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Via Certified Mail

May 18, 2006

Mr. Harold McGraw III
Chairman, President and Chief Executive Officer
The McGraw-Hill Companies
1221 Avenue of the Americas
New York, New York 10020-1095

- Re:
1. Notification of pending and anticipated litigation by United States creditors against the People's Republic of China for recovery on defaulted sovereign debt of the Chinese Government:

[Marvin L. Morris, Jr. v. People's Republic of China \(05 CIV 4470\).](#)
 2. Resultant implications to associated risk metrics involving the sovereign credit rating classification of the People's Republic of China.

Dear Mr. McGraw:

This letter references the evolution of the matter involving the continuing evasion of payment by the People's Republic of China of the defaulted full faith and credit sovereign debt of the Chinese Government in violation of accepted conventions of international law.¹ The ability of the People's Republic of China, as the internationally recognized successor government of China, to continue to evade honoring the claims of creditors holding defaulted sovereign obligations of the Chinese Government² has been, and continues to be, aided and abetted by the conduct of certain parties involved in the rating of China's sovereign debt and in the underwriting of recent sovereign debt issues of the internationally recognized Government of China.³

¹ See Restatement (Third) of the Foreign Relations Law of the United States, Section 712(2). See also, Creditors Claims in International Law. *The International Lawyer*, volume 34, page 235 (Spring, 2000). For a comprehensive legal analysis of the claims of defaulted creditors of the Government of China, see the series of legal memorandums prepared by the law firm of Stites & Harbison: (URL: <http://www.globalsecuritieswatch.org/s&hmemorandums.html>).

See the language specified in the Loan Agreement authorizing the Chinese Government Five Per Cent Reorganisation Gold Loan, which remains in a state of default: "These obligations are intended to be binding upon the Government of China and any Successor Government."

² See Aide Memoire issued by the Chinese Ministry of Foreign Affairs, included as pages 81-82 of the American Society of International Law, *International Legal Materials*, 221.L.M75 (1983), wherein the People's Republic of China declared "The Chinese Government recognizes no external debts incurred by the defunct Chinese Governments and has no obligation to repay them ...".

³ These actions were set forth and more fully described in our letter of complaint dated April 8, 2004 addressed to the Honorable Eliot Spitzer, Attorney General for the State of New York (URL:

The existence of defaulted sovereign debt of the Chinese Government was explicitly disclosed to each of the Nationally Recognized Statistical Rating Organizations (“NRSROs”) including Standard & Poor’s Corporation in a letter prepared by the American Bondholders Foundation⁴ dated November 27, 2002 and was further described in public testimony presented at a 2003 United States Congressional hearing conducted by the House Committee on International Relations.⁵ The prevailing credit rating classifications assigned to the recognized Government of China by the three largest NRSROs do not reflect the existence of the defaulted sovereign debt of the Chinese Government.⁶ The three largest NRSROs have thus knowingly acted to conceal the existence of a defaulted series of sovereign obligations of the Chinese Government. The deliberate, intentional and continuing failure to recognize the existence of the defaulted sovereign debt of the Chinese Government and the intentional concealment of such defaulted debt in their respective sovereign credit rating classifications (including the deviation from established rating criteria and methodologies) has impaired the ability of defaulted creditors of the Government of China to enforce the debt contract, and may therefore have acted to create a tort liability on the part of the three largest NRSROs, not only with respect to defaulted creditors attempting to enforce the debt contract, but also to investors in other classes of outstanding obligations of the People’s Republic of China whom have unwittingly become exposed to undisclosed embedded risks intrinsic to such obligations.⁷

The existence of the Chinese Government’s defaulted sovereign debt in conjunction with the continuing evasion of payment by the People’s Republic of China as the internationally recognized Government of China poses a significant risk to the investing public. None of these material risk metrics were disclosed in the Chinese Government’s 2003 sovereign bond offering prospectus and these risks continue to be excluded from the prevailing sovereign credit rating classifications assigned to the long-term foreign currency debt of the Government of China, in addition to the omission of the actuality and the possibility of litigation in United States and

<http://www.globalsecuritieswatch.org/Spitzer.pdf>) and also in our letter of complaint dated March 31, 2005 filed with the Division of Market Regulation of the United States Securities and Exchange Commission (URL: <http://www.globalsecuritieswatch.org/SEC.pdf>).

⁴ The American Bondholders Foundation is the incorporated organization representing the consolidated claims of approximately five thousand U.S. citizens holding defaulted sovereign obligations of the Government of China.

⁵ See public testimony presented before the House Committee on International Relations during the hearing entitled, “U.S.-China Ties: Reassessing the Economic Relationship” (October 21, 2003): (URL: http://www.house.gov/International_Relations/108/bian2021.htm).

⁶ The three largest NRSROs as of the date of this correspondence are Standard & Poor’s, Moody’s Investors Service and Fitch Ratings.

