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Civil Liability of Credit Rating Agencies after CRA 3– Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence

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* Professor of Law at the House of Finance, Goethe-University, Frankfurt; I would like to thank Jill Fisch for helpful comments and suggestions. All remaining shortcomings are mine. This article represents the case law and literature as of 30 May 2013.

I. Introduction

At Moody's one analyst recalls rating a \$1 billion structured deal in 90 minutes. 'People at the rating agencies used to say things like, "I can't believe that we got comfortable with that deal,"' says Raynes [an individual employed by Moody's in the 1990s].¹ Hand in hand with this situation went analysts' hope to be 'wealthy and retired by the time this house of cards falters' because the CDO market appeared as a 'monster'.² These quotes only give a slight idea of how bad a job the rating agencies did throughout the crisis, which resulted in quite a few lawsuits afterwards.³ At the same time, Fitch Investor Services insists that 'credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default'.⁴

With the agencies' ratings moving to the centre of the debate in the current sovereign debt crisis and the repercussions of wrong downgrades becoming greater,⁵ the liability issue is subject to an unprecedentedly intense regulatory debate in the rating industry. Only recently the European Commission has put forward a proposal for a regulation (CRA3), which was adopted by the European Parliament on January 16, 2013, to amend and strengthen the 2009 version of the EU Rating Regulation, among other things imposing civil liability on the agencies. Article 35a of the amendment of the EU Rating Regulation introducing civil liability of credit rating agencies has been one of the most controversial provisions of the amendment. In order to arrive at an independent evaluation of this liability rule, one first has to take a look at the existing rules on civil

¹ S. Jones, *How Moody's faltered*, Financial Times (London) 16 (Oct. 17, 2008).

² Securities Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating* (July 2008), 12, <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (accessed 30 May 2013).

³ *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155 (S.D.N.Y. 2009); for a preliminary decision of the Frankfurt Court of Appeals in Germany cf. *Wochenüberblick*, Betriebsberater (BB) 1482 (2010); for the overruling of the Frankfurt Higher Regional Court see Wertpapier-Mitteilungen (WM) 2360 (2011); for the following decision of the German Federal Court of Justice cf. *Verbraucher und Recht* (VuR) 94 (2013); *Bathurst Regional Council v. Local Government Financial Services Pty Ltd* (No. 5), [2012] FCA 1200, http://www.imf.com.au/pdf/Judgment%20of%20Jagot%20J%20dated%205%20November%202012%20re_%20Local%20Government%20Financial%20Services%20Pty%20Ltd%20%28No%205%29.pdf (accessed 30 May 2013).

⁴ Fitch Investor Services, *Understanding Credit Ratings - Limitations and Usage*, http://www.fitchratings.com/jsp/general/RatingsDefinitions.faces?context=5&detail=509&context_In=5&detail_In=500 (accessed 30 May 2013).

⁵ For the example of the wrong downgrade of France cf. BBC News, *S & P accidentally announces downgrade of French debt*, BBC News of Nov. 10, 2011, <http://www.bbc.co.uk/news/business-15686580> (accessed 30 May 2013).

liability of rating agencies under different legal systems (II.), before examining the provision under Article 35a of the Draft Proposal and the following political decision-making process that led to the liability rule as it now stands more closely (III.) and arriving at conclusions how to analyze the liability matter in a more differentiated way (IV.).

II. Civil Liability of Credit Rating Agencies in a Comparative Perspective

A. Contractual Liability

In the European Member States there is no specific legislation governing contracts between issuers and credit rating agencies, so that the general rules of contract law will apply in full. As a result, one has to overcome some major obstacles in order to hold rating agencies liable for breach of contract. First of all, for the most relevant scenario of an investor claiming damages he suffered from a flawed rating there is no immediate contractual relation between him and the potential addressee of such a contractual claim, i.e. the rating agency rating the issue in question. As far as any contractual claim of the issuer against the credit rating agency is concerned, the underlying contracts always include an exclusion of liability in favour of the agency. Only under the French *Loi de régulation bancaire et financière* ('Law regulating banking and finance' or 'RBF Act')⁶, enacted on October 23, 2010, these contractual clauses will be deemed null and void.⁷ In light of these hurdles, one has to draw on specific doctrinal exceptions in order to lay a basis for a contractual claim.

B. Implicit Agreement in Favour of a Third Party

Under German law the debate on contractual liability of rating agencies centres on the potential existence of an implicit agreement between the issuer and the rating agency so as to protect the investors as third parties. The prevailing doctrine states certain requirements that have to be met in order to be able to rely on such a contractually based claim, so that the potential range of those potentially liable in contract does not grow to an unreasonable extent. That is why the claimant of such a contractual claim

⁶ Loi n° 2010-1249 du 22 octobre 2010 de régulation bancaire et financière, http://www.legifrance.gouv.fr/affichTexte.do;jsessionid=D180F17E5A1D3FA8F1211F195C5004F6.tpdj_o09v_2?cidTexte=JORFTEXT000022940663&categorieLien=id#JORFSCITA000022940671 (accessed 30 May 2013).

⁷ Art. L. 544-6. - Les clauses qui visent à exclure la responsabilité des agences de notation de crédit mentionnées à l'article L. 544-4 sont interdites et réputées non écrites.

has to find him-/herself in a creditor like position. In the case of the rating agencies the rating aims at the capital market and the investor, who is supposed to take it into account for his investment decision. At the same time, however, the interests of the investor and the issuer are not aligned. Whereas the issuer is interested in the highest possible rating, the investor would prefer a lower rating in the interest of a cheaper entry-level price. Therefore, the contractual conceptualization of the underlying relationships may seem a little far-fetched from a doctrinal point of view.

Hand in hand with this interest analysis goes a second requirement for a claim based on an implicit agreement in favour of the investor that seems problematic, that is the investor's specific vulnerability. Such a vulnerability is absent in the presence of another potentially liable party. In the case of investor losses it is generally the issuer who is insolvent and unable to satisfy his/her investors' claims. If now the investor can have recourse to the rating agency, there is no denying the fact that there is a danger that the insolvency risk is shifted to the rating agency.⁸

C. *Quasi-contractual Liability*

1. Special Expertise and Causation as a Basis for Liability under German Law
Without a contractually based relationship between the rating agency and the investor, the role of the rating agency as an expert in the capital market enters into play as a circumstance possibly constituting the basis for quasi-contractual liability. Under German law § 311 para. 3 sent. 2 of the German Civil Code explicitly states someone's liability, if he or she inspires confidence, thus favourably influencing contract negotiations or the conclusion of a contract. In its narrow sense, the legal definition of the pre-contractual liability under § 311 para. 3 sent. 2 of the German Civil Code suggests some immediate contact between the party held liable and the claimant. According to the German case law on the legal liability for statements in the prospectus such a specific basis for investors' typical reliance on the misstatements is even required for liability in this more common scenario.⁹

⁸ For the danger of such a risk shifting see R. Lemke, *Haftungsrechtliche Fragen des Ratingwesens – ein Regelungsproblem?*, 82-83 (Peter Lang 2000).

