WHO'S GUARDING THE GATE? CREDIT-RATING AGENCY LIABILITY AS "CONTROL PERSON" IN THE SUBPRIME CREDIT CRISIS

> Imagine a country where a fifth of all mortgages are taken out by the shakiest borrowers. About half of those loans are written by companies that are almost entirely unregulated. The mortgages, on average, are worth almost 95% of the underlying house. Half of them demand no documentation of the borrowers' income.
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> These loans are then bundled and sliced into complicated debt instruments. The risk of these is gauged by credit-rating agencies which are paid by the very firms that created the securities and which make a lot of their money from advising on how to win the best ratings. Many of these structured debt instruments are bought by banks in other countries using off-balance-sheet entities for which they make little capital provision and about which banking supervisors know virtually nothing.[1]

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> Just remember this, Mr. Potter: that this rabble you're talking about, they do most of the working and paying and living and dying in this community. Well, is it too much to have them work and pay and live and die in a couple of decent rooms and a bath?[2]

INTRODUCTION

Home ownership and its central place in "the American dream" provided the background to the film classic *It's a Wonderful Life*. The film depicts George Bailey, a small-town banker who is desperate to save the Bailey Building and Loan Association so that the poor families in the town could continue to buy modest homes, rather than rent from the town slumlord, Mr. Potter. Although the story is dated relative to the complex financial institutions of today, that emotional connection to home ownership remains an important piece of the American dream. Today, the high value placed on home ownership continues to drive the American economy, along with its politics and fiscal policies. An unfortunate result of that drive was an increasingly lax lending environment that drove home

1. *On Credit Watch: Financial Supervision has been Found Wanting*, ECONOMIST, Oct. 20, 2007, at 24.
2. George Bailey to Mr. Potter, in IT'S A WONDERFUL LIFE (Liberty Films 1946).

ownership to record levels in the past decade, but that also set the stage for a disastrous financial event.[3]

The American economy is currently embroiled in a significant disruption in credit supply resulting from a major market failure in the securitization of mortgage debt into investment-grade securities. After the dot-com bust in 2001, investors increasingly turned to mortgage-backed securities[4] to pursue their desired rates of return.[5] This increased demand for mortgage-backed securities drove a major expansion in the use of mortgage-loan products aimed at individuals previously unqualified for home financing,[6] due to either their income or their FICO[7] scores being too low to qualify for traditional "prime" mortgages.[8] Lenders began extending home financing to these "subprime" borrowers at alarming rates, and an eager investment community readily funded these subprime loans through the magic of securitization.[9] The loans to the subprime market included several high-risk features: small or no down payments, high loan-to-value ratios, interest-only payment schedules, reverse-amortization loans (increasing rather than decreasing principal), or adjustable-rate mortgages (ARM) with prepayment penalties and initial "teaser rates."[10] In a rapidly appreciating real estate market where prices were rising at highly unusual rates, these mortgage products appeared to be safe.[11] When real estate prices

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3. *See* Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, at A1 (explaining the reluctance of the Federal Reserve and the Bush administration to reign in the subprime lending practices, despite growing evidence of predatory lending practices, in order to support President Bush's "ownership society" initiatives); U.S. CENSUS BUREAU, HOUSING VACANCIES AND HOMEOWNERSHIP (2006), http://www.census.gov/hhes/www/housing/hvs/annual06/ann06t12.html (showing national home-ownership rate hovering at 64% during the period 1960–1995, but then increasing to approximately 69% in 2006).

4. Mortgage-backed securities are large numbers of mortgages that are pooled and then divided into securities and sold to investors. The investors then own an entitlement to the cash flows generated from the principal and interest payments of those mortgages.

5. Bill Cummings, *Housing Crisis Hits Home*, CONN. POST (Bridgeport), Oct. 28, 2007, *available at* 2007 WLNR 21249914.

6. Ruth Simon et al., *Housing-Bubble Talk Doesn't Scare Off Foreigners*, WALL ST. J., Aug. 24, 2005, at A1.

7. FICO scores are issued by the Fair Isaac Corporation and estimate an individual's credit worthiness. They are widely used as a tool to determine whether credit should be extended to an individual.

8. Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: Not Again!*, AM. BANKR. INST. J., Sept. 2007, at 6.

9. Simon et al., *supra* note 6, at A1.

10. Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, at A1.

11. James J. Cramer, *Bloody and Bloodier*, N.Y. TIMES, Aug. 20, 2007 (Magazine), *available at* http://nymag.com/news/businessfinance/bottomline/35813.

> Where did the money come from? Banks lent it, mortgage brokers lent it, and even home builders themselves got into the act. The housing markets were so hot the lenders barely had time to check if their buyers were deadbeats, cheats,

are rising consistently, mortgages with these features are attractive and seemingly low risk because the borrower retains the option of refinancing the mortgage in the future. When values fall, however, that option evaporates, leaving the mortgagor holding a debt that may no longer be affordable and whose underlying property cannot be sold to cover the debt. Always lurking in the background of the real estate and subprime boom was a nightmare scenario: rising interest rates and decreasing property values would render many of the loan payments unmanageable for the high-risk subprime borrower and cause many of them to default.[12]

This Note will focus on the liability of credit-rating agencies (rating agencies) to the investors who purchased these now-failing mortgage-backed securities, possibly in reliance on the debt ratings issued by rating agencies. In July 2007, Bear Stearns, a major investment bank, announced that two of its hedge funds with significant investments in mortgage-backed securities were nearly valueless, just a week after both Moody's and Standard & Poor announced a series of bond downgrades related to weakness in mortgage-backed securities.[13] Bear Stearns' announcement

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> speculators, or actual honest-to-Betsy hardworking people who wanted nothing more than what Tom Joad wanted 70 years ago. Oh, and the buyers didn't have time to check out the terms, either; the value of the houses was going up too fast. Gotta close now! Nor did the regulators tap the brakes—whoops, there were no regulators. If something went wrong, who cares? The buyers could always sell their ever-appreciating home to the next guy on the reservation list or the ten after him. The builders, brokers, and bankers then shipped these mortgages east to the big Wall Street firms, which bundled them together and merchandised them as high-yielding bonds often backed up by nothing more than the full faith and credit of, well, no one.
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> Over and over, Greenspan hailed these fabulous financial breakthroughs that gave everyone a chance at the American Dream (or multiple dreams, in the case of speculators who took down homes and flipped them). And why not? Don't homes always increase in value? Won't there always be willing buyers armed with ARMs?
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> Except that wasn't how it went down. The same guy who prescribed the mortgage elixir for all Americans then laced it with seventeen straight interest-rate increases, increases that brought rates to levels so high that legions of people who bought a home with a teaser rate couldn't afford the payments. Between 2004 and 2006, just as interest rates started spiking and homes kept being churned out in these saturated areas, 14 million families purchased houses, many taking advantage of teasers and piggybacks. Given that the average home went for about $250,000, that's hundreds of billions in loans that cost a lot more per month than when they were taken. Now these people are stuck. They can't refinance because the rates are too high, and they can't sell their homes to repay their mortgage, either. In every area of this country—and in particular, in the once-hot markets like the ones I mentioned earlier—there are just too many other homes for sale and too many new homes still being pumped out.

Id.

12. *Id*.

13. Frank McGuire, *Year-End Review of Markets and Finance 2007*, WALL ST. J., January 2, 2008, at R12.

marked the beginning of a financial crisis whose impacts are still being realized. Credit markets have tightened significantly as banks attempt to guard against further losses. Tightened credit translates into less access to capital for corporations, municipalities, and individuals; placing the entire economy in a precarious position.

The rating agencies played a central role in this drama and are currently under investigation by the Securities and Exchange Commission (SEC).[14] Allegations are being made that the rating agencies violated conflict of interest safeguards.[15] They not only rated the mortgage-backed securities and related instruments, but acted in a consulting role with the investment banks to structure complex securities that converted risky subprime mortgage-backed products into AAA-grade securities.[16] Because the rating agencies are paid by the investment banks for both the consulting services and the ratings process, there is a great deal of suspicion within the investment community that the rating agencies facilitated a sort of "alchemy"—converting high-risk mortgages into seemingly low-risk investment vehicles.[17] Only after the bottom dropped out of the real estate market did that mitigated risk surface and ultimately show that the risk never left.

The credit-rating agencies have enjoyed significant barriers to liability in past financial and corporate scandals. Part I of this Note will examine the background of mortgage-backed securities and related structured securities and then describe the special risks involved in these products. Part II will provide an overview of the current subprime lending crisis. Part III will then detail the role of the rating agencies within the mortgage-backed securities market, focusing on the regulatory environment and the potential conflict of interest that exists when the rating agencies are paid by the firms that are issuing the securities. Part IV will then review the barriers to liability of the rating agencies to damaged investors, first looking at the

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14. Stephen Labaton, *Debt-Rating Agencies Are Under Scrutiny by S.E.C.*, N.Y. TIMES, Sept. 27, 2007, at C4.

15. *Id.*

16. *Id.*

17. John C. Coffee, Jr., *The Mortgage Meltdown and Gatekeeper Failure*, N.Y. L.J., Sept. 20, 2007, at 5. For a broad discussion of asset securitization, see Stephen L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994).

