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## Note

### **Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation**

*Theresa Nagy\**

“The story of the credit-rating agencies is the story of a colossal failure.”<sup>1</sup>

Although Representative Henry A. Waxman’s statement may be an exaggeration, the biased, overvalued appraisal of risky securities by rating agencies has undermined the entire United States financial system.<sup>2</sup> The agencies’ failure to accurately evaluate structured-finance risks contributed to the housing market collapse and a spike in foreclosure activity, thereby triggering a global financial crisis.<sup>3</sup> The finance industry has faced great political and public hostility for its role in precipitating this severe economic downturn, and the backlash

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1. Amit R. Paley, *Credit-Rating Firms Grilled over Conflicts: Risks Were Known, Documents Show*, WASH. POST, Oct. 23, 2008, at A1 (quoting Representative Henry A. Waxman, the Chairman of the House Committee on Oversight and Government Reform).

2. *See id.* (“Executives at the country’s leading credit-rating companies, whose optimistic assessments of risky investments helped fuel the financial meltdown, have privately acknowledged for more than a year that conflicts of interest contributed to the industry’s failures, according to internal company documents . . .”).

3. *See* DICK K. NANTO, CONG. RESEARCH SERV., *THE U.S. FINANCIAL CRISIS: THE GLOBAL DIMENSION WITH IMPLICATIONS FOR U.S. POLICY* 9–11 (2009), available at <http://graphics8.nytimes.com/packages/pdf/globaleconcrs.pdf>.

against the industry will only intensify as more Americans lose their jobs and homes.<sup>4</sup>

Accordingly, a surge of litigation flowing from the financial crisis has begun to flood the United States judicial system.<sup>5</sup> Subprime mortgage lenders were the first targets of the lawsuits focused on the structured-finance industry.<sup>6</sup> But angry investors are now taking aim at the rating agencies for their role in the crisis,<sup>7</sup> suing the three major United States credit rating agencies—Moody's Investment Service (Moody's), Standard & Poor's (S&P), and Fitch Ratings (Fitch)—for giving inflated evaluations to subprime residential mortgage-backed securities.<sup>8</sup> In short, these agencies' ratings greatly underestimated the risks associated with subprime securities.<sup>9</sup> Since millions of investors relied on these purportedly "independent, objective assessments,"<sup>10</sup> they lost billions of dollars when the market collapsed.<sup>11</sup>

Despite harboring enormous influence in all areas of the financial market,<sup>12</sup> rating agencies have deflected liability for

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4. Aaron Unterman, *Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 79 (2009).

5. *Id.* ("As of July 2008, at least 132 subprime and [structured-finance] related class action lawsuits have been initiated in the [United States].").

6. *Id.* Most of these defendants rendered themselves judgment proof, however, by either closing their businesses completely or filing for bankruptcy. *Id.*

7. See generally Martha Graybow, *Credit Rating Agencies Fending Off Lawsuits from Subprime Meltdown*, INS. J., July 14, 2008, <http://www.insurancejournal.com/news/national/2008/07/14/91841.htm> (providing an overview of recent litigation against rating agencies).

8. *Id.*; see, e.g., Complaint at 2, *In re Moody's Corp. Sec. Litig.*, 612 F. Supp. 2d 397 (S.D.N.Y. 2009) (No. 07 CIV 8375) (charging that Moody's assigned "excessively high ratings to bonds backed by risky subprime mortgages"); Complaint for Violation of Federal Securities Laws at 1, *Ind. Laborers Pension Fund v. Fimalac, S.A.*, No. 1:08 CV 05994 (SAS) (S.D.N.Y. voluntarily dismissed Oct. 3, 2008) (charging that Fitch failed to disclose that its ratings of residential mortgage-backed securities and collateralized debt obligations were based on misleading information); Consolidated Class Action Complaint for Securities Fraud at 1–4, *Reese v. Bahash*, 248 F.R.D. 58 (D.D.C. 2008) (No. 1:07-cv-01530-CKK) (charging that S&P assigned misleading ratings to subprime residential mortgage-backed securities and collateralized debt obligations).

9. See Gretchen Morgenson, *House Panel Scrutinizes Ratings Firms*, N.Y. TIMES, Oct. 23, 2008, at B5.

10. *Id.* (quoting Representative Henry A. Waxman, the Chairman of the House Committee on Oversight and Government Reform).

11. See NANTO, *supra* note 3, at 11 fig.2.

12. Stéphane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 617, 621

their inaccurate ratings<sup>13</sup> by claiming that their core function is journalism—that they serve to gather and analyze newsworthy financial information and then disseminate opinions about this information to the public.<sup>14</sup> Therefore, the rating agencies claim protection under the First Amendment as a matter of free speech and freedom of the press.<sup>15</sup> A number of courts have agreed with this position and applied the Supreme Court’s actual malice standard for journalistic liability<sup>16</sup> in determining the agencies’ liability for the accuracy of their credit ratings.<sup>17</sup> Consequently, plaintiffs generally have been unsuccessful in suits against these agencies<sup>18</sup>—a reality that can only prolong the agencies’ deficient performances and their failure to prioritize investors’ interests over their own profits.<sup>19</sup> Of course, new government regulations and the agencies’ own initiatives may enhance the integrity of the rating process,<sup>20</sup> but these prospective actions offer little comfort to the millions of investors already suffering in the wake of the subprime mortgage crisis.<sup>21</sup>

This Note argues that the First Amendment should not shield rating agencies from legal liability for their grossly inaccurate ratings of residential mortgage-backed securities. Part I provides an overview of the role rating agencies played in the subprime mortgage crisis and describes their past success in defending lawsuits using a First Amendment shield. Part II ar-

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(2006) (describing rating agencies as having become “central institutions in financial markets”).

13. *Id.* at 642 (noting that liability “plays a limited role in disciplining rating agencies operating in the American markets”).

14. Gregory W. Smith, *The Deterioration of Investor Tools and the Resulting Fiduciary Challenges*, 57 J. GOV’T FIN. MGMT. 26, 29 (2008).

15. *See id.*; *see also* U.S. CONST. amend. I (establishing that “Congress shall make no law . . . abridging the freedom of speech, or of the press”).

16. *N.Y. Times v. Sullivan*, 376 U.S. 254, 280 (1964).

17. Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 352–53 (2006).

18. *Id.* at 353.

19. *See* Paley, *supra* note 1, at A1.

20. *See, e.g.*, Deven Sharma, Op-Ed, *The Market Alone Won’t Make It*, WASH. TIMES, Mar. 6, 2009, at A19 (agreeing that new regulations may be necessary in these “unprecedented times” and stating that “[w]e at Standard & Poor’s agree with President Obama’s call for an open and transparent financial system that speaks in plain language investors can understand”); STANDARD & POOR’S, DESCRIPTION OF NEW ACTIONS TO STRENGTHEN RATINGS PROCESS AND BETTER SERVE MARKETS 1–10 (2008), [http://www2.standardandpoors.com/spf/pdf/media/Leadership\\_Action\\_Details.pdf](http://www2.standardandpoors.com/spf/pdf/media/Leadership_Action_Details.pdf) (describing new policies that Standard & Poor’s has adopted to improve the transparency, accuracy, and credibility of their credit ratings).

21. *See* Paley, *supra* note 1, at A1.

gues that various characteristics of the agencies distinguish them from the traditional press and thus render the First Amendment inapplicable to cases involving the accuracy of these agencies' ratings. Part III suggests that courts should refuse to automatically afford rating agencies First Amendment protection in future litigation related to the inaccurate rating of residential mortgage-backed securities. Instead, courts should use a three-factor test to determine if an agency actually qualifies for constitutional protection. This Note concludes that the judicial system must hold rating agencies accountable for their role in the subprime mortgage crisis. Even though the legislature also needs to increase regulation of the credit rating industry in order to prevent future deceptive and unjust practices within it, Moody's, S&P, and Fitch should not escape legal liability for the irreparable damage they have caused to millions of investors and the global financial market.

