

## **S&P Seen Able to Explain Fraud Suit Embarrassing E-Mail Claims Bloomberg News**

By David Glovin

8 February 2013

Feb. 8 (Bloomberg) -- Standard & Poor's lawyers will have no shortage of legal arguments as the ratings service defends a novel U.S. claim that it defrauded investors by deliberately understating the risk of mortgage-backed bonds.

The Justice Department on Feb. 4 accused the McGraw-Hill Cos. unit of deceiving federally insured financial institutions by issuing inflated ratings on bonds backed by mortgages made to the riskiest borrowers to win business from Wall Street banks. Investors including Western Federal Corporate Credit Union, which subsequently collapsed, lost billions of dollars, U.S. lawyers said.

U.S. success in the lawsuit in federal court in Los Angeles is "far from clear," said Jeffrey Manns, an associate professor at George Washington University Law School. S&P's defense may include evidence that the agency believed in its ratings and proof that U.S. fraud allegations are unfounded. Company lawyers are also weighing whether to argue that the 1989 statute underpinning the case doesn't apply to S&P.

"We start with proposition that we deny there was any fraud," Floyd Abrams, one of the lawyers for the ratings service, said yesterday in a phone interview. Fraud claims have "a high burden of proof."

S&P rated more than \$2.8 trillion of residential mortgage-backed securities and about \$1.2 trillion of collateralized-debt obligations from September 2004 to October 2007, the government said.

### **Inflated Rankings**

The Justice Department accuses S&P in its complaint of falsely representing to investors that its ratings were objective, independent and uninfluenced by any conflicts of interest. The company shaped its ratings to suit its business needs by weakening adjustments to its analytical models and by issuing inflated rankings on CDOs collectively worth hundreds of billions of dollars, according to the complaint.

In the 128-page civil complaint, the U.S. cites internal e-mail exchanges to bolster its case, including one in which an S&P analyst allegedly telling a colleague in April 2007 that deals "could be structured by cows and we would rate it."

The U.S. may seek more than \$5 billion in damages, acting U.S. Associate Attorney General Tony West said on Feb. 5. McGraw-Hill, which had net income of \$867 million in the past four quarters, denies wrongdoing.

"The fact is that S&P's ratings were based on the same subprime mortgage data available

to the rest of the market -- including U.S. government officials who in 2007 publicly stated that problems in the subprime market appeared to be contained," Catherine Mathis, a company spokeswoman, said in an e-mailed statement after the lawsuit was filed.

### **Heart of Case**

As the case progresses, S&P will likely take direct aim at the heart of the U.S. case by explaining the justification for its ratings model, offering evidence of internal deliberations and comparing the firm's economic forecasts to similar ones by U.S. officials, Manns said.

S&P may also say the sophisticated investors who purchased the securities weren't misled by the ratings, although that's not necessarily a defense in a fraud case, he said.

Proving fraud "is a very substantial bar," Manns said in a phone interview. "The government has compiled lots of e-mails that show rogue activities by low-level employees. That's not going to win the game."

S&P will likely provide context for the e-mail exchanges, said Claire Hill, a law professor at the University of Minnesota who has written about the ratings firms.

### **Market Share**

"Within any organization, there would be people who would be more conservative and people who would be less conservative," she said in an interview. "The e-mails show they were mindful of market share. Looking at market share is not necessarily problematic."

A December ruling in a lawsuit against S&P may work to the firm's advantage. In that case, the U.S. Court of Appeals in New York upheld the dismissal of a complaint claiming the company deceived investors when it defended its ratings method while knowing the system was a sham.

The appeals court said in a nine-page ruling that company statements about its advanced software, transparent operations and integrity, which investors claimed to be misleading, weren't sufficient grounds to support a securities-fraud claim.

"I'm confident we'll be talking about that," said Abrams, a partner at Cahill Gordon & Reindel LLP in New York.

### **Case's Foundation**

The defense may challenge the U.S. reliance on the 1989 law that forms the basis for the case. Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act, which targets fraud of federally insured financial institutions, in the wake of the 1980s savings-and-loans crisis.

“One thing we’re exploring is whether the statute applies at all to a case of this sort,” Abrams said.

S&P won’t argue that its rating opinions were protected by the U.S. Constitution’s guarantee of free speech, as the firm has previously done.

“It’s not a First Amendment case,” Abrams said in a Feb. 5 interview with Bloomberg Television. “The government is alleging that S&P didn’t believe what it said. The First Amendment doesn’t protect against that.”

The complaint includes at least 58 examples of S&P executives ignoring internal warnings from analysts and others, dismissing relevant data, taking steps to appease issuers or acknowledging how pressure from banks could lessen the quality of its grades or delay downgrades.

### **Housing Bubble**

The Financial Crisis Inquiry Commission and a Senate panel have previously said that inflated mortgage-bond grades from S&P, Moody’s Investors Service and Fitch Ratings helped fuel the lending practices that let the housing bubble get so big before it burst.

Even with the legal arguments in its arsenal, S&P may be unwilling to sustain further damage to its reputation from a fight with the U.S. government, Manns said.

“The settlement incentives are strong,” he said.

The case is U.S. v. McGraw-Hill, 13-00779, U.S. District Court, Central District of California (Los Angeles).