August 19, 2010

A JUSTIFIED ASSAULT UPON THE CITADEL OF PRIVITY AND THE FIRST AMENDMENT

Joseph G Bunn, Esq.

A JUSTIFIED "ASSAULT UPON THE CITADEL OF PRIVITY"[1]

AND THE FIRST AMENDMENT:

A Theory of Liability for Investors Seeking Recovery From Credit Rating Agencies

Joseph G. Bunn

West Virginia University, College of Law

Fall 2009

1 *Ultramares v. Touche*, 174 N.E. 441, 445 (N.Y. 1931) (Cardozo, J.).

TABLE OF CONTENTS

INTRODUCTION

The active involvement of credit rating agencies ("CRAs") in the structured finance market and the recent financial crisis is an adequate basis for investors to pursue claims against CRAs for negligent misrepresentation. Traditionally, CRAs have qualified for protection from suit by investors under the privity doctrine and under the First Amendment. CRAs qualified for protection under the privity doctrine because CRAs are not typically in a contractual relationship with investors who utilize their ratings. CRAs qualified for protection under the First Amendment because courts viewed their ratings as "speech" regarding public matters. However, this dual protection is limited in certain circumstances.

Third party beneficiaries of a contract may have a cause of action against a service-providing party when there is a relationship "approaching that of privity." Such a relationship exists when a contract party provides services for a particular purpose in furtherance of which a known party or parties are intended to rely, and the service-providing party provides those services in a manner that constructively links the service provider to the reliant party. The ratings of structured financial products ("SFPs") serve a particular purpose because those ratings provide issuers the ability to offer SFPs to qualified institutional investors under Rule 144A. Qualified institutional investors are known, reliant parties of such ratings because many of them are required by law to only purchase securities equal to or exceeding investment-grade. Finally, CRAs provide these ratings in a manner that constructively links them to investors because the process of providing SFP ratings is plagued by conflicts of interest, improper management, and poor use of information. Thus, CRAs are in a relationship that is "approaching privity" with investors and should be liable for losses incurred by investors who relied on their inflated structured financial product ratings.

Furthermore, the First Amendment should not protect CRAs from this liability because a structured financial product rating is "speech" that is not "of public concern." First Amendment protection is extended only to matters "of public concern." A credit rating's "content, form, and context . . . as revealed by the whole record" indicates whether such rating is "of public concern" or not. There are a variety of factors that indicate SFP ratings are not a matter "of public concern." First, SFP ratings are solely in the interests of CRAs and their specific audience because they are the only parties who will financially benefit from an SFP rating's issuance. Second, SFP ratings are not typically disseminated in a broad fashion. Third, the large profit margin that CRAs derive from each SFP rating will encourage CRAs to continue providing SFP ratings, despite additional regulation. Fourth, SFP ratings are more objectively verifiable than other protected forms of speech. Because the "content, form, and context" of a typical SFP rating indicates that such rating is not a matter "of public concern," the First Amendment should not protect SFP ratings.

To fully explain the issues discussed above, the following analysis is composed of three parts: (I) Credit rating agency involvement in the financial crisis, (II) An "approaching privity" relationship among credit rating agencies and structured financial product investors, and (III) The First Amendment's lack of protection for structured financial product ratings.

I. CREDIT RATING AGENCY INVOLVEMENT IN THE RECENT FINANCIAL CRISIS.

Prior to exploring CRAs' potential liability to investors for inflated credit ratings, an examination of many facts is necessary. Understanding the CRAs' origins is necessary because they give insight into the limits of CRAs' First Amendment protection. Examining the CRAs influence and function in the structured finance market is essential because it sheds light on the special relationship that CRAs have with structured financial product investors. Finally, understanding that institutions suffered losses in excess of the risk of loss represented to them by CRAs before the recent financial crisis strengthens the argument for liability exposure.

Thus, this section is separated into the following subsections: (A) The traditional credit rating business model, (B) Credit rating agencies' regulatory entanglement, (C) The emergence of structured financial products, (D) The structured financial product rating process, (E) Inherent flaws in the structured financial product rating process, and (F) Damage caused by inaccurate structured financial product ratings.

A. The traditional credit rating business model.

Near the beginning of the 20th century, John Moody began rating the creditworthiness of railroad, utility, and industrial corporation bonds.[2] Soon thereafter, Standard Statistics (predecessor to Standard & Poor's) and the Fitch Publishing Co. introduced a similar service.[3] Ratings were delivered in the form of a letter grade, which indicated the likelihood of a debt instrument's default, or failure to pay.[4] The ratings typically ranged in descending order from Aaa to C. Obligations rated Aaa were represented as the highest quality with minimal credit risk, and obligations rated C were represented as the lowest-rated class of bonds that were typically in default with little prospect for recovery of principal or interest.[5] Various objective and subjective characteristics[6] of obligors were used to distinguish between the low-risk obligors and

