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I. INTRODUCTION AND PRELIMINARY CONSIDERATIONS

Credit rating agencies (CRAs) evaluate the creditworthiness of financial instruments or the issuers of such instruments.[1] They examine the risk that the payment of interests and capital will not, or not completely, take place at the promised time.[2] By rating financial instruments, CRAs help to reduce informational asymmetries between lenders and investors on one side and borrowers or issuers on the other side.[3] Investors, who in most cases do not have the capacity or time to examine and evaluate the quality of financial instruments or the creditworthiness of the issuer of such instruments, use the ratings issued by CRAs to make investment decisions.[4]

Incorrect ratings of structured products contributed to the collapse of the subprime-mortgage market in the United States, which eventually led to the financial crisis.[5] Deceived investors are increasingly trying to hold CRAs liable for the issuance of such flawed ratings.[6] They often claim that the "issuer-pays model" was an

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1. JOHN C. COFFEE, GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE 283–84 (1st ed. 2006).

2. Eddy Wymeersch & Marc Kruithof, *Regulation and Liability of Credit Rating Agencies in Belgium*, *in* THE BELGIAN REPORTS AT THE CONGRESS OF UTRECHT OF THE INTERNATIONAL ACADEMY OF COMPARATIVE LAW 351 (Eric Dirix & Yves-Henri Leleu eds. 2006).

3. Harry McVea, *Credit Rating Agencies, The Subprime Mortgage Debacle and Global Governance: The EU Strikes Back*, 59 INT'L & COMP. L.Q. 701, 706–07 (2010); Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 628–38 (1999).

4. ALICE DARBELLAY, REGULATING CREDIT RATING AGENCIES 38 (1st ed. 2013); Wymeersch & Kruithof, *supra* note 2, at 353; *see also*

important cause of inadequate ratings. Moreover, so they argue, CRAs did not only rate securities but also helped issuers to structure them. CRAs advised issuers on the design of their securities to assure that they would qualify for the highest ratings. In turn, CRAs were given a fee that depended upon the success of the rated securities. This created conflicts of interest compromising the objectivity of CRAs and the quality of their ratings.[7]

Not surprisingly, the role and especially the liability of CRAs has recently attracted much attention from a policy[8] and an academic point of view. Following the financial crisis, scholars have suggested a wide variety of measures to increase the quality[9] and accuracy[10] of ratings. Some of the most important and innovative proposals are briefly discussed in Part II. Each idea obviously has its own advantages and flaws. It would, however, lead me too far afield to extensively discuss the pros and cons of each suggestion, especially because seveelisv svoc91 Tm7,them. CR0.0u13 -1.1-4(ob0h sugg)1paJ0.000

by criticizing the existing practices and other proposals.[11]

None of the suggestions to increase the quality of ratings seem convincing. Despite the sometimes very innovative ideas, Part III of the article relies on several arguments to conclude that the threat of civil liability and actual litigation against CRAs remains in prime position to guarantee that CRAs issue accurate ratings. The article concludes that the discussion in academic scholarship should no longer be whether CRAs have to face liability but should instead focus on the modalities of an appropriate liability regime for CRAs (e.g. strict or fault-based liability, capped, or unlimited liability).

II. Improving the Quality and Accuracy of Ratings – *Status Quæstionis*

Commentators have advocated several proposals to improve the accuracy of credit ratings. Firstly, an agency or entity established or supervised by the national government might minimize financial pressures that cause CRAs to issue flawed ratings.[12] Secondly, some scholars have advanced alternatives to the issuer-pays business model or have even claimed that re-establishing the once-existing investor-pays business model might increase the quality of ratings.[13] Thirdly, financial or regulatory rewards and sanctions might be implemented to incentivize CRAs to issue accurate ratings.[14] Fourthly, there have been more "radical" approaches and even suggestions to totally change the rules of the rating process.[15] Finally, several other measures to improve the accuracy of ratings have been implemented both in the United States and in the European Union.[16]

11. *See* Coffee, *supra* note 7, at 251–66; Jack T. Gannon, *Let's Help the Credit Rating Agencies Get it Right: A Simple Way to Alleviate a Flawed Industry Model*, 31 Rev. Banking & Fin. L. 1015, 1037–41 (2012) (extensively discussing the benefits and disadvantages of several proposals); Claire Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. Pitt. L. Rev. 585, 602–07 (2010); Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 Yale J. on Reg. 91, 100–04 (2010).

12. *See* discussion *infra* Part II.A.

13. *See* discussion *infra* Part II.B.

14. *See* discussion *infra* Part II.C.

15. *See* discussion *infra* Part II.D.

16. *See* discussion *infra* Part II.E.

