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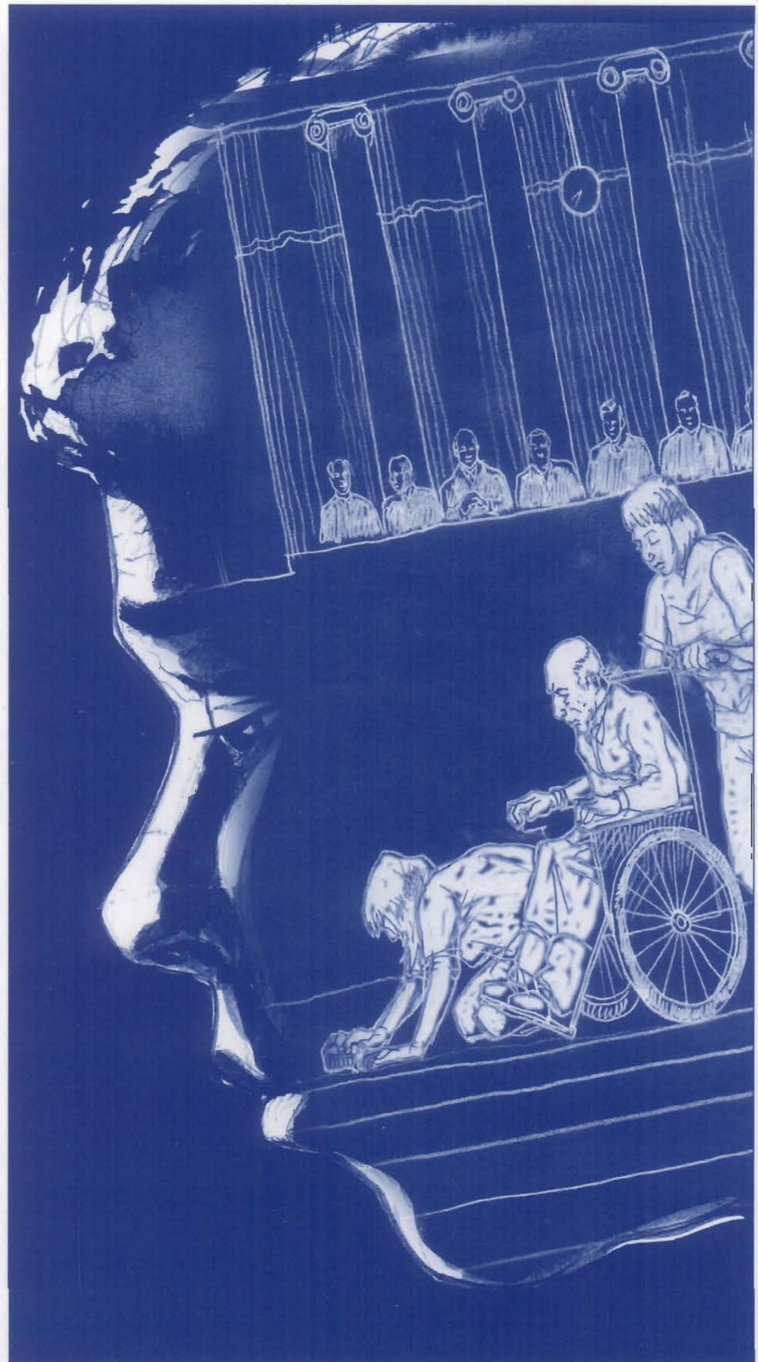

Continuing Labor's Divide:

Government Sanctions Exploitation

Mark R. Humowiecki, Esq.
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The Myths of Big Firm *Pro Bono*

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The Trickle Down System Bottoms Out

Sean R. Olender, Esq.

Spoliation of Evidence by Prosecutors

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The Trickle Down System Bottoms Out

by Sean R. Olender, Esq.

Editor's Note: The current "housing" crisis arose from United States government economic policies that prioritize military spending and infusion of our taxes into major corporations under the false notion that those monies will then "trickle down" to the rest of the population and motor the economy.

Following World War II, the U.S. was the world's sole creditor nation. Finance capital exported money out of the country, while the Cold War consumed ever-expanding armament expenditures. By the end of the Vietnam War, U.S. labor policy promoted expansion of the service sector and subsidized production using cheap labor overseas.

By the 1980's, the Reagan Administration gave this policy a name: supply-side economics. Reagan expanded weapons programs and relied heavily on corporate tax cut programs such as enterprise zones and other forms of welfare for the rich while cutting social programs for low-income workers, the elderly and disabled.

Later, the North American Free Trade Agreement (NAFTA) and others encouraged additional industries to move abroad, taking living wage jobs with them.

By the late 1990's, this process had overdetermined itself. First, the Asian bubble burst and then the dot com sector in the U.S followed suit. To keep the U.S. economy from recession, the Federal Reserve cut interest rates, giving away huge amounts of money to private banks and investment firms. Much of this money, which taxpayers will have to repay, was loaned to individuals to purchase homes at variable rates. When the housing bubble burst, the nation was again threatened with recession, only this time it was deeply in debt through war and government-inspired speculation.

