Three Rating Agency Wins

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In three recent cases, investors who had purchased about $155 billion worth of mortgage pass-through certificates between 2005 and 2007 sought damages against the rating agencies involved (the "Rating Agencies") "as underwriters or control persons for misstatements or omissions in securities offering documents in violation of" the Securities Act. Upon the dismissal of the claims by the district court, the investors appealed.

Investors purchased securities from various underwriters, which were rated by one or more of the Rating Agencies. No certificates were bought from a Rating Agency, and each certificate was underwritten by a party other than the Rating Agencies. While rating agencies generally serve as passive evaluators of credit risk, the investors alleged that the Rating Agencies being sued in these actions "exceeded their traditional roles by actively aiding in the structuring and securitization process." To support this allegation, the investors further alleged that the issuing banks had engaged in a "ratings shopping" process, whereby the Rating Agencies would provide preliminary ratings for a mortgage pool. The banks and Rating Agencies would then negotiate the amount of credit enhancements necessary to achieve certain desired ratings, and would go back and forth until the issuers had adjusted the certificates' structures such that they achieved the desired ratings. Finally, as a result of an alleged failure to update risk models to accurately reflect the higher risk inherent in certain underlying loans (like sub-prime loans, etc.), and a failure to adequately consider deteriorating loan origination standards, the investors complained that the AAA rating did not accurately reflect the relative risk of these securities. Based on these allegations, the investors sought damages under the Securities Act.

The plaintiffs argued that "the Rating Agencies qualify as underwriters because they structured the certificates here at issue to achieve desired ratings, which was a necessary predicate to the securities' distribution in the market." The court first reviewed the statutory definition of "underwriter," and determined that the crucial language in the definition was "any person who has purchased from an issuer *with a view to…the distribution of any security*, or participates…in any such undertaking[.]" Based on this language, the court concluded that the Rating Agencies had to participate in the distribution of the securities to be considered underwriters.

The investors further maintained that relevant case law had interpreted the term "underwriter" broadly. Nevertheless, in reviewing the cited cases, the court concluded that the "precedent cannot be read to expand the definition of underwriter to those who participate only in non-distributional activities that may facilitate securities' offerings by others."

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Lastly, the court reviewed the legislative history of the Act, and concluded that "Congress did not intend for strict underwriter liability to extend to persons merely interested in a distribution by virtue of their provision of nondistribution services to an offeror." [Emphasis supplied by court.]

In sum, the appellant court affirmed the district court, holding that "to qualify as an underwriter under the participation prongs of the statutory definition, a person must participate, directly or indirectly, in purchasing securities from an issuer with a view to distribution, in offering or selling securities for an issuer in connection with a distribution, or in the underwriting of such an offering."

As to the argument that the Rating Agencies played a necessary role in the securities' distribution due to their role in structuring the securities, the court stated that "even assuming, as we must, that the Rating Agencies had a good deal to do with the composition and characteristics of the pools of mortgage loans and the credit enhancements of the certificates that ultimately were sold, plaintiffs failed to allege that defendants participated in the relevant undertaking: that of purchasing securities from the issuer with a view towards distribution, or selling or offering securities for the issuer in connection with a distribution." Furthermore, the court held that "the mere structuring or creation of securities does not constitute participation in statutory underwriting."

The court also noted in a footnote that the remedy sought by the investors would more accurately be described by the "expert" provision of the Securities Act. Although expert liability was inapplicable to rating agencies when this suit was brought (as per SEC Rule 436(g)), that rule has since been repealed by the Dodd-Frank Act. However, the court further noted that "it appears that any potential 'expert' liability requires…that 'written consent' of named experts be filed with the registration statement[,]" and no such consent was given here.

Some of the investors further alleged that the Rating Agencies could be held liable as a "control person" under the Act. In discussing this claim, the court stated that "the only question on appeal is whether the facts alleged permit an inference that the Rating Agencies controlled the primary violators." After reviewing the relevant case law, the court defined "control" as "the power to direct or cause the direction of the management and policies of the primary violators, whether through the ownership of voting securities, by contract, or otherwise." To bring the Rating Agencies within the definition of a "control person," the investors contended that the Rating Agencies' roles of advising and guiding the depositors was an "active collaboration" tantamount to control. In affirming the district court on this point, the court stated that "allegations of advice, feedback, and guidance fail to raise a reasonable inference that the Rating Agencies had the power to direct, rather than merely inform, the banks' ultimate structuring decisions. Put another way, providing advice that the banks chose to follow does not suggest control." The court further pointed out that the investors' control person argument was directly undercut by their "rating shopping" argument (alleging that the banks pitted rating agencies against each other), which the court found was more indicative of the banks actually controlling the Rating Agencies.