> [S]ecuritization is an alchemy that really works. In securitization, a company partly "deconstructs" itself by separating certain types of highly liquid assets from the risks generally associated with the company. The company can then use these assets to raise funds in the capital markets at a lower cost than if the company, with its associated risks, could have raised the funds directly by issuing more debt or equity. The company retains the savings generated by these lower costs, while investors in the securitized assets benefit by holding investments with lower risk.

Id. at 134 (footnotes omitted).

traditional threshold, publication-of-opinion, protection that rating agencies enjoy under the First Amendment of the United States Constitution.[18] This Part will then cover the heightened pleading standards required for private securities litigation and why those standards present significant challenges to investors and possible litigation against the rating agencies.

Finally, in Part V, this Note proposes Control Person Liability under § 20(a) of the Securities Exchange Act of 1934 as the most likely path to successful litigation against the rating agencies. A circuit split regarding the definition of "control person" under this Act will be examined and applied to the circumstances surrounding rating-agency actions within the subprime crisis. Given the current crisis and importance of ensuring that this breakdown in financial markets is averted in the future, this Note concludes that plaintiffs may find success in the Second Circuit, but that the Fifth Circuit standard for defining "control person" offers the greatest odds of success. The rating agencies may suffer liability in forthcoming litigation if plaintiffs follow this pathway. These agencies will thus be held accountable for their alleged contribution to the significant damage suffered by investors who relied on investment-grade ratings to risk billions of dollars of investment funds.

I. BACKGROUND OF MORTGAGE-BACKED SECURITIES

A. Changes in Mortgage Industry

The residential-home lending industry has seen tremendous change over the past two decades. Traditionally, a person wishing to purchase a new home sought a loan from the local branch of a bank or similar financial institution. That bank then collected payment on that loan over the usual thirty-year amortization schedule, and once the debt was settled, the underlying mortgage was released. Today, that type of financial arrangement is the anomaly. Banks and other lenders generally do not want to carry long-term residential loans as assets and thus sell these debts and underlying mortgages to other financial entities.[19] These debts are then pooled together in large numbers, divided into risk levels, and issued as securities, which are then sold to investors.[20]

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18. U.S. CONST. amend. I.

19. Joseph R. Mason & Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions 10 (unpublished draft, May 14, 2007), http://www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf.

20. *See* Michael C. McGrath, *Structural and Legal Issues in Securitization Transactions*, *in* ASSET BASED FINANCING 2007, COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 491,

This basic process of securitization, wherein the loan originator passes on the credit risk to the mortgage-backed-security investor, decouples the traditionally inherent incentives of the lender to ensure that the borrower is credit-worthy.[21] This very basic and inevitable effect of securitization is at the very heart of the subprime lending crisis. Although the securitization process manages the transferred credit risk effectively under normal market conditions, that risk is ultimately realized in rising default rates due to increasingly lax lending standards.[22] The discussion below will detail the structure of the mortgage-backed securities and derivative securities for the purpose of understanding the role of the credit-rating agencies in the securitization process and in the unraveling mortgage-backed securities market.

B. Mortgage-Backed Securities

> Securitization is the process whereby a large number of financial contracts, receivables or, in some instances, operating assets . . . are transferred by the originator, seller or lessor to a bankruptcy-remote entity which (directly or indirectly) issues a new financial instrument either collateralized by, or representing an ownership interest in, the financial contracts and the receivables thereunder.[23]

Mortgage-backed securities are, in simplest terms, a variety of fixed-income investment, much like municipal or corporate bonds.[24] Mortgages are pooled together, and then the entitlement to collect the principal and interest payments is divided and sold as securities.[25] The simplest form of a mortgage-backed

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493 (2007) (quoting Regulation AB, 17 C.F.R. § 229.1101(c)(1) (2008)) ("[A]n asset backed security [is defined] as a security that 'is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite period of time.'").

21. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007) (discussing the hazards of securitization to the borrower that "dilute[] incentives by lenders and brokers to avoid making loans with excessive default risk by allowing them to shift that risk to the secondary market, which has other ways to protect itself").

22. For an extensive discussion of the many risks inherent in mortgage-backed securities, see Joseph R. Mason & Joshua Rosner, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? (February 13, 2007), http://www.hudson.org/files/publications/Mason_RosnerFeb15Event.pdf.

23. McGrath, *supra* note 20, at 493.

24. Mark Adelson, *MBS Basics*, *in* NUTS & BOLTS OF FINANCIAL PRODUCTS 2007: UNDERSTANDING THE EVOLVING WORLD OF CAPITAL MARKET AND INVESTMENT MANAGEMENT PRODUCTS, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 359, 361 (2007).

25. *Id*. at 364.

security is the "pass-through" security, in which the payments on the underlying mortgages, including both principal and interest, are simply "passed through" to the investors in that particular pool of mortgages.[26]

Mortgage-backed securities, though, contain special features that distinguish them from conventional investment bonds and make accurate valuation a more difficult task for investment professionals.[27] In most mortgage loans issued within the United States, a prepayment option is available to borrowers that allows for prepayment of the loan without any penalty.[28] The investor who owns shares of a mortgage-backed-security pool expects a certain cash flow from that investment. Prepayment of a loan within that pool disrupts that expected cash flow. Default risk is defined as "the risk that a borrower will not repay, on time and in full, all principal and interest as promised in the financial instrument."[29] Default risk is well understood after years of statistical history with FICO scores.[30] However, that same level of understanding for prepayment risk is absent.[31] Prepayment risk is a function of variables not normally at play in risk calculations.[32]

The prepayment risk is amplified because of an interesting effect: standard interest-rate risk dictates that as interest rates rise, "the value of the mortgage pool declines" because the interest payments are less than what is available in the current market.[33] The reverse economic condition of falling interest rates causes the value of the mortgage pool to increase but also creates a strong incentive for the borrower to refinance the underlying mortgage at lower interest rates.[34] This refinancing deprives the investor of expected interest payments.[35] Thus, when interest rates move in either direction, an investor in a mortgage-backed security suffers a loss, either in value of the security or in loss of interest payments.[36]

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26. *Id*.
27. Mason & Rosner, *supra* note 22, at 16–19.

> MBS, like other fixed-income financial instruments, are valued as the present discounted value of expected cash flows. Like most fixed-income investments, MBS are affected by default risk. MBS, however, are substantially affected by prepayment risk—that is, the risk that the borrower will unexpectedly pay off the loan early. While a great deal is known about measuring borrower default risk, relatively little is known about measuring borrower prepayment risk.

Id. at 16–17 (footnote omitted).

28. Adelson, *supra* note 24, at 361.
29. Mason & Rosner, *supra* note 22, at 17 n.20.
30. *Id.* at 17.
31. *Id*.
32. *Id*.
33. *Id*. at 18.
34. *Id.*
35. *Id*.
36. *Id*.

The surge in mortgage-backed securities can be traced to this prepayment risk and the resulting higher yield to investors. In recent years, as the Federal Reserve Board raised interest rates (an action that normally represses housing demand), lenders responded by easing credit terms for borrowers to meet the increasing appetite for high-yield mortgage-backed securities.[37] Between 2000 and 2005, outstanding mortgage-backed securities grew by 61%, totaling $4.6 trillion in March 2005.[38] This trend continued despite increasingly dire warnings of an impending crisis of defaults, with approximately $6.5 trillion in outstanding securitized mortgages at the end of 2006.[39]

C. Collateralized Debt Obligations: Further Complicating the Risk Evaluations

The difficulty in assessing risk in mortgage-backed securities is further complicated by an ingenious and complex financial instrument known as a collateralized debt obligation (CDO). A CDO is similar to a mortgage-backed security in that it involves pools of debt contracts.[40] A *cash flow* CDO is comprised of real fixed-income assets purchased by a bankruptcy-remote Special Purpose Entity, which are then sliced into "tranches" by issuing new securities specific to each tranche.[41] The tranches are organized from senior to most junior according to priority of payment of underlying debt obligations.[42] In other words, the cash flow from the underlying assets is paid first to the senior tranche, and then to each subsequent junior tranche, much like a cascading "waterfall."[43] A junior tranche is entitled to its expected cash flow only after all the more senior tranches have been fully paid.[44]

This cascading effect provides an opportunity for investors to purchase securities with higher credit ratings than the underlying mortgage-backed

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37. Cramer, *supra* note 11.

38. Simon et al., *supra* note 6, at A1.

39. Gretchen Morgenson, *Foreclosures Hit a Snag for Lenders*, N.Y. TIMES, Nov. 15, 2007, at C1, *available at* 2007 WLNR 22578820.

40. Frank Partnoy & David A. Skeel, Jr., *The Promise and Peril of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007). The authors note that "[c]redit derivatives play an increasingly important and controversial role in financial markets. Commentators have labeled credit derivatives as either good or evil: some have lauded them for enabling banks to hedge credit risks while others have warned of hidden dangers and systemic risks." *Id*. at 1020–21 (citations omitted).

