2009

Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry

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Source: CONNtemplations

Citation: 42 CONNTEMPLATIONS 13 (2009).

Title: *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry*

CONNECTICUT LAW REVIEW

VOLUME 42 *CONNtemplations* FALL 2009

Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry

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I. INTRODUCTION

Broad reliance on excessively optimistic credit ratings of structured financial products[1] helped ignite and spread the recent financial crisis. A misalignment of incentives at rating agencies such as Fitch Inc., Moody's Corporation, and Standard & Poor's ("S&P") contributed significantly to this excessive optimism. One proposal for better aligning incentives is to facilitate more lawsuits against the rating agencies for shoddy work. Courts have traditionally dismissed such lawsuits, deeming ratings to be fully protected speech under the First Amendment. However, two recent district court cases, *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*,[2] and In re *National Century Financial Enterprises, Inc., Investment Litigation*,[3] adopt a different view. They hold that ratings on securities sold in private placements, as distinct from public offerings, do not constitute matters of public concern, and do not qualify for full First Amendment protection. Many of the structured finance products at the heart of the financial crisis were sold in private placements, while most

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I am grateful to Michael Klausner for extremely helpful feedback, and to Courtney Scala and the editors of *CONNtemplations* for fast and first-rate editing. Many thanks to Olivia for all her support.

[1] "Structured finance" refers to the issuance by bankruptcy-remote, special-purpose entities of securities with graduated repayment priorities. The special purpose entities are in turn collateralized by assets such as mortgages or credit card receivables.

[2] No. 08-CV-7508, 2009 WL 2828018, at *9 (S.D.N.Y. Sept. 2, 2009).

[3] 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008).

corporate debt is sold in public offerings. This Essay argues that in the structured finance arena, the costs of facilitating litigation against the rating agencies are lower, and the potential benefits greater, than in traditional corporate finance. Irrespective of constitutional merits, good economic policy may prescribe facilitating lawsuits in structured finance but not in traditional corporate finance. By happy coincidence, the holdings in *Abu Dhabi Commercial Bank* and *National Century* approximate this result.

II. HOW INFLATED RATINGS FED THE CRISIS

Ratings pervade the architecture of debt markets. A raft of federal regulations restrict what securities banks and various investment vehicles may hold based on credit ratings.[4] Most investment funds have internal guidelines that impose further ratings-based restrictions on fund managers.[5] These restrictions aim to limit the risk that banks or fund managers assume. They help address the danger that a fund manager will increase his or her compensation by imposing unwanted risk on investors, or that a bank will impose unwanted risk on depositors and the deposit insurer.

Sufficiently high ratings from an approved agency[6] are prerequisites to the broad salability of most debt instruments. Ratings allow mortgage lenders—directly or through third-party arrangers—to securitize claims on mortgages that will pay out over a number of years (if all goes well) and sell them for upfront cash, which they can then re-lend, starting the process anew. Securities sold against pools of home mortgages are called residential mortgage-backed securities (“RMBS”). RMBS are issued in a hierarchy of “tranches,” with repayment priority for higher-rated tranches. Mid- and lower-level RMBS tranches are often pooled with other RMBS and/or securities from other structured financial products, and collateralized debt obligations (“CDOs”) are sold against this pool, again in a hierarchy of tranches. CDOs were essential to an active RMBS market, as the CDOs were the primary purchasers of the lower-rated RMBS tranches; without the sale of the most junior, “first-loss” tranches of securitized pools of assets, most deals could not go forward.[7]

High ratings on RMBS and CDOs contributed to a high degree of liquidity in the mortgage market; overly optimistic ratings contributed to

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[4] *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 690–703 (1999).

[5] Richard Cantor et al., *The Use of Credit Ratings in Investment Management in the US and Europe* (Working Paper Feb. 16, 2007), *available at* http://ssrn.com/abstract=996133.

[6] An “approved agency” is one recognized by the Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (“NRSRO”).