#### I. OVERVIEW OF THE CREDIT RATING AGENCIES' ROLE IN THE CURRENT FINANCIAL CRISIS AND THEIR USE OF THE FIRST AMENDMENT TO DEFEND AGAINST LIABILITY

Rating agencies emerged in the financial market at the beginning of the twentieth century,<sup>22</sup> likely to help level the information imbalance that inherently exists in lending relationships.<sup>23</sup> Accordingly, they have evolved with the constantly changing economy over the past one hundred years into increasingly influential market participants.<sup>24</sup> The primary function of rating agencies is to assess "the creditworthiness of companies and public entities that issue debt."<sup>25</sup> The agencies claim

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22. See TIMOTHY J. SINCLAIR, *THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS* 24 (2005).

23. See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 632 (1999) ("Rating agencies may exist because of information asymmetry between debt issuers and investors. Information asymmetry exists in markets where sellers have superior information to buyers about product quality, yet cannot costlessly convey this information to buyers."); Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?*, 20 SETON HALL LEGIS. J. 293, 294 (1996) (describing how rating agencies create "an efficient interface between investors and issuers" that reduces the cost of securities research for individual investors).

24. See Rousseau, *supra* note 12, at 627.

25. Amy Borrus et al., *The Credit Raters: How They Work and How They Might Work Better*, BUS. WK., Apr. 8, 2002, at 38; see also Pinto, *supra* note 17, at 341.

to “make judgments on the ‘future ability and willingness of an issuer to make timely payments of principal and interest on a security over the life of the instrument.’”<sup>26</sup> The agencies grade the issuer to provide investors with ratings,<sup>27</sup> which range from an extremely low credit risk to a highly speculative investment.<sup>28</sup> An important distinction is made between investment and speculative grades because 1930s securities legislation prevents fiduciaries from investing in bonds rated below a certain level.<sup>29</sup> Until recently, Moody’s, S&P, and Fitch benefited from an oligopolistic market structure, as the Securities and Exchange Commission (SEC) had designated only these three agencies as Nationally Recognized Statistical Rating Organizations (NRSROs).<sup>30</sup>

Due to the nature of the industry and the market, most scholars argue that the success of these powerful ratings agencies depends on their integrity, dependability, and reliability.<sup>31</sup>

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26. Timothy J. Sinclair, *Passing Judgment: Credit Rating Processes as Regulatory Mechanisms of Governance in the Emerging World Order*, in *GLOBALIZATION AND ECONOMY: GLOBALIZING FINANCE AND THE NEW GLOBAL ECONOMY* 248, 253 (Paul James & Heikki Patomäki eds., 2007) (citation omitted).

27. See Borrus et al., *supra* note 25, at 38. The agencies utilize a letter-based rating system, in which “AAA,” the highest score, is awarded to financially stable companies and “D” is given to companies in default. DAVID F. HAWKINS ET AL., *RATING INDUSTRIAL BONDS* 25–29 (1983); Rhodes, *supra* note 23, at 303 n.41.

28. Frank Packer, *Credit Ratings and the Japanese Corporate Bond Market*, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM* 139, 140 (Richard M. Levich et al. eds., 2002). Generally, anything below a “BBB” rating is considered noninvestment grade or a “junk bond.” See Mark Carey, *A Guide to Choosing Absolute Bank Capital Requirements*, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM*, *supra*, at 117, 134.

29. JEROME S. FONS, MOODY’S INVESTORS SERV., SPECIAL COMMENT: TRACING THE ORIGINS OF “INVESTMENT GRADE” 2 (2004), available at <http://www.moody.com.br/brasil/pdf/InvGradeOrigins.pdf> (explaining how during the Great Depression the United States Office of the Comptroller of the Currency required bank holdings of publicly rated bonds to be rated at investment grade or better). The regulation specified that “bonds rated [investment grade] may be carried at cost, but defaulted bonds and those of lower ratings had to be marked to market.” *Id.*

30. For a description of the structure of the credit rating business and the significance of the NRSRO designation, see generally Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004). There are currently ten agencies designated as NRSROs. U.S. Sec. & Exch. Comm’n, *Credit Rating Agencies—NRSROs*, <http://www.sec.gov/answers/nrsro.htm> (last visited Oct. 20, 2009).

31. See Frank Partnoy, *The Paradox of Credit Ratings*, in *RATINGS, RATING AGENCIES, AND THE GLOBAL FINANCIAL SYSTEM*, *supra* note 28, at 65, 67. But see *Credit Rating Agencies and the Financial Crisis: Hearing Before the H.*

Therefore, it is not surprising that the failure of these agencies to live up to the public's expectation of objective, accurate, and independent investigation of issuer creditworthiness has spurred public outrage,<sup>32</sup> spawned numerous lawsuits,<sup>33</sup> and led to new regulations.<sup>34</sup> An overview of the rating agencies' role in the subprime mortgage crisis and past litigation involving the agencies' reliability provides insight into the future legal challenges facing Moody's, S&P, and Fitch.

#### A. RATINGS OF RESIDENTIAL MORTGAGE-BACKED SECURITIES

The ratings of many residential mortgage-backed securities have become a source of controversy and contention in the fallout of the financial crisis. Residential mortgage-backed securities are defined as "bonds issued by large financial institutions backed by pools of individual home mortgages."<sup>35</sup> Federal agencies, government-sponsored enterprises, and private businesses purchase mortgages and assemble them into pools.<sup>36</sup> The purchasing entity issues securities that represent the principal and interest payments on the individual loans within the pool.<sup>37</sup> Since default on a single loan does not significantly affect the value of the aggregated pool, investor risk is decreased.<sup>38</sup> Inves-

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*Comm. on Oversight and Government Reform*, 110th Cong. 1, 2-3 (2008) (statement of Rep. Henry A. Waxman, Chairman, H. Comm. on Oversight and Government Reform), available at <http://oversight.house.gov/documents/20081022102221.pdf> (repeating claims by Ray McDaniel, CEO of Moody's, that the market "penalizes quality" and citing an S&P employee document that claimed "[a security] could be structured by cows and we would rate it").

32. See Paley, *supra* note 1, at A1.

33. Graybow, *supra* note 7.

34. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, 74 Fed. Reg. 6456, 6465-67, 6483 (Feb. 2, 2009) (to be codified at 17 C.F.R. pts. 240, 249b), available at <http://www.sec.gov/rules/final/2009/34-59342fr.pdf> (including a ban on rating a security after the agency has made recommendations regarding the issuer's structure of the finance product, a restriction on rater participation in fee discussion, and significant new disclosure obligations for rating agencies).

35. Press Release, Office of the N.Y. State Attorney General Andrew M. Cuomo, Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies (June 5, 2008), [http://www.oag.state.ny.us/media\\_center/2008/jun/june5a\\_08.html](http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html).

36. See SEC. INDUS. & FIN. MKT. ASS'N, INCLUDING JUMBOS IN TBA-ELIGIBLE POOLS WILL RESULT IN HIGHER COSTS FOR BORROWERS 1 (2008), [http://www.sifma.org/capital\\_markets/docs/TBA-Pools-2008-MBS-Brief.pdf](http://www.sifma.org/capital_markets/docs/TBA-Pools-2008-MBS-Brief.pdf).

37. See U.S. Sec. & Exch. Comm'n, Mortgage-Backed Securities, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Oct. 20, 2009).

38. See Derrick M. Land, *Residential Mortgage Securitization and Consumer Welfare*, 61 CONSUMER FIN. L.Q. REP. 208, 209 (2007).

tors only face serious problems when numerous mortgages in the pool default,<sup>39</sup> as occurred in the United States beginning in 2006.<sup>40</sup> In 2007 alone, 2.2 million American properties were subject to a foreclosure filing.<sup>41</sup> This foreclosure crisis triggered the global market meltdown of 2008.<sup>42</sup>

Although the enormous risk involved in residential mortgage-backed securities investment is evident today, rating agencies had given many of these securities investment-grade ratings.<sup>43</sup> In order to rate the securities, the agencies looked at characteristics of each individual mortgage in the pool, the proposed structure of the aggregated pool, and the proposed degree of credit enhancement.<sup>44</sup> Using this information, the agencies completed a series of analyses and assigned a rating to the securities.<sup>45</sup> Due to risk distribution and diversification, the agencies typically graded the aggregated pool much higher than they would have rated the individual loans.<sup>46</sup> The agencies assigned “AAA” ratings to almost all residential mortgage-backed securities.<sup>47</sup> These high ratings promoted investment in these securities.<sup>48</sup> When the number of defaults on subprime mortgages rapidly increased, major banks and financial institutions—key investors in residential mortgage-backed securities—reported losses in the hundreds of billions.<sup>49</sup> Bank failures triggered extreme stock market volatility, which decreased stockholder wealth by trillions of dollars and sunk the economy into a deep recession.<sup>50</sup>

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39. *See id.*

40. *See* Vikas Bajaj, *Foreclosures Rose as Delinquencies Eased in Quarter*, N.Y. TIMES, Sept. 6, 2008, at B8.

