percent.114 In 2006, WaMu began issuing loans that would provide financing for 100% of a property's purchase.115 While issuing more mortgage loans with high LTV ratios, WaMu was also pressuring appraisers to inflate home values.116 In November 2007, then New York Attorney General, Andrew Cuomo, filed suit against WaMu's primary appraiser for appraisal fraud, which later settled for a substantial amount.117

Outright mortgage loan fraud was also rampant at WaMu. In 2005, WaMu's General Counsel initiated an internal investigation of two WaMu offices in Southern California, finding fraud in forty-two percent of loans reviewed.118 Examples of the fraud included employees willfully misrepresenting a borrower's identity, income, and assets.119 A broker who led one of these offices claimed to have made 2,300 mortgages in 2005 - a rate of six mortgages every day, including weekends and holidays.120 WaMu not only failed to close the office, but also rewarded the broker with a lavish trip to Hawaii and other perks.121

WaMu was largely unconcerned with the poor quality of its loan underwriting because it passed much of the risk onto other financial institutions and investors.122 This strategy was successful until the crash of the real estate market.123

Some prominent WaMu insiders opposed its reliance on risky mortgage loans. At a 2004 corporate retreat, Jim Vanasek, WaMu's Chief Risk Officer, publicly

112 See id. at 114–115.
113 See id. at 119.
114 See id. at 84, 119. In 2005, WaMu actually set up automatic loan approval for Option Arms and home equity loans with a 90% LTV. Id. at 119. Borrowers with credit scores as low as 620 were eligible. Id.
115 See id. at 120.
116 See GRIND, supra note 94, at 178.
119 Id. at 124–25.
120 GRIND, supra note 94, at 144.
122 See id. at 148. WaMu issued $37.2 billion in RMBS securitizations directly to investors in 2004, $73.8 billion in 2005, and $72.8 billion in 2006. See id.
123 See id. at 66. WaMu, in some cases, securitized the mortgage loans that were most likely to default or were suspected to be fraudulent. See id. at 148.
challenged WaMu's management by suggesting that "the power of yes absolutely needed to be balanced by the wisdom of no." 124 Vanasek also circulated a memorandum prior to the initiation of the High Risk Lending Strategy that expressed his concerns regarding the unsustainability of home prices and encouraged the Bank to adopt tighter underwriting standards.125 Vanasek earned the moniker "Dr. Doom" for his warnings about WaMu's exposure to the housing market, but neither WaMu's CEO, nor its Board of Directors, heeded his concerns.126

Another dissenting voice within WaMu was its General Counsel, Fay Chapman. In 2003, Chapman stopped all securitizations from Long Beach, WaMu's subprime lending arm, after one of her subordinates reported that Long Beach was engaging in mortgage fraud and misrepresenting its underwriting standards.127 Although some WaMu officers opposed the stoppage of Long Beach's lucrative securitizations, Chapman was able to convince WaMu CEO Killinger that securitizations should not proceed until Long Beach's lending practices no longer posed a litigation risk.128

A subsequent three-month investigation led by Chapman revealed that many mortgage files were missing basic paperwork.129 Some of the files were so incomplete that Long Beach would not be able to foreclose in the event of a default.130 Chapman and her team ultimately determined that of the 4,000 mortgages reviewed, only 950 could be sold to investors.131 Long Beach securitizations were reinstated in 2004 after Chapman concluded that it no longer represented a significant liability risk.132 A few months later, however, Long Beach's management loosened its underwriting standards to again increase its output of mortgage loans.133

124 Id. at 182. The Chief Risk Officer is "directly responsible for the enterprise risk management system, which tracks some of the major risks that the firm faces" and ensures that the firm avoids "excessive risk exposures." Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance, 76 U. CHI. L. REV. 219, 250 (2009).
126 See Id. at 88, 141; see also GRIND, supra note 94, at 123–24 (noting that WaMu never embraced Vanasek's idea to adopt more stringent lending practices).
127 See GRIND, supra note 94, at 56, 76.
128 See id. at 76.
129 Id. at 76–77.
130 Id. at 77.
131 Id.
133 See id. at 100; GRIND, supra note 94, at 136–37 (noting that the oversight instituted by Chapman had become "unglued"). Long Beach loans performed so poorly in 2004 and 2005 that it was obligated to purchase nearly $837 million in loans. See STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A COLLAPSE 102–03 (Comm. Print 2011). Although Long Beach's problems resurfaced after Chapman's intervention, Chapman fulfilled her ethical obligations in stopping the Long Beach securitizations after
While it is difficult to know whether WaMu's collapse could have been avoided, the Bank may have benefitted from greater coordination between its Risk Management department and General Counsel's office. Vanasek frequently expressed his concerns about WaMu's lax underwriting to WaMu's board, but Vanasek was not a lawyer and conceived the threat to WaMu largely in terms of the underperformance of WaMu's mortgage loan portfolio if housing prices ceased their upward trajectory. Under such circumstances, WaMu's Board of Directors could have reasonably deferred to the Bank's long-time CEO as to the Bank's proper business direction. A lawyer in Vanasek's position may have conceived of the threat differently – namely in terms of litigation risk emanating from selling and securitizing mortgages that were not originated in accordance with WaMu's representations and warranties.

Similarly, Chapman did not appear to be aware that many of the problems she had observed at Long Beach were characteristic of WaMu as a whole. Indeed, she had supported WaMu's High Risk Lending Strategy because she erroneously assumed that Vanasek could keep WaMu from carrying too much risk. However, WaMu had been issuing risky loans prior to the formal adoption of the strategy, and WaMu had cut the ranks of its Risk Management department significantly. Chapman eventually came to oppose the High Risk Lending Strategy, but, by that time, Vanasek had been retired for several years, and she lacked allies within upper management.

Irrespective of whether WaMu's collapse could have been averted, personnel inside WaMu had contested its lending practices long before the implosion of the United States real estate market. There is no record of WaMu's outside counsel she was informed of its fraudulent lending practices. A lawyer who knows of "a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization," is generally expected to report the violations to a higher authority in the organization. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2013). In this case, Chapman reported Long Beach's problematic underwriting to Killinger, who acquiesced to her demand to stop all Long Beach securitizations. See GRIND, supra note 94, at 76. Chapman was not obligated to go to WaMu's board of directors because Killinger took corrective action. See MODEL RULES OF PROF'L CONDUCT R. 1.13 cmts. 4-5 (2013).


See id. at 87–88; GRIND, supra note 94, at 135.

As Professor Bainbridge notes, business risk management and legal risk management differ because the former is inevitably linked with risk-taking. See Stephen M. Bainbridge, Caremark and Enterprise Risk Management, 34 J. CORP. L. 967, 990 (2009). However, in the words of one WaMu executive, attorneys tend to "want[.] to be open kimono about everything." GRIND, supra note 94, at 179; see also Langevoort, supra note 4, at 501-02 (discussing the debate regarding whether legal compliance and business ethics should fall under the auspices of the General Counsel's office).

See GRIND, supra note 94, at 123.

For example, nearly sixty percent of the loans that WaMu was making were higher-risk loans before the High Risk Lending Strategy. See id. at 122.

See id. at 122–23.

See id. at 149,179–80; Symposium, Corporate Compliance: The Role of Company Counsel, 21 GEO. J. LEGAL ETHICS 491, 528 (2008) (suggesting that having coordination between the General Counsel's office, risk management, audit, and compliance is more likely to lead to effective gatekeeping).
having raised similar concerns, and as set out below, offering documents for WaMu's MBS did not reflect the deterioration of its underwriting standards. This may be because, as some scholars have suggested, outside counsel generally have less capacity than in-house counsel to ferret out wrongdoing. However, the significant disconnect between what was known within the Bank about its lending practices and what was disclosed to investors strongly suggests that attorneys who represented WaMu failed to inform themselves about its lending practices. Attorneys who represented other financial institutions that securitized WaMu mortgages also appeared to not question that WaMu was a prudent lender.

B. The Misrepresentation of WaMu's Underwriting Standards

After WaMu's collapse, investors filed a number of securities class actions against WaMu, its officers, and its directors for failing to disclose the lax nature of WaMu's mortgage loan underwriting. Some of these actions concern alleged material misrepresentations and omissions in WaMu's MBS offering documents, whereas others pertain to alleged material misrepresentations and omissions in offering documents for other WaMu securities. Separately, plaintiffs have initiated securities fraud actions against other financial institutions that securitized WaMu mortgages. This section will examine these actions.

