CREDIT RATING AGENCIES AND MUNICIPAL BONDS: HOW A MISUNDERSTOOD INDUSTRY HAS COST TAXPAYERS

*Jason Saylor**

INTRODUCTION

In 2008, the global financial crisis opened the eyes of many investors to the fact that Credit Rating Agencies ("CRAs") do not always give accurate, reliable ratings to investments.[1] During the debt-ceiling debacle of 2011, it became apparent that CRAs also have significant influence over the global economy. The mere threat of a rating downgrade for United States Treasury Bonds shocked financial markets. When Standard & Poor's ("S&P") eventually downgraded the rating, stocks plummeted for several days, even though the United States has never defaulted on its debt obligations.[2] S&P's representatives indicated that they might cut the rating again if the country did not arrange to reduce its deficit.[3]

A downgrade in debt rating for the United States or any other bond issuer means the cost of the debt increases, or even worse, creditors refuse to lend. This phenomenon is a result of the value investors place on these ratings as indicators of a borrower's ability to pay. CRAs also have great influence over state and local governments. In order to finance civic projects, states, cities, towns, and other municipal entities issue bonds.[4] Many investors feel that municipal bonds are an extremely safe investment, second only to United States

---

* J.D. Candidate 2013, George Mason University School of Law. The author would like to thank Mr. Michael Kelly for his teaching and guidance. Any errors are those of the author.

1 *See, e.g.*, John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 121-22 (2009) (the common criticism of credit rating agencies with respect to the financial crisis "is that the rating agencies did a poor job of assessing the default risk of . . . instruments based on subprime [mortgage backed securities] . . . and that when a large number of borrowers started to default on subprime mortgages in 2007, the low quality of the ratings was revealed and systemic consequences ensued.") (internal citations omitted).

2 *See* Craig McCann, Sherry Liu, Geng Deng, and Joseph Pendergast, *Leveraged Municipal Bond Arbitrage: What Went Wrong?*, 1755 PLI/Corp 205, 207 (2009) ("Treasury securities are free of default risk . . . ."); *but see*, Gold Clause Cases (Norman v. Baltimore & Ohio R.R. Co., 294 U.S. 240 (1935), United States v. Bankers Trust Co., 294 U.S. 317 (1935), Perry v. United States, 294 U.S. 330 (1935)) (indicating that the United States was in a state of technical default).

3 Walid Petiri, *After the Downgrade...Patience & Pragmatism is a Must*, Examiner (Aug. 23, 2011), htttp://www.examiner.com/finance-in-baltimore/after-the-downgrade-patience-pragmati sm-is-a-must#ixzz1VtyASlCg.

4 Education, *Two Types of Bonds: General Obligation vs. Revenue Bonds*, MunicipalBonds.com, http://www.municipalbonds.com/education/read/60/two-types-of-bonds-general-obligation-vs-revenue-bonds (last visited Sept. 21, 2011) ("There are over 80,000 issuers of municipal bonds in the United States. With so many different types of issuers ranging from states to cities, transportation systems, school districts, hospitals, and housing projects . . .".).

Treasury bonds. A default on a General Obligation Municipal bond ("GO bond") is an extremely rare occurrence because municipalities can repay them with almost any source of income, including the tax base.[5] Even with a rate of default near zero, municipal bonds generally receive ratings lower than their corporate counterparts, leading some states to cry foul.[6]

CRAs are such an integral part of our financial system that they seem to have near regulatory authority.[7] Though CRAs perform an essential function in our financial system, they are independent, for-profit companies, whose incentives may occasionally be misaligned. Historically, there has been little accountability for any misrepresentations in their ratings. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") tried to alleviate some of these problems.[8] In addition to creating greater transparency, Dodd-Frank potentially opens the door to liability in instances when CRAs have traditionally enjoyed protection. This paper will discuss in further detail how misaligned incentives have led CRAs to diminish ratings of municipal bonds, how CRAs have forced municipalities to purchase their services, how courts and regulators have missed opportunities to hold CRAs accountable, and how new laws may offer relief.

Section I of this paper will discuss the background of CRAs, including their history, current status, potential conflicts of interest. It will also discuss the basics of municipal bonds and the criteria the major CRAs use to evaluate the risk associated with municipal bonds. Section II will analyze the First Amendment issues, argue that those issues have inappropriately shielded CRAs from liability, and explore potential antitrust theories that could hold CRAs accountable. Finally, Section III will discuss Dodd-Frank may reduce the First Amendment defense and open the door for antitrust liability.

---

5 Moody's Investors Serv., THE U.S. MUNICIPAL BOND RATING SCALE: MAPPING TO THE GLOBAL RATING SCALE AND ASSIGNING GLOBAL SCALE RATINGS TO MUNICIPAL OBLIGATION, 3 (Mar. 2007) *available at* http://www.moodys.com/sites/products/DefaultResearch/102249_RM .pdf [hereinafter GLOBAL RATING SCALE].

6 *See* Press Release, Connecticut Attorney General, Attorney General Sues Credit Rating Agencies For Illegally Giving Municipalities Lower Ratings, Costing Taxpayers Millions (July 30, 2008), *available at* http://www.ct.gov/ag/cwp/view.asp?Q=420390&A=2795.

7 *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies,* 77 WASH. U. L.Q. 619, 682 (1999) (explaining the regulatory function of ratings agencies: "[i]f the applicable regulation imposes costs, and a favorable rating eliminates or reduces those costs, then rating agencies will sell regulatory licenses to enable issuers and investors to reduce their costs.").

8 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2010).

I. BACKGROUND

A. *Credit Rating Agencies*

1. History

Understanding the power and influence of CRAs is difficult without first looking at the background of the agencies. CRAs provide an essential service to our financial system by providing an ostensibly objective analysis of the likelihood that a corporation, government, or municipality will be able to repay its debts.[9] In doing so they facilitate transactions and create market efficiencies that could not otherwise exist.[10] They are "central to capital formation, investor confidence, and the efficient performance of the United States economy."[11]

CRAs began in the early 1900s when John Moody applied a simple rating methodology to bonds.[12] He wanted to synthesize the complex data found in financial reports into a single rating symbol to sell the information to the public.[13] These ratings became very popular because they increased market efficiencies by allowing investors to compare a variety of securities at a glance instead of analyzing each investment with the limited and often unreliable public information.[14] Seeing the popularity of Moody's ratings publications, Poor's Publishing, Standard Statistics,[15] and Fitch Publishing soon began publishing their own ratings on a scale similar to Moody's.[16] In the early years, CRAs utilized a subscription-based model by selling ratings information directly to the

---

[9] *See* Hunt, *supra* note 1, at 114-15 ("Credit rating agencies provide evaluations of the likelihood that obligations will be repaid. The agencies issue ratings on . . . corporate, government, and municipal bonds.").

[10] *See* Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1035 (2009) ("Ratings agencies serve to bridge an information gap between issuers and existing and prospective creditors. Sifting through the myriad of financial and nonfinancial disclosures of issuers may simply be economically infeasible for most creditors . . . .").

[11] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2010).

[12] Partnoy, *supra* note 7, at 637-38.

[13] *Id.*

[14] *See id.* at 636 ("[I]t was difficult for sellers to gather credible information about the reputation of buyers: letters of reference were faked or forged, detailed financial data were not available, and the process was tediously slow. As Markets and trade evolved during the nineteenth century, it became clear that there were economies of scale associated with gathering and disseminating credit information in a systematic, organized way.").

[15] Poor's Publishing and Standard Statistics eventually merged to become Standard and Poor's (S&P).

[16] Partnoy, *supra* note 7, at 642.

investors, which resulted in low barriers to entry in the credit rating market.[17] If the ratings agencies did not produce high quality and accurate ratings, customers would purchase ratings from another company.[18] As a result, their revenues came largely from their reputation for accurate ratings.

2. Current State

The subscription-based business model used in the early years may have kept CRAs incentives properly aligned, but as is the trouble with any publication, CRAs could not keep their subscribers from sharing the valuable information with non-subscribers. The CRAs ended the subscription-based model in the 1970s to eliminate the free rider problem.[19] Under the current business model, the bond issuers pay CRAs to rate their bonds instead of potential investors or subscribers. CRAs, therefore, derive a substantial portion of their revenue from bond issuers.[20] This business model creates a significant conflict of interest by encouraging CRAs to give a higher than warranted rating to paying customers.[21] The problem worsens when the financial instruments are complex and it is harder to question the rating provided.[22]

What enables these agencies to continue this business model is that the largest three ratings agencies – Moody's, Standard and Poor's, and Fitch, (the "Big Three") – enjoy an oligopoly by regulation, and they no longer rely on their reputations for new business. The federal government "[issued] numerous regulations that require[] issuers to secure ratings concerning their creditworthiness in order to participate in financial markets."[23] In an effort to ensure the legitimacy of CRAs, the Securities and Exchange Commission ("SEC") designated that they meet certain requirements.[24] The CRAs who met the requirements were designated Nationally Recognized Statistical Ratings

---

17 *See id.* at 639 (stating that there was evidence that in the early years there were low barriers to entry and "the cost of accumulating the relevant statistics and data to generate a rating were not prohibitively high."); *see also* Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 623 (2009) ("While these CRAs originally charged subscription fees, they switched to the issuer pays model in the mid-1970s.").

