The Need for a Negligence Standard of Care for Credit Rating Agencies

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THE NEED FOR A NEGLIGENCE STANDARD OF CARE FOR CREDIT RATING AGENCIES

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INTRODUCTION

As the financial markets have evolved from relatively straightforward bond transactions to a web of securitized debt vehicles, the level of investor sophistication required to analyze the risk involved in a transaction has steadily grown. Credit rating agencies lend transparency to the financial services market by evaluating financial instruments to determine the likelihood that the debt will be repaid. This transparency serves as an important source of information between issuers and financiers of debt. However, credit rating agencies do not audit companies, offer advice, or recommend certain products. While rating agencies view their role in the market as limited to providing opinions on the chances of default for a particular debt, investors have given credit rating agencies vast power over an array of financial transactions. The market, through investors and government regulators, has assigned the task of risk assessment to credit rating agencies, but the agencies have only quasi-accepted this role of risk assessor. This Note examines the disconnect

1. SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, RECOMMENDATIONS OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION CREDIT RATING AGENCY TASK FORCE 16 (2008), available at www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf [hereinafter SIFMA REPORT] (stating that the increased complexity of financial instruments has led to an increased reliance on credit rating agencies' opinions by investors and regulators).

2. Turmoil in U.S. Credit Markets: The Role of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. 3 (2008) [hereinafter Turmoil in Credit Markets] (written statement of Claire Robinson, Senior Managing Director, Moody's Investors Service); Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 CARDOZO L. REV. 1553, 1692 (2008) (describing ratings “not [as] factual disclosures about the issuer,” but as “predictions of the likelihood that the rated security will default;” predictions “are inherently forward-looking, and as with any prophesy, they are inherently subjective”).


5. Aaron Unterman, Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt, 4 HASTINGS BUS. L.J. 77, 121 (2008) (“Their [rating agencies] valuation of securities … have a tremendous impact on trading prices as well as market confidence. Investors worldwide rely on these ratings to make financial decisions.”).

6. Frank Partnoy, How and Why Credit Rating Agencies Are Not Like Other Gatekeepers, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 89 n.104
between the role the market has assigned to rating agencies and the role the agencies assert for themselves; this disconnect is exacerbated by the First Amendment defenses that agencies assert to avoid legal responsibility despite falling short of due diligence standards. This Note does not, however, examine the myriad of other issues concerning credit rating agencies, such as a potential need for greater government regulation or conflict of interest in their business model. This Note will focus on only one particular aspect of a rating agency’s business model: solicited ratings for debt obligations. Solicited ratings play a major role in the securities market, but government intervention has reduced incentives, which accompany a competitive market, for self-regulation among rating agencies. In addition, due to First Amendment concerns, neither the courts nor Congress are holding companies liable for their ratings when those ratings are formed negligently. Credit rating agencies should not

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(Yasuyuki Fuchita & Robert E. Litan eds., 2006).


8. SEC REPORT, supra note 3, at 41-44 (analyzing conflict of issues, such as the fact that rating agencies are paid by the company issuing the debt). The SEC has recently issued proposed rules to address some of these conflict of interest concerns. For more information on the SEC’s press release outlining the proposed rules, see Press Release, SEC, SEC Proposes Comprehensive Reforms to Bring Increased Transparency to Credit Rating Process (June 11, 2008), available at http://www.sec.gov/news/press/2008/2008-110.htm.

9. Credit rating agencies rate companies’ debt by one of two methods: unsolicited or solicited ratings. For unsolicited ratings, agencies use public documents to formulate their opinion without working with the company or receiving money from the company for the rating. SIFMA REPORT, supra note 1, at 7 (stating that unsolicited ratings need to be clearly indicated as such to ensure consumers are aware that they are based on less information). Unsolicited ratings, therefore, have a stronger argument for First Amendment protection. Solicited ratings occur when companies reach out to the credit rating agency and pay for the rating. Rosenbaum & Rydarowski, supra note 4, at 21. See Part II which discusses why there is a weaker argument for the protection of solicited ratings.

10. Pinto, supra note 7, at 342-44.


have First Amendment protection for their solicited ratings, and instead should be open to civil liability for negligent misrepresentation.\(^{13}\)

This Note first analyzes in Part I the structure of the ratings industry. The Note will illustrate that rating agencies are not accountable for negligent ratings from traditional sources of accountability—the market, government regulation, or consumers through lawsuits. In Part II, the Note will focus on why rating agencies are not accountable to investors through private lawsuits. The Note then analyzes previous rulings that have extended First Amendment free speech protection to ratings. The Note demonstrates that the justifications for the First Amendment protections no longer apply due to changes in rating agencies’ business practices. In Part III, the Note briefly discusses some of the recent actions of rating agencies that could potentially result in liability to investors. Finally, in Part IV, the Note concludes with a discussion of negligent misrepresentation as a cause of action against rating agencies.

I. MARKET STRUCTURE FOR CREDIT RATINGS

The market structure for credit ratings reduces economic pressure for rating agencies to produce the best product.\(^{14}\) Usually, a market encourages company due diligence as a result of competition for business, but in the ratings market there is a lack of competition among the agencies.\(^{15}\) The credit rating market has an oligopolistic market structure

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13. Pinto, supra note 7, at 353 ("The tort of negligent misrepresentation is a possible basis of liability for users of the credit rating information."); Aaron Unterman, Innovative Destruction-Structured Finance and Credit Market Reform in the Bubble Era, 5 HASTINGS BUS. L.J. 53, 98-99 (2009) ("[Credit rating agencies] play the role of professionals and are compensated as such. It follows that their 'opinions' should be accorded the same responsibilities and should be held liable for professional negligence. The illusory treatment of ratings as mere opinions and 'freedom of speech' defenses which accompanies such classification do not reflect the true role of ratings in the market. Clearly, the fact that ratings are required and relied upon elevates their work from that of an editorialist.").


15. Unterman, supra note 5, at 122. A lack of competition in the ratings market is an international issue as much as it is a United States issue. Fitch Ratings, Moody's, and
meaning the market is dominated by a few major companies. The two major raters in the United States are Moody’s and Standard & Poor’s (S&P). This dominance is due in part to the federal government’s official recognition of the few existing credit rating agencies in 1975, as well as natural barriers to entry associated with the industry. In 2003, there were only three nationally recognized credit rating agencies: Moody’s, S&P, and Fitch Ratings. The government has enacted legislation to increase competition in the market, and while there are now more than three recognized agencies, the industry is still dominated by Moody’s and S&P. In addition, it is traditional for each company’s debt to be rated by two credit rating agencies, which gives the two major companies even less competition for their products. Moody’s and S&P have so much market power that they have had profit margins of up to 55 and 42 percent respectively. Despite government efforts to increase competition, the industry is still concentrated. A concentrated industry exerts less pressure on individual companies to ensure a quality product.

The concentrated market for credit rating would be less of a concern if the market itself had close substitutes. If there were close substitutes, then companies looking to convey the investment potential of their product could convey that information through an avenue different than credit rating agencies, thereby giving the credit rating market itself

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16. SEC REPORT, supra note 3, at 5.
17. Id.
18. Id. at 8-9, 24. To be recognized, rating agencies have to meet certain SEC criteria, including registration with the SEC. Ratings are opinions regarding potential for default on debt, and the value of that opinion is based on the reputation of the rater. New rating agencies have to compete with the established reputation of existing firms, which creates a barrier to entry, limiting the number of firms providing ratings.
20. White, supra note 19.
22. Id.
23. Unterman, supra note 5, at 121.
competition. However, rating agencies “provide some of the only information available regarding market instruments.” There are no close substitutes for credit ratings. This leaves issuers of debt only the credit rating market to validate the quality of the debt for investors.