141 See Gilson, supra note 19, at 914–15 (“Reduced costs of changing lawyers made private gatekeeping an increasingly difficult proposition.... If we want a private gatekeeper, and the market power necessary for private gatekeeping has moved in-house, then so too must the gatekeeping function.”); Sung Hui Kim, Gatekeepers Inside Out, 21 GEO. J. LEGAL ETHICS 411, 462-63 (2008) (“[I]t is no longer the case that outside market gatekeeping firms are the self-evident choice for the company's gatekeeping function.... [Gatekeepers] may already be embedded within the firm, in the form of inside counsel, awaiting the opportunity to activate the corporate conscience.”). But see Stephen M. Bainbridge, The Tournament at the Intersection of Business and Legal Ethics, 1 U. ST. THOMAS L.J. 909, 920 (2004) (“Even if the legal department's human resources policies do not create a promotion tournament... in-house lawyers have strong incentives to stay on the good side of senior management. Although the general counsel often is formally appointed by the board of directors, his tenure normally depends mainly on his relationship with the CEO.”); Langevoort, supra note 4, at 503–05 (suggesting that in-house attorneys with a high appetite for risk may have a competitive advantage over their risk-averse peers under certain circumstances).

142 See STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A COLLAPSE 148-49 (Comm. Print 2011) (demonstrating that other companies continued to constantly buy securities from WaMu).

143 The primary cases were consolidated into In re WaMu Mortgage-Backed Securities Litigation (hereinafter MBS). See Boilermakers Nat'l Annuity Trust Fund v. WaMu Mortg. Pass Through Certificates, Nc. C09-0037MJP, 2010 WL 1336959, at *2 (W.D. Wash. Mar. 25, 2010).

144 The 'non-MBS cases were consolidated into In re WaMu, Inc., Securities Litigation. See In re WaMu, Inc. Secs., Derivative & ERISA Litig., 259 F.R.D. 490, at 494 (W.D. Wash. May 15, 2009) (explaining the procedural history and order to consolidate the securities actions and appointment of Ontario Teachers' Pension Plan Board as lead plaintiff).
1. Litigation against WaMu.—After the crash of the United States real estate market, MBS investors brought actions under Sections 11 and 12 of the Securities Act against WaMu for misrepresenting its lending practices.\textsuperscript{145} Purchasers of other WaMu securities also filed suits on similar bases.\textsuperscript{146}

The main MBS litigation against WaMu was filed in the Western District of Washington and consolidated as \textit{In re Washington Mutual Mortgage-Backed Securities (MBS) Litigation}.\textsuperscript{147} The class action concerned thirty-six offerings of MBS that took place between January 26, 2006 and June 26, 2007, with a collective value of nearly $47.25 billion.\textsuperscript{148}

The two registration statements\textsuperscript{149} for the offerings at issue in \textit{In Re WaMu MBS Litigation} stated that:

In the loan application process, prospective mortgagors generally will be required to provide information regarding such factors as their assets, liabilities, income, credit history, employment history and other related items. . . . With respect to establishing the prospective mortgagor’s ability to make timely payments, the mortgage loan seller may require evidence regarding the mortgagor’s employment and income . . . .\textsuperscript{150}

Whether or not WaMu “generally” required borrowers to provide information regarding assets and the like, the registration statements failed to set out the reality of WaMu’s mortgage origination. As set out in the previous section, WaMu was increasingly securitizing loans from independent brokers and other loan originators and therefore could not be certain what information borrowers were required to provide.\textsuperscript{151} Many of the loans that WaMu itself originated were “stated income loans,” suggesting that WaMu would only rarely require evidence regarding the


\textsuperscript{146} See Amended Consolidated Class Action Complaint ¶ 1, \textit{In re WaMu, Inc. Secs. Litig.}, 259 F.R.D. 490 (W.D. Wash. 2009) (No. 2:08-md-1919 MJP), 2009 WL 2175220 [hereinafter WaMu Sec. Litig. Compl].

\textsuperscript{147} See Boilermakers, 2010 WL 1336959, at *2.


\textsuperscript{149} All of the offerings implicated in the litigation were based on two registration statements filed by WaMu. See id. ¶ 1. Registration statements that are filed in anticipation of future offerings are known as shelf registration statements and are effective for up to three years. See 17 C.F.R. § 230.415(a)(5) (2014).

\textsuperscript{150} WaMu MBS Second Compl., supra note 148, ¶ 138 (quoting Washington Mutual Asset Acceptance Corp. (“WMAAC”), Registration Statement (Form S-3/A) (Jan. 3, 2006); WMAAC, Registration Statement (Form S-3/A) (Apr. 9, 2007)).

\textsuperscript{151} See id. ¶ 139(b), (c); see also supra Part II.A.
mortgagor's employment and income. WaMu even waived documentation requirements for borrowers with poor credit.

The plaintiffs also identified material misrepresentations and omissions in the prospectuses for WaMu's MBS offerings. The prospectuses claimed that WaMu's underwriting guidelines "generally are intended to evaluate the prospective borrower's credit standing and repayment ability and the value and adequacy of the mortgaged property as collateral." These claims about WaMu's general underwriting guidelines were also misleading because WaMu was issuing loans on the basis of little-to-no documentation and was unconcerned with repayment ability, since WaMu originated mortgages to sell to other financial institutions and investors. In terms of the "adequacy of mortgaged property as collateral," WaMu was issuing loans with higher-than-recommended LTV ratios while pressuring appraisers to inflate home values.

The district court judge dismissed the claims in *In Re WaMu MBS Litigation* with respect to twenty-five of the offerings because the named plaintiffs lacked standing. The remaining claims survived WaMu's motion to dismiss, with the judge finding that the plaintiffs had stated a claim with respect to WaMu's alleged misrepresentation of its underwriting guidelines. The parties settled the case for $26 million.

A more recent MBS action was initiated by MBS investors in 2012 in the Southern District of Ohio. Although the Sections 11 and 12 claims concern different MBS offerings from *In Re WaMu MBS Litigation*, the investors

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152 See Staff of S. Permanent Subcomm. on Investigations, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Collapse 117–18 (Comm. Print 2011); WaMu MBS Second Compl., supra note 148, ¶ 141(a); Grind, supra note 94, at 123.

153 See Staff of S. Permanent Subcomm. on Investigations, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Collapse 117–18 (Comm. Print 2011). This is in direct conflict with another claim in the registration statements that only borrowers who met certain eligibility criteria would be able to receive loans without providing documentation. See WaMu MBS Second Compl., supra note 148, ¶ 140 (referencing Washington Mutual Asset Acceptance Corp. ("WMAAC"), Registration Statement (Form S-3/A) (Jan. 3, 2006); WMAAC, Registration Statement (Form S-3/A) (Apr. 9, 2007)).

154 WaMu MBS Second Compl., supra note 148, ¶ 143 (quoting WAMU Series 2007-HY5 (Form 424B5 Supplement) (Apr. 23, 2007)). Eighteen additional offerings contained this exact language. See id. (noting the location of the representation in Prospectus Supplements for nineteen offerings).


156 See WaMu MBS Second Compl., supra note 148, ¶¶ 146, 147(b); see also supra Part II.A.


158 See id. at 1255.


identified many of the same types of material misrepresentations and omissions in WaMu's offering documents. The prospectus supplements for these offerings suggested that WaMu would rarely process loans without full documentation,\textsuperscript{161} when WaMu was in fact regularly waiving documentation requirements.\textsuperscript{162} The complaint also alleges that WaMu was notified by a due diligence firm that fifty-four percent of its loans did not meet their underwriting guidelines, but that WaMu nevertheless securitized the loans without informing investors.\textsuperscript{163}

Investors in other WaMu securities have also sued WaMu with respect to its lax underwriting of mortgage loans. In \textit{In Re WaMu Securities Litigation}, investors in WaMu notes filed class actions against WaMu, its directors, underwriters, and accounting firm for violations of Sections 11 and 12 of the Securities Act as well as violations of Section 10(b) of the Exchange Act.\textsuperscript{164} The complaint alleges \textit{inter alia}, that WaMu misrepresented the value of its mortgage loan portfolio by not disclosing its lax lending practices\textsuperscript{165} and by pressuring appraisers to inflate home values.\textsuperscript{166}

The offering documents for the notes stated that "[WaMu] seeks to mitigate the credit risk in this portfolio by ensuring compliance with underwriting standards on loans originated to subprime borrowers" and "actively manages the credit risk inherent in its Option ARM portfolio primarily by ensuring compliance with its underwriting standards."\textsuperscript{167} As noted, WaMu was likely not in a position to ensure "compliance with its underwriting standards" because many loans were initiated by third parties and even risky borrowers were able to receive loans without having to submit the required documentation.\textsuperscript{168} WaMu was also not actively managing its credit risk because it was issuing loans with higher-than-recommended LTV ratios.\textsuperscript{169} \textit{In Re WaMu Securities Litigation} ultimately settled for $208.5 million dollars.\textsuperscript{170}

That WaMu would wish to avoid disclosing its problematic loan origination practices in its offering documents for MBS and other securities is unsurprising.

