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Expert Analysis

Civil Liability of Rating Agencies: Past Success, Future Danger?

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In the wake of the financial crisis, credit rating agencies have been named in dozens of lawsuits by investors seeking to recover on the huge losses suffered when the subprime market collapsed. Despite widely reported shortcomings in recent years, the rating agencies have largely prevailed in these cases on motions to dismiss. In the few cases in which plaintiffs have been allowed to proceed to discovery, it is hardly certain that the rating agencies will face substantial liability for their contribution to the subprime collapse.

While courts have begun to address claims for alleged past misconduct, the new Dodd-Frank Wall Street Reform and Consumer Protection Act relaxes the pleading standard in future private securities cases against rating agencies and rescinds a Securities and Exchange Commission rule which previously exempted rating agencies from liability for false ratings in public registration statements. The new law increases the rating agencies' future exposure to civil liability. Below, we examine how rating agencies have fared in the courts to date and how they might fare under the new rules.

Rating Agencies in the Courts

Since the early 1900s, credit rating agencies have acted as "gatekeepers" to financial markets by providing assessments of the creditworthiness of financial instruments.[1] In 1975, the SEC began designating rating agencies that met certain criteria as "nationally recognized statistical rating organizations" (NRSROs), thus permitting financial firms subject to various regulatory requirements and restrictions to rely on the NRSROs' ratings. Regulatory developments since the 1970s have contributed to the dominance of the three leading rating agencies: Moody's Investor Service Ltd. (Moody's); Standard & Poor's (S&P); and Fitch Inc.

Beginning in July 2007, S&P, Moody's and Fitch began a series of large-scale downgrades of mortgage-backed securities that left many investors holding securities of little or no value. Numerous lawsuits followed.

1933 Act Claims

Historically, rating agencies have been shielded from civil liability by the First Amendment, subject to an "actual malice" exception, because ratings have been considered opinions or matters of public concern.[2] In the wake of the financial crisis, plaintiffs who presumably could not adequately plead actual malice turned to §§11, 12(a) and 15 of the Securities Act of 1933, which impose strict liability for material misstatements and omissions in public offering documents.[3]

Judge Lewis A. Kaplan was the first to decide the soundness of such claims in *In re Lehman Bros. Securities and ERISA Litigation*.[4] Investors who purchased mortgage pass-through certificates sued S&P and Moody's under §§11, 12(a)(2) and 15 for alleged misrepresentations on the theory that rating agencies could be sued as statutory underwriters or sellers, or as control persons. The court dismissed the claims, holding that the rating agencies' alleged activities did not make them statutory underwriters, sellers or control persons.

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Section 11 claims against rating agencies were dismissed in at least five other cases following *Lehman Bros.*[5] In one of those cases, Judge Jed S. Rakoff recognized that to hold the rating agencies liable as "underwriters" would contradict SEC Rule 436(g)(1), which exempts NRSROs from civil liability under §11.[6]

Common Law

Fraud claims under the common law and §10(b) of the Securities Exchange Act of 1934 have had more success at the pleading stage, notwithstanding the higher pleading standard under Federal Rule of Civil Procedure 9(b).[7] In two recent cases, *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.* and *Kings County, Washington v. IKB Deutsche Industriebank AG*, Judge Shira A. Scheindlin upheld common law fraud claims against S&P and Moody's for assigning allegedly false and misleading high ratings to certain structured finance products.[8]

In *Abu Dhabi*, the court rejected the rating agencies' claim to First Amendment immunity because plaintiffs alleged that the ratings were disseminated to a select group of investors in connection with a private placement rather than to the general public. Two other courts reached the same conclusion under similar facts,[9] though this conclusion is subject to question. In a private placement, though the ratings are purchased by a limited number of investors and are not disclosed in SEC filings, Moody's and S&P typically announce their ratings at the time of the private placement on their Web sites and through various financial media, arguably constituting public dissemination.

In *Abu Dhabi*, Judge Scheindlin also rejected the rating agencies' argument that the ratings were nonactionable opinions, holding that plaintiffs had sufficiently pled that the rating agencies did not genuinely or reasonably believe that "the ratings they assigned to the Rated Notes were accurate and had a basis in fact." The court held that a disclaimer by the rating agencies in the Information Memorandum was insufficient to protect the rating agencies from liability for misleading ratings.