---

[2] *See* RICHARD SYLLA, A HISTORICAL PRIMER ON THE BUSINESS OF CREDIT RATINGS 2, *available at* http://www.docstoc.com/docs/18666517/a-historical-primer-on-the-business-of-credit-ratings/; WILLIAM E. FRUHAN, JR., NOTE: CREDIT RATING AGENCIES 1 (Harvard Business School Publishing May 18, 2009)
[3] *See* FRUHAN, *supra* note 2, at 1.
[4] *See* Moody's Investors Service Homepage, *Rating Definitions* (August 2, 2008), *available at* http://www.moodys.com (indicating that Moody's ratings actually reflect *both* the likelihood of default and any financial loss suffered in the event of default).
[5] *See id.*
[6] Some of the various objective characteristics used by the CRAs include a firm's annual earnings coverage of fixed charges, debt to capitalization ratio, annual cash flow to long-term

the high-risk obligors. Customers of CRAs valued this service because the rating provided a simplistic, independent opinion as to the creditworthiness of their investments from a qualified, reputable source. In exchange for this value-added service, customers paid CRAs subscription fees similar to newspaper or magazine subscribers.

B. Credit rating agencies' regulatory entanglement.

Because CRAs provided an independent evaluation of very complex financial products and delivered their findings in a simple form, the U.S. government endorsed their service by adopting their letter grade system as a standard of creditworthiness in many statutes, regulations, and rules. In 1936, the Federal Reserve endorsed the CRAs by requiring all commercial banks to purchase only bonds rated above "investment grade," or BBB in CRA lingo.[7] Many other government institutions soon followed the Fed's lead by substantively incorporating the CRAs' letter system into their regulations.[8] With these government endorsements, the credit rating agencies' effectively controlled what investments the U.S. government and regulated industries could purchase with their spare capital. Surprisingly, CRAs were not regulated during this time period.

Partial regulation came in 1973 with the issuance of 17 C.F.R. § 240.15c3-1, which created the Nationally-Recognized Statistical Rating Organization ("NRSRO") designation. While the impetus for the SEC's issuance of Rule 15c3-1 is unclear, the replacement of Bretton

---

debt outstanding. *See* FRUHAN, *supra* note 2, at 5. One of the subjective factors used for arriving at a final credit rating is the perceived quality of a firm's senior management team. *Id.*

[7] *See* TIMOTHY J. SINCLAIR, THE NEW MASTERS OF CAPITAL 43-44, Table 3 (Cornell University Press 2005).

[8] For example, the Securities & Exchange Commission created the uniform net capital rule by incorporating credit ratings into Rule 15c3-1, the Finanncial Institutions Recovery and Reform Act of 1989 prohibited Savings & Loans from investing in below-investment grade bonds, and the Transport Infrastructure Finance and Innovation Act of 1998 prohibited the Department of Transportation from extending credit assistance to projects with below-investment-grade ratings. *See id.* (discussing these particular examples and indicating numerous other examples).

Woods System by a floating-exchange rate regime created an opening for freer international capital flows and financial globalization, which led to the need for a global investment standard.[9] The NRSRO designation substantially restricted the number of CRAs because the designation required new entrants to be "nationally-recognized."[10] New players found it hard to qualify as "nationally-recognized" because they did not have the experience of issuing ratings for a large number of bond issues over a considerable period of time. Thus, competition was nearly eliminated, and existing CRAs were granted something near an oligopoly on the market[11] of selling regulatory compliance licenses to entities bound by regulations that substantively incorporated their ratings.[12] Armed with legally guaranteed business and very few competitors, CRAs became extremely influential entities.[13]

C. The emergence of structured financial products.

CRAs found the opportunity they had been waiting for when the U.S. Federal Reserve Bank began dropping interest rates to unprecedented levels from 2000 to 2007. Because interest

---

[9] *See* SYLLA, *supra* note 2, at 23.

[10] The SEC on a case-by-case basis granted the CRA designation to credit rating agencies through the issuance of a no action letter. While many objective criteria were examined in this process, the key issue was whether the agency was "nationally recognized" by issuers who used the ratings. *See* SEC. & EXCH. COMM'N, SEC REPORT ON CREDIT RATING AGENCIES 9-10 (January 2003).

[11] *See The Role of Credit Rating Agencies in the Structured Financ. Mkt.: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Entities, House Comm. on Financ. Servs.*, 110th Cong. 137 (Sept. 27, 2007) (statements of Julia Whitehead and Sean Mathis) (testifying that the credit rating market share of Moody's, Standard & Poors, and Fitch were 39%, 40%, and 16%, respectively, and 95% collectively);

[12] *See generally* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U. L.Q. 619 (1999).

[13] As Thomas Friedman stated in a 1996 television interview,

> There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. An believe me, its not clear sometimes who's more powerful.

See id., no. 3 at 620.

rates were so low, many new homebuyers entered the market and the outstanding amount of mortgages in United States rose from $6.785 trillion to $14.557 trillion, an increase equal to 214.54%.[14] This massive growth caught the eye of many financial players.

