Pulling the Trigger: On the Activation of Rating Triggers in Abnormal Market Conditions in Light of the Coronavirus Pandemic

# A General Overview of Rating Triggers

# Ratings and Rating Triggers

Rating Triggers are a contractual covenant based on the rating provided by credit rating agencies with respect to one of the parties to a contract (an **issuer**).[[1]](#footnote-1) Rating triggers are designed as a conditional clause assuring additional rights to the unrated party (the **investor**) in the event of a downgrade of the issuer below a stipulated grade. Rating triggers and the additional rights provided by them vary in accordance with the specific needs of the parties and the nature of the contractual relationship.

Rating triggers can be incorporated into two kinds of contractual relations. The first is a contractual relationship with a direct connection to the rated debt; this includes mainly loan agreements, debentures, etc. In these kinds of contracts, the investor is relying on the rated debt as an inexpensive and reliable inspection tool for ensuring that its claims are well secured. Rating triggers incorporated into in such contracts restrict the issuer’s conduct, and thus help redistribute the risk of default. The second kind of contractual relationship in which rating triggers are incorporated are ones where the investor has an indirect relation to the rated debt. In such cases, the rated debt is used as a signaling tool for the parties for insuring the issuer’s solvency. In essence, the investor uses the rated debt as a proxy for the financial state of the issuer, without having a direct relation to the rated debt. An example is a rating trigger incorporated into a merger and acquisition transaction allowing the purchaser to not complete the transaction in the event of a downgrade below a stipulated grade.

Rating triggers differ from one another according to the specific needs of the parties to an agreement.[[2]](#footnote-2) Yet, it is still possible to identify some general types of triggers related to the parties to a transaction and the transaction type.[[3]](#footnote-3)

Rating triggers can be used as part of a loan agreement,[[4]](#footnote-4) where the investor uses a rating trigger to protect its interests from a financial deterioration that could result in a default. The rating trigger provides the investor with a certain set of rights in case the issuer’s rating falls below a stipulated level. The set of rights the investor will receive varies, and could range from a requirement for additional or better collateral, such as cash, or, in some extreme cases, to the right to enable acceleration or exercise a “put” option on the outstanding debt (rate and principle) by defining the downgrade itself as a default event.

Rating triggers can also be used in third party agreements,[[5]](#footnote-5) so that the commercial relationship between the issuer and the parties with which it conducts business is influenced by the issuer’s rating, although they have only an indirect relation to the rated debt. Thus, for example, an issuer that conducts business with a supplier may be required to supply better collateral, in the form of cash, due to the activation of a rating trigger.

As mentioned, rating triggers are based on ratings provided by credit rating agencies. The main purpose of ratings from these agencies is to fill the asymmetric information gap between issuers and investors.[[6]](#footnote-6) Credit rating agencies collect and analyze all available public information, and in some cases, even non-public information about the issuer for the purpose of better assessing the issuer’s creditworthiness and real risk of default. The conclusions of such analysis are summarized and distilled into a simple letter grade that reflects the credit rating agency’s current assessment of the issuer’s financial condition.[[7]](#footnote-7)

Ratings are a sort of “public good,”[[8]](#footnote-8) in that they are out in the open, non-excludable and non-rivalrous. As a result, once ratings are published, all investors can use them without impairing their value. The high demand for ratings from investors drives their creation by agencies, as ratings are very costly to produce.[[9]](#footnote-9) It would be very expensive and time consuming for an investor to conduct a rating analysis on its own for a potential investment, thus possibly reducing the attractiveness of the investment. It is also unrealistic to assume that every investor, many of whom are unsophisticated, has the tools and capacity, let alone the means, to conduct such research and reach valid and valuable conclusions.[[10]](#footnote-10) For example, a bondholder cannot – and probably would not want – to perform such in-depth and comprehensive research, preferring to invest in an asset that does not require such high levels of inspection and analysis, especially if the research and inspection costs combined with the expected yield from the investment are lower or equal to an alternative investment that does not require any additional costs. At the aggregate level, it is preferable for such research to be conducted only once for each potential investment vehicle, and then only by skilled financial institutions. To conclude, the rating of debt by sophisticated and professional institutions is an efficient solution for the problem of asymmetric information in the loan market. Ratings offer expertise and eliminate the need for an investor to conduct expensive independent research, thus lowering the costs of information and making information more accessible.[[11]](#footnote-11)

By helping to reduce information gaps in the debt market, ratings help to solve the adverse selection problem in the debt market.[[12]](#footnote-12) Without ratings, and without conducting prior independent research, investors would be forced to assume that the risk of all issued debt is equally valued as the average risk for default. Based on such an assumption, the price of capital would be determined as a fixed and equal price for all issuers, without exceptions. As a result, all issuers with a low probability of default (i.e., all the issuers with a probability of defaulting lower than the average probability for default in the debt market) would leave the debt market and find alternative ways of funding. In such circumstances, there would be a rise in the expected risk of default, as fewer low-risk issuers would remain in the debt market. Eventually, this process would lead to a cyclic reaction of revaluing the price of capital until the natural process of elimination would leave the debt market with high-risk issuers only. This problematic outcome of information asymmetry in investing has been termed the “Market for Lemons” dilemma by the economist George Akerlof.[[13]](#footnote-13) Ratings can help prevent this problem by ascertaining the real risk level of each issuer. Armed with this information, investors can act efficiently, using the ratings to discriminate between issuers with different risk levels, thus preserving all types of issuers in the market, with all sorts of risk levels. It should be noted that the mere existence of ratings acts as an incentive for all issuers to try to obtain a rating, without which they will be considered as “risky.” The refusal of an issuer to undergo such thorough inspection is likely to raise suspicions concerning the issuer's risk level and reflect a lack of transparency, thus making it much more difficult for the issuer to access capital.

While of immense importance, ratings are helpful only up until the initial stage of the investment, and will not necessarily be helpful from that point onwards. Once a transaction has been entered into, investors virtually become “captive” to the conduct and aspirations of the issuer and its shareholders, and cannot secure their interests. Essentially, the risk level about which the investor was informed prior to or upon entering into an investment will not necessarily remain stable throughout the course of the investment. In the absence of any specific clauses that prevent the issuer from doing so, the issuer might have incentive to significantly change its risk levels, whether in “natural” ways that occur in the normal course of business, or in an active way, as described in the issuer’s “asset substitution” problem explained below.

The asset substitution problem[[14]](#footnote-14) illustrates the difference between the interests of shareholders (which are represented in the issuer’s conduct) and creditors (investors in this context). An asset substitution problem occurs when a company replaces high quality assets with lower quality assets after a credit rating has been carried out and the investment has been made. While shareholders are interested in their investment's yields – and the higher, the better – higher yields are frequently, if not usually, achieved by raising the company's risk levels. Creditors that receive a fixed return and will prefer that the issuer maintain its existing risk level and avoid jeopardizing their returns. In this battle of interests, where the creditors have no real ability to influence the issuer’s conduct, creditors are destined to lose. Creditors might find themselves in a situation where the company’s risk levels rise immediately after they have signed the investment contract, particularly since the investment itself encourages the issuer to leverage its activities. This rise in risk levels is the issuer’s attempt to shift the risk from its business activities onto the investor or creditor, without previously calculating it into the agreement’s price.

The agency problem, describing the conflict of interests inherent in a relationship where one party is expected to act in the best interests of another, is reflected in the asset substitution problem. The agency problem is not unique to the investor-issuer relationship, to which rated debt is highly critical, but even exists in relationships that have an indirect connection to the rated debt. An example of this is a buyer of a company in a merger transaction that wants to ensure that the company’s financial state does not deteriorate in the interval between the due diligence process and the closing date. The buyer, already contractually bound to complete the transaction, and perhaps unable to cancel it, is concerned that the company might experience a material change that could cause the buyer damages. Even if the buyer has the option to cancel the transaction in the event of a material change, the detection of such a change would require the investment of high supervision costs by the buyer, which could impair the viability of the transaction.

To solve this problem, investors strive to secure their interests as part of the contractual relationship, which ultimately increases supervision costs. Investors will want to incorporate contractual clauses into their agreements that will ensure that the issuer preserves risk levels until the completion of the contractual relationship. Such clauses should also address the tools the investor is granted in the event of a material change in risk level. These contractual clauses in loan agreements are referred to as debt covenants, which impose various and diversified pledges on issuers to limit their conduct, all aimed at securing investor’s interests.[[15]](#footnote-15) A debt covenant can be either an affirmative or a negative one. Thus, for example, a debt covenant can: limit the issuer’s business areas or its investment policy; restrict the issuer’s ability to dispose of assets, especially strategic ones; demand that the debt be secured; restrict the ability to change control in the issuer or in a dividend distribution to shareholders; or establish a duty to inform investors of any material change in the issuer.[[16]](#footnote-16)

Nevertheless, debt covenants, while securing investor’s interests contractually, are insufficient to completely secure investors’ interests.[[17]](#footnote-17) Debt covenants do nothing to ensure that investors are aware of changes in risk levels, let alone grant them the ability to exercise their rights in response. As noted, in order to ensure that an issuer will act in accordance with a debt covenant, the investor must closely supervise the issuers’ conduct, which can prove quite difficult, as this supervision is directed at limiting the issuer’s actions. These challenges are reflected in high costs, which might render debt covenants impractical or not worthwhile. In essence, debt covenants do not help lower supervision costs, but may actually increase them, making the existing agency problem even more complex.[[18]](#footnote-18)

Using a rating trigger debt covenant helps solve the above-mentioned problems while lowering supervision costs.[[19]](#footnote-19) First, like all debt covenants, a rating trigger debt covenant will predetermine the risk distribution between the parties and will stipulate that a change in the issuer’s risk levels, which will be reflected in a downgrade of the issuer’s rating below a stipulated level, will endow the investor with certain rights Thus, rating triggers help limit the issuer’s ability to make a material change in risk levels while concomitantly reducing the investor’s inspection costs.[[20]](#footnote-20) In addition, a rating trigger covenant will normally set a clear and simple outcome that is easily executed, thus helping to lower inspection costs in the event that such a clause is activated.[[21]](#footnote-21)

How does the use of rating triggers reduce supervision costs? The answer to this lies in the use of ratings as an independent source of information when determining rights or obligations of parties to an investment. First, by incorporating rating triggers, the parties agree to rely on ratings as a conclusive signal for the issuer’s creditworthiness. Second, the parties agree that if a downgrade below a stipulated rate occurs, the protection of the investor’s interest will change in accordance with the terms of the covenant. For that purpose, the parties will agree in advance on a predetermined set of rights to which the investor is entitled in the event that such a downgrade occurs. These rights vary, ranging from a requirement to provide better collateral to the full acceleration of the debt.[[22]](#footnote-22)

In summation, first, when parties enter into a rating trigger covenant, they agree to use the ratings issued by credit rating agencies, which entails no additional cost. Second, in a rating trigger covenant, the rights granted to the investor as a result of a downgrade below the stipulated grade are easy to monitor and to enforce. Those two factors make rating triggers an efficient tool for both investors and issuers: for investors, as they help lower their supervision costs, and for issuers, as they help reduce the price of access to capital, at least indirectly, since the price of access to capital is partly based on the supervision costs incurred by investors.