\textsuperscript{161} See id. \textsuperscript{¶} 72–77 (citations omitted).
\textsuperscript{162} See id. \textsuperscript{¶} 78, supra Part II.A.
\textsuperscript{163} See Ohio MBS Compl., supra note 160, \textsuperscript{¶}¶ 81–84. The SEC has recently amended its regulations to require that the results of such reviews be disclosed. See 17 C.F.R. § 229.1111(7)(ii) (2014).
\textsuperscript{164} WaMu Sec. Litig. Compl., supra note 146, \textsuperscript{¶}¶ 8–9.
\textsuperscript{165} See id. \textsuperscript{¶}¶ 769, 793.
\textsuperscript{166} See id. \textsuperscript{¶} 772.
\textsuperscript{167} See id. \textsuperscript{¶} 774.
\textsuperscript{168} See id. \textsuperscript{¶}¶ 169–74 (discussing the loosening of standards and use of exceptions to increase loan volume); see also supra Part II.A.
\textsuperscript{169} See supra Part II.A.
Public companies are often reluctant to acknowledge issues that might affect the marketability of their securities, and WaMu was highly motivated to dispose of much of its mortgage portfolio. Yet WaMu did not work on these offerings alone. Prominent law firms represented the depositors and underwriters in the various WaMu offerings and permitted these offerings to proceed.

Orrick, Herrick, & Sutcliffe LLP ("Orrick") represented the WaMu-affiliated depositor ("WaMu depositor") and WaMu-affiliated underwriter ("WaMu underwriter") in many of the offerings at issue in In re WaMu MBS Litigation. Orrick also represented the WaMu depositor in all of the offerings challenged in the Ohio MBS litigation, while McKee Nelson LLP ("McKee") represented the WaMu underwriter in three of these offerings. The law firms of Heller Ehrman LLP and Cleary Gottlieb Steen & Hamilton LLP represented WaMu and the third-party underwriters in the August and September note offerings at issue in In re WaMu Securities Litigation.

WaMu's shoddy lending eventually became a problem for other banks as well. Goldman Sachs, Credit Suisse, Citigroup, and many other financial institutions had acquired WaMu loans to securitize and sell to investors, and they all had incorporated WaMu's misleading representations regarding its underwriting and loan origination practices into their own MBS offering documents. The lawyers who worked on these offerings, much like those who worked on WaMu's offerings,

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171 See Warren, supra note 59, at 396–97.
176 See WMI Holdings Corp., (Form 424B5 Supplement) S–33, (Sept. 13, 2006); WMI Holdings Corp., (Form 424B5 Supplement) S–15 (Aug. 23, 2006). The lead underwriters for these two offerings were Goldman, Sachs & Co. and Lehman Brothers. WMI Holdings Corp., (Form 424B5 Supplement) S–30, (Sept. 13, 2006). Note that WMI Holdings Corp. is the new name of WaMu.
177 Id.
did not ascertain whether WaMu was originating mortgage loans in a responsible manner and failed to provide investors with a realistic sense of these loans' quality.

2. Actions Against Other Financial Institutions.—Many financial institutions purchased mortgage loans from WaMu and other loan originators that they would securitize and sell to investors. These institutions' MBS offering documents would include representations concerning the originators' purported lending practices. When MBS lost value, investors sued the financial institutions that sponsored these offerings for misrepresenting the originators' lending standards. This section will highlight three representative actions involving WaMu mortgages.178

In *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, MBS investors sued Goldman Sachs for misrepresenting the loan underwriting of several originators, including Countrywide, Greenpoint, Wells Fargo, and WaMu.179 Goldman's offering documents claimed, for example, that WaMu originated mortgage loans by "evaluat[ing] the prospective borrower's credit standing and repayment ability and the value and adequacy of the mortgaged property as collateral."180 However, the complaint alleges that Goldman's offering documents failed to disclose that, *inter alia*, WaMu applied pressure on appraisers and provided them with pre-determined home values so that it could originate more home loans.181 McKee represented Goldman in the MBS offering backed by WaMu mortgages.182

Similarly, in *AllState Insurance Co. v. CitiMortgage, Inc.*, MBS investors brought an action against Citigroup and certain affiliates under Sections 11 and 12 of the Securities Act for misrepresenting the underwriting process used by WaMu and other loan originators.183 The claims with respect to WaMu mortgage loans focused on WaMu’s alleged practice of extending loans to borrowers who were not

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178 See also Berger, supra note 54, at 6 (noting private litigation involving originators' underwriting standards).


181 See Goldman MBS Compl., supra note 179, ¶ 129.

182 GSR 2007-3F Supp., supra note 180, at S-134. As noted in Part II.B.1., the WaMu underwriter was also a McKee client. Although this may not have constituted a conflict because the interests of Goldman and the WaMu underwriter were not necessarily in conflict, any concerns raised by McKee to Goldman regarding WaMu's lending likely would have led it to lose the WaMu underwriter business. Consequently, the representation of Goldman may have been "materially limited" by the representation of the WaMu underwriter, and McKee should have sought the consent of both WaMu underwriter and Goldman to proceed with the representation. See MODEL RULES OF PROF'L CONDUCT R. 1.7 (2013).

capable of making the required loan payments. Citigroup's offering documents did not include information specific to WaMu but represented that "[t]he originators' underwriting standards were applied to evaluate the prospective borrower’s credit standing and repayment ability and the value and adequacy of the mortgaged property as collateral." Citigroup also claimed that "[a]ll mortgage loans will have been subject to underwriting standards acceptable to the depositor." Thatcher Proffitt & Wood LLP represented Citigroup in the WaMu offering.

Lastly, in Prudential Insurance Co. of America v. Credit Suisse Securities (USA), LLC, MBS investors sued Credit Suisse for fraud and other violations of New Jersey law for misrepresenting the underwriting standards of WaMu and other originators. The complaint alleges that WaMu "pervasively violated its stated underwriting and appraisal standards" and that due diligence providers found that "significant percentages of loans WaMu originated did not adhere to underwriting guidelines." The prospectus for the offering did not contain any originator-specific information but claimed that WaMu and other originators evaluated both "[whether] mortgagor's monthly income . . . will be sufficient to enable the mortgagor to meet its monthly obligations on the mortgage loan and other expenses" and "[t]he adequacy of the mortgaged property as security for repayment of the related mortgage loan." Orrick represented both the Credit Suisse depositor and underwriter in the MBS offering involving WaMu mortgages.

The attorneys who represented Goldman, Citigroup, and Credit Suisse in the above offerings were certainly aware that mortgage originators' lax underwriting could expose their clients to liability. The offering documents for these securities indicated that originators did not use underwriting standards that were as stringent as those used by Fannie Mae and Freddie Mac. Originators were also contractually obligated to repurchase loans that did not conform to the

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184 See id. ¶ 178.
186 Id. at 195.
187 Id. at 255. Thacher is now defunct, largely because of its heavy focus on securitization. See generally David Bario, A Really Bad Bet, AM. LAW., Mar. 1, 2009. By 2007, 70% of its revenue came from structured finance and related work. Id.
189 Id. ¶¶ 264–65. The complaint quotes one employee of a due diligence firm as referring to WaMu loans as "a joke." Id. ¶ 461.
191 Id. at S-106. Orrick was heavily involved in WaMu's own offerings of MBS. See supra Part II.B.1. Therefore, for reasons set out in note 182, would have almost certainly had a conflict of interest and should have sought the consent of both WaMu and Goldman to proceed with the representation.
representations and warranties made to the depositor. But, notwithstanding the inclusion of cautionary language in the offering documents and the theoretical availability of recourse against WaMu and other loan originators, none of the aforementioned financial institutions apprised investors of the degree to which WaMu and other institutions were deviating from responsible lending practices. Indeed, some offerings did not even provide investors with any originator-specific information.

