Liability of Credit Rating Agencies – A Legal Comparative Analysis

Credit rating agencies (CRAs) such as Standard & Poor’s (S&P), Moody’s or Fitch evaluate the creditworthiness of financial instruments or issuers of such instruments. They examine the risk that the payment of interests and capital will not or not completely take place at the promised time. CRAs thus predict the ability of an entity to meet its financial obligations with regard to the financial instruments it issues. CRAs issue ratings in the form of letters or alphabetic symbols. The higher the given rating, the lower the credit risk for investors. The highest rating on long-term debt securities is AAA (‘triple A’) followed by ratings descending to BBB or below. A triple A rating means that the risk of default for investors is low. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. Ratings below BBB are considered non-investment grade or ‘junk rating’. They indicate that the full and timely repayment of financial products may be speculative and uncertain. The use of those symbols thus makes “ratings easily comprehensible to even the dullest user and enables markets to respond quickly and, more or less, uniformly to changes in ratings”.

The rating process has been extensively regulated because CRAs are seen as “reputational intermediaries” playing a key role in capital markets. Several parties rely on ratings for commercial decisions and other regulatory purposes. CRAs reduce informational asymmetries between lenders and investors on the one hand and borrowers or issuers on the other hand. This allows investors, who do not always have the (professional) capacity, nor the time to evaluate the quality of financial products or the creditworthiness of the issuer, to use ratings to make investment decisions. Ratings are also useful for other participants in capital markets. For instance, issuers of financial instruments benefit from services provided by CRAs.

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4. It should, however, be noted that each CRA of course has its own specific rating symbols. Whereas Fitch, for instance, uses BBB+, Moody’s uses bbb1.
because higher ratings result in competitive advantages. The issuer can use a high rating for marketing and advertising purposes. More importantly, a higher rating gives the issuer access to cheaper credit. It reflects a lower risk and allows the issuer to offer a lower interest rate or demand a higher price at which the instrument is issued. This results in a lower cost of capital. Finally, regulators promulgated legislation that depends on ratings. Regulators have to a certain extent “outsourced their safety judgments to third-party CRAs”.

Flawed ratings of structured products contributed to the collapse of the subprime-mortgage market in the United States (US), which eventually led to the financial crisis in 2008. Following the financial crisis, deceived investors have filed claims against CRAs to hold them liable for the issuance of flawed ratings. The article will focus on some of the elements that have been important in legislation and case law dealing with the role and liability of CRAs. I will thereby take a comparative legal approach considering that litigation has mainly been filed in the US and in Australia (part 1). Based on this general overview, the article will briefly assess how the accuracy and reliability of credit ratings might be safeguarded (part 2). I will conclude by summarising the main findings of the article (part 3).

1. Credit Rating Agencies (Ten Years) After the Financial Crisis

Following the involvement of CRAs in the 2008 financial crisis, two major tendencies can be identified. Policymakers have, on the one hand, adopted extensive legislation on their liability and functioning (part 1.1). Courts have, on the other hand, been confronted with claims initiated by investors against CRAs (part 1.2.).

1.1. Legal Framework on Credit Rating Agencies

Credit rating agencies operate on a global scale. It is, therefore, no surprise that international organisations have addressed their working. The International Organization of Securities Commissions (IOSCO) took several initiatives to regulate CRAs. Examples include the Statement of Principles Regarding the Activities of Credit Rating Agencies and the Code of Conduct Fundamentals for CRAs. None of these initiatives, however, deal with the liability of CRAs. Shortcomings also remain with regard to the Code of Conduct itself. Besides the fact that some CRAs failed to fully implement the Code, it uses undefined principles, and liability of CRAs. I will thereby take a comparative legal approach considering that litigation has mainly been filed in the US and in Australia (part 1). Based on this general overview, the article will briefly assess how the accuracy and reliability of credit ratings might be safeguarded (part 2). I will conclude by summarising the main findings of the article (part 3).

17. The Code of Conduct is intended to offer a set of robust, practical measures as a guide to and a framework for CRAs with respect to protecting the integrity of the rating process, ensuring that investors and issuers are treated fairly, and safeguarding confidential material information provided by issuers (Technical Committee of the International Organization of Securities Commissions, “Code of Conduct Fundamental for Credit Rating Agencies”, August 2008, www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf).
1.1.1. Legislation on Credit Rating Agencies at the European Union Level

The European Union (EU) adopted Regulation 1060/2009 on CRAs. The Regulation lays down the conditions for issuing ratings and includes rules on the organisation and conduct of CRAs to promote their independence. It introduces a regulatory oversight regime on CRAs that are subject to validation based on historical experience. The EU adopted additional legislation that explicitly and clearly defines when methodologies are rigorous, systematic, continuous rating methodologies that are subject to validation based on historical experience. The extent to which CRAs can be held liable is thus primarily determined by supranational (part 1.1.1.) or national law (part 1.1.2.).

There are also several provisions in EU legislation dealing with the registration of CRAs. Credit rating agencies have to apply for registration before they can provide their services in the EU. They have to submit an application for registration to the European Securities and Markets Authority (ESMA). CRAs are granted registration only when they demonstrate their ability to meet the applicable regulatory requirements. The application for registration needs to contain information on those elements in Annex II of Regulation 1060/2009 on CRAs. ESMA has to ensure that the Regulation on CRAs is applied and can conduct all necessary investigations of CRAs to that end. After registration, ESMA supervises the registered rating agencies through a combination of desk-based supervisory activities and investigation. It can withdraw the registration if the CRA expressly renounces the registration or has provided no ratings for the preceding six months, obtained the registration by making false statements or by any other irregular means, or no longer meets the conditions under which it was registered. Moreover, if ESMA’s Board of Supervisors finds that a CRA has committed one of the infringements listed in Annex III of Regulation 513/2011, it can take several actions. These, for instance, include a withdrawal of the CRA’s registration, a temporary prohibition for the CRA to issue ratings until the infringement has been brought to an end, or the suspension of the rating’s use for regulatory purposes until the infringement has been brought to an end.