[7] *See* Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 69–72 (Working Paper May 14, 2007), *available at* http://ssrn.com/abstract=1027475.

excessive liquidity, as investors were willing to fund mortgages at rates that fell far short of compensating them for the actual risk. This helped feed the real estate bubble.

When the bubble burst, the breakdown in investor confidence in ratings helped the crisis spread to the broader financial system. The highest rated RMBS and CDO tranches constituted what Gary Gorton has termed "informationally insensitive" debt, or debt that "is very liquid because its value rarely changes and so . . . can be traded without fear that some people have secret information about the value of the debt."[8] Debt obligations with the highest agency ratings were viewed as informationally insensitive, or safe.

When the crisis hit, there were approximately 37,000 structured finance tranches in the United States with AAA ratings (the highest possible rating).[9] These highly rated securities helped lubricate the broader economy as institutions used them as collateral in a variety of transactions. Perhaps most importantly, institutions with large temporary cash surpluses would, instead of depositing the money in a commercial bank (where deposit insurance was capped prior to the crisis at $100,000 per account), lend the money to other financial institutions with short-term cash needs, and accept AAA-rated RMBS and CDO securities, inter alia, as collateral. These loans—called repurchase ("repo") agreements—were usually for a single night, but could be rolled over indefinitely by mutual consent. They were viewed as risk-free, with rates of return essentially equal to that of Treasury bills. Estimates of the size of the repo market before the crisis were as high as $10 trillion.[10] It constituted a parallel (unregulated) banking system as large as the commercial banking system. For it to work smoothly, collateral had to be informationally insensitive—parties could not spend time worrying about its value. When home prices started falling, investors saw risk where previously they had seen only safety in highly rated mortgage-backed securities. They hoarded cash and stopped rolling over repo loans. Investors knew the system was insolvent, but information about the location of losses—which securities were toxic and to what degree—was startlingly opaque.[11] Suddenly, the value of AAA-rated securities became highly informationally sensitive, but no one possessed the relevant information. "Not only [did] information now have to be produced, but the expertise [was] lacking"[12]—and this because of the prior

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[8] Gary Gorton, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007*, at 4 (Yale Sch. Mgmt. Working Paper, May 9, 2009), *available at* http://ssrn.com/abstract=1401882.

[9] Joshua D. Coval et al., *The Economics of Structured Finance* 3–4 (Harv. Bus. Sch. Fin. Working Paper No. 09-060, Oct. 20, 2008), *available at* http://ssrn.com/abstract=1287363.

[10] Gorton, *supra* note 8, at 30.

[11] *See* Gary Gorton, *The Subprime Panic* 1 (Yale Int'l Ctr. for Fin., Working Paper No. 08-25, 2008), *available at* http://ssrn.com/abstract=1276047.

[12] Gorton, *supra* note 8, at 37.

heavy reliance on what turned out to be highly flawed ratings.

Thus began a "run" on the parallel banking system—the refusal to roll over repo loans was the functional equivalent of depositor withdrawals—with all the adverse systemic consequences of previous banking crises. Indeed, the consequences were worse, as ratings-based rules and capital requirements forced institutions to sell securities into illiquid markets, driving down prices, which forced other institutions to mark down the value of comparable securities and to hold their own fire sales to maintain required capital ratios, feeding a vicious cycle.

III. How the Rating Agencies Got it Wrong

The ratings agencies' errors in rating mortgage-backed securities contributed to and exacerbated the crisis. How did they get things so wrong? In contrast to the more qualitative judgments about credit risk applied to corporate issuers, agencies relied primarily on statistical models in rating structured financial instruments.[13] In hindsight, the rating agencies fed the models unrealistically optimistic assumptions about continuing house price appreciation, the probability of borrower defaults, and correlation among defaults.[14] In corporate finance, a rating error on one firm is unlikely to be replicated in the analysis of other firms, as analysis focuses on the idiosyncratic risks of the individual business. In structured finance, however, models are applied to whole classes of issuances, and model error affected the ratings on broad swaths of securities.