41. Dave Mulcahey, *Tranche Warfare*, IN THESE TIMES, July 17, 2007, http://www.inthesetimes.com/main/article/3275.

42. Partnoy & Skeel, *supra* note 40, at 1027–28.

43. Engel & McCoy, *supra* note 21, at 2047.

44. *Id.*

security.[45] Here is where the credit-rating agencies stepped in, providing "investment grade" ratings to all but the most junior tranches of CDOs.[46] Investors were unaware that the rating agencies "were helping issuers construct the very financial instruments they eventually judged."[47] The CDO issuer worked with the rating agency on structuring the CDO to maximize value of the issued securities by minimizing the "non-investment grade" tranches.[48] The complexity of CDOs, and the difficulty in assigning risk to the individual tranches, compelled investment banks to involve these agencies in the process.[49] In addition, that complexity resulted in much higher fees charged for the rating service, compared to fees for traditional bond offerings, and those structured finance ratings fees now make up as much as one-half of the rating agencies' revenues.[50] The sizable structured finance revenues are derived from a small number of investment-bank clients, giving those clients a significant amount of market power.[51] This has seriously brought the objectivity of the rating agencies and their management of conflict-of-interest concerns into question.[52]

II. THE SUBPRIME LENDING CRISIS

The United States experienced a tremendous appreciation in residential home values in the past decade. This was, to some degree, propelled by increasingly lax lending standards that provided access to capital for a much broader swath of the U.S. population.[53] These lax lending standards were in turn driven by a growing appetite within the investing public for high-yield mortgage-backed securities, including those backed by subprime mortgages.[54] Analysts have observed that lenders "have become less stringent in their loan terms because they can sell almost any type of loan to those who package mortgage securities for investors."[55]

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45. Portnoy & Skeel, *supra* note 40, at 1028.

46. Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2204 (2007).

47. Arthur Leavitt Jr., *Regulatory Underkill*, WALL ST. J., March 21, 2008, at A13. Mr. Leavitt Jr., chairman of the SEC from 1993 to 2001, opposes the SEC's current lack of regulatory oversight needed to ensure the objectivity of rating agencies. *Id.*

48. *See* Coffee, *supra* note 17, at 2 (commenting on the maneuvering necessary to get a credit rating "into the promised land of investment grade").

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id*. For a more thorough discussion of these concerns, see *infra* Part III.B.

53. Simon et al., *supra* note 6, at A1.

54. *Id.*

55. *Id.*

Historically, banks made a profit by the interest-rate spread—the difference between interest paid to depositors and the interest earned from outstanding loans—and other miscellaneous banking fees. Now, with securitization, lending banks quickly take those receivables off their books by selling them to the securitizers.[56] The fees and points collected during the origination of the mortgages drives the lending institutions to obtain an ever-increasing number of mortgages.[57] By selling those receivables and the attached risk, the originators are not married to that risk and thus face little incentive to engage actively in traditional risk minimization.[58]

As housing prices escalated in the past decade, increasing numbers of individuals were motivated to purchase residential properties. These properties were purchased for primary residences, long-term investment properties, second homes, or in many cases, for the purpose of "flipping" the property—buying the property during accelerating valuation periods with the clear intention of quickly selling at a nice profit. Because home values had been increasing steadily, and in some areas rapidly, individuals became highly confident that the trend would continue. This überconfidence was not diminished by the numerous historical examples of past housing boom-bust cycles.[59] Such confidence is closely akin to the "irrational exuberance" problem identified in the 1990s by Alan Greenspan, then the Chairman of the Federal Reserve, regarding the perceived bubble in the U.S. stock market.[60] Alan Greenspan's fear of the possible impacts of

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56. Mason & Rosner, *supra* note 22, at 14.

57. *Id.*

58. *See id*. at 14–15 ("[T]he focus of some lenders has shifted from assessing the ability of borrowers to repay both principal and interest during the life of the loan to a greater emphasis on the repayment of interest.").

59. Alan Greenspan, Chairman, Fed. Reserve, Remarks at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, D.C.: The Challenge of Central Banking in a Democratic Society (Dec. 5, 1996) (transcript available at http://federalreserve.gov/ (search for "Challenge of Central," then follow "FRB: Speech, Greenspan" hyperlink)).

60. *Id.*

> Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance

collapsing asset values on the broader economy are being realized in the current perfect storm of falling real-estate values, accelerating default and foreclosure rates, and severe tightening of worldwide credit markets.[61]

The depth and breadth of this crisis is still evolving and coming into focus. The general perception is that the borrowers who took out these subprime loans were either high credit risks with low FICO scores or low-income borrowers who took out no-documentation loans, or were otherwise unqualified for the amount of debt they were taking on.[62] However, that perception is changing as analysis of the underlying debts show that a large percentage of those loans went to prime borrowers.[63] The peak year of the subprime-lending boom was 2005 and data shows that 55% of those loans were made to borrowers with relatively high FICO scores.[64] This surprising trend can be explained by the aggressive practices of mortgage lenders and the compensation structures of the mortgage brokers pushing the loan packages.[65] It also reflects on the "irrational exuberance" of borrowers who could qualify for better loan packages.[66] These borrowers were so confident in the real estate market that they felt safe in securing higher-interest-rate loans or ARMs.[67] Some thought they could simply refinance or sell the property quickly in what appeared to be an ever-appreciating market.[68] Other borrowers just wanted to get a quick loan for a speculative property purchase without all the normal hassles associated with traditional full-documentation loans.[69] A recent special report by Fitch Ratings found that defaults were exceeding expectations.[70] Even when factors such as low-

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> sheets generally, and in asset prices particularly, must be an integral part of the development of monetary policy.

Id.

61. Cramer, *supra* note 11.
62. Brooks & Simon, *supra* note 10, at A1.
63. *Id.*
64. *Id*.

> In 2005, the peak year of the subprime boom, the study says that borrowers with such credit scores got more than half—55%—of all subprime mortgages that were ultimately packaged into securities for sale to investors, as most subprime loans are. The study by First American LoanPerformance, a San Francisco research firm, says the proportion rose even higher by the end of 2006, to 61%. The figure was just 41% in 2000, according to the study. Even a significant number of borrowers with top-notch credit signed up for expensive subprime loans, the firm's analysis found.

Id.

65. *Id*.
66. *See supra* text accompanying note 60.
67. Brooks & Simon, *supra* note 10, at A1.
68. *Id.*
69. *Id*.
70. FITCH RATINGS, RESIDENTIAL MORTGAGE SPECIAL REPORT: DRIVERS OF 2006 SUBPRIME

equity and low-income documentation were considered, it was "evident that poor underwriting and, in some instances, extensive fraud have generated loans that are even weaker than their attributes would suggest."[71] In a later Fitch press release regarding steps that the credit-rating agency was taking to mitigate future impacts on the accuracy of its ratings, the firm explained the lending practices that lead to this problem:

> [F]or an origination program that relies on owner occupancy to offset other risk factors, a borrower fraudulently stating intent to occupy will dramatically alter the probability of the loan defaulting. When this scenario happens with a borrower who purchased the property as a short-term investment, based on the anticipation that the value would increase, the layering of risk is greatly multiplied. If the same borrower also misrepresented his income, and cannot afford to make the payments, the loan will almost certainly default and result in a loss, as there is no type of loss mitigation, including modification, which can rectify these issues.[72]

Although financial analysts began warning of these converging problems within the home-lending industry and the mortgage-backed-securities market years ago, the trends continued. The still-appreciating real-estate market was irresistible to buyers, and the high yields of the subprime-backed products were irresistible to investors.[73] Signs of a weakening housing market began appearing in 2005.[74] These steadily escalating warnings did nothing to stop the growing reliance on risky mortgage products.[75]

This scenario has resulted in falling home prices, an increasing number of foreclosures, and a credit and money market that is suddenly short on liquidity. Henry Paulson, the current U.S. Treasury Secretary, has acknowledged that technological innovations in the financial markets "got

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VINTAGE PERFORMANCE 10 (2007), *available at* http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=353344 (subscription required).

71. *Id.* at 10.

72. Press Release, Fitch Ratings, Fitch: Underwriting & Fraud Significant Drivers of Subprime Defaults (Nov. 28, 2007), *available at* http://www.americansecuritization.com/uploadedFiles/Fitch_Originators_1128.pdf [hereinafter *Fitch Press Release*].

73. Simon et al., *supra* note 6, at A1.

74. *See* A. Gary Shilling, *The Pin That Burst the Housing Bubble*, FORBES.COM, July 21, 2005, http://www.forbes.com/columnists/investmentnewsletters/2005/07/21/lennar-hovnanian-kb-cz_ags_0721soapbox_inl.html (citing rampant speculation and the inevitable increase in housing inventory when housing prices become unsustainable and rents do not support investment property purchase).

75. *Id.*

ahead of" the regulatory ability of government agencies.[76] The ratings of the CDOs were higher than the underlying securities and there was serious opacity in these instruments that rendered their true risk indeterminate to even sophisticated investors.[77] Consequently, these securities, which were rated as safe, suddenly lost value.[78]

As this financial crisis unfolds, harmed investors are seeking blameworthy defendants from whom to recoup their losses. Primary among those discussed as potential defendants are the investment banks, the lenders, and the credit-rating agencies. The role of the rating agencies and the particular challenges of successfully litigating against them will be discussed in the following parts.

III. THE CREDIT-RATING AGENCIES

There are many credit-rating agencies operating in the U.S. market, but the three most prominent are Standard & Poor's (S&P), Moody's, and Fitch. These companies have operated for many years by issuing credit ratings on various bonds and other securities. In the past, a rating agency's revenue was derived from subscription fees paid for access to its issued ratings, but in recent decades they moved to an issuer-paid revenue stream.[79] Thus, the rating agencies are now working for the firms whose securities they are rating.

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76. Paul Krugman, Op-Ed, *Innovating Our Way to Financial Crisis*, N.Y. TIMES, Dec. 3, 2007, at A25.

