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## Get Shorty

Once upon a time there was a land far, far away named NotMyFault. There three sophisticated businessmen decided to enter into a complex and dangerous transaction involving the construction, sale and leasing of an office condominium building. They were assisted by a fourth businessman-broker called a market maker. Unfortunately, shortly after it was constructed, the building was rendered uninhabitable as a consequence of being built with lower grade construction materials, making the office tenants unwilling or unable to continue to pay on their leases.

A catastrophe ensued which was nobody's fault.

This is that story.

### The Parties:

1. Commercial office broker, **Gold Man (Goldie, for short);**
2. Business man number one, structural steel broker and speculator, **Shorty Paulson;**
3. Business man number two, commercial contractor, construction manager, insurance company and experienced investor; **ACA Managers and Insurers;**
4. Business man number three, a German commercial office investor; **IKB Speculator;**
5. NotMyFault building inspector, **Careless Moody;**
6. NotMyFault's policeman-on-the-beat and regulator, **S.E. Commission;**
7. NotMyFault's elected and appointed officials, the **Grand Pooh Bahs** and **Wise Old Men,** and
8. The building, **The CDO Centre.**

### **The Setting:**

In NotMyFault the value of homes and office buildings had been rising for years. And at a skyrocketing clip for the last five. The Wise Old Men who controlled the country's interest rates kept them low for years in order to keep mortgage rates enticingly low for the increasing numbers of potential home buyers.

In NotMyFault, home ownership for all citizens became an embedded, positive cultural value, constantly trumpeted by those Grand Pooh Bahs in their visits to their constituents.

The Grand Pooh Bahs in the country's capital passed laws which required quasi-federal institutions called Fan and Fred to buy these mortgages, even the shaky ones, and to guarantee their repayment to lenders if home buyers defaulted on their obligations to those lenders.

Mortgage brokers, incited by the fees they received for placing mortgages, encouraged John Q Public to take on increasingly higher debt and riskier loans. Home buyers, many of whom no longer needed to verify their income, greedily took on bigger mortgages in order to move up or into the McMansion of their dreams. Some John Qs even bought investment houses one month only to flip them shortly thereafter and for a tidy profit.

At a place called Wall Street, banks and investment banks greedily bought multiples of these mortgage loans, and then packaged them into new and exotic instruments, selling them to institutional and high net worth customers, making ever larger fees on each and every sale.

The most highly regarded investment bank was Gold Man. It wore several hats and had several distinct legal duties to its clients, depending on the hat worn at the time. If it provided investment advisory services, it had to act in the client's best interest at all times. But when it acted as a broker, including as a commercial office broker, it only needed to make sure that the product sold was "suitable" for its sophisticated client buyers.

Gold Man did not sell any products or provide any advice to John Q, but only to institutional and high net worth investors. Its advice was respected and highly sought out by the titans of industry in NotMyFault.

Many years before, NotMyFault suffered from a Great Depression. In order to protect John Q the S.E. Commission was created by the Grand Pooh Bahs of the time. However, over the years S.E. got lax in enforcing the laws of NotMyFault, which were intended to protect John Q when he invested.

The perceived wisdom in NotMyFault was that housing prices would only go in one direction ... and that wasn't down.

Except Shorty Paulson, being an iconoclast, didn't believe in that wisdom. He thought prices would fall and precipitously. In NotMyFault at the time, Shorty was practically alone in that belief.

### **The Story:**

Shorty Paulson was an immensely wealthy but secretive and generally unknown steel broker who wanted to make money on his crazy belief about housing. He knew more about structural steel than most anybody else in NotMyFault.

The best structural steel, the triple-A kind, was called grade #1. Other steel, not of the same quality but still serviceable, was sold as grades #2 or #3. The worst quality was #4. Shorty respectively called those grades A, BBB and junk.

Shorty had noticed that grade 3 steel produced today was not of the same quality as the grade 3 steel in years past. But no one else had picked up on that distinction yet.

This was the cockamamie way Shorty felt he could make his bet: He would sell some construction company grade #3 structural steel, the BBB grade, for an office condo building project. Then he would buy insurance on that structure in case it collapsed. While office buildings constructed with grade 4 steel had collapsed in the past, it was very rare for that to happen to a building constructed mostly with grade 3 steel. Indeed, office buildings constructed with grade 3 steel were still referred to as "investment grade" buildings.

Shorty took this idea to several commercial office brokers who laughed at him and turned him down flat.

But Goldie, who had made handsome brokerage fees from its past representation of Shorty Paulson in other deals, didn't want to disappoint its client. It agreed to try to put this idea into place, to "make a market."