The federal government and other advisory boards reinforce the market’s need for credit ratings by mandating ratings use by certain organizations. For example, the amount of capital banks must hold can depend upon the ratings assigned by credit rating agencies. Insurance companies also have obligations to hold investments of only a certain grade, as the National Association of Insurance Commissioners attaches a high capital charge to holdings below that grade. Companies are also forced to have credit rating agencies rate their instruments in order for many institutional investors, such as pension funds, to invest. These mandates guarantee a market for credit rating agencies, which in turn reduces reputational concerns for the agencies.

In addition to the market’s lack of incentives for rating agency self regulation, Congress and the Securities and Exchange Commission (SEC) have been hesitant to enact legislation and regulations concerning the manner in which ratings are formed. In addition to the current financial crisis, which has renewed pressure on Congress to enact greater federal regulation of credit rating agencies following the early 2000 Enron

24. Id.
25. Id.
26. Id.
28. Unterman, supra note 5, at 121-22.
29. Turmoil in Credit Markets, supra note 2, at 2 (written statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Law School) (“[E]ven if [credit rating agencies] views were not respected or their ratings were known to be inflated, they would still be retained to grant ‘regulatory licenses.’”).
30. Partnoy, supra note 6, at 81-82.
31. See Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7 (2006). The main legislative effort in the United States centers around disclosure and transparency and does not make raters liable for their ratings. In contrast, European Union regulators have a current proposal for rating agency reform that would hold rating agencies liable for their opinions. See White, supra note 19. The rules could become effective as soon as 2010. The new regulations would not allow rating agencies to claim ratings are “just opinions,” and agencies could face liability from the European Union for professional misconduct based on their ratings. Id.
32. See generally Turmoil in Credit Markets, supra note 2 (written statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Law School) (concerning not only the role of rating agencies in the credit crunch, but also potential changes to the
scandal, rating agencies faced pressure from Congress to enact due diligence standards. After the scandal, Congress held hearings and commissioned a report which found that the success of rating agencies’ First Amendment defense contributed to their lack of oversight. Congress found that the “agencies are subject to little formal regulation or oversight, and their liability traditionally has been limited by regulatory exemptions and First Amendment protections, [so] there is little to hold them accountable for future poor performance.” Congress then passed the Credit Rating Agency Reform Act of 2006, which increased the SEC’s oversight of rating agencies, but did not give the SEC authority over how ratings would be formed. In addition to limiting the SEC’s regulatory authority, the law has a disclaimer in regard to private lawsuits and the content of credit ratings. The Act states:

(1) No waiver of rights, privileges, or defenses- Registration under and compliance with this section does not constitute a waiver of, or otherwise diminish, any right, privilege, or defense that a nationally recognized statistical rating organization may otherwise have under any provision of State or Federal law, including any rule, regulation, or order thereunder.

(2) No private right of action- Nothing in this section may be construed as creating any private right of action, and no report furnished by a nationally recognized statistical rating organization in accordance with this section or section 78q ... shall create a private right of action under section 78r ... or any other provision of law.

An early version of the bill that led to the law would have provided for more substantive regulation of ratings, but critics of that bill stated that authority over the content would “transform the agencies from ventures publishing comments that enjoy the [F]irst [A]mendment’s protection of free speech into wards of the ... [SEC] that must subject their opinions to regulatory review.” As a result of these concerns, the legislation that was

33. SEC REPORT, supra note 3, at 32.
34. There were several bills introduced, hearings conducted, and reports issued by Congress over the potential failures of the rating industry. For the legislation passed by Congress in response to the rating agencies and the Enron crisis, see the Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7 (2006).
35. SEC REPORT, supra note 3, at 4.
36. Id.
38. Id.
ultimately enacted did not include the ability for the SEC to take enforcement actions against rating agencies that negligently issued ratings. 40

Following the guidelines established by Congress, the SEC has only regulated external factors that indirectly affect ratings. 41 As recently as the summer of 2008, in the midst of the current credit crisis, SEC Commissioner Paul Atkins stated that the SEC cannot act outside of the scope of Congress. 42 Commissioner Adkins specifically mentioned the First Amendment as justification for the SEC’s limitations on regulating the rating agencies; “[w]e must remember the explicit intent of Congress that we not substitute the commission’s judgment for that of the rating agencies. Ultimately, a rating is an expression of opinion – one that, barring self-dealing or lack of integrity, enjoys the protection of the First Amendment.”43

With both Congress and the SEC withholding due diligence requirements for rating agencies because of the courts’ application of First Amendment protections, there are no external forces to ensure that rating agencies are not negligent in their work. 44 The blanket acceptance of ratings as a measure of quality illustrates the disconnect between how the market interprets credit ratings and how credit ratings view their own role in the market. 45 A recent report by the SEC stated: “The credit rating agencies seem to be trying to walk a fine line between maintaining their

40. See Rosenbaum & Rydarowski, supra note 4, at 21. (“The Act prohibits such conflicts of interest as (1) conditioning ratings on services; (2) lowering ratings if an entire product is not rated; and (3) modifying ratings based on the purchase.”). While these conflicts of interest were important failures in the market, they do not address concerns with due diligence.


42. Id.

43. Id.

44. Oversight and Operation, supra note 14, at 4 (testimony of Jeffrey J. Diermeier, President and Chief Executive Officer, Chartered Financial Analyst Institute).

45. Id. (stating agencies embrace the regulatory requirement that debt is rated, yet reject “any semblance of regulatory checks-and-balances”). To complicate the financial markets, investors cannot rely on their own evaluation of the rating agency because the rating process is private and the methodology is opaque, so investors cannot evaluate the quality of a rating. SIFMA REPORT, supra note 1, at 3 (“[E]ven if an investor licensed the [credit rating agencies’] models and obtained all the data inputs to run the model … the investor still could not determine what assumptions and adjustments the [agencies] employed … [I]nvestors … could not on their own determine any potential flaws in the [rating agencies’] analyses.”).
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enormous market power through both official and unofficial uses of their ratings, and insisting their ratings are purely their ‘opinion.’” The rating agencies benefit from the market’s treatment of ratings as an assessment of risk, but deny any legal obligation in regard to the benefit. The unique circumstances of the credit rating market structure reduce accountability, which increases the importance of establishing external market controls such as private lawsuits.

II. FIRST AMENDMENT CONCERNS

The potential for external market controls, government regulation, and private lawsuits has been limited by the success of rating agencies asserting the First Amendment as a defense to negligence actions. Private lawsuits against rating agencies may be brought by investors who relied upon the ratings in determining the quality of debt for investment purposes. If the debt defaults and investors felt rating agencies failed in evaluating the credit worthiness of the debt, the investors may bring a lawsuit against the rating agencies for negligence. Rating agencies raise

46. ENRON REPORT, supra note 12, at 123. If the ratings are deemed opinions, then they are encompassed by First Amendment protections. See Part II for further analysis of how First Amendment protection changes the standard of liability in tort cases.

47. Id.

48. Mark P. Zimmett, A Primer on the ABCs of CDO Litigation, N.Y. L.J., Apr. 1, 2008, at 62, available at http://www.mpzlaw.com/downloads/CDOARTICLEAPRIL12008.pdf (arguing that several market failures should result in agencies being subject to private litigation, including civil liability under the Securities Act). Other options may include granting the SEC sole enforcement ability. Rating agency legislation could also mirror other SEC enforcement powers in which the SEC can bring causes of action, but where there is no accompanying private right of action.