> In a direct sense, this collapse of trust has been caused by the bursting of the housing bubble. The run-up of home prices made even less sense than the dot-com bubble—I mean, there wasn't even a glamorous new technology to justify claims that old rules no longer applied—but somehow financial markets accepted crazy home prices as the new normal. And when the bubble burst, a lot of investments that were labeled AAA turned out to be junk.

Id.

77. *Id.*

78. *Id*.

> Thus, "super-senior" claims against subprime mortgages—that is, investments that have first dibs on whatever mortgage payments borrowers make, and were therefore supposed to pay off in full even if a sizable fraction of these borrowers defaulted on their debts—have lost a third of their market value since July.

Id.

79. JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 295–96 (2006).

A. Regulation and the Credit-Rating Agencies

The SEC has relied since 1975 on what it calls "Nationally Recognized Statistical Ratings Organizations" (NRSROs) as a means of distinguishing between levels of credit worthiness under various SEC regulations.[80] The use of NRSROs was first incorporated into SEC regulations under the "Net Capital Rule," which "requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions."[81] The SEC stipulated that the rating agency must be "nationally recognized" to provide assurance that the credit rating was accurate.[82] From this initial usage of NRSROs by the SEC, the reliance on them has expanded dramatically to include many SEC regulations as well as state, foreign, and institutional investment regulations.[83] In addition, Congress has required the use of NRSRO ratings within various financial legislation.[84] In particular, Congress defined the term "mortgage related security" in the Exchange Act of 1934 to include the requirement that the security be rated in either of the top two rating categories by at least one NRSRO.[85] Including NRSROs within the various investment regulations has the result of effectively mandating that issuers contract with one of the major credit-rating agencies (currently only Moody's, S&P, and Fitch) to rate any security issued to the investing public.[86]

In 2002, the SEC began investigating the role of the NRSROs in the collapse of Enron.[87] The NRSROs had rated Enron a good credit risk until only four days prior to Enron's declaration of bankruptcy.[88] In October 2002, the Senate issued a report that concluded that the NRSROs exercised a lack of diligence in their coverage and assessment of Enron.[89] The report further concluded that because NRSROs' liability had traditionally been limited by regulatory exemptions and First Amendment protections,

80. U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 5 (2003).

81. *Id*. at 6.

82. *Id*.

83. *Id*. at 6–8.

84. *Id*. at 7.

85. *Id*. at 7–8 (citing 15 U.S.C. § 78c(a)(41) (2002)).

86. *Id.* at 8–9.

87. RICHARD SHELBY, COMM. ON BANKING, HOUS., AND URBAN AFFAIRS, CREDIT RATING AGENCY REFORM ACT OF 2006, S. REP. NO. 109-326, at 5 (2d Sess. 2006).

88. U.S. SEC. & EXCH. COMM'N, *supra* note 80, at 3.

89. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, S. REP. 107-75, at 115–16 (2002) [hereinafter ENRON OVERSIGHT SENATE REPORT].

accountability among the NRSROs was difficult to enforce.[90] The SEC acknowledged that the role and importance of NRSROs had dramatically increased in recent years.[91] NRSROs had a direct impact on "an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments."[92]

The Sarbanes-Oxley Act, enacted in response to the failure of gatekeepers such as the auditors in the Enron and other corporate scandals, required the SEC to study the role and function of the credit-rating agencies and submit a report on that study.[93] That report, *Report on the Role and Function of Credit Rating Agencies in Operation of the Securities Markets*, was issued in January 2003.[94] The result of those hearings, studies, and reports was new legislation known as the Credit Rating Agency Reform Act of 2006.[95] This new statute, among other things, gave express authority to the SEC to oversee the activities of NRSROs, to register NRSROs, and to withdraw registration if certain business practices regarding conflict of interest and the misuse of nonpublic information were in violation of Commission regulations.[96] This ability to withdraw registration of NRSROs is the greatest power expressly granted to the Commission as a means of sanctioning the rating agencies. That power is significant given the potential economic impact such a withdrawal could have on a credit-rating agency. That power does nothing, however, to mitigate the damage already incurred in the subprime crisis.

Credit-rating agencies evaluate a number of characteristics of a mortgage pool. They assess the credit risk of the underlying mortgages (the default risk and risk that a resulting foreclosure will not cover total debt of the defaulted loan) and the "pool risk."[97] They must consider factors such as expected default rates and amount of losses, pool characteristics, and credit enhancement features, such as the structure of the tranches or guarantees from insurance companies against losses from default or prepayment.[98]

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90. *Id*.

91. U.S. SEC. & EXCH. COMM'N, *supra* note 80, at 4.

92. *Id.*

93. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

94. U.S. SEC. & EXCH. COMM'N, *supra* note 80, at 1.

95. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 2, 120 Stat. 1327, 1327.

96. *Id.* § 4, 15 U.S.C. § 78o-7 (2006).

97. Peterson, *supra* note 46, at 2209–10.

98. David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1014 (2006); Peterson, *supra* note 46, at 2210.

B. The Conflict of Interest

A potential conflict of interest arises when a security issuer hires a rating agency to rate a particular security. A rating agency may see an incentive to rate a particular CDO tranche higher than is legitimately warranted for the purpose of keeping a "customer" happy and coming back to the rating agency for future issuances.[99] For this reason, there has been longstanding concern within the investment community, and more recently within Congress and the SEC, that the ratings issued by the rating agencies are not necessarily accurate reflections of the true risk level to the investing public.[100] This potential conflict of interest has been historically viewed as insignificant by the investment community because bonds are issued by such a large number of entities that there is little market power exerted by any one issuer.[101] A rating agency would not be concerned if a particular issuer moved its business to another agency because there was always another issuer in the queue. The advent of structured securities and the rapidly increasing power of the major rating agencies and investment banks, though, have altered this view drastically.[102]

The requirement that certain classes of investors may only purchase "investment-grade" securities is the first factor contributing to conflicts of interest.[103] Rule 2a-7 of the Investment Company Act of 1940 requires that money market funds ensure that their investments have high ratings.[104] Further, the only agencies authorized to provide such ratings are those designated as NRSROs by the SEC. Therefore, if an issuer wishes a security to be an investment available to the full marketplace, its choice of available credit-rating agencies is limited to just a handful.[105] In fact, because of this restriction applied by the SEC, the Department of Justice has referred to S&P and Moody's as a "partner monopoly."[106]

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99. *See* COFFEE, *supra* note 79, at 287 (noting that rating agencies do more than just provide information, but also create value for their customers).

100. *Id*. at 2.

101. Coffee, *supra* note 17, at 2.

102. *Id*.

103. Mason & Rosner, *supra* note 19, at 8.

104. 15 U.S.C. § 80(a) (2000). *See* David Evans, *Subprime Infects $300 Billion of Money Market Funds*, BLOOMBERG, Aug. 20, 2007, http://www.bloomberg.com/ (search for "subprime infects $300"; then follow hyperlink to the above-named article).

105. Mason & Rosner, *supra* note 19, at 8.

106. Letter from Sean J. Egan & W. Bruce Jones, Egan-Jones Ratings Co., to Jonathan G. Katz, Secretary, SEC (Nov. 10, 2002), *available at* http://www.sec.gov/news/extra/credrate/eganjones2.htm (citation omitted). Egan and Katz commented:

> Regarding the lack of competition, the number of [NRSROs] has declined from six three years ago to three currently. In the case of most [U.S.] corporate ratings and an increasing number of structured finance transactions, S&P and

The second, more troubling feature of the structured finance industry, however, is the concentration of CDO issuances among a handful of major investment banks.[107] In traditional bond ratings, there are thousands of individual corporations and government entities issuing new bonds. That diverse client base limits the market power of any one issuer. In contrast, CDOs are highly complex, and a small number of firms pay high fees to the rating agencies to advise them on the optimal structure and to rate the various tranches.[108] John C. Coffee Jr., Professor of Law at Columbia University and a leading expert on the role and regulation of the rating agencies, states concisely:

> Today, as much as half of some major rating agencies' revenues comes from structured finance; equally important, these amounts are paid by a small number of investment banks that know how to exploit their leverage and get the rating just over the line and into the promised land of investment grade.[109]

This concentration translates into greater market power for the issuers and potentially greater influence on the ratings their securities receive.

The revenue, profits, and stock prices of the major rating agencies have grown tremendously in recent years, and much of this growth is tied directly to the structured mortgage-backed-security industry. For example, Moody's stock price tripled and profits climbed by 27% from 2003 to 2006.[110] The SEC has begun investigations into this unprecedented growth.[111] The Commission suspects that it may find a correlation between the volumes of business that an investment bank sends to a credit-rating agency and the ratings that the investment bank's new issues receive.[112] Both the SEC and state attorneys general are examining how the rating

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> Moody's are the only firms used. The industry could more accurately be described as a "partner monopoly," a term used by U.S. Department of Justice personnel. A partner monopoly differs from an oligopoly in the sense that the two firms share the market whereby the gain in revenues by one firm does not reduce the revenues of the second firm. Since two ratings are normally needed for the issuance of bonds, the gains of Moody's do not come at the expense of S&P and vice versa.

Id.

107. Mason & Rosner, *supra* note 19, at 9–10.

108. Coffee, *supra* note 17, at 2.

109. *Id.*

110. Aaron Lucchetti, *Ratings Firms Get Rated: SEC Probes if Conflicts Fueled Subprime Troubles*, WALL ST. J., Sept. 7, 2007, at C1.

