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Dr. Anja Mayer, Dr. Friedrich Isenbart

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Financial regulation

Stricter liability rules for rating agencies

The pressure on rating agencies is growing: the European regulation on credit rating agencies issued in 2009 was reinforced by the EU with effect from 20 June 2013. According to the new regulation, rating agencies are liable to investors and issuers if they infringe rules when rating financial products. However, it is questionable whether institutional investors may hope for compensation for malinvestment.

Following the two last financial crises, rating agencies became subject of increasing criticism. Rating agencies are (among others) accused to have underestimated the risks of specific structured financial products (especially in connection with the subprime crisis). For example, mortgage backed securities and collateralized debt options often received excellent ratings. Such ratings lead to a wide distribution of respective securities since investors relied upon the rating agencies' assessment until these securities finally turned out to be toxic and caused high losses for the investors. For this reason, EU Internal Market Commissioner Michel Barnier is sure that rating agencies "strongly contributed to the financial crisis."

In addition, credit rating agencies (especially during the Euro debt crisis) are reproached to underrate individual European countries and to not adequately take into account

European rescue mechanisms. Another point of criticism aims at potential conflicts of interest, which result from the fact that issuers solicit ratings themselves (so-called solicited rating) and also pay the rating agencies for the rating.

EU reacts on financial crisis

As a reaction to the subprime crisis, the European Parliament and the Council of the European Union already in 2009 issued the Regulation (EC) 1060/2009 of 16 September 2009 on credit rating agencies ("Rating Regulation"). In the course of the Euro debt crisis, the European Commission came to the conclusion that the existing framework was not sufficient. In November 2011, the European Commission therefore issued a proposal for a regulation to amend the Rating Regulation. On 21 May 2013, the European Parliament and the Council of the European Union issued the Regulation (EC) 462/2013 amending Regulation 1060/2009 on credit rating agencies ("Amending Regulation"). The Amending Regulation entered into effect on 20 June 2013.

For the first time in European legislation, the amendments to the Rating Regulation stipulate a civil liability for rating agencies. Pursuant to Art. 35a para. 1 Rating Regulation, a rating agency has to compensate investors or issuers for losses resulting from infringements which were committed by the rating agency intentionally or grossly negligently and which had an impact on the rating. The Rating Regulation does not exclude further liability claims under national law.

New European liability regime

Art. 35a, which was newly inserted into the Rating Regulation, comprises the liability of rating agencies both towards issuers and investors. Especially for the latter, this constitutes a significant difference compared to former German law. While there usually is a contractual relationship between issuer and rating agency (at least in case of solicited rating), there is no contractual relationship between investor and rating agency. Thus, before the Amending Regulation came into force, the investor was limited to claims based on tort pursuant to sec. 826 German Civil Code (*Bürgerliches Gesetzbuch* "BGB") including the respective obstacles of intentional or immoral causation of damage that has to be proven by the investor.

The amendments to the Rating Regulation though bring little new to issuers. In case the rating is solicited by the issuer, there is a rating contract between issuer and rating agency. In case of a culpable breach of this contract, the rating agency has to compensate for the damage resulting thereof.

The possibility of contractual claims for damages remains. Only for ratings which were not solicited by the issuer (unsolicited ratings), the Rating Regulation extends the issuer's rights in a significant manner.

Obstacles to liability are high

Art. 35a Rating Regulation creates a new basis for claims. However, obstacles for liability are high. According to Art. 35a Rating Regulation, rating agencies are liable towards investors and issuers only if they commit intentional or grossly negligent infringements, which have an impact on the rating. Furthermore, the rating (in case of liability claims by investors) needs to have caused the investor's decision to invest into, hold onto or to divest from a rated security.

According to Art. 35a, rating agencies are liable both towards investors and issuers if they commit specific infringements listed in Annex III of the Rating Regulation. The Rating Regulation thus does not constitute a liability solely due to incorrect ratings. Infringements listed in Annex III of the Rating Regulation rather constitute violations of specific compliance, disclosure or other provisions regarding the supervision of rating agencies.

Respectively, the list of liability relevant infringements (again extended by the Amending Regulation) divides into the sec.s "infringements related to conflicts of interest, organizational or operational requirements" (para. I); "infringements related to obstacles to the supervisory activities" (para. II) and "infringements related to disclosure provisions" (para. III).

