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*Special Issue: Civil Liability of Credit Rating
Agencies in the European Union*

Selected Legal and Economic Aspects

*Editors: Gudula Deipenbrock and
Mads Andenas*



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*Special Issue: Civil Liability of Credit Rating Agencies in the
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EDITORIAL INTRODUCTION: CIVIL LIABILITY OF CREDIT RATING AGENCIES IN THE EUROPEAN UNION - SELECTED LEGAL AND ECONOMIC ASPECTS

Gudula Deipenbrock and Mads Andenas

A key challenge for the European Union (Union) since 2008 has been to design appropriate regulatory and supervisory responses in the realm of financial markets in order to tackle their dysfunctions as revealed in the recent financial crisis. Identifying and preventing systemic risks affecting the whole European financial system and those linked to individual financial market actors including improving their supervision in general also became core concerns, here. The Union legislator established accordingly a sophisticated system of 'macro-prudential supervision' and 'micro-prudential supervision'. In addition, the Union revisited existing financial market regulation and identified also new areas and sectors of the European financial market which require regulatory measures. Due to the role credit rating agencies played in the causation of the financial crisis and have played in general in global securities and banking markets the Union introduced in 2009 a European regulatory and supervisory regime for credit rating agencies and afterwards reformed it twice. Its second reform in 2013 provided for the first time a European civil liability provision for credit rating agencies. Designed as a rather fragmentary civil liability concept leaving the definition of its pivotal constituent elements and the filling of gaps in this context to the applicable national law multiple problems arise with a view to its interpretation and application. This special issue of the *International and Comparative Corporate Law Journal* is compiling papers addressing selected legal aspects of the European civil liability regime for credit rating agencies and those linked to civil liability regimes in the national law of selected Member States of the Union (Member States) complemented by papers addressing relevant economic issues in this context. The specific topics of the papers focussing on the legal view range from assessing critically the European civil liability regime for credit rating agencies with a view to private international law aspects, the problem of causation and from a broader European perspective to papers adding comparative aspects by analysing the civil liability of credit rating agencies under English law and Swedish law. The specific topics of the papers drafted from the economic point of view cover the qualitative and the quantitative aspects of damage assessment in context with the civil liability of credit rating agencies. The papers compiled in this issue are aimed at contributing to a lively debate amongst scholars, practitioners and those involved in the legislative procedures at Union and Member States' level on whether the new European civil liability regime for credit rating agencies and the relevant civil liability concepts of the Member States might have a disciplining effect on credit rating agencies and their

analysts. Valuable conclusions might also be drawn with a view to the evolution and perspectives of torts in European financial market law in general. This compilation of papers has resulted from a seminar held at the Department of Private Law at University of Oslo, Norway, in June 2013. The seminar was organised by the editors of this special issue. The editors of this special issue would like to express their thanks to the authors of the papers included in this issue for having contributed to the legal and economic analysis of the civil liability of credit rating agencies in the Union. The editors of this special issue would like to express also their thanks to The Finance Market Fund (Finansmarkedsfondet), the German-Norwegian E.ON Ruhrgas scholarship programme and the Research Council of Norway, for having contributed to the funding of the seminar.

**THE EUROPEAN CIVIL LIABILITY
REGIME FOR CREDIT RATING AGENCIES
FROM THE PERSPECTIVE OF PRIVATE
INTERNATIONAL LAW – OPENING PANDORA’S BOX?**

*Gudula Deipenbrock**

ABSTRACT

The European Union (Union) introduced several legal acts to regulate and supervise credit rating agencies (CRAs). In rapid succession between 2009 and 2013, the European regulation introducing the regulatory regime for CRAs was followed by two reform regulations and supplemented further by delegated regulations. Avoidable volume, complexity and sometimes opaqueness of the legislative approach characterises particularly the second reform of 2013. The European Commission (Commission) aimed to revisit important, still remaining dysfunctions of the credit rating sector with this second reform. The overreliance on credit ratings, the oligopolistic structure of the credit rating sector, the conflicts of interest, the quality of credit ratings and sovereign ratings in particular, and the lack of a European civil liability of CRAs were considered as unresolved flaws requiring legislative action. Against this backdrop, the second reform of the regulatory and supervisory regime for CRAs in the Union introduced various amendments to the rules including in particular the novel instrument of a civil liability regime for CRAs. The creation of a civil liability regime for CRAs as such marks a pivotal change in the Union’s regulatory approach to CRAs. Its details however require an in-depth analysis to assess whether the rules on civil liability of CRAs appropriately supplement the sanctions that the European Securities and Markets Authority (ESMA) might impose on CRAs in case of infringements of the regulatory regime. This paper focuses on selected private international law issues linked to the new European civil liability regime for CRAs. It first concisely introduces the design of the civil liability rules in the broader context of the regulatory framework for CRAs. This is followed by an analysis of the main private international law problems expected to occur when applying the new civil liability rules for CRAs. Against the backdrop of these findings the paper shows that the civil liability of CRAs as designed by the second reform appears to have only limited potential to achieve its ambitious goals. The exploration of the civil liability regime for CRAs in the Union from the perspective of private international law might be considered also to contribute to the general legal (-practical) and

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dogmatic discourse on liability rules in the realm of European financial market law. This debate has gained further momentum in the aftermath of the financial crisis and might lead to further actions of the European and national legislators in the near future.

A. INTRODUCTION

The core legal acts¹ of the regulatory and supervisory regime for CRAs in the Union are currently the Regulation (EC) No 1060/2009 on credit rating agencies² (CRA Regulation), which has been amended in rapid succession by the Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies, Regulation (EU) No 513/2011³ (1st Reform Regulation) and most recently by the Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies, Regulation (EU) No 462/2013⁴ (2nd Reform Regulation). Apart from these sector-specific regulations the Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority)⁵ (ESMA Regulation) plays a pivotal role with a view to the organisation, functioning and powers of ESMA. Whereas the CRA Regulation⁶ introduced for the first time a legally binding regulatory framework for CRAs in the Union, the 1st Reform Regulation transferred the exclusive power to register and supervise CRAs in the Union on ESMA.⁷ The recent 2nd Reform Regulation aims mainly at addressing those issues which were considered to have not been adequately solved. One of these 'leftovers' was the lack of a European approach to civil liability of CRAs.

¹ For more information on this and the various relevant Commission Delegated Regulations, see Gudula Deipenbrock, *Die zweite Reform des europäischen Regulierungs- und Aufsichtsregimes für Ratingagenturen – Zwischenstation auf dem Weg zu einer dritten Reform?*, 49 Wertpapier-Mitteilungen 2289, 2289 et seq. (2013). For a concise summary of the second reform of the regulatory and supervisory regime for CRAs, see Gudula Deipenbrock, *Der Stein des Sisyphus? – Die zweite Reform der europäischen Verordnung über Ratingagenturen*, 8 Recht der Internationalen Wirtschaft, 'Die erste Seite' (2013).

² Official Journal (OJ) EU L 302/L, 17 November 2009. The CRA Regulation came into force in December 2009.

³ OJ EU L 145/30, 31 May 2011. The 1st Reform Regulation came into force in June 2011.

⁴ OJ EU L 146/L, 31 May 2013. The 2nd Reform Regulation came into force in June 2013.

⁵ OJ EU L 331/84, 15 December 2010. The ESMA Regulation came into force in December 2010.

⁶ Unless expressly stated otherwise, this paper refers to provisions of the 'CRA Regulation' in the version of the CRA Regulation as amended by the 1st Reform Regulation. It marks provisions of the CRA Regulation which have been amended by the 2nd Reform Regulation by referring to 'CRA Regulation (new)'.

⁷ For more information on the 'regulatory rule book' for CRAs, see Gudula Deipenbrock, *Trying or failing better next time? – The European legal framework for credit rating agencies after its second reform*, in the process of publication.

B. CIVIL LIABILITY RULES – SOME GENERAL CONSIDERATIONS ON THEIR EFFECTS IN FINANCIAL MARKETS

The newly introduced civil liability regime for CRAs is aimed to supplement the administrative sanctions as provided in the CRA Regulation (new).⁸ Any preventive effects and behavioural monitoring or control by means of civil law might well be discussed controversially. From the German perspective the distinction between three legal disciplines including their however disputable autonomous objectives comes into play: (1) administrative law and the rule of law, (2) criminal law and the ‘evenness’ of punishment, and (3) private law and the principle of private autonomy.⁹ This dogmatic distinction has made it even more debatable which of the legal disciplines – altogether or separately – should perform a controlling function and how to tackle the thin line between prevention and penalization.¹⁰ But even this strict perspective might not seriously deny the controlling task of private law. The use of a smart mix of controlling instruments from various legal disciplines might enhance the potential to achieve the legislative goals.¹¹ One example is the realm of European competition law in which private enforcement was ‘discovered’ as an appropriate facet of effective enforcement of the competition rules thereby avoiding an enlargement of the surveillance apparatus.¹² Civil liability has been regarded also as an instrument to govern financial markets, the so-called regulation through litigation.¹³ With a view to the credit rating sector it has been argued that civil liability might have a preventive, disciplining effect on the conduct of CRAs and their analysts.¹⁴ Introducing a European civil liability regime to the Union’s credit rating sector might generally be regarded as fostering the compliance of CRAs with the relevant regulatory and supervisory rules

⁸ See Art. 35a Section 6 of the CRA Regulation (new) which provides that the right of redress set out in this article shall not prevent ESMA from fully performing its powers as laid down in Art. 36a of the CRA Regulation (new).

⁹ For a critical approach to this with further references, see e.g. Gerhard Wagner, *Prävention und Verhaltenssteuerung durch Privatrecht – Anmaßung oder legitime Aufgabe?*, 206 Archiv für die civilistische Praxis 352, 360 (2006).

¹⁰ See e.g. Gerhard Wagner, *Prävention und Verhaltenssteuerung durch Privatrecht – Anmaßung oder legitime Aufgabe?*, 206 Archiv für die civilistische Praxis 352, 360 et seq. (2006).

¹¹ See e.g. Gerhard Wagner, *Prävention und Verhaltenssteuerung durch Privatrecht – Anmaßung oder legitime Aufgabe?*, 206 Archiv für die civilistische Praxis 352, 435 (2006).

¹² See e.g. Gerhard Wagner, *Prävention und Verhaltenssteuerung durch Privatrecht – Anmaßung oder legitime Aufgabe?*, 206 Archiv für die civilistische Praxis 352, 447 et seq. (2006).

¹³ For more information on this with further references, see Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 IPRax 399, 400 (2012).

¹⁴ See e.g. Marthe-Marie Stemper, *Rechtliche Rahmenbedingungen des Ratings*, 161 (1st ed., Nomos C.H. Beck 2010).

in addition to any regulatory sanctions available. Civil liability towards investors might help restore confidence in the credit rating market. Civil liability towards issuers might strengthen their position towards CRAs. Recital 32 of the 2nd Reform Regulation explains why the European legislator introduced a new civil liability regime. It argues that issuers might face difficulties in enforcing CRAs' civil liability towards them in the absence of a contractual relationship and even also when they have a contractual relationship with the CRAs. Recital 32 of the 2nd Reform Regulation proceeds that claiming damages for an infringement of the CRA Regulation should be available for all investors and issuers whether or not there is a contractual relationship with the CRAs. The enforcement of civil liability of CRAs in national law systems¹⁵ encounters several difficulties. They range from the lack of specific liability provisions expressly addressing CRAs' activities and the lack of general liability provisions applicable to CRAs to the alleged quality of credit ratings as 'opinions'. From the multiple aspects to be analysed in context with the new civil liability rules for CRAs the paper focuses on the private international law perspective. Its findings shall contribute to the debate of whether this European civil liability regime might have the potential to strengthen the efficiency and effectiveness of the Union's regulatory and supervisory framework for CRAs. When exploring the European civil liability regime for CRAs in the Union below any reference to 'CRAs' shall be a reference to only those CRAs which fall within the scope of the relevant rules – unless the context suggests otherwise.

C. THE NEW CIVIL LIABILITY REGIME UNDER THE 2ND REFORM REGULATION

The new civil liability regime for CRAs is provided in Art. 35a of the CRA Regulation (new).¹⁶ The enacted version of Art. 35a of the CRA Regulation (new) differs significantly from the Commission's Proposal.¹⁷ On the one hand the group of claimants has been widened from only investors – as provided in the Commission's Proposal – to investors and issuers. On the other hand, the civil liability regime has been weakened in favour

¹⁵ For more information on early approaches to this issue from the German perspective, see Gudula Deipenbrock, *Externes Rating – "Heilsversprechen für internationale Finanzmärkte"?*, 36 *Betriebs-Berater* 1849 (2003). For more information on the current German perspective, see e.g. Marthe-Marie Arntz, *Die Haftung von Ratingagenturen gegenüber fehlerhaft bewerteten Staaten und Unternehmen*, 3 *Zeitschrift für Bank- und Kapitalmarktrecht* 89 (2012).

¹⁶ For more information on this, see e.g. Brigitte Haar, *Neues zur Haftung von Ratingagenturen im Zuge der zweiten Novelle der Rating-Verordnung (CRA III)?*, 44 *Der Betrieb* 2489 (2013); Karl-Philipp Wojcik, *Zivilrechtliche Haftung von Ratingagenturen nach europäischem Recht*, 33 *Neue Juristische Wochenschrift* 2385 (2013).

¹⁷ Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies, COM (2011) 747 final, 15 November 2011, 33.

of CRAs. The enacted version of the rule imposes the burden of proof on investors and issuers. In addition, it allows – although restrictedly – limiting the civil liability in advance. Article 35a of the CRA Regulation (new) provides that where a CRA has committed intentionally or with gross negligence any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that CRA for damage caused to it due to that infringement. It states that an investor might claim damages where it establishes that it has reasonably relied, in accordance with Art. 5a Section 1 or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating. The civil liability rule provides further that an issuer may claim damages under this article where it establishes that it or its financial instruments are covered by that credit rating and the infringement was not caused by misleading and inaccurate information provided by the issuer to the CRA, directly or through information publicly available. In addition, any limitation in advance of the civil liability of CRAs has to meet the requirements under Art. 35a Section 3 of the CRA Regulation (new). According to Art. 35a Sections 5 and 6 of the CRA Regulation (new) the right of redress shall neither exclude further civil liability claims in accordance with national law nor prevent ESMA from fully performing its powers under Art. 36a. It shall be the responsibility of the investor or issuer under Art. 35a Section 2 of the CRA Regulation (new) to present accurate and detailed information indicating that the CRA has infringed the CRA Regulation which had an impact on the credit rating issued. The provision however does not further define what constitutes ‘accurate and detailed information’. It provides instead that this has to be assessed by the competent national court which thereby shall take into consideration that the investor or issuer may not have access to information which is purely within the sphere of the CRA. The European legislator abstains also from providing full-fledged definitions of other constituent elements of Art. 35a of the CRA Regulation (new). Under Art. 35a Section 4 of the CRA Regulation (new) the terms ‘damage’, ‘intention’, ‘gross negligence’, ‘reasonably relied’, ‘due care’, ‘impact’, ‘reasonable’ and ‘proportionate’ which are referred to in this article but are not defined shall be interpreted and applied in accordance with the applicable national law as determined by the relevant rules of private international law. It states in addition, that matters concerning the civil liability of a CRA which are not covered by the CRA Regulation shall be governed by the applicable national law as determined by the relevant rules of private international law. The competent court to decide on a claim for civil liability brought by an investor or issuer shall be determined by the relevant rules of private international law according to Art. 35a Section 4 of the CRA Regulation (new).

The structure and wording of Art. 35a of the CRA Regulation (new) raise multiple legal questions which are crucial to its application. Procedural complications appear to be inevitable such as those linked to the burden of proof rule. Cross-border investigations and enforcement reveal manifold uncertainties also from the regulatory view. Above all, problems might occur when just applying the constituent elements of the provision to the various liability scenarios. The references to the applicable national law to be determined by private international law rules in particular add another layer of complexity to the provision. It becomes clear from that, that the European legislator did not create a complete and elaborate European civil liability norm defining all of its constituent elements. It rather provides only a rudimentary liability concept which has to be complemented by the relevant applicable national law. This does not only complicate the enforcement but adds to a re-nationalisation and fragmentation of the European civil liability regime for CRAs. The paper focuses below on the private international law issues of the concept of Art. 35a of the CRA Regulation (new).

D. THE PRIVATE INTERNATIONAL LAW ISSUES OF ART. 35A OF THE CRA REGULATION (NEW) – SETTING THE SCENE

I. Some Fundamental Legal Considerations

Some fundamental legal considerations shall prepare the ground for a more detailed analysis of the private international law issues of Art. 35a of the CRA Regulation (new). To this end, the legal nature of the CRA Regulation and its relationship to the national law of the Member States of the Union (Member States) should be highlighted first. The CRA Regulation is a European regulation. It forms part of European secondary law. Under Art. 288 of the Treaty on the Functioning of the European Union (TFEU)¹⁸ a regulation shall have general application and shall be binding in its entirety and be directly applicable in all Member States. The direct applicability of a European regulation signifies that it is part of the national legal systems of the Member States without any transformation or adoption by separate national legal measures.¹⁹ Such status of a European regulation corresponds to that of a national code in the legal systems of Member States and might therefore bind individuals also.²⁰ Thus, a European regulation is capable of being relied upon and enforced by individuals before their national courts if its provisions are sufficiently clear, precise, and relevant to the situation

¹⁸ OJ EU C 83/47, 30 March 2010.

¹⁹ Paul Craig, Gráinne de Búrca, *EU Law*, 105 (5th ed., Oxford University Press 2011).

²⁰ Harald Koch, Ulrich Magnus, Peter Winkler von Mohrenfels, *IPR und Rechtsvergleichung*, 5 (4th ed., C.H. Beck 2010).

of an individual litigant.²¹ Apart from the direct applicability of a European regulation the principle of primacy of Union law over national law as developed by the Union Courts has to be taken into account. According to this principle a Union measure renders inapplicable any conflicting provision of national law and prevents the adoption of new national law that would conflict with Union law.²² Accordingly, the CRA Regulation is (1) directly applicable, and (2) prevails over conflicting national law in the Member States. With a view to the principle of primacy of a European regulation, however, the design of Art. 35a of the CRA Regulation (new) requires a more sophisticated approach. In so far as Art. 35a of the CRA Regulation (new) refers to the applicable national law in order to interpret and apply the terms of the provision or to govern matters not covered by the civil liability regime of the CRA Regulation (new) the application of the national law falls outside the scope of the principle of primacy. The same applies to Art. 35a Section 5 of the CRA Regulation (new) which allows further civil liability claims in accordance with national law. Taking this approach, the Union legislator did not create a 'stand-alone' European civil liability norm for CRAs defining all of its constituent elements. It rather preferred a civil liability framework for CRAs to be supplemented considerably by the relevant applicable national law. Hence, the primary European civil liability regime is provided in the CRA Regulation (new). The relevant secondary or subsidiary civil liability regime is the applicable substantive national law to which Art. 35a Section 4 of the CRA Regulation (new) refers twice. Firstly, the applicable national law shall be decisive for the interpretation and application of all terms used but not defined by the CRA Regulation (new). Secondly, the applicable national law shall fill all gaps concerning the civil liability of a CRA not covered by the CRA Regulation (new). By that, the applicable national law as the subsidiary civil liability regime becomes decisive for the application of Art. 35a of the CRA Regulation (new). The same is true for the relevant private international law rules which shall determine the applicable national law. This law-making technique is not profoundly novel to Union law. The Court of Justice of the Union (CoJ) has encountered the limits of the principle that Union law has to be interpreted and applied autonomously without referring to the national law of the Member States particularly in liability cases or remained cautious regarding the uniform interpretation of general clauses.²³ The extent to which Art. 35a of the CRA Regulation (new) refers to the applicable national law however is remarkable. This

²¹ For more information on this with further references, see Paul Craig, Gráinne de Búrca, *EU Law*, 190 (5th ed., Oxford University Press 2011).

²² For more information on this with further references, see Paul Craig, Gráinne de Búrca, *EU Law*, 264 et seq. (5th ed., Oxford University Press 2011).

²³ For more information on this, see e.g. Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1730 (2013).

approach leaves only little room for an autonomous interpretation of the European civil liability regime.²⁴ The importance of the applicable national law in this context enhances also the status of the role the relevant rules of private international law play in applying Art. 35a of the CRA Regulation (new). The main civil liability scenarios here might be grouped according to who brings the claim – either an issuer or an investor – and whether or not the claimant and the defendant – here the CRA – have entered before into a contractual relationship. An investor might have concluded a contract with a CRA by subscribing to its publications or might not have any contractual relationship with it.²⁵ An issuer might have concluded a rating agreement with a CRA (solicited rating) or not (unsolicited rating).²⁶ The analysis below assesses also whether or not the variations in these civil liability scenarios impact the private international law issues linked to Art. 35a of the CRA Regulation (new).

II. The References to Private International Law in Art. 35a of the CRA Regulation (new)

Private international law forms part of the national law system. It applies only in situations involving one or more elements foreign to the internal social system of a country thereby giving the legal systems of several countries claims to apply ('international situations').²⁷ A court hearing a case involving a conflict of laws determines the applicable substantive law by the private international law rules forming part of its own national law system. The following analysis of what national law might be applicable to the various elements of Art. 35a of the CRA Regulation (new) is conducted – unless expressly stated otherwise – from the perspective of a German court. Private international law rules are referred to in Art. 35a of the CRA Regulation (new) either expressly or impliedly regarding (1) the assessment of 'accurate and detailed information' by the competent national court in connection with the investor's or issuer's burden of proof, and (2) the determination of the competent national courts in this context, (3) the interpretation and application of the terms 'damage', 'intention', 'gross negligence', 'reasonably relied', 'due care', 'impact',

²⁴ See also e.g. Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1730 (2013).

²⁵ For more information on the liability scenarios regarding investors, see Marthe-Marie Stemper, *Rechtliche Rahmenbedingungen des Ratings*, 172 et seq. (1st ed., Nomos C.H. Beck 2010).

²⁶ For more information on the liability scenarios regarding the rated entities, see Marthe-Marie Stemper, *Rechtliche Rahmenbedingungen des Ratings*, 161 et seq. (1st ed., Nomos C.H. Beck 2010).

²⁷ For more information on this with further references, see Matthias Weller in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 1 of the Rome I Regulation para 19 (Kluwer Law International 2011).

'reasonable' and 'proportionate', and (4) matters of civil liability of a CRA not covered in the CRA Regulation. In addition, Art. 35a Section 5 of the CRA Regulation (new) implies the application of private international law, also. It states that the article does not exclude further civil liability claims in accordance with national law. Such national law, however, has to be determined also by the relevant rules of private international law. This paper puts the main emphasis on the private international law issues of the European civil liability regime for CRAs in a strict sense. Issues of international civil procedural law relevant to the application of Art. 35a of the CRA Regulation (new) are therefore not further analysed below. Thus, the interpretation of the burden of proof rule by the competent national court and the determination of the competent court²⁸ fall outside the scope of this analysis. Rather, the express references to private international law are examined with a view to firstly, the interpretation and application of terms not defined in Art. 35a of the CRA Regulation (new), and secondly, the matters of civil liability of a CRA not covered in the CRA Regulation.

E. THE PRIVATE INTERNATIONAL LAW ISSUES IN ART. 35A SECTION 4 SENTENCES 1 AND 2 OF THE CRA REGULATION (NEW) IN MORE DETAIL

According to Art. 35a Section 4 Sentence 1 of the CRA Regulation (new) terms such as 'damage', 'intention', 'gross negligence', 'reasonably relied', 'due care', 'impact', 'reasonable' and 'proportionate' which are referred to in this article but are not defined shall be interpreted and applied in accordance with the applicable national law as determined by the relevant rules of private international law. In addition, Art. 35a Section 4 Sentence 2 of the CRA Regulation (new) provides that matters concerning the civil liability of a CRA which are not covered by the regulation shall be governed by the applicable national law as determined by the relevant rules of private international law. One might consider Art. 35a Section 4 Sentence 2 an omnibus clause. A matter not covered in the CRA Regulation is in particular the concept of 'causation' as Recital 35 of the 2nd Reform Regulation points out. Despite their legal methodological differences the above listed two references to the applicable national law refer to the same set of substantive rules: the subsidiary civil liability regime for CRAs to be determined in context with Art. 35a of the CRA Regulation (new). The paper explores below from the perspective of a German court how to determine the subsidiary civil liability regime by means of the relevant rules of private international law.

²⁸ See e.g. Peter Kindler, *Einführung in das neue IPR des Wirtschaftsverkehrs*, 2 et seq. (Verlag Recht und Wirtschaft 2009).

I. Situations Involving a Conflict of Laws

If an action under Art. 35a of the CRA Regulation (new) is brought before a German court the court will refer to the national private international law in order to determine the applicable (substantive) national law. The German statute on autonomous private international law is provided in the German Introductory Act to the Civil Code (EGBGB). Under Art. 3 of the EGBGB rules of private international law apply when the facts of the case are connected to a foreign country thereby involving a conflict of laws. In such cases involving a conflict of laws, the German court determines the relevant set of private international law rules under Art. 3 of the EGBGB. In all other cases not connected to a foreign country, the German court applies directly the *lex fori* that is the German substantive law.

In accordance with the hierarchy of norms Art. 3 of the EGBGB states that unless (1) immediately applicable rules of the Union apply, in particular Regulation (EC) No 864/2007 on the law applicable to non-contractual obligations (Rome II Regulation)²⁹, and the Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I Regulation)³⁰, or (2) rules in international conventions, insofar as they have become directly applicable in national law, the Second Chapter of the EGBGB applies.

II. Article 3 No 1 and No 2 of the EGBGB

Under Art. 3 No 2 of the EGBGB rules in international conventions, insofar as they have become directly applicable in national law take precedence over the autonomous German private international law. International conventions which created substantive uniform law exist in the realms of transport law, sales law and tort law.³¹ From the perspective of German law, no relevant rules of international conventions³² addressing the civil liability of CRAs might be determined. Rather, directly applicable Union law according to Art. 3 No 1 of the EGBGB might be relevant, here. Under Art. 3 No 1 of the EGBGB directly applicable rules of the Union, particularly the Rome I Regulation and Rome II Regulation³³ prevail over the autonomous national private international law. The list of European legal acts in Art. 3 No 1 of the EGBGB is not exhaustive. Hence, other specific European legal acts might take precedence over the listed ones as *leges speciales*. In this context,

²⁹ OJ EU L 199/40, 31 July 2007.

³⁰ OJ EU L 177/6, 4 July 2008.

³¹ For more information on this with further references, see Harald Koch, Ulrich Magnus, Peter Winkler von Mohrenfels, *IPR und Rechtsvergleichung*, 129 and 149 (4th ed., C.H. Beck 2010).

³² See e.g. Karsten Thorn in Palandt, *Bürgerliches Gesetzbuch*, Art. 3 of the EGBGB para 10 and Einleitung v EGBGB 3 para 6 (73rd ed., C.H. Beck 2014).

³³ The third legal act of the Union listed in Art. 3 No 1 c) of the EGBGB addresses maintenance obligations and is thereby not of interest in this context.

the CRA Regulation (new) could be considered as a *lex specialis* provided that it lays down directly applicable private international law rules addressing the European civil liability regime for CRAs. This is however not the case. The CRA Regulation (new) only expressly refers to the relevant rules of private international law. It does not stipulate such private international law rules which determine the applicable national substantive law.³⁴ Thus, the analysis proceeds with exploring the Rome Regulations. They provide uniform European private international law rules on contractual obligations (Rome I Regulation) and non-contractual obligations (Rome II Regulation). The decision on which of the Rome Regulations applies in context with Art. 35a Section 4 of the CRA Regulation (new) requires assessing the European civil liability of CRAs as either a contractual or a non-contractual obligation (liability). This raises the question of how to interpret the concepts of contractual and non-contractual obligations. The Rome Regulations do not provide a general rule of interpretation. Thus, the general principles developed in context with the interpretation of secondary Union law apply in order to secure uniformity in their interpretation.³⁵ The exclusive competence to set out the rules of interpretation of Union secondary law lies generally with the CoJ which has developed such principles from an autonomous, supranational point of view.³⁶ Hence, the autonomous concepts of contractual and non-contractual obligations decide on the qualification of the civil liability provision of Art. 35a of the CRA Regulation (new). To this end it appears to be methodologically justified – see Recital 7 of each of the Rome Regulations – to refer to the case law of the CoJ on the Union’s international civil procedural law, the Brussels I Regulation³⁷ in particular.³⁸ In this context, the CoJ embarked on a rather strict concept of contract. The core criterion of the European concept of contract is the free assumption of an obligation of the parties vis-à-vis each other presupposing the achievement of a direct or indirect agreement.³⁹

³⁴ See also Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1730 (2013).

³⁵ See Graf-Peter Callies in Graf-Peter Callies (ed.), *Rome Regulations*, Introduction para 27 (Kluwer Law International 2011).

³⁶ For more information on this with further references, see Graf-Peter Callies in Graf-Peter Callies (ed.), *Rome Regulations*, Introduction paras 28 and 30 (Kluwer Law International 2011).

³⁷ Regulation (EC) No 44/2001, OJ EC L 12/1, 16 January 2001, recast by Regulation (EU) No 1215/2012, OJ EU L 351/1, 20 December 2012. For more information on this, see Jan von Hein, *Die Neufassung der Europäischen Gerichtsstands- und Vollstreckungsverordnung (EuGVVO)*, 3 Recht der Internationalen Wirtschaft 97 (2013).

³⁸ See also Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1731 (2013).

³⁹ See e.g. with a view to the Brussels Convention CoJ Case C-265/02 *Frahuil* paras 24 et seq. (2004). For more information on this with further references to relevant case law, see Matthias Weller in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 1 of the Rome I Regulation para 13 (Kluwer Law International 2011).

Under Art. 35a of the CRA Regulation (new), however, an investor or issuer might bring a claim for damages against a CRA that infringed intentionally or with gross negligence specified rules of the CRA Regulation which had an impact on the CRA's credit rating and caused such damage. A credit rating addresses generally an indeterminate group of people. According to Recital 32 of the 2nd Reform Regulation credit ratings whether issued for regulatory purposes or not, have a significant impact on investment decisions and on the image and financial attractiveness of issuers. Hence, CRAs have an important responsibility towards investors and issuers in ensuring that they comply with the CRA Regulation so that their credit ratings are independent, objective and of adequate quality. In addition, Recital 32 of the 2nd Reform Regulation concludes that the possibility to claim damages for an infringement of the CRA Regulation should be available for all investors and issuers, regardless of whether there is a contractual relationship between the parties. The requirements the CRAs have to meet when issuing a credit rating under the CRA Regulation (new) are therefore primarily obligations towards everybody ('*Jedermannspflichten*')⁴⁰ acting in the financial market. As the European civil liability regime for CRAs does expressly not presuppose a contractual relationship between the investor/issuer and the CRA it should fall outside of the scope of the Rome I Regulation. To obligations that are not based on a voluntary declaration as it is typically the case in contracts the concept of non-contractual obligations of the Rome II Regulation applies.⁴¹ The civil liability under Art. 35a of the CRA Regulation (new) constitutes a non-contractual obligation according to the autonomous concept of non-contractual obligations and the more specific concepts mentioned in Art. 2 of the Rome II Regulation such as the concept of tort/delict and *culpa in contrahendo*.⁴² At this stage, it is not required to assess whether the civil liability rule constitutes a tort or a *culpa in contrahendo*. The Rome II Regulation covers both forms of civil liability in contrast to the German and Austrian civil law dogmatic view⁴³ and this is explored further below.

⁴⁰ For more information on this with a view to the prospectus liability, see Abbo Junker, *Der Reformbedarf im Internationalen Deliktsrecht der Rom II-Verordnung drei Jahre nach ihrer Verabschiedung*, 5 *Recht der Internationalen Wirtschaft* 257, 261 (2010).

⁴¹ See Axel Halfmeier in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 1 of the Rome II Regulation para 29 (Kluwer Law International 2011).

⁴² See also Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 *Wertpapier-Mitteilungen* 1729, 1731 (2013).

⁴³ For further references, see Christian Schmitt, *Die kollisionsrechtliche Anknüpfung der Prospekthaftung im System der Rom II-Verordnung*, 9 *Zeitschrift für Bank- und Kapitalmarktrecht* 366, 367 et seq. (2010). See also Jan von Hein in Harald Baum et al. (eds.), *Perspektiven des Wirtschaftsrechts* 371, 378 (De Gruyter Recht 2008).

III. Application of the Rome II Regulation

The interim result so far is that – from the perspective of a German court – the Rome II Regulation applies in order to determine the subsidiary civil liability regime for CRAs. As all other Member States – with the exception of Denmark – might apply also in general the Rome II Regulation in this context, this result is in line with the European decisional harmony.⁴⁴ Before turning to the specific private international law rules of the Rome II Regulation all three aspects of its scope of application are to be considered first: the subject matter, the temporal and the universal scope of application. Firstly, as to the subject matter the liability in question must be a non-contractual obligation in civil and commercial matters and should not be excluded by Art. 1 Section 2 of the Rome II Regulation. As already stated above, the European civil liability regime for CRAs is to be considered a non-contractual obligation under the Rome II Regulation. In addition, none of the exclusions in Art. 1 Section 2 of the Rome II Regulation applies. This is true in particular for the non-contractual obligations excluded by Art. 1 Section 2 (c) and (d) of the Rome II Regulation. The civil liability regime for CRAs in question is neither to be considered a genuine securities law nor a company law issue.⁴⁵ Secondly, with a view to the temporal scope of the Rome II Regulation under its Art. 31, the Regulation applies only to events giving rise to damage which occur after its entry into force (11 January 2009). Thirdly, the universal application of the Rome II Regulation has to be swiftly highlighted. Under Art. 3 of the Rome II Regulation any law specified by its rules shall be applied whether or not it is the law of a Member State. The Rome II Regulation is designed as a *loi uniforme*.⁴⁶ It is applied from the perspective of a German court even if the applicable law is not that of a Member State.⁴⁷ Bearing this in mind the paper explores below what specific provision of the Rome II Regulation applies to determine the subsidiary civil liability regime in context with Art. 35a of the CRA Regulation (new).

⁴⁴ See also Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1731 (2013).

⁴⁵ For more information on the considerations in context with the prospectus liability, see Peter Mankowski in Christoph Reithmann, Dieter Martiny, *Internationales Vertragsrecht*, para 2530 (7th ed., Otto Schmidt 2010). See also Christian Schmitt, *Die kollisionsrechtliche Anknüpfung der Prospekthaftung im System der Rom II-Verordnung*, 9 Zeitschrift für Bank- und Kapitalmarktrecht 366, 368 et seq. (2010).

⁴⁶ See e.g. Thomas Rauscher, *Klausurenkurs im Internationalen Privatrecht*, para 832 (3rd ed., C.F. Müller 2013).

⁴⁷ The Rome II Regulation however is not applied by Danish courts as it is not applicable in Denmark (see Harald Koch, Ulrich Magnus, Peter Winkler von Mohrenfels, *IPR und Rechtsvergleichung*, 149 (4th ed., C.H. Beck 2010).

1. Article 27 of the Rome II Regulation

Before analysing any of the specific private international law rules of the Rome II Regulation one has to consider first its Art. 27.⁴⁸ It states that the Rome II Regulation shall not prejudice the application of provisions of Union law which, in relation to particular matters, lay down private international law rules relating to non-contractual obligations. Such *leges speciales*⁴⁹ prevail over the Rome II Regulation insofar as they cover the facts of the case, but allow applying the Rome II Regulation in addition with a view to any matter not addressed. As stated above,⁵⁰ no prior-ranking specific private international law rules at Union level appear to address the civil liability regime of CRAs. This is true in particular with a view to Art. 35a of the CRA Regulation (new) which only refers to the relevant rules of private international law but does not provide such rules. It might be argued, however, that the country-of-origin principle is a primary Union law principle under Art. 27 of the Rome II Regulation which takes precedence over its specific rules.⁵¹ One might have to admit here, that the issue of the country-of-origin principle appears to have remained unsolved by Art. 27 of the Rome II Regulation.⁵² But even if one agrees to the debatable hypothesis that the country-of-origin principle forms part of primary Union law⁵³ its use as a private international law rule in context with the European civil liability regime for CRAs appears to be highly questionable. The Union legislator could have expressly mentioned the country-of-origin principle in context with the private international law references in Art. 35a of the CRA Regulation (new) but did not do so. Instead, Art. 35a of the CRA Regulation (new) expressly refers to private international law rules in general without detailing it further. Thus, the country-of-origin principle might not be referred to,

⁴⁸ For more information on this in context with the private international law issues of the German statutory prospectus liability, see e.g. Philipp Tschäpe, Robert Kramer, Oliver Glück, *Die Rom II-Verordnung – Endlich ein einheitliches Kollisionsrecht für die gesetzliche Prospekthaftung?*, 10 *Recht der Internationalen Wirtschaft* 657, 663 et seq. (2008).

⁴⁹ For more information on this in context with the private international law issues of the German statutory prospectus liability, see e.g. Philipp Tschäpe, Robert Kramer, Oliver Glück, *Die Rom II-Verordnung – Endlich ein einheitliches Kollisionsrecht für die gesetzliche Prospekthaftung?*, 10 *Recht der Internationalen Wirtschaft* 657, 663 (2008).

⁵⁰ See item E.II.

⁵¹ For more information on this in context with the private international law issues of the German statutory prospectus liability, see e.g. Philipp Tschäpe, Robert Kramer, Oliver Glück, *Die Rom II-Verordnung – Endlich ein einheitliches Kollisionsrecht für die gesetzliche Prospekthaftung?*, 10 *Recht der Internationalen Wirtschaft* 657, 664 et seq. (2008).

⁵² For more information on this with further references, see Axel Halfmeier, Nicolas Sonder in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 27 of the Rome II Regulation para 4 (Kluwer Law International 2011).

⁵³ For a dissenting view in context with the prospectus liability and the relevant private international law, see Peter Mankowski in Christoph Reithmann, Dieter Martiny, *Internationales Vertragsrecht*, para 2531 (7th ed., Otto Schmidt 2010).

here. As relevant prior-ranking specific private international law rules at Union level are lacking Art. 27 of the Rome II Regulation might not be applied in context with Art. 35a of the CRA Regulation (new).

2. Article 14 of the Rome II Regulation

The specific rules on various non-contractual obligation scenarios of the Rome II Regulation apply unless the parties agreed to submit non-contractual obligations to the law of their choice as further detailed in Art. 14 of the Rome II Regulation. Such choice of law might be made by an agreement after the event giving rise to the damage occurred. It might be made also before such an event if all the parties are pursuing a commercial activity and freely negotiated such an agreement. Parties may not derogate from internally mandatory laws in purely domestic cases according to Art. 14 Section 2 of the Rome II Regulation and its Art. 14 Section 3 provides another limitation in cases where the parties have chosen the law of a third state in a substantially intra-Union case.⁵⁴ However, in the realms of unfair competition and intellectual property rights choice-of-law agreements are not permitted according to Art. 6 Section 4 and Art. 8 Section 3 of the Rome II Regulation. The issue of a choice-of-law agreement made before the event giving rise to the damage occurred between commercially active parties might be relevant in a case of a solicited rating where an issuer claims damages under Art. 35a of the CRA Regulation (new). The issue of a choice of law made by an agreement after the event giving rise to the damage occurred might be relevant mainly in cases of unsolicited ratings. It has been discussed in context with the German statutory prospectus liability whether and to what extent one might apply *mutatis mutandis* Art. 6 Section 4 of the Rome II Regulation.⁵⁵ The questions of whether this analogy (1) might be justified in context with cases involving the German statutory prospectus liability, and if so (2) might offer a solution also for cases involving the civil liability of CRAs under Art. 35a of the CRA Regulation (new) require a separate legal in-depth analysis. The present author views this approach so far with scepticism.⁵⁶ Article 35a of the CRA Regulation (new) does not address the issue of a choice of law of the parties but addresses a possible contractual relationship between the parties substantively by restricting namely the limitation of the civil liability of CRAs in advance. Therefore, arguing in favour of an unplanned loophole that might justify applying

⁵⁴ For more information on this with further references, see Jan von Hein in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 14 of the Rome II Regulation paras 38 et seq. (Kluwer Law International 2011).

⁵⁵ For more information on this, see Dorothee Einsele, *Internationales Prospekthaftungsrecht – Kollisionsrechtlicher Anlegerschutz nach der Rom II-Verordnung* -, 1 *Zeitschrift für europäisches Privatrecht* 23, 42 et seq. (2012). See also item E.III.4.

⁵⁶ For more information on this, see item E.III.4.

mutatis mutandis Art. 6 Section 4 of the Rome II Regulation appears to be less plausible. It remains to be seen in particular how the judiciary will approach this problem. The paper turns now to the problem of what specific rule of the Rome II Regulation fits best to determine the subsidiary civil liability regime for CRAs in all cases in which a valid agreement on the choice of law does not exist.

3. Article 12 of the Rome II Regulation

To the extent that a choice-of-law agreement is not effective according to Art. 14 of the Rome II Regulation⁵⁷ Art. 12 might be applicable which addresses cases of *culpa in contrahendo*. In order to apply Art. 12 of the Rome II Regulation to the European civil liability regime for CRAs it has to be classified as *culpa in contrahendo*. In contrast to the German and Austrian civil law dogmatic view⁵⁸ the Rome II Regulation covers both, tort and *culpa in contrahendo*. It thereby considers *culpa in contrahendo* a non-contractual phenomenon. As stated above⁵⁹ all terms including the concept of *culpa in contrahendo* of Art. 12 of the Rome II Regulation have to be interpreted autonomously from the Union perspective.⁶⁰ Article 12 Section 1 of the Rome II Regulation provides what law is applicable to a non-contractual obligation arising out of dealings prior to the conclusion of a contract, regardless of whether the contract was actually concluded or not. The main civil liability scenarios addressed by Art. 35a of the CRA Regulation (new) however involve investors or issuers as claimants as well as solicited or unsolicited ratings. The Union legislator explains in Recital 32 of the 2nd Reform Regulation that it aims to offer one basic claim for damages in connection with an infringement of the CRA Regulation (new) to all investors and issuers regardless of any existing contractual relationships to the relevant CRAs. The concept of *culpa in contrahendo* covers – if at all – not every civil liability scenario addressed by Art. 35a of the CRA Regulation (new). And applying different sets of private international law rules to the various civil liability cases for CRAs appears to be not in line with the legislative goals of the CRA Regulation (new). Any such fragmentation with a view to the applicable private international law in this context should be avoided. Thus, the civil

⁵⁷ See Boris Schinkels in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 12 of the Rome II Regulation para 19 (Kluwer Law International 2011).

⁵⁸ For further references, see Christian Schmitt, *Die kollisionsrechtliche Anknüpfung der Prospekthaftung im System der Rom II-Verordnung*, 9 *Zeitschrift für Bank- und Kapitalmarktrecht* 366, 367 et seq. (2010).

⁵⁹ See item E.II.

⁶⁰ In German financial market law the legal nature – either tort or *culpa in contrahendo* – of the variants of the prospectus liability has been passionately debated. For more information on this with further references, see e.g. Christoph Weber, *Internationale Prospekthaftung nach der Rom II-Verordnung*, 34 *Wertpapier-Mitteilungen* 1581, 1582 et seq. (2008).

liability of CRAs under Art. 35a of the CRA Regulation (new) is not to be considered a *culpa in contrahendo*. Article 12 of the Rome II Regulation does not apply in this context.

4. Article 4 of the Rome II Regulation

As none of the specific rules for special torts as provided in Art. 5 to Art. 9 and Art. 12⁶¹ of the Rome II Regulation covers the European civil liability regime for CRAs⁶² the general rule for torts in Art. 4 of the Rome II Regulation⁶³ might apply in this context in the absence of a valid choice-of-law agreement. Article 4 Section 2 of the Rome II Regulation provides that in cases in which the parties involved have both their habitual residence in the same country at the time when the damage occurs, the law of that country shall apply. In all other cases the applicable law shall be the law of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur. An escape clause is laid down in Art. 4 Section 3 of the Rome II Regulation. It provides that if the tort/delict is manifestly more closely connected with a country other than that indicated in Sections 1 or 2, the law of that other country shall apply. In order to determine the subsidiary civil liability regime in context with Art. 35a Section 4 Sentences 1 and 2 of the CRA Regulation (new) one has to consider Art. 4 Section 1 of the Rome II Regulation as the default rule. The civil liability of CRAs under Art. 35a of the CRA Regulation (new) is to be qualified as a tort in financial markets. Such a tort in financial markets might be defined as any civil liability caused by an unlawful action or omission in financial markets such as – although not in all cases available under German law – liability scenarios involving prospectus liability, wrong or omitted *ad-hoc* information, an infringement of disclosure obligations with a view to shareholding, unlawful takeover bids, insider-trading and market abuse.⁶⁴ The connecting factor of Art. 4 Section 1 of the Rome II Regulation leads to the *lex loci damni*. Hence, the law of the country in which the damage occurs is applicable in this context, irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur. The

⁶¹ See item E.III.3.

