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# WHAT STANDARD OF CARE SHOULD GOVERN THE WORLD'S SHORTEST EDITORIALS?: AN ANALYSIS OF BOND RATING AGENCY LIABILITY†

“[Standard & Poor’s] does not encourage companies to manage themselves with an eye toward a specific rating. The more appropriate approach is to operate for the good of the business as management sees it, and to let the rating follow.”<sup>1</sup>

On January 19, 1990, Moody’s Investor’s Services, Inc., one of the nation’s largest bond rating agencies, lowered its rating on RJR-Nabisco’s existing debt, citing worries as to whether the company’s cash flow was sufficient to allow it to meet upcoming interest payments on its convertible debentures.<sup>2</sup> Even though Standard & Poor’s Corp., Moody’s major rival, reaffirmed its own higher rating, RJR-Nabisco’s bonds still lost twenty percent of their value within the next two days—a cumulative fall of several hundred million dollars.<sup>3</sup>

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† I thank Joanne W. Rose, Vice President & Counsel for Standard & Poor’s Debt Rating Services Group, for her helpful comments throughout the drafting of this Note. In addition, I thank Professors George Hay, Jonathan Macey, and Dale Oesterle, and Managerial Economics Ph.D. candidate Dan Lovallo, for their advice and comments. Finally, I am especially thankful for the assistance of Lori Bostrom, Chris Considine, Susan Green, and Anne Marie Hill during the editing and production of this piece. I add the obligatory disclaimer, of course, which is that all errors are solely mine.

<sup>1</sup> STANDARD & POOR’S CORPORATION, DEBT RATINGS CRITERIA 4 (Roy Weinberger ed. 1986) [hereinafter S & P DEBT RATINGS CRITERIA]; see MOODY’S INVESTOR’S SERVICE, INC., MOODY’S ON MUNICIPALS: AN INTRODUCTION TO ISSUING DEBT 49 (Fred S. Ackerman ed. 1987) [hereinafter MOODY’S ON MUNICIPALS].

Commentators disagree as to whether bond rating agencies affect the cost of the capital, or merely reveal the underlying risk. Compare DAVID F. HAWKINS, BARBARA A. BROWN & WALTER J. CAMPBELL, RATING INDUSTRIAL BONDS II, 15 (1983); James S. Ang & Kiritkumar A. Patel, *Bond Rating Methods: Comparison and Validation*, 30 J. FIN. 631, 631 (1975); Thomas M. Tole & Sammy D. McCord, *A Bond Rating Agency’s Influence on Utilities’ Cost of Capital*, PUB. UTIL. FORT., Feb. 20, 1986, at 34 with George W. Hettenhouse & William L. Sartoris, *An Analysis of the Informational Value of Bond-Rating Changes*, 16 Q. REV. ECON. & BUS. 65, 76 (1976); George E. Pinches & J. Clay Singleton, *The Adjustment of Stock Prices to Bond Rating Changes*, 33 J. FIN. 29, 42 (1978); Douglas Randall, *A Bond Rating Agency’s Lack of Influence on Utilities’ Cost of Capital*, PUB. UTIL. FORT., Feb. 20, 1986, at 52; Mark I. Weinstein, *The Effect of a Rating Change Announcement on Bond Price*, 5 J. FIN. ECON. 329, 331 (1977).

Whether the rating communicates new information to the market or only reveals existing information in a more efficient fashion, the rating does influence the cost of a security’s issue, its marketability, the status of a company’s existing securities, the company’s overall credit rating, the maturity date of the issue, and the company’s equity. D. HAWKINS, B. BROWN & W. CAMPBELL, *supra*, at 15.

<sup>2</sup> Judith H. Dobrzynski, David Zigas & Walecia Konrad, *Moody’s May Have Lowered the Boom Too Fast*, BUS. WEEK, Feb. 12, 1990, at 63.

<sup>3</sup> *Id.*

Some analysts declared that Moody's had "goofed," and that the "bomb" that Moody's had dropped on the investment markets was simply "overreaction."<sup>4</sup> Although it is still unclear whether Moody's simply made a mistake, one thing is certain: even if Moody's was clearly negligent in assigning its rating, neither the embattled RJR-Nabisco nor its disgruntled bondholders are likely to recover any of their losses from Moody's in court. Given tort law's emphasis on compensating harmed parties, how is it possible for one private, largely unregulated entity to exercise such discretion without having to compensate relying parties?

Bond rating agencies, such as Standard & Poor's<sup>5</sup> and Moody's,<sup>6</sup> specialize in gathering and analyzing public and private information<sup>7</sup> about debentures.<sup>8</sup> The results are reported in a letter

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<sup>4</sup> *Id.*; see David Zigas, *Why the Rating Agencies Get Low Marks on the Street*, BUS. WEEK, Mar. 12, 1990, at 106, 108 ("Many professionals in the market view the ratings of the three agencies as 'rear view mirror' analyses. 'They are lagging indicators of credit quality,' says Bruce N. Lehmann, an associate professor of law at Columbia University Business School.").

<sup>5</sup> Standard & Poor's Corporation was formed by the 1941 merger of Poor's, an agency that began rating securities in 1922, and Standard Statistics, which began rating securities in 1923. Louis H. Ederington & Jesse B. Yawitz, *The Bond Rating Process*, in HANDBOOK OF FINANCIAL MARKETS AND INSTITUTIONS (Edward I. Altman 6th ed. 1988). In 1966, McGraw-Hill, Inc., a major publisher of numerous financial books and magazines, including the popular magazine *Business Week*, acquired Standard's Poor's, Inc. Today, Standard & Poor's has ratings outstanding on issues of over 1700 corporations and 7000 municipalities and states, and commercial paper ratings on over 600 corporations. D. HAWKINS, B. BROWN, & W. CAMPBELL, *supra* note 1, at 18. In ratings matters, Standard & Poor's operates independently of McGraw-Hill. S & P DEBT RATINGS CRITERIA, *supra* note 1, at 5.

<sup>6</sup> Moody's Investor's Service, Inc. began rating railroad bonds in 1909, and industrial bonds in 1914. Since 1940, it has been a registered investment adviser under section 203 of the Investment Advisers Act of 1940, Pub. L. No. 76-768, ch. 686, § 203, 54 Stat. 847, 850-52 (current version at 15 U.S.C. § 80b-3 (1987)). Dun & Bradstreet, a firm involved in nearly all aspects of the financial markets, owns Moody's. D. HAWKINS, B. BROWN & W. CAMPBELL, *supra* note 1, at 17; Ederington & Yawitz, *supra* note 5, ch. 23, at 23.

<sup>7</sup> Public information is data that is available to the public, such as annual reports required by the Securities and Exchange Commission. Private information is data internal to the issuing corporation. The public information required usually includes a registration statement, a prospectus, the most recent annual or quarterly report, annual reports of the past five years, and subsequent quarterly financial statements. HUGH G. SHERWOOD, HOW CORPORATE AND MUNICIPAL DEBT IS RATED: AN INSIDE LOOK AT STANDARD & POOR'S RATING SYSTEM 22, 27 (1976).

Both Standard & Poor's and Moody's ask the issuer to provide financial statements dating back five years and forecasts of key elements of future earnings. Both agencies request the firm's capital spending plans and plans for future financing. Standard & Poor's also asks for comparisons with competitors. In addition, the issuing company often provides more information to bolster its chance for a better rating. See S & P DEBT RATINGS CRITERIA, *supra* note 1, at 13; Ederington & Yawitz, *supra* note 5, ch. 23, at 24. Moody's reports that the issuing firm's chief executive officer, chief financial officer, and treasurer usually attend rating meetings—"an indication of the importance attached to

grade, "primarily measur[ing] the likelihood of default."<sup>9</sup> The agencies compile these grades and send them to investors who subscribe to the service.<sup>10</sup>

The bond rating services are popular with investors because they can rate securities' riskiness far less expensively than can an individual investor.<sup>11</sup> The information the services provide improves the market's efficiency by equalizing prices at the margin so that the securities more accurately reflect the market's collective preference for risk.<sup>12</sup>

Bond rating agencies operate with surprisingly little government regulation.<sup>13</sup> The tort system and the market serve as the only checks on bond rating agencies.<sup>14</sup> Additionally, instead of being held to a negligence standard, as is the norm in other areas of the law,<sup>15</sup> bond rating agencies receive full first amendment protection

the rating." Ederington & Yawitz, *supra* note 5, ch. 23, at 24. The same is true at Standard & Poor's. See H. SHERWOOD, *supra*, at 22.

<sup>8</sup> A debenture is "a certificate or bond acknowledging a debt on which fixed interest is being paid." OXFORD AMERICAN DICTIONARY 218 (paperback ed. 1980).

<sup>9</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 40. Moody's agrees, noting that the fundamental goal of credit analysis is "evaluating the borrower's ability and willingness to pay." MOODY'S ON MUNICIPALS, *supra* note 1, at preface.

<sup>10</sup> The subscription price for Standard & Poor's flagship publication, *CreditWeek*, was \$1,450 per year at the beginning of 1989. STANDARD & POOR'S, INC., CREDITWEEK, Jan. 2, 1989, at 2 [hereinafter S & P CREDITWEEK]. The subscription price for *Moody's Bond Record* (published monthly) was \$160 per year. MOODY'S INVESTOR'S SERVICE, INC., MOODY'S BOND RECORD, Oct. 10, 1988, forward [hereinafter MOODY'S BOND RECORD].

<sup>11</sup> See *infra* notes 24-29, 41-42 and accompanying text. At the same time, the rated firm is willing to spend money to secure the benefits of a rating because the cost of a rating is less than the decrease in the cost of capital that the rating gives it. See *infra* note 86.

<sup>12</sup> See Ederington & Yawitz, *supra* note 5, ch. 23, at 18. Bond rating agencies do this by reducing information acquisition costs (the costs of initially producing information), information processing costs, and information verification costs (the costs of finding out if the information is accurate). Ronald J. Gilson & Reinier H. Kraakman, *Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 594-95 (1984). In addition, bond rating agencies cut the cost of inter-industry risk comparison by providing the investor with a common yardstick to measure risk. Cf. Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOKLYN L. REV. 1051, 1052 (1987).

<sup>13</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3; see MCGRAW-HILL, INC., STANDARD & POOR'S RATINGS GUIDE 4 (Kiril Sokoloff & Joan Matthews eds. 1979) [hereinafter S & P RATINGS GUIDE]; MOODY'S ON MUNICIPALS, *supra* note 1, at 2.

<sup>14</sup> H. SHERWOOD, *supra* note 7, at 137.

<sup>15</sup> See, e.g., RESTATEMENT (SECOND) OF TORTS § 552 (reprinted *infra* note 69); see also *infra* notes 73-88 and accompanying text for reasons why society imposes a negligence standard on suppliers of products.

Split ratings, in which the two major rating agencies give different ratings to the same issue, are potential evidence of mistaken ratings. For example, when International Paper issued \$150 million in sinking-fund debentures, Moody's upgraded the company from A to Aa, while Standard & Poor's downgraded it from AA to AA-. AHMED BELKAOUI, INDUSTRIAL BONDS AND THE RATING PROCESS 22 (1983). Split ratings affect approximately 13% of new industrial bonds. Studies show that the differences are probably mostly due to random factors and the complexity of bond rating. The differences

as a member of the media,<sup>16</sup> and are not held liable unless found to be reckless.<sup>17</sup>

In recent years, the accounting profession has experienced a rapid expansion in its potential liability to relying parties.<sup>18</sup> The rationales for much of this expanded liability are economic in nature. Many courts believe that accountants are best able to avoid mistakes at the least cost, better able to spread the risk of mistakes, and better able to insure against negligent missteps.<sup>19</sup> Thus, both the standard of care imposed on accountants, as well as the number of relying parties who are able to recover, are increasing dramatically. This revolution in accountant liability even has begun to affect other professionals, such as lawyers.<sup>20</sup>

Because many similarities exist between the advice of an accountant and the credit analyst at Standard & Poor's, some enterprising court may make what seems a logical step and attempt to import this expanded accountant liability to the ratings arena. Such an expansion would in turn rest largely on the same economic foundations which underlie the newly expanded accountant liability. The question remains, however, whether this expanded liability makes sense.

This Note attempts to determine the proper standard of care for bond rating agencies by employing both an economic and first

are evenly distributed, with Moody's rating being higher approximately half the time, and Standard & Poor's the other half. Louis H. Ederington, *Why Split Ratings Occur*, 15 FIN. MGMT. 37, 46 (1986); Ederington & Yawitz, *supra* note 5, ch. 23, at 49-50; see Pinches & Singleton, *supra* note 1, at 42 n.15.

<sup>16</sup> See, e.g., *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 869 F.2d 175 (2d Cir. 1989) [hereinafter *First Equity III*]; *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 690 F. Supp. 256 (S.D.N.Y. 1988), *aff'd*, 869 F.2d 175 (2d Cir. 1989) [hereinafter *First Equity II*]; *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 670 F. Supp. 115 (S.D.N.Y. 1987), *aff'd*, 869 F.2d 175 (2d Cir. 1989) [hereinafter *First Equity I*]; *Pittman v. Dow Jones & Co.*, 662 F. Supp. 921 (E.D. La. 1987), *aff'd*, 834 F.2d 1171 (5th Cir. 1987); *Gale v. Value Line, Inc.*, 640 F. Supp. 967 (D.R.I. 1986); *Milberg v. Western Pac. R.R.*, 51 F.R.D. 280 (S.D.N.Y. 1970), *appeal dismissed sub nom. Korn v. Franchard Corp.*, 443 F.2d 1301 (1971); *Jaillet v. Cashman*, 115 Misc. 383, 189 N.Y.S. 743 (Sup. Ct. 1921), *aff'd mem.*, 202 A.D. 805, 194 N.Y.S. 947 (App. Div. 1922), *aff'd mem.*, 235 N.Y. 511, 139 N.E. 714 (1923); *Daniel v. Dow Jones & Co.*, 520 N.Y.S.2d 334 (N.Y. City Civ. Ct. 1987); *Gutter v. Dow Jones, Inc.*, 22 Ohio St. 3d 286, 490 N.E.2d 898 (1986).

<sup>17</sup> For a sampling of traditional media cases, see, e.g., *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968); *Garrison v. Louisiana*, 379 U.S. 64, 74 (1964); *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964). For an article arguing that traditional negligence principles should apply to media defendants, see Gerald R. Smith, *Media Liability for Physical Injury Resulting from the Negligent Use of Words*, 72 MINN. L. REV. 1193 (1988).

<sup>18</sup> For a sampling of these cases, see *infra* note 72. For a good summary of this trend, see John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929 (1988). Comparisons and contrasts to this recent expansion of accountant liability as they apply to the topic of this Note are scattered throughout the text and footnotes. See, e.g., *infra* notes 71-72 and accompanying text.

<sup>19</sup> See Siliciano, *supra* note 18, at 1959.

<sup>20</sup> See *infra* note 71.

amendment analysis. Part I briefly describes the function of bond rating agencies and provides a brief discussion of how they operate. Part II considers whether any form of regulation is needed, given the strong economic incentives for non-negligent performance which the market imposes on bond rating agencies, and develops the economic arguments for and against retaining the recklessness standard. Part III analyzes the effect of the first amendment on bond rating agencies, and compares the result with the economic arguments developed within Part II. This Note concludes that extending the logic of recent accountant liability cases to bond rating agencies is troublesome from both an economic and a first amendment perspective.<sup>21</sup>

## I

### THE VALUE OF BOND RATING AGENCIES IN A WORLD OF UNCERTAINTY

“The paramount responsibility of [Standard & Poor’s] debt rating division is to provide an accurate appraisal of credit risk to the investor—nothing more, and nothing less.”<sup>22</sup>

Capital markets rely on accurate information to ensure that money moves to those who can use it most effectively, and to ensure that investors make optimal savings choices.<sup>23</sup> Securities research, however, exhibits many characteristics of a public good, making it unlikely that investors, if left to conduct securities research on their own, would produce sufficient information. Investors often can benefit from someone else’s research without themselves contributing to its production.<sup>24</sup> Because of this, investors will not conduct

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<sup>21</sup> This Note does not consider possible actions against a bond rating agency under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1982), promulgated under section 10(b) of the Securities Exchange Act of 1934. To win under Rule 10b-5, a purchaser must demonstrate that the misstatement caused her to invest in the securities. Moreover, she must show that the rating agency engaged in “knowing or intentional misconduct.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976). Because the continued existence of a rating agency depends on its conveying accurate information, the likelihood that a rating agency intentionally gave inaccurate information is very small. Thus, the plaintiff’s heavy burden of proof renders causes of action arising under Rule 10b-5 exceedingly difficult to win. See generally Mark A. Helman, *Rule 10b-5 Omissions Cases and the Investment Decision*, 51 *FORDHAM L. REV.* 399 (1982) (background on Rule 10b-5 and investing); Note, *Fraud-on-the-Market Theory After Basic Inc. v. Levinson*, 74 *CORNELL L. REV.* 964 (1989) (authored by Zachary Shulman).

<sup>22</sup> Randall, *supra* note 1, at 52.

<sup>23</sup> Frank Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 *VA. L. REV.* 669, 673 (1984); see also John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 *VA. L. REV.* 717, 747 (1984).