More importantly, article 35a of Regulation 1060/2009 as introduced by article 1(22) of Regulation 462/2013 contains the core provision on the liability of CRAs vis-à-vis issuers and investors. CRAs are only liable when they intentionally or with gross negligence commit any of the infringements listed in Annex III. The infringement of the Regulation must also have (had) an impact on the rating. It is the investor who has to present accurate and detailed evidence indicating that the CRA has committed an infringement of the Regulation and that this infringement terms (e.g. ‘sufficient’ or ‘reasonable’) and “suffers from critical limitations”. The Code is also based on voluntary compliance by CRAs and cannot be enforced by the IOSCO. It does not contain sanctions or a specific liability regime that regulators can use if CRAs breach one of the Fundamentals. Furthermore, national legislation in the jurisdictions where the CRA operates prevails over the Code of Conduct Fundamentals. The extent to which CRAs can be held liable is thus primarily determined by supranational (part 1.1.1.) or national law (part 1.1.2.).
has an impact on the rating. This implies that the rating issued by the CRA has to be different from the rating that would have been issued if the CRA had not committed that infringement.\(^{37}\) The competent court has to assess whether the presented information is accurate and detailed, taking into account that the investor or issuer may not have access to information which is purely within the sphere of the CRA.\(^{38}\) The Regulation also requires a link between the infringement and the loss suffered by the investor in two ways. Firstly, the investor has to establish that he reasonably relied on the rating in accordance with article 5a(1) of the Regulation or otherwise with due care.\(^{39}\) What is to be understood under the notion ‘reasonable reliance’ is unclear and not defined in the Regulation. It could imply that a CRA will not incur liability if the investors mentioned in the Regulation (e.g. investment firms, insurance undertakings, reinsurance undertakings or institutions for occupational retirement provision) did not make their own credit risk assessment but relied solely on ratings to assess the creditworthiness of an entity or financial instrument.\(^{40}\) Secondly, the investor must have reasonably relied on the rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.\(^{41}\)

If all of the requirements are met – namely (1) an intentional or gross negligent infringement, (2) impact of the infringement on the rating, (3) reasonable reliance on the rating for an investment decision regarding a financial instrument – the investor may claim compensation from the CRA for its financial losses.\(^{42}\) Several problems, however, remain with regard to the application of the Regulation. There is a high threshold of proof for third parties (e.g. reasonable reliance on the rating and its impact on decision-making processes regarding a financial instrument). In a recent decision, the Oberlandesgericht in Düsseldorf rejected an investor’s claim on the basis of article 35a as the issued ratings did not cover the purchased financial instrument (the bond) but solely the company.\(^{43}\) The requirement of reasonable reliance on the rating is problematic from another point of view as well. Institutional investors are the group of third parties most likely to file a claim against CRAs. As article 5a(1) of the Regulation requires them to make their own assessment and not solely rely on ratings, it is virtually impossible for institutional investors to argue they still relied on the rating to justify the claim against a CRA. If the rating and the own assessment are identical, the investor does not rely solely on the credit rating. An institutional investor exercising due care cannot rely on a rating when he has reason to believe that this rating is inaccurate. Such a reason exists if his own assessment is different than the given credit rating. Private investors, by contrast, are not required to conduct their own risk assessment. Such investors have to prove that they reasonably relied on the rating alone, which will be difficult. The requirement for investors to show that they exercised due care when using the rating “in practice restricts liability claims to private investors, which was not initially intended by the legislature. A liability claim by those most likely to sue [institutional investors] is thus practically prevented.”\(^{44}\) In sum, the regime in article 35a remains a “theoretical claim.”\(^{45}\) In addition, the Regulation refers to national law for the interpretation and application of notions such as damage, gross negligence, due care, reasonably relied and impact. Finally, matters concerning the liability of CRAs that are not covered by the Regulation such as causation and liability for ordinary negligence are governed by national law.\(^{46}\)

\(^{37}\) Article 35a, 1 & 2 Regulation 1060/2009 as introduced by Article 1(22) of Regulation 462/2013.

\(^{38}\) Article 35a, 2 Regulation 1060/2009 as introduced by Article 1(22) of Regulation 462/2013.

\(^{39}\) This article tries to overcome over-reliance by financial institutions on credit ratings. See for more information on ‘transaction causation’, which requires the plaintiff to prove that he would have taken another decision in the absence of the wrongful act on the part of the defendant rating agency: E. Vandendriessche, Investor Losses: A Comparative Legal Analysis of Causation and Assessment of Damages in Investor Litigation, Cambridge, Intersentia, 2015, 189-233.

\(^{40}\) Article 35a, 1 Regulation 1060/2009 as introduced by Article 1(22) of Regulation 462/2013.

\(^{41}\) Article 5a, 1 Regulation 462/2013 amending Regulation 1060/2009 on credit rating agencies.

\(^{42}\) Article 35a, 1 Regulation 1060/2009 as introduced by Article 1(22) of Regulation 462/2013.

\(^{43}\) Article 35a, 1 Regulation 1060/2009 as introduced by Article 1(22) of Regulation 462/2013.