18 *See* Partnoy, *supra* note 7, at 639 ("[A]n agency that did not generate accurate and credible ratings probably would not have expected to survive long."); *see also* Hunt, *supra* note 1, at 114-15 ("[t]he value of a rating agency's business derives from the agency's reputation for issuing high-quality ratings.").

19 Darcy, *supra* note 17, at 623.

20 *See* Partnoy, *supra* note 7, at 639 (stating that ninety-five percent of CRAs revenue comes from user fees); Darcy, *supra* note 17, at 622 ("CRAs receive approximately 90 to 95% of their annual revenues from issuer fees.").

21 *See* Darcy, *supra* note 17, at 622-45 (providing a complete analysis of the conflicts of interest created by the issuer pays model).

22 *See, id.*, at 623.

23 Manns, *supra* note 10, at 1035.

24 Parisa Haghshenas, *Obstacles to Credit Rating Agencies' First Amendment Defense in Light of Abu Dhabi*, 8 FIRST AMEND. L. REV. 452, 463-64 (2010).

Organizations ("NRSROs").[25] Since the 1970s, the SEC has utilized NRSROs and their ratings in many of its regulations.[26] The problem is that very few companies could meet the SEC's stringent requirements, and the Big Three quickly absorbed the smaller firms that could do so.[27] Since 2006, the SEC has tried to make it easier for other agencies to become NRSROs, but the damage to competition is still evident.[28] The Big Three still control around 95% of the market.[29] Unlike competitive markets, a tradition of obtaining two ratings for a bond issue has all but eliminated competition between the Big Three CRAs.[30]

The regulatory requirements and the increased complexity of financial instruments have increased investor reliance on CRAs and their ratings. "Ratings agencies serve to bridge an information gap between debt issuers and . . . creditors."[31] This information gap has expanded in recent decades as new types investments with growing complexity have entered the market making it more difficult for investors to analyze risk on their own.[32] The resulting increase in reliance on ratings has sometimes been to the detriment of investors, as we saw with the collapse of the mortgage backed securities market in 2008.[33]

---

25 *See id.* (stating that the SEC developed the designation of NRSRO in order to ensure the credibility of ratings).

26 *See, e.g.*, Darcy, *supra* note 17, at 623 ("According to the SEC, at least forty-four of its rules and forms incorporate references to credit ratings.") (citing Christopher Cox, Chairman, SEC, Statement on Proposal to Increase Investor Protection by Reducing Reliance on Credit Ratings (June 25, 2008), *available at* http://www.sec.gov/news/speech/2008/spch062508cc_credit. htm).

27 Haghshenas, *supra* note 24, at 463-65.

28 Manns, *supra* note 10, at 1051-52.

29 *See* SEC, 2011 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATION OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION (September 2011) (hereinafter "SEC EXAMINATION OF NRSROS") *available at* http://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf [hereinafter SEC Examination of NRSROs] (indicating that the Big Three have issued 97% of the outstanding ratings); *see also* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 59 (2004) (noting that Moody's and Standard and Poor's have over 80% of the market and Fitch approximately 14%).

30 *See* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 59-60 (2004) ("Issuers typically attempt to obtain both Moody's and Standard & Poor's ratings, and very occasionally use Fitch as a third rating."); *see also* Darcy, *supra* note 17, at 629 (noting that the two-rating norm allows Moody's and S&P to dominate the market); Manns, *supra* note 10, at 1035 (indicating that the two-rating norm has given Moody's and S&P a near duopoly in the ratings market).

31 Manns, *supra* note 10, at 1035.

32 *See* Hunt, *supra* note 1, at 118-19 (indicating that structured finance products have become more popular in the past 25 years and that they have also become more complicated than ever before and that investors prefer complex products carry ratings).

33 *See* Manns, *supra* note 10, at 1044 ("Rating agencies employed methodologies that failed to reflect the risks of subprime mortgage debt instruments . . . ."). *See also* The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2010) ("In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate . . . [which] contributed significantly to the mismanagement of risk by financial institutions and investors . . . .").

B. *Municipal bonds*

1. Overview

Generally, municipal bonds are the method by which state and local government raise capital for civic projects. There are two basic types of municipal bonds: GO bonds and Revenue bonds. The issuer guarantees to repay GO bonds by any means possible, including new taxes.[34] Some states even prioritize the repayment of municipal bonds in their constitutions.[35] On the other hand, public service providers such as hospitals, sewer systems, water authorities, and transit authorities issue revenues bonds, and the only guarantee of repayment is the revenue raised by the project.[36] For example, if a bond is issued to finance a road, the toll proceeds are then used to pay the bond.

Rates of default for municipal bonds are very low.[37] GO bonds in particular are extremely safe since their repayment sources are so flexible.[38] Similarly, certain revenue bonds, such as water and sewer utility bonds, have the ability to raise prices on an inelastic product, which decreases the risk of default.[39] Even with thousands of bond issuers in various state and local governments, GO, water and sewer bonds have experienced only one default since 1970.[40] During this same period, there were only 41 total defaults of all municipal bonds, with the bulk of those coming from the healthcare or housing sectors.[41] The default rate for investment grade municipal bonds between 1970 and 2007 is 0.1%, compared to 2.1% for investment grade corporate bonds over that same period.[42]

---

[34] Education, *What are municipal bonds?*, MunicipalBonds.com, http://www.municipal bonds.com/education/read/47/what-are-municipal-bonds (last visited Sept. 21, 2011).

[35] *See, e.g.*, Cal. Const. art. XIIIB, § 7. ("Nothing in this Article shall be construed to impair the ability of the state or of any local government to meet its obligations with respect to existing or future bonded indebtedness.").

[36] Education, *What are municipal bonds?*, MunicipalBonds.com, http://www.municipal bonds .com/education/read/47/what-are-municipal-bonds (last visited Sept. 21, 2011).

[37] *See contra* Jason Appleson, Eric Parsons, and Andrew Haughwout, *The Untold Story of Municipal Bond Defaults*, FEDERAL RESERVE BANK OF NEW YORK (Aug. 15, 2012) (arguing that municipal bonds have a much higher rate of default than most investors realize) *available at* http://libertystreeteconomics.newyorkfed.org/2012/08/the-untold-story-of-municipal-bond-defaults.html; *but see*, Mary Walsh, *Muni Bonds Not as Safe as Thought*, THE NEW YORK TIMES (Aug. 15, 2012) (noting that "[t]he lion's share of the defaults occur in the unrated market, and they have for many years.") (quoting Steve Murphy, Managing Director, Standard & Poors) *available at* http://www.nytimes.com/2012/08/16/business/municipal-bonds-default-more-than-advertised.html.

[38] *See* GLOBAL RATING SCALE, *supra* note 5, at 3 ("Since 1970, defaults of Moody's-rated general obligation (GO) and water and/or sewer (water/sewer) revenue municipal bonds have been extremely rare.").

[39] *Id.*

[40] *Id.* at 5, Figure 2.

[41] *Id.*

[42] *Id.* at 6, Figure 3.

Even though municipal bonds are generally thought to be extremely safe investments, they do not always receive the highest ratings.[43] Since ratings are supposed to be a measure of risk associated with a particular investment, investors will shy away from an investment whose rate of return does not sufficiently compensate for this perceived risk. Municipal bond issuers must, therefore, offer investors higher interest rates in order to compensate for a lower rating.[44] The only viable alternative to paying higher interest rates is purchasing bond insurance to raise the rating and thereby lower the perceived risk.[45] Either alternative creates additional cost for the bond issuer when financing civic projects. This additional cost is passed on to the citizens of the municipality in the form of higher taxes or fewer funds available for civic projects.

2. Municipal Ratings

When municipalities issue bonds, the CRAs rate them using the same symbols as corporate bonds but different criteria. For example, Moody's rates bonds by giving them one of the following classifications: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, with Aaa being the highest and C being the lowest. [46] The other two large CRAs, S&P and Fitch, use very similar scales with only minor variations.[47] There are also other increments to provide finder gradation, including symbols such as + or - and the numbers 1-3.[48] These same letter symbols are used to rate many types of investments, including corporate bonds, structured financial instruments, and insurance products.[49] As Moody's acknowledges, "municipal credit opinions are unique in that they are expressed through Moody's municipal bond rating scale, which while sharing the familiar symbology is nevertheless conceptually distinct from Moody's global rating scale that is used for debt issued by corporations, non-US governmental issuers and structured finance securities."[50]

These similar ratings symbols lead to comparisons between municipal and corporate bonds. They also give a misleadingly low indication of the credit worthiness of municipalities because the ratings are established using different

---

43 *See, e.g.*, GLOBAL RATING SCALE, *supra* note 5, at 3 (discussing the low default rate of municipal bonds and the criteria for their ratings).