49. While the First Amendment defense of rating agencies is a large factor in deterring lawsuits against these agencies, there are also securities laws that shield credit rating agencies from liability in certain circumstances. This Note will not examine the role of these shields for rating agencies. For more information on these shields, see Statement of Amy Lancellotta, Senior Counsel, Investment Company Institute, SEC Hearings on Issues Relating to Credit Rating Agencies (Nov. 21, 2002), available at http://www.sec.gov/news/extra/credrate/investcoinstit.htm.

50. See In re Enron Corp. Sec., Derivative & “ERISA” Litig., 511 F. Supp. 2d 742 (S.D. Tex. 2005), aff’d, 446 F.3d 585 (5th Cir. 2006). Any potential liability of ratings agencies should not be based on subsequent delinquencies, changes in market conditions, or fraud which occurs internally in a company outside of the knowledge of the rating agency. Jefferson County Sch. Dist. No. R-1 v. Moody’s Investors Servs., Inc., 175 F.3d 848, 856 n.3 (10th Cir. 1999).

51. See generally Enron Corp., 511 F. Supp. 2d at 742 (discussing liability of rating
the same First Amendment defense that courts apply to journalists to shield them from liability, that is, that the content of the rating, like the content of a news piece, is merely their opinion.  

First Amendment concerns shield rating agencies from negligence in their business dealings because First Amendment protections have been expanded beyond "their traditional application to the law of defamation, slander, and libel to reach other causes of action, e.g., breach of contract, misrepresentation, and tortious interference with contract or business." Thus, any potential tort action brought against a rating agency over the substance of its ratings potentially raises First Amendment issues.  

A rating raises First Amendment concerns because the ratings are viewed as analogous to the established journalistic privilege. It does not matter if the publication centers around business or economic issues. When rating corporate bonds, rating agencies gather information from a variety of sources, analyze the information, and create their own assessment of the risk, which is then published. Courts classify the ratings derived from the journalistic-style process of gathering and assessing the financial information as opinions on the chance of default on debt. Categorizing ratings as opinions means courts must analyze the ratings for application of additional protections from liability that the Supreme Court has set aside for journalists in order to protect the integrity of the press. The Supreme Court has previously held that if a "media defendant" is being sued, statements "on matters of public concern must 

agencies following the default of Enron).  
52. Id. at 809-10.  
53. Id. at 811.  
54. See, e.g., Compuware Corp. v. Moody's Investor's Servs., Inc., 499 F.3d 520, 530 (6th Cir. 2007) ("Compuware is hoping to escape the strict requirement of actual malice in the defamation claim by bringing the contract claim. The language of Cohen therefore requires me to apply... First Amendment protections to the contract claim.").  
56. Enron Corp., 511 F. Supp. 2d at 810.  
57. See Pan Am Corp., 161 B.R. at 581.  
58. See Compuware Corp., 499 F.3d at 529.  
59. Id. at 525-26.  
60. Rating agencies distribute their ratings in magazines and other media formats. See, e.g., Standard and Poor's, CreditWeek Subscription, http://sandp.ecnext.com/coms2/page_creditweek (last visited Feb. 6, 2010).
be provable as false before liability can be assessed." Therefore a statement "of opinion having no provably false factual connotation" from a media organization that involves a public concern has "full constitutional protection." There is an argument that since a rating is the chance of default on debt, it could not be provably false.

If courts hold that ratings are opinions that are not "provably false," then credit rating agencies face liability for negligence or defamation only if the plaintiff can prove "actual malice," as established by the Supreme Court in *New York Times v. Sullivan*. The "actual malice" standard is much more difficult to prove than a negligence standard, which is the standard rating agencies would be held to if rating agencies are not deemed analogous to journalists. Under the "actual malice" standard, potential plaintiffs would have to prove that the credit rating agency intended harm, instead of simply proving that it acted without care. The court describes "actual malice" as "with knowledge that the statement was false or with reckless disregard for whether or not it was true." The recklessness element of malice does not include a reasonable man standard regarding if a publisher should have investigated the truthfulness or doubted the validity of the publication. This distinction is important


62. Id. In applying the Milkovich test, the Court of Appeals of Oklahoma found that ratings "fall somewhere between those opinions which receive constitutional protection and those that do not." Commercial Fin. Servs., Inc. v. Arthur Anderson LLP, 94 P.3d 106, 109 (Okla. Civ. App. 2004).

63. See Milkovich, 497 U.S. at 9. The Court discussed a four point test to decide if a statement is a fact or an opinion. One factor that seems especially relevant for rating agencies is if the statement is "verifiable." Id. Using the Milkovich test, the Tenth Circuit held that a Moody's rating about creditworthiness was not provably false and therefore would receive the full protection of the First Amendment. Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 855 (10th Cir. 1999). The decision was not based on the rating agency's claim that the rating was an opinion, but instead on the agency's inability to prove false the general assertion that the school district had "ongoing financial pressures." See id. at 856; see also Compuware Corp., 499 F.3d at 529 ("We find no basis upon which we could conclude that the credit rating itself communicates any provably false factual connotation. Even if we could draw any fact-based inferences from this rating, such inferences could not be proven false because of the inherently subjective nature of Moody's ratings calculation.").

64. *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 511 F. Supp. 2d 742, 810 (S.D. Tex. 2005), aff'd, 446 F.3d 585 (5th Cir. 2006).

65. Id. at 811 (citing Time, Inc. v. Hill, 385 U.S. 374, 389 (1967)).

66. Id.

67. Id.

68. Id.
because, under the negligence standard, rating agencies could be liable for not investigating in circumstances when a reasonable person would have investigated. 69 Under the "actual malice" standard, rating agencies are not required to investigate facts even if the reasonable man would. 70 The "actual malice" standard requires the plaintiff to prove that the defendant subjectively had "serious doubts" about the validity of the publication. 71 These heightened requirements ensure that publishers are not liable for negligent misrepresentation. 72 Plaintiffs are unable to help ensure due diligence in the rating industry as long as the ratings are given full First Amendment protections. 73

There have been no Supreme Court decisions specifically addressing the question of whether rating reports are protected First Amendment speech, 74 but there has been one Court decision concerning ratings and First Amendment protection. 75 In Dun & Bradstreet v. Greenmoss Builders, a suit for defamation based on a false rating, the Court held that the rating at issue was not a public concern and therefore would not receive First Amendment protection. 76 One factor in the decision was the amount of exposure; the rating report was only available to five subscribers who could not disseminate the information to additional parties. 77 Due to the limited impact of the rating, the Court held that the speech did not deal with the "free flow of commercial information," and the context of the speech was more private than public. 78 The Court in Greenmoss Builders established precedent that the public nature of ratings should be analyzed using the Connicks v. Myers standard, which looks to the "content, form and context" of the statements. 79 The Court, however, cautioned lower courts against taking the decision as an absolute denial of First Amendment protection for rating agencies. 80 In fact, the general

69. Id.
70. Id.
71. Id.
72. Id.
73. See Andrew Ackerman, Ratings Bill Bashed, BOND BUYER, June 24, 2008, available at www.bondbuyer.com/issues/117_119/-290779-i.html (reporting that rating agencies raised First Amendment concerns to a 2008 bill by House Financial Service Chairman Barney Frank that would regulate criteria used by agencies).
74. Partnoy, supra note 6, at 85.
76. Id. at 763.
77. Id. at 762.
78. Id.
79. Id. at 761 (quoting Connick v. Myers, 461 U.S. 138, 147-48 (1983)).
80. Id. at 762 n.8 ("The protection to be accorded a particular credit report depends on
sentiment among lower courts is that while there “is no automatic, blanket, absolute First Amendment protection for reports,” rating agencies have generally been “shielded ... from liability for alleged negligent ratings.”

