Economic Crisis and the Law

Los Angeles Lawyer

October 2009 /$4

2009-10 LACBA Directory
PULLOUT SECTION

EARN MCLE CREDIT

Banks under FDIC Receivership page 31

PLUS

Liability of Bond Rating Agencies page 38

Tax Relief for Ponzi Scheme Victims page 10

Reopening Divorce Settlements page 15

Opening a Home Office page 18

Swap Meet

Los Angeles lawyer Mark Labaton explains the role of credit default swaps in triggering the collapse of the financial markets

page 24

BY MARK ANCHOR ALBERT

RATINGS WARS

The lawsuit filed by Calpers may be able to overcome the ratings agencies' traditional First Amendment defense

According to Thomas Friedman, a *New York Times* columnist, "There are two superpowers in the world today....There's the United States and there's Moody's Bond Rating Service."[1] As if to prove this point, claims against rating agencies arising from their credit rating activities have historically been unsuccessful against the defense that credit ratings are opinions protected under the First Amendment.[2] Under the standard articulated in *New York Times v. Sullivan*,[3] opinions cannot serve as a basis for liability unless the plaintiffs can establish actual malice by the credit rating agencies. These agencies have also won some early cases on the basis of the journalist's privilege and related shield laws, which provide a First Amendment-based defense to discovery requests seeking the basis for credit ratings.[4] Nevertheless, in June 2009, the California Public Employees Retirement System filed suit in San Francisco against Moody's,[5] Fitch,[6] and Standard & Poor's[7] for negligent misrepresentation in their ratings of $1.3 billion in "structured investment vehicles."

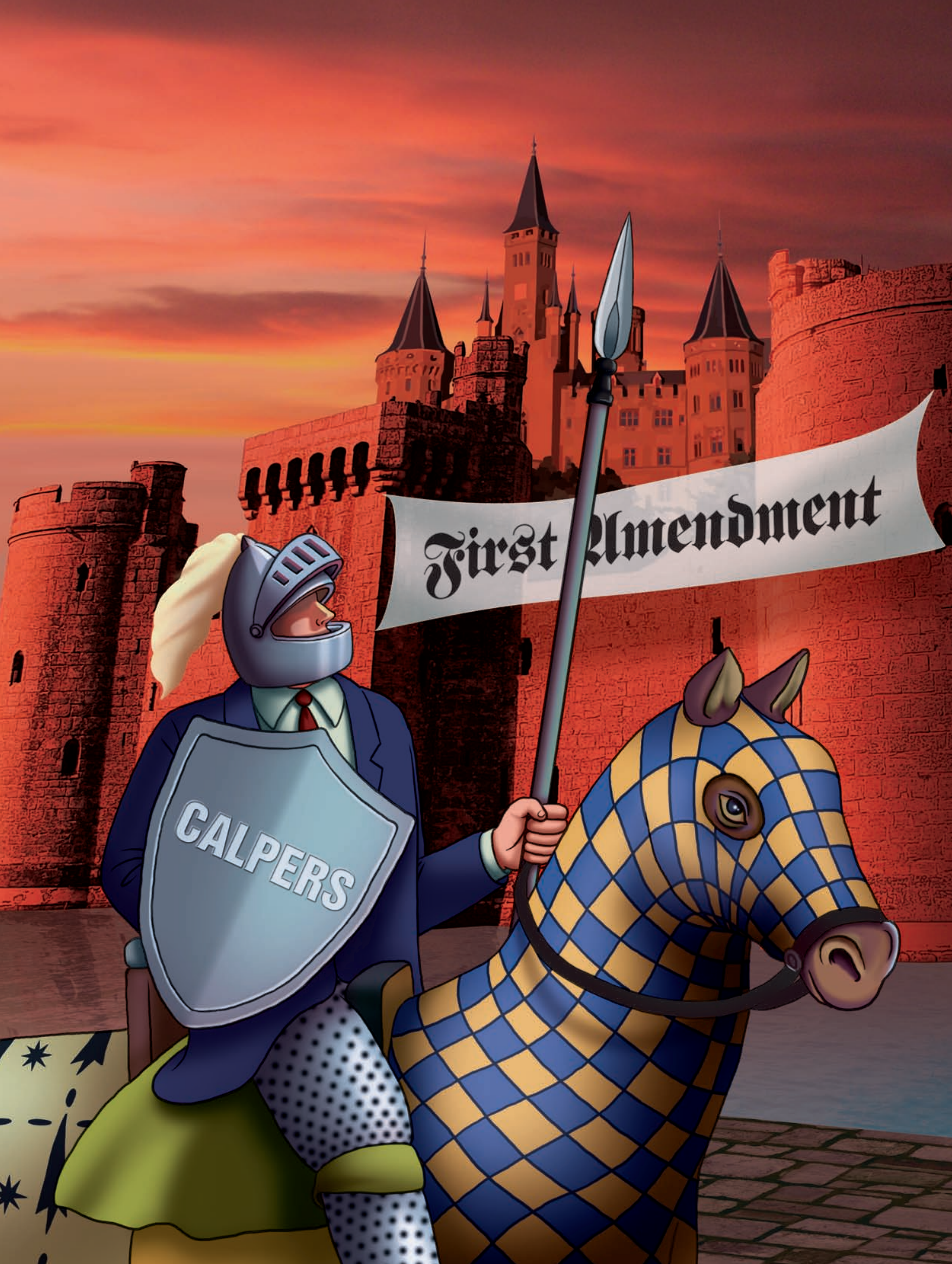
There is some hope for the Calpers lawsuit. An emerging trend in the law invalidates the credit rating agencies' First Amendment defenses and related journalist shield law defenses. The leading cases in this line suggest that four key elements need to be present to successfully assert rating agency liability in cases not involving misrepresentation or outright fraud:

