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Rating Agencies: Civil Liability Past and Future

Credit rating agencies have come under fire in recent months for their perceived contribution to the subprime mortgage “meltdown” and for failing to change their ratings until after that meltdown was well under way.

The rating agencies traditionally have avoided liability for their ratings, in part because of the presumption that they are independent financial reporters. However, they can be expected to come under increasing pressure as civil litigants and others seek to assign blame for the recent credit crisis.

Historical Role of Rating Agencies

Rating agencies have reported on the creditworthiness of financial instruments and publicly traded companies since the early 1900s, helping market participants make informed investment decisions. Although there are multiple such agencies, Moody's, Standard & Poor's (S&P), and Fitch dominate the ratings business. Each uses its own terminology, but all issue ratings on a letter scale reflecting credit quality. Under Fitch's rating scale, for example, the best rating possible is AAA, with investments between AAA and BBB considered “investment” grade. The lowest grades indicate speculative investments, the riskiest of which may be considered “junk” or “toxic.”

Rating agencies have been called “gatekeepers” for orderly financial markets, and they play a critical role in connection with the issuance of mortgage-backed securities.¹ Originally, the agen-



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cies were compensated by subscriptions paid for by interested investors. By the 1970s, however, the agencies changed from an “investor pay” to an “issuers pay” model, in which the issuers themselves generally pay for ratings.²

Regulatory developments in the 1970s cemented rating agencies' role as arbiters of investment value. The Securities and Exchange Commission (SEC) began subjecting broker-dealers to minimum capital requirements based on the credit quality of the positions held in their portfolios, following the lead of banking and insurance regulators requiring “investment grade” instruments. Consequently, agency ratings became crucial to underwriters and issuers of securities, and the demand for ratings increased. The SEC created a regulatory category of “nationally recognized statistical rating organizations,” or “NRSROs,” to clarify which agencies' ratings could be relied upon.

Recent Public Inquiry

Accompanying this dramatic increase in volume, some academics say, has been a shift in the underlying nature of ratings agencies' work. A recent study co-authored by Joseph Mason, a Drexel University professor, and Joshua Rosner, the managing director of an independent research

firm, concludes that rating agencies no longer play their traditional roles as aloof reporters. “[U]nlike the traditional ratings process in which an enterprise can do little to change its risk characteristics in anticipation of an issuance,” Msrs. Mason and Rosner argue, “in structured finance, the rating agency is an active part of structuring the deal.”³ Professor John C. Coffee Jr. recently said in this paper that the rise of structured finance has had a destabilizing influence on the agencies.⁴

This academic interest comes alongside heightened interest by lawmakers and regulators, an interest triggered by the subprime mortgage crisis. New York Attorney General Andrew Cuomo has subpoenaed documents from S&P and Fitch as part of a broader probe into New York's mortgage market. Ohio Attorney General Marc Dann is similarly investigating ratings firms' dealings with Wall Street underwriters.⁵

In September, the Senate's Banking Committee and the House Financial Services Committee held hearings on the role of rating agencies in the securitization and sale of subprime mortgages. Testifying before the Senate Committee, SEC Chairman Christopher Cox stated that pursuant to its broadened powers under the Credit Ratings Act of 2006, the commission is “examining whether these NRSROs were unduly influenced by issuers and underwriters...to diverge from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating.”⁶ The rating agencies in turn disclaimed having any role in structuring or marketing securitized instruments, attributing the subprime mortgage crisis to other factors, including increasingly aggressive loan underwriting practices, a contraction in housing values, and the sudden unavailability of refinancing alternatives.⁷

The recent subprime crisis notwithstanding,

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the larger questions concerning the role of rating agencies are not new ones. After Enron's collapse and the discovery that Moody's and S&P had maintained investment grade ratings on Enron debt until shortly before Enron's bankruptcy, Congress held hearings on the SEC's oversight of NRSROs. Ultimately, Congress passed the Credit Rating Reform Act of 2006 (act), requiring credit rating firms to meet certain criteria before registering as NRSROs. The SEC issued regulations implementing the act this past summer, including rules requiring rating agencies to have policies and procedures to prevent the misuse of nonpublic information, to disclose and manage conflicts of interest, and to refrain from engaging in unfair or coercive practices.⁸

Rating Agencies in Courts

Despite the concerns reflected in this new legislation, NRSROs are largely insulated from liability. Notably, NRSROs are shielded from potential liability under §11 of the Securities Act of 1933, which otherwise imposes strict civil liability on underwriters, accountants, and others for materially false registration statements.⁹ Although NRSROs are not similarly immune from fraud claims under §10(b) of the 1934 Act, a Senate staff report has indicated that under existing law NRSROs "are not held even to a negligence standard" for much of their work.¹⁰

Civil suits against rating agencies have generally come in two forms. In some cases, NRSROs have been sued by rated institutions. In others, rating agencies have been sued directly by investors. Plaintiffs have not been successful in either event.