While this business opportunity was new, the process that banks utilized to exploit it – securitization - was not. During the 1960s and 1970s, banks began selling off mortgage loans to outside investors in an effort to diversify their portfolios.[15] Because investors wanted to scrutinize the details of the mortgages to guard against the risk of default, these sales became too cumbersome for the banks.[16] Accordingly, the banks began to bundle up large quantities of loans in packages to spread the risk of any problematic loans across a large portfolio, which obviated the need for strict scrutiny of mortgage terms.[17]

Over time, the banks realized that they could use the cash flow from the mortgage payments to make an additional profit: banks began aggregating the future income streams of varying assets into a trust and then issuing securities granting investors rights to those income streams.[18] These securities – now known as SFPs – became a booming business for the banks because they allowed the banks to make money from both the mortgage payments and the sale of the securities.[19] Banks made money from the mortgage payments because their cost of capital was lower than the rate paid by mortgagors. Banks made money from the sale of securities through underwriting fees, retained equity positions in the newly created SFP, and other investment banking methods.

---

[14] *See* FRUHAN, *supra* note 2, at 5.
[15] *See* GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 52 (Free Press 2009).
[16] *See id.*
[17] *See id.*
[18] *See* FRUHAN, *supra* note 2, at 6.
[19] *See* TETT, *supra* note 15, at 52.

When the Fed began to drop interest rates dramatically, banks tweaked the securitization process further to entice a broader investor audience: development of different tranches of creditworthiness within these trusts. Sometimes the trust underwriter developed tranches based merely on a difference in the expected yield to investors. Other times, underwriters would subordinate the rights of high-risk, high-yield securities to its low-risk, low-yield securities. Occasionally, the high-risk nature of the assets contained in the trust required the underwriter to over-collaterize the pool, or contribute more assets to the pool per security than the sales price of such security. Frequently, underwriters used bond insurance to improve the creditworthiness of these artificial securities. These specific techniques along with many others, alone and in combination, created a plethora of SFPs.

A SFP composed of individual mortgages, or pools of mortgages, was particularly interesting to investors. Those SFPs offered reliable cash flows because mortgagors typically paid their mortgage payments on time. Aggregating mortgages of varying borrower risk profiles throughout different geographic regions also offered diversification. The tranche structures also allowed investors to theoretically choose the level of risk they desired.

Even though there was adequate supply and demand, a delivery method was needed. The method needed to be quick (to offset the interest rate exposure of underwriters) and reach a well-capitalized audience (to handle the cost inherent in the gluttony of new mortgages). The method was found in Rule 144A of the Securities Act of 1933.[20] A Rule 144A offering is quick because it does not impose the cumbersome, time-consuming disclosure requirements of public

[20] 17 C.F.R. 230.144A (2010).

offerings.[21] Rule 144A also reaches a well-capitalized audience because one of the essential qualifications for Rule 144A investors is substantial net worth.[22] However, many qualified institutional investors eligible for Rule 144A offerings are prohibited by other regulations from purchasing securities that are not investment grade. Because CRAs establish whether a security is investment-grade, CRAs held a pivotal role in completing the SFP supply chain. Recognizing their influence, CRAs demanded higher prices for their ratings of SFPs.[23]

D. The structured financial product rating process.

The CRAs' traditional rating process was not helpful when rating SFPs because SFPs did not have a history of financial performance like traditional financial instruments.[24] Underwriters began the process by sending a CRA a range of data on the income-producing assets contained in the trust, the proposed capital structure of the trust, and the proposed levels of credit enhancement applied to each tranche of securities in the trust.[25] After the lead analyst of the agency received this information, the analyst developed predictions as to how many assets in the trust would default under varying levels of economic stress.[26]

---

[21] *See id.*, Preliminary Note 4 (2008) (indicating that nothing in 17 C.F.R. 230.144A obviates the need for any issuer or any other person to comply with the securities registration requirements of the Securities Exchange Act of 1934 whenever such requirements are applicable).

[22] *See* 17 C.F.R. 230.144A(a)(1)(i)(2010) (indicating that any qualified institutional investor buyer must "in the aggregate own or invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity").

[23] Since the mid-1970s, CRAs have charged issuers fees, typically two to three basis points of a bond's face amount. *See* Partnoy, *supra* note 12, at 652. Today, ninety-five percent of the agencies' annual revenue is from those issuer fees. *Id.* The fee-shifting has been a windfall for the CRAs: between 2005-2007 Moody's and Standard & Poor's had operating profit margins equal to 53.6% and 44%, respectively. *See* FRUHAN, *supra* note 2, at 6.

[24] *See* SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMM'N STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 7-10 (July 2008).

[25] *Id.* at 7.

[26] *Id.* at 7-8.

The default predictions of each tranche were compared to the agencies' particular rating requirements. If the analyst concluded that the capital structure of the SFP did not support the underwriter's desired rating, that preliminary conclusion was communicated to the underwriter. The underwriter was free to move forward with the transaction based on the preliminary rating, to modify the capital structure and receive a lower or higher credit rating based on the effect such modification,[27] or to pursue the services of another CRA.[28]

Once this back-and-forth negotiation was complete, the analyst conducted a cash flow analysis on the trust's expected interest and principal payments to determine whether those cash flows were sufficient to pay the interest and principal due to each tranche. Following these initial steps, the analyst developed a rating recommendation for each tranche and presented those ratings to a rating committee composed of analysts and senior level analytic personnel. The rating committee voted on the analyst's recommendations and communicated its decision to the analyst. If the committee approved the recommendation, then the ratings were published and subsequently monitored through surveillance processes.[29]