A. Governmental & Supranational Supervised or Created Credit Rating Agencies

Several commentators suggest that governments should establish a national or supranational rating agency. This approach views ratings as public goods issued to the benefit of the investing public and the economy in general.[17]

Gudzowski suggests two reasons that a federal government entity (the Agency) should take over the responsibilities of CRAs to rate mortgage securities. Firstly, under this approach, conflicts of interest with the issuer would be eschewed because the Agency would operate with general revenues. Issuers would still have to pay for the ratings but the payments would go to a general revenue fund and not directly to the Agency. As such, there would be no contact between the Agency and the issuer because the rating entity would no longer

CRAs to the interest of the general public. For instance, the government could establish a taxpayer-funded agency that conducts and provides substantive risk analysis. The agency would use its resources to rate those securities and issuers that most adversely affect the general investing public. The agency would have to remain independent from political influence and should publically disclose its financial models, methodologies, procedures, assumptions, reports, and evaluations. This publically available information can subsequently be subject to public comments aiming to safeguard accurate ratings. The underlying idea is that a publically funded rating agency could overcome the existing issuer-pays business model which triggers CRAs to issue flawed ratings. The creation of a public agency, however, does not mean that private CRAs would disappear. Investors can still decide whether to use, interpret, and rely on ratings issued by private CRAs. In essence, the public agency only provides additional information, and it remains up to the investors to value the ratings, either those issued by the public agency or the private CRAs.[22]

This idea of a public or government-operated CRA has not remained purely within the academic sphere. In 2013, German consulting firm Roland Berger proposed creating a European CRA to counter the dominance of the major CRAs, which are of American origin. However, this promising attempt failed because the initiators were not able to collect the €300,000,000 necessary for launching the project.[23]

B. Alternatives to the Issuer-Pays Business Model

The existing issuer-pays business model leads to the remarkable situation where the issuer, whose creditworthiness is being controlled and rated, pays for these services.[24] This model has especially been criticized after the 2008 financial crisis due to potential conflicts of interest that can arise between the CRA and the issuer who is rated.[25] Research revealed that up to ninety-five percent of the CRA's annual

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22. Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 291–99 (2009).

23. *See, e.g.*, Nikolaj Nielsen, *EU-based credit rating agency buried*, EUOBSERVER (May 1, 2013, 9:25 AM), http://EUobserver.com/foreign/120005.

24. Lawrence J. White,

revenues comes from fees paid by issuers.[26] CRAs are required and expected to give an independent rating on the issuer's creditworthiness, while at the same being economically dependent upon the very same issuer. The question arises whether CRAs can really remain independent from the rated entity under these circumstances. There is an inherent risk that CRAs systematically assign a higher rating to an issuer in order to increase their revenues from the latter.[27] Phrased differently, CRAs have financial incentives to generate reports that please the issuers.[28] At the same time, issuers have the possibility to "shop around" for ratings and choose the CRA that assigns the highest rating or that uses less strict standards to achieve the desired rating.[29]

This conflict of interest seems even more acute when CRAs rate structured finance products considering the volume of deals and the corresponding rating business attributable to those transactions. Structured finance ratings were one of the fastest growing income streams for the major CRAs. As such, CRAs might be less inclined to use appropriate conservative and safe assumptions in their methodologies in order to maintain transaction flows.[30]

CRAs counter this argument by pointing out that they face reputational pressure to issue accurate ratings. A CRA would lose credibility in the eyes of investors if it only issued favorable ratings because of the positive influence this might have on the rating fee. Such conduct would harm the reputation of the CRA and could even lead to its collapse. Investors would not rely on a CRA's credit ratings if it did not give a true independent opinion of the issuer's creditworthiness. In essence, CRAs put their reputation at stake each time they issue ratings and, therefore, will do everything within their power to make sure that the ratings are independent opinions.[31]

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26. Partnoy, *supra* note 3, at 652.

27. Bai, *supra* note 7, at 263–64.

28. Boylan, *supra* note 7, at 362–63.

29. White, *supra* note 24, at 173; EFRAIM BENMELECH & JENNIFER DLUGOSZ, *The Credit Rating Crisis* 16–21 (Nat'l Bureau of Econ. Research, Working Paper No. 15045, June 2009).

30. TECH. COMM. OF THE INT'L ORG. OF SEC. ORG., THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS 12 (2008).

31. *See, e.g.*, Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1 (2002) (concluding that CRAs are already motivated to provide accurate ratin3.999533.9995s becau3.9995se their profitability is directly tied to their repu3.9995tation3.9995); Vickie

The reputation argument, however, is not as convincing as it seems at first sight to guarantee that CRAs issue accurate ratings.[32] Some scholars have proposed alternatives to the issuer-pays business model or claimed that re-establishing the once-existing investor-pays business model might increase the quality of ratings. The following paragraphs briefly shed light on some of these proposals.

The Senator Franken proposal[33] provides for the creation of a Credit Rating Agency Board (the Board) which would be driven by investors and under supervision of the U.S. Securities and Exchange Commission (SEC). The Board would assign the issuers who want to sell financial products and need an initial rating to a particular Nationally Recognized Statistical Rating Organization (NRSRO). The Board would not issue the rating but would only assign an issuer to a rating agency to prevent the former from shopping for the highest rating.[34] The proposal also obligates the SEC to place a reasonable ceiling on the rating fees charged by the CRAs. The issuer would remain free to solicit additional ratings once it obtained a mandatory rating.[35] The ambitious Franken Proposal was not adopted. Rather, Section 939F of the Dodd–Frank Act only requires the SEC to conduct a study on the feasibility of the proposal.[36]

Several alternatives, all aiming to strengthen or complement the Franken proposal, have been suggested. Horner, for instance, suggests establishing an independent committee (Board) composed either of SEC personnel, experts from NRSROs or institutional investors. The rating process would also need substantial changes and start with the issuer selecting the CRA (Hired CRA). The issuer would have to send the Hired CRA's analysis to the Board together with a standard fee.

are the most valuable long-term assets that would make it imprudent for CRAs to give anything other than fair, objective, and independent ratings).