⁹ 77 BGHZ 172, 176-177 (BGH 22.5.1980); 111 BGHZ 314, 319-320 (BGH 31.5.1990); BGH, *Neue Juristische Wochenschrift-Rechtsprechungs-Report* (NJW-RR), 879, 883 (1992).

That is why one would have to state the factual requirements for the liability of credit rating agencies more loosely and primarily base it on the intermediary function of rating agencies as gatekeepers of the capital market.¹⁰ In fact, the success of the agencies' business model depends on network effects that make personal contacts unnecessary and are key to their fundamental self-interest. Another possible basis for a claim against rating agencies under German law not requiring any contractual ties between the parties would, of course, be tort liability under § 826 of the German Civil Code. This provision reaches beyond any particular category of gatekeepers and served as a basis for auditor and lawyer liability for example in the past.¹¹ On the other hand, 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.¹²

In addition to the basis of trust outlined above, issues of causation remain to be resolved under German law in order to establish a valid claim against a rating agency. These issues are very similar to the discussion about causation between a misleading statement and an investment decision in different liability cases based on a prospectus or ad hoc disclosure rules. In prospectus liability cases based on general civil law the courts start from the presumption that the securities would not have been acquired because the investor would have acted according to the given information, if no misleading statement had been made at the time of the acquisition ('aufklärungsrichtiges Verhalten').

¹⁰ For such a more loose basis of a pre-contractual liability based on reliance cf. W. Canaris, *Die Reichweite der Expertenhaftung gegenüber Dritten*, 163 *Zeitschrift für das gesamte Handelsrecht (ZHR)* 206, 220-221, 229 (1999); P. Krebs, *Sonderverbindung und außerdeliktsche Schutzpflichten*, 557 (Beck 2000); D. Looschelders, *Schuldrecht Allgemeiner Teil*, note 218 (8th ed., Franz Vahlen 2010); M. Plötner, *Die Rechtsfigur des Vertrags mit Schutzwirkung für Dritte und die sogenannte Expertenhaftung*, 286-287 (Duncker & Humblot 2003); for the qualification of rating agencies as gatekeepers cf. J. Coffee, *Gatekeepers; The Role of the Professions in Corporate Governance*, 2 (Oxford University Press 2006); A. Peters, *Die Haftung und die Regulierung von Rating-Agenturen*, 119-120 (Nomos 2001); for a different view cf. F. Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeeper*, 59, 60-61 (Y. Fuchita, R. Litan, *Financial Gatekeepers: Can They Protect Investors?*, Brookings Institution Press 2006).

¹¹ For auditor liability see BGH, *Neue Juristische Wochenschrift (NJW)* 1595 (1956); for lawyer liability see BGH, *Neue Juristische Wochenschrift (NJW)* 678, 680 (1972).

¹² BGH, *Neue Juristische Wochenschrift (NJW)* 3282, 3283 (1991); for further references see H. Hirte, *Berufshaftung*, 64-65 (C.H.Beck 1996).

On the other hand, causation required under ad hoc disclosure rules has differed considerably from this far-reaching presumption. In these cases claims for violation of the obligation to disclose current reports (ad-hoc-publicity), the delay in the disclosure of insider information (§ 37b Wertpapierhandelsgesetz), and the publication of misleading insider information (§ 37c Wertpapierhandelsgesetz) are at stake. In these instances the German Federal Court of Justice used to require proof of actual reliance, refusing to adopt any reasoning along the lines of the American fraud-on-the-market-theory.¹³ Recently, on the occasion of the *IKB* case in December 2011 the Court changed its case law presuming relevance of information for securities prices in highly volatile markets, thus adopting the fraud-on-the-market-theory for the area of ad hoc disclosures regulated by the Securities Trading Act (Wertpapierhandelsgesetz).¹⁴ Dutch law seems to be based on similar considerations because in the *World Online* decision the Dutch Supreme Court requires proof of a causal connection between the misstatement in a prospectus and the investment decision, but at the same time brings to bear a presumption of reliance.¹⁵ Under German law, in this narrow sense the requirements for quasi-contractual liability are not met in the rating scenario under discussion. At the same time, there are loopholes that could serve as points of departure to introduce some kind of gatekeeper liability of rating agencies in analogy to liability for misstatements in a prospectus based on general German civil law.¹⁶

¹³ *ComROAD I* and *II*, BGH, Neue Zeitschrift für Gesellschaftsrecht (NZG) 345 and 346 (2007); *ComROAD III*, BGH, Neue Zeitschrift für Gesellschaftsrecht (NZG) 269 (2007); *ComROAD IV*, BGH, Wertpapier-Mitteilungen (WM) 1557 (2007); *ComROAD V*, BGH, Neue Zeitschrift für Gesellschaftsrecht (NZG) 708; *ComROAD VI* (2007), BGH, Neue Zeitschrift für Gesellschaftsrecht (NZG) 382, 383 (2008); *ComROAD VII*, BGH, Neue Zeitschrift für Gesellschaftsrecht (NZG) 385 (2008); *ComROAD VIII*, BGH, Neue Zeitschrift für Gesellschaftsrecht (NZG) 386 (2008); see also J. Hennrichs, in: Festschr. Hadding, 875, 891; T. Möllers, *Kausalität für den Differenzschaden und uferlose Haftungsausdehnung- Comroad I – VIII*, Neue Zeitschrift für Gesellschaftsrecht, 413 (2008); with reference to the liability issue in the rating sector e.g. K.-P. Berger and M. Stemper, *Haftung von Ratingagenturen gegenüber Anlegern*, Wertpapier-Mitteilungen (WM), 2289, 2294 (2010); not quite precisely however G. Wildmoser, J. Schiffer and B. Langoth, *Haftung von Ratingagenturen gegenüber Anlegern*, Recht der Internationalen Wirtschaft 657, 664 (2009).

¹⁴ *IKB*, BGH, Zeitschrift für Wirtschaftsrecht (ZIP) 318 (2012); for the foundations of the fraud on the market theory in US law see *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); with regard to the situation under German law after the *IKB*-decision Bachmann, *Anmerkung*, JuristenZeitung (JZ) 571 (2012); Klöhn, *Die Haftung wegen fehlerhafter Ad-hoc-Publizität gem. §§ 37b, 37c WpHG nach dem IKB-Urteil des BGH*, Die Aktiengesellschaft (AG) 345, 356 (2012); Wagner, *Die Haftung von Ratingagenturen gegenüber dem Anlegerpublikum*, Festschrift Blaurock, 467, 495 (Mohr Siebeck 2013).

¹⁵ *VEB e.a. / World Online e.a.*, Hoge Raad, Nov. 27, 2009, JOR 2010/43; for a further analysis of these particular aspects of this decision cf. B. de Jong, *Liability for Misrepresentation – European Lessons on Causation from the Netherlands*, 8 European Company and Financial Law Review (ECFLR) 352, 364-366 (2011).