- The rating agencies are paid for their credit ratings by the issuer or underwriter of the securities.
- The ratings are provided to a limited group of recipients to whom the securities are marketed and sold, rather than to a larger public audience.
- The rating agencies actively participate in the structuring of the securities transactions for which the ratings are provided.
- Taken together, these circumstances show that either privity or "near privity" exists between the rating agencies and the limited group of plaintiffs to whom the securities were marketed and sold.[8]

The role of rating agencies in the structuring, marketing, sale, and compensation schemes of many of the financial products and derivatives that were a key factor in last year's financial collapse went far beyond the bounds of traditionally protected journalistic analysis or opinion making. Rather, the rating agencies were active participants in the structuring of toxic mortgage-based debt instruments, from which they profited handsomely. Their complicity in these debt security arrangements may be enough to overcome existing rating agency protections, a possibility that is finding increasing favor in govern-

Mark Anchor Albert is a business litigator and appellate lawyer in Los Angeles.

AMANE KANEKO


First Amendment
CALPERS

ment and the judiciary, unless another crisis-driven government bailout provides a "get out of jail free" card in their favor.

Collateralized Debt Obligation

There is no doubt that the so-called toxic assets held by financial institutions have played a significant role in the financial and credit crisis still affecting the country. These toxic assets consist in large part of collateralized debt obligations (CDOs). A CDO typically is built from traditional debt and securities instruments[9] that are packaged together and sold to investors who, in return for periodic payments of interest, bear the losses that occur if instruments in the portfolio default. Many of the CDOs upon which the current credit and financial crisis turns contained large quantities of subprime and so-called Alt-A residential loans. (Alt-A loans were made to borrowers whose credit quality was in between prime and subprime.) These residential mortgage CDOs were also known as residential mortgage-backed securities, or subprime RMBS.

In forming a CDO, a sponsor—usually an investment bank—would create a trust to hold the CDO's assets, and the investment bank would issue securities representing interests in the CDO asset pool. In a subprime RMBS CDO pool, residential mortgages would make up the bulk of the underlying assets, but the trust might also hold other assets either to create a credit enhancement (for example, a holding of bonds could provide some income stability to a CDO, the assets of which were made of variable rate loans) or to "park" cash received from early payoffs or other unexpected events. The CDO trust would then obtain interest and principal payments from the underlying mortgagee obligors, which it would use to make interest and principal payments to the CDO investors. The trust would be structured to provide differing levels of credit enhancement to the securities issued in various CDO tranches. Credit enhancement would be provided through different mechanisms, such as subordination of lower tranches to higher tranches, overcollateralization, excess spread, bond insurance, and credit default swaps (CDS).

The underlying assets of a subprime RMBS CDO often were changed during the life of the CDO. For this task, the investment bank sponsor engaged a collateral or asset management firm that was charged with purchasing the securities that formed the substance of the CDO. The collateral manager could sell bonds or other portfolio enhancements and purchase other ones, all in the name of complying with the CDO trust agreement restrictions on holdings and the rating agencies' requirements necessary to maintain the specific ratings given to the various CDO tranches. Through this process, the rating agencies maintained an ongoing involvement in the CDO, creating an interface with the collateral manager to ensure regular asset composition compliance.

In fact, the collateral manager also typically was required to purchase a significant proportion of synthetic CDS contracts—a hedge against defaults in the underlying mortgage pools—from the investment bank sponsor, in which the investment bank would be the swap counterparty. In other words, the CDO was required to "sell protection" to the investment bank, which provided a "premium" in return to the CDO, with respect to a reference basket of securities. The investment bank was entitled to choose the securities that were in the synthetic reference basket and could change the composition, without notice to or control by the collateral manager or others.

