University of Oslo

University of Oslo Faculty of Law Legal Studies
Research Paper Series
No. 2015-06

Kern Alexander

Tort Liability for Ratings of Structured Securities under English Law

Electronic copy available at: http://ssrn.com/abstract=2547517

Tort Liability for Ratings of Structured Securities under English Law

Kern Alexander

Introduction

This article analyses whether there are legally cognisable claims for misrepresentation and negligence under English law that can be brought by a professional investor against a credit ratings agency for providing AAA ratings to structured finance instruments, such as collateralised debt obligations, when investors later discover that the ratings agency failed to act with due care in issuing the rating.

English courts have generally followed the doctrine of *Hedley Byrne*[1] and *Caparo Industries*[2] in holding that in a negligence action for economic loss for making careless statements the defendant does not have a duty of care to a claimant with whom the defendant does not have a direct relationship (ie., privity of contract) in respect of its claim, unless the claimant can show that the defendant knew or should have known that its representations would be disseminated and relied upon by the claimant. These tort law principles are especially relevant in considering the claims of investors in complex financial instruments which were sold to them before the global credit crisis erupted in late 2007 and which were rated AAA by credit ratings agencies. Indeed, these investors – many of them professional investors, including many British banks that suffered heavy losses and were later nationalized and/or subject to substantial taxpayer bailouts, such as the Royal the Bank of Scotland and Northern Rock – had purchased structured debt securities before the credit crisis began from special purpose vehicles or other legally distinct entities that were usually set up by the banks responsible for promoting and arranging the sale of the securities. These banks marketed and promoted complex and structured securities to professional investors, including large financial institutions, pension funds and asset manager firms. Moreover, the arranging and managing banks solicited the assistance of credit ratings agencies, such as, among others, Standard & Poors ('S&P), Moody's and Fitch, to provide these financial products with AAA

1 *Hedley Byrne & Co Ltd v Heller & Partners Ltd* ([1963] 2 All ER 575, [1964] AC 465).
2 *Caparo Industries plc v Dickman* ([1990] 1 All ER 568, [1990] 2 AC 605).

Electronic copy available at: http://ssrn.com/abstract=2547517

ratings so that they could be marketed as low risk investments to professional investors. In many cases, the arranging/managing banks and ratings agencies worked closely together on particular methodological and risk assessment issues to ensure that the products would receive an AAA rating for the primary purpose of marketing and selling them to professional investors.

Most investors who purchased these products relied on these direct marketing efforts and solicitations before deciding whether to invest. As a matter of standard practice in the City of London, however, the investment banks that conducted the marketing and solicitations had arranged for separate legal entities which they did not own or control to act as the party offering the securities to the investors in the offering circular. Further, the offering circular stated expressly that the purchaser, by entering the transaction to buy the securities, acknowledges that the arranging or managing banks (responsible for marketing the securities) did not make any representations to them regarding the riskiness or the viability of the securities. As a matter of English law and custom in the London markets, this had the effect of insulating the arranging/managing bank from any contractual or tortious liability in the sale of the securities. A claimant investor could therefore only seek compensation and damages directly from the special purpose entity which had formally sold them the securities and which often had inadequate or no assets to satisfy any claim. Moreover, any claim by the investors against the ratings agency for negligently or deceptively issuing the securities with an AAA rating could not surmount the legal obstacle that there was no privity of contract between the ratings agency and the claimant investor and so there was no duty of care owed by the ratings agency to the investor. This precluded any cognizable claim in contract or tort under English law for compensation or damages against the arranging/managing bank and/or the ratings agency for breach of contract and/or negligent misrepresentation or deceptive misrepresentation in the sale of the securitized investments.

The article addresses the issue of whether the English law of tort can be interpreted as providing a legally cognisable claim for negligent misrepresentation for claimant investors against ratings agencies when the investors relied on AAA ratings issued by the ratings agency to their detriment. In doing so, it will consider the English case law in light of the recent ruling by the Australian Federal Court in the *Bathurst*[3] case. Specifically, the analysis

[3] *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200.