¹⁶ B. Haar, *Haftung für fehlerhafte Ratings – Ein neuer Baustein für ein verbessertes Regulierungsdesign für Ratingagenturen?* Neue Zeitschrift für Gesellschaftsrecht (NZG), 1281, 1284-1285 (2010).

2. Liability in Different EU Member States

Credit rating agencies' liability for flawed ratings has been on the agenda in quite a few other EU Member States and the debate has intensified lately against the background of the proposal of a civil liability rule based on the amendment of the EU Rating Regulation. The French legislator, for instance, has already adopted a liability framework somewhat similar to the one envisioned by the Draft Proposal. Under Article L. 544-5 of the Monetary and Financial Code credit agencies can be held liable for damages either in tort or in quasi-tort by clients and third parties, if they are at fault or neglect to implement the provisions of the EU Rating Regulation.¹⁷ The French case law on civil liability for misstatements in prospectuses, however, is based on the comprehensive tort law liability clause in Art. 1382 of the Code Civil and Art. 225-252 of the Code de Commerce.¹⁸ In the United Kingdom issuer liability for misstatements made to the market other than through prospectuses has been codified in the newly inserted section 90A and Schedule 10A of the Financial Services and Markets Act in 2010.¹⁹ At the same time, with regard to the liability of rating agencies, authors refer to the common law 'promissory estoppel' doctrine²⁰ or to tort law²¹ as possible bases for liability claims against rating agencies in order to avoid privity of contract limitations.²²

¹⁷ Art. L. 544-5. - Les agences de notation de crédit mentionnées à l'article L. 544-4 engagent leur responsabilité délictuelle et quasi délictuelle, tant à l'égard de leurs clients que des tiers, des conséquences dommageables des fautes et manquements par elles commis dans la mise en œuvre des obligations définies dans le règlement (CE) n° 1060/2009 du Parlement européen et du Conseil, du 16 septembre 2009, précité.

¹⁸ Recent important cases include *Regina Rubens et Séverine Chapelier*, Paris, Cour d'appel, 14.09.2007), *Sidel*, Paris, Cour d'appel, 17.10.2007; *Vivendi*, Paris, Tribunal correctionnel 21.1.2011 (cf. Garrigues/Dezeuze/Ronchtchevsky, [2008] *Revue Trimestrielle de Droit Financier* 137; Hopt, *Die Haftung für Kapitalmarktinformationen*, Wertpapiermitteilungen (WM) 101 (2013).

¹⁹ Statutory Instruments 2010, 1192. Financial Services and Markets Act 2000, Regulations 2010.

²⁰ For the necessary requirements cf. Section 90 of the Second Restatement of Contracts which states: 'A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by the enforcement of the promise.' (Restatement [Second] of Contracts § 90 [1981]); see e.g. K. Nelson, *Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007/2008?* 63 U. Miami L. Rev. 1191-1196 (2009); A. Miglionico, *Enhancing the Regulation of Credit Rating Agencies, in Search for a Method*, 72-74, University of London, The Center for Financial and Management Studies, Research Paper 089_DP105 (July 2012), <http://www.cefims.ac.uk/documents/research-99.pdf> (accessed 30 May 2013).

²¹ O. v. Schweinitz, *Rating Agencies: Their Business, Regulation, and Liability under U.S., U.K., and German Law* (Unlimited Publishing 2007).

²² A. Miglionico, *Enhancing the Regulation of Credit Rating Agencies, in Search for a Method*, 72-74, University of London, The Center for Financial and Management Studies, Research Paper 089_DP105 (July 2012), <http://www.cefims.ac.uk/documents/research-99.pdf> (accessed 30 May 2013).

3. Reforms and Changes in US and Australian Law

a) US Law

Prior to the enactment of the Dodd-Frank Act²³, US case law centred on an argument different from privity of contract in order to deny rating agencies' liability, that is the First Amendment defence.²⁴ In order to avoid liability, rating agencies generally argued to be members of the press.²⁵ Therefore ratings had to be looked at as opinions to be protected under a heightened malice standard.²⁶ Despite this general protection, recently after the financial crisis there were unsuccessful attempts to raise this defence, when the agency was found to have been an active participant in structuring the proposed transaction²⁷ or to have been subject to conflicts of interest resulting from this role or from the fee structure underlying this issue and amounting to a contingent fee and the resulting improper motivation.²⁸ In the latter case the rating was only paid if the rating was actually used in the offering.

In light of these obstacles to plaintiffs bringing suits against credit rating agencies, in the aftermath of the financial crisis the US legislator introduced a private cause of action in the Dodd-Frank Act under which 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.²⁹ More importantly, Dodd-Frank included a repeal of Rule 436(g) of the Securities Act of 1933, thus subjecting rating agencies to 'expert liability' for misleading statements in registration statements under Section 11 of the 1933 Securities Act. Under such an expert liability according to

²³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (2010).

²⁴ For the prevailing case law on the protection of rating agencies under the First Amendment see C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 Cardozo L. Rev. 1553, 1689-1690 (2008); C. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L. Qu. 43, 56-57 (2004); T. Nagy, *Credit rating agencies and the First Amendment: applying constitutional journalistic protections to subprime mortgage litigation*, 94 Minn. L. Rev. 140-167 (2009).

²⁵ See e.g. T. Pate, *Triple-A ratings stench: may the credit rating agencies be held accountable?* 14 Barry L. Rev. 25, 45 (2010).

²⁶ *New York Times Co. v. Sullivan*, 376 U.S., 254 (1964); in the rating sector see *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 753 (citing *Sullivan*, 376 U.S. 254)

²⁷ *Cal. Pub. Employees' Retirement Sys. v. Moody's Corp.*, No. CGC-09-490241 (Cal. App. Dept' Super. Ct. July 9, 2009) § 47, 38, <http://online.wsj.com/public/resources/documents/calpers.pdf> (accessed 30 May 2013); for a detailed analysis cf. N. Ellis, L. Fairchild and F. D'Souza, *Conflicts of interest in the Credit Rating Industry after Dodd-Frank: Continued Business as Usual?*, 17 Stan. J.L. Bus. & Fin. 175, 203-210 (2012); D. Grais and K. Katsiris, *Not „The World's Shortest Editorial“: Why the First Amendment Does not Shield the Rating Agencies from Liability for Over-Rating CDOs*, Bloomberg L. Rep., (12 Nov. 2007), 40, 41.

²⁸ *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155, 166-167, 179-180 (S.D.N.Y. 2009).

²⁹ Dodd-Frank § 933.