After looking high and low, Gold Man finally found a construction company and manager, ACA Managers and Insurance, which said it would both (1) work with Paulson on the selection of the lower-rated steel, and (2) would actually build the ten story office condo which Gold Man would then attempt to sell.

ACA, a sophisticated, well respected and knowledgeable builder, was

convinced that its CDO Centre would not fail. But in order to be certain of that, ACA insisted on the final say for all steel which ultimately would go into the CDO Centre. Shorty agreed.

As Paulson was a steel broker, he was able to identify and suggest ten stories worth of grades 2, 3 and 4 steel, mostly grades 3 and 4, he thought should go into the CDO Centre. Shorty met face-to-face with ACA on several occasions, all but once with Goldie present, to discuss the steel which would go into the building.

ACA agreed with a lot of the steel suggested by Paulson and disagreed with others. However, all of the steel going into the building ultimately was reviewed, selected and approved by ACA. After all, ACA was the one building the structure, and its reputation was on the line.

ACA also knew that if it were also to be an investor in the structure that it could charge market rents to the office tenants, and that since the CDO Centre had been cheaper to build than competing office condos built with grade 1 steel, it could get a better relative return.

Once the CDO Centre had been built, Gold Man called upon the NotMyFault building inspector, Careless Moody, to inspect the CDO Centre and to advise whether it would be granted a certificate of occupancy.

Moody examined all ten floors (some investors called those floors "tranches" in NotMyFault in those days) including all the steel which went into the structure's construction. It rated seven and a half of the floors as AAA and said the remaining floors, while not AAA, were also investment grade floors. Accordingly, a certificate of occupancy was granted by Careless, permitting Gold Man to try to sell the condo floors to institutional buyers pursuant to a document which disclosed the CDO Centre's construction in excruciating detail.

In accordance with the legal requirements of NotMyFault, Gold Man prepared an offering prospectus, meeting the disclosure laws of NotMyFault and as enforced by NotMyFault's contract regulator, S.E Commission. Goldie offered the floors for sale at a cool \$100,000,000 per floor.

The offering document prepared by Gold Man did not disclose whether Shorty was or was not hoping the building would collapse. At the time, Shorty was a small potatoes and relatively unknown speculator. The offering circular did mention that ACA had constructed the CDO Centre completely with steel ACA had chosen. It also mentioned that all the floors were certified by Careless Moody as being safe to occupy.

Since this was not a house, but an office condo, no "ordinary citizens" were permitted to be buyers. Only sophisticated and experienced office condo buyers could consider Goldie's offer. The potential institutional buyers also knew that some other sophisticated buyer would be "taking the other side of the trade," betting on the failure of the building. This strange, exotic instrument being sold by Gold Man required two opposing views on that issue.

As Goldie was seeking buyers for the CDO Centre, a surprise buyer emerged. So certain was ACA that its office condo would stand firm and tall forever, that it bought the first eight floors of the CDO Centre itself, paying a cool \$800 million.

And not only that, but then ACA's insurance subsidiary even issued an insurance policy to Shorty, promising him full payment in the unthinkable event the CDO Centre collapsed. Since Shorty did not have an actual ownership interest in the CDO Centre, this was called a "synthetic" insurance policy. NotMyFault had the strangest of financial instruments at the time, this being but one. Of course, ACA insurance also pocketed the premium for issuing that policy; it never dreamed in its worst nightmare that the structure would, in fact, collapse.

A second company, IKB Speculator, also sophisticated in this arcane niche of the construction world, was located in Germany. It bought the ninth story of the CDO Centre. Even though it was in Germany, IKB nevertheless loudly proclaimed in its marketing materials that it knew how to determine the stability of office structures, including the steel with which they were built, here in NotMyFault.

Try as it might, Goldie couldn't sell the tenth and last story of the CDO Centre. Who knows, perhaps it was because the offering circular identified the poorer quality of the steel which supported each floor and no other sophisticated buyer would touch it. In any event, and in accordance with its legal requirements when an event like that happened, Goldie bought the last floor itself, keeping that floor in its office and housing inventory.

Soon the building leased up with office tenants who paid rents the first six months like clockwork to CDO's investors, ACA and IBK.

Then the unthinkable happened. Six months after construction, all the sprinklers broke on floor number ten and completely flooded the bottom floors. Because of the lower grade steel, the floors buckled, making them really difficult to work on. Tenants deserted in droves for office buildings with flat floors. Rents completely dried up. Sure enough, the flood had so weakened the lower grade steel that soon thereafter the CDO Centre actually collapsed. ACA

lost \$800 million dollars, IKB lost \$100 million and Goldie also lost \$100 million smackeroots.