<sup>24</sup> Coffee, *supra* note 23, at 722-33. This is true because securities information “seldom can be confined to a single user because many people have a motive to leak it. . . . In fact, it is generally in the tippee’s interest, once he has traded, to inform others to

enough research on their own.<sup>25</sup>

Rating agencies facilitate the flow of information by processing public information and distilling it into a useful form at a far lower cost than the individual investor would incur.<sup>26</sup> Thus, investor decisions are based on better information,<sup>27</sup> which in turn helps the market route capital to the best investments.<sup>28</sup> To the extent that

create excitement and induce a market upswing." *Id.* at 725; see Saul Levmore, *Efficient Markets and Puzzling Intermediaries*, 70 VA. L. REV. 645, 649 (1984). At the same time, investors produce an excess of other types of information by duplicating each other's research. See Coffee, *supra* note 23, at 734; *infra* notes 42, 198-201.

<sup>25</sup> See *infra* notes 30-40 and accompanying text.

<sup>26</sup> Since efficiency in the capital market depends on the distribution of information, it is ultimately a function of the cost of information to traders. The lower the cost of particular information, the wider will be its distribution, the more effective will be the capital market mechanism operating to reflect it in prices, and the more efficient will be the market with respect to it.

Gilson & Kraakman, *supra* note 12, at 593; see also *id.* at 616. See *infra* notes 34-40 and accompanying text for further discussion of how rating agencies help the markets work efficiently.

<sup>27</sup> The financial press also helps to reduce the costs of bringing information to the market. Indeed, it is not at all rare to find bond ratings or even market analyses published in various financial magazines. Although this at first seems paradoxical—giving the product away for free—in fact it is quite logical. Supplying the market with information helps ensure a self-fulfilling prophecy. If the paying customers have already used the information in their investments, its subsequent release accrues to their benefit: the trading activity of the nonpaying investors moves the price in favor of the original investors. Coffee, *supra* note 23, at 725-26; Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 801-02 (1985). See generally Gilson & Kraakman, *supra* note 12, at 600-03 (noting the role of the financial press in reducing costs of information distribution, and discussing a variety of market techniques which reduce information costs).

<sup>28</sup> "An efficient market is often defined as one in which securities prices impact all publicly available information instantaneously." Coffee, *supra* note 23, at 747; see ALAN GART, *HANDBOOK OF THE MONEY AND CAPITAL MARKETS* 2 (1988). However, commentators differ as to how much information is needed to make the markets function efficiently. According to the efficient capital markets hypothesis, information need only be available to a small group of traders. These traders, by their trading, transmit signals to the market that a security is misvalued, so that the security's price then moves to the proper level. Thus, "in a well-functioning market, the prices of . . . securities will reflect predictions based on all relevant and available information." William F. Sharpe, *Discussion*, 25 J. FIN. 418, 418 (1970); see also RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 415-19 (3d ed. 1986). If this is true, in the strong form of the efficient capital markets hypothesis, "a blindfolded chimpanzee throwing darts at the stock pages of *The Wall Street Journal* could . . . select a portfolio that performs as well as one carefully chosen by the experts." Burton J. Malkiel, *Is the Stock Market Efficient?*, 243 SCIENCE 1313, 1313 (1989). There are three forms of the theory, however, depending on whether the market incorporates only historical information (weak form), historical plus all publicly available information (semi-strong form), or all information known by any market participant (including nonpublic information (strong form)). *Id.* Though the efficient capital markets hypothesis long has been a fixture in economics, some empirical researchers have become "pessimistic about the chances of success for traditional models in which all agents are assumed to be fully rational." Werner F. De Bondt & Richard H. Thaler, *A Mean-Reverting Walk Down Wall Street*, 3 J. ECON. PERSP. 189, 200 (1989). For example, investors show a tendency to "overreact" to recent news. Because of this, stock market

the interest rate accorded each issue better reflects the underlying riskiness of the investment, potential issuers can better evaluate whether the project has a positive present value, and hence is worth supporting.<sup>29</sup>

To appreciate the value of bond rating agencies, consider a system in which bond rating agencies do not exist. Such a system's capital markets would be plagued with high information costs.<sup>30</sup> Of all the factors that a potential bond investor must consider, the probability that she will lose her investment is one of the most important. At the same time, the investor often wishes to increase her potential yield by investing in higher yielding but riskier bonds if she can do so with minimal extra risk.<sup>31</sup> To find these profit opportunities, the investor must spend time and money evaluating the riskiness and potential return of various investment opportunities.<sup>32</sup>

The returns from investing in research, however, are likely to

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"losers" which are trading at an abnormally low yield may produce supra-normal yields. See Werner F. De Bondt & Richard H. Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality*, 42 J. FIN. 557 (1987); see also DREXEL BURNHAM LAMBERT, *HIGH YIELD SECURITIES: AMERICA'S WORKING CAPITAL* 14 (Joseph C. Bencivenga & David M. Millison eds. 1988) (noting similar overreaction in the bond markets).

Even proponents of the efficient capital markets hypothesis disagree as to the mechanism's reaction time. Gilson & Kraakman, *supra* note 12, at 567-69. If the market reacts slowly, then searching out undervalued securities is a rational strategy. *Id.* One thing is certain, however: "[v]irtually all sophisticated commentators agree that no money manager is likely to outperform the market." Levmore, *supra* note 24, at 650; see R. POSNER, *supra*, at 416. Notwithstanding the verdict of all "sophisticated commentators," investors still seek out professional investing services. See, e.g., Jeffrey M. Laderman, *The Best Return For the Least Risk: Our Mutual Fund Scoreboard Can Help You Pick a Winner*, BUS. WEEK, Feb. 20, 1989, at 80; Jeffrey M. Laderman, *How Long Will Junk Be King of the Bond Funds?: In 1988 the Fixed-Income Winners Were the High-Yielders*, BUS. WEEK, Feb. 27, 1989, at 114.

<sup>29</sup> See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 268 (3d ed. 1988).

<sup>30</sup> Information costs are the costs of acquiring information necessary for informed investing. See WALTER NICHOLSON, *MICROECONOMIC THEORY: BASIC PRINCIPLES AND EXTENSIONS* 214-18 (3d ed. 1985). For a discussion of how bond rating agencies reduce investors' information costs, see *supra* note 12.

<sup>31</sup> This is because investors seek to maximize their expected yield over the life of the bond (present discounted expected value). A higher risk of loss lowers this return. See W. KLEIN & J. COFFEE, *supra* note 29, at 207-16. There are two components of risk. The first is the risk that the market in general will move adversely (Beta). The second is the risk that the particular security will move adversely, based on that security's own characteristics, independently of the market (Alpha). The investor can minimize this second risk by diversifying her portfolio of investments. See R. POSNER, *supra* note 28, at 406; Coffee, *supra* note 23, at 748; *infra* note 35.

<sup>32</sup> This Note assumes that the average investor is risk-averse. Thus, the investor requires a higher return to invest in riskier securities. For a general discussion of risk, risk-aversion, and expected utility maximization, see W. NICHOLSON, *supra* note 30, at 203-08; R. POSNER, *supra* note 28, at 406-13. For a critique of expected utility theory as a valid predictor of human behavior, see Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979); Mark J. Machina, *Choice Under Uncertainty: Problems Solved and Unsolved*, 1 J. ECON. PERSP. 121 (1987).



be too small to justify much investment.<sup>33</sup> The returns are small because the debenture landscape is so cluttered with differing issues that risk evaluation is very difficult. Worse yet, most investors are relatively unsophisticated in the techniques needed to evaluate the riskiness of debenture issues. For this unsophisticated investor, the optimum investment in gathering information is likely very low.<sup>34</sup> Even though she desires the added return that she might gain by searching out profit opportunities where the marginal interest gain outweighs the marginal increase in risk, the returns are not sufficient to warrant a move from a risk-free investment such as Treasury Bills.<sup>35</sup>

The issuing company, on the other hand, wishes to raise capital for its projects at the lowest possible cost. A system with high information costs forces the corporation to pay a large premium to encourage investors to invest in its bonds.<sup>36</sup> These high premiums drive up the costs of the issuer's best projects and may cause it to

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<sup>33</sup> The investor will continue to increase investment in research until the marginal cost of doing so matches the marginal return. See W. NICHOLSON, *supra* note 30, at 327-34.

<sup>34</sup> The investor has alternatives to personal information searches. She may rely on a professional portfolio investor to locate profit opportunities, or on research analysts at brokerage firms. One problem with this strategy, however, is that many brokerages are reducing the number of analysts they hire. See David B. Hilder & Barbara Donnelly, *Cutbacks Leave Gaps in Stock Research*, Wall St. J., Apr. 26, 1990, at C1, col. 3. In addition, these alternatives still result in duplicative analyses because many different researchers each perform separate searches. Not only is this inefficient, but researchers also lack the benefit of nonpublic information that sometimes is communicated to bond rating agencies by the issuing companies. See *infra* note 43. One problem with relying on traditional analysts is that they often are not free from outside pressures. Because many research departments rate clients of their firm's investment banking divisions, "analysts who don't provide appropriate opinions can find themselves in the frying pan." Ellen E. Schultz, *Analysts Who Write Lukewarm Reports Sometimes Get Burned*, Wall St. J., Apr. 5, 1990, at C1, col. 4. This perhaps is illustrated by a survey of 1500 companies which showed that brokerage firms issued "buy" recommendations 44.6% of the time, "holds" 45.6% of the time, and "sells" only 9.7% of the time. *Id.* at col. 5; see *infra* note 65.

<sup>35</sup> Treasury Bills are nearly riskless because they have the full credit of the United States Government behind them.

Investors also may decrease risk by buying diverse types of securities which have uncorrelated riskiness. The randomly distributed risks tend to cancel out, and, if enough securities are involved, the component of risk that is independent of large market movements is nearly eliminated. See *supra* note 31. If markets are not completely efficient, however, then "diversification is no longer the sole prudent investment strategy." Gordon & Kornhauser, *supra* note 27, at 800-02. In such a case, if the investor actually can identify undervalued securities at a low cost, then she should selectively invest in these. *Id.*; see also *supra* note 28.

<sup>36</sup> A bond's interest rate premium has three components: the risk of inflation, the opportunity cost of the capital, and the risk premium which compensates the investor for the chance that she will not recover her principal. *Id.* An unrated issuing company must sell its bonds for a lower price because of the higher perceived risk premium of an unrated bond.

abandon certain marginal but still profitable projects.<sup>37</sup> Further, the issuer often cannot fight high information costs directly. Any attempt to communicate to bond purchasers nonpublic information<sup>38</sup> about the worthiness of the planned projects may fall into the hands of the issuer's competitors, thereby lowering the potential returns to the proposed project.<sup>39</sup> The information costs of this poorly functioning system lead to a poor allocation of resources away from risky, but still valuable projects to less risky, but less valuable projects.<sup>40</sup>

Bond rating agencies help minimize high information costs. By specializing in information analysis, building confidential relationships with issuing companies, and cultivating reputations for accuracy, bond rating agencies increase the capital markets' efficiency. The investor who wishes to evaluate the riskiness of potential investments can consult specialists who can perform the evaluation at a drastically lower cost than she can.<sup>41</sup> At the same time, society

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<sup>37</sup> This poor allocation of resources causes trouble for both the issuer of the debt and the investor in the securities. For the issuer, there is a needless transfer of wealth to the bond holder, as well as a dead weight loss caused by projects not undertaken because of abnormally high capital input costs. If the market is selectively inefficient, with information only for certain projects communicated to the market, the market may act efficiently on the available information without choosing the project with the highest real return. Such a market is allocatively inefficient. *See id.* at 768-69.

For the investor, incomplete information results in improper savings. Because the real return on an investment includes a risk premium, the investor miscalculates the real rate while investing. The investor, therefore, either misses profitable opportunities to increase investment, or over-invests in projects where the real return is lower than expected. Such a market is speculatively inefficient. *See id.*

<sup>38</sup> This Note uses the term "nonpublic information" instead of the more common term "inside information" to distinguish this information from any connotation of illegal activity. "Nonpublic information," as used in this Note, is merely information that the market as a whole does not (yet) have.

The role of bond rating agencies in communicating nonpublic information to the market without revealing its content is considered more fully later. *See infra* note 43 and accompanying text.

<sup>39</sup> Even if the firm communicates directly with the market, however, it may misrepresent its future prospects. Because of this problem, the firm will still hire a rating agency even when it could communicate with potential investors without revealing data to competitors. *See* Gilson & Kraakman, *supra* note 12, at 614-15.

<sup>40</sup> *See* Easterbrook & Fischel, *supra* note 23, at 673 ("A world with fraud, or without adequate truthful information, is a world with too little investment, and in the wrong things to boot."); Gilson & Kraakman, *supra* note 12, at 602 ("Poor quality information drives higher quality information from the market.").

A system such as the one described introduces a second risk component. The normal component, the risk that the issuer will not repay the principal, is still present. However, an additional component, the risk that the corporation is misrepresenting the value of the proposed project, is added. Investors require a risk-premium for this risk, too, and hence are only willing to pay a lower price for these bonds. *See* Ederington & Yawitz, *supra* note 5, ch. 23, at 24.

<sup>41</sup> *See* MOODY'S ON MUNICIPALS, *supra* note 1, at 2. Another function of the bond rating agency, other than providing economies of specialization, is to verify the information that the corporation has decided to release to the market. Thus, if a high rating of a

avoids the potentially wasteful resources that duplicative risk analysis by individual investors causes.<sup>42</sup> Finally, by divulging the information to the rating agency, the issuing corporation can communicate nonpublic information to the market without alerting competitors. The rating agency then can consider the information when formulating its rating.<sup>43</sup>

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corporation's debt accompanies the corporation's assertions of its own secure financial base, the market is reassured of the integrity of the firm's representations. The bond rating agencies are trusted because they are third parties with no interest in misrepresenting the state of the corporation's finances, and because the rating agency puts its reputation and its prior investments in a ratings infrastructure on the line every time it makes a rating. See Gilson & Kraakman, *supra* note 12, at 601, 604-05. Bond rating agencies do not endorse this interpretation, however. See S & P RATINGS CRITERIA, *supra* note 1, at 3-4.

<sup>42</sup> Any investor will invest resources in procuring information so long as the marginal benefits that accrue to her exceed the marginal costs. This individually rational behavior causes net waste, however. "From a social welfare perspective, trading gains do not create additional wealth; one party's gain comes at the other party's loss, whereas the process of researching and verifying securities information consumes real resources." Coffee, *supra* note 23, at 733. The benefit to society of more than one individual performing the risk calculus is only equal to the cost of communicating the information from the first analyst to the others—an amount much less than the resources required to perform duplicative analyses. Easterbrook & Fischel, *supra* note 23, at 681-82. Thus, "it may be more efficient for a few specialists to undertake [bond rating] and sell summaries of their evaluations in the form of ratings than for all prospective bond purchasers to conduct their own analyses." Ederington, *supra* note 15, at 37-38.

If one views an undervalued security as an unrecovered treasure, the problem is very similar to the old economic problem underlying recovery of bullion lost at sea. If more than the efficient number of searchers mount expeditions to recover sunken ships, society's resources are wasted. Under the common law, the first searcher had the right to prevent others from interfering with her search. However, this solution does not transfer well to the case of overallocation of resources to securities research; unlike shipwrecks, it is impossible to establish defined areas of securities research. See R. POSNER, *supra* note 28, at 35. *But cf.* Coffee, *supra* note 23, at 733 n.45 ("Indeed, society might rationally decide to pay analysts not to engage in rival research efforts where the resources so utilized would only affect the distribution of trading gains and not increase market efficiency.").

<sup>43</sup> "Unless people who offer the 'better securities' . . . can distinguish themselves from others, investors will view all securities as average. Higher quality securities will sell at prices lower than they would if information were available costlessly, and there will be too little investment in good ventures." Easterbrook & Fischel, *supra* note 23, at 673-74.

For example, suppose a corporation wishes to raise capital to exploit a recent technological breakthrough but fears that doing so will tip off competitors. The corporation can use a rating agency to circumvent this problem. The company can confidentially meet with an independent rating agency, transmit the information, and secure a higher rating for its bonds. See Gilson & Kraakman, *supra* note 12, at 604-05 ("In many such cases, outside specialists acting as information intermediaries will offer their own reputation in lieu of the sellers' as a bond of quality . . . . [I]n the financial markets, the most obvious example is the role played by rating agencies such as Standard & Poor's and Moody's.").

The rating agency will keep the information confidential because the costs of leaking the information substantially outweigh the benefits of doing so. Lawsuits for agency

This centralization of research saves resources. Bond rating agencies, which have gained expertise through specialization, analyze issues less expensively than individual investors, help to avoid costly, duplicative research, and benefit from economies of scale.<sup>44</sup> Furthermore, bond rating agencies disseminate information to the market very quickly and thereby facilitate rapid market adjustments.<sup>45</sup>

Standard & Poor's Corp. and Moody's Investor's Service, Inc. are the major United States bond rating agencies.<sup>46</sup> These agencies, relying on both public and private information, analyze financial data and distill it into a concise symbolic representation of the probability that the rated security will default.<sup>47</sup> This information

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trading on confidential information would quickly dry up future business. See Easterbrook & Fischel, *supra* note 23, at 688; cf. Fischel, *supra* note 12, at 1052.

Several researchers have suggested this role for ratings agencies. See Ederington, *supra* note 15, at 38 ("Since the rating agencies claim to receive non-public information which is held in confidence, ratings may also provide a means of communicating relevant aspects of this 'inside' information to bond purchasers without revealing the details to the market—the firm's competitors in particular."); Paul A. Griffin & Antonio Z. Sancicente, *Common Stock Returns and Rating Change: A Methodological Comparison*, 37 J. FIN. 103 (1982). But see Ederington & Yawitz, *supra* note 5, ch. 23, at 24 ("Unfortunately, the nature of inside information makes it difficult, if not impossible, to determine its true importance in the rating process.").