Why did they make such unrealistic assumptions? Critics point to a conflict of interest at the core of the business model of the major rating agencies: they rate debt as a service to investors, but issuers pay their bills.[15] Issuers have a strong incentive to attain the highest possible rating, as higher ratings decrease the perceived risk of default, thus raising the price that investors will pay for the debt. Due to the payment structure, it is possible that rating agencies may bow to issuers' pressure to inflate ratings in order to keep their business.

In theory, rating agencies resist this pressure because of the desire to maintain a good reputation: if investors no longer trust rating agencies, they will not pay a premium for more highly rated securities, and issuers will have no incentive to pay to attain those ratings. Compromising quality standards today will harm the rating agencies' business in the long run.

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[13] *See, e.g.*, Mason & Rosner, *supra* note 7, at 17 (noting that "structured-finance rating analysis is essentially driven by statistical analysis").

[14] *See* Coval et al., *supra* note 9, at 2–4, 17 (explaining errors made when utilizing the models).

[15] *See, e.g.*, U.S. Sec. & Exch. Comm'n, Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies 23 (July 2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

This explanation carries some force, but two factors significantly attenuate the reputation mechanism. First, as outlined above, many securities require ratings for target investors to be able to buy them. Critics believe that rating agencies' primary function now is to provide regulatory licenses for the sale of securities, rather than to serve as reputational intermediaries.[16] In this view, reputation provides no meaningful constraint on the rating agencies, as demand will remain stable and they will continue to profit regardless of the accuracy of their ratings. A 2008 *Wall Street Journal* editorial asked, "How badly do the major credit-rating firms have to perform before investors stop using their services? That's a trick question, because investors aren't allowed to stop using them."[17]

The second factor working against reputation as a bulwark against the deterioration of rating quality is the tension between long-term and short-term incentives within the firms. It can take a long time for poor ratings quality to become apparent. A former Moody's managing director explains, "It is argued that building a stellar reputation requires a long-term horizon and view. Yet managers of publicly owned rating agencies are subject to intense short-term pressure to demonstrate earnings growth. It takes tremendous discipline to turn away business, particularly when competitors are building market share."[18]

There is anecdotal evidence that rating agencies did not always exercise this discipline. According to notes subpoenaed for congressional hearings, Moody's chief executive officer stated at one internal presentation that Moody's employees "'are continually pitched by bankers, issuers, investors' and sometimes 'we drink the kool-aid.'"[19] In another internal town hall meeting, he stated:

> "What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade. It didn't really matter. . . . We tried to alert the market. We said we're not rating it. This stuff isn't investment grade. No one cared . . . ."[20]

Issuers exploited their position as paying customers by seeking out

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[16] *See* Partnoy, *supra* note 4, at 681–703. Note that until recently it was next to impossible to attain NRSRO status—the major credit rating agencies were all "grandfathered" in. The Credit Rating Agency Reform Act of 2006 and subsequent rule changes have eased the process. *See* 17 C.F.R. § 240.17g-1. There are now ten firms with the official designation, but under the regulatory license view, this is unlikely to improve accuracy.

[17] Editorial, *The Ratings Racket*, WALL ST. J., June 25, 2008, at A14.

[18] Jerome Fons, *White Paper on Rating Competition and Structured Finance* 2 (Fons Risk Solutions, Working Paper, 2008), *available at* http://www.fonsrisksolutions.com/Documents/Ratings%20White%20Paper.pdf.

[19] *Credit Rating Agencies and the Financial Crisis*, 110th Cong. 2 (2008) (statement of Rep. Waxman, Chairman, House Comm. on Oversight and Gov't Reform) (quoting statements made by Ray McDaniel, CEO of Moody's).

