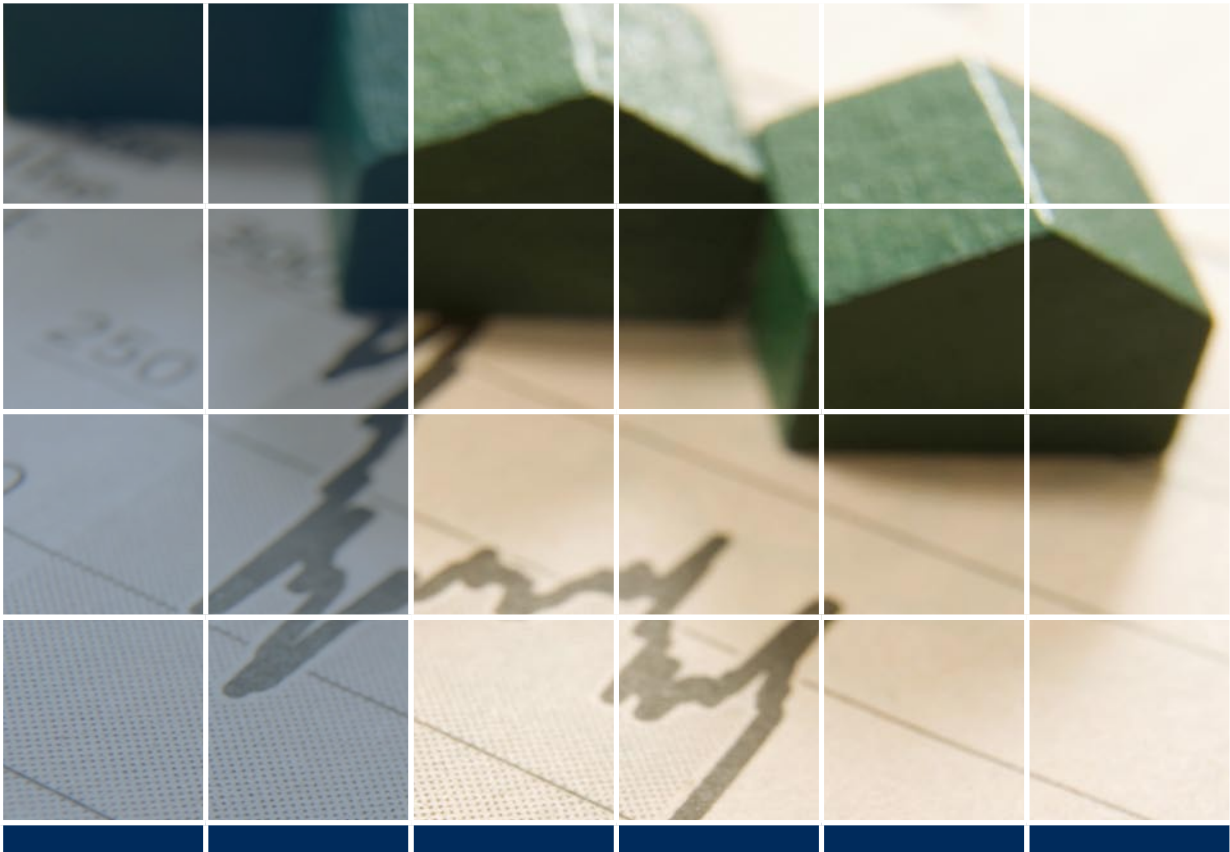

Credit In Crisis: An Analysis Of Credit Rating Agency Exposure To Sub-prime Claims

November 2008

Dewey & LeBoeuf

CREDIT IN CRISIS: AN ANALYSIS OF CREDIT RATING AGENCY EXPOSURE TO SUB-PRIME CLAIMS

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With the United States announcing a $700 billion bailout plan and the United Kingdom estimating an increased taxpayer burden of almost £1 trillion, the credit crisis will not soon fade from the public memory. What began as a housing bubble in the US ended with a collapse in the value of so-called "sub-prime" home mortgages and a virtual decimation of the value of securities collateralized by those mortgages. As recently as early September, the resulting credit crisis has seen bankers at Lehman Brothers pouring out of their offices in New York and London, cardboard boxes in hand, and flashing tickers spelling doom for worldwide markets. Current estimates place losses from the now year-long credit crunch in the hundreds of billions, and the end is not yet in sight.

The credit rating agencies – in particular the three "majors" (Fitch, Moody's and S&P) – have come under intense scrutiny in the wake of these mounting losses. While the agencies might seem only tangential players in the structured finance market, in truth the agencies' ratings helped create a market for real estate mortgage-backed securities ("RMBSs") and collateralized debt obligations ("CDOs"), the products principally at issue in the credit crisis. As it turns out, the ratings assigned to RMBSs and CDOs often significantly understated the level of risk associated with those securities. Now that the bottom has fallen out of the US housing market (making a substantial portion of sub-prime backed RMBSs and CDOs worthless), many are pointing the finger at credit rating agencies.

Until 2002, the credit rating agencies occupied a unique position in the world of investments, offering their own brand of investment advice while avoiding serious entanglements with regulators and largely escaping scrutiny by the courts. That all began to change when the collapse of Enron's energy trading market pushed the rating agencies into the hot-seat before the United States Senate, where they were forced to admit they made a mistake in failing to downgrade Enron's debt more hastily. The agencies paid for that mistake in the form of the first major regulation of their industry – the Credit Rating Agency Reform Act of 2006 – which subjected the industry to scrutiny by the Securities and Exchange Commission ("SEC") for the first time in history. Despite this legislation, neither the SEC nor the courts have ever taken decisive action against the rating agencies.

However, when the sub-prime crisis propelled the credit rating agencies back into the public eye, regulators and local governments in the US swiftly launched investigations into potential agency failures precipitating the credit crunch. In June of this year – amid a criminal investigation by the New York Attorney General Andrew Cuomo – the three "majors" agreed to a settlement that heralds far-reaching reforms to the way they conduct their business. And in July,

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following a year-long civil investigation, the SEC published a preliminary report documenting "serious shortcomings…including a lack of disclosure to investors and the public, a lack of policies and procedures to manage the rating process and insufficient attention to conflicts of interest." These investigations have undoubtedly fueled the claims of disgruntled investors who believe the credit rating agencies should bear some legal liability for the huge losses incurred by market participants who bought the products rated by the agencies.

This article analyzes the credit rating agencies' potential exposure to liability by looking at how the courts of New York and London (investors' likely jurisdictions of choice) would approach common law claims against the agencies under both US and English law. The article's focus on these two jurisdictions should not, however, be read to limit the potential applicability of other jurisdictions' laws. Given the multi-national nature of rating activities and the global reach of the investment community, any lawsuit involving the agencies is certain to raise questions about jurisdiction and governing law. This analysis circumscribes the discussion by focusing on the laws of just two jurisdictions which we already know to have been heavily affected by the collapse of the sub-prime mortgage market.

The analysis begins with a review of credit rating agencies' traditional treatment in the courts of the US, an examination of their process for rating RMBSs and CDOs, and a description of the current legal landscape in which the agencies now find themselves. The analysis ends with a discussion of the contours of common law negligence claims in the US and England and an assessment of the hurdles an investor might face in pursuit of the rating agencies in the courts of both countries.