The rating agencies played an integral and ongoing role in this process, because the collateral eligibility criteria and the purchase or sale of CDS protection were designed to ensure that the rating agencies would be able to assign specific ratings to the various CDO tranches offered for sale—from AAA super-senior notes in the top tranche, to BB notes in the mezzanine tranches, all the way down to the unrated equity tranche at the bottom. The credit rating for each rated tranche was supposed to reflect the rating agency's informed assessment of the creditworthiness of the securities issued from the tranche, based in part on the likelihood that the CDO issuer would default on its obligations to make interest and principal payments in full and on time. In fact, rather than independently evaluate a CDO investment after the fact, the rating agencies worked directly with the investment bank sponsor to produce the rating the sponsor wanted in order to better sell the CDOs to investors.

In particular, the collateral manager was supposed to apply what are commonly called collateral quality tests to assess whether the debt securities forming the vast bulk of the assets for the CDOs met the collateral eligibility criteria. All these tests and criteria were linked to rating agency tests, such as Moody's Asset Correlation Test, Moody's Weighted Average Rating Factor Test, Moody's Minimum Weighted Average Recovery Test, the Weighted Average Spread Test, the Weighted Average Coupon Test, the Weighted Average Life Test, the Standard & Poor's Minimum Recovery Rate Test, and the Fitch Weighted Average Factor Test. Subprime RMBS CDOs offering circulars and prospectuses typically included default probability assessments that, based upon their tests and linked to their corresponding ratings, were intended to meet investment guidelines and risk tolerances for institutional purchasers of the securities. These ratings were not vague, unspecific opinions but instead were touted as scientifically and empirically based and objective—with AAA ratings for the top tranche of super-senior notes supposedly corresponding to a very low risk of default.

Not only were the rating agencies complicit in structuring CDOs to achieve desired ratings, but the structure of the transaction assured that the rating agencies were paid for their services from the transaction itself, not from an independent fee or subscription. The CDO's trust indenture agreement almost invariably contained so-called waterfall provisions that determined the priority of interest and principal payments. Simply put, the waterfall provisions described how the cash flow from a CDO was distributed to the tranches. A typical priority of payments schedule, or waterfall, worked together with ongoing rating agency coverage tests to ensure that senior tranche debt holders would be paid even if equity and lower tranches received nothing. For example, in a typical waterfall arrangement, the CDO trust used interest (and principal) payments from the underlying assets to pay first the fees and expenses of the CDO, including trustee, custodian, and paying agent fees, and the fees of the rating agencies; second, the net periodic coupon payment owed to any swap counterparty; third, the periodic asset manager fees; and finally, interest on senior tranches. Lower tranches were only paid if the foregoing payments were already satisfied. Equity received no payments until all tranches above it and related administrative costs (and rating agency fees) had been paid.

In creating this multitiered payment structure, the investment banks made sure that the rating agencies also would be paid before nearly everyone else. The rating agencies also enjoyed a top-priority position to recover their fees for rating the various tranches and the RMBS supporting those tranches in the interest proceeds waterfall provisions of the trust indentures for the trusts that held the underlying assets. Moreover, the rating agencies had a critical, ongoing role in the pricing of the various tranches and in determining rating-related events of default that triggered the waterfall priorities, at the top of which sat the collateral managers and rating agencies.

Accordingly, in a typical subprime RMBS CDO, the interest and principal payment priorities for purpose of the waterfall provisions of the debt instruments were specifically tied to credit default tests that were linked to the ratings provided by the rating agencies. They used quantitative cash flow models that analyzed, under various stress scenarios, the amount of principal and interest payments

expected to be generated from the loan pool each month over the life of the RMBS tranche securities. The output of this model was then compared against the priority of payments (the waterfall) to the RMBS tranches specified in the CDO's trust documents.

Thus, far from providing a generic opinion of creditworthiness to a broad-based audience, the rating agencies were intricately linked to the structuring and payment provisions of the assets they rated, did so specifically for the benefit of targeted investors (CDOs were generally marketed in private placements to qualified institutional buyers under Rule 144A—Private Resales of Securities to Institutions—promulgated under the 1933 Securities Act[10]), and were directly compensated for this effort.

That these credit ratings were critical to the spread of CDOs in the financial markets is undeniable. Investors use credit ratings as a proxy for their own credit review and thus to support the level of credit risk they are willing to undertake with respect to particular debt securities. Fiduciary investors (such as pension funds, trustees, and insurance companies) typically may only acquire "investment grade" assets, primarily as determined by credit ratings. Assets that are below investment grade—speculative or junk bonds—are supposed to be excluded from the fiduciary investor's pool of appropriate potential investments. Higher-quality ratings directly affected the pricing and marketability of the subprime RMBS CDOs offered for sale. Through the financial alchemy of CDS contracts (which hedged the risk of underlying defaults) and associated higher-quality ratings, pools of low-quality residential mortgages could be marketed as high-grade investments.