⁶² For more information on financial market torts in general, see Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 IPRax 399, 400 (2012).

⁶³ For more information on this in context with the prospectus liability with further references, see Abbo Junker, *Der Reformbedarf im Internationalen Deliktsrecht der Rom II-Verordnung drei Jahre nach ihrer Verabschiedung*, 5 Recht der Internationalen Wirtschaft 257, 262 (2010).

⁶⁴ Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 IPRax 399, 399 (2012).

country in which the damage occurs is the place of injury (*Erfolgsort* in the German terminology).⁶⁵ This is notoriously difficult to assess when even the initial damage suffered by the victim is to be considered a pure economic loss as is the case in Art. 35a of the CRA Regulation (new).⁶⁶ In this context, the *Kronhofer*⁶⁷ case of the CoJ in the realm of the Union's international civil procedural law offers guidance. Here, the country in which the damage occurs, the *Erfolgsort*, is defined as the location of the assets affected, or – secondarily- the location of the main assets of the victim in cases in which even the initial damage suffered by the victim is a pure economic loss.⁶⁸

The application of Art. 4 Section 1 of the Rome II Regulation with the *Erfolgsort* as the connecting factor has been much criticised with a view to financial market torts in general and the German (statutory) prospectus liability in particular.⁶⁹ For the purposes of this paper a concise sketch of what might require further consideration might suffice. In the critics' view the *Erfolgsort* as the connecting factor might lead to negative ramifications such as the application of multiple law systems to the tort, the risk that the applicable law is not predictable, the economic risk of increasing prices or even the abandonment of the transactions in question and the loss of regulatory power on the part of the market state as most probably not its own law will govern the civil liability.⁷⁰ Several alternative solutions have been put forward to replace the connecting factor of the country in which the damage occurs in context with financial market torts in general or the prospectus liability in particular. The paper examines whether these proposals offer an appropriate dogmatic starting point to solve the private international law problems in context with Art. 35a Section 4 Sentences 1 and 2 of the CRA Regulation (new).

With a view to the German statutory prospectus liability it has been proposed to apply the country-of-origin principle in particular as a

⁶⁵ For more information on this with further references, see e.g. Jan von Hein in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 4 of the Rome II Regulation para 14 (Kluwer Law International 2011).

⁶⁶ See also e.g. Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1731 (2013).

⁶⁷ See e.g. CoJ Case C-168/02 *Kronhofer v. Maier* (2004).

⁶⁸ For more information on this with further references, see e.g. Abbo Junker in *Münchener Kommentar zum Bürgerlichen Gesetzbuch* volume 10, Art. 4 of the Rome II Regulation para 21 (5th ed., C.H. Beck 2010).

⁶⁹ For more information on this with further references, see Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 IPRax 399, 400 et seq. (2012).

⁷⁰ For more information on the private international law of financial market torts in general, see Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 IPRax 399, 400 (2012).

specific European rule of private international law according to Art. 27 of the Rome II Regulation.⁷¹ This solution, however, has already been discarded above.⁷² Others have proposed to apply directly Art. 4 Section 3 of the Rome II Regulation in the realm of financial market tort and/or the prospectus liability in particular.⁷³ Article 4 Section 3 of the Rome II Regulation states that if the tort/delict is manifestly more closely connected with a country other than that indicated in Art. 4 Sections 1 or 2 of the Rome II Regulation, the law of that other country shall apply. It proceeds that such a manifestly closer connection with another country might be based in particular on a pre-existing relationship between the parties, such as a contract, that is closely connected with the tort/delict in question. When applying Art. 4 Section 3 of the Rome II Regulation, some argue with a view to the German prospectus liability in favour of (primarily) the market of placing of the securities as the connecting factor.⁷⁴ Others advocate characterizing securities liability accessorially to the applicable capital markets duties.⁷⁵ In the latter view, this solution leads in most Union cases to the law of the state where the issuer is incorporated, the *lex incorporationis* of the issuer.⁷⁶ With respect to the European civil liability of CRAs the present author views the application of Art. 4 Section 3 of the Rome II Regulation as a default rule with scepticism. Firstly, the pre-existing relationship between the parties such as a contract, as an exemplary basis for a closer connection with another country does not exist in all civil liability scenarios under Art. 35a of the CRA Regulation (new). And even if one proposes to derive such a pre-existing relationship from public law it would not offer a basis for an accessory connection in context with Art. 35a of the CRA Regulation (new). Here, the civil liability of CRAs might not be connected to the law governing the requirements of the issuance of the credit rating in

⁷¹ See e.g. Philipp Tschäpe, Robert Kramer, Oliver Glück, *Die Rom II-Verordnung – Endlich ein einheitliches Kollisionsrecht für die gesetzliche Prospekthaftung?*, 10 *Recht der Internationalen Wirtschaft* 657, 663 et seq. and 667 (2008).

⁷² See item E.III.1.

⁷³ For more information on the various approaches regarding the international prospectus liability, see Christian Schmitt, *Die kollisionsrechtliche Anknüpfung der Prospekthaftung im System der Rom II-Verordnung*, 9 *Zeitschrift für Bank- und Kapitalmarktrecht* 366 (2010).

⁷⁴ See e.g. Christoph Weber, *Internationale Prospekthaftung nach der Rom II-Verordnung*, 34 *Wertpapier-Mitteilungen* 1581, 1586 et seq. (2008).

⁷⁵ See e.g. Wolf-Georg Ringe, Alexander Hellgardt, *The International Dimension of Issuer Liability – Liability and Choice of Law from a Transatlantic Perspective*, 1 *Oxford Journal of Legal Studies* 23, 45 et seq. and 54 et seq. (2011).

⁷⁶ See e.g. Wolf-Georg Ringe, Alexander Hellgardt, *The International Dimension of Issuer Liability – Liability and Choice of Law from a Transatlantic Perspective*, 1 *Oxford Journal of Legal Studies* 23, 54 (2011). See Alexander Hellgardt, Wolf-Georg Ringe, *Internationale Kapitalmarkthaftung als Corporate Governance*, 173 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 802, 833 (2009).

question.⁷⁷ Such requirements are provided in the CRA Regulation as a European legal secondary act and not in national law. Secondly, Art. 4 Section 3 of the Rome II Regulation is an escape clause. This entails that it has an exceptional character.⁷⁸ As an escape clause it aims to offer narrowly interpreted exceptions to individual cases serving the objective of justice (*Einzelfallgerechtigkeit*) but might not be used as a general rule addressing a specific tort.⁷⁹ Hence, the subsidiary civil liability regime for CRAs might not be determined by applying Art. 4 Section 3 of the Rome II Regulation as a default rule.

In context with the German statutory prospectus liability, Art. 6 of the Rome II Regulation has inspired other critics to advocate the market of placing of the relevant securities as the connecting factor.⁸⁰ Article 6 of the Rome II Regulation provides specific private international law rules for non-contractual obligations arising out of an act of unfair competition and out of a restriction of competition. It is questionable whether this solution might be used for the benefit of determining the applicable national law in connection with Art. 35a Section 4 Sentences 1 and 2 of the CRA Regulation (new). From the dogmatic viewpoint the application *mutatis mutandis* of Art. 6 of the Rome II Regulation requires at first a relevant unplanned loophole in the Rome II Regulation. Such an unplanned loophole however does not exist as the general rule of Art. 4 Section 1 of the Rome II Regulation covers financial market torts/delicts. Secondly, it is questionable whether the (claimed) points of similarity between the legislative goals of the prospectus liability and competition law⁸¹ justify applying *mutatis mutandis* Art. 6 of the Rome II Regulation in the realm of the German statutory prospectus liability.⁸² This requires even more argumentation in context with Art. 35a Section 4 Sentences 1 and 2 of the CRA Regulation (new). Due to these strong dogmatic reservations the solution inspired by Art. 6 of the Rome II Regulation as outlined above

⁷⁷ For more information on the pre-existing relationship with a view to prospectus liability, see Jan von Hein in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 4 of the Rome II Regulation para 64 (Kluwer Law International 2011).

⁷⁸ For more information on this with further references, see Jan von Hein in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 4 of the Rome II Regulation para 50 (Kluwer Law International 2011).

⁷⁹ See e.g. Karsten Thorn in Palandt, *Bürgerliches Gesetzbuch*, Art. 4 of the Rome II Regulation para 30 (73rd ed., C.H. Beck 2014). See also Peter Rott in Manfred Dausen (ed.), *Handbuch des EU-Wirtschaftsrechts* volume I, H.V. Verbraucherschutz para 800 (34th supplement, C.H. Beck 2013).

⁸⁰ Dorothee Einsele, *Internationales Prospekthaftungsrecht – Kollisionsrechtlicher Anlegerschutz nach der Rom II-Verordnung* -, 1 Zeitschrift für europäisches Privatrecht 23, 37 et seq. (2012).

⁸¹ Dorothee Einsele, *Internationales Prospekthaftungsrecht – Kollisionsrechtlicher Anlegerschutz nach der Rom II-Verordnung* -, 1 Zeitschrift für europäisches Privatrecht 23, 38 (2012).

⁸² See for a critical view on this also e.g. Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 IPRax 399, 402 (2012).

might not be used to determine the subsidiary civil liability regime for CRAs in the Union. To conclude: Despite all efforts to avoid the application of Art. 4 Section 1 of the Rome II Regulation to financial market torts/delicts it becomes apparent that this does not yield adequate results for assessing the applicable national law in context with Art. 35a Section 4 Sentences 1 and 2 of the CRA Regulation (new) *de lege lata*. It appears that the dissatisfaction with the current private international law regime for financial market torts might only be cured by means of amending the Rome II Regulation.⁸³ The Special Committee on Financial Market Law of the German Council for Private International Law has proposed such a reform of the Rome II Regulation.⁸⁴ It puts forward to insert a new Art. 6a to the Rome II Regulation, addressing illicit acts on the financial market. This proposal however requires a separate in-depth analysis to finally assess whether it adequately addresses also the European civil liability regime for CRAs.

De lege lata, Art. 4 Section 1 of the Rome II Regulation remains the default rule for the determination of the subsidiary civil liability regime for CRAs in the Union. Thus, the connecting factor to be applied is the country in which the damage occurs, the *Erfolgsort*.⁸⁵ In context with the civil liability of CRAs under Art. 35a of the CRA Regulation (new) even the initial damage suffered by the victim is to be considered a pure economic loss.⁸⁶ As stated above,⁸⁷ the *Kronhofer*⁸⁸ case of the CoJ might be referred to. It defines the *Erfolgsort* as the location of the assets affected, or – secondarily – the location of the main assets of the victim.⁸⁹ In one critic's view the *lex loci damni* in context with Art. 35a of the CRA Regulation (new) entails that the seat of the rated company or the rated state should be considered the connecting factor as these are the locations where the

⁸³ See e.g. Peter Rött in Manfred Dausen (ed.), *Handbuch des EU-Wirtschaftsrechts* volume I, H.V. Verbraucherschutz para 800 (34th supplement, C.H. Beck 2013); Christian Schmitt, *Die kollisionsrechtliche Anknüpfung der Prospekthaftung im System der Rom II- Verordnung*, 9 *Zeitschrift für Bank- und Kapitalmarktrecht* 366, 371 (2010).

⁸⁴ Resolution of the Special Committee on Financial Market Law of the German Council for Private International Law of 30 and 31 March 2012, 5 *IPRax* 471 (2012). For more information on this with further references, see Matthias Lehmann, *Vorschlag für eine Reform der Rom II-Verordnung im Bereich der Finanzmarktdelikte*, 5 *IPRax* 399 (2012).

⁸⁵ For more information on this with further references, see e.g. Jan von Hein in Graf-Peter Callies (ed.), *Rome Regulations*, Art. 4 of the Rome II Regulation para 14 (Kluwer Law International 2011).

⁸⁶ See also e.g. Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 *Wertpapier-Mitteilungen* 1729, 1731 (2013).

⁸⁷ See item E.III.4. at the beginning.

⁸⁸ See CoJ Case C-168/02 *Kronhofer v. Maier* (2004).

⁸⁹ For more information on this with further references, see e.g. Abbo Junker in *Münchener Kommentar zum Bürgerlichen Gesetzbuch* volume 10, Art. 4 of the Rome II Regulation para 21 (5th ed., C.H. Beck 2010).

pecuniary interests of the issuer or investor are first affected.⁹⁰ In the critic's opinion, the CRAs and their insurance companies might thereby better foresee the possible subsidiary civil liability regimes.⁹¹

The present author takes the view that this interpretation narrows considerably the definition of *Erfolgsort* as explained above without sufficiently justifying dogmatically such a deviation from the autonomous interpretation of the *Erfolgsort* in Art. 4 Section 1 of the Rome II Regulation. When an issuer/state or investor bring a claim against a CRA under Art. 35a of the CRA Regulation (new) the connecting factor as provided in Art. 4 Section 1 of the Rome II Regulation is the *Erfolgsort* defined as the location of the assets affected, or – secondarily – the location of the main assets of the victim. Thus, in context with Art. 35a of the CRA Regulation (new) multiple, not sufficiently predictable subsidiary civil liability regimes for CRAs might apply. It remains to be seen whether this result will foster a debate on the application of a different connecting factor or even trigger a reform of the current rules.

E. CONCLUDING REMARKS AND OUTLOOK

The European legislator did not create a complete and elaborate European civil liability norm defining all of its constituent elements. It rather provides only a rudimentary liability concept for CRAs. This concept has to be complemented by the relevant applicable national law. Apart from the various uncertainties linked to the structure and formulations of Art. 35a of the CRA Regulation (new) its private international law implications raise multiple problems. The present author however takes the view, that the current rules of private international law cover this form of tort in financial markets. *De lege lata*, Art. 4 Section 1 of the Rome II Regulation remains the default rule in order to determine the subsidiary civil liability regime for CRAs in the Union. The connecting factor here is the *Erfolgsort* defined as the location of the assets affected, or – secondarily – the location of the main assets of the victim. The lack of predictability of the multiple national laws that possibly apply in context with Art. 35a of the CRA Regulation (new) might lead to further discussions on other connecting factors in the realm of credit rating sector torts or financial market torts in general. The complexity the private international law adds to the new European civil liability regime for CRAs might hamper considerably its effective and efficient application. The problems arising

⁹⁰ See Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1731 (2013).

⁹¹ See Anatol Dutta, *Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang*, 37 Wertpapier-Mitteilungen 1729, 1731 (2013).

in the realm of the private international law rules in context with Art. 35a of the CRA Regulation (new) and those linked to its structure and formulations in general raise doubts whether the European civil liability regime for CRAs will have any disciplining effect on the conduct of CRAs and its analysts in addition to any regulatory sanctions available. The results of this analysis of the civil liability regime for CRAs in the Union from the perspective of private international law might be viewed to contribute also to the general legal (-practical) and dogmatic discourse on liability rules in the realm of European financial market law which has gained further momentum in the aftermath of the financial crisis.

TORT LIABILITY FOR RATINGS OF STRUCTURED SECURITIES UNDER ENGLISH LAW

*Kern Alexander**

INTRODUCTION

This article analyses whether there are legally cognisable claims for misrepresentation and negligence under English law that can be brought by a professional investor against a credit ratings agency for providing AAA ratings to structured finance instruments, such as collateralised debt obligations, when investors later discover that the ratings agency failed to act with due care in issuing the rating. English courts have generally followed the doctrine of *Hedley Byrne*¹ and *Caparo Industries*² in holding that in a negligence action for economic loss for making careless statements the defendant does not have a duty of care to a claimant with whom the defendant does not have a direct relationship (ie., privity of contract) in respect of its claim, unless the claimant can show that the defendant knew or should have known that its representations would be disseminated and relied upon by the claimant. These tort law principles are especially relevant in considering the claims of investors in complex financial instruments which were sold to them before the global credit crisis erupted in late 2007 and which were rated AAA by credit rating agencies. Indeed, these investors – many of them professional investors, including many British banks that suffered heavy losses and were later nationalized and/or subject to substantial taxpayer bailouts, such as the Royal the Bank of Scotland and Northern Rock – had purchased structured debt securities before the credit crisis began from special purpose vehicles or other legally distinct entities that were usually set up by the banks responsible for promoting and arranging the sale of the securities. These banks marketed and promoted complex and structured securities to professional investors, including large financial institutions, pension funds and asset manager firms. Moreover, the arranging and managing banks solicited the assistance of credit rating agencies, such as, among others, Standard & Poors ('S&P'), Moody's and Fitch, to provide these financial products with AAA ratings so that they could be marketed as low risk investments to professional investors. In many cases, the arranging/managing banks and ratings agencies worked closely together on particular methodological and risk assessment issues

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¹ *Hedley Byrne & Co Ltd v Heller & Partners Ltd* ([1963] 2 All ER 575, [1964] AC 465).

² *Caparo Industries plc v Dickman* ([1990] 1 All ER 568, [1990] 2 AC 605).

to ensure that the products would receive an AAA rating for the primary purpose of marketing and selling them to professional investors.

Most investors who purchased these products relied on these direct marketing efforts and solicitations before deciding whether to invest. As a matter of standard practice in the City of London, however, the investment banks that conducted the marketing and solicitations had arranged for separate legal entities which they did not own or control to act as the party offering the securities to the investors in the offering circular. Further, the offering circular stated expressly that the purchaser, by entering the transaction to buy the securities, acknowledges that the arranging or managing banks (responsible for marketing the securities) did not make any representations to them regarding the riskiness or the viability of the securities. As a matter of English law and custom in the London markets, this had the effect of insulating the arranging/ managing bank from any contractual or tortious liability in the sale of the securities. A claimant investor could therefore only seek compensation and damages directly from the special purpose entity which had formally sold them the securities and which often had inadequate or no assets to satisfy any claim. Moreover, any claim by the investors against the ratings agency for negligently or deceptively issuing the securities with an AAA rating could not surmount the legal obstacle that there was no privity of contract between the ratings agency and the claimant investor and so there was no duty of care owed by the ratings agency to the investor. This precluded any cognizable claim in contract or tort under English law for compensation or damages against the arranging/ managing bank and/or the ratings agency for breach of contract and/or negligent misrepresentation or deceptive misrepresentation in the sale of the securitized investments.

The article addresses the issue of whether the English law of tort can be interpreted as providing a legally cognisable claim for negligent misrepresentation for claimant investors against rating agencies when the investors relied on AAA ratings issued by the ratings agency to their detriment. In doing so, it will consider the English case law in light of the recent ruling by the Australian Federal Court in the *Bathurst*³ case. Specifically, the analysis will address the issue of whether the actual rating of the financial instrument or product by the rating agency constitutes a representation only to the issuer of the instrument or product (the party with whom the rating agency actually contracted to provide the rating), or does it also constitute a representation to the broader market of investors and in particular to investors who relied on the rating when

³ *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200.

deciding whether to purchase the instrument or product, even though the investor, as part of the investment contract, signs documentation that expressly states that by entering into the contract the investor has not relied on any representations by third parties, such as the arranging bank and/or the rating agency. The article argues that ratings agencies in issuing ratings are aware that their ratings are relied on by current or potential investors and that the ratings are issued with a view to their ultimate dissemination to investors in the market. Because rating agencies are in the business of accepting compensation for issuing ratings that they know are being issued for the primary purpose of being disseminated to potential investors in the market a duty of care arises under English tort law that is owed by the rating agencies to the class of current or potential investors to whom the ratings are disseminated.

The analysis in the article will be relevant in considering how English law governs tort claims by professional investors against credit rating agencies for allegedly rendering negligent and/or deceptive ratings of investment products that they knew or should have known were being directly promoted to third party investors. The article will focus on how English law treats the duty of care issue in negligent misrepresentation cases where the plaintiff has suffered pure economic loss and where there is no direct privity between the plaintiff and defendant. It will consider recent factual scenarios that are the subject of current proceedings before the High Court in London involving Standard & Poors (S&P), which filed a petition in December 2013 for a declaratory judgment that it does not owe a duty of care under English tort law to any professional investors who may be considering bringing civil claims against it for negligent misrepresentation, misrepresentation and/or deceit in issuing AAA ratings on complex securitized investment products that were sold to professional investors a few years before the onset of the global credit crisis in 2007 and which later lost all of their value during 2008 around the time of the collapse of Lehman Brothers Holdings.

Although the legal issues discussed in this article relating to the creation of a duty of care between plaintiff investors and the defendant rating agencies and arranging/managing banks appear to be settled as a matter of English law, the article suggests that English courts should reconsider the duty of care issue in tort actions involving negligent misrepresentation claims against rating agencies for negligently rating securitized investment products. The chapter suggests that a reconsideration of these legal issues is necessary in light of the lessons learned from the recent financial crisis and that London's future reputation as an international financial centre in the wholesale securities markets depends in part on the availability of adequate legal remedies under English law for professional investors with claims against credit rating agencies in their rating of securitized

and other complex financial products. In doing so, the article will mainly consider these legal issues as they relate to potential tort liability of credit rating agencies for negligently or deceptively rating complex financial products and the implications of the Australian federal court's decision in the *Bathurst* case. The article concludes that the reasoning of the *Bathurst* case is compelling and will contribute to developments in English law that may lead to the scope of the duty of care expanding to include professional investors who rely on ratings in making investment decisions and that this may serve as an effective remedy to hold rating agencies accountable in the future for negligent, reckless and deceitful conduct.

I. Establishing a Duty of Care to third party investors in securitized investments

Generally, a sophisticated investor holding a structured debt instrument issued as part of a securitisation who suffered losses as a result of negligent misrepresentation in the sale of that product might look for redress to those parties who sold it the instrument (the 'managers') or to those parties who structured the investment (the 'arrangers') or to the party which rated the investment AAA (the ratings agency). A preliminary issue would be whether the managers/arrangers/ratings agency acted *reasonably* and, if they did not, whether they are *liable* in negligence. If they did not act reasonably, to prove liability the investor must first show whether the manager/arranger/ratings agency owed a duty of care to the investor. Under English law, establishing a defendant's duty of care in a tort claim for pure economic loss requires one of three tests to be met. In an important House of Lords decision, Lord Bingham set forth these three tests in *Commissioners of Customs and Excise v Barclays Bank plc*⁴ for establishing a duty of care⁵ as follows: (1) assumption of responsibility; (2) a threefold test showing whether the loss to the claimant was a reasonably foreseeable consequence of what the defendant did or failed to do; whether the parties' relationship was sufficiently proximate; and whether it was fair, just and reasonable to impose a duty of care; and

⁴ *Commissioners of Customs and Excise v Barclays Bank plc* [2006] UKHL 28

⁵ In setting forth these tests, Lord Bingham cited the leading cases: *Hedley Byrne & Co Ltd v Heller & Partners Ltd* ([1963] 2 All ER 575, [1964] AC 465), *Ministry of Housing and Local Government v Sharp* ([1970] 1 All ER 1009, [1970] 2 QB 223; *Smith v Eric S. Bush* ([1989] 2 All ER 514, [1990] 1 AC 831), *Caparo Industries plc v Dickman* ([1990] 1 All ER 568, [1990] 2 AC 605), *Henderson v Merrett Syndicates Ltd* ([1994] 3 All ER 506, [1995] 2 AC 145); *White v Jones* ([1995] 1 All ER 691, [1995] 2 AC 207); *Spring v Guardian Assurance plc* ([1994] 3 All ER 129, [1995] 2 AC 296); *Williams v Natural Life Health Foods Ltd* ([1998] 2 All ER 577, [1998] 1 WLR 830) and *Phelps v Hillingdon London Borough Council* ([2000] 4 All ER 504, [2001] 2 AC 619).

(3) the incremental test: that the law should develop novel categories of negligence incrementally and by analogy with established categories.⁶

The first test assesses whether the defendant, objectively, assumed responsibility for their statements or conduct in relation to the claimant, or can be treated as having done so. In *Merrett Syndicates Ltd*,⁷ the assumption of liability test was set forth by the House of Lords in a case involving Lloyd's names as plaintiffs who were members of syndicates managed by the defendant underwriting agents. The relationship between names, members' agents and managing agents was regulated by the terms of agency agreements which gave the agent 'absolute discretion' in respect of underwriting business conducted on behalf of the name but *it was accepted that it was an implied term of the agreements that the agents would exercise due care and skill in the exercise of their functions as managing agents* (italics added). The plaintiffs brought proceedings against the defendants alleging that the defendants had been negligent in the conduct and management of the plaintiffs' syndicates, and wished, for limitation purposes, to establish a duty of care in tort in addition to any contractual duty that might be owed by the defendants.

The main issues considered were:

- (i) whether members' agents owed a duty of care to direct names notwithstanding the contractual relationship between the parties
- (ii) whether managing agents appointed as sub-agents by members' agents owed a duty of care to indirect names
- (iii) whether members' agents were responsible to names for any failure to exercise reasonable skill and care on the part of managing agents to whom underwriting was delegated by the members' agents, and
- (iv) whether the members' agents were required to exercise skill and care only in relation to those activities and functions which members' agents by custom and practice actually performed for the names personally.

The judge found in favour of the plaintiffs on all the issues. The defendants appealed to the Court of Appeal, which dismissed the appeal, and then appealed to the House of Lords, which dismissed the appeal for the following two reasons: First, where a person *assumed responsibility* to perform professional or quasi-professional services for another who

⁶ This third condition is addressed in greater detail in *Sutherland Shire Council v Heyman* (1985) 157 CLR 424, 481.

⁷ *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145, [1994] 3 All ER 506.

relied on those services, the relationship between the parties was itself sufficient, without more, to give rise to a duty on the part of the person providing the services to exercise reasonable skill and care in doing so. Accordingly, managing agents at Lloyd's owed a duty of care to names who were members of syndicates under the agents' management, since the agents by holding themselves out as possessing a special expertise to advise the names on the suitability of risks to be underwritten and on the circumstances in which, and the extent to which, reinsurance should be taken out and claims should be settled, plainly assumed responsibility towards the names in their syndicates.⁸

Second, an *assumption of responsibility* by a person rendering professional or quasi-professional services coupled with a *concomitant reliance* by the person for whom the services were rendered could give rise to a tortious duty of care irrespective of whether there was a contractual relationship between the parties. In consequence, unless the contract between the parties precluded him from doing so, a plaintiff who had available to him concurrent remedies in contract and tort was entitled to choose that remedy which appeared to him to be the most advantageous.

Alternatively, the second test – known as the *Caparo Industries* test⁹ – consists of three elements that the claimant must show to demonstrate a duty of care in negligence:

- the harm must be reasonably foreseeable as a result of the defendant's conduct;
- the parties must be in a relationship of proximity;
- it must be fair, just and reasonable to impose liability.

The House of Lords ruled in *Caparo Industries* that for a duty of care to exist between a third party adviser/auditor and a claimant a relationship of proximity must exist in which the third party adviser must, at the time at which the advice is given, be aware of (1) the identity of the person to whom the advice or information is to be communicated, (2) the purpose

⁸ Further, the court reasoned that the managing agents owed a duty of care to the names because the names placed *implicit reliance* on that expertise, in that they *gave authority* to the managing agents to bind them to contracts of insurance and reinsurance and to the settlement of claims. The fact that the agency and sub-agency agreements gave the agent 'absolute discretion' in respect of underwriting business conducted on behalf of the name did not have the effect of excluding a duty of care, contractual or otherwise. The discretion given to agents merely defined the scope of the agents' authority, not the standard of skill and care required of agents in carrying on underwriting business on behalf of names.

⁹ *Caparo Industries plc v Dickman* ([1990] 1 All ER 568, [1990] 2 AC 605).

for which the person is to be provided with the advice or information, and (3) the likelihood that the person to whom the advice or information is communicated will rely on it for the known purpose. The House of Lords in *Caparo Industries* observed that if the test were satisfied, a duty of care would be established between the auditors and third party investor/claimants with respect to a potential negligence claim against the auditors for the preparation of the company's accounts, even though the auditors had no privity of contract with the investors because the auditors were hired by the company and its board (not the investors) to conduct the audit. As discussed below, this rationale could also serve arguably to create a duty of care between a credit rating agency and the investors to whom the ratings were communicated by the issuer of investment securities.

The Court of Appeal applied the *Caparo Industries* test in a 2009 case¹⁰ to show whether a duty of care had been created by a bank to professional investors for alleged misrepresentations in the offer document.¹¹ The court held that for the duty of care to be established the test required that the investor show whether the loss was a reasonably foreseeable consequence of the bank's conduct, whether the relationship between the parties was of sufficient proximity, and whether it was fair, just and reasonable to impose a duty of care on the bank towards the investor.

Alternatively, the third test is known as the incremental test, which provides that new categories of negligence should be developed incrementally and by analogy with established categories. However this test has been criticised for providing limited assistance in determining whether a duty of care has arisen because it does not provide any measurable criteria.

Regarding the three tests, Lord Bingham observed the following in *Customs & Excise Commissioners v Barclays Bank*:¹²

1. [Liability could arise] where 'one party can accurately be said to have *assumed responsibility* for what is said or done to another, the paradigm situation being a relationship having *all the indicia of contract save consideration*' . . . (emphasis added). '[A]n assumption of responsibility [was to be regarded] as a sufficient *but* not a necessary condition of liability, a first test which, if answered positively, may obviate the need for further inquiry. If answered negatively, further consideration is called for.'
2. 'The assumption of responsibility test is to be *applied objectively* [. . .] and is not answered by consideration of what the defendant thought or intended.' (emphasis added)

¹⁰ *So v HSBC Bank plc* [2009] EWCA Civ 296.

¹¹ *Customs & Excise Commissioners v Barclays Bank plc* [2006] UKHL 28.

¹² See Lord Bingham, *Barclays Bank* [2006] paras. 4-5, at 1100.

3. 'The problem here is that the further this test was removed from the actions and intentions of the actual defendant, and the more notional the assumption of responsibility becomes the less difference there is between [that] test and the threshold test.' (Ibid., para 5)
4. The *Caparo Industries* 'threefold test itself provides no straightforward answer to the vexed question whether or not, in a novel situation, a party owes a duty of care.' (Ibid., para 6)
5. '[T]he incremental test was of little value as a test in itself, and [was] only helpful when used in combination with a test or principle which identifies the legally significant features of a situation.' (Ibid., para. 7).
6. 'The closer the facts of the case in issue to those of a case in which a duty of care has been held to exist, the readier a court will be, on the approach [...] adopted in *Caparo Industries v Dickman* to find that there has been an assumption of responsibility or that the proximity and policy conditions of the threefold test are satisfied. The converse is also true. (Ibid)
7. '[T]he outcomes, [...] of the leading cases [...] [are] in almost every instance sensible and just, irrespective of the test applied.' (Ibid., para. 108).

It should be noted that although Lord Bingham's observations supported a close examination of the detailed circumstances of the particular case and the particular relationship between the parties in the context of their legal and factual situation as a whole, it should not be interpreted as disparaging the value of and need for a test of liability in tortious negligence cases. Indeed, any coherent law of tort must be based on a set of consistently applied principles, if it is not to become a morass of *ad hoc* rulings seeking to achieve a just result.

II. The Implications of *Caparo Industries* for Ratings Agency Liability

Generally, establishing whether a duty of care exists in negligence which can be applied against a bank's mis-selling of complex financial products to professional investors and the analogous liability issues involving a credit rating agency issuing misleading ratings relied upon by professional investors will involve a close review of the facts of each case. In considering the facts, an English court would apply the basic tests set forth in case law, that is, whether the defendant either expressly or impliedly assumed responsibility for any advice or statements made directly to the claimant investors, and, if not,

whether it was foreseeable that such statements would reach investors and whether the investors were in a proximate relationship with the defendant that issued the statements, and finally whether it is fair, just and reasonable to impose liability on the defendant based on the facts of the case. As discussed above, the English courts recognise the test set forth in *Caparo Industries* as consisting of three elements: (1) the harm resulting from defendant's conduct must be reasonably foreseeable; (2) the defendant and claimant must be in a relationship of proximity; and (3) the imposition of liability must be fair, just and reasonable.¹³

Practically, this means that for a relationship of proximity to exist the third party adviser must, at the time at which the advice is given, be aware of (1) the identity of the person to whom the advice or information is to be communicated, (2) the purpose for which the person is to be provided with the advice or information, and (3) the likelihood that the person to whom the advice or information is communicated will rely on it for the known purpose. In *Caparo Industries*, the Court held that if the test were satisfied, auditors and other third parties may incur liability to third party claimants (i.e., shareholders) for negligence in the preparation of company accounts. Applying the *Caparo Industries* test to investor claims against rating agencies involved in rating securitized investments and other complex financial products that later lost most of their value in the 2007-08 financial crisis would create potential tort liability for negligent misrepresentation and/or deceit in the assessment and evaluation of risk factors that resulted in the AAA ratings on the grounds that the potential harm to the investors was reasonably foreseeable by the ratings agency because it was aware that its AAA rating was being disseminated to, and relied upon, by the investor in deciding whether or not to invest. Indeed, often the arranging banks and rating agencies shared credit market data and risk measurement methodologies as they worked closely together to test and measure which data would support a AAA rating for certain investment products. This close involvement by the ratings agency with the arranging bank to ensure that each structured investment was 'built to model' to ensure a AAA rating placed the rating agency into a proximate relationship with the potential investors to whom the AAA rating was disseminated. Through its involvement with the arranging bank, the rating agency knew that it was issuing a AAA rating that would be directly marketed to certain professional investors and that these investors would rely on the AAA rating in making their investment decisions.

¹³ An alternative test was set out in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, requiring an assumption of responsibility and reliance.

Moreover, as some professional investors have alleged in recent cases,¹⁴ it would be fair, just and reasonable and in support of public policy to impose liability on arranging banks and ratings agencies together because they – in violation of ethical principles that protect against conflicts of interest in the ratings process – apparently adjusted or manipulated credit market data and parameters to make highly risky investment products seem much less risky so that they would qualify for a AAA rating.¹⁵ Indeed, as discussed below, the Australian court accepted this type of argument in the *Bathurst* case in which the court found that the independence and credibility of the ratings process was undermined by the arranging bank (in this case ABN AMRO, now owned by the Royal Bank of Scotland) exercising undue influence with the rating agency (S&P) in adjusting the risk factors and model parameters that ultimately determined the AAA rating of a complex risky financial product that was sold to professional investors. The lack of legal and regulatory safeguards to ensure the independence and credibility of the ratings process resulted in a type of collusion between the ratings agency and the arranging bank to alter the data inputted into the risk model that determined the AAA rating.

The above analysis suggests that the English case law could possibly support the application of the *Caparo Industries* test to create a duty of care between a rating agency and a professional investor who relied on the ratings to purchase a complex financial product. In *Al Saudi Banque v Clark Pixley*,¹⁶ a decision that was referred to with approval by the House of Lords in *Caparo Industries*, it was found that the defendant auditors had neither supplied the plaintiff banks with their audit reports nor sent them to the company with the intention or in the knowledge that the company would supply them to the plaintiffs and therefore there was no relationship between the defendant auditors and the plaintiff banks. This however does not preclude the creation of a duty of care in a case where the rating agency was engaged by the arranging bank to issue a AAA rating to a complex security and the ratings agency knew that the AAA rating would be disseminated to, and relied upon, by professional investors.

Nevertheless, to date, the conventional view in English law has been that an inference can be drawn that liability would not be imposed on a credit

¹⁴ See the legal action filed in Dutch court against S&P/ABN AMRO ([http://www.imf.com.au/docs/default-source/site-documents/media-release---bentham-imf-backs-usd\\$250m-europe-claim-against-rbs-and-s-p](http://www.imf.com.au/docs/default-source/site-documents/media-release---bentham-imf-backs-usd$250m-europe-claim-against-rbs-and-s-p)); see also *Bathurst* (upholding third party liability in tort for a rating agency towards investors who relied on ratings in deciding whether to invest in an instrument that was rated negligently by the rating agency).

¹⁵ As discussed elsewhere, establishing a duty of care for credit rating agencies was examined in the Australian case *Bathurst*.

¹⁶ *Al Saudi Banque v Clark Pixley* [1990] 1 Ch 313.

rating agency for losses suffered by investors who relied on a AAA rating issued for debt securities that were issued as part of a securitization, even though the rating was knowingly based, in part, on negligent and/or false statements disseminated in an offering circular, on the grounds that there was no duty of care established between the rating agency and the claimant investors because the rating agency did not directly supply the claimant investors with the ratings report and were expressing only their opinion as to the riskiness of the credit instrument. To establish a duty of care, the claimant investors would have to show that the rating agency had voluntarily assumed liability, or alternatively, that it was reasonably foreseeable per the *Caparo Industries* test that it would know that the rating would be communicated to the claimant investors and that the claimants would rely on the rating in deciding whether to purchase the instruments in question. This would be a difficult hurdle (but not insuperable) for claimant investors to overcome in a tort action for negligence and/or misrepresentation against a credit rating agency.

III. The Bathurst case – its implications for English law

The *Bathurst* case¹⁷ in the Australian federal court, however, shows how a duty of care can be established between a rating agency and claimant investors who purchased instruments rated by the agency. In *Bathurst*, the Australian federal court ruled that a credit rating agency does have a duty of care to investors who purchase and suffer losses on certain investment products because of negligence and/or misrepresentations in the rating of the products on the grounds that it is reasonably foreseeable for the rating agency to know that its ratings would be communicated to the investors and that the investors would rely on the ratings in deciding whether to purchase the products. The case has important implications for the English law of tort liability for credit rating agencies that act negligently and/or make misrepresentations in issuing ratings of complex financial products that are sold to professional investors who rely on the ratings and suffer losses. It holds that the duty of care between a credit rating agency and investors who have suffered losses because of investing in a financial product that was rated AAA by the rating agency can be established if it can be shown that the rating agency issued the rating for the primary purpose of disseminating it to prospective investors and that the investors later relied on the ratings in deciding whether to invest in the rated financial product and incurred losses because of negligence or false statements in the rating of the product.

¹⁷ *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200.

This Australian case is reported to be the first case in the world where a rating agency has been held liable in relation to the ratings it gave to the kind of products that contributed to the global financial market downturn in 2007 and 2008. It provides the common law test for establishing a duty of care for credit rating agencies. In this case, local council governments brought claims in the Federal Court of Australia, against LGFS, ABN Amro and S&P.

In 2006 ABN AMRO created a new financial product known as the constant proportion debt obligation (CPDO). ABN AMRO retained Standard and Poor's (S&P), to rate the CPDO. S&P issued a AAA rating for the CPDO. LGFS, a financial advisor purchased these notes in order to be sold on to ('on-sale') to local councils. In October 2008 the CPDOs cashed out because their net asset value fell below 10% of the par price for which they had been acquired, causing loss to the councils. The councils brought claims in the Federal Court of Australia, against LGFS, ABN Amro and S&P. The claims against S&P alleged (i) misleading and deceptive conduct and (ii) negligence.

The purpose of ABNAMRO obtaining the S&P rating was for dissemination to potential investors so that they could rely on S&P's expert opinion of the creditworthiness of the CPDO notes as issued. It was thus reasonable for the councils to rely upon the rating and S&P knew or must have known that this is what any potential investor in the CPDO notes in the position of the councils would do. A negligent rating of the CPDO notes was inherently likely to cause loss because the subject matter of the rating was the expert opinion as to creditworthiness. Further, ABN AMRO obtained the rating because many potential investors would not have the resources or expertise to assess creditworthiness for themselves or to second-guess the rating, they were therefore 'vulnerable'. The plaintiffs were vulnerable in that they could not reasonably protect themselves from any lack of reasonable care by S&P in assigning the rating. It was reasonable therefore for the councils to rely on LGFS's advice and S&P's rating.

The Australian court's finding that, in issuing a financial product with a credit rating, the rating agency owed a duty of care to the end investor of such a wide scope is novel and contrasts with the general approach to tortious liability for pure economic loss, that foreseeability of loss is insufficient and the Australian courts take into account familiar factors when considering whether to impose a duty, such as the risk of indeterminate liability, vulnerability, directness of relationship and the existence of contractual relationships between relevant parties. It can be argued that it is fair, just and reasonable to impose a duty on CRAs to issue independent and competent ratings, particularly where it is known that its purpose is to assist in the marketing of products to

investors. Conversely, in circumstances where the rating agency (S&P in this case) makes available the basis (i.e. the methodology and base case assumptions) of its ratings, it is arguably not fair, just and reasonable for the investor to fail to take any steps of its own to assess that rating (by appointing and paying for specialist advisers if necessary) and then seek to recover its losses from the deep-pocketed rating agency on the basis of reliance solely on the rating.

In *Bathurst*, Jagot J distinguished the case from *Esanda Finance Corporation v Peat Marwick Hungerfords*¹⁸ which had held that it would be too removed for an auditor of a company to be liable to every person who placed reliance on its audit of a company and suffered loss as a result, as the rating by S&P in the *Bathurst* case was assigned to a financial instrument for the very purpose of communication to the class of potential investors and for them to take into account and rely on the rating in deciding whether or not to invest. Also, the risk of loss by potential investors in the CPDO notes was foreseeable (that is, it is a risk of which S&P knew or ought to have known) by reason of a negligent rating. Jagot J, held that in assigning a rating to the CPDO notes, S&P owed a duty of care to potential investors in those notes including the local council authorities. The Court concluded in its judgment that the councils proved that they suffered loss against LGFS, S&P and ABN AMRO, the damage being the amount each paid for the CPDO notes less the amount they received on the cash-out of those notes. Although the Australian Court did not specifically cite the *Caparo Industries* test, the court applied in substance a similar test for establishing the existence of a duty of care.

The Australian *Bathurst* case is a rare case where liability for financial loss was imposed on a bank and a credit rating agency for losses suffered by professional or sophisticated investors who had relied on AAA ratings that were negligently issued by both the arranging bank and rating agency in the wholesale securities market. It shows the general common law test to determine whether there is a duty of care between a defendant and claimant for pure economic loss in a negligence and/or negligent misrepresentation action could potentially hold a credit rating agency liable to a professional investor for negligent misrepresentation of complex securities on the grounds that the rating agency knew or should have known that its ratings would be disseminated to, and relied on, by certain investors. The *Bathurst* case demonstrates how another common law jurisdiction with very similar principles of negligence law can apply the traditional duty of care test as set forth in the *Caparo Industries* to show how a duty of care is created between the defendant rating agency and plaintiff investors. The decision in *Bathurst* would be

¹⁸ *Esanda Finance Corporation v Peat Marwick Hungerfords* [1997] HCA 8.

persuasive authority, but not legally binding precedent, for an English court. Therefore, the decision would be likely read closely by English legal practitioners and judicial authorities.

In addition, the *Bathurst* case should have particular resonance for recent legal actions brought in European courts by professional investors against both the arranging/managing banks and credit ratings agencies that allegedly were negligent in issuing AAA ratings of complex financial products which led to substantial financial losses for investors after the global financial crisis intensified in 2008. Some cases are based on claims by British and other European banks against the Royal Bank of Scotland as the current owner of the Dutch bank ABN AMRO and the credit ratings agency Standard & Poors for the negligent issuance of AAA ratings to complex derivative products that were purchased by the plaintiffs prior to the financial crisis in 2006. In early 2008, during a period of credit market stress, the value of these investments dropped precipitously and resulted in substantial losses – often at less than 10% of face value. The investors – including the British bank government owned bank Northern Rock – incurred substantial losses on its investment directly as a result of the negligent assessment of the credit quality of the products by S&P and related misrepresentations of the riskiness of the financial instruments in questions by both ABN AMRO and S&P. Although marketing material for these products (offering circulars) and credit ratings agencies pre-sale reports expressly stated that they were making no representations with respect to the investment products, the lawsuits allege that it is a question of fact whether the ratings agencies themselves knew or should have known that their representations about the credit quality of the investments having a AAA rating would be disseminated directly to all potential third party investors, and that in these cases the rating agencies knew that their rating would be disseminated to and relied upon by professional investors.

CONCLUSION

The article discusses how English law treats the duty of care issue in negligent misrepresentation cases involving claimants who have suffered losses for investing in securitized investment products that were carelessly rated AAA by rating agencies. In considering these issues, the article analyses the legal viability of professional investors' claims against rating agencies alleging (i) misleading and deceptive conduct and (ii) negligence in providing AAA ratings to securitized investment products. As discussed, English Courts have consistently demonstrated a reluctance to impose a duty of care to avoid economic loss other than in established categories of relationship, or where, in novel cases, it is fair, just and reasonable to impose such a duty in all of the circumstances.