111. *Id.*

112. *Id.*

agencies issued their ratings for mortgage-backed securities, particularly those involving subprime mortgages.[113]

A third significant contribution to the suspicion surrounding the ratings issued by rating agencies is the alarmingly active role they play in the actual design of a given structured security. Rather than rating a security after the structure of the tranches is determined, the rating agencies are now actively engaged with the investment banks in determining the proper structures to maximize ratings—thus lowering the interest rate paid to investors and the resulting cost of capital.[114] By providing this type of service, the danger exists that the agency will hesitate to downgrade a security once it has been issued according to a structure that it advised the issuer to adopt.[115]

Rating agencies have demonstrated a reluctance to change ratings, and this is especially true with downgrades.[116] Famously, the rating agencies downgraded Enron only four days prior to the corporation's filing for bankruptcy.[117] Also, in July of 2007, Moody's and Standard & Poor's made "a wave of downgrades" of mortgage-backed securities only a week before Bear Stearns announced that two of its hedge funds were essentially worthless.[118] Since that announcement, Bear Stearns has become the quintessential example of the risks to shareholders of firms that have significant holdings in these risky products.[119]

Finally, the rating agencies increasingly rely on revenues from the rating of mortgage-backed securities and CDOs. Approximately half of rating-agency revenues are now generated from the rating of structured securities, and these revenues are paid by a small number of investment

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113. *Id*.

114. Coffee, *supra* note 17, at 2.

115. *Id*.

116. *Id*.

> A rating agency earns no additional revenues from downgrading outstanding securities, but it does risk offending powerful clients—the issuer, its investment bank, and the institutional investors who hold the rated securities in their portfolio. No one is made happier by a downgrading, and many are outraged. Thus, downgradings tend to be delayed and seem to be motivated mainly by the fear that investment grade-rated debt securities might imminently default. In this respect, ratings downgrades are less prophecies of the future than slightly premature obituaries for terminally ill bonds.

Id.

117. *Id.*

118. McGuire, *supra* note 13, at R12.

119. *See* Kara Scannell & Sudeep Reddy, *Officials Say They Sought To Avoid Bear Bailout*, WALL. ST. J., April 4, 2008, at A1. Bear Stearns collapsed in March 2008 but was saved from bankruptcy by a weekend rescue buyout by J.P. Morgan with the backing of the United States Federal Reserve. *Id.* The last-minute buyout was offered at $2 per share but later raised to $10 per share—a small fraction of what Bear Stearns was valued at before the crisis. *Id.*

banks that issue these complex investment products.[120] Moody's provides an excellent example of the growing importance of these securities to the rating agencies. Moody's reports that 44% of its 2006 revenue was generated from structured-finance ratings following a 23% growth rate in that revenue stream.[121] Most significantly, Moody's reports a 375% increase in profits since 2000, while its share price quintupled.[122]

Evidence that Moody's changed its historically conservative approach to ratings is mounting. In particular, a *Wall Street Journal* article offers insight into a changed philosophy within the structured-securities business of Moody's.[123] Executive senior management reportedly drove the business towards more customer-service-oriented interactions with the clients.[124] One former Moody's executive has noted that a new dialogue between Moody's and Wall Street was a positive change, but "the most recent problem . . . is that the rating process became a negotiation."[125] Although there were growing signs of housing-market trouble throughout 2007, Moody's rated 94% of the total CDO issuances that year.[126] Moody's willingness to continue granting these increasingly risky securities with high ratings in the face of troubling market signals is yet more evidence of the importance of the structured securities—and the investment banks that issued them—to the rating agencies. This market power of the investment banks, coupled with the active role of the rating agencies, has led some critics to go so far as to recharacterize the role of agencies as *underwriters* rather than raters.[127] Regardless of how they are characterized, the changed market dynamics and industry practices have amplified the perception of potential conflicts. Despite this perception, legal methods of compelling the necessary changes to these practices present significant challenges. Such challenges are discussed in Part IV.

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120. Coffee, *supra* note 17, at 2.

121. Moody's Corp., Investor Presentation (March 2007), *available at* http://library.corporate-ir.net/library/12/123/123831/items/236937/MCO March Long FINAL.pdf [hereinafter *Moody's Presentation*].

122. Aaron Lucchetti, *Rating Game: As Housing Boomed, Moody's Opened Up*, WALL ST. J., Apr. 11, 2008, at A1.

123. *Id.*

124. *Id.*

125. *Id.* (quoting Paul Stevenson, former Moody's executive).

126. *Id*.

127. Mason & Rosner, *supra* note 19, at 11–16; *see also Moody's Presentation*, *supra* note 121 (describing in detail the level of involvement and impact of Moody's active role in the CDO market).

IV. BARRIERS TO LIABILITY OF THE CREDIT-RATING AGENCIES

The credit-rating agencies have emerged during this financial crisis as a popular target of investigations and possible litigation. Although their role is central to the damage incurred by investors and the larger American economic crisis, serious barriers exist to any party successfully litigating against the rating agencies. As a threshold matter, the litigant must first demonstrate that a rating agency should not be afforded its traditional First Amendment protection of the publication of opinions.[128] Once this threshold issue is successfully overcome, a litigant must demonstrate that a primary violation of securities laws has been committed either by the rating agency or by another party (such as the investment banks).[129] In order to survive a motion to dismiss in private securities litigation, the litigant's complaint must meet the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 (PSLRA).[130] Meeting the heightened pleading standards will prove highly difficult for the damaged investor since the inner workings of the rating agencies—and their communications with investment banks—are not accessible to investors.[131]

In light of these barriers, this Note proposes the use of "control person" liability as a potential means of successfully holding the rating agencies liable to damaged investors. As explained in Part V, the use of this feature of the securities acts may circumvent the heightened pleading standards of the PSLRA. Once a primary violation by an investment bank is demonstrated, the litigant must show that the rating agency acted under the definition of "control person"—a definition that varies among the Circuit Courts of Appeal. Those definitions are examined in Part V.B with respect to litigation against the rating agencies.

A. The First Amendment

Past litigants have generally failed to assert claims against rating agencies successfully because the agencies have enjoyed First Amendment protection by asserting that the published ratings are "opinions."[132] This

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128. *See infra* Part IV.A.

129. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

130. 15 U.S.C. § 78u-4(b) (2000).

131. *See* COFFEE, *supra* note 79, at 304 ("[T]he PSLRA further shelters credit-rating agencies from liability by mandating special pleading rules that require the plaintiff at the outset of its case to plead 'with particularity' facts giving rise to a 'strong inference of fraud.'").

132. Mason & Rosner, *supra* note 19, at 11.

> The changes in the role of rating agencies, as their business has evolved from the rating of dynamic and on-going enterprises to static and defined-lived [sic]

First Amendment protection for these ratings harks back to the time when the agencies were paid by subscribers rather than issuers, and those subscribers received the research and creditworthiness ratings of debt-security issuers.[133] The role of the agencies, however, has changed significantly in recent decades, and the agencies are now paid by the security issuers.[134] Ratings for complex structured-finance products have been a significant revenue driver for the rating agencies in recent years.[135] In the issuance of CDOs and other complex structured securities, experts assert that the agency plays an active role not only in rating the issue, but also in advising in the actual structuring of the security for maximum financial benefit to the issuer.[136] These changes suggest that the traditional First Amendment protection may fail to protect the credit-rating agencies from litigation resulting from the subprime lending crisis.

The First Amendment protection issue was first raised in *Jaillet v. Cashman* in 1921.[137] The court held that an error in a news-ticker report—regarding a court decision on a dividend-taxation issue—would be protected as though it were a newspaper report unless the error was intentional and there was a contractual or fiduciary relationship between the parties.[138] The first step in determining if a credit-rating agency is protected

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> structured assets, warrants inquiry into not only the rigors of their structured finance rating models but also their historic claims of being publishers protected by the First Amendment's protections of the freedom of the press. Historically rating agencies have claimed that their letter-grade ratings were merely an opinion of the creditworthiness of an issuer or, according to Fitch general counsel, "the world's shortest editorial."

Id. (quoting ENRON OVERSIGHT SENATE REPORT, *supra* note 89, at 123).

133. Mason & Rosner, *supra* note 19, at 7.

134. *Id*. at 8.

135. *Id*. at 8–9.

136. *Id*. at 12–14.

137. Jaillet v. Cashman, 189 N.Y.S. 743 (Sup. Ct. 1921).

> [T]he relation of the defendant association to the public is the same as that of a publisher of a newspaper, and that . . . its duties and obligations are to be measured by the same standard. A mistake in the report of a fact by one or the other is different in its effect only as to the number of people who may be misled and the extent to which individuals may be misled a matter of degree only.

Id. at 744. *See also* David J. Grais & Kostas D. Katsiris, *Not "The World's Shortest Editorial": Why the First Amendment Does Not Shield the Rating Agencies from Liability for Over-Rating CDOs*, BLOOMBERG L. REP., Nov. 2007, at 2, http://www.graisellsworth.com/Rating_Agencies.pdf (noting that courts decide whether a rating agency may claim First Amendment protection on a "case-by-case" basis).

138. *Jaillet*, 189 N.Y.S. at 744.

