

Credit crunch: does anyone owe a duty of care to investors?



BY TIM
HOWE QC
Fountain Court
Chambers



BY NIK YEO
Fountain Court
Chambers

THE 'CREDIT CRUNCH' IS HAVING SUCH WIDESPREAD effect within, and beyond, the banking sector that the natural reaction of companies caught up in it and wishing to explore their legal remedies or their defences might be 'Where on earth do we start?'. This article looks at the core of the credit crunch, a core that is well known to those in the capital markets: securitisations.¹

An investor holding structured debt instruments issued in a securitisation might look to those that sold it the instruments (managers), or those who structured the investment (arrangers),² and ask whether the manager/arranger acted reasonably or, if not, whether they are therefore liable in negligence. This article focuses on the question – highlighted by a recent case in the Commercial Court but yet to be clearly established in English law – of whether an arranger and/or manager of an issue of such debt instruments owes investors a duty of care.

Such debt instruments are either directly or indirectly issued on the basis of an underlying portfolio of assets (including other debts themselves). Securitisation enables the pooling of such assets and, crucially, the tranching of debt. Tranching has meant that underlying assets that might be sub-investment grade can be used to support debt instruments that are investment grade. This is done by issuing a prioritised slice (or tranche) of debt on the basis of those assets (equivalent to, say, 20% of the value of the entire portfolio) and by diverting cash from the entire portfolio to service that debt, while at the same time forcing lower-ranking tranches to suffer compulsory pre-payment if the underlying portfolio shrinks. If the prioritisation of the tranches is structured properly, the rating agencies have often been happy to give an investment-grade rating to the top-ranking tranche or tranches.³

Underlying the credit crunch are doubts over the value of investment-grade structured debt instruments issued through securitisations and like structures, given that some (but certainly not all) of these multi-tranche issues have suffered unexpected levels of default affecting even the top-rated tranches.

LIABILITY OF ARRANGERS AND MANAGERS

Since securitisations involve the financial re-engineering of debts of one sort (say, TV rights for the broadcast of Formula One racing, leasing payments from the hire of rolling stock to train operating companies, sub-prime residential mortgage debt) into tranches of debts of entirely different kinds, it is unsurprising that both the commercial and (thus) the legal structures are

immensely complex, with a corresponding complexity in the documentation required to give them effect. It is similarly unsurprising, therefore, that errors might creep into the structuring, documentation or sales information (written or oral). What sorts of statements or actions by arrangers or managers might give rise to potential liability? There may, for example, be statements as to:

- 1) the past performance of the assets that were securitised;
- 2) the projected future performance of those assets;⁴
- 3) the nature of any due diligence carried out on those assets for the purposes of either 1) or 2);
- 4) the nature of the financial modelling or stressing used in determining 2);
- 5) the nature and effect of the structure, including the extent of subordination of other tranches and the way in which the 'cashflow waterfall' operates.

The selling manager may have dealt with the investor directly and made such statements orally, but in any case it is likely to have provided certain written material, such as an offering circular, to the investor.⁵ The offering circular may contain such statements. Even if the arranger has not dealt with the investor directly, it will have had a guiding hand in the compilation of the offering circular, which is likely to have both the arranger's and managers' names on the front of it. However, their responsibility for the contents of the offering circular is far from straightforward.

ESTABLISHING A DUTY OF CARE

It is necessary first to set out the tests for establishing a duty of care before examining the regulatory regime governing offering circulars, and then turning to the most recent reported case in this area.

Three tests have been used in considering whether a duty of care is owed in tort by a defendant for pure economic loss.

- a) The first is whether, objectively,⁶ the defendant assumed responsibility for their words or conduct in relation to the claimant, or is to be treated as having done so (see *Henderson v Merrett Syndicates Ltd* [1995]). If this test is satisfied then there is no need to consider the other tests. (See also *Lord Bingham in Commissioners of Customs & Excise v Barclays Bank plc* [2007], para 190.)

- b) The second requires the claimant to show three things:
 - i) that the loss was reasonably foreseeable;
 - ii) that there was a relationship with the defendant of sufficient proximity; and
 - iii) that the imposition of a duty would in all the circumstances be fair, just and reasonable (see *Caparo Industries plc v Dickman* [1990]).
- c) The third is the incremental test. That test – that new categories of negligence should be developed incrementally and by analogy with established categories – is of limited assistance, since it does not provide any qualitative criteria by which to measure whether a duty should be held to arise (see Lord Bingham in *Barclays Bank*, para 192). But it may well operate as a brake to recovery.⁷

RESPONSIBILITY FOR OFFERING CIRCULARS

Turning to the regulatory regime governing offering circulars: although the regulatory position⁸ in relation to non-equity securities offered to the public or listed in London envisages that anyone ‘who has authorised the contents’ of an offering circular will be responsible, the situation is different for debt instruments issued in a securitisation. They will typically be exempt transactions under the Financial Services and Markets Act 2000 and (even if listed in London) will be ‘specialist securities’, in that they are dealt with in a ‘professionals-only market’ in which the experienced and sophisticated participants can be expected largely to look after their own interests.⁹ In these circumstances, the regulatory regime (at the very most) only pins responsibility upon those who expressly state that they accept responsibility for the offering circular, and the regulations only require that at least one person must be named as accepting responsibility. In practice, that one person is almost invariably the issuer.