\(^{47}\) Article 35a, 4 Regulation 1060/2009 as introduced by Article 1(22) of Regulation 462/2013.
1.1.2. Legislation on Credit Rating Agencies at the National Level

In addition to inter- or supranational initiatives, policymakers can also implement legislation on the role and liability of CRAs at the national level. Although EU member states are bound by the existing Regulations on CRAs, national law will remain important with regard to the interpretation of certain essential undefined concepts as well as with issues not addressed in supranational legislation. For instance, article 35a stipulates that the liability of CRAs for gross negligence or intention can only be limited in advance where the limitation is (a) reasonable and proportionate, and (b) allowed by the applicable national law. Whether a limitation is reasonable and proportionate needs to be interpreted in the light of national legislation.

Considering that the major CRAs are still from a ‘US origin’, it is not really surprising that policymakers have also adopted legislation on their role and liability in the United States. Although an extensive discussion does not fall within the scope of this article, the importance and shortcomings of some legal initiatives are discussed.

An important piece of legislation, for instance, is the Dodd-Frank Wall Street Reform and Consumer Protection Act (‘Dodd-Frank Act’). It was passed by the US Congress in July 2010. The Act contains requirements on the role and liability of CRAs. It requires greater transparency of rating procedures and methodologies, provides the Securities and Exchange Commission with more efficient enforcement mechanisms, aims to reduce reliance on ratings and minimises conflicts of interest. More importantly, the Dodd-Frank Act contains several provisions on the liability of CRAs. Two of these provisions are briefly addressed, namely prospectus liability on the one hand and securities fraud on the other hand.

Prior to the changes introduced by the Dodd-Frank Act, SEC Rule 436(g) stipulated that ratings from a Nationally Registered Statistical Rating Organisation (NRSRO) assigned to public offerings were not considered as an expert-certified part of the registration statement. As opposed to auditors, CRAs could thus not be held liable if the registration statement contained an incorrect rating. However, Section 939G of the Dodd-Frank Act repealed Rule 436(g). As a consequence, the issuer had to seek the written consent of a NRSRO before he could include a rating in the registration statement. By giving its consent, the NRSRO could incur liability as expert for material misstatements or omissions regarding the rating included in the registration statement. However, NRSROs refused to give their consent due to this threat of potential liability. This eventually led to the freezing and the collapse of the asset-backed securitisation market as issuers were no longer able to offer securities. The US House Financial Services Committee, therefore, approved the removal of expert liability for CRAs (“no-action relief”) in July 2011. The Asset-Backed Market Stabilisation Act of 2011 repealed section 939G of the Dodd-Frank Act and restored Rule 436(g).

48. See for example the English Credit Rating Agencies (Civil Liability) Regulations 2013, No. 1637.
49. In 2013, German consulting firm Roland Berger proposed creating a European CRA to counter the dominance of the major US-based CRAs. However, this promising attempt failed because the initiators were not able to collect the 300 million Euros necessary for launching the project (X, “EU-based credit rating agency buried,” EUBOSERVER, May 1, 2013, EUBOserver.com/foreign/120005).
51. Title XI, Subtitle C (“Improvements to the Regulation on Credit Rating Agencies”) Dodd-Frank Act.
52. See for more information on NRSROs the discussion supra in footnote 14.
57. Asset-Backed Market Stabilization Act of 2011, H.R.1339, Report No. 112–196, April 14, 2011. In the EU, Article 6 of the Prospectus Directive stipulates that Member States have to ensure that the responsibility for the information given in a prospectus attaches at least to the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor. Member States have to safeguard that their laws, regulations and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus (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, OJ 345). National legislation will thus determine whether auditors or CRAs can be held liable when their opinions are included in the prospectus. In Belgium, Article 61 of the Prospectus Act deals with the liability for incomplete, misleading or erroneous information contained in the prospectus (Loi du 16 June 2006 relating aux offres publiques d’instruments de placement et aux admissions d’instruments de placement à la négociation sur des marchés réglementés, no. 2006009492, published in the Moniteur belge on June 21, 2006). The Article lists parties that will be held jointly and severally liable for the damage in respect of any incomplete, misleading or erroneous information contained in the prospectus. The auditor and CRA are not mentioned as one of those parties. However, the auditor can be held liable on the basis of Article 140 of the Belgian Company Code as well as on the basis of the Articles 1382-1383 Belgian Civil Code (I. De Poorter, Controle van financiële verslaggeving: revisoriaal en overheidszicht, Antwerp, Intersentia, 2007,183-242). This is a different basis than liability for statements contained in a prospectus (see for more information: V. De Schryver, “Prospectusaansprakelijkheid”, in: E. Wymeersch, Financieel recht tussen...
Rating agencies can also be held liable for securities fraud. Deceived investors have already targeted CRAs alleging violations of Section 10(b) of the Securities and Exchange Act of 1934 and the thereunder promulgated SEC Rule 10b-5. Claims under Rule 10b-5 require a plaintiff to establish that the defendant CRA made a material misrepresentation or omitted to disclose material information with scienter in connection with the purchase or sale of securities justifiably relied on by plaintiffs and proximately causing them injury. An important element in the context of CRAs is the proof that they acted with scienter. The Supreme Court defined scienter as a “mental state embracing intent to deceive, manipulate or defraud.” Thus, CRAs had to act with the intention to deceive, manipulate or defraud.

Section 933(b) of the Dodd-Frank Act lessened the pleading requirements in private actions for securities fraud under Section 10(b) of the Securities and Exchange Act and the thereunder adopted SEC Rule 10b-5. Following Section 933(b) of the Act, plaintiffs must now only establish particular facts giving rise to a strong inference that a CRA either (1) knowingly or recklessly failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (2) knowingly or recklessly failed to obtain reasonable verification that such an investigation was done by a source independent of the issuer or underwriter.