I. BACKGROUND

In the United States, credit rating agencies ("CRAs") have historically avoided liability for overrating securities by relying on the First Amendment's protection of journalistic opinion.[2] This protection has insulated CRAs even against allegations of serious market malfeasance. Nevertheless, CRAs have not enjoyed absolute immunity, nor have the courts foreclosed the possibility of a successful investor suit against the CRAs in the appropriate circumstances. For example, several courts have suggested that, where a CRA is asked to rate a particular financial product and participates in the structuring of that product for compensation, the First Amendment may not protect the agency in the event that the rating proves to be inflated.[3] That situation is obviously much more likely to be the case in the current context of CRA rat-

2 *See, e.g., Jefferson County School Dist. No. R-1 v. Moody's Investor's Servs.,* 175 F.3d 848 (10th Cir. 1999) (dismissing, on First Amendment grounds, various tort claims against Moody's for allegedly assigning improper ratings to school district bonds); *In re Enron Corp. Securities,* 511 F. Supp. 2d 742, 820 (S.D. Tex. 2005) (treating credit ratings as opinions relating to matters of public concern and affording them Constitutional protection).

3 *See, e.g., In re Fitch, Inc.,* 330 F.3d 110 (2d Cir. 2003) (denying Fitch's motion to quash a subpoena seeking ratings-related communications between PaineWebber and Fitch because the evidence "reveal[ed] a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which a journalist reports."); *Jefferson County,* 175 F.3d at [•] (noting as persuasive in its decision to dismiss the complaint that Moody's had rated the bonds on its own initiative); *Compuware Corp. v. Moody's Investors Services, Inc.,* 324 F. Supp. 2d 860 (E.D. Mich. 2004) (holding that Moody's qualified for journalistic protection only because the plaintiff did not allege that the agency played a significant role in structuring the transaction it rated).

ings of CDOs and RMBS. As a result, CRAs may find that the First Amendment and case law invoking journalistic privilege does not apply in today's commercial environment.

The CRAs are certainly no strangers to controversy, nor are they unfamiliar with investigations by regulators. Indeed, in 2002, the CRAs came under fire in the wake of Enron's collapse, leading to investigations by Congress and the SEC.[4] A Senate report issued in October 2002 found that the CRAs approach to Enron "fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness."[5] The Report, along with a related concept release and the ensuing public commentary, led Congress to enact the Credit Rating Agency Reform Act of 2006, which was implemented by way of new SEC rules in June 2007.[6] That Act added a new Section 15E to the Securities Exchange Act of 1934, which gives the SEC authority to implement financial reporting and oversight rules with respect to Nationally Recognized Statistical Ratings Organizations ("NRSROs"). The Act also amended Section 17(a) of the Exchange Act to give the SEC authority to examine the ratings activities of registered NRSROs as well as to impose recordkeeping and reporting requirements. However, even with the implementation of this Act, CRAs have continued to enjoy a favored position in the eyes of the law, escaping liability for what some critics believe are major oversights.[7]

It is perhaps ironic that, just months after the Credit Rating Agency Reform Act took effect, the bottom fell out of the housing market, and the CRAs found themselves on the front line of one of the biggest market debacles in history.

II. THE CRA'S ROLE IN THE CREDIT CRUNCH

Before examining the CRAs role in the sub-prime crisis, it is important to understand how RMBSs and CDOs – the securities at the center of the crisis – are created. Broadly speaking, the RMBS process starts with an arranger (usually an investment bank) taking thousands of mortgage loans from a lending bank and packaging them into a pool. The arranger conducts due diligence of the mortgages and then approaches various parties (*e.g.*, a servicer, a cash manager, a rating agency, and potentially a liquidity provider or credit enhancer) to price the pool of mortgages and to arrange a securitization.[8] Once the arranger has obtained commitments from the necessary parties, it sets up a bankruptcy-remote special purpose vehicle

4 Carol Ann Frost, *Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies,* J. of Accounting, Auditing, and Finance (June 27, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941861#PaperDownload. *See also* Richard A. Oppel Jr., *Enron's Many Strands: The Hearings; Credit Agencies Say Enron Dishonesty Misled Them*, N.Y. Times, Mar. 21, 2002.

5 Staff of S. Comm. on Governmental Affairs, 107th Cong., Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 116 (Comm. Print 2006), *available at* http://www.senate.gov/~govt-aff/100702watchdogsreport.pdf.

6 Pub. L. No. 109-291, 120 Stat. 1327; Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Release No. 34-55957, Fed. Reg. 33,564 (June 18, 2007).

7 Enron is the oft-cited example. Despite the deterioration of Enron's credit over the course of several months in 2001, rating agencies retained Enron's investment grade rating. It was not until Enron's collapse was a fait accompli that the agencies rapidly downgraded its rating. *See* Roger Lowenstein, *Triple-A Failure*, N.Y. Times, Apr. 27, 2008 (discussing ratings agencies' failures vis-à-vis Enron).

8 "Securitization" simply refers to the process of pooling and repackaging cash-flow producing financial assets into securities that are then sold to investors. For lending banks, it is a means of offloading the risk associated with long-term mortgages and realizing immediate liquidity.

("SPV") – usually a trust – to purchase the pool of mortgage receivables from the lending bank. The SPV finances its purchase of the pool by issuing securities (representing RMBSs) to investors. The securities are usually arranged in different classes, called "tranches," according to their risk profile.

The process for creating CDOs is similar. A CDO is comprised of a bundle of debt securities (as opposed to pooled mortgage loans), which may themselves be RMBSs. As with an RMBS, a CDO is typically purchased by an SPV, which pays for the CDO by issuing securities to investors. Like RMBS notes, CDO notes are also issued in tranches with varying risk profiles.

Among the various players involved in the creation of RMBSs and CDOs, the CRA's role is perhaps the most critical. This is because most of the institutional investors who purchase RMBSs and CDOs are only permitted to purchase investment-grade securities.[9] As a result, unless the arranger can find a CRA willing to issue an investment-grade rating for the particular RMBS or CDO, the securitization cannot get done.

Given the role of the CRAs in the development of the RMBS and CDO markets, investors may have relied far more heavily on the CRAs ratings of these structured products than they did on ratings of straight corporate debt securities. For that reason, an examination of CRAs ratings, the process for rating RMBSs and CDOs, and analysis of potential flaws in that process, sheds light on their potential for future liability.

A. RATINGS: MEANING AND METHODOLOGIES

Despite the seemingly simplistic sliding scale that each CRA uses to measure the risk associated with a particular security, the lettered ratings assigned to securities are anything but simple. Not only are ratings definitions different at each of the major ratings agencies, the models used to derive those ratings are regularly changing in different ways at different paces at each agency.

1. "AAA" Defined

Even the least sophisticated investor understands that, generally speaking, a "AAA" rating means that an investment carries little risk. But the notion of "risk" is relative: what is risky in one context may not be risky at all in another. Moreover, a relatively risk-free proposition may become risk-intensive with the introduction of a single new factor. As a result, understanding exactly what kind of risk is being measured by the ratings agencies helps to explain why an "AAA" security may not necessarily be a low risk one.

As an initial matter, ratings agencies do not measure risk in the same way, with each defining a "AAA" rating slightly differently. For example, S&P says that "AAA" means an issuer has an extremely strong capacity to meet its financial commitments in a timely fashion, but the rating does not reflect the expectation of loss upon default.[10] By contrast, at Fitch, "AAA" means

9 Joshua Rosner & Joseph R. Mason, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions*,- Draft Working Paper, Hudson Inst., May 2007, at 11.

10 Belle Haven CDO Documentation, "Standard & Poor's Ratings Services Terms and Conditions Ap-

that the issuer has a low credit risk, as measured by the risk of default as well as the expectation of loss in the event of default.[11]

Notwithstanding these differences, according to the agencies, "AAA" means the same thing across securities classes at each agency. In other words, an AAA-rated corporate debt instrument carries the same level of risk as an AAA-rated structured product. This is true despite at least one agency's acknowledgement that "[s]ome securitization structures are more prone to … risk than standard corporate debt …."[12]

Importantly, although most investors would imagine an AAA-rated security carries low market risk, it is now clear that some AAA securities are more susceptible to market fluctuations than others. Indeed, in adopting new "volatility" scores to complement its traditional ratings, Moody's acknowledged in May 2008 that its new scores would "help signal that RMBS, ABS CDOs and market-value-based transactions have greater potential rating volatility than other similarly rated securities."[13] S&P has similarly introduced a proposal to incorporate credit stability into their rating methodology to better capture the impact of market volatility and to "align [ratings'] meanings more closely with … investors' desires and expectations."[14] In other words, in a highly stressed scenario with steep home price declines (a truly "volatile" market), historical structured finance ratings could not necessarily be trusted as predictors of likely risk.