The lower courts have thus distinguished Greenmoss Builders from subsequent cases based on different facts which affect the “context” of ratings. Therefore, if the ratings are viewed as public in nature, the rating agency is held to the “actual malice” standard and not the negligence standard of liability. In determining First Amendment protections in regard to ratings context, courts have identified four factors: whether rating agencies (1) rate debt which they are not paid to rate; (2) distribute the ratings through their publications; (3) have independence in gathering and evaluating information used for the rating; and (4) fulfill the general public function of providing information to the financial market.

A. Context of Ratings: An Editorial or a Business Report?

The first factor relevant to courts in finding First Amendment protection is whether rating agencies publish ratings of unsolicited debt, that is, debt which the company is not paid to rate. The two major credit rating agencies, S&P and Moody’s, rate debt that is both solicited and unsolicited for corporate bonds. Reporting on unsolicited debt is akin to journalists finding the most newsworthy story, which is why the presence of unsolicited debt has been weighed heavily by courts. However, the

whether the report’s content, form, and context indicate that it concerns a public matter.” (internal quotations omitted)).

81. In re Enron Corp. Sec., Derivative & “ERISA” Litig., 511 F. Supp. 2d 742, 817 (S.D. Tex. 2005), aff’d, 446 F.3d 585 (5th Cir. 2006).
83. Id.
84. Id. at 581.
85. In re Fitch, Inc., 330 F.3d 104, 110 (2d Cir. 2003). This standard for First Amendment protection should be viewed cautiously by the courts because it creates incentives for rating agencies to continue to rate unsolicited debt, despite the controversy surrounding unsolicited ratings. Partnoy, supra note 6, at 71 (discussing how unsolicited ratings are controversial because of allegations that unsolicited ratings pressure bond issuers into paying for the ratings and how the Department of Justice investigated their use of this form of ratings). Some industry commentators have speculated that rating agencies have continued to issue unsolicited ratings to protect their First Amendment status and that if rating agencies never issued unsolicited ratings, they would appear to be even less like financial publishers and therefore would be even less likely to be protected by free speech principles. Id.
86. Fitch, 330 F.3d at 110.
87. Id. at 109 (comparing the news print nature of Fitch to other rating agencies,
fact that agencies are paid for some ratings has been deemed less relevant by the courts if agencies publish opinions on both companies that pay for the ratings and companies that do not pay for the ratings. The Second Circuit found that S&P deserved journalist status, in part, because it rated "practically all public debt financings and preferred stock issues" whether they were issued by S&P clients or not. The more prominent the role that unsolicited ratings perform in a company's business model, the more likely the court will view the rating agency as a member of the financial press.

Another factor courts have found relevant in determining the context of the ratings is how the ratings are distributed. Rating agencies claim that publishing of the rating provides information to the market. In Scott Paper Co., the district court held that the distributional nature of the rating is what gives the rating a public function. Rating agencies claim that, like a newspaper, they serve the public good by "formulat[ing] opinions about those issuers and securities and broadly disseminate those opinions, which are of concern to the public." Courts have looked at the public concern requirement not as if the publication is directly for the public in a manner the public can understand, but if it serves the public indirectly as well. In Pan Am Corp., a bankruptcy case appealed to the Southern District of New York, the district court specifically distinguished the case from Greenmoss Builders due to the size of the intended audience of the rating. In Greenmoss Builders, the ratings were distributed to five subscribers, but in Pan Am Corp., the ratings were distributed to the

which have First Amendment protection.

88. Id. at 110 (denying Fitch First Amendment protections because Fitch only rated solicited debt); Pan Am Corp., 161 B.R. at 583 (finding First Amendment protection for S&P because, in addition to rating unsolicited debt, S&P "revises, updates and reviews a prior rating or analysis" without a request of fee from the issuer of debt).

89. Pan Am Corp., 161 B.R. at 583.

90. Id. at 583-84.


94. Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., 175 F.3d 848, 856 n.3 (10th Cir. 1999) ("Given the importance of financial information to investors and the economy as a whole," the opinions of ratings agents regarding creditworthiness of issuers are a "matter of public concern.").

95. Pan Am Corp., 161 B.R. at 583.
"public at large." The district court in *Enron* described how a credit rating agency acts as a traditional journalist by finding that rating agencies are "periodicals with a regular circulation to a general population ... mak[ing] its own analysis, designed not merely for the personal use of the rating companies, but for the benefit of all ... maintain[ing] complete editorial control over the form and content of its publications." In *American Savings Bank v. UBS Painewebber*, the district court described the periodicals as having a "regular circulation" distributed to the general population. S&P's also received First Amendment protection in *Scott Paper Co.*; the court found that the First Amendment should be applied because the rating agency "makes its own analysis, designed not merely for the personal use of the rated companies, but for the benefit of all who might read its publications." Ratings that are available to the general public are more likely to be considered a public concern than those distributed to a small pool of investors.

Another factor courts have cited in determining the public nature of a rating is the independence of rating agencies. For corporate bonds, rating agencies gather facts, analyze the information, and determine and publish ratings independent of the issuing company. In *Pan Am*, the court noted the rating agency's independent research, in particular, the fact that the agency did not solely rely on information from the issuing company as justification for finding First Amendment protection. The court also noted agencies' editorial control over the ratings, in other words the rating agency "retains ... control over the decision of which ratings to publish and form and content of its ratings." The independence associated with traditional journalists combined with the necessity that a journalist create his or her own conclusions from the research is the model

99. While the ratings magazines are available to anyone, a subscription is $1,500. Standard & Poor's, *supra* note 60.
100. See *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749 (1985) (holding that because the ratings were only distributed to a group of five investors, the court could not consider them a public concern, and holding that, in that instance, the First Amendment protections were not applicable).
102. *Id.*
103. *Id.*
104. *Id.*
rating agencies attempt to mitigate in order to be granted First Amendment protection.

Some courts, in conducting a First Amendment analysis, do not look to the context of the specific ratings in question, as outlined in Greenmoss Builders. Instead they look at the broader context of the ratings market. Some courts have held that the rating process itself is a matter of public concern because of the large role that corporate debt plays in the stability of the market. In Enron and Jefferson County School District No. R-1 v. Moody’s Investor’s Services, the courts engaged in a discussion concerning the public nature of the ratings market. Instead of analyzing the context of the ratings to determine if the opinions were a public concern, the courts, in part, analyzed the role ratings play in the financial market. The courts cited reasons, such as bringing transparency and efficiency to the market, as justification to find that the ratings deserve First Amendment protection. Moody’s argued in National Century Financial Enterprises that denying rating agencies First Amendment protection would damage the financial service market, therefore maintaining that the ratings process is a public concern. When the court utilizes a more expansive interpretation of public concern, there is less focus on the context of a particular rating. Therefore, as long as the court determines that ratings are important for stability in the financial market, the court may find ratings to be protected speech, regardless of the context of the individual rating.