Similarly, a particular legal hurdle for establishing the liability of credit rating agencies for third party liability in tort for negligence and/or misrepresentations has been the doctrinal requirements of privity of contract. There are no relevant cases in the English courts addressing the issue of rating agency tort liability for economic loss suffered by investors who purchased an investment that was negligently or deceptively rated by the rating agency. The test in *Caparo Industries* for establishing a duty of care has proved to be a significant enough hurdle to prevent any claims from proceeding. However, the recent Australian case *Bathurst* suggests a possible interpretation that could be adopted by English courts to argue that a duty of care does exist between a rating agency and the investors to whom it disseminates its credit ratings.

Based on analysis of English case law and on the *Bathurst* case, the article argues that rating agencies in issuing ratings are aware that their ratings are relied on by current or potential investors and that the ratings are issued with a view to their ultimate dissemination to investors in the market. Because rating agencies are in the business of accepting compensation for issuing ratings that they know are being issued for the primary purpose of being disseminated to current or potential investors, it is suggested that a duty of care arises under English tort law that is owed by the rating agencies to the class of current or potential investors to whom the ratings are disseminated.

**CIVIL LIABILITY OF CREDIT RATING AGENCIES
FROM A EUROPEAN PERSPECTIVE: DEVELOPMENT
AND CONTENTS OF ART 35(A) OF REGULATION
(EU) NO 462/2013**

*Francesco De Pascalis**

ABSTRACT

The set up of a civil liability regime for Credit Rating Agencies (CRAs) is one of the most noteworthy aspects of the new European legislation on CRAs. The purpose of this paper is to analyse the European civil liability regime for CRAs set out in Article 35(a) of Regulation (EU) No 462/2013. In doing so, it will examine the reservations that the major CRAs shared about the establishment of such a regime vis-à-vis the specific framework built up by the European Institutions through Article 35(a).

Taking stock of the evolutionary stages which led to the final draft of Article 35(a), this paper aims to understand: 1) why a common civil liability regime for CRAs was needed in the EU; 2) who benefits from this; and 3) whether the concerns initially expressed by the agencies are still valid in light of the framework resulting from the trilogue between the European Institutions.

1. INTRODUCTION

Credit Rating Agencies (CRAs) are key players in the financial markets. Their business is concerned with the assessment of the credit risk of borrowers such as governments, financial, and non financial firms.¹ In the aftermath of the 2007-2009 financial crisis, CRAs were subjected to close scrutiny at the international, national and regional levels due to their poor assessment of the credit risk associated with complex structured finance products. Within the EU, Regulation No 1060/2009 (hereinafter: CRA Regulation I) was the first piece of legislation addressing some of the key issues that the recent crisis had brought forward with regard to CRAs,

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¹ F. Amtenbrink & J. De Haan, *Regulating Credit Rating Agencies in the European Union: A Critical First Assessment of Regulation 1060/2009 on Credit Rating Agencies*, 46 CMLR 6, 1915-1949 (2009).

notably: conflict of interest; transparency in the rating methodologies and models; and CRAs' internal governance.² This regulation, however, did not mark the end of the European reforms of CRAs. In fact, CRA Regulation I should be regarded as a stepping-stone towards a broader regulation, one which encompasses all the other issues that had been left out. These include: over-reliance on external credit ratings; sovereign rating methodologies; and the establishment of a common European civil liability regime for CRAs. To this end, Regulation No 462/2013 (hereinafter: CRA Regulation III) is part of the last package of European reforms of CRAs, which entered into force on 20 June 2013.³ CRA Regulation III is a new body of rules which enhances the scope of the previous regulation by dealing with the above mentioned issues.

Among the new rules, the establishment of a European civil liability regime for CRAs is of interest. CRAs' civil liability has been hotly debated at all levels and any regulatory proposal has always encountered strong opposition by CRAs. In essence, the agencies have argued that credit ratings are forward-looking opinions subject to changes over time. The establishment of a civil liability regime would provide a contrast to this and would pave the way for unmeritorious claims every time a rating change occurs. At the EU level, this scepticism was expressed during the preliminary works leading to the draft of CRA Regulation III, when the European Commission (hereinafter: Commission) launched its consultation on the opportunity to introduce a European civil liability regime for CRAs.⁴

This paper focuses on the European civil liability regime for CRAs set out in Article 35(a) of the new regulation. The aim is to offer an examination of its contents by charting its evolution from the first draft proposed by the Commission, to the final version resulting from the trilogue between the Commission, the European Parliament and the Council of the European Union (hereinafter: the European Institutions). Answers are sought to a number of questions, including: why a civil liability regime for CRAs was necessary in the EU; who and how does Article 35(a) protect; and

² Regulation (EC) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies (2009) OJEU L302/52.

³ Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on Credit Rating Agencies (2013) OJEU L146/1; Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of over-reliance on credit ratings (2013) OJEU L 145/1.

⁴ Commission, *Consultation on Credit Rating Agencies (CRAs), new initiatives* (2010), available at: <https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp>.

whether the CRAs' reservations are still valid in light of the specific framework laid down in Article 35(a).

In addressing these issues, this work is structured as follows: section 2 sets the scene by providing some background information on the development of the European regulations of CRAs. Within this context, the facts characterizing the European policy on CRAs, in particular, the shift from the pre-crisis self-regulation model to the post-crisis legislative model, are reviewed. Then, the main features of CRA Regulation I, as well as the amendments to its supervisory rules through the issue of Regulation No 513/2011 (hereinafter: CRA Regulation II),⁵ are briefly highlighted in section 3. Finally, the European regulatory path on CRAs ends with CRA Regulation III, which will be introduced in section 4. Within the new body of rules, section 5 singles out the provision on the CRAs' civil liability regime with a view to analysing its features. To this end, the approach first takes into consideration the views expressed by CRAs with regard to the opportunity of establishing a European CRAs civil liability regime. Then, the viability of the agencies' reservations are questioned vis-à-vis the specific framework set out in Article 35(a). This part will take stock of the main changes and developments Article 35(a) went through: from the first, proposed version, to the final one. Finally, some conclusions will be drawn from the present examination.

2. EUROPEAN REGULATORY APPROACHES TO CRAS BEFORE THE 2007-2009 FINANCIAL CRISIS

2.1 Pre-crisis European self-regulation policy

The European Union (EU) may be regarded as a patchwork of states in which different cultures, policy strategies, and regulatory frameworks seek to converge towards the goal of full European integration. Over the past twenty years, these differences have become particularly evident with regard to the completion of the European single market for financial services. In this context, EU Member States have discussed the appropriate regulatory measures to overcome the fragmentation and segmentation which have always characterized some sectors, notably the retail financial market.⁶

⁵ Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies (2011) OJEU L145/30.

⁶ C. Stirbu, *Financial Market Integration in a Wider European Union*, HWWA Discussion Paper 297, 3-34 (2004).

Among Member States, Germany and France have always been in favour of strong European and global financial markets regulation.⁷ For instance, before the outbreak of the 2007-2009 financial crisis, the German and French governments proposed reforms on the regulation of over-the-counter (OTC) derivatives, hedge funds and on the operation of CRAs. These proposals, however, were strongly opposed by other countries, in particular, by the UK.⁸ Some scholars have therefore identified two competing groups or coalitions, namely, the Southern European group (France, Belgium and the Mediterranean countries) and the Northern European group (UK, Ireland, the Netherlands and the Scandinavian countries).⁹ As to financial services regulation, the former group has been in favour of a market-shaping, rule-based approach, as opposed to the latter which has encouraged a market-making, principle-based approach.¹⁰ During the years preceding the recent financial crisis, the Northern group had a predominant role in the negotiations of the measures set out in the Financial Services Action Plan (FSAP) for the completion of the single market for financial services.¹¹ Once such measures were all implemented at national levels, there was time for a “regulatory pause”¹² between the European Institutions. In the absence of concrete market failures, self-regulation was the preferred model to discipline some sectors and financial institutions, in particular, as will be shown below, the CRAs.¹³

⁷ H. Zimmermann, *Varieties of Global Financial Governance? British and German Approaches to Financial Market Regulation*, in E. Helleiner, S. Pagliari, H. Zimmermann eds., *Global Finance in Crisis, The Politics of International Regulatory Change*, Part II/8, 121-136 (Routledge 2010).

⁸ J. Buckley & D. Howart, *Internal Market: Gesture Politics? Explaining the EU's Response to the Financial Crisis*, 48 *JCMS Issue Supplement* s1, 119-141 (2010).

⁹ L. Quaglia, *Completing the Single Market in Financial Services: The Politics of Competing Advocacy Coalitions*, 17 *JEEP* (7), 1007-1023 (2010). According to the author, Germany falls in between the two coalitions because of the presence of competing advocacy coalitions domestically.

¹⁰ *Ibid.*, at 1012.

¹¹ Committee of Wise Men, *Final Report of the Committee of Wise Men on the Regulation of Securities Markets* (Brussels 2001). These measures were finally incorporated in the so-called ‘Lamfalussy Directives’: the Prospectus Directive (2003), the Market Abuse Directive (2003), the Transparency Directive (2004) and the Market in Financial Instrument Directive (2004).

¹² N. Moloney, *Reform or Revolution? The Financial Crisis, EU Financial Market Law and The European Securities and Market Authority*, 60 *ICLQ* 2, 521-533 (2011); Commission, *White Paper on Financial Services Policy 2005-2010* (COM 2005), 629.

¹³ S. Pagliari, *Who Governs Finance? The Shifting Public-Private Divide in the Regulation of Derivatives, Rating Agencies and Hedge Funds*, 18 *ELJ* 1, 44-61 (2012). According to the author, the European regulatory approach, at that time, was built on three pillars: 1) the decision to leave certain markets and institutions outside the regulatory oversight of public regulatory agencies; 2) the shift in the content of regulation from ‘command and control’ policies to a market-based form of regulation; and 3) an official public policy role granted to self-regulatory initiatives designed by financial groups, at 46.

2.2 FSAP Directives and the IOSCO Code of Conduct Fundamentals for CRAs

Following the default of the US multinational company Enron in 2001, the role and operations of CRAs came under regulatory scrutiny at the international, national and regional levels.¹⁴ At the international level, the Enron collapse prompted the International Organization of Securities Commissioners (IOSCO) to issue the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies* (the IOSCO Code) in 2004.¹⁵ The 2004 IOSCO Code was a set of best practices which CRAs were supposed to incorporate into their own codes of conduct in order to prevent conflict of interest, guarantee adequate disclosure of rating methodologies, and improve the timeliness and quality of their rating process.¹⁶ In essence, CRAs were expected to comply with the IOSCO Code or explain why certain principles had not been implemented in their own codes.¹⁷ Overall, the regulatory strategy on CRAs at the international level was of self-regulation based on voluntary compliance with the IOSCO Code.

By contrast, in the US a legislative approach was encouraged by the United States Congress and this ultimately resulted in the *Credit Rating Agency Reform Act of 2006*.¹⁸ From that moment, CRAs ceased to be unregulated entities in the US. At the EU level, the Commission did not embark on any reform and decided to leave the industry self-regulated on the grounds that some of the FSAP directives referring to CRAs, combined with self-regulation in accordance with the IOSCO Code, were a robust enough framework to deal with the rating sector.¹⁹ The directives that the Commission referred to were the Market Abuse Directive (MAD)²⁰,

¹⁴ During the NASDAQ bubble of 2001, Enron was found fraudulent and CRAs were accused of being too slow in recognizing the company's creditworthiness deterioration. Enron, as is known, was rated investment grade until four days before the company declared bankruptcy. C.A.E. Goodhart, *How, if at all, Should Credit Rating Agencies be Regulated?*, SP 181 LSE Financial Markets Group Paper Series, 1-34 (2010).

¹⁵ *Code of Conduct Fundamentals for Credit Rating Agencies* (2004), published by the Technical Committee of IOSCO, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>.

¹⁶ *Ibid.*

¹⁷ No 4.1 of the IOSCO Code states: 'If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provision.'

¹⁸ Security and Exchange Commission (SEC), *Credit Rating Agency Reform Act of 2006*, available at: <http://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf>.

¹⁹ Commission, *Communication from the Commission on Credit Rating Agencies* (2006) OJEU C59/2.

²⁰ Directive 2003/6/EC of 28/01/03 (OJ 2003 L 96/16) and implementing Directives and Regulations: Commission Directive 2003/124/EC of 22/12/03 (OJ 2003 L 339/70); Commission Directive 2003/125/EC of 22/12/03 (OJ 2003 L 339/73); Commission Directive 2004/72/EC of 29/04/04 (OJ 2003 L162/70) and Commission Regulation (EC) No 2273/2003 of 22/12/03 (OJ 2003 L 336/33).

the Capital Requirement Directive (CRD)²¹ and the Market in Financial Instrument Directive (MIFID).²²

Specifically, with regard to the first item of legislation which deals with insider dealing and market manipulation, the Commission noted that in the field of conflict of interest, fair presentation of investment recommendations and access to inside information, the provision of the MAD could constitute a comprehensive legal framework for the rating agencies.²³ As to the second item, the CRD allows the use of external credit ratings provided by CRAs for the determination of risk weights applied to bank or investment firms' exposures.²⁴ To this end, it is necessary that the agencies be formally recognized as European Credit Assessment Institutions (ECAIs) by the Member States' competent authorities.²⁵ The Commission acknowledged that the CRD did not constitute a form of regulation on the operation and conduct of CRAs. Consequently, it encouraged European national competent authorities to ensure that CRAs respected the criteria laid down to be recognised as ECAIs and to monitor whether CRAs performed their role as ECAIs in accordance with the CRD provisions.²⁶ Finally, the main objective of the third piece of legislation is to increase competition and ensure consumers' protection in investment services.²⁷ In relation to CRAs, the Commission stressed the applicability of the MIFID provisions concerning conduct of business and organizational requirements. In particular, the provisions on conflicts of interest would apply to CRAs in case the agencies provided investment services to clients that fell under the MIFID.²⁸

This framework was considered to be sufficient for the rating sector. Hence, there was no need to discuss new legislation.²⁹

²¹ CRD comprises Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ 2006 L177/1, and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), OJ 2006 L 177/201.

²² Directive 2004/39/EC of 21/04/04 (OJ 2004 L 145/1).

²³ Commission, *supra* note 19, at 3.1.

²⁴ Art. 80(1) Directive 2006/48/EC.

²⁵ Art. 81(1) Directive 2006/48/EC.

²⁶ See also Committee of the European Banking Supervisors (CEBS), *Guidelines on the Recognition of External Credit Assessment Institutions* (2006).

²⁷ Commission, *supra* note 19, at 3.1.

²⁸ *Ibid.*

²⁹ To this end, the European Commissioner Charlie McCreevy stated: 'last year, we told CRAs that they remain "on watch" and will be monitored actively. In this respect, I welcome CESR's report which provides a useful indication for the level of CRAs' compliance with the IOSCO Code. The report confirms that the self-regulation by CRAs functions reasonably well. The Commission will continue to monitor developments in this area, and, in particular, the impact of the new US Act on CRAs which will be operational by next summer', see Commission Press Release, *Internal Market: Commission Welcomes EU's Regulators Report on Credit Rating Agencies* (2007) IP/07/28.

3. EUROPEAN REGULATORY APPROACHES TO CRAS IN THE WAKE OF THE 2007-2009 FINANCIAL CRISIS

3.1 EU reforms to CRAs

When the financial crisis started in 2007 the European stance towards the self-regulation model went into reverse. As is well known, the crisis triggered worldwide government bail-outs and the granting of credit guarantees to large banks and financial institutions, which were on the brink of collapse in the wake of the Lehman Brothers bankruptcy.³⁰ In this context, the European regulators started to rethink their previous regulatory approaches and the rating sector was earmarked to be the first to receive such attention. There is a large body of literature analysing the reasons why CRAs were among the causes of the financial turmoil.³¹ In a nutshell, CRAs were accused of: 1) inflating the ratings assigned to some structured products such as residential mortgage backed securities (RMBSs) and collateralized debt obligations (CDOs) because of conflict of interest with the issuers; 2) having inadequate rating methodologies and models for assessing the risk inherent to such complex products; and 3) being slow in downgrading them promptly.³² More heavily than in the wake of the Enron default, CRAs were criticized and, once again, put under the regulatory spotlight at the national, international and regional levels.

In the EU, the abovementioned FSAP Directives were no longer considered a sufficient regulatory framework for CRAs, and the IOSCO Code was

³⁰ A. Felton & C. Reinhart, *The First Global Financial Crisis of the 21st Century*, VoxEU.org Publication, 1-169 (2008); J.B. Taylor, *The Financial Crisis and the Policy Response: An Empirical Analysis of What Went Wrong*, 14631 NBER WP, 2-28 (©2009); W. Naudè, *The Financial Crisis of 2008 and the Developing Countries*, UNU DP 01, 1-17 (2009).

³¹ C. W. Calomiris, *The Debasement of Ratings: What's Wrong and How We Can Fix it* (2009), available at: <http://www0.gsb.columbia.edu/faculty/ccalomiris/RatingAgenciesE21.pdf>; D. Darcy, *Credit Rating Agency and the Credit Crisis: How the "Issuer Pays" Contributed and what Regulators Might Do About it*, CBLR 2, 605 (2009); K. Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build-up to the Financial Crisis*, 69 UMLR 4,1111 (2009); T. J. Mollers, *Regulating Credit Rating Agencies: The New US and EU Law. Important Steps or Much ado About Nothing?*, 4 CMLJ 4, 477-500 (2009); A. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets*, IMF WP/09/129, 3-29 (2009); J. C. Coffee Jr., *Ratings Reforms: The Good, The Bad and The Ugly*, 1HBLLR, 236-276 (2011); E. Devine, *The Collapse of an Empire? Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 FJCF 1, 177-202 (2011); J. M. Griffin & D. Y. Tang, *Did Credit Rating Agencies Make Unbiased Assumptions on CDO?* 101 AER 3, 125-130 (2011).

³² Financial Stability Forum (FSF), *Report of the FSF on Enhancing Market and Institutional Resilience* (2008), available at: http://www.fsforum.org/publications/r_0804.pdf.

regarded as a ‘toothless wonder’ to discipline CRAs.³³ Consequently, the Commission sought advice from institutional bodies such as the Financial Stability Forum (FSF), the Committee of European Securities Regulators (CESR) and the European Securities Market Experts (ESME) group in order to evaluate the feasibility of shifting from the self-regulation to the legislative model.³⁴ Significantly, all the bodies consulted were against a full regulatory approach for CRAs, even though they remarked that simply relying on the improved version of the IOSCO Code, which the Technical Committee had issued in May 2008,³⁵ would not be sufficient.³⁶ However, at a political level there were unanimous calls for setting out an effective legislative framework for CRAs. For instance, in Germany the Issing Committee suggested: revisiting the use of credit ratings in public regulation; exercising a more effective control on the adequacy of the rating methodologies for structured products; minimizing rating shopping and strengthening the supervision of CRAs.³⁷ Then, in the G-20 summits of Washington and London between 2008 and 2009, strong oversight on CRAs was encouraged. To this end, the establishment of a system for the registration and supervision of CRAs in all G-20 states was considered vital.³⁸ Hence, self-regulation as the preferred option to discipline CRAs prior to the financial crisis was replaced by the new post-crisis watchword of strict legislative intervention. The Commission followed the trend and became an active player in the ensuing regulatory reforms of CRAs.

³³ C. McCreevy, *Regulating in a Global Market* (2008) SP/08/334, available at: http://europa.eu/rapid/press-release_SPEECH-08-334_de.htm?locale=de; F. Amtenbrink & J De Haan, *supra* note 1, at 1920: the authors underline the generic and abstract content of most of the Code provisions and, above all, the fact that the Code lacked any enforcement mechanism.

³⁴ FSF, *supra* note 32; Committee of European Securities Regulators (CESR), *CESR’s Second Report to the European Commission on the Compliance of Credit Rating Agencies in Structured Finance*, Ref: CESR/08-277 (2008); European Securities Market Expert Group (ESME), *Role of Credit Rating Agencies. ESME’s Report to the European Commission* (2008).

³⁵ The 2008 revised version of the Code is available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>

³⁶ According to ESME ‘the benefits of regulation would not exceed the costs and accordingly it is not recommended’, *supra* note 34, at 23; while CESR stressed that: ‘CESR and market participants believe that there is no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings of US subprime backed securities and hence continue to support market driven improvement’, *supra* note 34, at 3.

³⁷ Issing Committee, *New Financial Order: Recommendations by the Issing Committee Part I, Preparing G-20 Washington, November 15, 2008* (2008); Issing Committee, *New Financial Order Recommendations by the Issing Committee, Part II, Preparing G-20 London, April 2, 2009* (2009).

³⁸ Group of Twenty (G-20), *Declaration of the Summit on Financial Markets and the World Economy* (Washington 2008); G-20, *Declaration on Strengthening the Financial System* (London 2009).

3.2 CRA Regulation I

Published in the Official Journal of the European Union in November 2009, CRA Regulation I was the first European regulatory response to the problems that affected the European and global financial markets during the 2007-2009 turmoil.³⁹ One of the salient features of the regulation, in line with the G-20 policy recommendations, was the establishment of a registration⁴⁰ and supervisory system for CRAs, to be pursued by the competent authorities of the Member States in which the rating agency had its registered office.⁴¹ Accordingly, only the ratings issued by registered CRAs, or which comply with the equivalence and certification criteria laid down in the Regulation,⁴² can be used by financial institutions⁴³ for regulatory purposes.⁴⁴ Overall, CRA regulation I introduced a comprehensive set of conduct of business provisions targeting conflict of interest, rating methodologies, transparency and the corporate governance of CRAs.

As to conflict of interest, the regulation required CRAs to identify and eliminate or, where appropriate, manage and disclose all situations from which potential conflict of interests might derive and which could influence the issue of the credit ratings.⁴⁵ To this end, and with specific regard to the rating of structured finance products, rating analysts were banned from providing recommendations and advice on the design of these products and from participating in fee discussions with issuers.⁴⁶ Moreover, in an attempt to prevent rating shopping, CRAs were required to disclose information on all the structured products submitted to them, either for initial review or for preliminary rating. This disclosure was mandatory irrespective of whether or not issuers entered into a contract with the agency for a final rating.⁴⁷ Prescriptive requirements were also set out in order to ensure that rating methodologies were rigorous, systematic and subject to validation based on historical experience.⁴⁸ Moreover, rating agencies were compelled to disclose more information to the market with regard to: their ratings' historical performance; assumptions;

³⁹ CRA Regulation I, *supra* note 2.

⁴⁰ Arts 2(3) and 14.

⁴¹ Art. 23(2).

⁴² Art. 5.

⁴³ Art. 4 of CRA Regulation I refers to credit institutions, investment firms, insurance undertakings, assurance undertakings, reinsurance undertakings, undertakings for collective investment in transferable securities, and institutions for occupational retirement provision.

⁴⁴ Art 3(1)g: “regulatory purpose” means the use of credit ratings for the specific purpose of complying with Community law, as implemented by the national legislation of the Member States’.

⁴⁵ Art. 6 and Annex I, section A on organizational requirements and section B on operational requirements.

⁴⁶ Annex I, Section B(5).

⁴⁷ Annex I, Section D(II)(4).

⁴⁸ Art. 8(3).

methodologies; and the level of due diligence on the assets underlying a rated structured finance product.⁴⁹ Also, with a view to enhancing the agencies' internal governance, CRA Regulation I set out rotation arrangements for analysts, rules on the compensation of employees who take part in the rating process, and a series of requirements regarding other persons directly involved in credit rating activities.⁵⁰

On the whole, CRA Regulation I built on the revised version of the IOSCO Code, but it overcame the 'comply or explain' rationale behind this through provisions of 'legally binding character'.⁵¹ As mentioned, the supervision of CRAs was left to be dealt with at a national level, through colleges of competent authorities of the Member States. In this context, even though the final decision was to be taken by the competent authority of the Member State where the agency had been registered, the collegial system allowed all the competent authorities to take part in the registration and supervision process of a rating agency or group of agencies.⁵²

3.3 CRA Regulation II

However, such a supervisory system was soon considered inadequate in light of the reforms which brought fundamental changes in the European financial supervision architecture.⁵³ Following the creation of the European Systemic Risk Board (ESRB)⁵⁴ and the establishment of a European System of Financial Supervisors (ESFS) which included three new authorities, namely the European Securities Market Authority (ESMA),⁵⁵ the European

⁴⁹ Art. 8(4)(5)(6) and Annex I, Section E(I)(5); furthermore, in the context of structure finance products, CRAs are required to attach an additional symbol (AAA_{sf}, BBB_{sf}, etc.) to the rating categories assigned to such products in order to help investors distinguish between the ratings for structured products and the traditional ratings (AAA, BBB) assigned to other financial products, see Art. 10(3).

⁵⁰ Art. 7(4) and Annex I, Section C.

⁵¹ Commission Press Release, *Commission Adopts Proposal to Regulate Credit Rating Agencies* (November 2008) IP/08/1684; H. McVea, *Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: The EU Strikes Back*, 59 ICLQ 3, 701-730 (2010).

⁵² Art. 29.

⁵³ K. Alexander, *Reforming European Financial Supervision*, 12 JELA (ERA-Forum) 2, 229-252 (2011).

⁵⁴ Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European systemic Risk Board (2010), OJEU L331/1.

⁵⁵ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Market Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (2010), OJEU L331/84.

Banking Authority (EBA),⁵⁶ and the European Institution for Occupational and Pension Authority (EIOPA)⁵⁷, new supervisory rules on CRAs were placed under discussion.⁵⁸ Significantly, it was noted that:

[T]he supervision of such entities involves a clear Community dimension. For example, credit rating agencies based in one country can issue ratings which affect a large number of countries. Consequently, it is not optimal that a single national authority should be entrusted with the task of supervising them. From this perspective, granting this power to a European body could be more effective and coherent than sharing this competence with national supervisors. It would also be more efficient as it would concentrate the costs of supervision in only one authority avoiding any overlaps.⁵⁹

In essence, the centralization of the supervision of CRAs was based on a number of reasons. Firstly, the involvement of a multiplicity of supervisors was too risky in that the division lines between geographical competences of supervisors were rather blurred and this would facilitate potential intra-EU disputes.⁶⁰ Secondly, even though the competent authorities were supposed to work in colleges, the model of supervision was based on supervisory and enforcement tasks performed by the Member States' competent authorities. In this case, the risk was that the authorities could take individual initiatives not approved by the relevant college. Hence, individual acts by the Member States' supervisory authorities could result in divergent and inconsistent application of the CRA Regulation.⁶¹ Thirdly, only the competent authority of the Member State in which the CRA was established was responsible for charging registration and supervisory fees. This could lead host competent authorities to be less committed to contributing to the supervisory work.⁶²

⁵⁶ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (2010), OJEU L331/12.

⁵⁷ Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (2010), OJEU L331/48.

⁵⁸ Commission, Proposal for a Regulation of the European Parliament and of the Council on Amending Regulation (EC) 1060/2009 on credit rating agencies, (Brussels 2010) COM(2010)289 final.

⁵⁹ Commission Staff Working Document, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on credit rating agencies, SEC(2010)678, at 4.

⁶⁰ *Ibid.*, at 8-10.

⁶¹ *Ibid.*

⁶² *Ibid.*

Finally, the Commission cast doubts on the ability of national supervisors to cope with the pan European dimension of CRAs. Specifically, national supervisors could perceive the dimension of CRAs only from a national perspective, without considering the global nature and the potential impact of the agencies' operations outside the Member State in which the CRA is registered. Consequently, the home competent authorities could lack sufficient resources to deal with these important aspects.⁶³

All things considered, supervision of CRAs at the national level carried the risk of conflicts over competencies and arbitrage, and this would have resulted in ineffective supervision. These reasons paved the way for the amendment of the supervision rules of CRA Regulation I through CRA Regulation II which entered into force in June 2011.⁶⁴ CRA Regulation II provided for the transfer of registration responsibilities and supervisory duties of CRAs from the Member States' competent authorities to ESMA. National authorities were entrusted with supervisory tasks through delegation by ESMA, which remained legally responsible.⁶⁵ Under the new body of rules, ESMA now has investigative powers, such as the rights to request documents and data, to summon and hear people, and to conduct on-site inspections.⁶⁶ Should a breach of the CRA regulation be discovered, subject to the gravity of the breach, ESMA can impose fines,⁶⁷ withdraw the registration,⁶⁸ temporarily prohibit the concerned agency from issuing credit ratings,⁶⁹ or issue a public notice.⁷⁰ What is more, ESMA will monitor the degree of compliance with the regulation by CRAs through annually published reports.⁷¹

4. ENHANCING THE SCOPE OF THE EU REGULATION OF CRAS

4.1 Beyond CRA I and CRA II

The pace of the EU reforms of the rating sector was very fast. As explained, both CRA Regulation I and CRA Regulation II were issued

⁶³ *Ibid.*

⁶⁴ CRA Regulation II, *supra* note 5.

⁶⁵ Recital 5 & 6.

⁶⁶ Art. 23(c) and (d).

⁶⁷ Art.36(a).

⁶⁸ Art.24(1)(a).

⁶⁹ Art.24(1)(b).

⁷⁰ Art.24(1)(c).

⁷¹ All the reports published so far are available at: <http://www.esma.europa.eu/documents/overview/10>.

quite closely together. In parallel, important changes also happened in the US. President Obama signed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (hereinafter: Dodd-Frank Act)⁷² at the point when CRA Regulation I was already in force and CRA Regulation II was in progress. The Dodd-Frank Act is regarded as a broad-based reform package which regulates almost every part of the US financial system.⁷³ Its provisions on CRAs revisit the previous legislation on the rating sector by including, among others, new specific rules on reliance on external credit ratings⁷⁴ and CRAs' civil liability.⁷⁵ It is clear that, in the US a broad, fully comprehensive piece of legislation was introduced in the wake of the financial turmoil, whilst on the other side of the Atlantic, only selected aspects relating to the conduct and operations of CRAs were dealt with under CRA Regulation I. These differences can be traced back to the fact that CRAs operated as unregulated entities in the US until 2006, while in the EU self-regulation was the rule of the day until the crisis erupted.⁷⁶

As mentioned above, prior to the 2007-2009 financial crisis, the *Credit Rating Agency Reform Act of 2006* was already in place in the US. This could work as the basis upon which broader intervention could be built in order to deal with all the concerning issues that the rating sector raised. In contrast to the Dodd-Frank Act, CRA Regulation I was considered a small, insufficient intervention since it left out, among other issues, over-reliance and the introduction of a civil liability regime for CRAs.⁷⁷ To this end, the EU's Internal Market Commissioner, Michel Bernier, made it clear that the two pieces of legislation issued between 2009 and 2011 did not go far enough.⁷⁸ Consequently, a new, fully comprehensive package of reforms to CRAs had to be discussed. The current recession affecting most of the euro area countries and the downgrades applied to them by the major CRAs has given momentum to this reform process.

⁷² SEC, *Dodd-Frank Wall Street Reform and Consumer Protection Act* (July 2010) Public Law 111-203 (Dodd Frank Act).

⁷³ M. Labonte, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and The Federal Reserve*, Congressional Research Service, 1-26 (2010).

⁷⁴ Section 939(a) of the Dodd Frank Act: *Review of Reliance on Ratings*.

⁷⁵ See *infra* note 97.

⁷⁶ S. Utzig, *The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective* ADBI WPS No 188, 1-18 (2010).

⁷⁷ Commission Press Release, *Commission wants better quality credit ratings*, (Brussels 2011) IP/11/1355.

⁷⁸ N. Tait & R. Milne, *Moody's Clashes with EU on Advance Warnings* (*Financial Times* 2011).

4.2 EU sovereign crisis and new reforms of CRAs: CRA Regulation III

As explained above, the collapse of the US mortgage market and the ensuing global financial crisis set the stage for shifting from the market based, self-regulation model to the legislative model for CRAs in the EU. However, the European sovereign debt crisis acted as a catalyst for a new regulatory debate which definitely led to the final package of reforms of CRAs.

In April 2010 Standard & Poor's (S&P) downgraded the Greek sovereign debt to junk status. Bond yields rose dramatically in the wake of the downgrade⁷⁹ so that Greece was no longer able to access private capital markets as a funding source.⁸⁰ This forced the Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) (hereinafter: the troika) to discuss a rescue plan in order to prevent Greece from defaulting on its debt and, thus, seriously threatening the stability of the euro zone.⁸¹ However, criticism against CRAs started mounting between the spring and summer of 2011, when S&P declared that it would classify as a default any planned or voluntary restructuring of the Greek debt. This announcement was made while the European leaders were negotiating a second rescue packaging for Greece.⁸² Other European countries experienced downgrades by the major CRAs as well. For instance, Moody's Investors Services (Moody's) downgraded Portugal's sovereign debt to junk status soon after the set-up of a bail-out package by the troika.⁸³ As a result, the cascade of rating changes seemed to be unstoppable because of the sovereign downgrades applied by Moody's to Ireland⁸⁴ and by S&P to nine euro area countries between 2011 and 2012.⁸⁵ In the aftermath of the

⁷⁹ Commission, *European Economic Forecasts*, Staff Working Document, 44-45 (2011). In this study it is shown that sovereign downgrades are followed by rising sovereign spread changes.

⁸⁰ G. Tichy, *Credit Rating Agencies: Part of the Solution or Part of the Problem?*, 46 *Intereconomics* 5, 232-262 (2011).

⁸¹ *Ibid.*

⁸² C. Alessi, R. Wolverson, M. A. Sergies, *The Credit Rating Controversy* (October 2013), available at: <http://www.cfr.org/financial-crises/credit-rating-controversy/p22328#p7>.

⁸³ M. Wilson, *Moody's Downgrades Portugal Sovereign-Debt Rating*, (*The Wall Street Journal* 2010), available at: <http://online.wsj.com/article/SB10001424052748704518904575364320526044824.html>.

⁸⁴ D. Kruger & F. Flynn, *Ireland Cut to Junk by Moody's as EU Seeks to Contain Crisis* (*Bloomberg* 2011), available at: <http://www.bloomberg.com/news/2011-07-12/ireland-is-third-euro-area-country-cut-to-junk-joining-greece-portugal.html>.

⁸⁵ L. Elliot & P. Inman, *Eurozone in New Crisis as Rating Agency Downgrades Nine Countries*, (*The Guardian* 2012), available at: <http://www.guardian.co.uk/business/2012/jan/13/eurozone-crisis-france-credit-rating-aaa>.

sovereign downgrades, CRAs were accused of exacerbating the sovereign crisis⁸⁶ and of having an anti EU-bias.⁸⁷

A climate of political, economic and regulatory pressure prompted the Commission to rethink the legislation on CRAs. As mentioned, CRA Regulation I was considered an important step in the regulation of CRAs, but was still seen as insufficient. This was because it did not address such other issues of concern as the risk of over-reliance on external credit ratings by financial institutions and market participants, the high degree of concentration in the credit rating industry, the remuneration models used by CRAs, sovereign rating methodologies and the establishment of a civil liability regime for CRAs. All these issues were placed on the new regulatory agenda and have been finally incorporated into CRA Regulation III.⁸⁸

5. CIVIL LIABILITY REGIME OF CRAS UNDER ART. 35(A) OF CRA REGULATION III

From all the rules introduced in the new regulation, the following parts will concentrate on the establishment of a civil liability regime for CRAs. Overall, CRA Regulation III amends and improves the rules on conflict of interest,⁸⁹ widens the rules on rating methodologies by introducing specific provisions on the sovereign ratings⁹⁰, enhances disclosure requirements with regard to the structured finance ratings⁹¹; and, like the Dodd Frank Act, it introduces new rules on over-reliance⁹² and CRAs' civil liability.⁹³ While the provisions on over-reliance are built on the approaches elaborated and endorsed at the international level,⁹⁴ the civil liability regime can be defined as a brand new European framework related to one of the most delicate issues within the regulatory debate on CRAs.

⁸⁶ Empirical studies have shown that sovereign downgrades, though concentrated in Greece, Spain, Portugal and Ireland, can have significant spill-over effects across countries and financial markets. The magnitude of the spill-over effect depends on the linkages between countries, see R. Arzeki, B. Candelon & A. N. R. Sy, *Sovereign Rating News and Financial Market Spillovers: Evidence from the European Debt Crisis*, IMF WP/11/68 (2011).

⁸⁷ R. Buergin, *Junker Urges More Efforts to Create European Rating Agency* (Bloomberg 2011); S. Westall, *Rating Agencies Exacerbates Crisis: ECB's Nowotny* (Reuters 2011); M. Gartner, B. Griesbach, F. Jung, *PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies*, 2011-06 University of St. Gallen Discussion Paper, 3-18 (2011).

⁸⁸ CRA Regulation III, *supra* note 3.

⁸⁹ Arts 6, 6(a), 6(b).

⁹⁰ Art. 8(a).

⁹¹ Arts 8(b), 8(c).

⁹² Arts 5(a), 5(b), 5(c).

⁹³ Art. 35(a).

⁹⁴ Financial Stability Board (FSB), *Principles for Reducing Reliance on Credit Ratings* (2010).

As will be seen below, CRAs fear and strongly oppose any reforms on civil liability. Therefore, the Commission's reasons for the establishment of a European civil liability regime, as well as the scepticism of CRAs, are worthy of discussion by focusing on the framework embodied in Article 35(a) of CRA Regulation III.

5.1. European civil liability from the CRAs' perspective

In the US CRAs have largely been shielded from civil liability.⁹⁵ In most cases, the US Courts acknowledged and accepted the view that credit ratings are opinions such as those expressed by journalists. For this reason, they have been deemed deserving of protection under the First Amendment of the US Constitution as freedom of the press.⁹⁶ Based on this, CRAs have always opposed any proposal to introduce a regulatory liability regime for them on the grounds that this would create a discriminatory pleading standard with many unintended consequences for them and the rating market. This objection was raised within the US regulatory debate on CRAs' civil liability which eventually led to the setting up of a liability regime under Section 933 of the Dodd Frank Act.⁹⁷

The same argument was proposed as to the civil liability initiatives coming from the other side of the Atlantic. Initially, the Commission sought consultation on: 1) the possibility of introducing a common EU level principle of civil liability for CRAs; 2) whether an appropriate standard of fault could be found; and 3) whether the potential liability regime should cover both solicited and unsolicited ratings.⁹⁸ CRAs took part in the

⁹⁵ F. Partnoy, *The Paradox of Credit Ratings*, in R. M. Levich, G. Majnoni, C.M. Reinhart eds., *Ratings, Rating Agencies and The Financial System*, Ch. 3, 65-84 (Kluwer Academic Press 2002); *id.*, *How and Why Credit Rating Agencies are not Like Other Gatekeepers*, in Y. Fuchita & R. E. Litan eds., *Financial Gatekeepers: Can They Protect Investors?*, Ch. 3, 59-100 (Brookings Institution Press 2006); C. Hill, *Regulating the Rating Agencies*, 82 WULQ 43, 56 (2004); A. R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, Brooklyn Law School Legal Studies Research Paper No 119, 1-21 (2008); K. Nelson, *Rough Waters for the Rating Companies: Should the Securities Rating Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?*, 63 U. Miami L. Review 4, 1191-1196 (2009).

⁹⁶ 'Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances', Cornell University Law School Legal Information Institute [LII], available at: http://www.law.cornell.edu/constitution/first_amendment.

⁹⁷ Section 933 of the Dodd Frank Act: *State of Mind in Private Actions*, available at http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_933.html. Under Section 933, investors can sue credit rating agencies for knowingly or recklessly failing to conduct a reasonable investigation of facts or for failing to obtain an analysis from an independent source.

⁹⁸ Commission, *Overview of Responses to Public Consultation on Credit Rating Agencies* (2010), available at: http://ec.europa.eu/internal_market/securities/docs/agencies/summary-responses-cra-consultation-20110704_en.pdf.

European debate.⁹⁹ It has to be noted that, among them, Feri EuroRating Services AG (Feri), a German rating agency, supported the establishment of a civil liability regime for rating agencies within the new package of regulatory reforms.¹⁰⁰ All the other participating CRAs, in particular, S&P, Moody's, Fitch, and the Canadian rating agency Dominion Bond Rating Services (DBRS) were against.¹⁰¹ These agencies did not express different views on the subject and explained why a civil liability regime was not advisable. Basically, their contrariety can be reviewed as follows: 1) what they think of a European civil liability regime; 2) what they fear from that; and 3) how they may react consequently to its possible establishment.

To begin with, CRAs thought that the establishment of a European civil liability regime was unnecessary because adequate protection for investors was already in place at the national level through each Member States' civil liability regimes.¹⁰² Moreover, they observed that the European regulation of CRAs had several provisions which already put the agencies' analysts, methodologies, and the operation of CRAs under strict control. In particular, the strengthening of the supervisory powers of ESMA under CRA Regulation II was, according to them, sufficient to have an *ex ante* disciplining effect on the CRAs' conduct.¹⁰³ ESMA, as mentioned above, can conduct on site inspections, request information and impose sanctions on the agencies in the event of infringements of the rules set out in the CRA regulations. Against this background, establishing a civil liability regime would be superfluous. Secondly, they claimed that a potential liability regime was dangerous. In essence, they underlined the ways in which a civil liability regime would contrast with the nature of credit ratings as forward-looking opinions subject to changes over time. Consequently, they feared an unlimited exposure to litigation every time a rating change occurred.¹⁰⁴ In other words, they were worried that the regime would open the gate to unmeritorious and speculative claims against them.

Also, they warned that the European rating market could be affected by the risk of increased litigation. One of the possible consequences would be a convergence of CRA ratings in the markets since the agencies would reflect prevailing market sentiment rather than expressing controversial

⁹⁹ All responses authorized to publication can be accessed at <https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp>.

¹⁰⁰ Feri response to the European Commission consultation: 'yes it [CRAs civil Liability regime] is necessary. This is the logical consequence from the normalized regulations for CRAs in Europe. Differences in civil liabilities will in all likelihood lead to different rating procedures and results'.

¹⁰¹ Moody's, response; S&P response; Fitch response; DBRS response, *supra* note 99.

¹⁰² *Ibid.*

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

opinions which could expose them to unlimited litigation.¹⁰⁵ Where ratings conformed to market expectations, their pro-cyclicality would be likely to increase as they would reflect the higher volatility that was experienced in market measures of credit risk compared to credit ratings.¹⁰⁶ Furthermore, convergence would impact on the quality of the ratings being issued; that is to say, the rating alignment might have given the impression that the credit quality analysis produced in the EU was lower vis-à-vis the international markets.¹⁰⁷ Finally, a civil liability regime could impact on the independence of CRAs to the extent that issuers might have used the threat of legal action to delay or curb the production of any ratings that they found unfavourable.¹⁰⁸

The message from the CRAs was clear: including a civil liability regime in the new package of European reforms of CRAs was unnecessary and not advisable. Moreover, they might have tried to protect themselves against a regime they found dangerous. For instance, they might have decided to narrow the range of debt offering they rate, which means that smaller issuers, emerging markets, high yield corporations, and even new products could have stopped being rated.¹⁰⁹ This, in turn, would have hampered the possibility of issuers having access to the European debt markets and would have impacted on the ability of these market sectors to expand. Also, in an attempt to reduce their exposure to potential civil liability claims, CRAs might have decided to circumscribe their business and thus offer ratings only on a subscription basis to those entering into contracts with them.¹¹⁰ This would have had negative consequences for the rating market in that it would have reduced or, in the worst case scenario, eliminated the free public availability of ratings.¹¹¹ In substance, there was a danger that CRAs' operations could have been restricted, causing a dramatic reduction in the flow of information in the markets.¹¹²

¹⁰⁵ Moody's response, *supra* note 99, para. 4.11.

¹⁰⁶ *Ibid.*

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.* See also, S&P response, *supra* note 99, para. 3, 12.

¹¹⁰ *Ibid.*

¹¹¹ DBRS response, *supra* note 99, para. 4.

¹¹² These concerns were not exclusively brought forward by CRAs. Some public authorities involved in the debate were in line with the CRAs' views. Significantly, in the UK the Bank of England (BoE), the Financial Service Authority (FSA) and the HM Treasury (HMT) warned that: 'it [civil liability regime] may be a liability they are very unwilling to incur, with the possible consequence that they may substantially restrict their operations. The removal of protection from 'expert' liability enjoyed by NRSROs in the US before Dodd-Frank, has simply led them to withhold their permission for the inclusion of their ratings in official documentation that would lead them to have 'expert' liability. The result could well be less information for investors (if they refuse to rate complex products) and less regulation of CRAs (if they leave the EU), and excessive conservatism in ratings', The UK Authorities Consultation Response, *supra* note 99, para. 4.6, 19.