It is also worth noting that the AAA rating is assigned more sparingly in the corporate debt market than the structured finance market. According to Fitch, as of June 2007, only 1% of corporate and financial institution obligors carried an AAA rating.[15] By contrast, 60% of the outstanding structured product ratings were AAA.[16] What is more, Fitch reported many more instances of "multi-notch" rating changes in structured finance ratings than in corporate finance ratings.[17] Perhaps these changes were inevitable when CRAs were giving the designation "AAA" so much more frequently to structured securities. Indeed, armed with these statistics, an average investor could perhaps have guessed that an AAA-rated RMBS or CDO was riskier than an AAA-rated corporate security simply because there was a much bigger pool of structured securities subject to default.

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plicable to U.S. Structured Finance Ratings" (24 May 2006); House of Commons Treasury Committee, "Financial Stability and Transparency," Sixth Report of Session 2007-2008 (26 February 2008) ("Treasury Committee Report") at ¶ 55.

11 FitchRatings, "Fitch Ratings Defintions", available at http://www.fitchratings.com.

12 Standard & Poor's, "Principles-Based Rating Methodology Criteria for Global Structured Finance Securities" (26 June 2007).

13 Introducing Assumption Volatility Scores and Loss Sensitivities for Structured Finance Securities (May 2008) at 2, available at www.moodys.com.

14 *See* General Criteria: Request For Comment: Should S&P Explicitly Recognize Credit Stability As An Important Rating Factor? (July 16, 2008) (acknowledging that "specific business segments – such as housing, energy, retail, and transportation – could experience different degrees of stress over any given period" and proposing to downgrade securities where conditions of moderate stress would negatively affect the rating within one year of the security's issuance).

15 Inside the Ratings: What Credit Ratings Mean (August 2007) at 5, available at www.fitchratings.com.

16 *Id.*

17 *Id.* at 8.

2. *Rating an RMBS*

Initially, it is important to point out that the complex procedures and models used by CRAs to arrive at a rating for a particular structured product are just that: complex. Generally speaking, each agency follows a multi-step process for rating RMBSs and CDOs. That process is described briefly below.

As a first step in the RMBS rating process, a lead analyst examines the proposed RMBS structure by reviewing a range of data provided by the arranger.[18] Although the credit analyst does not have access to the individual sub-prime loan files, he or she typically does have a bevy of information about the loans underlying a proposed RMBS, including each loan's principal amount, the location of the mortgaged property, the borrower's credit history, the property's value, and the lien position (*i.e.*, whether it is a first or second mortgage).[19]

Taking this information, the analyst then plugs variables into a quantitative loss model to determine whether the product as structured can withstand certain stressors.[20] This modelling, in turn, allows the analyst to determine how much "credit enhancement" is needed to arrive at a particular category of rating.[21] The analyst also looks at the proposed capital structure of the RMBS to determine whether that structure supports the desired rating.[22] Finally, the analyst conducts a cash flow analysis to determine whether the principal and interest to be received by the SPV will be sufficient to pay the interest and principal due to each tranche of noteholders.[23]

After conducting these tests, the analyst can develop a rating recommendation for each tranche of the RMBS. The analyst ultimately presents the recommendation to a larger rating committee, which votes on the rating to be assigned.[24] If the arranger is unhappy with the rating decision, it may usually appeal the decision, although given the interactive nature of the structured product rating process, it is unclear how often such appeals are actually necessary or actually occur. After a final rating has been issued and published, the CRA monitors the rating to determine whether any changes in the rating are necessary.

3. *Rating a CDO*

The process for rating a CDO is similar and typically involves examining the pool of debt securities to determine how they would perform under various stress scenarios and whether the proposed credit enhancements are sufficient.

There is one major difference between the ratings process for CDOs and RMBSs worth mentioning. That is, for managed CDOs – those CDOs that are actively managed such that their

18 US Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies* (July 2008) at 7 (hereinafter, "SEC Report").
19 *Id.*
20 *Id.* at 7-8.
21 "Credit enhancement" refers to a level of protection designed to insulate a particular tranche of securities from loss. *Id.* at 6.
22 *Id.* at 8-9.
23 *Id.*
24 *Id.* at 9.

underlying assets may change over time – an analyst will look not at the pool of debt securities itself (which may change) but at the limitations placed on the manager regarding the type of assets that can be put into the pool.[25] The analyst will then plug different collateral pool scenarios into the rating agency's models to determine whether all possible pools meet the rating criteria. As with RMBS ratings, the analyst also looks at the CDO's proposed capital structure and cash flow to ensure the desired rating is appropriate. And as with RMBS, a ratings committee votes on whether to accept the analyst's recommended rating.

B. A FLAWED PROCESS?

Key to understanding whether the CRAs failed to appropriately assess the risks associated with real estate-backed structured products is appreciating the differences between structured products and ordinary corporate debt. The differences highlight the problems in the structured product rating process and help explain – at least in part – how the market ended up where it is today.

As an initial matter, because structured finance ratings rely on the use of statistical models rather than empirical data (as is the case with corporate debt securities), the resulting ratings are inherently less transparent, more complex, and harder for even the most sophisticated investors to deconstruct. And because the structured products themselves are extremely complex, investors are unlikely to run their own tests to determine whether the structured product is truly investment worthy. As a result, the market was and is far more reliant on the assigned RMBS or CDO rating than it would be for a corporate bond.

Moreover, the statistical models used to rate RMBSs and CDOs themselves raise a host of issues. First, because RMBS and CDO performance has not been tested over a "sustained period of economic volatility", it is unclear whether the models used – which test the potential for incidents of default rather than severity of default – can appropriately measure risk.[26] As one commentator aptly noted, "traditional corporate bond ratings have [] a long history of application and have been empirically tested through various economic cycles. Many structured products – notably CDOs – have not."[27] Indeed, although all CRA models employ "stress scenarios" to determine the risk of default, these scenarios are based on historical rates of default in the particular industry or for the particular type of security. In the RMBS market, history sometimes only stretches back a few years. As a result, the worst-case stress scenarios employed for sub-prime backed securities did not come close to the actual rates of default when the bottom fell out of the market.

Second, because the statistical models used by CRAs change often and are inconsistently applied,[28] it is unclear whether one AAA-rated CDO is as sound as the next. In some instances, timing alone (and the applicable model used at the time the rating was issued) may have been the deciding factor.

25 *Id.*
26 *See, e.g.,* Rosner & Mason, *Where Did the Risk Go?, supra* note [•] at 18.
27 Rosner & Mason, *Where Did the Risk Go?, supra* note [•] at 10.
28 *Id.* at 20.

Third, inconsistent ratings definitions make it difficult for investors to compare securities for credit risk. As one commentator noted:

> [A]ccording to S&P, a rating of "BBB" corresponds to a five-year default probability of 1.255% for asset backed securities, but a higher default probability of 2.323% for corporate bonds. Likewise, a rating of "AA" corresponds to a seven-year default probability of 0.315% for ABS, 0.420% for corporate bonds, and 0.701% for CDOs. At Moody's municipal bond ratings correspond to half the level of expected loss as corporate bond ratings for purposes of rating CDOs.[29]

In short, the process for rating structured products is far from an exact science.