The attorneys who worked on offerings involving WaMu loans may not have known that WaMu, or any other originator, was engaging in irresponsible lending. They may also have believed that qualifying language in the offering documents and the repurchase provisions would protect their clients from liability for securitizing poor quality mortgages. Without actually investigating the lending practices of WaMu and other loan originators, however, they could not meaningfully gauge whether additional disclosures were necessary or whether these originators would be able to honor their potentially significant repurchase obligations. Even if the attorneys were providing the type of representation desired by their clients, they did not possess enough information to fulfill their obligations qua advisors to “exercise independent professional judgment and render candid advice” with respect to these MBS offerings.

Poor quality loans issued by WaMu and other originators were subjected to minimal scrutiny by lawyers as they were bought, sold, and securitized into MBS. As a result, originators’ irresponsible lending exposed numerous financial institutions to liability and ultimately jeopardized the entire financial system. The next Part of this Article will explore whether the SEC should expressly require attorneys to conduct an inquiry of the claims made in the offering documents that they help to prepare.

III. SECURITIES OFFERINGS AND THE DUTY TO INVESTIGATE

Scholars have long argued that outside counsel are not ideally positioned to detect and act on client misconduct. There are both economic and psychological explanations for this phenomenon:

194 The repurchase provisions have provided minimal protection to MBS issuers because many originators filed for bankruptcy. See Tom Fitzpatrick, Complexity, Complicity, and Liability Up the Securitization Food Chain, THE CONGLOMERATE BLOG (Jan. 16, 2012), http://www.theconglomerate.org/2012/01/complexity-complicity-and-liability-up-the-securitization-food-chain.html (“Originator repurchase obligations are only effective if the originator is still around to repurchase the loans, which has been the case less and less frequently through the crisis.”); see also Kurt Eggert, The Great Collapse: How Securtization Caused the Subprime Meltdown, 41 CONN. L. REV. 1257, 1310 (2009) (noting that New Century Financial filed bankruptcy after financial institutions demanded that it repurchase $9 billion in mortgage loans).
196 See Gilson, supra note 19, at 914–15; Kim, supra note 141, at 462–63.
In the first place, all partners have an incentive to keep key clients happy. ... In the second place ... In recent years, law firms have shifted away from the old rules of partnership. ... The eat-what-you-kill phenomenon makes it highly unlikely that ... partner[s] will risk antagonizing key clients absent the proverbial smoking gun. ... In the third place, behavioral economic analysis suggests certain basic cognitive biases likely to discourage lawyers from detecting or acting upon management misconduct. ... These systematic decision-making biases generate a type of "cognitive conservatism" that makes a lawyer "likely to dismiss as unimportant or aberrational the first few negative bits of information that she receives regarding a client or situation." 197

Inside counsel may also be subject to some of the same pressures and biases because, to advance within an organization, lawyers will often need to possess a high tolerance for risk. 198

If lawyers had insisted upon investigating originators' lending practices in order to prepare the offering documents for MBS and related securities, they risked being replaced by firms that were more willing to sustain the MBS assembly line. 199 Corporate clients are not dependent on any one law firm to assist with a particular securities offering. 200

Assuming attorneys had investigated the lending standards of WaMu and other originators, however, they would have been able to ascertain relatively easily that originators were extending mortgage loans to individuals who could not meet their repayment obligations. Reviews of WaMu's internal files or interviews with risk management and legal personnel would have uncovered serious defects in WaMu's origination at several key offices. 201 Conversations with General Counsel would have indicated that origination at Long Beach, WaMu's subprime lending arm, had become so problematic that WaMu's General Counsel imposed a moratorium on securitizations in 2003. 202

Attorneys who represented financial institutions in the securitization of loans from WaMu and other originators may not have had access to internal files and personnel. Nevertheless, the media reported extensively on the general deterioration in lending standards of loan originators during the real estate

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197 Bainbridge, supra note 141, at 920–22 (citations omitted).
198 See Langevoort, supra note 4, at 503–05.
199 See Hill, supra note 87, at 59.
201 See supra Part II.A.
202 See supra Part II.A.
bubble. Consequently, attorneys for Goldman Sachs, Credit Suisse, Citigroup, and other financial institutions should have sought reassurance that WaMu's lending practices were sound by, for example, reviewing a random sampling of WaMu's mortgage files. Although, financial institutions did sometimes conduct reviews of mortgages prior to purchasing and securitizing them, these reviews were not carried out by lawyers, but by so-called “due diligence firms” that employed poorly trained non-lawyers. On the rare occasions that due diligence firms raised concerns about the quality of the mortgages, business personnel would overrule them so the MBS offerings could proceed.

This Part will argue that attorneys must play a greater role in verifying claims in public offering documents for securities. Specifically, attorneys who work on securities offerings should be required to form a good faith belief, after a reasonable inquiry, that the offering documents they helped to prepare for filing with the SEC do not contain material misrepresentations and omissions. The next Section will address why this duty, that is usually associated with claims made in litigation, should also apply to attorneys who practice before the SEC.

A. The Need for a Duty to Investigate

As this Article has sought to demonstrate, attorneys involved in the preparation of MBS offering documents for WaMu and other financial institutions failed to inform themselves about the underlying soundness of the mortgages they were securitizing. In so doing, they contributed to the excesses of the subprime era and facilitated securities fraud.

In certain representations it may be entirely ethical for attorneys to fail to inform themselves about significant aspects of their clients' businesses. Not every matter requires an extensive factual inquiry, and the client may be reluctant to pay the attorney to conduct such an inquiry. Indeed, lawyers are generally under no


204 See ROBERT W. KOLB, THE FINANCIAL CRISIS OF OUR TIME 209–211 (2011). Professor Kolb notes that “[i]n a typical assignment, the due diligence firm reviewed 5-20 percent of the loans being purchased, with the supervisor for the due diligence firm urging speedy reviews and the on-site representative of the purchaser urging approvals.” Id. at 210. The reviews became even more cursory as demand for MBS increased. See id.

205 See id.


207 See MODEL. RULES OF PROF'L CONDUCT R. 1.1 cmt. 5 (2013); see also Schwartz, supra note 54, at 34 (“[Structured finance] counsel cannot feasibly investigate for fraud in the way that a district attorney would investigate. That investigation—normally performed by litigators—would be time consuming and expensive, and no client would pay for its cost.”).
obligation to "initiate investigation of a client's affairs or to give advice that the client has indicated is unwanted." As Professor Luban has argued, forcing attorneys to investigate their clients against their clients' wishes may also sever the attorney-client relationship by creating distrust and stifling open communication.

A requirement to investigate one's clients would not only be costly and harmful to the attorney-client relationship, but would also be redundant in many representations. Attorneys will usually seek to obtain all of the material facts relevant to the representation because clients normally wish to have an informed understanding of their actions' legal consequences. Even in representations where clients do not wish to have this understanding, attorneys may be impaired in their ability to provide competent and diligent representation without investigating their clients' claims. Moreover, any information not obtained by counsel may possibly be obtained by the opposing party.

Although attorneys can generally be expected to investigate their clients' claims, it is not necessarily incompetent for an attorney to fail to do so. Ethical rules afford attorneys and clients wide discretion to structure representations as they see fit. The large financial institutions that issued MBS presumably understood the implications of incorporating questionable representations from loan originators into MBS offering documents. They also would have been able to consult with their in-house counsel about the risks of securitizing poor quality mortgages. It is not self-evident that ethical rules should compel attorneys to investigate what sophisticated clients advised by in-house counsel do not believe needs investigating.

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208 MODEL RULES OF PROF'L CONDUCT R. 2.1 cmt. 5 (2013).
209 See Julie Andersen Hill, Divide and Conquer: SEC Discipline of Litigation Attorneys, 22 GEO. J. LEGAL ETHICS 373, 377–78 (2009) (suggesting that the SEC should refrain from investigating litigators who represent issuers before the SEC so as to not interfere with issuers' entitlement to a diligent defense); Luban, supra note 67, at 977.
210 See MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 2 (2013).
211 See id. R. 1.1 cmt. 5 ("Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem . . . . [M]ajor litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence."); Freedman, supra note 67, at 1478–79 (describing the ability for an attorney to provide competent representation if not fully informed of the client's situation); Michels, supra note 26, at 116 ("[W]hen the attorney provides advice, it must be grounded on sufficient information if it is to be professional.") (emphasis added) (internal quotation marks omitted).
212 See MODEL RULES OF PROF'L CONDUCT R. 1.2(c) (2013) ("A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.").
213 The Model Rules are paternalistic insofar as they do not permit clients to waive their entitlement to competent representation. See MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(1) (2013). As Professor Michels has suggested, however, such prohibitions are intended to protect the client's ability to achieve his or her ends, not to interfere with the client's objectives. See Kevin H. Michels, What Conflicts Can be Waived? A Unified Understanding of Competence and Consent, 65 RUTGERS L. REV. 109, 135 (2012). Indeed, interfering with a client's ends is "far afield from the client autonomy that grounds our understanding of legal ethics." Id.; see also ROBERT J. HAFT ET AL., LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS § 5:19 (2014) ("Counsel should
The ethics of maintaining ignorance should not be assessed solely through the prism of client interests, however. Attorneys' duties are not limited to assisting clients achieve their ends. As advisors, lawyers cannot merely tell their clients what they wish to hear but must "exercise independent professional judgment and render candid advice." Ethics rules prohibit attorneys from asserting claims in litigation unless there is a "basis in law and fact for doing so." State law and the Restatement of the Law Governing Lawyers recognize that lawyers can even owe fiduciary duties to non-clients in limited circumstances, such as when the client invites a non-client to rely on the lawyer's services.