Clearly another solution is called for. We need policies that put the money in at the bottom of our communities, ensuring living wages for workers in this country, who will spend their money in our local economies. Mr. Olender, very ably and articulately, explains why.

America's mortgage crisis is worse than even gloomy headlines suggest. And it's going to get a lot worse. The losses that private investors, Wall Street banks, commercial banks, and others face are so large that they are exerting unprecedented pressure on the government to do something to stem their losses. That something is a taxpayer bailout to buy up bad loans on which investors can't collect.

Banks and investors pushing a bailout haven't yet devised a good reason for the public to accept other than, "if there's no bailout, the apocalypse will ensue." Public reaction to this unprecedented situation is unpredictable. At this time, Congress, industry, and the media are still gauging the public mood. No matter how hard banks and investors push, Congress will be wary to grant a bailout if the public figures out that a bailout will harm most Americans and not help them.

> ***The path to prosperity is where housing costs are reasonably related to incomes.***

A bailout *will* hurt most Americans, not help them. Lower home prices will allow more Americans to *actually afford* housing and allow our children to afford housing, too. Trying to prop up housing prices makes all Americans poorer because current prices are unsustainable and require Americans to devote more income to housing-related expenses. How many Boomers will have to choose between retirement and giving their child a *huge* down payment on a "cute" two bedroom, one bath condo? The path to increased prosperity for us and our children is not offering zero down negative amortization loans to borrowers who can barely pay the "teaser" payment.

The path to prosperity is where housing costs are reasonably related to incomes. A bailout brings the worst of both worlds by using $1 to $2 trillion of taxpayer money to buy bad loans from banks meaning higher taxes for us and our children to pay off interest on money given to wealthy investors. And it could temporarily slow price declines resulting in more empty houses, more vandalized houses and fewer affordable houses.

Sean R. Olender earned a juris doctor from the University of San Diego School of Law and a Bachelor of Arts in Political Science from the University of California at Santa Barbara. Mr. Olender exclusively practices immigration law in San Jose, California representing companies in the areas of high tech, biotech and accounting.

Mr. Olender has written extensively about the mortgage crisis for the San Francisco Chronicle *and has spoken on radio and television about the crisis. He has written on other topics for* San Francisco Attorney Magazine, *the magazine of the Northern California Human Resources Association, and other publications.*

Illustration by Matthew Snow

Mike Keefe/Denver Post

The Fed's efforts to bail out banks by issuing reckless credit are hurting Americans. People are abandoning houses because they are impossible to afford, but burglary to steal copper pipes and wire *out of the walls* is gaining popularity. Congress is investigating another material to make pennies and nickels because these coins are worth more melted than at face value. Gasoline is near $4 a gallon and at least one analyst suggested it will reach $7 a gallon in the next two years. These are signs that Fed action to expand credit to bail out housing is destroying the value of the dollar and giving *everyone* a pay cut.

This is not a Republican-Democratic divide. Both parties rely heavily on the real estate industrial-complex for campaign contributions and have sought for decades to benefit the wealthiest Americans with *dual use* tax policies (those that claim to help everyone, but mostly benefit wealthier Americans). A great example of the bipartisan nature of these efforts is Barney Frank's ongoing concern to help needy families seeking $729,750 mortgages. He's so concerned about this group that he's holding hearings to get to the bottom of why these poor borrowers face "sky high" interest rates of 7%! With the median family of four earning just over $65,000 a year, you'd think Congressman Frank was a Republican, preoccupying himself with such things. Republicans and Democrats alike want to save banks and investors using taxpayer money to buy up their bad debts.

Congress' embarrassing captivity to the housing industry was recently manifested in February 2008 when the National Association of Home Builders stopped making campaign contributions to candidates for Congress "until further notice" because Congress and the Bush administration had not "adequately addressed the underlying economic issues that would help to stabilize the housing sector…"[1] By April 2008 the Senate passed a tax-loss carryback estimated to cost $25 billion in lost tax revenue primarily from home builders by allowing them to carry losses from this year and next against income earned a long time ago.[2] When pundits scream, "those who aren't paying taxes shouldn't get a rebate," we should ask them if that includes home builders.

The House version proposes $300 billion in new FHA loan guarantees for borrowers "struggling to pay their current mortgages and who want to refinance." The law

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Sherry Gendelman
Attorney at Law

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would require the mortgage holder to agree to a "substantial reduction" of the loan's outstanding principal and provide new terms the borrower could afford. If the mortgage holder agreed, *and the borrower agreed to share future appreciation with the government*, the government would buy the old loan and assume the default risk for the new one. This legislation aims to help banks and mortgage bond investors struggling to collect payments on their bonds, but who fear that foreclosures will only recoup 50% to 60% of outstanding principal.

