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Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007–2008?

KRISTOFOR W. NELSON†

I. INTRODUCTION

The real estate downturn in 2007 created a drastic effect on US homeowners, lending institutions, and investors.¹ The fall of the housing market began a series of events which Alan Greenspan, the former chairman of the Federal Reserve, described as a “once in a century credit tsunami.”² In fact as of March 2009, one out of every eight residential mortgages in the United States was at least one payment behind or already in foreclosure.³ A real estate market that once demonstrated unprecedented growth and appreciation rates from 2001 to 2005 began to show signs of slowing as early as 2005.⁴ Newspaper and media stories have been written discussing the effect of the market downturn on homeowners, the housing industry, stock market, lending institutions, and the overall economy.⁵ This note considers whether securities ratings companies, such as Standard & Poor’s, Fitch, and Moody’s, should be held liable to the investors of residential mortgage backed securities

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1. See Chris Isidore, *It’s Official: Recession Since Dec. ’07*, CNNMONEY.COM, Dec. 1, 2008, <http://money.cnn.com/2008/12/01/news/economy/recession/index.htm>; Daniel Gross, *The S&P 500’s Bubble Trouble*, NEWSWEEK.COM, July 10, 2008, <http://www.newsweek.com/id/145406>; James Temple, *He’s Intent on Reviving Bayview*, S.F. CHRON., Jan. 1, 2008, at D1.

2. *The Financial Crisis and the Role Of Federal Regulators: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. at 15 (2008) [hereinafter *Role of Regulators Hearing*] (Testimony of Dr. Alan Greenspan, Former Chairman, Federal Reserve), available at <http://oversight.house.gov/documents/20081024163819.pdf>.

3. Press Release, Mortgage Bankers Association, *Delinquencies and Foreclosures Continue to Climb in Latest MBA National Delinquency Survey* (May 28, 2009), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/69031.htm>.

4. Michael Frattoni, *Where are House Prices Headed*, MORTGAGE BANKING at 32 (Jan. 1, 2006).

5. See, e.g., Jeannine Aversa, *Economy Contracts At A 5.7 Pct Pace in 1st Quarter; Analysts Believe Economy Doing Better Now*, YAHOO!FINANCE, May 29, 2009, <http://finance.yahoo.com/news/US-economy-sinks-at-a-57-apf-15383307.html>, (discussing the US economy in the longest recession since World War II and the effect on investors, lending institutions and consumers); David Bodamer, *Quesy Rider*, RETAIL TRAFFIC, December 1, 2005, at 18; *Macroeconomic Developments, Households and Enterprises*, NORGES BANK FIN. STABILITY, MAY 1, 2005, at 15; Lorraine Mirabella, *Regions Realty Market Cooling Home Sales Decline, Price Growth Slows in April in Key Period*, BALT. SUN, May 11, 2006 at 1A.

(also referred to as "RMBS"). These investors relied on the ratings of the securities issued by the ratings companies only to have the value of those securities decrease significantly due to real estate market downturn and subsequent re-rating of those securities by the ratings companies. The focus of this analysis will be on the liability of the securities ratings companies under both contract and tort theories. Specifically, potential liability will be analyzed under the doctrine of promissory estoppel in contracts and under an extension of negligence and products liability theories in torts.⁶ Accordingly, the stance of this article is speculative and normative rather than descriptive of accepted views on the current state of the law. In order to properly determine whether liability under these theories should exist, it is necessary to understand the relationship between investors and the ratings companies. Furthermore, it is important to understand the real estate market, the market for RMBS, and the underlying market conditions that led to the investors' losses and potential liability of the ratings companies.

II. THE PROBLEM: WHAT HAPPENED IN THE REAL ESTATE MARKET MELTDOWN OF 2006–2008

The overall effects of the real estate market downturn, or "meltdown" as it has been called, are still being determined.⁷ As the rate of housing foreclosures continue to rise, many lending institutions have announced large write-downs of assets related directly to the housing market, resulting in falling stock prices and business valuations.⁸ Other leaders in the real estate mortgage market have not survived, either having been acquired by a competitor, taken over by the government, or

6. There are obviously other theories and doctrines that could also be considered, such as misrepresentation, additional liability to third party beneficiaries under contract law and fraud under both tort and contract law. The extension of products liability to the ratings companies is an expansion of the theory developed by Oren Bar-Gill and Elizabeth Warren's application of products liability to consumer financial products. See Barr-Gill and Warren *infra* note 176; see also discussion *infra* p. 36.

7. Patrice Hill, *Page One Broken Foundations: The Housing Market, Blame Abounds for Housing Bust Easy Money, Greed a Toxic Mix*, WASH. TIMES, Dec. 26, 2007, at A01; Daniel McGinn, *With Lust in Our Hearts*, NEWSWEEK, January 14, 2008, at 50. The current economic recession which began in the aftermath of the housing downturn, is now being referred to as "The Great Recession." Chris Isidore, *The Great Recession: Economists generally agree this is the worst economic downturn since the Great Depression, but they say despite pain, another depression isn't likely.*, CNNMONEY.COM, Mar. 25, 2009, <http://money.cnn.com/2009/03/25/news/economy/depression.comparisons/>.

8. See *Role of Regulators Hearing*, *supra* note 2 at 16–20 (testimony of Dr. Alan Greenspan, Former Chairman, Federal Reserve); *How Subprime Started in Orange California*, TMC.NET, Jan. 2, 2008, <http://www.tmc.net.com>. (referencing "Top U.S. Financial Firms have announced more than \$80 billion in write downs on mortgage backed securities" with an additional \$33.6 billion forecast to be announced).

declared bankruptcy.⁹ In light of this, the lending institutions that remained tightened credit guidelines making it more difficult for borrowers to obtain credit.¹⁰ One major effect the tightening credit guidelines is that borrowers who previously would have been able to borrow more money or refinance their loans, are now unable to do so.¹¹ As a result, borrowers in risk of default and unable to refinance subsequently defaulted on their loans, while others no longer have access to funds that could be used to expand the economy.¹² By December 2007, the real estate market meltdown helped push the U.S. economy into the longest economic recession since World War II.¹³ To help avoid a potential economic recession, the Federal Reserve Bank lowered short-term US interest rates to almost zero from 2007 to 2008.¹⁴ In December 2007, the Federal Reserve issued a statement that it was more concerned with the current risk of an economic recession than the potential inflationary risk caused by lowering short-term interest rates.¹⁵

In the wake of this economic uncertainty and meltdown of the real estate market, the potential causes are being unraveled and discussed. Legislators held hearings to discuss the causes of what now seems to be

9. Kate Berry, *A Systematic Risk Averted in Servicing?*, AM. BANKER, Jan. 14, 2008, Mortgages at 1; Karen Sibayan, *ASR Looks Back at 2007*, ASSET SECURITIZATION REP., (Jan. 14, 2008).

10. Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve Sys., Address at the Economic Club of New York, New York (Oct. 15, 2008) [hereinafter Bernanke, *Club of New York*], available at <http://www.bis.org/review/r081016a.pdf>; Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Stamp Lecture, London School of Economics (Jan. 13, 2009), available at http://www.lse.ac.uk/collections/LSEPublicLecturesAndEvents/pdf/20090113_Bernanke.pdf; Becky Yarak, *Countrywide Tightens Loan Rules*, CHI. TRIB., August 24, 2007, at 3.

11. Bernanke, *Club of New York*, *supra* note 10; The Secretary-General of the Organisation for Economic Co-operation and Development [OECD], *Financial Markets Highlights November 2007*, FINANCIAL MARKET TRENDS, ISSN 0378-651X at 11 (Nov. 2007) [hereinafter Secretary-General of OECD, *Nov. 2007*], available at <http://www.oecd.org/dataoecd/53/18/39654572.pdf>. For a discussion and analysis regarding the effect of the credit market tightening in debtor-in-possession bankruptcy loans see Jarrod B. Martin, et al., *Free Falling With a Parachute That May Not Open: Debtor-In-Possession Financing in the Wake of the Great Recession*, 63 U. MIAMI L. REV. * (2009) (discussing alternative sources of DIP financing in the wake of the credit crisis).

12. Bernanke, *Club of New York*, *supra* note 10; Laura Smitherman, *Home Loan Reforms Planned O'Malley Seeks Changes To Address Foreclosure Threat*, BALT. SUN, Jan. 13, 2008, at A1.

13. Isidore, *supra* note 7. See 2009 ECONOMIC REPORT OF THE PRESIDENT at 96, available at http://www.nber.org/erp/2009_erp.pdf.

14. Jon Hilsenrath, *Fed Cuts Rates Near Zero to Battle Slump—Historic Move Boosts Stocks as Consumer Prices, Housing Starts Drop Sharply; Obama Calls for Government Spending Program*, WALL ST. J., Dec. 17, 2008, at A1.