Para. I of Annex III to the Rating Regulation for example lists infringements committed by the rating agencies by not identifying and eliminating conflicts of interest, by not having established appropriate arrangements to ensure that ratings are made on the basis of all relevant information available, by not periodically reviewing their ratings and by not appointing sufficiently skilled and reliable persons for their boards.

The rating agency violates para. II of Annex III for example by providing the European Securities and Markets Authority (ESMA) with incorrect or misleading information or by failing to provide necessary documents. Para. III of Annex III finally comprises infringements committed by the rating agencies by not disclosing specific information to the public (for example the names of specific rated companies, the reasons for discontinuing a rating and the policies and procedures regarding unsolicited credit ratings).

A liability of credit rating agencies pursuant to Art. 35a Rating Regulation further requires intent or gross negligence. Thus, simple negligence is not sufficient for a civil liability of a rating agency. Pursuant to Art. 35a para. 4 Rating Regulation, the terms "intention" and "gross negligence" shall be interpreted in accordance with applicable national law as determined by the relevant rules of private international law.

Infringements difficult to prove

Further, a damage claim by the investor or issuer against the rating agency does not only require that the infringement of the Rating Regulation had an impact on the rating but also that the damage was caused by that infringement. The issuers and investors bear the full burden of proof.

When claiming damages, an issuer has to prove that the rating affects him or his products and that the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available. The issuer thus has to provide negative evidence and has to prove that the rating was not based on his information. The issuer thus has to prove that he provided the rating agency with accurate information, respectively, that all information publicly available is correct.

An investor has to prove that he relied on a credit rating reasonably or with due care when deciding on a financial instrument (investment, hold or divestment). The regulation describes only in general to which extent it is reasonable for an investor to rely on the rating. The regulation refers to provisions for credit institutions and other commercial investors pursuant to Art. 5a para. 1 Rating Regulation. According to such provisions, investors shall not solely or mechanistically rely on ratings but have to make their own credit risk assessment. Whether this applies for private investors as well appears questionable. “Reasonable reliance” and “due care” are undefined legal terms. In case of dispute, detailed requirements will be determined by the competent court according to applicable national law. These courts will also determine whether the rating lead to the investment decision. Regarding capital market information, the German Federal Court of Justice requests from the investor to prove that the information had an impact on his decision to invest into, hold onto or divest from the financial instrument, even if the information was extremely dubious. Jurisdiction will not waive this proof of causality when it comes to the liability for ratings.

Proposal was defanged

The draft regulation facilitated the burden of proof of the investor. An investor merely had to show probable cause that the rating agency committed an infringement. The rating agency then had to prove that it had either not committed an infringement or that the infringement had no impact on the rating. Under pressure from the rating agencies, such facilitations regarding the burden of proof were dropped.

According to the Rating Regulation, investors as well as issuers bear the full burden of proof for the asserted damage claim. According to the new Art. 35a para. 2 Rating Regulation, the investor or issuer is responsible for presenting accurate and detailed information indicating that the credit rating agency committed an infringement of the regulation, and that such infringement had an impact on the credit rating issued. What constitutes “accurate and detailed information” shall be determined by the competent national court. The competent national court shall take into consideration that the information is only available to the credit rating agency.

According to the wording “accurate and detailed“, the prima facie evidence of an infringement is probably not sufficient. Without having access to the agency’s internal data, the proof of a violation of compliance and disclosure provisions will be difficult.

Possibility of liability limitation

According to Art. 35a para. 3 Rating Regulation, rating agencies can limit their civil liability for the rating issued in advance. A precondition for this is that the limitation is reasonable, proportionate and in accordance with applicable law. Under German law, this provision has only a small scope of application in case of gross negligence. The liability for intent cannot be limited in advance (sec. 276 para. 3 BGB). Beyond that, only a limitation of liability for gross negligence by contract between the rating agency and the issuer in case of solicited ratings could be possible. If the limitation of liability is part of the general terms and conditions of the rating agency, it is ineffective however if it aims at limiting the liability for grossly negligent infringement of fundamental contractual obligations. In case of unsolicited ratings or generally within the relationship to investors, liability cannot be limited at all. If a limitation of liability was applicable in such cases, Art. 35a Rating Regulation would have no effect.