On June 9, 2017, the House of Representatives passed the Financial Choice Act of 2017. The Act repealed Section 933(b) of the Dodd-Frank Act. The Senate, however, did not agree and adopted its own version: the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 also known as the ‘Financial Choice Act 2.0’ or ‘Crapo Bill’. At the end of May 2018, President Trump signed the Act into United States federal law. As far as I know, it does not contain provisions dealing with the pleading requirements in securities fraud against CRAs. As a consequence, Section 933(b) of the Dodd-Frank Act still applies. In any case, courts will have to interpret this provision. It remains unclear whether plaintiffs will be able to show that CRAs knowingly or recklessly failed to conduct a reasonable investigation, or precisely how courts will apply this standard.

1.2. Case Law Dealing with the Liability of Credit Rating Agencies

It has already been mentioned that deceived investors have filed claims against CRAs after the 2008 financial crisis to hold them liable for the issuance of ‘flawed’ and ‘incorrect’ ratings. These claims have especially been initiated in the US and in Australia. I will discuss some of the reoccurring legal issues often at stake in those claims. Attention is given to the potential bases upon which CRAs can be held liable for the issuance of an ‘incorrect’ or ‘flawed’ rating (part 1.2.1), to the freedom of speech argument invoked by CRAs (part 1.2.2) and to the use of disclaimers in rating agreements/reports (part 1.2.3).

1.2.1. Bases of Liability

Ligation against CRAs has been initiated on different grounds in the United States. However, credit rating agencies have traditionally been able to escape liability in many of these legal suits. Some of the reasons why holding CRAs liable is not always straightforward are discussed (part A). The Australian Bathurst case has been revolutionary as it imposed liability upon Standard & Poor’s. It is to my knowledge the only case in which a CRA has been held liable (part B).
A. Strict Requirements to Impose Liability Upon CRAs in the US

Investors have already based their claims on different grounds such as securities and common law fraud, negligent misrepresentation, and third-party beneficiary protection for CRAs under the rating contract. In all of these cases, investors have to prove several requirements before CRAs can be held liable. Investors are not always successful in doing so, which means that CRAs will not incur liability.

The concept of beneficiary to a contract, for instance, implies that an investor (or other third party) has the right to sue on the rating agreement, despite not being an active party to it. An investor can be qualified as third-party beneficiary in some US states if the issuer and the CRA intended to give him a right to enforce the contractual promises (the ‘intent to benefit-test’). Proving such an intent, however, can be difficult as there is a presumption that contractors will generally intend that the contractual provisions only apply to them and not towards third parties. Whether the CRA and the issuer had the intent to benefit the investor under the rating agreement was at stake in both Quinn v. McGraw-Hill and Abu Dhabi Commercial Bank v. Morgan Stanley.

The plaintiffs in Quinn asserted that S&P and the issuer must have known that investors were beneficiaries to the rating contract. S&P existed as an independent CRA because investors relied on its ratings. Without potential purchasers, ratings would exist in a “vacuum […] benefiting no one.” The US Court of Appeals for the Seventh Circuit held that investors might indeed derive valuable information from ratings. However, the contract between the issuer and S&P did not contain express language identifying purchasers such as Quinn by name. There were no explicit or implicit indications in the rating contract showing the necessary intent to benefit the investor. The District Court in the Abu Dhabi case also concluded that plaintiffs failed to allege “contract language or other facts sufficient to give rise to a plausible inference that any of these contracts clearly evidence […] an intent to permit enforcement by plaintiffs” (internal quotations omitted). Besides the use of express language in the rating agreement identifying certain purchasers, there are other ways as well to establish whether investors can be seen as third-party beneficiaries. The court in Quinn held that investors may be indirect beneficiaries of ratings to the extent they would not only have been issued to the benefit of the issuer. Although ratings are relevant to investors, they are also important for the issuer himself. The issuer enters into a rating agreement for its own purposes. Once he knows which rating will be given to his financial products, he “has a better idea of which customers are likely to be interested, what interest rate (or other element of price) to attach to the placement, and where it stands relative to others in its line of business.”

In the Abu Dhabi case, the District Court held that the investor could be the intended third-party beneficiary if no other party is able to recover its losses when the CRA breaches the rating agreement. The judge, however, held that the CRAs and the issuer retained the right to enforce the agreement if it had been violated and thus recover their losses. The plaintiffs’ allegation that they were third-party


71. See for more information: M.A. Eisenberg, “Third-Party Beneficiaries”, Columbia Law Review 1992, vol. 92, 1358; A. Corbin, “Contracts for Benefit of Third Persons”, Yale Law Journal 1918, vol. 27, 1009. The possibility for contracting parties to agree to a third-party beneficiary contract may also exist in civil law countries such as Belgium. If all the requirements for such a contract are satisfied, the third-party beneficiary has a contractual right against the promisor, even though he is not a contracting party (I. Claeys, “Contract Law”, in: M. Kruithof & W. De Bondt (eds.), Introduction to Belgian Law, Alphen aan den Rijn, Kluwer Law International, 2017, 241; N. Carette, Derdenheding, Antwerp, Intersentia, 2011, 892p.).


74. Quinn v. The McGraw-Hill Companies, 168 F.3d 331, 334-335 (7th Cir. 1999).


76. Quinn v. The McGraw-Hill Companies, 168 F.3d 331, 334-335 (7th Cir. 1999).


78. Quinn v. The McGraw-Hill Companies, 168 F.3d 331, 334-335 (7th Cir. 1999).


beneficiaries because the CRAs only contracted to generate revenues for themselves by providing service to the issuer and the latter’s investors was rejected as well. Similarly to the decision in Quinn, the importance of the rating agreement for the issuer was underlined. Allowing investors to bring a claim for a breach of the rating contract as third-party beneficiaries would undervalue the benefits that those contracts directly provide to the issuer.