44 *See, e.g.*, John Yinger, *Municipal Bond Ratings and Citizens' Rights*, 12 AM. L. & ECON. REV. 1, 8-10 (Spring, 2010) (indicating a link between municipal bond ratings and borrowing costs).

45 *See, e.g.*, *id*.

46 *Id*.

47 *See* Hunt, *supra* note 1, at 115-16 (listing the ratings for all three ratings agencies).

48 *See id.* at 116 n.10 ("Standard & Poor's uses the "+" and "-" notation; Moody's uses a three-level numerical code within each rating grade, i.e., B1, B2, B3.").

49 RATING SYMBOLS, *supra* note 46, at 9, 14.

50 Moody's Investors Serv., U.S. MUNICIPAL BOND DEFAULTS AND RECOVERIES, 1970-2009, 2 (2010) *available at* http://v2.moodys.com/cust/content/Content.ashx?source=StaticContent/Free%20Pages/Regulatory%20Affairs/Documents/us_municipal_bond_defaults_and_recoveries_02_10.pdf.

methodologies. There are two major factors determining the rating of a corporate bond: the probability of default and the expected loss in the event of a default.[51] On the other hand, municipal bond ratings measure the issuer's ability to pay its debt, looking only at the likelihood that the issuer will reach a state of financial distress.[52] Essentially, the analysis for municipal bond ratings ignores the "expected loss" factor. Brokers, fund managers, or other buyers then rely on these ratings when they buy or sell municipal bonds.[53]

The disparity in the equations is easy to see. Not only is "financial distress" not the equivalent of "default," but also the expected loss in the event of default is not factored in to municipal bond ratings at all. In addition, CRAs do not fully factor "extraordinary support," which is often available for municipalities, into the rating, and it is a major factor in determining the real risk of a municipal bond investment.[54] Even when municipalities default, they generally pay creditors in full due to extraordinary support from higher levels of government or tax increases.[55] For example, when Orange County, California defaulted on its obligations in 1994, creditors were still paid one hundred cents on the dollar.[56] Moody's claims to factor in extraordinary support,[57] but it acknowledges that "the form and timing of extraordinary support that will be provided . . . is usually not known until the municipality is under significant enough strain that there is considerable concern that a payment default on the debt may occur."[58] The fact that the extraordinary support cannot fully be factored in contributes to lower ratings for municipal bonds than the actual risk warrants.

---

[51] Moody's Investors Serv., REQUEST FOR COMMENT: MAPPING OF MOODY'S U.S. MUNICIPAL BOND RATING SCALE TO MOODY'S CORPORATE RATINGS SCALE AND ASSIGNMENT OF CORPORATE EQUIVALENT RATINGS TO MUNICIPAL OBLIGATIONS, 1 (2006), *available at* http://www.moodys.com/sites/products/DefaultResearch/102249_RM.pdf [hereinafter CORPORATE EQUIVALENT].

[52] GLOBAL RATING SCALE, *supra* note 5, at 3.

[53] CFR § 240.15c2-12(b)(1) ("Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review . . . [t]he offering price(s), interest rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, *ratings*, other terms of the securities depending on such matters, and the identity of the underwriter(s).") (emphasis added).

[54] *See, e.g.*, GLOBAL RATING SCALE, *supra* note 5, at 3 ("The Gulf Coast communities most severely affected by Hurricane Katrina provide a recent illustration of the occurrence of extraordinary support. Most of these municipalities are likely to avoid default because they have received, or will receive, extraordinary assistance from federal and state levels of government.").

[55] Education, *What are municipal bonds?*, MunicipalBonds.com, http://www.municipalbonds.com/education/read/47/what-are-municipal-bonds (last visited Sept. 21, 2011).

[56] *Id.*

[57] CORPORATE EQUIVALENT, *supra* note 51, at 2 ("Moody's considers extraordinary support to include any form of financial, legal or regulatory relief – *beyond routine or regular forms of ongoing support* – that is provided by an external entity or by the voters to assist a distressed municipal obligor in meeting its financial obligations.") (emphasis in original).

[58] *Id.* at 3.

According to Moody's, municipal bonds receiving a rating of investment grade (Aaa to Baa)[59] have fewer instances of default than even the highest rated corporate bonds.[60] Despite this fact, only 15% of state-issued GO bonds and 3% of local GO bonds received Moody's top rating.[61] Acknowledging this discrepancy, Moody's created a conversion to their "Global Rating Scale," which rates municipal bonds on a scale equivalent to that of corporate bonds.[62] While the Global Rating Scale factors in both the probability of default,[63] the "core U.S. municipal ratings" continues to be on the traditional municipal ratings scale.[64] The effects of this Global Rating Scale have yet to be borne out. This new scale may ultimately compound the problem as CRAs are now affirmatively representing, as opposed to tacitly allowing the belief, that the municipal scale is equivalent to the corporate scale. Moreover, there is still little accountability for the ultimate rating and nothing to prevent the undervaluation of municipal bonds.[65] In other words, by using this global scale, CRAs fail to acknowledge that they are comparing apples and oranges and continue to encourage the comparison.

One of the major costs of the municipal bond rating scale can be seen when bond insurers are brought into the equation. Bond insurers pay the debtors in the event the bond issuer defaults on its obligation.[66] The purpose of bond insurance is to lower a bond's perceived risk and raise its rating, thereby lowering the interest rate that the issuer must pay. Bond insurance companies, which are also rated entities, essentially pass on their strong rating to the investment they are insuring.[67] Bond insurance is very popular.[68] Since the cost of bond insurance is less than the cost of raising the interest rate of the bond, municipal issuers can save money by purchasing bond insurance.[69] The fact that CRAs rate municipal bonds and the bond insurance companies on different ratings scales is

---

59 *Id.*

60 *See* GLOBAL RATING SCALE, *supra* note 5, at 6 ("In fact, the 10-year cumulative default rate for all investment grade Moody's-rated municipal bond issuers, excluding GO and water/sewer revenue bonds, stands at 0.2883%, which is lower than the 0.5208% [sic] rate for Aaa-rated corporate bonds.").

61 *Id.* at 4.

62 *Id.* at 1.

63 *Id.* at 12.

64 *Id.* at 2.

65 *See infra* notes 175-178 and accompanying text (discussing the difficulties with enforcing transparency).

66 Angela Gore, Kevin Sachs & Charles Trzcinka, *Financial Disclosure and Bond Insurance,* 47 J.L. & ECON. 275, 276 (2004).

67 *Id.* at 279 ("Bond Insurance substitutes the default risk of the insurance company for the default risk of the issuer.").

68 *Id.* at 276 (indicating that as of 2004 over half of new debt issues in the municipal sector were insured).

69 *See, e.g.*, John Yinger, *Municipal Bond Ratings and Citizens' Rights*, 12 AM. L. & ECON. REV. 1, 8-10 (Spring, 2010) (indicating a link between municipal bond ratings and borrowing costs).

problematic.[70] Municipal bond issuers, rated by tougher criteria, may actually have a lower risk of default than the company insuring them against default may.[71] Insurers of municipal bonds benefit from the ratings discrepancy in two ways. First, they are highly rated because they insure extremely safe municipal bonds. Second, they receive business because the bonds issuers want to save money.

Municipal bond ratings may be deceptive on two fronts. First, CRAs knowingly use the same letter gradation to represent conclusions about diverse types of investments even though the formulation of the rating and the risks may be different. The CRAs are also aware that their ratings are used to compare these different types of investments against each other and encourage such comparison. Though technically distinct, the ratings criteria are reduced to identical nomenclature, which facilitates an easy comparison. These technically true statements have the potential to create widespread deception that is "designed to mislead others into inferring false beliefs . . . ."[72] Second, by not accounting for the loss given default, or the historically low incidence of default for municipal bonds, the ratings are not accurately calculating the true risk of these investments. In failing to fully measure the true risk of municipal bonds, CRAs are deceiving investors by using "careless falsehoods or half-truths that have the effect of misleading the intended audience, even if they are not designed to deceive . . . ."[73]

These lower ratings are costly to municipalities. For example, in a suit filed by the Connecticut State Attorney General, the complaint noted of several GO municipal bonds:

> Moody's gave each of New Haven's bonds an "A3" credit rating and each of East Hartford's bonds an "A1" credit rating. As a result of Moody's deliberate underrating of public bonds, New Haven taxpayers paid a total of $2.2 million in unnecessary bond insurance premiums to receive a higher "Aaa" rating from Moody's. East Hartford taxpayers paid over $150,000 for their "Aaa" bond insurer credit rating.[74]

According to Moody's own charting, if these bonds were rated on the global scale they each would have received a much higher "Aa1" rating.[75]

---

[70] *See, e.g.*, GLOBAL RATING SCALE, *supra* note 5 (explaining the differences between the two scales).

[71] *Id.* at 2 ("Moody's will use [global scale] metrics in . . . analyzing the municipal exposures of financial guarantors.").