Reducing the cost of capital is a particularly relevant consideration when taking into account the specific loan agreements in which investors tend to demand the incorporation of rating triggers. For the most part, rating triggers will be incorporated into loan agreements if the borrower (issuer) is in financial difficulties and is unable to raise capital in ordinary ways.[[23]](#footnote-23) In these situations, lenders will tend to use their position of power over the borrower to demand contractual protection for any claims that may arise, and a rating trigger can serve as a form of such contractual protection. For an issuer experiencing financial difficulties, reducing the cost of capital is critically important, and the use of rating triggers seems reasonable. The lower the grade an issuer has, the more tangible the fear of a downgrade. Moreover, the more financially distressed an issuer is, the greater the risk of default. Therefore, under such circumstances, it is only reasonable for an investor to demand greater contractual protection of its claims. The borrower, facing financial difficulties and having trouble raising capital, seeks to reduce the cost of capital as much as possible, as capital costs affect the borrower’s profitability and ability to repay the loan. Mechanisms for reducing investors’ risk is also efficient in the aggregate, as giving financially distressed issuers access to capital offers them some financial stability, thus enabling them to, literally, “get back to business.”

# The Dark Side of Rating Triggers

As discussed above, the use of rating triggers as a supervision and signaling tool is highly beneficial. However, these rating trigger mechanisms can also pose a disproportionate level of risk to issuers and investors. Undeniably, rating triggers can serve as a harmless means for repricing and assuring a party’s claims by demanding a new debt settlement or an increase in interest levels. However, rating triggers can also be used as a powerful and disruptive measure that could cause the collapse of the issuer by a mere downgrade, thus endangering not only the issuer but also other investors and creditors.[[24]](#footnote-24) Activating the contractual tool of a rating trigger can escalate any downgrade already suffered by the issuer by increasing the pressure the issuer faces, which could then lead to further financial deterioration.

The severe consequences that rating triggers can produce threaten the issuer’s unsecured creditors and, in some extreme cases, also its secured creditors, even those the trigger was aimed at protecting, [[25]](#footnote-25) as rating triggers tend to exacerbate an already existing liquidity crisis.[[26]](#footnote-26) Thus, the implications of activating rating triggers could prove financially catastrophic, primarily because they create a financing problem by publicly exposing the issuer as less creditworthy.[[27]](#footnote-27) Setting off a rating trigger just when an issuer is suffering financial problems is comparable to adding fuel to the fire, and could create a lethal combination from which not many firms can recover. This is an inherent problem for rating triggers, since their activation is based upon a downgrade event. The downgrade independently indicates a deterioration of the issuer’s financial condition following a complete analysis of the issuer’s current situation. This led to the conclusion that the issuer’s financial condition had deteriorated, rendering the issuer less able to guarantee repayment of its debts. Such a downgrade does more than publicly indicate the issuer's financial difficulties; it also acts as a signaling tool, warning investors that the risk of investing their money with the downgraded issuer just became a little higher. A downgrade will usually lead to either a repricing of existing and future loans (for example, by demanding higher interest level), or to avoidance of the investment altogether, which naturally presents the issuer with even greater difficulties in gaining access to new capital.

For example, rating triggers that define a downgrade as a default event, and thus lead to an acceleration or put option on the outstanding debt are especially risky.[[28]](#footnote-28) Such rating triggers cause a downgrade to end the contractual relations between the parties, thus cutting off the issuer’s financing options, or changing them in a material manner. Such trigger activation can harm the issuer’s financial position by adding a demand for cash on top of the issuer’s original condition. In the same manner, an acceleration or put option on the outstanding debt is in fact a termination of credit availability, precisely when the issuer is in desperate need of credit and while it is most difficult for the issuer to obtain it.[[29]](#footnote-29)

Very few issuers can recover from these “worst-case scenarios” described above. Furthermore, it should be noted that there is usually a negative correlation between the ability of the issuer to maintain its obligations after the activation of a rating trigger and the terms of the rating trigger.[[30]](#footnote-30) Meaning, the more severe and disruptive the rating trigger covenants are, the more likely that the issuer is less financially resilient to begin with. This negative correlation could be attributable to the possibility that the less resilient the issuer is, the less bargaining power the issuer has. Or, possibly, the less resilient the issuer is, the more investors will fear default and thus seek to better secure their claims.

Two prominent examples of rating triggers “gone bad” are the infamous high profile bankruptcies of Pacific Gas and Electric Company (**Pacific Gas**)and Enron Corporation (**Enron**).

# Rating Triggers Gone Bad

The Pacific Gas bankruptcy is one of the first and most disruptive cases demonstrating the domino effect that can occur with the use of rating triggers.[[31]](#footnote-31) PG&E Corporation and its subsidiary, Pacific Gas, faced a downgrade in early January of 2001. This downgrade was based on concerns regarding the liquidity of Pacific Gas in light of large payments that were due at the beginning of February 2001.

Existing rating triggers in the commercial paper backstop credit facilities of both companies enabled bank lenders to halt their funding obligations, causing both companies to lose their ability to receive credit through their credit facilities. This inability to receive credit led to a default in connection with maturing commercial paper, which set off a chain of default events in other long-term obligations which did not even include a rating trigger. Moreover, due to the downgrade, Pacific Gas was asked to post collateral in other transactions. Simultaneously, the PG&E downgrade exposed it to different liabilities under its trading agreements, which were eventually modified, thus preventing acceleration on the obligations related to them. The rating triggers, which caused this tangled web of cross defaults and enabled bank lenders to avoid funding the commercial paper, left the commercial paper holders as unsecured claim holders when Pacific Gas announced its bankruptcy on April 2001.

Enron’s collapse in 2001 is also partially attributable to the incorporation of rating triggers in its material contracts, trading agreements, and different securities.[[32]](#footnote-32) Enron’s downgrade set off multiple triggers, giving its counterparties the right to demand cash collateral, and lenders the right to demand repayment of outstanding loans. All this resulted in high demand for cash that Enron simply could not supply, further contributing to Enron's financial difficulties and causing a domino collapse effect, which adversely affected all creditors, even the ones who were supposed to be secured by those rating triggers.

The Pacific Gas and Enron crises came under the scrutiny of regulators and credit rating agencies, which started conducting intensive studies in order to better understand the nature and extent of the use of ratings in financial contracts and their impact on a company’s creditworthiness.[[33]](#footnote-33) These studies eventually led to the regulatory requirement of public disclosure concerning such rating trigger provisions,[[34]](#footnote-34) and also contributed to the consideration of such provisions as part of the credit rating agencies’ comprehensive analysis of the creditworthiness of a company. For example, Moody’s, one of the three big credit rating agencies in the United States, declared that it would incorporate the negative consequences of those triggers in the ratings and research it conducts.[[35]](#footnote-35) Moreover, it stated that in conducting its analysis for those issuers that have agreed to truly risky rating triggers, such as ratings-based default or acceleration provisions, it will consider whether the issuer has the ability and means to survive the rating trigger activation and repay its obligations despite fulfilling the terms of the rating trigger activation.[[36]](#footnote-36)

# Incorporation of Rating Triggers in Contractual Relationships

The benefits and disadvantages of using rating triggers have been reviewed, including the magnitude of the outcomes that could result from the activating rating triggers. Despite such disproportional damages, no regulatory or legal limitations were imposed on the use of rating triggers,[[37]](#footnote-37) and contractual parties continued to incorporate them in various transactions. There can be a few justifications for this noninterventionist approach.

First, it can be argued that based on common sense, and according to the principles of economic analysis, rating triggers should be considered the result of a simple cost-benefit analysis.[[38]](#footnote-38) An accurate method for weighing gains and costs starts by quantifying such values.[[39]](#footnote-39) By measuring the aggregate cost of using such a contractual covenant versus its benefits, it is possible to determine whether it is efficient, and therefore perhaps justified, to allow the use of the rating trigger mechanism.[[40]](#footnote-40) Here, the focus of the examination will be on the likelihood and extent of possible damages. If the expected damages from the use of rating triggers are higher than their anticipated benefits, then limitations on such use should be considered. However, such empirical research is beyond the scope of this analysis, which will focus on a theoretical examination of the existing justifications for and against the use of rating triggers with respect to all the factors that have evolved regarding the operation of this contractual mechanism.