Furthermore, the level of interaction between CRAs and arrangers has the potential for creating skewed ratings results and could lead the casual observer to conclude that ratings are not as impartial as they should be. This conclusion is bolstered by the CRAs fee structures. Typically, the CRA gets paid only if the credit rating is issued.[30] This structure and the CRAs relationships with issuers have led some critics to question whether the agencies should be considered underwriters for purposes of securities liability.[31] Perhaps the designation "underwriter" is a stretch, but it underscores the point: when it comes to structured products, CRAs may have difficulty arguing they are still merely "journalistic" observers of corporate dealmakers. And an April 2007 Moody's report suggests that, at the height of the securitized mortgage boom, Moody's did not have access to underlying information that it deemed "primary", "highly desirable", or even "desirable" in rating certain securitized products.[32] The absence of this information raises questions about whether the close relationships between CRAs and arrangers compromised the objective professionalism that market participants relied upon in making investment decisions based on ratings.

III. THE CURRENT LANDSCAPE

Every week brings news of a new investigation of the heavy-hitting players in the sub-prime market. Two recent investigations – one launched by New York Attorney General Andrew Cuomo and the other by the Securities and Exchange Commission – specifically targeted the CRAs and hinted at more serious problems behind the scenes than what the public may have initially imagined. What remains to be seen is whether evidence uncovered during those investigations will persuade private litigants to hop onto the proverbial bandwagon.

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29 Nomura Fixed Income Research, *Bond Rating Confusion*, June 29, 2006, at 2, available at http://www.securitization.net/pdf/Nomura/Nomura_Bond_Rating_Confusion_Update.pdf.

30 SEC CRA Report, *supra* note [•] at 9. By way of example, Moody's earnings grew by 900% in just six years, in large part due to fee increases from structured financial products. Bethany McLean, *The dangers of investing in subprime debt*, Fortune, Mar. 19, 2007, at [•].

31 SEC CRA Report, *supra* note [•] at 14.

32 Moody's Revised US Mortgage Loan-by-Loan Data Fields, Apr. 3, 2007.

A. DOMESTIC INVESTIGATIONS

1. New York Attorney General Investigation

In February 2008, New York Attorney General Andrew Cuomo launched an investigation into whether certain CRAs were criminally culpable for assigning inflated ratings to bonds backed by sub-prime mortgages and to CDOs that included subprime mortgages.[33] The AG based his authority for the investigation on the dreaded Martin Act, New York's version of a "blue sky" law aimed at preventing bogus stock schemes.[34] Wall Street players have long been wary of the Martin Act because it dispenses with certain evidentiary requirements for establishing fraud.[35]

It is perhaps not surprising then that the CRAs under investigation moved swiftly to broker a deal with Attorney General Cuomo. In June, the AG signed an agreement with all three CRAs under investigation that mandates several types of reforms, including reforms of fee structures, disclosure protocols, and due diligence procedures. In addition, the agreement requires investment banks to include certain representations and warranties in their securities documentation.[36]

What is remarkable about the New York Attorney General's investigation is his willingness to rely on a criminal statute like the Martin Act. Even if that Act relaxes the burden of proof for fraud, criminal liability requires a much higher standard of proof than civil liability. But consider too that CRAs did not give up much to broker the deal, merely agreeing to reforms that were probably inevitable as a result of the ongoing SEC investigation. Nevertheless, the investigation's suggestion of criminal liability did change the tone of public debate about how culpable the rating agencies are, and though the confidential settlement with the AG may have kept the CRAs skeletons in the closet for now, a civil discovery process might not be so forgiving.[37]

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33 Aaron Lucchetti, *Credit Crunch: Rating the Rating Overhaul – New York State Official Calls Voluntary Moves 'Window Dressing'*, The Wall Street Journal, Feb. 8, 2008, at C2.
34 In the early part of the 20th century, many states passed such laws, so named because the stock schemes they aimed to prevent had no more substance that the "blue sky above." Robert A. McTamaney, *New York's Martin Act: Expanding Enforcement in an Era of Federal Securities Regulation*, Legal Backgrounder, Vol. 18, No. 5 (February 28, 2003), at 2, available at http://www.wlf. org/upload/022803LBMctamaney.pdf. New York's blue sky law was passed in 1921. *Id.*
35 *Id.*
36 Press Release, Office of the New York State Attorney General Andrew M. Cuomo, *Attorney General Cuomo Announces Landmark Reform Agreements With the Nation's Three Principal Credit Rating Agencies*, June 5, 2008 (on file with the AG's office), *available at* http://oag.state.ny.us/press/2008/june/june5a_08.html.
37 Other state Attorneys General are now conducting similar investigations of the CRAs. Most notably, Connecticut's Attorney General is investigating the CRAs for potential antitrust violations and investigating Moody's specifically over whether the agency tried to conceal the computer error that led to higher ratings of a particular product. Press Release, Office of the Connecticut Attorney General, *Attorney General Issues Subpoenas To Three Major Debt Rating Agencies In Antitrust Investigation*, Oct. 26, 2007 (on file with the AG's office), *available at* http://ct.gov/ag/cwp/view.asp=2788&Q= 398096; Jesse Westbrook, *SEC Asks About Ratings Errors on Structured Products,* Bloomberg.com, May 28, 2008, *available at* http://www.bloomberg.com/aspps/news?idpid=20601087&sid= a0LEW9L8Ne5o&refer=home#.

2. *SEC Investigation*

The report recently published by the SEC following a year-long investigation originally launched in mid-2007 (the "SEC Report" or "Report") makes for uncomfortable reading for the CRAs. Although preliminary in nature, the Report is the culmination of the SEC's examination of "hundreds of thousands of pages of the rating agencies' internal records and e-mail records" and "the ratings history of thousands of structured finance products."[38] In the Report, the SEC documents "serious shortcomings" at the three major CRAs, "including a lack of disclosure to investors and the public, a lack of policies and procedures to manage the rating process, and insufficient attention to conflicts of interest."[39] More specifically, the Report noted the following problems:

- Ratings were issued notwithstanding a lack of information about certain deal risks or that there were outstanding unresolved issues at the time of the rating;[40]
- None of the CRAs had specific written procedures in place for rating RMBS and CDOs;[41]
- Key participants in the ratings process at each rating agency were allowed to participate in fee discussions;[42]
- Rating agency employees who were responsible for obtaining business would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria;[43]
- One agency issued ratings on almost a dozen securities using a model that contained an error and then failed to disclose that error for several months, until the securities were downgraded for other reasons;[44]
- In at least one case, upon investigation the CRA found the appearance of fraud or misrepresentation in virtually every underlying loan file;[45] and
- Other issues included non-compliance with document retention policies, lack of adherence to rating committee guidelines and failure of management to formally review/validate derivatives models prior to posting them for general use.[46]

Unsurprisingly, the SEC has suggested that, as a result of these deficiencies in process and oversight, new rules should be implemented to ensure the future integrity of the rating process for structured finance products. To this end, the SEC has published a list of proposed additional rules for NRSROs.[47]

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38 Chairman Christopher Cox, "Statement at News Conference Announcing Release of Examination Report on Credit Rating Agencies" (July 8, 2008).
39 *Id.* at 1.
40 SEC Report, *supra* note [•] at 12.
41 *Id.* at 16.
42 *Id.* at 24.
43 *Id.* at 25-26.
44 *Id.* at 26. Notably, the SEC is also currently investigating a reported computer error at Moody's that caused the agency to assign significantly higher ratings to certain debt obligations, resulting in the inflation of billions of dollars worth of European debt products. Samuel Howard, *SEC Probes Three Credit-Rating Giants Over Errors,* Securities Law 360, May 28, 2008, *available at* http://financialservice-slaw.law360.com/Secure/ViewArticle.aspx?id=57546.
45 *Id.* at 18, n. 23.
46 *Id.* at 30.
47 *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, June 16, 2008, available

Leaving aside the nature of the findings, the CRAs will undoubtedly be deeply concerned about the prospect of this and future reports acting as a roadmap for private litigants.