Role of banks

While for non-exempt/non-specialist securities it might be argued that those who have ‘authorised the contents’ of the document (and hence are responsible for it) include arrangers and managers as a result of their (typically, at least) appending their names to the bottom of the first page,¹⁰ the same is clearly not the case in relation to debt instruments issued in a securitisation. In particular, it is highly unlikely that any duty of care will arise as a result of any relationship between manager/arranger and investor by dint of the offering circular itself. For example, the title ‘manager’ or ‘co-lead manager’ may be given to a bank (and reflected on the face of the offering circular) primarily for that bank’s own marketing purposes and

as a condition of that bank’s own investment, rather than as recognition that that bank is itself intended actively to pursue further investors. It will hence rarely be sufficient merely to point to the fact that a bank is a manager or arranger in order to fix it with a duty of care to investors to ensure the accuracy of the offering circular.

Banks’ own due diligence

An investor who is also appointed as ‘manager’ will probably do its own due diligence prior to agreeing to become an investor/manager. But, for the reasons outlined above, it will rarely be sufficient to point to the fact that such due diligence has been carried out to show that the investor/manager owed a duty of care in respect of the completeness of such due diligence to other investors to whom the investor/manager may sell in the after-market.

WHEN MIGHT A DUTY OF CARE ARISE?

Nevertheless, a duty of care might arise by a manager or arranger voluntarily assuming responsibility for the correctness of what is said (the first test outlined above). The fact that the regulatory regime does not attribute responsibility for securitisation offering circulars to managers or arrangers is not conclusive in this context.¹¹ In the absence of an express disclaimer of responsibility by the manager/arranger, the way is open for courts to conclude (in the individual circumstances of any given case) that a manager/arranger did in fact assume responsibility for providing a particular answer to a particular investor’s question that the manager/arranger knew was required for a particular purpose (whether that answer is provided orally or by means, say, of the provision of the offering circular).

Boxclever litigation

The question of what duties of care were owed by managers and arrangers to investors was raised in the Boxclever litigation in the Commercial Court. Here, the French bank Natixis – which had purchased notes issued in the securitisation of the Boxclever group (the merger of the Radio Rentals business and Granada’s brown-goods hire business) – alleged among other things that Canadian bank CIBC as co-lead manager, from whom it purchased the notes in the after-market, and German bank WestLB, as arranger and co-lead manager, owed it duties of care in relation to the offering circular. The litigation recently settled and so the Court never came to decide this issue.

IFE Fund SA v Goldman Sachs International [2007]

The most recent relevant reported English decision is *IFE v Goldman Sachs*, where Goldman Sachs (as arranger) provided to IFE (as a potential investor in

‘It is highly unlikely that any duty of care will arise as a result of any relationship between manager/arranger and investor by dint of the offering circular itself.’

debt facilities) a syndication information memorandum (SIM), which was akin to an offering circular. The SIM was inaccurate and IFE brought a claim against Goldman Sachs on the basis of a misrepresentation that, among other things, it was not aware of facts which might render the SIM

incorrect. The Court at first instance and on appeal held that no duty of care arose.

At first instance, Toulson J, after noting that the SIM was only issued to those who were ‘financially sophisticated entities operating in a specialist market’, held:

‘Goldman Sachs was not acting as an adviser to IFE or purporting to carry out any professional service for IFE, as the terms of the SIM made plain. It was acting for the sponsors and not on behalf of the recipients of the SIM. In general, a party involved in negotiations towards a commercial venture owes no positive duty of disclosure towards another prospective party. A duty of disclosure may be undertaken, but no such duty was undertaken in this case either expressly or impliedly. The expression “assumption of responsibility” has on occasions been used in cases where it would be more accurate to speak of the court imposing a responsibility, but I can see no ground on which it would be fair to impose on Goldman Sachs the duty of care contended for by IFE.’

Of significance in this case was an express disclaimer. Goldman Sachs had stated in the SIM that it had not ‘independently verified’ the information in the SIM and hence made ‘no representation’ as to the accuracy or completeness of the SIM. The Court of Appeal put particular emphasis on this disclaimer, Waller LJ describing any attempt to establish a duty of care in light of it as ‘hopeless’. That must be right. However, in the absence of such an express disclaimer, there may be circumstances (at least in theory) where a duty of care could arise.