Undoubtedly, the scenario depicted by CRAs was rather negative. Their reservations, however, were concerned with the idea of introducing a civil liability regime, when things were still at an embryonic stage and a clearer framework had still to be proposed. The civil liability framework has finally been set out in Article 35(a) of CRA Regulation III. Charting the evolution of the contents of Article 35(a), from the first proposed draft to the final version, will permit us to evaluate the approach resulting from the trilogue between the European Institutions. It will also enable us to assess whether the objections raised by CRAs can still be regarded as sensible when directed towards the specific framework laid down in Article 35(a).

5.2 Civil liability of CRAs from the EU Institutions' perspective: why the civil liability regime was necessary

In the EU, access to justice against CRAs is regulated at the national level. This was made clear in recital 69 of CRA Regulation I, which stated that claims originating from infringements of the European legislation on credit ratings should be based on the applicable Member State's law on civil liability.¹¹³

This was the only reference to CRAs' civil liability in the first European piece of legislation. The establishment of a civil liability regime for CRAs under Article 35(a) of CRA Regulation III has marked a significant change vis-à-vis CRA Regulation I. This requires an analysis of why the European Institutions felt it necessary to create a common civil liability framework for CRAs in the EU. Answers to this can be found by focusing on the users of ratings. This term broadly refers to all those who interact with CRAs. In this context, distinctions can be made between those who seek and pay for the agencies' services (issuers), investors who subscribe for the agency's credit reports and investors who simply refer to credit ratings as the benchmark for their investment decisions without subscriptions.¹¹⁴ The first two categories have a contractual relationship with CRAs, while the third category does not. The existence or absence of a contractual relationship with CRAs has a significant impact on prospects for litigation. Issuers and subscribers will be able to base their claims in contract law, while investors without a contractual tie with the agencies, must refer to the law of tort.

The Commission analysed these different positions and concluded that there was not adequate right of redress for non-subscribing investors

¹¹³ CRA Regulation I, *supra* note 2.

¹¹⁴ Investors can have access to public credit reports free of charge or can subscribe and pay credit reports to the agencies.

against CRAs, in contrast to issuers and subscribing investors.¹¹⁵ In essence, the drawback for the first results from the fact that the possibility of basing claims against CRAs in tort varies considerably among Member States. The problems can be summarized as follows.

In general, there is little case law on CRAs' civil liability towards investors in EU Member States. In addition, in some Member States the conditions under which investors can ask for damages against CRAs are not completely clear and often left to the courts' interpretation. These are the main outcomes of a survey conducted by ESMA on a sample of Member States' civil liability orders.¹¹⁶ For example, in Germany, in the absence of a contract entered into between an investor and a rating company,¹¹⁷ a possible legal basis to set up claims against CRAs could be tort liability under § 826 of the German Civil Code.¹¹⁸ In Netherlands, there is neither case law nor specific legislation on CRAs. Consequently, in the event of civil liability claims against CRAs, Dutch courts may be likely to refer to case law relating to other information providers.¹¹⁹ Similarly, in the UK there are no specific cases relating to CRAs' liability. Whereas it is argued that an agency's duty of care arises from a contractual relationship, problems arise again in the absence of a contractual relationship.¹²⁰ To

¹¹⁵ Commission, Staff Working Paper Impact Assessment Accompanying the Document Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies and a Proposal for a Directive amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers, SEC(2011)1354, Section 4.4, 18.

¹¹⁶ *Ibid.*, Annex VI, Section 2.4, 141-144.

¹¹⁷ C. E. Ebenroth & T. J. Dillon, *The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24 *Law and Policy of International Business* 3, 793-799 (1993). The authors underlined that a subscription agreement between a rating agency and an investor to a magazine published by the rating company is sufficient privity of contract under German law so that the investor can sue the agency for a falsely high rating he relied upon for his investment decision.

¹¹⁸ B. Haar, *Civil Liability of Credit Rating Agencies-Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence*, 02 *University of Oslo Legal Studies Research Paper Series*, 2-19 (2013). With regard to the applicability of § 826 the author remarks that: 'tort liability under § 826 of the Civil Code requires the showing of a violation of public policy, scienter, and reliance, so that it will only lead to success in cases of clear mistakes, if the information is not verified by the defendant despite concerns on his part that he has ignored in an unscrupulous manner, in order to pursue his financial interests and without any regard for the investor's interests'.

¹¹⁹ H.A. de Savornin Lohman & M.G. van 't Westeinde, *Control and Liability of Credit Rating Agencies under Netherlands Law* 11 *EJCL* 1, 1-19 (2007); specifically, the authors refer to: 1) the liability of banks for a prospectus or a fairness opinion; 2) the liability of auditors for their opinions on the annual account; and 3) the liability of journalists and others who are involved in the media sector through the release of statements.

¹²⁰ Within a contractual relationship the CRAs' duty of care is meant as the duty to use reasonable skills in the execution of the contractual obligations, see Ebenroth & Dillon, *supra* note 117, at 789-790.

this end, by referring to some leading cases on the tort of negligence involving auditors,¹²¹ some scholars have discussed whether a CRA's duty of care to investors can be affirmed in the UK.¹²² Within the sample of European countries surveyed by ESMA, France emerges as the only country which adopted, in 2010, a specific law on CRAs' civil liability in tort and negligence towards clients and third parties (investors) for the harmful consequences of any infringement of CRA Regulation I.¹²³

Overall, this scenario contradicts the first objection raised by CRAs against the establishment of a European civil liability regime. Contrary to their assertions, the national legal orders do not guarantee sufficient right of redress, particularly to non-subscribing investors. According to the Commission, CRAs may take advantage of the different Member States' civil liability regimes and choose those jurisdictions in which their exposure to potential civil liability claims is very limited. In other words, the risk is one of jurisdictional arbitrage by CRAs. Consequently, the establishment of a civil liability regime for CRAs is needed in order to: 1) guarantee an adequate right of redress to investors and thus promote legal certainty; 2) prevent forum shopping; and, 3) have a disciplining effect on CRAs.¹²⁴

5.3 Widening the scope of protection

The European civil liability regime for CRAs can be analysed in Article 35(a) of CRA Regulation III.¹²⁵ As mentioned above, the rationale behind the establishment of such a regime is ensuring an adequate right of redress for investors who do not have a contractual relationship with the agencies, and whose possibilities of basing a claim in tort may be jeopardized by the highlighted differences among the Member States' regimes. In turn, the agencies could take advantage of these different levels of protection by engaging in forum shopping practices. Accordingly, the first proposed version of Article 35(a) stated that:

[W]here a credit rating agency has committed intentionally or with gross negligence any of the infringements listed in Annex III having an impact on a credit rating on which an investor has relied when purchasing a

¹²¹ *Candler v Crane, Christmas & Co* [1951] 2KB 164 (CA); *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; *Caparo Industries plc v Dickman* [1990] 2 AC 605.

¹²² A. Reisberg, *The Future role of Credit Rating Agencies in Contemporary Financial Markets-A Theoretical Perspective*, in D. Prentice and A. Reisberg eds., *Corporate Finance Law in the UK and EU*, Ch.7, 169-209 (OUP 2010).

¹²³ Art. L. 544-5 of the French Monetary and Financial Code, (English updated version 2010) available at: www.legifrance.gouv.fr.

¹²⁴ Commission, *Public Consultation on Credit Rating Agencies* (2010), section 4, 24.

¹²⁵ Regulation CRA III, *supra* note 3.

rated instrument, such an investor may bring an action against that credit rating agency for any damage caused to that investor.¹²⁶

Clearly, only investors were supposed to be the beneficiaries of the proposed civil liability regime for CRAs. The final version of Article 35(a), however, marks a significant change. The scope of protection is widened by including issuers as well:

*[W]here a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement.*¹²⁷

The reasons for including “issuers” here can be considered in relation to Recital 32 of CRA Regulation III.¹²⁸ Recital 32 underlines that the impact of credit ratings is different depending on whether it is considered from an issuer’s or an investor’s point of view. From the issuer’s perspective, credit ratings, as opinions on their creditworthiness, can impact upon their image and attractiveness. From the investor’s perspective, the different categories of creditworthiness (AAA, BBB, etc.) are likely to drive their investment decisions.¹²⁹ Where a credit rating is issued in breach of the provisions set out in CRA Regulation I, investors and issuers are in the same boat, that is to say, they may suffer damages and they must be enabled to exercise their right of redress against CRAs effectively.

With reference to issuers, Recital 32 refers first to issuers rated on an unsolicited basis. These issuers do not seek or pay for ratings. Credit ratings are not assigned to them as part of a contractual relationship and, thus, their position is not dissimilar to that of investors.¹³⁰ A downgrade applied to them in breach of the European regulation on credit ratings can jeopardize their reputation and attractiveness before investors. For this reason, they may suffer damages. From a right of redress perspective, they would then encounter the same problems that investors without contractual relationships would face in the EU. Seen from this angle, the establishment of a civil liability regime extended to investors and unsolicited rated issuers is logical. Issuers rated on an unsolicited basis cannot be left out.

¹²⁶ Commission, Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on credit rating agencies, (Brussels 2011), COM(2011)747.

¹²⁷ Article 35(a) para. 1 Regulation CRA III.

¹²⁸ Recital 32 Regulation CRA III.

¹²⁹ *Ibid.*

¹³⁰ *Ibid.*

At this stage, it may be argued that the European civil liability regime for CRAs is built around the protection of investors and issuers rated on an unsolicited basis, but this is only partially true. Recital 32 goes further and also includes within the scope of its protection issuers who have a contractual relationship with CRAs. This is quite revolutionary, if only because the regime was initially conceived for investors with no contractual ties to the agencies. The inclusion of issuers, whether solicited rated or unsolicited rated, denotes an important evolution in the scope of protection, which now encompasses all the categories of market participants who may use credit ratings: issuers and subscribers who have a contractual relationship with CRAs, and issuers and investors who do not have a contractual relationship with the agencies.

Basically, both issuers rated on a contractual and an unsolicited basis can suffer damages because of a rating issued in breach of the rules of CRA Regulation I; this impacts upon their reputation and funding costs. However, issuers enjoying a contractual relationship with CRAs can struggle in the event that a potential infringement of the European regulation is not covered by contractual liability.¹³¹ Consequently, they must benefit from the regime under Article 35(a) to the same extent as investors and issuers lacking contractual ties. In the final version of Article 35(a), the European Institutions have taken a holistic approach to the right of redress against CRAs, which has to be ensured irrespective of whether there is a contractual relationship between the parties.

5.4 Ensuring a level playing field between claimants and opponents under Article 35(a)

The extension of the scope of protection makes Article 35(a) an instrument that everybody, from investors to issuers, can refer to in the event of CRAs' infringements of the European rating regulation. Considering that Article 35(a) gives different claimants the opportunity to enter the litigation arena against CRAs, it is worth discussing this aspect in relation to the CRAs' fear that they risk being overexposed to claims. This risk can be assessed by verifying whether Article 35(a) ensures a level playing field between claimants and defendants before the courts.

¹³¹ In fact, according to Recital 32: 'issuers can also face difficulties in enforcing credit rating agencies' civil liability towards them even when they have a contractual relationship with the credit rating agency concerned: for instance, a downgrade of a credit rating, decided on the basis of an infringement of Regulation (EC) No 1060/2009 committed intentionally or with gross negligence, can impact negatively the reputation and funding costs of an issuer, therefore causing this issuer damage even if it is not covered by contractual liability'.

Putting things into a litigation perspective, the context can be seen as a triangle in which one party asserts by submitting a claim, the counterparty's defence replies, and the judge finally decides. In most jurisdictions, what characterizes this mechanism is the prima facie allocation of the burden of proof on the claimant.¹³² In other words, the claimant must produce sufficient evidence to support its claim in order to shift the burden onto the respondent. This principle guarantees the right equilibrium between the parties before a court. With this in mind, it has to be wondered whether the framework of Article 35(a) sufficiently ensures this equilibrium. The answer would most likely have been in the negative if the first version of Article 35(a), which provided a switch of the burden of proof from the claimant (investor) to the respondent (CRA), had been maintained.¹³³

Specifically, in the event of an investor's claim, it was initially proposed that CRAs would be required to prove either that they had not committed an infringement or that the infringement did not have any impact on the credit rating.¹³⁴ Maintaining this approach can be regarded as unfair for several reasons. Firstly, it is contrary to the abovementioned principle which is uniformly applied in most jurisdictions across the EU. Secondly, it can be perceived as discriminatory towards CRAs because they are being singled out as a category which deserves a different treatment compared to others for which the principle remains applicable. Thirdly, it creates an un-level playing field between the parties to a claim, since the investors only have to assert that an infringement occurred, while the burden to give evidence to the contrary is all on the concerned agency.¹³⁵ Had this approach been maintained, it would have made CRAs unfairly vulnerable to litigation.

Unlike the proposal, Article 35(a), resulting from the trilogue between the European Institutions, guarantees a level playing field between claimants and opponents by reinforcing the normal allocation of the burden of proof. While investors have to establish that they had reasonably, or otherwise, with due care, relied on a credit rating for their decision to invest or disinvest from a financial instrument covered by that rating, issuers have to prove that the infringement of the regulation does not

¹³² M. Kazazi, *Burden of Proof and Related Issues: A Study on Evidence Before International Tribunals*, Part 2, 53-70 (Hague; Boston: Kluwer Law International 1996).

¹³³ The reversal was justified on the ground that investors do not have close insight in internal procedures of CRAs and thus the switch of the burden of proof seemed to be appropriate where the investor has made a reasonable case in favour of the existence of such an infringement, see Recital 26 Commission Proposal, *supra* note 126.

¹³⁴ Proposed Article 35(a) para. 4, *supra* note 126.

¹³⁵ The threshold proposed for the burden of proof to be reversed was particularly low. Proposed Article 35(a) merely required that a claimant established facts from which 'it may be inferred' that an infringement has occurred.

depend on misleading or inaccurate information provided by them to the agency directly or through information publicly available.¹³⁶ The respective burdens are quite onerous. In fact, issuers and investors are additionally required to present accurate and detailed information, giving evidence that an infringement of the regulation has occurred and that such an infringement has had an impact on the credit rating.¹³⁷ In this respect, Article 35(a)2 states that:

[W]hat constitutes accurate information and detailed information shall be assessed by the competent national courts, taking into consideration that the investor or issuer may not have access to information which is purely within the sphere of the credit rating agency.

The utility of the last part of this provision within the framework of Article 35(a) is rather questionable. In one way, it may appear unnecessary in relation to the nature of the role of a judge, who is above the parties in terms of technical and judicial knowledge. Consequently, there is no need to bring to the courts' attention that CRAs may boast more information than investors and issuers; a judge is supposed to know the facts as well as the role of the parties from the moment the claim is addressed. On the other hand, this provision may be perceived as interfering with the independence of the judges. Underlining that courts must take into account that issuers and investors may not enjoy the same amount of information vis-à-vis CRAs might sound like an attempt to influence them, by suggesting that issuers and investors are always in a weaker position than CRAs. On the whole, it is fair that a provision on civil liability specifies what must be left to the interpretative powers of courts. This can be seen in the first part of paragraph 2 of Article 35(a), which tasks national courts with assessing detailed and accurate information. However, it may not be sensible that a civil liability rule also indicates to courts what they have to take into consideration within the respective positions of the potential litigants. This might appear to be out of tune with the equilibrium that the norm preserves between issuers and investors (claimants) and CRAs (respondents) in a litigation scenario.

5.5 Standard of fault under Article 35(a)

Article 35(a) of CRA Regulation III gives investors and issuers the possibility to bring claims against CRAs in the event that they suffer damages because of an infringement¹³⁸ of any of the obligations set out in CRA Regulation I, committed by the agencies intentionally or due to

¹³⁶ Article 35(a) paras (2)(3).

¹³⁷ Article 35(a)(2) para. 1.

¹³⁸ For a list of infringements, see Annex III of CRA Regulation III.

gross negligence.¹³⁹ The search for an appropriate standard of fault has gone through different stages which are worth analyzing.

During the consultation period preceding the first draft of CRA Regulation III, the Commission asked for opinions on the feasibility of establishing a civil liability regime with a view to holding CRAs liable for damages suffered by investors following an “incorrect rating”.¹⁴⁰ The majority of the participants observed that the meaning of the term ‘incorrect rating’ was rather nebulous and of difficult interpretation since it was not explained by the Commission either.¹⁴¹ In this respect, the major CRAs provided constructive criticism. Unanimously, they underlined the nature of credit ratings as forward-looking opinions addressing credit risk. As such, credit ratings are prone to changes over time. These changes, in turn, would not necessarily mean that the issued rating was incorrect or indicative of misconduct from the part of the agencies or its analysts.¹⁴²

This objection makes sense. In general, rating changes reflect the ups and downs that, often unpredictably, occur in the issuers’ economic, financial, and business life. Bearing this in mind, as well as the fact that credit ratings are not cast-iron guarantees of creditworthiness but opinions on creditworthiness, it would not be easy to find appropriate, uniform criteria according to which their incorrectness can be measured. Therefore, the involved CRAs cautioned against the use of generic and poorly defined concepts. They remarked that the proposed, unclear concept of ‘incorrect rating’ would make them too vulnerable every time a credit rating was published or changed.¹⁴³

Wisely, the European Institutions took these points into consideration and the approach which ultimately appears in Article 35(a) neither runs counter to the nature of credit ratings as forward-looking opinions nor leaves room for difficult interpretation. What can be constituted as the basis for investors and issuers to set up claims against CRAs can, ultimately, be articulated in three points: firstly, it is necessary that a violation of the European CRA rules has occurred; secondly, there must be a nexus between the breach of the rules and the issued rating (the violation impacts on the credit rating); thirdly, the violation must be

¹³⁹ Art 35(a)(1).

¹⁴⁰ Commission, *supra* note 124.

¹⁴¹ Commission, *supra* note 98.

¹⁴² CRAs responses, *supra* note 99.

¹⁴³ *Ibid*, to this end, Fitch stressed that ‘basing liability for a CRA solely on an “incorrect” credit rating would, in addition to being unfair, create an untenable situation[in which] issuers would sue if a credit rating was “too low” and investors would sue if it were “too high”.

committed by the concerned rating agency intentionally or with gross negligence.¹⁴⁴

Gross negligence was the chosen standard of fault from the very beginning and has remained fixed. However, in the first proposed draft of Article 35(a), a definition of gross negligence applying to the conduct of a CRA was provided: 'a credit rating agency acts with gross negligence if it seriously neglects duties imposed upon it by this Regulation'.¹⁴⁵ Had this remained, such a definition would have been difficult to interpret due to the lack of clarity as to the meaning of "serious".

Besides, the concept of gross negligence is not uniformly interpreted across the EU, and it is more developed in some jurisdictions than in others.¹⁴⁶

The European Institutions abandoned any attempt to define this concept in the final version of Article 35(a).¹⁴⁷ Within the framework of Article 35(a), gross negligence is among the range of undefined terms which are to be interpreted and applied in accordance with the applicable national law as determined under the rules of private international law.¹⁴⁸ In fact, the Commission proposed not to introduce civil liability into EU legislation. Instead, it was decided to 'ensure civil liability of CRAs towards users of credit rating before national courts' on the grounds that this 'has the advantage of taking into account the specificities of national

¹⁴⁴ Art. 35(a).

¹⁴⁵ Proposed Art. 35(a), *supra* note 126.

¹⁴⁶ For example, in the UK the line of demarcation between liability for ordinary negligence and gross negligence is somewhat blurred. This was clearly expressed by the English Courts in *Armitage v Nurse and Others* [1997] 3 W.L.R. 1046[1998] Ch. 241: 'It would be very surprising if our law drew the line between liability for ordinary negligence and liability for gross negligence. In this respect English law differs from civil law systems, for it has always drawn a sharp distinction between negligence, however gross, on the one hand and fraud, bad faith and wilful misconduct on the other. The doctrine of the common law is that: "Gross negligence may be evidence of mala fides, but is not the same thing."' Also, recently the English Courts sought to interpret the use of such a term in a contract and came to define the concept of gross negligence as a degree of negligence, *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011].

¹⁴⁷ This approach was also followed with regard to the specification of the criteria according to which an infringement of the regulation may be regarded as having an impact on a credit rating. Unlike, proposed Art. 35(a)(2) which stated: 'an infringement shall be considered to have an impact on a credit rating if the credit rating that has been issued by the credit rating agency is different from the rating that would have been issued had the credit rating agency not committed that infringement'.

¹⁴⁸ See Art. 35(a)(4), the other terms are: damage, intention, reasonable reliance, due care, impact, reasonableness and proportionality; a first implementation of Article 35(a) and interpretation of these terms under the applicable national law can be assessed in the UK *Credit Rating Agencies (Civil Liability) Regulations 2013*, No 1637 (July 2013), available at: http://www.legislation.gov.uk/uksi/2013/1637/pdfs/uksi_20131637_en.pdf.

civil law orders'.¹⁴⁹ This approach seems to recognize that both CRAs and claimants might find different jurisdictions more or less attractive. Consequently, it may be argued that the different interpretations of the term gross negligence across EU could encourage forum shopping.

In reality, this risk should be reduced through the rules of the Brussels Regulation and Rome II Regulation, which govern the jurisdiction and the law applicable to a claim within the EU. This is acknowledged under Article 35(a).¹⁵⁰ In any case, the degree to which all those concepts not expressly defined in Article 35(a) are uniformly or differently interpreted across the EU will be tested once specific case law based on infringements of the European regulations of CRAs is formed.

5.6 Excluding vis-à-vis limiting CRAs' civil liability

The civil liability framework has also experienced an interesting evolution in relation to the issue of excluding or limiting the civil liability of CRAs under contractual disclaimers. In most jurisdictions parties are allowed to limit or exclude civil liability in tort through specific disclaimers. However, some restrictions are applied in specific contexts. For example, restrictions are provided with regard to consumer contracts under the Unfair Terms in Consumer Contracts Directive¹⁵¹ and the Product Liability Directive.¹⁵² Despite these exceptions, limitation and exclusion of liability clauses are a matter of negotiation between the parties under the principle of 'freedom of contract'. The courts may interpret such clauses and decide the extent to which liability can be limited or excluded in the context of the agreement entered into between the opponents.¹⁵³

As to CRAs, the presence of such disclaimers is regarded as a problem which limits the possibility of establishing claims against them and

¹⁴⁹ Commission, *supra* note 115, at 47; Amtenbrink & De Haan, *Taming the Beast? New European Regulation on Credit Rating Agencies*, 10 JCGEP 4, 450 (2012). The authors argue that the reference to the domestic legal frameworks implies that some diversity in the liability of CRAs for infringements of the CRA regulation will inevitably occur.

¹⁵⁰ '.....The court that is competent to decide on a claim for civil liability brought by an investor or issuer shall be determined by the relevant rules of private international law'.

¹⁵¹ Annex I (a) Council Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts (1993) OJ L/095 P 0029-0034.

¹⁵² Art. 12 Council Directive 85/374/EEC of 25 July 1985 on the Approximation of the Laws, Regulations and Administrative Provisions of the Member States Concerning Liability for Defective Products (1985) OJ L/210 P 0029-0033.

¹⁵³ See *Kudos Catering (UK) Ltd v Manchester Central Convention Complex Ltd* [2013] EWCA Civ 38 (07 February 2013), available at: <http://www.bailii.org/ew/cases/EWCA/Civ/2013/38.html>.

thus jeopardizes the exercise of an adequate right of redress.¹⁵⁴ In the first version of Article 35(a), the Commission dealt with the possibility of limiting or excluding civil liability by proposing that 'the civil liability referred to in paragraph 1 shall not be excluded or limited in advance by agreement. Any clause in such agreements excluding or limiting the civil liability in advance shall be deemed null and void'.¹⁵⁵

The Commission's proposed approach, however, raised some criticisms. The Bank of England, for instance, remarked that limiting or excluding liability is recognized and accepted between commercial parties and, thus, proposed Article 35(a)(5) appears to 'run contrary to the general tenor and thrust of Member States' existing legal regimes and may have the effect of reducing contractual certainty'.¹⁵⁶ In the final version of Article 35(a) the approach has changed. Civil liability under Article 35(a)(1) cannot be excluded in advance but it can be limited in advance.¹⁵⁷ This is a significant difference. Specifically, it has to be noted how a line has been drawn between excluding and limiting civil liability. While in the first version both options were not possible and a clause limiting or excluding liability would be deemed null and void, in the final version of Article 35(a) only exclusion is not admissible, and as such, 'shall be deprived of any legal effect'.¹⁵⁸ A limitation of civil liability is, on the other hand, possible, provided that the limitation meets the requirement of being reasonable and proportionate, and that it is allowed by the applicable national law.¹⁵⁹ The evolution is on prohibiting exclusion and admitting only reasonable and proportionate limitations. Again, reference shall be made to the applicable national law to define when a limitation of civil liability can be regarded as 'reasonable' and 'proportionate'.

The approach followed by the European Institutions with regard to the discussed matter is fair. A balance has been struck between acknowledging that civil liability disclaimers are generally accepted in most jurisdictions and ensuring that the claimants' right of redress against CRAs is not frustrated by an outright exclusion of CRAs' civil liability.

¹⁵⁴ Haar, *supra* note 118, at 3; the author notes that this is a drawback which affects, in particular, issuers having a contractual relationship with CRAs.

¹⁵⁵ Proposed Art. 35(a)(5), *supra* note 126.

¹⁵⁶ Bank of England Financial Markets Law Committee, FMLC Issue 169: Regulation of Credit Rating Agencies (2012), 2.

¹⁵⁷ Art. 35(a)(3).

¹⁵⁸ *Ibid.*

¹⁵⁹ *Ibid.*

6. CONCLUSION

The set-up of a civil liability regime for CRAs is one of the most noteworthy aspects of the new European body of rules on the rating agencies. The Commission's arguments in favour of the creation of such a regime are more convincing than the concerns raised by the agencies. Firstly, the Commission stressed that there is not adequate protection, in particular, for investors lacking a contractual relationship with CRAs due to the profound differences among Member States' civil liability regimes. This legitimated a regulatory intervention in order to guarantee an adequate right of redress. However, this was only the first step which characterized the shape of the European civil liability regime for CRAs. Ultimately, the initial line of demarcation between protection under contract law vis-à-vis protection under tort law was blurred by encompassing issuers and investors irrespective of whether they have a contractual relationship with the agencies. This makes Article 35(a) an innovative tool for the protection of all those who use the information services provided by CRAs.

This specific framework would not make CRAs more vulnerable to litigation either. Article 35(a) guarantees the equilibrium between the parties in the context of litigation by maintaining the burden of proof on the potential claimants and by detailing what they have to evidence in order to support their claims. Hence, European civil liability for CRAs is not thought to protect investors and issuers at the expense of CRAs, but rather to protect all the actors involved in a litigation context at the same level. Nor can this regime be regarded as dangerous for the operation of CRAs in the European rating market. In fact, what it addresses is neither an 'incorrect rating' nor the CRAs' market operations, but an infringement of the European regulation of CRAs which had an impact on the credit rating used by issuers or investors. Consequently, the scenario CRAs depicted in the event of the introduction of a civil liability regime (rating convergence, increased pro-cyclicality, perceived low-quality of the European ratings, etc.) and, in particular the threat of leaving some issuers or new financial products unrated, appears to have no substance in light of the specific regime set out in Article 35(a).

Notwithstanding, there is still much to be seen. On the one hand, Article 35(a) serves the purpose of providing more legal certainty by guaranteeing an adequate right of redress in the event of damage caused by an agency's conduct in violation of the European rules on credit ratings. On the other hand, further reflections on this liability regime will be only possible once case law based on infringements of the European regulation of CRAs is formed at the national levels.

DOES MEMBER STATE LAW MAKE ARTICLE 35A OF THE EU REGULATION ON CREDIT RATING AGENCIES REDUNDANT?

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1. INTRODUCTION

In June 2013, the second reform of the EU Regulation (EC) No 1060/2009 on credit rating agencies (hereinafter ‘CRA III’) entered into force.¹ Among other things, the preamble states that ‘it is important to provide for an adequate right of redress for investors who have reasonably relied on a credit rating issued in breach of Regulation (EC) No 1060/2009 as well as for issuers who suffer damage because of a credit rating issued in breach of Regulation (EC) No 1060/2009.’² Thus, CRA III introduces Article 35a, which enables both issuers and investors to claim damages for financial loss regardless of whether there is a contractual relationship between the parties.

The first paragraph of Article 35a(1) of CRA III states: ‘Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III [to the regulation in question] having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement.’ The burden of proof rests on the party that seeks to obtain damages.³ In order to claim damages under Article 35a of CRA III, an investor must establish that it has reasonably relied, in accordance with Article 5a(1)⁴ of CRA III or otherwise with due care, on a credit

¹ REGULATION (EU) No 462/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ 2013 L 146/1. CRA III entered into force on June 20, 2013.

² See, Recital (32) of CRA III.

³ It shall be the responsibility of the investor or issuer to present accurate and detailed information indicating that the credit rating agency has committed an infringement of this Regulation, and that that infringement had an impact on the credit rating issued (Article 35a(2) of CRA III). What constitutes accurate and detailed information shall be assessed by the competent national court, taking into consideration that the investor or issuer may not have access to information which is purely within the sphere of the credit rating agency (Ibid).

⁴ According to Article 5a(1) of CRA III, financial institutions (such as credit institutions, investment firms, and institutions for occupational retirement provision) ‘shall make their own credit risk assessment and shall not solely or mechanically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument.’ This should not constitute much of a problem for institutional investors, because they frequently employ their own analysts and conduct their own credit analyses of issuers and securities. (International Organization of Securities Commission. *Report on the Activities of Credit Rating Agencies*. (September 2003) at 7).

rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.⁵

The establishment of a civil liability regime for credit rating agencies (hereinafter 'CRAs') comes as no surprise. In the wake of the recent global financial crisis, it became evident that the CRAs had systematically and grossly overrated structured financial instruments backed by American subprime mortgage loans; these securities would then be sold off to large-scale institutional investors (who thought that they made low-risk investments) both in the U.S. and worldwide. The CRAs' practice of turning high-risk bonds into AAA-rated products made them one of the key culprits in the creation of the U.S. subprime mortgage crisis and the ensuing global financial crisis. Investors suffering multimillion dollar losses due to inflated structured-finance ratings have filed numerous civil lawsuits against the CRAs in recent years. Lawmakers on both sides of the Atlantic (and elsewhere) have enacted new laws and regulations that increase the transparency, reliability, and liability of the CRAs.

This article suggests that Member State legislation and case law in a sense make Article 35a of CRA III redundant. More specifically, investors who reasonably rely on a negligently prepared rating to their detriment, would probably be able to obtain damages under the national civil liability regimes of England and Sweden. However, Article 35a of CRA III may play an important role in these and other Member State jurisdictions which allow investors to obtain damages from CRAs, because it may make the investors' case stronger and increase the CRAs' incentives to abide by the legal framework on CRAs.

This article also discusses the standard of culpable carelessness (gross negligence) required to hold a CRA accountable under Article 35a of CRA III.

2. CIVIL LIABILITY IN ENGLAND

2.1 Introduction

The EU Commission originally outlined harmonized proposals, which imposed a strict definition of legal liability on CRAs. The UK government opposed the Commission's proposals. In later draft texts, there was a shift in emphasis so that legal concepts such as causation or damages should be dealt with in line with the national law of Member States rather than by producing some harmonized legal regime for the whole EU. At a House of Commons committee debate on CRA III in 2012, Mr. Mark Hoban, the then Financial Secretary to the Treasury, welcomed the move

⁵ Article 35a(1) of CRA III.

to reflect local law and stated that ‘the UK already has rules in place on the liability of credit rating agencies; they are sufficiently nuanced to be able to hold CRAs liable where appropriate.’⁶ Subsections 2.2-2.3 take a closer look at some of those rules.

It seems that investors have not brought any civil lawsuits against CRAs before UK courts. At the abovementioned House of Commons committee debate, the then Financial Secretary to the Treasury indicated that he was not aware of cases of negligence proven in UK civil courts. ‘My understanding [...] is that there are no recent examples of such cases being won, although that does not necessarily rule out the possibility of cases brought but not won.’⁷ The following subsections will therefore take examples from the U.S. where investors have brought a number of suits against the CRAs.

2.2 The Financial Services and Markets Act 2000

Section 90 of the Financial Services and Markets Act 2000 (henceforth ‘the FSMA 2000’) imposes civil liability with respect to untrue or misleading statements (and omission of any matter that is required to be included) in prospectuses and listing particulars (section 90(1)).⁸ The implementing legislation (P.R 5.5)⁹ enumerates the responsible persons for a prospectus relating to transferable¹⁰ securities. In case of a debt security issue, the persons responsible include a) the issuer, b) each person who accepts and is stated in the prospectus as accepting responsibility for the prospectus, c) the offeror (if not identical with the issuer), d) the person requesting admission to trading of transferable securities (if not identical with the issuer), e) the guarantor (if not identical with the issuer), and f) each person not falling within any of the previous paragraphs who has authorized the contents of the prospectus (P.R

⁶ Mark Hoban, the then Financial Secretary to the Treasury. House of Commons (Session 2010-12). *European Committee: Financial Services Credit Rating Agencies*, <http://www.publications.parliament.uk/pa/cm201012/cmgeneral/euro/120416/120416s01.htm> (accessed March 21, 2013).

⁷ Ibid.

⁸ An offer of certain ‘transferable securities’ may not be made to the public in the UK, nor may request be made to have such securities listed on a regulated market in the UK, unless a prospectus, approved by the ‘competent authority’ has been published (Section 85 of the FSMA 2000. (John Cartwright, *Misrepresentation, Mistake and Non-Disclosure*, 395 (Sweet & Maxwell 2012)).

⁹ Financial Conduct Authority (FCA). *Prospectus Rules (P.R.) 5.5*, <http://fshandbook.info/FS/html/FCA/PR/5/5> (accessed 7 August 2013).

¹⁰ The FCA Handbook glossary defines *transferable securities*, for the purposes of P.R., as ‘anything which is a transferable security for the purposes of MiFID’. (<http://fshandbook.info/FS/glossary-html/handbook/Glossary/T?definition=G1186> (accessed 7 August 2013)).

5.5.4).¹¹ The last category, each person who has authorized the contents of the prospectus, seems to be the most interesting one in this context.¹²

The wording of P.R. 5.5.4 is comparable to section 11 of the U.S. Securities Act of 1933 (henceforth ‘the Securities Act’)^{13,14} Section 11 of the Securities Act, which imposes liability on various parties who are involved in the preparation of registration statements¹⁵, provides that in case any part of the registration statement contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security may sue:

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement [...]. (Section 11(a)(4) of the Securities Act) (emphasis added)

CRA are not specifically mentioned in section 11(a)(4) of the Securities Act, but they would probably fall under the category ‘any person whose profession gives authority to a statement made by him’. Professor John C. Coffee argues that CRA are clearly covered, which means that if the registration statement references their ratings, the ratings face liability

¹¹ Financial Conduct Authority (FCA), <http://fshandbook.info/FS/html/FCA/PR/5/5#D96> (accessed 7 August 2013).

¹² The second category, persons who accepts responsibility for the prospectus, would probably not be applicable to CRA. In practice, generally only the issuer and the directors accept responsibility. (Carsten Gerner-Beuerle, *Underwriters, Auditors, and Other Usual Suspects: Elements of Third Party Enforcement in US and European Securities Law*, 6 ECFR 4, 476, 494 (2009)) Furthermore, the prospectus rules stipulate that a person shall not be responsible merely by giving advice in a professional capacity. (P.R. 5.5.9) This is commonly interpreted to exclude the lawyers, although the precise reach of the provision is unclear. (Gerner-Beuerle, *Underwriters, Auditors, and Other Usual Suspects*, 476, 494).

¹³ Pub. L. N. 73-22, 48 Stat. 74 (1933).

¹⁴ Section 90 of the FSMA 2000 is structurally comparable to the Securities Act. (Gerner-Beuerle, *Underwriters, Auditors, and Other Usual Suspects*, 476, 493).

¹⁵ The Securities Act has two basic objectives: To require that investors receive financial and other significant information concerning securities being offered for public sale; and To prohibit deceit, misrepresentations, and other fraud in the sale of securities. The U.S. Securities and Exchange Commission accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. (The Securities and Exchange Commission. *Registration Under the Securities Act of 1933*, <http://www.sec.gov/answers/regs33.htm> (accessed on 27 February, 2013)).

under section 11 of the Securities Act.¹⁶ Furthermore, in 2010 the U.S. Congress repealed a rule that exempted ‘nationally recognized statistical rating organizations’ (henceforth ‘NRSROs’)¹⁷ from liability under Section 11 of the Securities Act.¹⁸ However, subsequently the U.S. Securities and Exchange Commission (henceforth ‘the SEC’) took measures that basically nullified that reform for an indefinite period of time.¹⁹

The fact that CRAs may face civil liability under section 11 of the Securities Act, which is similar to P.R. 5.5.4 both structurally and in terms of wording, underpins the former Financial Secretary’s assertion that English law is able to hold CRAs liable where. If the prospectus contains credit ratings or opinions with the consent of the CRA that have issued those ratings or opinions, the CRA could be said to have authorized that part of the particulars and should therefore face expert liability for that information;²⁰ consequently, investors who establish a causal link between the inaccurate rating or opinion and the loss suffered should be able to claim damages.²¹ There is no requirement that the investor should have been specifically aware of the false information and have relied upon it in making an investment decision. Furthermore, an investor bringing a claim under the securities legislation is not required to show that the responsible persons knew that the offending statements were wrong. Lack of such knowledge on the part of responsible persons is relevant only to the extent that this may provide the basis for a defense

¹⁶ John C. Coffee, *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HBLR 231, 264 (2001). Cf. Noemi Blumberg, Johanna Wirth & Nikita Litsoukov, *The Liability of Credit Rating Agencies to Investors: A Review of the Current Liability Regime and Recent SEC Proposals*, *Journal of Structured Finance*, 34, 41 (2001).

Under a literal reading of Section 11(a)(4) of the Securities Act, CRAs seem to be covered by ‘any person whose profession gives authority to a statement made by him’.

Blumberg, Wirth & Litsoukov argue that CRAs could be covered by the underwriter definition in Section 11(a)(5) of the Securities Act. (Blumberg, Wirth & Litsoukov, *The Liability of Credit Rating Agencies to Investors*, 34, 40).

¹⁷ The dominant CRAs, Moody’s, Standard & Poor’s and Fitch Ratings, were the only NRSROs until after the enactment of the Credit Rating Agency Reform Act of 2006 (Pub. L. No.109-291, 120 Stat. 1327 (2006)), which was aimed at, among other things, increasing the number of NRSROs in order to enhance competition in the credit rating industry.

¹⁸ Section 939G of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub.L. 111–203, H.R. 4173).

¹⁹ See, The Securities and Exchange Commission. *Ford Motor Credit Company LLC, SEC No-Action Letter (November 23, 2010) WL 2882538*, <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm> (accessed 14 Sept, 2012).

²⁰ An expert is responsible for a statement which he has authorized to be included in the listing particulars. (Cartwright, *Misrepresentation, Mistake and Non-Disclosure*, 408).

²¹ Evidence that the price at which securities were sold was affected materially by the false statement or omission could establish causation. (Eilís Ferran, *Principles of Corporate Finance Law*, 456 (Oxford University Press 2008)).

where they can establish that they believed on reasonable grounds that the information was true.²²

The CRAs would not face strict liability under section 90 of the FSMA 2000. Section 90(2) of the FSMA 2000 stipulates that subsection (1) is subject to exemptions provided by Schedule 10. The defendant does not incur liability if he ‘reasonably believed’ that the incorrect statement was true and not misleading and if he ‘made such enquiries, if any, as were reasonable’ to verify the correctness of the prospectus.²³ Again, the English regulation is similar to section 11 of the Securities Act. To avoid liability under section 11 of the Securities Act, an expert must merely prove that, after reasonable investigation he had reasonable ground to believe and did believe at the time the part of the registration statement that he expertized became effective, that the challenged statements were true and that there was no omission of a material fact required to be stated therein or necessary to make the statements therein not misleading (the ‘due diligence defense’).²⁴

Schedule 10 of the FSMA 2000 also defines the period during which the defendant must show that he continued in the belief that the statement was true and not misleading. One of the conditions is that ‘he continued in his belief until the time when the securities in question were acquired’.²⁵

There is no reported case of an investor succeeding in bringing a claim for compensation under the special statutory regime in the FSMA 2000 or its predecessor, the Financial Services Act of 1986. Nor is there much evidence in the reported decisions of investors even commencing such claims.²⁶

2.3 Common law (negligent misrepresentation)

For a long time there was essentially no tort liability for misstatements causing pure economic loss unless actual fraud²⁷ was involved or a special relationship (such as a ‘fiduciary relationship’)²⁸ could be established.

²² Ibid, 456 and 457.

²³ See, paragraph 1(2) of Schedule 10 of the FSMA 2000; Cartwright, *Misrepresentation, Mistake and Non-Disclosure*, 406; and Gerner-Beuerle, *Underwriters, Auditors, and Other Usual Suspects*, 476, 495. Cf. paragraph 2 of the Schedule 10, which concerns statements made on the authority of an expert. The effect of the defense under paragraph 2 is to exempt from liability others who are responsible for the particulars unless they cannot show that they actually believed, on reasonable grounds, that the ‘expert’ was competent. This would require a defendant to have made any relevant reasonable enquiries to verify the competence of the ‘expert’. (See, Cartwright, *Misrepresentation, Mistake and Non-Disclosure*, 408; and Gerner-Beuerle, *Underwriters, Auditors, and Other Usual Suspects*, 476, 495-496.).

²⁴ Section 11(b)(3)(B)(i) of the Securities Act.

²⁵ See, paragraph 1(3) of Schedule 10 of the FSMA 2000.

²⁶ See, Ferran, *Principles of Corporate Finance Law*, 460.

²⁷ *Derry v. Peek* (1889) LR 14 App. Cas. 337.

²⁸ *Nocton v. Lord Ashburton* [1914] AC 932.

In all other cases involving misstatements, the exclusionary rule barred recovery. This strict adherence to the exclusionary rule was maintained until 1964 and the House of Lords' groundbreaking decision in *Hedley Byrne v. Heller & Partners*²⁹. In short, the facts of the case were the following:

*A firm of advertising agents, Hedley Byrne, was asked by one of its clients to create an advertising campaign. Hedley Byrne's bank asked the client's bank, Heller & Partners, for a credit reference regarding the client. Heller & Partners responded that the client was creditworthy. On the basis of that information, Hedley Byrne placed substantial advertising orders. Presently, the client went bankrupt. Hedley Byrne was unable to recover the money it had already spent from its client. Consequently, Hedley Byrne filed a lawsuit against Heller & Partners, arguing that Heller & Partners had owed it a duty of care not to mislead it even though there was no contractual relationship between the parties.*³⁰

The House of Lords found that there can be liability for negligent misstatements causing economic loss in the absence of fraud or a contractual or fiduciary relationship, provided that there is a special relationship between the parties:

*The law will imply a duty of care when the advisee seeks information from an advisor who has special skill and where the advisee trusts the advisor to exercise due care, and that the advisor knew or ought to have known that reliance was being placed upon his skill and judgment.*³¹

Lord Reid noted that the required special relationship arises 'where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstances required, where it was reasonable for him to do that, and where the other gave the information or advice when he knew or ought to have known that the inquirer was relying on him.' In formulating this principle of proximity, Lord Reid put emphasis on the reasonable reliance of the plaintiff on the other's advice.³² Lord Devlin described the required special relationship as 'equivalent to contract'.³³

²⁹ *Hedley Byrne & Co. Ltd v. Heller & Partners Ltd* [1964] AC 465.

³⁰ Nicholas J. McBride & Roderick Bagshaw, *McBride and Bagshaw: Tort Law*, 125 (3rd ed., Pearson Education 2008); Mark Lunney & Ken Oliphant, *Tort Law: Text and Materials*, 403 (3rd ed., Oxford University Press 2007); Barbara Ann Hocking & Alison Smith, *Liability for Negligent Words*, 27 (Federation Press 1999); Jan Kleineman, *Ren förmögenhetsskada – särskilt vid vilseledande av annan än kontraktspart* (diss.), 345 (Juristförlaget 1987).

³¹ [1964] AC 465. However, in the *Hedley Byrne* decision itself, Hedley Byrne was not able to obtain damages because of a disclaimer that Heller & Partners had attached to the credit reference that was submitted to Hedley Byrne.

³² [1964] AC 465.

³³ [1964] AC 465.

