Credit rating agency liability in Europe: Rating the combination of EU and national law in rights of redress

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Summary

The first ideas for this PhD research developed in the aftermath of the global financial crisis. At that time, the Union legislature developed rules addressing the parties that were considered responsible for the crisis in order to stabilise the financial markets and to avoid another financial crisis. Although most of these European rules had a 'public law character', the Union legislature also introduced rules on civil liability that private parties could enforce. Consequently, in certain situations, private parties can sue the institution responsible for loss they suffered based on EU law, or are explicitly entitled to do so by EU law on the basis of national law.[1] This possibility was considered to represent a radical change, as non-contractual liability law and civil liability rules traditionally belonged to the competence of the Member States. This study concentrated on the most prominent example of a post-crisis pan-European rule on civil liability in the context of the financial sector: the legal basis for the civil liability of credit rating agencies under Article 35a CRA Regulation.

Article 35a (1) CRA Regulation provides issuers and investors with the opportunity to hold a credit rating agency liable if such agency has committed – intentionally or with gross negligence – one of the infringements listed in Annex III of the Regulation. Although the provision for civil liability under Article 35a CRA Regulation forms only a small part of the European regulatory framework for credit rating agencies, the provision has drawn the attention of legal scholars because of its remarkable structure.[2] Article 35a CRA Regulation introduced a basis for civil liability at the European level, but general tort law has not been harmonised at the EU level. Instead, the Union legislature attributed a crucial role to national private law: under Article 35a (4) CRA Regulation, the national laws of the Member States remain to be of crucial importance to interpret and apply the elements of Article 35a (1) CRA Regulation that were not defined. Article 35a CRA Regulation thus created a mould for civil liability, into which national legislatures or courts must pour the applicable national law.

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1 *E.g.* Art. 11 (2) PRIIPs Regulation, Art. 31 (2) and Art. 55 (3) PEPP Regulation and Art. 11 (2) Prospectus Regulation. Outside the scope of EU financial law, Art. 82 General Data Protection Regulation. Section 2.5.

2 On the relationship to other research on the civil liability of credit rating agencies, section 1.7.

This dissertation searched an answer to the following main questions:

> *Will the post-crisis goal of an adequate right of redress for issuers and investors against credit rating agencies be achieved whilst Article 35a CRA Regulation has to be interpreted under various systems of national law? Should civil liability be regulated differently based on that analysis and if so, in what manner?*

In order to answer these main questions, this study investigated the legal basis for civil liability under Article 35a CRA Regulation thoroughly and also investigated other ways in which European rules influence private law relationships and (national) non-contractual liability law. The following sub-questions were analysed:

1. *In which ways does EU law influence (national) rules on civil liability?*
2. *Which issues occur, if any, in determining the competent court and the applicable national law in respect of claims based on Article 35a CRA Regulation?*
3. *How will the conditions of Article 35a CRA Regulation be interpreted and applied under Dutch, French, German and English law?*
4. *If differences exist between the national interpretations and applications, to what extent could such differences lead to different outcomes in decisions on civil liability claims based on Article 35a CRA Regulation?*
5. *In light of the answers given to sub-questions 2-4, should Article 35a CRA Regulation be amended? If so, in what manner(s)?*

This study approached the subject of credit rating agency liability under Article 35a CRA Regulation from a legal perspective, with a focus on the vertical interaction between EU law and national private law. To that end, the research combined the legal disciplines of EU law, Private International Law, private law and regulatory law. The research was of a descriptive and normative nature: it provided an in-depth analysis of the functioning, interpretation and application of Article 35a CRA Regulation and determined how the current European civil liability regime for credit rating agencies could be improved from the perspective of a normative framework. The dissertation can roughly be divided into three main parts.

As the first part, Chapter 2 'Influence of EU law on civil liability' and Chapter 3 'Credit rating industry and its regulation' provided the context in which the specific analyses of Article 35a CRA Regulation made in Chapters 4 and 5 must be considered.

Chapter 2 aimed to map the ways in which EU law (regulations, directives and decisions of the CJEU) currently influences rules on civil liability and rights of redress, with a particular focus on examples derived from EU financial law. By providing the broader European legal context, it aimed to contribute to the understanding of the status, main features and effects of Article 35a CRA

Regulation. To analyse the influence of EU law on civil liability, section 2.5 distinguished three situations: (1) situations in which EU law leaves the enforcement of rights established at the EU level completely to Member States; (2) situations in which EU law imposes obligations on Member States in respect of their rules on civil liability or requires the application of their national civil liability regimes; and (3) situations in which EU law creates directly effective rights to damages or compensation for individuals and other private parties at the EU level for the violation of EU rights and obligations. The difference in result between situations 2 and 3 is a matter of degree; it is sometimes difficult to draw the line between situation 2 and 3, and the influence of the provisions falling in these categories can be similar.