LIABILITY OF SPECIAL PURPOSE VEHICLES (SPVs)

There may be a perception in the market that where (as is frequently the case) the issuer is an SPV, often incorporated in a fiscally-efficient jurisdiction and lacking any valuable assets, resources or substantive commercial (as opposed to legal) personality of its own, then the statement of responsibility by the issuer alone in an offering circular is tantamount to a legal fiction. There may be a perception that investors do not in reality take any comfort from or place any reliance upon the issuer in relation to the material aspects of the offering circular, or the transaction as a whole, but in practice look to the manager/arranger. If so, the courts are yet to grapple with these perceptions. When they do they will undoubtedly give weight to the fact that, despite an issuer’s lack of resources, were an investor to sue an issuer, the issuer in turn may have a cause of action against its advisers and agents (including managers and/or arrangers) and so it might be said that there is no need for the investor to have a direct right of

NOTES

- 1) For a good overview of the various forms of asset-based structured finance, see chapter four of *The Law and Practice of International Capital Markets* (Geoffrey Fuller, 2007, Butterworths).
- 2) The European Securitisation Forum ‘A Framework for European Securitisation’ (May 2002) states that arrangers are responsible for structuring securitisations, undertaking due diligence and being ‘responsible’ for the offering circular (para 2.2.22). However, the document makes clear that it is primarily ‘aspirational’; the extent of an arranger’s responsibility for offering circulars is considered in detail in this article.
- 3) The technique finds its parallel in the insurance world where it is very common to have varying ‘layers’ of cover, with the first layer bearing the risk, and proportionately greater premium, and the top layer being the least exposed.
- 4) There is obviously an issue as to whether any representation of fact (as distinct from opinion) is being made in this context.
- 5) Obviously, if the investor purchases in the ‘after-market’ – that is, after closing of the securitisation – then managers may have ceased to have any practical role; the investor will have purchased simply from another investor.
- 6) That is, the answer to the question does not depend upon what the defendant intended but, as in the case of contractual liability, upon what would reasonably be inferred from its conduct against the background of all the circumstances of the case: see Lord Bingham in *Commissioners of Customs & Excise v Barclays Bank plc* [2007], paragraph 199.
- 7) For example, it might be said, with some force, that where investors in structured debt instruments are experienced professionals then the cases in which duties of care have been extended to protect consumers or private individuals – such as *White v Jones* [1995] and *Smith v Eric S Bush* [1990] – are far removed and are irrelevant.
- 8) Provisions on listing documents in the EU Listing Directive (2001/34/EC) have been combined with the rules governing unlisted prospectuses by the second Prospectuses Directive (2003/71/EC) which was implemented by Commission Regulation 809/2004/EC. These enactments were then implemented in the UK by the Financial Services and Markets Act 2000. See in particular paragraph 5.5.3 of the Prospectus Rules made by the FSA and Regulation 6 of the Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations 2001 (the 2001 Regulations).
- 9) Under s86 of FSMA 2000 (eg, as a result of the instruments only being offered to ‘qualified investors’ or because the minimum consideration is €50,000) and Regulation 9 of the 2001 Regulations.
- 10) *Law and Practice of International Capital Markets* (Geoffrey Fuller, 2007, Butterworths, p241): the liability of arrangers and managers in this situation is at best an open issue.
- 11) It has been said that ‘the assumption of responsibility... is the defendant’s assumption of responsibility for the task, not the assumption of legal liability’ (Lord Browne-Wilkinson in *White*).

Caparo Industries plc v Dickman
[1990] 2 AC 605

Commissioners of Customs & Excise
v Barclays Bank plc [2007] 1 AC 181

Henderson v Merrett Syndicates Ltd
[1995] 1 AC 145

IFE Fund SA v Goldman Sachs
International [2007] 1 Lloyd's Rep 264;
[2007] 2 Lloyd's Rep 449

Smith v Eric S Bush [1990] 1 AC 831

White v Jones [1995] 2 AC 207

action against the manager/arranger. The difficulty for the investor is that it is unlikely to be aware of any limitation of liability agreed between the issuer and its advisers/agents.

WHETHER A REPRESENTATION WAS MADE

However, *IFE v Goldman Sachs* also illustrates another point: that the effect of a disclaimer as incorporated in the SIM will be to prevent any representation being made in the first place. Thus actions in that case for misrepresentation under the Misrepresentation Act 1967 also failed.

CONCLUDING COMMENTS

This article has not attempted to consider all the necessary elements of an action for negligent misstatement or under the 1967 Act, or under ss90 and 90A of FSMA. Even in a basic action for negligent misstatement there are other hurdles to consider, such as whether in fact the investor relied upon the relevant statements, and whether the investor was contributorily negligent in anything it did or failed to do (for example, in any of its own due diligence). Moreover, if an arranger (at one step removed from

the investor) were liable to the investor, there may be causes of action that the arranger might have against the manager who dealt directly with an investor (the manager might, for example, have been required, but failed, to obtain from the investor a release of liability that benefited the arranger as well as the manager).

In addition, there is the important question of whether the claimant has sufficiently mitigated its loss. In the present market conditions, this is likely to throw up many difficult issues of valuation and even causation that must be the subject of further discussion elsewhere.

However, so long as you keep in mind the complexity of the deals with which you are concerned, litigation arising out of the credit crunch need not involve the analytical difficulties that might at first sight seem inevitable.

By Tim Howe QC and Nik Yeo, barristers,
Fountain Court Chambers.
E-mail: th@fountaincourt.co.uk;
ny@fountaincourt.co.uk.