

Subprime – Law Firms

The Subprime Meltdown, Rating Agencies And Privilege

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While uncertainties abound in the current subprime crisis, one can reliably predict that the rating agencies are destined to be in the middle of much of the litigation arising out of the meltdown of subprime mortgage securitizations. For the vast majority of these securitizations, the senior tranche carried the agencies' highest ratings and the agencies worked closely with the issuers and underwriters to determine the structure of these transactions. Discovery and even direct lawsuits will attempt to explore the information issuers and underwriters provided to the agencies and the extent of due diligence performed by the agencies in the course of determining their ratings. A clear battle looms over the circumstances under which the courts will uphold the agencies' claim that their "newsgathering" function provides them either an absolute or qualified privilege that shields them from discovery and liability. The cases that have addressed this privilege issue have focused on the agencies' involvement in structuring the underlying transactions and the extent to which they also issued unsolicited ratings. Understanding how the securitizations were structured and the rating practices employed by the agencies is critical to appreciating how these two factors will likely impact the agencies' role in the subprime litigation.

Underlying Contracts And Structure

By definition, lenders issued the contracts or mortgages underlying these securitizations to subprime borrowers. Subprime borrowers are individuals with poor credit histories, high debt-to-income ratios, or other characteristics that demonstrate a higher probability of default. Approximately \$475 billion of subprime mortgage backed securities were issued in 2006 alone. These higher risks dictated higher interest rates and the typical subprime offering brought together a large pool of these contracts with similar characteristics in a securitization structure.

The typical subprime securitization structure utilizes credit tranching, which divides the securitization into different classes based on risk. The most senior tranche has first preference to the cash flows from the pool of contracts and offers the lowest yield. The lowest

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tranche has no preference and absorbs the first loss, but offers the highest yield. Bonds tied to the different tranches were then sold primarily to institutional investors with the interest and principal payments on the bonds being dependant on the pool's cash flows.

Rating The Transaction

For decades, rating agencies typically rated debt transactions on an unsolicited basis and sold subscriptions to their ratings to investors. In the 1970s, however, the agencies began charging issuers to rate each specific transaction. The number of unsolicited ratings declined as the revenues from solicited transactions rapidly grew. While S&P continues to rate unsolicited transactions, Moody's and Fitch had virtually abandoned the practice by 2000.

Without exception, the ratings that are candidates for involvement in the subprime litigation were solicited ratings for which the agencies were paid a fee by the issuers. Most issuers went to multiple agencies and sought AAA ratings for the highest tranche of each securitization. The AAA rating was a requirement for purchase by many portfolio managers so achieving that rating greatly broadened the marketability of an offer, while also allowing the issuer to pay the lower yield for the tranche that achieves that AAA rating.

Once hired, the rating agencies worked closely with the issuer and underwriters to rate the transaction. The agencies typically provide an initial list of questions and required information, and follow-up with additional requests and inquiry until they believe they have information sufficient to model and rate the transaction. While the agencies claim they are only involved in reviewing an opinion as to credit risk and have no role in structuring the transactions, it is clear that they make certain ratings criteria available to the issuers, and that the issuers are free to structure their transactions to their criteria if they so wish. In addition, the rating agencies played a critical role in how the transactions were structured by effectively setting the credit support levels for the transactions.

Subprime securitizations require credit support to reduce the impact of inevitable defaults in the underlying pool of subprime contracts. In the credit tranche structure, the subordinate tranches provide credit support for the most senior tranches. In other words, if 30 percent of the transaction is designated to the subordinate tranches, then the most senior tranche is generally protected from the first 30 percent of losses in the underlying pool.

The agencies dictate the subordinate levels that will allow the issuer to obtain the desired AAA rating for the most senior tranche. If more than one agency rates a transaction, then the credit support is usually set at the highest level required by any of the agencies. To the extent other forms of credit support are required, such as overcollateralization or excess spread, then the agencies will set these levels as well. If the issuer structures its transaction per the agencies' mandates, then the transaction will receive the desired ratings. Thus, because achieving the desired ratings is critical to the success of the transactions, the agencies have a big role in determining how the transactions will be structured.