106. Id.
107. In re Enron Corp. Sec., Derivative & “ERISA” Litig., 511 F. Supp. 2d 742, 818-19 (S.D. Tex. 2005), aff’d, 446 F.3d 585 (5th Cir. 2006). The current financial crisis is another reminder that the actions of Wall Street influence the flow of money at all levels of the national economy.
108. Id. at 823-25, 848 n.3; Jefferson County Sch. Dist., 175 F.3d at 856.
110. Id. (“The bond rating services are popular with investors because they can rate securities’ riskiness far less expensively than can an individual investor. The information the servicers provide improves the market’s efficiency by equalizing prices at the margin so that securities more accurately affect the market’s collective preference for the risk.” (quoting Gregory Husisian, What Standard of Care Should Govern the World’s Shortest Editorials? An Analysis of Bond Rating Agency Liability, 75 CORNELL L. REV. 411, 413 (1990))).
112. Id.
B. Exemptions to First Amendment Protections

There are some exceptions to the granting of First Amendment protection to ratings opinions. One factor analyzed by courts in determining the context of a rating is the presence of unsolicited ratings in a rating agencies' business model. Thus, an absence of rating unsolicited debt might lead a court to deny protection. In *Fitch*, the Second Circuit held that Fitch Ratings, the third largest rating agency, was "[u]nlike a business newspaper or magazine, which would cover any transactions deemed newsworthy" because "Fitch only 'covers' its own clients." The court held that only ratings paid for by clients transform ratings' purposes from reporting the financial news to catering to client needs. The Second Circuit distinguished Fitch Ratings from other rating agencies, in particular S&P, because its practice of only rating debt for which it was paid, separated the rating agency too much from the traditional journalist model.

Another change in context that might result in the loss of protection is whether ratings are offered to the investing public at large or to a select group of investors. In September 2009, Moody's First Amendment argument was rejected because the Southern District of New York Court held the ratings were not widely distributed. In *National Century*, the district court held that because the ratings in that case were only "being targeted to a select class of institutional investors with the resources to invest tens of millions of dollars in the notes," Moody's would not receive

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113. See, e.g., *In re Fitch*, 330 F.3d 104, 111 (2d Cir. 2003).
115. *Fitch*, 330 F.3d at 111. During cross examination in the district court, a Fitch employee stated Fitch did not rate debt unless a company solicited the rating. *Id.* at 110.
116. *Id.* at 109.
117. *Id.*
118. *Id.*
First Amendment protection at the initial stages of the litigation.121 In LaSalle National Bank v. Duff & Phelps Credit Rating Co., the district court found that Duff & Phelps credit rating agency did not merit First Amendment protection because the ratings were not widely distributed.122 In Duff & Phelps, the rating was to remain private and was not issued in order to be published.123 Again, in American Savings Bank v. USB PaineWebber, the New York district court found that Fitch Ratings could not take advantage of First Amendment protections that S&P and Moody’s had previously utilized because its ratings were not circulated to the general population.124 The court found that Fitch’s ratings were conducted from private contractual agreements instead of for the purpose of general distribution.125

Courts also distinguish between the different ways credit rating agencies conduct their rating and the relative independence that the rating agency has in drafting its ratings.126 Solicited ratings diverge from newsprint and traditional journalistic newsgathering functions, as solicited ratings do not require investigation.127 The more rating agencies detour from the print model of gathering facts and publishing opinions independent from those facts, the more likely courts will not find agencies are analogous to independent newsprint.128 In the Second Circuit opinion of Fitch, the Circuit found that “Fitch ... exchanges information with the companies it rates.”129 The court then held that the context of the ratings did not merit a First Amendment defense because of the rating agency’s interaction with its paid clients.130 Specifically, the court found the practice of giving the debt offeror the criteria Fitch would use to rate the

121. Abu Dhabi, 651 F. Supp. 2d at 155. The court stated that Moody’s would have the chance in discovery to prove that the ratings are a matter of public concern. Id.
123. Id.
125. Id.
127. Am. Sav. Bank, 2002 WL 31833223, at *3 (stating that because Fitch was not primarily involved in newsgathering and instead formed ratings based on issuers who sought them out, the rating agency was not analogous to other organizations that received First Amendment protections).
128. See id.
129. Fitch, 330 F.3d at 110.
130. Id.
debt was a marked departure from traditional journalist practices.\textsuperscript{131} This practice allows the issuing-company the ability to alter the debt being offered so that the debt receives the optimal rating.\textsuperscript{132} The fact that Fitch employees did not give recommendations or suggestions to the offering company did not deter the court from holding Fitch’s business practices were too far removed from traditional journalist procedures.\textsuperscript{133} The practice of offering the rating criteria combined with the presence of communication between Fitch and the debt-issuer was enough for the court to hold that Fitch took “an active role in helping ... structure the transaction.”\textsuperscript{134}

In another case, an Oklahoma state court held that the First Amendment would not protect a rating agency from liability to the issuer who contracted for the ratings due to a lack of independence.\textsuperscript{135} The court held that because the ratings were based on information furnished by that company and were paid a fee by that company, the suit for inaccuracies could continue.\textsuperscript{136} The court still classified the ratings as opinions, but stated that the opinions were more analogous to a journalist being hired to write a company report, and therefore, a different standard should apply.\textsuperscript{137} The court held that “the relationship between these parties goes beyond a relationship between a journalist and subject, and is more analogous to that of a client and the client’s certified public accountant” and then denied First Amendment protection.\textsuperscript{138}

\textit{C. Changes to Rating Agencies’ Business Model Make Raters More Analogous to Previously Held Exceptions}

The context of credit rating statements has changed as the rating agencies’ business model and profit structure have changed, thereby

\textsuperscript{131} Id.
\textsuperscript{132} Id.
\textsuperscript{133} Id.
\textsuperscript{134} Id. (holding that this level of involvement is not analogous to the relationship a journalist has with his or her clients).
\textsuperscript{136} Id.
\textsuperscript{137} Id.
\textsuperscript{138} Id. Accountants are not entitled to journalistic privilege. See In re Scott Paper Co. Sec. Litig., 145 F.R.D. 366, 369 (E.D. Pa. 1992). In \textit{Scott Paper}, the court held that S&P’s was not analogous to accounting firms because of its discretion in regard to which ratings to publish. Id.
distinguishing future lawsuits from the previous precedents which upheld the First Amendment defense for rating agencies. The analogy between traditional journalism and rating agencies has weakened as agencies have shifted from rating solicited and unsolicited bonds to rating, and aiding in designing, complicated financial instruments, such as residential mortgage backed securities (RMBS). The change in business procedures make the rating agencies’ business models more similar to the exceptions in earlier cases than the cases that previously upheld the application of the First Amendment.

In contrast to rating corporate bond debt, rating agencies only rate solicited RMBS and other collateralized debt products. When rating agencies first became recognized, the majority of their revenue came from subscriptions to their publication. This business model is more analogous to newsprint, but it is no longer the rating agency business model. Currently, about 90 percent of rating agencies’ revenue is from companies that solicit the agency for ratings. The changing business model of ratings agencies could have an effect on the context of ratings in the future. Fitch Ratings, as discussed in the previous section, was denied First Amendment protection in part because it only rated solicited debt.

