Common Law and the Making of Financial Markets: Credit Ratings Agencies as a Test Case

Joshua Getzler (joshua.getzler@law.ox.ac.uk) and
Alexandra Whelan (alexandra.whelan@new.ox.ac.uk)
Law Faculty, University of Oxford

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A. Investor Protection Law: The Changing Content of Trusteeship

We shall *not* begin with some large observations about 'Legal Origin' and the contested question of how law might influence the comparative performance of financial systems. Let us rather begin with a common lawyer's more manageable practical question: how can the law develop workable, litigable rules to measure the duty and standard of care owed by financial intermediaries to clients?

The fiduciary standard and its limits

The fiduciary standard evolved within trust and agency law goes some way to buttress due levels of care owed by investment managers by a negative strategy of cutting away distractions that could corrupt performance. The fiduciary standard aims to focus the attention of a manager of client money exclusively on the interests of the client and not the manager's own profits or the interests of rival clients. But the classical no-profit and no-conflict duties are easily eliminated by contract or trade custom; and parties may reasonably believe that the fiduciary standards actually get in the way. An intermediary may do better if permitted to achieve economies of scale and informational efficiencies by engaging with a large group of clients whose interest are not perfectly aligned; and a manager may also do better if their own profits are aligned with those of their clients. Since these are judgment calls to which no a priori answer is assured, the law has recently allowed free contracting decide where the fiduciary balance should be struck. The courts have also made clear that the fiduciary standard – at least in today's Anglo-Commonwealth law – does not yield any distinct standard of positive performance of investment or managerial functions. The duties of care of investment managers in the common law such as they exist are remarkably obscure in source; they may be concurrently tortious, contractual, or equitable in source, but in any case the positive duty of investment care is seen as a voluntarily assumed obligation, and as such may readily be excluded, displaced or reduced by agreement or custom. Even when such a positive duty is not cut back, it has proved very difficult to make such standards stick in ex post litigation addressing investment failures. The closest the common law in England has come to addressing this point was the Unilever Superannuation case of 2001, a £130 million claim brought against Mercury Asset Management for engaging in risky investment strategies alleged to fall outside the terms of the investment mandate agreed by the parties.[1] The case ended abruptly in a confidential settlement estimated at some £70 million, after 28 days of

[1] 'The Unilever/MAM Case: What are the Issues for Pension Scheme Trustees?' (Herbert Smith, London, 6 February 2002); David Blake, *Pension Schemes and Pension Funds in the United Kingdom* (Oxford, Oxford University Press, 2003) 538-547.

trial, with legal costs in the region of £5 million. Mr Justice Colman in ratifying the settlement expressed regret that the controversy had not been settled earlier through mediation, though he was relieved to be excused from writing a lengthy judgment. An alternative source of regret is that the issues of duty of care for financial intermediaries were not clarified by a legal judgment showing how the law could sanction breach of instructions and excessive risk taking by investment managers.

Modern legislation controlling fund management deals with control of investment discretions by instituting default performance norms pegged at professional levels of care. These can vary according to legal form, with trust, corporate or pension vehicles attracting differential standards. For example the Trustee Act 2000 s 1 states that a trustee –

> must exercise such care and skill as is reasonable in the circumstances, having regard in particular—
> (a) to any special knowledge or experience that he has or holds himself out as having, and
> (b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

However, Schedule 1 of the Trustee Act allows liberal contracting out from such a duty, and exclusion is very common in trust instruments. By contrast the Pensions Act 1995 s 33 prevents contracting out of 'any rule of law to take care or exercise skill'. However by permitting liberal delegation of decision-making to actuaries and investment advisers the legislation in practice makes liability for investment losses for pension trustees very difficult to establish. Thus *dilution* of liability by utilizing chains of delegation turns out to be practically effective, if more complex form of contracting out than direct and explicit *exclusion* of duty.

In the wake of the reshaping of fiduciary duties and duties of care by the courts and legislature, English law now applies situation-specific duties of care for investment managers, commonly overlaid by contract, allowing parties to price and set governing norms at will provided they use due bargaining procedures. Courts and regulatory agencies must then interpret and balance the initial default terms and overlaying contract norms, and will tend to excuse poor performance unless the setting of initial norms, or the execution of those norms, falls below the standard of any conceivable reasonable agent. The result is very few successful actions to discipline substandard investment managers.

Defining value in economics and law

Even if the law returned to its earlier protective mood, and boldly applied a rigorous, non-delegable, non-excludable duty of care – what should that standard of care ideally comprise? This is not simply a problem of legal grammar, but also of economic logic. The setting of standards in financial law is hampered by the difficulty of fixing the values that are being protected and describing a due process for that protection. Present asset values are intrinsically volatile or even arbitrary because prices are stated as a multiple of expected earnings over a stated time period where future profit and depreciation rates are set by wider equilibria and power relations in the economy that can only be estimated by observing return-

to-capital and income-multiple values in a partial sector.[2] Keynes illustrated the macro uncertainties of prices based on expected market values with the metaphor of a market-driven beauty contest, where each judge votes according to a guess as to how the other judges will vote. The instability inheres in that values determined by the market amount to mutual predictions of how others may value the asset over time. Because these predictions are reciprocal and constantly feed each other, financial prices are prone to bubbles, manias, crashes, herding and cascades.

The problem of volatile asset prices was well understood in the Age of Enlightenment by lawyers observing the rise of financial markets on the back of bond and securities trading and commodity futures. Mere falls in value, for example, in the wake of the pricking of the South Sea Bubble in 1720, could not be said to involve a breach of duty by an investment intermediary, who was merely investing in the same manner as every other market participant. Even the steepest losses could not be blamed on the individual investment agent or trustee, who was blindsided by shifts that hurt entire swathes of investors in a depressed market. In 1737 Lord Chancellor Hardwicke observed:[3]

> This is a mere falling of stock without the trustees' neglect … it is well known, that during the golden dream, people were so infatuated as to look upon imaginary wealth as equally valuable with so much money.

A decade later Lord Hardwicke further developed his theory granting immunities to intermediaries, on the alternative moral ground that trustee managers tended to be volunteers acting to protect the interests of friends or family as an act of grace, and should not be held accountable for misfortune or miscalculation in volatile markets as they were not paid to be insurers, and would not serve if they could so be held liable:[4]

> Suppose a trustee, having in his hands a considerable sum of money, places it out in the funds, which afterwards sink in their value; or on a security at the time apparently good (which afterwards turns out not to be so), for the benefit of the *cestui que* trust, was there ever an instance of the trustee's being made to answer the actual sum so placed out ? I answer, No. If there is no *mala fides* ,—nothing wilful in the conduct of the trustee, the Court will always favour him. For as a trust is an office necessary in the concerns between man and man, and which, if faithfully discharged, is attended with no small degree of trouble, and anxiety, it is an act of great kindness in any one to accept it: to add hazard or risque to that trouble, and to subject a trustee to losses which he could not foresee, and consequently not prevent, would be a manifest hardship, and would be deterring every one from accepting so necessary an office. This is my opinion upon the case had the trustees themselves acted.