IV. THE CASE FOR CIVIL LIABILITY

Private litigants have already begun suing CRAs in the US, although the agencies in these suits are never stand-alone defendants. Moreover, with one exception, most US lawsuits appear to be grounded in statutory securities law.[48] The one exception – which could prove a fertile test case for future litigation against the CRAs – is a suit brought by Abu Dhabi Commercial Bank ("ADCB") against Morgan Stanley, Bank of New York Mellon, Moody's, and S&P. The complaint, filed in August by ADCB in the Southern District of New York, seeks to hold the defendants liable for fraud, negligent misrepresentation, and unjust enrichment. With respect to the rating agencies, the complaint specifically alleges that Moody's and S&P were paid three times their normal fees, that payment was dependent upon the issuance of an investment-grade rating, and that the agencies earned success fees when Cheyne Finance (the structured investment vehicle that eventually issued the notes to ADCB) was launched. The suit, if successful, could prove extremely damaging to the CRAs in similar investor suits to come.

Even in its early stages, what the ADCB suit does make clear is that investors will likely rely on common law to assert claims against the rating agencies. In this regard, although the New York AG investigation hinted at the agencies' commission of fraud, fraud claims are inherently more difficult to plead and prove than negligence claims. For this reason, it seems likely that most claims brought by third party investors against the rating agencies will be framed in the tort of negligent misrepresentation under US law or negligent misstatement under English law. Broadly speaking, the requisite elements of these causes of action are the same: the existence of a false statement of fact, a duty of care owed by the defendant to the plaintiff, reliance on the false statement, causation, and damages.[49] However, a closer analysis reveals potentially significant differences in approach over whether a statement of opinion can qualify as an actionable statement of fact, whether a duty of care can be inferred as between the rating agency and a particular group of investors, and regarding the impact of disclaimers of liability.

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at http://www.sec.gov/rules/proposed/2008/34-57967.

48 Although an investor could certainly argue that a credit rating agency should be liable for securities fraud under section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, such a claim requires an inherently higher standard of proof (as would a claim for common law fraud) and would also require the aggrieved investor to prove that the rating agency was a "seller" of securities. This article avoids any discussion of these types of statutory claims, which are more difficult to prove and are, in any event, confined to the US.

49 *Hydro Investors, Inc. v. Trafalgar Power Inc.,* 227 F.3d 8, 20 (2d Cir. 2000) (citing *King v. Crossland Savs. Bank,* 111 F.3d 251, 257-58 (2d Cir. 1997) (citing *Eiseman v. State of New York,* 70 N.Y.2d 175, 187 (N.Y. 1987)) (listing all the elements of a negligent misrepresentation claim); *Savings and Investment Bank Ltd v Fincken Chani* [2001] EWCA Civ 1639 at ¶ 34.

B. STATEMENTS OF FACT VERSUS OPINION

In New York, the courts have adopted a narrow approach to what constitutes a statement of fact for purposes of an action in tort. In *Kimmell v. Schaefer*,[50] a New York appellate court explained that expressions of opinion are only actionable "if deemed to be statements of material facts."[51] In that case, the plaintiff was the purchaser of an investment in defendant Cogenic Energy's electrical generation installation.[52] To persuade the plaintiff to invest in the installation, the defendant provided the plaintiff with a detailed forecast showing that the installation was already achieving a sizeable cash flow that would only increase over time.[53] However, the defendant failed to disclose that the state utility commission had already approved rate reductions in the electricity industry and imposed design changes that would seriously undermine the project's financial viability.[54] When the project turned out to be worthless, the plaintiffs sued for negligent misrepresentation. In its defense, the defendant argued that the financial projections provided to the plaintiff were merely non-actionable statements of opinion.[55] The court disagreed, explaining that "where one party [has] superior knowledge, the expression of an opinion implies that the declarant knows facts which support that opinion and that he knows nothing which contradicts the statement."[56]

Although the court in *Kimmell* ultimately held the statement of opinion actionable, subsequent courts have cited the opinion for its language limiting liability for expressions of opinion.[57] Indeed, very few courts in New York have permitted an action for negligent misrepresentation based on a statement of opinion, and at least one court has described *Kimmell* as "contrary to the great weight of authority" for suggesting that statements concerning future outputs or financial projections could qualify as statements of fact.[58] Rather, as the Second Circuit has emphasized, projections of future performance are only actionable when those projections constitute a misapplication of existing data or information.[59] Thus, if a credit rating is deemed a mere opinion, it appears that any litigant hoping to sue on the basis of that opinion will have an uphill battle in the New York courts.

The English courts have long held the view that statements of opinion are actionable when made by a person who possesses and holds himself out as possessing special knowledge or skill in expressing the opinion and where it is reasonable to infer that the maker of the opinion is aware of facts that would justify that opinion.

This rule was established in the case of *Esso Petroleum Co Ltd v Mardon*.[60] The facts of the case concerned the sale of a petrol/gas station prior to which the seller had supplied the

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50 224 A.D. 2d 217 (N.Y. Sup. Ct. 1996).
51 *Id.* at 218.
52 *Id.* at 217.
53 *Id.*
54 *Id.*
55 *Id.* at 218.
56 *Id.*
57 *See, e.g., Canelle v. Russian Tea Room Realty LLC,* 2002 WL 287750 (S.D.N.Y. Feb. 27, 2002) (citing *Kimmell* in holding that a statement of opinion on the efficacy of an employment contract was not actionable in fraud).
58 *See Hydro Investors, Inc. v. Trafalgar Power Inc.,* 227 F.3d 8, 21 n. 1 (2d Cir. 2000).
59 *Id.*
60 [1976] Q.B. 801, 1976 WL 46821.

purchaser with an estimate of its sales capacity. The estimate far exceeded what was achieved in practice and the purchaser sought to make the seller liable for its losses based, amongst other things, on the tort of negligent misrepresentation. In rejecting the seller's argument that a forecast of sales was merely an opinion which could not give rise to a duty of care, Lord Denning said:

> [I]f a man, who has or professes to have special knowledge or skill, makes a representation by virtue thereof to another – be it advice, information *or opinion* – with the intention of inducing him to enter into a contract with him, he is under a duty to use reasonable care to see that the representation is correct, and that the advice, information or opinion is reliable.[61][our emphasis]

Applying this principle to the facts of that case, Lord Denning held that the claimants "professed to have – and did in fact have – special knowledge or skill in estimating the throughput of a filling station."[62] and found the seller liable in damages to the defendant accordingly.

Given that, in rating complex structured products, the CRAs will invariably have relied upon information and methodologies not readily available to or understood by investors, then as a general proposition they are likely to face an uphill struggle in arguing that the test formulated by Lord Denning is not satisfied when applied to them.

B. DUTY OF CARE

The New York formulation of the duty of care is slightly more simplistic than the English formulation. In New York, to establish a duty of care, "there must be a showing that there was either an actual privity of contract between the parties or a relationship so close as to approach that privity."[63] In England, courts have employed a variety of tests to determine whether a duty is owed. Of those, perhaps the most frequently cited are the "assumption of responsibility" test and the "three-stage" test. The former requires a showing that the defendant implicitly assumed responsibility for his statements,[64] and the latter requires proof that the claimant's reliance was foreseeable, that there was some proximity between the plaintiff and defendant, and that the imposition of a duty would be fair.[65] Despite the difference in applicable tests, in both the US and the UK, the critical element appears to be the "privity" or "proximity" of the parties.