Section 11 an expert is held liable except in cases where he shows that he met the due diligence requirement, i.e. that he had, ‘after reasonable investigation, reasonable ground to believe and did believe’ that there were no misstatements or omissions of material facts in the portions of the registration statement he prepared.³⁰

The implementation of this newly created liability turned out to be difficult and the repeal does not have the previously hoped for effect as regulatory behaviour control. The major rating agencies refused to have their ratings included in registration statements, so that issuers were unable to include them in their registration statements as prescribed by Regulation AB.³¹ A virtual standstill in the market for asset-backed securities resulted.³² As a consequence, the SEC found itself forced to release a no-action letter to avoid enforcement actions so long as the amendment could not be effectively implemented on July 22, 2010, which was to be applied until January 24, 2011. But even after that date, there has not been any evidence of activities of the SEC to bring enforcement practices in line with the newly introduced expert liability of rating agencies as provided for after the repeal of Rule 436(g) of the Securities Act, despite some officials’, such as Massachusetts Attorney General Martha Coakley’s pushing towards enforcement.³³ As a consequence of the no-action letter, on the one hand, it is true that the probability of SEC action has decreased, without however altering the technical requirements of Regulation AB. Therefore issuers who do not include ratings in their registration statement in reliance on the SEC’s no-action letter may be subject to investor claims of noncompliance with Regulation AB. As a result, the repeal of Rule 436(g) has created a dilemma in the sense that it results in either party’s liability, depending on whether the ratings are included or not, without actually clarifying the crucial issues of the liability problem. In the long run, it may even go so far as to make issuers rely on private placements, to which Rule 144A of the Securities

³⁰ Dodd-Frank/Securities Act 15 U.S.C. § 77k (b)(3)(B)(i).

³¹ SEC Regulation AB §§ 1103 and 1120, 17 C.F.R. § 229.1100.

³² B. Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 N.C. Banking Inst. 111 (2011).

³³ Letter from Martha Coakley, Attorney General of Massachusetts, to Mary Shapiro, Chairman of Securities and Exchange Commission (March 1st, 2011), <http://www.mass.gov/ago/docs/press/2011/2011-03-07-sec-letter-attachment1.pdf> (accessed 30 May 2013).

Act³⁴ and a safe harbour from registration requirements applies. As a result, these investment opportunities would not be open any more for retail investors.³⁵

b) Landmark Decision against Standard & Poor's of the Federal Court of Australia

At the other end of the world quite opposite changes have come about in the field of the liability of rating agencies. In *Bathurst Regional Council v. Local Government Financial Services Pty Ltd (No. 5)*³⁶ the Federal Court of Australia has overcome some of the well-known obstacles to civil liability of rating agencies as stated above, holding Standard & Poor's liable for its triple-A rating of complex financial products in 2006. In the underlying lawsuit the financial advisor Local Government Financial Services (LGFS), the investment bank ABN Amro, and Standard & Poor's were found liable for the losses suffered by thirteen local councils arising from the sale and purchase of a structured financial product known as the Rembrandt 2006-3 constant proportion debt obligation (CPDO). The councils based their claim on the contention of misleading and deceptive conduct with regard to financial products on the part of Standard & Poor's. As it has been common in the liability cases in the US, Standard & Poor's again referred to the disclaimers in the pre-sale and post-sale reports asserting that a rating is a statement of opinion.³⁷ Justice Jayne Jagot, however, refused to bring to bear the protection of the freedom of expression, so that rating agencies would be able to escape liability, distinguishing between this case and the relevant US case law, thus laying a basis for holding Standard & Poor's liable for misrepresenting that its rating was based on reasonable grounds and the product of the exercise of reasonable care.³⁸

Against this background the court looked at the misrepresentation claims raised against Standard & Poor's by both the LGFS and the councils. According to the court, the basis for Standard & Poor's misleading and deceptive conduct was the representation that this opinion had been reached on a reasonable basis and as a result of an exercise of

³⁴ 17 Code of Federal Regulations (C.F.R.) § 230.144A (2013).

³⁵ 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 J. of Structured Fin. 34, 44 (2011).

³⁶ *Bathurst Regional Council v. Local Government Financial Services Pty Ltd (No. 5)*, [2012] FCA 1200, http://www.imf.com.au/pdf/Judgment%20of%20Jagot%20J%20dated%205%20November%202012%20re_%20Local%20Government%20Financial%20Services%20Pty%20Ltd%20%28No%205%29.pdf (accessed 30 May 2013).

³⁷ *Ibid.* notes 2416-2418.

³⁸ *Ibid.* notes 2800-2802.

reasonable care.³⁹ Pointing out the modelling inputs used by Standard & Poor's, which would not have been used by any reasonable rating agency, and the underlying assumptions substantially more favourable to the performance of the CPDOs than the actual economic conditions, the court was satisfied by the evidence. The same applied to the knowledge on the part of Standard & Poor's that its representation was not true. Since Standard & Poor's failed to show a lack of due care and skill as well as unreasonable reliance on the triple-A rating on the part of the councils, the court found that Standard & Poor's rating was misleading and deceptive.⁴⁰

The main issue about the negligence claim also raised against Standard & Poor's was the question whether the rating agency owed a duty of care to potential buyers of the Rembrandt notes.⁴¹ Similarly to the argument made in the context of the privity of contract mentioned above, the Australian judge focuses on the primary goal of the issuer, which is to obtain the rating for communication purposes with regard to the investors as a basis for the latter's investment decisions.⁴² In contrast to the case law in the different member states cited above, as for the necessary causation the Australian court considered it sufficient to show that the triple-A rating was one of two principal reasons for the councils' agreement to invest in the Rembrandt notes besides the LGFS' recommendation.⁴³

Looking at the overall perspective of the court in this case and the standard of proof that seems to be lower than in the cases above, there is some indication that the reasoning may imply certain parallels to product liability law.⁴⁴ By referring to the objective standardized qualities of a rating when dismissing the First Amendment defense, the court is looking upon ratings as products. What is more, in the following analysis it brings to bear lower standards of proof than those applied in the applicable rules and cases mentioned above. Similarly to product liability cases, investors in *Bathurst Regional Council v. Local Government Financial Services Pty Ltd* had to prove that the

³⁹ *Ibid.* notes 2416-2418.

⁴⁰ *Ibid.* notes 1833-1840.

⁴¹ *Ibid.* notes 2455-2460.

⁴² *Ibid.* note 2455.

⁴³ *Ibid.* note 2458.

⁴⁴ For proposals to extend the doctrine of defective products liability to intangible consumer credit products cf. O. Bar-Gill/E. Warren, *Making Credit Safer*, 157 Penn. L. Rev. 1-101 (2008); A. Goldstein, *Why 'It Pays' to 'Leave Home Without It': Examining the Legal Culpability of Credit card Issuers under Tort Principles of Products Liability*, U. Ill. L. Rev. 827 (2006).

rating was defective, they were foreseeable third-party users, and they were harmed by these defective products. They were able to prove the defect of the ratings by simply showing that modelling inputs and underlying assumptions did not meet the necessary standard, and the proof of the exercise of due care and skill was lying with Standard & Poor's. Against this background, bringing to bear the legal framework of product liability, it appeared reasonable for the court to determine that the ratings were harmful defective products and therefore hold Standard & Poor's strictly liable for the ratings. The finding of actually misleading and deceptive conduct can only play a role in the sense that it may cap liability, when the defendant proves that such conduct is missing.