15. Peter G. Gosselin, *Fed Interest-Rate Cut a Wall Street Letdown Stocks Dive Quarter Point Not Seen as Dramatic Enough by Many Analysts*, SEATTLE TIMES, Dec. 12, 2007, at C1; Maura Reynolds, *The Economy, Fed Disappoints the Street*, L.A. TIMES, Dec. 12, 2007, at 1.

a gross over-valuation of real estate property across the United States.¹⁶ Numerous news articles and commentaries attributed the blame to all market participants.¹⁷ Some blame the greed of the speculative real estate investors who signed purchase contracts on newly constructed homes or purchased homes with the intention to take advantage of the rapidly increasing housing prices and resell the home without ever living in it, a practice known as “flipping.”¹⁸ Others blame the lending institutions for loosening their underwriting standards and being overly aggressive in extending credit to borrowers.¹⁹ While some blame the loan originators who, with or without the borrowers knowledge, may have defrauded the institutions into believing the loans met the required credit quality standards which actually did not.²⁰ Others have wondered if the legislators and regulators failed to properly monitor the real estate market and failed to use their powers to prevent this current meltdown.²¹ Others still have properly observed that the issue of the consumer credit meltdown may not be within the purview of the state offices to regulate via consumer protection laws on national banks and other federally chartered institutions, because the Supreme Court’s recent decision in *Watters v. Wachovia Bank, N.A.*²² largely supported the widely criticized

16. See *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before H. Comm. on Oversight and Government Reform*, 110th Cong. 1 (2008) (testimony of Daniel Mudd, Former CEO, Fannie Mae); *Federal Response to the Housing and Financial Crisis: Hearing Before S. Budget Comm.*, 111th Cong. (2009) (testimony of Douglas W. Elmendorf, Dir. Cong. Budget Office).

17. Gail Marksjarvis, *Could Mortgage Problems Have Been Prevented by Less Greed?*, PITT. POST-GAZETTE, Jan. 13, 2008, at G7; *Who’s To Blame: Washington or Wall Street?*, NEWSWEEK, Mar. 30, 2009, at 30 [hereinafter *Who’s To Blame?*].

18. Ada Focer, *Flip . . . Flip . . . Flip . . . Flop: Mortgage Fraud and Property “Flipping” Skew Low-I.come Housing Markets*, SHELTERFORCE, Sept. 2000, at 10, available at <http://www.nhi.org/online/issues/113/focer.html>.

19. Marksjarvis, *supra* note 17.

20. Christofor L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2189 (2007) (recognizing that loan originators assign predatory loans through a series of debt transactions to avoid liability); Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments* 12–20 (Univ. N.C. Kenan-Flagler Business School, Working Paper, 2005), available at http://www.fanniemae.foundation.org/programs/hpd/pdf/hpd_1503_Lax.pdf, (observing that subprime mortgage borrowers tend to be less educated, less sophisticated and less prepared than prime mortgage borrowers).

21. Ted Frank, *Prime Target*, WALL ST. J., Apr. 25, 2007, at A15 (discussing the subprime meltdown and state legislators moves to impose unlimited liability on purchases of mortgages despite for any violation of law by the loan originators, such as the 2002 Georgia Fair Lending Act); *Who’s To Blame?*, *supra* note 17. But see Preemption Determination and Order, 68 Fed. Reg. 46,264 (OCC, Aug. 5, 2003) (discussing Georgia’s legislative attempt to prevent predatory lending practices within its state, and the OCC’s adoption of regulations to effectively limit the application of state laws to national banks).

22. 550 U.S. 1 (2007).

federal conflict preemption of state regulatory efforts.²³

III. THE PARTIES IMPACTED BY INACTION AND INDECISION- WHO'S AFFECTED, ALL TO BLAME?

As mentioned above, the current market downturn had a direct or indirect effect on almost every party involved with the US economy.²⁴ As recently as 2005, subprime mortgages and home equity loans securitizations totaled a staggering \$525.7 billion.²⁵ Approximately 80 percent of subprime mortgages were securitized, adjustable rate mortgages.²⁶ As of March 2009, almost half of the subprime adjustable rate mortgages are either at least one payment past due in their payments or in foreclosure.²⁷ The real estate downturn greatly effected homeowners, hedge funds, investors, and lenders.²⁸ Investors in lending institutions and real estate secured investments all are adversely affected as the value of these investments decreased rapidly in this market environment.²⁹ To properly analyze the investors' legal recourse against the ratings compa-

23. See, e.g., Chad D. Ehrenkranz, *Can a Bank Have Its Cake and Eat It Too? Why Watters v. Wachovia Wrongly Infers Preemption of State Consumer Protection Laws*, 16 U. MIAMI BUS. L. REV. 139 (2008); Keith R. Fisher, *Toward a Basal Tenth Amendment: A Riposte to National Bank Act Preemption of State Consumer Protection Laws*, 29 HARV. J.L. & PUB. POL'Y 981 (2006) (discussing the negative aspects of the OCC rulings and preemption); Howell E. Jackson & Stacy A. Anderson, *Can States Tax National Banks To Educate Consumers About Predatory Lending Practices?*, 30 HARV. J.L. & PUB. POL'Y 831, 833-34 (2007) (noting that the tension between a state law's attempt to protect its citizens and federally chartered lending institutions has been "resolved largely in favor of federal preemption, at least with respect to state laws purporting to regulate the manner in which national banks and other federal instrumentalities extend credit to their customers" by the Supreme Court's decision in *Watters*).

24. The Secretary-General of the OECD, *Financial Market Highlights – May 2008: The Recent Financial Market Turmoil, Contagion Risks and Policy Responses*, FINANCIAL MARKET TRENDS, ISSN 1995-2864 at 12 (May 2008) [hereinafter Secretary-General of the OECD, May 2008], available at <http://www.oecd.org/dataoecd/55/51/40850026.pdf>; *Testimony Concerning Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy Before the H. Fin. Serv. Comm.*, 110th Cong. at 25 (Sept. 5, 2007) [hereinafter Sirri, Sept. 2007 Congr. Testimony] (Testimony of Erik R. Sirri, Dir., Div. of Mkt. Reg., SEC) available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=F:39537.pdf; Erik R. Sirri, Dir., Div. of Mkt. Reg., SEC, Remarks Before the AICPA/FMD National Conference on the Securities Industry (Nov. 28, 2007) [hereinafter Sirri, Remarks Before AICPA/FMD] available at <http://www.sec.gov/news/speech/2007/spch112807ers.htm>. See Bernanke, *Club of New York*, *supra* note 10.

25. See S&P, *The Subprime Market* 7 (June 17, 2005) (the sum of the home equity and subprime loans).

26. Senator Chris Dodd, *Create, Sustain, Preserve, and Protect the American Dream of Home Ownership*, February 7, 2007, <http://dodd.senate.gov/?q=node/3731>.

27. *Mortgage Defaults, Foreclosures Spreading*, MSNBC.com, May 28, 2009, <http://www.msnbc.msn.com/id/29528856/>.

28. Secretary-General of OECD, Nov. 2007, *supra* note 11 at 17-19.

29. See *id.*

nies, a cursory discussion in the securitization of real estate backed securities is necessary.

IV. THE DEVIL YOU KNOW—UNDERSTANDING SECURITIZATION OF REAL ESTATE BACKED SECURITIES AND THE RISE OF THE SUB PRIME MARKET

The real estate backed securities market in the US has exploded into a multi-trillion dollar market over the last thirty years.³⁰ In the 1970s, large financial institutions lenders began to pool residential real estate mortgages together and transfer the assets into a trust, usually held by a third party.³¹ The third party trustee often sold shares of the trust to large institutional investors who purchased the shares in return for the cash flow generated from the underlying mortgages.³² This type of transaction is commonly referred to as securitization.³³ Almost all types of loans could be securitized, such as residential real estate loans, commercial loans, car loans, student loans, and even credit card receivables.³⁴ However, this commentary focuses on RMBS.³⁵

Lending institutions benefited from selling RMBS in several ways. The sale of the long term cash flow generated by the RMBS provided the lending institutions immediate capital to expand, meet regulatory reserve requirements, and satisfy shareholder profitability budgets.³⁶ By transferring the mortgages into a third party trust, the lending institutions

30. *See id.*

31. *See, e.g.,* Steven L. Schwarcz, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* 1:2 (Adam Ford ed., 2002).

32. Charles M. Sivesind, *Mortgage-Backed Securities: The Revolution in Real Estate Finance*, in *HOUSING AND THE NEW FINANCIAL MARKETS* 311, 312–13 (Richard L. Florida ed., 1986); Joint Release, Department of the Treasury: Office of the Comptroller of Currency (OCC), Federal Reserve System (FRS) Board of Governors, Federal Deposit Insurance Corporation (FDIC), Department of the Treasury: Office of Thrift Supervision (OTS), *Interagency Guidance on Asset Securitization Activities*, 1999 OFIA Lexis 7, at 2 (Dec. 13, 1999) [hereinafter *1999 Joint Statement*].

33. *1999 Joint Statement*, *supra* note 32. *See, e.g.,* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994).

34. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization Evolution Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1376 (1991); David J. Weiner, Comment, *Assignee Liability in the State of Predatory Lending Laws: How Uncapped Punitive Damages Threaten the Secondary Mortgage Market*, 55 EMORY L.J. 535, 550 (2006).

35. “A typical residential mortgage-backed securitization (RMBS) involves the following key parties: (1) the borrower, who is obligated to repay the mortgage; (2) the mortgage broker or lender (the “originator”); (3) the entity which purchases the loans from the originator and then sells the security instrument (the “issuer”); (4) the investment bankers, who structure, underwrite, and sell the securities; (5) the rating agencies, who are responsible for assigning a credit rating; (6) a credit enhancer, who guarantees that there will be a source of funds available for payments as they become due on the securities; and (7) a servicer, who collects and distributes the principal and interest payments.” Weiner *supra* note 34.

