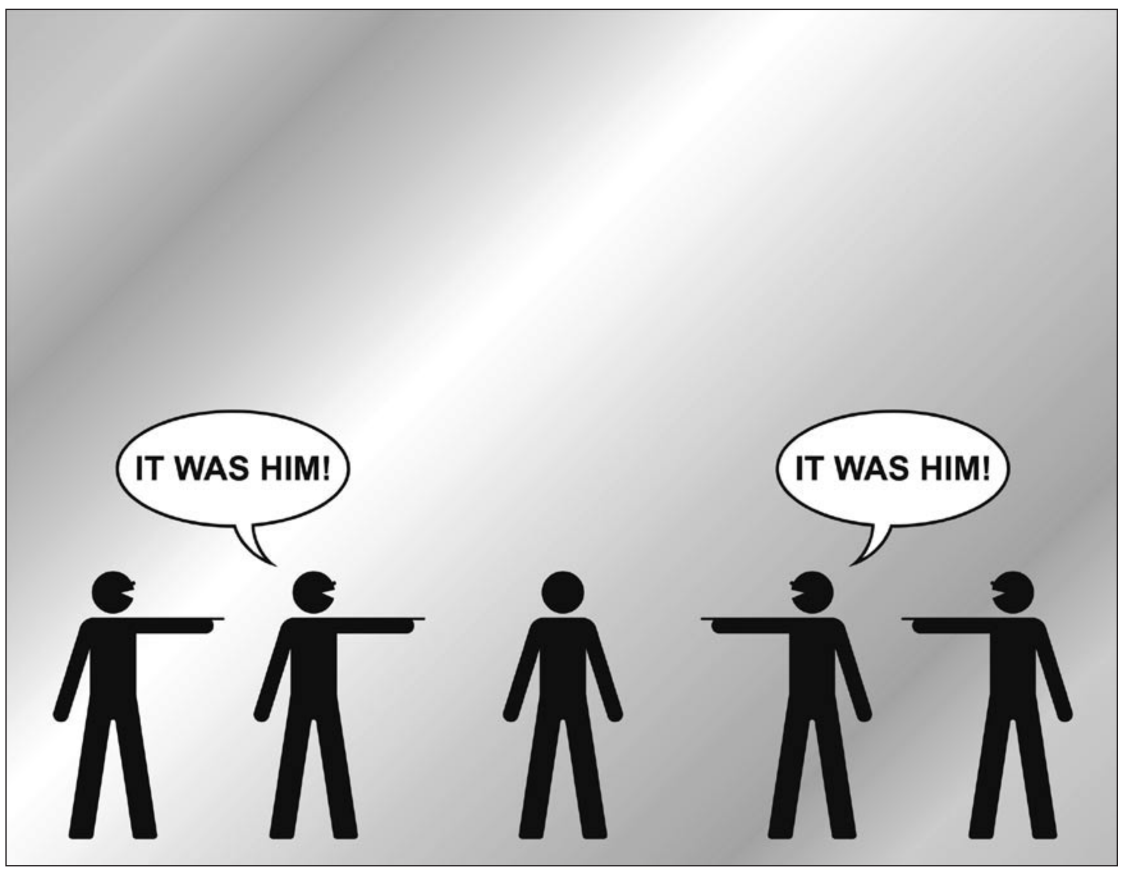
The Irrepressible Urge to Find Scapegoats



By Stuart L. Gasner

It has been a little over two years since Lehman Brothers declared bankruptcy, and so far no "iconic" white-collar prosecution has emerged from the scores of investigations underway all over the country. That actually makes a lot of sense: the collapse of the U.S. housing market (and with it the collapse of an intricate web of financial instruments based largely on mortgages) caught much of the world by surprise. This is not fertile ground for criminal prosecutions, which tend not to do well when the defendant can point to an unexpected downdraft in the market as the cause of the business disaster in question.

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Yet you may have recently noticed headlines announcing the launch of major criminal investigations, or suggesting new angles on the credit crisis (overly hasty foreclosures, for example) that supposedly warrant criminal treatment. One can almost hear the murmur of an angry crowd looking for an exemplary rogue to hang in the public square. The urge to criminalize some aspect — any aspect! — of the crisis seems almost palpable. Sure, the prosecution and conviction of the occasional Bernard Madoff seems to satisfy the crowd briefly, even if the crime bears little relation to the crisis. But only briefly. Especially as the economy continues to languish, the need for a symbolic scapegoat continues to simmer below the surface.