[2] This conundrum was heavily modelled in the course of the 'Cambridge Capital Controversies' of the 1960s, reviewed at length in Christopher Bliss, Avi J Cohen, and Geofrey Harcourt (eds) *Capital Theory*, 3 vols (Cheltenham, Glos., and Northampton, Mass., USA, Edward Elgar Publishing Limited, 2005) I-III.
[3] *Jackson v Jackson* (1737) 1 Atkyns 513 at 514; 26 ER 324 at 325.
[4] *Knight v Earl of Plymouth* (1747) Dickens 120, 127; 21 ER 214, 216; SC (1747) 3 Atkyns 480; 26 ER 1076.

Two possible legal solutions were developed by the Court of Chancery after Hardwicke, in the time of Lord Eldon in the early nineteenth century, to guide more securely trustee investment in the face of financial market volatility. The prime strategy was to ordain that trustees not enter into volatile markets at all unless protected by a deep margin of capital to afford insurance; Eldon identified two main permitted investment classes for trustees being land mortgages at two-thirds value maximum (but not direct land investment); and bonds in monied companies including the Bank of England, the East India Company, and (later) publicly supported utilities, as guaranteed by the state fisc. The alternative strategy was to permit sophisticated investors who were willing to seek returns in more volatile asset classes without security of capital or income to give an informed consent for their intermediaries to enter into markets for stocks, bonds and futures on a representative basis, with allocations and risks controlled by the principal. In a further step, the principal could bestow the investment agent with powers to choose investments, delegating discretion and control a further step. The rise of portfolio investment allowing investment returns to be smoothed through aggregation of inversely correlated and non-correlated asset classes held in intermediated funds promised the best of both worlds, giving security from capital loss together with the fullest access to the most entrepreneurial parts of the economy. Futures and derivative trading seemed to add to the sophisticated blend of entrepreneurship and smoothing inaugurated by portfolio trading. Provided principals understood the nature of the risk and consented to the delegation of investment powers and discretions and the use of more complex investment strategies, market arbitrage would then be the most effective guide to value, and the law would need make no further evaluations of performance. With time the secondary approach – consent to full market exposure of assets with allocation discretions vested entirely in delegated managers utilizing a chain of experts – became the dominant strategy. Eldon's old approach, the issuing *dirigiste* investment lists giving trustees safe harbour in a treacherous world of undeveloped and crisis-prone capital markets, was whittled away piece by piece in the USA and UK, and finally eliminated by legislation in the late 20th century. Provided the intermediary's strategies were 'prudent' in light of standard market practice, that is not unreasonable compared to what other agents were doing, then normally no liability could be attached even if losses were suffered. Investors who wished for further protection could simply by narrowing their agents' investment powers such that breach of instruction causing loss could be sued on the basis of breach of contract and excess of powers – thought courts have recently made it more difficult to prove that even a blatant breach of instruction can be said to be the legally effective cause of loss where counterfactual reasoning might suggest that other effective causes are present.[5]

Thus some version of the efficient market hypothesis infiltrated and transformed fiduciary investment law over the past century, whether the lawyers (especially the English ones) appreciated the intricacies of the underlying economic theory or not. But how was the theory to be 'operationalized' in the course of litigation? How could intermediaries establish that large investment losses suffered during sharp downturns, seemingly betokening a blindness to severe risk, could be judged as a valid exercise of *ex ante* market prediction? And there was a problem of *ex post* valuation also, since a mark-to-market pricing regime at the time of litigation to recover loss might fail to register the longer-term values of assets that could be predicted to rebound in value in due course. Who was to explain to the court the

[5] See *AIB v Mark Redler* [2014] UKSC 58 and the large debate that has been provoked by that decision.

reasonableness of prospective market predictions made by investment managers that later went wrong?

B. Credit ratings agencies: from expert witness to regulatory licence

Origins as financial almanac, then as probative evidence

The credit rating agencies began as publishers of financial journals or manuals conveying information about stocks and shares and factor prices for the public, much in the manner of the back financial pages of the *Wall Street Journal*, the *Financial Times* or *The Economist* or the various *Bloomberg* services today. Perhaps a better analogy would be the nineteenth century almanacs published to provide up-to-date information for a certain interested audience, be they farmers or sports fans or nature lovers. The story of the credit rating agencies as a set of institutions distinct from the financial press begins in 1860 with the publication of Henry Varnum Poor's *History of Railroads and Canals in the United States*, followed by Poor's more contemporary *Manual of Railroads and Canals in* 1868. Poor's work provided the trailblazer, digesting reams of detailed information extracted from state and company reports, covering such matters as the number of miles of railroad construction, gross costs and profits, company structure and manpower, and indices calculating key capital rations such as net earnings to cost, net earnings to gross, and stocks to bonds. Poor's *Manual* later expanded to embrace corporate stocks beyond the rail industry and also public and municipal bonds. It was followed by Moody's *Manual* (from 1900), *Standard Statistics* (from 1906) and Fitch's *Stock and Bond Manual* (from 1914). The business model of these publishers was to sell financial data to the buying public, and the statistics, analyses and ratings in these manuals soon were regarded as authoritative not only for business decisions, but also in legal affairs. Flandreau and Sławatyniec have shown how the ratings could be used in court to verify static and dynamic stock prices in litigations ranging from tax cases to insolvencies to derivative corporate actions. But the most common early twentieth-century cases included trials of trustees, agents and fund managers for fraud and incompetence in acquitting their investment functions. The rating agencies' publications including the prospective ratings of stocks and bonds were taken by courts to represent a kind of expert witness in written form, and attempts to throw out such evidence as mere opinion or hearsay were rebutted. The judicial notice accorded to the ratings agencies solidified their reputation still further and gave both the data and the ratings – denoted in letter form with AAA at the top as High Class and BBB as Good – authoritative legal status, much as the *Farmer's Almanac* weather reports could be cited in court to prove what the weather had been doing on any day in question.