The SEC has broad discretion to regulate the professional conduct of attorneys that appear before it. Attorneys – both in-house and outside counsel – who assist an issuer with the preparation of offering documents or opine on information that should be included therein are subject to the SEC's standards of conduct. Attorneys who violate the standards may be held in contempt and barred from practicing before SEC. The SEC standards do not specifically obligate attorneys to inquire into the content of offering documents, but several considerations unique to securities practice suggest that the SEC should impose heightened investigative duties on attorneys who practice before it.

First, although it is the issuer who bears the costs of preparing the offering documents, offering documents are ultimately for the intended benefit of non-client investors. By ensuring the inclusion of all material facts in the offering
documents, attorneys protect their clients while facilitating the ability of investors to make informed investing decisions.\textsuperscript{222} If attorneys do not seek to verify or corroborate any of the claims contained in their clients' offering documents, they cannot "exercise independent professional judgment" and provide an independent assessment of what should be disclosed to investors.\textsuperscript{224} While clients and attorneys should be afforded some flexibility in structuring their representations, the public interest in safeguarding issuers' ability to obtain assistance with securities offerings, without the issuer and its attorneys engaging in a meaningful dialogue as to what disclosures should be included in the offering documents, is minimal.\textsuperscript{225}

Second, unlike litigation and most transactional matters, there is no adversary or counterparty to contest misrepresentations in the offering documents.\textsuperscript{226} Although some investors may be sophisticated enough to conduct extensive due diligence into the issuer and its securities if afforded sufficient access, the SEC requires the filing of offering documents to relieve investors of this burden and to allow capital to move more efficiently.\textsuperscript{227} Both in-house and outside counsel are well-placed to ferret out information that potential investors cannot.\textsuperscript{228} By not seeking out this information prior to the time of the offering, lawyers shift the costs of investigation to the investing public and ultimately make \textit{ex post} litigation more likely.

Third, to the extent that such a requirement would impose additional costs on the issuer, these costs would be minimal compared to the wealth generated by most public offerings.\textsuperscript{229} Scholars have differed on whether investors in public offerings rely on reputations of the law firms involved in the offerings in making investment decisions or whether the lawyer's duties to the client, and enforcement of the obligations to the client are unlikely).\textsuperscript{221}

\textsuperscript{222} See Warren, supra note 59, at 395.

\textsuperscript{224} MODEL RULES OF PROF'L CONDUCT R. 2.1 (2013); see also id. R. 2.1 cmt. 1.

\textsuperscript{225} Lawyers have duties to their clients, themselves, and the greater public; conflicting responsibilities between these should be resolved in favor of the client's legitimate interests while maintaining respect for the other involved interests. See MODEL RULES OF PROF'L CONDUCT pmbl. (2013).

\textsuperscript{226} The SEC's Division of Corporate Finance selectively reviews corporate filings but specifically disclaims that its review indicates that a disclosure is complete and accurate. See Division of Corporation Finance: Filing Review Process, SEC.GOV, http://www.sec.gov/divisions/corpfin/cffilingreview.htm (last modified Sept. 22, 2014).

\textsuperscript{227} See 15 U.S.C. § 77b(b) (2013) (providing that the SEC may consider interests such as efficiency, competition, and capital formation in carrying out its duties); S. REP. NO. 73-47, at 1 (1933), \textit{reprinted in 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item no. 17 (comp. by Jack S. Ellenberger & Ellen P. Mahar, 1973) (noting that the purpose of registration is to inform investors of the facts concerning the securities to be offered).

\textsuperscript{228} See MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 12.06[2] (2005) ("[T]he SEC, with its limited resources, is particularly dependent on the probity and diligence of the professionals who practice before it.") (citation omitted) (internal quotation marks omitted); Bainbridge & Johnson, supra note 200, at 311.

decisions, but imposing investigative duties on attorneys would allow investors to more meaningfully gauge the significance of a particular law firm’s involvement (or lack thereof). Issuers that wish to minimize costs can also conduct offerings solely via inside counsel. Increasing numbers of issuers are already conducting smaller offerings without the assistance of outside counsel.

Lastly, any harm to the attorney-client relationship is minimal because the client is ultimately the issuer, not its managers or other employees. Indeed, when attorneys fail to investigate claims in offering documents with the overt or tacit blessing of an issuer’s managers, they ensure that other actors, such as the issuer’s board of directors, lack valuable information upon which they could intercede to prevent violations of the securities laws. As noted, the SEC currently obligates attorneys to report material violations of the securities laws to the issuer’s board under certain circumstances, but this obligation will rarely arise if attorneys do not seek to know whether their clients are complying with the securities laws.


232 See supra Part II.A. (noting that in MBS offerings, the client is the depositor).

233 See MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2013). A related argument, voiced extensively when the SEC first proposed requiring that attorneys who represent corporations “report up” managerial wrongdoing, is that managers and other employees will be less likely to confide in the corporation’s attorney because they fear that counsel will go over their heads even when they are not engaged in misconduct. See Bainbridge & Johnson, supra note 200, at 322 (citations omitted). These concerns are overblown insofar as the manager always has the opportunity to retain his or her own counsel and should do so when his or her interests are adverse to the corporation’s. See MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 10 (2013) (“There are times when the organization’s interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation.”).

234 See Roiphe, supra note 4, at 211 (“It is hard to determine when to defer to the managers’ judgment and when the managers have conflicts that render them untrustworthy arbiters of the organization’s best interests. There is no hope, however, that an attorney can determine the client’s interest (let alone when the managers have abandoned it) if the managers are allowed to keep him, with his own complicity, in the dark.”); see also Bainbridge & Johnson, supra note 200, at 324–25 (“A legal audit of [a] firm in connection with major transactions and/or the preparation of significant disclosure documents would increase the likelihood that counsel would become aware of evidence of client misconduct, which could then be reported up the ladder.”).

235 See 17 C.F.R. § 205.3(b)(1), (3) (2014).

236 See Bainbridge & Johnson, supra note 200, at 321 (suggesting that lawyers will not comply with the SEC’s “reporting up” requirement because “absent the proverbial smoking gun, lawyers can be expected to turn a blind eye to indicia of misconduct by those managers”). Bainbridge and Johnson also suggest an explanation as to why attorneys might be prone to defer to managers even though a corporation’s managers are not the client. See generally id. at 306–07 (arguing that outside counsel is
For all of these reasons, the SEC should require attorneys, after a reasonable inquiry, to form a good faith belief that the offering documents they helped to prepare contain no material representations or omissions. This obligation is consistent with lawyers' traditional role as advisors and counselors to their clients and, as set out in the next Section, follows from existing precedents.

B. Precedents for Imposing Due Diligence Obligations on Securities Attorneys

Despite disagreement as to whether attorneys who work on public offerings owe duties directly to the public, prominent scholars and securities lawyers have long considered it a fundamental part of the securities lawyer's role to investigate claims made in offering documents. As Professor Coffee has explained, "Few norms are less controversial among securities attorneys than that they should perform some due diligence in preparing prospectuses or other disclosure documents." Indeed, both the SEC and the ABA Committee of Ethics and Professional Responsibility ("ABA Ethics Committee") have found that attorneys involved in a securities offering have a professional responsibility to investigate an offering's material facts. This duty is especially pronounced in the opinion letter context. For example, a 1962 SEC release suggested that attorneys should not provide legal opinions on whether securities offerings are exempt from registration under the Securities Act without first undertaking an investigation. The statement noted:

237 See Model Rules of Prof'l Conduct R. 1.6(b) (2013). Attorney-client confidentiality also presupposes that attorneys will make themselves aware of the facts of their clients' situations. See id. R. 1.6 cmt. 2; Gordon, supra note 2, at 1202-03 (noting the irony of attorneys criticizing mandatory disclosure rules for discouraging communication between attorney and client while seeking to maintain ignorance of clients' wrongdoing). If a lawyer learns during the course of an investigation that the offering documents contain representations or material misrepresentations, the lawyer should resign from the representation if the client refuses to make the appropriate corrections, but, the lawyer would not have to reveal any client information. See 12 C.F.R. § 1014.3 (2013); Model Rules of Prof'l Conduct R. 1.6(b), 1.13(b) (2013).