Electronic copy available at: http://ssrn.com/abstract=2547517

will address the issue of whether the actual rating of the financial instrument or product by the rating agency constitutes a representation only to the issuer of the instrument or product (the party with whom the rating agency actually contracted to provide the rating), or does it also constitute a representation to the broader market of investors and in particular to investors who relied on the rating when deciding whether to purchase the instrument or product, even though the investor, as part of the investment contract, signs documentation that expressly states that by entering into the contract the investor has not relied on any representations by third parties, such as the arranging bank and/or the rating agency. The article argues that ratings agencies in issuing ratings are aware that their ratings are relied on by current or potential investors and that the ratings are issued with a view to their ultimate dissemination to investors in the market. Because rating agencies are in the business of accepting compensation for issuing ratings that they know are being issued for the primary purpose of being disseminated to potential investors in the market a duty of care arises under English tort law that is owed by the rating agencies to the class of current or potential investors to whom the ratings are disseminated.

The analysis in the article will be relevant in considering how English law governs tort claims by professional investors against credit ratings agencies for allegedly rendering negligent and/or deceptive ratings of investment products that they knew or should have known were being directly promoted to third party investors. The article will focus on how English law treats the duty of care issue in negligent misrepresentation cases where the plaintiff has suffered pure economic loss and where there is no direct privity between the plaintiff and defendant. It will consider recent factual scenarios that are the subject of current proceedings before the High Court in London involving Standard & Poors (S&P), which filed a petition in December 2013 for a declaratory judgment that it does not owe a duty of care under English tort law to any professional investors who may be considering bringing civil claims against it for negligent misrepresentation, misrepresentation and/or deceit in issuing AAA ratings on complex securitized investment products that were sold to professional investors a few years before the onset of the global credit crisis in 2007 and which later lost all of their value during 2008 around the time of the collapse of Lehman Brothers Holdings.

Although the legal issues discussed in this chapter relating to the creation of a duty of care between plaintiff investors and the defendant ratings agencies and arranging/managing banks appear to be settled as a matter of English law, the chapter suggests that English courts should reconsider the duty of care issue in tort actions involving negligent misrepresentation

claims against rating agencies for negligently rating securitized investment products. The chapter suggests that a reconsideration of these legal issues is necessary in light of the lessons learned from the recent financial crisis and that London's future reputation as an international financial centre in the wholesale securities markets depends in part on the availability of adequate legal remedies under English law for professional investors with claims against credit ratings agencies in their ratings of securitized and other complex financial products. In doing so, the article will mainly consider these legal issues as they relate to potential tort liability of credit ratings agencies for negligently or deceptively rating complex financial products and the implications of the Australian federal court's decision in the *Bathurst* case. The article concludes that the reasoning of the *Bathurst* case is compelling and will contribute to developments in English law that may lead to the scope of the duty of care expanding to include professional investors who rely on ratings in making investment decisions and that this may serve as an effective remedy to hold ratings agencies accountable in the future for negligent, reckless and deceitful conduct.

I. Establishing a Duty of Care to third party investors in securitized investments

Generally, a sophisticated investor holding a structured debt instrument issued as part of a securitisation who suffered losses as a result of negligent misrepresentation in the sale of that product might look for redress to those parties who sold it the instrument (the 'managers') or to those parties who structured the investment (the 'arrangers') or to the party which rated the investment AAA (the ratings agency). A preliminary issue would be whether the managers/arrangers/ratings agency acted *reasonably* and, if they did not, whether they are *liable* in negligence. If they did not act reasonably, to prove liability the investor must first show whether the manager/arranger/ratings agency owed a duty of care to the investor. Under English law, establishing a defendant's duty of care in a tort claim for pure economic loss requires one of three tests to be met. In an important House of Lords decision, Lord Bingham set forth these three tests in ***Commissioners of Customs and Excise v Barclays Bank plc***[4] for establishing a duty of care[5] as follows: (1) assumption of responsibility; (2) a threefold test