As a result, investors that would not buy individual subprime mortgages bought subprime RMBS aggregated into CDOs that sported high-quality ratings from the rating agencies. Subprime RMBS CDOs came to be held by pension funds, school districts, charitable organizations, municipal treasuries, and a vast number of other public and private trust fund investors that could ill afford the losses that were to come.

However, even though both purchasers and issuers of RMBS CDOs have suffered billions of dollars of losses resulting from the acquisition of interests in securities that now appear to have been wrongly labeled as investment grade by rating agencies, these purchasers and issuers typically have not sued the rating agencies. These investors are likely daunted by the legal precedents that protect rating agencies.

Rating Agency Defenses

Several recent cases, however, have been decided against credit rating agencies under circumstances that appear to coincide in critical respects with the involvement of the agencies in the structuring of subprime RMBS CDOs. One of these cases—*In re Fitch, Inc.*[11]—is particularly instructive. A bank purchased various CDOs structured by one of its brokers. The banking regulators concluded that the CDOs were not investment grade and compelled the bank to sell them. The broker refused to accept the return of the CDOs. The bank sued the broker and subpoenaed Fitch, having learned during discovery that Fitch and the broker "had extensive communications about the structure of the transactions."[12]

In response to an order to show cause regarding contempt due to the failure of Fitch to comply with the subpoena, the district court rejected Fitch's First Amendment defense under New York's shield law. The Second Circuit affirmed. "Unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy, Fitch only 'covers' its own clients. We believe this practice weighs against treating Fitch like a journalist."[13] In addition, the Second Circuit noted that an employee of Fitch took "a fairly active role…in commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings."[14] Fitch's active role in helping to structure the CDOs demonstrated "a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports."[15]

In *LaSalle National Bank v. Duff & Phelps Credit Rating Company,*[16] another New York case rejecting the rating agency's First Amendment defense, the court denied the rating agency's motion to dismiss claims based on its allegedly too-favorable rating. The dispositive factor in the court's decision to reject the rating agency's First Amendment defense was the rating agency's "substantial influence in the drafting" of the debt securities and the requirement for high ratings as a condition of the initial issuance of the bonds.[17] Due to the rating agency's active involvement in structuring the transactions, the agency was in "near privity" to the purchasers of the privately offered securities.[18]

The *Duff & Phelps* court also found privity under another theory. In the context of accountant liability to third parties, the New York Court of Appeals previously had established in *Credit Alliance Corporation v. Arthur Andersen & Company* that liability may be imposed when a professional or firm is aware that its work product is to be used for a particular purpose in furtherance of which a known party was intended to rely, and the professional's conduct connects to

that third party, thereby showing an understanding of that party's reliance on the professional's work.[19] The *Duff & Phelps* court noted that although the *Credit Alliance* test initially applied only to accountants, it has subsequently been applied to other professionals—including attorneys, real estate appraisers, architects, and realtors. The court saw no reason why it should not also apply the privity requirement to a securities rating company.[20]

Finally, in *Commercial Financial Services, Inc. v. Arthur Andersen LLP,* the court held that the First Amendment does not protect rating agencies from liability if they were asked to rate investment certificates by a debt collecting company, rated the bonds based on information furnished by that company, were paid a fee by that company, were therefore in privity with that company, and thus owed a duty of care to that company to provide accurate ratings.[21]

The *Commercial Financial* court noted a "crucial distinction" between the suit before it and *Jefferson County School District No. R-1 v. Moody's Investor's Services,*[22] which dismissed claims for tortious interference, injurious falsehood, and antitrust violations because Moody's credit ratings are "protected expressions of opinion." In *Jefferson County,* Moody's published its opinion for the benefit of subscribers and new services. "It had not been asked to rate the bonds [by the school district issuing them]."[23] By contrast, in *Commercial Financial* the professional role of the rating agencies went "beyond a relationship between a journalist and subject, and [was] more analogous to that of a client and the client's certified public accountant."[24] In such a case, the First Amendment does not shield the rating agencies from potential liability.

The *Commercial Financial* court also held that the facts of that case satisfied Section 552 of the *Restatement (Second) of Torts,* titled Information Negligently Supplied for the Guidance of Others,[25] which supported its analysis that liability may be imposed on a professional information provider that negligently furnishes information for a fee that it knows will be provided to and relied upon by a limited group of persons. Because the ratings at issue in *Commercial Financial* were done at the request of the plaintiff, for a fee, and were intended to be provided to the plaintiff, who could be expected to rely upon them, the *Commercial Financial* court held that Section 552 applied to the credit rating agency.[26]

Based upon the reasoning and analyses underlying the holdings in *In re Fitch, Inc., Duff & Phelps Credit Rating Company,* and *Commercial Financial,* the role of rating agencies in the structuring, marketing, and sale of subprime RMBS CDOs went far beyond the parameters of protected speech and analytical opinion established under First Amendment-based journalist's privilege or related statutory shield laws. In view of their central role in the structuring of subprime RMBS CDOs, and their dynamic and ongoing role in re-rating CDO tranches over time after their initial issuance, a strong argument can be made that the rating agencies were providing professional services to issuers and investment banks, with a clear set of potential investors in mind—typically qualified institutional buyers in private (nonpublic) securities Rule 144A offerings—and were not engaged in any meaningful sense or degree in news gathering, news analysis, or other journalistic activities.