Investors will also have to prove several elements in claims of negligent misrepresentation. One common element is that the investor who uses the rating has to be part of a limited class or select group of (qualified) investors whose reliance on the rating was foreseeable to the CRA. Actual knowledge of the identity of each particular investor is, however, not necessary as long as the rating is created to target a select group of qualified investors instead of the “faceless” investing public at large. Investors are not part of a limited class if the allegations suggest both a widespread availability of the securities and a widespread reliance on the ratings (e.g., because the securities were not offered through private placement to only a certain type of investor). Claims for negligent misrepresentation or common law fraud can also be dismissed if investors did not justifiably or reasonably rely on the credit rating. The Abu Dhabi court concluded that the plaintiffs reasonably relied on the ratings because the market at large, including sophisticated investors, has come to rely on ratings issued by independent CRAs given “their NRSRO status and access to non-public information that even sophisticated investors cannot obtain.” Similarly, the CalPERS court held that, contrary to the corporate market, investors in the structured finance market cannot reasonably develop their own informed opinions because there is insufficient public information to do so. Reliance on ratings is thus justified if (sophisticated) investors are unable to conduct an own analysis or develop their independent views about potential investments.

B. The Australian Bathurst Case and the Liability of CRAs for Negligence

As opposed to the situation in the United States, investors have been more successful in the Australian Bathurst case. Several New South Wales Regional Councils suffered financial losses after the purchase of CPDO (constant proportion debt obligations) notes. The structured products were marketed by Local Government Financial Services (LGFS), created by ABN Amro Bank and given a ‘triple A’ rating by S&P. The investors claimed recovery from the CRA for their losses.

The full Federal Court of Australia upheld the first instance decision. The judge held that S&P violated its duty of care towards investors. S&P owed such a duty of reasonable care and skill towards “vulnerable” and “unsophisticated” investors with whom the CRA does not have a contract. Investors are vulnerable when they are unable to assess the creditworthiness of the financial products or to “second-guess” the rating. This occurs if the only available information on the creditworthiness is the rating. The question was not whether S&P had to give another, more correct and appropriate rating. Instead, S&P violated its duty of care because the CRA did not have reasonable grounds to assign the rating. The rating was not the result of reasonable care and skill. S&P did not develop its own model for rating the securities but instead relied on the model created by the issuer. S&P also did not consider the model risk when assigning the rating. In addition, S&P adopted a 15% volatility figure which had been provided to it by ABN Amro. However,


S&P could have easily calculated the volatility and would then have realised that the correct figure was around 28%. In essence, S&P used a number of inputs that were incorrect to calculate the rating. This could have been prevented if the CRA had relied on information of sufficient quality and from accurate and reliable sources, and thus not only on information given by the issuer ABN Amro. It was held that the analysis of S&P “involve[d] failures of such a character that no reasonable ratings agency exercising reasonable care and skill could have committed in the rating of the CPDOs”. In sum, the “[rating] analysis was fundamentally flawed, unreasonable and irrational in numerous respects”.

The first instance court also held that it was reasonable for investors to rely on the rating. A credit rating is an opinion given by an expert in the field of structured finance who is assumed to exercise reasonable care and skill. S&P claimed that imposing a duty of care would lead to potential liability to an indeterminate number of purchasers. The first instance court per Justice Jagot, however, disagreed for two reasons.

On the one hand, the risk of loss by the potential investors in the CPDO notes was foreseeable for the CRA as it was the immediate consequence of S&P’s careless rating of the notes. S&P knew or ought to have known that investors would suffer losses by relying on the rating. A reasonable person in S&P’s position would have taken precautions against the risk for investors to suffer financial losses. The risk of the financial loss was not insignificant, either in possibility or in quantum. S&P had results of its own modelling that provided no rational basis upon which to decide to assign the securities the highest rating. Therefore, S&P’s conduct created a high probability of harm. Given the minimum investment tranches of $500,000, S&P knew that the potential losses for any investor would be serious. On appeal, it was affirmed that S&P knew the foreseeable type of loss. It is the nature of the loss – losing “the money [investors] had invested in the notes” – and not the precise amount that is important. S&P knew that if its opinion was given carelessly, investors were likely to lose the money they had invested in the notes.

Justice Jagot also held that the class of persons to whom S&P owed a duty of care was ascertainable. The class of persons comprised of potential purchasers of the minimum $500,000 subscription in the $40 million issue of the notes. Moreover, S&P controlled several factors confining the scope of potential liability such as the amount of issued products to which the rating relates. It also had the ability to control its liability by downgrading or withdrawing the rating. On appeal it was also decided that the liability was not indeterminate. S&P knew that the investors were members of a class, the essential characteristic of which was that each investor wanted to purchase the notes (an “identifiable class”). CRAs are not required to know the precise identity of the recipient of the rating, nor the exact number of members in the class or the exact loss. It is sufficient to identify the class of persons to whom the duty of care was owed. Expert information and advice is part of modern commercial life. Such information, as was the case in Bathurst, is often issued by reference to or in respect of an instrument and not with regard to a particular person’s individual position. Both the class of investors and foreseeable loss were identifiable and determined by the function that S&P undertook, which was “delineated by the purpose of the rating [...] and the known reasonable reliance”.

