IX. Justice or Retribution: The S&P Downgrade and Lawsuit

A. Introduction

In August of 2011, credit rating agency Standard and Poor's ("S&P") downgraded the United States' debt rating from AAA ("triple-A") to AA+.[1] The downgrade coincided with a congressional debate over the national debt ceiling, as the possibility of a government shutdown drew national attention.[2] The U.S. government fervently opposed the downgrade, maintaining that S&P's analysis of the situation was inaccurate.[3] On February 4, 2013, the Department of Justice ("DOJ") brought civil charges against S&P.[4] The charges alleged that the rating agency intentionally misled investors about the quality of mortgage-backed securities before the financial crisis.[5] The government asserted that the agency gave artificially high ratings to risky bonds in order to gain higher revenue and greater market share.[6] S&P's raised a puffery defense,[7] and further maintained that the charge was in retaliation for its downgrade

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[1] Dominic Rushe, *S&P Sues US Government Over Alleged Retaliation for AAA Credit Downgrade*, GUARDIAN (Sept. 4, 2013, 12:04 PM), http://theguardian.com/business/2013/sep/04/standard-poors-us-retaliation-lawsuit.

[2] *Id.*

[3] CNN Wire Staff, *Agency Downgrades U.S. Credit Rating*, CNN (Aug. 5, 2011, 10:51 PM), http://cnn.com/2011/BUSINESS/08/05/ global.economy.cnn.

[4] *See* Jean Eaglesham et al., *U.S. Sues S&P Over Ratings*, WALL ST. J. (Feb. 5, 2013, 12:37 AM), http://online.wsj.com/news/articles/SB1000142412788732445904578284064003795142.

[5] *Id.*

[6] *See* Louise Story, *U.S. Inquiry Is Said to Focus on S.&P. Ratings*, N.Y. TIMES, Aug. 18, 2011, at A1 ("During the boom years, S. & P. and other ratings agencies reaped record profits as they bestowed their highest ratings on bundles of troubled mortgage loans . . . .").

[7] Edvard Pettersson, *S&P Raises Puffery Defense Against U.S. Ratings Case*, BLOOMBERG (July 8, 2013, 4:15 PM), http://bloomberg.com/news/2013-07-08/s-p-to-argue-puffery-defense-in-first-courtroom-test.html.

eighteen months prior.[8] The DOJ's charge highlighted the role of credit rating agencies in the financial crisis.[9]

This article discusses the relationship between S&P's downgrade of the United States' credit rating, and the charges the government brought against S&P for their alleged involvement in the recent financial crisis. Part B provides an overview of the credit rating agencies' role in evaluating securities and how this function informed S&P's downgrade. Part C examines the effects of the downgrade on the financial market. Part D addresses the charges the DOJ brought against S&P for their alleged involvement in the financial crisis.

B. Overview

1. Credit Rating Agencies

Credit rating agencies evaluate securities, and their ratings determine how attractive a security is to investors.[10] The Securities and Exchange Commission ("SEC") has designated ten rating agencies as nationally recognized statistical rating organizations ("NRSROs").[11] The NRSRO designation is significant because "many regulated institutional investors are limited in what types of securities they may invest based on the securities' NRSRO ratings."[12] The three most prominent credit rating agencies are Fitch, Inc. ("Fitch"), Amici Moody's Investors Service, Inc. ("Moody's"),

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[8] Chris Isidore, *S&P: U.S. Lawsuit is Retaliation for Downgrade*, CNN MONEY (Sept. 4, 2013, 7:43 AM), http://money.cnn.com/2013/09/04/news/companies/sandp-downgrade-lawsuit.

[9] *See* Matt Taibbi, *The Last Mystery of the Financial Crisis*, ROLLING STONE (June 19, 2013, 9:00 AM), http://rollingstone.com/politics/news/the-last-mystery-of-the-financial-crisis-20130619.

[10] *See In re* Fitch, Inc., 330 F.3d 104, 106 (2d Cir. 2003) ("[O]nce the security or debt has received a favorable rating, that rating makes it easier to sell the security to investors, who rely upon Fitch's analysis and evaluation."); Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1278–79 (2009) ("[R]atings impact the marketplace because investors rely on them as an accurate reflection of the creditworthiness of the product or company.").

[11] Mulligan, *supra* note 10, at 1278–79.