The House of Lords' decision in *Caparo Industries plc v. Dickman*³⁴ is another authority for when recovery for economic loss is available for negligent misstatement. In short, the facts of the case were the following:

*A company, Caparo Industries, which already owned shares in another company, Fidelity, purchased more shares and made a successful takeover bid in reliance on favorable figures in Fidelity's annual audit. After the purchase, Caparo discovered that Fidelity was, in fact, almost worthless. Caparo then sued the auditors (Dickman) that had prepared the annual audit of Fidelity.*³⁵

In the view of the majority of the Court of Appeal, the auditor owed a duty to the shareholders individually.³⁶ However, the House of Lords overruled that decision. The Law Lords found that there was an important distinction between *Hedley Byrne* and the case at bar:

*The situation is entirely different 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 which the maker of the statement has no specific reason to anticipate.*³⁷

Fidelity's annual audit was required under the Companies Act of 1985 for certain limited purposes of which investment advice was not one. Lord Jauncey argued that:

*If the statutory accounts are prepared and distributed for certain limited purposes, can there nevertheless be imposed upon auditors an additional common law duty to individual shareholders who choose to use them for another purpose without the prior knowledge of the auditors? The answer must be no.*³⁸

Thus, there was not sufficient relationship of proximity between the parties in the present case. Lord Reid concluded that '[a]n essential ingredient of the 'proximity' between the plaintiff and the defendant' is 'that the defendant knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind (e.g. in a prospectus inviting investment) and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter upon that transaction or upon a transaction of that kind.'³⁹ If the auditors had been aware that Caparo was likely to rely

³⁴ [1990] 2 AC 605.

³⁵ [1990] 2 AC 605; Catherine Elliot & Frances Quinn, *Tort Law*, 23 (8th ed., Pearson 2011).

³⁶ [1989] Q.B. 653.

³⁷ [1990] 2 AC 605; Elliot & Quinn, *Tort Law*, 23.

³⁸ [1990] 2 AC 605.

³⁹ [1990] 2 AC 605.

on the annual audit in relation to the investment in Fidelity, they would probably have owed Caparo a duty of care.

We have seen that under certain circumstances both bankers and auditors may have liability in tort for negligent misstatements causing pure economic loss. But liability has been extended to other professionals as well, primarily surveyors⁴⁰ and solicitors⁴¹. In terms of the CRAs, no negligence cases seem to have been brought in the UK.⁴² The question therefore arises: Would courts be willing to extend liability to CRAs as well? Well, the relationship between certain types of investors and a negligent CRA seems to be sufficiently close to meet the requirements of the principle of proximity. The requirement that the CRA should have special skill is unproblematic (the CRAs employ professional credit analysts) as is the requirement that it should be reasonable for investors to trust the CRA's analysts to exercise due care in the rating process. The third requirement, that the CRA knew or ought to have known that reliance was being placed upon its skill and judgment, is more interesting. It does not seem that the defendant needs to have specific knowledge of the plaintiff's identity to owe him a duty of care; in *Caparo*, Lord Reid stated that it is sufficient that plaintiff belongs to an identifiable class. Private placement investors may constitute such an identifiable class. They are limited in number and the CRA is aware that its credit rating will be seen on the offering materials given to those investors. U.S. courts have argued similarly in negligent misrepresentation⁴³ cases brought against the CRAs. For example, in the case *In re National Century Fin. Enter, Inc. Inv.*⁴⁴ an Ohio court found that plaintiffs, who were institutional investors,

⁴⁰ *Smith v. Eric S. Bush* [1990] AC 831 and *Harris v. Wyre Forest District Council* [1989] 2 WLR 790. In both cases, plaintiffs purchased houses (of modest value) in reliance on valuations that were made by surveyors.

See, also *McCullagh v. Lane Fox & Partners Ltd* [1996] 1 EGLR 35, which concerned information given by a vendor's estate agent to a purchaser at the upper end of the housing market. Because of a disclaimer issued by the defendant, there was no assumption of responsibility under *Hedley Byrne*. (Elliot & Quinn, *Tort Law*, 32).

⁴¹ *White v. Jones* [1995] 2 AC 207. A solicitor had failed to prepare timeously a new will, thus thereby depriving the intended beneficiaries of the benefits intended by the testator.

⁴² See, section 2.1.

⁴³ In the U.S., the law of accountants' liability for negligent misstatements has essentially split into two main approaches: the Ultramares approach and the Restatement approach. The approaches have been applied to CRA cases. Under the former approach, a CRA may only be held liable when it was aware that its rating information was to be used for a particular purpose by a known party. Moreover, there must have been some conduct on the part of the defendant linking it to the plaintiff, which evinces the defendant's understanding of the plaintiff's reliance. (580 F.Supp.2d 630 (2008)) Section 552 of the *Restatement (Second) of Torts* does not have a similar near-privity requirement. It requires that plaintiff be part of a limited class of known or intended users of the rating information. (See, *Restatement (Second) of Torts*, American Law Institute, 1977.).

⁴⁴ 580 F.Supp.2d 630 (2008).

were part of a limited class and therefore had a cause of action.⁴⁵ Cf. *Ohio Police & Fire Pension Fund et al. v. Standard & Poor's Financial Services LLC et al.*⁴⁶, in which case the investors' action was disallowed, because they were not considered to be part of limited class.

Importantly, in a landmark decision by the Federal Court of Australia in 2012—*Bathurst Regional Council v Local Government Financial Services Pty Ltd*⁴⁷—Standard & Poor's (henceforth S&P) was found to owe a duty of care to potential investors. This is the first known decision of its type in the common law world. In short, the facts were the following:

*In 2006, ABN Amro Bank NV engaged S&P to rate constant proportion debt obligations (henceforth 'CPDO'), which are 'grotesquely complicated' financial instruments. S&P assigned an AAA rating to the CPDOs. An Australian local authority, the Local Government Financial Services, purchased A\$50 million of CPDO notes and sold approximately A\$16 million of CPDO notes to 13 local councils. After the outbreak of the global financial crisis, S&P downgraded its rating to BBB+. The councils received back less than 10% of the principal amount that they invested and commenced proceedings.*⁴⁸

The Federal Court of Australia found, among other things, that ABN Amro Bank NV had effectively 'gamed' the model it knew S&P would apply to rate the CPDO. Further, S&P's AAA rating was misleading and deceptive and involved the publication of information or statements false in material particulars and otherwise involved negligent misrepresentations to the class of potential investors in Australia, because by the AAA rating there was conveyed a representation that in S&P's opinion the capacity of the notes to meet all financial obligations was 'extremely strong' and a representation that S&P had reached this opinion based on reasonable grounds and as the result of an exercise of reasonable care when neither was true and S&P also knew not to be true at the time made. The CPDO could not have been rated AAA by S&P on any rational or reasonable basis. S&P's analysis was fundamentally flawed, unreasonable and irrational in numerous respects. Thus, S&P

⁴⁵ '[M]oody's prepared the bond ratings knowing that its ratings would be seen on the offering materials given to only a select class of qualified investors, of whom [plaintiff] was one.' (580 F. Supp. 2d 630, 647-648 (2008)).

⁴⁶ 700 F.3d 829 (2012).

⁴⁷ (No 5) [2012] FCA 1200.

⁴⁸ (No 5) [2012] FCA 1200; James Cooper, Zoe Millington Jones, John Imhoff, Ned Kirk, Rhiannon Eagles, & John Edmond *Tide is turning against credit rating agencies*, FI and D&O International review. 1-2 (March 2013). http://www.clydeco.com/uploads/Files/Publications/2013/CC002768_FI_and_DO_Review_20_03_13.pdf (accessed 24 Oct. 2013); Lisa McKenna, *An Uncertain Forecast for Credit Rating Agencies: Liability for Credit Rating Agencies after Bathurst*, CBLR Online (27 Nov. 2012), <http://cblr.columbia.edu/archives/12449> (accessed 20 Aug. 2013).

was in breach of its duty of care to potential investors. It did not help that it had included disclaimers, because none made clear that S&P's rating was an opinion which did not have reasonable grounds and was not the result of the exercise of reasonable care and skill.⁴⁹

S&P has indicated that the decision of the Federal Court of Australia will be appealed,⁵⁰ so it remains to be seen whether the decision will be upheld by a higher court. Even though the Australian decision does not bind English courts, they may consider it as "persuasive authority".⁵¹ Even so, English court may not follow the approach of the Australian decision in all respects. For example, it is not known whether an English court would find the CRA's disclaimers ineffective (*vis-à-vis* investors that have not paid the CRA for the rating).⁵² Under the Unfair Contract Terms Act 1977 (hereinafter 'the UCTA') the exclusion or restriction of liability in negligence for pure economic loss is subject to a test of reasonableness. Section 2(2) of the UCTA provides that in the case of loss or damage, other than death or personal injury, 'a person cannot so exclude or restrict his liability for negligence except in so far as the term or notice satisfies the requirement of reasonableness.'⁵³ Section 11(3) of the UCTA provides that 'In relation to a notice (not being a notice having contractual effect), the requirement of reasonableness under this Act is that it should be fair and reasonable to allow reliance on it, having regard to all the circumstances obtaining when the liability arose or (but for the notice) would have arisen.' In *Smith v. Eric S. Bush*⁵⁴ and *Harris v. Wyre Forest District Council*⁵⁵, two appeals heard together by the House of Lords, house purchasers sued surveyors who had provided them with negligently prepared valuations on which they had relied. There were no contracts between the purchasers and the surveyors, who were hired by the respective mortgagees, but the surveyors knew that the purchasers paid for the valuations. The House of Lords found that the surveyors were liable for damages to the purchasers notwithstanding the disclaimers. The disclaimers were struck down by Sections 2(2) and 11(3) of the UCTA.⁵⁶ However, it is important to note that in deciding to strike

⁴⁹ Ibid.

⁵⁰ Lucy Carter and staff, *Councils to recoup GFC losses after court ruling*, ABC News (5 November 2012) <http://www.abc.net.au/news/2012-11-05/councils-to-recoup-gfc-losses-after-court-ruling/4353000> (accessed 24 Oct. 2013).

⁵¹ It is relatively common that English courts cite decisions by courts in other common law jurisdictions (such as the U.S., Australia, New Zealand and Canada). (*See*, Lando, O., *Kort indføring i komparativ ret*, 2d ed., Jurist- og Økonomforbundets Forlag, København, 2004, at 178-179.)

⁵² *See*, Cooper et al., *Tide is turning against credit rating agencies*, 1, 3.

⁵³ The fact that the plaintiff was aware of or agreed to the terms of any such contract term or notice 'is not to be taken as indicating his voluntary risk.' (Section 2(3) of the UCTA).

⁵⁴ [1990] AC 831.

⁵⁵ [1989] 2 W. L. R. 790.

⁵⁶ [1990] AC 831; [1989] 2 W. L. R. 790.

down the disclaimers, the Law Lords attached importance to the fact that the case concerned consumers purchasing homes.⁵⁷ That situation does not seem to be easily transferable to losses suffered by investors at the capital market due to a negligently prepared credit rating. For example, it is far from certain that investors would be much less able to bear the risks than the CRAs, since claims for damages could amount to very large sums depending on the size and worth of the issue that was assigned an inflated credit rating. On the other hand, Section 11(5) of the UCTA provides that it is for those claiming that the disclaimer satisfies the requirement of reasonableness to show that it does. This militates against the effectiveness of exculpatory clauses.⁵⁸ English courts do not seem to have much sympathy for standard disclaimers.⁵⁹ But, having said that, it should be noted that a disclaimer is more likely to prevent liability in cases where the plaintiff could reasonably be expected to understand what it meant, such as where the plaintiff is a business, or someone experienced in the kind of transaction taking place.⁶⁰

3. CIVIL LIABILITY IN SWEDEN

3.1 Introduction

In Sweden, arguably a civil law country,⁶¹ the Swedish Tort Liability Act⁶² (henceforth 'the Tort Liability Act'), which was enacted in 1972, is the general and most important statute of tort law. Article 2 of Chapter 2 of the Tort Liability Act regulates pure economic loss (*Sw. ren förmögenhetsskada*).⁶³ It reads: 'A person who causes a pure economic loss through a criminal act shall compensate the damage.'⁶⁴ From a comparative perspective, the Swedish provision may seem peculiar in that it does not recognize a

⁵⁷ For example, Lord Griffith put emphasis on, *inter alia*, that the purchasers of a dwelling house of modest value are likely to be far less able to bear the risks than the surveyors. ([1990] AC 831; [1989] 2 W. L. R. 790).

⁵⁸ See, Abbey, R. M. & Richards, M. B., *Practical Approach to Conveyancing*, 9th ed., Oxford University Press, 2007, 145.

⁵⁹ See, *ibid*; and *First National Commercial Bank plc v. Loxleys* [1996] EWCA Civ 886; (1996) 93 (43) LSGaz 20.

⁶⁰ See, *Omega Trust Co Ltd v. Wright Son & Pepper* [1997] PNLR 424; and *McCullagh v. Lane Fox & Partners Ltd* [1996] 1 EGLR 35.

⁶¹ It is arguable that the Scandinavian countries form part of the civil law world, if as peripheral constituents. (See, Jacob W. F. Sundberg, *Civil Law, Common Law and the Scandinavians*, 13 *Scandinavian Studies in Law*, 179-205 (1969). <http://sisl.juridicum.su.se/> (accessed 18 June 2013); and Pierre Legrand, *European Legal Systems Are Not Converging*, 45 *ICLQ*, 52 (1996).).

⁶² *Sw. skadeståndslagen (1972:207)*.

⁶³ *Ren förmögenhetsskada* is an economic loss which is not causally consequent upon physical injury to the plaintiff or any other person (Article 2 of Chapter 1 of the Tort Liability Act).

⁶⁴ Author's translation.

cause of action for pure economic loss, unless it was caused by a criminal act.⁶⁵ However, a literal reading of the article in question does not give the entire picture. The law in this field has changed considerably over the course of the years, even though the wording of Article 2 of Chapter 2 of the Tort Liability Act has not changed. In fact, since the late 1980s, Swedish tort law has recognized a cause of action for pure economic loss caused by a negligent misstatement in the absence of a criminal act. The scope of civil liability under Article 2 of Chapter 2 of the Tort Liability Act was extended, not through an alteration of the said statute, but through a series of rulings by the Swedish Supreme Court, the most notable one being NJA 1987 s 692. This and other rulings by the Swedish Supreme Court are examined in the next section.

3.2 Case law on Article 2 of Chapter 2 of the Swedish Tort Liability Act⁶⁶

In short, the facts of the Swedish Supreme Court ruling NJA 1987 s 692 were the following:

An investment company granted a loan totaling 1 million Swedish crowns to an estate agency. The agency provided the investment company with a mortgage deed as collateral. It was accompanied by an appraisal (made by a real estate valuer hired by the agency) that valued the property at 4.3 million Swedish crowns. When the agency did not repay the loan, the investment company proceeded to use the collateral to satisfy the outstanding debt. But the value of the collateral did not, by far, suffice to cover the debt in question. Therefore, the company brought a negligent misrepresentation action against the real estate valuation company⁶⁷ to recover the money it had lost.

⁶⁵ Jan Kleineman, *Om den befogade tillitens skadeståndsrättsliga relevans*, Juridsk Tidskrift 3, 625, 626 (2001/02).

⁶⁶ This article focuses on civil liability. However, I would like to add that CRAs publishing negligently prepared ratings may face criminal liability under the Swedish Penal Code (Sw. *Brottsbalken (1962:700)*). Paragraph 1 of Article 9 of Chapter 9 of the Swedish Penal Code reads: 'A person who publishes or otherwise disseminates misrepresentation to the public in order to affect the price on a commodity, a security, or another type of property is guilty of swindling and is punishable by imprisonment for a maximum of two years or, if it is a minor offense, by fine or imprisonment for a maximum of six months.' (Author's translation.) Paragraph 3 reads: 'If a criminal act in this article is serious, it is punishable by imprisonment for a minimum of six months and a maximum of six years.' (Author's translation.) CRAs make credit ratings publicly available and, not least in view of the recent financial crisis, it is undeniable that those ratings have a huge impact on the market price of securities. In Sweden, only natural persons may be charged with crimes. Probably, the prosecutors would charge directors or senior analysts at the CRA with the crime in question. Provided that the defendants are found guilty, investors who suffered losses due to the misrepresentations may obtain damages from them.

⁶⁷ Thus, this case concerned vicarious liability (and not the real estate valuer's liability).

The Swedish Supreme Court found that the valuation gave the impression that it was possible to develop the property, although in reality the municipal authorities opposed development of the property. The real estate valuer had based his appraisal of the property's value on the premise that development was permitted. Since it would have been easy for the valuer to check whether development was permitted or not, the Swedish Supreme Court found that he had been negligent.⁶⁸

The Swedish Supreme Court went on to find that the real estate valuer had liability towards the investment company for the pure economic loss, even though the loss was not a result of a criminal act. Interestingly, the Swedish Supreme Court reasoned much like a common-law judge would be expected to do. It founded its decision on practical considerations, reasoning that a real estate valuation is often intended to serve as a basis for a decision to make a purchase or to grant a loan. Therefore, the real estate valuer must recognize that the valuation may be used for different purposes and by several parties. It is inevitable that the valuation will be of importance not only to the client but to other parties as well. If the real estate valuer merely had liability towards his client, it would lead to numerous double valuations that are of no real advantage to either the real estate market or the credit market. For these reasons, the Swedish Supreme Court established that a professional real estate valuer is, in principle, subject to liability for pure economic loss caused to third parties by their justifiable reliance on the information contained in the valuation. The court noted, however, that a real estate valuer can escape such liability if he or she adds an exculpatory remark to the valuation.⁶⁹

According to Professor Jan Kleineman, the Swedish Supreme Court's decision was carefully considered.⁷⁰ One might also say that the Swedish Supreme Court chose to adopt a commonsensical approach similar to the pragmatic methods characteristic of common-law judges. It did not abide by the formalism of code-based legal systems. In fact, in the preparatory works of the Tort Liability Act, the then Minister of Justice indicated that courts should set and develop the limits of liability for pure economic loss notwithstanding the enactment of the statute in question.⁷¹

In a subsequent case named NJA 2001 s 878, the Swedish Supreme Court reaffirmed and clarified the principles it had set out in NJA 1987 s 692. In short, the facts of the case were the following:

⁶⁸ NJA 1987 s 692, 702.

⁶⁹ NJA 1987 s 692, 703.

⁷⁰ Kleineman, *Om den befogade tillitens skadeståndsrättsliga relevans*, 625, 627.

⁷¹ Prop. 1972:5. *Kungl. Maj:ts proposition med förslag till skadeståndslag m.m.* Stockholm, http://www.riksdagen.se/sv/Dokument-Lagar/Forslag/Propositioner-och-skrivelser/prop-19725-Kungl-Majts-prop_FV035/?text=true (accessed 13 Aug. 2013).

A real estate valuation company was engaged by another company to value a property. Its value was estimated to be between 73–79 million Swedish crowns. The company intended to use the valuation in arbitration proceedings. In the valuation document, the real estate valuer stated that it was intended to be used in ‘proceedings’. Later, a bank granted the company a loan on the basis of the same valuation; the valued property was used as collateral. When the company defaulted on its loan, the bank sold the property. But the proceeds from the sale did not cover the debt, because the valuer had overestimated the market value of the property. The company brought a negligent misrepresentation action against the real estate valuation company to recover the money it had lost.

The majority of the Swedish Supreme Court noted that a third party who has suffered a pure economic loss due to a misrepresentation by a real estate valuer may recover only ‘if [the third party’s] reliance on the valuation was justifiable’. In this context, it is important to consider whether the valuer has disclaimed responsibility or whether he submitted the valuation without any reservations. Furthermore, when considering the consequences that might have followed had the court established liability for the valuer, the majority found that disclaimers should be accepted even if they are vaguely formulated. The majority also stated that it should be possible for the valuer to limit his responsibility by expressly referring to the purpose for which the valuation was sought. The valuation in question was intended to be used in arbitration proceedings, which the real estate valuer had indicated by stating that the valuation was intended to be used in ‘proceedings’. The majority recognized that he may not have expressed himself clearly on this point, but in their view the information should have prompted the bank to ask the valuer whether the valuation could serve as a basis for a decision to grant a loan. Since the bank could not show that it had done so, it was not entitled to obtain damages for the pure economic loss it had suffered due to the valuer’s negligence^{72, 73} (Two of the Swedish Supreme Court judges and the reporting clerk dissented. They held that the use of the word ‘proceedings’ in the valuation was too vague and could not be taken to mean that the valuer had exculpated himself from liability.)⁷⁴

There are negligence cases not dealing specifically with misrepresentation in which courts have established that the defendants have liability towards third parties in the absence of a criminal act under Article 2 of Chapter 2 of the Tort Liability Act. *See, e.g.,* NJA 1996 s 700 in which

⁷² The Swedish Supreme Court did not try the issue of negligence, because the real estate valuation company conceded that the valuer had negligently overestimated the value of the property. (NJA 2001 s 878, 885).

⁷³ NJA 2001 s 878, 886-887; Kleineman, *Om den befogade tillitens skadeståndsrättsliga relevans*, 625, 628-631.

⁷⁴ NJA 2001 s 878, 887-888.

a bankruptcy trustee negligently sold property that was not part of the bankruptcy estate but belonged to a third party. The trustee was held liable towards the third party for the pure economic loss that he suffered as a consequence of the sale.⁷⁵

Would it be possible for investors to bring successful claims against negligent CRAs under Article 2 of Chapter 2 of the Tort Liability Act? Well, the arguments on which the Swedish Supreme Court based its decision in NJA 1987 s 692 seem to be applicable to CRA cases. The purpose of credit ratings is to enable investors to make informed business decisions. The CRAs therefore recognize that ratings are of importance to investors. As to the question of justifiable reliance, it is unreasonable that CRAs should be able to escape liability towards investors by adding standard disclaimers to their ratings. It stands to reason that the possibility to exculpate oneself from tort liability must be limited; otherwise, such liability would be of no use to injured parties. Of course, it is more reasonable to uphold disclaimers that are limited in scope; for example, it seems reasonable to uphold a disclaimer that exculpates the issuer of the valuation from losses that may occur if the valuation is used for one purpose when it was given for another purpose (which was the case in NJA 2001 s 878; cf. the *Caparo* case).⁷⁶ But investors who rely on ratings to make informed business decisions use the ratings for the very purpose for which they were intended. Thus, it appears that investors meet the requirement of justifiable reliance.

Associate Professor Anne-Marie Pålsson argues that an investor who has a long and comprehensive experience of financial investments should not be able to obtain damages for misleading advice provided by a professional advisor, because the investor has sufficient knowledge to be able to evaluate the advice received.⁷⁷ However, this argument cannot be transferable to the field of credit ratings completely, because, as is widely acknowledged, not even experienced investors were able to fully comprehend the risks inherent in the complex structured financial instruments that were rated AAA by CRAs prior to the global financial

⁷⁵ See, also NJA 1998 s 520 in which an owner of shares entered a share pledge agreement with a company (hereinafter 'the creditor') that granted the owner a loan. The bank, in which the shares were deposited, was informed of the agreement. Later, the bank negligently transferred the shares to another bank at the request of the owner but without the creditor's consent. When the owner defaulted, the creditor found out that the shares had been moved. The creditor then filed a lawsuit against the bank to recover the money it had lost. The Swedish Supreme Court concluded that the bank had liability towards the creditor (even though there was no contract between the bank and the creditor).

⁷⁶ See, the dissenting opinion of Justice Svensson in NJA 2001 s 878, 887-888.

⁷⁷ Pålsson, A.-M., 'Lagreglering eller självreglering av marknaden för finansiell rådgivning' (2001) *SvJT*, 248, 256.

crisis. On the other hand, Pålsson's argument indicates that an experienced investor who has relied on a traditional corporate-bond rating should not be able to recover, because the investor was in a position to evaluate the rating. (Traditional corporate bonds are much less complex than structured-finance instruments.)⁷⁸

In NJA 1987 s 692, the Swedish Supreme Court noted that different types of property may be valued and for different purposes. Therefore, it would be virtually impossible for the court to make general statements about the limits of liability. The court therefore stated that its decision only has a bearing on valuations made by professional real estate valuers. But, in my view, this could not be taken to mean that the Swedish Supreme Court would refuse to extend liability under NJA 1987 s 692 to CRAs (much in the same way as it extended liability to a bankruptcy trustee in NJA 1996 s 700). Over a quarter of a century has passed since the Swedish Supreme Court delivered its decision in NJA 1987 s 625. Nowadays financial advisors and other professionals, such as CRAs, are more critical than ever to the functioning of the financial markets. Their increased power should be balanced by increased civil liability. Furthermore, it seems old-fashioned to allow recovery only in cases where the valuer happens to value real estate. Also, under Swedish statutory law, certain professionals—primarily auditors, real estate agents and insurance brokers—are subject to liability for their advice.⁷⁹ Those categories of professionals, arguably, often give advice on transactions of less significance to the stability of the financial market than the CRAs. Thus, it would be an anomaly to allow lawsuits against those professionals but not against the CRAs.

4. THE STANDARD OF CULPABLE CARELESSNESS

According to Article 35a of CRA III, CRAs can be held accountable for carelessness only if they have been grossly negligent.⁸⁰ The term 'gross

⁷⁸ See, e.g., Professor Lawrence J. White: 'the corporations and governments whose 'plain vanilla' debt was being rated were relatively transparent, so that an obviously incorrect rating would quickly be spotted by others [...].' (Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 JEP 2, 211, 215 (2010)).

⁷⁹ See, the Swedish Companies Act (sw. *aktiebolagslag* (2005:551)), the Swedish Real Estate Agency Act (sw. *fastighetsmäklarlag* (2011:666)), and the Swedish Insurance Brokers Act (*lag* (1989:508) *om försäkringsmäklare*). (Jan Kleineman, *Rådgivares informationsansvar – en probleminventering*, 83 Svensk Juristtidning, 185, 192-199 (1998)).

⁸⁰ But according to Article 35a(5) of CRA III, 'This Article does not exclude further liability claims in accordance with national law.' Thus, Member States can impose a stricter standard of liability ('mere' negligence) on CRAs under their national laws.

negligence⁸¹ shall be interpreted and applied in accordance with the applicable national law as determined by the rules of private international law.⁸² Thus, the following remarks apply when Member State courts apply national law in line with international private law.

Under the English doctrine on negligent misrepresentation there is no express requirement that the negligence be gross.⁸³ Neither do we find such a requirement in the Swedish case law cited in this article. But the standards of carelessness set out in both the English and the Swedish case law could be interpreted as something akin to gross negligence. Such an interpretation seems to be in line with the Australian *Bathurst* case (mentioned in section 2.3) where S&P was held liable in negligence for a 'misleading and deceptive' AAA rating. In short, S&P had made unfounded and rationally optimistic assumptions in its analysis of the relevant securities. S&P appears to have been so negligent that its behavior virtually amounted to fraudulent misrepresentation. Also, if, as was the case in *Bathurst*, an issue can be sold for a considerable price (A\$50 million) as a result of an inflated credit rating, courts would probably be more likely to conclude that the carelessness on the part of the CRA was gross. The recent turmoil in the financial markets has made it abundantly clear that overly optimistic credit ratings of large-scale issues can contribute to the emergence of a global financial crisis. Thus, due to the systemic risk inherent in such ratings, it is imperative that the CRAs ensure that they carry out the rating process with utmost care, disregarding any irrelevant factors (such as the prospect of generating

⁸¹ Gross negligence is 'A lack of slight diligence or care'. (*Black's Law Dictionary*, Ganer, Bryan A. (ed. in chief), 8th ed., Thomson West, 2004, 1062 (entry 'Negligence').) However, some courts have found that the term is similar to 'reckless disregard'. It has been interpreted as 'A conscious, voluntary act or omission in reckless disregard of a legal duty and of the consequences to another party, who may typically recover exemplary damages.' (Ibid) Cf. Prosser & Keeton: 'Gross negligence, as it originally appeared, means very great negligence, or the want of even slight or scant care. It has been described as a failure to exercise even that care which a careless person would use. Several courts, however, dissatisfied with a term so nebulous [...] have construed gross negligence as requiring willful, wanton, or reckless misconduct, or such utter lack of all care as will be evidence thereof... But it is still true that most courts consider that 'gross negligence' falls short of a reckless disregard of the consequences, and differs from ordinary negligence only in degree, and not in kind.' (See, *Prosser and Keeton on the Law of Torts*, W. Page Keeton (ed.), 5th ed., West Group, 1984, 211-212 (§ 34).)

⁸² Article 35a(4) of CRA III.

⁸³ English judges seem to have taken the view that there is one standard of negligence, namely ordinary negligence. (See, e.g., *Armitage v Nurse* [1997] EWCA Civ 1279 ("we regard the difference between negligence and gross negligence as merely one of degree", Millett L.J.)) But they will interpret contractual provisions referring to gross negligence. (See, e.g., *Camatra Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm).) *Camatra* was the first case where an English court ruled that 'gross negligence' is a different concept from 'negligence'.

extra fees through favorable ratings), and if they do not, they should be found grossly negligent.

Undoubtedly, gross negligence constitutes a significant obstacle for investors that want to hold CRAs accountable. However, when discussing the civil liability of raters one must keep in mind that credit rating is not an exact science. CRAs make predictions about future credit risk based on information available to them. Sometimes those ratings will prove to be wrong even though the CRAs had reasonable grounds to conclude that the ratings were accurate at the time they were issued based on the information that was available then. If CRAs were held to a mere negligence standard,⁸⁴ investors who have suffered losses due to erroneous ratings may be tempted to bring negligence lawsuits against CRAs in situations where it would not be clear that the CRAs did not have reasonable grounds to believe that the ratings were accurate at the time they were issued. Since investors are aware that there is a margin of error in every credit rating, they should, in principle, not have a cause of action against CRAs in the situation described. If the risk were to be placed on the CRAs in such situations, they would probably consider exiting the market in fear of a surge in protracted civil lawsuits with uncertain outcomes.

Article 35a(3) of CRA III states that ‘The civil liability of credit rating agencies, as referred to in paragraph 1, shall only be limited in advance where that limitation is:

- (a) reasonable and proportionate; and
- (b) allowed by the applicable national law in accordance with paragraph 4.

Any limitation that does not comply with the first subparagraph, or any exclusion of civil liability shall be deprived of any legal effect.⁸⁵

In my view, the fact that Article 35a of CRA III only allows recovery for carelessness when a CRA has been grossly negligent constitutes in itself a reasonable and proportionate limitation of the civil liability of CRAs. Further restrictions on the civil liability of CRAs could effectively exclude CRAs from civil liability under Article 35a. The imposition of a limitation under Article 35a(3) of CRA III should therefore only be imposed in extraordinary circumstances and be subject to judicial review as to whether it should be deprived of legal effect.

⁸⁴ Cf. footnote 80.

⁸⁵ Article 35a(4) of CRA III.

5. CONCLUSIONS

This article argues that Member State legislation and case law in a sense make Article 35a of CRA III redundant, because investors who have suffered financial loss due to negligently prepared credit ratings on which they reasonably relied would probably be able to obtain damages under the national civil liability regimes of England and Sweden. In England, the groundbreaking decision by the House of Lords in *Hedley Byrne* seems to support at least primary market investors' potential claims against negligent CRAs. In the recent Australian *Bathurst* case (although not yet finally decided), S&P was found to owe a duty of care to potential investors. It is the first known decision of its type in the common law world. As such, it paves the way for successful claims brought by investors. Also, CRAs probably have expert liability vis-à-vis investors under section 90 of the FSMA 2000. In Swedish law, the Swedish Supreme Court ruling NJA 1987 s 692 is central to investors that seek to obtain damages from professional valuers in the absence of a contract between the parties.

Article 35a of CRA III may play an important role in Member State jurisdictions that allow investors to obtain damages from CRAs. The article will make the investors' case stronger. Furthermore, it will increase the CRAs' incentives to abide by the legal framework on CRAs. The introduction of Article 35a CRA III could also be viewed as an important recognition on the part of the EU legislature that the CRAs wield enormous power over the global markets and that they were one of the main culprits behind the global financial crisis. It is appropriate to subject the CRAs' activities to civil liability in a way that balances their power and prevents future irresponsible behavior.

Section 4 of this article discussed the standard of culpable carelessness required to hold CRAs accountable. It concluded that the standard of gross negligence in Article 35a of CRA III is appropriate. Due to the systemic risk inherent in credit ratings of large-scale issues, it seems reasonable that that a CRA that has failed to undertake due care when rating such an issue should be found grossly negligent.

Section 4 also noted that Article 35a of CRA III does not exclude further liability claims in accordance with national law. If, however, CRAs were held to a mere negligence standard, they would probably consider exiting the credit rating industry.

THE CIVIL LIABILITY REGIME OF THE CRA-REGULATION AND THE REQUIREMENT OF CAUSATION

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1. INTRODUCTION AND BACKGROUND

The regulation of credit rating agencies has been a focal point in the field of financial regulation since the culmination of the global financial crisis in 2008. Before December 2009, when the CRA-Regulation (the CRA I) entered into force, credit rating agencies operating in the EU were largely unregulated.¹ The CRA I regulates credit rating agencies' conduct and their issuance of credit ratings.² It also introduces a registration requirement for credit rating agencies. A subsequent Regulation (the CRA II)³ transfers the task of supervising and registering credit rating agencies from national competent authorities to the newly set-up European Securities and Markets Authority (ESMA), effective from July 1, 2011.⁴ On June 20, 2013, the third Regulation concerning credit rating agencies (the CRA III) entered into force.⁵

The aim of the CRA III is to further improve the conduct of the credit rating agencies, while achieving a high level of investor protection.⁶ Importantly, the CRA III includes a provision, Article 35a, which introduces a civil liability regime for credit rating agencies. The aim of which is to enhance investor protection. However, this civil liability regime is not all-encompassing; since *inter alia* issues of causation and negligence will be governed by each Member State's own torts law.⁷ The civil liability regime of Article 35a thus contains gaps that need to be filled by the competent national court's application of the applicable national law.

This article focuses on the relationship between Article 35a's civil liability regime and national law when it comes to matters relating to the requirement

¹ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, O.J. L 302 of 17.11.2009.

² Article 1 of the CRA-Regulation.

³ Regulation (EU) no 513/2011 of the European Parliament and of the Council of 11 May 2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, O.J. L 145 of 31.5.2011.

⁴ Articles 15, 21 and 40a of the CRA II.

⁵ Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, O.J. L146 of 31.5.2013.

⁶ Article 1 of the CRA III.

⁷ Article 35a(4) of the CRA-Regulation. See also Recital 35 of the CRA III.

of causation.⁸ Although the analysis takes its basis in Swedish law and Swedish legal principles, the article's discussion and findings will hopefully be useful in other EU Member States' legal discourse as well.

The remainder of this article is structured as follows. Section 2 provides a detailed recollection of Article 35a's civil liability regime and Section 3 discusses its relation to the causation requirement. Section 4 analyses what the applicable burden of proof is when it comes to Article 35a's causation requirement. Both sections 3 and 4 include discussions on practical problems that may arise for the competent national courts in applying Article 35a and the concurrent applicable Swedish tort and procedural law, in accordance with principles of international private law. Section 5 concludes.

2. THE CIVIL LIABILITY REGIME FOR CREDIT RATING AGENCIES

2.1 General Features of the Civil Liability Regime

This section aims at providing a brief overview over the new civil liability regime for credit rating agencies that recently has been introduced in the EU through Article 35a of the CRA-Regulation.⁹ Initially, it should be noted that the application of this civil liability regime is restricted to certain parties. Hence, it is only applicable in instances where a credit rating agency¹⁰ has caused either an *investor* or an *issuer* to incur a loss.¹¹ The civil liability regime is further restricted as regards the basis for liability. In order for a credit rating agency to be held liable pursuant to Article 35a, it needs to have committed certain explicitly specified infringements of the

⁸ Consequently, I will not deal with other matters regarding the civil liability regime, such as the basis for liability or the calculation of damages.

⁹ A more detailed background and overview over the civil liability regime can be found in Brigitte Haar, *Civil Liability of Credit Rating Agencies after CRA 3 – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence*, (University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02). An account of the process leading up to the adoption of the CRA III can be found in Per Lamberth, *Changes to the EU Regulatory Framework for Credit Rating Agencies*, Perspectives on Credit Rating Agencies, 251, 260 (Editors Jan Kleineman, Lars Gorton & Aron Verständig, Jure Förlag 2013).

¹⁰ Article 3(1)(b) of the CRA-Regulation defines a credit rating agency as "a legal person whose occupation includes the issuing of credit ratings on a professional basis".

¹¹ According to Article 3(1)(s) of the CRA-Regulation, the definition of the term Issuer provided in Article 2(1)(h) of the Prospectus Directive (Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the Prospectus to be Published when Securities are Offered to the Public or Admitted to Trading and amending Directive 2001/34/EC, O.J. L 345/69 of 31.12.2003) should be employed. An Issuer is thus defined as "a legal entity which issues or proposes to issue securities". However, the CRA-Regulation does not offer a definition of the term Investor.

CRA-Regulation either with intention or gross negligence.¹² In addition, the infringement/infringements in question must have had an effect on a credit rating issued by that credit rating agency.

An *investor* is entitled to bring a claim against the credit rating agency only if the investor has relied upon that credit rating when deciding to invest into, hold onto or divest from a financial instrument covered by the CRA-Regulation.¹³ An *issuer* may claim damages resulting from a credit rating covering it or its financial instruments if the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency.¹⁴

Importantly, Article 35a only sets a minimum standard, i.e., it allows Member States to impose further regulation of credit rating agencies' civil liability vis-à-vis investors and issuers.¹⁵

2.2 The Status of National Law in the Civil Liability Regime

As mentioned above, the CRA-Regulation's civil liability regime requires the competent national court trying the claim against the credit rating agency to apply national law in addition to the provisions of Article 35a. Even though Article 35a provides a framework for holding credit rating agencies liable if certain criteria are satisfied, many issues are not expressly regulated by the CRA-Regulation. As mentioned above in section 1, matters such as causation and negligence are governed by the applicable national law as determined by the relevant rules of private international law.¹⁶

Since statutes and principles from different legal systems will be used when determining question regarding, inter alia, the requirement of causation of this civil liability regime, it is evident that national courts in different countries will make different assessments based on how the applicable provisions of national law are interpreted in each case. As previously mentioned, this article's analysis is based on Swedish statutes and Swedish legal principles that will be applied by a national court applying Swedish law in accordance with Article 35a(4), when dealing with questions relating to the requirement of causation regarding the civil liability regime provided in Article 35a of the CRA-Regulation.

¹² Namely those that are included in Annex III to the CRA-Regulation, see Article 35a(1).

¹³ Article 35a(1).

¹⁴ Article 35a(1).

¹⁵ Article 35a(5). Article 35a also contains provisions limiting the credit rating agencies' possibilities of limiting their liability in advance, see Article 35a(3).

¹⁶ Recital 35 and Article 35a(4) of the CRA III. See also Brigitte Haar, *Civil Liability of Credit Rating Agencies after CRA 3 – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence*, 15, 17 (University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02).

3 THE REQUIREMENT OF CAUSATION IN ARTICLE 35A

3.1 Overview

In Swedish tort law, causation is one of the basic components of the tort.¹⁷ The objective of causation is to be the link between the victim and the tortfeasor. A tortfeasor is usually only held liable when he or she has committed an act negligently, under the varying applicable standards for duty of care.¹⁸ In some instances a tortfeasor will be liable regardless of whether negligence can be proved, as long as the alleged victim can show that the tortfeasor's conduct has caused it to suffer damage (commonly referred to as strict liability). In other instances a qualified form of negligence is required for liability to occur, such as gross negligence.¹⁹ Causation remains a necessary criterion that always must be met in order for a tortfeasor to be held liable.²⁰

Although causation is a basic component of tort law, it is interpreted differently depending on the applicable law in each individual case. In section 2.2 above, it was concluded that matters such as, but not limited to, causation are to be determined in accordance with the applicable national law. Article 35a makes it explicit which causal links needs to be shown in order for a credit rating agency to be held liable. It also sets forth the burden of proof. Article 35a thus gives the framework for how the competent national court shall approach a claim brought by an investor or an issuer under the CRA-Regulation. Neither Article 35a nor any other provision of the CRA-Regulation provides any guidance for how the competent national court should assess causation in relation to a specific claim brought under the Article. Against this background, the analysis below will be based on Swedish law (as applicable according to the relevant principles of international private law).

Article 35a(1) stipulates what causal links must be established in order for the competent national court to hold a credit rating agency liable:

"Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement.

¹⁷ See e.g. Mårten Schultz, *Kausalitet*, 27-28 (Jure Förlag 2007) and W.V.H. Rogers, *Winfield & Jolowicz Tort*, 307 (18th ed. Sweet & Maxwell 2010). According to the latter, the requirement of causation is considered as "the bedrock of tort liability".

¹⁸ Cf. Chapter 2 Section 1 of the Swedish Tort Liability Act (1972:207).

¹⁹ The latter is the case when it comes to the civil liability regime provided in Article 35a of the CRA-Regulation. See Article 35a(1).

²⁰ Bill W. Dufwa, *Flera skadeståndsskyldiga*, 1066 (Juristförlaget 1993).

An investor may claim damages under this Article where it establishes that it has reasonably relied, in accordance with Article 5a(1) or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.

An issuer may claim damages under this Article where it establishes that it or its financial instruments are covered by that credit rating and the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available.”

The first paragraph contains general provisions, while the two following paragraphs set out specific provisions pertaining to investors and issuers respectively. A causal relationship between the infringement committed by the credit rating agency and the damage incurred by the plaintiff must be established regardless of whether the plaintiff is an investor or an issuer.

The first paragraph of Article 35a(1) indicates that the infringement in question must have had “an impact on a credit rating”. A causal link must in turn exist between the credit rating in question and the decision by an investor to “invest into, hold onto or divest from a financial instrument covered by that credit rating”. This wording should be understood as requiring that the investor’s decision to invest in fact resulted in the loss. The causal link thus connects the infringement committed by the credit rating agency to the damage incurred by the investor via a credit rating issued by that agency. If the claim is brought against the credit rating agency by an issuer instead of an investor, the issuer’s financial instruments must have been covered by the credit rating in question.

Swedish tort law requires the plaintiff to establish the existence of an “adequate causation” between an alleged tortfeasor’s action or omission and the alleged damage. Adequate causation requires the plaintiff to show not only that a causal link exists, but also that the link is of merit. The rationale is to limit the alleged tortfeasor’s liability to instances where the court perceives it being fair and reasonable to hold it liable.²¹ Article 35a also provides for the national court to consider whether or not the causal link at issue should be viewed as adequate or not. Regarding investors, Article 35a(1) requires that the investor’s reliance on the credit rating issued by the credit rating agency is “reasonable”. If the court does not consider the reliance as reasonable, it cannot hold the credit rating agency liable for the incurred loss. Again, the competent national court

²¹ See e.g. Mårten Schultz, *Kausalitetspraktikan*, Svensk Juristtidning, 465, 468 (2011).

must determine the issue of “reasonableness” in accordance with the applicable national law.²²

3.2 Practical Example I

A simple practical example could be useful to illustrate what has been said in the previous section. Let us assume that a credit rating agency has decided to upgrade its credit rating regarding a certain bond issued by Company X from BB+ to BBB-. When hearing the news, an investor decides to invest in the bonds issued by the company. After a couple of months the bond’s credit rating is downgraded. This causes the investor to incur a substantial loss. Following the downgrade, the investor finds out that the credit rating agency has failed to disclose a conflict of interest regarding the credit analyst in charge of rating the bond it invested in. According to Article 35a(1) of the CRA-Regulation a credit rating agency can be held liable if it commits any of the infringements listed in Annex III to the Regulation. It is further stated in Point 15 of section I of Annex III that a credit rating agency can be held liable if it fails to establish appropriate arrangements to disclose any conflicts of interest referred to in Point 1 of Section B of Annex I.²³

Article 35a(1) of the CRA-Regulation stipulates that the following facts regarding the requirement of causation must be shown in such a case:

- i. The credit rating agency has not established appropriate arrangements to disclose conflicts of interest regarding its rating analysts (i.e. it has committed an infringement of Annex III of the CRA-Regulation);
- ii. Its failure to establish the above-mentioned arrangements has had an impact on a credit rating;
- iii. The investor has incurred a loss due to the infringement committed by credit rating agency; *and*
- iv. The investor’s reliance on the credit rating in question was reasonable.

Three of these factors (i-iii) pertain to the actual causal link between the infringement committed by the credit rating agency and the loss incurred

²² See Article 35a(4).