In summary, the structure of typical subprime RMBS CDOs, and related CDS protection, provides a strong basis for liability against the rating agencies involved in those transactions, for negligent misrepresentation, because 1) they were paid fees to structure the transactions and had a direct financial incentive to be actively involved, in an ongoing, dynamic manner, in the management of the ratings process (i.e., the collateral manager could replace securities with higher-rated securities as necessary to maintain the overall rating of particular tranches, 2) the ratings of the subprime RMBS CDOs were provided to a limited group of recipients to whom the securities were marketed and sold, rather than to the larger public, at least with respect to the original purchases in the private placements (versus purchases made in the secondary market), and with respect to the original sellers of CDS protection in the initial private placements, 3) the rating agencies had an active, central, interactive, and ongoing role in the structuring and rating of the subprime RMBS CDOs and their respective tranches, and 4) taken together, these circumstances ought to be sufficient to show that either privity or near privity existed between the rating agencies, on the one hand, and the limited group of plaintiffs to whom the securities were marketed and sold, on the other.[27]

Negligence or Wrongful Acts

Once the four elements are shown to be satisfied, it is still necessary to show that the rating agencies acted negligently or wrongfully. In this regard, the question is whether the rating agencies knew or should have known that their assigned ratings were less reliable than the rating agencies made them appear, knowing the reliance placed on the ratings. When rating subprime RMBS CDOs, the rating agencies typically used indenture guide-

Brownstein | Hyatt
Farber | Schreck

Brownstein Hyatt Farber Schreck is pleased to announce the newest additions to our Los Angeles office.

Deborah Drooz
Shareholder
Litigation – First Amendment and Entertainment

Barry Langberg
Shareholder
Litigation – First Amendment and Entertainment

Prior to joining the firm, Ms. Drooz and Mr. Langberg were with Stroock & Stroock & Lavan in Los Angeles.

Tom Houston
Senior Counsel
Climate Change

Mr. Houston is the former Managing Director & General Counsel of Global Eco Rescue Ltd. where he worked on international carbon emission reduction projects.

ALBUQUERQUE
ASPEN
DENVER
LAKE TAHOE
LAS VEGAS
LOS ANGELES
ORANGE COUNTY
SACRAMENTO
SAN DIEGO
SANTA BARBARA
SANTA FE
WASHINGTON, DC

2029 Century Park East, Suite 2100 | Los Angeles, CA 90067-3007
Brownstein Hyatt Farber Schreck, LLP | bhfs.com
310.500.4600 *tel*
310.500.4602 *fax*

lines as a template to run worst-case scenarios based on the underlying assets. The rating agencies would apply their proprietary computer models to the types of collateral pools permissible under the indenture guidelines, placing the most emphasis on the weakest pools. Next they would compare the computer model results against the capital structure of the CDOs to assess whether the level of subordination, overcollateralization, and excess spread available to each rated tranche provides the necessary amount of "credit enhancement" to support a particular rating.

This sounds impressive, but the sad truth is that the rating agencies used computer models that were inadequate, were based upon inadequate information and faulty default assumptions, and were operated and analyzed by rating analysts who did not understand what they were doing and what the data revealed. In particular, the rating agencies and the issuers and underwriters that paid their fees relied almost universally on Monte Carlo simulation-based approaches to assessing default probabilities, predicated on a correlation model called the Gaussian copula formula, which was developed by former J.P. Morgan quantitative analyst David X. Li. Monte Carlo simulation-based approaches to assessing default probabilities rely on several key assumptions regarding default frequencies, recovery rates, and correlations. The primary rating agencies used proprietary software tools to conduct these complex Monte Carlo simulations. During the time leading up to the beginning of the financial crisis in 2007 and 2008, Standard & Poor's used CDO Evaluator 3.3, Moody's used CDOROM, and Fitch used VECTOR 3.0.

These computer models are only as reliable as the assumptions on which they are predicated and the people who operate and interpret the models. The assumptions were outdated. Assessing future default risk in subprime mortgage loans based upon past performance was not and could not be a reliable predictor when the fundamental underwriting criteria used in the past was not being used in connection with subprime RMBS that formed the core of the CDO tranches actually being rated. But the rating agencies evidently turned a blind eye to this problem, relying on the Gaussian copula formula to provide supposed added security to their probabilistic default assessments.