The first justification for the use of rating triggers is an economic one. The economic justification is based on the conduct of different players in the debt market: the parties to an agreement and regulators. For such an analysis, it must be assumed that all parties are rational; meaning they act based on a cost-benefit analysis for the purpose of increasing their well-being.[[41]](#footnote-41) Given these assumptions, it could be concluded that their benefits should outweigh their costs. This conclusion relies on two main facts. First, rating triggers have been reviewed by authorities as part of a thorough examination of credit rating agencies, particularly in light of cases like those of Pacific Gas and Enron, yet no legal prohibitions were made concerning their use. This lack of regulation could indicate that the use of rating triggers is efficient from the aggregate welfare point of view, as it can be argued that regulatory decisions (or lack thereof) should benefit society as a whole.[[42]](#footnote-42) The second fact supporting the conclusion that the benefits of rating triggers outweigh their risks is that the parties to commercial agreements willingly choose to incorporate rating trigger covenants into their agreements. Assuming that such parties are rational, an assumption that is especially true for sophisticated commercial parties, it is reasonable to conclude that rating triggers are considered efficient from the individual welfare perspective, or they would not be incorporated into agreements to begin with.[[43]](#footnote-43) By determining that rating triggers are efficient from the perspectives of both individuals’ interests and the aggregate interest of society, it may be concluded that these mechanisms are efficient overall. Consequently, the potential harm of using such contractual covenants must be lower than their benefits.[[44]](#footnote-44)

Another justification for the use of rating triggers and the lack of restrictions regarding them lays in the basic justification of contract law, the principle of “freedom of contracts,” respecting the autonomous will of the parties to a contract to agree to any contractual obligations they deem fit.[[45]](#footnote-45) The overriding principle of freedom of contracts dictates that any party that wishes to subject itself to contractual terms at its discretion should be allowed to do so, subject to several conditions: a meeting of intentions; specificity; lack of coercion, deception or errors; and more.[[46]](#footnote-46) This principle serves as the guideline for legislature and courts and prevents them from interfering in most contractual relations,[[47]](#footnote-47) particularly with respect to sophisticated parties.[[48]](#footnote-48) In the absence of any major power difference between two contractual parties, and when it can be assumed that both parties have entered into a contract willingly, informed, and with a full understanding of their obligations under the contract, there is normally no justification for intervention in the contractual relationship. This result can be justified from an economic point of view, which posits that contracts’ covenants distribute the risk factors inherent in a contractual relationship, eventually expressing the sum of them them in the contractual price.[[49]](#footnote-49) Thus, any intervention in the contractual relationship will lead to an unfair and unplanned distribution of the contractual cost, eventually creating higher transaction costs,[[50]](#footnote-50) especially if the contract is completely specified, the contractual covenants are clear, and there is no ambiguity about the parties’ intentions.[[51]](#footnote-51) With respect to the ambiguity factor, rating triggers are arguably patently clear and not open to interpretation, primarily because they are drafted with the help of expert professionals. In addition, a rating trigger is basically a simple, easy to follow, contractual mechanism containing an “if” and “what” component. The if part is focused on determining the grade that will activate the contractual mechanism, and the what part includes the remedies to which the breached party is entitled in the event of any activation. Thus, it appears that most of the conditions justifying the application of the “freedom of contract” principle by courts and legislatures to contracts with rating triggers have been met in the case of these contracts. The parties are autonomous, there are no significant power gaps between them, and they have entered into the contractual relationship informed, consenting, and understanding their actions and obligations under the contract. The fact that the losing party, meaning the one most adversely affected by the activation of the rating trigger, is the issuer, only eases the conflict, since in most cases, legal authorities favor protecting investors over issuers.[[52]](#footnote-52)

It should also be noted that the fundamentally simple structure of rating triggers, in contrast to the magnitude of its potential consequences, reveals quite a lot about the nature and expectations of parties turning to this contractual mechanism. These parties enter into long-term commercial contracts primarily to enable the parties to conduct business, without having to invoke rating trigger clauses,[[53]](#footnote-53) which are supposed to be turned to only as a last resort when the parties have reached an unbridgeable impasse in their relationship. Consequently, there are two perspectives about rating triggers: a contractual one and a business one involving the routine conduct of the parties. Considering rating triggers from the contractual perspective, their use indicates that the parties have chosen a strict and one-sided allocation, with their absolute reliance on ratings placing the entire burden of the risk upon the issuer. This arrangement is most efficient for the parties *ex ante*, as credit rating agencies and their ratings are deemed reliable and inexpensive indicators of the issuer’s financial condition, which dictates that the risk allocation be borne asymmetrically. This contractual perspective could be considered somewhat draconian, but it is tempered by the additional business perspective of a routine working relationship. On the contractual level, the parties chose a mechanism that offers no option for any independent discretion, with a downgrade alone providing sufficient cause for the investor to activate the trigger, even if other indications might lead to the conclusion that the downgrade does not reflect the issuer’s true financial condition. From a business perspective, the parties’ decision to allocate most, if not all of the risk, to the issuer may appear as or be an indication of serious power gaps or asymmetries that allow the issuer’s vulnerability to be exploited.

However, these aspects of rating triggers are actually the background of the contractual alignment and may not play such a significant role in the normal course of business, where the parties perceive that this contractual clause with major implications will be applied responsibly. A rating trigger incorporated into a contractual relationship will not necessarily be activated simply because it is possible to do so, as all the parties —issuers, investors, regulators, etc. — rely on the rationality assumption; that is, the assumption that the parties are rational and have a business understanding. This leads to the conclusion that rating triggers are not necessarily as dangerous as they may first appear. An investor protected by a rating trigger will activate it only if doing so will be beneficial to the investor. Thus, the mere existence of a rating trigger does not result in its activation in every circumstance that allows it. Both the investor and the issuer have a common interest in finding other solutions for securing investors’ interests other than activating these triggers. Consequently, rating triggers will be activated only if there is no other solution for adequately securing the investor’s interests,[[54]](#footnote-54) or, alternatively, only when not activating the trigger would lead to worse results than activating it would.

Therefore, given that the use of rating triggers is largely efficient, their incorporation into contracts and enforcement should, as a rule, be permitted. Failure to enforce such mechanisms will inevitably lead to high transaction costs.

# The Problems with Rating Triggers in Abnormal Market Conditions

Market conditions under crisis situations are inevitably suboptimal.[[55]](#footnote-55) The resulting abnormal conditions create high instability that contributes to a hidden market failure concerning credit rating agencies and their ratings. The combination of such market failure and the instability of the markets in these situations increases the likelihood of inefficient activations of rating triggers, which are contrary to the *ex ante* expectations of the parties. This situation threatens the resilience of issuers, unsecured creditors, and the market as a whole.

# Abnormal Market Conditions During Market Crises

Discussing abnormal conditions in the market during times of crisis is especially relevant today, with world markets reeling from one of the most serious crises they have ever faced, the coronavirus pandemic.[[56]](#footnote-56) Financial markets’ activity throughout the globe has been hard hit by the pandemic. The quarantines imposed in order to reduce infection rates have forced businesses to shut down, leading to a slowdown in business activity and causing irreversible damage to the global economy at times. Millions have lost their jobs, many others have been forced to close their businesses for an indeterminate period, which inevitably led to bankruptcies for many of them. Throughout the world, governments were required to formulate support and assistance programs for the private and business sectors.[[57]](#footnote-57) The crisis affected not only small businesses, but also even strong and powerful market players, such as energy and airline companies, which had not foreseen the deterioration in normal market conditions. Not surprisingly, in the wake of the pandemic, credit rating agencies issued a number of major downgrades in a variety of market sectors.[[58]](#footnote-58)

This corona-induced economic shock that world markets are experiencing has created a new economic reality, characterized mostly by its instability and uncertainty. Many market players have reacted with panic to these conditions, which is not reflective of their behavior in normal market conditions,[[59]](#footnote-59) and which raises the concern that this panic will affect their decision-making processes. Although uncertainty is a normal condition for market players, panic and instability are not. Uncertainty together with panic and instability can prove a fatal combination, creating a vicious cycle in which instability increases panicked behavior and amplifies uncertainty levels, which could potentially lead actors in the market to act or make decisions quite differently than they would under normal conditions.[[60]](#footnote-60) Such unexpected behavior floods the market with unreliable information that adds to the already existing panic. Some market players might choose to act upon such unreliable information, thus causing more uncertainty, thus leading to greater instability, all of which could eventually undermine market players’ rationality. Actions based on irrational considerations could potentially lead to the collapse of entire markets.[[61]](#footnote-61)

The instability and uncertainty described also affect credit rating agencies, a major market player in this context. Credit rating agencies have played a major role in past economic crises and are likely to continue to play one in the current crisis.[[62]](#footnote-62) Credit rating agencies, too, are to some extent affected by the unreliable information flooding the market. It can be assumed that the credit rating agencies are doing their best to act faithfully and to continue to produce informative and accurate ratings. Nonetheless, it should be asked whether these players, who have been severely criticized during past crises,[[63]](#footnote-63) might be incentivized to act in a suboptimal manner in the current crisis, whether to avoid further criticism or as a result of excessive deterrence.[[64]](#footnote-64) There is the danger, then, that credit rating agencies might exploit instability, uncertainty, and panic in the market to produce ratings that minimize their margin of error.

# Ratings’ Market Failure During Abnormal Market Conditions

Under abnormal market conditions, the conduct of credit rating agencies may be suboptimal, as they may be more prone to making “downward mistakes,” meaning, downgrading issuers’ ratings without sufficient cause. Such behavior is the result of both the incentives that resulted from the 2008 worldwide financial crisis and the fact that credit rating agencies are not affected by the real cost of a downgrade mistake, as opposed to an “upward mistake,” as will be explained below.

The 2008 financial crisis resulted in harsh criticism of the conduct of credit rating agencies and particularly of the reliability, or lack thereof, of their ratings.[[65]](#footnote-65) The main criticism was directed at their failure to identify the deterioration of issuers on time, which led to them issuing rating downgrades shortly and abruptly before the collapse.[[66]](#footnote-66) Other critics, while acknowledging that credit rating agencies were not the exclusive cause of the 2008 collapse, do blame them for the magnitude of the collapse. Credit rating agencies defended their conduct, explaining that their rating system deliberately entails long-term assessments with the aim of avoiding or overlooking the influence of short-term events.[[67]](#footnote-67) The agencies further claimed that their strategy during the 2008 financial crisis was to deliberately delay changes in ratings in order to avoid generating market instabilities.[[68]](#footnote-68) Yet critics have insisted that credit rating agencies’ failures can actually be attributed to their business model (the “issuer pay” model, whereby issuers pay agencies to provide a rating), which created an inherent conflict of interests.[[69]](#footnote-69) These circumstances have led to the concerns that credit rating agencies are unjustifiably favoring issuers.