This would turn homeowners into a bizarre class of quasi-renters. They would bear mortgage payments, taxes, insurance, maintenance and other burdens of ownership, but share the home's appreciation with the government (assuming there is appreciation). It's the American dream upside down. What incentive will these people have to not walk away? Borrowers underwater gain little by remaining in the house because they *often pay double the cost of renting the same house.* They could cut their housing expenses by half renting an empty house two doors away. The bill appears to hope that widespread financial illiteracy and the absence of calculators in America will protect taxpayers from homeowners walking away from their upside down mortgages *because they can't figure out it's the rational thing to do.*

On May 7, Congressmen Jerry McNerney, (D-CA), and Gary Miller, (R-CA), introduced H.R. 5958, the Homeowner Opportunity Act, seeking to make permanent the increase to FHA and GSE conforming loan limits for "high-cost areas" at $729,750. The bill would be an amendment to the housing stimulus bill. The National Association of Realtors sent a letter urging Congress to support the McNerney-Miller amendment noting, "Higher loan limits are critical to ensure that homeowners and those who aspire to own a home are given the same safe alternatives for mortgages regardless of where they live." The letter added, "It is simply a matter of equity for American families who live in high-cost communities." By the same logic it would simply be a matter of equity to provide food stamps to help American families who live in Hillsborough or Beverly Hills face the high cost of champagne and caviar. Congressman Miller's top five campaign contributors during the 2006 election cycle? The National Association of Mortagage Brokers, the National Association of Realtors, the National Association of Home Builders, the Beer Wholesalers Association, and Fannie Mae.[3] This group doesn't care about "safe alternatives." This group wants to drive up prices using taxpayer-backed loans to get big commissions and profits. Again, there's nothing wrong with commissions and profits, but in a captalist system, those should not be backed by the American taxpayer. Mr. Miller should see if there is a market-based solution to his friends' current financial problems instead of soaking the American taxpayer.

The goal obviously is not to help anyone afford a house in "high cost areas." Lenders don't want to make low-downpayment loans in these areas because they know prices are going to fall and they don't want to lose money. If you take away big loans with little downpayments, these won't be high cost areas any more.

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BRENDA BOUDREAUX

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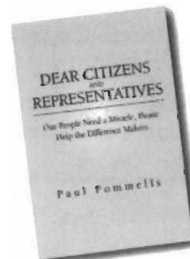
EMAIL brenda@brenboulaw.com



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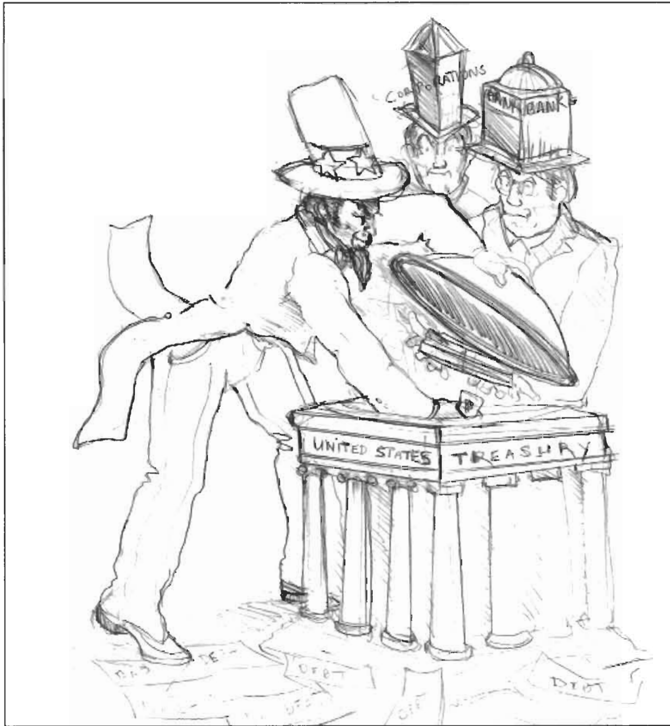

Illustration by Matthew Snow

I doubt the goal is even to keep wealthier homeowners from losing equity (although that's what wealthier homeowners think the goal is). Nothing can stop the fall in prices except a huge devaluation of the dollar that drives up the price of everything except housing. For housing not to drop in nominal terms, it will need to fall hard in real terms (adjusted for inflation). When a cup of coffee is $20, you'll know that home prices need not fall at all.

The Fed's efforts to bail out housing are debasing the dollar and sending gas and food prices soaring. Ordinary Americans struggle to buy groceries and gas because of policies designed to preserve banks' security interest in real estate. Lower Federal funds rates haven't lowered interest rates on mortgages and credit cards. It wasn't supposed to. The goal is to increase the *spread* between what banks borrow at and lend at so they can make more money for long enough to paper over their losses.