[20] *Id.*

agencies whose models most liberally assigned top ratings and channeling business to them. Two trends made this "ratings shopping"[21] more severe in structured finance than in corporate finance: issuers' willingness to eschew the services of Moody's or S&P for Fitch, and their willingness to use one rater rather than two,[22] as is the norm in corporate finance.[23] Raters are likely to be more sensitive to issuers' concerns if issuers can plausibly threaten not to use their services. For large public offerings, Moody's and S&P usually preempt such shopping by assigning unsolicited ratings.[24] This is impossible to do for most private placements, where key information is nonpublic. Rating shopping, combined with the conflict of interest inherent in the issuer-pays model, contributed to a systemic inflation of ratings on structured products, which in turn contributed to both the real estate bubble and the pernicious consequences of its bursting.

IV. ONE WAY TO IMPOSE DISCIPLINE ON RATING AGENCIES

One way to impose discipline on rating agencies is to expose them to liability for shoddy work. If the desire to please clients and win business inspires excessive optimism, the threat of lawsuits for failing to base ratings on sound analysis can push in the opposite direction. The costs and benefits of such lawsuits weigh differently in structured finance than in traditional corporate finance. Rating agencies' conflict of interest is more severe in structured finance, as losing a client has a bigger impact on profits. In 2006, structured finance accounted for forty-four percent of Moody's business, while traditional corporate finance accounted for just thirty-two percent.[25] In corporate finance, thousands of distinct issuers contribute to the revenue stream, and losing any one of them would not cause serious harm to the bottom line. In structured finance, a dozen big banks dominate the market.[26] Incurring the disfavor of one of these banks could significantly harm profits, especially as an issuer's threat to take its business elsewhere carries more force in structured finance. Further, to the degree that information is more often private and the models complex in structured finance, it may take longer for investors to realize ratings errors, which could exacerbate the short-term outlook of rating agency decision-

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[21] *See* ANDREW CARRON ET AL., NERA ECON. CONSULTING, CREDIT RATINGS FOR STRUCTURED PRODUCTS 31–32 (2003), *available at* http://www.nera.com/image/6384.pdf (discussing distribution of credit ratings by degree of subordination and the idea of "ratings shopping").

[22] *See id.* at Exhibit III.2. (showing an increase in the number of ratings using only one rating agency instead of a combination of two or more).

[23] *See* John C. Coffee, Jr., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 286–87 (2006) (discussing examples of industry-accepted rating systems used in corporate finance).

[24] Carol Ann Frost, Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies 20 (unpublished working paper, on file with Univ. North Texas; State Univ. New York at Buffalo, 2006), *available at* http://ssrn.com/abstract=904077.

[25] Coval et al., *supra* note 9, at 4.

[26] Mason & Rosner, *supra* note 7, at 9–10.

makers. In structured finance, it is easier for rating agencies to hide manipulative practices, at least in the short run, which translates to a bigger market failure that litigation might address.

The primary cost of permitting suits to go forward is that any downgrade would presumably invite a lawsuit, however frivolous. This could lead to excessive conservatism in ratings and delays in downgrades. The effect of litigation on systemic accuracy, then, is ambiguous. In structured finance, however, this poses less serious concerns, as investors are overwhelmingly sophisticated institutions that would be unlikely to team with plaintiffs' attorneys to launch frivolous suits.

In short, the reputational mechanism is weaker in structured finance than in traditional corporate finance, the conflicts of interest are more severe, and litigation costs are lower. All of these factors make exposure to lawsuits by investors more appropriate in structured finance than in corporate finance.

V. THE FIRST AMENDMENT AND RECENT CASES

Lawsuits against rating agencies have traditionally faced a formidable barrier: the First Amendment. Courts have accepted rating agencies' arguments that their ratings are opinions on matters of public concern, and are fully protected speech under the First Amendment, subject to the "actual malice" exception.[27]

Abu Dhabi Commercial Bank and *National Century*, however, depart from this traditional deference to ratings. They hold that ratings on instruments sold in private placements, because they are published to a limited group of targeted investors instead of to the world at large, do not constitute matters of "public concern," and hence do not qualify for full First Amendment protection.[28] In practice, this means that plaintiffs need not show actual malice, but may, for example, sue for negligent misrepresentation.