In an attempt to address the existing market failure, legislatures and regulators around the world enacted comprehensive reforms affecting various market players, including credit rating agencies. The major reform effort in the United States, the Dodd-Frank Act, was intended to prevent the reoccurrence of such events, by, inter alia, imposing liability on credit rating agencies,[[70]](#footnote-70) but it did not address the use of rating triggers. With regard to rating triggers, the assumption was that no intervention was needed as long as these mechanisms were based on reliable ratings reflecting the real conditions of the issuer.[[71]](#footnote-71)

However, the assumption that the new regulations would incentivize credit rating agencies to produce accurate ratings is problematic. Even before the 2008 crisis, many scholars raised real doubts about the quality and value of credit rating agencies’ ratings,[[72]](#footnote-72) claiming that these agencies lacked both the ability and the intention due to their analytical methods and their business structure. While the purpose of the reform was to address these doubts, subsequent critics viewing the market situation after the crisis had passed argued that the reform had failed.

Among the most vocal critics of credit rating agencies is Professor Frank Partnoy, who claims that the reform directed at the ratings market failed to achieve any of its goals. Consequently, Partnoy argues that all the flaws in credit rating agencies that existed prior to the reform continue to exist, and, in some respects, have intensified.[[73]](#footnote-73) In his opinion, credit rating agencies have and will continue to play a significant role in the market, although he does not believe that their ratings provide any added value at all. Partnoy reviews the new rating methodologies of credit rating agencies, which are now more widely disclosed, in part due to a regulatory requirement for transparency,[[74]](#footnote-74) concluding that they are inherently flawed, as they are overly simplistic and almost arbitrarily subjective. Finally, Partnoy predicts that at some point in the future, continued reliance on credit rating agencies’ erroneous ratings will inevitably lead to a collapse similar to that of the 2008 crisis. [[75]](#footnote-75)

Is this admittedly nearly-lone prophecy going to be realized in the current crisis that world economies are facing? Partnoy’s concerns may prove more pressing today, as market conditions evoke the memories of past crises, which might give credit rating agencies an incentive to try and avoid such criticism this time. The scale of the current economic crisis has yet to be fully understood, but it appears that it may be one of the worst crises experienced by world economies in quite some time.[[76]](#footnote-76) Although the current crisis cannot be attributed to credit rating agencies, their conduct could contribute to exacerbating the situation. Today’s crisis might reveal the real effect of the 2008 reform, which was to introduce an incentive for downward mistakes. Even if the influence of this incentive does not emerge in the current crisis, examining aspects of this incentive may prove relevant for similar future situations when market conditions are abnormal.

Partnoy’s claims about the lack of informative value of ratings are especially critical in times of crisis. On one hand, the regulatory limitations imposed on credit rating agencies have hardly affected how they actually conduct their routine “rating business,” nor have the regulations improved the accuracy or viability of credit rating agencies’ ratings. However, on the other hand, such regulation, together with post-2008 crisis conclusions, may have created an incentive for inefficient conduct that will be expressed through their ratings in times when the likelihood of their ratings being attacked is higher. The reason for this incentive is that if the ability of credit rating agencies to produce informative ratings is anyway limited, but the risk of being held liable is higher, credit rating agencies might be encouraged during times of crisis to reduce what they consider risk factors, resulting in “pro-issuer” ratings. If the 2008 crisis taught credit rating agencies anything, it should be that protecting investors in such times is crucial. Whether their conduct in the 2008 crisis was the result of conflicts of interests, or overly optimistic or even negligent analyses, they are highly likely to act differently during the next crisis. A pro issuer rating that is shown to be too optimistic or even too responsive will lead to harsh criticisms and might endanger the agencies’ position as significant market players. For that reason, credit rating agencies might try to produce more “investor-oriented” ratings. Essentially, during times of crisis, credit rating agencies will be more prone to produce careful analyses that will better secure investors.

The argument at the time was that credit rating agencies do not have a sufficient incentive to reduce mistakes,[[77]](#footnote-77) but that is not quite accurate. The reforms implemented encouraged credit rating agencies to make what can be termed upward mistakes, meaning that the agencies have invested fewer resources in preventing a rating mistake that would benefit issuers. Such mistakes jeopardize investors’ interests but might help issuers overcome financial distress. The main argument disputing this claim was the “reputational risk” or the “reputational capital” argument, which posits that credit rating agencies’ reputations should serve as an adequate incentive for ensuring credible ratings.[[78]](#footnote-78) However, this assertion has been rejected in numerous scholarly papers, basing their position on the credit rating agencies’ business model and the special conditions of the ratings market, which is a concentrated market with no real alternatives.[[79]](#footnote-79)

The post-2008 reform tried, among other things, to change such incentives and help prevent upward mistakes[[80]](#footnote-80) by trying to require greater transparency in the credit rating agencies’ rating methods and conduct, along with imposing a credible “punishment” in the form of legal liability.[[81]](#footnote-81) The new regulation, which was aimed at protecting investors, has shifted the equilibrium point toward avoiding upward mistakes, which can potentially lead to more accurate ratings. However, this can be achieved only when the cost of producing more accurate ratings is lower or equal to the damages credit rating agencies will be required to pay if they are found liable due to an upward mistake.[[82]](#footnote-82)

First, it should be understood that it is always more difficult to create accurate ratings based on detailed knowledge about a company as opposed to ratings that are based on general market knowledge. That is especially true when markets are in the midst of a crisis and market conditions are abnormal, with the instability of the market raising the costs of producing accurate ratings. Second, credit rating agencies are very well aware that during times of crisis, the expected risk of being found liable is higher. The greater the crisis, the greater the need to find someone liable for it. At the same time, it is important to note that the damages credit rating agencies might absorb from downward mistakes tend to be especially low, as opposed to the cost of upward mistakes.

As Partnoy has observed, the post-2008 reform did not have any real impact on the conduct of credit rating agencies; their ratings continued to be inaccurate and their conduct questionable. However, if the reform regulation had any impact on credit rating agencies, such impact should be manifested in their conduct during times of crisis. The pro-investors regulatory reform may not have changed the way credit rating agencies routinely act during normal market conditions. Indeed, they continue to produce ratings that are of no real value, because the regulation failed to create a real impact on their daily conduct.[[83]](#footnote-83) Also, under normal market conditions, an equilibrium point between upward and downward mistakes is barely felt, since costs of analysis and predictions are relatively low, making the mistake margin lower. Yet, during times of crisis, when market conditions are abnormal, and the ability of credit rating agencies to assess the behavior of different market players is more complicated, thus making the risk of a mistake more likely, credit rating agencies will tend to make mistakes that are more aligned to the “spirit” of the existing regulation to protect investors’ interests, and that minimize their costs. When markets are in crisis, credit rating agencies may be subject to greater scrutiny, thus making it more likely that their mistaken analyses would be caught, and rendering the impact of such mistaken predictions even greater. Such conditions should incentivize them to act in order to minimize their costs. However, such changes in agencies’ actions, motivated also by the reform regulation, might lead to a new type of market failure by encouraging credit rating agencies to make downward mistakes.

Downward mistakes are the ideal response to the criticism to which credit rating agencies were subject during the 2008 financial crisis, as downward mistakes reflect a more risk-averse attitude and therefore, in unstable market conditions, could be described as more pro-investors. There is a high likelihood of such downward mistakes being proven accurate during times of crisis; otherwise, investors will suffer direct damages. In this sense, credit rating agencies do not absorb the real costs of the downward mistake, and thus may be incentivized to act in a suboptimal manner.

Credit rating agencies are well aware of the costs of upward mistakes in times of crisis. The public and regulatory criticism following the 2008 crisis were reactions to the intense rage felt by investors who suffered immense and disproportionate economic damages. The cost of yet another upward mistake after the 2008 crisis will probably be even higher, resulting in new and harsher criticism and public backlash and even stricter regulatory reform, as well as reputational damage that cannot be easily repaired. Well aware of these potential consequences, credit rating agencies facing abnormal market conditions are likely to conclude that it is better for them to err, even slightly, “downward.” Taking the market conditions created in wake of the coronavirus pandemic as an example, it seems that once an issuer is placed under a “credit watch,”[[84]](#footnote-84) it would be much more likely for it to eventually be downgraded simply because the objective probability of insolvency in such times is significantly greater.

While the cost of an upward mistake is very high for credit rating agencies, it seems that this is not the case when it comes to a downward mistake, the cost of which appears to be nil for credit rating agencies. While downgrading entails significant costs for issuers, it does not have the same impact on credit rating agencies. It should be borne in mind that the real regulatory purpose of market oversight is overseeing issuers’ conduct to insure investors’ interests rather than the interests of issuers, based on the assumption that issuers do not need the help of regulators to secure their interests. This is also the reason why most of the regulation that has been enacted has focused on ensuring the avoidance of mistakes that could harm investors’ interests. The fact that a downgrade mistake, as opposed to an upward mistake reflects a more risk-averse approach, and thus tends to be described as a pro-investor approach, indicates that regulators might be less interested in detecting such mistakes.

Another reason for the lack of regulatory attention to downward mistakes is that they are almost impossible to detect. In contrast, an upward mistake can be detected easily, by a simple correlation of past ratings with actual defaults.[[85]](#footnote-85) If an issuer had a high rating and then suffered a rapid unexpected downgrade, followed by default, the credit rating agency is assumed to have been mistaken in its evaluation of the issuer’s risk levels. The possibility of detecting downward mistakes is somewhat limited, since such simple correlations between ratings and defaults are not very informative, as making a correlation between a downgrade that did not lead to a collapse, or even a downgrade that did lead to a collapse, will not indicate a downward mistake or the unreliability of the downgrade. This is because downward mistakes can be considered a sort of “chicken or the egg” paradox. One can never truly determine whether a downgrade is the main reason for an issuer’s financial collapse or whether it simply reflected what was about to happen.

Consider a downgrade that was followed by a complete collapse of the issuer, as in the Pacific Gas case. The fact that the results that followed the downgrade matched the downgrade itself does not necessarily mean that the downgrade was not a downward mistake. With regard to the question of whether the downgrade is mistaken or not, the market might deem it accurate and react accordingly. Such a downgrade will elicit a reaction among the issuer’s business counterparties, that might try to secure their claims or even avoid further dealing with the issuer. A downgrade is a painful measure in any circumstances. Consequently, even a mistaken downgrade can create financial difficulties for an issuer since it would immediately make the issuer’s options for raising new capital or repricing existing debt more expensive.[[86]](#footnote-86) In addition, other market players rely on ratings. For example, in some cases, asset managers and other investment agents are not allowed to hold bonds that are rated below a certain level.[[87]](#footnote-87) Consequently, a downward mistake will cause automatic damage for issuers, leaving them limited options for convincing investors that the downgrade is mistaken.