[12] *Id.* ("[M]any entities . . . are restricted to purchasing products that are rated investment grade by a NRSRO.").

and S&P.[13] S&P is the largest credit rating agency and accounts for nearly fifty percent of all credit ratings issued in the United States.[14] Collectively, the top three rating agencies issue approximately ninety-eight percent of all ratings in the United States.[15]

2. Proposed Reform Efforts

In 2006, Congress passed the Credit Rating Agency Reform Act, which required the SEC to institute well-defined guidelines under which credit rating agencies could qualify as NRSROs.[16] The Act also granted the SEC broad powers to regulate NRSROs.[17] Yet some commentators have suggested that the Act did not provide the SEC with adequate regulatory power over the NRSROs, as evidenced by the rating agencies contributory role in the financial crisis.[18] Prior to the financial crisis, investment banks "shopped around" between rating agencies, and allegedly bribed agencies for top credit ratings.[19] When such top-rated securities could not perform, they were downgraded, much to the detriment of investors who had relied on what they thought were accurate and unbiased credit ratings.[20]

Granting high credit ratings to troubled securities is now cited as one of the main reasons for the 2008 financial collapse.[21] In

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[13] *In re Fitch*, 330 F.3d at 106 (identifying Fitch, Moody's, and S&P as the agencies which have been designated as NRSROs).
[14] Marilyn Blumberg et al., *Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies*, 17 FORDHAM J. CORP. & FIN. L. 1063, 1072 (2012).
[15] *Id.*
[16] Credit Rating Agency Reform Act of 2006, 15 U.S.C.A. § 78a (2012).
[17] *Id.*
[18] Daniel Scheeringa, *Dodd-Frank Credit Rating Agency Reform in the Crosshairs*, ILL. BUS. L.J. (Mar. 29, 2011, 9:21 PM), http://law.illinois.edu/bljournal/post/2011/03/29/Dodd-Frank-Credit-Rating-Agency-Reform-in-the-Crosshairs.aspx.
[19] Story, *supra* note 6.
[20] *See* Blumberg, *supra* note 14, at 1124.
[21] *See* Story, *supra* note 6 ("During the boom years, S. & P. and other ratings agencies reaped record profits as they bestowed their highest ratings on bundles of troubled mortgage loans, which made the mortgages appear less risky and thus more valuable. They failed to anticipate the deterioration that would come in the housing market and devastate the financial system.").

response, the Dodd-Frank Act, signed into law in 2010, gave the SEC "stronger powers to oversee rating agencies."[22] The Act contains safeguards intended to preclude banks from shopping around for the best rating.[23] The Act also requires the SEC to adopt a number of new rules concerning credit rating agencies, granting the SEC expansive regulatory powers over this industry.[24]

3. The Downgrade

A triple-A rating represents the highest potential grade a country or company can receive.[25] The United States had consistently maintained a triple-A rating since Moody's first assigned the rating in 1917.[26] In 2011, S&P assigned the United States an AA+ rating.[27] The downgrade was the first time the United States had received anything other than a perfect credit rating from S&P in the past ninety-four years.[28] The head of sovereign ratings at S&P attributed the downgrade to the United States' budget deficit and its rising ratio of debt-to-Gross Domestic Product.[29]

Moreover, deliberations regarding the national debt ceiling may have also contributed to the downgrade.[30] The downgrade occurred during a period of national uncertainty, as Congress debated whether or not to raise the United States' debt ceiling.[31]

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[22] Daniel Wagner, *Q&A: The Federal Charges Against Standard & Poor's*, REV. (Feb. 5, 2013, 7:32 PM), http://the-review.com/ap%20financial/2013/02/05/q-a-the-federal-charges-against-standard-poor-s.
[23] *Id.*
[24] Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7 (2012).
[25] Graeme Wearden, *AAA Credit Ratings Explained*, GUARDIAN (July 27, 2011, 11:49 AM), http://theguardian.com/business/2011/jul/27/triple-aaa-credit-ratings-explained.
[26] CNN Wire Staff, *supra* note 3.
[27] *See* Rushe, *supra* note 1.
[28] *Id.*
[29] CNN Wire Staff, *supra* note 3.
[30] Agustino Fontevecchia, *Shutdown and Debt Ceiling Debate Prove U.S. Not Worthy of AAA Credit Rating: S&P*, FORBES (Sept. 30, 2013, 7:20 PM), http://forbes.com/sites/afontevecchia/2013/09/30/shutdown-and-debt-ceiling-debate-prove-u-s-doesnt-deserve-aaa-credit-rating-sp.
[31] Walter Brandimarte & Daniel Bases, *United States Loses Prized AAA Credit Rating From S&P*, REUTERS (Aug. 6, 2011, 1:10 PM), http:// reuters.com/article/2011/08/06/us-usa-debt-downgrade-idUSTRE7746VF20110806 ("The decision follows a fierce political battle in Congress