Another change in the rating agencies’ business model which affects the context of ratings is that rating agencies have not only been rating the

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139. See Zimmett, supra note 48.
140. Partnoy, supra note 6, at 73-80. Securitization occurs when debts which have a steady flow of payments (e.g. mortgages and credit cards) are pooled together. Each individual debt in the pool has a potential risk of default. The theory is, if varying degrees of risk are pooled, then the risk is not concentrated. A credit rating agency rates the risk of default for the entire bundle of debt. Jon Ogg, CDOs and the Mortgage Market, INVESTOPEDIA, http://www.investopedia.com/articles/07/cdo-mortgages.asp (last visited Jan. 3, 2010).
141. William G. McGuinness & John W. Brewer, Credit Ratings Agencies Under the Microscope: What to Expect in the Next Generation of Litigation, 241 N.Y. L.J., Jan. 5, 2009 (“In re Fitch ... may not bode well for agencies, as it reflects and endorses the common perception that the approach taken to rating structured-finance products in recent years was substantially less analogous to journalism than was the approach taken to rating corporate bonds in earlier decades.”).
142. Id. (“One particular factor noted [in previous litigation] was an allegedly significant decline in the issuance of ‘unsolicited’ ratings not requested and paid for by the issuer of the securities.”).
143. Partnoy, supra note 6, at 62.
144. McGuinness & Brewer, supra note 141.
145. Partnoy, supra note 6, at 62.
146. In re Fitch, 330 F.3d 104, 110 (2d Cir. 2003). See supra Part II.B for an analysis of the effect a lack of independence has on rating agencies’ First Amendment claims.
debt instruments, but working with the issuer of the debt to form the optimal rating. The rating agencies' shift to rate more complex debt products resulted in agencies earning a higher premium per dollar of debt rated and in agencies working directly with issuers of debt to structure the more complex financial instruments. The relationship between rating agencies and issuers of debt has been described as collaborative. Earlier decisions have denied First Amendment defenses when rating agencies engaged in cooperative behavior with issuers of debt. When agencies illustrate "complete editorial control over the decision of which ratings to publish and [the] form and content of its rating" they are more likely to be found as journalists, but the change in their business model has altered their editorial control. Rating agencies for solicited, complex ratings work directly with the issuers of debt to create a product that matches the ratings sought by the issuer. Rating agencies' lack of independence is a change in their business model and might be a factor that causes courts to deny rating agencies First Amendment protection.

In evaluating First Amendment claims, some courts have determined that ratings as a whole play an important function in the market. Recently there has been some debate about the value of ratings in the market. There have been concerns that ratings convey little information and only reiterate information that the market already knows. One commentator described ratings as a "degenerate certification practice:

147. Partnoy, supra note 6, at 68-71.
148. Id. at 69. Rating agencies can make up to about $300,000 to rate a corporate bond, while they can earn up to about $2,400,000 to rate a securitized financial product.
149. Id.
150. See Zimmett, supra note 48 (describing how rating agencies were "structuring sponsors" of various collateralized debt products).
155. Pamoy, supra note 6, at 90.
156. Unterman, supra note 13, at 99 (explaining how conflicts of interest in the securities market potentially decreased the reliability of ratings). For example, rating agencies are paid a percentage of the ultimate sale price of the instrument, giving the rating agency incentive to increase the rating. In addition, empirical evidence has shown that ratings tend to follow rather than lead the market. Jonathan M. Barnett, Certification Drag: The Opinion Puzzle and Other Transactional Curiosities, 33 J. CORP. L. 95, 139 (2007).
widespread skepticism about its marginal informational value coupled with widespread usage in the relevant market.  

157 In addition, it is alleged that rating agencies were a contributing factor in the current financial crisis due to consistently rating subprime mortgages as the highest quality debt.  

158 The potential negligence claims against rating agencies will be discussed subsequently in the Note; it is sufficient to note for purposes of the First Amendment application that the good public relations which rating agencies once used to assert that they were financial publishers concerned about market transparency might have been tarnished in the 2007-2009 financial downturn.  

159 The district court in Enron granted First Amendment protections in part because rating agencies “perform an essential service for the economy and efficiency of capital markets.”  

160 These market justifications for upholding First Amendment protections might serve as less of an influence now that rating agencies have been implicated in two major financial crises in less than ten years.  

The Supreme Court has stated that the purpose of the First Amendment is the “unfettered interchange of ideas for the bringing about of


158. See, e.g., Credit Rating Agencies and the Financial Crisis: Hearing Before H. Comm. on Oversight and Government Reform, 110th Cong. 10 (2008) [hereinafter Financial Crisis] (opening statement of Henry A. Waxman, Chairman, Comm. on Oversight and Gov’t Reform); Unterman, supra note 13, at 70 (“What is now common knowledge is that the ratings assigned to [collateralized debt obligations] failed to take into account all the risks involved.”); Restructured Products: Credit Rating Agencies, ECONOMIST, Feb. 7, 2008.

159. Financial Crisis, supra note 158.


161. Credit rating agencies were involved in the Enron bankruptcy scandal because they gave Enron’s corporate bonds their highest rating just days before the corporation collapsed. While agencies are not auditors, evidence was presented that the companies were aware of underlying financial irregularities and expended no effort to discern the truth. A Congressional report found that the agencies took

the word of Enron officials when issues were raised, and failed to probe more deeply.... [T]he credit rating agency analysts seemed to have been less than thorough in their review of Enron’s public filings.... Among other things, the rating analysts appeared to pay insufficient attention to the detail in Enron’s financial statements, failed to probe opaque disclosures, [and] did not review Enron’s proxy statements.

The need for a negligence standard marred their ability to bring “unfettered” transparency to the market. Their business model, relying on structured debt vehicles and solicited ratings, has separated them from the quasi-journalistic status they held when they truly did rate all corporate bond debt and subsequently publish the results in their magazines.

III. DUE DILIGENCE AND THE 2007 HOUSING CRISIS

The lack of accountability of rating agencies is allegedly one of the reasons why the mortgage bubble was able to form. It is alleged, rating pooled agencies contributed to the mortgage bubble by consistently rating subprime mortgages as having the same probability of repayment as the United States government, when in fact they have record delinquency rates. A former worker in the ratings industry testified before Congress that “it’s very easy to just go along with the flow because the downside is very limited. You can’t be sued, effectively ... there is no downside for being wrong.”

The alleged negligence of rating agencies contributed to the current financial crisis in that the ratings appear to have been formed without substantive knowledge of the underlying debt, and the methodologies for ratings apparently were not stress tested. Rating agencies overrated

163. Zimmett, supra note 48.
164. See generally id. (detailing how the model of rating agencies has changed in recent years).
165. Edward Chancellor, Inefficient Markets: Structural Flaws, INSTITUTIONAL INVESTOR (AMERICA’S EDITION), Apr. 2007 (“When banks discovered how to securitize loans, they inadvertently created a sexy alternative investment.”). Agencies were able to capitalize on the uncertainty and appeal of these “sexy” new products and double their industry earnings from $3 billion to $6 billion in five years. Financial Crisis, supra note 158 (statement of Henry A. Waxman, Chairman, Comm. on Oversight and Gov’t Reform).
167. Financial Crisis, supra note 158 (statement of Sean J. Egan, Managing Director, Egan-Jones Ratings Co.).
168. Id. (discussing rating agencies actions during the events leading up to the financial crisis).
credit worthiness for debt, and when rating agencies did downgrade creditworthiness, investors had to write off billions of dollars in losses, which resulted in a nationwide credit freeze.\textsuperscript{169}

The first potential allegation of negligence is the rating agencies’ cursory investigations into the quality of the individual debts that composed the collateralized debt instruments.\textsuperscript{170} It is not a business practice of rating agencies to independently verify the information about the loan.\textsuperscript{171} Rating agencies were on notice of the consequences of this business practice.\textsuperscript{172} The lack of diligence in seeking the information on which the published opinion is formed, is the same issue that arose in litigation and congressional reports following the Enron scandal.\textsuperscript{173} During a congressional hearing regarding the current economic crisis, representatives openly questioned rating agencies’ managements’ lack of action even though analysts notified management that a thorough analysis would require looking at the underlying debt itself.\textsuperscript{174} One employee asked management for the information on the quality of the underlying loans in the pooled instrument in order to assess the pooled debt, but was told such a request was “unreasonable” and that the information was not readily available.\textsuperscript{175} The e-mail correspondence between the analyst and management is only one anecdotal example, but does illustrate how insulation from liability allows companies to dismiss due diligence concerns, even from their own employees. Rating agencies had two forms of notice concerning their business practices. They were previously sued for

\textsuperscript{169.} Although there is a claim that agencies acted negligently in regard to their lack of due diligence in ratings formation, there are substantive claims that agencies also acted fraudulently in forming ratings, primarily as a result of the conflict of interest issues inherent in the structure of the ratings market. See Amit R. Paley, Credit-Rating Firms Grilled Over Conflicts: Risk Were Known, Documents Show, WASH. POST, Oct. 31, 2008, at A1.