41. *Number of Foreclosures Soared in 2007*, MSNBC, Jan. 29, 2008, <http://www.msnbc.msn.com/id/22893703>.

42. *See* NANTO, *supra* note 3, at 9–11.

43. *See* Unterman, *supra* note 4, at 69–70.

44. STAFF OF THE OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATION OF SELECT CREDIT RATING AGENCIES 7 (2008) [hereinafter 2008 SEC REPORT], *available at* <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

45. *Id.* An arranger could typically appeal an unfavorable ratings decision. *Id.* at 9. Also remarkable is the fact that the rating agency received compensation only if the rating was issued. *Id.*

46. Land, *supra* note 38, at 211.

47. *See* Unterman, *supra* note 4, at 69–70.

48. *See id.* at 95–96.

49. *See* Gretchen Morgenson, *The End of Banking as We Know It*, N.Y. TIMES, Jan. 18, 2009, at B1.

50. *See* Vikas Bajaj, *Markets Limp into 2009 After a Bruising Year*, N.Y.



Both the government and private investors are seeking answers and amends for the rating agencies' role in the subprime mortgage crisis. A prime example of such recourse is the recently filed action in *California Public Employees' Retirement System v. Moody's*.<sup>51</sup> The California Public Employees' Retirement System (CalPERS), the nation's largest state-run pension fund, had invested in structured investment vehicles that were largely comprised of subprime mortgages.<sup>52</sup> All of the major agencies had given the securities the highest possible rating.<sup>53</sup> CalPERS's complaint alleges that the agencies had misrepresented the true high-risk nature of the underlying mortgages as the ratings "ultimately proved to be wildly inaccurate and unreasonably high" and that the agencies' rating methodology was "seriously flawed in conception and incompetently applied."<sup>54</sup> CalPERS claims to have lost one billion dollars and seeks to hold the ratings agencies liable for this substantial decline in its 1.3 billion-dollar investment.<sup>55</sup> The plaintiffs in *California Public Employees' Retirement System v. Moody's* and those who bring future suits face a difficult challenge since the rating agencies have previously found protection under the First Amendment.

#### B. PRIOR LITIGATION INVOLVING THE CREDIT RATING AGENCIES

Prior litigation involving the rating agencies stemmed from charges opposite the one underlying recent complaints. That is, earlier lawsuits accused the agencies of unfairly and incorrectly rating the issuer too low and causing demand for the stock to drop without proper cause.<sup>56</sup> Although today's claims are dif-

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TIMES, Dec. 31, 2008, at B1.

51. Complaint for Negligent Misrepresentation Under Common Law and Cal. Civ. Code §§ 1709 and 1710 and Negligent Interference with Prospective Econ. Advantage, Cal. Pub. Employees' Retirement Sys. v. Moody's Corp., No. CGC-09-490241 (Cal. App. Dep't Super. Ct. July 9, 2009) [hereinafter CalPERS Complaint]. S&P's parent company and Fitch are also named defendants in this case. *Id.*

52. Jacqueline Bell, *CalPERS Sues Rating Agencies over \$1B in Losses*, LAW360, July 15, 2009, <http://www.law360.com/articles/111413>.

53. *Id.*

54. CalPERS Complaint, *supra* note 51, at 1.

55. Bell, *supra* note 52.

56. See, e.g., *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 751 (1985) (addressing allegations that a rating agency graded a construction contractor's securities too low in a private rating); *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*, 175 F.3d 848, 850-51 (10th Cir.

ferent, the principles of the arguments on both sides remain the same. This fact may be disconcerting for those bringing suit, because the rating agencies have been extremely successful in avoiding liability based on inaccurate ratings.<sup>57</sup> One reason for this success is the Securities Act Rule, which shields the rating agencies from liability for everything except fraud under federal securities law.<sup>58</sup> If investors cannot establish that the agencies acted fraudulently, they must look to other theories of liability.<sup>59</sup>

In the few cases in which the rating agencies faced tort claims, “the only common element . . . [has been] that the rating agencies win.”<sup>60</sup> The agencies’ success has often been based on standard defenses, such as lack of duty or unreasonable reliance.<sup>61</sup> Even if plaintiffs are able to overcome conventional tort defenses, the agencies can still raise a First Amendment defense based on the constitutional protection of commercial speech.<sup>62</sup> The Supreme Court has held that speech driven by profit may be constitutionally protected, but “false and misleading commercial speech is not entitled to any First Amendment protection.”<sup>63</sup> The rating agencies have been successful in numerous cases because courts have likened the agencies to journalists and the ratings to opinions, and, under this framework, ratings categorically cannot be “false or misleading.”<sup>64</sup> Courts have not yet conclusively tested the agencies’ use of journalistic

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1999) (ruling on claims brought by county that the credit rating had provided inaccurately low and unsolicited public ratings).

57. See Unterman, *supra* note 4, at 98; see also Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1687–93 (2008) (discussing rating agencies’ liability for their ratings).

58. See STAFF OF S. COMM. ON GOV’T AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 82 (2002) [hereinafter FINANCIAL OVERSIGHT]; see also 17 C.F.R. § 230.436(g)(1) (2007) (mandating an express exemption for NRSROs from liability under § 11 of the Securities Act of 1933).

59. See Kettering, *supra* note 57, at 1689.

60. *Id.* at 1688 (citing Partnoy, *supra* note 31, at 79).

61. *Id.* at 1691; see also, e.g., Quinn v. McGraw-Hill Co., 168 F.3d 331, 336 (7th Cir. 1999) (holding reliance on ratings was unreasonable); First Equity Corp. v. Standard & Poor’s Corp., 869 F.2d 175, 179 (2d Cir. 1989) (finding parties not to be in privity).

62. Kettering, *supra* note 57, at 1689.

63. Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm’n, 447 U.S. 557, 593 (1980).

64. Kettering, *supra* note 57, at 1689.

protections,<sup>65</sup> but there are currently two methods used to resolve such cases. The first approach adopts a general actual malice standard as defined by *New York Times v. Sullivan*.<sup>66</sup> The second approach is specific to rating agencies and exemplified by the two-prong test set forth by *In re Fitch*.<sup>67</sup> The court's choice of standard has a significant impact on the outcome of the agency's case.<sup>68</sup>

### 1. Actual Malice Standard

While not specifically deciding the First Amendment issue as applied to rating agencies, the Supreme Court held in *New York Times v. Sullivan* that a publisher is not liable for a false or misleading statement about "matters of public concern" unless it made the statement with "actual malice."<sup>69</sup> In the landmark case, Justice Brennan sought to avoid "a forbidden intrusion on the field of free expression" in a libel action brought by a city commissioner.<sup>70</sup> The Supreme Court found that an actual malice standard applies to false statements about public figures and matters where the statements are principally protected by the First Amendment.<sup>71</sup> The Court sought to preserve

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65. *Id.*

66. *Id.* (describing the standard in *New York Times v. Sullivan*, 376 U.S. 254, 280 (1964)).

67. See Larry P. Ellsworth & Ishan K. Bhabha, *A New Front in Subprime Litigation: Can Rating Agencies Be Held Liable?*, LAW360, Aug. 12, 2008, <http://www.law360.com/articles/65936> (describing the standard in *Am. Sav. Bank v. UBS PaineWebber, Inc. (In re Fitch, Inc.)*, 330 F.3d 104, 109–10 (2d Cir. 2003) (per curiam)).

68. Compare *Sullivan*, 376 U.S. at 279–80 (providing a blanket protection to rating agencies absent "actual malice"), with *In re Fitch, Inc.*, 330 F.3d at 109–10 (noting the absence of First Amendment protection when a rating agency's actions are based on client needs).

69. *Sullivan*, 376 U.S. at 280; see also *Hustler Magazine, Inc. v. Falwell*, 485 U.S. 46, 52 (1988); *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 348–49 (1974).

70. *Sullivan*, 376 U.S. at 285.