As a peg of value in crisis

The buyer-oriented status of the rating agencies was thus well-established prior to the Wall Street Crash of 1929 and the ensuing bank crisis of 1931. On 11 September of that year, in the wake of a slump in the value of bank assets that threatened the entire financial system, the Federal Comptroller of the Currency William Pole, who had the oversight of the national banking sector, announced that he would no longer value bank assets by 'mark to market' measures, since markets were so deeply depressed. Rather he would take at face value assets including US Government, State and Municipal bonds and all bonds enjoying any of the 'first four ratings by statistical corporations', as Moody's, Poor's, Standard Statistics and Fitch and

the like were then described. All other securities fetching lower grades from the rating agencies were marked to market.

'Regulatory licence'

The Great Depression was surmounted, American capitalism grew strong again in the way years, and emerged as the dominant global economic force in the late 1940s. The three major rating agencies (Poor's did poorly in the later 1930s and merged with Standard in 1941) now transmogrified their role for the fourth time, and became a marketing tool for issuers selling complex stock into a crowded investment market. The new role of the rating agencies requires some careful unpacking, and it must be remembered how they had begun first as a source of public information paid for by buyers, then won legal status as a source of durable expert financial evidence of probative force in court, and then in the Great Depression used as a pricing tool in time of crisis by regulators. The economist Frank Partnoy labelled the fourth phase of the agencies as the moment they had achieved a 'regulatory licence' – a monopoly power to charge a fee to certify all significant stocks offered to the market. The crucial changes in the postwar period were twofold: first, the public requirement that certain key financial institutions, such as municipalities and government organs, and also private institutions with systemic importance, such as the larger banks, insurers and pension funds, could only buy secure financial assets with a suitable risk certification from a publicly recognized rating agency. The second shift was the propensity of issuers to pay the rating agencies to certify their issues. We will take these developments in turn.

Gatekeeping and monopoly power

The complexity of ratings operations has led to concentration of ratings operations in the Big Three firms, namely Standard and Poor, Moody's, and Fitch, who between them control over 95% of the business in the U.S. and much of the non-U.S. business also. Just the first two firms cover 40% of the U.S. market for ratings each, or 80% between them.[6] Part of the market power of the three firms lies in public law requirements in the U.S. that their ratings be sought before certain large investors with a public role or public protection enter into any asset trades, for example, insurance and pension funds or government instrumentalities. We have seen how in 1931 the Comptroller of the Currency relied upon ratings to fix the values of the stronger securities held by banks outside instant market valuations, as a regulatory policy to rebuild business confidence. Then in 1936 the policy was extended from an emergency defensive measure announced in a memorandum, and instead launched as a formal proactive policy: the Comptroller prohibited banks from investing in securities less than 'investment grade' as determined by the manuals of the rating agencies, identifying today's Big Three as the key gatekeepers.[7] A further step was taken in 1975 when the Securities and Exchange

[6] Claire A Hill, 'Rating Agencies Behaving Badly: The Case of Enron' (2002) 35 *Connecticut Law Review* 1145.

[7] Eg United States Comptroller of the Currency, Purchase of Investment Securities, and Further Defining the Term "Investment Securities" as Used in Section 5136 of the Revised Statutes as Amended by the "Banking Act of 1935," Section II (February 15, 1936); Commodity and Securities Exchanges, Title 17, *Code of Federal Regulations*, section 240.15c3-1 (1998). See further Council for Foreign Relations, 'The Credit Rating Controversy', 19 February 2015; Lawrence J White, *A Brief History of Credit Ratings Institutions* (George Washington University, Mercatus, 2009); Richard Sylla, 'A Historical Primer on the Business of Credit Ratings', in Levich et al (eds), *Ratings, Rating Agencies and the Global Financial System* (2002), above n 16, 19-40; draft version at www1.worldbank.org/finance/assets/images/historical_primer.pdf.

Commission designated Moody's, Standard and Poor, and Fitch as 'Nationally Recognized Statistical Rating Organizations' (NRSROs) whose ratings were essential for certain investors to buy safe asset classes. Another source of monopoly position was the practical difficulty of entry for rivals, as the demands for gathering and assessing data and making ratings calculations integrating the fullest array of market information are technically formidable. To get some sense of the scale of the operations by the end of 2013 – after five years of financial disruption and deleveraging – Standard and Poors had live ratings on some 1.1 million issues, Moody's on 900,000. By 2010 there were ten publicly recognized ratings agencies in the U.S., but the Big Three now controlled 97% of the U.S. market for ratings, worth $3 billion a year, and also perhaps half of the non-U.S. market, worth another $3 billion.

The ratings agencies grew to still greater importance and profitability as financialization of the economy accelerated in the 1970s. Their growth was helped by strong economic incentives that helped *prevent* competition. Players in investment markets expected ratings from Standard and Poor or Moody's as an imprimatur of best practice, with Fitch ratings used as a tie breaker when the Big Two made widely varying assessments. Buying an investment grade or AAA security would of itself acquit an investment manager of the duty of prudent exercise of discretion. Conversely on the issuers' side a failure to hire a ratings agency could lead to a risk of an unsolicited rating that could badly damage an issuing business's credit. In a notorious case Hannover Re, a large German insurer, was invited by Moody's to contract with it to rate its bonds. Hannover Re already had longstanding relationships with Standard and Poor and AM Best (a boutique firm) to rate its issues, declined the new rating relationship. Moody's then rated its issues as junk, lopping $175 million off its market valuation in one afternoon as investors panicked.[8] One could not say *ex ante* whether the positive Standard and Poor rating or Moody's negative rating was the more accurate assessment, since market sentiment based on the latter rating made Moody's prediction self-fulfilling. Issuers learned quickly to come to heel and cooperate with – that is hire and pay – the ratings agencies, often in parallel, in order to keep them on side. Conversely, the ratings agencies would seek to ingratiate themselves to win and keep new business, often simply ratifying the credit risk models and data shown to them by their clients without adding much in the way of independent investigation or testing. As complex asset-backed security markets swelled after 2000, the ratings agencies might even serve as a research arm of the issuers, advising them what kind of combinations of securities and derivatives might be necessary to win the coveted investment grade ratings. There would often be a to-and-fro of bids and counter bids as both sides of the relationship would massage the figures to get over the AAA line. Tiny drifts in the investment parameters could make great differences to the risk assessments, but in a buoyant market the ratings agencies were happy to give large issuers the benefit of the doubt so long as the business kept flowing in and asset prices kept rising.

