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Grading the Rating Agencies

Greater exposure to litigation and regulation may lie ahead

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In the wake of the meltdown in the sub-prime mortgage market, increased scrutiny has been focused on both the mortgage-backed securities that many blame for fueling the crisis and the rating agencies that evaluated and graded them before they were sold to investors. Although likely unknown to the general public until the housing market tumbled, mortgage-backed securities have joined other previously obscure financial instruments, like credit default swaps and collateralized debt obligations, at the forefront of the public debate over the current situation. At the same time, the rating agencies that were required to evaluate these securities to ensure that they were "investment grade" have increasingly found themselves in the crosshairs of regulators and disgruntled investors. While rating agencies have traditionally enjoyed broad First Amendment protection from liability for the ratings they provide, these protections are now being challenged. This article examines the role of the rating agencies in the market, the immunity they have traditionally enjoyed and the recent events that may move the agencies towards greater exposure to litigation and regulation.

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As the name suggests, mortgage-backed securities are large groups of mortgages that are pooled together to create securities, similar to bonds, that can be sold to investors. Although they come in many different forms — from simple "pass-through" certificates to more complicated collateralized-mortgage obligations — the overwhelming majority of mortgages issued by banks and lenders in the United States are eventually packaged into some type of mortgage-backed security.

Because they are complicated and usually issued only in large denominations, the market for these securities is essentially limited to large, institutional investors. Before entities like these can purchase mortgage-backed securities, the securities must first be rated "investment grade" by one or more of the 10 registered rating agencies, of which Standard & Poor's, Moody's and Fitch are the largest. Accordingly, the issuer provides the rating agencies with information about the security that the agencies then use to determine the security's credit-worthiness and provide a rating. While the rating agencies do not structure the actual security, the process leading up to a rating usually involves some participation by the agencies — the level of which varies and is hotly disputed — regarding the requirements needed to attain a desired rating.

With mortgage-backed securities, the ratings are only meant to describe the likelihood of default. However, investors have alleged that they perceive the rating as a measure of the financial strength of the underlying mortgages. Accordingly, when mortgage-backed securities that were rated as investment grade dropped precipitously in value after the downturn in the housing market, investors and regulators alike began to question the accuracy of the ratings and the independence of the rating agencies. Specifically, the agencies have been criticized for rating securities containing risky, sub-prime mortgages too highly and failing to change these ratings when it became clear that borrowers were beginning to default on these loans in record numbers.

Criticisms like these are not new. Similar complaints emerged after high-profile financial crises in the past. In fact, the landscape in which rating agencies operate has largely been shaped by some of the most notable financial collapses in recent memory. The First Amendment protection enjoyed by the agencies in connection with their ratings was first recognized by courts after the largest municipal bankruptcy in United States history. The propriety of this approach was questioned, but left largely intact, after Enron's demise, when the rating agencies continued to rate Enron's debt as investment grade four days before the company filed for bankruptcy. Now, in response to the collapse in the sub-prime mortgage markets, both the courts and Congress are once again taking a close look at the role the rating agencies play in the market and the immunity they have historically enjoyed. Ultimately, although the law in this area remains in a state of flux, it appears clear that courts are taking a more expansive approach to rating agency liability with each passing crisis.

One of the earliest reported decisions discussing the potential liability of rating agencies was issued after Orange County, California, filed for bankruptcy in 1994. In that case, the district court established an elevated standard for rating agency liability, ruling that rating agencies were financial publishers who could only be held liable for allegedly misleading ratings upon a showing of "actual malice." Proving actual malice requires a showing that the rating agency had a "high degree of awareness of probable falsity," and not simply that a "reasonably prudent person" would have investigated certain issues further. Accordingly, the rating agencies were effectively immunized from liability. In its decision, however, the district court cautioned that these First Amendment protections might not apply in situations where a rating agency acts as more than just a financial publisher, and instead provides substantive financial services or advice to the issuer.

As it did for so many other aspects of the business world, however, the collapse of Enron seven years later changed the landscape in which the rating agencies operated. In a lawsuit arising out of Enron's sudden demise, a federal court in Texas ruled that the rating agencies were entitled to First Amendment protection for their ratings, but cautioned that this protection was "qualified." The district court observed that there were several seemingly inherent conflicts of interest between the agencies and the banks that hired them that might expose the rating agencies to liability. Another court put an even finer point on these concerns, holding that the relationship between issuers and rating agencies is "more analogous" to that of a client and its accountant or consultant, and the opinions rendered by the rating agencies more like advice than opinions that are generally entitled to constitutional protection. While these courts still applied the heightened "actual malice" standard that had been established years before, they expressed a willingness to consider a lesser standard in the appropriate situation.

The collapse of the sub-prime mortgage market may have presented courts with just such a situation. A recent decision from a federal court in New York suggests that courts are looking to narrow the First Amendment protections enjoyed by the rating agencies. That case involved a structured investment vehicle ("SIV") that "collapsed amid the credit crisis," despite having been given the "highest possible rating" by the rating agencies. In denying the rating agencies' motion to dismiss the complaint, the court acknowledged that the First Amendment protects rating agencies "under typical circumstances," but held that "typical circumstances" do not include instances where ratings are provided to "a select group of investors" as opposed to the public at large. The court further held that the ratings could not fairly be characterized as "non-actionable opinions" because the rating agencies did not "genuinely or reasonably believe" that their ratings were "accurate and had a basis in fact." Whether other courts follow this approach — particularly where ratings are provided for a public offering as opposed to a private offering — remains to be seen, but this decision is an important development because it is one of the rare instances where the rating agencies were denied the protections of the First Amendment.

The financial calamities described above have served, not only as the impetus for increased scrutiny from courts, but also for increased regulation from Congress. In response to the perceived role of the rating agencies in Enron's bankruptcy, Congress passed the Credit Rating Agency Reform Act, which gave the Securities and Exchange Commission more authority over the registration and regulation of rating agencies. After the collapse of the sub-prime mortgage markets, Congress has again revisited regulation, and the House of Representatives recently passed the Accountability and Transparency in Rating Agencies Act, which, among other things, creates a private cause of action against rating agencies for gross negligence. As some commentators have noted, this is a curious provision because it would make it easier to sue a rating agency for rating a security than the bank that issued the security (who could only be liable if plaintiffs could proffer facts that "give rise to a strong inference of fraud"). Ultimately, however, the amount of change that is brought to bear on the rating agencies may depend more on the strength of the economy than anything else. As the brief history recounted above reveals, interest in regulating the rating agencies tends to be inversely proportional to the overall strength of the economy, and this latest wave may therefore begin to wane as the economy improves.

Nonetheless, the implications of the changes described above extend beyond the mortgage-backed securities that were at the center of the credit crisis. Rating agencies evaluate all types of debentures and similar securities that are backed by assets ranging from student loan payments to the royalty stream from David Bowie's music catalog. As with mortgage-backed securities, these offerings are widely held by many of the same institutions, hedge funds and other large investors that have been impacted by the downturn in the mortgage market. Thus, the pressures that the rating agencies are currently experiencing may provide a cautionary tale for other portions of the securitization market and lead to change in the industry as a whole. ■