238 See James Cheek III, Professional Responsibility and Self-Regulation of the Securities Lawyer, 32 Wash. & Lee L. Rev. 597, 629 (1975); Coffee, supra note 221, at 1310; Warren, supra note 59, at 388-90.

239 Coffee, supra note 221, at 1310-11. Some scholars and practitioners have suggested that lawyers should conduct a legal audit of disclosure documents. See, e.g., A.A. Sommer, Jr., The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation & Business Law Section of the N.Y. State Bar Ass'n (Jan. 24, 1974), in Larry D. Soderquist & Theresa A. Gabaldon, Securities Regulation, 617-19 (4th ed. 1999); Coffee, supra note 221, at 1314 (suggesting that securities attorneys should be required to certify offering documents); Simon M. Lorne, The Corporate and Securities Adviser, the Public Interest, and Professional Ethics, 76 Mich. L. Rev. 423, 468-96 (1978). For a critique of the alleged lawyer/auditor dichotomy, see Kim, supra note 141, at 428-29.

[A]n attorney's opinion based upon hypothetical facts is worthless if the facts are not as specified, or if unspecified but vital facts are not considered. Because of this, it is the practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which [sic] he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct. 241

The professional obligation of securities attorneys to familiarize themselves with the circumstances of the transactions on which they are opining exists notwithstanding that they do not represent investors. 242

Commentators have claimed that there is a stark difference between a lawyer's responsibilities in issuing legal opinions and preparing offering documents. 243 But the obligation to seek out facts extends beyond the opinion letter context. In In re Ferguson, the SEC sanctioned an attorney who represented an issuer of municipal bonds that was implicated in securities fraud. 244 Although there was no clear evidence that the attorney knew that the prospectus for the bond offering contained fraudulent statements, the SEC reasoned that: "Because of his review of the prospectus . . . respondent should have known, if he did not know, that the prospectus omitted material facts." 245 The attorney entered into a consent decree with the SEC, whereby his firm was required to, inter alia, "undertake an appropriate investigation in connection with acting as bond counsel including, among other things, obtaining independently-audited financial statements and inquiring into the background of the various parties connected with the offering." 246

Bond lawyers have since adopted standards of conduct that embrace their investigative responsibilities. 247

The ABA has accepted the SEC's view that lawyers cannot rely on their clients' representations in writing legal opinions with respect to the sale of unregistered securities. 248 The relevant ABA Ethics Opinion stressed that:

It is . . . [the responsibility of lawyers to] competently and carefully consider what facts are relevant to the giving of the requested opinion and make a reasonable

241 Id. at *3.
242 See id. at *2.
243 See HAFT ET AL., supra note 213.
245 Id.
246 Id. at *2 n.3.
247 Warren, supra note 59, at 397–98; see also NAT'L ASSOC. OF BOND LAWYERS, THE FUNCTION AND PROFESSIONAL RESPONSIBILITIES OF BOND COUNSEL 41 (3d ed. 2011) ("Clearly, an attorney participating in a transaction has a substantial duty to investigate the facts and circumstances underlying that transaction.").
inquiry to obtain such of those facts as are not within his personal knowledge. . . .

The lawyer may or may not need to go beyond directing questions to his client and checking the answers by reviewing such appropriate documents as are available.259

The opinion also noted that while attorneys are not required to distrust their clients, they should refrain from authoring opinions when they lacked "sufficient confidence as to all the relevant facts."250

This analysis was subsequently applied by the ABA to tax attorneys who opine on the tax consequences of investments promoted by their clients.251 The ABA Ethics Committee found that, prior to issuing tax opinions to investors, tax lawyers should seek to verify information submitted to them by their clients and "should make reasonable inquiries to ascertain that a good faith effort has been expended to comply with laws other than tax laws."252 If the disclosures in the offering materials for the investment are insufficient, the tax lawyer must resign from the representation.253

There is also significant authority that suggests that attorneys' failure to investigate the representations in offering documents may constitute legal malpractice.254 In FDIC v. O'Melveny & Myers, the law firm of O'Melveny & Myers failed to detect that its client was overvaluing assets by engaging in sham transactions.255 The offering memoranda it prepared for the client significantly overstated the client's financial health.256 In reversing the lower court's summary judgment motion in favor of O'Melveny, the Ninth Circuit held that the firm should have undertaken a "reasonable, independent investigation" by, for example, contacting its client's former auditors and law firm in the course of preparing the offering memoranda.257 While O'Melveny has been criticized for imposing too great a burden on an issuer's attorneys,258 a number of courts have agreed with its analysis of the securities attorney's role.259

The duty to investigate is especially pronounced for attorneys who represent participants in an offering that may be able to avail themselves of the "due
diligence" defense under Sections 11 and 12 of the Securities Act. In *BarChris*, for example, the underwriters of a securities offering were held liable under Section 11 because the perfunctory investigation conducted by their counsel was insufficient to sustain a due diligence defense. Commentators have acknowledge the decision's significance for attorneys:

The implication arising from *BarChris* is that, if an underwriter is not able to sustain its "due diligence" defense in an action under section 11 because it relied upon its attorney as its agent and the attorney was not duly diligent, then the underwriter is able to sue its attorney in malpractice under a negligence theory for any damages which it might incur pursuant to a section 11 liability.

To insulate themselves fully from malpractice claims, attorneys would be well advised to investigate the claims in offering documents even if the client has not expressly requested that they do so.

Finally, while this Article does not propose that attorneys should be liable for aiding and abetting securities fraud under federal law if they fail to conduct a reasonable inquiry into the claims made in offering documents, there is some authority to suggest that liability should attach in these circumstances. As articulated by the district court in *Felts*:

The duty of the lawyer includes the obligation to exercise due diligence, including a reasonable inquiry, in connection with responsibilities he has voluntarily undertaken. A lawyer has no privilege to assist the [issuer] circulate statements

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260 See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968). Many of the MBS offerings discussed in Part II.B. involved the same law firm representing the depositor and underwriter. A law firm is generally permitted to represent both an underwriter and issuer in the same offering, particularly if informed consent is obtained from both parties. See N.Y. State Bar Assoc. Comm. on Prof'l Ethics, Formal Op. 818 (2007). Nevertheless, such an arrangement is fraught with the potential for conflicts of interest: Because the interests of an issuer and its underwriters may differ during the course of an offering (e.g., on what disclosures are necessary), it is possible that a law firm that currently represents both the underwriters and the issuer will be subject to "differing interests" that would preclude accepting the assignment as Designated Underwriters' Counsel or require withdrawing from it.

261 See *BarChris*, 283 F. Supp. at 697.


which he knows or should know to be false simply because they were furnished to
him by his client.264

The SEC can, consistent with its statutory authority, hold lawyers to a higher
standard than merely avoiding aiding and abetting violations of the securities laws.

Based on the foregoing, the notion that attorneys should endeavor to verify
claims made in offering documents — even if not expressly required to do so by their
clients — is not starkly at odds with the traditional role of securities attorneys.265
Indeed, this was essentially the position of the SEC until the late 1980s,266 and, by
contrast, far more is expected of attorneys in other common law countries.267 What
the subprime mortgage crisis illustrates, however, is that under prevailing SEC
regulations and market conditions, lawyers lack incentives to obtain information
that might lead them to doubt their clients' representations. By imposing
heightened duties on the attorneys who practice before it, the SEC would spur
attorneys to evaluate the propriety of the transactions they are facilitating before
filing offering documents with the Commission.

IV. POSSIBLE OBJECTIONS

This Article has sought to illustrate that attorneys involved in the issuance of
MBS and related financial products failed to determine whether originators were
lending responsibly. It has also sought to explain this failure. While it is impossible
to know whether attorneys could have mitigated the effects of the financial crisis by
insisting that their clients not proceed with MBS offerings unless the underlying
mortgages were sound, the financial crisis would not have occurred without
attorneys' facilitation of MBS and related offerings.

