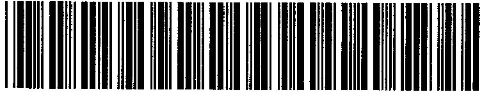

**SUPERIOR COURT OF CALIFORNIA**
**COUNTY OF SAN FRANCISCO**

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ORDER

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEMS VS. MOODY'S CORP et

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**FILED**
San Francisco County Superior Court

JUN 01 2010

CLERK OF THE COURT
BY: [signature]
Deputy Clerk

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM,

Plaintiff,

v.

MOODY'S CORP., MOODY'S INVESTORS SERVICE, INC., THE MCGRAW HILL COMPANIES, INC., FITCH, INC., FITCH GROUP, INC., FITCH RATINGS, LTD., and DOES 1 through 100,

Defendants.

Case No. CGC-09-490241

**~~[PROPOSED]~~ ORDER OVERRULING IN PART AND SUSTAINING IN PART DEFENDANTS' DEMURRERS TO COMPLAINT**

Honorable Richard A. Kramer
Department 304

Action Filed: July 9, 2009
Trial Date: None Set

EXHIBIT A

This matter came for oral argument on Friday, April 30, 2010 in the Superior Court of California, County of San Francisco, Department No. 304, before the Honorable Richard A. Kramer.

Having heard oral argument and considered the Plaintiff California Public Employees' Retirement System's ("CalPERS") Complaint, Defendants'[1] demurrers and replies and Plaintiff's Opposition thereto, the Court hereby ORDERS as follows:

Legal Standard on a Demurrer

The purpose of a demurrer is to test the sufficiency of the allegations of the complaint. *Fox v. Ethicon Endo-Surgery, Inc.*, 35 Cal.4th 797, 810 (2005). The Court is required to read the Plaintiff's complaint and take all allegations in it as true, for the purpose of these demurrers. The Court is required to make all reasonable inferences of fact regarding those allegations with an eye toward saving the cause of action, *i.e.* finding a cause of action. *Blank v. Kirwan*, 39 Cal.3d 311, 318 (1985); *Aubry v. Tri-City Hospital Dist.*, 2 Cal.4th 962, 966-67 (1992). The Court may also consider matters that are judicially noticeable. This does not mean, however, that additional facts outside the scope of the complaint may be factored into the Court's analysis. If the complaint has stated a legal cause of action, then the Court must overrule the demurrer.

Defendants Moody's and McGraw-Hill's Request for Judicial Notice

Defendants The McGraw-Hill Companies, Inc., Moody's Corp. and Moody's Investors Service, Inc., have asked the Court to take judicial notice of the following documents:

- Exhibit 1: Cheyne Finance LLC Commercial Paper Information Memorandum, dated October 2006;
- Exhibit 2: Stanfield Victoria Funding, LLC Offering Circular for Medium Term Notes, dated August 2006;

[1] The demurring defendants are: The McGraw-Hill Companies, Inc.; Moody's Corp. and Moody's Investors Service, Inc.; and Fitch, Inc. (collectively, "Defendants" or "Rating Agencies"). The Court does not rule on specially-appearing defendant Fitch Ratings Ltd's demurrer (consolidated with Fitch, Inc.'s demurrer) pending a ruling on Fitch Ratings Ltd's Motion to Quash Service of Summons For Lack of Personal Jurisdiction.

- Exhibit 3: Sigma Finance, Inc. Private Placement Memorandum for Medium Term Notes, dated November 2006;
- Exhibit 4: The Statement of Eugene Volokh to the Subcomm. on Capital Markets, Ins., & Gov't Sponsored Enters. Hearing of the House Fin. Servs., dated May 15, 2009;
- Exhibit 5: SEC Release No. 34-56513, Order Granting Registration of Standard & Poor's Rating Services as a Nationally Recognized Statistical Rating Organization, dated September 24, 2007;
- Exhibit 6: SEC Release No. 34-56511, Order Granting Registration of Moody's Investor Service, Inc. as a Nationally Recognized Statistical Rating Organization, dated September 24, 2007; and
- Exhibit 7: SEC Release No. 34-56509, Order Granting Registration of Fitch, Inc. as a Nationally Recognized Statistical Rating Organization, dated September 24, 2007.