36. *See* Schwarcz, *supra* note 26; *1999 Joint Statement*, *supra* note 32.

no longer carried the underlying mortgages on their balance sheets.³⁷ This transfer afforded lending institutions an additional method to manage loan concentration levels on their balance sheets.³⁸

By investing in the RMBS, investors were able to further diversify their investment portfolio to include what seemed to be a relatively secure income generating investment.³⁹ The investments seemed secure because, in addition to the diversification provided by the pooling of a large number of mortgages, initially RMBS primarily consisted of mortgages to high credit quality borrowers, often referred to as “prime mortgages” sold by large financial institutions to large institutional investors.⁴⁰ Investors, through market demand, helped direct the underwriting criteria and pricing for the types of mortgages that would be included in the securitizations.⁴¹

However, in the 1990s, lenders began to pool and securitize higher risk mortgages, referred to as “subprime mortgages.”⁴² Subprime mortgages are loans to borrowers who, for a variety of reasons, are considered to be at a higher risk of default than prime mortgages.⁴³ These reasons include, but are not limited to: prior bankruptcies, lower than average credit scores, unverifiable income, higher debt to income ratios, and higher loan to value ratios.⁴⁴ Historically, a disproportionate amount of subprime borrowers have consisted of lower income classes and the elderly.⁴⁵ The overrepresentation of these vulnerable classes raises concerns of predatory practices within the subprime lending markets.⁴⁶ While numerous articles and commentaries have been written addressing who should be liable to the borrowers who fell victim to predatory lending practices, this article does not address that issue focusing instead on potential liability to investors in RMBS.⁴⁷

37. 1999 Joint Statement, *supra* note 32.

38. *See id.*

39. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, at 2041 (2007); Micheal H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 *S. CAL L. REV.* 1261 (1991).

40. Engel & McCoy, *supra* note 39.

41. *Id.*

42. A. Brooke Overby, *Mortgage Foreclosure in Post Katrina New Orleans*, 48 *B.C. L. REV.* 851, 901–906. (2007) (describing the emergence of subprime loan growth, securitization of subprime loans, and definition of “subprime” loans).

43. Joint Release, OCC, FRS, OTS, *Expanded Guidance for the Subprime Lending Programs*, 2001 FDIC Interp. Ltr. Lexis 9 at 7 (Jan. 31, 2001) [hereinafter *2001 Expanded Guidance*]; Overby, *supra* note 42 at 898–99.

44. *2001 Expanded Guidance*, *supra* note 43; Overby, *supra* note 42 at 898–99.

45. Engel & McCoy, *supra* note 39 at 2041; Overby, *supra* note 42 at 898–99.

46. Engel & McCoy, *supra* note 39 at 2041; Overby, *supra* note 42 at 898–99.

47. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and*

Prior to the 1990s there was no viable market in which investors would purchase the subprime collateralized securities.⁴⁸ Advances in technology, however, made it possible to attempt to estimate and price the risk of subprime home loan pools.⁴⁹ In order for investors to be comfortable in purchasing shares collateralized by residential mortgages, a tranche system was created for these securities.⁵⁰ In this tranche system, various classes of securities were created in which senior classes of securities received credit support from junior, subordinated classes of securities sold by the same issuer.⁵¹ Under the tranche system, the investor who held the most senior position of the security would be repaid first until that investor was paid in full. Then the owner of the next senior tranche would be repaid.⁵² This method of repayment would continue until the entire debt to investors was repaid.⁵³ The investors in the most senior tranche had the benefit of knowing they would be repaid first by the issuer of the RMBS. Additionally, in the case of default of the mortgage and liquidation of the underlying property(ies), the senior tranche investors would be repaid first with any remaining funds passed to the junior tranches in order of their seniority.⁵⁴ This default repayment structure is by virtue of the contractual subordination language in instrument which all the securities were issued.⁵⁵ Some lenders continued to service the mortgages⁵⁶ and held the most junior tranches of the underlying debt on their balance sheets.⁵⁷ This provided investors some assurance that lenders were not just passing off undesirable loans to investors, as the lenders also had an economic incentive for the loans to be repaid because they retained a first loss position in the pool of mortgages subject to the RMBS transaction.⁵⁸ To further address investor concerns over the risk of subprime mortgage pools, many lenders also offered recourse to investors which required the lenders to take back any nonperforming mortgages in the pool and substitute them with perform-

Economics of Predatory Lending, 80 TEX. L. REV. 1255 (2002); Engel & McCoy, *supra* note 39 at 2041; Overby, *supra* note 42 at 898–99.

48. Engel & McCoy, *supra* note 39 at 2045.

49. *Id.*; Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL L. REV. 1261, 1268–72 (1991).

50. Engel & McCoy, *supra* note 39 at 2046–50; Schill, *supra* note 49.

51. Engel & McCoy, *supra* note 39 at 2046–50; Schill, *supra* note 49.

52. Engel & McCoy, *supra* note 39 at 2046–50; Schill, *supra* note 49.

53. Engel & McCoy, *supra* note 39 at 2046–50; Schill, *supra* note 49.

54. Engel & McCoy, *supra* note 39 at 2046–50; Schill, *supra* note 49.

55. Engel & McCoy, *supra* note 39 at 2046–50; Schill, *supra* note 49.

56. Engel & McCoy, *supra* note 39 at 2063 (“Some securitization deals require lenders to retain loan servicing rights.”).

57. *Id.* at 2046–67.

58. *See id.* at 2063.

ing mortgages held by the lending institutions.⁵⁹ Additionally, some lenders even provided credit enhancement insurance to help investors become comfortable in purchasing securities collateralized by sub prime mortgages.⁶⁰

Although some investors purchased RMBS directly from a third party trust in a private transaction, most investors purchased the RMBS in a public market.⁶¹ The investors in a public primary and secondary market (i.e. sold by others after initial offering) often rely on the investment ratings given by the ratings companies in determining the relative quality and underlying risk of the security.⁶² The securities ratings companies that issue the ratings are supposed to be impartial third parties that conduct an analysis of the security and modeling of the market in order to determine the risk of loss of investing in the security.⁶³ Many investors rely on the ratings because they lack the time or the information to conduct a thorough investigation on their own, especially in constantly changing markets.⁶⁴ The higher the security is rated by the companies, presumably, the less risk of loss on the investment.⁶⁵ The senior securities backed by the same collateral pool will have higher values than the junior securities that provide credit support.⁶⁶ The highest rating given by S&P is AAA, which is considered to be very low risk.⁶⁷ By comparison, US Treasury Bonds usually carry AAA ratings.⁶⁸ Notably, the most senior tranches of many sub prime RMBS were issued AAA ratings during the real estate market boom from 1998–2006.⁶⁹

59. *Id.* at 2062.

60. *Id.* at 2047–48. AIG the largest provider of credit enhancement insurance continues to teeter on the verge of bankruptcy for its exposure to this type of insurance. At the time of this writing, federal government twice injected AIG with emergency funds in order to avoid insolvency. David Ellis, *US Takes Another Crack at AIG Rescue*, CNNMONEY.COM, Mar. 3, 2009, <http://money.cnn.com/2009/03/02/news.companies/aig/index.htm>.

61. SECURITIES EXCHANGE COMMISSION, *Final Rule: Asset Backed Securities*, Release No. 33-8518, Dec. 22, 2004, available at <http://sec.gov/rules/final/33-8518.htm> [hereinafter *Final Rule: Asset Backed Securities*].

62. See Standard & Poor's, *Understanding Standard & Poor's Rating Definitions*, June 3, 2009, available at <http://www2.standardandpoors.com/portal/site/sp/en/eu/page.article/2,1,4,0,1204847187221.html>.

63. See *id.*

64. See e.g., Engel & McCoy, *supra* note 39 at 2070–72.

65. Standard & Poor's, *supra* note 62. See Engel & McCoy, *supra* note 39 at 2054.

66. Kenneth Temkin et al., *Subprime Markets, the Role of GSEs, and Risk-Based Pricing*, HUD OFFICE OF POLICY DEVELOPMENT AND RESEARCH (Mar. 2002) available at <http://www.huduser.org/Publications/pdf/subprime.pdf>.

67. Standard & Poor's, *supra* note 62.

68. Kathleen M. Howley, *Rating Subprime Investment Grade Made 'Joke' of Credit Experts*, BLOOMBERG.COM, Dec. 20, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajdL7eUHeUro>.

69. Sirri, *Sept. 2007 Congr. Testimony*, *supra* note 24; Sirri, *Remarks Before AICPA/FMD*, *supra* note 24; Engel & McCoy, *supra* note 39; Howley, *supra* note 68.