Similarly, accountants serve as information intermediaries. They also use their own independently cultivated reputation for accuracy to reduce the cost of investors' verifying the quality of the firm's disclosures. See Tim S. Campbell & William A. Kracaw, *Information Production, Market Signaling, and the Theory of Financial Intermediation*, 35 J. FIN. 863, 864 (1980) ("Our hypothesis is that intermediaries emerge as information producers because the production of information, the protection of confidentiality, the provision of transaction services, are naturally complimentary activities."); Easterbrook & Fischel, *supra* note 23, at 688.

<sup>44</sup> Cf. Coffee, *supra* note 23, at 724 (significant economies of scale associated with stock and bond analysis).

<sup>45</sup> The most recent example of this is the response of the market to the down grading of RJR-Nabisco's debt. See *supra* text accompanying notes 2-4. As *Business Week* notes, "pronouncements by rating agencies are scuttling billion-dollar deals and depressing bond prices." Zigas, *supra* note 4, at 106. Such market reaction illustrates the importance of bond rating agencies. As Professor Coffee writes:

[C]ritical information is not being disclosed to investors. Most observers would agree with this statement, but the neoclassical theorist will respond that little information need reach investors because they are protected instead by the bond rating agencies—Moody's or Standard and Poor's; these agencies digest the relevant information, which in the case of a debt security consists only of its risk level, and assign a rating to each security.

Coffee, *supra* note 23, at 745; cf. *supra* note 28.

<sup>46</sup> Although Standard & Poor's and Moody's are the two primary debt raters, three smaller firms, Fitch; Duff & Phelps; and McCarthy, Crisanti & Maffie, also rate debt. This Note, however, focuses on Standard & Poor's and Moody's as representative agencies.

<sup>47</sup> Standard & Poor's uses a rating system of ten grades ranging from AAA to D for its bonds. Debt rated AAA, AA, or A has a strong capacity to pay interest and repay principal, with AAA being the strongest. Debt rated BBB has an adequate capacity to

then is packaged and sold to investors who use it in formulating their own investment strategies.

The rating is a critical component in the average investor's investment strategy.<sup>48</sup> In fact, under the prudent man rule, managers of many fiduciary funds are not allowed to invest in low rated "junk bonds."<sup>49</sup> Still, the importance of the bond rating easily might be

pay interest and principal, and is the lowest ranking of investment grade debt. Debt rated BB or lower falls into the so-called "junk bond" category, and is considered to be a speculative investment. Debt rated C is debt on which no interest is being paid, and debt rated D is in default. Ratings from AA to B may be modified by the addition of a plus or minus to show its relative standing within the category. S & P DEBT RATINGS CRITERIA, *supra* note 1, at 10. Standard & Poor's uses a slightly different system for rating commercial paper (bonds with a term of less than 270 days). *Id.* at 43.

Moody's uses a system of seven grades running from Aaa to Caa for its bonds. Debt rated Aaa or Aa is a high quality investment grade. Debt rated A or Baa is a medium grade obligation that is currently secure, but might be susceptible to future changes. Debt rated Ba and B is considered to be uncertain. Finally, bonds rated Caa, Ca, or C are of poor standing, and bonds rated C may be in actual default. The numbers 1, 2, and 3 may be appended to a grade between Aa through B, with 1 indicating that it is a security near the top of its category, 2 average, and 3 below. MOODY'S BOND RECORD, *supra* note 10, at 1.

<sup>48</sup> However, even a top rating

is not a recommendation to purchase, sell or hold a particular security. The rating performs the isolated function of credit risk evaluation, which is only one element of the entire investment decisionmaking process. A rating cannot constitute a recommendation inasmuch as it does not take into consideration other factors, such as market price and risk preference of the investor.

S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3. Similarly, Moody's cautions that its ratings "have no value in forecasting the direction of future trends of market price." MOODY'S ON MUNICIPALS, *supra* note 1, at 49. It further notes that "[t]he attractiveness of a given bond may depend on its yield, its maturity date, or other factors for which the investor may search, as well as on its investment quality, the only characteristic to which the rating refers." *Id.*; *cf.* Coffee, *supra* note 23, at 745. For example, all issues by a company are rated similarly, even though the maturities of the company's issues may vary substantially. Longer duration bonds are riskier than short term bonds. Thus, even the same company's bonds' riskiness may vary, yet still have the same rating. See James H. Downs, *Time—The Enemy of a Company's Quality Rating*, TR. & EST., Aug., 1982, at 23.

<sup>49</sup> This *per se* rule against investing in low-grade bonds does not make economic sense. A well-diversified portfolio of independently risky junk bonds is not necessarily more volatile than investment grade bonds. In fact, on average, Treasury bond prices are roughly twice as volatile as junk bonds. Bencivenga & Millison, *supra* note 28, at 10.

The prudent man rule, formulated in *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830), originally was conceived as a flexible rule dictating the standard governing a fiduciary in charge of investing another's assets. However, courts and the Restatement have ossified the rule into a restrictive notion of prudent investing. See, e.g., *First Alabama Bank of Montgomery v. Martin*, 425 So. 2d 415 (Ala.), *cert. denied*, 461 U.S. 938 (1983) (Despite expert testimony that five of the thirty stocks comprising the Dow Jones Industrial Average did not meet strict prudence criteria for investment safety, investment in an undervalued, less well-known stock was considered imprudent.). Thus, nearly one and a half trillion dollars worth of assets—more than half the value of the entire New York Stock Exchange—is managed in an economically inefficient fashion. BEVIS LONGSTRETH, *MODERN INVESTMENT AND THE PRUDENT MAN RULE 3-5* (1988).

For an excellent discussion of the infirmities of the prudent man rule, see B. LONG-

overstated. Both Standard & Poor's and Moody's stress that they do not normally undertake investigative work of their own.<sup>50</sup> Rather,

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STRETH, *supra*; see also John Lennon & Paul McCartney, "Dear Prudence," *The Beatles*, (Columbia Records 1968) (detailing the Beatles's objections to the prudent man rule).

The members of the Beatles were well known advocates in the fight to abolish the prudent man—they called him a real "No Where Man." By ignoring the dictates of prudent investing, they were able to amass sizeable fortunes. They also wrote numerous songs in the fight to adopt a better set of fiduciary management rules, including "ERISA in the Sky with Diamonds," "A Day in the Life of a Trust Fund Manager," "The Ballad of John and Yoko's Money," "Back in the ERISA," and, of course, "Dear Prudence," an open letter to their mutual fund director, which later was set to music and became a hit in A major. In addition, they wrote numerous songs giving investment tips to the record-buying public. "Penny Lane" was a nostalgic look back on the penny stocks, while "Magical Mystery Bourse" touted the advantages of investing on the Tokyo stock exchange.

"I'll Follow the SUN," which outlined John's contrarian strategy of investing based on the acronym, Stocks Undervalued Now, was the first major work questioning the strong form of the efficient capital markets hypothesis. George Harrison, too, was a rock economist: for example, "While my Accountant Gently Weeps" outlined his despair at seeing his prudently invested trust funds losing their value. Even Ringo Starr joined the crusade for a better prudent man rule, recording "She's 16, She's Beautiful, and She's Mine," which told the story of his investment in Lockheed, which he bought at exactly one-fourth of its previous high of 64. The contrarian investment later soared.

Although the Beatles later broke up because of a fight over whether they should invest in tax-free municipals or high-growth equity investments, John Lennon and Paul McCartney did see eye-to-eye on the need for a better prudence standard. John Lennon released the poignant "Imagine," which painted the idyllic world where economics and efficiency would be the goal of all people, in the investment world or elsewhere. His words, as meaningful today as they were a decade and a half ago, were:

Imagine there's no prudence,  
It isn't hard to do,  
No U.S. bonds for us,  
Higher returns too.  
Imagine all the people,  
Investing for today.  
You may think I'm a dreamer,  
But I'm not the only one,  
We hope someday you'll join us,  
With alphas over one.

A cold realist, John also released the haunting "Cold Turkey," the story of his agony when his subscription to the *Wall Street Journal* was inadvertently cut off due to post office error.

It is time to acknowledge the contribution of these young millionaires to the financial scene. Although their music no longer tops the charts, their investment strategies still top the financial charts. Every fund manager today owes these visionary rock economists an enormous debt that she cannot hope to repay, even with high-yielding, imprudent junk bonds.

<sup>50</sup> "[T]he rating does not . . . attest to the authenticity of the information provided by the issuer and upon which the rating may be based." S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3. Standard & Poor's evaluates the data presented only to "determine whether the numbers and ratios overstate or understate the financial performance and position of the firm relative to its competitors." STANDARD & POOR'S, INC., CREDIT OVERVIEW: CORPORATE AND INTERNATIONAL RATINGS 27 (1983) (emphasis in original). Further, Standard & Poor's cautions in every issue of *CreditWeek* that "because of the possibility of human or mechanical error by our sources, *CreditWeek* or others, *CreditWeek* does not guarantee the accuracy, adequacy, or completeness of any information and is

they rely on public information and information provided to them by the rated company itself.<sup>51</sup> While the agencies do analyze the data to ensure that it conforms with Generally Accepted Accounting Principles,<sup>52</sup> they do not independently seek to verify the information.<sup>53</sup> In short, while the rating is a distilled, independent judgment as to the creditworthiness of a particular debt issue, it is not an audit. The information is an important part of an investor's information, but it does not by itself provide a quick route to high, risk-free returns.

Despite the rating agencies' disclaimers, investors still rely on the ratings to a considerable extent.<sup>54</sup> Moreover, despite the fact that the "rating agencies have become quasi-public bodies [with] a direct impact on the amount of interest that issuing corporations and governmental bodies must pay,"<sup>55</sup> they are largely unregulated. Even the tort system, often used to monitor wrongdoing in other unregulated areas, has little effect on rating agencies.<sup>56</sup>

To date, lawmakers and courts generally have imposed only a

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not responsible for any errors or omissions or for the results obtained from use of such information." S & P CREDITWEEK, *supra* note 10, at 2. Moody's similarly notes that "[t]he information herein has been obtained from sources believed to be accurate and reliable, but because of the possibility of human and mechanical error its accuracy or completeness is not guaranteed." MOODY'S BOND RECORD, *supra* note 10, at 1.

<sup>51</sup> See *supra* note 7 for a description of the information that rating agencies usually require.

<sup>52</sup> Generally Accepted Accounting Principles ("GAAP") are established by the American Institute of Certified Accountants. Auditors may issue unqualified opinions only when the method of accounting accords with GAAP. See AMERICAN INSTITUTE OF CERTIFIED ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 509.28 (1986).

The presence of uniform accounting standards does not mean that all audits are equally accurate, however. Different ways of approaching the same problem can result in different audits. Companies occasionally will employ another auditor when their current auditor refuses to treat their information favorably. See Daniel L. Goelzer, *The SEC and Opinion Shopping: A Case Study in the Changing Regulation of the Accounting Profession*, 52 BROOKLYN L. REV. 1057, 1058 n.1 (1987) ("According to the 1985 Annual Auditor Change Report, 542 public companies changed accountants in 1985, an increase of 82% from 1981. More specifically, 19% of the companies that changed accountants did so after an opinion concerning the company's financial statements was qualified or disclaimed."); Note, *The Opinion Shopping Phenomenon: Corporate America's Search for the Perfect Auditor*, 52 BROOKLYN L. REV. 1077 (1987) (authored by Mindy J. Smolevitz).

<sup>53</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 24.

<sup>54</sup> "Owing to the notable lack of information available to investors . . . ratings have doubtless played too important a role in investors' decision making process." PEACOCK, A REVIEW OF MUNICIPAL SECURITIES AND THEIR STATUS UNDER THE LAW 2037, 2040 n.22 (1976); see also Pinches & Singleton, *supra* note 1, at 42.

<sup>55</sup> H. SHERWOOD, *supra* note 7, at 143; see D. HAWKINS, B. BROWN, & W. CAMPBELL, *supra* note 1, at 15.

<sup>56</sup> This is because it is very difficult to recover against a rating agency under the current recklessness standard which applies to rating agencies. Part II *infra* discusses the relative merits of recklessness and negligence regimes.

recklessness standard on bond rating agencies.<sup>57</sup> Although the agencies are free to contractually set a stricter standard of care, they have not done so. The agencies instead have attempted to walk a narrow line, for they must keep the respect of all market participants, including both the rated companies and the agencies' subscribers. The agencies are operated as completely independent subsidiaries of their parent corporations, with "Chinese Walls" erected to prevent any data from the rating agencies from reaching other parts of the company.<sup>58</sup> Neither Standard & Poor's nor Moody's invest in the holdings that they rate.<sup>59</sup> All possible actions are taken to preserve the lifeline of the rating agencies' business, their continuing reputation for accuracy.<sup>60</sup>

## II

### AN ECONOMIC EVALUATION OF EXPANDING LIABILITY

"[A Standard & Poor's] rating is not a recommendation to purchase, sell or hold a security inasmuch as it does not comment as to market price, market supply or investor preference and suitability."<sup>61</sup>

#### A. Bond Rating Agencies and the Need for Judicial Oversight

Before considering whether lawmakers should expand rating agency liability to cover negligent actions, it is interesting to note that, absent any legal intervention whatsoever, market forces may be sufficient to regulate rating agencies in and of themselves. Bond rating agencies face significant economic pressures which force them toward the proper level of care.

A bond rating agency such as Moody's faces competitive pressures from several fronts. First, and most obviously, other rating agencies covet Moody's business, and seek to gain a competitive advantage by providing their subscribers with more accurate products. Second, there are several close substitutes for rating agency services, such as in-house technical analysts whose services many securi-

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<sup>57</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3; see also MOODY'S ON MUNICIPALS, *supra* note 1, at 2; S & P RATINGS GUIDE, *supra* note 13, at 4. *But see* Smith, *supra* note 17 (arguing that courts could, consistent with the first amendment, impose liability on media defendants for negligently published words).

<sup>58</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 5; S & P RATINGS GUIDE, *supra* note 13, at 17.

<sup>59</sup> See S & P RATINGS GUIDE, *supra* note 13, at 2.

<sup>60</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3. The publication also notes that "[r]atings are of value only so long as they are credible. Credibility arises primarily from the objectivity which results from the rater being independent of the issuer's business." *Id.*; see also S & P RATINGS GUIDE, *supra* note 13, at 2.

<sup>61</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at iii.



ties firms offer to both their clients and their own internal investors. Finally, the ratings firm is unlike the traditional manufacturer, which may have difficulty communicating its product safety information to the marketplace. The performance of rating agencies can be monitored by the simple method of correlating past ratings with actual defaults.<sup>62</sup>

Simply put, the bond rating agency sells its reputation along with every rating. As Professor Siliciano has stated the problem in the area of accountant liability,

[e]ven absent any liability rules, accountants would have a significant economic stake in establishing and maintaining a reputation for conducting good audits. This positive incentive works on at least two levels. The typical client, for its own internal monitoring purposes, will insist on a careful audit; accountants who fail to meet this standard will not be retained. Similarly, accounting firms with a reputation for care will enhance the client's prospects of obtaining credit on reasonable terms from outside parties. These factors suggest that accounting firms with an interest in permanence and growth will audit with care.<sup>63</sup>

The very value of an agency's ratings, like an accountant's opinions, lies in their independent, reliable evaluation of a company's financial data. Moreover, the arguments which militate against the recent expansion of accountant liability are even stronger in the rating agency arena. While a poor audit may be difficult to detect (except in the rare occurrences when the company actually goes bankrupt and its books are opened to all in bankruptcy court), a rating is much more visible. The ratings are published weekly, and eagerly tracked by both financial experts and academicians.<sup>64</sup>

Furthermore, rating agencies provide more checks on each other than do rival accounting firms. It is very common for several rating agencies to rate the same issuance, which means that it is immediately possible for a competitor to demonstrate its superior analysis, should a rival firm make a mistake. The market not only will punish poorly performing firms, but will do so swiftly.<sup>65</sup>

As a threshold matter, therefore, it is not at all apparent that *any*

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<sup>62</sup> For a sampling of some of these studies, see *infra* notes 121-24 and accompanying text. For some examples of the increasing competition in bond ratings, see *infra* note 125.

<sup>63</sup> Siliciano, *supra* note 18, at 1953.

<sup>64</sup> See *infra* notes 121-24 and accompanying text.

<sup>65</sup> Perhaps the greatest value of a bond rating agency lies in its independence from outside interests. Lately, there has been some criticism of analysts at security firms, who often are under pressure to give positive recommendations. See Schultz, *supra* note 34, at C1. These conflicting pressures on the typical securities firm analyst are illustrated by the recent case of a Janney Montgomery Scott, Inc. analyst who was fired after Donald Trump threatened to sue the firm because of one of its analyst's comments. See *id.*

system of regulation is needed for the regulation of bond rating agencies. This discussion, of course, raises another question: if rating agencies are so accurate, then what do they have to fear from courtrooms? The next subsections of this Note consider the costs of imposing a negligence regime on bond rating agencies, and demonstrate why an expansion of rating agency liability would impose significant costs on rating agencies without significantly increasing rating agency accuracy.

## B. Economics and Negligence in the Rating Context

As Part II(A) of this Note demonstrates, the market system itself already imposes strong incentives on a bond rating agency to eschew negligent conduct. This, however, does not end debate. The current movement in the law is toward a more relaxed definition of privity and looser standards of care for centralized producers, whether they produce tangible products or intangible services such as information. Although the above discussion is relevant when discussing the optimum level of care in the abstract, it is unlikely that bond rating agency liability ever will be left strictly to market forces. Given that some form of judicial oversight is likely to remain a permanent fixture for the foreseeable future, the question remains as to how strenuous this oversight should be.

