Credit Rating Agencies - From the Subprime Mortgage Crisis to the Coronavirus Pandemic

Adv. Rami Sofer, Head of the Corporate, Finance and Infrastructure Department

Times of crisis present critical challenges for credit rating agencies. During a crisis, these agencies are faced with complex dilemmas and legal exposure. Very few foresaw the extreme scenario that the world has encountered over the past few months. Expecting rating agencies to include such an extreme scenario in the risk factors they considered appears, at first glance, to be exaggerated. However, as the crisis began to spread to every inhabited corner of the planet, many questions have arisen in this regard. Were the ratings given by the rating agencies on the eve of the crisis accurate, and do they remain so? Did the rating agencies react to the upheaval in time and was their response measured and reasonable? Have they been able to analyze how the event may affect companies in different sectors, different companies in the same sector, or different financial instruments?

These questions have clear implications not only for investors - both individuals and institutional entities - who rely on ratings in making investment decisions, but also for the rated companies themselves. In Israel, there are two rating agencies regulated by the Israel Securities Authority. These agencies provide assessments on the ability of a debtor (the issuer) to meet its obligations or on the insolvency risk inherent in a financial instrument it issued, all in relation to comparable issuers or financial instruments. In this way, rating agencies help to bridge information gap between lenders and borrowers regarding the latter’s ability to repay their debt. In theory, and perhaps in practice, the more accurate the rating, the better information the lenders have in relation to the risk factors, which should serve to reduce the interest rates demanded from borrowers. The importance of refining and reducing financing costs is self-evident. Another common use of these agencies’ ratings is in loan and bond agreements. In such agreements, a downgrade below an agreed threshold often triggers an increase in the interest rate or an acceleration event.

In Israel, following the subprime mortgage crisis of 2008, a law was passed in 2014 regulating the activities of credit rating agencies[1], which subjected their activities to the supervision of the Israel Securities Authority. The law provides rating agencies with protection from civil suits filed by investors, as long as the agency acted in good faith and was not shown to have acted with **gross negligence**. The law establishes a presumption that a rating agency acted in bad faith in the event that it violated the specified duties of absence of conflict of interest or of the independence of the rating.

Concern regarding conflicts of interest is one of the most troubling issues when it comes to rating agencies’ performance, since it is the rated companies that pay the rating agencies. The law establishes rules designed to

[1] Law to Regulate the Activity of Credit Rating Companies – 5774-2014

mitigate this problem, but there does not appear to be a perfect solution, as the problem is inherent to the agencies' business model.

In the United States, following the subprime mortgage crisis, the leading rating agencies were forced to pay hundreds of millions of dollars in settlements. The main argument against the rating agencies was that they had rated financial instruments at the source of the crisis in a way that did not properly represent their inherent risk.

As noted above, under Israeli law, rating agencies are protected and are liable only in the event that gross negligence is established, but the law does not clarify the distinction between gross negligence and 'mere' negligence. The Israeli courts that have heard claims against rating agencies (in only a handful of cases)[2] have held that rating agencies have a duty of care towards investors who have relied on the agencies' opinions in arriving at their investment decisions. At the same time, the courts were careful not to extend this duty excessively, and held that if a rating agency acted in good faith, with awareness of the totality of the facts and circumstances, and accordingly applied their own policy guidelines to these facts, their conduct could not be considered negligent. The court applied this standard even while recognizing that the rating agencies could have acted differently and could have used a different rating methodology. On the basis of these basic criteria, it can be assumed that insofar as these matters are brought for future judicial decisions, a rating agency will be found to have acted with gross negligence if it did not collect all the information required to determine the rating, ignored relevant information or analyzed it in a manner that clearly and grossly deviates from accepted practices of analysis.

Even after proving that a rating agency acted with gross negligence, a number of hurdles remain for potential claimants, including demonstrating the causal link between the rating agency's breach of duty and the damage suffered, as well as establishing the value of the damage. The complexity of such a claim is perhaps the reason why in the United States, many of such claims were filed by institutional entities which, in this way, have sought to protect disastrous investments and possibly even the institutional entities' reputation. These issues were also raised in class actions following insolvency cases, where the investors sued the issuer and attempted to hold its accountants and rating agencies (or their insurers) accountable as well.

Another important issue arising at this time is whether or not a downgrade can constitute a cause of action by the issuer against its rating agency. This matter was brought before the District Court in 2008 in the midst of the subprime mortgage crisis, in the context of a rated company's request for a temporary declaratory injunction seeking to cancel a downgrade[3]. The company made a plethora of claims against the rating agencies and relied on the opinion of an authoritative economist. The company claimed that the agencies decisions to reduce its rating were unreasonable and devoid of any economic justification and that the rating agencies breached their duties of loyalty and trust duties towards the company, as well as their obligation to check the company's latest

[2] 31720-11-14 Lavi Vs. Midroog Ltd.

[3] 23686/08 TMI Limited Vs."Maalot" Israeli Securities Ranking Company Ltd.

data before reducing its rating. The court avoided deciding on the merits of these claims, content with the laconic reasoning that the position of the company and of the expert on its behalf are "not determinative" and that the matter is left to the rating agency's professional judgment.

It is doubtful whether a court required to address this issue in the future will settle for such reasoning. Hence, even with respect to the matter of a rating agency's responsibility towards the companies it rates, and not only towards a company's investors, the last word has not yet been spoken. It appears that following the current crisis, these questions may be put to the test again.

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Should you have any questions or need additional information regarding this matter, please feel free to contact Adv. Rami Sofer, Head of the Corporate, Finance and Infrastructure Department: rami.sofer@goldfarb.com, or at: +972-3-608-9369.