Both decisions rely on the Supreme Court's ruling in *Dun & Bradstreet, Inc. v. Greenmoss Builders*.[29] In *Dun & Bradstreet*, a credit reporting agency[30] erroneously sent five subscribing banks a confidential report that a small local business had filed for bankruptcy. The business

[27] New York Times Co. v. Sullivan, 376 U.S. 254, 279–80 (1964). "Actual malice" is a legal term of art that translates to knowledge of falsity, or reckless disregard for whether a statement is true or false. *Id.*

[28] Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc., No. 08-CV-7508, 2009 WL 2828018, at *9 (S.D.N.Y. Sept. 2, 2009); *In re* Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008).

[29] 472 U.S. 749, 763 (1985).

[30] Credit reporting agencies are distinct from credit rating agencies. They collect and report the credit histories of individuals and smaller businesses—entities likely to seek financing from a bank rather than the capital markets. They do not issue opinions on the creditworthiness of corporate bonds or structured financial instruments.

sued for defamation.[31] The Court rejected Dun & Bradstreet's First Amendment defense, holding that because its report was made available on a confidential basis to a small number of paying subscribers, it was not a matter of public concern.[32] Dun & Bradstreet could be held liable, therefore, even without a showing of actual malice.

One should note that *Dun & Bradstreet* is not necessarily dispositive of First Amendment arguments by rating agencies in the context of private placements. Privately placed bonds are generally sold to institutions representing thousands of small investors, making them more a matter of public concern than the solvency of a small local company. Further, ratings on the bonds, while published in documents sent only to targeted investors, are not confidential; a concerned party could ascertain such ratings with relative ease. Dun & Bradstreet also made a factual statement that was demonstrably false and harmful to its subject's reputation; the rating agencies in these cases issued opinions that, in retrospect, were not harmful enough to their subjects' reputations. Nonetheless, *Dun & Bradstreet* is essential to the courts' conclusions in *Abu Dhabi Commercial Bank* and *National Century*.

A. Abu Dhabi Commercial Bank

In *Abu Dhabi Commercial Bank*, two institutional investors sued Moody's, S&P, Morgan Stanley, and several other institutions involved in the arrangement, marketing, and management of a structured investment vehicle ("SIV") called the Cheyne SIV.[33] An SIV typically buys CDOs, RMBS, and other asset-backed securities with long maturities, and issues short-term notes to investors. Because longer-term assets are viewed as relatively riskier and thus demand higher interest rates, SIVs profit from the difference in interest rates between their long-term assets and their short-term liabilities. The SIV market essentially disappeared with the onset of the financial crisis.

According to the allegations in this case, the selling documents for the Cheyne SIV listed the rating agencies' responsibilities. These responsibilities included active monitoring of the SIV and approval authority for changes to the SIV's portfolio. Two specific responsibilities were to ensure the SIV's rated notes "would be supported by at least forty percent 'AAA'—and at least sixty percent 'AA'—collateral assets," and that "the amount of RMBS supporting the Cheyne SIV would never exceed fifty-five percent."[34]

The complaint further alleged that S&P and Moody's received larger-

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[31] *Dun & Bradstreet*, 472 U.S. at 751–52.
[32] *Id.* at 762.
[33] *Abu Dhabi Commercial Bank*, 2009 WL 2828018, at *1.
[34] *Id.* at *4.

than-usual fees for the deal and knew the fees were contingent on the provision of sufficiently high ratings.[35] The plaintiffs also claimed that shortly before they bought notes from the Cheyne SIV, S&P and Moody's both came out with new "models that eased . . . standards for evaluating the creditworthiness of nonprime securities like the Cheyne SIV."[36] Perhaps most damning, the rating agencies allegedly sat idly by as RMBS came to make up more than fifty-five percent of the Cheyne SIV portfolio, and AAA- and AA-rated assets both fell below the thresholds promised in the selling documents.[37]