Most importantly, the court held that plaintiffs had sufficiently pleaded facts from which one could infer that the rating agencies (1) knew that the credit ratings were false and (2) had the motive and opportunity to communicate to potential investors the allegedly false and misleading ratings. The court relied on, among other things, electronic communications between S&P analysts indicating that they knew that the rating process was unreliable.[10] One such instant message, unrelated to the structured product at issue, stated that the

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"model def[initely] does not capture half of the [risk]" and that "we rate every deal…it could be structured by cows and we would rate it."

The court further relied on the alleged fact that the rating agencies possessed nonpublic information that contradicted the assignment of high ratings to the notes; the rating agencies had known the process used to derive ratings was flawed and unreliable; the rating agencies had received substantially larger than usual fees for rating structured finance products; and the rating agencies' receipt of the fees being contingent upon the success of the rated products. Finally, the *Abu Dhabi* court held that plaintiffs' reliance upon the rating agencies was reasonable because of the market's reliance on rating agencies given "their NRSRO status and, at least in this case, the rating agencies' access to non-public information that even sophisticated investors cannot obtain."

In the other case before Judge Scheindlin, *Kings County, Washington v. IKB Deutsche Industriebank AG*, the court denied a motion to dismiss, holding that plaintiffs had adequately pleaded scienter for the reasons set forth in *Abu Dhabi* and that plaintiffs had "plausibly alleged that the materialization of the risk concealed by the [AAA ratings] caused plaintiffs' losses." The court noted that the rating agencies' argument that the losses were caused by an intervening market-wide credit crisis beginning in 2007 "may yet prevail at a later stage in this case."[11]

Changes in the Law

The Dodd-Frank Act, signed into law by President Barack Obama on July 21, 2010, seeks to promote accountability from the rating agencies in two ways. First, the act creates a regulatory scheme that will be administered by a newly created Office of Credit Rating within the SEC. Second, and of most relevance here, the act subjects rating agencies to the same standard of liability as other industry "gatekeepers" by imposing §11 liability, relaxing the pleading standard for private securities fraud actions, and declaring that ratings are not forward-looking statements protected by the safe harbor.

Section 939G of the Dodd-Frank Act repealed SEC Rule 436(g), which exempted NRSROs from civil liability under §11 for ratings that were published in registration statements. This change applies to all new registration statements filed with the SEC on July 22, 2010 or later. Under the Securities Act of 1933, the written consent of any person who is named in a registration statement as having prepared or certified a portion of the registration statement must be filed with the SEC, and that person is subject to liability under §11 for that portion of the registration statement.[12] Assuming that they consent, rating agencies can now be held liable under §11 for false ratings published in registration statements for new offerings. This change means a drastically different result in future cases like *Lehman Bros*.

Not surprisingly, many rating agencies have already announced that they will not consent to the use of their ratings in registration statements because of their fear of exposure to additional legal liability.[13] Rating agencies have also reportedly begun seeking indemnification from issuers and underwriters of new asset-backed bonds.[14]

Section 933 relaxes the pleading standard for private securities fraud actions against rating agencies. Under the PSLRA, a plaintiff is required to plead with particularity facts that give rise to "a strong inference of fraud." Section 933(b)(2)(B) of the Dodd-Frank Act amends §21D(b)(2) by providing that

> In the case of an action for money damages brought against a credit rating agency or controlling person under this title, it shall be sufficient for the purposes of pleading a required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.

In a posting on its Web site setting forth its position on the financial reform legislation passed by the Senate, which is identical to §933 of the Dodd-Frank Act, S&P characterized the state of mind requirement of §933(b)(2)(B) as "unprecedented," claiming that the standard makes rating agencies more vulnerable to lawsuits than other market participants and "could expose [rating agencies] to suit from a potentially unlimited number of claimants."[15] S&P warns that the heightened standard may inadvertently reduce the quality and timeliness of ratings and will be detrimental to global capital markets because, for fear of liability, rating agencies may decline to adjust outstanding ratings and may only rate well-established issuers, among other things.

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Conclusion

The Dodd-Frank Act greatly increases rating agencies' potential liability under the securities laws. We are on the cusp of a new regime for rating agencies—encompassing new regulations and new liability rules—though how these changes will ultimately affect the conduct of rating agencies is unclear. One impact is almost certain: in the future, rating agencies are unlikely to fare as well in the courts as they have in the past.