71. *Id.* at 279, 282, 285; see also *Falwell*, 485 U.S. at 50 ("At the heart of the First Amendment is the recognition of the fundamental importance of the free flow of ideas and opinions on matters of public interest and concern."). Some courts have found the reports of the credit rating agencies to constitute matters of public interest and concern. See, e.g., *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 511 F. Supp. 2d 742, 829–30 (S.D. Tex. 2005) ("The credit rating reports regarding Enron by national credit rating agencies were not private or confidential, but distributed 'to the world' and were related to the creditworthiness of a powerful public corporation that operated internationally."); *County of Orange v. McGraw Hill Co.*, 245 B.R. 151, 155 (C.D. Cal. 1999) (finding the county's debt offerings a matter of concern as the plaintiffs alleged

the “breathing space” that it found essential for freedom of expression.<sup>72</sup> Because plaintiffs must show that a publisher had knowledge that the statement in controversy was “false” or acted “with reckless disregard of whether it was false or not,” the *Sullivan* standard is difficult to overcome.<sup>73</sup>

Rating agencies have successfully argued for courts to apply the actual malice standard to cases involving ratings liability.<sup>74</sup> For example, in *County of Orange v. McGraw Hill Co.*, the claim that S&P, a subsidiary of McGraw Hill Company, breached its duty to competently provide ratings was subject to the actual malice standard.<sup>75</sup> The district court found that “the First Amendment protects S&P’s preparation and publication of its ratings”<sup>76</sup> because the cause of action “impacted expression” and involved “matters of public concern.”<sup>77</sup> A similar result was reached in the aftermath of the Enron scandal. In *In re Enron*, the district court rejected a blanket protection for the rating agencies, but considered the agencies’ First Amendment argument.<sup>78</sup> In examining all of the relevant information, including the alleged facts, context, nature of the content, and language of the statement, the court determined that the credit ratings were a combination of “subjective opinions” and “verifiable facts.”<sup>79</sup> It held that the ratings were matters of “public concern . . . even if negligently prepared” and thus constitutionally protected.<sup>80</sup>

Additionally, although the issuer in *In re Enron* had retained the agencies to rate its bonds, the court found that this privity and conflict of interest did not preclude First Amendment protection for the rating agencies.<sup>81</sup> Some courts contend

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the rating agency’s actions caused them to incur 500 million dollars worth of debt).

72. *Sullivan*, 376 U.S. at 272 (citation omitted).

73. *Id.* at 280.

74. See *Kettering*, *supra* note 57, at 1689.

75. *McGraw Hill Co.*, 245 B.R. at 156 (granting the defendant’s motion for summary judgment on breach of contract and professional negligence claims since the county was unable to show that S&P had acted “with knowledge that the statement was false or with reckless disregard for whether or not it was true” in rating the county’s debt securities (quoting *Falwell*, 485 U.S. at 52)).

76. *Id.* at 157.

77. *Id.* at 155 (citing *Sullivan*, 376 U.S. at 280).

78. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 511 F. Supp. 2d 742, 829–30 (S.D. Tex. 2005).

79. *Id.* at 825.

80. *Id.*

81. *Id.*

that the rating of securities generally constitutes a “matter of ‘public concern’” and bar recovery on a showing of anything less than recklessness.<sup>82</sup> These courts fear the chilling effect that would follow such liability and maintain that the “[F]irst [A]mendment’s concern for the free flow of commercial information”<sup>83</sup> should trump the “state’s interest in compensating relying investors.”<sup>84</sup> However, the Supreme Court has noted that “[s]ome tension necessarily exists between the need for a vigorous and uninhibited press and the legitimate interest in redressing wrongful injury.”<sup>85</sup> The Second Circuit took this recognition a step further and formulated a concrete assessment that includes consideration of issuer payment as a factor in assessing rating agency liability.

## 2. *In re Fitch* Standard

In *In re Fitch*, the Second Circuit created a new test to specifically determine if rating agencies are entitled to protections reserved for the press.<sup>86</sup> *Fitch* was a nonparty to the civil suit *American Savings Bank v. UBS PaineWebber* and sought to quash a subpoena under New York’s Shield Law.<sup>87</sup> The court considered two factors in determining whether it should designate a rating agency as a member of the press and thus protected under the shield law.<sup>88</sup> First, it looked at issuer payment and carefully considered whether the agency covered only securities transactions for which it received compensation.<sup>89</sup> Second, the court examined the agency’s level of activity in structuring the transaction to see if it was a typical media relationship.<sup>90</sup>

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82. *Jefferson County Sch. Dist. v. Moody’s Investor’s Servs., Inc.*, 175 F.3d 848, 856 n.3 (10th Cir. 1999) (quoting Gregory Husisian, *What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 460 (1990)).

83. *In re Enron Corp.*, 511 F. Supp. 2d at 824 n.82.

84. *Id.*

85. *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 342 (1974).

86. *In re Fitch, Inc.*, 330 F.3d 104, 109–10 (2d Cir. 2003) (per curiam).

87. *Id.* (describing how the subpoena sought disclosure of *Fitch*’s communications with the defendant regarding the ratings of securities that the defendant had offered the plaintiff).

88. *Id.*; see also N.Y. CIV. RIGHTS LAW § 79-h(b)–(c) (McKinney 1992) (exempting professional journalists and newscasters from contempt charges with an absolute protection for confidential news and a qualified protection for non-confidential stories).

89. *In re Fitch, Inc.*, 330 F.3d at 109–10.

90. *Id.* at 110–11.

Addressing the first element, the court determined that Fitch rarely rated transactions other than those of its clients, unlike the financial media, which would cover anything deemed newsworthy.<sup>91</sup> It contrasted Fitch with S&P and discussed *In re Pan Am*, a case that found that S&P had rated nearly all public-debt issues regardless of issuer payment.<sup>92</sup> The *In re Fitch* court found Fitch's information gathering and disseminating practices to be based on client needs rather than on a judgment of newsworthiness.<sup>93</sup> The court weighed this factor against Fitch in that agency's assertion of the journalist's privilege.<sup>94</sup>

For the second element, the court discussed Fitch's active role in planning the transactions that it analyzes and its close relationships with the companies that it rates.<sup>95</sup> Such a role is inconsistent with the traditional media, as a regular journalist would rarely have such a close level of involvement with the source of his or her reporting.<sup>96</sup> In light of the two factors, the court determined that Fitch did not fit New York's professional-journalist standard and was not entitled to assert the newsgathering privilege.<sup>97</sup> It left open the question as to whether a rating agency could ever claim the state's shield law protections<sup>98</sup> but set a clear precedent for a fact-specific inquiry into the is-

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91. *Id.* at 109.

92. *Id.* (citing *Pan Am Corp. v. Delta Air Lines, Inc. (In re Pan Am Corp.)*, 161 B.R. 577, 583 (S.D.N.Y. 1993)).

93. *Id.* at 110.

94. *Id.*

95. *Id.* at 110-11.

96. *Id.*

97. *Id.* at 111. The New York statute at issue in the case defines "professional journalist" as:

[O]ne who, for gain or livelihood, is engaged in gathering, preparing, collecting, writing, editing, filing, taping or photographing of news intended for a newspaper, magazine, news agency, press association or wire service or other professional medium or agency which has as one of its regular functions the processing and researching of news intended for dissemination to the public; such person shall be someone performing said function either as a regular employee or as one otherwise professionally affiliated for gain or livelihood with such medium of communication.

N.Y. CIV. RIGHTS LAW § 79-h(a)(6) (McKinney 1992).