32. *See, e.g.*, Lynch, *supra* note 22, at 250–67 (for further references); Partnoy, *supra* note 3, at 654–81; Jérôme Mathis, James J. McAndrews & Jean-Charles Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?*, 56 J. MONETARY ECON. 657, 657–674 (2009).

33. *See* Amendment to Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong., 156 Cong. Rec. 3648, 3648–60 (2010).

34. *See id.*

35. *See* Coffee, *supra* note 7, at 256; Olivia Schmid, *Rebuilding the Fallen House of Cards: A New Approach to Regulating Credit Rating Agencies*, 3 COLUM. BUS. L. REV

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The Board would subsequently have to submit the analysis to two

control of the sophisticated investor community. As such, the IOCRAs are oriented towards generating ratings that accurately reflect the credit risk. Every rating issued by a rating agency that is not an IOCRA such as Moody's and Standard & Poor's (S&P) should be accompanied by at least one rating issued by an IOCRA. Although issuers will still pay for the credit ratings, IOCRAs represent the investors' interest and if they would "fail to spot systematic rating inflation by the sell side, then the investment community will have only itself to blame."[43]

Finally, Manns notes that purchase

C. Conditioning "Pavlovian" CRAs Through Rewards and Sanctions

Some scholars opt for another approach and argue that financial or regulatory rewards or sanctions might incentivize CRAs to issue accurate ratings. These proposals often have a quasi-strict liability component since CRAs could be sanctioned if it turns out that their ratings are inaccurate.[46]

The reputation of CRAs does not necessarily make them issue accurate ratings for new products. CRAs have nothing to lose when they charge high rating fees and simultaneously issue low-quality ratings for new products. Even if low-quality ratings for new product types might harm their reputation when it comes to rating other product types, CRAs will keep issuing flawed ratings as long as new products are large enough in volume. Rational investors will rely on ratings for new products as long as the rating quality is high enough on average, even if they know that some of the ratings might be of low quality. CRAs should be required to disgorge the profits they receive from inaccurate ratings of new products that fall under a predetermined quality level, unless the CRAs themselves disclose that the ratings are of low quality.[47]

Harris argues that the profits for CRAs should rise if the bonds they rate as investment grade perform well and decrease if those bonds default. CRAs could create this scheme by placing a meaningful portion of their fees into escrow. The custody of these funds would return to CRAs if their ratings performed well.[48] The concentration in the rating market, coupled with the issuer-pays business model, reduces the incentive for CRAs to compete and issue accurate ratings.[49] To combat this phenomenon, a mandatory "pay-for-performance compensation scheme" could be established in which a fixed percentage of accrued revenue earned by the largest rating agencies would be ceded to fund a performance bonus. Regulators

46. Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2 COLUM. BUS. L. REV. 605, 662 (2009).

47. John P. Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiecy of Reform, and a Proposal for Improvement*, 1 C

could award the bonus at periodic intervals on a winner-take-all basis to the best performing CRA for a given period.[50]

According to Coffee, CRAs should have their NRSRO

Under the current issuer-pays business model, a CRA might give an AAA rating to debt which actually has a default probability of a BBB rating. The issuer might shop around and contract with the CRA that issues the most favorable AAA rating instead of the CRA that issues a lower but more accurate BBB rating. The debt compensation scheme advocated by Listokin and Taibleson overcomes this problem. Going back to the example, the CRA receives 555.56 units of debt if it rates the debt as AAA. However, at market prices, the debt is only worth $444.40 (555.56 x $0.80). As a consequence, the CRA has a strong incentive to rate the debt as BBB (the actual default probability). With this accurate rating, the CRA receives 625 units of debt. This means that the true value of the fee will correspond to the contractual agreed fee of $500 (625 x $0.80). In essence, the CRA will suffer a financial penalty when it overrates debt because the debt the CRA receives

golfers a scoring advantage over their competitors. The size of the advantage is determined by the difference between the two golfers' playing ability. When applying this to CRAs, the SEC should create "CRA handicaps" that predict the likelihood of an issuer's credit rating.[62]

The information used to calculate the future performance would consist of information that is currently required to be disclosed (e.g. accuracy of past ratings issued or the timeliness of downgrades). Once the handicap of a CRA is determined, the SEC needs to incorporate it into the regulatory structure by adjusting ratings according to the CRA's handicap. As such, the CRA's past performance needs to be tied with the regulatory benefits derived from its rating. Hosp clarifies his proposal with a simple example. Suppose that the issuer hires a particular CRA to rate a mortgage-backed security. The CRA issues an AA rating, which is considered the gross or unadjusted credit rating. The SEC subsequentl6dDdT15O5TA298rbh022 TA-(i)-_3(o-

threatening to hold CRAs liable for inaccurate ratings.[68]

1. Increasing Competition in the Rating Sector

Firstly, several scholars have argued that more competition in the rating sector, which is dominated by Moody's, Fitch and S&P, would make CRAs issue more accurate ratings.[69] As a response, the United States Congress adopted the Credit Rating Agency Reform Act (CRARA) in 2006. The Act aims to improve the quality of ratings by fostering accountability, transparency, and competition in the rating industry. More specifically, the barriers for CRAs to get NRSRO designation were lowered. The CRARA established "substantively undemanding"[70] registration criteria aiming for more CRAs to apply for NRSRO designation and boost competition in the rating sector.[71]