E. Inherent flaws in the structured financial rating process.

There were many flaws inherent in the SFP-rating process prior to the recent market meltdown. CRAs did not staff their organizations well enough to accommodate the huge volume

[27] *Id.* at 8.
[28] However, such an instance rarely happened. In an internal email in April 2007 between two agency analysts, one analyst expressed concern that the model did not capture "half" of the deal's risk, but that "it could be structured by cows and we would rate it." *Id.* at 12.
[29] In a typical surveillance scenario, issuers of structured products provide CRAs with information indicating the underlying performance of the assets contained in the SFP and CRA analysts relook at an existing deal by inputting those new assumptions into the existing model. *Id.* at 21. If the result differed from the SFP's current rating, the CRA would issue a downgrade or an upgrade, depending on the circumstances. *Id.*

of the SFP market.[30] Furthermore, CRAs did not document essential steps in the rating process or substantial participants in the rating process.[31] This apathetic routine of documentation also carried over into CRAs' surveillance processes for existing rated securities.[32] Furthermore, conflicts of interest involving the "Issuer Pays" pricing model,[33] securities transactions by CRA employees,[34] and internal audit procedures[35] plagued the rating process. Finally, CRAs' overreliance on dissimilar historical data negatively impacted the accuracy of their ratings.[36]

External factors also contributed to flawed ratings. The concentrated underwriting market for SFPs[37] encouraged CRAs to concede on negotiation points during the rating process to prevent the loss of a valuable customer. The CRAs standard-setting status also provided liability insurance to investment banks that chose to underwrite riskier investments, which

[30] *Id.* at 10.
[31] *Id.* at 13-20.
[32] *Id.* at 21-23.
[33] Most CRAs have adopted the "issuer pays" pricing model in the SFP rating businesses. Under the "issuer pays" model, the underwriter of the SFP pays the CRA who rates the SFP. *Id.* at 23-27, 31-32.
[34] Two of the three largest CRAs do not prohibit SFP analysts from owning shares of investment banks that may participate in SFP transactions. Furthermore, only one of the CRAs employs a third-party service to identify undisclosed brokerage accounts to ensure that employees are submitting complete information about their brokerage accounts. *Id.* at 28.
[35] One CRA only required a one-page checklist limited in scope to evaluate the completeness of deal files and the CRA only provided four examples where the reviewer forwarded findings to management and no examples of management's response thereto. Another CRA's internal audit revealed that its SFP rating group had failed to comply with document retention policies and had failed to adhere to rating committee guidelines. Furthermore, the same CRA's management had failed to formally review and validate derivatives models prior to posting for general use. *Id.* at 30.
[36] SFP analysts relied upon historical data in order to predict future behavior. However, the data that the analysts relied upon was very short and the information available occurred under very benign economic conditions. Even after realizing their flawed analysis, analysts infrequently re-estimated their models by applying new data. *Id.* at 35.
[37] *Id.* at 31 (explaining that 12 arrangers accounted for 80% of subprime mortgage-backed securities deals, in both number and dollar volume; and 11 arrangers accounted for 92% of the deals and 80% of the dollar volume of collaterized debt oglibations composed of mortgage-backed securities).

encouraged more risk taking.[38] These internal and external factors were essential ingredients in the financial crisis that followed this egregious conduct.

F. Damage Caused By Inaccurate Structured Financial Product Ratings.

In April of 2008, the International Monetary Fund reported that the recent financial crisis had caused prospective losses equal to $1 trillion.[39] The "root cause" of the recent financial crisis was the housing correction, which resulted in illiquid mortgage-related assets that choked off the vital flow of credit in our economy.[40] While the "root cause" of the recent financial crisis might have been the housing correction, the subsequent "choking off" of credit would not have occurred had CRAs assessed risk in the SFP market in a disinterested fashion.

By comparing the 2007 seven-year cumulative default rates of asset-backed securities to other securities with the same credit rating, the CRAs' failure and refusal to properly assess risk becomes obvious. The cumulative default rate of triple-A rated, asset-backed securities was 7.17%, whereas the default rate in the same time period for triple-A rated municipal debt, sovereign debt, and corporate debt was 0.00%, 0.00%, and 0.25%, respectively.[41] The cumulative default rate of Baa-rated asset-backed securities was 34.04%, whereas the default rate in the same time period for Baa-rated municipal debt, sovereign debt, and corporate debt was 0.11%, 3.90%, and 2.96%, respectively.

---

[38] *See* Marc Flandreau, *Rating Agencies v. Investment Banks: Who's Minding The Shop?*, Financial Times, (August 25, 2009), *available at* http://www.ft.com/economistsforum.

[39] *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: CONTAINING SYSTEMIC RISKS AND RESTORING FINANCIAL SOUNDNESS, (April 2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm; *See also* RGE Monitor, *Roubini Pegs Credit Related Losses at $2 trillion!*, RGEMONITOR, (Aug. 5, 2008), *available at* http://www.rgemonitor.com (claiming losses exceed $2 trillion).