The Court, having heard oral argument and considered the *Request for Judicial Notice In Support of Defendants' Demurrer to Complaint* denies the request to take judicial notice of Exhibit 4 to the Request—The Statement of Eugene Volokh to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing: Approaches to Improving Credit Rating Agency Regulation, dated May 15, 2009. This is a statement from a law professor to a Congressional Committee about the First Amendment. It is an opinion relative to one of the arguments made here. The statement is not an official act of the United States government. A law professor's view on the First Amendment has no bearing on a demurrer. It is not an appropriate document for judicial notice and it has no relevance to these proceedings.

There being no objection to the request for judicial notice of Exhibits 1, 2, 3, 5, 6 and 7, the Court hereby grants the request as to those documents only.

Defendant Fitch's Request for Judicial Notice

Defendant Fitch, Inc. and Specially Appearing Defendant Fitch Ratings Ltd have asked the Court to take judicial notice of Exhibit A to their Request, *The Subscription and Website License Agreement*, as well as the "non-controversial facts" regarding the parties to, and current status of, that agreement.

The Court, having heard oral argument and considered the *Request for Judicial Notice In Support of Defendant Fitch, Inc.'s and Specifically Appearing Defendant Fitch Ratings Ltd's Demurrer to The First and Second Causes of Action In Plaintiff's Complaint*, denies the Request to take judicial notice of both the subscription agreement and the fact of the agreement. The subscription agreement was not referenced in the Complaint and therefore the court declines to take judicial notice of it at the demurrer stage. As to the "non-controversial facts," regardless of whether certain facts are controversial or not, the court can only take notice of them if they are in the Complaint or are of such common knowledge that they could be readily ascertained—*e.g.*, that the Golden Gate Bridge is orange. The facts proffered by the Defendants are not of either ilk.

Factual Background

The Court has considered all of the facts alleged in the Complaint in reaching its conclusions. Among others, the Court takes particular note of the following:

Plaintiff alleges that each of the Defendants rated at least one of the following three Structured Investment Vehicles ("SIVs"): Cheyne Finance LLC, Stanfield Victoria Funding LLC, and Sigma Finance, Inc. ¶28. The Rating Agencies gave the SIVs their highest AAA or equivalent ratings. ¶¶54, 56, 58, 60, 62. In 2006, relying on the ratings given to the SIVs by the Defendants, Plaintiff CalPERS invested $1.3 billion in commercial paper and medium term corporate notes issued by these SIVs. ¶19.

The Complaint alleges that the Rating Agencies did not have a reasonable basis for giving the SIVs their highest ratings. ¶63. The Rating Agencies created or approved structural tests that, once in place, made the SIVs appear virtually impervious to default. ¶64. We now know that the SIVs were not impervious to default.

Plaintiff alleges that the Defendants' structural tests for the SIVs were flawed because they did not take into account the foreseeable scenario that if there were stresses in the marketplace, the SIVs would be unable to finance, or "roll," more paper to fund the SIVs as ongoing concerns or liquidate the assets in the SIVs' portfolios in a window. ¶64. The types

1 of investors who were funding these SIVs were mostly public pension funds, like CalPERS,
2 that were required to invest only in safe, liquid assets. ¶64. If there was a sign of trouble, it
3 was possible that these investors would pull their financing from the SIVs and the SIVs would
4 collapse. ¶64.

5 According to the Complaint, the tests were also flawed because the Rating Agencies
6 used asset correlations in their mathematical and statistical models that were insufficient to
7 capture a critical risk of the SIVs: that what turned out to be their large concentration of
8 residential mortgage backed securities ("RMBS") and collateralized debt obligations
9 ("CDOs"), which were themselves concentrated in sub-prime RMBS, meant the SIVs were
10 concentrated in assets that were of the same class, industry and geographic region, and
11 therefore made the SIVs more susceptible to risk of default. ¶¶65-66. The Complaint alleges
12 the Defendants used inadequate mathematical and statistical models, premised on useless or
13 outdated data, to structure and rate certain structured finance assets in the SIVs' portfolios,
14 which had severe effects on the SIVs' creditworthiness. ¶79. Plaintiff alleges Defendants then
15 used their own inaccurate ratings on the underlying assets as a parameter to gauge the
16 creditworthiness of the SIV, using the faulty output of their RMBS and CDO models as the
17 input for their SIV models. ¶79.