[72] Jonathan Varat, *Deception and the First Amendment: A Central, Complex, and Somewhat Curious Relationship*, 53 UCLA L. REV. 1107, 1109 n.3 (2006) (citing George Steiner, After Babel 214 (1975).

[73] *Id.*

[74] Connecticut v. Moody's Corp., Compl. at para. 8, No. 08-4038928-S (Conn. Super. Ct. July 30, 2008) *available a*t http://www.ct.gov/ag/lib/ag/antitrust/moodycomplaint73008.pdf.

[75] GLOBAL RATING SCALE, *supra* note 5, at 13, Figure 14.

II. ANALYSIS

CRAs enjoy a unique and somewhat ambiguous position in our economy. Despite the difficulties CRAs impose on municipalities, they face very little accountability in court.[76] They have successfully defended "Underwriter" liability and "Control Persons" claims brought under the Securities Act of 1933, among other securities law claims.[77] Often, securities laws are very specific to certain actors, and CRAs' ambiguous position allows them to avoid scrutiny.[78] If properly applied, traditional legal principals may help solve some of these issues.

A. *First Amendment*

Bonds issuers and purchasers suing CRAs often claim negligent misrepresentation or defamation.[79] In the past, they have been able to avoid liability by claiming that the ratings are only "opinion" and are therefore protected by the First Amendment. CRAs receive additional First Amendment protection by asserting they play a role similar to that of journalists.[80] Defamation cases require a plaintiff to show "that the statement in question was false and that the defendant had the requisite state of mind."[81] Under this rule, the first issue to address is if credit ratings are a matter of truth or if they are purely opinion.

---

[76] *See, e.g.*, Christopher Schmitt, *Holding the Enablers Responsible: Applying Sec Rule 10b-5 Liability to the Credit Rating Institutions*, 13 U. PA. J. BUS. L. 1035 (2011) (arguing for 10b-5 liability for CRAs as a way to fill the legal and regulatory gap that the CRAs have fallen into).

[77] *See, e.g.*, In re Lehman Brothers Mortgage-Backed Securities Litigation, 650 F.3d 167, 176-182, (holding that despite their role in structuring the investments CRAs did not qualify as "Underwriters" under § 11 of the 33 Act or as "Control Persons" under § 15).

[78] *See e.g.*, *id.* (despite their large role CRAs did not fit under any of the statutory definitions for liability).

[79] Haghshenas, *supra* note 24, at 469 ("In lawsuits against rating agencies, plaintiffs have alleged defamation, negligent misrepresentation and libel.").

[80] *See, e.g.*, Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability?*, 75 CORNELL L. REV. 411, 413-14, 414 n.16 (1990) ("bond rating agencies receive full first amendment protection as a member of the media . . .") (citing First Equity Corp. of Fla. v. Standard & Poor's Corp., 869 F.2d 175 (2d Cir. 1989); First Equity Corp. of Fla. v. Standard & Poor's Corp., 690 F. Supp. 256 (S.D.N.Y. 1988), aff'd, 869 F.2d 175 (2d Cir. 1989); First Equity Corp. of Fla. v. Standard & Poor's Corp., 670 F.Supp. 115 (S.D.N.Y. 1987), aff'd, 869 F.2d 175 (2d Cir. 1989); Pittman v. Dow Jones & Co., 662 F. Supp. 921 (E.D. La. 1987), aff'd, 834 F.2d 1171 (5th Cir. 1987); Gale v. Value Line, Inc., 640 F. Supp. 967 (D.R.I. 1986); Milberg v. Western Pac. R.R., 51 F.R.D. 280 (S.D.N.Y. 1970), appeal dismissed sub nom. Korn v. Franchard Corp., 443 F.2d 1301 (1971); Jaillet v. Cashman, 115 Misc. 383, 189 N.Y.S. 743 (Sup. Ct. 1921), aff'd mem. 202 A.D. 805, 194 N.Y.S. 947 (App. Div. 1922), aff'd mem., 235 N.Y. 511, 139 N.E. 714 (1923); Daniel v. Dow Jones & Co., 520 N.Y.S.2d 334 (N.Y. City Civ. Ct. 1987); Gutter v. Dow Jones, Inc., 22 Ohio St. 3d 286, 490 N.E.2d 898 (1986)).

[81] Jefferson County School Dist. v. Moody's Inv. Svc., Inc. 175 F.3d 848, 852 (10th Cir. 1999).

1. Credit Ratings as Opinion

The traditional view is that ratings are predictions about default risk, making them opinions because future events cannot be true or false.[82] In *Milkovich v. Lorain Journal*,[83] the Supreme Court, in discussing the First Amendment protections for opinions, points out that there is not a "wholesale defamation exemption for anything that might be labeled 'opinion.'"[84] Courts have recently begun to recognize that CRAs should not always receive full First Amendment protection.

One of the distinctions between CRAs and typical journalists is that the bond issuers pay the CRA for issuing its rating. In *In re Fitch, Inc.*,[85] the Second Circuit rejected granting Fitch protection under New York's Shield Law as a professional journalist.[86] The court considered it relevant that Fitch only rates bond issuers that pay for a rating, something that cannot be said of Moody's or S&P.[87] The court also found it relevant that Fitch played a role in structuring the transaction to achieve a desired rating.[88] In *Commercial Financial Services, Inc. v. Standard & Poor's*,[89] the court found it significant that the CRA and the issuer had a paid relationship, unlike a journalist reporting on a topic.[90] In *Abu Dhabi Commercial Bank v. Morgan Stanley,*[91] the Southern District of New York rejected granting a First Amendment immunity to a CRA because their "compensation was contingent upon the receipt of desired ratings…and only [happened] in the event that the transaction closed with those ratings."[92] These cases indicate that courts are beginning to recognize CRAs as different from typical journalists.

Another difficulty with the presumption that ratings are opinions is that they are not merely future predictions. In *Compuware Corp. v. Moody's Investor Services*,[93] the Sixth Circuit found that a "rating is a predictive opinion of a company's future creditworthiness . . . ."[94] Since ratings are based largely upon

---

82 *See* Haghshenas, *supra* note 24, at 472-73 ("Although the test for defamation requires that the statements be proven false, this test is misplaced in the rating agencies context because the ratings assigned are predictions about future issuances, and intuitively one cannot prove in the present that a prediction of future events is false.").

83 497 U.S. 1 (1990).

84 *Id.* at 18.

85 330 F.3d 104 (2nd Cir. 2003).

86 *Id.* at 109.

87 *Id.*

88 *Id.* at 110-11.

89 94 P.3d 106 (Okla. 2004).

90 *Id.* at 111.

91 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

92 *Id.* at 167.

93 499 F.3d 520 (6th Cir. 2007).

94 *Id.* at 522.

the issuer's current financial situation, they could also be viewed as an evaluation of a company's current state. This feature means that ratings are less like pure opinion than they are deductions, or conclusions based on facts.[95] Viewed as deductions, ratings are "assertion[s] of fact inasmuch as [they are] a claim of the past, present, or future existence or attribute of some event, person, place, or thing."[96] Although some debate remains,[97] courts continue to use a totality the circumstances test to make the determination.[98] Under this analysis, ratings are less likely to be opinion because CRAs purportedly use facts in making their ratings.

When establishing a rating, a CRA "considers several objective factors, but [the rating] is ultimately derived from the subjective weighing of those factors."[99] Conflicts of interest are inherent in the rating process, increasing the subjectivity of the process. Thus, ratings may be skewed when CRAs potentially benefit.[100] CRAs claim to disclose the methodology for how they arrive at a particular rating. This methodological transparency should help determine whether ratings are verifiable as true or false and ensure that they are objectively created.

In *Milkovich v. Lorain Journal*, the Supreme Court ruled that "[e]ven if the speaker states the facts upon which he bases his opinion, if those facts are either incorrect or incomplete, or if his assessment of them is erroneous, the statement may still imply a false assertion of fact."[101] Similarly, in *Jefferson County School Dist. v. Moody's Investment Services, Inc.*,[102] the Tenth Circuit found that if ratings "were shown to have materially false components, the issuer should not be shielded from liability by raising the word 'opinion' as a shibboleth."[103] Under this reasoning, if part of the rating criteria is "materially false" or if the ratings assessment is erroneous, then the rating itself may be a false statement. With increased methodological transparency, the ratings objective criteria gain weight and, if the objective data does not support the final rating, any subjective criteria that enter the equation should receive greater scrutiny.

---

95 Robert Sack, *Protection of Opinion Under the First Amendment: Reflections on Alfred Hill*, "DEFAMATION AND PRIVACY UNDER THE FIRST AMENDMENT", 100 Colum. L. Rev. 294, 299 (2000).

96 *Id.*

97 Restatement (Second) of Torts §566 (1977) ("The simple expression of opinion, or the pure type, occurs when the maker of the comment states the facts on which he bases his opinion of the plaintiff and then expresses a comment as to the plaintiff's conduct, qualifications or character.").

98 *Id.* (citing *Capan v. Daugherty*, 402 N.W.2d 561, 563 (Minn. Ct. App. 1987).

