

Delaware Corporate

SUBPRIME ISSUES

REPRINTED FROM VOLUME 23, ISSUE 7 / OCTOBER 20, 2008

Subprime Disputes Will Make Judges Rethink Del. Law, Professor Says

The unprecedented complexity of the subprime-mortgage-based securities that triggered the current fiscal crisis will force judges to reinterpret Delaware corporate law in resolving disputes over failed companies and deals, a leading law professor predicts.

Eric Talley, a law professor at the University of California at Berkeley and a noted economic expert, told a gathering of the bench and bar in Wilmington, Del., that key tenets of state case law will have to be adapted to a business landscape that will be radically changed by the economic meltdown.

For instance, Talley told the judges and lawyers who specialize in corporate cases that Delaware courts have long held that directors have a duty to comparison-shop to get investors the best price for their shares before approving a sale of the company.

However, in the post-subprime world fiduciaries might best serve shareholders by quickly taking the bird-in-hand offer because the buyer's shaky financing could fly away while the board beat the bush for better bids, he said.

The daunting intricacy of subprime-backed securities also will make it difficult to judge whether officers and directors acted prudently in betting heavily on those investments, Talley predicted, because even Wall Street's financial wizards did not completely understand them.

He said the computer-generated complexity of the investment entities created by slicing, dicing and securitizing B-grade mortgage loans spawned dangerous unknowns.

There were the "known unknowns and the unknown unknowns," Talley said, referring to a famous quote by former Defense Secretary Donald Rumsfeld.

"There were unknowns that we knew we didn't know about, but there were also unknowns that we *didn't*

know we didn't know about," Talley said in paraphrasing Rumsfeld.

He said some examples of "known unknowns" are:

- The complexity of subprime securities could create bubbles of artificially inflated prices and crashes when those bubbles burst;
- These extremely complex investments were much more susceptible to manipulation and misallocation; and
- The greater interdependence of more complex financial instruments made them much more volatile than other types of securities.

He said some of the "unknown unknowns" are:

- The interdependence of the various levels of subprime securities caused their failures to affect each other in unanticipated ways;
- For the first time, the default of underlying mortgages was nationwide rather than regional, thus compounding its effect; and
- The companies that bought and sold the subprime securities also bought and sold quasi-insurance contracts to back them up, so in effect everything failed at the same time.

"The dominos fell in patterns we didn't anticipate and with a speed we never expected," Talley said, noting the cataclysmic changes that have occurred on Wall Street and Main Street.

Talley predicted that the judges who will be called upon to untangle disputes over failed companies and transactions will face a task that is far more complex than deciding

previous merger-related and shareholder lawsuits because there will be many more players and layers of transactions involved in subprime-based cases.

Delaware generally has put the interests of shareholders first, but judges will have to reconsider this "shareholder primacy" rule in resolving those disputes, Talley said, because those cases will raise issues that blur the traditional lines among the rights of stockholders, creditors and other constituencies.

The vaunted experience of Delaware's bench and bar in dealing quickly with the most complex corporate issues will come in handy, he predicted.

Talley was the 24th speaker in the annual Francis G. Pileggi Distinguished Lecture in Law series presented by the Widener University School of Law and sponsored by attorneys Francis G. Pileggi and his son Francis G.X. Pileggi.

The breakfast lecture series at the Hotel du Pont explores cutting-edge issues of corporate and commercial law that come before the influential Delaware judges and attorneys in attendance.