\textsuperscript{170.} Turmoil in Credit Markets, supra note 2, at 9 (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Law School).

\textsuperscript{171.} Id.

\textsuperscript{172.} Id. at 9-11.

\textsuperscript{173.} The litigation from the Enron scandal absolved the rating agencies of liability for many due diligence requirements, but the new developments since Enron are different than corporate bonds. Id. at 9 (“In the case of corporate bonds, the issuer has released audited financial statements [and] is usually a ‘reporting’ company making regular, periodic filings with the SEC .... But in the case of structured finance products, there is only a pool of financial assets, and the quality of the collateral underlying it may range considerably.”).

\textsuperscript{174.} See Financial Crisis, supra note 158.

\textsuperscript{175.} Id. at 7 (statement of Henry A. Waxman).
conducting only cursory examinations of the underlying loan, and the raters themselves told management that the instruments could not be properly rated without more information about the loans.\footnote{See generally In re Enron Corp. Sec., Derivative & "ERISA" Litig., 511 F. Supp. 2d 742 (S.D. Tex. 2005), aff'd, 446 F.3d 585 (5th Cir. 2006); Financial Crisis, supra note 158.}

Another potentially negligent practice of rating agencies which could lead to liability is the use of models that have not been properly stress tested, a process to test the soundness of the model given different economic conditions.\footnote{Financial Crisis, supra note 158.} The rise in popularity of the secondary market was accompanied by a proliferation of untested models which were largely based only on positive data.\footnote{Id. at 19.} For example, one key assumption, that housing prices would always rise, is questionable.\footnote{Id. at 175 (statement of Congressman John Yarmuth, reading the rating agencies internal documents).} One S&P manager sent an electronic communication to another manager stating that the "model definitely does not capture half the risk."\footnote{Id. at 175 (statement of Congressman John Yarmuth, reading the rating agencies internal documents).} Another employee in the industry stated that with the presence of new financial vehicles and the opportunity for much greater profit, management started cutting expenses, which led to a decrease in the quality of the models and the data available.\footnote{Id. at 31-32 (statement of Frank Raiter, Managing Director and Head of the Residential Mortgage-Backed Securities Ratings Group at S&P's from 1995 to 2005).} The S&P employee said "appropriate methodology to keep track of the new products" was not taken and as "a result, we didn't have the data going forward in 2004 and 2005 to really track what was happening with the subprime products and some of the new alternative-payment type products."\footnote{Id. at 32.} Another industry analyst described the models as "largely untested quantitative models that were very different from the judgment-based methodologies that they used to assess default risk at individual issuers."\footnote{Turmoil in Credit Markets, supra note 2, at 10 (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Law School).} The models were the basis for exceptionally complicated financial products, products which rating agencies knew investors did not have the knowledge to independently evaluate.\footnote{Id.} The rating agencies knew the role they served in the market and performed superficial internal controls to ensure that these ratings, relied on so
heavily by investors, did convey some level of information concerning the quality and creditworthiness of the financial products.\textsuperscript{185}

The ratings market needs to have some form of incentive to ensure quality ratings, either in the form of internal or external market forces. Allowing rating agencies to be subject to the tort action of negligent misrepresentation is a potential tool for providing accountability in the market.\textsuperscript{186}

IV. APPLICABILITY OF THE TORT OF NEGligent MISrepresentation

Courts have leeway in determining the application of First Amendment protections to credit rating agencies.\textsuperscript{187} As a result, different courts have come to different conclusions on the applicability of negligent misrepresentation claims.\textsuperscript{188} If a court holds that a credit rating agency does not benefit from the journalistic privilege, then negligent misrepresentation is applicable when plaintiffs "justifiably rely on the false information when the agency supplies it for the guidance of others in

\textsuperscript{185} Litigation has already started in response to rating agencies' actions throughout the mortgage bubble. See Complaint for Violation of Sections 11, 12 and 15 of the Securities Act of 1933 at 3, N.J. Carpenters Vacation Fund v. Harborview Mortgage Loan Trust, 581 F. Supp. 2d 581 (S.D.N.Y. 2008) (No. 08601451), 2008 WL 2517997 (alleging that rating agencies "failed to conduct due diligence and willingly assigned the highest ratings to such impaired instruments since they were received substantial fees from the issuer," and that furthermore agencies "assigned inaccurate, inappropriate and inflated values and ratings to the Bonds"). The plaintiffs also allege misstatements based on the rating agencies inaccurate models. \textit{Id.}

\textsuperscript{186} Pinto, supra note 7, at 353.

\textsuperscript{187} See generally \textit{In re Enron Corp. Sec., Derivative \& "ERISA" Litig.}, 511 F. Supp. 2d 742 (S.D. Tex. 2005), aff'd, 446 F.3d 585 (5th Cir. 2006) (discussing whether First Amendment protections are applicable to credit rating agencies). In addition to First Amendment concerns, there is some debate that securities law shields rating agencies from lawsuit outside of fraud. \textit{ENRON REPORT, supra note 12, at 105 ("SEC Rule 436, promulgated under the Securities Act, expressly shields NRROS [recognized rating agencies] from liability under Section 11 of the Securities Act in connection with an offering of securities."). If courts hold First Amendment protections should no longer be applied to rating agencies and this law continues to prevent litigation, then Congress could repeal rating agencies' express exemption.

\textsuperscript{188} Compare \textit{id.} (holding absent actual malice, rating agencies were free from investors' claims of negligent misrepresentation), with \textit{In re Fitch}, 330 F.3d 104, 104 (2d Cir. 2003) (holding that the rating agency could be liable for negligent misrepresentation).
their business transaction and fails to exercise reasonable competence in obtaining or communicating the information."

The tort of negligent misrepresentation is a state action and each state has its own specific elements. The standards established by the state and the definition for negligent misrepresentation claims by third parties are relevant to how the court rules. For the purposes of this Note, negligent misrepresentation will be treated generally, and only major elements will be briefly analyzed.

The Restatement (Second) of Torts for the tort of Information Negligently Supplied for the Guidance of Others says:

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

Under the Restatement, the first general element of establishing a negligent misrepresentation claim against rating agencies is proving false representation. The allegations that would fulfill this requirement are discussed in the preceding Section. The second element of negligent misrepresentation is supplying the "false information for the guidance of

189. Pinto, supra note 7, at 353.
190. See Enron Corp., 511 F. Supp. 2d at 815 (discussing whether Connecticut should adopt the Restatement's language for the claim of negligent misrepresentation).
191. Pinto, supra note 7, at 354.
194. Id.
others in their business transactions.”

Agencies serve as gatekeepers between the financial services world and the investors. The sole purpose of the ratings agencies is to bring transparency to the financial markets in order to induce investors to invest in other companies.

The next element is justifiable reliance. Rating agencies argue that there is no justifiable reliance on the part of investors because ratings are only estimates of the likelihood of default and not guarantees. Rating agencies note that in addition to the fact that ratings only serving as advisory opinions, agencies also issue “cautionary statements” about the risk of default despite a high rating. For example, S&P’s has a warning that states

(1) 'substantial risks are involved in an investment in the Bonds,'
(2) an [S&P's] rating was 'not a recommendation to buy, sell, or hold any such Bonds and may be subject to revision or withdrawal at any time,' and
(3) the bonds were 'non-recourse obligations solely of the Issuer and are not insured or guaranteed.'