[40] *See Turmoil in U.S. Credit Mkts. Recent Actions Regarding Gov't Sponsored Entities, Investment Banks and Other Financ. Insts.: Hearing Before the Senate Banking Comm.*, 111th Cong. (statement of Treasury Secretary Henry M. Paulson, Jr.) (Sept. 23, 2008).

[41] *See* FRUHAN, *supra* note 2, at 23-24.

These disparities in default rates are evidence of SFP ratings' flawed nature. These disparities also represent a loss incurred by investors who relied on inflated SFP ratings before the recent financial crisis. Surprisingly, CRAs received excessive compensation during this same timeframe, but did nothing to improve the quality of their ratings. Because CRAs provided tainted SFP ratings to investors and disregarded the risk imposed on the market by their conduct, third party investors who relied on their SFP ratings should have the ability to recover damages from the CRAs.

II. AN "APPROACHING PRIVITY" RELATIONSHIP EXISTS BETWEEN CREDIT RATING AGENCIES AND STRUCTURED FINANCIAL PRODUCT INVESTORS.

An "approaching privity" relationship exists between CRAs and investors because CRAs provided SFP ratings to enable the SFP transactions, the CRAs knew that investors would rely on those ratings, and CRAs participated enough in the creation of these securities to link them to investors. Generally speaking, an individual who provides contract services to another in the course of his employment, profession, or business is not liable for negligent misrepresentations to third party beneficiaries of such contract.[42] However, third party beneficiaries of accounting services may sue professionals if a privity relationship or a relationship "approaching that of privity" exists.[43] A relationship "approaching that of privity" exists when a contract party

[42] *See Winterbottom v. Wright*, 10 M & W 109, 152 Eng.Rep. 402 (1842).
[43] *Compare Merit Ins. Co. v. Colao*, 603 F.2d 654, 659 (7th Cir. 1979) (recognizing a relaxed privity requirement in the case of negligent conduct by an accountant involving known parties who reasonably rely upon the accountant's negligent representations), *cert. denied* 445 U.S. 929 (1980); *and Rhode Is. Hosp. Trust Natl. Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847, 851 (4th Cir. 1972) (same); *and Seedkem, Inc. v. Saframek*, 466 F. Supp. 340, 343-44 (D.C. Neb. 1979) (same); *and Coleco Indus. v. Berman*, 423 F. Supp. 275, 309 (E.D. Pa. 1976) (same); *and Rusch Factors v. Levin*, 284 F. Supp. 85, 90 (D.C.R.I. 1968) (same); *and Prudential Ins. Co. of Am. v. Dewey, Ballantine, Bushby, Palmer & Wood*, 605 N.E.2d 318, 320 (N.Y. 1992) (same); *and Credit Alliance Corp. v. Arthur Anderson & Co.*, 483 N.E.2d 110, 115 (N.Y. 1985) (same); *and Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212, 214 (Ohio 1982) (same); *and*

provides services for a particular purpose in furtherance of which a known party or parties are intended to rely, and the service-providing party provides those services in a manner that constructively links it to the reliant party.[44] As time has progressed, an "assault of the citadel of privity"[45] has continued, and courts have extended the "approaching privity" doctrine to instances involving other professional services.[46]

Spherex, Inc. v. Grant & Co., 451 A.2d 1308, 1311 (N.H. 1982) (same); *and Larsen v. United Fed. Sav. & Loan Ass'n.,* 300 N.W.2d 281, 287 (Iowa 1981) (same); *and Aluma Kraft Mfg. Co. v. Fox & Co.*, 493 S.W.2d 378, 379 (Mo. App. 1973) (same); *and Glanzer v. Shepard*, 233 N.Y. 236, 239 (N.Y. 1922) (same); *and Shatterproof Glass Corp. v. James*, 466 S.W.2d 873, 876-77 (Tex. Civ. App. 1971) (same); *with Koch Indus. v. Vosko*, 494 F.2d 713, 724-25 (10th Cir. 1974) (granting recovery to third parties only in instances of intentional misrepresentation or fraud); *and Stephens Indus. v. Haskins & Sells*, 438 F.2d 357, 360 (10th Cir. 1971) (same); *and Jordan v. Madison Leasing Co.*, 596 F.Supp. 707, 710 (S.D.N.Y. 1984) (same); *and Aercona, Inc. v. Gorin*, 561 F. Supp. 370, 376 (S.D.N.Y. 1983) (same); *and Briggs v. Sterner*, 529 F.Supp. 1155, 1176 (S.D. Iowa 1981) (same); *and Shofstall v. Allied Van Lines*, 455 F.Supp. 351, 359-60 (N.D. Ill. 1978) (same); *cf. Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214, n. 33 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748 (1975).