18 Plaintiff alleges that the Rating Agencies were only paid by the issuer of the SIV if the
19 deal was rated and issued. ¶68. It is alleged that the Rating Agencies employed increasingly
20 lax standards when they rated SIVs and underlying structured finance assets such as RMBS
21 and CDOs, motivated to ensure the SIVs would be offered via private placement to
22 institutional investors like CalPERS and ensure Defendants would receive their contingent fee.
23 ¶68.

24 Plaintiff alleges that the Rating Agencies negligently misrepresented the investment
25 risk in the SIVs in other ways. For example, it is alleged the Rating Agencies had no policy or
26 procedure to address errors and faults in their models and methods. ¶73. With regard to rating
27 RMBS securities held within the SIVs, they did not take into account the deterioration of loan
28

origination standards, especially for sub-prime mortgage loans. ¶76. Plaintiff alleges the Defendants failed to differentiate between a first mortgage and a "piggyback" mortgage—a second loan, usually from a different lender, taken out to finance the entire purchase of a property—or acknowledge the default risk that a "piggyback" loan would create on the first mortgage loan. ¶77.

Plaintiff alleges that it relied on the ratings the Defendants issued. CalPERS alleges that had the Defendants not assigned the highest credit ratings to SIVs at issue here, CalPERS would have been prevented from purchasing the SIV debt issues for its portfolio and would not have suffered the related investment losses. ¶84. The Complaint alleges that only the SIV manager and the Rating Agencies knew which exact assets made up the SIVs. ¶86. The exact make-up of assets was treated as confidential, lest anyone, even investors, learn CUSIP-level data of what was contained in the SIVs and be able to copy it. Plaintiff alleges that no amount of diligence could have given Plaintiff actual knowledge of what assets the SIV actually contained or that a "race to bottom" amongst Defendants had gutted any legitimacy or assurance of competence in rating SIVs and other structured finance products held by SIVs. ¶85.

Taking these alleged facts into account, among others, the Court now turns to the various legal grounds which Defendants claim act to bar Plaintiff's causes of action.

New York's Martin Act

Defendants claim that New York's Martin Act, N.Y. Gen. Bus. Law § 352-c(1), preempts the Plaintiff's claims here. The Martin Act makes it unlawful to, among other things, use or employ "any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale ... where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from [New York] of any securities ...." N.Y. Gen. Bus. Law § 352-c(1). Under the Martin Act, the New York Attorney General possesses exclusive power to regulate the sale of securities.

"California applies its own rule of decision unless a party litigant properly invokes the law of a foreign state." *McGhee v. Arabian American Oil Co.,* 871 F.2d 1412, 1422 (9th Cir. 1989). When deciding whether to apply another state's law, California applies the governmental interest approach, which balances the interests of the involved states and parties to determine the law that most appropriately applies to the issue involved. *Reich v. Purcell,* 67 Cal.2d 551 (1967); *Offshore Rental Co. v. Continental Oil Co.,* 22 Cal. 3d 157, 161 (1978). Three steps are involved in the governmental interest approach:

- First, the court must determine whether the law of the foreign state differs from California law; (*Id.*)
- Second, if there is a difference, the court must determine whether a "true conflict" exists by determining whether both states have a legitimate interest in applying their own law to the case at hand. *American Bank of Commerce v. Corondoni,* 169 Cal.App.3d 368, 372 (1985). If both states have a legitimate interest in the application of their respective laws, then;
- Third, the court must analyze the "comparative impairment" of the interests of the two states and applies the law of the state whose interest would be the more impaired if its law were not applied. (*Id.*)

Plaintiff does not contest that the law of the foreign state differs from California law. The Court is not convinced, however, that there is a true conflict here. The Martin Act protects New York plaintiffs—people who avail themselves of the New York courts. It governs what sorts of claims can be brought, and by whom, in New York courts. The Martin Act organizes, for New York's purposes, who may investigate charges of wrongdoing in connection with the sale of securities on behalf of those that avail themselves of the New York courts. The state of New York cannot pass laws that govern who may avail themselves of California laws in California courts. Conversely, California may not pass laws directing that New York's Attorney General not bring charges in New York courts in connection with the sale of securities. Therefore, New York has no legitimate interest in applying its law to this case. The Court finds that there is no true conflict, that California law applies to this case, and that New York's Martin Act does not apply to preempt Plaintiff's claims.