In summary, in *Bathurst Regional Council v. Local Government Financial Services Pty Ltd* the Federal Court of Australia has overcome well-known hurdles to lay a legal foundation for the civil liability of rating agencies, so that more litigation and new actions can be expected to follow this landmark decision not only in Australia, but at least in those countries where this type of products was misrated as well.⁴⁵ Only on February 4, 2013, the US Department of Justice filed a lawsuit, seeking civil penalties in the amount of \$ 5 billion against Standard & Poor's because the latter defrauded investors during the financial crisis.⁴⁶ Hand in hand with it more lawsuits were brought by private parties, such as the Abu Dhabi Commercial Bank and King County Washington, which were just like the DoJ claim settled before the scheduled start of the trial.⁴⁷ In Germany the Federal Court of Justice confirmed jurisdiction of the Higher Regional Court Frankfurt for a lawsuit a retail investor filed against Standard & Poor's based on the sufficiently close domestic nexus required under case law because of the

⁴⁵ P. Durkin and H. Low, *IMF talks of new wave of litigation*, Australian Financial Review (7 Nov. 2012), 14; D. Fickling and M. Robinson, *McGraw-Hill Plummets After Australian Court Ruling*, Bloomberg 5 Nov. 2012), <http://www.bloomberg.com/news/2012-11-04/s-p-found-liable-by-australian-court-for-misleading-ratings.html> (accessed 30 May 2013); Author not named, *Australian Court issues landmark judgment against S&P*, Telegraph (5 Nov. 2012), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9655922/Australian-court-issues-landmark-judgment-against-SandP.html> (accessed 30 May 2013).

⁴⁶ *United States v. McGraw-Hill Cos., Standard & Poor's Financial Services LLC*, Complaint for Civil money penalties and jury trial, Case No. CV13-00779, <http://www.justice.gov/opa/pr/2013/February/13-ag-156.html> (accessed 30 May 2013).

⁴⁷ S. Foley, *Standard & Poor's and Moody's settle US subprime lawsuits*, Financial Times, April 27, 2013, <http://www.ft.com/intl/cms/s/0/d44c4d34-73ba-11e2-9e92-00144feabdc0.html#axzz2UsdoZc5E> (accessed 30 May 2013); Author Not Named, *Credit Rating Agencies Settle 2 Suits Brought by Investors*, New York Times, April 28, 2013, p. A 4, <http://www.nytimes.com/2013/04/28/business/credit-rating-agencies-settle-lawsuits-over-debt-vehicles.html?ref=standardandpoors> (accessed 30 May 2013).

plaintiff's domicile in Germany and his German nationality, thus laying the ground for liability claims against Standard & Poor's in Germany as well.⁴⁸

III. Procedural Facilitation as a Basis for Liability in Article 35a of the Amendment of the European Rating Regulation (CRA3)

A. Article 35a of the European Commission's Draft Proposal

In light of the serious flaws in the Big Three's ratings and their contribution to the financial crisis as well as their involvement in the sovereign debt crisis, in its CRA3 Draft Proposal of 2011 the European Commission included a very strict liability rule in Article 35a in order to avoid the shortcomings of existing liability rules as just put forward and to ensure the accountability of rating agencies for their ratings.⁴⁹ This becomes apparent from the following key points of this liability provision and their amendments throughout the draft's passage through the European Parliament, which therefore call for a closer analysis.

As a starting point, under Article 35a para. 1 of the Draft Proposal any 'infringement... listed in Annex III having an impact on a credit rating on which an investor has relied when purchasing a rated instrument' will be suitable to trigger liability of the 'credit rating agency for any damage caused to the investor'.⁵⁰ Without more these requirements do not necessarily facilitate the pursuit of legal remedies for investors because the investor is entitled to damages, only if the infringement has had an impact on the rating and he/she has relied on this rating and there has been causation between the infringement and the investor's damages (Article 35a para. 1 of the Draft Proposal). As has become apparent at the example of the different legal systems looked at above, these additional requirements have proved to be serious obstacles to rating agencies' liability. That is why the procedural facilitation that was included in Article 35a paras 2-4 of the Draft Proposal turns to be the actual trigger of liability.⁵¹

What is most important is the shift in the burden of proof according to Article 35a para. 4, so that it is sufficient for the investor to establish 'facts from which it may be inferred that a credit rating agency has committed any of the infringements' and the burden is on

⁴⁸ BGH (December 13, 2012), *Verbraucher und Recht* (VuR) 94 (2013).

⁴⁹ COM (2011) 747 fin. (15 Nov. 2011).

⁵⁰ COM (2011) 747 fin (15 Nov. 2011), 33.

⁵¹ COM (2011) 747 fin. (15 Nov. 2011), 33.

the credit rating agency to prove that it has not committed that infringement or that that infringement did not have an impact on the issued credit rating". At the bottom line, under this provision rating agencies have to provide proof of the flawlessness of their ratings, eventually putting them under pressure to disclose their methods and modeling inputs.⁵² This is very much at odds with the limits of disclosure duties as stated in the EU Rating Regulation of 2009, which should not jeopardize trade secrets nor impede innovation.⁵³ Such a disclosure might eliminate competition for the best rating methods,⁵⁴ thus thwarting the desired goal of the European Commission to strengthen competition and revealing the structural problems in the rating sector.⁵⁵ What is even more detrimental to competition, when it comes to the implementation of such a far-reaching liability rule, is its potential deterring effect on market entry of new competitors, who will shy away from these high liability risks. In addition, far-reaching liability will have a chilling effect on capital markets because, as has been seen in the aftermath of the passage of Dodd-Frank and the expert liability imposed on rating agencies, the latter may be reluctant to rate some financial instruments at all.⁵⁶ Looking at the reversal of the burden of proof more generally, in light of the complexity of the rating regulations, an investor will always find some questionable practice to exploit as an infringement, and under the Draft Proposal the rating agencies would then have to carry the burden of proof to establish their innocence.

⁵² S. Fischer, *Haftungsfragen des Ratings*, 67-68 (Dr. Kovac 2007); K. Serfing and A. Pries, *Möglichkeiten und Grenzen des Rating*, Die Bank 381 (1990); E. Vetter, *Rechtsprobleme des externen Ratings*, Wertpapier-Mitteilungen (WM), 1701, 1707 (2004).

⁵³ EU Regulation (EC) No 1060/2009 on credit rating agencies of 16.9.2009, Consideration 25, OJ EU L 302, 3.

⁵⁴ B. Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? Zur Regulierung und ihrer Implementierung im Ratingsektor*, 21 Zeitschrift für Bankrecht und Bankwirtschaft, 177, 182 (2009).

⁵⁵ EU Commission, Regulation of the European Parliament and of the Council to Amending Regulation (EC) No 1060/2009 on credit rating agencies, COM (2011) 747 fin. (Nov. 15, 2011), 5, 12.