44 *See Credit Alliance Corp.,* 483 N.E.2d at 118 (defining "relationship approaching privity" test in its application to accountants); *Coleco Indus.*, 423 F.Supp. at 309 (holding an accounting firm liable to a nonprivy party because the nonprivy party had chosen the accounting firm, had explained the role it would play in the ongoing transactions, and had direct dealings with throughout the transactions; *Seedkem, Inc.*, 466 F. Supp. at 343-44 (applying the "approaching privity" test because the accountant's notes to the audited financial statements specifically identified the nonprivy party); *see also Rusch Factors*, 284 F. Supp. at 90 (holding an accountant liable to a third party because the accountant had prepared balance sheets for his client with the "end and aim" of influencing the third party to extend credit to the accountant's client); *see also LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.,* 951 F.Supp. 1071, 1092-93 (S.D.N.Y. 1996) (applying *Credit Alliance* accountant standard to credit rating agencies intimately involved in structuring financial products); *Guildhall v. Silberman*, 688 F. Supp. 910, 914 (S.D.N.Y. 1988) (applying *Credit Alliance* standard to appraisers of real property).

45 *See Ultramares Corp.*, 174 N.E. at 445.

46 *See LaSalle Nat'l Bank*, 951 F. Supp. At 1092 (extending the "relationship approaching privity" test to credit rating agencies that are intimately involved in the structuring of financial products); *Guildhall*, 688 F. Supp. at 913 n. 2 (applying approaching privity test to "appraisers" of artifacts); *Chemical Nat'l Bank v. Nat'l Union Fire Ins. Co.*, 74 A.D.2d 786 (N.Y. App. Div. 1980) (extending relaxed privity requirement to appraisers of real property); *Gordon v. Holt*, 65 A.D.2d 344 (N.Y. App. Div. 1979) (recognizing the application of a relaxed privity requirement to architects for negligently preparing reports, but not holding architect liable under such standard).

The court in *LaSalle National Bank v. Duff & Phelps Credit Rating Co.* held that CRAs are in a relationship "approaching that of privity" with third party investors. In *LaSalle National Bank*, Duff & Phelps had been hired by Towers Financial Corp. to rate $200 million of bond issues, the proceeds of which would be used to acquire qualified healthcare receivables.[47] Duff & Phelps' involvement was necessary to sell the bonds because it was a condition of the initial issuance of each series of bonds that Duff & Phelps rate them "AA".[48] Prior to the issuance of each series of bonds, Duff & Phelps assigned a rating of "AA" and consented to the use of its name and the assigned rating in connection with the disclosure documents, advertisements, and description of the issue.[49] Duff & Phelps directly communicated with six of the twenty-six purchasers prior to and following their purchase regarding the rating process, and assured them of the merits of the bond issues.[50] In addition to rendering initial ratings of the bond issues, Duff & Phelps committed to perform due diligence on the underlying assets of the bonds every quarter "in order to enable it to reaffirm, upgrade, or downgrade the outstanding ratings."[51]

After purchasing the bond issues, the qualified institutional investors discovered that Towers Financial had engaged in a massive fraud by acquiring non-conforming healthcare receivables, selling those receivables to third party investors, and diverting millions of dollars its insiders' own purposes.[52] In response to Towers' fraud, the investors brought suit against Duff & Phelps asserting negligent misrepresentation. Duff & Phelps responded by making a motion to dismiss for lack of privity.[53]

---

[47] *See LaSalle Nat'l Bank*, 951 F. Supp. at 1074-75.
[48] *Id.* at 1076.
[49] *Id.*
[50] *Id.* at 1078-79.
[51] *Id.* at 1078.
[52] *Id.* at 1076.
[53] *Id.* at 1073.

The court reasoned that Duff & Phelps was aware of a particular purpose for the rating because Duff & Phelps consented to including their name and rating in the offering memoranda.[54] The court also found that Duff & Phelps knew that the investors would rely on the inaccurate ratings because Duff & Phelps consented to the use of its name in the offering memoranda and directly communicated to some investors regarding the merits of the investments.[55] Finally, the court found that Duff & Phelps' conduct linked it to the investors because Duff & Phelps had advised Towers how to apply credit enhancement features[56] to its securities, so that such securities could attain a "AA" rating, which was requirement of the offering.[57] The court also noted that Duff & Phelps's direct communications with some of the investors, and the subsequent purchases made by initial purchasers strengthened the evidence that Duff & Phelps "was particularly aware of the 'select group of qualified investors' to whom its ratings would be given to induce Bond purchases."[58] Therefore, the court held that Duff & Phelps had a relationship "approaching privity" with the qualified investors and denied its motion to dismiss for lack of privity.[59]

While *LaSalle National Bank* appeared to state a narrow holding, there is no reason why it should not apply more broadly because the essential facts are present in every typical SFP offering. First, most SFP ratings serve a particular purpose because SFP offerings could not occur without a rating. Without an investment-grade rating, many qualified institutional

---

[54] *Id.* at 1093.
[55] *Id.* at 1093-94.
[56] While the court did not specifically disclose what type of credit enhancement features Duff & Phelps had advised Towers to utilize, the typical credit enhancement features are creation of tranches within a pool with superior priority over other tranches, creation of tranches with superior yield over other tranches, over-collateralization, and utilization of bond insurance as discussed in part I(C), *supra*.
[57] *Id.* at 1094.
[58] *Id.*
[59] *Id.* at 1095.

investors could not participate in the offering because regulations or privately-tailored restrictions would prevent them from purchasing the products. Because CRAs have this gatekeeping power, the ratins they issue serve a particular purpose.

