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Subprime – Law Firms

Recovering From The Subprime Crisis: Is A Rating Merely An Opinion?

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The effects of the subprime mortgage crisis that shocked homeowners and mortgage lenders in the summer of 2007 have continued to devastate the international capital markets, leaving investors and issuers (and their lawyers) wondering who is to blame for the billions lost in so-called "investment-grade" investments. Structured investment vehicles such as collateralized debt obligations ("CDOs") have taken the brunt of the losses, as is evidenced in frequent news articles highlighting tens of billions of dollars written-down by well-known investment banks and subsequent layoffs of entire CDO departments. Although historically insulated from liability for their ratings, the rating agencies have emerged from the catastrophe among the targets for liability after profiting immensely from their structured finance business during the subprime boom. This article explores the role of the agencies in structuring CDOs and how the law is developing regarding rating agency liability.

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The rating agencies assert that they provide opinions, not investment advice, yet they actively work with investment banks to engineer transactions[1] and with CDO issuers to achieve targeted ratings.[2] As the media has put it, rating agencies work with banks to "develop the worst possible product that would still achieve a certain rating."[3] The agencies' role in structuring CDO transactions not only capitalizes on their market power, but moves them away from their traditional role of ratings publishers. The substantial fees that the agencies collect to rate a transaction – they charge as much as three times more to rate a CDO than to analyze a bond[4] – remove the agencies further from their traditional role.[5]

At the onset of the subprime crisis, rating agencies took cover by shifting responsibility to CDO sponsors and investment banks (underwriters) who provided the information underlying the CDO ratings.[6] According to *The New York Times*, Moody's, for its part, has conceded that it "made significant mistakes in the rating of structured finance products" and that "[i]n hindsight, it is pretty clear that there was a failure in some key assumptions that were supporting our analytics and our models."[7] In fact, Moody's shareholders have alleged that Moody's materially misled investors by assigning "excessively high ratings to

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bonds backed by risky subprime mortgages – including bonds packaged as collateralized debt obligations."[8] S&P's shareholders have made the same allegation against S&P.

Although some blame the federal government for the rating agencies' power, Congress recently has sought to reexamine the rating agencies' role in the capital markets. The Credit Agency Reform Act of 2006[10] (the "Act") gave the SEC oversight of the agencies, but arguably did not help with accuracy concerns.[11] The Act set forth a registration process to become a nationally recognized statistical rating organization, requiring that applicants provide procedures for calculating ratings, implement rules to prevent misuse and select a compliance officer.[12] The Act prohibits such conflicts of interest as (1) conditioning ratings on services; (2) lowering ratings if an entire product is not rated; and (3) modifying ratings based on the purchase.[13] The Act allows SEC enforcement and permits the SEC to make additional conflict of interest rules.[14] In addition, towards the end of 2007, the Senate held hearings to assess the role and impact of the rating agencies on the subprime market, and the House held hearings to assess the role of the agencies on the structured finance market.[15]

Notwithstanding recent governmental oversight, the agencies have a track record of success in the courts. Rating agencies historically have defended claims brought by investors who relied on credit ratings, and issuers who believe credit ratings have been wrongfully assigned or downgraded, by invoking the protections afforded to the press under the First Amendment of the United States Constitution and on grounds that investors lack contractual privity or reasonable reliance to support a claim for liability. *See, e.g., Quinn v. McGraw-Hill Co.*[16] (dismissing investor's claims against S&P arising from a collateralized mortgage obligation on grounds that the investor (1) lacked contractual privity with S&P; and (2) was a sophisticated party informed in writing of risks associated with the transaction, and was cautioned that S&P's rating was not investment advice); *Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc.*[17] (holding that Moody's was not liable for defamation for its unsolicited publication regarding plaintiff's bond issuance because the opinion was of a public concern and thus protected by the First Amendment, and because the opinion was not false); *In re Enron Corp. Secs., Derivative & "ERISA" Litig.*[18] (holding that S&P, Fitch and Moody's did not owe a duty to plaintiff, who loaned Enron money it could not repay after its collapse, because, *inter alia,* plaintiff contracted for rating services, not an analysis whether Enron could repay a debt). In most instances, particularly with respect to investors, the rating agencies have been shielded from liability absent a showing of willful misconduct.

