JUNE 2014

COMMENTARY

Rating Agency Liability to Investors Upheld by Australian Federal Court of Appeals

In a landmark decision, a bench of three judges of the Full Federal Court—which essentially acts as the Federal court of appeal in Australia—has, in *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, unanimously upheld a first instance decision which ruled that global ratings agency Standard & Poor's ("S&P") had breached a duty of care it owed to investors and had misled or deceived investors by assigning S&P's highest rating of AAA to a volatile structured finance product, known as constant proportion debt obligations ("CPDOs"), arranged by investment bank ABN Amro Bank NV ("Amro").

The particular CPDOs at issue in the case were sold by Amro as the "Rembrandt Notes". Twelve Local Councils in the State of New South Wales ("Councils") had invested in the Rembrandt Notes in late 2006 in reliance upon the AAA rating that S&P had assigned to the Rembrandt Notes. The Councils would not have invested in the Rembrandt Notes had they not had a AAA rating.

Less than two years after purchasing the Rembrandt Notes, the Local Councils lost more than 90 percent of their original A$17 million invested in them due to the Rembrandt Notes' very high level of volatility.

S&P accepted on appeal that the AAA rating it had assigned to the Rembrandt Notes was flawed.[1] In respect of the process undertaken by S&P to assign a AAA rating to the Rembrandt Notes, the Court concluded that "S&P's rating of the Rembrandt notes was unreasonable, unjustified and misleading (and ABN Amro knew that to be so)",[2] as the rating, the Court held, adopted a flawed base case volatility parameter—that is, S&P assumed the Rembrandt Notes were much less volatile than they should have assumed—and adopted other overly favourable assumptions.

Claim for Negligent Misstatement

The Councils claimed, and the Court agreed, that S&P owed them, as investors in the Rembrandt Notes, a duty to exercise reasonable care in forming, and to have reasonable grounds for, the opinion expressed by the rating.[3]

In upholding the Council's claim, the Court ruled that S&P's function was to rate the notes and, in particular, a certain aspect of the Rembrandt Notes—their creditworthiness. S&P knew that its function was specialised and that the members of that ascertainable class were likely to rely on S&P carrying out its function.[4]

Indeed, the only available information as to the creditworthiness of the notes was S&P's rating. None of the Councils could replicate or "second-guess" S&P's rating or undertake its own analysis of the credit risk of the Rembrandt Notes.[5]

S&P's duty was to exercise reasonable care in forming and expressing the relevant opinion about the credit risk of the Rembrandt notes. It was in that respect, and that respect alone, that S&P owed a duty of care to the Councils.[6]

S&P did not know the precise identity of the Councils. Nevertheless, the Court held, the class to which the Councils belonged was not indeterminate. It was both known and identified. The class to which the duty was owed was investors in the Rembrandt Notes.[7]

The Court also held S&P knew the foreseeable type of loss.[8] It is the nature of the loss, not the precise amount, which is relevant. Here, the Court held, the nature of the foreseeable loss was not in doubt. S&P knew that if S&P's opinion as to the creditworthiness of the Rembrandt Notes was careless, investors were likely to lose the money they had invested in the notes. And, in that context, S&P knew that based on the size of the notes issued and the level of minimum subscription, investors would rely on S&P's ratings and the 10-year period to the maturity of the notes.

The Court rejected arguments that the Councils were contributorily negligent.

As there were two other defendants who were also found to have breached their duties of care to the Councils, the Court apportioned S&P's liability arising from this cause of action as a third of the Councils' losses and a third each to Amro and another defendant.

Claim for Misleading or Deceiving Investors

The Court also held that S&P's rating of AAA, in contravention of a multitude of statutory provisions, was misleading and deceptive and involved the publication of information or statements false in material particulars to the class of potential investors in Australia, which included the Councils.

The statements were held to have been false because by the AAA rating there was conveyed a representation that in S&P's opinion, the capacity of the notes to meet all financial obligations was "extremely strong". The rating was also a representation that S&P had reached this opinion based on reasonable grounds and as the result of an exercise of reasonable care and skill. Neither of these representations was true, and S&P also knew them not to be true at the time they were made.

Amro

Although this update focuses on the position of S&P, as alluded to above, the Court was also critical of Amro. Amro was found to have inappropriately influenced S&P and misrepresented information that S&P then relied upon in formulating its incorrect AAA rating of the Rembrandt Notes. Moreover, the Court also ruled that Amro itself engaged in misleading and deceptive conduct and had breached various other fiduciary and contractual duties owed by them.

What's Next?

This judgment has serious implications for rating agencies. S&P and Amro may now seek special leave to appeal to the High Court of Australia, the highest court in this country. If judgment stands, it can be expected to encourage other investors in other jurisdictions to pursue ratings agencies. Elsewhere, for example, S&P already faces billions of dollars in litigation arising from ratings assigned in the lead-up to the credit crunch.

The decision could also lead to significant reforms by financial services regulators in order to "crack down" on the inherent conflicts that presently exist between investment banks and ratings agencies in the arrangement and rating of financial services products.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

Steven W. Fleming
Sydney
+61.2.8272.0538
sfleming@jonesday.com

Paul A. Smith
Sydney
+61.2.8272.0521
pasmith@jonesday.com

Endnotes

1 At [1].

2 At [563].

3 At [1260].

4 At [1265].

5 At [1265].

6 At [1266].

7 At [1260].

8 At [1260].