61 *Id.* at *820 (emphasis added).
62 *Id.*
63 *Prudential Ins. Co. of America v. Dewey, Ballantine, Bushby, Palmer & Wood,* 80 N.Y.2d 377, 382 (N.Y. 1992); *Parrott v. Coopers & Lybrand, L.L.P.,* 95 N.Y.2d 479, 483 (N.Y. 2000); *Mandarin Trading Ltd. v. Wildenstein*, 17 Misc.3d 1118(A), 2007 WL 3101235, at *5 (N.Y. Supp. Sep. 4, 2007); *LaSalle*, 951 F. Supp. at 1092 (internal citation omitted).
64 *Id.* at 528.
65 *See Caparo Industries plc v Dickman* [1990] 2 A.C. 205 (setting forth the elements of the test).

1. Privity in the US

Because investors are not likely to be in privity of contract with the rating agencies, they will have to demonstrate that their relationship "approached" privity to establish a duty of care.[66] A "near-privity" relationship may arise where (i) the relevant defendant was aware its advice would be used for a particular purpose; (ii) the plaintiff was known to the defendant; and (iii) the defendant engaged in some conduct linking it to the plaintiff and evincing an understanding that the plaintiff would rely on the defendant's advice.[67] If a plaintiff is unable to allege these requisite facts, it runs the risk that its complaint will be dismissed.[68]

Although this test appears stringent, in at least one case a group of investors was able to allege near-privity sufficiently to avoid dismissal.[69] In *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*, investors brought suit for losses sustained in connection with their purchase of bonds issued by Towers Financial Corporation ("Towers") that were rated by Duff & Phelps Credit Rating Co. ("D&P"). The *LaSalle* investors alleged that they relied on the inflated "AA" rating assigned to the bonds by D&P and that their "injuries would have been averted if . . . [D&P] had . . . initially either assigned appropriately lower ratings to the Bonds or refused to rate them at all and subsequently either lowered or withdrew the ratings."[70] To establish near-privity, the investors alleged not only that D&P knew its rating would be used to market the bonds to investors but also that the offering materials required an "AA" rating as a precondition to the issuance.[71] In addition, the investors alleged that D&P knew a select group of qualified investors would be targeted by Tower and that D&P had direct contact with some of those investors.

The District Court held that these allegations were sufficient to support a finding of near-privity and refused to dismiss the case. In reaching this conclusion, the Court noted that "[k]nowledge of the identity of each particular plaintiff is not necessary … if the defendant's representation is designed to target a 'select group of qualified investors' rather than 'the public at large.'"[72] The Court also found persuasive the allegation that D&P had directly spoken to six of the 26 plaintiffs in an effort to induce them to invest.[73] As a result of this contact,

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66 Note that not every jurisdiction requires a plaintiff to demonstrate privity or near privity. *See, e.g., In re Enron Corp. Sec.,* 511 F. Supp. 2d at 826 (no privity required under Connecticut law); *Quinn v. McGraw-Hill Cos., Inc.,* 168 F.3d 331 (7th Cir. 1999) ("The Illinois Supreme Court has recognized that the tort of negligent misrepresentation extends to third parties who lack privity with the defendant where the 'defendant knew the information would be used and relied upon' and 'the potential liability was restricted to a comparatively small group.'") (citation omitted).
67 *See Prudential Ins. Co. of America,* 80 N.Y.2d at 384.
68 *See, e.g., Mandarin Trading Ltd. v. Wildenstein*, 17 Misc.3d 1118(A), 2007 WL 3101235, at *6 (N.Y. Supp. Sep. 4, 2007) (dismissing negligent misrepresentation claims because plaintiff failed to allege privity or near-privity).
69 *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating*, 951 F. Supp. 1071 (S.D.N.Y. 1996) ("*LaSalle*").
70 *LaSalle*, 951 F. Supp. at 1075-76 (additionally alleging that D & P "rated each Bond series before issuance, and in fact had 'substantial influence' in the design of each Bond program and drafting the program's operational documents . . . .").
71 *Id.* 951 F. Supp. at 1093.
72 *Id.* at 1093 (noting that "[f]ederal courts have typically dismissed negligent misrepresentation claims brought by members of the general investing public") (citation omitted).
73 *Id.* at 1095.

the Court concluded that the ratings were designed to meet the intended investors' requirement of a "AA" rating.[74] Under these limited circumstances, near-privity was established.

This narrow view of the privity requirement reflects the New York courts' historically narrow construction of the requirement. In *Glanzer v. Shepard* – one of the first cases to consider this issue – Judge Cardozo held that a defendant could only be liable in negligence to a third party where the third party's reliance was "the end aim of the transaction."[75] Nevertheless, the defendant need not know the specific identity of the members of the public for near-privity to arise. In *Guidhall Ins. Co. v. Silberman*, for example, the court held that an appraiser could be liable to a third party insurance company for negligently misrepresenting the worth of the art collection it valued for an individual collector.[76] The appraiser did not know the collector would seek insurance from any particular insurer. Nevertheless, the court held that near-privity could exist (and therefore refused to resolve the case on summary judgment) because the appraiser knew that his appraisal was going to be used to obtain insurance and because the ethical code of the American Society of Appraisers made clear that appraisers owed a fiduciary duty to certain third parties.[77] These factors were sufficient for a finding of near-privity.

Despite this case law, a New York litigant would likely have difficulty showing the requisite privity. Although the first prong of the near-privity test – foreseeability of reliance – might be satisfied, it would be difficult in the majority of cases for an investor to establish that the investors were "known" to the rating agencies and that the agencies engaged in conduct linking them to particular investors. In this regard, the New York courts have repeatedly emphasized the need to impose fair and manageable bounds to what otherwise could prove to be limitless liability."[78] Using the "target group" rationale employed in *LaSalle*, investors would have to argue that the pool of potential investors in the synthetic securities market was relatively small. It would be further helpful if a claimant could establish that, within this small pool, the principal investors were institutions known to the entire financial world.[79] Of course, if any investors were particularly known to the CRAs, this would be an extremely helpful fact under the rationales of *Glanzer* and *Ultramares*. But that scenario is likely to be the exception rather than the rule.

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74 *Id.*
75 233 N.Y. 236, 238-39 (N.Y. Ct. App. 1922).
76 688 F. Supp. 910 (S.D.N.Y. 1988).
77 *Id.* at 914.
78 *See Parrott v. Coopers & Lybrand L.L.P.,* 95 N.Y.2d 479, 483 (N.Y. Ct. App. 2000) (citing cases to that effect) (internal quotations and citations omitted).
79 *C.f.,* Staff of S. Comm. on Governmental Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 100 ("Approximately 95 percent of corporate bonds are held by institutional investors, which have their own in-house analysts to assess the value of the bond in which they invest.").

2. "Proximity" in England

Lord Oliver's speech in *Caparo Industries plc v Dickman*[80] is perhaps the most enduring explanation of the circumstances which need to exist to give rise to a special relationship of "proximity" between a rating agency and an investor under English law. In *Caparo*, the question was whether an accountant who prepared a set of audited accounts for a client company could be held liable in negligence to a third party investor who relied upon those accounts in deciding to buy shares in the company. Lord Oliver held that the necessary special relationship only exists where the accountant knew, either actually or inferentially, that:

(1) the advice was required for a purpose, whether particularly specified or generally described;
(2) the adviser knew that his advice would be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose; and

(3) the advice was likely to be acted upon by the advisee for that purpose without independent inquiry.[81]

On the facts of *Caparo*, the investor's claim failed on the basis of the second of these requirements: the accountant had prepared the accounts to satisfy the company's statutory duty to produce annual audited accounts, not for the purpose of permitting an unknown stranger to decide whether or not to invest in the company.