And Shorty? Having predicted what no one else predicted, he pocketed a cool \$1 billion.

### **The Aftermath:**

By this time in NotMyFault, all hell had broken loose in the housing market. Home prices had fallen drastically. John Q defaulted on his liar loans. The subprime mess leaked out into conventional mortgage markets. Banks collapsed. The Grand Pooh Bahs in NotMyFault were forced to use oodles of taxpayer capital to shore up Fan, Fred, as well as every Tom, Dick and Harry in the world of finance. They also threw taxpayer dollars at two revered NotMyFault auto companies and the world's largest insurance firm which had recklessly issued insurance contracts to Wall Streeters like Gold Man covering their bets in the housing market should it collapse.

Financial scandals erupted, the worst being one involving a man named Bernard Madoff. The S.E. Commission had been explicitly warned about his illegal activities but chose to ignore the warnings. The second worst involved a banker named Allen Stanford who the S.E. Commission also failed to investigate in a timely fashion.

Finally and after much criticism, the S.E. Commission charged Gold Man with fraud for failing to disclose in its offering circular to ACA and IKB that Shorty intended to take the other side of the trade and buy an insurance policy in case CDO Centre collapsed. The question, yet to be answered in a court of law, was whether that disclosure was material to the decisions of ACA and IKB to buy floors in the CDO Centre.

Some found it curious that the lawsuit against Gold Man was filed the very day that S.E. was excoriated for failing to timely investigate Mr. Stanford. Others thought it unusual that S.E. didn't tell Gold Man that it was going to file and seek a negotiated settlement, as they traditionally did with others whom they investigated. Some were curious that S.E. filed the complaint in the morning while the stock market was open, causing Gold Man's stock to drop 15% that day, noting that the S.E. traditionally filed like-minded complaints after the close of business. Still others, including a former head of S.E. Commission, said it was out of the ordinary for the Commission to approve a filing on a 3 to 2 vote of the commissioners and especially since that vote followed strict party lines in this two political party country.

Nevertheless, by now the NotMyFault public was out for blood. Its

president, with his index finger wagging, proclaimed, "We want our money back" in a scolding tone to Goldie and friends. Goldie complied and completely paid all its money back to NotMyFault and with interest. (The car companies who got 9 times more than Goldie, the insurance company who got 18 times more, and Fan and Fred who got 12 times more than Goldie, didn't go that far. But that distinction didn't matter to the Grand Pooh Bahs, for now the Pooh Bah goal wasn't Get Shorty, but rather was Get Goldie).

So one warm April day in NotMyFault's capital a hearing was held. The Grand Pooh Bahs sat at a table which symbolically towered over the table where the employees of Gold Man sat, as the Pooh Bahs sought to put them on the country's proverbial hot seat. The CDO Centre deal took center stage in the Pooh Bahs' questions. Unfortunately it was as if the two parties spoke different languages in their respective questions and answers. This was because the Pooh Bahs had little to no experience in understanding the complex construction of office condominiums. You could tell however that the GPBs were upset with Gold Man and you could also perceive that Gold Man didn't understand why. The Gold Men kept saying "Not my fault."

Regardless, the Grand Pooh Bahs hoped that the hearing would help to restore their lost reputations amongst the populace and to maintain their jobs as the elected honorable ones of NotMyFault in the upcoming November elections.

### **The Moral:**

How will this turn out?

In NotMyFault much needed financial reform legislation is coming but is not yet finalized.

The S.E. Commission complaint has not yet been adjudicated. Gold Man may well settle in order to preserve its reputation and move beyond this issue. Most companies take that path rather than risk the uncertainty of a lawsuit. A convenient leak has also disclosed that Gold Man is now also subject to a criminal investigation.

For the time being, Gold Man is still standing. If it decides to fight, will Goldie be stronger or weaker, from a reputational and client point of view, in twelve months? Will it go the way of Arthur Andersen?

Who knows? I don't, but I do know this. In every morality play there needs to be a villain and he must be slain. If not Gold Man, then it will be surely be someone else.

If you were to ask the Grand Pooh Bahs, the Wise Old Men, S.E.

Commission, Careless Moody, Fan and Fred, AIG, the mortgage brokers and lenders, ACA and IKB, or even John Q if any of them are that villain, they would all have an identical answer - "Not My Fault."

What's your take?