⁵⁶ See s. II.C.3.a) *supra*; with regard to the liability rule included in Art. 35a of the Draft Proposal see e.g. Bundesverband der Deutschen Industrie, Deutsches Aktieninstitut, Verband Deutscher Treasurers; Kommentar von DAI, BDI und VDT zum Bericht des Ausschusses für Wirtschaft und Währung im Europäischen Parlament zum Vorschlag der Europäischen Kommission für eine „Verordnung des Europäischen Parlaments und des Rates zur Änderung der Verordnung (EG) Nr. 1060/2009 über Ratingagenturen“, Frankfurt M., Berlin, 14 Sep. 2012, http://www.dai.de/files/dai_usercontent/dokumente/positionspapiere/2012-9-14%20DAI-BDI-VDT%20Kommentar%20zum%20ECON-Bericht%20CRA%20III.pdf (accessed 30 May 2013); R. von Rosen, *Die Pläne der EU-Kommission zur Regulierung der Ratingagenturen schaffen nur neue Probleme*, Süddeutsche Zeitung, 18 (13 Apr. 2012).

B. Amendments by the Council of the European Union and by the European Parliament

1. The General Approach of the Council of the European Union
Therefore it comes as no surprise that this stringent liability rule has encountered incisive criticism not only from interest-groups, but also from the other European institutions involved in the legislative process, which have therefore presented alternative amendments. In its general approach on the subject of the Draft Proposal of May 25, 2012 the European Council provided for a considerable alleviation of the liability rule conceived by the European Commission in the Draft Proposal.⁵⁷ In effect, the general approach does away with the reversal of the burden of proof, so that under this approach damages may be claimed only if the investor or issuer establishes an infringement intentionally or grossly negligently committed by an agency that has an impact on a rating, reasonable reliance on that rating for an investment decision and causation between the infringement and the damages suffered by him.⁵⁸ Furthermore, within reasonable limits liability can be limited in advance under Article 35a para. 5 of the general approach. By giving Member States some leeway to interpret open-ended terms of the liability rule in accordance with the applicable national law in Article 35a para. 6 of the common approach, indirect reference is made to the national laws outlined above. As a result, the shortcomings of the traditional national liability provisions, such as the difficulties of proof and the causation issue remain unresolved.⁵⁹

2. The Amendments introduced by the European Parliament
This alleviation of liability in the general approach of the Council of the European Union of May 25, 2012 was again modified and a stricter version was proposed in its report by the Committee on Economic and Monetary Affairs on the Draft Proposal of August 23, 2012.⁶⁰ As becomes clear from this report, the European Parliament and the Legal Affairs Committee in particular have favoured the inclusion of common civil liability rules for deliberate and negligent infringements of the rules of the EU Rating Regulation. At

⁵⁷ Council of the European Union, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies, General approach*, Interinstitutional File 2011/0361 (COD), Brussels, 25 May 2012, <http://register.consilium.europa.eu/pdf/en/12/st10/st10452.en12.pdf> (accessed 30 May 2013).

⁵⁸ *Ibid.*, p. 44-45.

⁵⁹ See s. II.C.1. and 2 *supra*.

⁶⁰ European Parliament, Committee on Economic and Monetary Affairs, *Report on the proposal of Aug. 23, 2012. for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD))*, 23 Aug. 2012, A7-0221/2012, <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2012-0221+0+DOC+PDF+V0//EN> (accessed 30 May 2013).

the same time, they consider some changes necessary to ensure an appropriate balance between the different stakeholders involved.⁶¹ This is why the Committee on Legal Affairs proposes in its amendments of Article 35a that the reversal of the burden of proof on credit rating agencies should be struck down.⁶² In order to ensure coherence between civil liability proceedings and the existing supervisory measures of ESMA, the Committee on Legal Affairs also suggests that the court seized demand the opinion of ESMA and take into consideration any formal ESMA decision (Amendment Article 35a para. 3).⁶³ As far as the causation issue is concerned, the report considers a reversal of burden of proof inappropriate, so that under the amendment of Article 35a para. 4 the burden shall be on the investor to prove causation between the infringement and the impact on the issued rating and between the rating and his investment decision.⁶⁴ Furthermore, the report includes two amendments aiming for the consideration of national laws and courts in liability cases. The amendment to Article 35a para. 5a (new) declares ‘the civil liability regime of the Member State in which the investor sustaining the damage had his or her habitual residence when the damage occurred’ to be applicable.⁶⁵ In addition, jurisdiction shall lie with ‘the Member State in which the investor sustaining the damage had his or her domicile when the damage occurred’ according to the amendment of Article 35a para. 6 of the Committee of Legal Affairs.⁶⁶

C. The Liability Regime under the Amendment of the EU Rating Regulation as Adopted by the European Parliament in January 2013

Despite this wide range of proposals to amend the Draft Proposal of the EU Commission, on January 16, 2013 the European Parliament adopted the Amendment of the EU Rating Regulation, after the negotiations between the European Commission, the European Council, and the European Parliament had been concluded in early December 2012.⁶⁷ Under Art. 35a para. 1 of this amendment an investor can claim damages, if a credit rating

⁶¹ *Ibid.* 82.

⁶² *Ibid.* 83.

⁶³ *Ibid.* 83 and 84.

⁶⁴ *Ibid.* 83 and 84.

⁶⁵ *Ibid.* 68.

⁶⁶ *Ibid.* 85.

⁶⁷ *Position of the European Parliament*, 16, January 2013, adopted at first reading on 16 January with a view to the adoption of Regulation (EU) No. .../2013 of the European Parliament and the council amending Regulation (EC) No. 1060/2009 on credit rating agencies (EP-PE TC1-COD(2011)0361), <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TC+P7-TC1-COD-2011-0361+0+DOC+PDF+V0//EN> (accessed 30 May 2013); European Commission, *Press Release: Statement by Commissioner Michel Barnier following the agreement in trilogue of new European rules to regulate credit rating agencies*, Memo/12/911, Brussels, 27 Nov. 2012; for the finally adopted regulation see 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 L 146, 1

agency has committed intentionally or with gross negligence any of the infringement listed in Annex III having an impact on a credit rating.

As it had already become apparent throughout the process leading to the final adoption of the amendment by the European Parliament, the significance of this liability rule only fully emerges, once enforcement is considered. First, under Art 35a para. 2 of the amendment (Art. 35a para. 1 sent. 2 of Regulation [EU] No. 462/2013) the investor has to establish reasonable reliance in compliance with the newly inserted Art. 5a, which aims at mitigating over-reliance on credit ratings by financial institutions, or otherwise with due care on a credit rating for an investment decision covered by that credit rating. As has been shown above, before it comes to showing the reasonableness of reliance, first and foremost the allocation of the burden of proof and the closely related causation issue are crucial. On this matter Art. 35a para. 4 of the amendment (Art. 35a para. 1 sent. 2 of Regulation [EU] No. 462/2013) declares the investor or issuer responsible “... to present accurate and detailed information indicating that the credit rating agency has committed an infringement of ... (the) Regulation, and that that infringement had an impact on the credit rating issued.” By assigning the authority to determine what constitutes accurate and detailed information to the courts of the Member States, Art. 35a para. 4 sent. 2 of the amendment (Art. 35a para. 2 sent. 2 of Regulation [EU] No. 462/2013) slightly indicates what may develop a much higher impact in Art. 35a para. 5a (Art. 35a para. 4 sent. 1 of Regulation [EU] No. 462/2013). This latter provision states that the terms “...’damage’, ‘intention’, ‘gross negligence’, ‘due care’, ‘impact’, reasonable’ and ‘proportionate’ which are referred to in...” Art. 35a are interpreted in accordance with the applicable national law, without being defined in the regulation.