The presence of a disclaimer, however, does not make it legally binding. Another factor that could weigh against agencies’ claim of lack of justifiable reliance is the extensive use of ratings in regulation. If regulators rely on ratings for establishing capital standards for banks, then an investor could argue that an investor is reasonable in relying on the ratings, in part, when deciding on future investments. Other arguments for justifiable reliance are the level of sophistication required to analyze

195. Id.
196. Partnoy, supra note 6, at 59.
197. See Enron Corp., 511 F. Supp. 2d at 817 (explaining the importance of the rating agencies in bringing transparency to the market).
202. Rating agencies claim that it is good public policy for the investing public to consider the ratings as fallible opinions and not as truth bearing business reports. SEC Commissioner Atkins has made similar statements about avoiding overreliance on credit rating agencies in order to protect the integrity of the industry; rating agencies are “no substitute for an investor making an informed decision and undertaking careful due diligence. We should not create a regulatory regime that creates a moral hazard for investors by encouraging them to rely on credit ratings.” Commissioner Paul S. Atkins, SEC, Statement at Open Meeting to Consider Proposed Rules under the Rating Agency Act (June 11, 2008).
the debt instruments and the privileged information given to rating agencies to analyze the ratings.\textsuperscript{204} Rating agencies have professional analysts rate these instruments with information not available to the general public.\textsuperscript{205} The assumption that investors must do an independent analysis without relying on agencies ignores the realities of the industry.\textsuperscript{206}

In addition to proving the elements of negligent misrepresentation, a plaintiff would also have to illustrate privity between the rating agency and the investors because investors do not pay for the ratings.\textsuperscript{207} Rating agencies claim there is no privity and that their services are offered to the investing public as a large and indefinable group.\textsuperscript{208} How the courts interpret the size of the rating agencies investing audience is an important factor in determining their potential liability.\textsuperscript{209} If the rating agencies are deemed to provide the information to the general public, then it is much more likely that there is no privity between the agency and the investors.\textsuperscript{210} The size of the investment pool generally will be case specific, but the trend of companies' shift in focus on new securitized debt products should result in more findings that the ratings are not offered to the general public.\textsuperscript{211} These very complicated instruments are purchased by institutional investors and not the public generally.\textsuperscript{212} If the courts view investors using credit ratings as a select group of multi-million dollar

\begin{itemize}
\item \textsuperscript{204} \textit{In re} Pan Am Corp., 161 B.R. 577, 582 (S.D.N.Y. 1993).
\item \textsuperscript{205} Id.
\item \textsuperscript{206} SIFMA REPORT, \textit{supra} note 1, at 14.
\item \textsuperscript{207} SEC REPORT, \textit{supra} note 3, at 41.
\item \textsuperscript{208} LaSalle Nat'l Bank \textit{v.} Duff & Phelps Credit Rating Co., 951 F. Supp. 1071, 1093 (S.D.N.Y. 1996).
\item \textsuperscript{209} Id. ("[F]ederal courts have typically dismissed negligent misrepresentation claims brought by members of the general public" (citing \textit{In re} Time Warner Inc. Sec. Litig., 794 F. Supp. 1252, 1264 (S.D.N.Y. 1992))).
\item \textsuperscript{210} \textit{In re} Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 640, 646-47 (S.D. Ohio 2008). Privity was found by the court because the offered debt was "targeted to a select class of institutional investors with the resources to invest tens of millions of dollars in the notes. And the only place that the ratings are alleged to have appeared were in the offering materials given to the select class of investors." \textit{Id.} See \textit{LaSalle Nat'l Bank}, 951 F. Supp. at 1092-96 for a discussion of a successful application of privity for a credit rating agency under New York law.
\item \textsuperscript{211} \textit{See generally} \textit{In re} Fitch, 330 F.3d 104 (2d Cir. 2003).
\item \textsuperscript{212} Ogg, \textit{supra} note 140 ("Generally speaking, it is rare for John Q. Public to directly own a [collateralized debt obligation]. Insurance companies, banks, pension funds, investment managers, investment banks and hedge funds are the typical buyers. These institutions look to outperform Treasury yields, and will take what they hope is appropriate risk to outperform Treasury returns.").
\end{itemize}
investors, then there is a much greater chance that the courts will recognize privity between the parties. The last element is whether there is a duty owed by a defendant-agency to a plaintiff-investor to communicate accurate information. Duty is not predefined and can be determined by the court. The court in *Enron* looked at two factors to determine if a duty was owed. The first was whether “an ordinary person in the defendant’s position, knowing what the defendant knew or should have known, would anticipate that harm of the general nature of that suffered was likely to result.” While credit rating agencies might not have been able to predict the extent of the harm that has resulted from their write-downs, the nature of the injury was foreseeable. The failure of Enron is evidence against any rating agency dispute that negligent ratings have market reaching effects.

The second element that the court looked at was based on “a public policy analysis.” In this situation the policy justifications for finding a duty have been elaborated on throughout the Note. The credit rating market is crucial to linking the financial service market and investors. The flow of the money depends on investors buying debt and requiring market transparency. The court cited one additional factor in determining the presence of a duty: the avoidance of additional litigation. Not surprisingly, rating agencies claim that allowing investors to sue for negligence would hamper the industry. While this point can

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213. See generally Fitch, 330 F.3d at 104.
215. Nat’l Century Fin. Enter., 580 F. Supp. 2d at 652-55 (stating there is no predetermined test for duty and advocating the use of a foreseeability test, a test based on if the defendant should have anticipated the harm).
217. Id.
218. See generally SEC REPORT, supra note 3 (discussing potential responses to perceived rating agency failures from the 2000 Enron scandal).
219. Id.
221. Unterman, supra note 5, at 121.
222. See generally Partnoy, supra note 6, at 59 (discussing the role rating agencies fulfill in the financial markets).
224. Id. at 815. Rating agencies state that they “must be allowed to maintain independence and objectivity and not be swayed by risk of unlimited liability for errors to either issuers or investors; instead the market should be the appropriate means for ensuring the reliability of credit opinions and of rating agencies.” Id. There are legitimate concerns about the ability of the rating agency market to fulfill this function. See supra
be debated, it appears reasonably obvious that there are large potential social costs for both allowing litigation and minimizing litigation.\textsuperscript{225}

CONCLUSION

Credit rating agencies have been crucial players in the financial market for decades. The rating agencies began by rating commercial bonds and publishing the information through financial news mediums. The publication of their evaluation of corporate debt served as a valuable resource for perspective investors in evaluating the debt. The publications served a social purpose of bringing information and transparency to the bond market. When investors sued concerning the formation of rating agency opinions, courts often insulated agencies from liability for mere negligence. The courts wanted to protect the public function of ratings and did so by upholding the First Amendment as a defense for substantive suits concerning content of a rating. In the early to mid 2000s, the public context of ratings altered. Rating agencies began to rate debt differently. Rating agencies rated a greater percentage of debt for which they were paid and did not remain independent from the issuers of debt. These changes separate rating agencies from the journalistic model that encouraged the flow of unbiased information which the courts originally sought to protect. The reason for courts’ application of First Amendment protections are no longer applicable and agencies should no longer be deemed financial publishers.

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\textsuperscript{225} Cf. Enron Corp., 511 F. Supp. 2d at 815; Irwin & Goldfarb, supra note 161 (describing the United States federal government’s efforts to allay the worsening financial crisis).

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