Economic reasons to require ratings

The entrenchment of issuers paying for ratings of their own products was not simply a byproduct of the monopolist powers granted to the rating agencies by their regulatory licences. There was a strong demand for expert rating of investments in order to fuel market

[8] Alec Klein, 'Credit Raters' Power Leads to Abuses, Some Borrowers Say', *Washington Post*, 24 November 2004. More evidence of the use of unsolicited ratings to force new customers to join is adduced in *Compuware v Moody's Investment Services Inc* 324 F Supp 2d 860 (ED Mich 2004).

trading quite apart from regulatory pressure; but there was also a gap in market structure preventing wholly independent ratings advice from being produced. Why there was a demand for investment ratings that proved difficult to meet by independent advice is an intriguing puzzle with many layers. We will take those layers one by one.

Investors were aware that arbitraged prices in heavily traded securities, such as shares in large public companies or public bonds, might not be good predictors of value in more distant time periods. As asset markets grew in scale, variegation, and velocity, investors increasingly needed and sought professional help to predict risk spreads of particular asset classes. Larger and more confident investors might do their own research and analysis or hire their own professionals to do it for them. But there may still be a call to seek independent advice, not only to meet government regulatory requirements, and not only to supplement and challenge one's own partial views; to meet government regulatory demands in certain sectors; but most tellingly, to forestall criticism by shareholders or sub-investors who might be tempted to test misfired investment decisions in court and seek recompense. The combination of these pressures made reliable and recognized external investment advice well worth paying for before enacting investments.

Turning next to the other side of the trade: an issuer could itself vouch for the value of its securities, as it does where it issues a prospectus. The issuer has access to richly relevant information and has a good incentive to describe the product convincingly and accurately in order to win reputation and build value into that and succeeding products. But as secondary trading takes securities through multiple trades that arbitrage and re-arbitrage the price, the fundamental knowledge possessed by the issuer becomes only one part of the financial data required to assess the security beyond initial price predictions at launch. Overall market sentiment including the performance of rival or connected securities becomes part of the story, and there is no reason to place special faith in the predictions of the issuer regarding such wider market movements.

The issuer could instead afforce its claims about prospective risks and profits by hiring its own auditors or analysts to investigate its business and vouch for its prospects to particular purchasers. Investment banks, accountancy firms, and other intermediaries helping companies and government entities issue and distribute complex products will have the skills to offer a more expert and independent analysis of securities than the initial issuers, and as part of the intermediated marketing process can make that analysis available to prospective purchasers. The intermediaries can also guarantee their assessments through underwriting and insurance. But such intermediaries face an obvious conflict of interest in advising purchasers that a complex product has a certain predicted value and risk profile adapted to their needs; such advice invites strong reliance on professional skill and puts the intermediary into a position in tension with its own role as a profit-taking agent assisting the issuer. It is notorious that the lines between broker-dealers and investment advisors have become increasingly hard to draw, and a suspicion is aroused that ministerial and advisory roles are being compromised by leakage from the marketing role, a fear that is compounded where there is evidence of secret commissions and undisclosed profit-taking by agents helping match sellers to buyers and generate trades.[9]

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[9] Tamar Frankel, 'The Regulation of Brokers, Dealers, Advisors and Financial Planners' (2010-11) 30 *Review of Banking and Financial Law* 123.

Chains of investment exacerbate the problems just identified. Wholesale purchasers may themselves serve as agents or nominees serving retail purchasers down the line, and will owe separate fiduciary, prudential, and regulatory duties to their own sub-investors. Such wholesale purchasers need to be able to vouch for the suitability of the assets that they procure when they are themselves reliant on profit-taking market professionals serving the issuers. As chains of investment lengthen the potential for conflicts of interest multiply and advice and analysis becomes suspect.

Since issuers and their agents cannot describe or warrant the risks associated with their financial products without standing as advisers with a fiduciary or insurance liability, and since wholesale buyers are unable to verify asset suitability to their sub-clients, a circuit breaker is needed, an independent actor who can verify and certify the assets being traded. Enter the credit rating agencies. They can usefully serve as third-party professionals hired to make independent ratings using the fullest array of technical tools to make the valuations as robust as financial science can make them.[10] We have noted how in large sectors of the market, government regulation may insist that the rating agencies with regulatory licences be used to certify all investments acquired by certain large institutions with a systemic or fiduciary role. And even without a government mandate, institutional buyers may feel that an accredited rating from one of the licenced agencies is an essential element of prudent investment and will help keep them out of court if ultimate investment clients lose out.

The next set of questions are – who hires the independent rating agency, who pays them, and to whom are duties owed by those agencies?

Issuer pays systems

The identity of the *hirer* has morphed over time. We noted that in the early days in America, the 'statistical corporations' sold their data and analyses en masse to the buying public via manuals and news services. Then in the 1920s specific purchasers formed syndicates that made ratings available to subscribers as a kind of club good, with higher investment in information and analysis supposedly yielding a higher private return to that investment. But in time these private rating syndicates were edged out by the modern system of issuer-hired ratings. This was far more profitable for the agencies and easier to organize, such that nothing was left of the syndication model by the 1970s.[11] There seems to be no viable market today

[10] Richard M Levich, Giovanni Majnoni, and Carmen Reinhart (eds), *Ratings, Rating Agencies and the Global Financial System* (Boston, Kluwer Academic, 2002); Timothy J. Sinclair, *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness* (Ithaca, Cornell University Press, 2005); Lawrence J White, 'Markets: The Credit Rating Agencies' (2010) 24 *Journal of Economic Perspectives* 211. Andreas Kruck, *Private Ratings, Public Regulations: Credit Rating Agencies and Global Financial Governance* (London, Palgrave Macmillan, 2011); Marc Flandreau and Joanna Kinga Sławatyniec, 'Understanding Rating Addiction: US Courts and the Origins of Rating Agencies' Regulatory License (1900-1940)' (2013) 20 *Financial History Review* 237; Susan K Schroeder, *Public Credit Rating Agencies: Increasing Capital Investment and Lending Stability in Volatile Markets* (New York, Palgrave Macmillan, 2015).