99 499 F.3d at 522.

100 *See* Haghshenas, *supra* note 24, at 494 (indicating that conflicts of interest cloud the subjectivity of ratings).

101 497 U.S. at 18-19.

102 175 F.3d 848 (10th Cir. 1999) (hereinafter *Jefferson County*).

103 *Id.* at 856.

2. Required State of Mind

The Supreme Court has held that public figures must prove "actual malice" in order to recover for a defamatory falsehood relating to matters of public concern.[104] In *County of Orange v. McGraw-Hill*,[105] after the county defaulted on its debt obligations, it sued S&P for the rating it gave its bond issue.[106] The district court held the plaintiff must meet the actual malice standard to prove that S&P did not issue a rating in a competent manner.[107] The *McGraw* case shows that municipalities, often considered matters of public concern, require plaintiffs to show "actual malice" to prevail.[108]

To prove "actual malice" the plaintiff must show that the CRA acted "with knowledge that the statement was false or with reckless disregard for whether or not it was true."[109] While no case has shown actual malice on the part of CRAs, courts have found them to be liable under certain circumstances. In *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*,[110] the Supreme Court found that a company's credit report was not a matter of public concern because it remained confidential, and therefore, the plaintiff did not have to show actual malice.[111] In *In re National Century* and in *Abu Dhabi Commercial Bank*, the respective courts relied on *Dun & Bradstreet* in finding that the defendant CRAs did not qualify for full First Amendment protection because the ratings were only disseminated to a limited number of people.[112] While these decisions will allow for a lesser mental state in private placements,[113] they will likely not have an effect on municipal bonds. Municipal bonds are available to the public at large, and it would be difficult to claim that a municipal bond rating is not a matter of public concern.

As with the fact/opinion determination, CRAs and ratings do not fit well into the actual malice evaluation. As previously discussed, CRAs are often incentivized to increase or decrease a particular rating because the issuer pays for the service. Perhaps these misaligned incentives are enough to show actual

---

[104] *See* New York Times Co. v. Sullivan 376 U.S. 254, 279-80 (1964) (holding that public officials must show actual malice for defamatory falsehoods relating to official conduct);Curtis Pub. Co. v. Butts, 388 U.S. 130, 164-65 (1967) (Warren, C.J., concurring) (applying the public official standard to public figures if the matter is a public concern).

[105] 245 B.R. 151 (C.D. Cal. 1999).

[106] *Id.* at 153-54.

[107] *Id.* at 157.

[108] *Id.* at 160-61 (holding that credit ratings were statements of opinion and that "actual malice" must be shown in order to overcome First Amendment protection.).

[109] *Id.* at 155 (quoting Hustler Magazine v. Falwell, 485 U.S. 46, 56 (1988)).

[110] 472 U.S. 749 (1985).

[111] *Id.* at 761-63.

[112] In re Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008); Abu Dhabi Comm. Bank v. Morgan Stanley & Co., Inc., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

[113] *See* John Crawford, *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives In the Credit Rating Industry*, 42 CONNTEMPLATIONS 13, 23 (2009).

malice when a court finds that the objective criteria do not match the final rating, resulting in a financial benefit to the CRA.

B. *Antitrust Liability*

1. Monopolization

Municipalities have also charged CRAs with violations of the Sherman Antitrust Act with historically little success. The case of *Jefferson County* provides an illustration.[114] Despite previously working with Moody's, the School District chose two other CRAs for this particular bond issue.[115] When the bonds were brought to the market, they initially sold well based on favorable ratings by the two other agencies. Soon after the sales period began, Moody's published an unsolicited opinion, giving the School District a negative outlook.[116] This unsolicited article created a chilling effect on the sales of the School District's bond issue, resulting in an increased interest rate.[117]

In addition to its state tort claims, the School District tried to amend its complaint to allege that this was an act of monopolization under Section 2 of the Sherman Act.[118] The School District claimed that the publication of the article was an attempt to monopolize the ratings market.[119] In denying the motion to amend, the district court held – and the Tenth Circuit affirmed – that Moody's statements about the bond issue were opinions, immunizing Moody's from federal antitrust claims.[120] The Circuit Court went on to hold that antitrust claims could not be predicated on speech protected by the First Amendment.[121]

This reasoning leads to a bizarre result. If an issuer does not wish to pay one of the Big Three to rate its bonds, the snubbed CRA may then publish a rating or article that negatively influences the bond issue with virtually no repercussions. The *Jefferson County* court looked to prior Supreme Court precedent with respect to applying the laws of defamation to media defendants.[122] The Tenth Circuit held that the article did not constitute a

---

[114] *See Jefferson County*, *supra* note 102.

[115] 175 F.3d at 850.

[116] *Id.* Note that although the unsolicited "negative outlook" was in an article published by Moody's, the same analysis would apply to an unsolicited rating since, as CRAs acknowledge, these ratings are a symbolic representation of this same kind of analysis.

[117] *Id.* at 851.

[118] *Id.*

[119] *Id.* at 860.

[120] *Id.* at 860.

[121] 175 F.3d at 860.

[122] *See id.* at 852 (citing 497 U.S. 1 (1990); New York Times v. Sullivan, 376 U.S. 254 (1964); Curtis Publishing Co. v. Butts, 388 U.S. 130 (1967); Philadelphia Newspapers, Inc. v. Hepps, 475 U.S. 767 (1986)).

provably false factual assertion, either expressed or implied, and that the statements deserved protection under the First Amendment.[123]

The court in *Jefferson County* uses a markedly flawed reasoning. While the First Amendment affords the highest protection for media defendants, it does not immunize them from liability when they use their position to attempt to monopolize. Even news organizations are subject to scrutiny under the antitrust laws. "The First Amendment does not Preclude Application of the [Sherman] act to a news gathering organization, nor does freedom of the press authorize a newspaper to attempt to monopolize in violation of it."[124] The fact that a particular publisher handles news while others trade in goods does not afford the publisher the constitutional privilege to violate the antitrust laws with impunity.[125] As discussed in the previous section, CRAs' statements regarding the creditworthiness of a municipality are not typical media reports.[126] In addition, methodological transparency makes ratings somewhat verifiable as facts and not purely opinions that deserve full constitutional protection. The ratings system and other possibly monopolistic actions of CRAs should, therefore, be subject to antitrust scrutiny.

If the monopolization claim in *Jefferson County* had survived the motion to dismiss, a jury may have found Moody's actions to be anticompetitive. Section 2 of the Sherman Act states: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce . . . shall be deemed guilty of a felony."[127] In *Spectrum Sports, Inc. v. McQuillan*,[128] the Supreme Court noted that in order to succeed in an attempted monopolization claim a plaintiff must prove that: (1) the defendant has engaged in predatory or anticompetitive conduct with both (2) a specific intent to monopolize and (3) a dangerous probability of achieving monopoly power.[129] If the *Jefferson County* court allowed a jury to evaluate Moody's conduct under these criteria, it may very well have found a Section 2 violation.

First, Moody's conduct with respect to the School District's bond issue was potentially predatory. By giving poor evaluations of bonds for which Moody's has no contract to rate, Moody's is able to discourage bond issuers from utilizing its main competitors, S&P and Fitch. At the very least, they are able to coerce bond issuers into engaging Moody's. In other words, Moody's extorts issuers into hiring them or having their bond issue and reputation

---

[123] *Id.* at 860.

[124] 58 AM. JUR. 2D *Newspapers, etc.* § 57 (2013).

[125] *See, e.g.*, Lorain Journal Co. v. United States, 342 U.S. 143 (1951) (holding that a newspaper's efforts to harm its competitors constituted a violation of the Sherman Act); Associated Press v. United States, 326 U.S. 1 (1945) (holding that a news gathering association's practices, which prevented members from sharing news with non-members, were monopolistic).

[126] *See infra* Section A.

[127] 15 U.S.C.A. § 2 (West 2004).

[128] 506 U.S. 447 (1993).

[129] *Id.* at 456.

harmed. In *Lorain Journal v. United States,*[130] a newspaper refused to publish ads from companies who advertised with a competing radio station.[131] The Supreme Court held that a "publisher may not accept or deny advertisements in an 'attempt to monopolize . . . .'"[132] The conduct in that case, as in *Jefferson,* discouraged clients from purchasing services from a competitor.[133] While *Lorain Journal* involved a mere refusal to deal with clients of a competitor,[134] Moody's actions in *Jefferson County* were even more egregious. They took overt actions to harm a consumer who did not seek their services.[135] Further evidence of the pernicious nature of this act is that Moody's previously gave the School District a high rating.[136] Any factors that would have significantly changed the risk of the Jefferson County bond would have been reflected in the S&P or Fitch ratings.