Understandably, an investor relying on the rating to determine the investment risk would perceive the risk of investing in the most senior tranche of a sub prime RMBS similar to that of investing in the United States Government issued treasuries.⁷⁰ In fact, during the recent real estate market boom, S&P not only rated the most senior tranche of sub prime RMBS AAA, but also issued upgrades to many of the junior tranches that were initially given lower ratings.⁷¹ This signaled to investors, who rely on the ratings to assess their investment risk, that even the junior tranches of the sub prime RMBS were of investment grade quality similar to the quality of investing in the bonds of many Fortune 500 companies.⁷²

V. WHO SHOULD BE ACCOUNTABLE? EXAMINING THE FACTS SURROUNDING POTENTIAL LIABILITY OF THE RATINGS COMPANIES

The current real estate downturn created an environment in which many of the subprime mortgages that secured the RMBS began to default or experience higher risk of default.⁷³ By early 2005, the government, media, and economists began to express concern that a potential real estate market bubble loomed due to inflated real estate prices and increasing mortgage defaults.⁷⁴ Yet, ratings companies' upgrades of subprime RMBS continued to surpass the downgrades.⁷⁵ In fact, the ratings companies issued statements praising their overly conservative view of the risk of the subprime RMBS as late as 2006.⁷⁶ By mid-2007, however, many of the previously rated investment grade securities were downgraded by the same ratings companies, with many being rated

70. See Sirri, *Sept. 2007 Congr. Testimony*, *supra* note 24; Sirri, *Remarks Before AICPA/FMD*, *supra* note 24; see also Standard & Poor's, *supra* note 62.

71. See Standard & Poor's, *Rating Transitions 2004: U.S. RMBS Stellar Performance Continues to Set Records*, Jan. 21, 2005, available at http://www.securitization.net/pdf/sp/Rating_Tran_21Jan05.pdf [hereinafter *S&P, Ratings Transitions 2004*]; Standard & Poor's, *Rating Transitions 2005: U.S. RMBS Volume and Rating Activity Continue to Set Records*, Jan. 24, 2006, available at <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,0,1139588867949.html> [hereinafter *S&P, Ratings Transitions 2005*]; Standard & Poor's, *Transition Study: U.S. RMBS Upgrades Are Down and Downgrades Are Up in 2006*, Jan. 26, 2007, available at http://www2.standardandpoors.com/spf/pdf/media/subprime_upgrades_downgrades_012607.pdf [hereinafter *S&P, Transition Study*].

72. Mark Adelson et al., *Subprime Surprise . . . Not!*, NOMURA FIXED INCOME RESEARCH Apr. 18, 2007, available at http://www.federalreserve.gov/SECRS/2007/July/20070726/OP-1288/OP-1288_2_1.pdf.

73. *Id.* See Press Release, Mortgage Bankers Association, *supra* note 3.

74. Adelson et al., *supra* note 72.

75. *Id.*

76. *S&P, Rating Transitions 2004*, *supra* note 71; *S&P, Rating Transitions 2005*, *supra* note 71; *S&P, Transition Study*: *supra* note 71.

below investment grade also known as “junk.”⁷⁷ On July 10th, 2007, S&P downgraded 562 cases of RMBS securities totaling 6.39 *billion dollars*.⁷⁸ Notably, this mass downgrade occurred *the same day* an inter-agency report by the FDIC, OCC, Federal Reserve, Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA) issued a joint statement clarifying and expanding on two previous joint statements issued in 1999 and 2001 by the OCC, Federal Reserve, FDIC, and the OTS regarding the government’s concern of the risks associated with subprime mortgage lending.⁷⁹ The government expressed a concern in all three joint statements that lenders may not be fully assessing or protecting against the risks involved in making the subprime loans.⁸⁰ The concerns of the government regulators focused on lack of consumer understanding, potential predatory lending, rapidly increasing interest rates, lenders’ inability to assess the risks of granting the loan, and the risks to the lenders in the face of large defaults.⁸¹ Furthermore, the ratings companies, like the government regulatory agencies, are supposed to be impartial third parties that objectively assess the risks of the securities.⁸² The ratings companies arguably should have been aware of the government agencies’ concerns and should have taken those factors identified by the government agencies into consideration during their own analysis of rating the companies. Instead, a majority of the ratings companies’ risk assessment of the underlying collateral focused on proper documentation of the loan and legal compliance of the originator rather than an assessment of the stability and projections

77. Howley, *supra* note 68.

78. Alistair Barr, *S&P Cuts \$6.39 Bln in Mortgage-Backed Securities*, MARKETWATCH.COM, July 12, 2007, <http://www.marketwatch.com/story/sp-cuts-639-billion-in-mortgage-backed-securities>.

79. *Statement on Subprime Lending*, 72 FR 37569 (July 10, 2007) (Department of the Treasury: Office of the Comptroller of Currency (OCC), Federal Reserve System (FRS) Board of Governors, Federal Deposit Insurance Corporation (FDIC), Department of the Treasury: Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA)); *Agencies Issue Guidance on Asset Securitization Activities; Consider Regulatory Restrictions*, 1999 OFIA Lexis 7 (Dec. 13, 1999) (Department of the Treasury: Office of the Comptroller of Currency (OCC), Federal Reserve System (FRS) Board of Governors, Federal Deposit Insurance Corporation (FDIC), Department of the Treasury: Office of Thrift Supervision (OTS)); *Guidance Issued in Subprime Lending* (Mar. 1, 1999) (Department of the Treasury: Office of the Comptroller of Currency (OCC), Federal Reserve System (FRS) Board of Governors, Federal Deposit Insurance Corporation (FDIC), Department of the Treasury: Office of Thrift Supervision (OTS)); *2001 Expanded Guidance*, *supra* note 43.

80. *Statement on Subprime Lending*, *supra* note 79; *Agencies Issue Guidance on Asset Securitization Activities*, *supra* note 79; *1999 Guidance Issued in Subprime Lending*, *supra* note 79; *2001 Expanded Guidance*, *supra* note 43.

81. *Statement on Subprime Lending*, *supra* note 79; *Agencies Issue Guidance on Asset Securitization Activities*, *supra* note 79; *1999 Guidance Issued in Subprime Lending*, *supra* note 79; *2001 Expanded Guidance*, *supra* note 43.

82. See Standard & Poor’s Ratings Definitions, *supra* note 62.

of the real estate market, and interest rate shock risk.⁸³ The timing of the massive downgrade in July 2007—the same day as the release of the joint agency statement—could be seen as more of a reaction to the statement issued by the government than the ratings companies' own independent risk analysis.⁸⁴ Not surprisingly, in response to the S&P's announcement of the downgrades in July 2007, one analyst openly questioned why the downgrades were not issued months in advance.⁸⁵ As a result of the downgrades, many of the securities' value dropped and investors lost millions.⁸⁶ Securities that were once highly liquid and in high demand, seemingly overnight had lost their marketability.⁸⁷ Many investors and market observers began to question how the ratings issued by "objective" ratings companies could have been so inaccurate in their assessment of default risk.⁸⁸

VI. THEORIES OF RECOVERY FOR INVESTORS WHO PRESENTLY
HAVE NONE: SHOULD THEY BE EXTENDED TO
MAKE INVESTORS WHOLE?

Investors who purchased the highly rated RMBS did so under the belief that the security they were purchasing was of high quality and had a low risk of default.⁸⁹ As a result, the purchase prices of the securities were higher than those of similar income producing securities with lower ratings.⁹⁰ Once the ratings companies downgraded the RMBS, investors not only saw the value of their investments drop drastically overnight, but the downgrade signaled to investors that their seemingly low risk investments were now, in fact, considered a high default risk.⁹¹ This situation caused market observers and investors to question the reliability of the ratings generated by the ratings companies.⁹² Further, some investors adversely affected by their reliance on the ratings also sought government aid to recoup the losses they incurred as a result of their reliance on the investment ratings generated by the ratings companies.⁹³

83. Engel & McCoy, *supra* note 39 at 2068.

84. See, e.g., Howley, *supra* note 68; *Statement on Subprime Lending*, *supra* note 79.

85. Howley, *supra* note 68.

86. Secretary-General of OECD, *Nov. 2007*, *supra* note 11.

87. Howley, *supra* note 68.

88. Adelson et. al., *supra* note 72; Gretchen Morgenson, *Will Other Mortgage Dominoes Fall?*, N.Y. TIMES, Feb. 18, 2007, at C1.

89. See Standard & Poor's Ratings Definitions, *supra* note 62.

90. See Secretary-General of OECD, *Nov. 2007*, *supra* note 11; see also Standard & Poor's Ratings Definitions, *supra* note 62.

91. Secretary-General of OECD, *Nov. 2007*, *supra* note 11; See also Standard & Poor's Ratings Definitions, *supra* note 62.