Understanding the purpose and moral implications of a bailout as well as the risk to the country requires us to understand whence the mortgage meltdown sprang, who benefited from it and who will benefit from a bailout.

Existing Housing Subsidies Benefited the Wealthy and Directed Far Too Much Malinvestment to Housing

The idea of a bailout is doubly disturbing because federal housing subsidies already conferred huge unjust windfalls on wealthy Americans and encouraged huge malinvestment in housing that the market would not otherwise support. Malinvestment driven by below market interest rates results in houses sitting vacant and being more valuable for copper wire and pipes than shelter. Fed policy is why this is happening.

The worst excess started when the Clinton Administration passed the Taxpayer Assistance Act in 1997, allowing a tax-free windfall of up to $250,000 in capital gains from the sale of a primary residence in which the seller lived for two years and up to $500,000 tax-free for married couples. Until recently, the law allowed a person to own multiple homes and move into a different one every two years, sell it and claim the exclusion on appreciation that occurred before they moved in! For example, if you bought three houses in 1997 and rented out two, in

MARVIN E. SCHECHTER
ATTORNEY AT LAW

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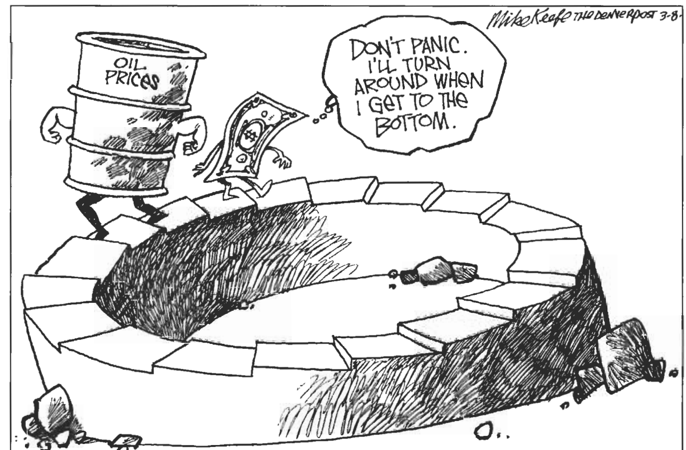
2002 you could sell your primary residence and move into house two, in 2004 sell house two and move into house three, and in 2006 sell house three. The capital gains exclusion included capital appreciation from the time the houses were purchased and allowed, in this example, an exclusion for a couple of up to $1.5 million in capital gains 100% tax free over four years. Not a lot of median income families get that sort of bang out of the tax code.

Then there's the mortgage interest deduction. First, it encourages homeowners to borrow too much. It encourages interest-only loans. It encourages debt. Because it operates *separately* from the standard deduction, many Americans get little or no benefit from it. For a single person, the standard deduction in 2007 was $5,350 and for a married couple $10,700. Taxpayers itemize only if their itemized deductions exceed these amounts. Thus, the tax benefit of itemizing is very small at the margin and increases as one moves further from the margin. A couple paying a $1,500 a month mortgage that they've had for a few years might only get to deduct $5,000 or so from their income *over* what they would have gotten from the standard deduction. In 2006, the median monthly mortgage payment was $1,132 (up dramatically from $840 in 2003).[4] That means more than half of American homeowners get nothing from the mortgage interest deduction unless they have other itemized deductions to get past the standard deduction.

However, for folks with money, the mortgage interest deduction turns almost anything into a tax deductible expense. By using home equity loans to finance cars, college tuition, and vacations, *they get to deduct all of the interest payments on that debt regardless of their income.* To an average income earner, their car payment is not tax deductible. Even the student loan interest deduction is phased out for those earning $65,000 a



Mike Keefe/Denver Post

year or more, and can't ever exceed $2,500 a year, which is the equivalent of interest on consolidated loans totaling about $30,000 at 6%. But in 2007 the average cost of a public college education was $54,356 and $129,228 for private college.[5] Americans with expensive homes can simply borrow $200,000 against their home and deduct the interest from their taxable income regardless of total income.

The moral implication is not that a tax deduction is itself wrong; it's that *this* deduction places an unfair tax burden on poorer taxpayers and it contributes to wealth disparities. A struggling young person with $54,356 in student loans and an annual income of $32,000 a year will only be able to deduct about half the interest he pays each year on his student loans, but another making $250,000 at a Wall Street investment bank can deduct all of the interest if his parents had the good fortune to finance his education with home equity.

Some people were duped into loans they shouldn't have taken. But a whole lot of people took easy money

Peter M. Sproul, Esq.

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and splurged on his and hers Escalades with those wheels that keep spinning after you come to a complete stop. They bought fancy watches, vacations, dropped $100,000 into their checking accounts for a rainy day. And by the mid-2000s many of those taking huge sums of cash out of their homes hadn't paid much, if any, of a down payment in the first place.