[4] *Commissioners of Customs and Excise v Barclays Bank plc* [2006] UKHL 28

[5] In setting forth these tests, Lord Bingham cited the leading cases: *Hedley Byrne & Co Ltd v Heller & Partners Ltd* ([1963] 2 All ER 575, [1964] AC 465), *Ministry of Housing and Local Government v Sharp* ([1970] 1 All ER 1009, [1970] 2 QB 223; *Smith v Eric S. Bush* ([1989] 2 All ER 514, [1990] 1 AC 831), *Caparo Industries plc v Dickman* ([1990] 1 All ER 568, [1990] 2 AC 605), *Henderson v Merrett Syndicates Ltd* ([1994] 3 All ER 506, [1995] 2 AC 145); *White v Jones* ([1995] 1 All ER 691, [1995] 2 AC 207);

showing whether the loss to the claimant was a reasonably foreseeable consequence of what the defendant did or failed to do; whether the parties' relationship was sufficiently proximate; and whether it was fair, just and reasonable to impose a duty of care; and (3) the incremental test: that the law should develop novel categories of negligence incrementally and by analogy with established categories.[6]

The first test assesses whether the defendant, objectively, assumed responsibility for their statements or conduct in relation to the claimant, or can be treated as having done so. In *Merrett Syndicates Ltd*,[7] the assumption of liability test was set forth by the House of Lords in a case involving Lloyd's names as plaintiffs who were members of syndicates managed by the defendant underwriting agents. The relationship between names, members' agents and managing agents was regulated by the terms of agency agreements which gave the agent 'absolute discretion' in respect of underwriting business conducted on behalf of the name but *it was accepted that it was an implied term of the agreements that the agents would exercise due care and skill in the exercise of their functions as managing agents* (italics added). The plaintiffs brought proceedings against the defendants alleging that the defendants had been negligent in the conduct and management of the plaintiffs' syndicates, and wished, for limitation purposes, to establish a duty of care in tort in addition to any contractual duty that might be owed by the defendants.

The main issues considered were:

(i) whether members' agents owed a duty of care to direct names notwithstanding the contractual relationship between the parties

(ii) whether managing agents appointed as sub-agents by members' agents owed a duty of care to indirect names

(iii) whether members' agents were responsible to names for any failure to exercise reasonable skill and care on the part of managing agents to whom underwriting was delegated by the members' agents, and

(iv) whether the members' agents were required to exercise skill and care only in relation to

---

Spring v Guardian Assurance plc ([1994] 3 All ER 129, [1995] 2 AC 296); *Williams v Natural Life Health Foods Ltd* ([1998] 2 All ER 577, [1998] 1 WLR 830) and *Phelps v Hillingdon London Borough Council* ([2000] 4 All ER 504, [2001] 2 AC 619).

6 This third condition is addressed in greater detail in *Sutherland Shire Council v Heyman* (1985) 157 CLR 424, 481.

7 *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145, [1994] 3 All ER 506.

those activities and functions which members' agents by custom and practice actually performed for the names personally.

The judge found in favour of the plaintiffs on all the issues. The defendants appealed to the Court of Appeal, which dismissed the appeal, and then appealed to the House of Lords, which dismissed the appeal for the following two reasons: First, where a person *assumed responsibility* to perform professional or quasi-professional services for another who *relied* on those services, the relationship between the parties was itself sufficient, without more, to give rise to a duty on the part of the person providing the services to exercise reasonable skill and care in doing so. Accordingly, managing agents at Lloyd's owed a duty of care to names who were members of syndicates under the agents' management, since the agents by holding themselves out as possessing a special expertise to advise the names on the suitability of risks to be underwritten and on the circumstances in which, and the extent to which, reinsurance should be taken out and claims should be settled, plainly assumed responsibility towards the names in their syndicates.[8]

Second, an *assumption of responsibility* by a person rendering professional or quasi-professional services coupled with a *concomitant reliance* by the person for whom the services were rendered could give rise to a tortious duty of care irrespective of whether there was a contractual relationship between the parties. In consequence, unless the contract between the parties precluded him from doing so, a plaintiff who had available to him concurrent remedies in contract and tort was entitled to choose that remedy which appeared to him to be the most advantageous.