Congress eventually agreed to raise the debt ceiling, thereby avoiding a government shutdown.[32] Failure to raise the debt ceiling would have likely caused the United States to miss its debt payments and default on its debt.[33] Although the government averted a shutdown, the government's temporary instability may have led to S&P's downgrade.[34]

C. Impact on Financial Markets

After the United States' credit downgrade, analysts speculated as to how the reduced rating would affect a variety of financial services and markets.[35] Commentators observed that analyzing the downgrade's impact would be difficult, "because so many of the potential stress points for the financial system [were] relatively opaque areas like over-the-counter derivatives markets."[36] While some predicted markets freezing and banks collapsing—similar to the effects of Lehman Brothers' bankruptcy in September of 2008—others harbored more modest expectations.[37] A recent downgrade in Japan that resulted in very minimal long-term effects led some analysts to anticipate only marginal effects from the downgrade.[38] Another important consideration was that the other two major credit rating agencies did not downgrade the United States' credit rating.[39] This may be attributed to the fact that most credit

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over cutting spending and raising taxes to reduce the government's debt burden and allow its statutory borrowing limit to be raised.").

32 Tom Cohen & Holly Yan, *Obama Signs Bill to End Partial Shutdown, Stave Off Debt Ceiling Crisis*, CNN (Oct. 17, 2013, 12:51 AM), http://cnn.com/2013/10/16/politics/shutdown-showdown.

33 Fontevecchia, *supra* note 30.

34 *Id*.

35 *See* Paritosh Bansal & Dan Wilchins, *Debt Issuers Brace for Impact from U.S. Downgrade*, REUTERS (Aug. 7, 2011, 7:20 PM), http://reuters.com/article/2011/08/07/us-usa-ratings-financialsystem-idUSTRE7762W720110807.

36 *Id*.

37 *Id.*

38 Charles Riley, *S&P Rating: Ripple Effects of Downgrade*, CNN MONEY (Aug. 6, 2011, 8:11 PM), http://money.cnn.com/2011/08/06/news/economy/sp_rating_fallout.

39 Felix Salmon, *The Difference Between S&P and Moody's*, REUTERS (Aug. 9, 2011), http://blogs.reuters.com/felix-salmon/2011/08/09/the-difference-between-sp-and-moodys.

rating agencies focused on expected losses incurred by the United States, whereas S&P focused on the probability of the United States defaulting on its debt.[40]

In the immediate aftermath of the downgrade, stock market values fell across Asian, European, and American markets.[41] The Congressional Research Service ("CRS") predicted that borrowing costs for the United States could increase "to compensate investors for added risk in holding Treasuries."[42] On the first day following S&P's downgrade, however, "yields on 10-year Treasury bonds fell; [and] investor interest in buying them remain[ed] strong"—a convincing indicator that borrowing costs would not rise.[43] The CRS observed another corollary in that "several entities related to the U.S. government" were also downgraded, including Fannie Mae, Freddie Mac, the Farm Credit System, and obligations of the Federal Home Loan Banks.[44] The CRS report described these organizations as "likely to receive government support," and thus, "their creditworthiness is linked to that of the U.S. Treasury."[45]

The long-term effects of the downgrade were relatively limited, despite initial concerns that it would have drastic, enduring consequences.[46] A year after the downgrade, mortgage rates dropped to record lows, yields on treasury notes plummeted, and the strength of the dollar increased.[47] In 2013, Warren Buffet confidently stated, "The U.S. is still triple-A . . . . In fact, if there were a quadruple-A rating, I'd give the U.S. that."[48]

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[40] *Id.* ("An S&P ratings [sic] seeks to measure *only* the probability of default . . . [and] Moody's, by contrast, is interested not in default probability *per se*, but rather expected losses.").

[41] Fontevecchia, *supra* note 33; *see also* Bansal & Wilchins, *supra* note 35 (characterizing "U.S. sovereign credit" as "bedrock to the world financial system").

