May 23, 2011

Second Circuit Holds That Rating Agencies Were Not "Underwriters" or "Controlling Persons" Within the Meaning of the Securities Act of 1933

In *In re Lehman Brothers Mortgage-Backed Securities Litigation*, Nos. 10-0712-cv, 10-0898-cv, 10-1288-cv, 2011 WL 1778726 (2d Cir. May 11, 2011), the United States Court of Appeals for the Second Circuit affirmed three lower court decisions holding that various defendant rating agencies, including The McGraw Hill Companies, Inc., Moody's Investors Service Inc. and Fitch, Inc. ("Rating Agencies"), were not liable as "underwriters" or as "controlling persons" under Sections 11 and 15 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77k, 77*o*. Rating agencies typically assign credit ratings for issuers of certain types of debt obligations as well as the debt instruments themselves; plaintiffs argued, however, that the Rating Agencies here exceeded their traditional, passive role as credit risk evaluators by actively aiding the issuers in the structuring and securitization process, thereby assuming the role of underwriters or controlling persons of the issuers. In rejecting plaintiffs' arguments, the Second Circuit clarified who would qualify as an underwriter and controlling person under the Securities Act, and in the process stymied yet another attempt by securities plaintiffs to hold rating agencies liable for losses in rated securities.

This caseconsolidated three appeals that raised common questions of law. The underlying actions were brought by persons who had purchased mortgage pass-through certificates, registered with the Securities and Exchange Commission ("SEC") and entitling them to distributions from underlying pools of mortgages. These certificates were rated by one or more of the defendant Rating Agencies.

According to plaintiffs, the Rating Agencies actively assisted the issuer banks in the structuring of the securities and the securitization process, ostensibly in order to achieve the desired high rating. Plaintiffs complained that this collaboration resulted in high ratings on debt that ultimately proved to be much riskier than the ratings suggested.

Plaintiffs asserted two bases for the Rating Agencies' liability under the Securities Act: strict underwriter liability under Section 11(a)(5) of the Securities Act and controlling person liability under Section 15 of the Securities Act. Section 11(a)(5) of the Securities Act establishes strict liability of underwriters for misstatements and omissions made in registration statements filed with the SEC. Plaintiffs argued that the Rating Agencies qualified as "underwriters" because they structured the certificates at issue to achieve desired ratings, which was a necessary predicate to the securities' distribution in the market. Section 15 of the Securities Act establishes liability of controlling persons for Securities Act violations of the issuers they control.

The United States District Court for the Southern District of New York granted the Rating Agencies' motions to dismiss, holding that the facts alleged did not support the conclusion that the Rating Agencies were underwriters or controlling persons within the meaning of the Securities Act. Plaintiffs appealed.

The Second Circuit affirmed. First, the Court examined the applicable statute. Section 2(a)(11) of the Securities Act, 15 U.S.C. § 77b(a)(11), defines an "underwriter" 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.

The Court held that the plain language of the statute limits liability to persons who participate in the purchase, offer or sale of securities for distribution.

Second, the Court examined the precedent cited by plaintiffs, focusing on *SEC v. Kern*, 425 F.3d 143, 152 (2d Cir. 2005). In disagreeing with the plaintiffs' interpretation, the Court stated that though *Kern* defines an "underwriter" as one who takes "steps necessary to the distribution" of securities, *Kern* should not be read to expand the definition of underwriter to include one who participates only in non-distributional activities that may facilitate securities' offering by others. Rather, the Court concluded that *Kern* instructs that only persons playing roles essential in the actual distribution of securities qualify as underwriters.

Third, the Court reviewed the legislative history of Section 11. It held that Congress did not intend strict underwriter liability to extend to persons merely interested in a distribution by virtue of their provision of non-distribution services to an offeror.

For these reasons, the Court did not extend strict underwriter liability to the Rating Agencies, reasoning that the mere structuring or creation of securities does not constitute participation in statutory underwriting.

A group of plaintiffs also appealed the district court's dismissal of their Section 15 controlling person claims. To establish Section 15 liability, a plaintiff must show a "primary violation" of Section 11 and control of the primary violator by defendants. The Court acknowledged that a primary Section 11 violation by the certificates' issuers or depositors was undisputed. However, the Court declined to agree with plaintiffs that the Rating Agencies controlled the violators.

The Court reasoned that at most, plaintiffs' allegations suggested that the Rating Agencies provided advice and strategic direction on how to structure transactions to achieve particular ratings. According to the Court, providing advice that the banks chose to follow did not suggest control.

Rating agencies have been widely criticized for alleged failures that contributed in the 2008-2009 global credit and financial crises. Perhaps cognizant of this criticism, the Second Circuit noted that its conclusion in this case would not necessarily absolve the Rating Agencies of all potential liability, observing that plaintiffs could attempt to bring securities fraud claims against them under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). Nevertheless, with rare exceptions (*see* blog article here) securities plaintiffs generally have not fared well in claims against rating agencies. This decision confirms the difficulty in holding rating agencies liable for losses in rated securities.

For further information, please contact John Stigi at (310) 228-3717 or Kathryn Hines at (212) 634-3054.