The publication of a bond rating agency currently is treated as are any other publications under the first amendment.<sup>66</sup> A bond rating agency thus is not liable for negligent misrepresentations unless its mistaken advice reaches the level of reckless disregard for the truth.<sup>67</sup> This heightened standard differs from recent developments in other areas of the law.<sup>68</sup> For example, the Second Restatement of Torts would allow recovery for "negligent misrepresentation" by all people in the class of persons that the provider of the information knows will reasonably rely on the information.<sup>69</sup> This standard is

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<sup>66</sup> See *infra* notes 138-94 and accompanying text.

<sup>67</sup> This language is from traditional first amendment cases. See *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968); *Garrison v. Louisiana*, 379 U.S. 64, 74 (1964); *New York Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964). Many courts, however, have applied similar principles to rating agencies. See *supra* note 16 for cases applying the first amendment to publishers of financial data.

<sup>68</sup> See, e.g., *Williams v. Polgar*, 391 Mich. 6, 215 N.W.2d 149 (1974) (abstractor liable for negligent misrepresentation to all parties that could have been reasonably foreseen); *International Prods. Co. v. Erie R.R.*, 244 N.Y. 331, 155 N.E. 662 (1927) (bailor liable for giving negligent instructions to bailee), *cert. denied*, 275 U.S. 527 (1927); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971) (accountant liable for certifying audits that it knew would be relied upon by creditors). *But cf.* *Stephen K. v. Roni L.*, 105 Cal. App. 3d 640, 164 Cal. Rptr. 618 (1980) (false representation that unmarried sexual partner was using birth control pills not actionable).

<sup>69</sup> Section 552 of the *Restatement (Second) of Torts* provides:

followed by many courts.<sup>70</sup>

Accountants and attorneys once enjoyed widespread immunity from many negligent misrepresentation suits.<sup>71</sup> Many courts, how-

§ 552: Information Negligently Supplied for the Guidance of Others

(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.

RESTATEMENT (SECOND) OF TORTS § 552 (1977). This section on negligent misrepresentation covers only cases in which information is negligently supplied; section 311 covers negligent misrepresentation that results in physical harm, *id.* § 311, while other sections cover liability for negligently supplying chattels that imperil another's property or person. *Id.* §§ 388-402.

Section 551 also imposes liability for nondisclosure of a material fact; however, this only applies if the party was under a duty to the other "to exercise reasonable care to disclose the matter in question." *Id.* § 551.

<sup>70</sup> See generally W. PAGE KEETON, DAN B. DOBBS, ROBERT E. KEETON & DAVID B. OWEN, PROSSER AND KEETON ON TORTS 747 (5th ed. 1984) [hereinafter PROSSER] ("Thus, liability has not in fact been extended much beyond that indicated in the Second Restatement of Torts, if any.").

As Dean Prosser notes, "[t]he shift on the whole [in tort law] has been heavily toward the side of the plaintiff, with expanded liability in nearly every area." *Id.* at xxi. Courts allow recovery for negligent misrepresentation because they have decided that as between the innocent third party and the negligent misrepresenter, it is better that the innocent party recover her losses. See, e.g., *Stein v. Treger*, 182 F.2d 696 (D.C. Cir. 1950); *Russo v. Williams*, 160 Neb. 564, 71 N.W.2d 131 (1955).

<sup>71</sup> See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (1987); *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969); *White v. Guarente*, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977); *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. Ct. App. 1986); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971).

For years, accountant liability was governed by the standard of *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931). In that case, Judge Cardozo denied the plaintiff recovery on his negligence claim, even though he found the auditors negligent and knew creditors such as *Ultramares* would rely on the certified balance sheets. *Id.* at 170-71. Cardozo noted that:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw

ever, have expanded accountant liability, relying on such economic rationales as risk-spreading and least cost-avoider.<sup>72</sup> The following

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may not exist in the implication of a duty that exposes [auditors] to these consequences.

*Id.* at 179-80, 174 N.E. at 444. This remains the law in many jurisdictions, including New York. *See, e.g.*, *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (accountant not liable to non-contractual parties for inaccurate financial reports), *order amended*, 66 N.Y.2d 812, 489 N.E.2d 249, 488 N.Y.S.2d 362 (1985) (dismissal of fraud cause of action without prejudice).

Curiously, Judge Cardozo also was the first judge to author an opinion holding someone liable to a third party for economic loss caused by giving false information. The case was *Glanzer v. Shepard*, 233 N.Y. 236, 135 N.E. 275 (1922), and he and the New York Court of Appeals majority found that a public weigher who had given the incorrect weight of beans was liable to a relying third party despite the lack of privity.

Meanwhile, the emphasis in tort law moved to compensating innocent parties. As Dean Prosser states, "[a]n honest blunder . . . may absolve [the defendant] from moral blame, but the harm to others is still as great, and the actor's individual standards must give way to those of the public." WILLIAM L. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 146 (4th ed. 1971) (footnote omitted); *see also* PROSSER, *supra* note 70, at xxi.

The Restatement reflects this concern for innocent parties. Even under the Restatement, however, liability is not unlimited. For the accountant to be held liable, the client would have to notify her that a party would be relying on her work. This is the case even if the auditor "knows that the financial statements . . . are customarily used in a wide variety of financial transactions by the corporation and that they may be relied upon by lenders, investors, shareholders, creditors [and] purchasers . . . in numerous possible kinds of transactions." RESTATEMENT (SECOND) OF TORTS § 552 illustration 10 (1977). Thus, the Restatement is not as broad as some of the more recent accountant liability cases. For the text of the Restatement, *see supra* note 69.

Limited attorney liability also is under attack. The Supreme Court previously had mirrored the language of Cardozo's *Ultramares* decision in *National Sav. Bank v. Ward*, 100 U.S. 195 (1879), which held that the attorney is not liable for negligent actions to other than his client, absent special circumstances. Newer cases attack this limited privity. *See, e.g.*, *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985); *Ingram Indus. Inc. v. Nowicki*, 527 F. Supp. 683, 684 (E.D. Ky. 1981) (lawyer may be liable to third party based on wanton and reckless misstatement). *See generally* Leslie Gardner, *Attorney Liability to Third Parties for Corporate Opinion Letters*, 64 B.U.L. REV. 415, 422-33 (1984); Jerold S. Solovy, Ronald L. Marmer, Thomas J. McCarthy & Mark A. Dupont, *Potential Liability of Attorneys in Securities Transactions*, 335 PLI/Ltr. 621 (1987).

<sup>72</sup> *See, e.g.*, *Toro Co. v. Krouse, Kern & Co.*, 644 F. Supp. 986 (N.D. Ind. 1986), *aff'd*, 827 F.2d 155 (7th Cir. 1987); *In re DeLorean Motor Co.*, 56 Bankr. 936 (Bankr. E.D. Mich. 1986), *aff'd*, 59 Bankr. 329 (1986); *MacNerland v. Barnes*, 129 Ga. App. 367, 199 S.E.2d 564 (1973).

For cases with expansive definitions of who may recover, *see, e.g.*, *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986) (*construed in Nicolos v. Grover*, 186 Cal. App. 3d 858, 231 Cal. Rptr. 79 (1986)) (certified public report of an accountant is intended for public reliance); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983); *see also* Leonard P. Novello, *Current Developments in Accountant's Liability*, 335 PLI/Ltr. 463 (1987) (compendium of cases).

Many commentators advocate expanding tort liability for accountants, despite the dubious economic logic of some of their arguments. *See, e.g.*, Albert O. Besser, *Privity?—An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL 507 (1976); Kenneth I. Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968); Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983);

subsections analyze the economic arguments for and against applying a negligent misrepresentation standard to bond rating agencies and conclude that economic reasoning favors retaining the current recklessness standard rather than expanding liability to cover negligent behavior.

### 1. *The Case for a Negligence Standard*

The premise of the economic arguments favoring use of a negligent misrepresentation standard for bond rating agencies is that holding rating agencies liable for their negligence will increase the accuracy of their analyses. This argument assumes that the rating agency can avoid mistakes more cheaply than can the investor,<sup>73</sup> and that without the negligence standard, the rating agency would maintain a less than optimum amount of care. If a rating agency is liable for mistakes where the cost of avoiding the mistake is less than the benefits, it will increase its investment in accuracy until the marginal return of doing so is just equal to the marginal cost.<sup>74</sup> The rating agency will increase its investment in care until it no longer is negligent.

#### a. *Least-cost avoider rationale*

In general, the tort system imposes liability on the least-cost avoider of mistakes.<sup>75</sup> The system thus encourages the party who can most inexpensively avoid the harm to take steps to avoid mis-

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Note, *Accountants' Liability for Negligence—A Contemporary Approach for a Modern Profession*, 48 *FORDHAM L. REV.* 401 (1979) (authored by Judah Septimus); Note, *Tort Law—The Enlarging Scope of Auditors' Liability to Relying Third Parties*, 59 *NOTRE DAME L. REV.* 281 (1983) (authored by Mark D. Boveri & Brent E. Marshall). *But see* Fischel, *supra* note 12; Siliciano, *supra* note 18; Comments, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 *WASH. L. REV.* 675 (1971) (authored by Joseph R. Dawson).

<sup>73</sup> A recent case in this area asserts that the investor, not the rating agency, is responsible for checking the substantive accuracy of a publication before investing, reasoning that the information in an investment publication is not a substitute for a prospectus. *First Equity III*, 869 F.2d at 180 (“[W]e believe that a user is in the best position to weigh the danger of inaccuracy and potential loss arising from a particular use of a summary against the cost of verifying the summary by examination of the original documents or prospectus.”). The *First Equity* cases are more fully explored *infra* in notes 144-58.

<sup>74</sup> R. POSNER, *supra* note 28, at 147-51, 160-63.

<sup>75</sup> See GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 312 (1970); R. POSNER, *supra* note 28, at 148-60. Furthermore, before courts allow recovery for the defendant's negligence, they examine whether the plaintiff also has been negligent. If the defendant can show this, then the courts either reduce recovery (comparative negligence), or disallow recovery entirely (contributory negligence). This forces each economic actor to take the optimal amount of care to avoid accidents. See R. POSNER, *supra* note 28, at 148-60.

In cases of negligent misrepresentation, the Restatement adopts a contributory negligence standard while specifically reserving comment on the recent trend of imposing comparative negligence in lieu of contributory negligence. *RESTATEMENT (SECOND) OF TORTS* § 552A comment b (1977); see also *Alvis v. Ribar*, 85 Ill. 2d 1, 421 N.E.2d 886

takes.<sup>76</sup> As between the investor and the bond rating agency, this party is likely to be the rating agency. Bond rating requires specialized knowledge and capabilities which most investors do not possess.<sup>77</sup> In addition, because bond rating agencies have established symbiotic relationships with frequent issuers who need to communicate inside information to the markets, they often possess confidential information not available to the market as a whole.<sup>78</sup> Finally, the costs to an investor of playing detective are much greater than they are for the rating agency, as the agency has better expertise to spot mistakes. Because tort law generally takes the position that the risk of loss should be imposed on the party best able to avoid it, this analysis, absent more, would argue for imposing liability on the bond rating agencies.<sup>79</sup> Thus, because bond rating agencies can best avoid mistakes, courts relying only on the least-cost avoider rationale would impose liability on the agencies.

b. *The optimum level of care rationale*

Proponents of increased liability for financial intermediaries believe that expanded liability will provide “a financial disincentive for socially unreasonable conduct.”<sup>80</sup> In theory, this point is perfectly valid. In a world of perfect information, consumers would discount the product of the firm that slips into the negligence zone through inefficiency or underinvestment in accuracy. As the product of a bond rating agency becomes less accurate, it becomes less valuable to investors, who would either turn to competitors or near substitutes, conduct more research on their own, or simply become less willing to pay the full price for the now less accurate product. The firms, in turn, would be forced to discount their product to reflect their below-optimum investment in accuracy. The agency would either have to increase its investment or lose market share as competitors market a more accurate product. In the real world of significant information costs, however, a rating agency will invest in

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(1981) (history and comparison of the development of contributory and comparative negligence).

Judge Posner notes that “[c]omparative negligence makes economic sense only when society wants to use the tort system to provide insurance to accident victims, because it gives the careless victim of a careless injurer something . . . .” He then observes that in an era of widely available market insurance, why “there should be a desire to provide insurance through the tort system is a mystery to the positive economic theorist of the common law.” R. POSNER, *supra* note 28, at 157-58.

<sup>76</sup> R. POSNER, *supra* note 28, at 148-60.

<sup>77</sup> See *supra* notes 41-45 and accompanying text.

<sup>78</sup> See *supra* note 43.

<sup>79</sup> A similar approach is that the risk of loss should fall on the party best able to insure against the loss. This also is likely to be the bond rating agency.

<sup>80</sup> Weiner, *supra* note 72, at 256.

accuracy only until the marginal cost of doing so equals the increase in marginal revenue achieved by greater accuracy. The bond rating agency will consider that it can make a certain number of negligent errors through underinvestment in accuracy of which the market will not learn, or which will be reflected in a marginal change in revenue that is less than the savings from not investing in an optimal level of accuracy.<sup>81</sup> In such a case, underinvestment in accuracy (planned negligence) is a rational profit-maximizing strategy.

Because of imperfect information, negligence proponents would argue, imposing a negligence standard might increase the standard of care that the bond rating agencies will supply.<sup>82</sup> For any degree of negligence, the agency would have to consider whether it is opening itself up to potential liability. Imposing these costs on the firm would serve to internalize the costs of the negligence, and thus create an incentive for the firm to act in a non-negligent manner.

### c. *Risk-spreading rationale*

Another argument often used for imposing tort liability on centralized manufacturers is the risk-spreading rationale.<sup>83</sup> This theory maintains that if courts hold rating firms liable for negligence, then the firms will internalize all costs within the price that the firms charge for their services. The bond rating agency will charge higher prices, and out of these higher prices the agency will compensate innocent relying parties.

The firm can pass these increased costs on to consumers to the extent that supply is elastic and demand is inelastic.<sup>84</sup> The more willing consumers are to absorb the increased costs of bond rating, and the less willing bond rating agencies are to bear them, the more costs the bond rating agencies will pass downstream to consum-

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<sup>81</sup> The returns on negligent behavior may be high when the negligent firm takes only a few sales from many competitors. No competitor will have sufficient incentive to take action to prevent the lost sales. Even if they do act, the process is not instantaneous; in the interim, the negligent firm might make enough extra profit to make the negligence worthwhile. See R. POSNER, *supra* note 28, at 98.

<sup>82</sup> Judge Posner notes:

If compensation is the only purpose of the negligence system, it is a poor system, being both costly and incomplete. Its economic function, however, is not compensation but the deterrence of inefficient accidents. If the system yields substantial savings in accident costs, its heavy administrative costs, which relate primarily to the determination of liability—the determination whether the accident was uneconomical—may be justified.

*Id.* at 187.

<sup>83</sup> See, e.g., *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, 150 P.2d 436 (1944) (Traynor, J., concurring).

<sup>84</sup> See W. NICHOLSON, *supra* note 30, at 173.

ers.<sup>85</sup> Those firms that are more negligent than their competitors will have higher costs to pass on. These underinvesting firms will be forced to bring their investment in accuracy closer to the optimal level. If they do not, then they will lose business to competitors who do.

In addition, because bond rating agencies derive much of their income from charging bond issuers a fee for rating their bonds,<sup>86</sup> the bond rating agencies will have an incentive to charge higher prices to those clients who misrepresent their finances or give poor data to the agency. By doing so, the bond rating agencies will encourage bond issuers to give the rating agencies the most accurate information possible. Failure to provide accurate information will increase the bond issuer's costs of raising capital.<sup>87</sup> Thus, the rating agencies will pass on in an economically efficient manner the costs of negligence to those firms who have in the past given sub-optimum information, or who now appear to be concealing material information. The result, according to proponents of expanded liability, will be more accurate information from the least-cost prov-

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<sup>85</sup> "The amount of passing on depends on the elasticity of demand. The more elastic the demand, the smaller the fraction of the overcharge that will be passed on . . . ." R. POSNER, *supra* note 28, at 194 n.2.

<sup>86</sup> Standard & Poor's instituted user fees in the early 1970s; Moody's did so in 1969. Today, the user fees have become important enough that "the users of the ratings (investors) do not incur the major costs" of ratings. Ederington & Yawitz, *supra* note 5, ch. 23, at 19. The fees for Moody's range from \$1,000 to \$125,000, MOODY'S BOND RECORD, Oct. 1988, vol. 55, no. 10, while the fees for a Standard & Poor's rating generally range from \$2,500 to \$50,000. The smaller rating agencies, however, usually do not charge user fees; only after the market has accepted the ratings as valuable can rating agencies convince security issuers to pay them for their services. Ederington & Yawitz, *supra* note 5, ch. 23, at 19.

Although the fact that a fee is charged does not imply that the bond rating agencies are biased (such a presumption would also disqualify underwriters and attorneys, who are similarly paid by their clients), their position is different from that of the securities analyst who looks primarily to the investor for his compensation. Thus, there is a relative difference in the degree of disinterestedness.

Coffee, *supra* note 23, at 746 n.83; *but see supra* notes 34 & 65 (noting that analysts often are under pressure to change unfavorable ratings). However, the agencies have taken every step to protect their reputations. For example, in 1969 Standard & Poor's downgraded the debt of its parent, McGraw-Hill, Inc.