Where does this irrepressible urge to find and punish a scapegoat come from? One great explanation can be found in a slim volume entitled *"A Short History of Financial Euphoria,"* written by the well-known Harvard professor of economics John Kenneth Galbraith. Galbraith's theory is that speculative episodes, which he calls periods of "financial euphoria," are just an inherent part of capitalism, and that classic incidents such as the Tulip Mania in Holland in the 17th century, the South Sea Co. bubble in the 18th century (the original "bubble"), and the Great Crash of 1929 are bound to repeat themselves.

What ties these events together, in Galbraith's view is a common pattern of investor behavior. First, there must be a seemingly new idea that purports to "change the rules of the game." The idea can be tulip bulbs becoming the new repository of value, or, as proved to be the case just a few years after Galbraith first published his book in 1990, that "eyeballs" would replace earnings for companies having anything to do with the Internet.

Second, the participants in this "next big thing" have to convince themselves that "some new price-enhancing circumstance is in control" (Euphoria at 5) so that the market can be expected to go up and up indefinitely. This typically proves easy, because the participants in the rising market become convinced of their own acumen as they grow richer; the purveyors of Internet stock or credit default swaps or Florida real estate have a vested interest in seeing the market go higher; and doubters are branded as "unable, because of defective imagination or other mental inadequacy, to grasp the new and rewarding circumstances that sustain and secure the increases in values." (Euphoria at 6). On this last point, check out Michael Lewis' *"The Big Short"* or Lawrence MacDonald's *"Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers"* to get a sense of how hard it was for "shorts" to convince anyone that the U.S. housing market was a bubble.

Third, Galbraith writes, the speculative episode is bound to end in a crash. A decline is inevitable because there is really nothing all that new under the sun, and eventually everyone figures out that there are just so many routers needed to build out the Internet or just so many houses in Stockton that people actually want to pay for. The decline is typically a crash rather than a gentle decline because the leverage that was so profitable on the way up turns into accelerated disaster on the way down. And all the esoteric financing that clouded the leverage suddenly can be seen for what it really was: plain old debt unsecured by sufficient hard assets. End result: a smoking crater in the ground where there once was a bank or a company, and a lot of angry investors, especially the ones who arrived late in the game.

The final stage of the classic speculative bubble — and the one of the most interest to me as a white collar criminal lawyer — is what Galbraith calls " a time of anger and recrimination and also of profoundly unsubtle introspection." His description of what has typically happened throughout the history of capitalism fits the current mood to a T. The "anger will fix upon the individuals who were previously most admired for their financial imagination and acuity...their fall and occasionally, their incarceration will now be viewed with righteous satisfaction." There also will be "talk of regulation and reform," including "scrutiny of the previously much-praised financial instruments and practices — paper money; implausible securities issues; insider trading; market rigging; more recently, program and index trading — that have facilitated and financed the speculation." (Euphoria at 22). What will *not* be discussed much in these periods of "profoundly unsubtle introspection" is the true cause of the phenomenon, that is, the recurrent bouts of optimism that occasionally possess the entire financial community. That unpleasant topic — an inherent problem in a market economy that allows and even encourages speculation and its attendant crashes — will never be given much traction or credence, because, as Galbraith puts it, "whereas it is acceptable to attribute error, gullibility and excess to a single individual or even to a particular corporation, it is not deemed fitting to attribute them to a whole community, and certainly not to the whole financial community." (Euphoria at 23). Nor is it acceptable to brand crashes as an inherent flaw in a market economy: "Markets in our culture are a totem; to them can be ascribed no inherent aberrant tendency or fault."

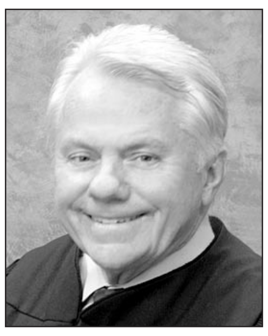
So what will become of this latest speculative mania, this time involving the supposedly limitless housing market, supported by financial "innovations" such as the credit default swap, now culminating in the rounding up of the usual suspects for the final round of recrimination and "reform"? Hard to say. Ideally prosecutors and Securities and Exchange Commission enforcement lawyers will read Galbraith's slim volume before pulling the trigger. I'll send a copy to any prosecutor who asks!