[11] Frank Partnoy, 'The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies' (1999) 77 *Washington University Law Quarterly* 619; Ai-Lin Lee, 'Credit rating agencies - do they adequately fulfil their gatekeeper role in debt capital markets?' (2015) 30(2) *Journal of International Law and Banking Regulation* 82.

for purchasers to commission their own ratings. A purchaser can obviously run its own investment analyses in pursuit of arbitrage opportunities using outside information or making inquiries of the issuers; but a purchaser-commissioned rating would have to win full cooperation from the issuer, pushing up transaction costs; and even if purchasers who had tested the waters by ad hoc analysis had any incentive to disseminate their commissioned ratings, it would then be difficult to spread the costs of procurement of a private report (which may not be acted on), in the manner that issuers may by making their ratings public in order to add value to their offerings.[12]

In the result, market structure and incentives led to rating agency services being hired, and paid at considerable expense, by the issuers. Whether for regulatory or prudential reasons, without a favourable rating the issuers often cannot sell their products to large institutional investors and banks; whilst a favourable rating can add to the profits of the issuer, sometime more than ten times the cost of the ratings fee. With these incentives in place, ratings services are freely used and generously paid by issuers; there is commonly a negotiation between issuer and ratings agency as to the design of products to ensure that a top public rating may be given; and ongoing report of ratings is designed into complex financial contracts as a monitoring and renegotiation mechanism, welding the credit rating agencies into the issuers' business models.[13] If the ratings process becomes a costly annex to the issuing business, those costs may then be fed into the overall price of the issued products to be paid for by the ultimate consumer. However the buyer to whom the rating was communicated and who acted on that rating when investing could have no contractual privity or direct legal relationship with the agency making the rating; those parties were unknown to each other, even if there was strong reliance by purchasers on the ratings issued by the agencies, so much so that the trades would be impossible without a high rating. And where there was privity between issuer and rating agency, there was a danger to independence since the agency might not wish to jeopardize fees through repeat plays by giving adverse ratings to products.

The system that emerged in the 1970s was clearly flawed, but despite hiccups it grew apace into a multi-billion dollar operation. The breakdown of the system came in the early 21st century, when technology drove up the complexity and opacity or securities, notably in the sub-prime mortgage market which was invented by investment banks partly in order to meet the insatiable need for 'investment grade' or stable AAA securities driven by the larger funds. Post-2008, it became clear that the ratings agencies did not understand the products they were certifying, but simply rubber-stamped the issuers' own valuation models, freely giving the issuers the ratings they needed in order to maintain their business relationships and profit flows.

Liability and immunity

At all times the law has to make decisions about the liabilities or immunities of those who make financial representations to targeted investors, whether as prime issuers, or part of the

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[12] Harold L Cole and Thomas F Colley, 'Ratings Agencies' (National Bureau of Economic Research Paper No 19972, March 2014, at http://www.nber.org/papers/w19972).

[13] For examples see *Deutsche Trustee Company Limited v Cheyne Capital (Management) UK (LLP), Deco 15 – Pan Europe 6 Limited* [2015] EWHC 2282 (Ch); *CBRE Loan Servicing Ltd v Gemini (Eclipse 2006-3) Plc* [2015] EWHC 2769 (Ch).

supporting cast of auditors, bankers, advisers, underwriters, broker-dealers – or rating agencies. The legal crux of the matter in each case is usually: to whom were significant financial representations made, and in which manner? Was it a sufficiently focussed class for the law to ascribe an assumption of responsibility to those defined representees on the part of the representor? Does a flow of payment from representee to representor appear in order to cement the legal assumption of responsibility?

Take the source of payment question first. In a sense the purchasers are ultimately providing consideration for the contracted work of the ratings agencies when they pay the issuers for the cost of making and marketing their products. But on the other hand this three-way shift of value cannot easily be 'invented' into contractual consideration since the ratings are issued to the entire world rather than any finite targeted counter-parties. Issuers can disclaim any responsibility to purchasers for the risk profiles of their product provided they make no culpable factual misrepresentations about the product. At the same time ratings agencies also disclaim any legal liability for the accuracy of data supplied to them by issuers, nor do they guarantee the robustness of their ratings, stating that these are best possible professional opinions about the future, but disclaiming any responsibility to reliant third parties for misprediction causing loss. The ratings are held out as just one piece of information to help the investor make that entrepreneurial calculation and clear regulatory or prudential requirements; they are not offered as a legal guarantee.

Thus purchasers of securities, be they banks, mutual funds, pensions, or insurance pools, and who themselves have a duty to make prudent investments with due professional care, are left with a dilemma. They are forced to delegate the technical assessment of investments to outside ratings agencies with monopoly power and with whom they have no contractual relationship. Their hope is that reliance on a top rating by a reputable agency will by itself amount to an acquittal of the duty of due diligence and prudence in choosing investments.[14] But responsibility for the risk assessment is not accepted by the ratings agencies themselves. The agencies used contracts of adhesion to limit or eliminate the liabilities they owed to direct counterparties in contract, tort, or fiduciary law. And then the risk assessment made in exchange for payment is offered to the world as an opinion only, made with serious professional skill, but involving no legal assumption of responsibility as purveyors of financial advice. And the ratings advices themselves stipulate that no legal responsibility for the accuracy or competence of the advices can be accepted towards any person who might use or rely upon that advice, even though the whole point of the rating is to have it relied upon by purchasers. If no one in the framework of investment deal-making accepts risk responsibility, if liability for prudent assessment of securities values is diluted by this division of roles, does this mean that the law will allow losses, like profits, to lie where they fall? For this interpretation to stick, it is essential that the courts accept the ratings agencies' characterization of their statements as 'opinions', maybe known to be relied upon by issuers within contractual relations as well as purchasers outside privity, but involving no possible assumption of legal responsibility.

[14] A problem trenchantly analysed by Tony Molloy, 'I am a trustee. I can't make head or tail of Po=SoN(d1) -Xe-rtN(d2).... Am I at risk?' (2009) 15(7) *Trusts & Trustees* 524.

The Reckoning

Provided issuers and investors could get from the rating agencies the product ratings they needed to do business, the market could disregard a track record of obviously flawed assessments as someone else's problem. Thus ratings business continued to grow despite stark examples of manifest failures by the agencies to assess risks accurately, including Penn Central's default in 1970, which helped to undermine the market for commercial paper in the United States; the bankruptcy of Orange County in 1994 which harmed the municipal bond market; and the Enron and Parmalat failures in the early 2000s which cast doubts on corporate bond valuations. In all these cases the ratings agencies gave the troubled entities high ratings all the way up to the moment of crisis, yet despite this evidence of fallibility their businesses grew exponentially as demand for investment grade securities grew after 2000.[15] It was the 2008 financial crisis, and most spectacularly the AIG and Lehman failures in September of that year, that finally undermined confidence in the ratings agencies competence. AIG and Lehman were given AAA and AA ratings by the Big Three up to the very moment of their collapse. A defence given by the agencies was that an expectation of political rescue was always built into those ratings, and those expectations were falsified by real-time government decisions that surprised everybody. But this could not explain the massive over-rating of mortgage-backed securities that was the upstream cause of the 2007-8 crash. For example in late 2007 Moody's downgraded 83% of the $869 billion in mortgage securities it had rated as AAA investment-grade with negligible chance of default in 2006. In that year Moody's had taken $881 million in profits just from rating mortgage-backed securities alone – more than the rest of its business combined. Standard and Poor's record was no better. Error of this scale could not be dismissed as an unforeseen black swan or political blip; private companies taking huge profits in a quasi-public gatekeeper role had clearly failed badly in their primary mission. The central role of the ratings agencies in building the financial crisis that brought havoc to the Western economics led to damning assessments. The Financial Crisis Inquiry Commission of the U.S. Government made this summary of its findings in January 2011:[16]