98. *In re Fitch, Inc.*, 330 F.3d at 111. ("For the sake of clarity, we note that we are not deciding the general status of a credit rating agency like Fitch under New York's Shield Law: Whether Fitch, or one of its rivals, could ever be entitled to assert the newsgathering privilege is a question we leave for another day.").

sue that disfavored an extension of journalists' privileges and protections to the agencies.<sup>99</sup>

Like the Second Circuit in *In re Fitch*, other courts have been reluctant to grant media protections to rating agencies where the issuer had retained and paid a fee to the agency or the agency was otherwise significantly involved in the transaction.<sup>100</sup> Generally, journalists and editors do not receive compensation from the subject of their opinion or directly participate in the subject's activities, unlike the dominant rating agencies.<sup>101</sup> The agencies are almost always paid their fees by the issuer of securities applying for the rating, which "raises the possibility that the issuer will use, or the rating agency will perceive, monetary pressure to improve the rating."<sup>102</sup> While not specifically following the two prongs of the *In re Fitch* test, *Commercial Financial Services v. Arthur Andersen* illustrates the importance many courts place on these issues.<sup>103</sup>

The *Commercial Financial Services* court held that the First Amendment did not protect bond ratings when the rating agencies had entered into a contract with the company to rate investments in exchange for compensation.<sup>104</sup> The court focused on this special relationship between the parties and found that the rating agencies owed a duty to the company to rate investments accurately.<sup>105</sup> Since the ratings were intended to provide "benefit and guidance" to the company, the court concluded that the rating agencies were subject to potential liability for negligently supplying this information and could be liable for resultant economic losses if demonstrated on remand.<sup>106</sup> The court noted a crucial distinction between the case at hand and *Jefferson County School District v. Moody's Investor's Services*.<sup>107</sup> In *Jefferson County*, Moody's published an unsolicited article discussing the school district's financial conditions and

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99. *See id.*

100. *See, e.g., Commercial Fin. Servs., Inc. v. Arthur Andersen LLP*, 94 P.3d 106, 110 (Okla. Civ. App. 2004).

101. *See id.*

102. *See* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 15.

103. *See Commercial Fin. Servs., Inc.*, 94 P.3d at 109–12.

104. *Id.* at 108.

105. *Id.* at 110, 112.

106. *Id.* at 112–13.

107. *Id.* at 110 (contrasting case at hand with *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*, 175 F.3d 848 (10th Cir. 1999)).

remained uninvolved in its activities.<sup>108</sup> Thus, the rating agency owed the plaintiff no duty and the court applied First Amendment protections to its ratings.<sup>109</sup> Such a distinction may be crucial in future litigation.

As described above, *California Public Employees Retirement System v. Moody's*,<sup>110</sup> is one of the first of what will likely be numerous lawsuits brought against the rating agencies for their role in the subprime mortgage crisis. The court's approach for determining the applicability of First Amendment protections is crucially important in the case, as the decision will likely set the tone for future litigation involving the rating agencies. Thus, the ruling in the CalPERS case could significantly affect both the ratings industry and millions of investors.

## II. CREDIT RATING AGENCIES SHOULD NOT BE ENTITLED TO FIRST AMENDMENT PROTECTIONS

The issue at the center of many cases involving a rating agency's liability for inaccurate ratings is whether the First Amendment shields the agencies from certain tort claims. One line of cases, marked by *County of Orange v. McGraw Hill Co.*<sup>111</sup> and *In re Enron*,<sup>112</sup> indicates that this constitutional protection is appropriate. However, because the rating agencies do not perform normal journalistic functions, courts should not afford them constitutional protections reserved for the press. This Section analyzes the constitutionality of rating agencies seeking protection under the First Amendment.

### A. CHARACTERISTICS OF THE CREDIT RATING AGENCIES DISTINGUISHING THEM FROM THE TRADITIONAL MEDIA

The First Amendment of the United States Constitution states that "Congress shall make no law . . . abridging the freedom of speech, or of the press."<sup>113</sup> In order to gain the protection of the First Amendment, rating agencies insist that their ratings are purely opinions produced as the result of their primary newsgathering function and thus are pure speech under a

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108. *Jefferson County Sch. Dist.*, 175 F.3d at 850.

109. *See id.* at 856.

110. CalPERS Complaint, *supra* note 51.

111. *County of Orange v. McGraw Hill Co.*, 245 B.R. 151 (C.D. Ca. 1999).

112. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 511 F. Supp. 2d 742 (S.D. Tex. 2005).

113. U.S. CONST. amend I.



constitutional analysis.<sup>114</sup> The judiciary has agreed with this characterization to a certain extent and erroneously given heightened protection to the agencies' so-called opinions.<sup>115</sup>

Courts that have used the actual malice standard in cases involving rating agencies have crossed "the line between speech unconditionally guaranteed and speech which may legitimately be regulated" as described by the Court in *New York Times v. Sullivan*.<sup>116</sup> Although commercial speech warrants First Amendment protection,<sup>117</sup> the agencies' credit ratings do not reach the echelon of fundamentally protected speech. However, many courts have still bestowed First Amendment protections upon Moody's, S&P, and Fitch and thus shielded them from liability for their inaccurate ratings.<sup>118</sup>

Most courts find that there is no automatic, absolute First Amendment protection for the rating agencies.<sup>119</sup> Yet many have found a qualified protection and exempted the agencies from liability.<sup>120</sup> These courts have found the inaccurate ratings to be constitutionally protected opinions or an extension of the journalist's privilege.<sup>121</sup> Both of these characterizations are overly simplistic and ignore the true nature of the agencies' work.

Several features distinguish the agencies' ratings from ordinary publishers' news pieces and editorials. First, the major rating agencies receive payment from the issuer of the rated security to write their opinion,<sup>122</sup> whereas most journalists do not

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114. Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 124–25 (2008).

115. See *In re Enron Corp.*, 511 F. Supp. 2d at 825.

116. *N.Y. Times v. Sullivan*, 376 U.S. 254, 285 (1964) (quoting *Speiser v. Randall*, 357 U.S. 513, 525 (1958)).

117. *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n*, 447 U.S. 557, 562–63 (1980) (finding that commercial speech is not wholly outside the protection of the First Amendment); see also *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 456 (1978) (finding that commercial speech occupies a "subordinate position in the scale of First Amendment values").

118. See, e.g., *In re Enron Corp.*, 511 F. Supp. 2d at 825.

119. See, e.g., *id.* at 819 ("[A]n examination of the specific facts and circumstances of a credit rating agency's report is necessary to determine the extent, if any, of First Amendment protection it should receive.")

120. See, e.g., *id.*; *County of Orange v. McGraw Hill Co.*, 245 B.R. 151, 160 (C.D. Ca. 1999).

121. See, e.g., *In re Enron Corp.*, 511 F. Supp. 2d at 825 (citing what the court claimed "to be a policy of heightened protection for credit reports under the First Amendment" in allowing the credit rating agencies to use the defense).

122. See Schwarcz, *supra* note 102, at 15.

receive compensation from their subjects.<sup>123</sup> Second, the rating agencies' activities associated with assisting the structuring of a transaction, in contrast with rating a complete transaction after issue, are far more involved than ordinary journalistic activities.<sup>124</sup> Finally, law and the financial markets value the agencies' ratings more than mere opinions and treat them instead as a "certification" or "benchmark" of transactions.<sup>125</sup> Courts should recognize these differences as significant in the upcoming litigation arising out of the residential mortgage-backed securities crisis and not award the rating agencies First Amendment protection reserved for bona fide journalists.

### 1. Credit Rating Agencies Receive Compensation from the Issuers They Rate

The first major distinction between rating agencies and traditional journalists is compensation arrangements. While not "free speech," commercial speech warrants First Amendment protection.<sup>126</sup> Cases may turn on the issue of whether the agency had been asked by the issuer to rate its securities and then received payment for the ratings.<sup>127</sup> Traditionally, rating agencies earned their revenues from subscriber fees paid by investors, much like readers pay for a newspaper or magazine subscription.<sup>128</sup> The system changed in the early 1970s, as the agencies altered their business model and started charging the issuers of securities for their rating services.<sup>129</sup> Today, the major rating agencies derive a majority of their revenues from fees charged to issuers.<sup>130</sup> Thus, the rating agencies have become, in

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123. Kettering, *supra* note 57, at 1690.

124. See Partnoy, *supra* note 23, at 664.

125. Cf. Jonathan M. Barnett, *Certification Drag: The Opinion Puzzle and Other Transactional Curiosities*, 33 J. CORP. L. 95, 139 (2007) (discussing certification practices and credit agencies).

126. *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n*, 447 U.S. 557, 562–63 (1980).

127. See, e.g., *Commercial Fin. Servs., Inc. v. Arthur Andersen LLP*, 94 P.3d 106, 110 (Okla. Civ. App. 2004) (holding that the First Amendment did not protect Moody's when it had been paid for the rating); cf. *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.* 175 F.3d 848, 860 (10th Cir. 1999) (holding that the First Amendment was applicable when Moody's had neither been asked to rate the bond nor paid for its services and plaintiff failed to allege a provably false statement).