²³ From Point 1 of Section B of Annex I of the CRA-Regulation we learn that “[a] credit rating agency shall identify, eliminate, or manage and disclose, clearly and prominently, any actual or potential conflicts of interest that may influence the analyses and judgments of its rating analysts, employees, or any other natural person whose services are placed at the disposal or under the control of the credit rating agency and who are directly involved in credit rating activities and persons approving credit ratings and rating outlooks.”

by the investor, whereas the fourth (iv) relates to the question whether or not the causal link should be considered as adequate. It is clear from this practical example that the causal link that needs to be present in order for a credit rating agency to be held liable pursuant to Article 35a in fact consists of many components, both objective (i-iii) as well as subjective (iv).

3.3 Contributing Factors

A classic problem in torts is the question of contributing factors. Frequently, two or more unrelated factors are claimed to have caused the same damage. Dealing with the issue of contributing factors is – naturally – relevant also when it comes to the issue of credit rating agencies' liability pursuant to Article 35a of the CRA-Regulation. As has already been mentioned, liability is conditioned upon the investor's reliance upon a certain credit rating when deciding to "invest into, hold onto or divest from a financial instrument". However, if the credit rating agency can show that other factors present at the time of the investor's decision possibly affected its decision to invest, the court will find that there is no causal link between the infringement committed by the credit rating agency and the damage incurred. Hence, the credit rating agency cannot be held liable towards the investor.²⁴

3.4 Practical Example II

Let us take a new example using the same investor and credit rating agency as above in section 3.2. This time the investor, instead of relying only on the credit rating, consults a financial advisor whether or not it should invest in the bonds. The advisor, also under the influence of a conflict of interest, recommends the investor to invest in the bonds issued by Company X. The question then arises if the credit rating agency could be held liable despite the advice provided by the financial advisor. In my opinion, the first issue that needs to be addressed is whether both the favourable credit rating and the financial advisor's advice were necessary for the investor to make the investment decision.

A long-standing principle in Swedish law is that when two or more factors have caused the same damage to occur, the parties responsible for each factor should be held jointly and severally responsible.²⁵ The Swedish

²⁴ The same argument can be applied on an issuer seeking to hold a credit rating agency liable in accordance with Article 35a, if it can be shown that other factors that were present also could have caused the issuer to incur the loss.

²⁵ See e.g. Bill W. Dufwa, *Flera skadeståndsskyldiga*, 969-982 (Juristförlaget 1993) and Marcus Radetzki, *Skadeståndsberäkning vid sakskada*, 148-155 (2nd ed. Svenska Försäkringsföreningen 2012).

Supreme Court recently confirmed this principle in NJA 2012 p. 597.²⁶ The case concerned a construction project that had been delayed due to two separate factors, which both were necessary conditions in order for the delay to occur. The defendant was considered responsible only for one of these factors, but was nonetheless held liable for the entire delay. I believe that this precedent would guide the Swedish courts in deciding whether the financial advisor and the credit rating agency in the example above should be held jointly and severally responsible for the incurred loss. Conditioned upon both factors (the credit rating and the investment advice) being necessary for the investor's investment decision, it is thus likely that a Swedish court would hold the advisor and the credit rating agency jointly and severally liable.

A variation of the example above is as follows: a grossly negligent credit rating agency and a general decline in the financial markets, such as a financial crisis, has caused an investor to incur a loss. Under Swedish law it is generally not possible for a financial advisor or a credit rating agency to escape liability for its incorrect advice or incorrect rating, merely because a financial crisis coincides with it.²⁷ In a judgment by the Scania and Blekinge Court of Appeal regarding the liability of a financial advisor, the court did not take the general decline in the financial markets into account, the rationale being that the liability of financial advisors then would become an "illusion".²⁸

A more complex question is presented by the following fact pattern. An investor, who is seeking a suitable investment, consults a financial advisor. The advisor negligently advises the investor to invest in a certain financial product. After a while the investor begins to feel a bit unsure about the investment. However, noting a certain credit rating agency's favourable credit rating, the investor decides to keep the financial products. Later it is revealed that the favourable credit rating was awarded based upon a conflict of interest on behalf of the responsible rating analyst (something that the credit rating agency failed to disclose in accordance with Point 1 of Section B of Annex I of the CRA-Regulation).

²⁶ The case has been discussed in, inter alia, Mårten Schultz, *Några frågor i kommersiell skadeståndsrätt*, Svensk Juristtidning, 1017, 1020 (2013).

²⁷ Subsequent to the Swedish Supreme Court's ruling in NJA 2012 p. 597, it has been argued that a plaintiff could be held liable in a situation where a damage has occurred due to a negligent act committed by the plaintiff and an act that was not caused by negligence on the side of the plaintiff. See Mårten Schultz, *Några frågor i kommersiell skadeståndsrätt*, Svensk Juristtidning, 1017, 1026 (2013).

²⁸ Judgment by the Scania and Blekinge Court of Appeal, case no. T 1799-07, January 16, 2009. The judgment is discussed in Fredric Korling, *Rådgivningsansvar*, 580 (Jure Förlag 2010).

A competent national court, finding that Swedish law should apply to the dispute under the applicable principles of international private law, would approach this question by determining at what stage the damage that the investor has incurred should be considered as “complete”.²⁹ Already, this gives cause for complex considerations. For example, imagine that the credit rating agency as a defence would argue that the investor incurred the loss already at the time of the investment. Let’s say the investor purchased the products for € 100 and that the credit rating agency can prove that the products at the time of investment should have been valued at only € 70.³⁰ The investor would respond by arguing that the loss was incurred first when it was revealed that the products’ proper value was € 70 instead of € 100, or at the time when the investor sells the products.³¹ Let’s assume that the investor sells off the products for € 70 thereby incurring a loss of € 30. How would the court solve this dispute? Will the investor be able to successfully claim damages from the credit rating agency?

It is evident that the investor incurs the loss when it sells off the financial products in question. If the damage had occurred before the investor even took note of the credit rating, it is difficult to see how the credit rating agency could be held liable. Hence, this hypothetical problem becomes more complex if one would regard the damage as not being “complete” until the investor sells off the financial products. One way for a court, applying Swedish law in accordance with principles of international private law, to solve this problem would be to differentiate between reversible and irreversible damages.³² Under Swedish law, a loss is regarded as irreversible if the additional information – received after the initial information was provided – cannot change the way the receiver of the information would have acted.³³ Here, an irreversible damage would occur when the investor could not have avoided the loss, even though the credit rating agency subsequently would provide it with the correct information. For example, the investor was perhaps unable to dispose of the financial products at all or without incurring a substantial loss.

²⁹ See e.g. Bill W. Dufwa, *Flera skadeståndsskyldiga*, 975-977 (Juristförlaget 1993).

³⁰ It should be noted that Article 35a(1) of the CRA-Regulation is applicable regarding a decision to invest in a certain product but also regarding a decision to “hold onto or divest from a financial instrument”.

³¹ There does not seem to be a consensus in the Swedish legal doctrine regarding the question of when damage should be considered as being complete when it comes to financial products. See Fredric Korling, *Rådgivningsansvar*, 579-580 (Jure Förlag 2010).

³² Regarding reversible and irreversible damages, see Jan-Ove Færstad, *Erstatningsansvar for villedende informasjon*, 397-400 (Universitetet i Bergen 2011). See also Nils Nygaard, *Skade og Ansvar*, 333-335 (Universitetsforlaget 2007) and Peter Lødrup, *Lærebok i erstatningsrett*, 343-345 (Gyldendal Akademisk 2009).

³³ Jan-Ove Færstad, *Erstatningsansvar for villedende informasjon*, 398-399 (Universitetet i Bergen 2011).

In comparison, reversible damage would occur when the investor could have avoided the loss if it had obtained the correct information by the credit rating agency. In such a situation, where the competent national court applying Swedish law would arrive at the conclusion that the investor would have sold off the products without incurring a loss, the court should regard the damage as reversible. If the investor was unable to dispose of the products or its only possibility to sell them off was associated with incurring a loss, the damage, on the other hand, should be considered as irreversible.³⁴ The credit rating agency should not be held liable for irreversible damage, since the rating was unaffected by the above described conflict of interest. The investor would have incurred the loss anyway since the option of selling off the products did not remain open at the time it was given notice of the credit rating agency's amended rating.³⁵

Although it may seem simple enough in theory, in reality it is often a complicated task to discern what information an investor has been given before and after the decision to invest in a certain financial product.

4 BURDEN OF PROOF

4.1 Overview

A closely related question to what was discussed above in the previous sections concerns the burden of proof for the requirement of causation. The initial proposal by the EU Commission that was presented on November 15, 2011 provided for a shared burden of proof. According to the initial version of Article 35a the plaintiff investor/issuer only had to establish facts from which it could be inferred that the defendant credit rating agency had committed any of the infringements listed in Annex III of the CRA-Regulation. If this initial burden was met, the credit rating agency had to prove that it had not committed the infringement in question.³⁶

³⁴ See Jan-Ove Færstad, *Erstatningsansvar for villedende informasjon*, 398-400 (Universitetet i Bergen 2011).

³⁵ See Olav Perland, *Tilretteleggeransvar – Verdipapirforetaks erstatningsansvar ved tilrettelegging av aksjeemissjoner*, 767 (Universitetet i Bergen 2009). See also Jan-Ove Færstad, *Erstatningsansvar for villedende informasjon*, 398-399 (Universitetet i Bergen 2011), Nils Nygaard, *Skade og Ansvar*, 334-335 (Universitetsforlaget 2007) and Peter Lødrup, *Lærebok i erstatningsrett*, 343-344 (Gyldendal Akademisk 2009).

³⁶ Article 35a(4) of the EU Commission's Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on Credit Rating Agencies COM(2011) 747/2 (SEC(2011) 1354 final). See Per Lamberth, *Changes to the EU Regulatory Framework for Credit Rating Agencies*, Perspectives on Credit Rating Agencies, 260-261 (Editors Jan Kleineman, Lars Gorton & Aron Verständig, Jure Förlag 2013). A shared burden of proof regarding the liability of credit rating agencies can, however, be found in the French civil liability regime for credit rating agencies. See Article 10 of the Loi Française de Régulation Bancaire et Financière (Loi n°2010-1249 du 22 Octobre 2010), Codified in the Code Monétaire et Financière, Art. L.544-5.

However, the burden of proof was changed during the negotiations with the European Parliament. Article 35a of the CRA-Regulation now requires that the plaintiff investor/issuer carries the burden of proof.³⁷ The central provision guiding this issue is now found in Article 35a(2):

"It shall be the responsibility of the investor or issuer to present accurate and detailed information indicating that the credit rating agency has committed an infringement of this Regulation, and that that infringement had an impact on the credit rating issued."

Further, Article 35a(1) stipulates:

"An investor may claim damages under this Article where it establishes that it has reasonably relied in accordance with Article 5a(1) or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating."

On the face of the above-cited provisions, it is clear that the investor or the issuer seeking to hold a credit rating agency liable carries the burden of proof regarding the requirement of causation. More specifically, the investor/issuer needs to prove that the credit rating agency has committed at least one of the infringements listed in Annex III of the CRA-Regulation, and that the infringement has had an impact on the credit rating it issued. If the plaintiff is an investor, the investor must establish that it relied on the credit rating at issue when deciding to invest into, hold onto or divest from a certain financial instrument. A plaintiff issuer would need to establish that it or its financial instruments were covered by the credit rating in question and that the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency. As for the subjective elements of causation, the investor must further show that its reliance on the credit rating was reasonable.

4.2 Standard of Proof

Although it is evident from Article 35a of the CRA-Regulation that the investor/issuer carries the burden of proof, it remains unclear which standard of proof that needs to be met in order for a court to hold a credit rating agency liable in accordance with the CRA-Regulation. Article 35a explicitly provides that the plaintiff needs to present *accurate and detailed information* pertaining to the facts that the credit rating agency committed

³⁷ The party asserting that a certain circumstance has occurred usually carries the burden of proof. The simple explanation being that it is far easier to prove that something has occurred than proving that it did not. See e.g. Lars Heuman, *Bevisbörda och beviskrav i tvistemål*, 269-270 (Norstedts Juridik 2005).

any of the infringements listed in Annex III of the CRA-Regulation and that that infringement had an impact on the credit rating in question.³⁸ The plaintiff investor also needs to *establish* that it relied upon the credit rating in question and that its reliance was reasonable, while the issuer needs to prove that the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency. Accordingly, the investor must establish both that it de facto relied on the credit rating and that it was reasonable to do so.

The first question that arises is how the standard *accurate and detailed information* (Article 35a(2)) relates to the standard *establish* (Article 35a(1)). I would suggest that the latter entails a higher standard of proof than the former. The plaintiff has to establish that it relied upon the credit rating when making a decision to invest in a certain financial product and that its reliance was reasonable. This is quite logical considering that one objective of the CRA-Regulation is to reduce the risk of over-reliance on credit ratings by market participants.³⁹ Therefore, the investor must prove that its reliance was reasonable, something that the defendant credit rating agency likely would have a very hard time proving.

The standard *accurate and detailed information* refers to facts that the credit rating agency should be in a better position to prove than the investor or the issuer. The Swedish Supreme Court has, in a number of cases, lowered the standard of proof when it comes to the requirement of causation in instances where the order of events is complex and thus hard for the plaintiff to prove.⁴⁰ Applying these precedents a national court, applying Swedish law in accordance with principles of international private law, would likely find it sufficient if the plaintiff investor/issuer can point to information indicating that an infringement has occurred and that the credit rating, on which it reasonably has relied upon, was impacted. In addition, Article 35a(2) instructs the competent national court to consider the fact that the investor or issuer may not have had access to information that is purely within the credit rating agency's control.

Further, the plaintiff investor or issuer might also encounter difficulties meeting the burden of proof when it has incurred a loss due to an omission (such as in the example provided above under section 3.2) and not through an act committed by the credit rating agency in question.

³⁸ According to Article 35a(2) of the CRA-Regulation, it is the task of the competent national courts to determine what constitutes accurate and detailed information.

³⁹ See Recital 49 and Article 1 of the CRA III. See also Article 5a(1) of the CRA-Regulation, which urges market participants to not mechanically rely on credit ratings.

⁴⁰ Per Olof Ekelöf, Henrik Edelstam & Lars Heuman, *Rättegång IV*, 130 (7th ed. Norstedts Juridik 2009). Cf. the Swedish Supreme Court's judgments in NJA 1984 p. 501 and NJA 1986 p. 3.

It is typically easier to prove that someone has committed a certain act, which in turn resulted in a loss, than it is to prove that someone did *not* commit a certain act, which in turn would have resulted in the absence of a loss. Recently, the Swedish Supreme Court has dealt with the standard of proof for a plaintiff that has incurred a loss as a result of an omission committed by the defendant.⁴¹ The case concerned a young girl that had set a department store on fire while being under the legal custody of a municipality. The municipality had, according to relevant Swedish legislation, assumed legal responsibility over her and was aware of her fallacy for setting objects on fire. The case was brought by the insurers of the department store, who alleged that the municipality had failed to exercise due care when placing the girl with her mother, who had been held unfit to take care of her.

The court discussed what standard of proof that should apply when the issue is whether a party omitted to perform a certain task, rather than committed a certain action. It concluded that a party seeking to prove liability due to an omission only has to show that an alternative course of action was available for the defendant and that that course of action would have prevented the damage from occurring. Hence, the court introduced a lower standard of proof than is normally required.⁴² It is thus likely that a national court applying this line of argument when trying a claim under Article 35a according to Swedish law pursuant to principles of international private law, would lower the standard of proof if the credit rating agency has caused the damage to occur by committing an infringement specified in Annex III in the CRA-Regulation through an omission rather than an action.

My conclusion is that there are strong reasons for a competent national court applying Swedish law to apply this lower standard of proof when it comes to an omission committed by a credit rating agency. Requiring the investor/issuer to provide extensive evidence regarding circumstances in the credit rating agency's sole control might render this civil liability regime rather weak.⁴³

⁴¹ NJA 2013 p. 145. The case has been discussed in Märten Schultz, *Några frågor i kommersiell skadeståndsrätt*, Svensk Juristtidning, 1017, 1023 (2013).

⁴² See Point 43 of the Judgment. The Court of Appeal for Western Sweden has subsequently applied this lowered standard of proof in a recent judgment in a case concerning the liability of an accountant. Court of Appeal for Western Sweden, case no. T4207-10 of August 15, 2013. See also Märten Schultz, *Några frågor i kommersiell skadeståndsrätt*, Svensk Juristtidning, 1017, 1029 (2013).

⁴³ See Brigitte Haar, *Civil Liability of Credit Rating Agencies after CRA 3 – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence*, 18 (University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02).

4.3 Insufficient Documentation

A specific problem relates to the situation where the plaintiff issuer/investor fails to present accurate and detailed information indicating that the defendant credit rating agency has committed an infringement, and that that failure is due to insufficient documentation on the side of the credit rating agency. It will – naturally – be difficult for the investor/issuer to prove that the credit rating agency has violated the CRA-Regulation if the agency has failed to adequately document the situation. Accordingly, the CRA-Regulation provides that a credit rating agency must keep adequate records and, where appropriate, audit trails of its credit rating activities. These records should, inter alia, include the identity of the rating analysts participating in the determination of each credit rating, the records documenting the established procedures and methodologies used by the credit rating agency to determine credit ratings, and the internal records and files used to form the basis of any credit rating decision taken.⁴⁴

The Swedish Supreme Court held in a recent judgment discussed above in section 4.2 that the defendant had a legal obligation to evaluate different risks associated with a certain action. In addition, the defendant was required by law to keep an adequate record showing, inter alia, its decisions and other relevant actions it had taken in this regard. When determining the issue of liability the court was unable to establish whether or not the defendant had been negligent due to the lack of documentation. The record failed to show which measures the defendant had taken to evaluate the previously mentioned risks. The Supreme Court concluded that if a party has an obligation to document certain facts, and that party has failed to do so, it is presumed that the damage would not have occurred if the tortfeasor had acted in the prescribed manner. The tortfeasor can then only escape liability if it in turn can show that it had no possibility to prevent the damage from occurring.

The question of how insufficient documentation affects the standard of proof was also discussed when the Swedish Financial Advisory Services to Consumers Act (2003:862) was enacted.⁴⁵ According to the Act, a financial advisor is required to document what has occurred at the time the advisory service was provided.⁴⁶ The Act's *travaux préparatoires*, states that the obligation for the advisor to document what has occurred was

⁴⁴ See Article 6.2 and Point 7, Section B, Annex I of the CRA-Regulation.

⁴⁵ The Swedish Financial Advisory Services to Consumers Act applies to financial advisory services provided to consumers relating to the investment of the consumer's assets in financial instruments or life assurance containing a savings element. See Section 1 of the Act.

⁴⁶ Section 4 of the Financial Advisory Services to Consumers Act (2003:862).

likely to facilitate future disputes, as it would make it easier to prove what had happened when the advisory service was provided to the customer.⁴⁷ It further noted that, if an advisor fails to document what has occurred, a court should generally rely upon the statement provided by the customer.⁴⁸

As mentioned above, credit rating agencies are under the obligation to keep adequate records. The requirement is, however, not included in Annex III of the CRA-Regulation, which means that an investor cannot hold the agency liable in accordance with Article 35a of the CRA-Regulation solely based on its failure to comply with the requirement to keep adequate records. Considering the fact that credit rating agencies are under the obligation to keep adequate records, it would hardly be fair if a lack of documentation on the side of the credit rating agency would affect the plaintiff (that carries the burden of proof) in a negative way. Therefore, a competent national court applying Swedish law in accordance with principles of international private law should lower the standard of proof if a credit rating agency is unable to present adequate documentation that is relevant for determining whether or not it has committed any of the infringements listed in Annex III of the CRA-Regulation.

5 CONCLUSIONS

When introducing a new civil liability regime it is important to assess how the new regime relates to already existing principles within, e.g., national tort and procedural law. This is even more relevant here, since Article 35a(4) of the CRA-Regulation explicitly provides that it is the applicable national law that governs matters concerning the civil liability of a credit rating agency that are not covered by the CRA-Regulation.

This article attempts to offer some thoughts from a Swedish perspective on Article 35a of the CRA-Regulation's requirement of causation, including, what burden of proof to apply. This article makes it evident that the civil liability regime in Article 35a will give the competent national court cause for some complex considerations when trying a case brought by an investor or an issuer under Article 35a.

When determining the liability of a credit rating agency in accordance with Article 35a, the competent national court should bear in mind how

⁴⁷ Bill 2002/03:133 p. 33.

⁴⁸ Bill 2002/03:133 p. 33. It should, however, be noted that this Act only applies to the financial advisory services that a businessman provides to a consumer (Section 1 of the Financial Advisory Services to Consumers Act). See also Fredric Korling, *Rådgivningsansvar*, 587-588 (Jure Förlag 2010).

its application of the relevant national law affects the general objectives of the CRA III. Article 1 of the CRA III provides that the regulation aims at, *inter alia*, enhancing the level of investor protection. One important step in this regard is the introduction of a civil liability regime.⁴⁹ It is, against this background, important that the application of national law is consistent with the objectives of the CRA III. A strict application of, *inter alia*, the requirement of causation might therefore thwart the EU's ambition to enhance the position of investors and issuers *vis-à-vis* the credit rating agencies.

⁴⁹ Recital 32 of the CRA III.

CIVIL LIABILITY OF CREDIT RATING COMPANIES – QUALITATIVE ASPECTS OF DAMAGE ASSESSMENT FROM AN ECONOMIC VIEWPOINT*

Andreas Horsch[†]

1 THE STORY SO FAR

The question of liability of Credit Rating Companies (CRCs) is not a new one. However, market and regulatory processes since the crisis events of 2007 have led to innovative answers to this question. For decades, CRCs seemed to be beyond the reach of liability rules that connect corporate negligence with the obligation to compensate for financial damages caused. Now, however, the most recent, crisis-influenced institutional change has brought forward liability rules of this kind.

CRCs act as informational intermediaries, reducing information asymmetry between financing and investing actors.¹ That they were able to evade liability for decades becomes understandable when the historic context is examined: During the 19th century, CRCs evolved in the (capital market surroundings of the) United States of America (US) for particular reasons.² Consequently, the question of their liability was originally raised – and answered – on the grounds of US law, when

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¹ For more information on the role of CRCs, see the seminal contribution of M Millon, A Thakor, *Moral hazard and information sharing: A model of financial information gathering agencies*, 40 *Journal of Finance* 1403 (1985). For a groundbreaking elaboration of the law and economics of gatekeepers, see S Choi, *Market Lessons for Gatekeepers*, 92 *Northwestern University Law Review* 916 (1998). Recently, see e.g. J-C Duan, E Van Laere, *A public good approach to credit ratings – From concept to reality*, 36 *Journal of Banking & Finance* 3239, 3240 (2012); Y Listokin, B Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 *Yale Journal on Regulation* 91, 95-97 (2010).

² Among the earliest monographs dealing with CRCs is the one of Harold, see G Harold, *Bond Ratings as an Investment Guide* 9-19 (Ronald Press New York 1938). Later, see also R Cantor, F Packer, *The Credit Rating Agency*, 19 (2) *FRB of New York Quarterly Review* 1, 1-4 (1994); extensively R Olegario, *Credit-Reporting Agencies: Their Historical Roots, Current Status, and Role in Market Developments* (The World Bank 2001); also U Blaurock, *Control and Responsibility of Credit Rating Agencies*, 11 (3) *Electronic Journal of Comparative Law* 1, 5-6 (2007).

(ratings of) CRCs happened to be erroneous and subsequent investor and issuer dissatisfaction led to a legal evaluation of their activities. Naturally, legal considerations at first applied to the *mercantile agencies* specializing in non-securitized credit,³ being the forerunner of CRCs, which in contrast are specialized in issuers and issues of securitized credit, i.e. in bonds. Compared to their predecessors, CRCs were able to successfully claim that they provide mere opinions – which are protected by the First Amendment to the US constitution. Until recently, this constitutional privilege – in combination with other parts of US public law – has shielded CRCs from claims of negligence.⁴ However, economic crises, for which the CRCs were deemed jointly responsible, spurred calls for their regulation in general, and for a reconsideration of their liability in particular. Although reasons to regard CRC ratings as free speech (at least as long as the CRC is not involved in the structuring of the rated entity) have not vanished,⁵ the reinterpretation of the role of CRCs has led to amendments of liability regimes. At the beginning of the 21st century, this debate not only encompassed the US, but also reached European capital markets and their regulatory frameworks. Regardless of regulation that de facto hit CRCs, although it was aiming at different

³ For more information on the origins and development of the mercantile agencies, see retrospectively J H Madison, *The Evolution of Commercial Credit Reporting Agencies in Nineteenth-Century America*, 48 (2) *Business History* 164 (1974). As an early consideration of their liability, see J Smith, *Conditional Privilege for Mercantile Agencies – Macintosh v. Dun*, 14 (3) *Columbia Law Review* 187 (1914). See also – although the title suggests an analysis of CRCs – the Note of G.P.V., *Liability for Misstatements by Credit-Rating Agencies*, 43 *Virginia Law Review* 561 (1957).

⁴ For more information on the First Amendment-based defence strategy of CRCs, see extensively T Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 *Minnesota Law Review* 140 (2009), with further references; see also J W Heggen, *Not Always the World's Shortest Editorial: Why Credit-Rating-Agency Speech is Sometimes Professional Speech*, 96 *Iowa Law Review* 1745, 1754-1766 (2011); R Jones, *The Need for a Negligence Standard of Care for Credit Rating Agencies*, 1 *William & Mary Business Law Review* 201, 209-223 (2010); L Freeman, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 *Vermont Law Review* 585, 604-609 (2009). Summaries of First Amendment concerns are part of most articles on the liability of CRCs: see e.g. B H Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 *North Carolina Banking Institute Journal* 111, 116-117 (2011); N Blumberg, J Wirth, N Litsoukov, *The Liability of Credit Rating Agencies to Investors: A Review of the Current Liability Regime and Recent SEC Proposals*, 16 (4) *Journal of Structured Finance* 34, 35-36 (2011); T Johansson, *Regulating credit rating agencies: The issue of conflict of interest in the rating of structured finance products*, 12 (1) *Journal of Banking Regulation* 1, 14-16 (2010).

⁵ See e.g. J W Heggen, *Not Always the World's Shortest Editorial: Why Credit-Rating-Agency Speech is Sometimes Professional Speech*, 96 *Iowa Law Review* 1745, 1765-1766 (2011); see also F Partnoy, *How and Why Credit Rating Agencies Are Not Like other Gatekeepers*, in: Y Fuchita, R E Litan, *Financial Gatekeepers: Can They Protect Investors?* 59, 88 (Brookings Institution Press Baltimore 2006).

actors or market processes, it took European regulators until 2009 to pass explicitly ratings-directed regulation for the first time.⁶

One year later, ratings-directed regulation in the US was refurbished by the *Dodd-Frank Act*, which included several norms aiming at the CRCs in general, and elaborated a standard of their liability in particular.⁷ With accelerating speed, amendments were also added to the original European regulation – which finally included a comprehensive liability rule, namely Art 35a CRA III.⁸ As with liability of CRCs in general, this specific norm also has to be – and already is⁹ – considered from the viewpoint of legal science in particular. At the same time, economic science could provide useful insights that are necessary for a thorough evaluation of this first European liability rule. While this paper is dedicated to general and rather qualitative economic considerations, particular problems of quantification (of damage) would need to be examined by further analyses.¹⁰

⁶ *Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies*, 52 Official Journal of the European Union 1 (17 Nov. 2009). For more information on this regulation in particular, see e.g. F Amtenbrink, J de Haan, *Regulating Credit Ratings in the European Union: A Critical First Assessment of Regulation 1060/2009 on Credit Rating Agencies*, 46 *Common Market Law Review*, 1915 (2009). On the evolution of (explicitly / implicitly) ratings-directed regulation in general, see A Horsch, *Regulation of Credit Rating Companies: An Economic Point of View*, 25 *European Business Law Review* 227 (2014), with further references.

⁷ See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, §§ 931-939H, 124 Stat. 1376 (2010). For more information on the Act and its coverage of CRCs, see E I Altman, T S Öncü, M Richardson, A Schmeits, L J White, *Regulation of Rating Agencies*, in: V V Acharya, T F Cooley, M P Richardson, I Walter, *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* 443 (Wiley Hoboken/NJ 2011); see also C W Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Succeed in Preventing Future Crises?*, 64 *S.M.U. Law Review* 1243 (2011). For an overview on the Dodd-Frank Act's impact on CRC regulation, see e.g. D B H Martin, M C Franker, *Rating Agency Regulation After The Dodd-Frank Act: A Mid-Course Review*, 25 (12) *Insights – The Corporate & Securities Law Advisor* 19 (2011); D Carbone, *The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies*, 24 (9) *Insights – The Corporate & Securities Law Advisor* 19 (2010).

⁸ See CRA III, i.e. *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union 1, 20 (31 May 2013).

⁹ See B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence*, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013). Besides, see the other contributions in this compilation of papers.

¹⁰ An economic analysis of this kind is provided by J Kleinow, *Civil Liability of Credit Rating Companies: Quantitative Aspects of Damage Assessment from an Economic Viewpoint*, in this compilation of papers.

The paper is organized as follows: After this short introduction based on recent institutional change, we discuss characteristics that make for a good rule (Section 2). Thereafter, Section 3 examines the mechanism of the current European liability rule for CRCs and to what extent it complies with those requirements. In particular, we will show in Section 4 that the rule is too inaccurate and thus insufficient regarding several aspects of damage assessment, especially regarding the scope of possible damage cases. Combined with fundamental information problems (Section 5), this leads to our conclusion of Section 6, which is rather sceptical regarding the degree to which the new rule makes economic sense.

2 CHARACTERIZING RULES OF LIABILITY

Rules make up the institutional framework of markets, being the ‘rules of the game ... that shape human interaction’¹¹, while this human action in turn is at the heart of the market (processes).¹² From a market economic viewpoint, rules other than those of market origin, and especially rules imposed by government, should be the exception. As rules of liability aim at the allocation of property rights, they supersede their market-based coordination. Liability rules protect entitlements by saying that ‘their transfer or destruction is allowed on the basis of a value determined by some organ of the state rather than by the parties themselves’.¹³ The essential rationale for introducing these rules alongside – or instead of – property rules is that they help to protect entitlements of actors

¹¹ D C North, *Institutions, Institutional Change and Economic Performance* 3 (Cambridge University Press Cambridge et al. 1990). See also D C North, *Institutions*, 5 (1) *Journal of Economic Perspectives* 97 (1991).

¹² The understanding of the market as a process that is driven by (entrepreneurial) human action is nothing less than the core of the Austrian, in particular *Misesian* view of the market. See L von Mises’ seminal work, *Human Action – A Treatise on Economics* 258-259 (Yale University Press New Haven 1949): ‘The market is not a place, a thing, or a collective entity. The market is a process, actuated by the interplay of the actions of the various individuals cooperating under the division of labor. ... The market process is entirely a resultant of human actions.’ Reviewing ‘The Economics of The Market Process’, see the homonymous chapter of his remarkable biography by I Kirzner: *Ludwig von Mises – The Man and his Economics* 93-119 (ISI Books Wilmington/Del. 2001). For a recent discussion of the Misesian concept, see e.g. F Sautet, *The competitive market is a process of entrepreneurial discovery*, in: P J Boettke, *Handbook on Contemporary Austrian Economics* 87 (Edward Elgar Cheltenham & Northampton/Mass. 2010).

¹³ Taken from one of Guido Calabresi’s seminal contributions to the (economic) theory of liability, i.e. G Calabresi, A D Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 *Harvard Law Review* 1089, 1093 (1972). Savouring this article, see also L Kaplow, S Shavell, *Property Rules versus Liability Rules: An Economic Analysis*, 109 *Harvard Law Review* 715, 756 (1996). Hereafter, the paper will continue to refer to contributions of US-American legal scholars, too, even though the European liability rule of CRA III is based on different legal principles of European origin. Consequently, the references are limited to general aspects of liability rules or illustrative purposes.

in a (transaction) cost-efficient way: They seem justified when market evaluations based on individual negotiations of the very entitlement seem inefficient (because they are too expensive – and thus possibly unavailable – compared to the collective valuation provided by a general liability rule).¹⁴ In general, (the action based on) a property right inflicts costs on other actors, to whom there may or may not exist a contractual relationship.¹⁵ Regarding credit ratings, liability rules are thus deemed applicable because the rating actions of CRCs affect the value of (property rights connected to) financial assets of other actors. Consequently, ratings are viewed as sources of negative (harmful) *externalities*, which are one traditional problem to which liability rules haven been applied.¹⁶

In a market economy, any governmental intervention has to be scrutinized. The general market economic principle is that the state should abstain from economic do-it-yourself and piecemeal *regulation* as far as possible. Nevertheless, even market economists admit that it is essential that the government issues several *fundamental norms*, which then serve as guardrails of the human action that drives market processes:

*This particular function of government is somewhat like that of a maintenance squad of a factory, its object being not to produce any particular services or products to be consumed by the citizens, but rather to see that the mechanism which regulates the production of those goods and services is kept in working order.*¹⁷

Regulation going beyond those general guardrails has to meet certain standards, requiring the existence of *market failure* as well as the proof of the *effectiveness* and the *efficiency* of the suggested regulation.¹⁸ In general, liability rules could be regarded as necessary guardrails, and not as regulation:

Consequently, the elementary constitutional rules are based on the principle of the inviolability of individual property rights. This demands an elementary legal order, plus its enforcement mechanism, regulating: (1) the property rights of

¹⁴ See G Calabresi, A D Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harvard Law Review 1089, 1106, 1110 (1972).

¹⁵ See the seminal paper of R H Coase, *The Problem of Social Cost*, 3 Journal of Law and Economics 1, 44 (1960): 'The cost of exercising a right ... is always the loss which is suffered elsewhere in consequence of the exercise of that right'.

¹⁶ See L Kaplow, S Shavell, *Property Rules versus Liability Rules: An Economic Analysis*, 109 Harvard Law Review 715, 719-721, 723-757 (1996).

¹⁷ F A von Hayek, *Law, Legislation and Liberty, Vol. 1: Rules and Order* 47 (University of Chicago Press Chicago 1973).

¹⁸ See e.g. R D Skipper, R W Klein, *Insurance in the Public Interest: The Path Towards Solvent, Competitive Markets*, 25 Geneva Papers of Risk and Insurance 492, 500 (2000).

individuals according to the general principles of private property, (2) the transfer of these rights by consent according to the principle of freedom of contract, and (3) individual liability for contractual obligations or in case of tortious acts.¹⁹

Taking liability rules as part of the fundamental constitutional framework implies that their justifiability does not depend on the existence of market failure as much as other rule making. However, there is a difference between general and ratings-directed liability rules that apply to CRCs exclusively. Consequently, the latter have to be regarded as part of the regulatory framework, and thus require market failure as a prerequisite for their being acceptable from an economic viewpoint. Unfortunately, the existence of ‘market failure’ that is serious enough to justify the regulation of ratings markets is, of itself, debatable.²⁰ Because the economic analysis of ratings-directed liability could, but should not, end here, it is continued in the light of the current support for ratings-directed regulation. As different approaches to liability are possible, the prevailing question of effectiveness and efficiency are essential for the evaluation of those rules. Effectiveness of a rule in general, and of a liability rule in particular, depends on its comprehensibility, applicability (including sufficient flexibility and enforceability) and compatibility with fundamental legal and economic principles, in total contributing to their being believable and acceptable for human actors affected by the rule. Subsequently, it has to be asked to what extent a rule that is effective is efficient, too, i.e. whether it reaches the regulatory goal at minimal cost. During this analysis, also unintended side-effects of the rule have to be considered.

To be effective, liability norms have to outline ‘that each member of a certain class of people (norm’s subjects) has an obligation (norm’s character) to do something (norm’s act) in certain circumstances (norm’s conditions), subject to a penalty for noncompliance (norm’s sanction)’.²¹

¹⁹ E G Furubotn, R Richter, *Institutions and economic theory: The contribution of the new institutional economics* 11 (University of Michigan Press Ann Arbor 1997), with a reference to no lesser than W v Humboldt. Since then, updates of this seminal monograph on institutional economics have been limited to its German version: see R Richter, E G Furubotn, *Neue Institutionenökonomik* (4th ed., Mohr Siebeck Tübingen 2010). Of their English contributions, see the recent summary of their approach, i.e. E G Furubotn, R Richter, *The New Institutional Economics – A Different Approach to Economic Analysis*, 28 (3) *Economic Affairs* 15 (2008). For more information on the underlying concept of property rights, see the extensive – and itself renowned – review of groundbreaking works provided by E G Furubotn, S Pejovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 *Journal of Economic Literature* 1137, esp. 1142-1146 (1972).

²⁰ See A Horsch, *Regulation of Credit Rating Companies: An Economic Point of View*, 25 *European Business Law Review* 227 (2014).

²¹ R D Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 *University of Pennsylvania Law Review* 1643, 1661 (1996), referring to G H von Wright, *Norm and Action: A Logical Enquiry*, 70-92 (Routledge London 1963).

In a comprehensive, applicable, and compatible way, liability rules must determine the following, with the details depending on the relevant institutional framework:

- I. the rationale of/reason for a liability ('why'); as well as
- II. the situations/actions triggering liability ('when');
- III. the parties involved ('who');
- IV. a verbal description of the recoverable loss / compensation ('what'); and, finally,
- V. a means of quantifying respective amounts.

Re I.: The rationale of a rule that affects the freedom to act should refer to general principles of law or a failure of the market it is applied to. From an economic viewpoint, additional reference to the effectiveness and efficiency of the concept – compared to alternative approaches – are also necessary to prove a legitimate purpose of the rule.

Re II.: Triggers of a (liability) rule could be (i) already the mere (non-) action of a party, regardless of culpability (strict liability²² of Anglo-Saxon jurisdictions), (ii) negligent (non-)action that violates a general principle ('due care', 'due diligence' etc.)²³, or (iii) can be part of a (conclusive) enumeration of triggering events.

²² 'The concept of strict liability is a various one, but at its core is the notion that one who injures another should be held liable whether or not the injurer was negligent or otherwise at fault.' – R A Posner, *Strict Liability: A Comment*, 2 *Journal of Legal Studies* 205, 205 n. 2 (1973). Among the major articles Posner criticized, see in particular RA Epstein, *A Theory of Strict Liability*, 2 *Journal of Legal Studies* 151 (1973). Regarding the understanding of strict liability, see also S Shavell, *Strict Liability versus Negligence*, 9 *Journal of Legal Studies* 1, 3-4 (1980). The concept of strict liability is rooted in Anglo-Saxon, and especially US tort law, while EU rule makers preferred to use a different concept for the liability rule of CRA III. This does not mean that strict liability is absolutely incompatible with the law of EU member states. On strict liability in European private law, see e.g. G Wagner, *Strict Liability*, in J Basedow, K J Hopt, R Zimmermann, A Stier *Max Planck Encyclopedia of European Private Law* 1607 (Oxford University Press Oxford 2012). See also E Büyüksagis, WH van Boom, *Strict Liability in Contemporary European Codification: Torn Between Objects, Activities, and their Risks*, 44 *Georgetown Journal of International Law* 609. Anyway, strict liability has to be mentioned here to illustrate the general scope of alternative triggers.

²³ For more information on such 'broad principles that apply in many different circumstances', see e.g. R D Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 *University of Pennsylvania Law Review* 1643, 1652 (1996).

Re III.: Parties involved necessarily encompass the definition of the (potential) injurer, the (potential) injured and plaintiff, and the judicial institution that could be addressed by the claimant.

Re IV.: Regarding the qualities of the claimable damage / compensation, a liability rule has to define what is (not) covered by it. In particular, boundaries could result from time (limitation), the kind of damage (restriction to economic loss), and the dimension of damage (floors or caps).

Re V.: Elaborating quantification could mean method, but in particular *benchmarking*. For example, an injurer could be obliged by law to restore the original state of wealth of the injured. Depending on the surrounding legal framework, the quantification can be of double relevance: Naturally, quantitative considerations are necessary to calculate the volume of damage and subsequent compensation. But on a more fundamental level, quantitative considerations can also be essential to deduce a damage and compensation case at all. Although being another principle of US (tort) law, that differs from the law of EU member states, the seminal formula of Judge *Learned Hand*²⁴ nevertheless helps to illustrate this general problem: The approach states that negligence – and coherent liability – of an actor are given, if his precautions (care C) have been too little compared with the probability (P) and the magnitude of a loss (L), i.e. if the Cost of $C < P \times L$ ²⁵ – or undercuts the optimal level of care that is calculated by a marginal approach²⁶, satisfying

²⁴ The formula is an important, but not the only reason, why Judge *Learned Hand* is regarded to this day as one of the most important judges in US history. As an extensive biography, see G Gunter, *Learned Hand: The Man and the Judge* (Alfred Knopf New York 1994). For a critical review of this book, see R A Posner, *The Learned Hand Biography and the Question of Judicial Greatness*, 104 Yale Law Journal 511 (1994). For more information on the seminal meaning of the Hand Formula and its – imperfect – reception by legal science, see P J Kelley, *The Carroll Towing Company Case and the Teaching of Tort Law*, 45 Saint Louis University Law Journal 731, esp. 732-735 (2001).

²⁵ *United States v. Carroll Towing Co.*, 159 F.2d 169, 173: 'It becomes apparent why there can be no such general rule, when we consider the grounds for such a liability. Since there are occasions when every vessel will break from her moorings, and since, if she does, she becomes a menace to those about her; the owner's duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether $B < PL$.' For an elaboration of the principle, see R A Posner, *A Theory of Negligence*, 1 Journal of Legal Studies 29, 32-52 (1972). For a critical review of the (applicability of) the Learned Hand Rule, see J P Brown, *Toward an Economic Theory of Liability*, 2 Journal of Legal Studies 323, 331-335 (1973). For more recent reviews of the original rule, see e.g. S G Gilles, *United States v. Carroll Towing Co.*, *The Hand Formula's Home Port*, in: R L Rabin, S D Sugarman, *Tort Stories* 11 (Foundation Press New York 2003); A M Feldman, J Kim, *The Hand Rule and United States v. Carroll Towing Co. Reconsidered*, 7 American Law and Economics Review 523 (2005).

²⁶ For an elaboration of the *marginal Hand-Formula*, see R D Cooter, *Economic Analysis of Punitive Damages*, 56 California Law Review 79 (1982). In brief, see also R A Posner, *Economic Analysis of Law* 213-217 (8th ed. Wolters Kluwer / Aspen Publ. New York et al. 2011).

$$\text{Total Cost} = P(C) \times L(C) + \text{Cost of } C(C) \rightarrow \min! \Leftrightarrow$$

$$\frac{dP}{dC} L(c) + \frac{dL}{dC} P(c) + \frac{dCoc}{dC} = 0.$$

Apparently, using quantitative approaches like the Hand Formula requires considerable economic knowledge on the side of the evaluating judge. Unfortunately, ‘applying cost-benefit techniques like the Hand Rule ... often demands more information than judges possess’.²⁷ Consequently, this leads back to the question of the prerequisites of a liability case (‘when’), so that this quantitative consideration of due care might be replaced by others, for example by a positive list of actions of undue care. From an economic point of view however, this raises the fundamental questions of appropriate selection and knowledge: Were the decision-makers who wrote the list experienced, informed, willing and capable enough to make an unbiased selection? Among others, the problem of (pretended) knowledge will be addressed hereafter.

Before, the current European Liability Rule for Credit Rating Companies will be reviewed in a descriptive way first. Subsequently, a general evaluation of the rule will be given, focusing on qualitative considerations.

3 THE EUROPEAN LIABILITY RULE FOR CREDIT RATING COMPANIES

As expected, European rule makers reacted to the crisis processes evolving since 2007 by passing extensive (re-)regulations of financial markets, in particular of selected financial institutions. While the banking sector saw massive amendments of the basic regulatory regime Basel II in the shape of Basel III, and of the European capital requirements directives based thereupon, the rating industry received an explicitly ratings-directed European regulation for the first time. Until 2013, neither the first (CRA I) nor the second (CRA II) wave of crisis-driven European regulation of ratings markets²⁸ contained a liability rule. Obviously, European lawmakers saw this as an omission in need of correction, so they further drove institutional change by initiating the third wave (CRA III) of ratings-directed regulation. Amongst others, it led to the insertion of a

²⁷ RDCooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 *University of Pennsylvania Law Review* 1643, 1680 (1996).