> We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms. In our report, you will read about the breakdowns at Moody's, examined by the Commission as a case study. From

[15] Tobias Adrian and Hyun Song Shin, 'The Changing Nature of Financial Intermediation and the Financial Crisis of 2007–2009' [2010](2) *Annual Review of Economics* 603; Gary Gorton, Stefan Lewellen and Andrew Metrick, 'The Safe-Asset Share' (2012) 102(3) *American Economic Review* 101; Roberta Romano, 'For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basal Architecture' (2014) 31 *Yale Journal of Law and Regulation* 46.

[16] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (US Government Printer, Washington DC, January 2011) xxv.

> 2000 to 2007, Moody's rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody's put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded. You will also read about the forces at work behind the breakdowns at Moody's, including the flawed computer models, the pressure from financial firms that paid for the ratings, the relentless drive for market share, the lack of resources to do the job despite record profits, and the absence of meaningful public oversight. And you will see that without the active participation of the rating agencies, the market for mortgage-related securities could not have been what it became.

Attempts at clean-up

Despite the glaring problems, governments have struggled to restructure or regulate the credit ratings agencies after 2008. Some feared that the power of the ratings agencies to harm state credit was enough to repel meaningful regulation by the states themselves, or constrained the states to design only such economic policies that the ratings agencies would approve of, even though the agencies themselves were discredited. Sharp downgrades of Greece, Portugal and Ireland contributed to their borrowing costs and arguably exacerbated the Eurozone crisis; recent downgrades of some of the strongest economies, including the United States (2011) and the European Union overall (2013), as well as Austria, France and the United Kingdom in 2011-12 and again this year, raised questions of the meaningfulness of such country credit gradings (where is safer?).[17] The impact on politics can be direct. In the 2011 Congressional negotiations over United States deficit levels, threats to further downgrade of the nation's credit by Standard and Poor was reported to be the clinching factor in forcing a rise in the debt ceiling. A dysfunctional profit-taking corporation with a proven track record of failure was still able to dictate policy to the world's superpower. Well before the Global Financial Crisis the New York Times pundit Thomas L Friedman quipped: 'We live again in a two-superpower world. There is the U.S. and there is Moody's. The U.S. can destroy a country by levelling it with bombs. Moody's can destroy a country by downgrading its bonds'.[18]

Since 2008 new public controls of the ratings agencies have been attempted, with some initial success. One dead end has been the legal sanctioning of individuals responsible for the ratings debacle. In the U.S. it has proved nearly impossible to prosecute individuals for fraudulent conduct or breach of securities laws no matter how egregious the conduct uncovered. Indeed Congressional hearings in 2009 revealed that no ratings analysts had been fired or disciplined at the Big Three after the almost complete failure of ratings in the mortgage-backed securities sectors. This lack of personal accountability proved a general problem in the wake of the 2008 crisis: diffusion of responsibility through large financial organizations seems to have granted immunity to all who work within them, and regulators prefer to enter into plea bargains with

[17] 'The EU and credit rating agencies: Poor Standards?', *The Economist*, 20 December 2013.
[18] 'Foreign Affairs; Don't Mess With Moody's', *New York Times*, 22 February 1995.

firms leading to negotiated fines and promises of voluntary reform, without any admissions of liability or even commencement of trials.[19]

Nor were actions against the ratings agencies as entities with collective responsibilities notably successful before 2015. Up to that date some forty-one suits against Standard and Poor alone were dismissed, usually on the dual grounds that the ratings were mere opinion akin to editorial comment rather than commercial statements like those issued by auditors or financial advisers; and that these statements of opinion were addressed to the entire public rather than any closed class of individuals and so could attract First Amendment protection as free speech.[20] These defences were jettisoned on demurrer in the 2009 cases of *Abu Dhabi Commercial Bank v Morgan Stanley*[21] and *California Public Employees Retirement System v Moody's,*[22] where courts in New York and California held that a money-making assessment of financial risk, addressed not to the public at large but to a particular targeted class of investors in order to earn money, did not attract First Amendment protection, and was not comparable to opinions in the financial press. In the wake of these judgments the share prices of Moody's and Standard and Poor declined to half of their record highs as of June 2007, and many shareholders divested, including Warren Buffett who reduced his 12.1% holding of Moody's stock by half.[23] After further suits were brought in New York[24] Moody's reached a confidential out of court settlement in 2013 in order to avoid a large legal precedent that might harm its business model.[25] Encouraged by this litigation breakthrough, in 2013 the Federal Government and a number of states filed a £5 billion law suit against McGraw Hill, the parent company of Standard and Poor, using the new tactic of suing for misrepresentation under legislation from the savings and loans era.[26] The chairman of the company, Harold McGraw, claimed that Treasury Secretary Timothy Geithner had telephoned to threaten his firm with payback in 2011 following the downgraded rating McGraw's firm had just assigned to U.S. debt; McGraw argued that the suit should therefore be quashed as politically motivated.[27] In February 2015 McGraw Hill settled the U.S. suit against Standard and Poor for the record sum of $1.5 billion. McGraw Hill simultaneously settled claims from the California Public Employees Retirement System for $125 million and the Securities and Exchange Commission

[19] Brandon L Garrett, *Too Big to Jail: How Prosecutors Compromise with Corporations* (Cambridge, Harvard UP, 2004); Jed S Rakoff, 'The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?' (New York Review of Books, 9 January 2014); 'Justice Deferred Is Justice Denied' (New York Review of Books, 19 February 2015).

[20] Gary Shorter and Michael V Seitzinger, *Credit Rating Agencies and Their Regulation* (Washington DC, *Congressional Research Service*, 3 September 2009); 'Free speech or knowing misrepresentation?', *The Economist*, 5 February 2013.