⁷ First Amendment protection does not protect actions which are knowingly false and injurious to others. See *County of Orange v. McGraw-Hill Companies* (no. SA CV 96-0765-GLT, 1997 U.S. Dist., LEXIS 22459, C.D. Cal. June 2, 1997) wherein the Court stated, “S&P’s position in the securities field may have caused it to assume an independent professional duty enforceable in a tort action.” The Court further noted that the ratings could be the basis of liability if the plaintiff proved by clear and convincing evidence that Standard & Poor’s acted with knowledge that the ratings were false or with reckless disregard of their truth or falsity.

Belgian courts against the Chinese Government and paying agent(s) of its recently-issued sovereign bonds which the Chinese Government selectively honors.⁸

Such risk metrics include and are not limited to, the following:

1. Failure to disclose the existence of a pending judicial action and the credible threat of additional judicial actions petitioning for judgment involving recovery of defaulted obligations and the associated risk of seizure of commercial property in satisfaction of such judgments, including the potentially adverse effect on the ability of the People's Republic of China to honor payment of outstanding claims and obligations owing to the emergence of a significant contingent liability including the possible seizure of proceeds of securities offerings and commercial assets of the People's Republic of China in the United States (and in other jurisdictions respecting a U.S. court's judgment) and resultant negative effect concerning the *ability to pay* metric.⁹
2. Failure to disclose the existence of a credible threat of judicial action through the Belgian Commercial Court by defaulted creditors asserting *pari passu* doctrine (i.e., equal standing among creditors) and successfully attaching interest payments to other creditors holding sovereign obligations of the People's Republic of China and on which that government continues to selectively honor payment.¹⁰
3. Failure to disclose the existence of the risk of international setoff of the Chinese Government's defaulted sovereign debt, and subsequent adverse effect on China's *ability to pay* metric.¹¹
4. Failure to properly assess the *willingness to pay* metric, as evidenced by the actions of the People's Republic of China, as the internationally recognized Government of China, in continuing to evade payment of the Chinese Government's defaulted full faith and credit

⁸ See prospectus supplement to the People's Republic of China sovereign bond offering prospectus dated October 16, 2003. U.S. Securities and Exchange Commission EDGAR web-link:

(URL: <http://www.sec.gov/Archives/edgar/data/909321/000114554903001347/u98681p1e424b5.htm>).

The 2003 People's Republic of China sovereign bond offering prospectus also intentionally misstates the total value of the Chinese Government's outstanding external indebtedness through the willful omission of the contractual value of the full faith and credit sovereign debt of the Chinese Government existing in a state of default.

⁹ See *Republic of Austria v. Maria V. Altmann*. Docket no. 03-13 (June 7, 2004). Decision by the United States Supreme Court enabling the commercial activities exemption to the Foreign Sovereign Immunities Act (28 U.S.C. §§ 1602, et seq.) to be retroactively applied in U.S. courts, enabling judicial actions for recovery of pre-1952 defaulted sovereign debt. In that regard, see *Marvin L. Morris, Jr. v. The People's Republic of China* (05 CIV 4470).

¹⁰ See *Elliott Associates, L.P.*, General Docket no. 2000/QR/92. Court of Appeals of Brussels, 8th Chamber, September 26, 2000. We are aware of a credible pending threat of this same nature against creditors of the People's Republic of China.

¹¹ See *National Bank v. Republic of China* (348 U.S. 356) for a U.S. Supreme Court decision affirming the right of international setoff of China's defaulted sovereign debt. This represents an additional undisclosed risk factor which is not reflected in the prevailing sovereign credit rating classifications assigned to the People's Republic of China by the three largest NRSROs.

sovereign debt, including selective default and discriminatory settlement.¹² The willful and intentional concealment of the Chinese Government's defaulted full faith and credit sovereign debt as evidenced by the prevailing sovereign credit rating classifications assigned by the three largest NRSROs acts to misstate the actual risk of sovereign obligations of the Government of China, since the demonstrated existence of an empirical relationship reveals that a nation's past default history represents a statistically valid predictor of future default risk¹³

The U.S. Supreme Court's decision in *Altmann* may well have opened the door to successful civil suits through U.S. courts for recovery of pre-1952 defaulted debt of the Chinese Government, a possibility not reflected in the prevailing sovereign credit rating classification assigned by Standard & Poor's to the People's Republic of China.¹⁴ The same is true of the Belgian Court's decision in *Elliott*. The cumulative value¹⁵ of the defaulted sovereign debt of the Chinese Government represents a significant contingent liability of the People's Republic of China¹⁶ as we reported in our publication dated January 20, 2004¹⁷ and as was previously disclosed in public testimony presented at a hearing conducted by the House Committee on International Relations.¹⁸

We enclose with this correspondence a copy of the first such lawsuit filed in the United States. We expect that this development, in conjunction with the reasonable expectation of additional claimants preparing for litigation in this matter, constitutes a material component of sovereign

¹² See the exclusionary settlement with British bondholders entered into by the People's Republic of China in 1987. This settlement resolved the defaulted claims of British creditors only, and did not provide for settlement of the Chinese Government's defaulted sovereign debt held by non-British creditors.