The roadmap demonstrated that the introduction of the right of redress for issuers and investors under Article 35a CRA Regulation does not stand on its own. One can find a growing number of provisions of a private law nature in regulations and directives.[3] EU law leaves its traces on (national) civil liability rules mainly by setting common, and mostly minimal, standards of conduct for private parties at the EU level and by requiring Member States to apply their national regimes for civil liability to violations of EU law.[4] The Union legislature has not developed a uniform approach to civil liability matters and regulates civil liability in a 'fragmented' way.[5] Provisions of EU law that explicitly arrange for civil liability and rights of redress do so in all sorts of wordings and are often included in a broader package of rules to achieve certain objectives set at the EU level.[6] From this perspective, Article 35a CRA Regulation is exemplary for the approach taken by the Union legislature in private law matters. The structure of Article 35a CRA Regulation is unique, and Article 35a CRA Regulation was included in a broader regulatory package for credit rating agencies. Furthermore, Article 35a CRA Regulation is exemplary for the approach to civil liability taken by the Union legislature in the area of EU financial law: the influence of EU law increases, but national civil liability regimes continue to play a large role.[7] Issuers and investors can base a claim directly on Article 35a CRA Regulation, but Article 35a CRA Regulation is not an independent and autonomous EU legal basis for civil liability.

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3 *E.g.* Ackermann 2018 and, *focusing on regulations*, De Graaff & Verheij 2017.

4 *Cf.* Vandendriessche 2015, no. 71. Vandendriessche concluded that liability rules 'have been harmonized in a fragmented fashion and to a very limited degree only', but, at the same time that 'some impact nevertheless has been felt' (Vandendriessche 2015, no. 72 and no. 71, respectively).

5 Vandendriessche 2015, no. 71. *Also e.g.* Ackermann 2018, p. 743 and pp. 761-762 and Kuipers 2014, p. 161.

6 *See* Ackermann 2018, pp. 761-762 and De Graaff & Verheij 2017, p. 992.

7 *Cf. in general (i.e. not in the specific context of credit rating agencies)* Vandendriessche 2015, no. 71. Art. 82 General Data Protection Regulation is the only example of a right to compensation with direct horizontal effect established at the EU level, which the CJEU can interpret autonomously.

Whereas Chapter 2 broadened the scope of the study to include the European legal context in which Article 35a CRA Regulation could be considered, Chapter 3 zoomed in on the credit rating industry and its regulation in particular. It provided relevant background information on (the history of) the credit rating industry, credit ratings, the EU regulatory framework for credit rating agencies, and the factual side of credit rating agency liability. The historical analysis made in section 3.2 demonstrated that debates on the position of the credit rating agency industry and, in particular, on its civil liability have taken place since the establishment of the first credit reporting agencies in the mid-19th century. The criticism addressed at credit rating agencies in the aftermath of the financial crisis was not new, and, instead, a pattern throughout history can be noticed. Despite the returning commotion on the inaccuracy of credit ratings, credit rating agencies faced few civil liability threats throughout their existence. From this perspective, the introduction of Article 35a CRA Regulation was a breakthrough.

As a prelude to Chapters 4 and 5, section 3.5 paid attention to the legislative history of Article 35a CRA Regulation and investigated the scope of application of Article 35a CRA Regulation by describing which credit rating agencies, issuers and investors could be involved in legal proceedings based on Article 35a CRA Regulation.[8] The analysis revealed that the scope of application of Article 35a CRA Regulation is limited in several respects. Issuers and investors can only bring claims for damages under Article 35a CRA Regulation against credit rating agencies established and registered in the EU, and not against the headquarters of Moody's and Standard & Poor's in the US. Furthermore, the strictly grammatical interpretation of the investor-specific requirement of reasonable reliance of the German lower courts severely limits the scope of application of Article 35a CRA Regulation, namely to investors who relied on a credit rating for the decisions to invest in, hold onto or divest themselves of financial instruments only. Even though the first sentence of Article 35a (1) CRA Regulation, which creates the right of redress, does not provide for such restrictions and one cannot see why the Union legislature would restrict the scope of application of Article 35a in this manner, the wording of the investor-specific requirement does not excel in clarity.

As the second part of this dissertation, Chapter 4 'Private International Law aspects' and Chapter 5 'Interpretation and application Article 35a under Dutch, French, German and English law' provided an in-depth analysis of the current functioning, interpretation and application of Article 35a CRA Regulation.