The payment of fees to the bond rating agencies is voluntary, as is supplying information. However, if the company chooses to pay the fee and requests one of the major agencies to rate its bonds, then it must give the information mentioned *supra* note 7. Most rated companies choose to pay this voluntary fee, as this allows them to present their case to the bond rating agency, and possibly to appeal a low rating. The cost of the fee apparently is less than the present discounted expected cost of a lower rating, especially if the company is risk averse. Ederington & Yawitz, *supra* note 5, ch. 23, at 19.

<sup>87</sup> This is especially true for multiple users of rating agency services. Because of their future need for a bond rating agency's services, potentially fraudulent issuers must consider not only the possible gains from fraud on this transaction, but also the discounted future costs of higher fees.



iders of the information, the rated companies themselves.<sup>88</sup>

## 2. *The Case for Retaining a Recklessness Standard*

Courts have used many of the above arguments to expand liability in other areas of tort law, such as accountant liability.<sup>89</sup> This expansion of liability, however, is troubling from an economic viewpoint. This Note does not discuss whether the expansion of accountant liability was proper.<sup>90</sup> This Note instead will show that many factors are unique to bond rating agencies, such as the relative ease with which agency mistakes may be monitored, which means that imposing a system of negligence will drive up rating costs while yielding little increase in rating accuracy.

### a. *The cost of defensive rating*

The first cost of imposing liability for negligence is the "paper trail." To avoid liability, a rating agency will have to do more than simply engage in non-negligent behavior. In the event of a lawsuit, the agency will have to *prove* that it acted non-negligently once the plaintiff establishes a prima facie case. To meet this evidential burden, the agency will have to document its actions, draft extra reports listing the reasons for its ratings, and always conduct its business with an eye toward how its actions would look to a judge and jury.<sup>91</sup>

The rating agency will practice "defensive rating" as long as the marginal costs of doing so are less than the marginal expected value of the unfavorable judgments that it otherwise would incur due to its failure to document its actions.<sup>92</sup> The problem is that such documentation does not produce a better product; rather, it merely shows that the agency already has produced a non-negligent product. The costs are "wasted" from a societal standpoint; they have not gone into the making of a better good, but rather are spent only to prevent the possibility of a future transfer of wealth from one

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<sup>88</sup> One can still argue that the gains from one time fraud outweigh the costs. Proponents of a negligent misrepresentation standard, however, respond that the rating agencies, rather than the consumer, should bear the burden of fraud detection because the rating agency is in a better position to detect the fraud.

<sup>89</sup> See cases cited *supra* notes 71-72.

<sup>90</sup> For two excellent articles arguing that the expansion of accountant liability was a mistake, see Fischel, *supra* note 12, and Siliciano, *supra* note 18.

<sup>91</sup> Of course, the burden of proof in a negligence action is on the plaintiff. In reality, however, the rating agency is more likely to be on the defensive once the plaintiff shows the rating was *ex post* mistaken. Cf. Fischel, *supra* note 12, at 1054-55.

<sup>92</sup> These losses would also include the intangible but still important costs to reputation exacted from rating agencies against whom suits are filed. Even a suit dismissed as completely without merit may cause investors to lose confidence in the rating agency's services. See Alain Sheer & Asghar Zardkoohi, *An Analysis of the Economic Efficiency of the Law of Defamation*, 80 Nw. U.L. REV. 364, 375, 415-24 (1985).

party to another, a fact of little economic significance apart from the incentives it gives to each party to shape their behavior accordingly.<sup>93</sup>

b. *The problem of cross-subsidization*

Bond rating agencies collect revenue by charging bond issuers fees that vary according to the size of the offering,<sup>94</sup> (and thus varying at least roughly in accordance with possible negligence liability), and by charging subscribers fees for the information services. Because it is difficult to price discriminate between large and small investors, rating agencies charge a fixed price for each subscription.<sup>95</sup> This is unlikely to change. Given the difficulty of preventing subscribers who have paid a low price for the publication from transferring the information to heavy users who value it more, subscribers will arbitrage away the attempt to charge differing prices.<sup>96</sup>

These fixed fees, combined with the fact that a heavy user of the service is more likely to suffer a loss when negligent information is published, leads to a curious result. If tort liability is imposed on the bond rating agency, and then passed on to consumers through higher rates to cover either outside insurance or self-insurance, then the rating agency will pass it on to all subscribers equally. This means that small subscribers will cross-subsidize large subscribers.<sup>97</sup> The small investor's cost of subscription will rise by more than the expected value of the suits that she might bring in the future. The large investor's costs will rise by less than the expected value of the suits she might bring. This is because each investor pays the same

<sup>93</sup> See R. POSNER, *supra* note 28, at 156.

<sup>94</sup> See *supra* note 86.

<sup>95</sup> See *supra* note 86.

<sup>96</sup> Arbitrage is defined as trading a good in different markets in which it commands differing prices. See W. KLEIN & J. COFFEE, *supra* note 29, at 297-300; W. NICHOLSON, *supra* note 30, at 423-26; R. POSNER, *supra* note 28, at 259.

A firm can price discriminate when 1) there are two different markets, 2) there are different elasticities of demand, and 3) the markets are effectively separated so that a buyer cannot shift from one market to the other, or sell to a participant in another market. Under these conditions, a monopolist sells until the marginal revenue equals the marginal cost in each market. W. NICHOLSON, *supra* note 30, at 423.

The ratios of the prices in the two markets will be:

$$\frac{P_1}{P_2} = \frac{(1 + 1/e_1)}{(1 + 1/e_2)} \quad \text{Where } e_1 \text{ and } e_2 \text{ represent the elasticities of demand in each market.}$$

*Id.* at 425.

<sup>97</sup> Cross-subsidization occurs when one consumer pays a portion of the costs of another without receiving any compensation for absorbing the extra costs. This occurs in this context because the large investor either takes a position in more securities, making it more likely to be hurt by a negligent rating, or takes larger positions, making damages upon injury greater.

amount for the insurance, but the large investor is more likely to "cash in" the policy in the courtroom. This result is analogous to what would happen if insurance companies charged customers the same dollar amount for insurance covering two-bedroom bungalows as for insurance on eighteen-room mansions. The initial price would be somewhere between the present discounted expected cost of either house burning down.

The cost of an insurance plan is very dependent on the mix of properties insured. It is unstable when its participants are paying the same amount for differing amounts of insurance.<sup>98</sup> The small investor receives little increase in protection, despite a greater increase in costs. At the same time, the large investor's actual cost of a subscription to the rating agency's services drops, for with every subscription comes a subsidized insurance policy. The number of large investors subscribing will increase, while the number of small investors subscribing will fall. To continue the housing insurance analogy, equilibrium would be reached when none but the most risk-averse bungalow owners still have insurance, and all but the least risk-averse mansion owners in the market are covered.<sup>99</sup> The price of the insurance component of the subscription will rise to reflect this change in the insurance portfolio until equilibrium is reached near the high end of the market.<sup>100</sup> By introducing a self-selection bias, this system results in investors at the margin being

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<sup>98</sup> Professor Nicholson states it thus:

Adverse selection occurs in situations where individuals are in a position to assess the risks they face in a situation better than an insurance provider can. In this case individuals who know they have small risks will not buy insurance coverage (because it is too expensive given what they know), whereas high-risk individuals will purchase coverage (because, for them, it is a good buy). Hence only high-risk individuals will buy insurance, thereby raising its cost.

W. NICHOLSON, *supra* note 30, at 217-18; see also Gary S. Becker, *Not Everyone Deserves Affordable Auto Insurance*, BUS. WEEK, Feb. 19, 1990, at 18 (noting that state insurance plans which do not accurately reflect driver riskiness are economically inefficient).

<sup>99</sup> A similar point is made by Peter Huber: "If an insurer cannot distinguish the young Corvette enthusiast from the middle-aged driver of a weekend Oldsmobile, high-risk drivers will stock up on bargain coverage while low-risk drivers will cut back, and the insurer will eventually have to charge everyone something approaching a Corvette rate." PETER HUBER, *LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES* 12 (1988); cf. R. POSNER, *supra* note 28, at 188 ("If the liability insurance market were not regulated, insurance companies would charge different premiums to their customers according to differences in the probability that a customer would, through his negligence, injure someone in an accident.").

<sup>100</sup> If investors show uniform risk aversion, and there are no information costs, then equilibrium will be reached at the point where only one home—the most valuable—is insured, at a price equal to the present expected value of that home catching fire. Of course, in the real world, people are uncertain of the chance of their own home burning down, and often do not know of competitive insurance companies' lower priced plans. Thus, the market will stabilize before it reaches this extreme. See W. NICHOLSON, *supra* note 30, at 203-08.

frozen out of information that they value at more than its marginal cost. Such a system is inefficient, in both a Kaldor-Hicks and a Pareto optimality sense, as it guarantees the existence of parties who could be made better off by a nonregulated market transfer. Furthermore, the newly inaugurated negligence standard would lead to underinvestment in the market by smaller investors.<sup>101</sup> Smaller investors, after all, are the market participants who are most likely to be marginal investors, and less likely to have access to services competing with rating agencies, such as in-house technical analysts.<sup>102</sup> This is particularly troublesome because imposing a negligence standard should increase the level of investment based on good information, not decrease it.<sup>103</sup>

c. *The distortion of the calculus of publication*

In economic terms, the bond rating agency will decide whether to publish a given rating based on the expected profit or loss of doing so.<sup>104</sup> However, the rating agency cannot fully know the proper rating in advance. At best, it can estimate the rating with some probability of accuracy. This probability, in turn, depends on the amount of investigation that the agency has undertaken and the likelihood that the information given to it by the rated company is accurate.<sup>105</sup>

Imposing a negligence standard will decrease the number of small bond floatings rated. An increased chance of liability for the rating agency is an increase in the variable costs of publishing a rating. This is because, for every rating, there is a chance that courts will find the bond rating agency liable for a negligent mistake. In reaction to this increase in variable costs, the rating agency will cut back on those ratings which increase its marginal variable costs the most.<sup>106</sup>

The bonds that are most expensive to rate are small and new firm issues. This is true for several reasons. First, the Securities and Exchange Commission does not require as much public information

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<sup>101</sup> The extent to which small investors will be frozen out depends on how much the subscription price reflects the insurance component. This, in turn, depends on how many lawsuits will be successfully instigated against the bond rating agencies.

<sup>102</sup> JOHN BROOKS, *THE TAKEOVER GAME* 136 (1987) (noting that trading is backed by "extensive in-house research"); see *infra* note 125.

<sup>103</sup> Cf. *id.*

<sup>104</sup> See Sheer & Zardkoohi, *supra* note 92, at 415-18.

<sup>105</sup> The decision on the appropriate amount of investigation will depend upon (i) the cost of marginal increases in the value of probable truth, (ii) the reduction in the marginal expected cost of liability, and (iii) the increase in the market value of the publication resulting from increased accuracy.

<sup>106</sup> Rating agencies may, instead, charge the rated companies more, causing the marginal players to drop out, yielding the same result.

from small firms, which means that the agency must do more research to rate these firms.<sup>107</sup> Second, small firms are more likely to be one-time users of bond rating agencies' services. In these cases, the bond rating agencies must always investigate the company anew, without the benefit of previously discovered information. Third, small firms are more likely to be volatile startup companies, which often provide investors with greater returns, at the price of greater risk and chance of default.<sup>108</sup> However, a greater chance of default means potentially more disgruntled investors looking for a deep pocket to recover from. Thus, rating small and new firms is more costly than rating established firms.

Just as accountants now have an incentive to limit their services to those clients who have few third party contacts, and to withdraw services altogether from clients in high-risk industries,<sup>109</sup> so will rating agencies tend to withdraw from those companies which pose the greatest threat of liability. Unfortunately, this increased liability, which was intended to increase the level of investment based on accurate information, will instead restrict the ratings to those arenas where it is less relevant. To paraphrase Professor Siliciano, those "[f]irms that would benefit most from an independent [rating]—because they are young or small or unstructured—may be denied such services on the ground that they pose excessive [rating] risks."<sup>110</sup> The companies most likely to receive audits will be precisely those firms which are least likely to need them, as the additional information that the rating of a well-established firm's securities carries to the market is less than that which a rating of a new, unknown firm's securities accomplishes. The push for higher information *quality* will force a lower *quantity* of information. It is unclear whether this will lead to more or less investment based on quality information.<sup>111</sup>

In light of these increased expenses, imposing a negligence system will result in an agency bias against small and new companies. In addition, it will result in a bias against new financial instruments,

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<sup>107</sup> See, e.g., Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251 (1982) (exempting small issuers from filing certain statements); Securities Act Release No. 33-5450, 39 Fed. Reg. 2353 (1974) (exempting securities offered and sold within one state from certain registration requirements); 17 C.F.R. 230.251 to 230.264 (1989) (relaxing certain registration requirements). Congress also authorized relaxation of securities standards for small business in the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified in various sections of 15 U.S.C. (1988)).

<sup>108</sup> See W. KLEIN & J. COFFEE, *supra* note 29, at 282-86.

<sup>109</sup> See Siliciano, *supra* note 18, at 1967 (noting that the "promised response of the accounting profession to third-party liability exposure will be to limit their auditing function to 'safe' companies, rather than to audit all companies more thoroughly.") (footnote omitted).

<sup>110</sup> *Id.*

<sup>111</sup> *Cf. id.* at 1967-68 (developing similar analysis for accounting firms).

which offer many of the same hazards as rating a startup company. This bias will impair the ability of small and new firms to raise capital needed for expansion and growth. Imposing a negligence standard therefore disadvantages the smaller market players on both the investor and investment side.

Finally, imposing a negligence standard will result in a nonsystematic bias in ratings in favor of investors and against rated companies. This bias flows from the asymmetric incentives of the two sides to sue a bond rating agency for a false rating. If the rating is negligently made too high, the relying investors will have full incentive to sue. Because they potentially can recover full compensatory damages, and because they can still use the bond rating agencies even after the filing of the lawsuit, investors will not hesitate to sue when ratings are erroneously too high. The rated company, on the other hand, often will be unable to sue for a negligent rating that is unfavorable to them. If they sue, they may endanger all future bond floatings which also will need ratings. Therefore, it will be in the rating agencies' interest to err in favor of the investor, at least in cases on the margin where the rating is more likely to lead to a potential lawsuit.<sup>112</sup> Thus, the primary function of the bond rating agencies, accurately rating securities, will be endangered by imposing a negligence standard.

d. *The problem with deterrent effects*

"When all is said and done, the modern [negligence] rules do not deter risk: they deter behavior that gets people sued, which is not at all the same thing."<sup>113</sup> A negligence system's deterrent effect is the difference between the probability of the actor incurring liability when she is not negligent and the probability when she is.<sup>114</sup> Courts should impose liability only if it will cause actors that are underinvesting in accuracy to increase their investment.<sup>115</sup> A forced

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<sup>112</sup> Of course, if the bias were systematic, then investors would merely discount all ratings by a certain percent to come up with the correct rating. In fact, the bias will be concentrated in those issues which pose the greatest threat of future lawsuits. Because investors cannot determine which of these issues the rating agencies consider most vulnerable (for if the agency were to let investors know, then differing ratings would become meaningless), their only solution will be to discount all rating agencies' risk analysis. When this occurs, the bad ratings taint the good ratings, and investors are worse off.

<sup>113</sup> P. HUBER, *supra* note 99, at 164.

<sup>114</sup> "The deterrent force of any rule is the *difference* between how the rule treats those who obey and how it treats those who disobey." Easterbrook & Fischel, *supra* note 23, at 678 (emphasis in original); see R. POSNER, *supra* note 28, at 513-14; Fischel, *supra* note 12, at 1055.

<sup>115</sup> Furthermore, it only makes sense if the increase in value to consumers of the bond rating agencies' services exceeds the administrative costs of the system. See R. POSNER, *supra* note 28, at 187.

increase in investment in other circumstances is wasted—the value of the increased accuracy is worth less than its cost. A dollar wasted in increasing accuracy beyond the optimal level, after all, is just as wasteful as a needed dollar unspent by a negligent firm.

Imposing a higher standard of care on rating agencies is proper only if: a) the market system will not force rating agencies to make investments in accuracy by itself,<sup>116</sup> and b) the judicial system can pinpoint most instances of negligent behavior without falsely implicating non-negligent behavior.<sup>117</sup> If the rating agency's actions have little to do with whether it will be found guilty of negligence, then there is little reason for it to increase its investment in accuracy.

Even granting these two assumptions, courts should not impose a greater standard of care unless the value of the increases in accuracy are greater than the monitoring costs of administering the system.<sup>118</sup> If the increases in accuracy are worth less than the combination of attorney fees, opportunity costs of court time, and the increased documentation costs that the bond rating agency will have to bear, then the lawmakers or courts should not impose a greater standard of care.<sup>119</sup>

### 1. *Bond Rating Agencies Rate Bond Issues Accurately*

In Part II(A), this Note established the theoretical reasons why a bond rating agency will not engage in negligent behavior, even absent any judicial controls over its actions.<sup>120</sup> The marketplace is too pervasive a task master, and monitoring costs are too low to permit a negligent rating agency to survive for long. This subsection expands that discussion by moving outside the theoretical framework to evaluate the actual performance of bond rating agencies. After all, if the goal of expanding liability is to force an optimal

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<sup>116</sup> If the bond rating agency already is exercising the proper degree of care, forcing it to exercise greater care creates a loss from overinvestment in accuracy. The increased level of accuracy is worth less than the cost of the resources used to increase accuracy, which could have been used more productively elsewhere. See Easterbrook & Fischel, *supra* note 23, at 678. Increasing investments in accuracy in this situation actually makes society worse off.

<sup>117</sup> *Id.*; see also R. POSNER, *supra* note 28, at 513-14 (as the risk that legitimate conduct will be found to violate a rule increases, the deterrent effect of that rule decreases).