As applied to a hypothetical claim against the CRAs, Lord Oliver's three-pronged test leads to the following general propositions:

(1) A CRA will likely have difficulty arguing that it did not know the ratings would be relied upon for a particular purpose. Ratings of structured products are primarily produced and paid for precisely to induce potential investors to buy the relevant product; conversely, the rating agencies are well aware that structured products are almost unmarketable without the attachment of a suitable rating.

(2) It is less certain that a CRA could be expected to know the identity of the investor "either specifically or as a member of an ascertainable class." Although there are situations in which the rating agency knows the identity of the potential investor, these situations tend to be the exception rather than the rule. Given the important policy of fairness underlying this prong of the test, courts would likely be reticent to extend liability if the number or amount of claims is indeterminate.[82]

80 [1990] 2 A.C. 605, 638.
81 *Id*.
82 *See, e.g., Candler v Crane, Christmas & Co* [1951] 2 K.B. 164, 183-84 ("[I]t would be going too far to make an accountant liable to any person in the land who chooses to rely on the accounts in matters of business, for that would expose him to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class.'") (citing the opinion of Judge Cardozo in *Ultramares Corp v Touche,* 174 N.E. 441 (N.Y. 1931)); *Morgan Crucible* [1991] 1 All E.R. 148 (distinguishing the situation where "a statement is put into more or less general circulation and may foreseeably be relied on by strangers to the maker of the statement for any one of a variety of different purposes").

(3) Whether the CRA would have known its rating would be acted on "without independent enquiry" might also be controversial. It seems clear that the spectrum of investors was sufficiently broad to include those who would have relied on the ratings without question or enquiry as well as those who would have paid little or no attention to ratings and instead would have relied on their own due diligence.

3. Reliance

Although reliance is an element of actionable negligence according to both US and English law, in New York the courts have required the plaintiff to allege and prove that his reliance was reasonable.[83] In this regard, it is important to note that institutional investors are considered sophisticated investors who employ their own teams of analysts to assess risk.[84] A court may question whether it is reasonable for such investors to rely without question on an agency's rating. Nevertheless, a potential claimant can make several arguments that might support a finding of reasonable reliance.

Generally speaking, a potential litigant may make several allegations to support a finding of reasonable reliance. First, a litigant may point out that rating agencies are privy to information that is not available to the general public.[85] Second, a plaintiff may argue that because the offering documents reference the agencies' ratings, those documents reflect an expectation that the ratings are important and highly correlative of the risk associated with a particular security. Third, a litigant may emphasize that reliance on ratings is reasonable because even sophisticated institutional investors require the issuance of an investment-grade rating before they may invest in certain securities.[86] Finally, a claimant could bolster an allegation of reasonable reliance by pointing out that the market as a whole highly valued ratings as a measure of risk. In particular, market reliance on RMBS and CDO ratings was demonstrated by the CRAs huge increase in profitability over a very short period of time. Each of these allegations may help bolster a claim of reasonable reliance.

Although there are certainly arguments to be made to support an allegation of reasonableness, the mere imposition of a reasonableness requirement under New York law makes New York a more challenging jurisdiction for a claimant looking to sue the CRAs.

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83 *See Hydro Investors, Inc.,* 227 F.3d at 20.
84 *See* Staff of S. Comm. on Governmental Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 100 ("Approximately 95 percent of corporate bonds are held by institutional investors, which have their own in-house analysts to assess the value of the bond in which they invest.").
85 Staff of S. Comm. on Governmental Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 122 ("The credit rating agencies acknowledged in interviews with Committee staff that others in the market believe the agencies have access to more information about companies than any other outsiders due to their market power . . . and their exemption from SEC Regulation F-D [(prohibiting issuers from making selective disclosure of material information)].").
86 *LaSalle*, 951 F. Supp. at 1075-76 (finding that "unlike debt obligations of operating companies or governmental entities (such as municipal bonds), asset-backed securities typically are not issued at all unless they are rated double- or triple-A. The rating is therefore not determined by an analysis of an already-issued security, but rather by structuring the receivables program as required by the rating agency so as to be able to obtain the desired rating. . . . Moreover, . . . it is the structure of the program and the quality of its services . . . rather than the credit worthiness of the issuing entity . . . that determines the ratings.").

4. *Effect of Disclaimers*

Yet another potential legal issue is the import of any disclaimers of liability made by the CRAs in the relevant documentation. The documents accompanying an RMBS or CDO offering will invariably contain a statement that the rating is merely an opinion of the relevant CRA and should not be relied upon for the purpose of making a decision to invest in the offered security. Some offerings will even attach detailed letters from the relevant CRA explaining in clear terms that the rating is not intended to constitute investment advice and will not give rise to third party liability. Under such circumstances, the CRA may argue that the disclaimer obviates any duty of care which would be owed or otherwise precludes a finding of breach of that duty.

The courts in the US and England approach disclaimers slightly differently. In New York, a disclaimer is typically evaluated in the context of reliance. That is, the courts will often find that reliance was unreasonable in the face of an explicit disclaimer. But disclaimers appear to play no role in the determination of whether a duty of care is owed. By contrast, in London, courts often consider disclaimers in the context of a duty of care and, in some cases, find that a disclaimer prevents a duty from arising. This was the approach adopted by the Court of Appeal in *McCullagh v Lane Fox & Partners Ltd*[87] Other English courts ignore the disclaimer when analyzing the existence of a duty of care and only consider it once they have determined a duty exists. A reasonable disclaimer can then sometimes negate that duty. This was the approach taken by the House of Lords in *Smith v Bush*.[88] The former approach purports to give greater consideration to the doctrine of assumption of responsibility.[89] As the *McCullagh* court explained, a party can hardly be said to have assumed responsibility for a statement if, while making it, he is expressly disclaiming any responsibility.[90] Regardless of the approach adopted, any disclaimer in the UK must meet the test of reasonableness set forth in the Unfair Contract Terms Act 1977, which is applicable to claims in tort.[91] In sum, it is clear that a reasonable, explicit disclaimer can negate liability for negligent statements in both the US and UK. As a result, a brief analysis of the courts' approach to disclaimers is necessary.

In New York, courts are notoriously reluctant to permit tort claims in the face of a specific disclaimer of liability. Under the rule established by the New York Court of Appeals in *Danann Realty Corp. v. Harris*, when a disclaimer of reliance is specific, it "destroys the allegation in the plaintiff's complaint that the agreement was executed in reliance" on contrary representations.[92] In *Danann*, the purchaser of a building lease sued the seller for fraud, claiming it was fraudulently induced to make the purchase by the seller's oral misrepresentations about the building's operating expenses and profitability.[93] The purchase contract contained a clause stating that the seller had not made any representations about the building's operat-

87 [1996] P.N.L.R. 205.
88 [1990] 1 A.C. 831.
89 *Id*.
90 *Id*. at 238.
91 *See Hedley Byrne* [2005] 1 A.C. 831 at 849 ("[A]ll exclusion notices which would in common law provide a defense to an action for negligence must satisfy the requirement of reasonableness."); *McCullagh* [2006] P.N.L.R. 205 at 238 (explaining that the Unfair Contract Terms Act applies to extra-contractual terms).
92 157 N.E.2d 597 (N.Y. Ct. App. 1959).
93 *Id*. at 320.

ing expenses or condition and that the purchaser acknowledged that no such representations had been made.[94] In the face of these contractual disclaimers, the court held that the purchaser could not have relied on the oral statements made by the seller.[95] Subsequent courts have similarly refused to impose liability in negligence where a specific disclaimer applies to the statement negligently made.[96]

There are two limitations to the New York courts' seemingly strict treatment of disclaimers. First, the case law in New York addressing disclaimers almost always involves a situation where the plaintiff and defendant are in contractual privity and the disclaimer is part of the contract executed by both parties. It is unclear whether a court would adopt such an unbending approach in a situation where the plaintiff and defendant are not in privity of contract and the plaintiff had no power to negotiate the terms of the disclaimer with the defendant. Second, it must be emphasized that the disclaimer must be specific to the situation. A general disclaimer of "all liability" associated with a particular transaction will not suffice. Rather, the disclaimer must be addressed specifically to the type of statement that the plaintiff claims induced his reliance. These limitations indicate that, while a disclaimer is a significant obstacle to a claim in negligence under New York law, it is not preclusive of a claim.