Chapter 4 discussed the main elements of Private International Law in the context of the civil liability of credit rating agencies. The Chapter centred around the three main questions of Private International Law: which national

8 Section 5.3 discussed the conditions for civil liability under Art. 35a CRA Regulation in detail in the context of the legal comparison.

court can assume jurisdiction? What law is applicable? And, how shall an eventual judgment be enforced? Through this broad overview of the relevant Private International Law aspects, this Chapter addressed several issues that could occur when a national court must determine its competence in respect of claims based on Article 35a CRA Regulation and the law applicable to claims based on Article 35a CRA Regulation. It was concluded that issues – in terms of foreseeability and predictability for the stakeholders involved – mainly arise: (1) if a jurisdiction clause exists in favour of the courts of a third country (a non-Member State); and (2) if a national court must determine the *Erfolgsort* of financial loss under Article 7 (2) Brussels I Regulation (recast) or the place where the damage occurred under Article 4 (1) Rome II Regulation.

If an exclusive jurisdiction clause exists in favour of the courts of a third country, European rules of Private International Law do not provide guidance as to how national courts must assess the validity of such clauses: in accordance with national Private International Law or in accordance with the other – i.e. not Art. 25 Brussels I Regulation (recast) – provisions of the Brussels I Regulation (recast).[9] As contracts concluded by credit rating agencies can often include jurisdiction clauses in favour of the US courts, it is, hence, currently difficult for parties to predict whether Member State courts will uphold an exclusive jurisdiction clause in favour of third country courts.

In addition, it is uncertain how a national court must determine the *Erfolgsort* of financial loss under Article 7 (2) Brussels I Regulation (recast) and the place where the damage occurred under Article 4 (1) Rome II Regulation. The unforeseeability and unpredictability stemming from the CJEU's case law in the context of the *Erfolgsort* is most problematic in relation to the assessment of the applicable national law, as the *lex loci damni* is the main rule. Both in relation to jurisdiction and choice of law, the intangible nature of financial loss lies at the heart of the current uncertainty. Indeed, the *Erfolgsort* under Article 7 (2) Brussels I Regulation (recast) and the place where the damage occurred under Article 4 (1) Rome II Regulation assume that loss occurs at a physical place, while the intangible nature of financial loss renders it difficult, if not impossible, to pin financial loss down to a physical place. In its recent decisions in *Universal Music*[10] and *Helga Löber v Barclays Bank*,[11] the CJEU did not designate a single, decisive connecting factor to locate financial loss. The approach does not help solve cases in which the relevant connectors are spread over multiple countries, because it fails to make a fundamental choice with regard to the location of financial loss. In the context of Article 35a CRA Regulation, the lack of certainty is especially unfortunate, because the applicable national law is the cornerstone for stakeholders to structure their claims

9 Assuming that the Hague Choice of Court Convention does not apply.
10 CJEU 16 June 2016, C-12/15, ECLI:EU:C:2016:449 (*Universal Music International Holding*).
11 CJEU 12 September 2018, C-304/17, ECLI:EU:C:2018:701 (*Helga Löber v Barclays Bank*).

and defences and is essential for stakeholders involved to assess whether a claim may be successful.

Chapter 5 investigated how the requirements of Article 35a (1) and Article 35a (3) CRA Regulation are interpreted and applied under Dutch, French, German and English law. As national courts cannot apply Article 35a CRA Regulation without assistance of the applicable national law, an understanding of the meaning of its terms under Member State laws was needed in order to be able to conclude in Chapter 6 whether Article 35a CRA Regulation has created an adequate right of redress for issuers and investors. Prior to the presentation of the national law reports, section 5.3 provided for an analysis of the framework set by Article 35a CRA Regulation. Section 5.3 already revealed several issues in relation to the wording of Article 35a CRA Regulation. For instance, it addressed issues in relation to the attribution of acts and omissions to credit rating agencies, issues in relation to the wording of the investor-specific requirement of reasonable reliance and inconsistencies in the wording of Article 35a CRA Regulation in relation to the remedy involved (damages or compensation). Subsequently, sections 5.4-5.7 involved reports of the interpretation and application of Article 35a CRA Regulation under Dutch, French, German and English law. The national law reports revealed uncertainties as regards the exact interpretation and application of Article 35a CRA Regulation. It was sometimes difficult to predict the exact interpretation and application due to a scarcity or even a lack of legal sources in respect of credit rating agency liability. Furthermore, the sometimes imprecise wording of Article 35a CRA Regulation, disparities between the conditions of Article 35a CRA Regulation and the structure of Article 35a CRA Regulation caused uncertainties and frictions.