²⁸ See CRA I, i.e. *Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies*, 52 *Official Journal of the European Union* 1 (17 Nov. 2009), and CRA II, i.e. *Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies*, 54 *Official Journal of the European Union* 30 (31 May 2011).

new Article 35a into the original text of CRA I, its tenor of civil liability being as follows:

*Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement.*²⁹

Referring to the contents and criteria described in the previous chapter, the European liability rule for credit rating companies can be assessed as follows:

- I. The rationale of (the urgency of) a liability rule for CRCs is extensively elaborated in several recitals of regulation CRA III.³⁰ Scrutinizing the explanations, however, the justification is ultimately based on the de facto importance of credit ratings. The alleged significance of ratings leads rule makers to conclude particular responsibility of their producers first, and the urgency of additional liability rules enforcing this responsibility second.³¹
- II. Situations / actions triggering liability ('when'): If an infringement of certain obligations (listed in Annex III of CRA I as amended by CRA III) – that impacts a credit rating – has its root in the intention or gross negligence of the CRC, a damage might be claimed. The need for the combination of infringement and harmful impact means that only one of the four general possibilities illustrated in Diagram 1 leads to a liability according to CRA III:

Diagram 1: Legal consequences of CRC action

Infringement \ Damage	No		Yes	
	No	1	No legal consequence	2
Yes	3	Fine	4	Fine + compensation

²⁹ See Art. 1 Sec. (22) para. 1 subpara. 1 of CRA III, i.e. *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union 1, 20 (31 May 2013).

³⁰ For the considerations underlying the aforementioned tenor and the subsequent elaborations, see recitals 32-36 of CRA III, *ibid.* 7-8.

³¹ See recital 32 of CRA III, *ibid.* 7-8: 'Credit ratings, whether issued for regulatory purposes or not, have a *significant impact* on investment decisions and on the image and financial attractiveness of issuers. Hence, credit rating agencies have an *important responsibility* towards investors and issuers ... However, investors and issuers are not always in a position to enforce credit rating agencies' responsibility towards them. ... Therefore, it is important to provide for an adequate right of redress for investors ... as well as for issuers who suffer damage ...' (emphasis added).

While the liability rule itself deals with situation 4, at the same time it declares that there is no exclusion of further civil liability claims,³² thus allotting situation 2 to the responsibility of national jurisdictions.

- III. Parties involved ('who'): While the role of the potential injurer is reserved for CRCs, potential claimants are investors as well as issuers:

An investor may claim damages ... where it establishes that it has reasonably relied ... with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.

An issuer may claim damages ... where it establishes that it or its financial instruments are covered by that credit rating and the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available.³³

Here, further conditions (detailing the 'when') become obvious, as a claim additionally requires the absence of co-negligence of the claimant, be it unreasonable reliance / insufficient care (investor) or misleadingly informing the CRC (issuer). Furthermore, the injured party has to prove that the CRC committed an infringement, and that this had an impact on the credit rating³⁴ (which, in turn, affected the claimant negatively). The role of the judging party is assigned to national institutions of Member States, including their responsibility to interpret vague legal concepts such as reasonable reliance.³⁵

- IV. Verbal description of the recoverable loss and respective compensation ('what'): The European liability rule restricts the qualitative identification of damages by only specifying their origin. As long as damages of an issuer / investor are caused by infringements of the CRC, a damage claim becomes possible. Inspired by the subprime crisis, promoters of liability prefer to use the example of the investor whose wealth is impaired by the default of apparently 'overrated' issues³⁶. However, economic loss is not restricted to this textbook case. Instead, thorough analysis shows a diversity of probable

³² See *ibid.*, Art. 1 Sec. (22) para. 5.

³³ Citing *ibid.*, Art. 1 Sec. (22) para. 1 subpara. 2-3.

³⁴ See *ibid.*, Art. 1 Sec. (22) para. 2.

³⁵ See *ibid.*, Art. 1 Sec. (22) para. 4.

³⁶ See e.g. L Freeman, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 Vermont Law Review 585, 587-588 (2009); R Jones, *The Need for a Negligence Standard of Care for Credit Rating Agencies*, 1 William & Mary Business Law Review 201, 223-224 (2010); Y Listokin, B Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 Yale Journal on Regulation 91, 93 (2010).

damage cases caused by infringements that would be covered by the liability rule:

Diagram 2: Scope of damage cases

		At the moment of bond issue, the rating is...	During the term of the security, the rating remains/becomes...
... <i>excessively positive:</i>	Issuer	overestimates funding opportunities (price/quantity): unreasonable euphoria if rating is rectified later	buys back at increased costs
	Investor	receives an effective yield too low for corresponding risk; unexpected devaluation or even default after biased/distorted perception of credit risk; breaches investment rules	
... <i>excessively negative:</i>	Issuer	bears excessive financing costs and exceedingly low volume for corresponding rated issue	has increased costs and difficulties in obtaining follow-up financing (even without rating, since ratings-based covenants may be triggered)
	Investor	underestimates investment opportunities (price/quantity); inhibited/discouraged from investing	suffers from accounting and/or realised loss through listing / sale of held bonds at less than fair value

As none of these cases is excluded by CRA III, any of them have to be regarded as an application of the liability rule for the time being.

- V. Means to quantify respective amounts: The European liability rule gives no information on how to calculate damages and respective compensations. Instead, detailed information is given on the (amended) amount of fines that follow certain infringements regardless of liability claims.³⁷ This rather evasive approach becomes understandable when the complexity of the quantification of loss³⁸ is considered.

³⁷ See Art. 1 Sec. (23) of CRA III, i.e. *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union 1, 21 (31 May 2013).

³⁸ See B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 16-18, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013).

Following this descriptive overview, it is possible to contrast the European liability rule with the aforementioned criteria for good rule making.

4 FUNDAMENTAL PROBLEMS OF COMPATIBILITY

Regarding compatibility of the new rule with basic economic and legal principles, doubts arise in particular from considering pretence of knowledge,³⁹ punitive damages, and characteristic patterns of the regulation of financial institutions. Respective considerations are provided in this chapter, before further problems of the rule at work are highlighted.

4.1 Pretended Knowledge

The previous chapter illustrated the broad scope of damage cases to which the new liability rule could apply. Regardless of the details, each case was based on (1) an evidentially erroneous ('too optimistic' or 'too pessimistic') rating, while (2) the CRC has committed an infringement causing the erroneous rating – and thus a violation of the property rights of a protected issuer or investor. Based hereupon, a quantification of the damage and, thus, the obligation to compensate has to be conducted. Although quantification approaches exist – and have been applied already – they are exposed to fundamental criticism that goes beyond the problem of ambiguity.

Any attempt in assessing the damage has to start with the expected difference between the issued (and allegedly erroneous) rating and an accurate one. Subsequently, to what extent this rating gap led to the economic loss of a claimant has to be quantified. Unfortunately, the 'true' rating is difficult, if not impossible, to determine. In fact, it is essential to be able to define which rating would have been appropriate at the moment of the erroneous rating, based on conditions (in particular: knowledge, financial information, analytic procedures, and regulations) at that time. To gauge the dimension of a CRC's misjudgement and responsibility, the judge would have to reposition himself into the former situation of the CRC at the date of the rating issue, meaning, in particular, that he would have to disregard any information that was receivable since then. Assuming that the 'true' rating is known, a subsequent problem arises from the connection between the rating gap and the loss caused by it, because it naturally remains hypothetical what a claimant would

³⁹ For an elaboration by Nobel Laureate Friedrich August von Hayek, see his Nobel lecture, i.e. F A von Hayek, *The Pretence of Knowledge*, 77 *Swedish Journal of Economics* 433, 438 (1975): 'a pretence of exact knowledge that is likely to be false.' Numerous reprints of this lecture exist; see, alternatively, F A von Hayek, *The Pretence of Knowledge: Nobel Memorial Lecture, December 11, 1974*, 79 (6) *American Economic Review* (Papers & Proceedings) 3, 5 (1989).

have done if he had known the ‘true’ rating then. However, ‘it cannot be concluded that a rating was incorrect solely due to the fact that the rating grade turns out to be unfounded *ex post*’.⁴⁰ Only someone who possesses superior or, even better, perfect knowledge regarding those hypothetical situations could be expected to deliver an appropriate benchmark.

However, a world of fundamental uncertainty⁴¹ prevents any single person from having perfect knowledge of a particular problem. Consequently, perfect knowledge means *pretended* rather than actual knowledge.⁴² And as it is knowledge of an economic kind, it would be even more questionable if judges could have this essential knowledge, as the ‘ability to know the extent to which market prices are incorrect is fundamentally an entrepreneurial skill, and the courts are not populated by entrepreneurs’.⁴³

Pretence of knowledge also applies to another aspect of the European liability rule: Negligence rules in general mean that ‘all that an injurer needs to do to avoid the possibility of liability is to make sure to exercise due care [i.e., as defined by the regulator] if he engages in his activity’,⁴⁴ and thus shapes human action. Instead of or supplementary to general principles, a rule could rely on catalogues of (non-)actions specifying negligent behaviour. The European liability rule for CRCs combines both: Negligence of CRCs is defined by the catalogue of Annex III of CRA I, while general principles (like ‘due care’) apply to identify co-negligence of claimants. A catalogue like this however, implicitly assumes that its author has been able to analyze the problem perfectly and, thus, to define

⁴⁰ U Blaurock, *Control and Responsibility of Credit Rating Agencies*, 11 (3) *Electronic Journal of Comparative Law* 1, 17 (2007). See also *ibid.*, 24 on the connection between rating and investor action.

⁴¹ The distinction between fundamental uncertainty and risk was introduced by Frank Knight, see F H Knight, *Risk, Uncertainty and Profit*, passim, e.g. 232-233 (Houghton Mifflin Boston 1921).

⁴² The ‘problem of the utilization of knowledge which is not given to anyone in its totality’ – and thus always is incomplete – has also been elaborated by Friedrich August von Hayek in particular, see here F A von Hayek, *The use of knowledge in society*, 35 *American Economic Review* 519 (1945).

⁴³ M Rizzo, *Law Amid Flux: The Economics of Negligence and Strict Liability in Tort*, 9 *Journal of Legal Studies* 291, 310 (1980). See also E Stringham, M D White, *Economic Analysis of Tort Law: Austrian and Kantian Perspectives*, in: M Oppenheimer, N Mercurio, *Law and Economics: Alternative Economic Approaches to Legal and Regulatory Issues* 374, 377 (M.E. Sharpe New York/London 2005).

⁴⁴ S Shavell, *Strict Liability versus Negligence*, 9 *Journal of Legal Studies* 1, 3 (1980). The quote illustrates the universal connection of due care, (avoidance of) negligence, and liability, while the details differ among jurisdictions.

the optimal level of both care and liability.⁴⁵ In a world of fundamental uncertainty, however, it seems utterly questionable if any regulator could possess this perfect knowledge. Instead, we have to assume that the catalogue is based on the pretended knowledge of the rule / catalogue maker. Consequently, accepting this catalogue without criticism would be another example of putting ‘tremendous faith in the ability of the regulator to monitor and evaluate the ratings agencies’ performance’.⁴⁶ Thus, based on pretended knowledge, the European liability rule for CRCs seems incompatible with general economic principles stressing the incompleteness and dispersion of imperfect human knowledge.⁴⁷

4.2 Matters of Misallocation

In an overall view, liability of CRCs could lead too far, depending on the (legal) understanding of damage. A negligently-issued erroneous rating could, for example, mean that an issuer X, who was rated too positively, pays insufficiently-low risk premiums to investor Y. Consequently, *Y and other investors suffer* from inflated prices at the issue date and an inappropriately low interest income, negatively affecting their wealth. At the same time,

⁴⁵ For a tentative discussion of the amount of CRC liability, see e.g. U Blaurock, *Control and Responsibility of Credit Rating Agencies*, 11 (3) *Electronic Journal of Comparative Law* 1 (2007), esp. 30 on the problem of ‘the availability of a well-established and fixed set of obligations.’ See also F Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, 25 (4) *Journal of International Banking Law and Regulation* 188, 195-197 (2010); id., *How and Why Credit Rating Agencies Are Not Like other Gatekeepers*, in: Y Fuchita, R E Litan, *Financial Gatekeepers: Can They Protect Investors?* 59, 83-89, 95-96 (Brookings Institution Press Baltimore 2006). See also J W Heggen, *Not Always the World’s Shortest Editorial: Why Credit-Rating-Agency Speech is Sometimes Professional Speech*, 96 *Iowa Law Review* 1745, 1758-1759 (2011).

⁴⁶ M Richardson, L White, *The Rating Agencies: Is Regulation the Answer?*, 18 (2) *Financial Markets, Institutions & Instruments* 146, 147 (2009).

⁴⁷ For more information on the (importance of) the incompleteness and dispersal of knowledge among human actors, see the writings of Friedrich August von Hayek, who points out that ‘the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the *dispersed* bits of *incomplete* and *frequently contradictory* knowledge which all the separate individuals possess.’ – Taken from F A v Hayek, *The use of knowledge in society*, 35 *American Economic Review* 519 (1945), emphasis added. Besides the writings already named above (see footnotes 39, 42), see also F A v Hayek, *Economics and Knowledge*, 4 *Economica* 33, 45, 52 (1937); Id., *Law, Legislation and Liberty, Vol. I: Rules and Order* 11-17 (University of Chicago Press Chicago 1973). For a clarification of the meaning of Hayek’s ideas for economic science, see e.g. I Kirzner, *Prices, the Communication of Knowledge, and the Discovery Process*, in: K R Leube, A H Zlabinger, *The Political Economy of Freedom – Essays in Honor of F. A. Hayek* 193 (Philosophia Munich/Vienna 1985): ‘Hayek decisively drew the attention of the economics profession to the unique problems that arise from the dispersal of knowledge. ... Hayek’s insight represented a breakthrough, of course, in the modern history of welfare economics ...’ See also D Lavoie, *The Market As A Procedure for Discovery and Conveyance of Inarticulate Knowledge*, 28 (1) *Comparative Economic Studies* 1, 1-3, 10-14 (2001).

not the CRC, but *the issuer X profits* from the erroneous rating, as he saves interest payments. Analogous situations occur when erroneously-rated securities are traded at a secondary market: Primary market buyer Y, who paid too much and received too little debt service since then, now sells the – assumed still erroneously-rated – security to a secondary market buyer, Z. Now Y profits from the inflated market price of the security, thus receiving compensation for his initial investment, while Z overpays.⁴⁸

Regarding total wealth, the erroneous rating is of no damaging effect in either case, but it leads to misallocations of funds. Consequently, it should first be discussed whether the benefiting issuer X (primary market) or Y (secondary market) were enjoying unjustified enrichments, and thus should be obliged to make a restitution of the income or saving they did not deserve. This problem shows apparent parallels to further issues of the regulation of securities markets, in particular situations of securities fraud conducted by issuers, leading to losses incurred by some investors while other investors did benefit from the erroneous market price. Against the backdrop of US law, it was concluded that ‘there is no legal or practical basis for forcing restitution by those ... who were unjustly but innocently enriched’⁴⁹. But for the time being, this would be infeasible under European law as well. Thus, beneficiaries of erroneous ratings keeping were allowed to keep their profit, leading to an asymmetry of opportunity and risk, as only the latter has to be borne by CRCs. Consequently, (not only) ‘the insolvency risk is shifted to the rating agency’⁵⁰.

The European liability rule does not address this problem. Instead, if investor Y or Z now successfully claim damage and the CRC is found accountable for an infringement, the CRC is obliged to pay, while market counterparties of the claimant, who inversely profited from the claimant’s loss, are unaffected. If the liability rule worked perfectly, the compensation payment CP that is paid by the CRC would equal the initial loss IL of the claimant, while the counterparty keeps the respective initial profit IP. The misallocated net wealth amendments then are: CRC: - CP; claimant: 0; counterparties: + IP (IL). In an overall view, the underlying obligation of the CRC might even qualify as a kind of punitive damage. However, punitive damages could be inadmissible in negligence cases even under

⁴⁸ See, in brief, B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 16-17, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013).

⁴⁹ R A Posner, *Economic Analysis of Law* 611 (8th ed. Wolters Kluwer / Aspen Publ. New York et al. 2011).

⁵⁰ B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 4, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013).

US law⁵¹, and especially under European law, where they are regarded a rare exception or even excluded instrument.⁵² Anyway, the illustrated misallocation could mean over-deterrent effects of the European liability rule that definitely deserve further legal research.⁵³

4.3 Patterns of Regulation

Looking back at the history of ratings and regulation, developments have become increasingly dynamic in recent years.⁵⁴ Although ratings markets were not unregulated in the past, regulatory action has considerably accelerated and culminated in several directives, the European liability rule representing the most recent step. However, one fundamental problem of governmental rule making is its tendency to be crisis-driven. Against the background of economic crises, decision makers in legislative and regulatory bodies feel considerable incentives to act, frequently for the sake of action itself. During this 'regulatory actionism', strictness and speed of regulatory innovation often outweigh the market economic principle of minimizing governmental interference with market processes. Positive and behavioural approaches to regulation help to explain this traditional pattern.⁵⁵

Among the dangers of behavioural regulation is the insufficient consideration of new regulations being part of a complex institutional framework. As other systems, legal systems are characterized by their *complementarity*, i.e. the well-fitting and frictionless interplay of components.⁵⁶ This becomes relevant for ratings-directed regulation, too: In particular, 'complementarity is crucial for understanding the characteristics and the

⁵¹ See R A Posner, *A Theory of Negligence*, 1 *Journal of Legal Studies* 29, 49 (1972).

⁵² For an extensive discussion from a German point of view, see e.g. P Müller, *Punitive Damages und deutsches Schadenersatzrecht* 15-30 (De Gruyter Berlin/New York 2000).

⁵³ For a critical assessment, see B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 15-16, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013).

⁵⁴ For a recent overview, see A Darbellay, *Regulating Credit Rating Agencies* 45-90 (Edward Elgar Cheltenham/Northampton 2013).

⁵⁵ For an introduction, see A Horsch, *Financial Crisis and Institutional Change*, in: R Barczyk, H Brezinski, K von Delhaes, *Consequences of World Economic Crisis for Poland and Central East Europe* 9, 35-38 (Poznań University of Economics Press Poznań 2012).

⁵⁶ The concept of complementarity was elaborated by several authors dealing with different economic problems. As a seminal contribution, see P Milgrom, J Roberts, *Complementarities and fit: Strategy, structure, and organizational change in manufacturing*, 19 *Journal of Accounting and Economics* 179 (1995). For an application of the concept to financial systems, see also A R Hackethal, M Tyrell, *Complementarity and Financial Systems – A Theoretical Approach*, Working Paper No. 11, Wilhelm Merton Professur für Ökonomie des Welthandels, Johann Wolfgang Goethe-Universität Frankfurt (Frankfurt/M. 1998).

dynamic properties of entire legal systems, financial systems and other similar complex systems⁵⁷. Inter alia, complementarity of a system means that the adding or retracting of an element has to be analysed thoroughly, integrating (instead of segregating) its components. Thoroughness also means that the functioning of a system should be observed in a long-term rather than a snapshot perspective. Applying these considerations to ratings-directed regulation, it becomes obvious that important (re-) regulations have taken place since 2007, although there has not been sufficient time to evaluate their de facto effects. While it is still unclear if and to what extent actors will adjust to former regulatory innovation – such as the Credit Rating Agency Reform Act of 2006⁵⁸, Dodd-Frank, CRA I of 2009, and CRA II of 2011 – during normal times, another regulation has been added in 2013. It is hardly possible to gauge if the set of rules – including infringement rules – set by CRA I/II could have posed a feasible enhancement of the incentives that discipline CRCs sufficiently according to the *reputational capital view*.⁵⁹ Instead, the high frequency of regulatory addition makes the complementarity of the system of ratings-directed regulation even more questionable, since conflicts between previous and recent regulations become observable, as will be illustrated hereinafter. Instead of further (and probably prematurely) driving forward institutional change, a wait-and-see approach would have been recommendable. Unfortunately, this market economic viewpoint has not been shared by crisis-driven rule makers, so that the perils of fundamentally flawed and incompatible regulation prevail.

5 SUBSEQUENT PROBLEMS OF RULE-INDUCED BEHAVIOUR

A new liability rule represents an intentional change of the institutional framework, i.e. the rules of the game. As human actors adapt to the rules of

⁵⁷ R H Schmidt, G Spindler, *Path Dependence, Corporate Governance and Complementarity*, 5 *International Finance* 311, 313 (Note 3), 318-319 (2002).

⁵⁸ For more information on the Credit Rating Agency Reform Act of 2006 (CRARA), see e.g. L J White, *A New Law for the Bond Rating Industry*, 29 (Spring) *Regulation* 48 (2007); G Deipenbrock, *Der US-amerikanische Rechtsrahmen für das Ratingwesen – ein Modell für die europäische Regulierungsdebatte?*, 61 *Wertpapier-Mitteilungen* 2217 (2007); A Darbellay, *Regulating Credit Rating Agencies* 68-69 (Edward Elgar Cheltenham/Northampton 2013). CRARA was a legislative response to the corporate scandals of the early 21st century, so that it was driven by economic crises, too.

⁵⁹ Although he is led to the suggestion of an alternative explanation, see, extensively and with further references, F Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 *Washington University Law Quarterly* 619, 628-636 (1999). For a recent promotion of the opposing view that '[t]he state, not investors should police the rating agencies', see D A Maas, *Policing the Rating Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market*, 101 *Journal of Criminal Law & Criminology* 1005, 1016 (2013).

the game, rule amendments will spur human (re-)actions. Some of them will be intended by rule makers, some of them will not: Comparably to the field of medicine, any regulation will have unintended side effects. Because these side effects contribute to the evaluation of a rule, they have to be considered thoroughly.⁶⁰ Unfortunately, the analysis of regulatory side-effects seems insufficient so far, so that some general qualitative considerations are briefly presented hereinafter.

The intended rationale of a liability rule is to ensure a certain allocation of property rights by incentivizing potential injurers to avoid actions deemed undesirable (because they would affect the property rights of others). Put differently, the 'goal is to induce an efficient pattern of individual behaviour'⁶¹. With respect to the regulation of CRCs, it is expected that 'market participants ... be mindful of these reforms and be ready to adjust policies and procedures to accommodate new rules'⁶². It cannot be predicted perfectly, however, if and to what extent adjustments take place. In general, they could prove counterproductive, with undesired side effects negatively affecting the goal of the liability rule or the goals of further regulatory approaches. In particular, deficits of comprehensibility, acceptability, applicability and credibility contribute to negative side effects.

5.1 General Comprehensibility

Article 35a CRA III is a lengthy and detailed rule. Although the basic rationale and mechanism (i.e. proven negligence, resulting erroneous rating(s), evidentially-caused damage, compensation if claimed) seems understandable, the details of the rule considerably mitigate its comprehensibility. Linking liability to a number of positively-named events is plausible at first sight, while comprehensibility in detail depends on the contents of the list of violations. Annex III, which was added to CRA I by CRA II, already specified no less than 73 different infringements related to several aspects of CRC business, regulation, and disclosure,

⁶⁰ See e.g. L J White, *Credit Rating Agencies & Regulation – Why Less Is More*, in: R Johnson, E Payne, *Make Markets Be Markets* 43, 46-48 (The Roosevelt Institute Washington, D.C./ New York 2010).

⁶¹ W Emons, *Some Recent Developments in the Economic Analysis of Liability Law: An Introduction*, 146 *Journal of Institutional and Theoretical Economics* 237, 237 (1990). See also R D Cooter, *Economic Theories of Legal Liability*, 5 (3) *Journal of Economic Perspectives* 11, 12 (1991).

⁶² D B H Martin, M C Franker, *Rating Agency Regulation After The Dodd-Frank Act: A Mid-Course Review*, 25 (12) *Insights – The Corporate & Securities Law Advisor* 19, 26 (2011).

with CRA III raising the number of infringements to 81.⁶³ Taking into account the fragmentation of several infringements and their detailed reference to articles of the directive, the liability rule becomes even more difficult to comprehend. Furthermore, the rule remains rather vague and opaque as it assigns the disambiguation of seminal legal terms to national law.⁶⁴ The rule also treats investor and issuer claims analogously, disregarding not only that different fields of law could be applicable here, but also further liabilities according to national law: Under the current investor-pays regime, issuers could refer to contractual liability, while investors could only plead tort liability, as they lack a contractual relationship with the CRC.⁶⁵ Regardless thereof, actors will develop a certain understanding of the rule, leading them to subsequent action. Limitations of comprehensibility, such as those mentioned above, lead to a growing probability of unintended side-effects that question the effectiveness and efficiency of this rule.

5.2 Claimants

Although primarily aiming at potential injurers, a liability rule might evoke actions of those who are protected by the rule, too, because it ‘imparts the correct incentive to the injurer but eliminates the incentive of the victim to take cost-justified precautions’.⁶⁶ Protective rules can incentivize protected actors to act more carelessly. At the worst, a protective rule spurs action that distorts the concept behind the rule, as protected actors may devote their resources not to the avoidance of damage cases, but to their identification and even their creation: The more beneficiaries of a rule hope to profit from successful lawsuits, the more ‘liability brings forth the possibility of

⁶³ See, at first, Appendix III as inserted by CRA II, i.e. *Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies*, 54 Official Journal of the European Union 30, 51-56 (31 May 2011), into CRA I. Thereafter, CRA III has further elaborated this original catalogue, see *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union 1, 29-33 (31 May 2013).

⁶⁴ See Art. 1 Sec (22) para. 4 of CRA III, i.e. *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union 1, 21 (31 May 2013).

⁶⁵ See e.g. N Blumberg, J Wirth, N Litsoukov, *The Liability of Credit Rating Agencies to Investors: A Review of the Current Liability Regime and Recent SEC Proposals*, 16 (4) *Journal of Structured Finance* 34, 34-35 (2011); T Johansson, *Regulating credit rating agencies: The issue of conflicts of interest in the rating of structured finance products*, 12 (1) *Journal of Banking Regulation* 1, 14 (2010).

⁶⁶ R A Posner, *Economic Analysis of Law* 139 (1st ed. Little, Brown & Co. Boston 1973).

frivolous suits'.⁶⁷ The European rule seeks to mitigate these types of *moral hazard* by imposing certain obligations on claimants.⁶⁸ Especially because those obligations have been vague legal concepts thus far, the incentivizing effect seems unclear for the time being. Since the extensive catalogue of objectionable infringements of the European rule appears rather strict, it seems to be prone to stimulating undesirable actions of claimants – prima facie. On closer inspection, however, this effect will be mitigated by considerable obligations assigned to a claimant: (1) Art 35a CRA III states that it is the responsibility of the claimant to 'present accurate and detailed information indicating that the credit rating agency has committed an infringement of this Regulation, and that that infringement had an impact on the credit rating issued'.⁶⁹ Consequently, information deficits and the expected transaction cost of a lawsuit based on their giving evidence would rather discourage possible claimants from seeking liability of a CRC on the one hand, while the extension of the rule encourages them on the other hand. (2) Further complicating matters, the claimant has to prove misconduct of the CRC on the one hand, and his own good conduct on the other hand⁷⁰, what further reduces the moral hazard on his side. Altogether, it seems doubtful if protected issuers and investors are able

⁶⁷ S Choi, *Market Lessons for Gatekeepers*, 92 *Northwestern University Law Review* 916, 948 (1998). See also C M Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 *Boston College Law Review* 1275, 1297 (2009); C A Hill, *Regulating the Rating Agencies*, 82 *Washington University Law Quarterly* 43, 89-91 (2004). Recently, the significance of this consideration was downplayed by N S Ellis, L M Fairchild, F D'Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 *Stanford Journal of Law, Business & Finance* 175, 217 (2012).

⁶⁸ Moral hazard arises from situations in which an actor has the power as well as the incentive to alter a state of nature or her/his behaviour, as this action cannot be observed by others, see e.g. M V Pauly, *Overinsurance and Public Provision of Insurance: The Roles of Moral Hazard and Adverse Selection*, 88 *Quarterly Journal of Economics* 44, 45 (1974). As the cited example, the majority of contributions regarded as seminal for the economics of moral hazard deal with problems of insurance. This applies even to Knight's groundbreaking monograph: see F H Knight, *Risk, Uncertainty and Profit* 249-256 (Houghton Mifflin Boston 1921). Indeed, and unfortunately, 'Knight's reference to moral hazard appeared in conjunction with his discussion of insurance, where the term has a well-defined technical meaning. Its more general relevance to the study of economic organization went unnoticed.' – O E Williamson, *The Economic Institutions of Capitalism* 3 (The Free Press New York 1985). As seminal contributions that revived the discussion of moral hazard thereafter, see K J Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 *American Economic Review* 941 (1963); M V Pauly, *The Economics of Moral Hazard: Comment*, 58 *American Economic Review* 531 (1968).

⁶⁹ See Art. 1 Sec. (22) para. 2 of *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 *Official Journal of the European Union* L 141, 21 (31 May 2013).

⁷⁰ See *ibid.*, Art. 1 Sec. (22) para. 1 subpara. 2-3: Investors must have 'reasonably relied, ... with due care, on a credit rating'; issuers must not cause 'credit rating and the infringement ... by misleading and inaccurate information provided'.

to efficiently seek to establish CRCs' liability. Consequently, it should be more thoroughly evaluated to what extent fines, possibly combined with disincentives provided by criminal law, provide sufficient incentives for CRCs.⁷¹ Otherwise, the unclear responsibilities and obligations of claimants suggest thinking of respective catalogues, too: While the actions of CRCs could be benchmarked against further-developed rating principles, issuers and investors could be benchmarked against rating utilization principles.⁷² In particular, those should include a barrier to overreliance on CRC-ratings, as the importance of ratings is not driven by their producers, but their consumers, and in particular by regulators. For the time being, claimants' behaviour becomes increasingly uncertain for a CRC, consequently motivating adaptive (risk-oriented) behaviour of its decision makers.⁷³

5.3 Courts

Although no legislative bodies, courts take part in the processes that drive institutional change. While the set of rules they apply is meant to reduce uncertainty of actors, courts' understanding and handling of the same rules can be a source of uncertainty.⁷⁴ Here, the particular liability risk a CRC is facing is further aggravated when the influence of courts is considered: As discussed in the previous chapter, the measurement or quantification

⁷¹ See D A Maas, *Policing the Rating Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market*, 101 *Journal of Criminal Law & Criminology* 1005, 1021-1037, (2013) esp. 1034: 'Although the risk of civil liability can also generally deter misconduct, the possibility of losing one's liberty provides an incentive on an entirely different order of magnitude.' On the difficulties of plaintiffs (pleading fraud against CRCs), see also L Freeman, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 *Vermont Law Review* 585, 609-610 (2009).

⁷² So-called GARP – Generally Accepted Rating Principles – have originally been suggested to benchmark internal rating approaches of banks, but the authors already suggested to further discuss the extension of application to CRC ratings: 'Internal rating systems are therefore the primary fields of application for our principles; at this stage we leave open the question of their applicability to external ratings.' – J P Krahnert, M Weber, *Generally accepted rating principles: A primer*, 25 *Journal of Banking & Finance* 3, 4 (2001). Unfortunately, the discussion of their approach remained tentative: see e.g. E Lehmann, D Neuberger, S Rätke, *Lending to Small and Medium-Sized Firms: Is There an East-West Gap in Germany?*, 23 *Small Business Economics* 23, 25 (2004); H Benink, J Danielsson, Á Jónsson, *On the Role of Regulatory Banking Capital*, 17 *Financial Markets, Institutions & Instruments* 85, 88 (2008). For the suggestion of an extension of GARP not only to CRCs, but to rating users, see J Kleinow, *Civil Liability of Credit Rating Companies: Quantitative Aspects of Damage Assessment from an Economic Viewpoint*, in this compilation of papers.

⁷³ For general considerations on managerial perspectives on risk (taking), see J G March, Z Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 *Management Science* 1404 (1987), with extensive references.

⁷⁴ For a groundbreaking elaboration of 'the institutional framework ... being continuously but incrementally modified by the purposive activities of organizations bringing cases before the courts', see D C North, *Institutions, Institutional Change and Economic Performance* 96-98 (Cambridge University Press Cambridge et al. 1990).

of risk leads back to the fundamental problem of knowledge about the correct rating. However, even if this hypothetical benchmark could be known in general, and would be known by human actors in courts, it is a different matter in how far these actors would be able and willing to apply the liability rule.⁷⁵ These uncertainties regarding the interpretation and application of the rule by courts let the measurement of liability risk become even more difficult. This problem is multiplied when the rule's application is left to *national* institutions, making different interpretations by different courts of different jurisdictions at the same time for the same CRC possible.⁷⁶ While the duration of a rule being in force and being applied by courts will reduce the uncertainty of its legal handling, it could belatedly bring forward moral hazard of claimants: The more plaintiff-friendly the application of a rule turns out to be, the higher the probability of undesirable behaviour of those protected by the rule.

5.4 Injurers/CRCs

Liability rules expose CRCs to a specific kind of (legal) risk,⁷⁷ i.e., of being found accountable for an infringement of rules and, thus, being obliged to pay compensation. Consequently, such rules are likely to spur respective actions aimed at an improved measurement and management of this risk. The perils of claimants' moral hazard, further aggravated by the uncertain application of the liability rules by courts, amplify the loss expectations that CRCs will attach to the liability rule. Using the approach currently promoted by (banking) regulators to determine expected losses due to credit risk,⁷⁸ the expected loss induced by CRA III liability (ELL) could be written based on the probability of a successfully-claimed damage (PD), the CRCs exposure to damage claims as defined by the volume of issues it has rated (ED), and the loss given the success of the claim (LGC), i.e. the quota of compensation the CRC has to bear:

$$ELL = PD \times ED \times LGC$$

⁷⁵ See E Stringham, MD White, *Economic Analysis of Tort Law: Austrian and Kantian Perspectives*, in: M Oppenheimer, N Mercurio, *Law and Economics: Alternative Economic Approaches to Legal and Regulatory Issues* 374, 375-377 (M.E. Sharpe New York/London 2005).

⁷⁶ For general considerations on this problem, see U Blaurock, *Control and Responsibility of Credit Rating Agencies*, 11 (3) *Electronic Journal of Comparative Law* 1, 17-26 (2007).

⁷⁷ For a consideration of liability risk as a kind of firm-specific risk, see e.g. K D Miller, *A Framework for Integrated Risk Management in International Business*, 23 *Journal of International Business Studies*, 311, 318-319 (1992).

⁷⁸ Expected losses are an important part of the regulatory credit risk measurement suggested by Basel II, see Basel Committee on Banking Supervision, *An Explanatory Note on the Basel II IRB Risk Weight Functions* 3-4 (BIS Basel 2005). However, considerable criticism is directed at neglected dependencies of the allegedly independent variables, see e.g. E I Altman, B Brady, A Resti, A Sironi, *The Link between Default and Recovery Rates: Theory, Empirical Evidence, and Implications*, 78 *Journal of Business* 2203 (2005), with further references.

As seen above, the European liability rule aims to make liability claims easier for those protected, probably leading to an increased PD. Based on a wider understanding of damage cases, LGC is enhanced, too. Consequently, CRCs are facing a considerably higher expected loss due to legal / liability risk. While the basic formula used for illustration appears rather simple, the exact assessment of this risk is already of considerable complexity,⁷⁹ thus imposing extra transaction cost on CRCs.

Following results of their risk *assessment*, CRCs will turn to risk *management*. Risk management instruments used during the institutional response to risk or uncertainty are numerous and have been systemized in several ways.⁸⁰ One applicable risk-management strategy for CRCs would be *risk reduction* by spending additional time on a rating. While this might enhance the rating's accuracy in a desirable way, it definitely prolongs the time needed to deliver a rating, thus reducing the efficiency of capital markets.⁸¹ At the moment, it is assumed that CRCs would act in an overly-cautious manner. Insofar as overly-pessimistic ratings turn out to represent another basis for damage cases, this incentive would be mitigated by a distorting effect in the opposite direction.⁸² Alternatively, CRCs could feel incentivized to spend additional time on legal instead of economic analysis, i.e. the accuracy of the economic analysis would remain unaffected, while extra money would be invested in legal advice, leading to definitions and explanations of ratings that aim at an avoidance of liability.⁸³ Anyway, both approaches to risk reduction during the production of ratings would consume more time, making a rating costlier. Another risk management strategy could be *risk transfer*, in particular by insurance. Apart from the fact that respective insurance

⁷⁹ Although focused on auditors, see the considerations of E L Talley, *Cataclysmic Liability Risk among Big Four Auditors*, 106 Columbia Law Review 1641, 1673-1693 (2006), as they appear applicable to CRCs in principle, too.

⁸⁰ See e.g. D Vose, *Risk Management: A Quantitative Guide* 7-12 (3rd ed. Wiley Chichester 2008). See also – with extensive references – K D Miller, *A Framework for Integrated Risk Management in International Business*, 23 Journal of International Business Studies, 311, 320-325 (1992).

⁸¹ See B H Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 North Carolina Banking Institute Journal 111, 133 (2011).

⁸² For considerations on the complexity of antagonistic incentives and their manipulation, see Y Listokin, B Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 Yale Journal on Regulation 91, 108-111 (2010).

⁸³ See Y Listokin, B Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 Yale Journal on Regulation 91, 102 (2010). See also B H Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 North Carolina Banking Institute Journal 111, 133 (2011). The traditional First-Amendment-defence strategy is the basic example, as CRCs try to avoid liability by explicitly explaining their ratings to be opinions, not recommendations, see e.g. F Partnoy, *How and Why Credit Rating Agencies Are Not Like other Gatekeepers*, in: Y Fuchita, R E Litan, *Financial Gatekeepers: Can They Protect Investors?* 59, 95-96 (Brookings Institution Press Baltimore 2006).

solutions would have to be developed first, they would inevitably lead to insurance premiums paid by the CRCs, also raising their cost of providing ratings. Naturally, producers are incentivized to pass this additional cost on to others and, in particular, to customers. Although rule makers apparently have decided that the adverse effects of stricter liability are a *quantité négligeable* compared to its benefits, it remains to be seen if and to what extent it is going to drive rating fees upwards, thus endangering the affordability of credit ratings for issuers.⁸⁴

Insofar as attempts to shift additional cost to other parties fail, profit expectations of CRCs are reduced. Consequently, the attractiveness of founding and running a CRC institution recedes. It is even possible that the perceived risk of being held liable could discourage the market entry of newcomer CRCs. Consequently, a liability rule would further *enhance* the regulatory *barriers to entry to the ratings market* that already exist, so that this fundamental problem of current ratings-directed regulation, which is still waiting to be solved, would become even more serious.⁸⁵ Also, the increased risk could provoke active CRCs to give up business because they no longer see sufficiently-attractive risk-return-positions. However, hampered market entry and provoked market exit would negatively affect the number of competitors while favouring large CRCs (with ‘deep pockets’).⁸⁶ This would be quite the opposite of what regulators

⁸⁴ For an elaboration of the meaning of increased cost, see J C Coffee, *Gatekeepers: The Professions and Corporate Governance* 303 (Oxford University Press Oxford/New York 2006); C M Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 *Boston College Law Review* 1275, 1297 (2009); L J White, *Credit Rating Agencies & Regulation – Why Less Is More*, in: R Johnson, E Payne, *Make Markets Be Markets* 43, 46 (The Roosevelt Institute Washington, D.C./New York 2010). For a downplaying of the meaning of increased cost, see especially J P Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 (1) *Columbia Business Law Review* 109.

⁸⁵ For more information on liability rules enhancing (regulatory) barriers-to-entry, see B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 12, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013). For general introductions to regulatory barriers to entry to the ratings market, see e.g. E McClintock Ekins, M A Calabria, *Regulation, Market Structure, and Role of the Credit Rating Agencies*, Policy Analysis No. 704 19-23 (2012); R H Weber, A Darbellay, *The regulatory use of credit ratings in bank capital requirement regulations*, 10 *Journal of Banking Regulation* 1, 5-6 (2008); A Darbellay, *Regulating Credit Rating Agencies* 51-54 (Edward Elgar Cheltenham/Northampton 2013).

⁸⁶ See S Choi, *Market Lessons for Gatekeepers*, 92 *Northwestern University Law Review* 916, 948, 954 (1998). While providing a risk buffer on the one hand, ‘deep pockets’ might also attract risk-enhancing actions of others and encourage frivolous suits among them, because certain actors take it as an opportunity: see e.g. J Bohn, S Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Action*, 144 *University of Pennsylvania Law Review* 903, 918-923 (1996). Addressing the same effect on ratings markets, see also B H Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 *North Carolina Banking Institute Journal* 111, 134-135 (2011); J S Sack, S M Juris, *Rating Agencies: Civil Liability Past and Future*, 238 (88) *New York Law Journal* 3 (5 Nov. 2007).

announced as desirable when promoting previous regulations of CRCs: Here, the alleged rating oligopoly is among the most popular grounds for attempts to justify ratings-directed regulation, while EU-institutions have identified ‘a need for a sufficiently high number of credit rating agencies’.⁸⁷ Here, the insufficient compatibility of the liability rule becomes visible once more.

Altogether, the liability rule is necessarily based on mere assumptions of induced behaviour. Especially regarding recent experience, the possibilities of behaviour other than the one intended by rule makers seem insufficiently addressed: Even prior to the passing of the European rule, CRCs refused to rate structured finance instruments any longer, thus reacting to the reinforced liability rules of the Dodd-Frank Act.⁸⁸ As early as mid-2011, the US House of Representatives approved the ‘Asset-Backed Market Stabilization Act of 2011’, repealing the liability regime for CRCs that had been introduced by Dodd-Frank, thus responding to the threat of capital markets drying up.⁸⁹ These re-regulatory processes should have led towards a more tentative attitude towards liability rules than has been shown by European rule makers thereafter.

6 CONCLUSION

Altogether, the European liability rule seems prematurely and poorly designed from an economic viewpoint. To begin with, the economic questions of market failure, effectiveness, and efficiency have been insufficiently addressed. Even when the existence of proper market failure is assumed, effectiveness and efficiency of the new rule seem questionable. Regarding effectiveness, the danger of ineffectiveness (a ‘paper tiger’⁹⁰) prevails - along with the danger of over-deterrence (‘over-effectiveness’

⁸⁷ See recital (21) of *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union L 151, 5 (31 May 2013). For a critical review of this market structure-based rationale of ratings-directed regulation, see A Horsch, *Regulation of Credit Rating Companies: An Economic Point of View*, 25 *European Business Law Journal* 227 (2014).

⁸⁸ See *Raters go on strike*, *Financial Times* July 23, 2010.

⁸⁹ See B Haar, *Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 8-9, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (University of Oslo 2013).

⁹⁰ While the first use of this expression is being attributed to Chinese politicians, in particular Mao Zedong, a more general use is common today in international politics, characterizing persons or institutions that appear outwardly powerful or important, but are actually weak or ineffective; see e.g. G Corsetti, P Pesenti, N Roubini, *Paper tigers? A model of the Asian crisis*, 43 *European Economic Review* 1211, 1212 (1999). In a liability context, see also R H Rowe, *A SEC Staff ‘No-Action’ Position: An Impervious Shield Against Liability or a Paper Tiger?*, 6 (7) *Insights: The Corporate & Securities Law Advisor* 21 (1992).

harming the CRCs' business model)⁹¹. Regarding efficiency, numerous unintended side effects and their consequences have been insufficiently considered to date. Furthermore, the application of the rule requires a feasible and precise assessment of damage in qualitative as well as in quantitative respects. However, claiming this feasibility pretends knowledge of the unknown and, probably, 'unknowable' correct rating at the moment of creation of the erroneous rating. Combined with the problems of misallocated risk and the disregard of the complementarity of a regulatory system, the benefits of the liability rule remain more questionable than its drawbacks. From an economic viewpoint, the European rule should be revoked or, at least, thoroughly redesigned.

⁹¹ See e.g. Y Listokin, B Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 *Yale Journal on Regulation* 91, 101 (2010); L J White, *Credit Rating Agencies & Regulation – Why Less Is More*, in: R Johnson, E Payne, *Make Markets Be Markets* 43, 46-48 (The Roosevelt Institute Washington, D.C./New York 2010).

CIVIL LIABILITY OF CREDIT RATING COMPANIES: QUANTITATIVE ASPECTS OF DAMAGE ASSESSMENT FROM AN ECONOMIC VIEWPOINT*

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1 INTRODUCTION: CRISES AND SCAPEGOATS

Crises bring opportunities for regulatory reforms, and for building consensus among the different parties affected¹. However, it cannot be ruled out that imprudent regulations are also capable of causing a crisis². Among the scapegoats for the most recent financial crisis and the ensuing sovereign debt crisis are *Credit Rating Agencies* (CRAs), which are profit-oriented firms that should, rather, be called Credit Rating Companies (CRCs)³. At the beginning of the crisis in 2007, they were accused of having mis-rated mortgage-backed securities, thereby triggering the subprime crisis⁴. Although it was not the first time that ratings had been obviously – albeit

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¹ See M Andenæs, *Harmonising and Regulating Financial Markets* 3, in: M Andenæs, C B Andersen, *Theory and Practice of Harmonisation* (Cheltenham 2012), A Horsch, *Regulation of Rating Companies: An Economic Point of View*, 25 *European Business Law Review* 227 (2014).