<sup>118</sup> See R. POSNER, *supra* note 28, at 517.

<sup>119</sup> Judge Easterbrook and Professor Fischel note:

For any offense, there is an optimal level of enforcement at which the costs of expending an additional enforcement dollar equal the gains from reducing the incidence of the offense. The optimal level of enforcement allows some violations to occur because the costs of stamping out these violations exceed the costs of the violations themselves.

Easterbrook & Fischel, *supra* note 23, at 678.

<sup>120</sup> See *supra* notes 61-65 and accompanying text.

level of accuracy, then the initial question should be whether the current standard is working.

Considerable evidence supports the proposition that bond rating agencies exercise a level of care that is, in fact, quite close to the optimum level of care. First, as explained above, bond rating agencies possess a significant continuity. The five major firms have existed for decades, and have rated bonds for a long period of time.<sup>121</sup> With such continuity, the market can use past performance as a proxy for present and future performance. By examining how often the rating agencies have been wrong in the past, investors can appropriately discount the value of the services to reflect the likelihood of current mistakes.

Several studies have correlated the relationship between bond ratings and failures. One study collected the rating data for all firms that defaulted between January 1970 and December 1984. It found that:

[O]f the 88 defaulting firms for which ratings were available one year prior to default, only one (Manville, which was rated A) was rated above triple B by Standard & Poor's. Only 16 were rated higher than B. Altman and Nammacher estimate that between 1974 and 1984 the average default rate on nonconvertible debt rated double B or lower was 1.60% a year versus .08% a year for all nonconvertible debt. Based on these results, it appears that ratings do indeed reflect relative default risks.<sup>122</sup>

This data is important for two reasons. First, it illustrates that investors can track the accuracy of rating agencies with relative ease, and second, that the ratings generally reflect the relative risk of default.<sup>123</sup> Though the market is one of differentiated oligopoly, the major players are very competitive in preserving their considerable investments in their rating infrastructures.<sup>124</sup> In addition, there are

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<sup>121</sup> Of the five largest bond rating agencies, four began rating securities early in the twentieth century. One, McCarthy, Crisanti & Maggee, was formed in 1975. Ederington & Yawitz, *supra* note 5, ch. 23, at 4-5.

<sup>122</sup> Ederington & Yawitz, *supra* note 5, ch. 23, at 17 (which also catalogues other studies on bond rating accuracy reaching the same conclusion); see also STANDARD & POOR'S, CREDITWEEK, Feb. 20, 1985 (detailing the results of a study showing that bond rating agencies are very good predictors of risk).

Researchers also have attempted to duplicate bond rating results with econometric models. The best results have reached a high of over 70% agreement. Whether the failure to get better agreement is because of deficiencies of the models or agencies is unknown. See Ang & Patel, *supra* note 1, at 631-40; Hettenhouse & Sartoris, *supra* note 1, at 66-76; Pinches & Singleton, *supra* note 1, at 29-43.

<sup>123</sup> They at least show the expected correlation between risk and subsequent default. Market forces must adjust the rating structure into the appropriate discount for riskier ventures, and thereby have prices that reflect expected default rates.

<sup>124</sup> See W. NICHOLSON, *supra* note 30, at 448-65. An oligopolistic bond rating agency engaging in monopolistic competition (with similar but differentiated products and sev-



several mid-size competitors and many niche players well positioned to expand should the major agencies falter. These fringe players all work together to ensure that the major rating agencies keep their investment in accuracy near the optimal level.<sup>125</sup> The data, in turn, shows that this competitive pressure has resulted in a high level of rating agency accuracy.

The evidence that the major bond rating agencies usually "get the rating right" suggests that imposing a negligence standard will not increase the level of accuracy in ratings. The market forces described above encourage the rating agencies to pursue the maximum accuracy that they reasonably can obtain. Additional liability will only increase their costs, which they will partially absorb and partially pass on to the ultimate consumers, the subscribers to their periodicals. Thus, a negligence system would hurt the very people it is designed to help.

## 2. *Bond Rating Agency Negligence Would Be Very Difficult to Determine Within the Courtroom*

The tort system, by its very nature, is a backward-looking system which attempts to recreate within the courtroom the optimum level of care an actor should have exercised with full benefit of hindsight. Viewed from the vantage point of a subscriber (and jury) who knows a company has defaulted, key documents that might have indicated potential trouble are easily emphasized, even if it was quite reasonable to give them less weight at the time of rating.

Accountants have responded to their increased liability not by increasing their level of accuracy, but rather by seeking to contract around their new-found liability.<sup>126</sup> Because the determination of negligence "is often dangerously open-ended and subjective,"<sup>127</sup> some commentators have noted that "courts and juries frequently hold accountants to unrealistic and unattainable standards that effectively force them to act as insurers of the businesses they audit."<sup>128</sup> In light of the above facts,

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eral players) will react similarly to a monopolist, but subject to the constraint that it will not raise prices high enough to make customer raiding profitable to a rival firm. In such markets, competition tends to focus on quality and advertising rather than price, once the participants have reached a stable price solution. *Id.* at 462-63; *see also id.* at 455-61 (various models of firm pricing behavior under imperfectly competitive conditions).

<sup>125</sup> For example, Fitch currently is attempting to expand into the traditional markets of Standard & Poor's & Moody's. Zigas, *supra* note 4, at 108. In addition, six of the largest U.S. securities firms currently are forming an Electronic Joint Venture which would distribute bond prices and data world wide. Tom Herman & William Power, *Wall Street Group Plans to Provide Bond-Data Service*, *Wall St. J.*, Mar. 23, 1990, at C1, col. 6.

<sup>126</sup> Siliciano, *supra* note 18, at 1959-60.

<sup>127</sup> *Id.* at 1962 (footnote omitted).

<sup>128</sup> *Id.*; *see* Minow, *Accountant's Liability and the Litigation Explosion*, *J. Acct.*, Sept. 1984,

the evasive behavior of accountants is hardly surprising. Faced with the prospect of a reckless client, a limited technology, and an error-prone adjudicative process, the profession might reasonably view the enhanced liability imposed by the reform courts simply as a tax on the activity of accounting. Worse yet, it is a tax that to a significant extent appears to operate independently of the accountant's level of care.<sup>129</sup>

The same problems are likely to arise again if similar legal liability is placed on rating agencies.

This problem is not unique to rating agencies or to accountants. Juries regularly evaluate such difficult cases as those involving antitrust violations and complicated contract disputes. Yet a rating agency violation differs from, say, an attempted monopolization case, in that in the antitrust case, society must rely on the courtroom because no market alternative exists. The market may give a competitor an incentive to monopolize or to breach her contract—results that society deems undesirable—but in the case of a rating agency, the market and the jury push in the same direction. Society tolerates the false positives of jury inaccuracy in antitrust cases because it needs a counterweight to the market. But where the market actually encourages the optimal societal result, and where the market is likely to do so in a fashion that is much more cost-effective than the courtroom, then lawmakers should be particularly wary of imposing liability.

Securities rating is so specialized that juries unfamiliar with the field will have great difficulty distinguishing significant factors from insignificant ones. Because of this, even if the bond rating firm regularly acts negligently, the deterrent effect of a system of liability rules will be minimal. The difficulty of identifying negligent behavior in all but the most obvious cases will lead to identification of proper behavior as blameworthy, and the exoneration of negligent behavior. Because the actual level of negligence will have little correspondence with the likelihood of being found liable for negligence, there will be little incentive to improve accuracy,<sup>130</sup> especially considering that bond rating agencies already are consistently very accurate.<sup>131</sup> Thus, implementing a negligence standard will only encourage suits brought for harassment or mistaken rea-

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at 77 (noting "the failure of courts and juries to distinguish between an audit failure and a business failure").

<sup>129</sup> Siliciano, *supra* note 18, at 1962-63.

<sup>130</sup> In a world where it is difficult to distinguish the guilty from the innocent, "even truth-tellers will say as little as possible in order to avoid paying the penalty for lying." Easterbrook & Fischel, *supra* note 23, at 678.

<sup>131</sup> See *supra* notes 121-25 and accompanying text.

sons, without increasing the welfare of investors or encouraging a higher level of care on the part of defendants.

### C. Economic Analysis Favors Retaining a Recklessness Standard

Advocates of a greater standard of care often trot out the rationales of deterrence and risk-spreading to convince courts that centralizing risk on the seller will result in a more economically fair result. The economic arguments are not one-sided, however. A system of tort negligence is not costless, especially given that the bulk of any compensatory recoveries would be consumed through the transaction costs required to allocate blame, namely the opportunity costs of the courts' and parties' time, and both sides' legal fees.<sup>132</sup> A negligence standard requires the rating agencies to provide an insurance policy against negligence with every bond rating periodical subscription. Such coverage is costly, especially when one considers that these policies sometimes will be "cashed in" even when the rating agency has not been negligent, and that the rating agencies' practice of providing subscriptions for a fixed price will lead to a self-selection bias which will selectively drive out the smaller investor.

These costs are worthwhile only if the deterrent effect is so great that the value of the increased accuracy plus the value of the insurance provided is greater than the costs of the tort system, including litigation fees, mistaken verdicts, and the costs of "defensive rating." Yet, as supported by both theory and empirical evidence, the market system gives firms the utmost reason to pursue accuracy. Rating agencies competing both among themselves and against close market substitutes must value accuracy highly. Studies showing that bond rating agencies have maintained a high degree of accuracy in the past demonstrate this.<sup>133</sup> In these circumstances, a system of negligence liability provides minimal deterrent effects. Courts, therefore, should be wary of imposing negligence liability on bond rating agencies.<sup>134</sup> Doing so in the belief that a negligence

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<sup>132</sup> Richard Willard notes that a Rand Study found that over half the money involved in lawsuits covers lawyers and other legal costs. See Richard K. Willard, *Changing the Law: The Role of Lawyers, Judges and Legislators Concerning Social Engineering and the Common Law*, 11 HARV. J.L. & PUB. POL'Y 23 (1988).

<sup>133</sup> See *supra* notes 120-25 and accompanying text.

<sup>134</sup> Professor Levmore asserts that "[e]conomists are quick to assume, in the absence of collusion or other market imperfections, that prevailing economic arrangements are sensible and, at times, ingenious." Levmore, *supra* note 24, at 666. Yet this is not the criticism he intends, but instead a rational presumption. Economic systems adapt to fit the legal structures in place. Flexible prices and bargaining among economic actors renders the system relatively efficient by rerouting resources to those best able to use them. This Note attempts to show that the current system rests on a solid economic

standard will be economically efficient, as the courts appear to be doing in accountant liability cases, may hurt the very consumer that the court is attempting to help.<sup>135</sup>

#### D. A Postscript on Privity

Although this Note deals mostly with the proper level of care which should govern bond rating agency liability, it is worth at least a passing mention that reform-oriented courts often extend liability in two ways simultaneously. In addition to allowing recovery using a looser standard of care, they often also allow more parties to recover by loosening the privity standards. Although the two issues theoretically are quite independent, one cannot evaluate them completely separately, for the rating agency is concerned not only with the ease with which an investor can recover, but also the amount of recovery. This Note so far has treated the two issues simultaneously.

One issue, however, deserves separate mention. As already noted, securities research has many attributes of a public good in that it confers a benefit not only on a bond rating agency's client, but also on other potential investors.<sup>136</sup> Even parties who decide not to invest in the market, based on this information, benefit from its existence. This is one social benefit which rating agencies bring to the capital markets.

When privity is expanded, however, these free-riding third parties become potential liabilities. Loosening the privity rules means that certain individuals always will be able to benefit from securities information on the upside, while being insured on the downside. Furthermore, the rating agency will not be compensated for this additional liability. This is a variable cost which it only partially can pass on to its subscribers. The agency, in response, will be forced to decrease the amount of ratings it undertakes because it suddenly has become liable to parties who have not contracted with it. The courts, believing they have solved the problem of a set of "foreseeable" plaintiffs who reasonably have relied on negligent informa-

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foundation. The arguments intend more than mere support of the status quo; hopefully, they demonstrate that the current system of freely-made decisions voluntarily establishing the burden of care is the best system. Tampering with it in the belief that doing so would increase efficiency, as has been done with attorney and accountant liability, is ill-advised.

<sup>135</sup> If courts adopt the negligence standard, it is unlikely that legislatures will overturn the result. Even if investors would be made better off in the aggregate by reversal, because the costs are distributed among many potential beneficiaries, no one will have an incentive to lobby for change. See Easterbrook & Fischel, *supra* note 23, at 672.

<sup>136</sup> See *infra* notes 198-202 and accompanying text (discussion of third-party effects and free-riders), and *supra* notes 23-24 & 42 and accompanying text (discussion of the public good aspect of securities research).

tion, instead have deliberately created a classic externality which allows third parties not only to receive valuable information free (as they formerly did), but now adds the further indignity of requiring the agency to insure the quality of this free information.<sup>137</sup> Thus, the expansion of privity is as troublesome as an expansion of the duty of care, from an economic perspective.

### III

#### FIRST AMENDMENT ASPECTS

##### A. First Amendment Protections of Commercial Information

“[Standard & Poor’s] simply has a right, as part of the media, to express its opinions in the form of letter symbols.”<sup>138</sup>

Although this Note focuses on the economic consequences of different legal regimes in the rating agency arena, this topic would not be complete without a discussion of the role that the first amendment plays for the bond rating agencies. As the introductory quote to this section illustrates, the most significant distinction between agencies and the now-liable accountants is that the rating agencies can cling to the first amendment. Traditional first amendment analysis fully supports the economic arguments against a negligence standard which this Note already has developed. This conclusion, however, is not obvious, nor fully addressed by the Supreme Court. A bond rating—the heart of the information which rating agencies publish—is at most three letters long. While they communicate a lot of information, and represent much work, it is not immediately obvious that bond ratings were what the framers had in mind when they proposed the first amendment. If they are protected at all, then bond ratings are the world’s shortest editorials.

The Supreme Court has noted that “[s]ome tension necessarily exists between the need for a vigorous and uninhibited press and the legitimate interest in redressing wrongful injury.”<sup>139</sup> However, society’s substantial interest in ensuring the free flow of ideas has led courts to value the benefits of information availability more highly than the protection of private persons who have been

<sup>137</sup> Cf. Siliciano, *supra* note 18, at 1965-67.

<sup>138</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3.

As the Supreme Court has stated, “[t]he press in its historic connotation comprehends every sort of publication which affords a vehicle of information and opinion.” *Lovell v. City of Griffin, Ga.*, 303 U.S. 444, 452 (1938); *see also* *Harper & Row Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 561 (1985) (“[c]ourts should be chary of deciding what is and what is not news.”) (quoting *Harper & Row Publishers, Inc. v. Nation Enters.*, 723 F.2d 195, 215 (1983) (Meskill, J., dissenting)).

<sup>139</sup> *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 342 (1974).

harmed.<sup>140</sup> As this Note concludes, similar reasoning should protect rating agencies.

Most cases involving publication of allegedly false material are libel and defamation cases.<sup>141</sup> However, as the Supreme Court recently has noted, “in cases raising First Amendment issues . . . an appellate court has an obligation to ‘make an independent examination of the whole record’ in order to make sure ‘that the judgment does not constitute a forbidden intrusion on the field of free expression.’”<sup>142</sup> Thus, any case alleging negligent misrepresentation against a bond rating agency implicates first amendment issues.<sup>143</sup>

*First Equity Corp. of Florida v. Standard & Poor's Corp.* is the most recent case in which an investor accused a bond rating agency of negligent misrepresentation.<sup>144</sup> The item of contention in this case was volume 46, no. 11 of *Standard & Poor's Corporation Records*.<sup>145</sup> In that issue, Standard & Poor's provided a rating for convertible secured trust notes issued by Pan American World Airways, Inc. The description of the bonds was inaccurate. Standard & Poor's listed the convertible bonds as including accumulated interest upon conversion. In reality, when the notes were converted into common stock in August 1985, only the principal, and not the interest, was counted in calculating the conversion rate.<sup>146</sup> Two plaintiffs, clients of First Equity, alleged that they had invested in the corporation's notes in reliance on the description in *Corporation Records*. The dis-

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<sup>140</sup> E.g., *Pittman v. Dow Jones & Co.*, 662 F. Supp. 921, 922 (E.D. La.), *aff'd*, 834 F.2d 1171 (5th Cir. 1987). See *infra* notes 216-19 for cases in which courts have decided that the first amendment allows a negligent party to trump the claim of a relying party.

<sup>141</sup> See, e.g., *Philadelphia Newspapers, Inc. v. Hepps*, 475 U.S. 767 (1986); *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749 (1985); *Time, Inc. v. Firestone*, 424 U.S. 448 (1976); *Gertz*, 418 U.S. 323; *Time, Inc. v. Hill*, 385 U.S. 374 (1967); JOHN NOWAK, RONALD ROTUNDA & J. NELSON YOUNG, *CONSTITUTIONAL LAW* 926-39 (3d ed. 1986) (summarizing recent trends in the libel area).

<sup>142</sup> *Bose Corp. v. Consumers Union of United States, Inc.*, 466 U.S. 485, 499 (1984) (quoting *New York Times v. Sullivan*, 376 U.S. 254, 284-86 (1964)).

<sup>143</sup> The first amendment provides in relevant part: “Congress shall make no law . . . abridging the freedom of speech, or of the press . . . .” U.S. CONST. amend. 1. This applies to states through the fourteenth amendment.

In *New York Times*, the Court identified several functions of the first amendment, including “freedom of expression upon public questions,” assuring the “unfettered interchange of ideas for the bringing about of political and social changes desired by the people,” and “[t]he maintenance of the opportunity for free political discussion to the end that government may be responsive to the will of the people.” *New York Times*, 376 U.S. at 269.