After the Cheyne SIV failed in 2007, the plaintiffs brought claims for, inter alia, negligence, negligent misrepresentation, and common law fraud against S&P, Moody's, and the other defendants.[38] Because the court's ruling was in response to a Rule 12(b)(6) motion, it assumed that all the allegations were true in determining whether the claims could go forward. The court ruled that New York's Martin Act[39] barred all private securities-related claims that "do not require proof of deceitful intent."[40] So, for example, private litigants in New York can press state law securities fraud claims, but only the state attorney general can pursue a negligence claim in a securities case. The court thus dismissed every claim except for common law fraud against the rating agencies and Morgan Stanley.[41]

Relying on *Dun & Bradstreet*, the court rejected the rating agencies' claim to full First Amendment protection. It reasoned that because ratings were published only in documents distributed to a limited number of target investors, they were not a matter of public concern. The rating agencies could thus be held liable for damages without a showing of actual malice.[42] The court's ruling on this issue was arguably unnecessary, as the only claim to survive its order, common law fraud, requires showing "the defendant possesses an intent to deceive, manipulate or defraud."[43] Because such intent would entail knowledge of falsity, it should automatically trigger the "actual malice" exception to First Amendment protection. The First Amendment would not protect the rating agencies against a fraud claim even for publicly issued ratings. Nonetheless, the court's decision is sure to have an impact on other cases that involve allegations of negligence or negligent misrepresentation on the part of the rating agencies—perhaps even cases brought by New York's Attorney

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[35] *Id.* at *3.
[36] *Id.* at *11.
[37] *Id.* at *4.
[38] *Id.* at *1.
[39] N.Y. GEN. BUS. LAW § 352-c (1996).
[40] *Abu Dhabi Commercial Bank*, 2009 WL 2828018, at *7 (internal quotation marks omitted).
[41] The Martin Act was only one basis for the dismissal of the other claims. The court also, for example, dismissed the plaintiffs' claims for breach of contract on other grounds. *Id.* at *19.
[42] *Id.* at *9.
[43] *Id.* at *6 (internal quotation marks omitted).

General.

B. National Century

The litigation in *National Century* pre-dated the financial crisis. It arose out of a massive fraud at the Ohio-based National Century Financial Enterprises, Inc., which collapsed in 2002.[44] The company provided loans to healthcare providers to cover the period between patient treatment and reimbursement by third-party insurers.[45] In a structure akin to RMBS, it packaged these loans into (supposedly) bankruptcy-remote vehicles, which then issued notes to investors secured by the healthcare loan receivables.[46] The vehicle at issue in this case, NPF XII, sold separate series of privately placed notes over time. Lloyds TSB Bank PLC purchased notes in a series rated by Moody's, and a group of New York-based public pension funds (with Lloyds, the "plaintiffs") purchased notes in a series rated by Fitch.[47] After the notes defaulted, the plaintiffs sued the rating agencies separately, and the cases were consolidated. The judge's decision was an order in response to a Rule 12(b)(6) motion by the rating agencies.[48]

The plaintiffs' suit against the agencies included claims of fraud, aiding and abetting fraud, and negligent misrepresentation, inter alia.[49] The plaintiffs claimed that both rating agencies had access to information that should have alerted them to National Century's noncompliance with the terms in its Master Indenture, and that would have undermined the high ratings they had assigned to the NPF XII notes.[50] The plaintiffs claimed, for instance, that Fitch received three anonymous letters outlining the fraud at National Century, but after an investigation determined the letters were baseless.[51]

The court concluded that the plaintiffs failed to state a claim of fraud because they did not plead with sufficient particularity.[52] As fraud was the only claim likely to qualify for the actual malice exception, the court's ruling on the agencies' First Amendment defense was crucial to the survival of the lawsuit. The court found "that the complaint [did] not

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[44] Press Release, Dep't of Justice, Former National Century Financial Enterprises CEO Sentenced to 30 Years in Prison, Co-Owner Sentenced to 25 Years in Prison for Conspiracy, Fraud and Money Laundering (Mar. 27, 2009), *available at* http://www.justice.gov/opa/pr/2009/March/09-crm-282.html.