1. See Jonathan S. Sack and Stephen M. Juris, "Rating Agencies: Civil Liability Past and Future," NYLJ (Nov. 5, 2007).
2. See *Compuware v. Moody's Investors Servs. Inc.*, 499 F.3d 520, 525 (6th Cir. 2007) (Moody's rating of a publicly-held corporation was subject to an "actual malice" standard).
3. See 15 U.S.C. §§77k(a), 77l(a)(2), and 77o.
4. No. 09 MD 2017 (LAK), 2010 WL 337997 (SDNY Feb. 1, 2010).
5. *In re: Indymac Mortgage-Backed Sec. Litig.*, No. 09 Civ. 4583 (LAK), slip op. (SDNY Feb. 5, 2010); *Tsereteli v. Residential Asset Securitization Trust 2006-A8, et al.*, No. 08 Civ. 10637 (LAK), slip op. (SDNY Feb. 5, 2010); *New Jersey Carpenters Vacation Fund v. Royal Bank of Scotland, PLC*, No. 08 CV 5093 (HB), 2010 WL 1172694, at 6 (SDNY March 26, 2010); *In re Wells Fargo Mortgage-Backed Certificates Litig.*, No. C. 09-01376 SI, 2010 WL 1661534, at 8 (N.D. Cal. April 22, 2010); *Public Employees' Ret. System of Miss. et al. v. Merrill Lynch & Co. Inc. et al.*, No. 08 Civ. 10841 (JSR), 2010 WL 2175875 (SDNY June 1, 2010).
6. *Public Employees' Ret. System of Miss.*, 2010 WL 2175875, at 4 (citing 17 CFR §230.436(g)(1) and SEC Release No. 33-6336, 46 Fed. Reg. 42024-01, 42024 (Aug. 18, 1981)).
7. Notwithstanding the rating agencies' success in past litigation, on at least one occasion plaintiffs survived a motion to dismiss Rule 10b-5 and common law fraud claims when, as the plaintiffs recently did in *Abu Dhabi Commercial Bank*, they were able to allege facts showing that the rating agency was aware of, or recklessly disregarded, facts that undermined the accuracy of the published rating. See *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*, 951 F.Supp.1071, 1086 (SDNY 1996).
8. *Abu Dhabi Comm. Bank*, 651 F.Supp.2d 155, 175-76 (SDNY 2009); *Kings County, Washington,* No. 09 Civ. 8387 (SAS), 09 Civ. 8822 (SAS), 2010 WL 1702196 (SDNY Apr. 26, 2010). See also *In re National Century Financial Enterprise Inc. Investment Litigation*, 580 F.Supp.2d 630, 644 (S.D. Ohio 2008) (dismissing §10(b) and common law fraud claims against the rating agencies but upholding negligent misrepresentation, Ohio's blue sky, and aiding and abetting fraud claims).
9. *In re Nat'l Century Fin. Enters. Inc. Inv. Litig.*, 580 F.Supp.2d 630, 639-40 (S.D. Ohio 2008); *Cal. Public Employees Ret. System*, No. CGC-09-490241, slip op. at 10 (Cal. Super. Ct. S.F. Cty. June 1, 2010).
10. First Amended Complaint for Common Law Fraud, Negligent Misrepresentation, Negligence, Breach of Fiduciary Duty, Breach of Contract, Unjust Enrichment and Aiding and Abetting at ¶¶129, 130, *Abu Dhabi Comm. Bank et al. v. Morgan Stanley & Co. Inc. et al.*, No. 08 Civ. 07508 (SDNY March 31, 2009).
11. 2010 WL 1702196, at 3.
12. See 15 U.S.C. §77k.
13. Anusha Shrivastava, "Bond Sale? Don't Quote Us, Request Credit Firms," WALL ST. J., July 21, 2010, at C1.
14. "Dodd-Frank Wrinkle Reshapes Rating Process," ASSET-BACKED ALERT, THE WEEKLY UPDATE ON WORLDWIDE SECURITIZATION, Aug. 6, 2010, at 1-2.
15. http://www.standardandpoors.com/about-sp/on-the-issues/en/us (follow "Our Positions on Pending Legislation" and then "Position on Dodd Bill" hyperlinks).

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