[42] MARK JICKLING, CONG. RESEARCH SERV., R41955, STANDARD & POOR'S DOWNGRADE OF U.S. GOVERNMENT LONG-TERM DEBT 3 (2011).

[43] *Id*.

[44] *Id.*

[45] *Id.* at 3–4.

[46] Bansal & Wilchins, *supra* note 35.

[47] *See* Mike Dorning et al., *The S&P Downgrade, One Year Later*, BLOOMBERG BUSINESSWEEK (July 19, 2012), http://businessweek.com/articles/2012-07-19/the-s-and-p-downgrade-one-year-later.

[48] *Id*.

D. The Governments' Action Against S&P

Eighteen months after the downgrade, the DOJ brought an action against S&P.[49] The civil charges alleged that S&P misled investors about the quality of mortgage-backed securities.[50] S&P, along with the other credit rating agencies, rated mortgage bonds very favorably, "suggesting there was little risk that home borrowers would default on their loans."[51] When the real estate market collapsed and home prices dropped suddenly, financial institutions suffered large losses as borrowers failed to make payments.[52] These defaults are recognized as a primary cause of the 2008 financial crisis.[53]

The DOJ will likely assess substantial fines against S&P if the claims against the rating agency are successful.[54] During settlement negotiations, informants revealed that S&P was concerned that a deal could send them into bankruptcy.[55] In 2012, the Australian government found that S&P misled investors prior to the global financial crisis.[56] S&P was forced to pay $31 million in damages to Australian authorities.[57] Now, the U.S. government is seeking as much as $5 billion in penalties from S&P: "the biggest sanction imposed on a firm related for its actions in the crisis."[58]

If the investigation reveals illegal practices, S&P must be held accountable, especially given the fact that such practices may have been a significant factor in the financial collapse.[59]

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49 Eaglesham, *supra* note 4.
50 *Id.*
51 Isidore, *supra* note 8.
52 *Id.*
53 *Id.*; Blumberg, *supra* note 14, at 1124.
54 Eaglesham, *supra* note 4.
55 *Id.* ("The two sides have discussed a possible settlement for about four months, according to people close to the negotiations, but S&P balked over concerns that a deal could sink the company.").
56 *Standard & Poor's Misled Investors—Australian Court*, BBC (Nov. 6, 2013, 9:58 AM), http://bbc.co.uk/news/business-20216638.
57 *Id.*
58 Eaglesham, *supra* note 4; Pettersson, *supra* note 7.
59 Blumberg, *supra* note 14, at 1124 ("In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and Investors, which in turn adversely impacted the health of the economy in the United States and around the world.").

1. Puffery Defense

S&P argues that reasonable investors should not have relied on the agency's ratings, and characterizes its own statements as "puffery."[60] Assertions that "are too general to cause a reasonable investor to rely upon them" are considered puffery, which may be offered as a defense to allegations of securities fraud.[61] S&P claims that its "assertions that its ratings were independent, objective and free of conflicts of interests" were too "vague and generalized" to be relied upon by a reasonable investor.[62] On the other hand, the DOJ counters that such "puffing" was "material," since the ratings "reassure[ed] investors about the credit quality of the securities they bought from investment banks."[63]

The puffery defense relies on S&P showing that it was not reasonable for investors to rely on claims that their ratings were objective and independent.[64] Considering a similar argument, the Southern District Court of New York held that, "[w]hile ratings are not objectively measurable statements of fact, neither are they mere puffery or unsupportable statements of belief akin to the opinion that one type of cuisine is preferable to another."[65] Moreover, it would be difficult to prove that these ratings were not material, considering that they served as a prominent motivation for many investments in these troubled securities.[66]

2. Retaliation Defense

S&P also argues that the charges brought against it constitute retaliation for its 2011 downgrade of the United States' credit rating.[67] In support of this claim, S&P argues that mortgage-backed securities "were given the same high ratings from an S&P rival" that

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[60] Pettersson, *supra* note 7.
[61] *See* ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 206 (2d Cir. 2009).
[62] Pettersson, *supra* note 7.
[63] *Id*.
[64] *Id.*
[65] Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 888 F. Supp. 2d 431, 454–55 (S.D.N.Y. 2012).
[66] Pettersson, *supra* note 7.
[67] Isidore, *supra* note 8.