For example, in *Compuware Corp. v. Moody's Investors Servs. Inc.*,¹¹ a case decided this past summer, a rated company sued Moody's in the U.S. District Court for the Eastern District of Michigan for breach of contract, defamation, fraud, and alleged violations of the Investment Adviser's Act for issuing a negative report on the company's financial future. The district court dismissed all claims, and the U.S. Court of Appeals for the Sixth Circuit affirmed. Regarding Compuware's defamation claim, the Sixth Circuit held that Compuware was a public figure and therefore required to prove that Moody's acted with "actual malice," actual knowledge of falsity or with reckless disregard

of the truth. The court held that Compuware had failed to produce sufficient evidence of actual malice, and that Moody's rating was merely a "predictive opinion."

The Sixth Circuit similarly applied an "actual malice" standard to Compuware's breach of contract claim, reasoning that Compuware could not "avoid the First Amendment

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by asserting an implied contractual duty to perform the rating function competently." The Court cited *County of Orange v. McGraw Hill Cos.*,¹² which had previously applied the "actual malice" standard to breach of contract and professional negligence claims against S&P. In that case, Orange County alleged that S&P had breached its implied duty to perform contractual services in a competent and reasonable manner by failing to perform the analytical review necessary to rate its debt offerings. Though the County of Orange court found that issues of material fact precluded summary judgment, Orange County's \$2 billion suit against S&P was settled by the parties for \$140,000, a small fraction of the damages claimed.¹³

The U.S. Court of Appeals for the Tenth Circuit reached a similar conclusion in *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*¹⁴ In that case, a county school district alleged that Moody's negative rating of school district bonds was materially false, asserting claims for defamation and tortious interference with contractual and business relations. The district court dismissed the school district's complaint for failure to state a claim and denied the school district's request to file an amended complaint. On appeal, the Tenth Circuit held that Moody's statements constituted opinions protected by the First Amendment.

Lawsuits brought by individual investors have met a similar fate. In 2005, Enron inves-

tors brought negligent misrepresentation and unfair trade practices claims against various rating agencies in the U.S. District Court for the Southern District of Texas for failing to downgrade Enron's investment ratings prior to that company's bankruptcy. The district court dismissed all claims, finding, among other things, that the ratings at issue were protected by the First Amendment and that plaintiffs had failed to plead actual malice.¹⁵

Likewise, in *Quinn v. McGraw-Hill Cos.*,¹⁶ the majority shareholder of several Illinois banks sued McGraw-Hill, S&P's parent company, as the result of ratings given by S&P to collateralized mortgage obligations (CMOs). The banks had invested in the CMOs after being assured by a broker that S&P would give the bonds an "A" rating. S&P initially did so but later downgraded its rating to "CCC," resulting in large losses for both the banks and plaintiff. The district court dismissed plaintiff's negligent misrepresentation and breach of contract claims for failure to state a claim, and the Seventh Circuit affirmed, rejecting plaintiff's contention that he was a third-party beneficiary of the contract between the issuer and S&P. The Seventh Circuit also rejected plaintiff's tort claim, finding his purported reliance on S&P's ratings to be unreasonable in light of express disclaimers that S&P's ratings were "not a recommendation to buy, sell, or hold any such Bonds and may be subject to revision or withdrawal at any time."

Rating agencies' First Amendment protections have been further reinforced by several cases in which NRSROs have successfully resisted third-party discovery. In several such cases, courts have found that the agencies are entitled to the same privileges as journalists.¹⁷

However, the U.S. Court of Appeals for the Second Circuit reached a different result in *In re Fitch Inc.*¹⁸ In that case, a bank sued its brokers, seeking rescission of investment agreements and damages related to transactions that were not consummated because various collateralized loan obligations were not considered "investment grade." The bank thereafter sought enforcement of a subpoena issued to Fitch, seeking information regarding communications between Fitch and the brokers. The district court directed Fitch to comply with the subpoena and Fitch refused,

claiming a newsgathering privilege under the First Amendment and New York's Shield Law.

On appeal, the Second Circuit found that the district court had not abused its discretion. Noting that both New York and federal law recognize journalists' privileges in varying degrees, the Second Circuit nonetheless found that those privileges did not apply under the specific facts of that case. First, responding to Fitch's claim that it was engaged in protected "newsgathering," the court said that Fitch's rating had not been based on a judgment about newsworthiness, but rather on "client needs." Second, the court held that Fitch had played an "active role" in planning the transaction and communicated with the defendant regarding how best to structure that transaction to reach the desired rating, a role deemed "inconsistent with traditional journalism." The court noted that while Fitch's activities were not improper, Fitch could not invoke journalists' privileges under the circumstances.