[21] *Abu Dhabi Commercial Bank v Morgan Stanley & Co 651 F. Supp. 2d 155 (Southern District of New York, 2009).*

[22] *California Public Employee's Retirement System v Moody's (CalPERS) Order of demurrer (motion to dismiss), No.09-490241 (California Court of Appeals, 1st District, 2009.*

[23] John Lippert, 'Credit Ratings Can't Claim Free Speech in Law Giving New Risks', *Bloomberg Business*, 8 December 2010.

[24] *Abu Dhabi 2009 651 F. Supp. 2d 155 (Southern District of New York, 2009)*; *Abu Dhabi Commercial Bank v Morgan Stanley & Co, 888 F. Supp. 2d 431 (Southern District of New York, 2012)* ("*Abu Dhabi 2012*"); *King County 863 F. Supp. 2d 288 (South District New York, 2012)*.

[25] Ai-Lin Lee, 'Credit rating agencies - do they adequately fulfil their gatekeeper role in debt capital markets?' (2015) 30(2) *Journal of International Banking Law and Regulation* 82.

[26] *United States of America v McGraw-Hill Companies Inc., et al,* No. 13-0779 (2013), C.D. Calif.

[27] Report in Reuters, 21 January 2014.

for $81 million.[28] A condition of the Standard and Poor settlements was that no wrongdoing or violations should be registered against the firm; so on one account this was yet another example of a miscreant firm buying off justice, albeit at a high dollar price. Just how high may be debated: by one estimate this global settlement amounted to all the profits Standard and Poor had made between 2002-2007 from rating mortgage-backed securities; by another measure it represented just one year of current net earnings. By early 2014 the profitability of the Big Three had returned to match or exceed 2007 levels, perhaps in part because government requirements for more careful risk management of complex fianncial products enhanced demand for their services.[29] The last thing any of the firms wanted was a fresh liability regime to emerge from high profile judgments that might curb the onward pace of profit-making. Standard and Poor did issue an emollient statement at the moment of settlement conceding that it may have made favorable ratings due to its drive to build up its business, but admitting to no wrongdoing; yet evidence was already emerging that issuers were again eliciting over-optimistic ratings from the agencies to boost their profits.[30] We shall return to this point.

What of changes to the legal and regulatory environment to constrain the ratings agencies in the future? In the United States the Dodd-Franks Act of 2010 made two significant changes: ratings were defined to be a type of professional commercial service akin to auditing and investment banking advice. This cleared away two important defences that had been used successfully by the ratings agencies to fend off law suits; henceforth ratings were neither (i) mere opinion protected under the securities laws, nor (ii) constitutionally protected free speech. The public mandating of use of nationally recognised ratings agencies that had begun in the 1930s was also removed by Dodd-Franks in order to encourage fresh entrants; and the Federal Reserve and the Securities and Exchange Commission were charged with creating new ratings systems including enhanced oversight of the existing industry. Results of this reform process are yet to emerge, partly due to industry lobbying, partly because the regulators remain unsure how best to proceed. One result of the stripping of legal defences and the Standard and Poor settlement has been a sharp rise in ratings agencies fees and more aggressive use of contractual disclaimers, but there has been no discernible diminution of ratings business.

The regulatory position in the European Union and the United Kingdom will be picked up at the end of the paper. First will be investigated non-U.S. common law responses to the problems raised by rating agency conduct. Then we can gauge how attempts at new public regulation join to the efforts of the courts.

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[28] Timothy W Martin, 'S&P Ratings, Calpers Settle Suit over Mortgage Deals for $125 Million', *Wall Street Journal,* 2 February 2015.

[29] 'Credit where credit's due: the ratings industry has bounced back from the financial crisis', *The Economist,* 19 April 2014; 'Undue Credit: Regulation is helping the very firms it is designed to tame' *The Economist*, 30 May 2015; for evidence of how regulation post-2008 adds to the ratings business see Financial Conduct Authority, *Supervisory Formula Method and Significant Risk Transfer* FSA-FG11/14 (London, FSA, September 2011, revised October 2014), at http://www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg1114.

[30] Matt Robinson, Jody Shenn and Sarah Mulholland, 'Ratings Shopping Revived in Asset-Backed Rebound: Credit Markets', *Bloomberg Business*, 14 May 2013.

C. Credit ratings agencies: liability in the Anglo- Commonwealth common law

The work of the ratings agencies extended across the globe as securitization of mortgage loans fuelled a frenzy of security trading in the 2000s. In the wake of the 2008 crash and the mass defaults on mortgage securities collapsing the long chains of collateralized debt obligations and derivatives, it was said that Deutsche Bank and the Royal Bank of Scotland ended up as some of the biggest landlords in Detroit, a form of security that perhaps they had not bargained for. And in Australia aggressive selling of complex financial products to local councils seeking to protect their reserves and pension funds had caused much destruction of capital, albeit on a smaller scale. This raised the issue of whether the ratings agencies could be sued under English or Australian (i.e. Commonwealth) common law. In England the cases indices reveal that no such actions seeking to attach the credit ratings agencies have yet been brought. This may mean that litigants and their counsel have made a fair assessment that the English courts would not see any path to ratings agencies liability. Australia tells a different story. The enquiry now turns to properly doctrinal arguments, since English and Australian law does not use the overt policy language of American law.

The legacy of Caparo v Dickman

First let us consider the English approach to the liability of financial institutions vis-à-vis third parties. The case of *Caparo v Dickman* [1990] 1 All ER 568 (UKHL) is the leading English authority on the duty of care owed by auditors, including to third parties, building on, and perhaps refocussing, the law on pure economic loss inaugurated by the seminal decision of *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1963] 2 All ER 575, [1964] AC 465.[31] In *Caparo* the House of Lords considered a claim for negligent misstatement by an auditor in the audit report it prepared for the company. The House of Lords held that the purpose of the audit, in accordance with the English statutory scheme, was to provide information to the company and its shareholders so as to enable them to exercise their rights in their respective capacities. As such the auditor owed a duty of care to the company and its shareholders as a whole and in their capacity as shareholders. The House of Lords then held that the auditor did not owe a duty of care to a member of the public who relied on the accounts to invest in the company or to an individual shareholder in their capacity as a potential investor.[32] The applicable test was either the threefold test of foreseeability, proximity and what is just and reasonable,[33] or the assumption of responsibility test.[34] To establish that the auditor owed a duty to a third party, it was necessary to prove that the auditor knew that its conclusions would be communicated to the third party in connection with a specific transaction and that the third party would be likely to rely upon those conclusions in relation to it.[35] The requisite relationship of proximity did not obtain between the auditors and a member of the public who bought shares in the company.[37] Further, Lord Oliver stated, there was no good reason

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[31] See e.g. *Mitchell (AP) v Glasgow City Council* [2009] UKHL 11; *Moore Stephens (a firm) v Stone Rolls Limited (in liq)* [2009] UKHL 39. See further essays in Kit Barker, Ross Grantham, and Warren Swain (eds) *The Law of Misstatements: 50 Years on from* Hedley Byrne v Heller (Oxford, Hart Publishing, 2015).