Now assume a downgrade in a rated issuer’s ratings that is not followed by any special market reaction, and the issuer continues its normal business activities and eventually returns to its previous rating. In such a scenario, it could be argued that the downgrade was in error to begin with. But that is not necessarily the case. While the downgrade did not “prove” itself in the sense that the default concerns have not materialized, it does not necessarily follow that a rating mistake was made. The downgrade may have been accurate at the time, but the issuer was nevertheless able to repair its financial problems and recover its strength. This is a familiar scenario following rating downgrades.[[88]](#footnote-88) Because a financial deterioration occurs not abruptly, but gradually, a single downgrade cannot act as a certain proxy for the creditworthiness of an issuer at a specific point in time. Nor is a downgrade necessarily justified. The fact that the issuer succeeded in restoring its financial stability or security says a lot about its resilience and might indicate that the downgrade was actually mistaken.

Even if a downward mistake is detected, it is not likely to be presumed to have caused damage. The only detectable mistake is one that does not lead to the issuer’s collapse. In contrast to an upward mistake, a downgrade that is followed by a rapid upgrade reflecting the issuer’s restored financial stability will not be perceived as having caused any damage. On the other hand, a legal claim that a downward mistake caused an issuer’s collapse will face many evidentiary difficulties and probably will be dismissed in court.

It should also be noted that issuers are limited in their ability to hold credit rating agencies accountable for a downward mistake because of the concentrated nature of the rating market.[[89]](#footnote-89) Issuers cannot really avoid being rated because not receiving a rating will be considered suspicious by potential investors, and there are no real alternatives to the ratings credit rating agencies produce.

To conclude, the fact that the cost borne by credit rating agencies of a downward mistake is not equal to the cost borne by society as a whole threatens to create an harmful incentive for the agencies to engage in suboptimal behavior.

# Unreliable Ratings and Rating Triggers

As the impact of unreliable ratings on the market is now clear, the problem of downward mistakes described above might have an even larger and disproportional impact with regard to rating triggers, as the downward mistakes create a “collective action” problem associated with a multiple rating triggers scenario.

Suppose that an issuer’s rating has been downgraded, and the downgrade does not reflect its real financial condition. In a single rating trigger scenario, all that is required from the investor to avoid unnecessary damages is to understand that such a downgrade does not necessarily jeopardize its financial interests, that the alternative investments are not necessarily worthwhile or superior, and that therefore there is no real need to activate the trigger. In such a case, the rating trigger can be used solely as leverage for obtaining a better security, without activating the trigger.[[90]](#footnote-90)

Now consider the same circumstances, only instead of the issuer being subject to just one rating trigger, the issuer is now subject to several triggers. Recall that the most severe damage caused by rating triggers was the result of the near simultaneous activation of multiple triggers by various investors, against one issuer in the case of Pacific Gas.[[91]](#footnote-91) Meaning that in such a scenario, a downward mistake will almost certainly cause the issuer’s collapse. For the issuer to survive a downward mistake under such circumstances, all investors must conclude that their interests are not jeopardy and that they will not be in a better position if they decide to activate the trigger. Arriving at such a conclusion in the multiple triggers case is more complex than in the single trigger scenario, as investors need to consider not only what will be their best option in light of the downgrade, but also in light of the actions of other investors. Not only the issuer’s financial state that has purportedly caused the downgrade should be taken into consideration, but the issuer’s financial state post-downgrade must be determined as well, especially if the downgrade might cause other investors to activate their triggers. Those investors activating their triggers may have an incentive to do so even when they have faith in the issuer’s resilience. That is due to the nature of multiple rating triggers. Like shootouts in old Westerns, when both parties have everything to lose, the first one to “pull” the trigger has the best chance of winning it all.

Thus, there are times when an investor’s best course is to avoid activating a trigger and to settle for less severe measures, especially if the downgrade is a downward mistake. Yet each investor cannot be certain that other investors will understand that the downgrade does not represent the real condition of the issuer, and thus avoid activating the trigger. Although it is in the best interests of all parties to avoid the trigger activation, the lack of certainty about other investors’ behavior might lead to a suboptimal result.[[92]](#footnote-92)

# Why Investors’ Rationality is not Sufficient in Abnormal Market Conditions

An argument can be made that the described market failure — the incentive favoring downward mistakes and its effects on rating triggers — can easily be overcome, as investors are rational and sophisticated and will know how to identify a downward mistake, or at least not act on every downgrade without exercising any independent judgment. While this may be the case under normal market conditions, it does not necessarily hold true under abnormal market conditions.

It is reasonable to assume that a contractual relationship between sophisticated business parties is based on rationality,[[93]](#footnote-93) as rationality is the cornerstone in cost-benefit analysis, upon which most commercial, profit-seeking contracts are based.[[94]](#footnote-94) Rationality is necessary when trying to draw conclusions in uncertain conditions.[[95]](#footnote-95) When market conditions are normal, investors and issuers can try to anticipate each other’s moves and respond accordingly. They can anticipate that the mere issuing of a downgrade will not necessarily activate a rating trigger unless doing so is the rational, thus optimal, action in such conditions. If the rationality assumption holds, a downgrade will not result in automatic activation of a trigger, because a rational approach acknowledges that a downgrade will be followed by the investor’s consideration of whether to activate or avoid the trigger. Thus, a downgrade will be followed by a rating trigger activation only if the downgrade reflects a real deterioration in the issuer’s financial condition that threatens its ability to insure the investor’s investment.

Similarly, in the case of the multiple rating trigger scenario, all parties have entered into contractual relationships with the issuer under the assumption that the investment is worthwhile. The rating triggers have been incorporated as a protective measure against a specified financial risk. If investors can be assured that such risk has not occurred place, none of them will not activate the triggers.

However, this may not prove to be the case in abnormal market conditions. The above assumes a rational decision-making mechanism that is based on reliable and complete information. But during times of crisis, these assumptions are not necessarily valid. During times of economic crisis, when the market operates under unusual conditions, such as false information, uncertainty, and anxiety, irrational considerations may skew the investor’s decision-making process.

First, markets in crises are unpredictable, thereby creating a shortage of reliable information.[[96]](#footnote-96) This shortage arises either because such information is out of reach, due to the inability to foresee the influences of the crisis on the market and on specific market players, or because market players’ behavior impedes the dissemination of reliable information.[[97]](#footnote-97) One example is credit rating agencies’ incentives for a downward mistake, as discussed above. In other instances, market players could try to take advantage of the existing chaos and use it to reduce transparency levels concerning their financial conduct, creating an intentional shortage in reliable information. In such circumstances, although rationality itself is not distorted, the lack of trustworthy information, and the need to constantly determine what information is reliable makes it much more difficult for investors to reach informed and optimal decisions.

In addition, as already mentioned, the unpredictability forces investors to make decisions under uncertain market conditions. In uncertain conditions, rational market players will tend to base their decisions on the anticipated risk or value such decision involves.[[98]](#footnote-98) To do so, they must understand the probability of such risk or value materializing. But in times of crisis, the risk or uncertainty is not what investors are accustomed to facing. Because markets do not act according to normal patterns during times of crisis, such calculations tend to have little to no value for investors. Investors are unable to determine the magnitude of the crisis, its duration, and the resources needed for recovery. These conditions mean that investors have no relevant tools for assessing whether, and to what extent, the crisis will affect a specific investment or issuer. Thus, abnormal market conditions prevent investors from being able to calculate the risk they are facing, thereby forcing investors to essentially gamble their money. In the absence of the ability to calculate the probability of a risk occurring, investors might turn to a simpler probability-based decision-making process, basing their decisions on general considerations, such as the overall effect of the crisis on issuers, without inspecting the specific issuer. Investors might assume that, in general, due to market conditions, the possibility of a default after a downgrade is greater than the possibility of recovery. A probability analysis such as this might create an incentive to be the first to pull the trigger and dodge a potential collapse.

Furthermore, an important factor should be borne in mind about the point in time when investors are weighing the decision to activate the trigger. If, at first, ratings are used as a consideration before entering into an investment, an activation is considered at the post-investment stage. This factor has important implications in markets during crises. A downgrade in the post-investment stage during a crisis opens an escape door, just at that point when the entire market seems about to collapse. Investors then need to assess whether or not to act upon the downgrade. At such a point in time, investors are asked to determine whether the credit rating agencies’ information reflects a real danger for their investment, or whether they can rely on the issuers’ signaling that implies otherwise. While in the pre-investment stage investors use ratings as a tool to help them insure their optimism about *gaining* from the investment profits, now they are using ratings to indicate their chances of *losing* their investment, which might result in their making more irrational decisions due to a more risk-averse approach.[[99]](#footnote-99)

The increase in irrationality during market crises is understandable considering that investors, much like issuers and others, are market players that may have suffered a financial hit themselves from the crisis. That alone is enough to distort their judgment about their investments, leading them to choose to take advantage of the situation to activate the trigger and reduce their risk levels. Even if the investor suffered no damages, the uncertainty and instability of a financial crisis might cause market players to act irrationally, or even panic. For example, markets experiencing extreme shocks tend to be characterized by a surge in the public toward certain resources that are described as “limited,” even if they are not actually limited in any way.[[100]](#footnote-100) Irrational, panicky behavior may affect investors’ risk preferences, causing them to act in a more risk-averse manner: “keeping their money where they can see it,” which, in the context of rating triggers, means exploiting the downward mistake as an option for recouping their investment.

1. *Problems with the Contractual Justification Under Abnormal Market Conditions*

Although it might be argued that choosing to activate a trigger in abnormal market conditions may actually be a rational decision, due to the uncertainty and instability of the market, it is surely not what the parties had actually sought. Even if each party is acting rationally, that is, striving to maximize its own interests in abnormal market conditions, their decisions may not reflect the real risk the parties had anticipated when entering into the contractual relationship. In that respect, the contractual justification for legislatures and others not intervening in the use of rating triggers is not applicable during abnormal market conditions. That is, if indeed credit rating agencies are more prone to making downward mistakes, and investors’ rationality is faulty under abnormal market conditions, then allowing an activation of a trigger, without any further requirements or inspection, will not necessarily be compatible with the real intent of the parties to the contract.