Thus, to assess the myriad variables and the range of different probabilistic outcomes arising from multiple ever-changing variables, the rating agencies relied on the Gaussian copula formulation to simplify and quantify RMBS default probabilities based upon complex and exceedingly variable correlations.[28] (In statistics, a copula is used to couple the

TRUST DEED FORECLOSURES

"Industry Specialists For Over 22 Years"

At Witkin & Eisinger we specialize in the Non-Judicial Foreclosure of obligations secured by real property or real and personal property (mixed collateral). When your client needs a foreclosure done professionally and at the lowest possible cost, please call us at:

1-800-950-6522

We have always offered free advice to all attorneys.

WITKIN & EISINGER, LLC

RICHARD G. WITKIN, ESQ. ✦ CAROLE EISINGER

Does LACBA have your current e-mail address?

The Los Angeles County Bar Association is your resource for information delivered via e-mail on a number of subjects that impact your practice.

Update your records online at **www.lacba.org/myaccount** or call Member Services at 213.896.6560.

SAVE YOUR CLIENTS FROM THE JAWS OF

BANKRUPTCY

Bankruptcy litigator and strategist with 30+ years experience helps law firms and their clients with all aspects of bankruptcy.

- Bankruptcy Avoidance
- Strategic Pre-Bankruptcy Planning
- Business & Personal Bankruptcies
- Debtor & Creditor Representation
- Adversary Proceedings & Appeals
- Fraudulent & Preferential Transfers
- Nondischargeability Proceedings
- Settlement & Judgment Protection

UCLA Law Graduate
Phi Beta Kappa
Magna Cum Laude

Balance the scales in your clients' favor. Keep your clients in-house.

BankruptcyFocus@aol.com
Beverly Hills Westlake Village
323.954.9144 805.557.7001

Confidence At The Courthouse.

Business litigation is increasingly complex. That is why we believe valuation issues must be addressed with the same meticulous care as legal issues. Analysis must be clear. Opinions must be defensible. Expert testimony must be thorough and articulate. HML has extensive trial experience and can provide legal counsel with a powerful resource for expert testimony and litigation support.

HIGGINS MARCUS & LOVETT
BUSINESS VALUATION

For More Information Call 213-617-7775
Or visit us on the web at www.hmlinc.com

BUSINESS VALUATION • LOSS OF GOODWILL • ECONOMIC DAMAGES • LOST PROFITS

expert4law–The Legal Marketplace

Target Your Online Search for Experts Quickly, Easily

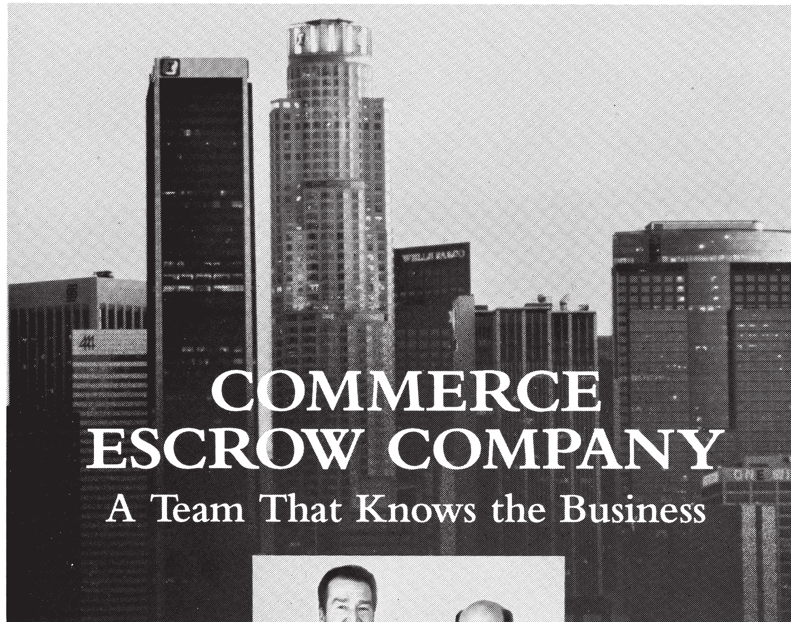
Need an Expert? Find one here.

The Los Angeles County Bar Association's official online referral service for expert witnesses, legal consultants, litigation support, lawyer-to-lawyer referrals, and dispute resolution service providers.

For more information, call 213.896.6470 or e-mail forensics@lacba.org

AVAILABLE 24 HOURS A DAY!

www.expert4law.org



Phil Graf
President

Mark Minsky
Vice President

Phil Graf and Mark Minsky lead teams of people with long and successful experience in all aspects of the escrow business. Often, a thorough understanding of the tangled web of real property complexities may be a decisive factor in a successful transaction.