² For an instructive comment on crises and regulation, see M Andenæs, *Crisis and regulation*, 30 *The Company Lawyer* 65 (2009).

³ The misleading name ‘agency’ is derived from their function, namely ‘to provide a particular service, typically one that involves organizing transactions between two other parties’, Oxford US English dictionary, *Agency*, www.oxforddictionaries.com/definition/american_english/agency (accessed 21 Aug. 2013). Another connection can probably be drawn to their predecessors in the US that emerged in the middle of the nineteenth century: ‘Mercantile or commercial agencies are establishments which make a business of collecting information relative to the credit, character, responsibility and reputation of merchants for the purpose of furnishing the information to subscribers. These agencies have become recognized and permanent adjuncts to the world of trade and commerce. The community cannot do without them.’, J W Errant, *The Law Relating to Mercantile Agencies* 3, Johnson Prize Essay of the Union College of Law (University of California, Los Angeles: 1886). For more information on their evolution in the nineteenth century, see J H Madison, *The Evolution of Commercial Credit Reporting Agencies in Nineteenth-Century America*, 48 (2) *The Business History Review* 164 (1974). To distinguish rating companies from rating rules, we will use the abbreviation CRC for the former and CRA for the latter.

⁴ Cf. R Garcia and J Ruiz, *Credit Rating Agencies on the Watch List – Analysis of European Regulation* 27 (Oxford University Press, Oxford 2012).

based on hindsight – wrong⁵, such events had never led European regulators to call for a liability regime⁶. CRCs have historically been exempted from statutory liability, except for fraud⁷. ‘The dominant view concerning [CRC] regulation [was] based upon the “reputational capital” theory which holds that a ... [CRC’s] success is primarily a result of the ... track record in issuing accurate ratings’⁸. However the first explicitly ratings-directed regulation of European origin (CRA I of November 2009) started to tighten the regulatory noose around the CRCs⁹.

Shortly after being blamed for under-cautiously *overrating* structured financial instruments, CRCs were accused of over-cautiously *underrating* sovereign bonds, thus triggering the sovereign debt crisis. Especially in the last case, politicians from (traditionally highly-rated) Member States of the Eurozone became increasingly annoyed, since they had to vindicate themselves following downgrades of their countries. The regular response after a sovereign downgrade exhibits a characteristic pattern: (1) First, local authorities are surprised¹⁰ about the downgrade, then they (2) assert

⁵ Comparable allegations against CRCs were made following the 1997 Asian financial crisis, see e.g. G Ferri, L G Liu and J E Stiglitz, *The Procyclical Role of Rating Agencies – Evidence from the East Asian Crisis*, 28 Economic Notes by Banca Monte dei Paschi di Siena SpA 335 (1999); for the 2001 Enron Scandal, see e.g. Committee on Governmental Affairs US Senate, *Rating the Raters – Enron and the Credit Rating Agencies* (US Government Printing Office, Washington, DC 2002); and for the 2002 WorldCom Scandal, see e.g. L J White, *Markets - The Credit Rating Agencies*, 24 Journal of Economic Perspectives 211, 218 (2010).

⁶ There is no reference to liability in the proposal for the first amendment of the Regulation (EC) No 1060/2009 (CRA I), which was published on 2 June 2010.

⁷ Against the backdrop of US-American Law N S Ellis, L M Fairchild, F D Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 (2) Stanford Journal of Law, Business & Finance 175, 177 (2012).

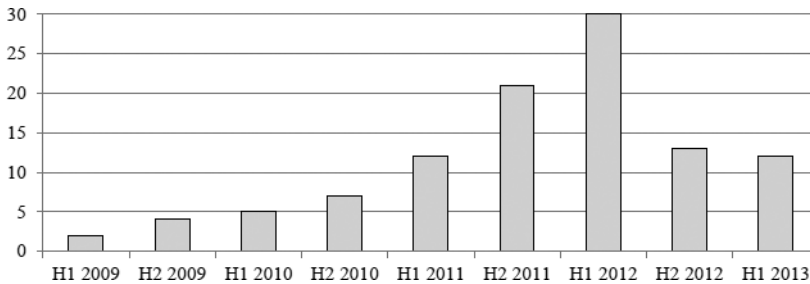
⁸ K Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 University of Miami Law Review 1111, 1114 (2009).

⁹ ‘To some extent, any discussion of imposition of civil liability on CR[C]s is a part of a larger discussion of whether regulation is needed or whether CR[C]s are sufficiently incentivized by their desire to protect their reputational capital’, N S Ellis, L M Fairchild, F D Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 (2) Stanford Journal of Law, Business & Finance 175, 211 (2012).

¹⁰ S Nisbet, H Papachristou, *Greece says surprised by S&P downgrade warning*, Reuters 3 Dec. 2010, in.reuters.com/article/2010/12/03/idINIndia-53336620101203 (accessed 21 Aug. 2013); S Castle, *European Leaders Question Timing of Credit Downgrade Warning*, The New York Times 6 Dec. 2011, www.nytimes.com/2011/12/07/business/global/germany-calls-sp-threat-a-spur-to-action.html (accessed 21 Aug. 2013); H Carnegie, *Paris hits back at Moody’s downgrade*, Financial Times 20 Nov. 2012, www.ft.com/intl/cms/s/0/035edeb8-3309-11e2-aabc-00144feabdc0.html#axzz2cczW1N19 (accessed 21 Aug. 2013).

that the CRC did not consider all the relevant information¹¹ (especially regarding the recent reforms¹²), and lastly they (3) downplay the impact¹³ of ratings (sometimes combined with a threat of legal action¹⁴). As shown in Figure 1 below, the number of sovereign downgrades in the Eurozone rose from 2009 and peaked in the first half of 2012, when S&P's and Moody's initiated downgrades of several countries¹⁵.

Figure 1: Number of sovereign downgrades by S&P's, Fitch, and Moody's per half year in the Eurozone¹⁶



¹¹ G Somerville, R Younglai, *Obama officials attack S&P's credibility after downgrade*, Reuters 6 Aug. 2011, www.reuters.com/article/2011/08/06/usa-rating-sp-error-idUSN1E77500420110806 (accessed 21 Aug. 2013); G Wiesmann, P Spiegel, R Wigglesworth, *S&P downgrades France and Austria*, Financial Times 14 Jan. 2012, www.ft.com/intl/cms/s/0/78bf6fb4-3df6-11e1-91f3-00144feabdc0.html#axzz2cczW1N19 (accessed 21 Aug. 2013).

¹² J Toyer, D Bases, *S&P downgrades Spain, calls for EU action*, Reuters 26 Apr. 2012, www.reuters.com/article/2012/04/27/us-spain-standardandpoors-downgrade-idUSBRE83P1LE20120427 (accessed 21 Aug. 2013); H Carnegie, *Moody's downgrades France from triple A*, Financial Times 19 Nov. 2012, www.ft.com/intl/cms/s/0/cb1b35f4-3297-11e2-ae2f-00144feabdc0.html#axzz2cczW1N19 (accessed 21 Aug. 2013); unknown author, *Moody's downgrades France despite reform plans*, France 24 20 Nov. 2012, www.france24.com/en/20121120-moodys-downgrade-france-aaa-aa1-hollande-recession-deficit-unemployment-eurozone (accessed 21 Aug. 2013).

¹³ J Ewing, *European Leaders Use Debt Downgrades to Argue for Austerity, and for Stimulus*, The New York Times 14 Jan. 2012, www.nytimes.com/2012/01/15/business/global/after-downgrades-european-leaders-argue-for-both-austerity-and-stimulus.html?_r=0 (accessed 21 Aug. 2013); unknown author, *France shrugs off Moody's downgrade*, The Daily Telegraph 20 Nov. 2012, www.telegraph.co.uk/finance/9689811/France-shrugs-off-Moodys-downgrade.html (accessed 21 Aug. 2013).

¹⁴ E Moya, *EU plans to create watchdog to curb credit rating agencies*, The Guardian 2 June 2010, www.theguardian.com/business/2010/jun/02/european-union-credit-agency-watchdog (accessed 21 Aug. 2013); unknown author, *Temporary Prohibition: EU Considers Ban on Country Ratings*, Der Spiegel 20 Oct. 2011, www.spiegel.de/international/europe/temporary-prohibition-eu-considers-ban-on-country-ratings-a-792970.html (accessed 21 Aug. 2013).

¹⁵ Cf. J Kleinow, L Heinrich, A Horsch, *Die neue Europäische Ratingverordnung CRA III – eine kritische Bestandsaufnahme*, 66 Zeitschrift für das gesamte Kreditwesen 297, 299 (2013) with further references.

¹⁶ Source: the present author with data from online rating data bases of S&P's, Moody's, and Fitch.

It therefore did not take long for politicians to start thinking of a liability regime for erroneous ratings at the European level¹⁷. The first legislative proposal for a liability regime surfaced together with the first proposal for the CRA III¹⁸ in Nov. 2011 – shortly after the first downgrades of some EU Member States – and came into force on 20 June 2013¹⁹. Furthermore, CRCs are comparably vulnerable to regulation since the industry is relatively small (with only 21 registered firms in the EU²⁰ besides S&P's, Moody's and Fitch), has no organized lobby, a low level of cooperation, and no support from other financial intermediaries such as banks and insurance companies.

The remainder of this article is organized as follows: In Section 2, a theoretical model for the design of an optimal liability regime for CRCs is introduced. Section 3 explains the impact of ratings on the valuation of securities in practice, because that determines the impact of erroneous ratings. Section 4 discusses two cases of quantifiable damage caused by an inappropriate rating. The shortcomings of the current liability regime will be analysed in Section 5, while Section 6 concludes with proposals for improvements towards an effective liability regime in the European Union.

2 STRICTNESS OF LIABILITY AND OPTIMAL LEVEL OF CARE

The liability rule of European ratings-directed legislation is as follows: 'Where a credit rating agency has committed, *intentionally* or with *gross negligence*, any of the *infringements* listed in Annex III having an *impact on a credit rating*, an *investor* or *issuer* may claim damages from that credit

¹⁷ The first serious discussions at the European level started with another consultation on CRC regulation in Nov. 2010 (European Commission, *Public Consultation on Credit Rating Agencies* [Brussels: 5 Nov. 2010]) – chronologically quite close to the first wave of downgrades in 2010. Although the European reactions may seem quite timely, civil liability of CRCs had been introduced in the US legal system by the Dodd-Frank Act just three months previously, in Aug. 2011: 'Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial "gatekeepers" do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers' (Dodd-Frank Act §931 Art. 3).

¹⁸ See European Commission, *Proposal for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies* Art. 35a (Brussels: European Commission 2013).

¹⁹ CRA III: see *Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) 1060/2009 on credit rating agencies*, 56 Official Journal of the European Union 1 (31 May 2013).

²⁰ ESMA, *List of registered and certified CRA's* [sic], www.esma.europa.eu/page/List-registered-and-certified-CRAs (accessed 22 Aug. 2013).

rating agency'²¹. The infringements from Annex III that function as a *condicio sine qua non* for a liability claim can be divided into:

- (1) infringements related to conflicts of interest, organisational or operational requirements;
- (2) infringements related to obstacles to the supervisory activities; or
- (3) infringements related to disclosure provisions.

Besides compensation for the damage, CRCs also have to pay a surcharge to the European Securities and Markets Authority (ESMA) when found to have committed one of those infringements. A selection of possible infringements and the corresponding fine scheme is presented and discussed in Section 5.

However, the European regulator/legislator seeks to achieve a higher quality of ratings with the liability regime²². Essentially, the legislative goal of liability is to ensure the high quality of ratings²³, but from an economic viewpoint, a liability regime can primarily be understood as an instrument for the *(re-)establishment of a non-existent market on damages*. Liability internalizes externalities²⁴, i.e. makes negative externalities costly for the causer. Since an aggrieved party normally does not agree *ex ante* to be injured (just as no-one voluntarily and deliberately permits others to damage his/her private car), a 'fair price' for, or an 'acceptable level' of damage has to be determined *ex post*. The valuation of a fair price for the damage (to a rating user) is essentially a question of the optimal level of care applied by the causer (the rating producer, i.e. the CRC): Which level of care is economically preferable, and what are its costs? The following diagrams illustrate the relationship between the (costs of) marginal damage (*MD*) to a rating user (on the y-axis) relative to a certain level of (marginal costs of) care (*MCoC*) for a rating producer²⁵

²¹ Art 35a CRA III, the present author's emphasis.

²² Recital 32, CRA III, p. 7.

²³ See (with further references) T Theurl, D Schätzle, *Reformvorschläge für Ratingagenturen: Eine Analyse von Anreizen, Interessen und Restriktionen* 118, in: C Müller, F Trosky, M Weber, *Ökonomik als allgemeine Theorie menschlichen Verhaltens* (Lucius & Lucius Stuttgart: 2012).

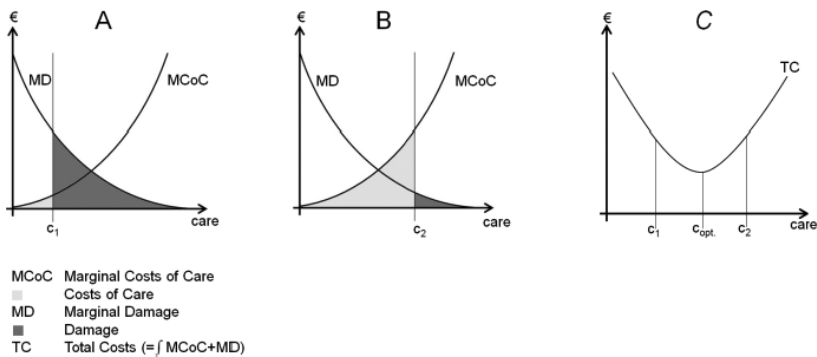
²⁴ For more information on the idea of internalization, see A C Pigou, *The Economics of Welfare* Chapter IX (Macmillan and Co. Ltd. London: 1932). For a detailed overview on the (various) definitions of externalities, see J M Buchanan, W C Stubblebine, *Externalities*, 29 *Economia* 371 (1962).

²⁵ Against the backdrop of US-American law see K Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 *University of Miami Law Review* 1111, 1147 (2009) states that negligence schemes 'lead to deadweight losses due to unbeneficial documentation' that CRCs are obliged to.

(x-axis). The costs for suppliers of ratings are determined by the level of their precautions (e.g. for an internal risk management system). As the marginal costs of the care curve shows, it is comparably cheap for a CRC to assure at least a low level of care. However, improved rating processes (e.g. including more sophisticated analytical tools, or Chinese Walls to reduce conflicts of interest) are more expensive, with marginal costs of care increasing exponentially. The total costs of care for the CRC are expressed by the light grey area below the MCoC curve (Diagram A and B). An inverted relation applies to the costs of damages that users of ratings (investors/issuers) have to bear: Low levels of CRC care (which result in low-quality ratings) are excessively costly for their users. The total costs of damage that users of ratings have to bear are expressed by the dark grey area below the MD curve.

If the liability regime is rather lax and, therefore, the level of care is rather low (c_1), the users of ratings would have to bear high costs (Diagram A). In Diagram B, another disproportionate level of avoidance is illustrated: If a liability rule would be very strict (c_2), the CRC itself would have to bear correspondingly high costs (Diagram B).

Figure 2: Costs of Care and Marginal Damages²⁶



The total costs of damages and applied care (TC) shown in the Diagram C (not to scale) are the sum of the light grey and dark grey areas. From a theoretical point of view, there is an economically optimal level of care where the total costs are minimized: At the intersection of both marginal cost curves MD and MCoC (Diagram A and B) lies the optimum of minimum total cost (right diagram: c_{opt})²⁷. Although a liability scheme

²⁶ Source: The present author's illustration in the style of M Fritsch, *Marktversagen und Wirtschaftspolitik* 87 (8th ed. Vahlen München: 2011)

²⁷ The described model is an application of the *Coase Theorem*, which goes back to R H Coase, *The Problem of Social Cost*, 3 (Oct.) *Journal of Law and Economics* 1 (1960).

ensuring this level of care can itself be justified in this way, the shortfall of this theoretical model is the identification of the curves, and thus of the optimal level of care (because they are not static, but changing continuously). Furthermore, the costs of care for CRCs may be identified quite exactly. However, the value of the damage from one erroneous rating for its broad group of users is less easily identifiable, since it depends strongly on the value/informational content users ascribe to ratings.

3 SECURITY VALUATION BY RATINGS

CRCs unequivocally influence investment decisions²⁸. But a rating is one of many criteria that determine the price of a security, which in the end is the result of the actions of all buyers and sellers of such securities. As those actions are driven by the knowledge of the actors, the question is how much users of ratings could be misled in their (dis-)investment decisions by an erroneous rating. Important drivers of the price of a security besides ratings are e.g. the industry and the overall economic situation of a firm. Besides the rating, investors also take qualitative information about the management, data from annual reports, and collaterals, etc. into consideration for the valuation of a bond. Some scholars even argue that (in particular, unsolicited) ratings have no informational content, since they only incorporate publicly available information that is already priced into securities²⁹. There are a numerous studies that try to assess the impact which informational content has on bond prices and effective yields. This can be done by an event study that measures the impact of a rating (change) on the development of the prices of the security³⁰, or by a regression analysis (usually multivariate) that

²⁸ Already CRCs' predecessors had a significant impact on investment decisions: 'The responsibilities of these agencies are very great. Upon them the merchant relies for information. Character and credit depend upon the care with which they perform their duties. In many ways they are influences for weal or woe.', J Y Errant, *The Law Relating to Mercantile Agencies* 3, Johnson Prize Essay of the Union College of Law (University of California, Los Angeles: 1886).

²⁹ For more information on the informational value of bond rating changes, see G Hettenhouse and W Sartoris, *An analysis of the informational value of bond rating changes*, 16 *Quarterly Review of Economics and Business* 65 (1976), and M Weinstein, *The effect of a rating change announcement on bond price*, 5 *Journal of Financial Economics* 329 (1977).

³⁰ As one of the earliest papers, see G E Pinches and J G Singleton, *The Adjustment of Stock Prices to Bond Rating Changes*, 33 *Journal of Finance* 29 (1978); more recently e.g. J Kiff, S Nowak and L Schumacher, *Are Rating Agencies Powerful? An Investigation into the Impact and Accuracy of Sovereign Ratings*, 12/23 IMF Working Paper (2012); or P Behr and A Güttler, *The Informational Content of Unsolicited Ratings*, 32 *Journal of Banking and Finance*, 587 (2008).

measures the impact of ratings and other (potentially) influencing variables on financing costs³¹.

Hereafter, it is proposed to determine the damage an erroneous rating can cause by *analysing the change of market prices* of a security around the date of a rating change publication. The theoretical background says that market prices are 'ideal indicators' for the informational content of an event, since they are the result of human expectations, knowledge and actions – concentrated in one measure – as, in particular, *von Hayek* and *von Mises* established³²:

*The sum of information reflected or precipitated in the prices is wholly the product of competition, or at least of the openness of the market [...] Competition operates as a discovery procedure not only by giving anyone who has the opportunity to exploit special circumstances the possibility to do so profitably, but also by conveying to the other parties the information that there is some such opportunity. It is by this conveying of information in coded form that the competitive efforts of the market game secure the utilization of widely dispersed knowledge*³³.

New rating information can change the perception of the market participants (e.g. of the investors) about the value of a good (e.g. a security). Changing ratings can trigger human action and market processes that then change market prices. An erroneous rating can cause damage, since market participants use the information involved regarding the likelihood of proper debt service. The more market participants receive the information and the more importance they attach to it, the higher

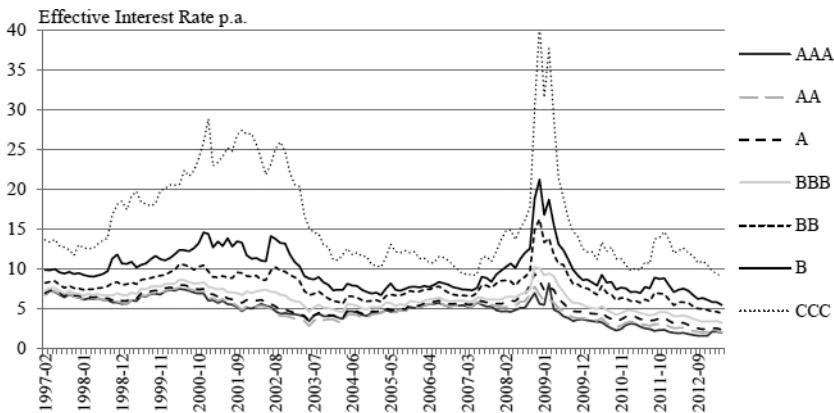
³¹ For a seminal paper on this topic see S Katz, *The Price and Adjustment Process of Bonds to Rating Reclassifications - A Test of Bond Market Efficiency*, 29 *Journal of Finance* 551 (1974); more recently, see e.g. D Kliger and O Sarig, *The Information Value of Bond Ratings*, 55 *Journal of Finance* 2879 (2000).

³² Cf. the influential F A von Hayek, *Economics and Knowledge* 48, 4 *Economia* 33 (1937): 'As all ... People will change their decisions as they gain experience about the external facts and other people's action, there is no reason why these processes of successive [price] changes should ever come to an end', and L von Mises, *Human Action* 252 (4th ed., Fox & Wilkes, San Francisco: 1996): 'In the imaginary construction of the evenly rotating economy there is no room left for entrepreneurial activity, because this construction eliminates any change of data that could affect prices. As soon as one abandons this assumption of rigidity of data, one finds that action must needs be affected by every change in the data.'

³³ F A von Hayek, *Law, Legislation and Liberty – A new statement of the liberal principles of justice and political economy - Vol. 2 The Mirage of Social Justice* 117 (Routledge & Kegan Paul, London: 1976).

their effect on prices should be³⁴. The correlation of credit ratings and bond prices/effective yields can be observed empirically, as the following figure 3 shows:

Figure 3: Ratings and corresponding effective interest rates in % over time (US Corporate Ratings Effective Yield)³⁵



The lower the rating of a security turns out to be, the higher its risk premium, and the higher its effective interest rate usually is. However, a new rating will not trigger the same action by all market participants:

The ultimate source of the determination of prices is the value judgments of the consumers. Prices are the outcome of the valuation [...] They are social phenomena as they are brought about by the interplay of the valuations of all individuals participating in the operation of the market³⁶.

The impact of a new item of information also depends on the efficiency of the respective capital market, i.e. if ‘security prices at any time “fully reflect” all available information³⁷. Empirical research has proven the existence of semi-strong efficiency of capital markets, e.g. that ‘prices seem to efficiently adjust to obviously publicly available information³⁸. Besides other market information, the vast majority of investors, if not all, have ready access to ratings. However, it is impossible to predict

³⁴ See S Hundt, A Horsch, *Kapitalmarktreaktionen auf Ankündigungen von M&A-Transaktionen – Eine Ereignisstudie am Beispiel der Unicredit*, 3 Corporate Finance biz 141, 142 (2012).

³⁵ Source: The present author’s figure with data from Bank of America, *Merrill Lynch US Corporate Ratings Effective Yield*, m.research.stlouisfed.org (accessed 1 May 2013).

³⁶ L von Mises, *Human Action* 330 (4th ed., Fox & Wilkes San Francisco 1996).

³⁷ E F Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 Journal of Finance 383, 383 (1970).

³⁸ *Ibid.*, 388.

how much confidence one single investor has and can have on a rating. It is certain that a rating can only be one piece of the puzzle that is the valuation of a security.

Therefore, the vital question with respect to any joint responsibility of the plaintiff is whether they 'reasonably relied ... with due care on the rating'³⁹. The definition of this proper level of care should not depend on the EU member jurisdiction, as it does now⁴⁰, but on the user and the type of the rating. For example, institutional investors like a bank or insurance company should e.g. have their own, specialized, and professional credit risk assessment departments, so that ratings *ought to* play a minor role. Analogously, a distinction should be made between different types of ratings: There is a lot of information available for publicly listed companies, such that their rating should also play only a minor role, since CRCs have less information advantage from undisclosed company data. However, the creditworthiness of a single purpose vehicle (SPV) that has been designed for just one single transaction is less clear for investors, and therefore its ratings or rating changes could play a greater role. It is obviously not only necessary to have a comprehensive framework for evaluating the quality of rating systems (such as the 'generally accepted rating principles' (GARP) proposed by *J P Krahen/M Weber (2001)*⁴¹, which are comparable to the US-GAAP generally accepted accounting principles), but to additionally formulate standards for the use of ratings. For that reason, a formulation of *generally accepted rating usage principles* (GARUP) could give rating users a clear guideline. A certain degree of complicity may also lie with the issuers if they intentionally approve an erroneous rating (or, rather, one that is excessively positive) before publication to lower their financing costs.

4 APPROACHES TO QUANTIFY DAMAGE BY ERRONEOUS RATINGS

While the damage caused by an erroneous rating that leads to a loss of reputation or opportunities is difficult to measure (or even to recover), there are selected cases where a quantification of damage seems possible⁴². Pecuniary losses for (the entities of) investors

³⁹ CRA III Art. 35a I.

⁴⁰ Ibid.

⁴¹ See J P Krahen, M Weber, *Generally accepted rating principles: A primer*, 25 (1) *Journal of Banking & Finance* 3 (2001). In their paper, Krahen and Weber suggest fourteen 'principles that ought to be met by "good rating practice"', *ibid.* 3.

⁴² For an elaboration of the possible categories of damages, see HORSCH in this compilation of papers. Note that the cases of damage shown are only related to ratings of simple, straight corporate senior bonds. The damage from other types of financial instruments being mis-rated may not be comparable, and goes beyond the scope of this paper.

and issuers must be measurable and realized (in other words, no accounting loss), i.e. after the publication of the erroneous rating, either a security purchase/sale must have taken place, or the security must have defaulted. If, for instance, the rating of a corporate entity was excessively positive at the moment of the bond issue, the investor would receive an effective yield that is too low in relation to the corresponding risk, causing damage on his side. If this overrated bond defaults, the investor would have to bear the maximum loss. In this article, these two (particularly illustrative) cases of damage caused by erroneous ratings will be discussed in detail in an attempt to quantify the damages:

- (1) the investors' loss following the purchase of an overrated security;
- (2) the investors' loss in the wake of the default of an overrated bond.

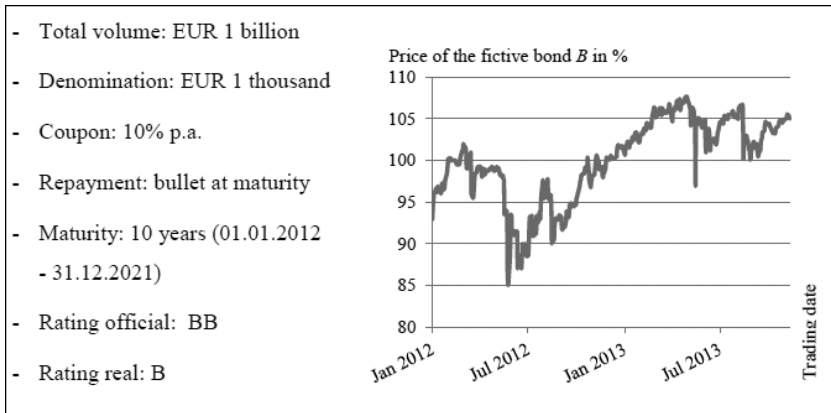
The damage caused by an erroneous rating can be evaluated by using the differences of average yield spreads for bonds of different rating categories (cf. Figure 3). In both cases, we assume that the prices of the bond change immediately after the new rating changes⁴³.

Case 1: Investor's damage through an overrated bond

In the first case, it is assumed that an A-rating for a fictive senior unsecured bond B was excessively positive at the moment of the bond issue. The following data are given:

⁴³ Although this assumption is quite normal for economic models that study the short term impact of rating changes (see e.g. J R Hand, R W Holthausen, R W Leftwich, *The Effect of Bond Rating Agency Announcements on Bond and Stock Prices*, 47 (2) *The Journal of Finance* 733 (1992) or M Micu, E Remolona, P Wooldridge, *The price impact of rating announcements: which announcements matter: Working Papers No 207 2* (BIS Basel: 2006) or J Hull, M Predescu, A White, *The relationship between credit default swap spreads, bond yields, and credit rating announcements*, 28 (11) *Journal of Banking & Finance* 2789 (2004)) strong doubts about the realism of this assumption prevail – cf. L von Mises, *Human Action* 328 (4th ed., Fox & Wilkes San Francisco 1996): 'In an economic system in which every actor is in a position to recognize correctly the market situation with the same degree of insight, the adjustment of prices to every change in the data would be achieved at one stroke. It is impossible to imagine such uniformity in the correct cognition and appraisal of changes in data except by the intercession of superhuman agencies'.

Figure 4: Bond characteristics and price chart⁴⁴



We can value the bond and its effective yield (yield to maturity) by using the present value formula: *present value (bond) = present value (coupon payments) + present value (final repayment)*⁴⁵. In our case, the present value of the bond equals its market value (i.e. the opening price of EUR 929.00, or 92.90% of the nominal value). The coupon payment is 10% p.a. of the nominal bond value, i.e. EUR 100 p.a., and the final repayment after the bonds 10 year maturity is 100% of the nominal value, or EUR 1,000. Therefore, to value the effective yield (*y*), we need to resolve the following formula into *y*: *present value (bond) = (coupon x 10-year-annuity-factor) + (final repayment ÷ discount factor)* or

$$p = coupon \cdot \frac{(1+y)^n - 1}{(1+y)^n \cdot y} + \frac{repayment}{(1+y)^n}$$

$$92.90 = 10 \cdot \frac{(1+y)^{10} - 1}{(1+y)^{10} \cdot y} + \frac{100}{(1+y)^{10}}$$

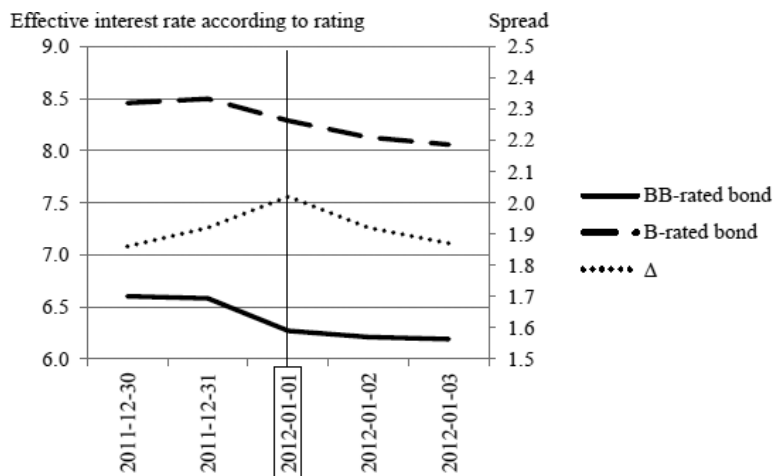
where *p* is the price, *n* is the maturity of the bond, and *y* is its effective yield. The effective yield of the bond is *y* = 11.22%.

⁴⁴ This example is chosen for illustrative purposes and for comprehension. It does not reflect real market conditions.

⁴⁵ See any basic finance text book, e.g. R A Brealey, S C Myers, F Allen, *Principles of Corporate Finance* 73–78 (10th global ed., McGraw-Hill Irwin: 2011), or B Casu, C Giardone, P Molyneux, *Introduction to Banking* 453–456 (Pearson Education Harlow: 2006).

In our case (1), it is now assumed that the official BB-rating was excessively positive, and the appropriate rating at issue would have been B. Therefore, the risk premium paid by the issuer (and thus incurred by the investors) was too low. The result is a violation of the investors' property rights. Given that investors discover Art.-35a-infringements of the responsible credit rating company that produced the erroneous rating⁴⁶, the assessment of the damage and its compensation would be possible under the European CRC liability regime. The average yield spread between BB-rated and B-rated bonds at the issue date (01 Jan 2012) could be quantified as 2.02% (= 8.29% - 6.27%), as the following Figure 5 illustrates⁴⁷:

Figure 5: Average effective interest rates and spread for BB-rated and B-rated bonds⁴⁸



That means the expected yield had to be $y_e = y + 2.02\%$. Then the correct/expected price p_e would have been 82.60% of the denomination value:

$$p_e = 82.60 = 10 \cdot \frac{(1 + y_e)^{10} - 1}{(1 + y_e)^{10} \cdot y_e} + \frac{100}{(1 + y_e)^{10}} \text{ with } y_e = 13.24\% (= 11.22\% + 2.02\%).$$

⁴⁶ For a list of possible infringements, see Annex III CRA III.

⁴⁷ Instead of the yield spread on the (single) issue day, which may be quite volatile, we could also use an average spread (e.g. from the interval of -2/+2 days around the issuance).

⁴⁸ Source: The present author's figure with data from Bank of America, Merrill Lynch US Corporate Ratings *Effective Yield*, m.research.stlouisfed.org (accessed 1 May 2013).

The difference between the actual and the expected price is $p - p_e = 10.30\%$ ($=92.90\% - 82.60\%$). Therefore the initial investors' loss would be EUR 103 per bond. That means that the total loss or maximum compensation a credit rating company would have to pay for the damage would be 10.30% of EUR 1 billion (total bond volume), i.e. EUR 103 million, while capitalized interest is neglected. Still, that amount could be only applicable if the investor relied solely on the rating. As shown above, such *overreliance* on a rating is not admissible. The investor should in this case share the responsibility for the incurred losses. In any case, the likelihood of a producer of a (temporarily) erroneous rating being brought to justice and being obliged to compensate the claimant is limited, since individual injured investors would be discouraged from suing the CRC – facing, as they would, the high hurdles of the burden of proof and limited chances for loss compensation. However, as first cases that have been brought to justice⁴⁹ show, overrated bonds that default bring sufficient incentives for aggrieved parties to claim compensation.

Case 2: Investor's damage through an overrated bond defaulting

In the second case, we assume that the same overrated bond *B* (cf. *Figure 4: Bond characteristics and price chart*) defaults. Such a case is more likely to be brought to court, since a default is inevitably connected with severe losses for every current investor. Dead losses involve strong incentives for the injured parties to obtain a repayment. If we again assume underlying Art-35a-infringements of the responsible credit rating company that issued the erroneous rating, what amount of damage is the CRC responsible for in the case of a default? It cannot be the total loss through default, since even the best rating for a bond does not imply that a default is absolutely impossible⁵⁰. In the second (virtual) bond *B* case, it is assumed that the overrated bond defaults after 5 years. S&P's states that the probability of default (PD) of a BB-rated bond within the next five years is 12.6% (or 41.2% for a B-rated bond)⁵¹.

⁴⁹ Cf. an Australian case: L McKenna, *An Uncertain Forecast for Rating Agencies: Liability For Negligent Misrepresentation After Barthurst*, Columbia Business Law Review Online 27 Nov. 2012, cblr.columbia.edu/archives/12449 (accessed 22 Aug. 2013), and for a case from Abu Dhabi, cf. J Neumann, *Cost of Ratings Suit: \$225 Million*, Wall Street Journal 29 Apr. 2013, online.wsj.com/article/SB10001424127887323528404578453292918428224.html (accessed 22 Aug. 2013).

⁵⁰ See Standard and Poor's, *Guide to Credit Rating Essentials 4* (The McGraw-Hill Companies 2010): 'ratings opinions are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default'.

⁵¹ See Standard and Poor's *2012 Annual Global Corporate Default Study And Rating Transitions* 38 (18 Mar. 2013). The S&P's numbers are taken as an example. Data of other qualified CRCs would be equally appropriate.

The question is for which proportion of the loss could the CRC be responsible? A CRC could be held liable for the proportion of the additional default risk that was obscured by the better rating: The investor/holder of a bond B was obviously willing to hold a bond with a 5-year probability of default of 12.6%, but errantly invested in a bond with an average 5y-PD of 41.2% due to its deceptive rating. In this case, it could be argued that with the erroneous rating, only the expected loss was considered too low, and the CRC only has to bear that additional expected loss. This would be 28.6% (=41.2%-12.6%) of the regular repayment (or: exposure at default). On the other hand, it could be argued that the *proportional extra default probability* was 69.4% (=41.2-12.6)/41.2) of the repayment. While already the first proposed number (28.6%, equal to EUR 286 million) seems to be relatively high, the second proposed number (69.4% of the total bond volume, or EUR 694 million) is very high. For both the enforcement before a court is questionable. However, in 2012, a first successful case was brought against Standard and Poor's in Australia, with a penalty payment to the *full amount of the realized loss* to the investors⁵² and, in 2013, a US court found a compromise agreement between the plaintiff and S&P's when the plaintiff sued for the erroneous rating of mortgage-backed securities, with a penalty payment of USD 225 million. Additionally, in 2013, S&P's was accused by the US Department of Justice of defrauding investors in mortgage-related securities out of at least USD 5 billion⁵³. Even after extensive research, it remains unclear how such a high penalty was calculated for the latter case⁵⁴.

5 SURVIVAL OF THE FITTEST

As CRA III provides for 'unlimited'⁵⁵ liability, the reluctant reaction of the CRCs comes as no surprise, and is exemplified by Standard and Poor's

⁵² See B Haar, *Civil Liability of Credit Rating Agencies: Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 9-11, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02 (2013).

⁵³ Cf. J Neumann, *Cost of Ratings Suit: \$225 Million*, Wall Street Journal 29 Apr. 2013, online. wsj.com/article/SB10001424127887323528404578453292918428224.html (accessed 22 Aug. 2013), and see K Scannell, *Rating agencies' subprime trial is rehearsal for federal case* 17 (5 Mar. 2013, Financial Times US)

⁵⁴ The only useful reference was found in US District Court Central District of California, *Complaint for Civil Money Penalties and Demand for Jury Trial CV13-00779* No. 275 (2013): 'In issuing these CDO ratings, S&P deceived financial institutions that invested in these CDOs into believing that S&P's ratings reflected its true current opinion regarding the credit risks of these CDOs, when in fact they did not. This deception was material to financial institutions' investment decisions, and the financial institutions suffered extensive losses, in excess of \$5 billion, based on currently identified transactions, when the ratings ultimately were downgraded and the CDOs defaulted.'

⁵⁵ Recital 33, CRA III, p.8.

stating in a recent report for the SEC that ‘results could be adversely affected because of public statements or actions by ... government officials ... who may be advocates of increased regulation, regulatory scrutiny or litigation’⁵⁶.

CRCs rate a considerable number of securities, which amount to an even more considerable issued volume: In 2012, S&P’s had one million outstanding ratings valuing securities of a nominal EUR 45 trillion⁵⁷, equalling 3.83 times the value of the total annual GDP of all 28 Member States of the European Union⁵⁸. Thus, if the damage from the first virtual bond B-case – i.e. EUR 286 million – is taken as a benchmark, only 0.00054% (= $EUR \frac{1,540}{286} \text{ million} \div 1 \text{ million ratings}$ of all published ratings (or 5.4 such bond B-cases) could use up the entire 2012 revenue of S&P’s, to the sum of EUR 1,540 million⁵⁹ and, consequently, would question the business model of S&P’s Ratings Services. Under these circumstances, S&P’s would end up in the situation of a level of care that is too high (c2), as shown in diagram B of Figure 2. Even if the three big players S&P’s, Moody’s, and Fitch were able to diversify, insure, or otherwise manage such business risks, or compensate subsequent losses, smaller CRCs would most probably be forced to give up their business due to the magnitude of risk involved. A ‘survival of the fittest’ CRC, which may be the desired goal of the liability regime, cannot be assured. The liability regime could even damage the users of ratings in another way: For fear of liability, rating agencies could refuse to rate, in particular, smaller (less capital-market oriented) companies, where the level of informational asymmetry is high⁶⁰.

However, CRCs are not only held liable for the damage caused. Additionally and strictly separated from the civil liability regime CRCs have to pay further fines for more than 80 (!) of the possibly liability-triggering infringements listed in Annex III CRA III (Table 1 gives examples).

⁵⁶ United States Securities and Exchange Commission, *Form 10-K - Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934* 9 (New York, 2011).

⁵⁷ See Standard and Poor’s, *S&P by numbers*, <https://ratings.standardandpoors.com/about/who-we-are/s-and-p-by-numbers.html> (6 July 2013).

⁵⁸ The present author’s calculation with data from Eurostat, *GDP and main components - volumes*, dataset code: nama_gdp_k (13 December 2013).

⁵⁹ Data taken from McGraw-Hill Companies, *Annual Report 2012* 12 and 14. Exchange rate as of 6 Aug. 2013.

⁶⁰ T Theurl, D Schätzle, *Reformvorschläge für Ratingagenturen: Eine Analyse von Anreizen, Interessen und Restriktionen* 119, in: C Müller, F Trosky, M Weber, *Ökonomik als allgemeine Theorie menschlichen Verhaltens* (Lucius & Lucius Stuttgart: 2012).

Table 1: Infringements and corresponding fines according to CRA III⁶¹

Fines incurred if a CRC is not ensuring that:	
Credit ratings issued in a third country are not endorsed with the intention of avoiding the requirements of the CRA III	EUR 500,000-700,000
Business interest does not impair the independence or accuracy of the credit rating activities	
Internal control mechanisms and procedures for risk assessment are effective	
Conflicts of interest are prevented	
Ratings are based on a thorough analysis of all the information that is available and relevant	
Appropriate methodologies and models or key rating assumptions are implemented	EUR 300,000-450,000
No advisory services regarding the design of financial instruments are made	
Personnel is qualified	
The rotation system for rating analysts is maintained	
Ratings or methodologies are reviewed on an on-going basis	

The fines vary from EUR 10,000 to EUR 750,000. The fine actually charged depends on the size of the CRC (measured in annual turnover), the severity of the infringement, and countermeasures that may be taken. The basic amount of the fine shall be at the lower/higher end for CRCs with less than EUR 10 million/with more than EUR 50 million annual turnover, and in the middle for CRCs with a turnover between these limits⁶². Furthermore, there are aggravating or mitigating coefficients that shall be applied to the basic amount, e.g. 2.0, ‘if the infringement has been committed intentionally’⁶³, or 0.6 if the CRC ‘has voluntarily taken measures to ensure that [a] similar infringement cannot be committed in the future’⁶⁴. Lastly, the fine shall not exceed 20% of the turnover, but has to be at least as high as the financial benefit from the infringement⁶⁵. Like Ellis/Fairchild/Souza we recommend a liability with a cap ‘which could provide sufficient deterrence, but not drive CR[C]s away from the market’⁶⁶.

⁶¹ Art. 36a, Annex III.

⁶² Art. 36a II, CRA III.

⁶³ Annex IV I.5, CRA III.

⁶⁴ Annex IV II.4, CRA III.

⁶⁵ Art. 36a IV, CRA III.

⁶⁶ Against the backdrop of US-American law see N S Ellis, L M Fairchild, F D Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 (2) *Stanford Journal of Law, Business & Finance* 175, 218 (footnote 182) (2012) with further references.

6 CONCLUSION: POLITICAL COMPROMISE OVERRULES ECONOMIC REASONING

The current concept of liability of CRCs in the European Union confirms once again that ‘empirical or theoretical study usually follows after the regulatory system has been reformed’⁶⁷. There is gain to be had from an integration of law and economic analysis, since the economic analysis of law provides astonishing recommendations for the design of laws. Admittedly, solutions that are suggested based on economic theory often appear more abstract than feasible, with rules of liability being no exception. Liability rules could help to correct or even avoid market failure, since they can be a substitute for an absent market. In our case, they could enable a reconciliation of the damage potential posed and the profit earned by ratings. But with their ‘great leap forward’ in CRC liability, the European regulators may have done themselves a disservice: On the one hand the new European liability regime could lead to the elimination of small CRCs that cannot survive under the regulatory hurdles, what depends essentially on the outcome of the damage assessment/valuation. If this is done rigorously, reserves of CRCs (especially smaller entities) would quickly be exhausted. On the other hand the liability regime could lose credibility, degenerating into nothing but a ‘paper tiger’ if claims on its basis are unable to be enforced in national courts. This is why regulators should introduce a well-thought-out liability regime, which is not obliterated by poor political compromise. Finally, it will be some time before the European liability rules bear their first fruits. However, we saw in some rare CRC liability cases in courts beyond the European borders that the quantification of damage from erroneous ratings has so far been neglected. In this paper we give a market price-oriented proposal for the assessment of damage caused by erroneous *bond* ratings. This method can be applied to other forms of securities, though this remains a task for future research.

⁶⁷ M Andenæs, *Crisis and regulation*, 30 *The Company Lawyer* 65, 65 (2009).