On the other hand, there needs to be a special relationship of proximity between the CRA and the investors before a duty of care can arise. The speaker must realise or the circumstances must be such that the speaker ought to have realised that the recipient of the information or advice intends to act on it for commercial decisions. This requirement was also established in the Bathurst case. ABN Amro obtained the rating to disseminate it to
potential investors. This allowed investors to rely on the rating as an expert opinion regarding the creditworthiness of the notes and/or to take it into account when deciding whether or not to invest. The issuer was aware that many institutional investors could only invest in notes that had a certain rating (investment grade or above). More importantly, S&P knew that its ratings were intended to be used for these purposes. The judge even stressed that it was difficult to think of any other purpose for which the ratings were given. S&P was paid for the very purpose to allow potential investors to rely on the ratings

1.2.2. The Freedom of Speech Argument

Credit rating agencies often argue that their ratings should be protected under the constitutional freedom of speech when facing litigation. Rating agreements or reports, for instance, stipulate that ratings are no absolute assurances of credit quality or exact measures of the probability that an issuer or financial product will default. They are opinions on the credit quality and do not recommend purchasing, holding or selling securities. CRAs gather complex information from different sources and transform this into future predictions by using simple symbols. CRAs argue that they are financial journalists and their ratings opinions that do not contain provably false facts. Credit ratings are the “world’s shortest editorials” written on an item or company’s creditworthiness. CRAs, therefore, consider themselves as members of the financial press. As a consequence, credit ratings should be fully protected as journalistic speech. An extensive analysis does not fall within the scope of this article, especially as the protection for ratings has already been thoroughly examined elsewhere. I will discuss some elements that influence the protection given to CRAs under the First Amendment of the United States Constitution (freedom of speech and press).

One element that influences the protection given to CRAs under the First Amendment relates to the qualification of an ‘opinion’ as opposed to ‘facts’. CRAs have already argued that their ratings are non-factual opinions that should be fully protected by the First Amendment. Several courts have considered this line of reasoning and qualified misleading credit ratings as predictive opinions not containing provably false factual connotations. Not all judges, however, agree with this conclusion. The Court for the Eastern District of North Carolina held in First Financial Savings Bank that the First Amendment protection was without merit and that any further discussion on this matter was “a waste of paper”. Moreover, protection is not absolute or unconditional only because a rating is labelled as opinion. Ratings can imply an assertion of an objective fact that may be false or that can be coupled with false factual assertions. If credit ratings contain false components, the issuer should “not be shielded from liability by raising the word ‘opinion’ as a shibboleth”. The court in California Public Employees’ Retirement System v. Moody’s Corp, however, agreed with the plaintiffs that ratings are not mere predictions of the future value

109. Bathurst Regional Council v. Local Government Financial Services Pty Ltd (No 5), [2012] FCA 1200, paragraphs 2759, 2780 & 2816. The Esanda Finance case illustrates that it is different for audit opinions. The auditor’s potential liability was disproportionate because the auditor did not intend investors to rely on the audit and was not paid for that purpose. The reliance by the investor on the audit opinion was “self-induced” (Esanda Finance Corporation Ltd v. Peat Marwick Hungerfords, [1997] 188 CLR 241, 289). The rating is assigned to a financial instrument to be communicated to potential investors to take it into account and rely upon in deciding whether or not to invest. The same cannot be said of an audit, which is undertaken for the company’s own purposes to comply with the company’s statutory obligations (Bathurst Regional Council v. Local Government Financial Services Pty Ltd (No 5), [2012] FCA 1200, paragraphs 222, 233, 235, 253-254, 2480 and 2754-2760). ABN AMRO Bank NV v. Bathurst Regional Council, [2014] FCAC 65, paragraph 580).

110. Moody’s, Ratings Definitions, www.moodys.com/Pages/am002002.aspx. See in this regard also the wording used in the different CRAs’ codes of conduct.


113. See: J. De Bruyne, Third-party certifiers: an inquiry into their obligations and liability in search of legal mechanisms to increase the accuracy and reliability of certification, Doctoral Dissertation, Ghent University Faculty of Law and Criminology, 2018, 169-206 with further references to scholarship.

114. See for example: Ohio Police & Fire v. Standard & Poor’s Financial Services Inc., No. 05-1851, August 23, 2007, 7 (6th Cir. 2007); In Re Credit Suisse First Boston Corp., 431 F.3d 36, 47 at paragraph 32 (1st Cir. 2005); In Re Pan Am Corp., 161 B.R. 577, 586 (S.D.N.Y. 1993).


117. Jefferson County School District No.R-1 v. Moody’s Investor’s Services Inc., 175 F.3d 848, paragraph 26 & 34 (10th Cir. 1999). Thus, a CRA’s “status as a financial publisher does not necessarily entitle it to heightened protection under the First Amendment” (County of Orange v. McGraw Hill Companies Inc., 245 B.R. 151, 154 (C.D. Cal. 1999)).
of structured investment vehicles (SIVs). Rather, they are affirmative representations regarding the present state of the SIVs’ financial health and capacity to provide payments to investors as promised.

A second element that determines the protection for CRAs under the First Amendment is the extent to which their ratings are issued in a private contractual relationship or, instead, made available to the public. When ratings are a matter of public concern, they will more likely be protected speech. A rating is a matter of public concern the moment CRAs make it available to the benefit of the public at large. In other words, when it is distributed “to the world” (internal quotation marks omitted). Ratings are a matter of private concern if they are issued “solely in the individual interest of the speaker and its specific business audience.” This is the case when ratings are privately contracted between the CRA and a select group of qualified investors or intended for use in private placement offerings to only a very limited number of persons, rather than for publication in the interest of the general investing public.

A third element that shapes the boundaries of the First Amendment protection given to ratings is the involvement of CRAs in structuring securities and the extent to which they have been paid by the issuer to rate the securities.