In the EU, Regulation 462/2013 on CRAs also contains several provisions that aim to increase competition in the rating market. For instance, where two or more ratings are sought, the issuer should consider appointing at least one smaller CRA that does not have more than ten percent of the total market share 1To1S6 71.6(e6(a.5(optb7(r)12.pnm4 Tc 0R)12

creditworthiness. Multiple and different views, perspectives, and methodologies applied by CRAs should produce more diverse credit ratings and ultimately improve the

verified, (2) to document any model adjustments made to ratings, and (3) to disclose how frequently they review their ratings.[78]

The EU Regulation on CRAs also contains several disclosure requirements. CRAs, for instance, are required to publically disclose conflicts of interest, their rating methodologies or models and key rating assumptions used in rating activities.[79] According to the Regulation, the ability of investors to make an informed assessment of the creditworthiness of structured finance instruments is improved if they are given sufficient information on those instruments. Considering that the risk on structured finance instruments to a large extent depends on the quality and performance of the underlying assets, investors should be provided with more information on the underlying assets. This would reduce investors' dependence on ratings. Moreover, disclosing relevant information on structured finance instruments is likely to reinforce the competition between CRAs because it could lead to an increase in the number of unsolicited ratings.[80]

3. Managing Conflicts of Interest with the Issuer

Thirdly, it has already been mentioned that investors alleged that conflicts of interest were one of the main reasons why CRAs issued inaccurate ratings for mortgage-backed securities.

mechanism.[91] In this regard, lead rating analysts may not be involved in rating activities on the same entity for a period exceeding four years. Similarly, people who approve ratings shall not be involved in

to rate.[97] Moreover, CRAs or any person holding directly or indirectly at least five percent of either the capital or voting rights of the CRA (or who is in a position to exercise significant influence on the business activities of the CRA) are not allowed to provide consultancy or advisory services to the rated entity with regard to its corporate or legal structure, assets, liabilities, or activities. Although CRAs may offer certain ancillary consulting services (e.g. market forecasts, estimates of economic trends, or pricing analysis), they must always ensure that this does not cause conflicts of interest with their rating activities.thes(ght1s), th)11.9

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party CRAs."[101] As a consequence, CRAs shifted from selling information to selling "regulatory licenses,"[102] the "keys that unlock the financial markets."[103] CRAs thus remain in business because financial legislation often requires a rating issued by an NRSRO as prerequisite for market access, for purchasing bonds by institutional investors or for other market activities, even if the rating later turns out to be incorrect.[104] The fact that CRAs offer services that became necessary for regulatory compliance is one of the reasons that created and sustained the "paradox of credit ratings."[105] The paradox implies that although the informational value of ratings decreases (e.g. because investors increasingly allege that CRAs issued flawed credit ratings), CRAs, nonetheless, remain profitable and their ratings of major importance to regulate financial markets.[106]

Both EU and U.S. regulators have tried to eliminate reference to the use of ratings in legislation or other documents. The Financial Stability Board[107] and the EU implemented measures to reduce overreliance on ratings. The EU pursues this objective by adopting a "multi-layer approach"[108] which implies, *inter alia,* that financial

101. Darbellay, *supra* note 4, at 40.

102. Partnoy, *supra* note 3, at 683.

103. Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, 25 J. INT'L. BANKING L. REV. 188, 189 (2010).

104. *Id.* at 190; LAWRENCE J. WHITE, FINANCIAL REGULATION AND THE CURRENT CRISIS: A GUIDE FOR THE ANTITRUST COMMUNITY 30–31 (2009); *see, e.g.*, BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS 13–14 (2013) (stating that level 2A assets are limited to corporate debt securities (including commercial paper) and covered bonds that have a long-

institutions are required to make their own credit risk assessment and not rely solely on credit ratings when assessing the creditworthiness of an entity or financial instrument.[109] The EU recommended that legislation and supranational institutions should refrain from referring to ratings in their guidelines, recommendations, and draft technical standards if it would cause authorities or other financial participants to rely solely or mechanistically on ratings.[110]

In the U.S., the Dodd–Frank Act deals with the removal of references to ratings in a similar manner. Section 939A directs each federal agency to review (1) any regulation it issued and which requires the use of an assessment of the creditworthiness of a security

in violation of Commission Regulation 1060/2009.[114] Article 35a of Regulation 462/2013 addresses the liability of CRAs towards both issuers and investors.[115] Investors bringing an action against CRAs under Article 35a must prove several elements, which are discussed in the following paragraphs.

Under Commission Regulation 1060/2009 as amended, CRAs are only liable when they commit any of the proscribed infringements intentionally or with gross negligence.[116] CRAs will not face liability for simple negligence or for merely issuing an "incorrect" rating, nor

the burden of proof for claims against CRAs.[123] The competent court must assess whether the presented information is accurate and detailed, taking into account the fact that the investor or issuer may not have access to the CRA's proprietary information.[124]

The Regulation also requires a link between the infringement and the loss suffered by the investor in two ways. Firstly, the investor must establish that he reasonably relied on the rating in accordance with Article 5a, or otherwise.[125] While the Regulation does not define "reasonable reliance," it could imply that a CRA will not incur liability if the investors mentioned in the Regulation did not make their own credit risk assessment but relied solely on ratings to assess the creditworthiness of an entity or financial instrument.[126] Secondly, the investor must have reasonably relied on the rating for a decision to invest into, hold on to, or divest from a financial instrument covered by that rating.[127]