To cap off this drunken revelry, President Bush passed the Mortgage Forgiveness Debt Relief Act of 2007 exempting mortgage debt forgiven in 2007-09 from an IRS rule that treats forgiven mortgage debt as taxable income. The idea behind the old IRS rule is that if someone loans you money, you spend it and don't pay back the loan, and the lender gives up trying to get it back, you made money just the same as if you'd worked for it, were gifted it by a relative, or won it in Vegas. People who put zero or 5% down on homes in the 1997 to 2006 period pulled big money out of their houses to buy cars, Rolexes, college tuition — when these folks default, the things they bought with their loans become essentially free. Now they don't even have to pay taxes on the money they spent. But average Americans who spent money earned from work pay a hefty combined state, federal and payroll tax of 35% to 40%. The moral dilemma is obvious, viewing tax policy from the perspective of fairness: current law penalizes work and rewards speculating on real estate and then defaulting on the loans.

Housing Subsidies Never Helped Most Homeowners and Neither Will a Bailout

The myth of the mortgage interest deduction, enormous capital gains exclusions, subsidized "below market rate housing" and myriad other nonsense is that they help "consumers" afford houses. To the contrary, this all causes the price of homes to rise. The sole beneficiaries are the banking system and the real estate-industrial complex because it creates greater demand for their product: credit and houses. American consumers pay on average 17% of their income in interest payments each year. What better illustrates the evil of this system?

We observe the same shtick across securitized lending sectors. In housing, the real estate agents, mortgage brokers and appraisers conspired to get buyers to pay as much as possible. The financer worked with the seller's agent who advised the buyer (I see all real estate agents as seller's agents because they are all paid by the seller — one agent merely claims to be the buyer's agent, but both agents want to close the deal at the

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highest price and have a financial incentive to do so). I remember countless agents telling people, "if you wait any longer, you'll be priced out of the market and you'll *never* be able to buy a house."

We observed this shtick in student lending when they got busted in 2007. Student lenders worked with admissions offices and paid kickbacks to get "preferred" status. Admissions offices became agents of the lenders while trying to appear a devoted fiduciary to the students they advised. Lenders profited because the more students borrowed, the more they'd pay in interest. Universities profited because they could raise tuition as high as lenders would lend.

High home prices don't benefit homeowners in a wholesome way. The homeowner still lives in the same exact home — it hasn't grown or transformed in any way — but it is now "worth" twice as much as it was just five years ago. This is not because people are willing to write checks to buy homes for twice as much as they were a few years ago. It is because banks are willing to lend people twice as much as before. When someone buys an identical home (it's no different than it was five years ago), he takes a mortgage that is twice as large and burdensome as the one needed to buy the same exact house five years earlier. This new buyer doesn't live more luxuriously; he is merely a doubly profitable source of income for international investors.

Lower home prices would benefit most Americans. Instead of paying 50% of income to carry a risky interest-only or negative-amortization loan, a big drop in prices might render the average couple able to spend 25% to 30% of income on housing for a fixed-rate mortgage.

Even the 30-year mortgage is exotic in context. Until the creation of the Federal Housing Administration (FHA) in 1934, the standard residential mortgage was five years. Franklin Roosevelt noted that FHA's effort to expand mortgages to a 30-year repayment period was to (you guessed it) make them more "affordable." And it did make them more affordable temporarily. But the market eventually renders any subsidy pure profit by raising prices. Banks are now pushing 40-year mortgages. In the United Kingdom there's been talk of *intergenerational mortgages.*

How Mortgage Securitization Works

Debt securitization is when an investment bank takes a bunch of loans (called a "pool"), puts them into a fund and sells interests in that fund, usually in the form of bonds. Each bondholder owns an interest in the

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fund and a proportional right to interest income, principal and collateral from the loans in the pool.

Structured finance is where the investment bank selling bonds arranges them in "tranches" or sections where the owners in each section have different rights in the event that mortgage borrowers default. Instead of each bondholder suffering the same loss, *structure* divides the tranches' exposure to loss so that more senior tranches don't suffer a loss until lower tranches are wiped out. For example, if a bond offering sells its most senior tranche as consisting of the top 20% of rights, 80% of the loan value in the mortgage pool would have to default before owners of bonds in the most senior tranche suffered losses. Structured finance is highly lucrative because it allows investment banks to sell a portion of bonds as investment grade in a fund consisting of mostly risky loans.

As investment banks bought up mortgage loans at attractive premiums from originating banks (the ones who make the loans to borrowers), they paid the banks money for the loans, thus increasing the originating banks' capital. This gave originating banks the money and incentive to lend more. Because originating banks did not hold the loans, they didn't care whether borrowers defaulted. They strained to find ways to lend to people who had little hope of paying.

An example: you make loans to friends and you can sell their obligation to pay you to another person for more than the friends owed you. Suppose a loan buyer called regularly asking for more of these obligations. You can imagine that (1) you wouldn't care whether your friends paid back the loans, and (2) you'd realize that you could make a lot of money by loaning as much as possible to as many people as possible: "please take this money, I'll give you a 1% introductory interest rate." Because you sell the loans to the loan buyer, it's practically a risk-free business.