In re Fitch, the Court of Appeals for the Second Circuit upheld a lower court decision, in which the court did not accept that Fitch was a member of the financial press. The dissemination of financial information by Fitch was not based on a judgment about newsworthiness but rather on its client’s needs. The Second Circuit Court of Appeals considered that it was the issuer (UBS) and not the subscribers/investors (American Savings Bank) who paid for the rating. Fitch was also actively involved in structuring the securities and planning the transaction to reach the desired ratings. This reveals a level of involvement with the client’s transactions that is not typical for the relationship between a journalist and the activities upon which he reports. A quite similar conclusion was reached in Commercial Financial Services Inc. v. Arthur Andersen. The Oklahoma Court of Civil Appeals concluded that the relationship between the CRA and the issuer goes “beyond a relationship between a journalist and subject.” Thus, ratings that result from such a relationship of privity are barred from First Amendment protection. The court justified that if “a journalist wrote an article for a newspaper about the bonds, the First Amendment would presumably apply. But if [the issuer] hired that journalist to write a company report about the bonds, a different standard would apply.”

A last element can be found in the Bathurst case. Justice JAGOT qualified a rating as an opinion on the creditworthiness of a financial product. It is issued by a professional entity that claims and represents itself as having expertise in assessing an item’s creditworthiness. It is neither a guarantee, nor a statement of fact or advice to invest or not. However, CRAs should not be able to shield behind the ‘mere opinion’ argument. The Bathurst decision thus nuances the distinction that is traditionally made between statements of fact and opinions. The court underlined that the CRAs knew that the intended recipients of the rating would rely on it to make decisions. S&P knew and intended its rating to be perceived by investors as a representation of its opinion that the notes had an extremely strong capacity to meet their financial commitments. Moreover, the assignment of a triple A rating carried with it a “representation that S&P has a genuine and reasonable basis, formed following the application of its expertise, for reaching the conclusions that it reached.” Ratings, whether or not qualified as predictive opinions, can be

actionable if they are not based on reasonable grounds and the result of a CRA’s lack of reasonable care and skill. 132

1.2.3. The Use of Disclaimers

Besides relying on freedom of speech protection, CRAs often invoke disclaimers in rating reports or agreements to refute any liability towards deceived investors. A brief analysis of case law, however, shows that disclaimers excluding the liability of CRAs are not always opposable towards investors or per se valid only because CRAs claim they are.

The court in the CalPERS case, for instance, held that an investor could recover his losses unless his conduct, in the light of his own information and intelligence, was “preposterous and irrational” 133. The effectiveness of exclusion clauses used in rating reports has to be assessed in light of these principles as well. The court held that the mere presence of broad clauses in rating reports does not necessarily render an investment decision to purchase securities preposterous or irrational 134. Exclusion clauses included in rating reports will not automatically have effect and bar investors from recovery. In other words, a decision of an investor is not per se preposterous and irrational only because the report contains an exclusion clause. Especially the behaviour of the investor, namely his professional capacity and the information at his disposal, seems to determine whether CRAs can successfully exclude their liability.

The Australian Bathurst decision also addressed the use of exclusion clauses in rating reports. The reliance of S&P on extensive clauses included in the reports to bar the plaintiff’s recovery was rejected by the court. The specific context was invoked to conclude that it would be difficult for CRAs to draft an effective exclusion clause. 135. They can be used to make sure that investors understand that CRAs do not give financial advice on the purchase of financial instruments. That is because CRAs are often not aware of the particular reasons and circumstances why the purchaser wants to buy securities. However, the provisions cannot be interpreted as clauses excluding any exercise of care and skill when CRAs issue ratings. That would make the rating “futile and selfdefeating” 136 and “content-less” 137.

2. Credit Rating Agencies – The Way Forward

The analysis in the previous parts showed that CRAs have to a large extend been able to escape liability for their role in the 2008 financial crisis. Even though S&P was held liable in the Bathurst case, the decision remains quite isolated. Holding CRAs liable is challenging for several reasons. The legal framework, for instance, can have shortcomings. Reference can in this regard be made to the high burden of proof faced by investors under article 35a of the Regulation on CRAs making the application of this liability regime unlikely. Several strict requirements also have to be established by investors in claims against rating agencies in the US (e.g. reliance on the credit rating or membership of a limited group). CRAs might under certain circumstances (still) be able to shield behind the freedom of speech protection as well.

More generally, CRAs will not be held liable merely because the rating does not correspond with the ‘true or real value’ of the rated financial product. The mere fact that a rating is incorrect or wrong is no basis to impose liability upon a CRA. The actual process of calculating the rating ultimately remains the result of “une appréciation humaine” 138. This also corresponds to the wording used in the Regulation 462/2013 on CRAs, which stipulates that the business of rating involves a degree of assessment of complex economic factors. The Regulation does not impose liability for CRAs when they commit the infringement by mistake or because they did not display reasonable care when issuing the rating. CRAs are only liable when they commit an infringement intentionally or with gross negligence. This standard of fault is “appropriate” as rating activities involve a degree of assessment of complex economic factors. The use of different methodologies can lead to different credit ratings, none of which can actually be considered incorrect 139. One might in this regard also refer to case law dealing with the liability of issuers under

135. See in this regard also A. Sahore, “ABN Amro Bank NV v Bathurst Regional Council: Credit Rating Agencies and Liability to Investors”, (37) Sydney Law Review 2015, 448.
139. Recital (33) Regulation 462/2013 on credit rating agencies.
Based on these findings, one can argue that CRAs (still) do not face a sufficiently high risk of liability, even more than ten years after the financial crisis. The lack of such a sufficient risk of liability can have an influence on the accuracy and reliability of ratings. According to law and economics scholars, tort law is an instrument aimed largely at the goal of deterrence. The purpose of damage payments in tort law is to provide incentives for potential injurers to take efficient cost-justified precautions to avoid causing the accident. An individual or entity makes the decision about whether or how to engage in a given activity by weighing the costs and benefits of the particular activity. The risk of liability and actual imposition of damage awards may lead parties to take into account externalities when they decide whether and how to act. The fact that someone can be held liable ex post can thus provide the necessary incentives ex ante to act in such a way to prevent liability.