92. Adelson et. al., *supra* note 72; Morgenson, *supra* note 88 at C1.

93. See *The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 110th Cong. (Sept. 26, 2007)

Next, the SEC and the States of New York and Ohio began investigating the ratings companies' practices of rating the RMBS.⁹⁴ Additionally, a large New York Pension Fund, a large holder of RMBS in its portfolio, sued the ratings companies in an attempt to recover its losses as a result of its reliance on the ratings.⁹⁵

A. *Ratings Companies Strike Back!*

To date, the ratings companies have successfully avoided class action liability for their ratings.⁹⁶ The ratings companies have supplied compelling legal and policy arguments that support their contention and belief that they should not be held liable for investors' losses. First, the ratings companies will likely rely on legal precedent and claim that their ratings are protected under the First Amendment.⁹⁷ Previous courts have held that the ratings of corporate bonds by the ratings companies equated to editorial commentary, which is constitutionally protected under the First Amendment right of freedom of the press.⁹⁸ Under such protections, in order to recover damages, plaintiffs must demonstrate that the defendants meet the *New York Times v. Sullivan*⁹⁹ standard of "actual malice." While the standard of "actual malice" may be difficult for RMBS investors to prove, the Second Circuit presented two factors to consider in determining whether a rating company should receive the same protections as the traditional press.¹⁰⁰ First, according to the Second Circuit, courts should consider whether ratings companies are only "reporting on" the transactions for which they were hired.¹⁰¹ If so, the

(testimony of Christopher Cox, Chairman, SEC), available at http://banking.senate.gov/public/index.cfm?FuseAction=files.View&FileStore_id=aca8c940-17ee-4416-a201-01e0b5536010 [hereinafter *Cox Testimony*].

94. *Id.*

95. *Id.*

96. Tomoe Murakami Tse & Carrie Johnson, *Mortgage Mess Unleashes Chain of Lawsuits*, WASH. POST, Sept. 11, 2007, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/09/10/AR2007091002327.html> (quoting Columbia Law School Professor John C. Coffee, "Credit-rating agencies have never been held liable in any class-action suit since the beginning of time. They have had virtual legal immunity to any kind of statement."). For example, the ratings agencies did not downgrade Enron or its debt until four days prior to Enron's bankruptcy filing, but they were neither targeted nor held liable in the class action lawsuit that followed. *Id.*

97. See, e.g., *County of Orange v. McGraw Hill Cos.*, 245 B.R. 151, 155 (C.D. Cal. 1999); *In re Enron Corp. Sec., Derivative & "ERISA" Litigation*, 511 F. Supp. 2d 742 (S.D. Tex. 2005).

98. *County of Orange*, 245 B.R. at 154–55; *In re Enron Corp.*, 511 F. Supp. 2d at 822.

99. 376 U.S. 254, 280 (1964).

100. See *Am. Sav. Bank, FSB v. UBS PaineWebber (In re Fitch, Inc.)*, 330 F.3d 104, 109–11 (2d Cir. 2003). While the court does not directly discuss whether the ratings companies should have First Amendment protections directly, the court analyzes whether the lower court abused its discretion in not applying the New York Press Shield Law to the ratings companies as members of the press. *Id.*

101. *Id.* at 109.

Second Circuit stated the limited scope of the ratings “weighs against” allowing the agencies to claim the legal protections of a journalist.¹⁰² Second, the court in *In re Fitch, Inc.* stated that the ratings agency’s active participation in structuring the transactions it subsequently rates likely went beyond journalism.¹⁰³ In light of *In re Fitch, Inc.*, investors of RMBS securities may successfully sustain claims against the ratings agencies by similarly demonstrating that ratings of RMBS securities should not be considered mere journalism.

If no longer found to have First Amendment protection, the ratings companies can point to the fact that they have no direct privity of contract with the investors to attempt to avoid liability.¹⁰⁴ The ratings companies are engaged by and compensated by the companies wishing to package and sell the securities.¹⁰⁵ Investors do not have the capabilities or the resources to independently research and analyze all of the companies and securities to adequately determine their risk and value compared to other securities.¹⁰⁶ As a result, investors usually will not purchase any securities that have not been rated by one of the major ratings companies like Standard and Poor’s, Fitch, or Moody’s.¹⁰⁷ The companies that wish to sell their securities to the larger market and intend to generate the most income for their sale are compelled by market demand to hire the rating companies to rate the securities.¹⁰⁸ As a result, the privity of contract for the rating of the security is between the ratings companies and the companies that initially sell the securities.¹⁰⁹

To further their legal defenses, the ratings companies may point to an unforeseeable change in the real estate market conditions, which resulted in the losses to investors. Under this argument, the ratings companies can point to the sudden change in the real estate market and the market’s subsequent meltdown as unforeseeable market events. As such, the ratings companies can argue that they should not be held liable for events that could not have been foreseen. Therefore, their ratings of the RMBS were accurate considering all of the foreseeable risks in the market. Thus, the losses suffered by investors were the result of an assumed risk by the investors for unforeseeable market events.

In addition to the legal arguments, the ratings companies could also

102. *Id.*

103. *Id.* at 110–11.

104. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1688 (2008).

105. *Id.*

106. Engel & McCoy, *supra* note 39 at 2068.

107. *See id.*

108. *See id.*

109. Kettering, *supra* note 104 at 1680.

introduce some policy arguments against holding them liable for the losses of investors in RMBS. The ratings companies could argue that they provide an integral service to market investors in rating the securities and companies.¹¹⁰ As noted above, investors do not have the resources to research and evaluate all of the companies and securities that are currently rated. The ratings companies could argue that if they were held liable for investors' losses, many ratings companies may not be able to pay the damages and therefore would no longer rate companies or their securities. The companies that survive could be hesitant to continue to rate companies in light of the new legal liability. Therefore they may choose to rate only a small percentage of the companies and securities that are rated as of today. The absence of the ratings would likely upset the bond and security market and lead to further disruption of the overall credit market.¹¹¹ Without the ratings, investors will either have to choose investments based on insufficient or expensive data, or more likely, seek other types of investments. This scenario would lead to information inequality which, in a market system, could lead to large gains by the few who have the resources and losses by those who do not possess the resources to accurately assess the risk of the securities or the companies. Should the market demand for the securities and bonds disappear due to the lack of the ratings, major companies and employers could face serious cash flow and expansion challenges, the effects of which could be felt in the overall national as well as global economies.

B. Possible Recovery for the Investors by Analogizing to the Restatement's View of Promissory Estoppel

Despite many of the arguments ratings companies could assert against liability, investors have compelling arguments and counterarguments as to why ratings companies should be held liable. Under classic contract theory, the investors of RMBS could try to seek damages from the ratings companies under the theory of promissory estoppel, Section 90 of the Second Restatement of Contracts.¹¹² Although the investors do not have a direct contractual relationship with the ratings companies, courts have held that third parties are entitled to relief under the doctrine of promissory estoppel.¹¹³ Thus, the facts present in the situation with

110. See Kettering, *supra* note 104 pp. 1671–1680 (discussing the role of ratings companies in the securitization market becoming “too big to fail”).

111. *See id.*

112. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

113. *Atl. Masonry v. Miller Constr.*, 558 So. 2d 433, 434–35 (Fla. Dist. Ct. App. 1990) (holding that relief to third parties can be granted under promissory estoppel); *Flattery v. Gregory*, 489 N.E.2d 1257, 1262 (Mass. 1986) (holding that an injured driver was an intended beneficiary of an alleged agreement between the insured and the insured's agent); *Raritan River Steel Co. v.*

investors of RMBS and the ratings companies may create a situation that could meet the necessary requirements of Section 90 of the Second Restatement of Contracts which states:

A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee *or a third person* and which does induce such action or forbearance is binding if injustice can be avoided only by the enforcement of the promise.¹¹⁴

In this situation, the investors of RMBS, who have no direct agreement or interaction with the ratings companies, would argue that they qualify under Section 90 as third parties.¹¹⁵ The investors' reliance on the ratings of the RMBS was a reasonably foreseeable result of the action taken by the ratings companies in rating the securities.¹¹⁶ Additionally, the investors will argue that the ratings companies in issuing and *maintaining* the rating of the RMBS, did so with the intention that investors would rely on the ratings and purchase the securities with the underlying risk of default being designated by the securities' ratings. Therefore, the ratings companies could reasonably foresee that their ratings would induce investors to purchase RMBS in reliance on the ratings.

The investors could point to several factors to establish that the ratings companies could reasonably foresee their reliance. First, the ratings companies have been providing this service to investors for over sixty years.¹¹⁷ Additionally the ratings companies' activities are monitored by the SEC, an agency of the United States government. Furthermore the SEC has designated only a select, limited number of companies, called Nationally Recognized Statistical Ratings Organization (or "NRSROs"), to issue securities ratings.¹¹⁸ Furthermore, under the \$20 billion Term Asset-Backed Securities Loan Facility (TALF) program established in late 2008 to stimulate the credit markets, the government would only provide funds collateralized by asset-backed securities that have been rated among the highest investment by two or more

Cherry, Bekaert & Holland, 398 S.E.2d 889, 891 (N.C. Ct. App. 1990) (allowing the seller of steel to sue the accountants of a bankrupt steel purchaser), *rev'd*, 407 S.E.2d 178 (N.C. 1991); Hoffman v. Red Owl Stores, 133 N.W.2d 267, 275 (Wis. 1965) (holding it would be unjust to not hold defendant liable to third-party plaintiff).

114. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981) (emphasis added).

115. *See id.*

116. *See id.*

117. *See Cox Testimony, supra* note 93.

118. Notably, the 2006 SEC amendment to the 1934 Act clearly states that a company's distinction as a NRSRO does not waive any rights, privileges, or defenses to the company under federal or state law. 15 U.S.C. § 78o-7(m)(1) (2006). However, the theory presented in this note does not require a waiver of right or defense in order to hold the ratings companies liable to investors. Instead the company's designation as a NRSRO by the SEC supports the argument that reliance on the RMBS ratings was not only foreseeable, but also reasonable.