If an investor shows (1) intentional or gross negligent infringement by the CRA; (2) actual impact of the infringement on the rating; (3) reasonable reliance on the rating; (4) for an investment decision, the investor may claim compensation from the CRA for its financial losses.[128] Several problems, however, remain with regard to

national law for the interpretation and application of essential notions such as "damages," "gross negligence," "reasonably relied," "due care," and "impact." Additionally, national law governs the liability of CRAs in areas such as causation and liability for ordinary negligence that the Regulation does not reach.[130]

Several sections of the Dodd–Frank Act also contain provisions dealing with the liability of CRAs. Prior to the changes introduced by the Dodd–Frank Act, Rule 436(g) of the Securities Act stipulated that credit ratings from a NRSRO[131] assigned to public offerings were not considered as an expert-certified part of the registration statement.

securities.[134] The U.S. Committee on Financial Services, therefore, approved the removal of expert liability for CRAs ("no-action relief") in July 2011.[135]

Section 933(b) of the Dodd–Frank Act lessened the pleading requirements in private actions for securities fraud under Section

The threat of civil liability or actually holding CRAs liable increases the accuracy of credit ratings. The following parts, therefore, examine the reasons why regulators did the right thing to

Hill and Moody's plummeted.[158] Future cases imposing liability upon CRAs might have similar consequences, which may make CRAs more diligent when issuing ratings. McKenna concludes in this regard that such a "market reaction is likely to alert ratings agencies of the costly effects of careless analysis."[159] Secondly, several commenters acknowledge that the *Bathurst* decision might not only have consequences for the conduct of CRAs but can also be a precedent for courts in other jurisdictions.[160] This can make CRAs aware that they are no longer bullet proof against liability depending on the jurisdiction in which they operate.[161] This might lead to greater care

> MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" . . . . MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer . . . . It would be dangerous for "retail clients" to make any investment decision based on MOODY'S credit rating.

One can conclude that the inclusion of this clause in the contract explicitly referring to Australia and emphasizing once again that ratings are mere opinions is a direct result of the *Bathurst* case. As such, the decision concerning the liability of S&P in *Bathurst* is taken into account by CRAs when drafting rating agreements and thus indirectly influences their behavior.

B. Favoring Liability of CRAs from a Theoretical Perspective

There are also several theoretical reasons why liability increases the accuracy of ratings. Scholars argued that if CRAs are considered gatekeepers,[162] the threat of civil liability can be used to deter wrongdoing.[163] That is because the primary objective of tort liability is the deterrence of unreasonable risks.[164] Whereas some favor a negligence-based liability regime for CRAs,[165] others have proposed a

the grounds of liability (e.g. whether CRAs should face strict or fault-based liability) and several other modalities (e.g. toward which third parties they can be held liable) should be thoroughly analyzed in another study, it suffices for now to note that imposing civil liability upon CRAs might increase the quality of ratings from a theoretical point of view.[167] The following paragraphs will set forth several arguments that either find their roots in a strict- or negligence-based regime to underpin the conclusion that the threat of civil liability increases the accuracy of ratings.

Moreover, as previously discussed, CRAs are no longer able to hide behind the traditional defenses. This paves the way for judges to actually assess whether CRAs are liable. The concern of the government's promulgation of performance standards also needs to be seen in a nuanced light. That is because extensive standards and regulations have already been adopted by the SEC, the EU and especially the IOSCO.[177] In addition, one can also think to establish some formal and periodic assessment of how accurate the CRAs were in calculating ratings, in other words somebody who rates the CRAs themselves.[178]

The threat of liability is an effective way to make sure that CRAs issue accurate ratings. The analysis in the following paragraphs is based on the findings of Husisian. Husisian extensively relies on works by Posner[179] and Calabresi,[180] and gives three general reasons why imposing liability upon CRAs for negligence might increase the accuracy of their ratings: the "least-cost avoider" argument,[181] the "optimum level of care" argument,[182] and the "risk-spreading" argument.[183] Although he eventually concludes that expanding CRAs' liability for negligence remains problematic from an economic point of view, the arguments underpinning this conclusion no longer seem convincing in the current post-financial-crisis era. In essence, I re-evaluate the arguments of Husisian to conclude that the threat of holding CRAs liable triggers them to issue accurate ratings. Imposing liability, for instance, would increase the CRAs' variable cost and make them cut back on rating those securities that pose the greatest

177. *See* TECHNICAL COMMITTEE OF THE INT'L ORG. OF SEC. COMMISSIONS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2004) (updating the Code after the 2008 financial crisis to cover the rating of structured finance products and related transactions); *see also* TECHNICAL COMMITTEE OF THE INT'L ORG. OF SEC. COMMISSIONS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES 2008 (where CRAs are expected to give full effect to the Code of Conduct as investors might see compliance with it as a sign of good governance); Graeme Baber,

risk. Some argue that the securities with the biggest risk are those issued by new and young firms. However, the financial crisis showed that this is not per se the case.[184] Similarly, the argument that holding CRAs liable might open the floodgates and even lead to their collapse needs to be taken with a grain of salt.[185]

1. The Least-Cost Avoider Argument

This rationale implies that the tort system should impose liability on the least-cost avoider of mistakes. The system encourages the party that can most easily avoid the harm (e.g. financial losses) by incurring the least expenses to take steps to avoid mistakes such as investment in a product that later defaults. In the rating business, the CRA is probably the least-cost avoider, not only because of its expertise and potential access to the issuer's confidential information, but also because it would cost the investor much more to "play[] detective" and investigate the issuer's creditworthiness.[186] Courts grounding their decision on the least-cost avoider argument would, therefore, be inclined to impose liability on CRAs as they are able to avoid potential mistakes more cheaply than investors.[187]

