

## Full Federal Court of Australia upholds Rating Agency duty of care to investors in rated product

On 6 June 2014, the Full Federal Court of Australia dismissed an appeal by Standard and Poors ("S&P") against a decision of a single judge of the Federal Court holding that, as a matter of Australian common law, a rating agency owes a duty of care to investors in a rated financial instrument.

The principal basis on which the Court reached this conclusion was that S&P knew that potential investors would rely on S&P's rating when making investment decisions.

The decision is understood to be the only common law case (in the countries to which New Zealand compares itself) in which a ratings agency has been found liable to compensate investors for losses suffered as a result of negligently rated products in the wake of the Global Financial Crisis.

\* Stuart Dalzell, Partner and James Wollerman, Senior Associate discuss the decision – *ABN Amro Bank NV v Bathurst Regional Council* [2014] FCAFC 65.

### Background Facts

- ABN Amro is an investment bank. In 2006 it created a financial product which it called the *Rembrandt Notes* and proposed to sell to investors.
- Rating Agency Standard & Poors (S&P) was asked by ABN Amro to provide a rating for the Rembrandt Notes. S&P gave the Rembrandt Notes a AAA rating which was found by the Court (and accepted by S&P on appeal) to be flawed.
- ABN Amro marketed and sold the Rembrandt Notes to a company called Local Government Financial Services Pty Ltd (LGFS). LGFS sold on a large portion of the Rembrandt Notes it had purchased to local councils in New South Wales (the Councils).
- The Councils lost large amounts of money which they had invested in the Rembrandt Notes. Accordingly,

the Councils sought damages from ABN Amro, S&P and LGFS bringing claims for misleading and deceptive conduct and claims in negligence (amongst others). The primary Judge found in favour of the Councils.

On appeal, the Full Federal Court described the complexity of the appeal where ABN Amro, S&P and LGFS 'put in issue just about every finding of fact and conclusion of law made by the primary judge and for the most part pursued each allegation of error with undiscriminating vigour'. Additionally, there were various cross-claims, contributory negligence and proportionate liability issues argued between the parties.

This case note does not attempt to canvass the entire judgment, much of which involves analysis of statutory claims under Australian legislation. Rather, the following comments are focused on the Federal Court's analysis and finding that S&P owed and breached a duty of care to the Councils as investors in assigning a AAA rating to the Rembrandt Notes.

### Purpose of Rating

As explained by the Full Federal Court, the purpose of a Rating is to describe the likelihood that the principal and the interest due under a financial instrument will be paid in accordance with the terms of the instrument. The stronger the rating, the more likely the instrument is to meet its financial commitment. S&P defines its AAA rating, which is the highest possible rating it provides, as 'the obligor's capacity to meet its financial commitment on the obligation is extremely strong'.

### Claim in negligence Duty of care

The duty of care the primary Judge found that S&P owed the Councils (upheld by the Full Federal Court) was a duty to exercise reasonable care in forming, and to have reasonable grounds for, the opinion expressed by the rating it provided.

It was held that the AAA rating conveyed a representation that, in S&P's opinion, the capacity of the Rembrandt Notes to meet its financial obligations was 'extremely strong', and a representation S&P had reached this conclusion on reasonable grounds and as a result of the exercise of reasonable skill and care.

### Arguments raised by S&P on appeal

S&P argued (unsuccessfully) on appeal that it did not owe a duty of care to the Councils for the following reasons:

- It was not reasonably foreseeable that S&P's conduct would cause loss/damage to the Councils;
- The salient features of a duty of care were not present;
- The special prerequisites for a duty in negligent misstatement were not present.

It was also argued that a duty should not exist in circumstances where Councils were in breach of the Local Government Act in investing in the Rembrandt Notes. However, the following comments focus on the formulation of the duty and arguments for and against the imposition of the duty.

### Formulation of the Duty

The Full Federal Court, set out the applicable principles for a duty to exercise reasonable skill and care when providing a statement or giving advice. In summary:

- The maker of the statement must realise, or the circumstances must be such that the speaker ought to have realised, the recipient intends to act on the information or advice;
- It must be reasonable for the recipient to rely on the advice in the circumstances;
- There must be an assumption of responsibility by the maker of the statement or known reliance on the statement;

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- A duty is imposed when information or advice is communicated to an identifiable class of people;
- The fact that a person making a statement has some special expertise is consistent with a duty (but not always necessary for a duty to be imposed).