NRSROs.¹¹⁹ Ironically, billions of dollars of RMBS securities would have theoretically met the government's requirements prior to the mortgage crisis that ultimately created the need for the TALF program.¹²⁰ With the seeming support from the United States government and the long history of the ratings companies, the investors' reliance on the ratings companies' ratings would seem reasonable.

In contrast, the ratings companies will argue that the disclaimers they issue, warning investors not to rely exclusively on the ratings, protect them from liability under Section 311 of the Second Restatement of Contracts.¹²¹ The Restatement provides, in relevant part:

Discharge or modification of a duty to an intended beneficiary by conduct of the promisee . . . is ineffective if a term of the promise creating the duty so provides. In the absence of such a term, the promisor and promisee retain power to discharge or modify the duty by subsequent agreement. Such a power terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his position in justifiable reliance on the promise or brings suit on it or manifests assent to it at the request of the promisor or promisee.¹²²

The ratings companies will maintain that, under Section 311, the disclaimers discharged their duty to investors who relied on the ratings, because the investors were properly notified in advance of their purchase of the securities, as the disclaimers were issued contemporaneously with the RMBS ratings.¹²³ However, as discussed above, the main purpose of the ratings companies is founded and created by the investors' reliance on those ratings when making their investment decisions.¹²⁴ The courts have repeatedly held that companies' disclaimers do not absolve companies of liability in cases in which they would otherwise be held liable under the doctrine of good faith and fair dealing.¹²⁵ The courts' rationale in these cases is that the disclaimer, if upheld, would frustrate the pur-

119. Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Reserve Announces the Creation of the Term Asset-Backed Securities Loan Facility (TALF) (Nov. 25, 2008), *available at* <http://www.federalreserve.gov/newsevents/press/monetary/monetary20081125a1.pdf>.

120. *See id.*

121. RESTATEMENT (SECOND) OF CONTRACTS § 311 (1981).

122. *Id.*

123. *See id.*

124. *See, e.g., id.*; *see also* discussion *supra* pp. 13–14, 22–24.

125. *See, e.g., Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965) (rejecting disclaimer under principles of good faith and fair dealing); *Tunkl v. Regents of the Univ. of Cal.*, 383 P.2d 441, 447 (Cal. 1963) (same); *Henningson v. Bloomfield Motors, Inc.*, 161 A.2d 69, 95 (N.J. 1960) (same); *Worley v. Wyo. Bottling Co.*, 1 P.3d 615, 626–27 (Wyo. 2000) (rejecting disclaimer in an at-will employment context due to good faith and fair dealing considerations).

pose of the doctrine of good faith and fair dealing in contracts.¹²⁶ Similarly, this would hold true if the ratings companies' disclaimers were to absolve the companies of any legal liability to investors, whose reliance on the ratings was otherwise found to be reasonable and foreseeable.¹²⁷

Further, in addition to demonstrating reasonably foreseeable reliance, the investors will be challenged to demonstrate that the actions of the ratings companies induced them into purchasing the RMBS.¹²⁸ To sustain a successful claim under Section 90, the investors must show that the main reason the issuing companies contracted with the ratings companies to issue and maintain the risk ratings was to attain a risk rating that would meet investment quality.¹²⁹ This, in turn, induced investors to purchase the RMBS. To support their claim, the investors will argue the reason the issuing companies paid for the ratings was to generate a belief that initial and subsequent investors would be able to rely on the ratings in determining whether or not to purchase the securities or invest in a similar investment vehicle.¹³⁰ The issuing companies benefited from higher securities ratings because the higher a security was rated, the lower the perceived default risk. Issuers with higher-rated securities could then demand a higher price from the market of investors.¹³¹ This relationship clearly signals that it was the intention of the companies issuing the securities and the ratings companies that investors would subsequently rely on the ratings of the securities to determine their investment value and default risk.¹³² Further, the investors who purchased the securities benefited from the ratings companies continuing to maintain and monitor the ratings of the securities, as these investors could offer to resell the security to subsequent investors, who were further expected to rely on the ratings.¹³³ In continually monitoring their ratings, rating companies support a larger secondary market for the securities.¹³⁴ The initial rating benefits the issuer and the initial direct purchaser of the security.¹³⁵ If ratings companies did not continually monitor their ratings, the investors in the secondary market would likely

126. See, e.g., *Williams*, 350 F.2d at 449; *Tunkl*, 383 P.2d at 447; *Henningsen*, 161 A.2d at 95; *Worley*, 1 P.3d at 626-27.

127. See RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

128. See, e.g., *id.*

129. This idea of issuers shopping for investment grade ratings from ratings companies is supported by scholars such as Kettering. Kettering, *supra* note 104 at 1681. The SEC also noted a concern with the management of the conflict of interests between ratings companies and issuers. *SEC Ratings Agency Report*, *infra* note 181 at 23-26.

130. See RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

131. See *Final Rule: Asset Backed Securities*, *supra* note 61.

132. See *id.*

133. *Id.*

134. *Id.*

135. *Id.*

lack the confidence in the initial rating and be hesitant to purchase a security with an older initial rating.¹³⁶ Without the secondary markets' willingness to invest in securities, the market price of the initial securities would be adversely affected. The initial purchasers would have a less liquid investment.¹³⁷ This would decrease the demand for the securities because initial investors would have difficulty reselling the securities to subsequent investors. The result is a lower initial price for the initial sale of the security than the price of a security that is continually monitored. Again, the value of the ratings companies to the companies who pay for their services is created and supported by the investors who rely on the accuracy of the ratings. The investors could argue that the actions and motivations of the RMBS issuers and the ratings companies satisfied the reasonable foreseeability of reliance and inducement elements of Section 90 as well as making any purported disclaimers of liability ineffective.¹³⁸

To satisfy the final element of Section 90, the investors must demonstrate that the remedy of receiving damages for their losses is necessary to avoid injustice.¹³⁹ The necessity of proof of injustice may effectively limit overextension of this doctrine and reserve liability to only those cases in which real issues have arisen, such as the predatory lending cases.¹⁴⁰ In such cases, persons of limited or fixed income find themselves with subprime mortgages, which swallow up nearly all of their monthly income.¹⁴¹ These "predatory lending practice" cases could be discouraged by decreasing the supply side. For instance, if the motivation to engage in predatory lending practice is undermined by the threat that such cases would be facially indefensible should they sour, the investors would have obvious cases because they relied upon the third-party recommendation of designated RMBS issuers and ratings companies in approving such risks.¹⁴² The investors could seek justice by attempting to recover damages from ratings companies and/or issuers, under traditional Restatement principles, upon a showing that investors lost money on the overrepresentation of such risks and that such

136. *Id.*

137. *Id.*

138. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

139. *Id.*

140. See *id.*; see also *Predatory Mortgage Lending: The Problem, Impact, and Responses: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 18–19 (2001) (statement of Mrs. Mary Ann Podelco) (testifying about an incident where she was on fixed income, had her house paid off, and was solicited by a mortgage company to finance home improvements for a payment that amounted to more than half of her fixed income, which was \$458; as a result, she lost her home) [hereinafter *Predatory Mortgage Lending Hearing*].

141. See *Predatory Mortgage Lending Hearing*, *supra* note 140.

142. See, e.g., *id.*

overselling resulted in investor loss.¹⁴³

*C. Potential Liability by Extension of Tort Law to
RMBS Ratings Companies*

Investors may also attempt to argue for extension of the tort laws to their claims against RMBS ratings companies. If so, then the standards that may be applied would be similar, by analogy, to third party auditors' liability to non-clients. Here, the RMBS ratings companies and the independent auditor are similar in function. Both the third-party auditor and RMBS ratings companies are thought to be independent.¹⁴⁴ In fact, a credit-rating agency that attempts to compete in the industry must first apply with the U.S. Securities and Exchange Commission.¹⁴⁵ In doing so, the credit-rating agency must make certain disclosures as part of the application process, designed to reveal any potential issues associated with its credibility, confidentiality of non-public information, and conflicts of interest.¹⁴⁶ Pursuant to statutory mandate, rules have been implemented to ensure that should the credit-rating agency become a NRSRO, all conflicts of interest are known and no impermissible conflicts of interest exist.¹⁴⁷

Additionally, the expertise and opinion of these independent parties—the auditor and the credit ratings companies—are all equally valuable to investors in the financial world. As such, just as auditors have not always been able to shirk responsibility for their negligence in overselling or over-valuing companies when their reports are relied upon by non-clients, the RMBS credit ratings companies should similarly not be allowed to escape liability by simply arguing that they lack privity with those who would rely so heavily upon their opinions. Courts typically apply three standards to accountants in negligent misrepresentation cases when, as here, privity probably would not be held to exist. They are: (1) the reasonable foreseeability rule, (2) the restatement rule, which applies to parties known to rely upon an accountant's advice, and (3) near privity.