> There is no privity between this plaintiff and the defendant. He is but one of a public to whom all news is liable to be disseminated. His action can be sustained only in case there was a liability by the defendant to every member of the community who was misled by the incorrect report. There was no contract or

by the First Amendment is to determine if it is acting as a member of the press.[139] Commentators have classified two sets of cases that deal with this question. First, there are cases involving subpoenas issued to rating agencies for information regarding a rating it issued as part of a lawsuit between parties not including the credit-rating agency.[140] Second are those cases in which the agency is facing a suit by either the issuer or investors for damage allegedly inflicted by the published rating.[141]

The history of constitutional jurisprudence regarding the expression of opinions is critical to this analysis. In 1964, the United States Supreme Court issued a decision in *N.Y. Times Co. v. Sullivan* that established "actual malice" as the proper standard for claims of defamation by public officials.[142] The Court defined actual malice as a statement made "with knowledge that it was false or with reckless disregard of whether it was false or not."[143] The Court expanded this doctrine in *Curtis Publishing Co. v. Butts*, saying that the *N.Y. Times* test should apply to criticism of "public figures" as well as "public officials."[144] Then in *Gertz v. Robert Welch, Inc.*, the Court considered the complaint of a private citizen and held that the *N.Y. Times* standard only applies to this class of plaintiffs when they seek punitive damages.[145] Importantly, the *Gertz* Court noted that:

> Under the First Amendment there is no such thing as a false idea. However pernicious an opinion may seem, we depend for its correction not on the conscience of judges and juries but on the competition of other ideas. But there is no constitutional value in false statements of fact.[146]

> fiduciary relationship between the parties, and it is not claimed that the mistake in the report was intentional.

Id.

139. Grais & Katsiris, *supra* note 137, at 2.

140. *Id.*

141. *Id*.

142. N.Y. Times Co. v. Sullivan, 376 U.S. 254, 279–80 (1964).

143. *Id.*

144. Curtis Pub. Co. v. Butts, 388 U.S. 130, 155 (1967).

> We consider and would hold that a "public figure" who is not a public official may also recover damages for a defamatory falsehood whose substance makes substantial danger to reputation apparent, on a showing of highly unreasonable conduct constituting an extreme departure from the standards of investigation and reporting ordinarily adhered to by responsible publishers.

Id.

145. Gertz v. Robert Welch, Inc., 418 U.S. 323, 348–49 (1974) ("States not may not permit recovery of presumed or punitive damages, at least when liability is not based on a showing knowledge of falsity or reckless disregard for the truth.").

146. *Id*. at 339–40 (citation omitted).

The *N.Y. Times* standard was further restricted in *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.* by establishing that the standard only applies when the published material is a matter of public concern.[147] The Court further clarified that speech "motivated by the desire for profit" is less deserving of First Amendment protection.[148]

These cases are important in this discussion of the potential liability of credit-rating agencies to investors of subprime-backed CDOs. The cases address three important features of the published information at issue. First, the information—ratings of specific securities relied on by a limited group of investors—is likely not "of public concern" in the sense of a news article published in a broadly distributed newspaper. Second, the potential plaintiff investors would not be considered "public figures." Finally, the speech is clearly motivated by the "desire for profit" for the benefit of both the rating agencies and the investors. Thus, the agencies here would likely merit a lesser degree of First Amendment protection.

The protection of "opinion[s]" arose in *Milkovich v. Lorain Journal Co.*, where a local newspaper columnist wrote that a high-school wrestling coach had perjured himself in a court case regarding his team.[149] The Court held that if the published opinion contained provably false facts, then the opinion must meet the standards set in *N.Y. Times* and *Dun & Bradstreet*.[150] The Court considered the "marketplace of ideas" notion articulated by Justice Holmes, but rejected the argument that any expressed "opinion" gains unquestioned protection under the First Amendment.[151] The Court noted that "expressions of 'opinion' may often imply an assertion of objective fact."[152]

This line of decisions clearly shows that, although "opinion" is protected under the First Amendment, the protection is not complete and unlimited. The rating agencies, in the inevitable litigation flowing from the subprime lending crisis, will likely attempt to hide behind their traditional First Amendment curtain of protection but will be challenged to overcome those limitations. The ratings that the agencies have issued for the mortgage-backed securities and CDO products are at the core of

147. Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 761 (1985).

148. *Id*. at 762. "In any case, the market provides a powerful incentive to a credit reporting agency to be accurate, since false credit reporting is of no use to creditors. Thus any incremental 'chilling' effect of libel suits would be of decreased significance." *Id*. at 762–63.

149. Milkovich v. Lorain Journal Co., 497 U.S. 1, 3 (1990) (internal quotations omitted).

150. *Id.* at 18.

151. *Id*. (quoting *Abrams v. United States*, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting) ("[T]he ultimate good desired is better reached by free trade in ideas— . . . that the best test of truth is the power of the thought to get itself accepted in the competition of the market.") (alteration in original).

152. *Id*.

this crisis and it will be challenging to protect them under the standards discussed above.

The courts have ruled on the availability of First Amendment protection to rating agencies in a number of cases. These cases generally uphold the First Amendment protection for credit-rating agencies. In *First Equity Corp. of Florida v. Standard & Poor's Corp.*, the court recognized First Amendment protection for the rating agency.[153] The Court held that plaintiff–investors claiming reliance on false information from the agency must show actual malice to survive a summary judgment motion.[154] In *Jefferson County School District v. Moody's Investor's Services, Inc.*, the Tenth Circuit affirmed the dismissal of a defamation claim brought by a security issuer against Moody's.[155] The court noted that rating agencies deserve a high level of constitutional protection because their ratings are expressions of opinion.[156]

This line of reasoning, however, fell short for the defendant in *In re Fitch, Inc.*[157] In *Fitch*, the Second Circuit held that the defendant was not accorded First Amendment protection in the factual context presented because "Fitch play[ed] an active role in structuring the transaction."[158] The court clarified that, although the communications between Fitch and the security issuer were not improper, they did warrant First Amendment protection:

> [W]e believe that they reveal a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports. Accordingly, we believe that this evidence also counsels strongly against finding that Fitch may assert the privilege for this information.[159]

The *Fitch* court also considered the asserted fact that Fitch only rated its own clients.[160] It distinguished a district court finding in *In re Pan Am Corp.* of First Amendment protection where S&P rated "virtually all public debt financing and preferred stock issues whether they were done by S&P

153. First Equity Corp. of Fla. v. Standard & Poor's Corp., 690 F. Supp. 256 (S.D.N.Y. 1988).
154. *Id.* at 258–59.
155. Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc., 175 F.3d 848, 855–56 (10th Cir. 1999).
156. *Id.* at 856.
157. *In re* Fitch, Inc., 330 F.3d 104 (2d Cir. 2003).
158. *Id*. at 110.
159. *Id.* at 109.
160. *Id.*

clients or not."[161] This distinction will likely prove important in upcoming litigation. State prosecutors are already issuing subpoenas to the Wall Street investment banks regarding the packaging and selling of these securities in order to explore the "banks' relationship with credit-rating firms."[162] As discussed previously, the unique relationship between the CDO issuers and the rating agencies, and the alleged *Fitch*-like active involvement will likely render the protective curtain of the First Amendment fruitless for the rating agencies who gave investment-grade ratings to these failing subprime mortgage-backed securities.

B. Central Bank, the PSLRA, and the Difficulty of Plaintiffs Successfully Pleading Fraud Against Rating Agencies

The availability of private litigation against secondary actors in securities fraud has been severely restricted in recent years. In 1994, the U.S. Supreme Court issued the landmark *Central Bank* decision.[163] This decision limited causes of action to primary violations of the Securities Exchange Act of 1934 and precluded private aiding-and-abetting liability.[164] That decision, though, left open the possibility of secondary actors being liable as primary violators if they met all the elements of fraud.[165] Then in 2008, the Court closed that opening substantially in its *Stoneridge Investors* decision, clarifying that a direct misrepresentation to the public was required to establish reliance—a necessary element of fraud under section 10(b).[166] Because of these two controlling Supreme Court decisions, successfully litigating a primary violation of the Securities Act by the rating

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161. *Id*. (citing *In re* Pan Am Corp., 161 B.R. 577, 583 (S.D.N.Y. 1993)).

> We do not suggest that an ostensible newsgathering organization is required to cover all events in order to qualify as journalists—part of a journalist's job is exercising judgment about which events are newsworthy and which are not. We believe, however, that Fitch's information-disseminating activity does not seem to be based on a judgment about newsworthiness, but rather on client needs. We believe this weighs against Fitch being able to assert the privilege for the information at issue.

Id. at 110.

162. *Wall St. Firms Subpoenaed by N.Y. Prosecutors*, REUTERS, Dec. 5, 2007, http://www.reuters.com/article/domesticNews/idUSN0555776120071205.

163. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

164. *Id.* at 191.

165. *Id*. (noting that "[a]ny person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) . . . may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met").

166. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 770 (2008) ("[W]e conclude respondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance.").

agencies—who are secondary actors in this controversy—will be very difficult, and perhaps impossible, to accomplish.