128. Hill, *supra* note 30, at 50; Rhodes, *supra* note 23, at 308–09.

129. Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, *supra* note 28, at 41, 47.

130. See Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED.

a practical sense, agents of the issuer, paid to speak on the issuer's behalf.<sup>131</sup>

Courts are taking note of this relationship. The *Commercial Financial Services* court analogized Moody's rating of asset-backed securities, to which it did not afford First Amendment protections, to a traditional journalist's work.<sup>132</sup> It found that, although a journalist's speech might be protected, a different standard applies if a company has been hired to rate the securities.<sup>133</sup> The courts have not conclusively decided the role of issuer payment in the rating agencies' First Amendment defense, but they appear to be more sympathetic when the agency issues unsolicited ratings and not just those for which it is paid.<sup>134</sup> Some courts based their decisions in part on the fact that some rating agencies rate all issuers, regardless of payment. In these cases, the courts are more likely to afford them First Amendment protections, as was the result in *In re Pan Am*.<sup>135</sup>

In a recent report examining Moody's, S&P, and Fitch, the SEC noted the many problems inherent in the issuer-pays model.<sup>136</sup> The rating agencies' interest in generating business from the issuers can conflict with the investors' right to receive accurate reports on credit risk.<sup>137</sup> This finding further supports the theory that receiving compensation from the issuer that the agency is evaluating should weigh against providing First

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RES. BANK OF N.Y. Q. REV., Summer-Fall 1994, at 1, 4, available at [http://www.newyorkfed.org/research/quarterly\\_review/1994v19/v19n2article1.pdf](http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n2article1.pdf); see also Roy C. Smith & Inco Walter, *Rating Agencies: Is There an Agency Issue?*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, *supra* note 28, at 289, 298–301 (describing the three major rating agencies).

131. See Smith & Walter, *supra* note 130, at 289–91; see also Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1080 (2003) (proposing a theory of agency for securities analysts).

132. *Commercial Fin. Servs., Inc.*, 94 P.3d at 110.

133. *Id.*

134. See, e.g., *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*, 175 F.3d 848, 860 (10th Cir. 1999) (allowing the First Amendment to protect Moody's); see also Partnoy, *supra* note 23, at 711 (arguing that "credit rating agencies should not have their cake and eat it too" by benefiting from ratings-dependent regulation and simultaneously receiving First Amendment protections from misrepresentation claims).

135. *Pan Am Corp. v. Delta Air Lines, Inc. (In re Pan Am Corp.)*, 161 B.R. 577, 581 (S.D.N.Y. 1993) (citing that S&P did not merely provide ratings to issuers who paid a fee).

136. 2008 SEC REPORT, *supra* note 44, at 23.

137. *Id.*

Amendment protections for the agency's subsequent ratings. Courts should carefully consider this critical distinction between the rating agencies and traditional media in the upcoming residential mortgage-backed securities litigation.

## 2. Credit Rating Agencies Are Involved in the Structuring of Transactions

A second major difference between rating agencies and traditional media is the significant role the agencies play in some of the transactions that they cover. The agencies often work with issuers to rate a deal before it is complete in order for it to receive the desired rating, specifically in cases of structured-investment vehicles like residential mortgage-backed securities.<sup>138</sup> Courts have not conclusively ruled on this issue, but they have been less willing to grant free speech protection when the rating agency played an active role in structuring the transaction.<sup>139</sup> For example, the *In re Fitch* court found that Fitch's relationship with the issuer was "not typical of the relationship between a journalist and the activities upon which the journalist reports."<sup>140</sup> Such a high level of involvement is extremely unusual for the traditional media; significant and continued involvement with financial institutions to structure securities should strongly weigh against affording the rating agencies protections reserved for the press.

The ratings process also indicates that rating agencies differ significantly from the media. The issuer asks the agencies to rate its new security and pays for this service.<sup>141</sup> In order to retain the issuer's business, agencies often downplay credit risk or inflate ratings, and issuers have the option of appealing ratings with which they are dissatisfied.<sup>142</sup> Both procedures substantially contributed to the residential mortgage-backed securities problem.<sup>143</sup> Commenting on the issuer-pays model, one

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138. Kettering, *supra* note 57, at 1691; *see also* Partnoy, *supra* note 23, at 664 ("These transactions indicate that the agencies are selling something other than the information associated with a particular rating.").

139. *See, e.g., In re Fitch, Inc.*, 330 F.3d 104, 111 (2d Cir. 2003).

140. *Id.*

141. *See* Partnoy, *supra* note 23, at 652–54.

142. *Id.* at 652.

143. Rousseau, *supra* note 12, at 629. Downgrades became nearly impossible to make. *See* Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 342 (2003) (arguing that issues

expert stated: “It would be like cattle ranchers paying the Department of Agriculture to rate the quality and safety of their beef.”<sup>144</sup> Similarly, a journalist may submit his work to an editor, but the subject of the piece does not have the opportunity of appealing publication if he or she is dissatisfied with the piece’s content or to receive a more favorable portrayal in the finished product.

The major rating agencies are not principally engaged in newsgathering.<sup>145</sup> They claim that their core business is financial publishing, but they participate in the structuring of complex transactions with their clients.<sup>146</sup> Such business practice is far removed from traditional journalism. It also proved to be a conflict of interest particularly devastating in the residential mortgage-backed securities crisis.<sup>147</sup> Therefore, agencies actively involved in such structuring should not receive First Amendment protections in upcoming litigation.

### 3. The Market and the Law Regard the Ratings as “Certifications” or “Benchmarks”

A third main distinction between rating agencies and traditional press is that the financial market and the law value the rating agencies’ ratings more than they do opinions and regard the ratings as a “certification” or “benchmark” of a transaction rather than an opinion regarding the transaction.<sup>148</sup> The agencies consistently rely on the argument that their reports are mere opinions, and courts have been apt to agree with this

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“capture” rating agencies and prevent them from reporting a downgrade, a so-called nuclear bomb).

144. *The Role of Credit Rating Agencies in the Structured Financial Market: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 110th Cong. app. at 70–71 (2007) (statement of J. Kyle Bass, Managing Partner, Hayman Capital Partners, L.P.).

145. See, e.g., *In re Fitch, Inc.*, 330 F.3d at 109.

146. *Turmoil in the Financial Markets: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. (2008) (statement of Sean J. Egan, Managing Dir., Egan-Jones Rating Co.) (“[D]ebt issuers invite some or all of the major rating agencies to preview the collateral pools so the rating agencies can provide preliminary rating indications that can be used to size the bond classes and structure the bond transactions.”).

147. See *id.*

148. See Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in *FINANCIAL GATEKEEPERS* 59, 88 (Yasuyuki Fuchita & Robert E. Litan eds., 2006) (describing an opinion as a recommendation whereas a certification is far more influential than mere advice).

assessment.<sup>149</sup> In explicit disclaimers, the rating agencies maintain that rating creditworthiness is not “an exact science.”<sup>150</sup> They argue that evaluation involves interpretive skills that result in reports that produce unverifiable statements of opinion.<sup>151</sup>

The Supreme Court has not rigidly defined “opinion.”<sup>152</sup> It rejected “an artificial dichotomy between ‘opinion’ and ‘fact’” when determining whether First Amendment protections should apply.<sup>153</sup> The Court found that “a statement of opinion relating to matters of public concern which does not contain a provably false factual connotation will receive full constitutional protection.”<sup>154</sup> In other words, if a statement “cannot reasonably [be] interpreted as stating actual facts,”<sup>155</sup> it is shielded by the First Amendment. As factors to consider in the determination of whether a statement can reasonably be interpreted as one of fact, the court may examine the language employed—whether it is “loose, figurative, or hyperbolic language” uncharacteristic of facts.<sup>156</sup> It may also examine the context in which the statement was made and the “general tenor of the article.”<sup>157</sup> This flexible standard has naturally led to varying viewpoints on whether the credit ratings are facts or opinions.

A recent SEC report reached a different conclusion than the courts in *County of Orange v. McGraw Hill Company* and

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149. *But see Assessing the Current Oversight and Operations of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 50 (2006) (statement of Frank Partnoy, Professor of Law, University of San Diego School of Law) (“Credit ratings are not merely opinions, any more than fairness opinions of investment banks, audit opinions of accounting firms, legal opinions of attorneys, buy/sell ratings of securities analysts, or even the certifications of financial statements made by CEO’s and CFO’s are mere opinions.”).

150. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 511 F. Supp. 2d 742, 822 (S.D. Tex. 2005).

151. For example, S&P’s Rating Services stated that “[a] Standard & Poor’s credit rating represents Standard & Poor’s opinion as of a specific date on the creditworthiness of an obligor.” Standard & Poor’s Ratings Services, Statement of Standard & Poor’s on Credit Rating Agencies to the U.S. Securities and Exchange Commission (Nov. 15, 2002), <http://www.sec.gov/news/extra/credrate/standardpoors.htm>.

152. *See Milkovich v. Lorain Journal Co.*, 497 U.S. 1, 18 (1990).

153. *Id.* at 19.

154. *Id.* at 20.

155. *Id.*

156. *Id.* at 21.

157. *Id.*

*In re Enron*, finding the agencies' ratings to be mere opinions.<sup>158</sup> The SEC had previously noted that the market "seems to value the agencies' ratings mostly as a certification (investment grade versus non-investment grade) or as a benchmark (the ratings trigger in agreements) and not as information."<sup>159</sup> The SEC had also described how the law relies on rating agencies, an indication that "their ratings are not the equivalent of editorials in the *New York Times*."<sup>160</sup> Hundreds of regulations have incorporated credit ratings, creating a statutory dependence on them.<sup>161</sup> Thus, SEC positions support the position that the ratings are not mere opinions.

Finally, disclaimers should not protect the rating agencies from liability, because they do not do so in analogous situations. For example, a lawyer issuing a title opinion does not receive an automatic exemption from all related liability because he called it an "opinion."<sup>162</sup> In such cases, courts must closely examine statements in the context in which they were made.<sup>163</sup> The *Commercial Financial Services* court compared the rating issued at the request of an issuer to an audit opinion issued by a certified public accountant at the request of its client.<sup>164</sup> It stated that, "[w]hile the Rating Agencies gave 'opinions,' they did so as professionals being paid to provide their opinions to a client."<sup>165</sup> Courts should recognize these comparable professional examples when determining if credit ratings are in fact opinions.

The SEC commentary and some recent decisions, including *In re Fitch*, show that the rating agencies are not entitled to the same treatment that the Supreme Court has afforded tradi-

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158. See 2008 SEC REPORT, *supra* note 44, at 7.

159. Partnoy, *supra* note 31, at 89 n.104 (citing FINANCIAL OVERSIGHT, *supra* note 58, at 124). The agencies' business depends on the high market value of their ratings, so although they issue disclaimers, they do not actively attempt to diminish the significance of the ratings in the industry. See *id.* at 49.

160. *Id.* at 89 n.104.

161. *Id.*; see also Partnoy, *supra* note 23, at 690 ("[R]atings have been incorporated . . . in various substantive areas, including securities, pension, banking, real estate, and insurance regulation.").

162. See *Great Plains Fed. Sav. & Loan Ass'n v. Dabney*, 846 P.2d 1088, 1092 (Okla. 1993).

163. See *id.* at 1091.

164. *Commercial Fin. Servs., Inc. v. Arthur Andersen LLP*, 94 P.3d 106, 110 (Okla. Civ. App. 2004).

165. *Id.* But see *Jefferson County School Dist. v. Moody's Investor's Servs. Inc.*, 175 F.3d 848, 856 (10th Cir. 1999) (noting that the information was not guaranteed to be accurate and asserting that Moody's ratings are opinions).

tional media.<sup>166</sup> In the case of the residential mortgage-backed securities, courts should carefully examine the agencies' ratings to determine if they are more similar to opinions or more like "certifications" or "benchmarks" heavily relied upon by the financial market.

In sum, the judiciary has given rating agencies excessive latitude with their ratings; this latitude surpasses the appropriate constitutional limits of the First Amendment. The actions of Moody's, S&P, and Fitch in rating residential mortgage-backed securities gives rise to a number of difficult questions as to whether the member-of-the-press defense properly applies and will likely generate contentious litigation in the future. The best way to resolve this issue is for courts to incorporate the *In re Fitch* factors in their determination as part of a modified-liability standard.<sup>167</sup> If courts maintain the status quo, claimants will be unable to hold rating agencies accountable for their role in the subprime mortgage crisis. Without a new standard, the agencies will have little incentive to discontinue their destructive practices.

### III. APPLICATION OF A HEIGHTENED *IN RE FITCH* STANDARD TO DETERMINE IF FIRST AMENDMENT PROTECTIONS ARE WARRANTED

Inflated ratings from Moody's, S&P, and Fitch boosted investment in residential mortgage-backed securities, and investors lost billions of dollars as a result.<sup>168</sup> However, this fact alone should not make the agencies automatically liable in upcoming litigation. Future cases should adopt a standard based on the *In re Fitch* test in order to determine if a rating agency should be treated as a member of the media and if its rating is an opinion deserving the constitutional protections reserved for the press. As set forth in the Second Circuit opinion, a First Amendment analysis involving rating agencies should consider agency compensation and examine the level of involvement the rating agency has in the transaction it is rating.<sup>169</sup> This Note proposes that courts take the *In re Fitch* test one step further and add a third prong that analyzes the "certification" or "benchmark" quality of the rating. This final prong represents the third major distinction between the rating agencies and

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166. See *In re Fitch, Inc.*, 330 F.3d 104, 111 (2d Cir. 2003).

167. See *id.* at 109–10.

168. See NANTO, *supra* note 3, at 11 fig.2.

169. *In re Fitch, Inc.*, 330 F.3d at 109–11.



traditional media and is an essential addition to the Second Circuit's test. If the agencies fail to meet this heightened *In re Fitch* standard, they should not be entitled to the protection of the actual malice standard in upcoming subprime litigation.

A. THREE-PRONG TEST: RATING AGENCY COMPENSATION, LEVEL OF INVOLVEMENT IN STRUCTURING THE TRANSACTION, AND OPINION VERSUS CERTIFICATION OR BENCHMARK

The appropriate standard for a rating agency using the First Amendment defense requires three prongs. To meet the first prong, a rating agency must not have been paid to rate the transaction at issue.<sup>170</sup> Like the traditional media, it must report on all noteworthy transactions and maintain a standard practice of covering more than just its clients.<sup>171</sup> A rating agency that rates most public securities issues, regardless of compensation, would meet this prong of the test.<sup>172</sup> A nonpayment prong ensures that the agency's decision to disseminate information is a judgment based on newsworthiness rather than solely on its clients' needs.<sup>173</sup>

The second prong requires a rating agency to demonstrate that it took a passive role in the planning of the transaction at issue.<sup>174</sup> An agency that is active in the preparatory stages of transactions and closely involved with the companies it rates strays from the traditional role of a journalist.<sup>175</sup> Making ratings criteria available to the subjects of the rating in order for the issuers to arrange the transaction in a favorable manner weighs against the award of First Amendment protections.<sup>176</sup>

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170. *Id.* at 109–10.

171. *Id.*

172. *See id.* at 110.

173. *Id.*; *cf.* Schwarcz, *supra* note 102, at 15–17 (discussing the “conflict of interest inherent in the way ratings agencies are paid”).

174. *In re Fitch, Inc.*, 330 F.3d at 110. The 2009 amendments to the SEC rules address this prong and were proposed to prohibit an NRSRO from rating an issuer after it has made recommendations regarding the issuer's activities. *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, 74 Fed. Reg. 6456, 6474 (Feb. 9, 2009), available at <http://www.sec.gov/rules/final/2009/34-59342fr.pdf> (“The amendments to Rule 17g-5 will prohibit an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate provided recommendations on the structure of the transaction being rated . . . .”); *see also* 17 C.F.R. § 240.17g-5 (2009).

175. *In re Fitch, Inc.*, 330 F.3d at 110.

176. *Id.* at 110–11; Partnoy, *supra* note 23, at 664–68 (providing an overview of “ratings-driven transactions”).