The rating agencies' defenses, however, are not absolute. In *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.,* for example, a credit rating agency was alleged to have recklessly disregarded the issuer's history of fraud and non-compliance with governing agreements.[19] The court allowed investors' claims that the agency misrepresented the strength of the issuer and its bonds to proceed, reasoning that the agency's specific knowledge of each particular investor was not required where the representation at issue was intended to target a select and identified group of qualified purchasers.[20] The court emphasized, nonetheless, that "there must have been some conduct on the part of the professional linking him to that party, which evinces [his] understanding of that party's reliance."[21] *See also Comm'l Fin'l Servs., Inc. v. Arthur Andersen LLP*[22] (reversing the lower court's dismissal of negligence-based claims against Moody's); *First Fin'l Sav. Bank, Inc. v. Am. Bankers Ins. Co. of Fla., Inc.*[23] (referring to S&P's argument that its ratings are opinions, not representations of fact, and thus cannot be actionable and are protected by the First Amendment as "a waste of paper"); accord, *County of Orange v. McGraw Hill Cos.*[24]

The role the rating agencies have played in structuring transactions for a fee makes them more likely to be targets than constitutionally protected journalists. The fallout from the subprime sector remains in its nascent stages, and the law continues to evolve. We expect that the agencies will be subject to further litigation due to enhanced public attention and – most importantly – the fact that rating agencies were instrumental in the execution of subprime mortgage-backed securities and CDOs. The success of these claims will turn on the level of misfeasance, or even malfeasance, proven against the rating agencies for their structured finance and CDO practices. Likewise, courts will need to weigh the rating agencies' conduct against their historic and professed role as unbiased purveyors of opinion in the capital markets. Time, of course, will tell, though change is nearly certain.

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[1] *The GSE Report (June 18, 2007), www.gsereport.com.*

[2] *Joshua Rosner*, Stopping the Subprime Crisis, The N.Y. Times *(July 25, 2007), www.nytimes.com/2007/07/25/opinion/25rosner.html.*

[3] Id.

[4] *The GSE Report.*

[5] *Arturo Cifuentes*, The Rating Agencies and the Fixed Income Markets: Suggestions to Improve the Current Situation *(Sept. 2007) (presentation to the U. S. Senate Banking Committee*).

[6] *Janet Tavakoli*, Misfortune's Formula: Structured Credit Ratings, Daily News, White Plains, *www.industrywatch.com/pages/iw2/printStory.nsp?ID=iw&story_id=110536500.*

[7] *Floyd Norris*, Moody's Official Concedes Failures in Some Ratings, N.Y. Times *(Jan. 26, 2008*), *www.nytimes.com/2008/01/26/business/26moodys.html.*

[8] Nach v. Huber, *No. 07-CV-4071 (N.D. Ill. filed July 19, 2007*).

[9] Reese v. Bahash, *No. 07-CV-01530-CKK (D. D.C. filed August 28, 2007*).

[10] *Credit Agency Reform Act of 2006, 15 U.S.C. § 78o-7 (2006).*

[11] *Arturo Cifuentes*, Essentials of Collateralized Debt Obligations: Key Concepts & Recent Developments *(Apr. 2007) (presentation to Office of the Comptroller of the Currency, U.S. Department of the Treasury).*

[12] *15 U.S.C. § 78o-7.*

[13] Id.

[14] Id.

[15] *Mid-Hudson Valley Mortgage Bankers Ass'n*, Mortgage Action Alliance Newsletter *(Sept. 24*, 2007*), www.mhvmba.com/wordpress/?p=28.*

[16] *168 F. 3d 331, 334-337 (7th Cir. 1999).*

[17] *988 F. Supp. 1341 (D. Colo. 1997).*

[18] *No. MDL-1446, 2007 WL 1662658 (S.D. Tex. June 5, 2007).*

[19] *951 F. Supp. 1071, 1096-97 (S.D.N.Y. 1996).*

[20] Id. *at 1093-94.*

[21] Id. *at 1092-93.*

[22] *94 P. 3d 106 (Okla. Civ. App. Div. 2004).*

[23] *No. CIV.A. 88-33-CIV-5, 1989 WL 168015, at *5 (E.D.N.C. Aug. 4, 1989) (vacated in part on other grounds).*

[24] *245 B.R. 151 (C.D. Cal. 1999).*