Alternatively, the second test – known as the *Caparo Industries* test[9] – consists of three elements that the claimant must show to demonstrate a duty of care in negligence:

- the harm must be reasonably foreseeable as a result of the defendant's conduct;

[8] Further, the court reasoned that the managing agents owed a duty of care to the names because the names placed *implicit reliance* on that expertise, in that they *gave authority* to the managing agents to bind them to contracts of insurance and reinsurance and to the settlement of claims. The fact that the agency and sub-agency agreements gave the agent 'absolute discretion' in respect of underwriting business conducted on behalf of the name did not have the effect of excluding a duty of care, contractual or otherwise. The discretion given to agents merely defined the scope of the agents' authority, not the standard of skill and care required of agents in carrying on underwriting business on behalf of names.

[9] *Caparo Industries plc v Dickman* ([1990] 1 All ER 568, [1990] 2 AC 605).

- the parties must be in a relationship of proximity;
- it must be fair, just and reasonable to impose liability.

The House of Lords ruled in *Caparo Industries* that for a duty of care to exist between a third party adviser/auditor and a claimant a relationship of proximity must exist in which the third party adviser must, at the time at which the advice is given, be aware of (1) the identity of the person to whom the advice or information is to be communicated, (2) the purpose for which the person is to be provided with the advice or information, and (3) the likelihood that the person to whom the advice or information is communicated will rely on it for the known purpose. The House of Lords in *Caparo Industries* observed that if the test were satisfied, a duty of care would be established between the auditors and third party investor/claimants with respect to a potential negligence claim against the auditors for the preparation of the company's accounts, even though the auditors have no privity of contract with the investors because the auditors were hired by the company and its board (not the investors) to conduct the audit. As discussed below, this rationale could also serve arguably to create a duty of care between a credit ratings agency and the investors to whom the ratings were communicated by the issuer of investment securities.

The Court of Appeal applied the *Caparo Industries* test in a 2009 case[10] to show whether a duty of care had been created by a bank to professional investors for alleged misrepresentations in the offer document.[11] The court held that for the duty of care to be established the test required that the investor show whether the loss was a reasonably foreseeable consequence of the bank`s conduct, whether the relationship between the parties was of sufficient proximity, and whether it was fair, just and reasonable to impose a duty of care on the bank towards the investor.

Alternatively, the third test is known as the incremental test, which provides that new categories of negligence should be developed incrementally and by analogy with established categories. However this test has been criticised for providing limited assistance in determining whether a duty of care has arisen because it does not provide any measurable criteria.

---

10 *So v HSBC Bank plc* [2009] EWCA Civ 296.

11 *Customs & Excise Commissioners v Barclays Bank plc* [2006] UKHL 28.

Regarding the three tests, Lord Bingham observed the following in *Customs & Excise Commissioners v Barclays Bank*:[12]

1. [Liability could arise] where one party could accurately be said to have assumed responsibility for what was said or done to another: the paradigm situation being a relationship having all the indicia of contract save consideration.
2. An assumption of responsibility was to be regarded as a sufficient but not a necessary condition of liability, a first test which, if answered positively, might obviate the need for further inquiry; if answered negatively, further consideration was called for.
3. The assumption of responsibility test was to be applied objectively and was not answered by what the defendant thought or intended.
4. The problem here was that the further the test was removed from the actions and intentions of the actual defendant, and the more notional the assumption of responsibility became, the less difference there was between that test and the threefold test.
5. The *Caparo Industries* threefold test itself provided no straightforward answer to the vexed question whether or not in a novel situation a party owed a duty of care.
6. The incremental test was of little value in itself and was only helpful when used in combination with a test or principle which identified the legally significant features of a situation.
7. The closer the facts of the case in issue to a case in which a duty of care had been held to exist, the readier a court would be, on the approach adopted in *Caparo Industries*, to find that there had been an assumption of responsibility or that the proximity and policy conditions of the threefold test were satisfied. The converse was also true.
8. The outcomes of the leading cases were in almost every instance sensible and just, irrespective of the test applied.