The already fetid stink of corruption that envelopes the residential real estate industry, with its appraisers paid by real estate agents, buyers' agents paid by the seller and mortgage brokers paid secret kickbacks from lenders, that *machine* was oiled and ready to roll when the new, powerful demand for mortgage loans came. Real estate agents, mortgage brokers and appraisers sprang into action, making bags of money for closing sales at the highest price to anyone and everyone as quickly as possible.

While some commentators blame bond investors for "incessant demand," it is unfair to blame this group. Although a taxpayer bailout of bond holders is morally reprehensible, this group relied on bond rating agencies in the pocket of Wall Street investment banks to decipher the value of bonds holding a complex mix of loans from a mix of geographical areas simply beyond the attention span of investors to evaluate. Investors were desperate for decent returns because US interest rates were held below the rate of inflation for so long.

Keep up the good work CCLP!

Sheldon Siegel

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San Francisco, CA 94104
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Investors should sue Wall Street banks and get their money back, but not from the taxpayer.

How the Fed's Lending Facilities and the Bear Stearns Bailout Worked

The Fed is handing out a lot of money these days. It lends through the Term Auction Facility (TAF) created in December 2007, which distributes $50 billion for up to 28 days twice a month, and the Term Securities Lending Facility (TSLF) where it lends up to $200 billion in treasuries against AAA and Aaa-rated GSE and non-GSE mortgage-backed securities since March 2008. On March 16, the Fed announced the Primary Dealer Credit Facility (PDFC) would extend credit for up to 90 days instead of 30. In May, the Fed announced it would expand the TAF from $50 billion to $75 billion.

The Fed claims it is trying to calm credit markets by lending against good collateral that the "market" is too stupid to correctly value (it is always amusing when capitalists claim that the market "needs help" or is "irrationally valuing" an asset). What the Fed is really doing is giving low-interest loans to banks for long enough to allow price inflation to work its magic. Once a dozen eggs cost $20 and gasoline is $7 a gallon and rampant inflation has permeated the economy, the banks' losses will magically inflate away. As an extreme example, if a cup of coffee cost $1 billion after this inflation is done, Bear Sterns could have absorbed its $29 billion in losses by sending a single trader out to panhandle in Manhattan for the day. This level of inflation isn't necessary to make banks solvent, but that's the idea. The Fed is loaning big money to banks at low rates against deficient collateral to keep them operating until inflation makes us all poorer and the banks solvent.

The Bear Stearns bailout was excessive even for the Bernanke Fed. The Fed went beyond lending and guaranteed $29 billion in bad debt with what will ultimately be taxpayer funds. This was for a single investment firm. The terms were set behind closed doors without any laws passed, public debates held, or accountability to anyone. To give an idea of magnitude, the entire federal education budget for preschool through university was about $64 billion in 2007. The Fed just gave away an amount roughly equal to half of the annual federal education budget to a single firm over a single weekend without any voter recourse. Americans should riot in the streets over this and demand the decision be reversed. It is a theft of public money for nefarious purposes. If the government won't listen, perhaps it's time for a mob to give the Fed an old-fashioned ransacking. Sometimes that's the only message politicians can hear with all that money stuffed in their ears.

The Fed and many commentators have reasoned that the Bear Stearns bailout was necessary to avoid a "cascade" of losses on credit derivatives and other instruments totaling *trillions* of dollars that operate in a secret, unregulated financial world. The question arises, if *trillions* of dollars in credit derivatives are held together by $29 billion of bad loans, how is this Fed bailout going to

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help for more than a short time? How could participants in trillions of dollars in credit derivatives believe that $29 billion could hold it all together?

The media spins the issue: "If the Fed is going to bail out brokerages that are not subject to regulation, then maybe we should subject them to some sort of regulation." This skips past the point, which is that the Fed shouldn't be allowed to give out that much money to anybody, whether a regulated bank, or not. This was not a loan; it was a guarantee. JP Morgan Chase bought Bear Stearns, but doesn't have to take more than the first $1 billion in losses on those bad loans. After that, the Fed uses taxpayer money to absorb these private losses.

Congress is testing the waters to see what the public will accept. Time is running short for a bailout because as home prices fall, the price at which the government buys up bad loans will have to be lower. The news media and Presidential candidates keep raising the *moral hazard* issue. But the question shouldn't even get to moral hazard. The only question is whether taxpayer money should be lawfully or morally used for this purpose at all. Clearly it shouldn't.

It's not that *someone* shouldn't help lenders. Maybe CNBC can. Warren Buffett said the Bear Stearns bailout was necessary and appropriate. Mr. Buffett is worth quite a lot of money; perhaps he can bail out Bear Stearns. Extremely wealthy people keep saying that the Bear Stearns bailout was necessary, but the median family income is just over $65,000 a year for a family of four. So why use taxpayer money to bail out banks and brokerages? If the wealthiest among us think it's important, why don't they start a fund themselves and *use their own money*?

