The Second Circuit Holds That Rating Agencies Are Not "Underwriters" Under The Securities Act of 1933

On May 11, 2011, the United States Court of Appeals for the Second Circuit, in *In re Lehman Brothers Mortgage-Backed Securities Litigation*,[1] affirmed the District Court's dismissal of claims filed against certain credit rating agencies in three matters. The Second Circuit agreed with the District Court that credit rating agencies Standard & Poor's Ratings Service, Moody's Investors Service, Inc., and Fitch, Inc. (collectively, the "Rating Agencies") could not be held liable as "underwriters" within the meaning of Section 11 of the Securities Act of 1933 (the "Securities Act").[2] Additionally, the Court affirmed the District Court's opinion that the Rating Agencies' alleged activities were insufficient to plead "controlling person" liability under Section 15 of the Securities Act.[3]

I. Background and Procedural History

Section 11 of the Securities Act provides for a cause of action against certain statutorily enumerated persons to the extent material misstatements or omissions are made in registration statements filed with the SEC. These potential defendants include the "underwriter" for the offering, which the Securities Act defines as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking."[4]

Plaintiffs in a number of recent actions filed across the country have argued that, although the Rating Agencies had not "purchased from an issuer with a view to . . . distribut[e] . . . any security," the Rating Agencies qualified as "underwriters" under Section 11 because they had "participated" in such an "undertaking" through the issuance of credit ratings which plaintiffs alleged were conditions to the securities offerings and/or by advising issuers on the structure and credit enhancement necessary for the securities to be rated at a particular rating level.[5] Every District Court judge to consider this claim to date has rejected it.[6] In the District Court

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1 2011 WL 1778726 (2d Cir. May 11, 2011) (affirming *In re Lehman Brothers Securities and ERISA Litigation*, 681 F. Supp. 2d 495 (S.D.N.Y. 2010) (Kaplan, J.); *In re IndyMac Mortgage-Backed Securities Litigation*, 09-CV-04583, slip op. (S.D.N.Y. Feb. 5, 2010) (Kaplan, J.); and *Tsereteli* v. *Residential Asset Securitization Trust 2006-8, et al*, 08-CV-10637, slip op. (S.D.N.Y. Feb. 5, 2010) (Kaplan, J.)).

2 *Id.* at *14.

3 *Id.* at *16.

4 Securities Act Section 2(a)(11).

5 *See Lehman*, 681 F. Supp. 2d 495; *IndyMac*, 09-CV-04583; *Tsereteli*, 08-CV-10637; *New Jersey Carpenters Vacation Fund et al.* v. *Royal Bank of Scotland Group, PLC et al.*, 720 F. Supp. 2d 254 (S.D.N.Y. 2010) (Baer, J.); *In re Wells Fargo Mortgage-Backed Certificates Litigation*, 712 F. Supp. 2d 958 (N.D. Cal. 2010) (Illston, J.); *Public Employees' Retirement System of Mississippi* v. *Merrill Lynch & Co. Inc.*, 714 F. Supp. 2d 475 (S.D.N.Y. 2010) (Rakoff, J.); *Federal Home Loan Bank of Pittsburgh* v. *J.P. Morgan Securities LLC, et al*, 2010 WL 547006, No. GD09-016892, slip op. (Pa. Ct. Com. Pl. Nov. 29, 2010) (Wettick, J.); *Public Employees' Retirement System of Mississippi* v. *Goldman Sachs Group, Inc.*, 2011 WL 135821 (S.D.N.Y. Jan. 12, 2011) (Baer, J.); *New Jersey Carpenters Health Fund* v. *NovaStar Mortgage, et. al*, 2011 WL 1338195 (S.D.N.Y. March 31, 2011) (Batts, J.).

6 *See Royal Bank of Scotland*, 720 F. Supp. 2d at 263-64; *Wells Fargo*, 712 F. Supp. 2d at 968-69; *Merrill Lynch*, 714 F. Supp. 2d at 481-82; *Federal Home Loan Bank*, 2010 WL 547006, No. GD09-016892, slip op. at 5-7; *Goldman Sachs*, 2011 WL 135821, at *5; *NovaStar Mortgage*, 2011 WL 1338195, at *7-*9.

proceedings underlying the Second Circuit's recent ruling, Judge Kaplan of the Southern District of New York ruled, in three different cases, that allegations that the Rating Agencies provided credit ratings and were involved in "structuring" the securities do not "suggest that [the Rating Agencies] participated in the relevant 'undertaking'—that of purchasing the securities . . . at issue . . . 'from the issuer with a view to their resale.'"[7] Plaintiffs' Section 11 claims thus failed as a matter of law.[8]

Many of the same plaintiffs, including the *Lehman* plaintiffs, also alleged that the Rating Agencies were liable as "controlling persons" under Section 15 of the Securities Act, which provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

In the underlying cases, Judge Kaplan dismissed the Section 15 claims, holding that Plaintiffs' "complaint, fairly read, allege[d] only that the Rating Agencies had the power to influence [the issuer] with respect to the composition of the pools of mortgages to be securitized and the credit enhancements the Rating Agencies regarded as necessary to obtain the desired ratings."[9] Section 15, however, required Plaintiffs to plead and ultimately show that the Rating Agencies had "'the practical ability to *direct* the actions of people who issue or sell securities.'"[10]

II. The Second Circuit's Decision

The Second Circuit, in affirming Judge Kaplan's decisions, held that the Rating Agencies are not as a matter of law underwriters under the federal securities laws and thus cannot be subject to underwriter liability under Section 11. The Court held that the Rating Agencies' participation in "the mere structuring or creation of securities does not constitute participation in statutory underwriting."[11] Instead, the Court found that, to qualify as an underwriter, it is necessary for a defendant to engage in the *distribution* of securities and that "[t]he Rating

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7 *Lehman*, 681 F. Supp. 2d at 499-500; *see also IndyMac*, 09-CV-04583, slip op. (dismissing claims "for the reasons stated in" the *Lehman* opinion); *Tsereteli*, 08-CV-10637, slip op. (same).