Some question whether CRAs actually are the least-cost avoiders of mistakes. Husisian, for instance, concludes that in reality CRAs will have to show that they did not act negligently if the plaintiff proves a prima facie case.[188] To meet this burden of proof, CRAs will have to document their actions, report the reasons why a particular rating was given and "always conduct [their] business with an eye toward how their actions would look to a judge and jury."[189] Liability for CRAs will lead to increased costs in terms of monitoring and recordkeeping requirements. These costs will probably be passed on to the issuers, resulting in higher credit-rating fees.[190] The problem, however, is that recordkeeping requirements do not necessarily result in better ratings but only show that CRAs already produced non-

184. *See infra* Part III.B.4.

185. *See infra* Part III.B.5.

186. Husisian, *supra* note 169, at 431.

187. *Id.* at 430–31.

188. S*ee Prima facie*, BLACK'S LAW DICTIONARY (6th ed. 1990) (a fact presumed to be true unless disproved by some evidence to the contrary).

189. Husisian, *supra* note 169, at 434 (citing Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 B, e (a)]TJ0.2570 87L52 56

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obligations, aimed at providing proof that CRAs acted with reasonable care, will increase the costs for CRAs. CRAs must already extensively document their actions and disclose information on their credit rating methodologies under both EU[199] and U.S. law.[200] As such, the argument that liability will only increase costs in terms of

and social losses misses an essential point because holding CRAs liable would make a difference in terms of "allocative efficiency."[202] More specifically, if ratings are reliable, investors will not have to bear the costs of doing their own investigation or buying information from other sources. On the other hand, if ratings are unreliable, investors will incur costs as they will have to protect themselves from losses that can incur in capital markets. Each investor would have to collect and analyze public information, seek advice from other experts, or perform an own analysis before purchasing financial products. The private and social costs associated with such activities are substantial compared to a situation in which only one expert institution, the CRA, would issue reliable ratings that can be used by all investors. Moreover, flawed ratings can lead to a misallocation of resources throughout the general economy. Take the example of mortgage-backed securities. Investors would not have purchased those securities if CRAs had been subject to stricter standards of care when calculating the ratings. Money would have stopped flowing into those products much earlier resulting in a different allocation of capital. In sum, the social losses caused by inadequate ratings, although smaller than the private losses, are "greater than zero."[203]

2. The Optimum Level of Care Argument

The optimum level of care is another argument relied upon to advocate liability for CRAs. In an ideal world of perfect information, investors might contract with another CRA or pay less rating fees when discovering that the initial rating of the hired CRA is inaccurate. Consequently, the hired CRA would have to reduce the price of its products to reflect the below-optimum investment in accuracy. In sum, the CRA will have to increase its investment in accuracy in order to avoid lowering the price or losing market share to other CRAs that offer more accurate ratings.[204]

Taking into account the information costs,[205] CRAs will, however, invest in the accuracy of their credit ratings only until the marginal cost of doing so equals the increase in marginal revenue achieved by displaying greater accuracy. CRAs are aware that they

can make some errors through underinvestment in accuracy, which

the information, namely the rated companies themselves, to give information of sufficient quality, which in turn might lead to more accurate ratings.[208]

At the same time, however, Husisian notes that the problem of cross-subsidization might occur when CRAs face potential liability in tort. It has already been mentioned that CRAs, besides rating fees, can also charge subscription fees to investors. The CRA will downstream the potential costs of tort liability (e.g. the costs related to insurance coverage) to all its subscribers equally. That is because CRAs charge a fixed price for each subscription, as it remains difficult to price discriminate between large and small investors. As a consequence, the small subscribers will "cross-subsidize"[209] the large subscribers. The cost of subscription for small investors will rise by more than the expected value of future suits they might bring against CRAs. The cost for large investors, on the other hand, rises by less than the expected value of the lawsuits they might initiate against CRAs. Each investor pays the same amount for the CRA's insurance costs, but larger investors are more likely to "cash in the policy in the courtroom."[210] As a result, the number of small subscribing investors might decrease, whereas the number of large subscribing investors will increase. This ultimately leads to the result that those investors who most value ratings are not able

fees.[212] Moreover, although CRAs still "make some money from subscriber fees,"[213] much of the information provided by CRAs is freely available for the public through registration on the websites of CRAs.

4. Rating (Risky) Securities of New & Young Firms

The financial crisis also showed that some other arguments against keeping CRAs immune from liability are no longer valid. It has, for, instance, been argued that liability would increase the CRA's variable cost. CRAs decide whether to publish a rating based on the expected profits or losses of doing so. A higher chance of liability for CRAs increases the variable costs of publishing a rating. That is because there is a chance that courts will find the CRA liable for a negligent mistake with regard to every rating it issues. In reaction to this growth of variable costs, the CRA might cut back on those ratings that increase its marginal variable costs the most. The bonds and securities issued by small and new firms are the most expensive to rate. As a consequence, CRAs will not be inclined to rate companies that pose the greatest threat of liability, namely new or small firms that actually most benefit from independent ratings.[214]

Besides the lack of data underpinning this argument, the financial crisis showed that not the "young or small or unstructured"[215] companies posed the greatest risk. Rather, the financial incentives and unreasonable conduct of CRAs themselves contributed to the collapse of the financial markets. The unreasonable and profit-oriented behavior of CRAs, and not the position or size of issuers, was the primary reason why CRAs have been held liable so far. This follows from the cases in which investors have targeted CRAs for the flawed ratings given to structured asset-backed securities.[216] In this regard, both the extent to which CRAs were involved in structuring the issuer's financial instruments as well as the remuneration structure play a key role in determining the First

212. Lynch, *supra* note 22, at 239–40; Partnoy, *supra* note 105, at 69.

213. Claire Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1147–48 n.20 (2003).

214. Husisian, *supra* note 169, at 437–39.

215. John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1967 (1988); *see also* Coffee, *supra* note 7, at 252 (arguing that the threat of liability could lead the CRAs to stop rating "risky structured finance products").

