Department of Justice (DOJ) Files Civil Suit Against McGraw-Hill Companies and Standard & Poor's

Kenneth M. Vittor - Executive Vice President and General Counsel Remarks at the McGraw-Hill Companies' 2012 Earnings Conference Call (February 12, 2013)

Last Monday, February 4, the Civil Division of the United States Department of Justice filed a civil lawsuit against The McGraw-Hill Companies and Standard & Poor's Financial Services LLC in federal court in California. No other companies are named as defendants in the case nor are there any individuals who have been named as defendants. The case was brought under the Financial Institutions Reform Recovery and Enforcement Act of 1989, known as the FIRREA statute. This is a federal statute that permits the Department of Justice to seek civil penalties if it can establish that violations occurred of a number of other statutes and that the violations affected a federally insured financial institution.

In this case, the government is alleging that violations of the mail fraud, wire fraud and bank fraud statutes occurred and that they affected financial institutions, including Western Corporate Federal Credit Union, known as WesCorp; Citibank; and Bank of America. The government alleges that the company violated these statutes when it issued its forward-looking rating opinions concerning creditworthiness or confirmed those opinions of 33 collateralized debt obligations, known as CDOs, in 2007. The government claims that in preparing its ratings, S&P knowingly failed fully to take into account risks associated with residential mortgage-backed securities, known as RMBS, that were being used as collateral for the CDOs.

The government also claims in its lawsuit that S&P statements about its independence and objectivity were false because during the years 2004 to 2007, S&P allegedly made adjustments or delayed adjustments to the models it used to rate RMBS and CDOs in order to preserve market share at the expense of analytical accuracy. The government says that it is seeking more than $5 billion in penalties. This figure is based on losses that were allegedly suffered by federally insured financial institutions that purchased CDOs rated by S&P in 2007. The complaint includes specifics regarding only about $500 million of the $5 billion the government is seeking. The government has not explained where the other $4.5 billion in alleged losses come from.

The revenues S&P earned in connection with the CDOs identified in the complaint were less than $15 million. About half of the par value of the CDOs identified in the complaint relates to losses that allegedly affected Citibank and Bank of America after purchasing CDOs that they, or their affiliates, had underwritten or arranged. The penalties that the government is seeking in this case are based on its position that they are not required to show that the losses were proximately caused by S&P's rating opinions.

The government cannot recover any penalty, of course, unless it first proves that a violation of one of the statutes occurred. S&P believes that to do this, the government is required to prove that S&P rating committee did not believe the ratings that S&P gave to the CDOs at the time these rating opinions were issued; that S&P assigned those ratings with the intent to defraud the investors, which purchased those CDOs; and that S&P's rating opinions affected a federally insured financial institution.

As I said at the beginning of my remarks, the company intends to defend this lawsuit vigorously. We believe that the complete record does not support the government's theory. S&P did not make changes to its model that it believed were not analytically justified nor could S&P refuse to make changes that had been determined to be analytically justified by a committee. The culture at S&P has always been characterized by vigorous debate and robust analysis. Although there may have been opinions within the company, even very strongly held opinions, that did not carry the day, this is not evidence of fraud.

The government's claim that S&P did not fully take into account the risk of RMBS that were going into CDOs in 2007 is also, we believe, a hindsight criticism of S&P's rating opinions during this turbulent time, which we don't think can support a fraud claim. The complaint details information about deteriorating residential mortgages that S&P had available to it in February, March, April, May, June and July of 2007. This data, by the way, about the rate at which residential mortgages were becoming delinquent, is the same data that was available to the rest of the market and to the government. It is the same data that the Federal Open Market Committee was reviewing during 2007 in the transcripts that were made public a few weeks ago.

What the complaint leaves out is all of the work being done by S&P in each of those months to understand that data and to make good-faith judgments about what it might mean for the security that S&P rated. In fact, S&P reviewed this data every month and developed more stressful tests to help it update its opinion of any RMBS that was exposed to these delinquent mortgages. As a result, S&P took an increasing number of negative rating actions, CreditWatch actions and downgrades in February, March, April, May, June and July 2007, even before its large-scale rating actions in mid-July. These negative rating actions had a direct and automatic impact on S&P's CDO ratings. If the RMBS that was put on CreditWatch were downgraded within a CDO or was being considered for a new CDO, S&P's CDO rating took that negative status into account and required additional protection for the CDO.

Unfortunately, these actions turned out to be insufficient in anticipating the great speed, depth and duration of the housing crisis that ultimately came to pass. But the company does not believe the government can prove that this failure, common to nearly everyone at the time, was the product of intentional misconduct by anyone at S&P.

Significantly, the government's complaint also ignores the fact that all of the CDOs that it identifies received a virtually identical rating from at least one other rating agency.

The company has publicly responded to the government complaint in 2 press releases last week. These press releases and additional information about the government's case is also available on S&P's website.

Following the announcement of the DOJ lawsuit, 13 additional states and the District of Columbia filed lawsuits against McGraw-Hill and S&P. These losses generally follow the pattern of the lawsuits that were already pending in Connecticut, Illinois and Mississippi, although there are some differences among them. One state, California, is suing for losses incurred by 2 state pension funds under a statute, the California False Claims Act,that potentially allows for treble damages. The lawsuits in Connecticut and Mississippi were brought against both S&P and Moody's. It is possible that additional states will file similar lawsuits.

Generally speaking, these cases are being brought under each state's consumer protection law and focus on S&P's statements regarding the independence and objectivity of its ratings practices.

The company has been vigorously defending these lawsuits. It is the company's position that its statements about objectivity and independence cannot be the basis for a claim of deception.

The company has recently received a very favorable ruling on this issue from the United States Court of Appeals for the Second Circuit. In addition, the United States Court of Appeals for the Sixth Circuit recently dismissed a civil lawsuit brought by the Ohio Attorney General against S&P, Moody's and Fitch arising from its pension fund's purchase of RMBS rated by the 3 rating agencies. In short, we believe that we have strong defenses in the DOJ and the state lawsuits and expect to prevail.

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