It should be noted that although Lord Bingham's observations supported a close examination of the detailed circumstances of the particular case and the particular relationship

[12] See Lord Bingham, *Barclays Bank* [2006] para. 192.

between the parties in the context of their legal and factual situation as a whole, it should not be interpreted as disparaging the value of and need for a test of liability in tortious negligence cases. Indeed, any coherent law of tort must be based on a set of consistently applied principles, if it is not to become a morass of *ad hoc* rulings seeking to achieve a just result.

II. The Implications of *Caparo Industries* for Ratings Agency Liability

Generally, establishing whether a duty of care exists in negligence which can be applied against a bank's mis-selling of complex financial products to professional investors and the related liability issues involving a credit rating agency issuing misleading ratings relied upon by professional investors will involve a close review of the facts of each case. In considering the facts, an English court would apply the basic tests set forth in case law, that is, whether the defendant either expressly or impliedly assumed responsibility for any advice or statements made directly to the claimant investors, and, if not, whether it was foreseeable that such statements would reach investors and whether the investors were in a proximate relationship with the banks/rating agencies that issued the statements, and finally whether it is fair, just and reasonable to impose liability on the banks and/or the rating agencies based on the facts of the case. As discussed above, the English courts recognise the test set forth in *Caparo Industries* as consisting of three elements: (1) the harm resulting from defendant's conduct must be reasonably foreseeable; (2) the defendant and claimant must in a relationship of proximity; and (3) the imposition ofliability must be fair, just and reasonable.[13]

Practically, this means that for a relationship of proximity to exist the adviser must, at the time at which the advice is given, be aware of (1) the identity of the person to whom the advice or information is to be communicated, (2) the purpose for which the person is to be provided with the advice or information, and (3) the likelihood that the person to whom the advice or information is communicated will rely on it for the known purpose. In *Caparo Industries*, the Court held that if the test was satisfied, auditors and other third parties may incur liability to third party claimants (i.e., shareholders) for negligence in the preparation of company accounts. Applying the *Caparo Industries* test to investor claims against ratings agencies involved in rating securitized investments and other complex financial products that

[13] An alternative test was set out in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, requiring an assumption of responsibility and reliance.

later lost most of their value in the 2007-08 financial crisis would create potential tort liability for negligent misrepresentation and/or deceit in the assessment and evaluation of risk factors that resulted in the AAA ratings on the grounds that the potential harm to the investors was reasonably foreseeable by the ratings agency because it was aware that its AAA rating was being disseminated to, and relied upon, by the investor in deciding whether or not to invest. Indeed, often the arranging banks and ratings agencies shared credit market data and risk measurement methodologies as they worked closely together to test and measure which data would support a AAA rating for certain investment products. This close involvement by the ratings agency with the arranging bank to ensure that each structured investment was 'built to model' to ensure a AAA rating placed the rating agency into a proximate relationship with the potential investors to whom the AAA rating was disseminated. Through its involvement with the arranging bank, the ratings agency knew that it was issuing a AAA rating that would be directly marketed to certain professional investors and that these investors would rely on the AAA rating in making their investment decisions.