The next step in evaluating an attempted monopolization claim would be determining if a specific intent to monopolize existed. The Supreme Court has acknowledged that when a defendant engages in predatory conduct, the conduct itself is evidence of an attempt to monopolize.[137] The same factors that are relevant to the predatory nature of the action are also evidence of Moody's intent. The timing and other circumstances surrounding the article indicate Moody's intent to both punish the School District for not using their service and discourage others from doing the same. Moody's would likely argue that it published the article to convey to investors its opinion on the School District's credit risk. Investors, however, would have a more accurate evaluation of this risk based on the ratings of the two CRAs that had up-to-date information. Moody's article contradicting its competitors could only serve to undermine the School District's ratings and confuse potential investors.

The final step in evaluating an attempted monopolization claim is to determine whether there was a possibility of achieving monopoly power. One of the difficulties in evaluating CRAs under antitrust law is that two major companies dominate the market. Together, S&P and Moody's control the bulk

---

[130] 342 U.S. 143 (1951).

[131] *Id.* at 146-47.

[132] *Id.* at 156 (quoting 15 U.S.C.A. § 2 (West 2004)).

[133] *Id.* at 149-50.

[134] *Id.* at 152 ("The publisher's attempt to regain its monopoly of interstate commerce by forcing advertisers to boycott a competing radio station violated [Section 2 of the Sherman Act].").

[135] *See* 175 F.3d, at 850-51 (10th Cir.1999) (Moody's issued an unsolicited negative outlook for the bond issue, only two hours into the bond issue, without garnering the most up-to-date and accurate information).

[136] Jefferson Cnty. Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc., 988 F. Supp. 1341, 1343 (D. Colo. 1997) ("Moody's had an outstanding rating on the School District's Series 1985C Bonds.").

[137] *See, e.g.*, Spectrum Sports, Inc., 506 U.S. at 458 (1993) (stating that when a "defendant has engaged in 'unfair' or 'predatory' tactics, [s]uch conduct may be sufficient to prove the necessary intent to monopolize.") (quoting McQuillan v. Sorbothane, Inc., 907 F.2d 154 (9th Cir. 1990)).

of the market with Fitch a distant third.[138] Given this market structure, it is tough to understand how one of these companies could be close to obtaining monopoly power. As previously discussed, however, the norm for bond issuers is to obtain two ratings.[139] As an illustration of this tradition's influence on the market, investors may become suspicious if issuers only obtain one rating.[140] Moody's and S&P reinforce this two-rating norm as Moody's did in *Jefferson County*. As Claire Hill stated:

> Should the two-rating norm show some sign of eroding, Moody's and Standard & Poor's can reinforce it by threatening to issue ratings the issuer has not solicited, using only the information publicly available. The implicit threat is always that without an issuer's active participation in (and payment for) the rating, the issuer will not be given an opportunity to rebut any negative inferences that might be made from the public information.[141]

With this two-rating norm, ratings by S&P and Moody's are complements, not substitutes. A successful attempt to drive out Fitch, the only other large competitor, would essentially give Moody's and S&P a duopoly. In other words, the two-rating norm effectively gives both Moody's and S&P each the possibility of achieving monopoly profits.

2. Conscious Parallelism

Conscious parallelism is another potential antitrust theory under which to evaluate CRAs, specifically the municipal bond rating scale. Under Section 1 of the Sherman Act, every contract, combination, or conspiracy in restraint of trade is illegal.[142] In *Monsanto v. Spray-Rite*,[143] the Supreme Court interpreted this phrase as requiring "a conscious commitment to a common scheme designed to achieve an unlawful objective."[144] In other words, there must be some sort of agreement in order to find a Section 1 violation.[145] Finding an agreement with concrete evidence is inherently difficult in antitrust litigation simply because of the nature of the crime. Conspiracies are typically implicit agreements that the parties do not want to write in ink. In addressing this issue, the Supreme Court

---

138 *See* Darcy, *supra* note 17, at 612-13 ("Fitch, Moody's, and S&P hav[e] issued almost 99% of all outstanding ratings . . . commentators have traditionally considered Moody's and S&P as the most prominent agencies, ranking Fitch a distant third.").

139 *See id.* at 613 ("[A] two rating norm has historically existed where issuers usually try to obtain ratings from Moody's and S&P.").

140 Hill, *supra* note 30, at 61 (indicating that the second rating often pays for itself in the form of better sales because of the suspicion surrounding instruments sold with only one rating).

141 *Id.*

142 15 U.S.C.A. § 1 (West 2004).

143 46 U.S. 752 (1984).

144 *Id.* at 768.

145 *See, e.g.*, Eastern States Retail Lumber Dealers' Ass'n v. United States 34 S.Ct. 951, 954 (1914) ("[I]n order to show a combination or conspiracy within the Sherman act some agreement must be shown under which the concerted action is taken . . . .").

noted that "conspiracies are seldom capable of proof by direct testimony, and may be inferred from the things actually done . . . ."[146] Moreover, a formal agreement is unnecessary to show an unlawful conspiracy and circumstantial evidence is admissible, including the business practices of the alleged conspirators.[147] In order to prove that an antitrust agreement exists, a plaintiff must show "evidence that tends to exclude the possibility of independent action" on the part of the defendant.[148]

Each of the Big Three CRAs rates bonds using similar criteria and very similar numerical symbols.[149] The Supreme Court has indicated that parallel business practices, such as this, may not necessarily prove an antitrust agreement exists.[150] Without an explicit agreement, competitors may find it in their best interest to have the same business practices as a competitor.[151] This type of parallel business practices becomes more troublesome when the particular behavior would not be in the unilateral self-interest of one of the businesses without an agreement among them. In *Interstate Circuit v. United States*,[152] the Supreme Court found an implicit agreement when several movie theaters complied with a movie distributor's request to raise prices without evidence that they explicitly agreed with each other.[153] The court reasoned that unless each movie theater knew that its competitors would raise prices, it would not be in their unilateral self-interest to do so.[154]

Without an implied or expressed agreement, the Big Three CRAs would face a prisoner's dilemma.[155] They would each have an incentive to be the first to provide more accurate, verifiable ratings and gain market share. On the other hand, if they all do so, the industry as a whole will not be quite as profitable since their illicit practices may be impossible. With an agreement in place, each of the Big Three will continue with the status quo so that they can all extract higher profits without the risk of a competitor dropping the practice and cutting into their market share. The lesson from utilizing the prisoner's dilemma in

---

146 *Id.*

147 Gregory Werden, *Economic Evidence on the Existence of Collusion: Reconciling Antitrust Law with Oligopoly Theory*, 71 ANTITRUST L.J. 719, 734-35 (2004) (citing Norfolk Monument Co. v. Woodlawn Mem'l Gardens, Inc., 394 U.S. 700, 704 (1969) (per curiam)).

148 465 U.S. at 768 (1984).

149 *See* Hunt, *supra* note 1, at 115-16.

150 *See* United States v. Int'l Harvester Co., 274 U.S. 693, 708-09 (1927) ("And the fact that competitors may see proper, in the exercise of their own judgment, to follow the prices of another manufacturer, does not establish any suppression of competition or show any sinister domination.") (citing United States v. United States Steel Corp. 251 U.S. 417, 448 (1920)).

151 *See id.*

152 306 U.S. 208 (1939).

153 *Id.* at 226-27.

154 *Id.* at 223 ("But we are unable to find in the record any persuasive explanation, other than agreed concert of action, of the singular unanimity of action on the part of the distributors by which the proposals were carried into effect . . . .").

155 *See* Werden, *supra* note 147 at 727-28 (explaining the prisoner's dilemma game thoroughly).

evaluating the possible CRA cartel "is that cooperation cannot be expected to just happen."[156] Put simply, there must be an agreement, expressed or implied, for this practice to continue.

3. The Municipal Bond Rating Scale as an Unfair Trade Practice

CRAs have some oversight over the bond market by controlling the bonds that will receive high ratings. CRAs also have incentives to give high ratings to certain financial products. In *Abu Dhabi Commercial Bank v. Morgan Stanley*, the court noted that CRAs often receive compensation contingent upon an investment receiving a desired rating.[157] The *Abu Dhabi* court recognized the potential conflict of interest because of this compensation scheme.[158] Municipal bonds compete with these other securities when trying to attract investors. CRAs give other securities a distinct advantage by using a deceptive ratings scale that undervalues municipal bonds. As a result, municipal bond issuers must buy costly – and often unnecessary – bond insurance to prop up their rating and compete for investors. Since municipalities are direct competitors with marketable securities in which CRAs have a vested interest, CRAs effectively increase the cost of their rivals by using a more difficult ratings scale. Raising rivals cost is a long-recognized predatory act under the Sherman Act.[159]

The Supreme Court has found certain practices anticompetitive when they reduce the use of a rival's product "through something other than competition on the merits."[160] In the case of CRAs, the municipal ratings scale reduced the incentives to purchase municipal bonds not because of their inherent value, but because of their rating compared to their competition. Thus, it is reasonable to argue that the bond's reduction in value is due to "something other than competition on the merits."[161] This reduction in value has significantly cost municipalities and taxpayers by making municipal bonds less marketable.