216. *See supra* footnotes 6–7(overviewing cases); *see also* discussion *infra* Part III.B.5.

Amendment protection given to ratings. The *Abu Dhabi* court, for example, acknowledges the relationship between the existence of conflicts of interest and their impact on the dissemination of false ratings on the one hand and the First Amendment protection on the other hand. The CRAs did not only rate such complex securities but also advised issuers on how to structure and design them to qualify for the highest rating. At the same time, they received rating fees which were "contingent upon the receipt of desired ratings [for such securities] and only in the event that the transaction closed with those ratings."[217] As such, CRAs knew "that the ratings process was flawed[,] . . . that the portfolio was not a safe, stable investment, and . . . that [they] could not issue an objective rating because of the effect it would have on their compensation."[218]

Similarly, the court in the Australian *Bathurst* case concluded that S&P violated its duty of care because the CRA did not have reasonable grounds to assign the rating. The rating was not the result of reasonable care and skill.[219] S&P did not develop its own model for rating constant proportion debt obligation (CPDOs), but instead relied on the model created by ABN Amro. The CRA did also not give any consideration to the model risk when assigning the credit rating.[220] S&P adopted a 15% volatility figure that had been provided to it by ABN Amro. There was no evidence that S&P checked the 15% volatility figure itself. However, S&P could have easily calculated the volatility and would then have realized that the correct figure was around 28%. A reasonable and prudent CRA would have done its own calculations and surely not have adopted a volatility figure of 15%.[221]

217. Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., 651 F. Supp. 2d 155, 167 (S.D.N.Y. 2009).

218. *Id.* at 178–79; *see also* Fed. Home Loan Bank of Boston v. Ally Fin., No. 11–10952–GAO, 2013 WL 5466628, at *2 (D. Mass. Sept. 30, 2013) ("[Plaintiff has] "pled with sufficient particularity that the Rating Agency Defendants issued ratings that they did not genuinely or reasonably believe. For example, the Amended Complaint alleges that the Rating Agency Defendants diluted their own standards and carried out their ratings procedures in an intentionally lax manner as to [private label mortgage-backed securities] while maintaining higher standards in other contexts. The Bank has also sufficiently pled scienter, alleging that

The court held that the analysis of S&P did not comprise mere mistakes or errors of judgment. Rather, it "involve[s] failures of such a character that no reasonable ratings agency exercising reasonable care and skill could have committed in the rating of the CPDOs." In sum, the "[rating] analysis was fundamentally flawed, unreasonable and irrational in numerous respects."[222]

5. Does Liability of CRAs Really Open the Floodgates?

The concern also arose that, even if liability for CRAs has the effect of deterring "bad" behaviors, it might result in frivolous lawsuits and open the floodgates against CRAs. This would have dramatic consequences for the rating business.[223] However, the threat of liability does not necessarily mean that CRAs will automatically be held liable once courts are confronted with claims. That is because plaintiffs often have to prove several elements for liability claims against CRAs to be successful.[224]

From a Belgian perspective, for instance, in the absence of specific legislation on the liability of CRAs, investors have to ground their claims on the Articles 1382-1383 of the Belgian Civil Code (BCC) to recover in tort from the CRA. Pursuant to the Articles 1382-1383 BCC, an investor will have to prove that the CRA committed a wrongful act, that he incurred damages, and that there is a causal link between both elements.[225] As such, courts will not automatically hold CRAs liable only because they have already incurred liability in the past. Reference can in this regard be made to Belgian case law dealing with the third-party liability of the auditor. The investor still has to prove in each case that he incurred financial losses and that there was a causal link with the issuance of the wrong audit opinion, even when courts already held the auditor liable towards third parties at several occasions in the past.[226]

Harding & Donovan, *supra* footnote 6, at 192.

222. *Bathurst*, at paragraph 2836; *ABN AMRO Bank NV*, FCAFC 65 at paras. 12, 566–722; Banton & Theodorou, *supra* note 160, at 5; Harding & Donovan, *supra* footnote 5, at 192.

223. Hill, *supra* note 7, at 89; Horner, *supra* note 37, at 504; Mulligan, *supra* note 190, at 1297; Arthur Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMPARATIVE L. 341, 355 (2006).

224. Ellis, Fairchild & D'Souza, *supra* note 5, at 217.

225. HUBERT BOCKEN, INGRID BOONE & MARC KRUITHOF, HET BUITENCONTRACTUEEL AANSPRAKELIJKHEIDS-RECHT EN ANDERE SCHADEVERG OEDINGSMECHANISMEN [OUTSIDE THE CONTRACTUAL LIABILITY: LAW AND OTHER COMPENSATION MECHANISMS] 46–203 (3d ed. 2014).

