

Rating Agencies Next Targets in Financial Crisis Fallout?



by [Maggie Tamburro](#)

A case filed by the U.S. government alleging one of the nation's three top credit rating agencies improperly misrepresented and manipulated ratings of certain structured debt securities in a "scheme to defraud investors" during the financial crisis has perhaps cleared its first big legal hurdle.

On July 16, Judge David O. Carter, sitting in the U.S. District Court for the Central District of California, officially entered an order denying a request made by the rating agency named as defendant that the government's complaint be tossed out for failure to state a claim upon which relief can be granted – better known in the legal world as a FRCP 12(b)(6) motion to dismiss.

The case – and surviving complaint – now capturing the attention of institutional (and other) investors, attorneys, financial analysts and experts alike, was originally brought by the U.S. government against nationally known credit rating agency McGraw-Hill Companies, Inc. and its subsidiary Standard & Poor's Financial Services LLC (S&P).

In a February 5 [Department of Justice \(DOJ\) news release](#), which called the alleged conduct "egregious," the DOJ touted the case as important in ongoing governmental efforts to investigate and punish conduct that allegedly helped fuel the economic crisis, in large part crediting the President's Financial Fraud Enforcement Task Force.

The government's original complaint, filed one day prior, alleges that defendant engaged in a fraudulent scheme targeting federally insured financial institutions and other institutional investors when it knowingly issued false and misleading credit ratings allegedly designed to downplay the true and declining credit risks involving certain structured debt securities, namely Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs) tranches during 2004-2007.

The government's complaint also alleges the defendant made false representations that its credit ratings were independent, objective, and free from influence, instead claiming they were improperly influenced by business relationships defendant allegedly had with certain of the investment banks that issued the RMBS and CDOs.

The government's lawsuit, filed pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), seeks civil penalties in accordance with losses suffered, which the DOJ press release has reported to be more than \$5 billion.

Puff the Not-So-Magic Dragon

Fast forward to July 16. On that day last week, the judge in the case officially issued an order effectively allowing the government's complaint to proceed, in a ruling that may have dealt a heavy blow to S&P and knocked the wind out of its sails.

In support of dismissal of the case, according to the court's ruling, S&P had proposed that statements it made about the creditworthiness of the structured debt securities at issue were merely general, subjective, and amounted to non-actionable "puffery," and therefore should not have been relied upon by consumers (citing a 9th Circuit case for the proposition that statements which are mere puffery are unlikely to induce consumer reliance, and cannot be the basis for claims of fraud).

But the court rejected that proposition stating,

[Defendants] claim that, out of all the public statements that S&P made to investors, issuers, regulators, and legislators regarding the company's procedures for providing objective, data-based credit ratings that were unaffected by potential conflicts of interest, not one statement should have been relied upon by investors, issuers, regulators, or legislators who needed to be able to count on objective, data-based credit ratings."

This proposition, the court stated, was one it found to be "deeply and unavoidably troubling when you take a moment to consider its implications."

Following a statement like that, one wouldn't expect this case to retire to the fictional land of Honalee any time soon. In sum, the court found the government's allegations sufficient to establish a plausible claim for relief and survive the motion to dismiss. Suffice it to say the government's allegations are, at least after this ruling, alive and well.

Green Light for Other Cases?

Could the unfolding of the events in this case perhaps signal the next big chapter in the fallout from the financial economic crisis?

Other followers of the court's ruling in favor of the DOJ have perhaps suggested as much, noting that it has potentially opened the door for private institutional investors to bring common law actions for fraud against nationally known credit agencies. At least one such case is very likely underway in New York state court, as recently reported by [Reuters](#).

According to initial court documents, plaintiffs in the New York state case, the Joint Official Liquidators of Bear Stearns High Grade Structured Credit Strategies (Overseas) Ltd. and Bear Stearns High Grade Structured Credit Strategies Enhanced Leverage (Overseas) Ltd., are bringing an action for common law fraud involving claims of misrepresentation and wrongdoing against certain nationally known rating agencies.

The claims perhaps sound all too familiar in light of the DOJ's ongoing federal case, alleging that defendant rating agencies misrepresented certain information, including, among other things, information pertaining to their independence, the accuracy of their ratings and models, as well as knowingly omitted material information from their ratings analyses involving certain CDOs and RMBS at issue. Initial court documents suggest plaintiffs have suffered losses in excess of \$1.1 billion.

In Sum

Perhaps the rating agencies are being unfairly targeted as the next named scapegoats by those seeking something – or someone – to blame for the economic fallout and huge losses many are still experiencing in the wake of the financial economic crisis and collapse of the housing market.

Only time and further resolution of cases at issue will provide an answer. But in the meantime, you can bet the cases, and any others like it that may try to follow, will be closely watched.

Tell us your viewpoint – are the claims against the rating agencies with merit? Or have they gone too far?

The federal case, which was filed in United States District Court, Central District of California, Southern Division is *United States of America v. McGraw-Hill Companies, Inc.*, 13 CV-779 (**Order Denying Defendants' Motion to Dismiss** entered July 16, 2013.)

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