Finally, in upholding the district court's denial of leave to amend the original complaints, the court first noted that this review would be for abuse of discretion, then cited authority that the district court may implicitly deny leave to amend by simply not addressing requests made in a brief filed in opposition to a motion to dismiss. Since the district court did not dismiss with prejudice, and no formal motion to amend was made thereafter, the court held this was not an abuse of discretion. The court further noted that denial of leave to amend could not be an abuse of discretion if amendment would have been futile as, in the court's opinion, it would have been here.

Although it was initially reported by *The Wall Street Journal* that this decision upheld the Rating Agencies' First Amendment defense (where rating agencies assert protection of their opinions as free speech), these reports were erroneous. It should be noted, however, that in *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, a case involving ratings of structured investment vehicles (SIVs) disseminated to a small group of private investors, the First Amendment defense was rejected. Although the court did note that "[i]t 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[,]" it went on to hold that "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."

As seen above, the important factual hook supporting this argument was that the First Amendment only applies to matters of public concern; however, this same hook severely limits the application of this case to the atypical facts seen here. While there has not been a subsequent New York case commenting on this analysis, it has been cited in one Pennsylvania case and one California case.

In the Pennsylvania case, *Federal Home Loan Bank of Pittsburgh v. J.P Morgan Securities LLC*, the court held that the facts did not "bring this case within the exception recognized in *Abu Dhabi* because…the ratings were included in the offering documents filed with the SEC and were made available to the world. Thus, the ratings were not being provided in connection with a private placement to a select small group of investors, but instead, were intended to be included in offering documents available to all potential investors."

On the other hand, in *California Public Employees' Retirement System v. Moody's Corp.*, a case also related to the rating of SIVs, the court disallowed the First Amendment defense, following the lead of the *Abu Dhabi* court.

In sum, the First Amendment defense still appears to be available to rating agencies in the typical situation, so long as the ratings were widely disseminated; however, when the ratings were given only to a small group of investors, especially when dealing with SIVs, this defense may not be allowed.

This article was written by Joseph Forte, a partner in the New York office and a member of its Global Finance & Debt Products Group, and Michael Igyarto, a 2011 summer associate in the New York office.

ALSTON+BIRD LLP

www.alstonfinance.com

Atlanta: One Atlantic Center • 1201 West Peachtree Street • Atlanta, Georgia, USA, 30309-3424 • 404.881.7000 • Fax: 404.881.7777
Brussels: Level 20 Bastion Tower • Place du Champ de Mars • B-1050 Brussels, BE • +32 2 550 3700 • Fax: +32 2 550 3719
Charlotte: Bank of America Plaza • 101 South Tryon Street, Suite 4000 • Charlotte, North Carolina, USA, 28280-4000 • 704.444.1000 • Fax: 704.444.1111
Dallas: 2200 Ross Avenue • Chase Tower • Suite 3601 • Dallas, Texas, USA, 75201 • 214.922.3400 • Fax: 214.922.3899
Los Angeles: 333 South Hope Street • 16th Floor • Los Angeles, California, USA 90071-3004 • 213.576.1000 • Fax: 213-576-1100
New York: 90 Park Avenue • New York, New York, USA, 10016-1387 • 212.210.9400 • Fax: 212.210.9444
Research Triangle: 4721 Emperor Blvd., Suite 400 • Durham, North Carolina, USA, 27703-85802 • 919.862.2200 • Fax: 919.862.2260
Silicon Valley: 275 Middlefield Road • Suite 150 • Menlo Park, California, USA, 94025-4004 • 650-838-2000 • Fax: 650.838.2001
Washington, DC: The Atlantic Building • 950 F Street, NW • Washington, DC, USA, 20004-1404 • 202.756.3300 • Fax: 202.756.3333
Ventura County: Suite 215 • 2801 Townsgate Road • Westlake Village, California, USA 91361 • 805.497.9474 • Fax: 805.497.8804