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Regulator's move risks opening floodgates for subprime lawsuits

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The Securities and Exchange Commission's charges of fraud against Goldman Sachs could prompt a fresh wave of lawsuits by banks, insurance companies and investors that lost hundreds of billions of dollars on risky debts backed by subprime mortgages.

Numerous cases have already been filed related to losses on collateralised debt obligations - the debt instruments at the centre of the SEC's case against Goldman Sachs - as well as other investments related to subprime US mortgages.

The detailed allegations outlined by the SEC are likely to spur more lawsuits, and could also give existing cases a boost.

"The SEC's charges are a validation of a lot of the civil suits that have been brought and these are likely to be followed by more suits," said Jonathan -Pickhardt, co-chair of the structured finance litigation practice at law firm Quinn Emanuel Urquhart and -Sullivan.

"We're just seeing the beginning. We will see a number of lawsuits filed in the coming weeks and this will continue."

Mr Pickhardt represents Rabobank, the Dutch bank that in 2009 filed a suit against Merrill Lynch related to losses on CDOs.

Within hours of the SEC -filing charges against Goldman on Friday, Mr Pickhardt wrote to the judge presiding over the Merrill case arguing that his client's complaints against Merrill were similar to the SEC's against Goldman.

The SEC on Friday accused Goldman and one of its vice-presidents of failing to disclose that in 2007 the hedge fund Paulson & Co helped to create a security backed by subprime mortgages called Abacus so that the fund could bet against it. Goldman denied the charges and vowed to "vigorously contest them and defend the firm and its reputation".

The charges knocked 13 per cent off Goldman Sachs shares on Friday and many other bank shares were also hit, partly on worries that the case could unleash a surge in litigation related to the derivatives market.

However, shares in some sectors rose, such as those in insurance companies that have come close to collapse because they insured losses on such CDOs.

Ambac and MBIA, bond insurers, and AIG were the biggest providers of such insurance, offered in the form of credit default swaps - derivatives that pay out on default - on the CDOs. AIG's exposure to such losses required the US government to bail out the insurer, and both Ambac and MBIA have filed -lawsuits relating to losses on mortgage-backed securities.

The SEC case is important because regulators' actions often pave the way for other litigation.

"Historically, suits by the SEC can serve as a -harbinger for more private cases," said Jeff Nielsen, managing director at Navigant.

As a result of the SEC's charges, Goldman Sachs may be the target of lawsuits brought by investors who lost money in Abacus and other securities like it.

It also paves the way for investors to examine how other investment banks assembled their CDOs.

Campbell Harvey, professor of finance at the Fuqua School of Business at Duke University, said: "This is potentially a litigation bonanza. This is not necessarily just a Goldman situation. People will scrutinise the deals that other banks did and try to get some money back."

The SEC case specifically targets "synthetic" collateralised debt obligations, or CDOs. These securities are not backed by actual bonds and loans, but by the value of derivatives of bonds. The Abacus deal was backed by derivatives on mortgage-backed bonds.

"It would not be surprising if other people who were smashed by their holdings of synthetic CDOs would be looking more closely at what they bought," said Arturo Cifuentes, a CDO expert now working at the University of Chile. He said changing the synthetic loan pool was as simple as deleting one name from a spreadsheet and typing in another.

Still, the Goldman suit and other potential cases would be challenging to win, said Peter Henning, a law professor at Wayne State University Law School in Detroit and a former SEC enforcement lawyer. Most cases involve large institutional investors, not retail investors.

"The SEC has to prove more than Goldman was playing both sides of the street. It is a disclosure case," he said.

Additional reporting by Nicole Bullock and Greg Farrell in New York