Moreover, as some professional investors have alleged in recent cases,[14] it would be fair, just and reasonable and in support of public policy to impose liability on arranging banks and ratings agencies together because they - in violation of ethical principles that protect against conflicts of interest in the ratings process - apparently adjusted or manipulated credit market data and parameters to make highly risky investment products seem much less risky so that they would qualify for a AAA rating.[15] Indeed, as discussed below, the Australian court accepted this type of argument in the *Bathurst* case in which the court found that the independence and credibility of the ratings process was undermined by the arranging bank (in this case ABN AMRO, now owned by the Royal Bank of Scotland) exercising undue influence with the ratings agency (S&P) in adjusting the risk factors and model parameters that ultimately determined the AAA rating of a complex risky financial product that was sold to professional investors. The lack of legal and regulatory safeguards to ensure the independence and credibility of the ratings process resulted in a type of collusion between the ratings agency and the arranging bank to alter the data inputted into the risk model that

[14] See the legal action filed in Dutch court against S&P/ABN AMRO (http://www.imf.com.au/docs/default-source/site-documents/media-release---bentham-imf-backs-usd$250m-europe-claim-against-rbs-and-s-p); see also *Bathurst* (upholding third party liability in tort for a rating agency towards investors who relied on ratings in deciding whether to invest in an instrument that was rated negligently by the rating agency).

[15] As discussed elsewhere, establishing a duty of care for credit rating agencies was examined in the Australian case *Bathurst*.

determined the AAA rating.

The above analysis suggests that the English case law could possibly support the application of the *Caparo Industries* test to create a duty of care between a ratings agency and a professional investor who relied on the ratings to purchase a complex financial product. In *Al Saudi Banque v Clark Pixley*,[16] a decision that was referred to with approval by the House of Lords in *Caparo Industries,* it was found that the defendant auditors had neither supplied the plaintiff banks with their audit reports nor sent them to the company with the intention or in the knowledge that the company would supply them to the plaintiffs and therefore there was no relationship between the defendant auditors and the plaintiff banks. This however does not preclude the creation of a duty of care in a case where the ratings agency was engaged by the arranging bank to issue a AAA rating to a complex security and the ratings agency knew that the AAA rating would be disseminated to, and relied upon, by professional investors.

Nevertheless, to date, the conventional view in English law has been that an inference can be drawn that liability would not be imposed on a credit ratings agency for losses suffered by investors who relied on a AAA rating issued for debt securities that were issued as part of a securitization, even though the rating was knowingly based, in part, on negligent and/or false statements disseminated in an offering circular, on the grounds that there was no duty of care established between the ratings agency and the claimant investors because the ratings agency did not directly supply the claimant investors with the ratings report and were expressing only their opinion as to the riskiness of the credit instrument. To establish a duty of care, the claimant investors would have to show that the ratings agency had voluntarily assumed liability, or alternatively, that it was reasonably foreseeable per the *Caparo Industries* test that it would know that the rating would be communicated to the claimant investors and that the claimants would rely on the rating in deciding whether to purchase the instruments in question. This would be a difficult hurdle (but not insuperable) for claimant investors to overcome in a tort action for negligence and/or misrepresentation against a credit ratings agency.

III. The *Bathurst* case – its implications for English law

[16] *Al Saudi Banque v Clark Pixley* [1990] 1 Ch 313.

The *Bathurst* case[17] in the Australian federal court, however, shows how a duty of care can be established between a ratings agency and claimant investors who purchased instruments rated by the agency. In *Bathurst,* the Australian federal court ruled that a credit ratings agency does have a duty of care to investors who purchase and suffer losses on certain investment products because of negligence and/or misrepresentations in the rating of the products on the grounds that it is reasonably foreseeable for the ratings agency to know that its ratings would be communicated to the investors and that the investors would rely on the ratings in deciding whether to purchase the products. The case has important implications for the English law of tort liability for credit rating agencies that act negligently and/or make misrepresentations in issuing ratings of complex financial products that are sold to professional investors who rely on the ratings and suffer losses. It holds that the duty of care between a credit ratings agency and investors who have suffered losses because of investing in a financial product that was rated AAA by the ratings agency can be established if it can be shown that the ratings agency issued the rating for the primary purpose of disseminating it to prospective investors and that the investors later relied on the ratings in deciding whether to invest in the rated financial product and incurred losses because of negligence or false statements in the rating of the product.