<sup>144</sup> *First Equity III*, 869 F.2d 175; *First Equity II*, 690 F. Supp. 256; *First Equity I*, 670 F. Supp. 115. See *supra* note 16 for other cases involving allegedly negligent publishers of financial information and the first amendment.

<sup>145</sup> *Standard & Poor's Corporation Records* “contains factual descriptions of the principal terms and provisions of bonds issued by leading corporations.” *First Equity I*, 670 F. Supp. at 116.

<sup>146</sup> *Id.*

strict court, ruling on a motion for summary judgment, rejected the plaintiffs' claims for negligent misrepresentation<sup>147</sup> and fraud,<sup>148</sup> and decided that the Restatement's negligent misrepresentation standard did not apply to a newspaper publisher such as Standard & Poor's.<sup>149</sup>

The court applied the widely cited *Jaillet* rule.<sup>150</sup> Under that rule, a newspaper publisher is not liable "to a member of the public for a non-defamatory negligent misstatement of an item of news, 'unless he wilfully . . . circulates it knowing it to be false, and it is calculated to and does . . . result in injury to another person.'" <sup>151</sup> This rule is efficient and practical, as it is nearly impossible for a newspaper to attain perfection. Furthermore, the rule shields publishers from "the spectre of unlimited liability,"<sup>152</sup> which would have a staggering deterrent effect on publishers.<sup>153</sup> The court noted that the first amendment requires a showing of falsity or at least recklessness before a court may constitutionally impose liability on a newspaper for publishing a non-defamatory misstatement.

<sup>147</sup> *Id.* at 118-19.

<sup>148</sup> *First Equity II*, 690 F. Supp. at 260.

<sup>149</sup> See *supra* note 69 for the text of section 552 of the *Restatement (Second) of Torts*.

<sup>150</sup> *First Equity I*, 670 F. Supp. at 117. The widely cited *Jaillet* rule comes from an early New York trial court case. In *Jaillet*, the court found that Dow Jones & Co. was not liable for negligently supplying its subscribers with incorrect information. Dow Jones incorrectly reported over its ticker tape service the result of a United States Supreme Court case on the taxable status of stock dividends as income. The plaintiff sold his stocks, instead of buying more, based on this report. The court found that no contract or fiduciary relationship existed between the parties, and that the "the relation of the defendant association to the public is the same as that of a publisher of a newspaper, and that its duties and obligations are to be measured by the same standard." *Jaillet v. Cashman*, 115 Misc. 383, 384, 189 N.Y.S. 743, 744 (Sup. Ct. 1921), *aff'd mem.*, 202 A.D. 805, 194 N.Y.S. 947 (App. Div. 1922), *aff'd mem.*, 235 N.Y. 511, 139 N.E. 714 (1923).

<sup>151</sup> *First Equity I*, 670 F. Supp. at 117 (citation omitted).

<sup>152</sup> *Id.* As the comment to the Restatement notes:

When the harm that is caused is only pecuniary loss, the courts have found it necessary to adopt a more restricted rule of liability, because of the extent to which misinformation may be, and may expect to be, circulated, and the magnitude of the losses which may follow from reliance upon it.

RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977).

As an example of "unlimited liability," the value of the securities listed in the issue of *Corporation Records* litigated in *First Equity I* was over \$65 billion. *First Equity I*, 670 F. Supp. at 117 n.3. If the court had accepted the plaintiff's contention that section 552 allowed recovery, then the plaintiff's recovery would be governed by section 552B. Under that section, compensatory damages would be:

(a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and

(b) pecuniary loss suffered otherwise as a consequence of the plaintiff's reliance upon the misrepresentation.

RESTATEMENT (SECOND) OF TORTS § 552B (1977).

<sup>153</sup> See *supra* notes 113-19 and accompanying text for an economic analysis of the deterrent effects of a system of negligence.

The court stated that to find reckless disregard, “[t]here must be sufficient evidence to permit the conclusion that the defendant in fact entertained serious doubts as to the truth of his publication.”<sup>154</sup> Because the plaintiff had not shown any evidence of such doubts, the case was dismissed.<sup>155</sup>

The court of appeals affirmed, after noting that Standard & Poor’s occupied a space somewhere between that of a publisher of a general-interest newspaper and an advisory newsletter making specific investment recommendations.<sup>156</sup> Although the court affirmed on grounds other than the first amendment, it briefly summarized the reasons for applying the first amendment to investment publications. The court noted that the readership of a publication such as *Corporation Records* is very large, and that this implicates many possible plaintiffs. Further, it stated that “[t]he potential for meritless or even fraudulent claims [was] high, and the cost of even successful defenses [potentially] prohibitive.”<sup>157</sup> Finally, the court observed that the contents of *Corporation Records* were not a viable substitute for the actual prospectus issued by a company under federal law. The court concluded:

In such circumstances, we believe that a user is in the best position to weigh the danger of inaccuracy and potential loss arising from a particular use of a summary against the cost of verifying the summary by examination of the original documents or prospectus. That being the case, the user should bear the risk . . . of proof of a knowing misstatement.<sup>158</sup>

Both *First Equity* courts were on firm ground in their decisions. The Supreme Court has stated that society should not depend on courts for correction of false information, but on the marketplace of ideas.<sup>159</sup> The Court, in a series of cases starting with *New York Times Co. v. Sullivan*,<sup>160</sup> has fashioned strong protections for publishers who have published false information. In *New York Times*, the Court

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<sup>154</sup> *First Equity II*, 690 F. Supp. at 259 (quoting *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968)). *St. Amant* also noted that “reckless conduct is not measured by whether a reasonably prudent man would have published, or would have investigated before publishing.” *St. Amant*, 340 U.S. at 731; accord *Garrison v. Louisiana*, 379 U.S. 64, 74 (1968) (requirement of “high degree of awareness of their probable falsity”).

<sup>155</sup> *First Equity II*, 690 F. Supp. at 259-60.

<sup>156</sup> *First Equity III*, 869 F.2d at 176.

<sup>157</sup> *Id.* at 180.

<sup>158</sup> *Id.*

<sup>159</sup> “Under the First Amendment there is no such thing as a false idea. However pernicious an opinion may seem, we depend for its correction not on the conscience of judges and juries but on the competition of other ideas.” *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 339-40 (1974) (footnote omitted).

<sup>160</sup> 376 U.S. 254 (1964); see J. NOWAK, R. RGTUNDA & J. YOUNG, *supra* note 141, at 926-39.



held that the first amendment prohibits a public official from recovering damages for utterances connected with her official conduct unless she proves "that the statement was made . . . with knowledge that it was false or with reckless disregard of whether it was false or not."<sup>161</sup> In a later case, the Court defined "reckless disregard" as meaning that the defendant had "in fact entertained serious doubts as to the truth of his publications."<sup>162</sup>

In the related context of libel suits,<sup>163</sup> the Supreme Court has formulated a two-part analysis in which the degree of care that a publisher owes a plaintiff depends on the plaintiff's societal position (public or private figure),<sup>164</sup> and whether the matter is one of "public concern."<sup>165</sup> The first test is irrelevant to the question of bond rating agency liability; however, the issue of whether a bond rating raises an issue of public concern is critical. Although the Court never has laid out a systematic checklist of the particular facts that distinguish an issue of public concern from a purely private matter,<sup>166</sup> an analysis of recent cases reveals the following factors as most significant:

- whether the market provides a powerful incentive for accuracy;<sup>167</sup>
- whether the speech was of interest to more than solely the speaker and the specific business audience;<sup>168</sup>
- whether the speech involves a "strong interest in the free flow

<sup>161</sup> *New York Times*, 376 U.S. at 279-80.

<sup>162</sup> *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968).

<sup>163</sup> Libel and defamation suits comprise most of the suits in this area of the law. See *supra* note 141 for a list of major Supreme Court cases in this area.

<sup>164</sup> See *Philadelphia Newspapers, Inc. v. Hepps*, 475 U.S. 767, 775 (1986).

<sup>165</sup> See *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 755-63 (1985). "It is speech on 'matters of public concern' that is 'at the heart of the First Amendment's protection.'" *Id.* at 758-59 (citations omitted); see also *Philadelphia Newspapers*, 475 U.S. 767 (where the defamatory statements are of public concern, a plaintiff who is a private figure bears the burden of proving that such statements are false).

<sup>166</sup> "Those who thought that the constitutional law of libel could not be made more complex must be few in number after the fragmented Supreme Court decision in *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*" J. NOWAK, R. ROTUNDA & J. YOUNG, *supra* note 141, at 937.

<sup>167</sup> *Dun & Bradstreet*, 472 U.S. at 762-63. Actually, this factor cuts both ways. On the one hand, if the market compels accuracy by agencies, then there is little need to allow potentially chilling negligence suits. On the other, if the market compels accuracy, then the incremental chilling effect of imposing a negligence system is minimal. This tension is reflected in a comparison of the Court's language in footnote 8 of the *Dun & Bradstreet* opinion and its language on pages 762-63.

The role of the market in forcing bond rating accuracy is described *supra* notes 62-65, 121-25 and accompanying text.

<sup>168</sup> *Id.* at 762. See *infra* notes 198-202 and accompanying text (discussion of third party effects and free-riders) and *supra* notes 23-24 and accompanying text (discussion of the public good aspect of securities research).

of commercial information”;<sup>169</sup>

- whether the speech contains any true elements;<sup>170</sup>
- whether the speech requires special protection to keep debate uninhibited and wide-open;<sup>171</sup>
- whether the speech is likely to be deterred by incidental state regulation;<sup>172</sup>
- whether the speech involves matters “at the core” of the first amendment protections (*i.e.*, political speech);<sup>173</sup>
- whether the speech involves a matter that is in the news.<sup>174</sup>

The more affirmative responses a court provides to these questions, the more likely it will find the speech to be of public concern and thus protected by the first amendment from burdensome state regulation.<sup>175</sup>

Applying this analysis, a strong case can be made for not holding bond rating agencies liable for a negligent printing. These factors indicate that the Court is quite willing to consider the role of commercial markets and how they interact with the first amendment marketplace of ideas. Given the Court’s preference for allowing the impartial market, rather than the government, to regulate speech, the economic analysis developed above is still quite relevant, even when the debate shifts to the seemingly economically neutral constitutional arena.

The first amendment provides an additional reason for not holding rating agencies liable for negligent conduct. As already examined in detail above, the markets and competition provide a strong incentive to keep rating agencies from engaging in negligent

<sup>169</sup> *Id.* See *supra* notes 23-60 and accompanying text (society’s interest in the free flow of commercial information).

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*; see also *New York Times v. Sullivan*, 376 U.S. 254, 270 (1964).

<sup>172</sup> *Dun & Bradstreet*, 472 U.S. at 762-63. The ambiguity of this factor is explored *infra* note 202.

<sup>173</sup> *First Nat’l Bank of Boston v. Bellotti*, 435 U.S. 765 (1978).

<sup>174</sup> *Don Lewis, Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., Philadelphia Newspapers, Inc. v. Hepps, and Speech on Matters of Public Concern: New Directions, in First Amendment Defamation Law*, 20 IND. L. REV. 767, 786 (1988).

<sup>175</sup> *Dun & Bradstreet*, 472 U.S. at 759. Although the first amendment only applies on its terms to governmental bodies, a similar result obtains when a suit is brought by a private party. This is because “the need to encourage debate on public issues . . . is of concern in a similar manner in [a] case involving a private suit for damages.” *Philadelphia Newspapers, Inc. v. Hepps*, 475 U.S. 767, 777 (1986).

The dissent in *Philadelphia Newspapers* feared that the majority’s decision protected negligent publishers: “[T]he only litigants—and the only publishers—who will benefit from today’s decision are those who act negligently or maliciously.” *Id.* at 780. Nothing in the majority’s opinion dispels this view, which strengthens the case for a negligent publisher.

behavior.<sup>176</sup> A rating is of interest to people throughout the investment community and beyond, and it is difficult to imagine a type of speech that presents a stronger interest in the free flow of information. Accurate information concerning investments, especially information about the risk of bond defaults, is critical to the proper functioning of the securities markets. Bond investment data is commercial information at its purest.

The Supreme Court applied many of the factors listed above in *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*<sup>177</sup> In that case, a construction contractor brought a defamation action against Dun & Bradstreet for issuing a credit report which mistakenly listed the plaintiff as having filed a voluntary petition for bankruptcy.<sup>178</sup> The Supreme Court, in holding that the plaintiff could recover libel damages, examined each factor, and answered them all negatively. The Court found that there was little public interest in the speech, as only five people received the credit report.<sup>179</sup> The Court also stated that speech of such limited circulation was of interest only to the targeted business audience, and not the general public. Finally, the Court found that, because the speech was for a profit motive—speech which is less likely to be deterred by imposing liability for libel—there was less need to fear the chilling effect on publication warned of in *New York Times*.<sup>180</sup>

While a potential plaintiff could use the last factor to argue that the commercial, profit-motivated speech of a bond rating agency thus deserves less protection, the Court, in a footnote to *Dun & Bradstreet*, explicitly rejected the notion that courts should give all economic or commercial speech reduced constitutional protec-

<sup>176</sup> See *supra* notes 61-65 and accompanying text.

<sup>177</sup> 472 U.S. 749 (1985).

<sup>178</sup> *Id.* at 751.

<sup>179</sup> *Id.* at 762. While a publication such as *Corporation Records* is published "purely for profit," and communicates information about the economic health of its subject, a credit report actually has more in common with an audit than it does with a security rating. Like the credit report in *Dun & Bradstreet*, an audit is intended for a limited audience. Similarly, both involve specific matters of interest to only a few people.

Security ratings, on the other hand, are intended for widespread dissemination to the general financial community. This implicates a "strong interest in the free flow of commercial information." *Id.* at 750 (quoting *Virginia Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 764 (1976)). There are fewer foreseeable relying parties in the context of an audit than in the context of bond ratings. Indeed, the number of foreseeable relying parties may well be the entire financial community, including investors who did not pay for a subscription. Because of this, the chilling effect that a negligence standard has on accountants is drastically less than the effect would be on bond rating agencies.

<sup>180</sup> *Id.* at 762-63. As the *New York Times* Court noted, courts should avoid imposing liability where publishers fear to publish "even though [a statement] is in fact true, because of doubt whether it can be proved in court or fear of the expense of having to do so." *New York Times*, 376 U.S. at 279.

tion.<sup>181</sup> When all the other factors indicated by the Court are answered positively, the declining distinctions between commercial and noncommercial speech do not dictate a conclusion that a bond rating agency's risk reports are not items of public concern.<sup>182</sup> Unlike the plaintiff in *Dun & Bradstreet*, who recovered only because of the narrow circulation of the credit report in that case, the general community benefits from the wide circulation of credit ratings.

For speech on issues of public concern, negligence "is constitutionally insufficient" to sustain liability.<sup>183</sup> If the rule were otherwise, it would be difficult to ensure that debate on public issues remain "uninhibited, robust, and wide-open."<sup>184</sup> Under this standard, if bond rating is a matter of public concern, courts could not hold a bond rating agency liable unless there is evidence that the agency "in fact entertained serious doubts as to the truth of [its] publication,"<sup>185</sup> or that it knew that there was a "high degree of awareness of the[ ] probable falsity"<sup>186</sup> of its publication. As in the libel context, "reckless conduct is not measured by whether a reasonably prudent man would have published, or would have investigated before publishing. There must be sufficient evidence to permit the conclusion that the defendant in fact entertained serious doubts as to the truth of his publication."<sup>187</sup>

## B. Applying the First Amendment to Bond Rating Agencies

"Accuracy in news reporting is certainly a desideratum, but the chilling effect of imposing a high duty of care on those in the business of news dissemination and making that duty run to a wide range of readers or TV viewers would have a chilling effect

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<sup>181</sup> *Dun & Bradstreet*, 472 U.S. at 762 n.8. This interpretation mirrors the language of *Lovell v. City of Griffins Ga.*, 303 U.S. 949 (1938), which stated that all publications which communicate "information and opinion" are covered under the first amendment.

<sup>182</sup> See *Virginia Bd. of Pharmacy*, 425 U.S. 748 (statute prohibiting the advertisement of prescription drugs held invalid because society has strong interest in the free flow of commercial information).

One could argue that Standard & Poor's speech is not commercial speech as the Supreme Court has defined it. The Court has stated that commercial speech is speech that does "no more than propose a commercial transaction." *Pittsburgh Press Co. v. Pittsburgh Human Relations Comm'n*, 413 U.S. 376, 385 (1973). This definition is "the core notion of commercial speech." *Bolger v. Youngs Drug Prods. Corp.*, 463 U.S. 60, 66 (1983). A bond rating agency's speech, however, does not propose a commercial transaction. Rather, it disseminates information so that others may enter into commercial transactions on their own. Because they report items of general interest, and do not engage in commercial speech, bond rating agencies merit full first amendment protection.

<sup>183</sup> *New York Times*, 376 U.S. at 288.

<sup>184</sup> *Id.* at 270.

<sup>185</sup> *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968).

<sup>186</sup> *Garrison v. Louisiana*, 379 U.S. 64, 74 (1968).