The Journalist's Privilege

Rating agencies claim that the information gathered during the rating process and their analysis is protected by a journalist's privilege. While newsgathering is afforded some First Amendment protection and a journalist's privilege is commonly recognized by the states, it is not settled under what circumstances rating agencies can assert the privilege.

In *Branzburg v. Hayes*, 408 U.S. 665 (1972), while recognizing that newsgathering is not without its First Amendment protections, the United States Supreme Court refused to adopt a constitutional journalist's privilege. Instead, the Court left it to the state legislatures to adopt their own privilege within the protections provided by the First Amendment. Some federal courts, including the Second Circuit, have adopted a "common law" qualified privilege for journalists.

While the privilege analysis in each case will be conducted pursuant to the applicable state statute and any adopted common law privilege, many of the subprime cases will likely be governed by New York law. In *In re Fitch, Inc.*, the Second Circuit held that information gathered by Fitch while rating a specific collateralized loan obligation was not protected by the journalist's privilege as codified in New York's Shield law or the recognized common law privilege. Several factors weighed against application of the privilege. Initially, the Court found that because Fitch only rates specific transactions for which it has been hired, it should not be treated like a journalist. Further, Fitch played an active role in structuring the transaction, which was not typical of the relationship between a journalist and the activities that a journalist reports. The Court limited its holding, however, to the facts and circumstances before it, and noted that it was not deciding the general status of credit rating agencies.

The District Court for the Eastern District of Michigan subsequently reached a different conclusion, albeit under different circumstances, in analyzing New York's Shield law. In *Compuware v. Moody's*, the Court proclaimed that even assuming that Moody's abandoned its practice of issuing unsolicited ratings, the most important factor was the nature of the relation-

ship between Moody's and the issuer. The Court found that because there was no evidence that Moody's participated in the structuring of the transaction, the privilege was applicable. The Court required Moody's, however, to detail the contents of all documents withheld for the Court's in camera review. The Court stated that notwithstanding the privilege, it would order the production of any materials that are (i) highly material and relevant; (ii) critical or necessary to the party's claim; and (iii) is not obtainable from an alternative source. Thus, even if a rating agency can establish the privilege under New York law, the privilege is qualified and can be overcome by a sufficient showing.

Rating agencies also assert that the journalist's privilege provides a defense to claims asserted directly against them. This assertion will be tested in a class action filed by the Teamsters Local 282 Pension Trust Fund against Moody's in the Southern District of New York. The class is defined as all persons who purchased Moody's common stock between October 25, 2006, and July 10, 2007. The suit alleges that Moody's failed to disclose that it assigned excessively high ratings to the subprime mortgage securitizations and that the revelation of the inflated ratings caused Moody's stock price to decline.

Likely Outcome On The Privilege

It is unknown whether the courts will recognize the journalist's privilege in response to the inevitable subpoenas and shareholder claims. Under the Second Circuit's analysis in *Fitch*, however, the fact that Moody and Fitch rate few if any unsolicited transactions will undermine their argument that the privilege applies. S&P will have a better argument with respect to this factor because it frequently rates unsolicited transactions, but as the Court pointed out in *Compuware*, this is not the primary consideration.

Further, litigants are on notice to document the agencies' roles in structuring the transaction before raising the issue with the court. Thus, it is likely that the party opposing the privilege will be able to show through documents and information produced by the issuers and underwriters that the rating agencies played a critical role in structuring the transactions, including setting the credit enhancement levels. Such a showing will offer a strong argument to defeat the privilege claims.

In cases involving subpoenas, look for the agencies to try to settle the disputes by producing the materials provided to them during the rating process while retaining the privilege claim on their internal analyses. Moody's will not likely be able to take such an approach in the shareholder action against it, and will have to litigate the issue or find another avenue to get the action dismissed. In any event, it is clear that the privilege is not as robust as the rating agencies would like and following the meltdown of their AAA rated transactions one can predict that the rating agency "privilege" will confront significant challenges.

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