Congress passed the PSLRA of 1995 as a means of lowering corporate capital costs by preventing "frivolous 'strike' suits . . . while maintaining the incentive for bringing meritorious actions."[167] The effect of this legislation on the liability of rating agencies is twofold. First, joint and several liability is replaced by the limitation of "proportionate liability."[168] This limits the amount of damages that a plaintiff may collect to a defendant's proportionate share of culpability for the damages suffered by the plaintiff.[169] Second, the PSLRA imposes a heightened pleading standard upon plaintiffs in private security litigation, specifically requiring that a complaint must "state with particularity all facts" upon which the allegations are based.[170] Further, the plaintiff must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[171]

The Federal Rules of Civil Procedure also dictate a heightened pleading standard when alleging fraud. Rule 9(b) states: "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally."[172] Rule 9(b) sets a less onerous burden for the plaintiff than the PSLRA because it excludes state of mind from the heightened pleading standard.[173]

The purpose of these heightened standards is to discourage frivolous litigation in general, but they had the impact of essentially eliminating claims by potential plaintiffs against rating agencies who are secondary actors in securities fraud.[174] The remainder of this Note will examine whether damaged investors might succeed in litigating against the agencies under section 20(a) of the 1934 Act. Courts have varied widely in their interpretation and application of this section of the 1934 Act.[175] The large damages to investors and to the greater economy will compel courts to clarify those interpretations.[176]

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167. S. REP. NO. 104-98, at 4, *as reprinted in* 1995 U.S.S.C.A.N. 679, 683.

168. 15 U.S.C. § 78u-4(f) (2000).

169. *Id.*

170. 15 U.S.C. § 78u-4(b)(1).

171. *Id.* § 78u-4(b)(2).

172. FED. R. CIV. P. 9(b).

173. *Id.*

174. *See* COFFEE, *supra* note 79, at 304 ("[T]he plaintiff faces a 'Catch 22'-like dilemma: it is unable to plead fraud with respect to a secondary defendant without first obtaining substantial discovery from it, and it cannot get that discovery until it first pleads fraud with particularity.").

175. *See infra* Part V.B.

176. *See, e.g.*, Carrick Mollenkamp, *Stocks Surge as 2 Major Banks Advance Turnaround*

V. Can the Rating Agency Be Held Liable Under Securities Statutes as a "Control Person"?

In light of the limited direct role the SEC is authorized to employ in its regulation of the activities of NRSROs, the liability of credit-rating agencies to investors in the subprime lending crisis still remains an important and troubling question in upcoming private litigation. This Part will explore the potential for "control person" liability imposed on the rating agencies in their gatekeeper/advisory role with CDO issuers as a means of circumventing the statutory and judicial barriers discussed in Part IV.B.

A. "Control Person" Liability Under the 1933 and 1934 Acts

Control Person liability under the Securities Act of 1933 (the 1933 Act) falls within section 15, which addresses misinformation in registration statements, prospectuses, and the distribution of securities:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.[177]

The two statutes referenced within this section are section 11 of the 1933 Act,[178] which "creates civil liability for false registration statements,"[179] and section 12,[180] which addresses "liability for information contained within prospectus and communications."[181] The usefulness of section 15 with regard to the rating agencies, however, is compromised by

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Plans—UBS, Lehman Act To Bolster Capital; More Pain to Come?, WALL ST. J., April 2, 2008, at A1 (citing a Standard & Poor's estimate that investor losses tied to mortgage-backed securities writedowns will total approximately $285 billion).

177. 15 U.S.C. § 77*o* (2000).

178. *Id*. § 77k.

179. Laura Greco, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 171 (1999).

180. 15 U.S.C. § 77*l* (2000).

181. Greco, *supra* note 179, at 171.

SEC Rule 436, which exempts the rating given a particular new issue from liability under section 11.[182] Furthermore, section 12 is of limited use to shareholders because it only addresses information within prospectus and communications. Because of these limitations, this subpart will focus on Control Person liability under section 20(a) of the 1934 Act.

Unlike sections 12 and 15 of the 1933 Act, section "20(a) applies to all violations of the [1934] Exchange Act. This includes [section] 10(b) and [SEC] Rule 10b-5 violations," which are broad anti-fraud provisions.[183] Section 20(a) says in part:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[184]

Section 10(b) of the 1934 Act provides broad grounds for liability with notoriously vague and ambiguous language:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[185]

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182. 17 C.F.R. § 230.436(g)(1) (2008).

> Notwithstanding the provisions of paragraphs (a) and (b) of this section, the security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization, or with respect to registration statements on Form F-9 (§ 239.39 of this chapter) by any other rating organization specified in the Instruction to paragraph (a)(2) of General Instruction I of Form F-9, *shall not be considered* a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.

Id. (emphasis added).

183. Erin L. Massey, *Control Person Liability Under Section 20(a): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 113 (2005).

184. 15 U.S.C. § 78t(a) (2000).

185. *Id.* § 78j.

Section 10(b) was passed by Congress in the aftermath of the stock market crash and Great Depression of 1929 to 1933, in part to instill confidence in the integrity of the markets.[186] The SEC then promulgated Rule 10b-5 as a means of enforcing section 10(b).[187]

In order for a plaintiff to successfully claim a section 20(a) Control Person violation within the framework of these statutes and rules, that plaintiff must first demonstrate a primary violation by the "controlled person" of the 1934 Act, under section 10(b).[188] The Supreme Court has repeatedly affirmed the implied private right of action under section 10(b),[189] and for the purpose of this Note, the analysis will proceed under the assumption that the plaintiff–investors will be able to properly claim a primary violation under section 10(b) against the CDO issuers.

B. Section 20(a) of the 1934 Act and the Circuit Split

The language of section 20(a) purposefully fails to define the word "control" and thus leaves the scope of its application intentionally broad and flexible.[190] The SEC has interpreted "control" to mean "the possession, direct or indirect, of the power to direct or cause the direction of the

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186. *See* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (identifying as "an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence").

187. 17 C.F.R. § 240.10b–5 (2007).

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

188. *Id.*

189. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 171 (1994). "Private plaintiffs may sue under the express private rights of action contained in the Acts. They may also sue under private rights of action we have found to be implied by the terms of [section] 10(b) . . . of the 1934 Act." *Id*. (citing Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971)).

190. *See* H.R. REP. NO. 73-1383, at 26 (1934). "[It is] undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted." *Id. See also* Massey, *supra* note 183, at 114. "Many circuits refer to this definition in their opinions, but the definition is not controlling on the courts. In fact, some courts completely ignore the SEC's definition and apply their own alternative interpretation of 'control.'" *Id.* (footnotes omitted).

management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[191] The SEC definition is not controlling in federal courts, but it does inform this discussion.

Courts have approached the concept of "controlling person" within the meaning of section 20(a) with two primary standards: "culpable participation and potential control."[192] Culpable participation first surfaced in *Lanza v. Drexel & Co.* in 1973 when the Second Circuit noted that the congressional intent of adding section 20(a) "was obviously to impose liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons."[193] The Second Circuit later articulated this test more clearly in *SEC v. First Jersey Securities, Inc.*:

> In order to establish a prima facie case of controlling-person liability, a plaintiff must show a primary violation by the controlled person and control of the primary violator by the targeted defendant and show that the controlling person was "in some meaningful sense [a] culpable participant[] in the fraud perpetrated by [the] controlled person[]" . . .[194]

This approach, however, is in the minority among the circuits, with only the Third and Fourth Circuits joining the Second in this culpable-participation test.[195]

Because the culpable-participation standard implies a required state of mind of the defendant, the question arises whether the PSLRA heightened pleading standards apply to section 20(a) complaints. The Southern District of New York has required the heightened standards, and said that "[t]his burden is satisfied if plaintiffs plead facts 'giving rise to a strong inference that the controlling person knew or should have known that [the controlled person] was engaging in fraudulent conduct,' but 'took no steps to prevent the primary violation.'"[196] That same general standard has been applied by other jurisdictions as well.[197]

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191. 17 C.F.R. § 240.12b–2.

192. Massey, *supra* note 183, at 114.

193. Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973).

194. SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996) (citations omitted) (alterations in *First Jersey*) (quoting Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974)).

195. Jeff G. Hammel & Robert J. Malionek, *Elusive Standard to Plead § 20(a) Control Person Liability*, N.Y. L.J., Mar. 5, 2007, at 2, *available at* http://www.lw.com/upload/pubContent/_pdf/pub1822_1.pdf.

196. Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452, 484 (S.D.N.Y. 2001) (quoting Gabriel Capital, L.P. v. NatWest Fin., Inc., 122 F. Supp. 2d 407, 428–29 (S.D.N.Y. 2000)) (internal quotations omitted).

197. *See, e.g.*, *In re* Cendant Corp. Sec. Litig., 76 F. Supp. 2d 539, 548 n.5 (D.N.J. 1999)

Conflict exists even within jurisdictions that rely on the culpable-participation standard, and some courts have found that something less than the PSLRA standards are required in section 20(a) complaints. In *Derensis v. Coopers & Lybrand Chartered Accountants*, the District of New Jersey noted that "[t]he plaintiff need only plead circumstances establishing control because: (1) the facts establishing culpable participation can only be expected to emerge after discovery; and (2) virtually all of the remaining evidence, should it exist, is usually within the defendants' control."[198] Even within the Second Circuit and Southern District of New York, there is disagreement on this issue.[199]

With the question still open among the courts—and in particular the Second Circuit—whether the heightened pleading standard applies to the culpable-participation standard, this standard remains a viable attack by plaintiffs on the controlling credit-rating agencies. Plaintiffs will likely see some success, depending on the facts of the specific case, to reach the discovery phase of litigation in the Second, Third, and Fourth Circuits. Litigants may reach discovery and eventual trial by including in the complaint allegations that demonstrate the credit-rating agencies' ability to control the investment banks in their efforts to issue the risky subprime-backed investment products: the active role of the credit-rating agencies in the structuring of the mortgage-backed securities; the complexity of these debt instruments, which necessarily makes their risk impossible to evaluate without the direct involvement of sophisticated analysts working for the rating agencies; and the absolutely critical role of the rating agency as a gatekeeper that has the power to control the issuance of the CDOs by withholding investment-grade ratings required by statute and regulation.[200]

The contrasting test for a successful claim of section 20(a) Controlling Person liability is known as the "potential control" or "control by status"

(stating that the required state of mind for a section 20(a) violation is culpable participation, and so the "plaintiff must plead 'particularized facts of the controlling person's conscious misbehavior as a culpable participant in the fraud'") (quoting Mishkin v. Ageloff, No. 97-2690, 1998 WL 651065, at *25 (S.D.N.Y. Sept. 23, 1998)).