is not under investigation.[68] DOJ officials have denied that they filed the suit in retaliation for the downgrade, stating the investigation into S&P's subprime mortgage ratings began in 2009, two years before the downgrade.[69] Moreover, in November of 2013, the liquidators of two Bear Stearns hedge funds filed a separate action for fraud against the top three credit rating agencies in a New York State Court.[70] The liquidators alleged that all three agencies "assign[ed] artificially high credit ratings" to mortgage-backed securities.[71] However, the DOJ has not commented on whether the government will file similar charges against any other credit agencies.[72]

The crux of S&P's defense will likely be the retaliation argument —especially if the United States fails to bring charges against any other rating agency who engaged in similar misleading practices.[73] But, the United States may be able to argue that they pursued charges solely against S&P because they are the largest credit rating agency.[74] Considering the rating agency's size, the government's success against S&P would have a substantial impact on the credit rating industry as a whole.[75] This approach would save the United States the administrative burden and costs of filing claims against multiple credit rating agencies, and the SEC has well-grounded authority to make this judgment call.[76]

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[68] Eaglesham, *supra* note 4; Isidore, *supra* note 8.
[69] Isidore, *supra* note 8.
[70] Peter Lattman, *Suit Charges 3 Credit Rating Agencies with Fraud in Bear Stearns Case*, N.Y. TIMES DEALBOOK (Nov. 11, 2013, 9:00 AM), http://dealbook.nytimes.com/2013/11/11/suit-charges-3-credit-rating-agencies-with-fraud-in-bear-stearns-case.
[71] *Id.*
[72] Isidore, *supra* note 8.
[73] *See* Eaglesham, *supra* note 4 ("S&P suggested Monday it was being unfairly singled out. The CDOs under scrutiny were given the same high ratings from an S&P rival, the firm said.").
[74] *See* Blumberg, *supra* note 14, at 1072.
[75] Story, *supra* note 6 ("A successful case or settlement against a giant like S.&P. could accelerate the shift away from the traditional ratings system . . . . A government case that showed problems beyond ineptitude might spur greater reforms . . . .").
[76] Moog Indus. v. Fed. Trade Comm'n, 355 U.S. 411, 413 (1958) ("[T]he Commission alone is empowered to develop that enforcement policy best calculated to achieve the ends contemplated by Congress and to allocate its available funds and personnel in such a way as to execute its policy efficiently and economically.").

Furthermore, the DOJ began its investigation into S&P two years prior to the downgrade.[77] While this evidence may not be dispositive as to the retaliation argument, it does suggest that the United States lacked retaliatory motive in initially scrutinizing S&P's ratings practices.[78]

E. Conclusion

Credit rating agencies have served an important function in the United States' financial system.[79] The DOJ's action against one of the largest agencies, S&P, has criticized the rating agency's role in the financial crisis.[80] In its defense, S&P has asserted that its statements to investors were "puffery," and moreover, that the DOJ's suit was retaliation for S&P's downgrade of United States' credit, a year and a half earlier.[81] While the case is not yet settled, its outcome will certainly have a strong impact on the relationship between credit rating agencies and the U.S. government in the near future.

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[77] Isidore, *supra* note 8.
[78] *See id*.
[79] *See* Blumberg, *supra* note 14, at 1071 ("CRAs 'help lenders pierce the fog of asymmetric information that surrounds lending relationships. . . . [and] help borrowers (and their credit qualities) emerge from that same fog.'" (quoting Lawrence J. White, The Credit Rating Industry: An Industrial Organization Analysis 4 (Feb. 12, 2001) (unpublished manuscript), *available at* http://www.stern.nyu.edu/eco/wkpapers/workingpapers01/01-02White.pdf)).
[80] Blumberg, *supra* note 14, at 1124 ("In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and Investors, which in turn adversely impacted the health of the economy in the United States and around the world."); *see* Jim Puzzanghera, *S&P Helped Cause Financial Crisis With Faulty Ratings, Feds Allege*, L.A. TIMES (Feb. 05, 2013), http://articles.latimes.com/2013/feb/05/business/la-fi-mo-standard-poors-justice-suit-credit-rating-holder-20130205.
[81] Isidore, *supra* note 8 ("[L]awyers for S&P parent company McGraw Hill charged that the suit was simply retaliation for [the] August 2011 downgrade . . . ."); Pettersson, *supra* note 7 ("Standard & Poor's . . . argued reasonable investors wouldn't have relied on its 'puffery' about credit ratings.").
[82] Student, Boston University School of Law (J.D. 2015).