The State of Connecticut made this argument in an effort to hold CRAs accountable for the additional costs they imposed on municipalities. In June of 2008, Connecticut Attorney General Richard Blumenthal sued each of the Big Three CRAs ("*Connecticut cases*").[162] The complaint alleged that the Big Three undertook the "unfair, deceptive, and illegal business practice of systematically

---

[156] *Id.* at 728.

[157] 651 F. Supp. 2d at 167.

[158] *Id.* at 178-79.

[159] *See, e.g.*, 342 U.S. at 149.

[160] United States v. Microsoft Corp., 253 F.3d 34, 65 (D.C. Cir. 2001).

[161] *Id.*

[162] Connecticut v. Fitch, Inc., Compl., No. 08-4038926-S (Conn. Super. Cr. 2008) *available at* http://www.ct.gov/ag/lib/ag/antitrust/fitchcomplaint073008.pdf; Connecticut v. Moody's Corp.,Compl., No. 08-4038928-S (Conn. Super. Cr. July 30, 2008) *available at* http://www.ct.gov/ag/lib/ag/antitrust/moodycomplaint73008.pdf; Connecticut v. McGraw-Hill Co.'s, Inc., Compl. No. 08-4038927-S (Conn. Super. Ct. July 30, 2008) *available at* http://www.ct.gov/ag/lib/ag/antitrust/s&pcomplaint7308.pdf.

and intentionally giving lower credit ratings to bonds issued by states, municipalities, and other public entities as compared to corporate and other forms of debt with similar or even worse rates of default."[163] The complaint focuses on the ratings' symbols as a cause of confusion, stating "[b]ecause Moody's public and corporate bond ratings are identical on their face, consumers of Moody's ratings quite reasonably assume they mean the same thing."[164] The complaint further alleged that the CRAs colluded with bond insurance providers to keep municipal bonds rated on a more stringent scale but with the same symbols.[165] After bouncing between state and federal courts for three years on procedural grounds, the Connecticut Attorney General accepted a settlement agreement from the CRAs.[166] According to the settlement, the CRAs will give $900,000 in credit to the state for future credit ratings from these agencies.[167]

CRAs have given a procompetitive justification for utilizing two distinct ratings scales.[168] They claim the separate scales are necessary to provide larger spreads when comparing municipal bonds.[169] If CRAs rated municipal bonds on the corporate scale, the bonds would likely remain bunched together in the Aaa or Aa range.[170] This argument is unpersuasive because it does not address why it is necessary for competing securities to use the same nomenclature. Perhaps policymakers should reconsider the ratings scales *in toto* to achieve finer gradation.[171]

---

[163] Connecticut v. Moody's Corp., Compl. at para. 1.

[164] *Id.* at para. 61.

[165] *See id.*, at paras. 68–71.

[166] Press Release, George Jepsen, Attorney Gen., Conn., Office of the Attorney General Settles Public Finance Lawsuits Against Moody's, Standard & Poor's, and Fitch (Oct. 14, 2011), *available at* http://www.ct.gov/ag/cwp/view.asp?A=2341&Q=488608.

[167] *Id.*

[168] *See, e.g.*, Board of Trade of City of Chicago v. U.S., 246 U.S. 231, (1918) ("The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.").

[169] GLOBAL RATING SCALE, *supra* note 5, at 2 ("Because many municipal investors and issuers place a high value on the fine gradations of risk provided by the municipal rating scale, Moody's will continue to use this scale for our core U.S. municipal ratings.").

[170] *See* CORPORATE EQUIVALENT, *supra* note 51, at 3 ("[F]iscally sound issuers in these sectors [GO, water, and sewer municipal bonds] would likely map to a rating of Aaa or Aa on the corporate rating scale.").

[171] An antitrust plaintiff could argue that the benefits from finer gradation in the separate scales is outweighed by the confusion in using the same nomenclature. *See, e.g.*, United States v. Microsoft Corp., 253 F.3d 34, 64 (D.C. Cir. 2001) ("[I]f the monopolist's procompetitive justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit.").

While these cases venture into unexplored legal territory, it is not first time a practice of those controlling a financial market has come under antitrust scrutiny. In the class-action suit *In re NASDAQ Market-Makers Antitrust Litigation,*[172] private plaintiffs alleged that several so-called market makers engaged in unfair conduct that inflated the price of certain investments.[173] The practice was improper because the defendants agreed by implicit agreement to disallow quoting prices in "odd-eights" on the NASDAQ exchange.[174] That practice, like the municipal bond scale, affected the pricing of some of the securities in the market.[175] The settlements in *In re NASDAQ* totaled over $1 billion.[176] This case was "the largest recovery, class action or otherwise, in the hundred-year history of the state and federal antitrust laws."[177]

Compared to the *In re NASDAQ* case, the settlement agreement of the *Connecticut Cases* seems inadequate. In the *Connecticut Cases*, the alleged damages totaled over $6.2 Million.[178] Extrapolating across the fifty states and thousands of bonds issued, the potential for liability could be enormous. In light of this fact and the sizeable settlement in *In re NASDAQ*, it is likely that the settlement reached in the *Connecticut cases* was largely symbolic. The aftermath of the 2008 financial crisis highlighted the need for reform in this area. According to the settlement announcement, the reform sought by the lawsuits has been implemented since the suits were filed.[179] Since this reform is what was truly sought, the cases were never adjudicated on their merits.

---

[172] 894 F.Supp. 703 (S.D.N.Y. 1995).

[173] *Id.* at 705-07.

[174] *Id.* at 707.

[175] *Id.* at 707-09.

[176] In re Nasdaq Market-Makers Antitrust Litigation, 187 F.R.D. 465, 472-73 (S.D.N.Y. 1998) ("The Proposed Settlements provide for aggregate payments by all 37 defendants, which, including interest, will total approximately $1,027,000,000.00 (before deductions for fees and expenses) by the anticipated time of distribution in 1999.").

[177] *Id.* at 471.

[178] Each complaint gave examples of the cost of bond insurance on municipal bonds rated by the respective CRAs. Connecticut v. Fitch, Inc., Compl. at paras. 8-10 No. 08-4038926-S (Conn. Super. Ct. July 30, 2008) *available at* http://www.ct.gov/ag/lib/ag/antitrust/fitchcomplaint 073008.pdf (giving examples of the cost of bond insurance on Fitch rated municipal bonds); Connecticut v. Moody's Corp., Compl. at paras. 8-9 (Conn. Super. Ct. July 30, 2008) *available at* http://www.ct.gov/ag/lib/ag/antitrust/moody complaint73008.pdf (giving examples of the cost of bond insurance on Moody's rated municipal bonds); Connecticut v. McGraw-Hill Co.'s, Inc.., Compl. at para.s 6-8 (Conn. Super. Ct. July 30, 2008) *available at* http://www.ct.gov/ag/lib/ag/anti trust/s&pcomplaint7308.pdf (giving examples of the cost of bond insurance on Fitch rated municipal bonds).

[179] Jepsen, *supra* note 166.

III. DODD-FRANK AND OTHER LEGISLATION

In July 2010, President Obama signed Dodd-Frank into law.[180] Subtitle C of Title IX of Dodd-Frank addresses CRAs, implementing reforms through various measures.[181] The act emphasizes that "credit rating agencies are central to the capital formation, investor confidence, and the efficient performance of the United States economy."[182] It specifically addresses the areas of reliance, oversight, accountability, conflicts of interest, and the risks of inaccuracy.[183]

A. *Reducing Reliance on CRAs*

As previously discussed, CRAs are an integral part of the financial regulation.[184] Dodd-Frank tries to reduce regulatory dependence on CRAs. Specifically, it removes references to CRAs and rating in the Federal Deposit Insurance Act, the Federal Housing Enterprises Financial Safety and the Soundness Act of 1992, the Investment Company Act of 1940, and the Securities and Exchange Act of 1934, among others.[185] Dodd-Frank also requires each federal agency to review its regulations that reference credit ratings or CRAs[186] to create their own uniform standards of creditworthiness, removing any reference to credit ratings.[187] The goal behind reducing the regulatory reliance is ultimately to reduce investor reliance on ratings and prevent another financial collapse. If investors are not as reliant on the rating system, they will likely place more weight on the strong history of municipal bonds. While the effect of these measures remains unseen, municipalities and taxpayers should benefit from the reduced cost of borrowing.

B. *Conflicts of Interest*

Dodd-Frank also looks to enhance oversight of CRAs. It requires the SEC to establish an Office of Credit Ratings to conduct an annual examination of CRAs.[188] The purpose of the new office is to: "(i) to protect[] … users of credit ratings . . .; (ii) to promote accuracy in credit ratings . . ., and (iii) to ensure that

---

180 BINGHAM MCCUTCHEN LLP, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: A SUMMARY intro. (2010).

181 Dodd-Frank, Pub. L. No. 111-203, §§ 931–939, 124 Stat. 1376, 1872–83 (codified in scattered sections of 12, 15, 22 U.S.C. (2010)).

182 § 931(1), 124 Stat. at 1872.

183 § 931(1)-(5), 124 Stat. at 1872-83.