Commerce Escrow teams command an intricate understanding of the figures, interpretations, inclusions, contracts and financial, civic, state, city and county codes that permeate escrow and title transactions. These include commercial, industrial, developer site acquisitions, single and multi-family, business opportunity, and stock transfer escrows.

Before beginning Commerce Escrow in 1980, Graf and Minsky were executives at Title Insurance and Trust Company. Graf, and later Minsky, served as Vice President and Manager of Escrow Operations in Los Angeles County.

Since its founding, Commerce Escrow continues to grow with its client base expanding throughout California and beyond.

Commerce Escrow Company

1545 Wilshire Blvd. / Suite 600 / Los Angeles, CA 90017

213-484-0855 • 310-284-5700 • 888-732-6723

http://www.comescrow.com

behavior of two or more variables.) The Gaussian copula soon became such a universally accepted part of the world's financial vocabulary that brokers started quoting prices for bond tranches based on their correlations. "Correlation trading has spread through the psyche of the financial markets like a highly infectious thought virus," wrote derivatives guru Janet Tavakoli in 2006.[29]

But this Gaussian copula formula was simplistic and flawed. The damage was foreseeable and foreseen. In 1998, before Li had even invented his copula function, Paul Wilmott wrote that "the correlations between financial quantities are notoriously unstable."[30] Yet the rating agencies in rating subprime RMBS CDOs relied heavily on this copula correlation model that they did not really understand, even though they claimed that their ratings were based upon objective, thorough, and comprehensive analyses.

Finally, in addition to turning a blind eye to the increasingly lax underwriting standards used by loan originators and to the overly optimistic and reductionist formula used to quantify default risk, the rating agencies also mistakenly relied upon CDS to "insure" tranches that they were rating in order to buttress the ratings assigned to those tranches. A CDS typically acts—or rather, is supposed to act—like an insurance contract that protects the protection purchaser from the decline in value or other trigger event in a referenced entity or security in relation to which the CDS provides credit default insurance. In the case of subprime RMBS CDOs, "insurance" often was provided against default rates exceeding the predicted range for the asset type supporting a particular investment grade by the rating agencies for particular CDO tranches.

The key problem with the use of CDS to support the creditworthiness of particular tranches of subprime RMBS CDOs—a problem that should have been obvious to issuers, investors, and rating agencies alike—is that CDS contracts were freely tradable, usually without notice to CDO investors, and it was almost always difficult, if not impossible on an ongoing basis, to determine who the CDS counterparty was at any particular time and whether and to what extent that CDS counterparty was sufficiently solvent, creditworthy, and ready to fulfill its insurance obligations in an event of default. In fact, the CDS became a financial product with a life of its own, and CDOs were often linked with synthetic credit default swaps and complex hedging structures that in many cases were themselves linked to yet other CDOs imbedded with credit default swaps and hedging structures whose values and risk levels were not and could not be assessed accurately.

This history should provide more than

enough to overcome the traditional defenses of ratings agencies and expose them to liability. However, given the continuing central role that ratings agencies play in our financial and credit markets, it remains to be seen whether Congress, the Executive Branch, or the judiciary will be willing to address the massive liability that could face the rating agencies as a result of their complicity in the financial crisis. ■

---

[1] PBS Online, *Free Market Society,* THE ONLINE NEWS HOUR, Feb. 13, 1996, *available at* http://www.pbs.org/newshour/gergen/friedman.html.

[2] Credit reporting services (not credit rating agencies) lost the First Amendment issue in Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749 (1985); Oberman v. Dun & Bradstreet, Inc., 460 F. 2d 1381 (7th Cir. 1972); and Grove v. Dun & Bradstreet, Inc., 438 F. 2d 433 (3d Cir. 1971), *cert. denied,* 404 U.S. 898 (1971).

[3] New York Times v. Sullivan, 376 U.S. 254 (1964). *See also* Compuware Corp. v. Moody's Investors Servs., Inc., 499 F. 3d 520 (6th Cir. 2007) (affirming grant of summary judgment in favor of rating agency sued by issuer over an allegedly erroneous downgrade and ratings report); Newby v. Enron Corp. (In re Enron Corp. Sec. Derivative & ERISA Litig.), No. MDL-1446, 2005 U.S. Dist. LEXIS 4494 (S.D. Tex. Feb. 16, 2005) (granting motions by rating agencies to dismiss tort claims by Enron creditor grounded on their allegedly too-favorable ratings of Enron debt), *motion for reconsideration denied,* 2007 U.S. Dist. LEXIS 41091 (S.D. Tex. June 5, 2007); Jefferson County Sch. Dist. v. Moody's Investor's Servs., 175 F. 3d 848, 856 (10th Cir. 1999) (dismissing claims for tortious interference, injurious falsehood, and antitrust violations because Moody's credit ratings are "protected expressions of opinion"); County of Orange v. McGraw-Hill Cos., 245 B.R. 151, 157 (C.D. Cal. 1999) ("The First Amendment protects S&P's preparation and publication of its ratings.").