This Australian case is reported to be the first case in the world where a ratings agency has been held liable in relation to the ratings it gave to the kind of products that contributed to the global financial market downturn in 2007 and 2008. It provides the common law test for establishing a duty of care for credit rating agencies. In this case, local council governments brought claims in the Federal Court of Australia, against LGFS, ABN Amro and S&P.

In 2006 ABN AMRO created a new financial product known as the constant proportion debt obligation (CPDO). ABN AMRO retained Standard and Poor's (S&P), to rate the CPDO. S&P issued a AAA rating for the CPDO. LGFS, a financial advisor purchased these notes in order to be sold on to ('on-sale') to local councils. In October 2008 the CPDOs cashed out because their net asset value fell below 10% of the par price for which they had been acquired, causing loss to the councils. The councils brought claims in the Federal Court of Australia, against LGFS, ABN Amro and S&P. The claims against S&P alleged (i)

[17] *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200.

misleading and deceptive conduct and (ii) negligence.

The purpose of ABN AMRO obtaining the S&P rating was for dissemination to potential investors so that they could rely on S&P's expert opinion of the creditworthiness of the CPDO notes as issued. It was thus reasonable for the councils to rely upon the rating and S&P knew or must have known that this is what any potential investor in the CPDO notes in the position of the councils would do. A negligent rating of the CPDO notes was inherently likely to cause loss because the subject matter of the rating was the expert opinion as to creditworthiness. Further, ABN AMRO obtained the rating because many potential investors would not have the resources or expertise to assess creditworthiness for themselves or to second-guess the rating, they were therefore 'vulnerable'. The plaintiffs were vulnerable in that they could not reasonably protect themselves from any lack of reasonable care by S&P in assigning the rating. It was reasonable therefore for the councils to rely on LGFS's advice and S&P's rating.

The Australian court's finding that, in issuing a financial product with a credit rating, the rating agency owed a duty of care to the end investor of such a wide scope is novel and contrasts with the general approach to tortious liability for pure economic loss, that foreseeability of loss is insufficient and the Australian courts take into account familiar factors when considering whether to impose a duty, such as the risk of indeterminate liability, vulnerability, directness of relationship and the existence of contractual relationships between relevant parties. It can be argued that it is fair, just and reasonable to impose a duty on CRAs to issue independent and competent ratings, particularly where it is known that its purpose is to assist in the marketing of products to investors. Conversely, in circumstances where the ratings agency (S&P in this case) makes available the basis (i.e. the methodology and base case assumptions) of its ratings, it is arguably not fair, just and reasonable for the investor to fail to take any steps of its own to assess that rating (by appointing and paying for specialist advisers if necessary) and then seek to recover its losses from the deep-pocketed rating agency on the basis of reliance solely on the rating.

In *Bathurst*, Jagot J distinguished the case from *Esanda Finance Corporation v Peat Marwick Hungerfords*[18] which had held that it would be too removed for an auditor of a

[18] *Esanda Finance Corporation v Peat Marwick Hungerfords* [1997] HCA 8.

company to be liable to every person who placed reliance on its audit of a company and suffered loss as a result, as the rating by S&P in the *Bathurst* case was assigned to a financial instrument for the very purpose of communication to the class of potential investors and for them to take into account and rely on the rating in deciding whether or not to invest. Also, the risk of loss by potential investors in the CPDO notes was foreseeable (that is, it is a risk of which S&P knew or ought to have known) by reason of a negligent rating. Jagot J, held that in assigning a rating to the CPDO notes, S&P owed a duty of care to potential investors in those notes including the local council authorities. The Court concluded in its judgment that the councils proved that they suffered loss against LGFS, S&P and ABN AMRO, the damage being the amount each paid for the CPDO notes less the amount they received on the cash-out of those notes. Although the Australian Court did not specifically cite the *Caparo Industries* test, the court applied in substance a similar test for establishing the existence of a duty of care.

