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NEW YORK FEDERAL DISTRICT COURT REJECTS CREDIT RATING AGENCIES' FIRST AMENDMENT DEFENSE

In *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 2009 WL 2828018 (S.D.N.Y. Sept. 2, 2009), the United States District Court Southern District of New York (Scheindlin, J.) held recently that First Amendment free speech immunity does not protect credit rating agencies from claims by investors "where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large." Although this is not the first decision to deny the rating agencies' First Amendment defense when the opinion is not published to the "public at large," it is one of the first decisions to reject the defense in the context of ratings of mortgage backed securities.

Beginning in approximately 2004, investors, including plaintiffs, began purchasing interests issued by a non-party Cheyne Finance PLC and its subsidiaries Cheyne Finance LLC and Cheyne Capital Notes LLC (collectively "Cheyne). Cheyne issued three types of notes: commercial paper, medium term notes and mezzanine capital notes collectively, "Rated Notes"), each of which was rated by Moody's Investors Service, Inc. ("Moody's") and/or Standard & Poor's Rating Services ("S&P"; together with Moody's, the "Rating Agencies"). The Rating Agencies typically evaluate a debt offering based on public, and sometimes non-public, information, regarding the assets of an issuer and assign the debt offering a rating to convey information to potential creditors/investors about the creditworthiness of that issuer's debt. According to plaintiffs' allegations, the Rated Notes all received high ratings from the Rating Agencies. These ratings were included in Cheyne's information memoranda and other selling documents that Morgan Stanley & Co. Inc. ("Morgan Stanley"), acting as the arranger and placement agent for the Rated Notes, distributed to potential investors for the purpose of issuing up to $20 billion dollars of "top rated" senior notes and $3 billion in "investment grade" capital notes.

Although typically a rating agency's role is as an "unbiased reporter", independent from placement manager, plaintiffs alleged that the Rating Agencies worked directly with Morgan Stanley to structure the Rated Notes in such a way that they would qualify for the Rating Agencies' highest ratings. In exchange for these services, the Rating Agencies received substantial fees, in excess of three times their customary fees.

Plaintiffs sued eight defendants, including Morgan Stanley, Moody's and S&P, on thirty-two claims of common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract

and related contract claims, unjust enrichment, and aiding and abetting fraud. In defense of the fraud claim against them, the Rating Agencies argued that plaintiffs did not plead an actionable misrepresentation as required when pleading fraud because (1) the Rating Agencies are entitled to immunity under the First Amendment and (2) even if the Rating Agencies could be held liable, their ratings are non-actionable opinions.

In evaluating the First Amendment defense, the court focused on plaintiffs' allegations that the Cheyne ratings were "never widely disseminated, but were provided instead in connection with a private placement to a select group of investors." For this reason, the court rejected the Rating Agencies' First Amendment defense. Likewise, the court was not persuaded by the Rating Agencies' second defense that opinions are non-actionable as misrepresentations. Here, the court found 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," and any disclaimers in the information memoranda could not act as shield from liability.

This decision from the Southern District of New York is likely to receive a great deal of attention from the plaintiffs' bar and consequently the credit rating industry. The rating agencies are attractive "deep pocket" targets for investor claims when highly rated companies suddenly go bankrupt. Historically, the rating agencies have been able to rely on the First Amendment or on their position as rendering only an "opinion" to defend claims of fraud or misrepresentation. This may change as plaintiffs look for instances where the ratings are not widely published or to establish that the rating agencies had no reasonable basis in fact to support the accuracy of the ratings they assigned to an issue. Ratings agencies will likely take efforts to ensure that their ratings are widely disseminated in future offerings and to conduct and record additional due diligence to support the bases for their opinions.

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