[4] *See, e.g.,* In re Scott Paper Co. Sec. Litig., 145 F.R.D. 366 (E.D. Pa. 1992); In re Burnett, 269 N.J. Super. 493 (Super. Ct. 1993); In re Pan Am Corp., 161 B.R. 577 (S.D. N.Y. 1993); Stephens v. American Home Assur. Co., No. 91 Civ. 2898 (JSM) (KAR) (S.D. N.Y. Apr. 17, 1995).

[5] Moody's has been a stand-alone public company since 2000, when it was spun off from Dun & Bradstreet.

[6] Fitch is owned by Fimalac, S.A., in France, which is controlled by Group Marc de Lachairière.

[7] Standard & Poor's is a division of the McGraw-Hill Companies, Inc.

[8] *See infra* notes 15-31 and accompanying text.

[9] A CDO can hold different types of loans, emerging market debt, sovereign debt, high-yield corporate bonds, distressed securities (also junk bonds), asset backed securities, commercial mortgage backed securities, and commercial and industrial loans. By means of credit default swaps and other vehicles, access to these assets also can be achieved synthetically.

[10] 17 C.F.R. §230.144A (2009).

[11] In re Fitch, Inc., 330 F. 3d 104 (2d Cir. 2003).

[12] *Id.* at 107.

[13] *Id.* at 109.

[14] *Id.* at 110.

[15] *Id.* at 111.

[16] LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. 1071 (S.D. N.Y. 1996). The district court adopted the magistrate judge's opinion, with its recommendation regarding the critical First Amendment issue, in toto.

[17] *Id.* at 1076.

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

[19] Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y. 2d 536 (1985).

[20] Duff & Phelps, 951 F. Supp. at 1093.

[21] Commercial Fin. Servs., Inc. v. Arthur Andersen LLP, 2004 OK CIV APP 56, 94 P. 3d 106 (Okla. Civ. App. 2004).

[22] Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., 175 F. 3d 848, 856 (10th Cir. 1999).

[23] Commercial Fin., 94 P. 3d at 110 (quoting Jefferson County, 175 F. 3d at 850).

[24] *Id.* at 110.

[25] *Id.* at 112-14.

[26] *Id.* at 113.

[27] *Compare, e.g.,* In re Fitch, Inc., 330 F. 3d 104, 110-11 (2d Cir. 2003) (communications between rating agency and arranger "reveal a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports") *with* Compuware Corp. v. Moody's Investors Servs., Inc., 222 F.R.D. 124, 131 (E.D. Mich. June 10, 2004). *Cf.* Compuware Corp. v. Moody's Investors Servs., 324 F. Supp. 2d 860, 862, and 904 n.7 (E.D. Mich. 2004).

[28] *On Default Correlation: A Copula Function Approach,* 9 J. OF FIXED INCOME 43-54 (Mar. 2000).

[29] Felix Salmon, *Recipe for Disaster: The Formula That Killed Wall Street,* WIRED MAGAZINE, Feb. 23, 2009 (quoting Janet Tavakoli), *available at* http://www.wired.com/techbiz/it/magazine/1703/wp_quant?currentPage=all.

[30] *Id.* (quoting Paul Wilmott).

SURPRISE

YOU THOUGHT YOU HAD EVERYTHING ...AND THEN ...A FLAW NO ONE SAW IS BROUGHT UP...

AND YOUR AIR-TIGHT, CAN'T-FAIL CASE...FAILS!

DON'T GET THAT SURPRISE ! WHEN WE INSPECT A SITE, WE WILL LOOK AT IT FROM THREE PERSPECTIVES ...

ACCIDENT RECONSTRUCTION • TRAFFIC TRANSPORTATION ENGINEERING • AND HUMAN FACTORS!

Send Us An Accident Report For A

No Cost Consultation, And...

We'll Show You How To Save

TIME & MONEY!

Ask How We Can Preserve The Scene

Perfectly, With Every Detail...

All At The Cost Of A

SIMPLE SURVEY!

Ph (800) 675-7667

11440 BERNARDO CT, SUITE 300
SAN DIEGO, CA 92127

2900 ADAMS STREET
RIVERSIDE, CALIFORNIA 92504

FIELD & TEST ENGINEERING, INC.

ACCIDENT RECONSTRUCTION SPECIALISTS

4510 Pacific Coast Highway, Suite 200 • Long Beach, CA 90804

Fax (877) 494-7667

8275 SOUTH EASTERN AVENUE, SUITE 200
LAS VEGAS, NEVADA 89123

7362 REMCON CIRCLE
EL PASO, TEXAS 79912

www.FieldAndTestEngineering.com

info@AccidentReconstructionSpecialists.com