[45] David Hammer, *Former Executives of Loan Company Charged with Fraud*, ASSOCIATED PRESS FINANCIAL WIRE, May 23, 2006.

[46] *See* Harold L. Kaplan & Stephanie Wickouski, *Health Care Financing and Securitization After* National Century, AM. BANKR. INST. J., May 2003, *available at* http://www.drinkerbiddle.com/files/Publication/d5263820-0353-4db6-abbd-3a818e490977/Presentation/PublicationAttachment/0bb58994-e659-4d3b-8bec-361d2fb1e32d/HCFinancingAfterNationalCenturyABIArticleMay03.pdf.

[47] *In re* Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 634–35 (S.D. Ohio 2008).

[48] *Id.* at 636, 638.

[49] *Id.* at 635–36.

[50] *Id.* at 634–36.

[51] *Id.* at 636.

[52] *Id.* at 645.

allege that the ratings of the NPF XII notes were published to the investing public at large."[53] Citing *Dun & Bradstreet* for the proposition that speech to "a specific business audience" does not qualify as a matter of public concern, the court rejected the agencies' First Amendment arguments.[54] The plaintiffs' negligent misrepresentation and other claims thus survived the motion to dismiss.[55]

VI. CONCLUSION

The impact of these decisions will be felt more in structured finance than in corporate finance. Many RMBS and virtually all CDOs are sold in private placements.[56] In contrast, private placements in the United States of "plain vanilla" debt amounted to less than ten percent of total U.S. investment-grade corporate debt issuances in 2006.[57]

Some may criticize the constitutional merits of the opinions, as ratings of bonds purchased by institutions that represent thousands of individual investors are arguably more a matter of public concern than the financial health of a small local company. But irrespective of the constitutional merits of their rulings, the courts have hit upon a potentially happy compromise between exposing rating agencies to excessively burdensome costs, and holding them to account where their conflicts of interest are most severe and the potential adverse impact of inflated ratings on the financial system most pernicious. While the courts' reasoning was entirely distinct from the policy issues outlined above, they fortuitously, if imperfectly, deny full First Amendment protection to a broad swath of structured finance deals, which are largely sold in private placements, while preserving it for most of corporate finance, where public offerings constitute the bulk of the market. Given the theoretical and practical difficulties of effecting a comprehensive solution to the misaligned incentives in the credit rating industry, this outcome marks a positive, if incremental, step in the right direction.

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[53] *Id.* at 640.

[54] *Id.* at 640 (citing Dun & Bradstreet, Inc. v. Greenmoss Builders, 472 U.S. 749, 762 (1985)).

[55] *Id.* at 656. The other claims to survive included violations of blue sky laws and aiding and abetting fraud.

[56] S*ee* Richard Tomlinson & David Evans, *The Ratings Charade*, BLOOMBERG MARKETS, July 2007, http://www.bloomberg.com/news/marketsmag/ratings.html.

[57] *See* THOMSON REUTERS, DEBT CAPITAL MARKETS REVIEW, US INVESTMENT GRADE CORPORATE DEBT (F9) (Fourth Quarter 2007), *available at* http://online.thomsonreuters.com/DealsIntelligence/Content/Files/4Q07_Debt_Capital_Markets_R1.pdf (providing a total industry debt of $935,191,700,000 for 2006); THOMSON REUTERS, US PRIVATE PLACEMENTS REVIEW, PLAIN VANILLA DEBT EXCLUDING REG. S (AN 10) (Second Half 2007), *available at* http://online.thomsonreuters.com/DealsIntelligence/Content/Files/4Q07_Private_Placement.pdf (providing a total industry plain vanilla debt of $44,225,200,000 for 2006).