This Article has proposed that the SEC require that attorneys who appear
before it have a good faith belief, formed after reasonable inquiry, that the offering
documents they helped to prepare contain no material misrepresentations or
omissions. This ethical obligation can be inferred from the Model Rules'

264 Felts, 469 F. Supp. at 67; see also Walco Invs., Inc. v. Thenen, 881 F. Supp. 1576, 1586 (S.D.
Fla. 1996) ("While a law firm generally represents only its client, under certain situations, a duty may
arise to third parties whereby a law firm cannot merely be a conduit for its client’s illegal activity.").
265 Even some critics of the SEC’s Standards of Conduct have acknowledged this point. See Evan A.
(suggesting that the notion of the lawyer as gatekeeper is uncontroversial insofar as lawyers frequently
provide negative assurance opinions with respect to disclosure).
266 See Amendment to Rule 105(e) of the Commission’s Rules of Practice, Securities Act Release
the SEC overreached in prominent actions against attorneys and has since retreated); Simon M. Lorne
& W. Hardy Callcott, Administrative Actions Against Lawyers Before the SEC, 50 BUS. LAW. 1293,
267 See Andrew F. Tuch, Multiple Gatekeepers, 96 VA. L. REV. 1583, 1661 (2010) (noting that in
Australia and other common law countries lawyers work collaboratively with other gatekeepers to verify
disclosures and produce a written report attesting to the accuracy of the offering document).
requirement that attorneys *qua* advisors "exercise independent professional judgment and render candid advice."\(^{268}\)

It is nevertheless the case that law firms might be more reluctant to work on securities offerings if this Article's proposal is adopted. What constitutes a "good faith belief" and how much due diligence on the part of the firm is sufficient to constitute a "reasonable inquiry" will depend on the facts of each offering. It is conceivable that some issuers will be deprived of counsel if law firms or their insurers conclude that a particular offering is simply too risky.

Another possible objection to this Article's proposal is that it will not deter violations of the securities laws. An issuer's officers and directors cannot be expected to confide their intentions to commit securities fraud. A basic inquiry may not reveal any wrongdoing, particularly as transactional attorneys are not trained investigators.\(^{269}\) Indeed, to truly uncover wrongdoing, attorneys might have to carry out a full legal audit, which would be time-consuming and very costly.\(^{270}\) These objections are addressed in turn.

### A. Will Firms Work on Securities Offerings?

The securities bar has often resisted the SEC's efforts to regulate it. For example, the bar widely denounced the SEC's decision to prosecute the lawyers and law firms involved in the disastrous merger between Interstate National Corporation and National Student Marketing Corporation on the basis that the lawyers had a duty to stop or rectify their clients' fraud.\(^{271}\) Until the passage of Sarbanes-Oxley, the ABA also thwarted proposals that would have provided for up-the-ladder reporting of corporate fraud and other malfeasance.\(^{272}\)

SEC regulations that mandate that attorneys acquire a good faith belief after a reasonable inquiry into the contents of offering documents may engender similar apprehension. Such concerns are exacerbated by the ambiguity of regulations, which require that attorneys have a "good faith belief" and conduct "reasonable inquiries."

\(^{268}\) [Model Rules of Prof'l Conduct R. 2.1 (2013)].

\(^{269}\) See Bainbridge & Johnson, *supra* note 200, at 321–26; Schwarcz, *supra* note 54, at 34 ("[Structured finance] counsel cannot feasibly investigate for fraud in the way that a district attorney would investigate.").


\(^{271}\) See Complaint, SEC v. Nat'l Student Mktg. Corp., 430 F. Supp. 639 (D.D.C. Feb. 3, 1977) (No. 225-72) 1972 WL 296505 (C.C.H.); Kim, *supra* note 141, at 462–63; see also Koniak, *supra* note 14, at 1249 ("It is difficult to overstate the vehemence of the bar's reaction to the SEC complaint [in the National Student Marketing case]; references to the return of King George were commonplace, and the rhetoric suggested that the liberty of all Americans was at stake.").

\(^{272}\) See Bainbridge, *supra* note 141, at 914–15 (detailing the efforts of Professor Richard Painter and others in advocating for up-the-ladder reporting). But see Koniak, *supra* note 14, at 1278 (claiming that the final up-the-ladder reporting rule "looked tough, but wasn't").
Of course, neither the National Student Marketing case, nor more recent actions such as In Re Carter & Johnson,273 prevented large law firms from participating in MBS and related securities offerings. Given the lucrative nature of much securities work, most firms are likely to continue to work on securities offerings and will not be dissuaded from doing so by the theoretical possibility of SEC discipline. This stands to reason irrespective of an offering’s complexity.274 There is, moreover, a substantial body of case law that sets out what constitutes reasonable due diligence in the context of a securities offering, which can be used to inform attorneys’ duties of inquiry.275 For example, the lawyers who worked on MBS offerings for WaMu and other financial institutions should have certainly reviewed any pre-existing reports concerning the loans they were securitizing.276

The unlikelihood that issuers will be deprived of outside counsel is also illustrated by the impact of Rule 11 of the Federal Rules of Civil Procedure on litigation in the federal courts. After Rule 11 was amended in 1983 to require that attorneys undertake a reasonable pre-filing inquiry before bringing suit, some commentators claimed that the amended rule would have a chilling effect on attorneys, particularly in unpopular actions.277 These concerns seem overstated in retrospect, especially after the Rule was amended again to its current form.278 What

273 See In re Carter & Johnson Release, supra note 263, at *5.
274 Since complex transactions are bound to generate more fees, attorneys will likely participate in them even if they calculate that the likelihood of discipline is somewhat higher because of uncertainty as to the proper amount of due diligence.
276 Cf FDIC v. O’Melveny & Myers, 969 F.2d 744, 749 (9th Cir. 1992) (suggesting that law firms should have reviewed previous audits to ascertain issuer’s financial condition prior to finalizing the offering documents).
277 See generally William W. Schwarzer, Sanctions Under the New Rule 11 – A Closer Look, 104 F.R.D. 181, 184–85 (1985) (assessing amendments to Rule 11 and noting that “imposing sanctions on lawyers for their conduct of litigation raises the specter of chilling advocacy”); Georgene M. Vairo, Commentary, Rule 11: Where We Are and Where We Are Going, 60 FORDHAM L. REV. 475, 484–85 (1991) (arguing on the basis of empirical research that Rule 11 sanctions are primarily levied against plaintiffs in “disfavored lawsuits” such as employment discrimination and civil rights cases).
278 Professor Spiegel’s survey of the empirical literature on Rule 11 raises doubt, for example, that civil rights cases have been disproportionately affected as has been commonly alleged: “The Rule 11 studies are suggestive but not conclusive. It is not merely that they suffer from methodological problems. More significantly, even if we accept the conclusion that civil rights cases have been disproportionately singled out for disparate treatment, we still must interpret what that means.” Mark Spiegel, The Rule 11 Studies and Civil Rights Cases: An Inquiry into the Neutrality of Procedural Rules, 32 CONN. L. REV. 155, 206 (1999). One possibility is that more frivolous actions are brought in these types of actions or that counsel lacks the funds to litigate motions for sanctions. See Paul D. Carrington & Andrew Wasson, A Reflection on Rulemaking: The Rule 11 Experience, 37 LOY. L.A. L. REV. 563, 570–71 (2004); see also Lonnie T. Brown, Jr., Ending Illegitimate Advocacy: Reinvigorating Rule 11 Through Enhancement of the Ethical Duty to Report, 62 OHIO ST. L.J. 1555, 1576 (2001) (suggesting that
the revisions to Rule 11 seem to have done, however, is force attorneys to “stop and think” before proceeding with baseless actions.\footnote{See Carrington \& Wasson, supra note 278, at 567; Melissa L. Nelken, \textit{The Impact of Federal Rule 11 on Lawyers and Judges in the Northern District of California}, 74 \textit{JUDICATURE} 147, 149–50, (1990).} This Article’s proposal may have a similarly beneficial effect by making it less likely that public securities offerings will proceed without offering documents first being subject to some due diligence by the issuer’s attorneys.