Falling Real Wages of Workers

Headlines ask, "Have we hit bottom in housing?" The answer is not even close. I expect within five years, the words "American dream" and "house" will not be associated except as an historical reference.

Economic conditions were benign as far as the government's "major economic indicators" were concerned until mid-2007, and those indicators are devised according to government unemployment statistics, which do not reflect "discouraged" workers no longer looking for work, workers reduced to part-time or temporary work,

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Attorney at Law

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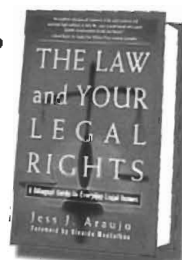

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those formerly working part-time or temporarily, and formerly self-employed workers. In fact, according to the same Department of Labor Bureau of Labor Statistics that provides us with the government unemployment figures, 30% of the entire workforce consists of "contingent workers," who in the broadest definition, do not expect their job to last longer than a year. So, the situation even then was far worse than the statistics indicated.

It is also with a near historically low "conforming" mortgage rate that the mother of all housing busts began. It's like watching someone laboring to walk down a flat road. You know it's going to get bad when the hills come. Higher unemployment and higher mortgage rates are a virtual certainty and when they arrive, they will hammer housing.

An end to mortgage equity withdrawal, lost jobs from not building millions of homes no one will live in, lost commissions and fees from agents and brokers "assisting" people endlessly swapping homes makes it impossible that these losses won't cause a deep, prolonged recession. Home prices are way too high for people to afford at current incomes. There is nothing that can stop this process. A government bailout can't stop it and will merely delay it while lining the pockets of banks, and investors buying their bad debt and then saddle the public treasury with resulting defaults at a time when public resources may be crucial for anti-poverty programs. Every solution Congress poses will inevitably *require* handing one trillion or more of taxpayer dollars to banks and investors, whether directly, or through hapless homeowners with no equity and who reap no benefit from the transfers.

Americans are deeply indebted and shopped out. Inflation is on a tear and yet the Fed keeps lowering overnight rates, a stunning 3.25% since September 2007. The cuts have stimulated the price of milk, rice, eggs, crude oil, gasoline, and other commodities. In this way, inflation is a method of effectively lowering wages because, as Keynes noted, although it may be illogical for labor to powerfully resist a reduction in money-wages, but not resist a reduction in real wages

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(inflation adjusted for purchasing power), "this is in fact how labor behaves."[6] Milton Friedman termed it the "money illusion." In short, the Fed is giving 80% of Americans a pay cut that they don't understand as we head into a severe, prolonged recession.

The Real Costs of a Bailout

Because these secret truths of economics appear to have been lost to the present generation, it bears repeating: when something costs more, it is less affordable. When something costs less, it is more affordable. Loans do not make things more affordable. Most often, they make them less affordable because as soon as a lender makes more loans available, sellers raise prices to accommodate the newly available money. Every effort to hold home prices flat using taxpayer money will fail, but even if it were effective, it would have the perverse result of using taxpayer money to prop up prices so that taxpayers pay more for houses — it would use taxpayer money to make housing *less* affordable for taxpayers.

Fannie Mae and Freddie Mac, the two lenders created by Congress to purchase mortgages from banks and other lending institutions, are likely to fail, too. Fannie and Freddie are now about 80% of the mortgage market. How's that for capitalism? Fannie and Freddie borrow at very low rates because investors believe the government will bail them out with taxpayer money if they fail. Before the Bear Stearns bailout, not many people thought the government *could* use taxpayer money to bail out a Wall Street brokerage. But after Bear Stearns, Federal backing of Fannie and Freddie seems certain.

Fannie announced May 6 that it lost $2.2 billion in the first quarter of 2008, an amount multiples of the most pessimistic predictions. The same day, Fannie's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), which is part of the Department of Housing and Urban Development, announced it was *reducing* Fannie's capital requirements. Required capital, or reserves, is the money Fannie has to hold in safe assets like treasuries to cover losses on loan delinquencies and foreclosures. Fannie and Freddie own or guarantee at least $5 trillion of mortgages and had only $53 billion in capital to cover losses on that! But that was under the *old*, higher capital requirements. Now they need to keep even less on hand for emergencies. A

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recent report noted a risk that *the US government could lose its credit rating* if Fannie and Freddie failed and the feds bailed them out. The consequence of that would be much higher taxes just to pay interest on the current debt.