The contractual justification principle is based on the assumption that activating a rating trigger realizes the parties’ real contractual intentions. However, it is unclear whether such activation indeed does so under abnormal market conditions. Rather, it is possible that rating triggers in abnormal market conditions are likely to be activated in a way that will fail to realize the real intentions of the parties to the contract. As has been shown, credit rating agencies are incentivized towards downward mistakes, which are especially problematic in the case of rating triggers, since they become the reason for activating a trigger. But an activation that is the result of a downward mistake was not foreseen by the parties, and thus does not realize the parties’ intentions and is therefore contrary to the contractual justification principle.

One of the conditions that should be met if the contractual justification principle is to apply is that the activation of the rating trigger was foreseen by the parties to the contract *ex ante*.[[101]](#footnote-101) Such a requirement ensures that the risk that has materialized was indeed considered by the parties as part of the cost-benefit calculations they conducted prior to entering into the contractual engagement, and not that the activation actually presents a new risk that was not taken into consideration.[[102]](#footnote-102) Permitting the activation of a rating trigger merely because circumstances so allow, and despite such risk not having been foreseen by the parties in advance, and not realizing the parties intentions, is actually contrary to the contractual justification for the use of rating triggers. Therefore, such an unintended activation should act as a sufficient reason for not enforcing such a contractual clause.[[103]](#footnote-103)

An argument regarding lack of foreseeability means that the parties to the contract did not foresee, nor could have foreseen, and also, were not supposed to foresee, the circumstances that occurred and that led to the activation of the rating trigger.[[104]](#footnote-104) Essentially, an argument about lack of foreseeability posits that the risk that has materialized was not calculated as part of the allocation of risk between the parties. If this is indeed the case, the activation of the rating trigger is, in fact, contrary to the contractual justifications, to the principle of freedom of contracts, and to the intentions of the parties.

The argument of lack of foreseeability is a prior condition for raising a claim of contractual inefficiency.[[105]](#footnote-105) Meaning, if the unforeseen circumstances had been considered in the negotiations stage, then such a contractual clause would not have been incorporated. The mere fact that a contractual clause is not “economically viable,” in the sense that it is inefficient, or unduly detrimental to one of the parties to the contract, does not necessarily suggest that parties should not be subordinated to it,[[106]](#footnote-106) as in the case when a party failed to understand the real economic implications of such a clause.[[107]](#footnote-107) At the same time, when the risk that has occurred is not a risk that the parties have allocated, there is no necessity or justification for said risk being borne solely by the issuer.[[108]](#footnote-108)

The economic shock suffered by markets due to the coronavirus pandemic can be used as a good example of the lack of foreseeability argument in connection with rating triggers. The coronavirus pandemic has forced governments across the world to impose strict restrictions that have led to major slowdowns in various market activities for an unknown period. It has had an impact on huge corporations across the board and caused severe upheavals in many trading markets, causing downgrades across industries.[[109]](#footnote-109) A close examination of rating markets during the coronavirus pandemic reveals that some of the downgrades did not reflect the individual financial condition of the issuer, but rather the general market situation, along with future concerns about the recovery of the economy.[[110]](#footnote-110)

Should the parties have foreseen such a risk? The answer to this question is complex, requiring answers to a number of questions. First, what risk did the parties choose to allocate? Did they anticipate the risk of a downgrade per se, or did they anticipate a downgrade caused by a specific sequence of events? Is the mere downgrade event sufficient to express the parties’ intent, or should such a downgrade clause identify a set of specific circumstances?

If the risk that was foreseen lies in the downgrade itself, then there is no importance to what led to it. In such a case, a downgrade is a defined event, devoid of ambiguity, completely separate from the sequence of events leading to it and indicating solely a realization of the risk to the investor’s returns. In this sense, a “risk” refers to any risk, whether or not it is the issuer’s “fault.”[[111]](#footnote-111) Thus, the activation of a rating trigger is possible even if the downgrade is not strictly related to the issuer’s subjective financial condition. Defining the foreseen risk as “any risk” means that the parties have exclusively allocated all the risk of a downgrade to the issuer, and, therefore complete protection of its interests is required. If that is indeed the case, then a “lack of foreseeability” claim is not applicable.

On the other hand, if the risk foreseen by the parties is related to the issuer’s “fault,”[[112]](#footnote-112) and focuses on the objective risk regarding the issuer’s endogenous characteristics and its creditworthiness, then it should be separated from the systematic risk factors affecting the market as a whole.[[113]](#footnote-113) This means that the parties have relied on ratings only as a proxy for the issuer’s conduct, as opposed to a comprehensive analysis of market latitude effects, where these effects do not necessarily have a proven impact on the issuer. For example, a slowdown in market activity during a financial crisis will not necessarily affect the issuer’s solvency or its ability to repay its commitments, if it does not suffer from liquidity problems.

There are good reasons to believe that the risk that the parties sought to allocate was not the risk of a downgrade per se, but the risk of a downgrade that indicates a specific, subjective financial risk for default.

First, the definition of the term “ratings” indicates that the risk allocated by the parties is the risk related directly to the issuer.[[114]](#footnote-114) This definition involves performing microeconomic rather than macroeconomic analysis as assessments. Therefore, a downgrade that deviates from the direct impact on the specific issuer, or that does not consider the issuer’s specific characteristics, goes beyond the true purpose of the ratings intended by the parties.

Second, the parties’ behavior in real time provides indications about their intentions. A rating trigger is not designed as an automatic mechanism. The parties have discretion left in their hands, which allows them to decide whether they wish to activate the trigger or not, indicating that a downgrade is a necessary but not sufficient condition for activating a rating trigger. As described before, all parties are assumed to be rational, implying that another necessary condition is that the activation would occur only if this is the correct business decision at a specific point in time. Thus, the parties will examine all alternative options available before activating a trigger, and will avoid its activation if the investor’s alternatives are not significantly advantageous.

In addition, despite the parties’ intention to lower and simplify supervision costs over issuers through the use of rating triggers,[[115]](#footnote-115) it cannot be assumed that such sophisticated business counterparties would have agreed to relinquish all their discretion. Of course, there is no equivalence between a party’s option not to exercise its contractual right and the full extent of such right. Therefore, it can be argued that while in certain circumstances the investor chooses not to activate the trigger, this does not necessarily suggest that the investor is unable to do so because such risk was foreseen. While there is validity to this argument, it is sufficient that the trigger mechanism was not designed as an automatic mechanism to reject the interpretation of the risk as the downgrade itself, and to determine what was the actual contractual risk the parties sought to ensure.

The foregoing leads to the conclusion that the activation of a rating trigger foreseen by the parties to a contract does not follow a downgrade per se; meaning, an activation that follows a downgrade that is a result of a downward mistake is not compatible with the contractual justification of the use of rating trigger.

# Conclusions

Abnormal market conditions call into question the justifications underlying the use of rating triggers. Such conditions create dangerous incentives for credit rating agencies to produce unreliable ratings, impair investors’ rationality, or at least affect their ability to arrive at informed decisions, and thereby lead to the activation of rating triggers in a manner that was not foreseen by the parties to the contract. It should also be note that there tends to be an increase in the incorporation of rating triggers into debt instruments during abnormal market conditions.[[116]](#footnote-116) Since abnormal market conditions cast doubts on the fundamental justifications for the use of rating triggers, it can be argued that rating triggers’ activation should be limited during abnormal market conditions. That does not mean completely preventing their incorporation into a contract or the parties’ reliance on ratings, as both have been shown to have some advantages for market players. Yet, it is clear that in such desperate times there is a need for desperate measures. Abnormal market conditions require some extent of inspection and review regarding their activation and enforcement.

The analysis presented here is consistent with that of previous commenters seeking to encourage market players to use additional sources of information to determine their risk assessment analyses.[[117]](#footnote-117) I believe that such an approach is especially called for during market crises.

This conclusion actually pushes against an already open door. The regulations enacted after the 2008 crisis themselves point in this direction of encouraging more diverse forms of analysis, and many sophisticated investors have already started adopting independent and more accurate risk analysis methods. If this is approach applies to normal market conditions, then it is certainly fair to argue that it should be applied when abnormal market conditions prevail.

Supervision of triggers’ activation of triggers can be accomplished in many ways. For example, abnormal market conditions may be used as a justification for imposing a burden of proof on investors seeking to activate a rating trigger without sufficient cause. Such a burden will require investors to show that the downgrade indeed reflects an imminent danger to the issuer’s solvency, in accordance with the risk and remedies specified under the contract’s terms. Thus, it is reasonable to require that investors review a downgrade, especially if the downgrade is based on exogenic, cross-market influences, also known as systematic risk. Because such a downgrade cannot be described as one that indicates the financial conditions of a specific issuer, it should not be sufficient for activating a trigger in abnormal market conditions. In order for such a downgrade to be a sufficient condition, it has to take into account all exogenic influences related to the issuer, and combine them with the information concerning the subjective conditions of the issuers, which could balance the negative effect of a certain systematic risk. A cross-market influence will not have the same effect on each issuer, since the direct effect is derived from the combined subjective conditions of each issuer. The financial condition of each issuer, its liquidity, and its unique characteristics are all of great importance with respect to its ability to recover from a financial crisis. Such variables need to be considered, if not by the credit rating agencies, then by the contractual parties relaying on ratings. An outstanding example is the national airline companies during the coronavirus pandemic. Despite their activity being significantly affected by the crisis, national airline companies, unlike small private airline companies, are unlikely to default, as they receive significant government support packages that will eventually help them recover from the crisis. While such issuers are clearly affected by the same systematic risk, their creditworthiness should not be measured by the same criteria as others types of issuers.

Supervision of the activation of rating triggers could also be considered by focusing on the identity of the investor. In many cases, these investors will be sophisticated entities already conducting independent analysis for determining risk levels. As such, it may be appropriate to restrict their ability to activate triggers that are based on ratings. Since such entities do not need ratings to make risk assessments, restricting their use in rating triggers will not cause any additional transaction costs, but only help allocate the cost of the credit risk more efficiently.

Finally, it should be noted that in the current crisis, it is evident that many investors have realized the disadvantages of blindly relying on ratings, and have chosen not to do so, thereby creating a de facto change in the market.