198. Derensis v. Coopers & Lybrand Chartered Accountants, 930 F. Supp. 1003, 1013 (D.N.J. 1996) (quoting Easton & Co. v. Mut. Benefit Life Ins. Co., No. 91-4012, 1992 WL 136857, at *6 (D.N.J. Mar. 29, 1992).

199. *See In re* Initial Public Offering Sec. Litig., 241 F. Supp. 2d 281, 392–97 (S.D.N.Y. 2003) (discussing confusion over *First Jersey* requirements and holding that "culpable participation" is not an element of section 20(a) and scienter must be proved only after the defendant offers the affirmative defense of "good faith").

200. *See* 15 U.S.C. § 80a (2000) (defining "control" and outlining liability for investment companies); 17 C.F.R § 270.2a–7 (2007) (limiting money market funds to investments in "one of the two highest short-term rating categories" of an NRSO).

test.[201] Simply put, this test requires no showing of actual willful participation in the fraud, but only that the person is in the position to control the allegedly controlled person.[202] The *Metge* test, articulated by the Southern District Court of Iowa and approved by the Eighth Circuit, is the most rigid test among the circuits rejecting the culpable-participation standard.[203] The test requires that the plaintiff must first show that the defendant "actually participated in (i.e., *exercised* control over) the operations of the corporation in general."[204] The plaintiff must also "prove that the defendant possessed the power to control the specific transaction upon which the primary violation is predicated."[205] Other Circuits have adopted variations on the *Metge* test.[206] The Eleventh Circuit, in *Brown v. Enstar Group, Inc.*, ruled that no demonstration of actual control of the general affairs of the corporation was necessary; only the ability to control the general affairs and "the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability."[207]

Under these variations of the *Metge* test, with the requirement to demonstrate control of the general operations of the corporation, the rating agencies will escape liability. That requirement is questionably useful in the context of this current market failure and potential litigation against a critical gatekeeper. However, the Ninth Circuit has applied a looser definition of control person, stating that "[t]o establish 'controlling person' liability, the plaintiff must show that a primary violation was committed and that the defendant 'directly or indirectly' controlled the violator."[208] The court further

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201. Greco, *supra* note 179, at 173.

202. *Id.*

203. Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985) (quoting Metge v. Baehler, 577 F. Supp. 810, 817–18 (S.D. Iowa 1984)).

204. *Id.*

205. *Id.*

206. *See, e.g.*, Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873 (7th Cir. 1992). *Harrison* used an analysis for establishing control that considered:

> [W]hether the alleged control-person actually participated in, that is, exercised control over, the operations of the person in general and, then, to whether the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised.

Id. See also Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) ("[A] plaintiff need not make a showing as to defendant's culpable participation; rather, a defendant has the burden of pleading and proving his good faith.").

207. Brown v. Enstar Group, Inc., 84 F.3d 393, 396 (11th Cir. 1996) (quoting Brown v. Mendel, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)).

208. Paracor Fin., Inc. v. Gen. Elec. Capital Corp., 79 F.3d 878, 888–89 (9th Cir. 1996) (quoting *Hollinger*, 914 F.2d at 1575).

stated that "[t]he plaintiff need not show the controlling person's scienter or that they 'culpably participated' in the alleged wrongdoing."[209]

The Fifth Circuit has held that the plaintiff sufficiently pleads a section 20(a) violation by showing that the defendants possess, directly or indirectly, "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise," thus adopting the definition provided by the SEC.[210] The Southern District of Texas expressed this clearly in *In re Enron Corp. Sec., Derivative & "ERISA" Litigation*:

> Plaintiff has adequately asserted a claim under § 20(a) . . . for its control of its subsidiaries, divisions, and affiliates named as defendants here, based on underlying primary violations by these entities. As this Court has recognized, the Fifth Circuit requires only that the plaintiff plead that the control person has the power to direct or cause the direction of the management and policies of the controlled person, not actual exercise of that power.[211]

Under this test for control-person status, the rating agencies are highly vulnerable. The potential plaintiff may plead allegations that the agencies "had the power to direct" the policies of the investment banks through a combination of factors unique to these securitizations: their position as gatekeeper to the financial markets for these risky and complex securities; the heavy involvement of the rating agencies in structuring the securities; and the regulatory requirements for investment-grade ratings by one of only three NRSROs, thus ensuring market power.[212] Doing so will likely enable them to reach the discovery phase of litigation, at which time the plaintiffs will have much greater access to the records of those agencies—and thus will have circumvented the major barrier of PSLRA heightened pleading standards.

These varying judicial approaches to control-person status will yield equally varying results for investor–plaintiffs wishing to hold rating agencies liable as control persons over the issuers of the subprime-backed CDOs. In any litigation occurring within the Second Circuit, the outcome will likely turn on the application of the culpable-participation standard.

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209. *Id.* (quoting Arthur Children's Trust v. Keim, 994 F.2d 1390, 1396 (9th Cir. 1993))

210. *See* G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 957–58 (5th Cir. 1981) (quoting 17 C.F.R. § 230.405(f) (1979)) (rejecting the requirement of actual participation in the fraudulent transaction).

211. *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., No. MDL-1446, 2005 WL 3504860, *15 (S.D. Tex. Dec. 22, 2005).

212. *Id*.

Although meeting the standard of culpable participation is generally viewed as the most onerous of the standards among the circuits, plaintiffs will likely find those circuits accommodating to their claims if they can get past the heightened pleading standards. With growing evidence of the significant involvement of the agencies in the structuring of the securities, the culpable-participation element will not prove a daunting barrier, so long as the litigants survive a Rule 12(b)(6) motion and enjoy the fruits of discovery. The litigants will find greatest success if they can establish jurisdiction in the Fifth and Ninth Circuits, where they must only establish that the defendant–rating agency possessed the "power to direct or cause the direction of the management and policies of the controlled person" with no heightened pleading standard, since neither a state of mind nor allegations of fraud are elements in this standard.[213]

The credit-rating agencies, by means of regulatory requirements that offer them untempered market power with any firm wishing to issue debt securities, along with the tremendous hunger in the market for these high-yield securities, exhibited significant control over these CDO issuers by instructing them on how to structure the tranches to earn the required investment-grade ratings. The issuers allegedly structured the securities according to the guidance of the rating agencies, and without that guidance and the subsequent ratings, those securities would likely have never reached the market of investors. That control may well result in the agencies, for the first time in any systemic rather than anomalistic manner, realizing liability as a major player in this financial tragedy.

CONCLUSION

The years ahead will see volumes of litigation regarding the loss of hundreds of billions of dollars' worth of securities. Although the rating agencies have generally escaped liability in similarly difficult financial meltdowns—both because of the traditional First Amendment protections and the limitations of current securities laws—they may not be so fortunate under the circumstances present in this crisis. The very nature of the active role that the rating agencies have played in this controversy, along with the large fees they were paid to participate in these potentially fraudulent securities transactions with investment banks, may well leave them liable as "controlling persons" in section 10(b) violations. Already, the rating agencies have been "circling the wagons," issuing press releases that

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213. *Id.*

attempt to downplay the active advisory role they have taken.[214]

A tremendous need exists for the circuits to unify their approaches to defining "control person" status. The Second Circuit, in particular, has shown a wide variation in its application of section 20(a). Proposed changes in the regulation of the rating agencies and securities laws may help to avoid future problems, but litigation appears to be the only path in the current crisis to ensure that the rating agencies share in the liability to damaged investors.

—Lisbeth Freeman[*]

214. *See* Press Release, Moody's Corp., Moody's Corporation Announces New Business Unit Structure (Aug. 7, 2007), *available at* http://ir.moodys.com/releasedetail.cfm?ReleaseID=288698 (announcing a new structure designed to "capture a broad range of growth opportunities in debt markets worldwide and reinforce the independence of the company's ratings business"); *Fitch Press Release*, *supra* note 72 (pointing to failures of loan originators and fraud among borrowers as "drivers" of subprime defaults); Letter from Vickie Tillman, Executive Vice President, Standard & Poor's Credit Mkt. Servs., to Editor of the *Wall Street Journal* (Sept. 17, 2007), *available at* http://www.spviews.com/presentationsTestimoniesOpeds/wsj091707.html. The letter stated: "Our credit ratings provide objective, impartial opinions on the credit quality of bonds. We have institutional safeguards in place to ensure the independence and integrity of these opinions, and our excellent long-term track record of assessing risk demonstrates that integrity." *Id.*

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