Overall the finally adopted liability rule in Art. 35a of the amendment of the EU Rating Regulation includes features specific to both contributions to the preceding political decision-making process discussed above, both the general approach of the Council of the European Union⁶⁸ and the amendments introduced by the European Parliament⁶⁹, thus bearing traits of a political compromise. The considerable priority attached to the national laws of the Member States is consistent with Art. 35a para. 6 of the general approach of the Council to leave leeway for interpretation of open-ended terms to the Member States, whereas the proposal to include ESMA in civil liability proceedings to ensure coherence in Art. 35a para. 3 of the amendments introduced by the European Parliament was not

⁶⁸ III.B.

⁶⁹ III.C.

adopted. In addition, the removal of the reversal of the burden of proof from the liability rule as proposed in the general approach and the amendments seems to have been upheld by the finally adopted version of Art. 35a. Under the newly adopted Art. 35a para. 2 of Regulation [EU] No. 462/2013 the investor has to “...present accurate and detailed information indicating that the credit rating agency has committed an infringement of ... (the) Regulation, and that that infringement had an impact on the credit rating issued”.

As far as this latter point is concerned, the liability rule could turn out to be rather toothless depending on what degree of accurateness and detail of information is required of investors to prove an infringement of the regulation and an impact of the latter on the credit rating. By leaving the definition of the decisive standard to the national laws of the Member States in Art. 35a para. 4 sent. 2 and para. 5a (Art. 35a para. 2 sent. 2 and para. 4 of Regulation [EU] No. 462/2013) the European Parliament seems to delegate the actual decision on whether to impose civil liability on credit rating agencies to the Member States as well. The defining questions to arrive at a convincing liability concept in the rating sector are not answered. Looking at the impact of such a liability rule on the Common Market in a more general respect, even more serious flaws of this rule become apparent. Since a lot remains to be determined by national laws, Member States’ reputation could come into play as regards the effective regulation of financial markets despite EU-wide regulation. In case of a Member State taking a tough stance, the negative consequences for its capital market are self-evident and therefore questions as to the impact on an open market for capital in the European Union may be raised..⁷⁰ In light of these yet open problems the newly inserted Art. 35a of the amendment of the EU Rating Regulation is far from resolving the liability issue in the rating sector.

IV. Main Parameters of an Effective Liability Rule in the Rating Sector

In light of the dangers of an excessive liability of rating agencies to the capital markets and companies’ ability to raise capital, some careful analysis seems to be in order as to

⁷⁰ For similar concerns about potential consequences of fragmentation of European supervision cf. M. Lamandini, *Credit Rating Agencies (CRAs) and European Regulation*, 6 *European Company Law*, 131, 133 (2009).

whether such a manipulation with capital markets eliminates more serious distortions resulting from flawed ratings.⁷¹

A. *Excessive Liability Versus Immunity – The Causation Issue*

1. Dangers of Excessive Liability

Talking about market mechanisms, with regard to investors the point of departure of the analysis is the benefit the latter receive from ratings without payment under the issuer pay model. Therefore the question must be raised whether this has to be taken into account for the calculation of damages because some equivalence between liability and costs seems to be called for. In addition, ratings do not necessarily only lead to immediate financial loss on the part of the investor, as is the case if the issuer benefits from the flawed unjustifiably positive rating and receives a higher payment from the investor. Damages are different, when it comes to transactions in the secondary market which are influenced by flawed ratings. In these latter cases, the financial loss of the acquirer is compensated by the gain in the security price for the seller, so that the damage can be looked at as a matter of redistribution rather than an actual loss of resources.⁷² Therefore one may wonder whether to take into account these flawed ratings that from a macroeconomic point of view have not lead to a loss of value. It is true that the latter may result from the misallocation of capital and the deterioration of capital market integrity.⁷³ These losses are, however, hardly quantifiable and therefore it seems unjustifiable to put them on one level with a loss of resources because over-deterrence may result.

2. Limits to Immunity

In light of these dangers of excessive liability, the privity limitations common in a lot of legal systems seem plausible.⁷⁴ At first sight the same may hold true for the required

⁷¹ B. Haar, *Haftung für fehlerhafte Ratings von Lehman-Zertifikaten – Ein neuer Baustein für ein verbessertes Regulierungsdesign im Ratingsektor?* Neue Zeitschrift für Gesellschaftsrecht, 1281, 1284 (2010).

⁷² For this differentiation see T. Baums and C. Fischer, *Haftung des Prospekt- und des Abschlussprüfers gegenüber den Anlegern*, 25, 40, 47 (F. Richter, A. Schüler and B. Schwetzler, *Kapitalgeberansprüche, Marktwertorientierung und Unternehmenswert*, Festschrift für Jochen Drukarczyk 2003); from an economic perspective cf. J. Bigus and H.B. Schäfer, *Die Haftung des Wirtschaftsprüfers am Primär- und Sekundärmarkt. Eine rechtsökonomische Analyse*, 77 *Zeitschrift für Betriebswirtschaft*, 19-49 (2007).

⁷³ H.-B. Schäfer, *Haftung für fehlerhafte Wertgutachten aus wirtschaftswissenschaftlicher Perspektive*, 202 *Archiv für die civilistische Praxis* 809, 814 (2002); similarly G. Wagner, *Die Haftung von Ratingagenturen gegenüber dem Anlegerpublikum*, 467 (P. Jung, P. Lambrecht, Katrin Blasek and M. Schmidt-Kessel, *Einheit und Vielheit im Unternehmensrecht*, Festschrift Blaurock, 2013).

⁷⁴ See s. II.C.1. and 2 *supra*.

proof of causation or reliance. At the same time, as has been seen at the example of the German case law on investor reliance, these requirements can eliminate liability altogether. Therefore a less onerous burden of proof may be justified. The general application of the fraud-on-the-market theory, however, may extend liability without reasonable bounds, even though capital market integrity may lie within the protective aim of the civil liability regime, as stated above. In addition, one may find this standard increasingly unconvincing, considering the growing evidence of systematic deviation of investor behaviour from the rationality hypothesis. These objections can, however, be mitigated to a certain degree, if the recoverable damages are restricted to the excess amount the investor paid, but do not include restitution after total loss of the investment.⁷⁵ Under this approach the causation issue mixes with aspects of liability caps which for purposes of analytical clarity shall be treated separately.