Under the reasonable foreseeability rule, auditors have been held liable to parties with whom they lack privity in some jurisdictions.¹⁴⁸ Where auditors could reasonably foresee that their statements would be

143. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

144. Sirri, *Sept. 2007 Congr. Testimony*, *supra* note 24.

145. *Id.*

146. *Id.*

147. *Id.*

148. *See, e.g., Touche Ross & Co. v. Commerical Union Ins. Co.*, 514 So. 2d 315, 321–22 (Miss. 1987); *Rosenblum, Inc. v. Adler*, 461 A.2d 138, 152 (N.J.1983), (overruled by legislative enactment after New Jersey enacted it's accountant privity statute in 1998, N.J. STAT. ANN. §

relied upon by third parties with whom they lack privity, the New Jersey Supreme Court declined to let them avoid liability in *Rosenblum, Inc. v. Adler*.¹⁴⁹ In *Rosenblum*, the issue of what duty, if any, an auditor might owe to a third party without privity was extended to provide that auditors have a duty to anyone who the auditor should reasonably foresee to rely upon his statements and opinions, so long as the third party obtained the statement directly from the auditor and relied upon it for a proper business purpose.¹⁵⁰

In this case, the reasonable foreseeability rule has both positive and negative aspects in applying it to impose liability on the rating companies. On the positive side, the ratings companies prepare reports for an express group of people to rely upon it for business purposes.¹⁵¹ Furthermore, the statutory and regulatory hurdles imposed by the U.S. Securities and Exchange Commission provide built-in rules to prevent any conflicts of interest on the part of the RMBS issuers and rating companies. Thus, the reports are necessarily prepared and relied upon for proper business purposes.¹⁵² Further, there is only a narrow use for such ratings; therefore, the pool of plaintiffs is both limited and reasonably foreseeable. However, it should be noted that this would extend the reasonable foreseeability rule beyond a strict reading of *Rosenblum*, because accountant liability was cut-off to only those third parties who actually received statements from the auditor.¹⁵³ If someone had received it from another market source or even acquired an auditor statement on the internet or at the library, liability would not apply even if it was for a proper business purpose and was embarrassingly, but unintentionally wrong.¹⁵⁴

Section 552 of the Restatement (Second) of Torts, if anything, is more amenable to possible liability of the rating agencies than the reasonable foreseeability rule, because it is not as limited in that it would allow plaintiffs who were foreseeable but did not receive their statements directly from accountants.¹⁵⁵ Section 552 provides, in relevant

2A:53A-25 (1998)); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W. 2d 361, 386 (Wis. 1983).

149. 461 A.2d 138, 152 (N.J. 1983).

150. *Id.* at 153.

151. Sirri, *Sept. 2007 Congr. Testimony, surpa* note 24; Sirri, *Remarks Before AICPA/FMD, supra* note 24.

152. *See Rosenblum, Inc.*, 461 A.2d at 153; *see also* Sirri, *Sept. 2007 Congr. Testimony, surpa* note 24; Sirri, *Remarks Before AICPA/FMD, supra* note 24.

153. *See Rosenblum, Inc.*, 461 A.2d at 153.

154. Denzel Causey, *Accountants' Liability in an Indeterminate Amount for an Indeterminate Class: An Analysis of Touche Ross & Co. v. Commercial Union Insurance Company*, 57 Miss. L.J. 379, 380 (1987). *See Rosenblum, Inc.*, 461 A.2d at 153;

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

part:

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) 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.¹⁵⁶

Thus, under Section 552, an accountant would be liable for incorrect financial statements, audits or reports, as long as they were actually relied upon by plaintiffs who were foreseeable and part of limited class.¹⁵⁷ Thus, an accountant who prepares financial reports for a client owes a duty not only to the client but to any other person who is part of a limited group of persons whom the accountant knows will ultimately receive and rely upon it regardless of whether the financial reports came directly from the accountant or were forwarded from the client.¹⁵⁸ Next, the issue is whether or not the person that receives the financial materials relies upon them in a transaction that the accountant intends the information to influence or one that is substantially similar to that transaction.¹⁵⁹ Finally, a person would have to show their individual loss as a result of that reliance.¹⁶⁰ If so, then an individual would have a claim against the accountant for negligent misrepresentation.¹⁶¹

The extension of Section 552 of the Restatement from negligent

156. *Id.*

157. *Id.*

158. *See id.*

159. *See id.*

160. *See id.*

161. *See, e.g.,* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) (expanding the duty in the negligent misrepresentation context to specifically include foreseen or known users in accounting cases); *Raritan River Steel v. Cherry*, 367 S.E.2d 609, 614-18 (N.C. 1988) (applying section 552 of the Restatement in the accounting context to require only that the accountant be aware at the time he prepares his report that his work product will be relied upon by another person or a limited class of persons). Whether an accountant is told this directly by his client or if he learns this through other means does not control. *Id.* at 618-619; *Amwest Sur. Ins. Co. v. Ernst & Young*, 677 So.2d 409, 411 (Fla. Dist. Ct. App. 1996) (holding that under Restatement (Second) of Torts Section 552, an accountant need not know exactly who is relying on his work product to be liable for negligent misrepresentation, only that the person be part of a class of people that the accountant is actually aware that will rely on his financial statements).

misrepresentation cases in accounting cases to those involving the subprime market would seem especially appealing. Like accountants, the ratings companies would be liable for their financial analysis to those people that: (1) specifically request and pay for it; or (2) that they know will rely upon it by the person specifically requesting and paying for it or is within an limited group of persons whose reliance on their analysis is foreseeable.¹⁶² The ratings companies prepare reports for a specific group of investors for a specific purpose.¹⁶³ Moreover, the number of participants in the credit rating agency markets is limited by federal legislation.¹⁶⁴ Thus, the pool of individuals which investors can rely is limited, just as the market itself is limited.¹⁶⁵ In this context, the rating companies should foresee that their ratings will be relied upon by the investors in this market and should they make negligent financial misrepresentations, liability must result.¹⁶⁶ Thus, under this model, investors in the subprime market could sue a rating company that negligently inflated their security ratings, if they can show reliance upon that information to their financial detriment.

The third basis for tort liability to the rating companies is the near privity rule, which is closely related to the concept of privity and, consequently, more narrow than the approach to negligent misrepresentation take by Section 552 of the Restatement (Second) of Torts, or even the reasonable foreseeability rule. As alluded to earlier, many states require strict privity to impose liability on accountants for negligent misrepresentation.¹⁶⁷ However, as circumstances have evolved, the strict privity rule has been eroded to a more fluid concept, which is able to reach injustices that the privity rule does not. For example, the New York Court of Appeals in a 1985 case, *Credit Alliance v. Arthur Andersen & Co.*,¹⁶⁸ applied near privity in the accounting context by clarifying its near privity rule with a three-prong test.¹⁶⁹ Under the *Credit Alliance* test, a person seeking to impose liability on an auditor must show: (1) that the accountant knew his or her financial statements were going to be used for a specific purpose or for a set of limited, specific purposes; (2) that the accountant knew that certain parties would rely on his statements in furtherance of those purposes; and (3) that the accountant was familiar enough with the third party through his or her affirmative con-

162. See RESTATEMENT (SECOND) OF TORTS § 552 (1977).

163. See *id.*

164. See *id.*

165. See *id.*

166. See *id.*

167. See, e.g., *Ward v. Ernst & Young*, 435 S.E.2d 628, 634 (Va. 1993) (requiring strict privity); *Landell v. Lybrand*, 107 A. 783 (Pa. 1919) (establishing strict privity).

168. 483 N.E.2d 110 (N.Y. 1985).

169. *Id.* at 118.

duct that it is clear that the accountant knew of the plaintiff's potential reliance on his financial statements.¹⁷⁰

Applying this rule by analogy to investors hit in the credit meltdown, there would be little hope for an investor who lost money because of the misdeeds of the rating companies. First, the investor would have to show that the rating companies knew that their AAA ratings would be used for a specific purpose or set of specific purposes.¹⁷¹ At first blush, that would seem fairly obvious as the RMBS market and the use of those ratings in that market is well-known and regulated.¹⁷² Second, the investor would have to show that the rating companies knew that certain parties would rely upon the credit ratings for limited, specific purposes.¹⁷³ This too would seem fairly straightforward as the credit ratings are used for specific purposes in securitization and investment in securitization. The third test, however, would be fatal if not adapted to fit the RMBS market.¹⁷⁴ There, the investor would have to express through his or her conduct that the rating company knew the investor, such that it is clear that they were aware of his potential reliance on the credit ratings.¹⁷⁵ Although one could imagine situations where perhaps this would apply, in the usual case it would not. It would essentially require substantial evidence of conduct showing that there was a relationship between the investor/plaintiff and the rating company that was not quite enough to establish privity, but far too inflexible to rescue most investors from the sub prime mortgage meltdown. Thus, only by modifying this test to meet the realities of the market could this test be useful in providing potential liability to investors.

Finally there has been a recent movement among legal scholars to attempt to extend the doctrine of defective products liability to intangible consumer credit products.¹⁷⁶ These arguments are being developed to expand the defective products liability doctrine in order to protect consumers by holding the issuers of consumer credit products strictly liable for the harm their products cause where they currently escape lia-

170. *Id.*

171. *See id.*

172. *See id.*

173. *See id.*

174. *See id.*

175. *See id.*; *see also* Bank v. Strauhs & Kay, 483 N.E.2d 110, 120 (N.Y. 1985) (satisfying the conduct requirement in the near privity test by proffering evidence of direct communications, including written and oral conversations, along with a series of personal meetings with the accountant).