226. See INGRID DE POORTER, CONTROLE VAN FINANCIËLE VERSLAGGEVING:

Another case which shows that the mere possibility of holding certifiers liable will not open the floodgates is the *Vie d' Or* decision, in which the Dutch Supreme Court clearly set the boundaries of the third-party liability of the auditor. The *Hoge Raad* (Supreme Court of the Netherlands) held that accountants have a duty of care towards third parties when performing tasks that have a wider public importance such as the certification and control of annual accounts (the so-called public role of the auditor). To determine if auditors can be held liable towards a specific third party, the judge needs to examine how a reasonable and competent accountant who carefully performs his duties and takes into account the third party's interests, would have acted. Whether the accountant violated his duty of care has to be established by taking into account all circumstances of the case.

The *Hoge Raad* subsequently enumerated a checklist to decide if the accountant violated his duty of care. Factors that have to be taken into account are (1) the extent to which the requirements concerning financial audit reporting incorporated in EU and national legislation have been respected; (2) the nature of the violated norm; (3) the

plaintiff to establish particular facts giving rise to a strong inference that a CRA knowingly or recklessly (1) failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its methodology for evaluating the credit risk, or (2)

identity of each particular investor, however, is not necessary as long as the rating is created to target a select group of qualified investors instead of the "faceless"[232] investing public at large.[233] Investors are not part of a limited class if the allegations suggest both a widespread availability of the securities and a widespread reliance on the ratings (e.g. because the securities were not offered through private placement to only a certain type of investor).[234]

Finally, claims for negligent misrepresentation or common law fraud can be dismissed if the investors did not justifiably or reasonably rely on the rating. The *Abu Dhabi* court, for instance, concluded that the plaintiffs reasonably relied on the ratings because the market at large, including sophisticated investors, has come to rely on ratings issued by independent CRAs given "their NRSRO status and access to non-public information that even sophisticated investors cannot obtain."[235] Similarly, the *CalPERS* court held that, contrary to the corporate market, investors in the structured finance market cannot reasonably develop their own informed opinions because there is insufficient public information to do so. Reliance on credit ratings is justified if investors are unable to conduct their own analysis or develop independent views about potential investments.[236]

It remains uncertain whether the Australian *Bathurst* decision will open the liability floodgates. That is because the court limited the circumstances in which a CRA can incur liability towards third parties.[237] The class of persons to whom S&P owed a duty of care was ascertainable. More specifically, the class comprised of potential purchasers of the minimum $500,000 subscription in the $40 million issue of the notes. S&P also controlled several factors confining the

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232. *Ohio Police & Fire Pension Fund*, 700 F.3d at 841.

233. *King Cty.*, 863 F. Supp. 2d at 309–10; *LaSalle Nat'l Bank*, 951 F. Supp. at 1093–94; *see also In re Nat'l Century Fin. Enter.*, 580 F. Supp. 2d at 647 (holding that misrepresentations to the general investing public are not actionable because this is not a limited class of persons whom the speaker intends to benefit or guide).

234. Ohio Police & Fire Pension Fund v. Standard & Poor's Fin. Serv. LLC, 813 F. Supp. 2d 871, 880–82 (S.D. Ohio 2011), *aff'd by* Ohio Police & Fire Pension Fund v. Standard & PoPensiedn

scope of potential liability (e.g. the amount of issued products to which the rating relates, the conditions to impose on the communication of any rating, and the ability to reduce or control its liability by downgrading or withdrawing the rating).[238] On appeal, the court held that the liability was not indeterminate because S&P knew that the investors were members of a class, the essential characteristic of which was that each investor wanted to purchase the notes. In addition, the type of loss was foreseeable; it is the nature of the loss (e.g. losing the money invested in the notes) and not the precise amount that has to be taken into account.[239] In other words, both the class of investors and the foreseea

6. Other Arguments Favoring Liability of CRAs

There are three additional arguments why the threat of liability is the path that legislators should follow to increase the quality of credit ratings.

Firstly, some maintain that it remains unclear when exactly a credit rating can be qualified as inaccurate or "bad". It is, therefore, difficult to determine when a CRA's conduct can lead to liability.[244] Although rating defaults are indeed inevitable, CRAs do not violate their contractual obligations merely because the rating turns out to be incorrect later. Issuing an incorrect rating is not per se a reason to hold CRAs liable. That is because rating agreements and codes of conduct stipulate that CRAs do not intend to guarantee the correctness of the rating.[245] The EU Regulation on CRAs is also very clear in this regard; the business of rating involves a degree of assessment of complex economic factors. The use of different methodologies can lead to different ratings, none of which can be considered incorrect as such. In other words, CRAs will not violate their contractual obligations merely because the given rating does not correspond to the creditworthiness of the issuer or the financial product. It is only when the incorrect rating is the result of a CRA's negligent or fraudulent violation of its contractual obligations that liability should

crushing liability); Scarso, *supra* note 167, at 162–89 (concluding that any limitation of

be imposed.[246] In this regard, it can be argued that CRAs have several contractual obligations, namely issuing an independent credit rating and managing or minimizing conflicts of interest, ensuring that the information they use is of sufficient quality and from accurate and reliable sources, and using rigorous, systematic and continuous methodologies based on historical experience.

if they are subject to a risk of liability. Such a threat of liability should, therefore, be expanded to include the activities of CRAs.[250]

The United States Congress happened to hear the results of this comparative analysis as the Dodd–Frank Act "reflects the sentiment"