¹³ See Determinants of Sovereign Risk. Hilscher, Jens and Nosbusch, Yves. Harvard University (November, 2004). See also, Determinants of Spreads on Sovereign Bank Loans: the Role of Credit History. Benczur, Peter and Ilut, Cosmin. Magyar Nemzeti Bank (October, 2005). See also, Serial Default and the 'Paradox' of Rich to Poor Capital Flows. Reinhart, Carmen and Rogoff, Kenneth. *American Economic Review* (May, 2004). See also, Willingness to Pay and the Sovereign Debt Contract. Fernandez, Katherina and Fernandez, Roque. Universidad del CEMA (March, 2004). See also, Determinants and Impacts of Sovereign Credit Ratings. Cantor, Richard and Packer, Frank. *Economic Policy Review*. Federal Reserve Bank of New York (October, 1996). See also, Exploring for the Determinants of Credit Risk in Credit Default Swap Transaction Data. Cossin, Didier and Hricko, Tomas. University of Lausanne (October, 2001).

¹⁴ Upon which the People's Republic of China as the internationally recognized successor government of China continues to evade payment to defaulted creditors.

¹⁵ See Choate valuation memorandum concerning the present value of the defaulted sovereign debt of the Chinese Government.

¹⁶ See *Pravin Banker Associates v. Banco Popular del Peru* (109 F.3d 850) for a United States appellate court decision affirming the right of creditors to receive full contractual value of defaulted sovereign debt.

¹⁷ See "People's Republic of China Sovereign Credit Rating Research Bulletin." Sovereign Advisers (January 20, 2004):
(URL: http://www.globalsecuritieswatch.org/Sovereign_Rating_Research_Bulletin/China.pdf).

¹⁸ See public testimony presented before the House Committee on International Relations during the hearing entitled, "U.S.-China Ties: Reassessing the Economic Relationship" (October 21, 2003):
(URL: http://www.house.gov/International_Relations/108/bian2021.htm).

risk and merits a review and adjustment of the prevailing sovereign credit rating classification assigned to the People's Republic of China by Standard & Poor's.¹⁹

Due to the significant impact on, and alteration of, the credit risk associated with sovereign obligations of the People's Republic of China as described in the information presented herein, we strongly encourage you to consider immediate incorporation of this information into all pertinent credit risk disclosure and ratings publications, as well as future communications pertaining to the sovereign credit rating classification and attendant risk metrics associated with investment in sovereign obligations of the People's Republic of China. Accordingly, we are confident that you will undertake the proper and appropriate adjustment to the prevailing sovereign credit rating classification assigned to the long-term foreign currency debt of the People's Republic of China.²⁰

Sincerely,

Kevin O'Brien
President

KO:jwc

Enclosure (copy of complaint filed in United States District Court):

Marvin L. Morris, Jr. v. The People's Republic of China and the Republic of China
United States District Court for the Southern District of New York
(05 CIV 4470)

¹⁹ Please be advised that we are aware of additional civil suits presently under preparation (both within the United States as well as in foreign jurisdictions) to be filed against the People's Republic of China for the purpose of seeking recovery on the Chinese Government's defaulted sovereign debt, including attachment of interest payments to other creditors of the People's Republic of China. This prospect represents a grave risk to current and future investors in sovereign obligations of the PRC, and also entails the risk of seizure of proceeds from debt or equity offerings by the Chinese Government in jurisdictions respecting judgments rendered by U.S. or Belgian courts.

²⁰ We note that the objective application of Standard & Poor's own sovereign ratings criteria and definitions to the facts comprising the immediate instance reveals that the proper rating classification for the long-term foreign currency debt of the People's Republic of China is "Selective Default". See Standard & Poor's definition of the "Selective Default" rating classification: "*An obligor rated 'SD' (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An 'SD' rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner.*" (URL: <http://www2.standardandpoors.com>). Recent instances in which Standard and Poor's has assigned an "SD" rating classification to the long-term foreign currency debt of a sovereign issuer include Russia in 1998 (which defaulted on its domestic obligations while continuing to service its eurobonds); Argentina, following its sovereign debt default in December 2001 and subsequent restructuring, including an exchange offer to existing bondholders; and the Dominican Republic in 2005 (which became delinquent on payments owed to commercial bank creditors while continuing to service its bonded debt). The "SD" rating remained in full force and effect until all outstanding defaulted obligations were resolved.

Mr. Harold McGraw III
May 18, 2006
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cc: Members of the 109th United States Congress

Honorable Larry M. Wortzel, Chairman
United States-China Economic and Security Review Commission

Honorable Christopher Cox, Chairman
United States Securities and Exchange Commission

Honorable Alberto R. Gonzales, Attorney General for the United States
United States Department of Justice

Honorable Michael Garcia, United States Attorney for the Southern District of New York
United States Attorney's Office for the Southern District of New York

Honorable Eliot Spitzer, Attorney General for the State of New York
New York Department of Law, Office of the Attorney General
(Internal Reference No.: 05/001211)

Honorable Robert M. Morgenthau, Esq.
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Mr. John Petty, President
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Ms. Jonna Z. Bianco, President
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Ms. Gillian Tett, Capital Markets Editor
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Mr. Adam Harper, East Asia Editor
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