176. *See* Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008); Adam Goldstein, *Why "It Pays" to "Leave Home Without It": Examining the Legal Culpability of Credit Card Issuers Under Tort Principles of Products Liability*, note, 2006 U. ILL. L. REV. 827 (2006).

bility under simple negligence doctrine.¹⁷⁷ If the courts accept these arguments and expand strict products liability standards to include RMBS ratings, investors will only need to prove that the ratings of the RMBS themselves are: (1) intangible products which should be analyzed similar to other tangible products, (2) defective at the time they were issued, (3) the investors were foreseeable third party users, and (4) harmed by the defective products.¹⁷⁸

First the investors will need to demonstrate that the ratings were in fact intangible products issued by the ratings companies. The ratings companies will likely attempt to use previously stated arguments that the ratings are not in fact products, but rather editorial reporting protected by the First Amendment or mere puffery not to be relied upon.¹⁷⁹ As stated, the nature of the ratings of RMBS securities likely surpasses editorial journalism, and thus, under the analysis of *In re Fitch*, should not be afforded First Amendment Protection.¹⁸⁰ Additionally, considering the amount of information and analysis the ratings companies claim to use in determining the ratings, coupled with the amount of money the companies make generating the ratings, the claim that the ratings are mere puffery rather than actual products is untenable. In fact, in order to maintain the NRSRO rating with the government, the agencies are “required to produce credit ratings with integrity” or risk losing their valuable distinction as NRSROs.¹⁸¹ The language of the NRSRO Guidelines indicates the ratings provided by the agencies are viewed by the government as quantifiable products of importance rather than mere puffery or editorial commentary.¹⁸²

Next, the investors, to obtain strict liability under the doctrine of

177. See Bar-Gill and Warren, *supra* note 176; see also RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 2 (1998).

178. *Id.* The manufacturing defect was chosen over design defect in this example because it is the author’s view that a court might more readily apply manufacturing defect products liability principles in finding that the failure of RMBS ratings were a result of insufficient modeling or poor analysis by the ratings agencies rather than ruling that design of the ratings themselves is defective. The court may rule that the designs of the ratings are defective, but such a ruling could be a death blow to the future of credit ratings. The ratings, when accurately issued, are vital to the credit markets and for over sixty years served a useful purpose to the credit markets. Furthermore, plaintiffs will not be charged under manufacturing defect, as they would with design defects, to provide the court an alternative product design.

179. See discussion *supra* pp. 18–19.

180. See *Id.*; see also, *In re Fitch, Inc.*, *supra* note 100.

181. Staff Office of Compliance Inspections and Examinations Division of Trading and Markets and Economic Analysis, *Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies*, Securities Exchange Commission at 22 (July 2008)[hereinafter *SEC Ratings Agency Report*] available at: <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

182. See *id.*; see also discussion of ratings companies’ claims of First Amendment protection *supra* pp. 18–19.

manufacturer's defect, must show that the rating product was defective at the time it was issued.¹⁸³ To prove this, investors will initially direct the courts' attention to grossly understated ratings of default risk of RMBS. In response, ratings companies will argue that the real estate meltdown and its severity was an unforeseeable event. Thus, the ratings company will argue RMBS ratings products were not defective merely because they grossly underestimated default risk at the time they were issued, but rather, they were just another casualty of unforeseeable market events. However, investors could again point to warnings and market conditions that were essentially ignored by the ratings companies.¹⁸⁴ Furthermore, a July 2008 SEC investigation found several issues of concern with the ratings companies' practices in issuing RMBS ratings.¹⁸⁵ Investors could use the findings of the SEC investigation to demonstrate that the RMBS ratings were defectively issued for a variety of reasons. First, the SEC found that the agencies were severely understaffed in order to meet the volume of the ratings they issued at the peak of the market.¹⁸⁶ As a result, the investors could argue risk analysis of the RMBS were incomplete or rushed, creating the defective rating products.¹⁸⁷ Second the SEC identified concerns regarding the inherent conflict of interests between the ratings agencies and the clients from which they hoped to continue to generate business.¹⁸⁸ The SEC in its report noted that such conflicts could impair the integrity of the ratings.¹⁸⁹ Third, both Moody's and S&P acknowledged the existence of computer glitches that may have lead to inaccurately high ratings.¹⁹⁰ Finally, the SEC report referenced internal emails from employees of ratings agencies indicating a lack of good faith belief in the RMBS ratings.¹⁹¹ One particularly troubling e-mail expressed concerns that RMBS ratings models did not capture "half" of the risk of a particular transaction, but

183. See RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 2 (1998).

184. See *Statement on Subprime Lending*, *supra* note 79.

185. *SEC Ratings Agency Report*, *supra* note 181. Some of the issues discussed in the SEC report were: (1) the ratings companies inability to adjust to the growth in RMBS rating demand, (2) the lack of disclosure in the ratings process, (3) lack of documentation of the policy and procedures of RMBS ratings, including instances where the companies deviated from their own models in issuing ratings, (4) the surveillance process or the process where the ratings were monitored were less thorough than the initial rating process, and (5) the lack of proper management of the conflict of interests between the ratings companies and the issuing companies. *Id.*

186. *Id.* at 12.

187. See *id.* at 12.

188. *Id.* at 23.

189. *Id.* at 23.

190. *Id.* at 23.

191. *Id.* at 12.

“it could be structured by cows and we would rate it.”¹⁹² Another e-mail from a manager at a ratings agency referred to the RMBS market as a “monster” and said, “Let’s hope we are all wealthy and retired by the time this house of cards falters.”¹⁹³ Investors could proffer these SEC findings to show that the RMBS ratings were produced by the employees in a manner that made the RMBS ratings defective.

After demonstrating the RMBS ratings were defectively made, the investors must next show that they were foreseeable third party users harmed by the product. Again, the investors are ultimately the reason why issuers paid for the ratings agency to rate the RMBS securities.¹⁹⁴ The investors used the ratings products in order to determine the price they were willing to buy or sell the security and underlying risk of the RMBS securities.¹⁹⁵ Also the ratings product helped guide the price investors would pay to buy or sell the securities.¹⁹⁶ With the catastrophic failure of the ratings of RMBS, billions of dollars were lost by investors who relied on the ratings products. Considering the harm caused to both investors and the economy as a result of the defectively rated RMBS ratings, courts could reasonably determine the RMBS ratings were harmful defective products. Should the courts decide to extend the doctrine of manufacturing defect to RMBS ratings, ratings companies could be held strictly liable for their RMBS ratings.

VII. CONCLUSION

Financial institutions are not stagnant and injustice will occur if our legal system cannot adapt itself to meet the economic realities, such as those that led to the current real estate meltdown. This note examined the problem of the implosion of RMBS securities and the events leading up to it with an eye toward fashioning a speculative remedy to provide for justice. Unfortunately, our legal system currently does not have any law directly applicable to handle the situation and the state and Federal response to the crisis has provided mixed, albeit, limited success. By applying standards of contract theory such as promissory estoppel and tort theories of negligence and products liability to these security ratings companies, investors may be left with some recourse.

Extending liability to ratings companies is not, however, without unintended consequences. First, the ratings companies could not survive if they were held liable for all RMBS investor losses. The ratings com-

192. *Id.* at 12.

193. *Id.* at 12.

194. See discussion *supra* pp. 13–14, 22–24.

195. See discussion *supra* pp. 13–14.

196. See *id.*

panies play an essential role to the credit markets and their sudden collapse could disrupt the world economy.¹⁹⁷ This raises the issue of how far should the courts extend the liability to the ratings companies. Ideally the liability to ratings companies should not extend to the entire RMBS market. Doing so would essentially cause the ratings companies to be the unknowing guarantors to the RMBS market. This would go too far to prevent injustice. Also, even with some limits to the scope of liability to the ratings companies, the cost of corporate credit would become more expensive. The potential future liability would decrease the number of companies willing to issue ratings and act as a barrier to entry for smaller companies. Ratings companies that survive would likely increase the cost of their products to offset some of the liability risk and capitalize on the decreased competition. The increased costs of corporate credit as a result of the ratings companies' liability could adversely effect the economy.

Nonetheless, justice would not be served by allowing to the ratings companies to continue to avoid liability solely based on the potential unintended consequences. Ratings companies presented themselves as impartial third parties providing useful ratings products that reflect the default risk of the underlying investment. Over the past sixty years the ratings companies have in fact provided a valuable, and usually reliable, service to the credit markets. With the expansion into the market of sub-prime RMBS ratings, the ratings companies seemed to abandon their principles and controls upon which their reputation and credibility was established. As a result, investors who relied on the RMBS ratings suffered greater losses and the credit market as a whole was adversely effected. By maintaining liability for RMBS ratings, the ratings companies will perhaps be motivated to use more care in issuing their ratings in the future, an oft cited motivation for the imposition of tort liability. Furthermore, holding ratings companies accountable for improper credit ratings could restore investor confidence and help stimulate the weakened credit markets and the economy. Ideally expanding liability to ratings companies now will provide more stability to the credit markets and hopefully prevent unnecessary losses in the future.

197. See discussion *supra* pp. 21–22; see also Kettering, *supra* note 104 at 1671–80.