Finally, section 5.8 investigated which similarities and differences exist between the four national interpretations and applications and whether any differences can lead to different decisions on civil liability claims based on Article 35a CRA Regulation. At the risk of oversimplifying the results of the legal comparison, French law generally adopts the most flexible approach to the interpretation and application of Article 35a CRA Regulation (to the benefit of issuers and investors), while the English interpretation and application under the UK Implementing Regulations is very restrictive (to the disadvantage of issuers and investors). Dutch and German law take up middle positions, the former system being inclined to the French interpretation and application and the latter system being inclined to the English interpretation and application. It was observed that English law stands out in adopting a restrictive approach to almost all terms and subjects investigated, leading to rather limited possibilities for issuers and investors to hold credit rating agencies liable when English law applies to their claims. The advantage of the method adopted by the UK legislature is, however, that English law at least provides rather clear guidance on how national courts should deal with credit rating agency liability, while this guidance is lacking and causing uncertainty within the other legal systems

investigated. The final question then is whether the four national approaches to Article 35a CRA Regulation can lead to different results in legal proceedings, depending on what national law applies. It was concluded that the differences can have effects on decisions in concrete cases, but that one must put these differences into perspective. The current combination of stringent conditions set at the EU level and restrictive national interpretations (will) cause(s) many claims to strand.

As the third part, Chapter 6 aimed to answer the main research questions of whether Article 35a CRA Regulation creates an adequate right of redress for issuers and investors, and of whether Article 35a CRA Regulation should be amended and, if so, how. To that end, Chapter 6 discussed the findings of Chapters 2-5 from the perspective of the normative framework. Subsequently, it formulated recommendations to improve Article 35a CRA Regulation.

The observations within the normative framework demonstrated that Article 35a CRA Regulation currently does not form an adequate right of redress for issuers and investors. Article 35a CRA Regulation is a political compromise;[12] proponents and opponents of credit rating agency liability can present the right of redress under Article 35a CRA Regulation to their own advantage. Yet, a politically balanced right does not necessarily entail a legally substantively balanced right as well. Creating a framework for a right to damages at the EU level is in itself not necessarily sufficient to increase issuer and investor protection. On the contrary, the structure of Article 35a CRA Regulation itself marginalises the provision's added value as compared to the civil liability regimes of the Member States investigated. In addition, uncertainties exist in relation to the way in which national courts must determine the competent court and the applicable national law. These uncertainties are especially unfortunate, because Article 35a CRA Regulation depends on the applicable national law for its interpretation and application. Finally, it was concluded that Article 35a CRA Regulation does not provide sufficient substantive guidance on the conditions of civil liability.

The only manner to increase the level of protection of issuers and investors, and to enhance legal certainty, is by reducing the influence of the applicable national law.[13] To that end, the Union legislature could change the structure of Article 35a CRA Regulation in two ways: (1) by imposing more detailed obligations on Member States by describing when issuers and investors are entitled to damages under the applicable national law; and (2) by extending the current system under Article 35a CRA Regulation by severely reducing the importance of the applicable national law. Other recommendations involve

12 *Cf. e.g.* Haar 2014, p. 329. *Also* Deipenbrock 2018, p. 561.

13 *For this recommendation also* Heuser 2019, p. 267. Furthermore, Wimmer proposed to codify part of the additional substantive guidance in a new Annex IV CRA Regulation (Wimmer 2017, p. 440).

restricting the use of exclusive jurisdiction clauses in favour of the courts of third countries and including specific rules on jurisdiction and applicable law within the CRA Regulation. Finally, the Union legislature could consider providing more detailed substantive guidance on terms such as 'gross negligence', on relaxing the requirement of reasonable reliance, and on deciding what type of investor loss is eligible for compensation by analysing the initial justification for credit rating agency liability and restricting the opportunities for credit rating agency's to limit their civil liability in advance.

Finally, the broader implications of this study were analysed. It was concluded that, instead of using the template of Article 35a CRA Regulation, the Union legislature should rather consider other possibilities to arrange for provisions on civil liability at the EU level. In situations in which no fundamental differences between Member States exist, the Union legislature could simply require Member States to apply their civil liability regimes. As a more intrusive legal measure, the Union legislature could decide to impose more detailed obligations on Member States by describing when issuers and investors have a right of redress under the applicable national law or to create autonomous rights of redress. These options have their own advantages and disadvantages, but they avoid the problematic combination of EU law and national law within EU rights of redress. Especially in situations in which the template of Article 35a CRA Regulation provides an attractive political compromise because little consensus exists on the desirability of a right of redress, its usefulness for the Union legislature from a legal perspective is generally rated at BB or Ba1[14] and, in other words, is generally rated below investment grade.

14 These credit ratings are the highest non-investment grade ratings pursuant to the rating scales employed by Standard & Poor's (the scale for long-term issue credit ratings available at www.standardandpoors.com//en_US/web/guest/article/-/view/sourceId/504352, last accessed at 31 August 2019) and Moody's (available at www.moodys.com/sites/products/productattachments/ap075378_1_1408_ki.pdf, last accessed at 31 August 2019), respectively.