As set forth above, in England, only a "reasonable" disclaimer can prevent a duty of care from arising or negate that duty. In evaluating whether a disclaimer is "reasonable," Lord Templeman set forth a number of factors in *Smith* which, in his view should "always" be considered, including:

(1) whether the parties are of equal bargaining power (considering in particular whether the disclaimer was imposed on someone who had no power to object);

(2) whether it would have been reasonably practicable to obtain the advice from an alternative source, taking into account cost and time;

(3) how difficult the task was for the offending party to undertake; and

(4) the practical consequences of a finding of reasonableness (considering in particular whether one party is better able to bear the loss as a result of, for example, insurance).[97]

In addition to these factors, a court may consider how the offending party was compensated for completing the task[98] as well as the way in which the relevant term came into being and is used generally.[99]

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94 *Id.*
95 *Id.* at 320-21.
96 *See, e.g., Harsco Corp. v. Segui,* 91 F.3d 337, 342-43 (2d Cir. 1996) (contractual disclaimers precluded reasonable reliance); *Dyncorp v. GTE Corp.,* 215 F. Supp. 2d 308, 328 (S.D.N.Y. 2002) (same); *Goodman Manuf. Co. v. Raytheon Co.,* 1999 WL 681382, at *16 (S.D.N.Y. Aug. 31, 1999) (same).
97 *Smith* [1990] 1 A.C. 831 at 858-59.
98 *Id.* at 860.
99 *Killick & Anor v PriceWaterhouse Coopers (A Firm)* [2001] P.N.L.R. 1, ¶ 19.

In the case of an investor lawsuit against a CRA, it is unclear how the courts of the US and England would treat a disclaimer of liability contained in an offering circular or subscription memorandum. Applying the House of Lords' reasoning in *Smith*, it is at least plausible that an investor could convince a court that it would be unreasonable to impose a boilerplate disclaimer of liability on an investor who had no choice but to accept the disclaimer, could not have practically obtained alternative ratings advice from another agency, and is no better able to bear the loss than the CRA.

On the other hand, in reality very few English courts have found the disclaimer at issue unreasonable.[100] Moreover, the House of Lords appears to have limited the universe of cases in which a disclaimer must be disregarded to those where the amount at stake is modest and the potential reliance of the claimant is widely expected in the particular industry.[101]

In New York, investors will have equal difficulty proving reasonable reliance in the face of specific disclaimers of liability. Obviously, the arguments that might work before an English court could also persuade a New York court. In addition, it may help an investor to point out that it had no opportunity to negotiate the terms of a disclaimer of CRA liability, as the CRA was not even a party to the subscription agreement. Further, if the disclaimer is a general disclaimer of liability to third parties rather than a specific disclaimer of responsibility for the implications of the rating, an investor may persuade a court that reliance on the rating was reasonable even in the face of the disclaimer. Other things that might help an investor are the agencies' public statements that their business depends upon investors' reliance on their ratings[102] and the refusal of several courts to shield parties from liability based on a disclaimer where the disclaimer related to misleading or false material information.[103] Nevertheless, the issue is a difficult one that is likely to require factual development to resolve.

VI. CONCLUSIONS

Despite the investigations, the lawsuits, and public rancor about the rating agencies' role in the sub-prime crisis, the agencies so far have avoided the courtroom battles that are playing out very publicly for other players in the crisis. But as with every major economic meltdown,

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100 *See, e.g., Fuller Peiser* [2002] P.N.L.R. 13 (disclaimer negated liability); *Omega Trust C Ltd and Banque Finindus v Wright Son & Pepper (A Firm)* [1997] P.N.L.R. 424 (same); *McCullagh* [1996] P.N.L.R. 205 (same).

101 *Smith* [1990] 1 A.C. 831 at 859-60.

102 *E.g.,* Staff of S. Comm. on Governmental Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 99 ("as S&P explains on its website, its 'recognition as a rating agency ultimately depends on investors' willingness to accept its judgment."); 123 ("Standard & Poor's recognition as a rating agency ultimately depends on the credibility of its opinions with investors, importantly, but also with bankers, financial intermediaries, and securities traders.").

103 *In re National Century Financial Enterprises, Inc., Investment Litigation,* 541 F. Supp. 2d 986, 1005 (S.D. Ohio 2007) (holding that disclaimers in offering materials and participation agreement did not preclude institutional investors from showing that they justifiably relied on bank's alleged misrepresentations); *Milman v. Box Hill Systems Corp.,* 72 F. Supp. 2d 220, 231 (S.D.N.Y. 1999) ("[N]o degree of cautionary language will protect material misrepresentations or omissions where defendants knew their statements were false when made."); *ML-Lee Acquisition Fund, L.P. v. Deloitte & Touche,* 463 S.E.2d 618, 634 (1996), *aff'd in part and rev'd in part on other grounds,* 489 S.E.2d 470 (1997) (finding that where an accountant provided a letter to a lender as required by a loan agreement entered into by the accountant's client, and that letter contained a disclaimer, the court was not obligated to find that lender's reliance was unjustified).

there is a test case for everything. The success or failure of Abu Dhabi Commercial Bank's lawsuit against Moody's and S&P may persuade other similarly situated investors to either run to the courthouse or steer clear. Further investigations by the SEC, the FBI, or other governmental or regulatory bodies may uncover evidence that opens the floodgates for claims against the credit rating agencies. But so far, the agencies appear to have dodged a very expensive bullet.

Predictions aside, what is clear is that any private litigant hoping to recoup losses from a credit rating agency will have to have relatively specific evidence, and set forth compelling allegations, to avoid dismissal or strikeout in the early phases of litigation. Even assuming a claimant could overcome disclaimer language in the offering documentation and the characterization of ratings as "statements of opinion", there is serious doubt about whether any particular claimant could prove the necessary special relationship to a rating agency to give rise to liability. It is this latter element of proof that is likely to quench most private lawsuits.

The enduring question is whether the contours of current tort law in both the US and England is too restrictive in this rather novel context. Many commentators have argued that credit rating agencies, as key participants in the CDO and RMBS structuring process, should bear some responsibility for investors' resulting losses. And there is some force to that argument, particularly since the rating agencies continue to have rather deep pockets in this dire economic climate. But even the rating agencies' pockets are not deep enough to right every economic wrong that investors have suffered. And the law rightly attempts to circumscribe the realm of liability to what is immediately foreseeable and therefore manageable. Relaxing legal standards of privity or proximity or the duty of care would only open the floodgates to litigation that would, ultimately, bankrupt the credit rating agency industry. That result, while perhaps satisfying in the short-term for those creditors that are fortunate enough to get paid before the money runs out, would not necessarily be palatable for the market as a whole in the long-term. After all, the rating agencies, when properly regulated and properly functioning, serve a very useful and unique purpose. Thus, the law does and should only reward those litigants (which may be very few in number) who can prove that their relationship to the rating agencies, and the circumstances of their investment, warrant liability.

When the dust settles, we may find that credit rating agencies have left the boardrooms and returned to the sidelines to act as the "journalists" they once argued they were. Certainly, regulators are pushing for that result by imposing reforms that both minimize interaction between CRAs and arrangers and enhance the transparency of the rating process. But it will take years to know whether the rating agencies will emerge from the sub-prime crisis truly unscathed and how they will function in a much-changed market. For now, the world will simply watch and wait.

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