B. *Liability Caps*

Another important parameter to arrive at a differentiated adjustment of liability in the rating sector could be the introduction of liability caps. At first sight one could consider to limit the damages eligible for compensation to the financial loss suffered by the investors in the primary market, whereas the loss resulting from redistribution in the secondary market would not have to be compensated. Overall this would allow a cap in the amount of the losses sustained on balance by the investment community.⁷⁶ The implementation of this proposal is confronted with insurmountable difficulties because the loss would have to be claimed collectively by the investment community.⁷⁷ Alternatively, one could also look at the loss of the issuer as a cap. This solution seems questionable, though, because the issuer's interests are contrary to the investors' with regard to the rating. Countervailing incentive effects would result and what would seem to be a loss for the investor, would be a contractually agreed performance with regard to the issuer.

In light of these difficulties of loss assessment and the dangers of excessive liability it seems plausible to try to tie the amount of damages to the amount of fees earned by the

⁷⁵ G. Wagner, *Die Haftung von Ratingagenturen gegenüber dem Anlegerpublikum*, in Einheit und Vielheit im Unternehmensrecht, Festschrift Blaurock 467, 495 (Mohr Siebeck 2013).

⁷⁶ See for this proposal J. Bigus and H.-B. Schäfer, *Die Haftung des Wirtschaftsprüfers am Primär- und Sekundärmarkt. Eine rechtsökonomische Analyse*, 77 Zeitschrift für Betriebswirtschaft 19, 36 (2007).

⁷⁷ C. Ott, *Die Haftung von Wirtschaftsprüfern gegenüber Anlegern am Kapitalmarkt*, 171, 181, (T. Eger, J. Bigus, C. Ott and G. v. Wangenheim, Internationalisierung des Rechts und seine ökonomische Analyse, Festschr. f. H.-B. Schäfer, Gabler 2008).

agencies. There has been a proposal to implement an earnings-based cap on liability and limit financial liability to cases of gross negligence.⁷⁸ Another proposal forwarded by John Coffee is based on a modified form of strict liability for rating agencies that would cap obligations at a multiple of annual revenues.⁷⁹ Another proposal calculates on the basis of a percentage of damages.⁸⁰ The common flaw of these proposals lies in the arbitrariness of the determination of the cap they rely on.

If one considers the specific liability case in question, it appears plausible to look at the fees earned from the individual issue because it would be exaggerated to hold rating agencies liable for the full value of the issues they rate on a regular basis. The volume of issues rated by rating agencies goes far beyond the fees they earn. Considering the enormous harm to the capital market they can cause, higher liability caps may still be justified in cases of gross negligence or recklessness as they have become evident from the email correspondence published in the Summary Report of the Securities Exchange Commission in 2008.⁸¹ On the other hand, in day-to-day business damages in cases of simple negligence should not exceed the total fee. In fact, one might consider a cap based on the idea to disgorge the profits of the rating agency in these cases in order to avoid over-deterrence. There may still be the argument that this would lead to under-deterrence because such a cap is too low. If rating agencies, however, risk to lose entire fees for simple negligence, they will be more diligent, considering their high revenue generated from rating structured finance.⁸²

⁷⁸ J. Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. Rev. 1011, 1076 (2009); S. Harper, *Note. Credit-rating agencies deserve credit for the 2007-2008 financial crisis: an analysis of CRA liability following the enactment of the Dodd-Frank Act*, 68 Wash. & Lee L. Rev. 1925 (2011).

⁷⁹ F. Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L.Rev. 365 (2004); S. Harper, *Note. Credit-rating agencies deserve credit for the 2007-2008 financial crisis: an analysis of CRA liability following the enactment of the Dodd-Frank Act*, 68 Wash. & Lee L. Rev. 1925, 1969 (2011).

⁸⁰ F. Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L.Rev. 365-366 (2004); S. Harper, *Note. Credit-rating agencies deserve credit for the 2007-2008 financial crisis: an analysis of CRA liability following the enactment of the Dodd-Frank Act*, 68 Wash. & Lee L. Rev. 1925, 1969 (2011).

⁸¹ 'Rating agencies continue to create an even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters.' Securities Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating* (July 2008) 12, <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (accessed 30 May 2013).

⁸² See e.g. E. Blair Smith, *Bringing Down Wall Street as Ratings Let Loose Subprime Scourge*, Bloomberg, 24 Sep. 2008, <http://www.bloomberg.com/apps/news?sid=ah839IWTLP9s&pid=newsarchive> (accessed 30 May 2013).

The concept of disgorgement of profits seems to be a suitable basis to deal with the danger of excessive liability for a number of reasons. First of all, it is a well-known legal instrument of ex ante behaviour control in US regulation of insider trading⁸³ and in German antitrust⁸⁴. Section 16(b) of the US Securities Exchange Act permits the issuer (or a shareholder on its behalf) to recover all profits received by statutory insiders from any purchase and sale or sale and purchase of the issuer's equity securities within a six-month period without proof of actual use or intent to use inside information.⁸⁵ This shows how such a legal remedy may ease the burden of proof for causation and facilitate the determination of damages.⁸⁶ It is true, though, that the problems of more serious cases of false and misleading conduct may not adequately be dealt with and under-deterrence may result. Therefore some differentiation is in order that is missing in Art. 35a of the Amendment of the EU Rating Regulation as adopted by the European Parliament. It seems that the liability issue is far from being settled yet for an optimal liability concept to be legislated.

V. Summary

Under most legal systems contractual liability of rating agencies is limited by doctrinal requirements of privity of contract. Tort claims are generally confronted with difficulties of proof relating to causation. Strict statutory expert liability, on the contrary, may lead to over-deterrence and result in a market freeze.

Article 35a of the Draft Proposal of the EU Commission to Amend the Rating Agency Regulation introduced strict liability for rating agencies which is at odds with the aim to strengthen competition in the rating sector and could have a chilling effect on capital markets. That is why the reversal of the burden of proof was under discussion in the legislative process and has in part been alleviated in the final version of Art. 35a of the Amendment of the EU Rating Regulation as adopted by the European Parliament. This mitigation comes at the price of a considerable deference to the national laws of the

⁸³ Securities Exchange Act of 1934 § 16 (a), 15 U.S.C. § 78p.

⁸⁴ § 34 Abs. 2 GWB (German Antitrust Act).

⁸⁵ *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235-236 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

⁸⁶ For details cf. B. Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? Zur Regulierung und ihrer Implementierung im Ratingsektor*, 21 *Zeitschrift für Bankrecht und Bankwirtschaft*, 177, 185 (2009); J.P. Hunt, *Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, *Colum. Bus. L. Rev.* 109, 207 (2009).

Member States, which may eventually prove to be detrimental to a level playing field in financial regulation and the open market for capital.

The distinction between an actual loss in resources in the primary market and a loss resulting from redistribution in the secondary market may lead to a more differentiated analysis of the liability question. Facilitations to prove in favour of the investor such as the fraud on the market theory may help to overcome the insurmountable difficulties of proof relating to causation, but raise analytical concerns. Liability caps based on the concept of disgorgement of profits of the rating agencies may help to strike an adequate balance between the danger of macroeconomic harm created by reckless rating agencies and the threat of a market freeze resulting from over-deterrence.