<sup>187</sup> *St. Amant*, 390 U.S. at 731.

which is unacceptable under our Constitution."<sup>188</sup>

The crucial issue is, therefore, whether bond ratings and investment information are matters of "public concern." Several courts have found that published financial information is of public concern, basing their findings on the value of the free flow of public information on investments.<sup>189</sup> In other contexts, the Supreme Court has stated that "[w]hether . . . speech addresses a matter of public concern must be determined by [the expression's] content, form, and context . . . as revealed by the whole record."<sup>190</sup> The Court used this process when it determined that the credit report in *Dun & Bradstreet* was a private matter.<sup>191</sup> When the "speech" is a general circulation tabloid, however, a general view has emerged that "[no] action for damages lies against a newspaper for merely inaccurate reporting when the publication does not constitute libel."<sup>192</sup> As the court in *First Equity* stated:

It is widely recognized that in the absence of a contract, fiduciary relationship, or intent to cause injury, a newspaper publisher is not liable to a member of the public for a non-defamatory negligent misstatement of an item of news, "unless he wilfully . . . circulates it knowing it to be false, and it is calculated to and does, . . . result in injury to another person."<sup>193</sup>

Ratings are editorial opinions, published in letter form. The purpose of any editorial, whether or not it is in the financial arena, is to communicate information to the reader. The form of the speech is irrelevant, as the Court has recognized by granting first amendment protections to certain symbolic acts, such as flag-burning. The first amendment is only concerned with whether ideas are being communicated from one person to another, and not the form of the communication.

It is apparent, therefore, that bond ratings are indeed the world's shortest editorials. As editorials, courts should grant them the same deference they grant any other protected first amendment publication. Ratings merely provide a simple means for consumers to compare rough levels of risk among varying companies and

<sup>188</sup> *Tumminello v. Bergen Evening Record, Inc.*, 454 F. Supp. 1156, 1160 (D.N.J. 1978).

<sup>189</sup> See cases cited *supra* note 16.

<sup>190</sup> *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 761 (1985) (quoting *Connick v. Meyers*, 461 U.S. 138, 147-48 (1983)).

<sup>191</sup> *Id.* at 762.

<sup>192</sup> *Langworthy v. Pulitzer Publishing Co.*, 368 S.W.2d 385, 390 (Mo. 1963).

<sup>193</sup> *First Equity I*, 670 F. Supp. at 117 (quoting 58 AM. JUR. 2D *Newspapers, Periodicals & Press* § 22 (1971)); see also *Langworthy*, 368 S.W.2d 385 (no action for damages for merely inaccurate reporting).

industries.<sup>194</sup>

### C. A Comparison of the First Amendment and Economic Analysis

“Moreover, because we have squarely held that the expression of opinion about a commercial product such as a loudspeaker is protected by the First Amendment, it is difficult to see why the expression of an opinion about a marketable security should not also be protected.”<sup>195</sup>

Because there is no fiduciary relationship and no contractual relationship for imposing a higher standard of care, courts cannot impose a negligent misrepresentation standard on bond rating agencies without risking a potentially chilling effect on the publication of credit report ratings.<sup>196</sup> Thus, this Note’s economic analysis leads to the same conclusions as its first amendment analysis. This result is not unexpected. The first amendment, after all, anticipates and encourages that truth should have a free reign in the marketplace of ideas, and this has the economic meaning implied by the phrase.<sup>197</sup> Information is valuable, and benefits more than just the parties who contract for its production.<sup>198</sup> The first amendment was adopted in part to reduce information costs that would stand in the way of private orderings of affairs;<sup>199</sup> imposing a negligence standard would contravene this goal.

Society has an interest in encouraging publication so long as the benefits of publication outweigh the costs.<sup>200</sup> In the bond rating context, if a plaintiff were allowed to recover on a showing of mere

<sup>194</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3.

<sup>195</sup> *Lowe v. Securities & Exch. Comm’n*, 472 U.S. 181, 210 n.58 (1985).

<sup>196</sup> *See supra* notes 138-94.

<sup>197</sup> “Ideas are a useful good produced in enormous quantity in a highly competitive market. The marketplace of ideas of which Holmes wrote is a fact, not merely a figure of speech.” R. POSNER, *supra* note 28, at 627; *see Abrams v. United States*, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting).

<sup>198</sup> The public good aspect of securities research is discussed *supra* notes 23-24 & 42 and accompanying text.

<sup>199</sup> As one commentator has noted,

[t]he application of such algebraic thinking to speech issues is not unfamiliar in our jurisprudence: Judge Hand himself applied a variation of his *Carroll Towing* formula when he interpreted the “clear and present danger” test as an issue of “whether the gravity of the ‘evil,’ discounted by its improbability, justified such an invasion of free speech as is necessary to avoid the danger.” The Supreme Court accepted Hand’s formulation, legitimizing the use of cost/benefit theory in first amendment analysis.

Rodney A. Smolla, *Let the Author Beware: The Rejuvenation of the American Law of Libel*, 132 U. PA. L. REV. 1, 83 (1983) (footnotes omitted).

<sup>200</sup> The publisher has an incentive to publish in the same circumstances and to maximize the value of the publication. *See Sheer & Zardkoohi, supra* note 92, at 416-18.

negligence, then the bond rating agency would face asymmetric costs. Financial information is like a public good, and it is difficult to keep such information strictly between the parties who contract for its production—and nearly impossible once actual trades are executed. Thus, whenever the rating agency discovers something useful, it will only be compensated for part of the value of its information. The costs of mistakes, however, would fall entirely on the bond rating agency, despite the generally beneficial nature of its research to society in general.<sup>201</sup> This would lead to underproduction of financial information, which is exactly what the first amendment was intended to prevent.

To ensure the free ordering of private affairs based on efficient information disclosure, we traditionally regulate publications only where there are significant third party effects.<sup>202</sup> In the case of a negligent rating, the only entities possibly harmed by a negligent rating are the rated company and the subscriber, both of whom are parties to the transaction. Both parties can discount the price of the services supplied by the bond rating service. If courts were to allow a relying plaintiff to recover for agency negligence, she would receive a duplicate recovery.

#### D. Some Miscellaneous Avenues of Recovery

A relying investor also might contend that, although there is no general liability for bond rating agencies, her dealings with the rating agency have established, by contract, a greater standard of care on the part of the agency. However, the major bond rating agencies have not negotiated such contracts.<sup>203</sup> Instead, most bond rating agencies have explicitly disclaimed liability, pointing out that they rely on information supplied by others. Standard & Poor's warns that "because of the possibility of human or mechanical error by our sources, . . . [Standard & Poor's] does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or for the results obtained from use of such information."<sup>204</sup> Similarly, Moody's notes that while it "has used due care and caution in the preparation" of its publications, its

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<sup>201</sup> Agencies are not fully compensated because not all people who benefit from bond ratings subscribe to their publications. The ratings make their way into the general financial press, where people consume them for the price of a newspaper.

<sup>202</sup> Examples include obscenity, military secrets, incitement, libel, and fighting words. *See, e.g.*, *Brandenburg v. Ohio*, 395 U.S. 444, 447 (1969) (per curiam) (states may proscribe advocacy directed at inciting lawlessness); *Roth v. United States*, 354 U.S. 476, 485 (1957) (obscenity not constitutionally protected); *Chaplinsky v. New Hampshire*, 315 U.S. 568, 573 (1942) (state may proscribe "fighting words").

<sup>203</sup> *First Equity III*, 869 F.2d at 179.

<sup>204</sup> S & P CREDITWEEK, *supra* note 10, at 2.

information "has been obtained from sources believed to be accurate and reliable, but because of the possibility of human and mechanical error its accuracy or completeness is not guaranteed."<sup>205</sup> In short, while the major bond rating agencies are free to ensure that their publications meet a higher standard of care, they have chosen not to.<sup>206</sup> Consumers discount the price they pay for the agencies' services to reflect this lower standard of care. Allowing recovery on a lesser showing would give the consumer a windfall, a recovery on an insurance contract for which she has not paid.<sup>207</sup>

A relying investor also might contend that the bond rating agency is her fiduciary.<sup>208</sup> In the investment field, however, fiduciary duties are implied only where there is a more specialized relationship than that which exists between a rating agency and its subscribers.<sup>209</sup> The basis may be contractual or imposed by operation of law, such as where one party holds herself out as a guarantor of accuracy (*e.g.*, an accountant).<sup>210</sup> Bond rating agencies are re-

<sup>205</sup> MOODY'S BOND RECORD, *supra* note 10, at i.

<sup>206</sup> According to Supreme Court precedent, a plaintiff seeking damages under Rule 10b-5 of the Securities Exchange Act of 1934 must show (1) a misrepresentation, an omission, or incomplete disclosure, (2) the existence of a duty, (3) scienter, (4) materiality, (5) reliance, and (6) an injury caused by that reliance. See *Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646, 653-54 (1983); *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

In contrast, the accounting profession's Professional Standards require that:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL STANDARDS (CCH) § 431.01 (1980). The auditor is assumed to take full responsibility for the documents to which her name is attached, unless she clearly states otherwise.

<sup>207</sup> See *supra* notes 94-112 and accompanying text.

<sup>208</sup> Judge Posner notes that the "[t]he fiduciary principle is the law's answer to the problem of unequal costs of information. It allows you to hire someone with superior information to deal on your behalf with others having superior information. It is thus a device for lowering transaction costs." R. POSNER, *supra* note 28, at 101.

<sup>209</sup> See *id.* at 389-90.

<sup>210</sup> See, *e.g.*, *Zahorik v. Smith Barney, Harris Upham & Co., Inc.*, 664 F. Supp. 309, 314 (N.D. Ill. 1987) (duty under tort law is dependent on the relationship that exists between broker and investor).

The accounting profession itself acknowledges its public responsibility:

The ethical code of the American Institute emphasizes the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal, and as government increasingly relies on accounting information.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL STANDARDS: CODE OF PROFESSIONAL ETHICS, ET § 51.04 (1982). In addition, the ethical code re-



sponsible to thousands of investors. As the subcommittee report preceding the adoption of the Investment Advisers Act of 1940 noted:

The accepted rights of freedom of the press and due process of law might prevent any general regulation and perhaps also supervision over particular types of publications, even if the advertisements of these publications occasionally quite exaggerate the value of the factual information which is supplied. That the constitutional guarantee of liberty of the press is applicable to publications of all types, and not only to newspapers, has been clearly indicated by the United States Supreme Court.<sup>211</sup>

As the parties' relationship changes from one of private counseling to one of public offerings of information, the client's fiduciary interest declines, and the publisher's first amendment protections increase.<sup>212</sup> Once the publication reaches the level of general publishing, where the clients are known to the publisher only as names on a mailing list, the publishers' fiduciary duty diminishes to zero. Thus, Standard & Poor's has ample support for its contention that "[r]atings do not create a fiduciary relationship between [Standard & Poor's] and users of the ratings since there is no legal basis for the existence of such a relationship."<sup>213</sup>

#### IV

##### THE EFFECT OF RETAINING A RECKLESSNESS STANDARD

"If competition among ideas is the method by which truth is established, the suppression of an idea on the ground that it is false is irrational, barring some market failure. An idea is false only if rejected in the marketplace, and if it is rejected, there is no occasion to suppress it."<sup>214</sup>

If courts were to reject the negligent misrepresentation standard, those parties who relied on negligent ratings would not be compensated for their losses. This is the cost of a system that only compensates victims of reckless behavior.<sup>215</sup> The tradeoff, however, is worthwhile, for it ensures a vigorous press that can publish with-

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quires that auditors evaluate the internal statements the company provides and decide whether they meet generally accepted accounting standards. Only if they do so may auditors use them.

<sup>211</sup> *Hearings on S. 3580 Before the Subcomm. on Securities and Exchange of the Senate Comm. on Banking*, 76th Cong., 3d Sess. pt. 1, 1007-09 (1940) (quoted in *Lowe v. Securities & Exch. Comm'n*, 472 U.S. 181, 198 (1985)).

<sup>212</sup> See *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 759 (1985) ("[s]peech on matters of purely private concern is of less first amendment concern.").

<sup>213</sup> S & P DEBT RATINGS CRITERIA, *supra* note 1, at 3.

<sup>214</sup> R. POSNER, *supra* note 28, at 627.

<sup>215</sup> Remarking on the similar preclusion of claims in the libel area, the Supreme Court has noted:

out fear of crippling lawsuits. As in the related area of defamation, society has decided that "the competing public policy and constitutional concerns tilt decidedly in favor of the press when mere negligence is alleged."<sup>216</sup> Thus, courts have not allowed recovery against publishers of poisonous recipes in cookbooks,<sup>217</sup> publishers of defective advice on using tools,<sup>218</sup> or publishers of dangerous medical formulas.<sup>219</sup> They have not done so because the remedy for false—or negligent—information is more information. Courts rely on the market to chastise negligent ratings, not the judicial system.<sup>220</sup> If the market is deemed sufficient to protect the writers of dangerous medical formulas, where information costs are high, and fewer market incentives exist to promote accuracy, then surely society should be less concerned about the dangers of potentially poorly rated securities. Because it is relative easy to track the relative merits of different rating agencies, the first amendment's admonishment against excessive government oversight of the marketplace of ideas bears a special warning. Careful examination of the rating agencies' work shows that they generally produce a fine product. This is the best reason of all for not changing a system that works.

### CONCLUSION

Although the tort of negligent misrepresentation is making significant inroads into the area of accountant liability, courts should not extend the reasoning to bond rating agencies. First, the eco-

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Plainly many deserving plaintiffs, including some intentionally subjected to injury, will be unable to surmount the barrier of the *New York Times* test. Despite this substantial abridgment of the state law right to compensation for wrongful hurt to one's reputation, the Court has concluded that the protection of the *New York Times* privilege should be available to publishers and broadcasters of defamatory falsehood concerning public officials and public figures.

Gertz v. Robert Welch, Inc., 418 U.S. 323, 342-43 (1974).

<sup>216</sup> Gutter v. Dow Jones, Inc., 22 Ohio St. 3d 286, 291, 490 N.E.2d 898, 902 (1986); see also Gertz, 418 U.S. at 340-41 ("Allowing the media to avoid liability only by proving truth of all injurious statements does not accord adequate protection to First Amendment liberties.").

<sup>217</sup> Cardozo v. Trne, 342 So. 2d 1053 (Fla. Dist. Ct. App. 1977).

<sup>218</sup> Alm v. Van Nostrand Reinhold Co., 134 Ill. App. 3d 716, 480 N.E.2d 1263, 89 Ill. Dec. 520 (1985).

<sup>219</sup> MacKown v. Illinois Publishing & Printing Co., 289 Ill. App. 59, 6 N.E.2d 526 (1937). In fact, this case is the basis of one of the Restatement's illustrations. RESTATEMENT (SECOND) OF TORTS § 552 illustration 2 (1977).

A publisher might lose to a relying plaintiff, however, if they publish negligent flight charts. This is probably due to the dangerous nature of the potential harm, namely, loss of life. See Brocklesby v. United States, 767 F.2d 1288 (9th Cir. 1985), cert. denied sub nom. Jeppsen & Co. v. Brocklesby, 474 U.S. 1101 (1986). See generally Note, *Publisher Liability for Material That Invites Reliance*, 66 TEX. L. REV. 1155 (1988) (authored by Daniel McNeel Lane, Jr.).

<sup>220</sup> Gertz v. Robert Welch, Inc., 418 U.S. 323, 339-40 (1974).

conomic reasoning that many of the courts use to impose liability on accountants is not nearly as clear-cut as these courts indicate. Second, the economic case is weakened further in the context of security rating agencies.

Economic theory indicates that rating agencies have a strong incentive not to pursue negligent behavior, regardless of the standard of care required of them in court. Market studies show that bond rating agencies have an enviable track record in evaluating risk of default. Where there is little evidence of negligence, and where the market provides large incentives to rating agencies to act non-negligently, imposing a negligence standard is likely to increase costs to the ultimate user without materially increasing bond rating agencies' levels of investment in accuracy.

In addition, imposing a negligence standard will lead to consumers paying mandatory negligence insurance with each subscription to a security rating publication. Because it is difficult to price discriminate between risky subscribers and relatively safe subscribers, liability for negligence will result in a cross-subsidized insurance plan in which the small subscriber subsidizes the larger subscriber. This, in turn, will lead to a self-selection bias whereby the smaller investor is likely to be driven out of the market for rating publications. This is of particular concern because the imposition of a negligence standard should increase the level of investment based on good information, not decrease it.

Courts cannot constitutionally allow recovery on any showing less than recklessness because of the potential chilling effect that imposing a negligence standard would have on rating publications. Given the importance of financial information to investors and the economy as a whole, bond rating constitutes a matter of "public concern." Applying traditional first amendment law, the state's interest in compensating relying investors must give way to the first amendment's concern for the free flow of commercial information. Society must rely on the market and competition to keep rating agencies operating at their negligence threshold, not on courts and juries.

The recent, questionable trend of imposing liability on accountants for negligence can easily be distinguished. An accountant audits a company, and has access to many internal documents that a rating agency, which only performs a survey, does not. In addition, the two businesses are intended for different audiences, with the accounting firm's audience being much smaller. Under the Supreme Court's formulation of the first amendment in *Dun & Bradstreet*, this is the difference between a news item of public concern and a private report to which the public is indifferent.

Both economics and the first amendment dictate the appropriate standard of care for security rating agency liability. The voracious appetite of negligent misrepresentation which has engulfed the accounting profession and threatens the legal profession should not be extended to the securities rating industry. Attorneys and accountants had only the persuasive force of economic arguments, but these were swept away by the perceived equities favoring liability. The rating agencies, however, should be able to hold the line with two additional weapons: new scholarship questioning the old economic assumptions underlying the expansion of liability in other areas, and the bulwark of the first amendment. Should those courts which have expanded accountant liability be tempted to sidestep the first amendment, they should keep in mind that doing so on the basis of perceived economic efficiency is no longer the obvious solution it once appeared.

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