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Ohio Sues Rating Firms for Losses in Funds

By DAVID SEGAL

Already facing a spate of private lawsuits, the legal troubles of the country’s largest credit rating agencies deepened on Friday when the attorney general of Ohio sued Moody’s Investors Service, Standard & Poor’s and Fitch, claiming that they had cost state retirement and pension funds some $457 million by approving high-risk Wall Street securities that went bust in the financial collapse.

The case could test whether the agencies’ ratings are constitutionally protected as a form of free speech.

The lawsuit asserts that Moody’s, Standard & Poor’s and Fitch were in league with the banks and other issuers, helping to create an assortment of exotic financial instruments that led to a disastrous bubble in the housing market.

“We believe that the credit rating agencies, in exchange for fees, departed from their objective, neutral role as arbiters,” the attorney general, Richard Cordray, said at a news conference. “At minimum, they were aiding and abetting misconduct by issuers.”

He accused the companies of selling their integrity to the highest bidder.

Steven Weiss, a spokesman for McGraw-Hill, which owns S.& P., said that the lawsuit had no merit and that the company would vigorously defend itself.

“A recent Securities and Exchange Commission examination of our business practices found no evidence that decisions about rating methodologies or models were based on attracting market share,” he said.

Michael Adler, a spokesman for Moody’s, also disputed the claims. “It is unfortunate that the state attorney general, rather than engaging in an objective review and constructive dialogue regarding credit ratings, instead appears to be seeking new scapegoats for investment losses incurred during an unprecedented global market disruption," he said.

A spokesman for Fitch said the company would not comment because it had not seen the lawsuit.

The litigation adds to a growing stack of lawsuits against the three largest credit rating agencies, which together command an 85 percent share of the market. Since the credit crisis began last year, dozens of investors have sought to recover billions of dollars from worthless or nearly worthless bonds on which the rating agencies had conferred their highest grades.

One of those groups is largest pension fund in the country, the California Public Employees Retirement System, which filed a lawsuit in state court in California in July, claiming that "wildly inaccurate ratings" had led to roughly $1 billion in losses.

And more litigation is likely. As part of a broader financial reform, Congress is considering provisions that make it easier for plaintiffs to sue rating agencies. And the Ohio attorney general's action raises the possibility of similar filings from other states. California's attorney general, Jerry Brown, said in September that his office was investigating the rating agencies, with an eye toward determining "how these agencies could get it so wrong and whether they violated California law in the process."

As a group, the attorneys general have proved formidable opponents, most notably in the landmark litigation and multibillion-dollar settlement against tobacco makers in 1998.

To date, however, the rating agencies are undefeated in court, and aside from one modest settlement in a case 10 years ago, no one has forced them to hand over any money. Moody's, S.& P. and Fitch have successfully argued that their ratings are essentially opinions about the future, and therefore subject to First Amendment protections identical to those of journalists.

But that was before billions of dollars in triple-A rated bonds went bad in the financial crisis that started last year, and before Congress extracted a number of internal e-mail messages from the companies, suggesting that employees were aware they were giving their blessing to bonds that were all but doomed. In one of those messages, an S.& P. analyst said that a deal "could be structured by cows and we'd rate it."

Recent cases, like the suit filed Friday, are founded on the premise that the companies were aware that investments they said were sturdy were dangerously unsafe. And if analysts knew that they were overstating the quality of the products they rated, and did so because it was a path to profits, the ratings could forfeit First Amendment protections, legal experts say.

"If they hold themselves out to the marketplace as objective when in fact they are influenced by the fees they are receiving, then they are perpetrating a falsehood on the marketplace," said Rodney A. Smolla, dean of the Washington and Lee University School of Law. "The First Amendment doesn't extend to the deliberate manipulation of financial markets."

The 73-page complaint, filed on behalf of Ohio Police and Fire Pension Fund, the Ohio Public Employees Retirement System and other groups, claims that in recent years the rating agencies abandoned their role as impartial referees as they began binging on fees from deals involving mortgage-backed securities.

At the root of the problem, according to the complaint, is the business model of rating agencies, which are paid by the issuers of the securities they are paid to appraise. The lawsuit, and many critics of the companies, have described that arrangement as a glaring conflict of interest.

"Given that the rating agencies did not receive their full fees for a deal unless the deal was completed and the requested rating was provided," the attorney general's suit maintains, "they had an acute financial incentive to relax their stated standards of 'integrity' and 'objectivity' to placate their clients."

To complicate problems in the system of incentives, the lawsuit states, the methodologies used by the rating agencies were outdated and flawed. By the time those flaws were obvious, nearly half a billion dollars in pension and retirement funds had evaporated in Ohio, revealing the bonds to be "high-risk securities that both issuers and rating agencies knew to be little more than a house of cards," the complaint states.