Second, due to the large number of assets contained in a SFP and the complexity of the SFP's trust agreement, investors have no option but to rely on the rating. SFPs typically contain thousands of individual loans with different borrowers in different geographic regions bound by different terms and conditions. The complexity of a SFP is amplified by its trust agreement because most SFP trust agreements are littered with complex provisions that subordinate rights to future income streams between tranche owners and create indemnity relationships between the trust and insurers.[60] CRAs' ability to perform due diligence services on already existing ratings in exchange for a fee is further evidence of the complexity of SFPs and the reliance it creates between investors and CRAs. Because a SFP is so immensely complex, investors must rely on the credit rating to make an investment decision.

Finally, the process by which a SFP rating is created establishes conduct that links reliant investors to credit rating agencies. After the underwriter has forwarded information regarding the offering to credit rating agencies, the credit rating agencies disclose preliminary ratings of the different tranches to the underwriter. If the preliminary ratings do not conform with the underwriters' representations to potential investors, then the underwriter and the credit rating agency negotiate about modifying particular features of the trust's structure to ensure conformity with investors' expectations. While this preliminary negotiation might pass muster if the bargaining power of the parties was equal and no conflicts of interest were present, a typical SFP offering does not satisfy either of these requirements.

[60] *See* Part I(C), *supra*.

The fee of SFP rating equals as much as three times the amount of a typical bond-rating fee.[61] Furthermore, most SFP offerings are conducted by a small number of large investment banks, which are repeatedly returning to CRAs to rate new SFP offerings. If the CRAs want to ensure repeat, high-profit margin business; then the rating agencies must concede on particular points of the negotiation or suffer a major loss of business to a competitor who will probably concede on those points. Because the rating process is plagued by these conflicts of interest, CRAs are not acting in a disinterested fashion, which is conduct that links the CRAs to reliant third party investors. Therefore, a relationship "approaching privity" should be present between CRAs and SFP investors because the ratings serve a particular purpose, affect a known reliant party, and involve conflicted conduct by CRAs.

III. THE FIRST AMENDMENT'S LACK OF PROTECTION FOR STRUCTURED FINANCIAL PRODUCT RATINGS.

When rendering SFP ratings, CRAs should not qualify for First Amendment protection because SFP ratings are not matters "of public concern." Generally speaking, speech in the form of a credit rating is fully protected by the First Amendment because the intent of the speaker is to use the material to disseminate information to the public.[62] However, First Amendment protection is not granted to speech involving "no issue of public concern"[63] or to commercial speech.[64]

---

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

[62] *See, e.g.*, *Compuware Corp. v. Moody's Investors Servs., Inc.*, 499 F.3d 520, 529 (6th Cir. 2007); *Jefferson County School Dist. No. R-1 v. Moody's Investor's Servs., Inc.*, 175 F.3d 848, 856 (10th Cir. 1999).

[63] *See Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 757 (1985) (plurality).

[64] The commercial speech exception is well recognized in Supreme Court jurisprudence. *See Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 554 (2001); *U.S. v. United Foods, Inc.*, 533 U.S. 405, 409 (2001); *Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 504 (1996); *Rubin v. Coors Brewing Co.*, 514 U.S. 476, 482 (1995); *City of Cincinnati v. Discovery Network, Inc.*, 507 U.S. 410, 421 (1993); *Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc.*, 425 U.S.

A credit rating's "content, form, and context . . . as revealed by the whole record" indicates whether such rating is "of public concern" or not.[65] Some factors that indicate a credit rating is not a matter "of public concern" are the rating is rendered "solely in the individual interests of the speaker and its specific audience," the rating is "wholly false and clearly damaging," the rating is not broadly disseminated, the rating is "hardy and unlikely to be deterred by incidental state regulation,"[66] and the rating is "more objectively verifiable than speech deserving of greater protection".[67] Appling these factors, some courts have recently held that credit ratings are not matters "of public concern" and, accordingly, have denied CRAs of First Amendment protection.

LaSalle National Bank v. Duff & Phelps Credit Rating Co. sheds light on the lack of First Amendment protection entitled to CRAs in the SFP context. In *LaSalle National Bank*, LaSalle and other qualified institutional investors brought suit against Duff & Phelps for negligent misrepresentation, and Duff & Phelps moved to dismiss the action by asserting First Amendment immunity. However, the court rejected this argument because the rating was privately contracted for between the underwriter and Duff & Phelps.[68] Duff & Phelps also argued that it was entitled to publisher immunity because its rating had been broadly disseminated like other financial information entitled to First Amendment protection. The court also rejected this defense because

748, 761 (1976). However, applying the commercial speech exception to CRAs' SFP credit ratings could impose dire consequences on commercial entities seeking to protect their interests. For example, a misleading Consumer Reports opinion regarding the quality of a consumer product would fall within the commercial speech exception if Consumer Reports also received advertisement revenue from the manufacturer of that product. Such a result is inconsistent with the broad principles of the First Amendment. Thus, the commercial speech doctrine is inappropriate in this context.

[65] *See Dun & Bradstreet, Inc.*, 472 U.S. at 761.