1. U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market 30 (2003), <https://www.sec.gov/news/studies/credratingreport0103.pdf> (hereinafter *SEC Report*); *See also* Federico Parmeggiani, *Rating Triggers, Market Risk and the Need for More Regulation*, 14 Eur. Bus. Org. L. Rev. 425 (2013); Karan Bhanot & Antonio S. Mello, *Should Corporate Debt Include a Rating Trigger?*, 79 J. Fin. Econ. 69 (2006); Christian Koziol & Jochen Lawrenz, *Optimal Design of Rating-Trigger Step-Up Bond: Agency Conflicts versus Asymmetric Information*, 16(2) J. Corp. Fin. 182 (2010);  [↑](#footnote-ref-1)
2. Special Comment, *The Unintended Consequences of Ratings Triggers*, Moody’s Global Credit Research 3 (December 2001) (hereinafter *Moody's Special Comment*). [↑](#footnote-ref-2)
3. *Id.* at 3-5; *See also* Parmeggiani at 5-8. [↑](#footnote-ref-3)
4. *Id.* [↑](#footnote-ref-4)
5. Moody's Special Comment, *supra* note 2, at5. [↑](#footnote-ref-5)
6. *See e.g.* Frank Partnoy, *What's (Still) Wrong with Credit Ratings* 92 Wash. L. Rev. 1407, 1409 (2017) (noting that "credit rating agencies fill an important need arising from the information asymmetry between issuers and investors: credit rating agencies are reputational intermediaries that bridge the information gap"); [↑](#footnote-ref-6)
7. SEC Report, *supra* note 1, at 21. [↑](#footnote-ref-7)
8. Frank Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev.669, 673 (1984); John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev.717, 722-33, 747 (1984). *See also* Gregory Husisian, *What Standard of Care Should Govern the World’s Shortest Editorials? An Analysis of Bond Rating Agency Liability*, 75 Cornell L. Rev. 410, 415-16 (1990) (noting that "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"). [↑](#footnote-ref-8)
9. Husisian, supra note 8, at 413, 415-16; Gilson & Kraakman, *infra* note 77, at 593; [↑](#footnote-ref-9)
10. For evidence that unsophisticated investors fail to analyze information, *see* Allen M. Poteshman & Reza S. Mahani, *Overreaction to Stock Market News and Misevaluation of Stock Prices by Unsophisticated Investors: Evidence from the Option Market* (2004) [https://ssrn.com/abstract=473263](https://ssrn.com/abstract%3D473263) (finding that unsophisticated investors overreact to past news on underlying stocks and mistakenly believe that mispriced stocks will move even further away from fundamentals at impending scheduled news releases; *see also* Choi, infra note 50, at 296-302 (noting that some investors lack the necessary information or expertise to make value-maximizing decisions). [↑](#footnote-ref-10)
11. This conclusion is subject to the assumption that ratings are a reliable source of information, which is not necessarily a conventional assumption as will be furthered discussed. [↑](#footnote-ref-11)
12. Louis H. Ederington & Jesse B. Yawitz, *The Bond Rating Process,* in Handbook of Financial Markets and Institusions 18 (6th ed., 1988); Husisian, *supra* note 8, at (stating that the information Credit Rating Agencies 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") [↑](#footnote-ref-12)
13. George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (1970). [↑](#footnote-ref-13)
14. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3(4) *J. Fin. Econ.*, 305 (1976); Johann Reindl & Alexander Schandlbauer, *Do Bond Covenants Prevents Asset Substitution: Using a Novel Stractural Estimation Approach*, ?, (2014) <https://www.bi.edu/globalassets/forskning/centre-for-corporate-governance-research/events/15wcgi/reindl_paper.pdf> ; Bezalel Gavish & Avner Kalay, *On the Asset Substitution Problem*, 18 J. Fin. & Quantitative Analysis 21-30 (1983). [↑](#footnote-ref-14)
15. Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. Fin. Econ. 125-6 (1979). [↑](#footnote-ref-15)
16. *Id.* at 117; *See also* Parmeggiani, *supra* note ?, at 17; Mitchell Berlin &Jan Loeys, *Bond Covenants and Delegated Monitoring*, 43(2) J. Fin. 397 (1988). [↑](#footnote-ref-16)
17. Reindl & Schandlbauer, *supra* note 14, at ? (noting that "for the average firm with no covenants attached to its bonds, the agency cost from asset substitution is lower than the inefficiency the firm would incur had it included covenants in its bond contracts"). [↑](#footnote-ref-17)
18. [↑](#footnote-ref-18)
19. [↑](#footnote-ref-19)
20. [↑](#footnote-ref-20)
21. [↑](#footnote-ref-21)
22. [↑](#footnote-ref-22)
23. [↑](#footnote-ref-23)
24. [↑](#footnote-ref-24)
25. [↑](#footnote-ref-25)
26. See for example, the case of Enron and Pacific Gas and Electric Company as further explained in SEC, 29 [↑](#footnote-ref-26)
27. *See* Moody's Special Comment, *supra* 2, at 3. [↑](#footnote-ref-27)
28. [↑](#footnote-ref-28)
29. STUMPP, P. M. & Coppola, M.M, (2002), (note 6), page 5. / Rating Triggers, Market Risk and the Need for More Regulation f.n. 7; *See* Moody’s Special Comment*, supra* note 75./ SEC f.n. 76 [↑](#footnote-ref-29)
30. [↑](#footnote-ref-30)
31. [↑](#footnote-ref-31)
32. For a comprehensive discussion on the chain of events that lead to the Enron collapse, *see* Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 Conn. L. Rev. 1145, 1148–1149 (2003); SEC Report, *supra* note 1, at 16-7; Moody's Special Comment, *supra* note 2, at 8. [↑](#footnote-ref-32)
33. *See* Moody's Special Comment, at pp. ?, overview of several defaults that occur due to the use of Rating Triggers; *See also* Special Comment, *Moody’s Analysis of US Corporate Rating Triggers Heightens Need for Increased Disclosure*, (July 2002). [↑](#footnote-ref-33)
34. SEC report, *supra* note 1, at 30-1; also locate the relevant law maybe?: Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 780) (hereinafter *Dodd-Frank Act*). For a discussion of the Dodd-Frank reforms related to credit rating agencies, *see* Aline Darbellay & Frank Partnoy, *Credit Rating Agencies Under the Dodd-Frank Act*, 30 BANKING & FIN. SERVS. POL’Y REPORT 1, 2 (2011); Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATION LAW (Claire A. Hill & James L. Krusemark eds., 2012). [↑](#footnote-ref-34)
35. *See* Moody's Special Comment, at pp. ?. [↑](#footnote-ref-35)
36. *Id*. at 9; *See also e.g*.,Standard & Poor's, Evaluating Liquidity Triggers in Insurance Enterprises, November 2008 (noting that the affect of a downgrade on an issuer with a Rating Trigger could precipitate serious liquidity problems, or even cause insolvency). [↑](#footnote-ref-36)
37. [↑](#footnote-ref-37)
38. Richard A. Posner Economic Analysis of Law ? (?). [↑](#footnote-ref-38)
39. [↑](#footnote-ref-39)
40. [↑](#footnote-ref-40)
41. Posner, supra note , at . [↑](#footnote-ref-41)
42. [↑](#footnote-ref-42)
43. Posner, supra note , at ; Steven Shavel, Foundations of Economic Analysis of Law, 293 (2004) ("contracts tends to be mutually beneficial: If contract can be altered in a way that would raise the expected utility of each party, we would think that this would be done"). [↑](#footnote-ref-43)
44. [↑](#footnote-ref-44)
45. Farnsworth, ?. [↑](#footnote-ref-45)
46. Farnsworth ; Shavel, supra note ?, at 329-337. [↑](#footnote-ref-46)
47. [↑](#footnote-ref-47)
48. [↑](#footnote-ref-48)
49. Posner , ; Shavel,supra note, at 296-9 (explaining the contracts are mutually beneficial for reallocation or sharing of risk, and that withough cotrants' enforcement most financial contracts would become unworkable). [↑](#footnote-ref-49)
50. Shavel, supra note , at [↑](#footnote-ref-50)
51. Shavel, supra note ?, at 339-42. [↑](#footnote-ref-51)
52. Stephen Choi, *Regulating Investors not Issuers: A Maeket-Based Proposal*, 88 Clif. L. Rev. 279 (2000) (noting that regulatory regime in the United States focuses on investor's protection). [↑](#footnote-ref-52)
53. [↑](#footnote-ref-53)
54. Shavel, supra note , at 316 ("If contracts will be renegotiated when difficulties arise, then performance of cpntracts will occur whenever that would be mutually beneficial"). [↑](#footnote-ref-54)
55. [↑](#footnote-ref-55)
56. The information presented is based on the OECD September Interim Report, *see* OECD Economic Outlook Interim Report (Sptember 2020), available at <https://doi.org/10.1787/34ffc900-en>. [↑](#footnote-ref-56)
57. [↑](#footnote-ref-57)
58. [↑](#footnote-ref-58)
59. For a discussion on market players behaviors as a result of market shock, *See e.g*., Mark Loxton et al., *Consumer Behavior during Crises: Preliminary Research on How Coronavirus Has Manifested Consumer Panic Buying, Herd Mentality, Changing Discretionary Spending and the Role of the Media in Influencing Behavior*, 13(8) J Risk & Fin, Management 166 (2020) (discussing "panic buying" in respect to consumers as a result of the coronavirus pandemic).

 [↑](#footnote-ref-59)
60. [↑](#footnote-ref-60)
61. [↑](#footnote-ref-61)
62. [↑](#footnote-ref-62)
63. [↑](#footnote-ref-63)
64. [↑](#footnote-ref-64)
65. Paul Ramskogler, *tracing the Origins of the Financial Crisis*, 2014(2) OECD J. Fin. Market Trends 47, 56-7 (2015);

Fender, I. and J. Mitchell (2005), “Structured finance: Complexity, risk and the use of ratings”, *BIS*

*Quarterly Review*, June, available at *www.bis.org/publ/qtrpdf/r\_qt0506f.htm*.