Even assuming, however, that there is a true conflict here, the Court nonetheless finds that California's interests predominate and would be most affected if its law was not applied. New York has an interest in limiting the availability of its courts to actions brought by the New York Attorney General for legitimate reasons: focusing the prosecution of these actions, reducing caseloads in New York, and avoiding disparate decisions from different litigants. California has the opposite interest in allowing its citizens access to its courts for private causes of action such as this, thereby allowing for redress where the New York Attorney General chooses not to act in the interest of somebody from California. If the Court were to accept that New York's interest is a legitimate interest and that there is a true conflict, the next step in the analysis is not to weigh whose interest is more important, but to determine which state's interest would be most impaired by the application of the other state's law.

If the Court were to find that New York's policy is subservient and honor California's interest in allowing access to California, there would be no effect on New York courts. New York courts could still choose to exclude non-Attorney General actions and completely satisfy, as to the courts, the policy reflected in the Martin Act. Allowing broad access to California courts would not impair New York's ability to limit access to the court system for causes of action brought in connection with the sale of securities.

On the other hand, if this Court were to honor the New York policy of limiting access to the judicial system to only the Attorney General, the effect on California's policy of free access to the courts by private litigants would be ~~decimated~~ SUBSTANTIALLY IMPAIRED. RAK Therefore, under California's governmental interest test, the ~~inexorable~~ conclusion is that the Court should apply California's policy to its own courts and leave New York to its own devices.

Defendants argue that New York has a policy interest in providing foreseeability and clarity to New York entities about which state's law they can be sued under for their actions. This Court's ruling, however, provides certainty. Plaintiff has properly alleged that the Defendants have used their ratings to entice CalPERS, a California resident, to purchase securities. Taking this allegation as true, it is certain that if a New York entity sells something

or uses its ratings to entice a buyer in a different forum, then it runs the risk of being subjected to that forum's law regarding access to the courts. Again, flipping Defendants' argument on its head, if California were to pass an analog law that says no Attorney General can file charges in connection with the sale of securities, *only* individuals can, it might provide business entities with certainty, but it would not be enforceable in New York. Defendants suggest that New York has the power to give tort immunity to its citizens for acts committed anywhere in the country. This would certainly benefit New York residents, but that is not how our federal court and government system works.

This Court's decision is in accord with Judge Scheindlin's decision in *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F.Supp.2d 155, 182 (S.D.N.Y. 2009), which applied New York law in New York and has no application to a California action with California litigants.

First Amendment[2]

The court rejects Defendants' argument that the First Amendment to the United States Constitution preempts Plaintiff's claims. The right to free speech allows us to give our opinions on things of public concern. The issuance of these SIV ratings is not, however, an issue of public concern. Rather, it is an economic activity designed for a limited target for the purpose of making money. That is not something that should be afforded First Amendment protection and the Defendants are not akin to members of the financial press. In *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F.Supp.2d 155, 182 (S.D.N.Y. 2009), Judge Scheindlin correctly concluded that where a credit rating is directed not to the public at large but "provided instead in connection with a private placement to a select group of

[2] In their demurrers, defendants The McGraw-Hill Companies, Inc., Moody's Corp. and Moody's Investors Service, Inc. cite to the California Constitution and the New York Constitution as well as the United States Constitution. This Court's analysis of the First Amendment argument applies equally to the free speech arguments under the state constitutions.

RAR investors," that rating is not a matter of public concern. *Id.* at 175-176. That is the case here. I ~~echo~~ concur with Judge Scheindlin:

> It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an "actual malice" exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern. However, where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection.

*Id.* at 175-176. This distinction is also seen in California's Anti-SLAPP statute, Code of Civil Procedure, Section 426.16 and 426.17, a statute that is also designed to encourage public discourse. The anti-SLAPP statute was amended with Section 426.17 to differentiate between matters of public concern, which remain protected, and matters designed to sell something.

<u>CRARA</u>

Defendants have not met their burden of showing that the Federal Credit Rating Agency Reform Act ("CRARA"), 15 U.S.C. § 78o-7, was intended to preempt this lawsuit.