Further liability claims under national law

Art. 35a Rating Regulation does not exclude further liability claims in accordance with national law. In case of solicited ratings, rating agencies might be liable under contract towards issuers for slight negligence if liability was not limited in advance. German Law grants investors and issuers only very limited possibilities of damage claims in case of unsolicited ratings. German Law will provide for a liability beyond that of Art. 35a Rating Regulation only in exceptional cases.

In case of an unsolicited rating, the issuer is basically limited to claims for intentional damage by the rating agency. Still, in particular cases, liability for slight negligence might come into consideration. If a rating does not only contain an indication that endangers the creditworthiness but also a verifiably wrong statement (e.g. the verifiable statement concerning the financial difficulties of a company in case of downgrading), the rating agency is liable for negligent endangerment of creditworthiness if additional preconditions of sec. 824 BGB are fulfilled. However, any subjective assessment by rating analysts will probably be protected by the freedom of expression. A liability resulting from sec. 823 para. 1 BGB in conjunction with the right to an established and operating business and the general right of privacy therefore is difficult to achieve, since rating agencies enjoy the protection of the freedom of expression. A rating agency may consequently only be held liable if the rating is based on unsubstantiated grounds or cannot be objectified, if it is biased or if it deliberately contains false statements.

Investors are also only entitled to claims pursuant to sec. 826 BGB. Further claims discussed under German law resulting from an inclusion of the investor into the scope of contract between issuer and rating agency (contract with protective effect for third parties) as well as by laying claim to being given a special degree of trust pursuant to sec. 311 para. 3 s. 2 BGB will be difficult to assert due to the potentially unlimited, unpredictable increase of the liability risk for rating agencies and also since rating agencies have no own financial interest in the investors‘ decision and even point out that their rating does not constitute an investment recommendation. It is questionable whether these arguments apply in individual cases. The liability risk is containable (limited to the emission value). Furthermore, rating agencies know that the purpose of the rating is to decide on investments.

International competence of courts

Every court determines its own (international) competence for decisions on damage claims against rating agencies.

In case of solicited ratings, contracts often stipulate a certain competent court for the assertion of claims by the issuer.

Pursuant to Art. 35a Rating Regulation, the place of jurisdiction for damage claims by issuers and investors against rating agencies located or registered within the EU, follows Art. 5 No. 3 Brussels I Regulation (Council (EC) Regulation No. 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters dated 22 December 2000). According thereto, jurisdiction shall be with the courts for the place where the harmful event occurred or threats occur. According to jurisdiction of the European Court of Justice, the harmful event occurs both at the place of performance and the place of effect. The place of performance will regularly be the seat or registered office of the rating agency that issued the rating in dispute. The place of effect is where the damage occurred. This will be at the registered office of the issuer respectively of the investor since it will be a mere loss to property.

If the rating agency does not have a registered office or branch within the EU or in Germany, the investor or issuer may sue the rating agency pursuant to sec. 23 German Code of Civil Procedure (*Zivilprozessordnung* "ZPO") before courts of that German district where the rating agency holds assets in Germany (an office, a bank account or similar). Every investor or issuer with domicile or office in Germany may claim before such court.

Conclusion

With the amendments to the Rating Regulation, the European legislator for the first time created a liability of rating agencies towards investors and issuers without contractual relationship. The EU wants rating agencies to assume responsibility for the consequences of their ratings. However, claims for damages will still be difficult to assert by investors or issuers.

It is up to German courts whether they regard the protection granted by Art. 35a Rating Regulation as sufficient or if they extend liability according to German Law (contract with protective effect for third parties, liability for trust) to protect investors. The provisions on liability might also be reinforced again on European level if capital markets suffer further problems.

Dr. Anja Mayer
Lawyer

Wilhelm Rechtsanwälte
Partnerschaft von Rechtsanwälten
Reichsstraße 43
40217 Düsseldorf

Telephone: + 49 (0)211 687746 - 24
Telefax: + 49 (0)211 687746 - 20

www.wilhelm-rae.de
anja.mayer@wilhelm-rae.de

Dr. Friedrich Isenbart
Lawyer

Wilhelm Rechtsanwälte
Partnerschaft von Rechtsanwälten
Reichsstraße 43
40217 Düsseldorf

Telephone: + 49 (0)211 687746 - 21
Telefax: + 49 (0)211 687746 - 20

www.wilhelm-rae.de
friedrich.isenbart@wilhelm-rae.de