This second prong ensures that the rating agencies are not assisting in the structuring of securities which the market relies on them to objectively rate.<sup>177</sup>

To meet the third prong, a rating agency must show that its reports are more akin to an opinion than to a "certification" or "benchmark." This criterion may be difficult for the rating agencies to meet, as the market perceives the agencies' reports as factual, verifiable information rather than opinions, despite the agencies' explicit disclaimers.<sup>178</sup> Moreover, the law, "in hundreds of laws and statutes," views their ratings as certifications or benchmarks.<sup>179</sup> Investment-grade ratings are a prerequisite for many mutual and retirement funds,<sup>180</sup> so their standing is elevated from the level of an editorial to an industry stamp of approval.<sup>181</sup> Inclusion of this third factor is necessary because it closes a loophole that allows agencies to avoid liability for their mistakes.

To properly assess rating agencies' use of the First Amendment defense, courts must rely on all of the factors in the heightened *In re Fitch* standard. The Sixth Circuit ignored the first factor in its analysis and solely relied on the undisputed fact that Moody's was a "public figure" in *Compuware v. Moody's Investors Services* to reach the erroneous conclusion that Moody's was entitled to the actual malice standard in defense of its allegedly inaccurate downgrade of Compuware.<sup>182</sup> The court essentially failed to consider issuer compensation in its analysis and only discussed the issue of agency participation in the building the transaction.<sup>183</sup> This relaxed standard (a test without a nonpayment prong) would allow ratings agencies that do not publish unsolicited ratings to qualify for media protections. The third prong has a broader scope than the first two prongs, but it is necessary to account for the substantial value

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177. See *In re Fitch, Inc.*, 330 F.3d at 106.

178. See *Morgenson*, *supra* note 9, at B5. (quoting Rep. Henry A. Waxman).

179. Partnoy, *supra* note 31, at 89 n.104 (quoting FINANCIAL OVERSIGHT, *supra* note 58, at 126).

180. See *Cantor & Packer*, *supra* note 130, at 5 (explaining that mutual and pension funds place limits on the amount of a portfolio that can be invested in noninvestment-grade securities and bonds).

181. Barnett, *supra* note 125, at 96 (identifying ratings agencies as a member of a group of "certification intermediaries" which provide "stamps of approval").

182. *Compuware Corp. v. Moody's Investors Servs., Inc.*, 499 F.3d 520, 525-26 (6th Cir. 2007).

183. *Id.* at 526-27 (describing how Compuware had the opportunity to review Moody's ratings before they were issued).

the market places on the ratings. The rating agencies have made huge profits from the financial market's dependence on their certifications of quality,<sup>184</sup> so they should be held accountable for their failure to meet industry expectations.

B. APPLICATION OF THE HEIGHTENED *IN RE FITCH* TEST IN RESIDENTIAL MORTGAGE-BACKED SECURITIES LITIGATION

The heightened *In re Fitch* test is an appropriate standard by which to judge the viability of First Amendment defense claims that Moody's, S&P, and Fitch are likely to raise in *California Public Employees' Retirement System v. Moody's* and future litigation based on inaccurate ratings of residential mortgage-backed securities. In *California Public Employees' Retirement System v. Moody's*, the plaintiffs allege that the three major rating agencies assigned the highest ratings to residential mortgage-backed securities that did not merit the AAA grade.<sup>185</sup> Like similar funds of its kind, CalPERS relied heavily on the agencies' ratings because the fund required certain holdings to be investment grade.<sup>186</sup> Thus, the plaintiff alleges that the failure to properly rate the securities contributed to its billion-dollar loss.<sup>187</sup>

The rating agencies will have difficulty claiming the First Amendment defense if the California court uses the *In re Fitch* factors, especially if the court adopts the third prong proffered by this Note. In the recent past, Moody's, S&P, and Fitch have all followed the practice of only rating transactions for which they were paid.<sup>188</sup> Thus, the first factor of the *In re Fitch* standard, the issuer-compensation prong, weighs against affording the rating agencies First Amendment protections. Moody's, S&P, and Fitch also had significant, active involvement in the structuring of the residential mortgage-backed securities.<sup>189</sup> Hence, the second factor of the *In re Fitch* standard, the issuer-level-of-involvement prong, weighs against affording the agencies journalistic protections. Finally, the third factor proffered

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184. See Paley, *supra* note 1, at A1, A8.

185. CalPERS Complaint, *supra* note 51, at 1–2.

186. See Bell, *supra* note 52; Jennifer E. Bethel et al., *Legal and Economic Issues in Litigation Arising from the 2007–2008 Credit Crisis* (Harvard John M. Olin Center for Law, Econ. & Bus. Discussion Paper Series, Paper No. 612, 2008), available at <http://ssrn.com/abstract=1096582> (describing the investment-grade requirement and similar litigation involving other funds).

187. CalPERS Complaint, *supra* note 51, at 1; see also Bell, *supra* note 52.

188. White, *supra* note 129, at 47.

189. See Kettering, *supra* note 57, at 1691.

by this Note, the opinion-versus-certification-or-benchmark prong, also opposes the agencies, because investment-grade ratings were required by the fund.<sup>190</sup> Therefore, the ratings should not be viewed as opinions but rather as a certification, and the agencies should not be entitled to First Amendment protection. The rating agencies are facing years of contentious litigation and will likely fight the application of the *In re Fitch* test, but it is currently the best means of determining the viability of their First Amendment defense.

Applying the heightened *In re Fitch* standard to residential mortgage-backed securities litigation involving the rating agencies will not cause permanent damage to the financial market or freedom-of-speech jurisprudence.<sup>191</sup> The Supreme Court observed that the speech at issue in cases involving rating agencies "is solely motivated by the desire for profit, which . . . is a force less likely to be deterred [by regulation] than others."<sup>192</sup> The Court further stated that "the market provides a powerful incentive to a credit reporting agency to be accurate, since false credit reporting is of no use to creditors."<sup>193</sup> Therefore, the Court found "any incremental 'chilling' effect of libel suits would be of decreased significance."<sup>194</sup> The speech at issue in these cases reflects an unsettled area of law that needs clarification and reform. The heightened *In re Fitch* test is a viable solution that could accomplish these goals without negatively affecting freedom of expression.

## CONCLUSION

The judicial system should hold rating agencies accountable for their role in the subprime mortgage crisis. The fallout from the crisis has been severe; its impact is wide ranging and

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190. See Bell, *supra* note 52.

191. See, e.g., Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 771 n.24 (1976) ("[C]ommercial speech may be more durable than other kinds . . . there is little likelihood of its being chilled by proper regulation . . .").

192. Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 762 (1985).

193. *Id.* at 762-63.

194. *Id.* at 762. *But see* Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc., 175 F.3d 848, 856 n.3 (10th Cir. 1999) ("[O]ne commentator has concluded that the tort of negligent misrepresentation should not be extended to [rating agencies]: 'Courts cannot constitutionally allow recovery on any showing less than recklessness because of the potential chilling effect that imposing a negligent standard would have on rating publications.'" (quoting Husisian, *supra* note 82, at 460)).

most likely long lasting. Mortgage lenders, investment banks, and companies that purchased subprime mortgage securities can be expected to be held responsible for their role in the financial market disaster, so the rating agencies should not escape liability by hiding behind a First Amendment shield to which they are not entitled.

Although Moody's, S&P, and Fitch have been successful in defending past suits using the First Amendment, courts should not ignore the major differences between the rating agencies and the traditional press. The three major rating agencies are paid by the issuers, take an active role in the structuring of transactions, and their ratings are more akin to certifications than opinions. The Second Circuit set out a standard that addresses these distinct characteristics of the rating agencies in the *In re Fitch* case. A factor considering the use of a rating as a "benchmark" or "certification" rather than as an opinion would enhance the *In re Fitch* test and make it a sagacious standard for future use. The three prongs of this heightened *In re Fitch* standard are appropriate guidelines for the upcoming litigation involving the rating agencies' grossly inaccurate ratings of residential mortgage-backed securities, and the court should focus on them in *California Public Employees' Retirement System v. Moody's* and in other future litigation.

Even if the legislative branch strengthens ratings regulation, Moody's, S&P, and Fitch should not escape liability for the irreparable damage that they have already caused the global financial market. A heightened *In re Fitch* test is the first step toward bringing the rating agencies to justice. Such a standard will not result in complete restitution to the millions of investors devastated by the unscrupulous and self-serving actions of the rating agencies, but the standard will hold the agencies accountable for their disappointing performances and force them to take on greater responsibility for their ratings. The story of the credit rating agencies does not have to be a failure.