Prejudgment Interest: Overlooked Until Now

By Rex Heeseman

Although "around for awhile," some legal principles mainly surface later. For example, prejudgment interest has been codified for years, but with merely an occasional reference in insurance litigation. Such interest thus has been generally "overlooked" until three recent decisions: *Howard v. Amer. Nat. Fire Ins. Co.* (2010) 187 Cal.App.4th 498; *Amerigraphics Inc. v. Mercury Cas. Co.* (2010) 182 Cal.App. 4th 1538; and *Evanston Ins. Co. v. OEA Inc.* (9th Cir. 2009) 566 F.3d 915 (applying California law). (Note: while this article discusses insurance litigation, the points herein apply to many other lawsuits.)

According to Civil Code Section 3287(a), prejudgment interest should be awarded if the party is entitled to recover "damages certain, or capable of being made certain by calculation...." The usual test is whether that recovery could have been computed earlier from information then reasonably available. *Chesapeake Industries Inc, v. Togova Enterprises Inc.* (1983) 149 Cal.App.3d 901, 906-907 (rule liberally construed).



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Recovery under Section 3287(a) is not precluded if liability turns upon disputed facts, only if the amount of damages turns upon disputed facts. In other words, uncertainty as to liability is irrelevant. Just because the insurer thought nothing was owed "in no way affected its liability to pay...the amount being certain, interest commenced to run...." *Oil Base Inc. v. Transport Indem. Co.* (1957) 148 Cal.App. 490, 492.

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In some first party litigation, when benefits (e.g., death under Insurance Code Section 10172.5) are payable turns upon policy language. That is, a successful policyholder recovers prejudgment interest if and when the policy says benefits are owing. In other scenarios, benefits are payable due to an event over which neither the insurer nor the policyholder has any control; prejudgment interest runs from the date the insurer's liability becomes reasonably clear. See, e.g., *Pacific-Southern Mortgage Trust Co. v. Insurance Co. of No. America* (1985) 166 Cal.App.3d 703, 716.

In most litigation in which the plaintiff sues the defendant policyholder, the former has no right to prejudgment interest as the damages claimed (say, from an automobile accident) are not certain. But other third party scenarios may produce a different result. For instance, if an insurer improperly refuses to defend and the defendant policyholder pays its own defense costs (as well as, perhaps, a reasonable amount to settle the third party's lawsuit), that policyholder is entitled to prejudgment interest from the date of the payment(s).

The *Howard* court evaluated prejudgment interest at some length. Although bad faith cases commonly involve disputed issues of fact as to liability, damages may still be certain. For example, as the policyholder there paid monies to settle some claims, plaintiffs as assignees could recover prejudgment interest as to those payments. And, plaintiffs were entitled to such interest with reference to policy limits; while the insurer's liability was uncertain, those limits were not. Alternatively, added *Howard*, even if no interest was due under Section 3287(a), it was due under the policy's "Supplementary Payments" provision, with that rate applying "until the contract is superseded by a judgment."

The policyholder in *Amerigraphics* asserted that, for purposes of analyzing the "ratio" of compensatory to punitive damages, the former should include the award of prejudgment interest. The appellate court disagreed, as the policyholder cited no authority such interest should be treated as part of the ratio analysis. (It should be noted the jury, atypically, made that award; in *Bartis v. Oates* (2004) 119 Cal.App. 4th 1, 17, the jury also awarded prejudgment interest but in a usual evidentiary fashion — there, the appellate court, as distinguished from *Amerigraphics*, evidently included such interest in the ratio analysis.)

In *Evanston*, the policyholder challenged the award of prejudgment interest to the insurer "because the amounts paid for defense and settlement did not vest as required by California Civil Code [Section] 3287(a)....[and] prejudgment interest should not be applicable in the insurer-insured context." The 9th U.S. Circuit Court of Appeals rejected both arguments. First, the right to reimbursement arose when the insurer paid, as the "amount must be vested, not that the legal entitlement to that amount be vested." Additionally, this section applies to "Every person;" an insurer is thus entitled to recover prejudgment interest.

(As an aside, even if the amount of damages is not certain, a party may still recover prejudgment interest under Civil Code Section 3287(b). In making that discretionary determination, a judge ponders factors such as prevailing interest rates and principles of equity and fairness. *A&M Produce Co. v. FMC Corp.* (1982) 135 Cal.App. 473, 496.)

There are many considerations, including options, in deciding whether to award prejudgment interest and, if so, in what amount. Additionally, such interest is a "two-edged sword" because, as *Evanston* demonstrates, the insurer may be the beneficiary, albeit this statutory right typically benefits the policyholder.

In short, prejudgment interest is a topic deserving of more evaluation by the bench and the bar.