Now that OFHEO removed Fannie and Freddie's already thin capital requirements and Congress raised the cap on the size of mortgages they can buy and guarantee to $729,750, Fannie and Freddie's risks have multiplied. Considering likely further home price declines, Fannie and Freddie's thin capitalization, the new conforming loan caps, and Fannie's exposure to risky Alt-A mortgages. (An Alt-A mortgage is one where the borrower has a good credit score, such as where he made his car payment on time for years, but his income and/or assets are "stated" and undocumented. For example, a person making $30,000 who had made their car and/or credit card payments for years religiously, creating a high credit score, could get an Alt-A loan and write on it that they made $250,000 a year), it is virtually certain that Fannie and/or Freddie will be insolvent within 24 months. The only question is who will pay for it.

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Why a Bailout Is a Bad Idea

A bailout is a bad idea for obvious moral reasons: it is undeniably wrong to take taxpayer money collected under the threat of force and give it to banks and investors in exchange for worthless mortgage loans. There is no way to describe this transaction as anything other than corrupt. If this is "necessary" to save the economy, then why bail out only powerful banks and bond investors? My aunt's friend lost a lot of money in the 1990s on Beanie Babies. Why can't she sell her four "Peace Bears" to the Fed for $1,000 each as she can only get $25 each on the irrational "free market?" She'd be more likely to spend the money here than an investor, who might put it into a condominium tower in Dubai.

Aside from the moral implications of resurrecting the medieval practice of taxing ordinary people to give money to the truly wealthy, there is the practical problem of finite resources. There's only so much that the Fed and the government can spend. As this crisis and price inflation spread, people will need help buying groceries and

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fuel to get to work. Many may be unemployed. Odds are in the next couple of years ordinary people aren't going to worry about where to get zero down mortgages. They are going to be worried about eating, paying rent, and having enough money to operate their cars to get to and from work. Extending and increasing unemployment benefits would be better than a housing bailout.

Yoking underwater borrowers to overpriced homes isn't doing them a favor. What no one wants to talk about is if it is even in the interest of distressed borrowers to be refinanced into government-backed loans. When a family's home is worth less than their mortgage, financial assistance doesn't make paying the mortgage a wise financial decision because, in this market, renting the same house often costs *half as much* a month as owning. With prices falling fast, even a deal that seems good later this year will seem bad by 2009. Many people who can't afford their homes will benefit more by walking away than by committing themselves through a government program to bind them to their overpriced home.

Bank of America has lobbied for a "Federal Homeowner Preservation Corporation" that would buy up $739 billion of mortgages at moderate to high risk of defaulting over the next five years.[7] Congress has been cool to announcing this as a great idea because they remain nervous about how the common man will take the news. But everyone is working hard to get the public to accept this as good and necessary.

The End Game

The problem isn't housing; it only appears to be because housing was the last and largest conduit through which the true problem operated: credit. For 25 years, government and the financial-industrial complex encouraged consumer credit growth to mask disturbingly stagnant wages. Or from another perspective, banks took advantage of stagnant wages to provide another source of funds to the majority of Americans.

In the early 1980s four trends began that intersect today at the mathematical point at which they may not continue. That's going to make the next decade or two quite unpleasant. First was increasing the payroll tax and using the proceeds for general expenses under an idea hatched by Alan Greenspan before he was Chairman of the Fed. Congress sold the public a fake "social security crisis" in 1983 and convened a bipartisan commission to "fix" it, chaired by Alan Greenspan. The Commission decreed the solution to this imaginary problem: increase "payroll taxes" dramatically, take the massive surplus revenue and pretend it is part of general tax revenue.

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That allowed the government to reduce "income" taxes and not suffer a fiscal crisis during the Reagan defense build up.

For 25 years the government ran a grossly regressive tax system where Congress spent "surplus" social security taxes totaling $2.3 trillion on general tax fund expenses, making the deficit seem smaller and allowing tax cuts for wealthier taxpayers who don't pay much in payroll taxes anyway.

The second trend was the democratization of credit that saw regular large increases in consumer credit and auto loans over 25 years, with the last seven marking a *doubling* of outstanding mortgage debt. The third trend is the falling savings rate, taking average American savings from about 8% of income down to -0.5% to -1%.

The fourth trend is a 25-year Baby Boomer shopping spree on houses, stocks, bonds and a lot of other things that propped up home prices, stock prices and provided high demand for all sorts of products and services.

These four trends have reached their end. The savings rate can't get much lower. Payroll taxes will increasingly bring in little more than they pay out and Congress is scrambling to cut Social Security benefits to avoid raising taxes to pay back the misappropriated trust fund money. Americans certainly can't borrow much more money. In 2006, I spoke with a restaurant delivery driver making about $40,000 a year who had a $650,000 interest only mortgage. It's *not mathematically possible* for Americans to pay interest on existing debt, let alone borrow more. The Baby Boomer retirement is an aggravating factor. Boomer 401k stock plans, bonds and home buying drove up asset prices for 25 years and, assuming they retire, Boomers are about to become net sellers of assets including homes. These problems are going to require real resources. Policy makers should keep their powder dry.

A bailout is morally wrong and it will hurt Americans for generations at a time when powerful changing trends require caution and reflection in spending finite resources.

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