The Australian *Bathurst* case is a rare case where liability for financial loss was imposed on a bank and a credit ratings agency for losses suffered by professional or sophisticated investors who had relied on AAA ratings that were negligently issued by both the arranging bank and ratings agency in the wholesale securities market. It shows the general common law test to determine whether there is a duty of care between a defendant and claimant for pure economic loss in a negligence and/or negligent misrepresentation action could potentially hold a credit ratings agency liable to a professional investor for negligent misrepresentation of complex securities on the grounds that the ratings agency knew or should have known that its ratings would be disseminated to, and relied on, by certain investors. The *Bathurst* case demonstrates how another common law jurisdiction with very similar principles of negligence law can apply the traditional duty of care test as set forth in the *Caparo Industries* to show how a duty of care is created between the defendant ratings agency and plaintiff investors. The decision in *Bathurst* would be persuasive authority, but not legally binding precedent, for an English court. Therefore, the decision would be likely read closely by English legal practitioners and judicial authorities.

In addition, the *Bathurst* case should have particular resonance for recent legal actions brought in European courts by professional investors against both the arranging/managing banks and credit ratings agencies that allegedly were negligent in issuing AAA ratings of

complex financial products which led to substantial financial losses for investors after the global financial crisis intensified in 2008. Some cases are based on claims by British and other European banks against the Royal Bank of Scotland as the current owner of the Dutch bank ABN AMRO and the credit ratings agency Standard & Poors for the negligent issuance of AAA ratings to complex derivative products that were purchased by the plaintiffs prior to the financial crisis in 2006. In early 2008, during a period of credit market stress, the value of these investments dropped precipitously and resulted in substantial losses – often at less than 10% of face value. The investors – including the British bank government owned bank Northern Rock - incurred substantial losses on its investment directly as a result of the negligent assessment of the credit quality of the products by S&P and related misrepresentations of the riskiness of the financial instruments in questions by both ABN AMRO and S&P. Although marketing material for these products (offering circulars) and credit ratings agencies pre-sale reports expressly stated that they were making no representations with respect to the investment products, the lawsuits allege that it is a question of fact whether the ratings agencies themselves knew or should have known that their representations about the credit quality of the investments having a AAA rating would be disseminated directly to all potential third party investors, and that in these cases the rating agencies knew that their rating would be disseminated to and relied upon by professional investors.

Conclusion

The article discusses how English law treats the duty of care issue in negligent misrepresentation cases involving claimants who have suffered losses for investing in securitized investment products that were carelessly rated AAA by rating agencies. In considering these issues, the article analyses the legal viability of professional investors' claims against ratings agencies alleging (i) misleading and deceptive conduct and (ii) negligence in providing AAA ratings to securitized investment products. As discussed, English Courts have consistently demonstrated a reluctance to impose a duty of care to avoid economic loss other than in established categories of relationship, or where, in novel cases, it is fair, just and reasonable to impose such a duty in all of the circumstances. Similarly, a particular legal hurdle for establishing the liability of credit rating agencies for third party liability in tort for negligence and/or misrepresentations has been the doctrinal requirements

of privity of contract. There are no relevant cases in the English courts addressing the issue of ratings agency tort liability for economic loss suffered by investors who purchased an investment that was negligently or deceptively rated by the rating agency. The test in *Caparo Industries* for establishing a duty of care has proved to be a significant enough hurdle to prevent any claims from proceeding. However, the recent Australian case *Bathurst* suggests a possible interpretation that could be adopted by English courts to argue that a duty of care does exist between a ratings agency and the investors to whom it disseminates its credit ratings.

Based on analysis of English case law and on the *Bathurst* case, the article argues that ratings agencies in issuing ratings are aware that their ratings are relied on by current or potential investors and that the ratings are issued with a view to their ultimate dissemination to investors in the market. Because rating agencies are in the business of accepting compensation for issuing ratings that they know are being issued for the primary purpose of being disseminated to current or potential investors, it is suggested that a duty of care arises under English tort law that is owed by the rating agencies to the class of current or potential investors to whom the ratings are disseminated.