If an issuer does not believe that the cost of retaining outside counsel to assist with a public offering is justified or cannot find a firm that is willing to assist with a certain offering, it can conduct a public offering with the assistance of its in-house counsel or choose to raise capital through private placements.\footnote{As noted \textit{infra} Part IV.B., while in-house counsel may also fall under the proposed regulation, they presumably have a far better understanding of their organization’s business and would not need to engage in as extensive due diligence as outside counsel.} Imposing heightened duties on attorneys involved in public securities offerings is not unreasonable\footnote{Professor Schwarcz appears to be of this view. See generally Schwarcz, supra note 34 (suggesting that imposing heightened duties on attorneys in public securities offerings will have negative economic effects).} simply because some issuers might find it more difficult to access the capital markets and others would prefer to pay their attorneys less.\footnote{One of the virtues of this Article’s proposal from the perspective of an attorney is that attorneys would likely be able to charge more for assisting with securities offerings given the amount of time required to review the representations in the offering documents.}

\section*{B. The Deterrence of Securities Fraud}

Another possible objection to this Article’s proposal is that attorneys, especially outside attorneys, are poorly equipped to deter their clients’ wrongdoing.\footnote{See Bainbridge \& Johnson, supra note 200, at 321 (“Managers who intentionally commit fraud or breaches of fiduciary duty will only rarely consult their legal counsel.”); Gilson, supra note 19, at 914–15; David McGowan, \textit{Why Not Try the Carrot? A Modest Proposal to Grant Immunity to Lawyers Who Disclose Client Financial Misconduct}, 92 \textit{CALIF. L. REV.} 1825, 1832–33 (2004) (suggesting that attorneys’ disclosure costs will often exceed the expected benefits).} Under this view, imposing heightened duties on securities attorneys may increase the costs of securities offerings without providing attendant benefits.

As an initial matter, although this Article has focused chiefly on outside counsel who were primarily responsible for preparing MBS for WaMu and other financial institutions, the proposed rule will also apply to in-house counsel in certain circumstances. For example, in-house counsel “practice[e] before the [SEC]” and are subject to its standards of conduct when they provide advice on the securities laws to an issuer in connection with a public offering.\footnote{See 17 C.F.R. § 205.2(a)(1)(iii) (2014).} In any event, this Article does not presuppose that outside attorneys will be able to detect and prevent securities fraud singlehandedly. They will have a higher
capacity to detect fraud, however, when they work closely with in-house counsel and compliance personnel. Indeed, by inquiring into the claims made in offering documents, outside attorneys are likely to make contact with individuals within the issuer who can alert outside counsel to potential fraud and illegality. Even brief conversations with Risk Management personnel might have alerted WaMu's outside attorneys to the recklessness of WaMu's lending.

Moreover, not all violations of the securities laws are the product of conscious wrongdoing. As Professor Langevoort has observed:

[A] firm's managers may well have come to believe in good faith (a cognitively-loaded legal construct, to be sure) that no risk or problem is big enough to worry about, while an outside observer in possession of the same information would disagree. As one organizational behaviorist has said, "once you've been in water long enough[,] you no longer perceive you're in water."

Outside counsel can deter corporate wrongdoing by providing an outside perspective and notifying managers of risks that they may not have fully appreciated. To fulfill this role, however, attorneys must first be willing to inform themselves about their clients' businesses. Even if attorneys cannot be expected to interdict securities fraud and other illegality in most cases, the SEC would nevertheless be justified to impose heightened investigative duties on attorneys who practice before it. This is because SEC regulations and ethics rules already contemplate that attorneys will act as gatekeepers by, for example, reporting breaches of fiduciary duty, fraud, and criminal conduct up-the-ladder in certain circumstances. These regulations cannot be effective if attorneys do not investigate the representations in their clients' offering documents and otherwise seek to understand their clients' businesses. This Article's proposed regulation should not be considered in isolation from attorneys' existing obligations under the SEC's Standards of Conduct.

It also does not follow that because attorneys cannot always prevent securities fraud that they should be entitled to facilitate and profit from it. Past corporate scandals such as Enron have damaged the reputation of the legal profession, notwithstanding the Enron attorneys' protestations that they were ignorant of the true nature of their clients' actions. Attorneys involved in the issuance of MBS

285 See Symposium, supra note 140, at 528.
287 See id. at 1214.
288 See 17 C.F.R. § 205.3(b)(1), (3) (2014); MODEL RULES OF PROF'L CONDUCT R. 1.13(b), (c) (2013); Zacharias, supra note 214, at 1389 ("Lawyers are gatekeepers and always have been. . . . Everyone will agree that lawyers are clients' agents and that lawyers' traditional role in the adversary system is to help clients pursue lawful goals. . . . That, however, is quite different from saying that lawyers should do whatever clients want . . . .").
289 See Gordon, supra note 2, at 1193–94; Koniak, supra note 14, at 1278 (claiming that post-Enron, the SEC was empowered to hold lawyers to account).
and other related securities were able to reap tremendous profits from MBS and CDOs even though they appear to have conducted minimal due diligence into originators' lending practices, and the securities ultimately became toxic. That attorneys may not have known with certainty that originators were using shoddy lending practices does not change the fact that they enabled and profited from the securitization of mortgages that should have never been marketed and sold to investors.290

CONCLUSION

Scholars have long expressed skepticism that attorneys are able to fulfill the gatekeeping responsibilities that are imposed on them by ethics rules and regulatory bodies such as the SEC.291 This Article has shown that this skepticism is largely justified through its examination of the work of attorneys involved in the issuance of MBS and related securities during the subprime era. What differentiates the subprime mortgage crisis from previous corporate scandals, however, is the sheer number of firms and attorneys involved on all sides of MBS, CDOs, and related transactions, and that they collectively failed to ascertain the poor quality of the mortgages that were being securitized.

This Article does not dispute that attorneys are entitled to aid their clients in achieving legal ends. Nor does this Article claim that “willful ignorance” can never be ethically justified. Even scholars who have argued that willful ignorance should not relieve lawyers from professional discipline have acknowledged that exceptions might be justified in certain representations.292 However, in the context of securities practice, where offering documents are largely prepared for the benefit of investors, and where authorities have long intimated that attorneys are professionally obligated to verify their contents,293 an explicit obligation on the part of attorneys who practice before the SEC to conduct their own inquiries and not rely solely upon their clients’ assurances will make it more likely that investors will receive accurate information and will not unduly interfere with the relationship between an issuer and its attorneys.294

In the current era, law firms must compete intensely for the business of corporate clients such as large financial institutions.295 Lawyers are consequently

290 In this sense, lawyers were unjustly enriched by their involvement in MBS offerings. See Szulik v. Tagliaferri, 966 F. Supp. 2d 339, 348, 360 (S.D.N.Y. 2013) (refusing to dismiss unjust enrichment claims brought by the beneficiaries of trust against attorney who received fees for structuring fraudulent transactions in which the trust invested).
291 See Bainbridge & Johnson, supra note 200, at 306–07; Gilson, supra note 19, at 914–15; Kim, supra note 141, at 462–63.
292 See Roiphe, supra note 4, at 204.
293 See supra Part III.B.
294 The attorney–client relationship could in fact be strengthened if the attorney’s advice ultimately prevents the client from embarking on a disastrous course of conduct.
295 See Henderson, supra note 200, at 381; see also Bainbridge & Johnson, supra note 200, at 306 (describing law firms as “something akin to [] fungible good[s]”).
inclined to defer to their clients unless there is clear, perhaps incontrovertible, evidence of wrongdoing. As corporate clients grow in both sophistication and bargaining power, they may be able to entirely cabin off attorneys from information that might cast doubt on the legality of their actions. Often corporate clients can justify these actions as cost-saving. The SEC can simply allow these processes to continue while maintaining the pretense that attorneys will, *inter alia*, encourage their clients to make disclosures in offering documents that their clients would rather not make. Alternatively, attorneys can be incentivized to inform themselves about representations in offering documents so that they are able to independently evaluate whether the offerings that they are facilitating comply with the securities laws.

More vigilant lawyering may not have prevented the recent financial crisis. However, attorneys who see their role solely in terms of “papering the deal” are not advisors and counselors to their clients, but well-compensated scriveners. The SEC and lawyers who practice before it would do well to repudiate this model of lawyering.

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296 See Bainbridge & Johnson, supra note 200, at 321; Koniak, supra note 14, at 1275-76.

297 Professor Henderson writes approvingly of Cisco that, for example, pledges to save costs by using technology to answer many legal questions generated by employees and pressuring outside counsel to “do more with less.” See Henderson, supra note 200, at 383-84. While minimizing legal costs is clearly beneficial in many circumstances, such a system may keep the company from learning of significant legal problems until it is too late. Even sophisticated legal departments can underestimate the degree of legal exposure the company may have and in-house attorneys often have incentives to defer to management. See Bainbridge & Johnson, supra note 200, at 306 (suggesting that a general counsel’s tenure depends on his or her relationship with the CEO); Langevoort, supra note 4, at 504-05 (suggesting that, prior to the financial crisis, in-house counsel at financial firms likely needed a high tolerance for risk in order to advance). Requiring outside counsel to “do more with less” also lowers the likelihood that outside counsel will uncover wrongdoing.