This Court agrees with the reasoning in *In re Nat'l Century Fin. Enters.*, 580 F. Supp. 2d 630, 650-52 (S.D. Ohio 2008) that "[t]he presumption is that Congress does not intend to preempt state law." The statutory title of CRARA sets forth its limited purpose: "Registration of nationally recognized statistical rating organizations." 15 U.S.C. § 78o-7. The goal of CRARA is to avoid states setting conflicting standards regarding how ratings should be conducted. A claim for negligence under state law does not intrude, in any way, on Congress' ability to set standards for the ratings agencies. The statute does not state that ratings that fall within the parameters of the federal law, if violative of state law, are inactionable.

Defendants' argue that CRARA offers complete immunity to the Rating Agencies from any state activity that could impose ratings-related liability. If that were true, the Rating Agencies would be immune from liability for actions between both ends of the spectrum—those constituting pure negligence (such as incorrectly transcribing ratings) and those arising out of intentional torts (such as deceit). The Court rejects Defendants' position. Neither of these scenarios intrudes on the ability of Congress to regulate the Rating Agencies.

There being no preemption impediments to Plaintiff's causes of action, the Court turns to the sufficiency of the pleadings themselves. The Court finds that: (1) as to the first cause of action for negligent misrepresentation, the demurrers are overruled; and (2) as to the second cause of action for negligent interference with prospective economic advantage, the demurrer is sustained with leave to amend.

First Cause of Action: Negligent Misrepresentation

Under California law, the elements of a claim for negligent misrepresentation are: (1) the defendant made a misrepresentation as to a past or existing material fact; (2) the representation was untrue; (3) the defendant, regardless of his actual belief, made the representation without reasonable grounds for believing it to be true; (4) defendant intended to induce plaintiff to rely on the fact misrepresented; (5) plaintiff was unaware of the falsity of the representation and acted in justifiable reliance thereon, and (6) plaintiff sustained damages as a result of his reliance. *Cont'l Airlines, Inc. v. McDonnell Douglas Corp.*, 216 Cal.App.3d 388, 402 (1989); *Fox v. Pollack*, 181 Cal.App.3d 954, 962 (1986) (citing 4 Witkin, Summary of Cal. Law (8th ed. 1974) Torts, §§ 480-82).

Having considered all of the allegations of the Complaint, the Court finds that Plaintiff has properly and fully alleged, with specificity, each and every element of a cause of action of negligent misrepresentation against each Defendant. As to the first cause of action for negligent misrepresentation, the demurrers are overruled.

Second Cause of Action: Negligent Interference with Prospective Economic Advantage

In order to sustain a cause of action for negligent interference with prospective economic advantage, the Complaint must allege (1) that there is an economic relationship between the plaintiff and a third party which contained a reasonable probable future economic benefit to the plaintiff; (2) the defendant had to know about that relationship; (3) the defendant was negligent somehow; and (4) that negligence caused damage to the plaintiff, in that the relationship was actually interfered with to the economic detriment of the plaintiff. *Venhuas v.*

*Schultz,* 155 Cal.App.4th 1072, 1078 (2007); *North American Chemical Co. v. Superior Court of Los Angeles County,* 59 Cal.App.4th 764, 786 (1997).

Here, the SIVs are the claimed economic relationship. The allegation is not that but for Defendants' negligent acts Plaintiff would have earned income or developed an economic relationship. Rather, the allegation appears to be that there was no income available, yet the negligence of Defendants made it seem as though there was. That is not sufficient to state a cause of action for negligent interference with prospective economic advantage. As to the second cause of action, the demurrers are sustained with leave to amend.

IT IS HEREBY ORDERED:

(1) as to Plaintiff's first cause of action, the demurrers are overruled;

(2) as to Plaintiff's second cause of action, the demurrers are sustained, with leave to amend;

(3) defendants The McGraw-Hill Companies, Inc., Moody's Corp. and Moody's Investors Service, Inc.'s Request for Judicial Notice is granted as to Exhibits 1 through 3 and 5 through 7, and denied as to Exhibit 4; and

(4) defendant Fitch, Inc.'s Request for Judicial Notice is denied in its entirety.

SO ORDERED THIS 24 DAY OF MAY, 2010.

Honorable Richard A. Kramer