Tort law aims to promote overall social welfare by efficiently deterring and reducing accidents in the future. Law and economics scholars argue that injurers will adopt cost-justified safety measures if the system holds them liable for the injury costs they generate. The risk of having to bear financial burdens due to liability could serve as an incentive for potential tortfeasors to avoid injury-causing activities or at least to provide them with greater regard for safety. If tort law is working correctly, the threat of civil liability will cause actors to take all and only those precautions that cost less than the harm that is expected to result if those precautions are not taken. Based on this reasoning, CRAs will take into account – ‘internalise’ – the risk of civil liability when issuing their ratings. This in turn will induce them to act more carefully during the rating process, which could increase the accuracy and reliability of ratings.

The assumptions upon which the traditional law and economics literature is based have, however, been challenged in academia. Behavioural law and economics scholars question the underlying rational choice assumptions and endeavour to render economic analysis more realistic by using psychological insights. Several (empirical) studies even show that tort law does not always have the expected...
deterring influence on someone’s behaviour\textsuperscript{154}. That being said, there still are several reasons why I decided to depart from the classical law and economics approach in this article. CRAs, for instance, are rational actors and attempts are even taken in legislation to reduce irrational human behaviour during the rating process (e.g. adoption of provisions aiming to ensure a CRA’s independence and increase the accuracy and reliability of credit ratings\textsuperscript{155}). The threat of liability and its influence to shape a particular behaviour might thus play a more important role in the context of CRAs than, for example, in traffic-related matters. The incentive provided by tort law will be lower in traffic as people are inclined to prevent accidents by the wish to protect their own safety rather than by the risk to be sued in court. This is an instinctive reaction and not ‘calculated negligence’\textsuperscript{156}. Credit rating agencies by contrast are professional entities operating on a commercial basis and can be presumed to act more rationally. As profit maximisers, they can weigh the costs and benefits of their actions carefully and take a decision to prevent liability\textsuperscript{157}. More importantly, Zabinski & Black find evidence “that reduced risk of med mal litigation, due to state adoption of damage caps, leads to higher rates of preventable adverse patient safety events in hospitals [...] Our study is the first, either for medical malpractice or indeed, in any area of personal injury liability, to find strong evidence consistent with classic tort law deterrence theory – liability for harm induces greater care”.\textsuperscript{158} Professor Schwartz concludes that “tort law, while not as effective as economic models suggest, may still be somewhat successful in achieving its stated deterrence goals”. More specifically, “[t]he information suggests that the strong form of the deterrence argument is in error. Yet it provides support for that argument in its moderate form: sector-by-sector, tort law provides something significant by way of deterrence\textsuperscript{159}. Handbooks and academic articles also acknowledge the deterring function\textsuperscript{160} or consequences\textsuperscript{161} of tort law. Professor Popper further writes that deterrence is a real and present virtue of the tort system. The actual or potential imposition of civil tort liability changes the behavior of others. He concludes that “[a] tort case can communicate a normative message, an avoidance message, or a message affirming current practices. [footnote omitted] To deny that judicial decisions provide a valuable deterrent effect is to deny the historic role of the judiciary, not just as a matter of civil justice but as a primary and fundamental source of behavioral norms”.\textsuperscript{162} Based on a restricted survey, he even finds empirical evidence of the deterring function of tort law\textsuperscript{163}. Policymakers should thus ensure that CRAs face a sufficiently high risk of liability, which currently seems lacking. Such a risk of tort litigation might increase the accuracy and reliability of ratings, thereby eventually reducing the risk of a (new) financial crisis. To (properly) restore the deterring effect of tort litigation and hence increase the accuracy and reliability of credit ratings, policymakers have several options such as working with a reversal of the burden of proof regarding a CRA’s negligence\textsuperscript{164} or introducing additional peer review mechanisms on the rating process\textsuperscript{165}.


155. See in this regard the discussion and references to EU law supra in part 1.1.1.


161. M. Kruthof, Tort Law in Belgium, Alphen aan den Rijn, Kluwer Law International, 2018, 35 concluding that “[i]n general, however, while Belgian authors recognize that liability law has this preventing effect, they more rarely invoke the prevention of losses as the function of liability law”.


164. The EU Commission Proposal for a Regulation amending Regulation 1060/2009 on credit rating agencies contained such a reversal of the burden of proof. It was specified that when an investor establishes facts from which it may be inferred that a CRA committed any of the listed infringements, the CRA has to prove that it has.

165. See in this regard: J. De Bruyne, Third-party certifiers: an inquiry into their obligations and liability in search of legal mechanisms to increase the accuracy and reliability of certification, Doctoral Dissertation, Ghent University Faculty of Law and Criminology, 2018, 267-381.
3. Concluding Remarks

This article examined the role and liability of CRAs from a legal comparative perspective. I first elaborated on legislation that has been adopted following the 2008 financial crisis at the inter-, supra- and national level. The liability regimes included in this legislation often remain problematic. Investors, for instance, face a high burden of proof and/or the meaning of certain concepts remains unclear. Despite the many initiatives that have been taken by policymakers, it remains unlikely that CRAs will be held liable under the applicable legislation. Deceived investors have also filed claims against CRAs in the aftermath of the financial crisis in 2008. With the exception of the Australian Bathurst case, CRAs have been able to escape liability when facing (tort) litigation. The freedom of speech protection as well as the strict requirements investors have to prove for legal claims to be successful have allowed CRAs to refute liability. One could, therefore, conclude that the risk of liability faced by CRAs is not high enough to ensure that they issue accurate and reliable ratings. CRAs are thus still bulletproof more than ten years after the financial crisis, despite the (many) evolutions discussed in this article.