A case recently filed in the U.S. District Court for the Southern District of New York could test the limits of rating agencies' liability in this new climate. In September, the Teamsters Local 282 Pension Trust Fund filed a class-action lawsuit accusing Moody's of engaging in securities fraud by giving excessively high ratings to bonds backed by subprime mortgages. The lawsuit alleges that Moody's misrepresented or failed to disclose the quality and riskiness of the investments, but the case remains in its earliest stages.¹⁹

Moreover, rating agencies are likely to be affected by more general developments regarding the standards governing private rights of action under the securities laws. Professor Coffee has noted that rating agencies receive a significant measure of protection from the strict pleading standards imposed by the Private Securities Litigation Reform Act of 1995, which requires plaintiffs to plead with particularity facts giving rise to a strong inference of fraud.²⁰ Likewise, the Supreme Court's much-anticipated decision in *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*²¹ could affect rating agencies' potential exposure to secondary liability. Just as investment banks, auditors, and other professionals eagerly await the Supreme Court's decision in that case, so too will the outcome of that case impact rating agencies' potential exposure as secondary actors.

Conclusions

Whatever the outcome of the latest subprime crisis, rating agencies are likely to come under increased pressure as courts and commentators reexamine their business model. Rating agencies' avoidance of litigation and liability in the past was premised, in large measure, on their circumscribed activities. If their role is shown to have changed, so too may the standards by which their conduct is scrutinized. Indeed, governmental scrutiny of the agencies has not been limited to the United States. The European Union's Internal Market Commissioner and president of the European Central Bank recently asked European Union regulators to report on rating agency conflicts, given the heavy impact of the recent credit crisis on European markets.²²

Professors Rosner and Mason in particular believe that rating agencies' close cooperation with issuers could lead courts to consider the agencies akin to underwriters under federal securities law. The rating agencies reject this notion, stating that their role remains limited to producing a rating opinion and informing the investing public. And commentators have yet to reach a consensus as to whether exposing rating agencies to enhanced liability would be a positive development for the financial markets. Professor Coffee has suggested that the SEC define a maximum default rate for each rating, such that rating agencies would forfeit their ability to serve as NRSROs if their problematic ratings were to exceed SEC parameters.²³ Others have suggested greater regulation by the government and enhanced civil liability.²⁴

However, the practical effect of more civil claims could be crippling liability. The brunt of this liability would invariably be borne by the three largest rating agencies, potentially decreasing competition and choice in an already thin marketplace. This would in turn reduce the amount of information available to the investing public—an ironic result given the primacy of promoting the free flow of information under the First Amendment and the securities laws.

ing Industry—For Better or for Worse?" NYU L.&Econ. Working Papers (2007).

3. Joseph R. Mason & Joshua Rosner, "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," Hudson Inst. Working Paper (2007).

4. Coffee, *supra*.

5. Jesse Eisinger, "Overrated," *Conde Nast Portfolio*, September 2007.

6. Testimony of Honorable Christopher Cox Before the Senate Banking Committee (Sept. 26, 2007).

7. Testimony of Michael Kanef and Vickie Tillman Before the Senate Banking Committee (Sept. 26, 2007).

8. SEC Release No. 2007-104 (May 23, 2007).

9. 17 C.F.R. §230.436(g)(1).

10. Report of the Staff to the Senate Committee on Governmental Affairs, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," Oct. 8, 2002, at 105.

11. ___F.3d___, 2007 WL 2386565 (6th Cir. Aug. 23, 2007).

12. 245 B.R. 151 (C.D. Cal. 1999).

13. Frank Partnoy, "The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies," 77 Wash. U. L.Q. 619, 641 n.97 (1999).

14. 175 F.3d 848 (10th Cir. 1999).

15. *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, ___F.Supp.2d___, 2005 WL 5784354 (S.D. Tex. Feb. 16, 2005).

16. 168 F.3d 331 (7th Cir. 1999).

17. See, e.g., *In re Pan Am Corp.*, 161 B.R. 577, 581-83 (S.D.N.Y. 1993); *In re Scott Paper Co. Sec. Litig.*, 145 F.R.D. 366, 370 (E.D. Pa. 1992).

18. 330 F.3d 104 (2d Cir. 2003).

19. *Teamsters Local 282 Pension Trust Fund v. Moody's Corp. et al.*, No. 07 Civ. 8375 (S.D.N.Y.).

20. Coffee, *supra*.

21. 127 S.Ct. 1873 (2007).

22. David Gow, "Brussels Says Credit Agencies Face More Controls After Crisis," *The Guardian*, Oct. 4, 2007.

23. Coffee, *supra*.

24. See, e.g., Joshua Rosner, "Subprime Offender," *The New Republic*, Sept. 10, 2007.



1. John C. Coffee, Jr., "The Mortgage Meltdown and Gatekeeper Failure," NYLJ, Sept. 20, 2007.

2. Lawrence J. White, "A New Law for the Bond Rat-