[66] The court clarified that "hardy" speech is speech that is solely motivated by the desire for profit, which is a force that is less likely deterred than others. *See id.*

[67] *Id.*

[68] *See LaSalle Nat'l Bank*, 951 F. Supp. at 1096.

Duff & Phelps's rating was only published through a very limited means, i.e. the offering memoranda.[69] Because Duff & Phelps's rating was rendered in accordance with a specific, private contract and was disseminated only to a limited number of people, the court determined that the rating was not a matter "of pubic concern" and rejected Duff & Phelps's plea for First Amendment protection.

Another particularly instructive case regarding SFP rating's protection under the First Amendment is *In re Fitch, Inc.* where the Second Circuit only found that Fitch participated unlike a journalist in a SFP transaction, but nevertheless denied First Amendment protection. After bank regulators concluded that a bank's CDOs were not investment grade and compelled the bank to sell them, the bank demanded that its broker accept return of the CDOs. The broker refused to accept the CDOs. Accordingly, the Bank sued the broker and subpoenaed Fitch after learning that Fitch and the broker "had extensive communications about the structure of the transactions."[70] Fitch refused to comply with the subpoena asserting a defense under New York's shield law and the First Amendment. However, the district court rejected Fitch's defense because Fitch only covered its own clients, unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy. Unhappy with the district court's holding, Fitch appealed the district court's decision to the Second Circuit.

The Second Circuit noted that Fitch was not entitled to First Amendment protection because a Fitch employee took "a fairly active role . . . in commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings," which demonstrated "a level of involvement with the client's transactions that is not typical of the

[69] *Id.*
[70] *See In re Fitch*, 330 F.3d 104, 107 (2d Cir. 2003).

relationship between a journalist and the activities upon which the journalist reports."[71] Because Fitch was not behaving like a typical journalist, the court held that its CDO rating was not an issue "of public concern" and denied Fitch protection under the First Amendment.

Because most typical SFP ratings are rendered under factual circumstances similar to *LaSalle National Bank* and *Fitch*, a typical SFP rating should not possess First Amendment protection. First, SFP ratings are disseminated to a relatively small audience because most SFPs are offered to investors under Rule 144A. Rule 144A requires potential investors to be qualified institutional investors. Because qualified institutional investors must have assets in excess of $100 million, the audience of a SFP transaction is relatively small when compared to the audience of a newsworthy article.

Second, the ratings are solely in the individual interests of CRAs and their audience because only CRAs, underwriters, broker-dealers, and qualified institutional investors stand to financially benefit from information contained in the rating. Unlike a newsworthy article where the subject matter involves an issue that pertains to a broad class of individuals and entities, the outcome of a particular SFP rating only affects the interests of a select group of stakeholders. CRAs get upfront fees from the rating. Underwriters capture any gain between their basis in the assets contained in the SFP and the price that those assets are sold to investors in the form of a SFP. Broker-dealers usually get a piece of the underwriter's profit and investors hope to experience an increase in the value of their investment. Any other party involved, i.e. the mortgagors of the mortgages contained in the SFP, do not stand to benefit from the rating because their rights are already contractually fixed before the rating is rendered. Because the subject matter of a SFP rating do not directly bear upon an issue that affects a broad class of

[71] *Id.* at 110.

individuals and entities, a SFP rating is solely in the interests of CRAs and other SFP market participants.

Third, while many SFP ratings were not verifiably false prior to the financial meltdown, the subsequent downgrades and resulting losses are evidence that they were misleading and clearly damaging. As indicated in Part I(F), *supra*, the default rates of asset-backed securities varied significantly from other asset classes with the same credit rating between 2000 and 2007.

Fourth, the ratings are hardy, and unlikely deterred, because they provide CRAs with huge profits. Moody's and Standard & Poor's had operating profit margins equal to 53.6% and 44%, respectively, during the 2005-2007 timeframe. Furthermore, CRAs have continued doing business with severe conflicts of interest -- back-and-forth negotiation, issuer-pays model, etc. -- despite regulations prohibiting analogous conduct. Because CRAs have reaped major profits from these ratings and have rendered these ratings through seriously conflicted processes, despite regulation, SFP ratings are hardy speech that is unlikely deterred by further regulation.

Finally, SFP ratings are more objectively verifiable than political opinion, or other strictly protected speech, because of their numerical nature. As indicated in Part I(D), most of the SFP rating process involves applying assumptions to the underlying performance of an SFP's assets to determine the SFP's performance in varying market conditions. Therefore, a typical SFP rating is probably not a matter "of public concern," which deserves First Amendment protection, because a typical SFP's "content, form, and context" indicates that it is not a matter "of public concern."

CONCLUSION

The egregious errors committed by CRAs during the boom days of SFPs are factually similar to the egregious errors committed by accounting firms during the Enron, WorldCom, and Adelphia scandals. Yet, Congress has refused to address the conflicts of interest and poor management practices inherent in a typical SFP rating. Thus, courts should slacken the privity requirement in suits by third party beneficiaries of SPF ratings to respond to a problem that Congress is unwilling to address. For similar reasons, courts should not shield CRAs from liability by applying the First Amendment. Both approaches clearly fall within established legal exceptions and will protect the coffers of Wall Street and Main Street.