8 *Lehman*, 681 F. Supp. 2d at 499. In *Lehman*, and other cases, plaintiffs also alleged that the Rating Agencies were liable as "sellers" of securities under Section 12(a)(2) of the Securities Act. *See id.* at 499-500. Judge Kaplan ruled that, like the Section 11 claims, Plaintiffs' Section 12 claims failed as a matter of law. *Id.* at 500 (reasoning that "the Ratings Agencies' alleged involvement in advising on what loans to purchase for the pools, drafting Prospectus Supplements, collaborating on credit enhancements and using their model to aid Lehman in structuring the deals that ultimately were offered . . . . [is] no different than [the role] of an architect or builder in designing and constructing a house for an owner who later resells the house through the sole efforts of a real estate broker. While it doubtless is true that the architect or builder had a lot to do with the characteristics of the house — no doubt characteristics that made it an attractive and salable product — they cannot properly be said to have participated in any legally relevant sense in its resale down the line."). The plaintiffs in *Lehman* did not appeal the dismissal of their Section 12 claims.

9 *Lehman*, 681 F. Supp. 2d at 501.

10 *Id.* at 500 (quoting *In re Flag Telecom Holdings, Ltd. Securities Litigation*, 352 F. Supp. 2d 429, 458 (S.D.N.Y. 2005)).

11 *Lehman*, 2011 WL 1778726, at *13.

Agencies' efforts in creating and structuring certificates occurred during the initial stages of securitization, not during efforts to disperse certificates to investors."[12]

In support of its holding, the Second Circuit first looked to the statutory text. The Court stated:

> The plain language of the statute limits liability to persons who participate in the purchase, offer, or sale of securities for distribution. While such participation may be indirect as well as direct, the statute does not reach further to identify as underwriters persons who provide services that facilitate a securities offering, but who do not themselves participate in the statutorily specified distribution-related activities.[13]

The Court found that "[n]othing in the statute's text supports expanding the definition of underwriter to reach persons not themselves participating in such purchases, offers, or sales, but whose actions may facilitate the participation of others in such undertakings."[14]

The Second Circuit also found support for its interpretation in the relevant legislative history, which "reinforce[d] [the Court's] holding that the Rating Agencies do not qualify as 'underwriters.'"[15] The legislative history led the Court to conclude that "[b]y focusing on persons playing roles similar to those disposing of or reselling securities, or those participating in such actions, [the relevant House] [R]eports indicate that 'congressional intent was to include as underwriters all persons who might *operate as conduits* for securities being placed into the hands of the investing public.'"[16] The Court concluded that the "participation" in underwriting that may underlie liability "must be in the statutorily enumerated distributional activities, not in non-distributional activities that may facilitate the eventual distribution by others."[17] To hold otherwise could create the "implausible result of transforming every lawyer, accountant, and other professional whose work is theoretically 'necessary' to bringing a security to market into an 'underwriter' subject to strict liability under § 11, a dramatic outcome that Congress provided no sign of intending."[18]

Thus, the Court rejected Plaintiffs' argument that "any persons playing an essential role in a public offering—including the Rating Agency Defendants—may be liable as underwriters."[19]

Likewise, the Second Circuit upheld the District Court's dismissal of claims against the Rating Agencies for "controlling person" liability under Section 15 of the Securities Act. The Second Circuit held that the allegations against the Rating Agencies merely suggested "that the Rating Agencies provided advice and strategic direction on how to structure transactions to achieve particular ratings" and "[s]uch purported involvement in transaction-level decisions falls far short of showing a power to direct the primary violators' management and policies."[20] The Second Circuit further found that "allegations of advice, feedback, and guidance fail to raise a

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12 *Id.* at *12.

13 *Id.* at *5.

14 *Id.* at *6.

15 *Id.* at *9.

16 *Id.* at *10 (quoting 2 Thomas Lee Hazen, *Law of Securities Regulation* § 4.27).

17 *Id.*

18 *Id.*

19 *Id.* at *7.

20 *Id.* at *15 (citations and internal quotation marks omitted).

reasonable inference that the Rating Agencies had the power to *direct*, rather than merely inform, the banks' ultimate structuring decisions" and that "providing advice that the banks chose to follow does not suggest control."[21]

III. Significance of the Decision

This decision should largely resolve the issue of whether credit rating agencies are subject to liability as underwriters and/or control persons under the Securities Act. But the decision also extends far broader than rating agencies in concluding that "mere structuring" or the "creation of securities does not constitute participation in statutory underwriting." Accordingly, the opinion could have implications for many other entities that play a role in registered offerings but are not involved in the actual distribution or selling of such securities.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Garrett Ross at 212.701.3234 or gross@cahill.com.

[21] *Id.*