The Court rejected S&P's arguments that the elements of a duty had not been made out. Nineteen of the key factual findings are set out in the Full Federal Court judgment at [580] and include (amongst other relevant findings):

- S&P was paid money knowing the only purpose of the rating was to facilitate the marketability of the product. The sole purpose of the rating was to communicate it to potential investors;
- S&P had specialist expertise;
- S&P knew that investors would rely on the rating as the only independent evidence of risk of loss on an investment;
- S&P expressly and unconditionally authorised the dissemination of the AAA rating to interested parties.

Turning to the issue of foreseeability, the Court found the loss to the Councils was foreseeable as part of a class of investors who would rely on the rating (and could not otherwise assess the creditworthiness of the Rembrandt Notes themselves) and were exposed if the notes were not creditworthy as S&P represented.

In summary, the Court upheld the findings that S&P knew that potential investors would rely on S&P's rating as to the creditworthiness of the Rembrandt Notes and that it was reasonable for the Councils to rely on that rating.

Three arguments raised by S&P were considered in some detail by the Court, including indeterminacy of liability, vulnerability (or lack thereof) of the Councils and the absence of a contractual relationship.

#### **Indeterminacy**

A key argument raised by S&P was its lack of knowledge as to the identity or the number of the actual investors in the Rembrandt notes.

S&P noted that it publishes tens of thousands of opinions each year with

anyone, anywhere being able to access S&P's opinion. In the circumstances, S&P submitted that no duty should be imposed as its liability would be too indeterminate and the effect '*would be to turn predictions about the future into guarantees*' essentially for anyone.

The Court rejected this submission as ignoring established legal principles. The Court found that liability was not indeterminate. Although S&P did not know the precise identity or number of members in the class or the exact loss, S&P knew the *characteristics of the class* and that each member was a Rembrandt Note investor. S&P also knew the foreseeable *type* of loss. The size of notes issued, the minimum level of subscription, the fact that investors would rely on the Rating and that there was a 10 year period to the maturity of the notes were all relevant matters known to S&P.

#### **Vulnerability**

S&P submitted that the Councils were not vulnerable because they were capable of protecting themselves from the loss suffered and therefore no duty of care could arise.

Revisiting the legal principles, the Court noted that vulnerability is the consequence of knowledge of reasonable reliance for a claim in negligent misstatement. It is not an additional criteria which is required to establish a duty of care.

The Court found that S&P knew an ascertainable class of investors would rely on S&P's conduct and in particular S&P's specialised expertise. The Councils could not 'second guess' the Rating provided or undertake their own analysis of the credit risk of the Rembrandt Notes. Accordingly, the Court found the Council were vulnerable as they were not capable of protecting themselves against the loss suffered.

#### **No contractual relationship or direct dealing**

The lack of a contractual relationship and the absence of any direct dealing between the Councils did not negate the existence of a duty of care.

While S&P had no contractual relationship with the Councils, the contract between S&P and ABN Amro did not exclude liability to non-parties. Importantly, the rating letters provided by S&P described the ratings as '*public ratings*', authorised the ratings to be disseminated to interested parties and reserved the right for S&P

to inform its own clients and the public of the rating.

The lack of direct dealing did not preclude a duty as it was inconsistent with principle that a duty can be owed to a class and the established principle that a duty can be owed regardless of whether there is a direct relationship between the parties. Additionally, the Court noted the '*real nature*' of the transaction between S&P and ABN Amro (the contracting parties) was to provide a Rating to be communicated to '*interested parties*' that may be willing to invest.

#### **Relevance of case in New Zealand**

*ABN Amro v Bathurst Regional Council* is the first common law decision where a rating agency has been found liable to investors on the basis of a negligently issued credit rating. While any case brought must depend on its particular facts, *ABN Amro* provides some guidance as to how Courts in New Zealand may approach the assessment of the existence of a duty of care owed by a credit rating agency to investors.

Any assessment will be based on whether it is *fair, just and reasonable* that a duty be imposed in the circumstances. In light of the comments provided by the Full Federal Court, it is anticipated that the factual analysis of the information provided (whether the advice is restricted or unrestricted), whether there is an *ascertainable* class of investors and the vulnerability or knowledge of reliance of the class on the advice provided will be of particular relevance. The contractual relationships (or lack of) will also be relevant to the existence of a duty (see, eg, the NZ Court of Appeal decision in *Rolls Royce New Zealand Ltd v Carter Holt Harvey* [2005] 1 NZLR 324). However, the simple absence of a direct contractual relationship is unlikely to be seen as negating a duty.