Fender, I., N. Tarashev and H. Zhu (2008), “Credit fundamentals, ratings and value-at-risk: CDOs versus

corporate exposures”, *BIS Quarterly Review*, March, available at *www.bis.org/publ/qtrpdf/r\_*

*qt0803i.htm*. [↑](#footnote-ref-65)
66. Hill, *supra* note 32, at 1149. [↑](#footnote-ref-66)
67. Lawrence J. White, *Markets: The Credit Rating Agencies*, 24(2) J. Econ. Persp. 211, 218 (2010). [↑](#footnote-ref-67)
68. Eckstein, *supra* note 76, at 251-52; Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U. L.Q. 619, 621 (1999) (claming that Credit Rating Agencies have become reactance rather than proactive). [↑](#footnote-ref-68)
69. Claire A. Hill, *Regulating the Rating Agencies*, 82(1) Was. Uni. L. Rev. 43, 50-3 (2004); Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers*, in Financial Gatekeepers: Can They Protect Investors? 59, 69 (2006); John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009(1) COLUM. Bus. L. REV. 109, 152 (2008); White, *supra* note 65, at 214-16; Eckstein, *supra* note 76, at 229; Coffee, supra note 8, at 253-54. [↑](#footnote-ref-69)
70. Historically, credit rating agencies enjoyed the First Amendment defense, based on their claim that the core function of ratings is journalism, and thereby protected under the First Amendment as a free speech, *e.g.*, Husisian, *supra* note 8, at 445-458; Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140, 142,-8 (2009). Credit Rating Agencies have also got other kinds of defenses, *see* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 302-3 (2006) (explaining the "unreasonable reliance" defiance in respect to investors reliance on ratings). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 had addressed rating agency accountability. Yet such increased liability had remained insufficient, *see* Partnoy, *supra* note 6, at ?. [↑](#footnote-ref-70)
71. [↑](#footnote-ref-71)
72. [↑](#footnote-ref-72)
73. Partnoy, supra note? (claiming that the reforms in the 2010 Dodd-Frank failed, that Credit Rating Agencies continue to generate little or no informational value, and that the fundamental problems that led to the worldwide financial crisis remain as significant as they were before the financial crisis); *Id.* at 1425 and note 85 ("explicit reliance on credit ratings […] increased after the financial crisis" and that "scholars have found that the informational content of credit ratings declined after Dodd-Frank"). [↑](#footnote-ref-73)
74. Dodd-Frank Act § 932; Partnoy *supra* note6, at 1413; Eckstein, *supra* note 76, at 253-4. [↑](#footnote-ref-74)
75. Partnoy*, supra* note6, at 1418. [↑](#footnote-ref-75)
76. OECD Interim Report, *supra* note 53. [↑](#footnote-ref-76)
77. Asaf Eckstein, *Skin in the Game for Credit Rating Agencies and Proxy Advisors: Reality Meets Theory*, 7 Harv. Bus. L. Rev. 221, 229 (2017) (indicating that " market observers have complained that credit rating agencies lack sufficient incentives to minimize errors and the Dodd-Frank Act sought to address some of those concerns"); For a general discussion on the ability of reputation to use as a solution to agency problems, *see* Eckstein, *supra* note 76, at 239-241; For a general discussions on the incentive for prevention negligent mistakes *see e.g.*, Guido Calabresi, The Cost of Accidents: A Legal and Economic Analysis (1970); Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 Yale L.J. 1055 (1972); Richard A. Posner, *A Theory of Negligence*, 1 J. Legal.Stud. 29 (1972). [↑](#footnote-ref-77)
78. James McAndrews & Jerome Mathis, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?*, 56(5) J. Monetary Econ. 657 (2009) (examining the validity of the reputational risk argument and finding that the reputation argument only works when a sufficiency large fraction of the Credit Rating Agency's income comes from other sources than rating complex products); Partnoy, *supra* 6, at 1409;Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 604-5 (1984) (claiming that Credit Rating Agencies are the most obvious example of information intermediaries); Robert J. Rhee, *On Duopoly and Compensation Games in The Credit Rating Industry*, 108 NW. U. L. REV. 85, 95 (2013); SEC Report, *supra* note 1, at 23; For a general discussion on reputation as an extra-legal mean for contract enforcement, see Shavel, *infra* note ?, at 323-4. [↑](#footnote-ref-78)
79. White, supra note 65, at 216-18; *See also* Staff of the office of the Credit Ratings of the U.S. SEC & Exch. Comm’n, *Report to Congress: Credit Rating Agency Independence Study* 7 (-2-013), https://www.sec.gov/files/credit-rating-agency-independence-study-2013.pdf; *See also* Hunt, *supra* note 67 at 131-38; Rhee, *supra* note 77, at 95 (noting that reputation can use as an incentive for performance only in competitive marks); Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 ADMIN. L. REV. 557, 582 (2009); Partnoy, *supra* note 6, at 1427; Rhee, *supra* note 77. [↑](#footnote-ref-79)
80. *see* Eckstein, *supra* note 76, at ?; Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, ? (2010). [↑](#footnote-ref-80)
81. For further review on legal protection Credit Rating Agencies received prior to the reform, *see* County of Orange v. McGraw-Hill Cos., 245 B.R. 151 (Cal. Dist. Ct. 1999); New York Times v. Sullivan, 376 U.S. 254 (1964); Jefferson County School District v. Moody’s Investor’s Services, 175 F.3d 848 (10th Cir. 1999); Timothy J. Sinclair, The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness

7 (2005); Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well Placed Reliance or Free-Market Interference?* 20 Seton Hall Legis. J. 293, 315–316 (1996) [↑](#footnote-ref-81)
82. משהו שקשור ללרנד הנד [↑](#footnote-ref-82)
83. Partnoy, *supra* note 6, at ?. [↑](#footnote-ref-83)
84. For explanations on Credit Rating work orders in general, and on the meaning of “credit-watch” or “watch-list” in particular, *see* SEC Report, *supra* note 1, 25-7. [↑](#footnote-ref-84)
85. [↑](#footnote-ref-85)
86. “*There are two superpowers in the world today in my opinion. There’s the United States, and there’s Moody’s Bond Rating Service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful*”. (New York Times columnist Thomas L. Friedman’s remarks in a PBS “News Hour” interview on February 13, 1996/ Interview with Thomas Friedman, *The MacNeil/Lehrer Newshour* (PBS television broadcast, Feb. 13, 1996). ) [↑](#footnote-ref-86)
87. אצל פרטנוי במאמר החדש 1455 [↑](#footnote-ref-87)
88. [↑](#footnote-ref-88)
89. *See supra* note 78 and accompanying text*.*

*Industry*, 108 NW. U. L. REV. 85, 94-5 (2013).;

Eckstein, *supra* note 76, at 228-9 and note 31 (noting that the possibility of Credit Rating Agencies being criticized by issuers who claim that they were injured by overly pessimistic ratings is less likely to occur) [↑](#footnote-ref-89)
90. Shavel, *supra* note , at 315-7 (noting that when difficulties arise and a mutually beneficial renegotiated contract exists in principle, it will be made). [↑](#footnote-ref-90)
91. [↑](#footnote-ref-91)
92. Such incentive resembles the incentive creditors face when they are assuming a soon to occur insolvency. [↑](#footnote-ref-92)
93. [↑](#footnote-ref-93)
94. [↑](#footnote-ref-94)
95. [↑](#footnote-ref-95)
96. [↑](#footnote-ref-96)
97. [↑](#footnote-ref-97)
98. [↑](#footnote-ref-98)
99. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47(2) Econometrica 263 (1979) (showing that there are inconsistent preferences when the same choice is presented in different forms. The value function is normally concave for gains, commonly convex for losses, and is generally steeper for losses than for gains, meaning that an individual will react in a more risk averse manner when they prescribe the situation as the risk for loss). [↑](#footnote-ref-99)
100. Loxton, *supra* note 58. [↑](#footnote-ref-100)
101. The preliminary principle of foreseeability was first established in Hadley v. Baxendale, 156 Eng. Rep. 145 (1854) (where damages calculated were limited to losses reasonably foreseen by both parties at initiation of contract); *see also* Restatement (second) of Contracts § 351 (1981); U.C.C. § 2-715 (1978). [↑](#footnote-ref-101)
102. *Id*. *see also* E. Allan Farnsworth, Contracts § 12.14 (1982) (discussing the influence of foreseeability on the assessment of damages). [↑](#footnote-ref-102)
103. For a further discussion on economic analysis in respect to contract enforcement and interpretation, *see* Shavel, *supra* note ?, at 296-304. [↑](#footnote-ref-103)
104. [↑](#footnote-ref-104)
105. [↑](#footnote-ref-105)
106. [↑](#footnote-ref-106)
107. [↑](#footnote-ref-107)
108. Shavel, supra note , at 311. [↑](#footnote-ref-108)
109. [↑](#footnote-ref-109)
110. [↑](#footnote-ref-110)
111. Banks Mcdowell, *Foreseeability in Contract and Tort: The Problems of Responsibility and Remoteness*, 36(2) Case W. Res. L. Rev. 286,288 (1985) (noting that foreseeability is related to the general concept of fault). [↑](#footnote-ref-111)
112. *Id.* [↑](#footnote-ref-112)
113. That is of course as long as such systematic factors do not affect him directly. [↑](#footnote-ref-113)
114. Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, page 5 (In essence, a credit rating reflects a rating agency’s opinion, as of a specific date, of the creditworthiness of a particular company, security, or obligation. For almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and their financial obligations) [↑](#footnote-ref-114)
115. to the relevant chapter above [↑](#footnote-ref-115)
116. Moody’s Investor Services, *Uptrend in rating trigger usage and the impact for US life (re) insurers* (2009) (noting that "The results of Moody Investors Service 2008 Rating Trigger Survey of U.S. life (re)insurers indicate both greater rating trigger usage and harsher consequences of breach during the past year […] We attribute both the reversal in the previous downtrend and the rise in usage to the weakening of the economic and credit environment, which started with the subprime crisis in August 2007 […] during periods of economic weakness, like the current one, with rising corporate defaults, rating trigger usage and severity tend to climb as the life (re)insurance industry's business partners and counterparties seek additional protection from the potential credit deterioration of their (re)insurance partners"). [↑](#footnote-ref-116)
117. Partnoy*, supra* note6, at 1418. [↑](#footnote-ref-117)