184 *See supra* note 7 and accompanying text.

185 Dodd-Frank § 939, 124 Stat. at 1885–87.

186 § 939A(a), 124 Stat. at 1887.

187 § 939A(b), 124 Stat. at 1887.

188 §932(a)(8), 124 Stat. at 1885.

such ratings are not unduly influenced by conflicts of interest."[189] Other provisions include a review of former employees and the establishment of an industry code of ethics.

CRAs have experienced major criticism due to this transparency problem. The concern is that CRAs lack accountability for inaccuracies without transparency in their ratings. A SEC study of CRAs in 2008 concluded that "the agencies did not always fully disclose significant components of the ratings process and methodologies for rating[s] . . . despite claims from the CRAs that they disclosed their ratings process."[190] In light of the transparency concerns, which arose from the 2008 financial crisis, Dodd-Frank is intended "to enhance the regulation of NRSROs by imposing new reporting disclosure, and examination requirements."[191] The heart of the transparency problem is the inherent conflict of interest in ratings agencies. In an effort to increase transparency, Dodd-Frank authorizes the SEC to establish rules requiring NRSROs to disclose information relating to their rating methodology and track the performance of their ratings.[192]

This increased transparency should help to alleviate some of the problems associated with CRAs, such as the motivation behind unsolicited ratings. In *Jefferson County*, Moody's published an unsolicited article giving the School District a negative outlook.[193] This kind of unsolicited rating – and other articles like it – is commonplace in the ratings industry. The suspicion that CRAs are behaving in a monopolistic manner should reduce with increasing transparency. If Moody's chose to disclose its methodology in *Jefferson County*, the School District would not be able to claim that Moody's actions were predatory. This increase in transparency, therefore, would not only protect issuers from predatory actions by CRAs but also protect CRAs from defamation claims. Further, increased transparency would give greater legitimacy to the ratings as investors would not have reason to question the motives of the CRAs.

A SEC study released in 2011 indicated similar transparency problems persist even after Dodd-Frank. The study found that one of the Big Three "had failed to follow its methodology" in rating certain securities and that this "error resulted in the issuance of ratings that were inconsistent with the [CRAs] methodologies."[194] The study went on to find that "[a]ll of the [CRAs] failed to follow their ratings procedures in some instances."[195] When CRAs fail to follow the published methodology for ratings, it is difficult for investors to determine exactly how a rating was established. Moreover, with thousands of ratings being

---

[189] § 932, 124 Stat. at 1885.

[190] Darcy, *supra* note 17, at 628-29 (2009) (citing SEC, SUMMARY OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATION OF SELECT CREDIT RATING AGENCIES 1, 13 (2008)).

[191] SEC EXAMINATION OF NRSROS, *supra* note 29, at 2 (citing Dodd-Frank, § 923, 124 Stat. 1376, 1849 (2010)).

[192] *Id.*

[193] 175 F.3d at 850-51.

[194] SEC EXAMINATION OF NRSROS, *supra* note 29, at 11.

[195] *Id.* at 13.

issued, it is nearly impossible for an investor to determine which ratings are accurate and which are based on poor methodology or biased by subjective components.

C. *Universal Ratings Symbols*

Universal rating symbols could be a major win for municipalities, especially since the Connecticut Attorney General cited it as a factor in the decision to settle the case against the Big Three.[196] As stated in the press release announcing the settlement, the "Dodd-Frank Act now requires rating agencies to clearly define the meaning of their rating symbols and to apply such symbols consistently across all securities, including public and corporate bonds, for which the symbols are used."[197] In addition, Moody's implemented its "Global Scale" in order to compare municipal and other bonds on an equal manner.[198] Celebrating a victory may be premature at this point because Moody's declared that it will still use the normal municipal bond rating scale unless the issuer requests otherwise.[199] Moreover, two different scales for evaluating municipal bonds may only add to the confusion associated with municipal bond ratings.

D. *Accountability*

Dodd-Frank has addressed the state of mind requirement for private action suits against CRAs for money damages,[200] but it is unclear how this requirement will affect CRA liability. Dodd-Frank amends the Securities and Exchange Act of 1934 with regard to pleading purposes so that the state of mind required by the complaint is whether the rating agency knowingly or recklessly failed either to "conduct a reasonable investigation of the rated security with respect to the factual elements . . ." or "obtain reasonable verification of such factual elements . . . ."[201] This "knowing or reckless" requirement is similar to the "actual malice" standard that courts typically apply. It also seems to place some burden on the CRAs to investigate the truth of their rating. Instead of requiring knowledge or reckless disregard with respect to the rating itself, this standard requires only that the CRA know about either reasonable investigations undertaken or facts that have not been verified. In this sense, the legislation seems to define what will be considered reckless on the part of CRAs.

Dodd-Frank creates another potential form of liability for CRAs, or at the very least, it reduces potential defenses. Ratings should be verifiable to a greater

---

196 Jepsen, *supra* note 166.

197 *Id.*

198 GLOBAL RATING SCALE, *supra* note 5, at 1.

199 *Id.* at 2.

200 Dodd-Frank, Pub. L. no. 111-203 § 933(b), 124 Stat. 1367, 1883–84 (2010).

201 *Id.* (amending Securities and Exchange Act of 1934 at 15 U.S.C. 78u-4(b)(2)(B)(i–ii)).

degree because Dodd-Frank requires that CRAs disclose their methodology and adhere to those methods. As discussed in Section II, CRAs can avoid liability by arguing that they deserve protection under the First Amendment as journalists expressing opinion. The Dodd-Frank transparency requirements now offer the potential to recreate or verify a particular rating, making the nature of ratings more formulaic and thereby tipping the scales closer to fact than opinion.

Finally, Dodd-Frank addresses the state of mind requirement for private actions under the Securities and Exchange Act.[202] While the requirement is not necessarily intended to offer First Amendment protections, it addresses the state of mind and provides a standard for liability similar to the actual malice standard. Unlike the actual malice standard, however, the requirements of Dodd-Frank targeted the investigation and verification of the factual elements that the CRA relied upon. Moody's actions in *Jefferson County*, for instance, may potentially constitute this requisite state of mind. In evaluating the School District, Moody's did not have the latest financial information and did not seek to verify the information upon which it based its negative opinion.[203] The effect of this lack of verification was a discrepancy between S&P's and Fitch's positive ratings and Moody's negative outlook for the same bond. If the court heard this case today, it may have come out differently.

CONCLUSION

CRAs have clear alternatives to their current ratings systems. First, they could use a system similar to Moody's Global Ratings Scale as the published rating system for all bonds. This alternative would have the effect of clarifying the comparison between types of bonds.[204] CRAs could also calculate loss given default in the municipal bond scale, which would have the same effect as using the "global scale."[205] The problem with this type of scale is that the gradation is not fine enough to show the distinctions within each category of bonds. As Moody's noted, GO bonds would largely receive the highest ratings. CRAs

---

[202] The Dodd-Frank Wall Street Reform and Consumer protection Act, Pub. L. no. 111-203, § 933, 124 Stat. 1367, 1884 (2010) ("In the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed – (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluation credit risk; or (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.").

[203] 175 F.3d at 850–51 ("The School District further maintains that the most recent financial information that it had sent Moody's was more than a year old.").

[204] GLOBAL RATING SCALE, *supra* note 5, at 1.

[205] *See id.* ("The product of the default rate and the loss severity results in an expected loss value for each rating by sector. We then use the expected loss value of the municipal rating to map to its equivalent rating on the global scale.").

could also take the opposite approach by creating a symbolic scale that is distinct for the risk associated with each type of investment they analyze. In other words, it would help investors compare apples to apples and oranges to oranges. Another alternative would be to depart from the somewhat arcane letter grading system and use a numerical scale. If the ratings represent a measure of risk, a 1-100 scale, based on percentages, would provide a natural, intuitive solution with plenty of gradation for all types of securities. This proposed scale would also reduce confusion, create variation between the agencies, and reduce the weight of one particular rating.[206]

Ratings agencies' incentives are often misaligned. Partly due to the "issuer pays" conflict, ratings agencies have substantially decreased the ratings of municipal bonds compared to corporate bonds or other types of securities, which vie for top ratings. As a result, municipalities must pay higher interest rates or pay for costly bond insurance. The systematic decrease of municipal bond ratings is a profitable situation for credit ratings agencies, resulting in an inefficient use of tax dollars. Though often protected by the First Amendment, CRAs will lose this protection if ratings are verifiable facts, and the door will be open for various types of litigation, including antitrust. Dodd-Frank addressed many of the issues surrounding CRAs, which should have a positive effect on the ratings systems for municipal bonds. It has also potentially opened the door to greater accountability. Ultimately, it is up to the courts to properly understand the nature of credit ratings and hold CRAs accountable for their actions.

---

[206] If a percentage scale is used and there are two or more ratings given by different CRAs, it would be easy to estimate that the real risk of the investment would be somewhere between the numbers given. Currently, with the increments being so large, bonds usually receive similar ratings from two or more agencies.