[32] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 650 per Lord Oliver.

[33] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 617-618 per Lord Bridge and [1990] 1 All ER 568, 584-586 per Lord Bridge and 637-642 per Lord Oliver.

[34] See *Henderson v Merrett Syndiates Ltd* [1995] 2 AC 145 (UKHL) 181.

[35] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 642 per Lord Oliver.

[37] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 643 per Lord Oliver.

of policy to extend the duty of care to this relationship, even though it was foreseeable that potential investors might rely on the audit report in making their investment decisions.[38] The House of Lords also held that the auditors did not owe a duty of care to an individual shareholder seeking to buy further shares in the company because the duty of care owed to shareholders was owed to them only in their capacity as shareholders.[40] The purpose of the audit report was central to these findings: the statutory duties of the company's auditor were not intended by parliament to protect the interests of investors in the market nor to enable individual shareholders to engage in speculation with a view to profit.[41]

In reaching its decision, the House of Lords approved an earlier decision of Millett J in *Al Saudi Banque v Clark Pixley (a film)*[42] where Millett J held that the statutory duty to report to the company and its members did not give rise to a duty of care to the company's lenders. Notably, in that case, the auditors had not sent the report to the lenders, nor had they sent copies of the report to the company with the intention or in the knowledge that the company would supply the report to the lenders. Auditors do not owe a duty of care to creditors of the company (even though creditors are more easily identifiable than potential investors) because the purpose of the audit is not to provide information to them.

The principle in *Caparo* thus provides that liability for economic loss caused by negligent misstatement is limited to cases where the statement was made to a sufficiently defined recipient for a specific purpose of which the maker was aware, and the recipient incurred loss in reliance upon that statement. Subsequent applications of the *Caparo* principle have emphasized that the purpose for which the statement is made is central to determining to whom the maker of the statement owes a duty in respect of that statement and the scope of that duty. While *Caparo* might seem to rule out many claims by third parties for loss suffered in reliance on negligent statements, the Courts have emphasized that these cases are particularly fact-sensitive.[43] The questions for delimiting ratings agency liability thus become: For what *purpose* is the rating provided? And is the recipient of the ratings advice *sufficiently identified*?

Extending the doctrine of pure economic loss

An important example of an extension of liability for pure economic loss came in 1995 with *White v Jones.*[44] There the House of Lords held that a solicitor who was negligent in drawing up a testator's will owed a duty of care towards a disappointed beneficiary. Lord Goff referred to assumption of responsibility as the test that 'as a general rule' determines whether or not there can be liability for pure economic loss.[45] He recognized that a testator's solicitor does not actually assume responsibility towards a disappointed beneficiary but held that the

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[38] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 643 per Lord Oliver.
[40] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 651-652 per Lord Oliver.
[41] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 649, 653-654 per Lord Oliver.
[42] [1990] BCLC 46, [1990] Ch 313.
[43] See *Electra Private Equity Partners v KPMG Peat Marwick* [2001] 1 BCLC 589, 614 where Auld LJ stated: 'Actions of negligence against auditors … are a notable example of facts-sensitive cases where the law is still in a state of transition and in which courts should normally take particular care before determining the matter against the plaintiff before the full facts are known.'
[44] [1995] 1 All ER 691.
[45] *White v Jones* [1995] 1 All ER 691, 700.

Hedley Byrne v Heller principle ought to be extended to the present case.[46] Lord Browne-Wilkinson made a similar finding. He stated:[47]

> If the responsibility for the task is assumed by the defendant he thereby creates a special relationships between himself and the plaintiff in relation to which the law (not the defendant) attaches a duty to carry out carefully the task so assumed.

Lord Browne-Wilkinson viewed *Caparo* as consistent with his view that in order for liability to arise there must be 'a conscious assumption of responsibility for the task rather than a conscious assumption of legal liability to the plaintiff for its careful performance'.[48] While English law does not impose a general duty of care to avoid negligent misstatements or to avoid causing pure economic loss even if that loss was foreseeable,[49] such a duty will arise where there is a special relationship between the parties.[50] The categories of special relationship were not closed although thus far only two had been identified: where there is a fiduciary relationship; and 'where the defendant has voluntarily answered a question or tenders skilled advice or services in circumstances where he knows or ought to know that an identified plaintiff will rely on his answers or advice'.[51] Lord Browne-Wilkinson accepted that neither of these categories covered the circumstances in *White v Jones*. Nonetheless, he held that a duty of care was justified in the circumstances and that the negligent solicitor owed a duty of care to the disappointed beneficiary.[52] It is thus clear that *Caparo* does not forestall the development of new categories of special relationship and that the focus will be on what the defendant undertook to do or be responsible for, as construed objectively.

The outcome in *Law Society v KPMG Peat Marwick*[53] can be contrasted with the outcome in *Caparo,* and reflects the more liberal attitude expressed in *White v Jones.* In *Law Society v KPMG Peat Marwick* the defendants supplied a firm of solicitors with a report required by legislation. The report effectively provided that the firm had complied with various professional accounting rules. The defendants knew the report would be sent to the Law Society. It turned out that two partners of the firm had used clients' money, leading to a large compensation payment by the Law Society. On a preliminary issue, the Court of Appeal held that the defendants owed the Law Society a duty of care even though the firm had obtained and paid for the report. The Court of Appeal embraced the test from *Caparo*,[54] and then concluded there was a duty of care owed to the Law Society because the purpose of the reporting scheme was to allow the Law Society to intervene in the management of the firm in order to protect the Law Society's compensation fund. The decision of *Law Society v KPMG Peat Marwick* again illustrates that the purpose of the statement is central to determining the existence and scope of any duty to third parties. Notably, in this case there were no concerns

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[46] *White v Jones* [1995] 1 All ER 691, 704 and 710.
[47] *White v Jones* [1995] 1 All ER 691, 715-716.
[48] *White v Jones* [1995] 1 All ER 691, 716
[49] *White v Jones* [1995] 1 All ER 691, 716
[50] *White v Jones* [1995] 1 All ER 691, 716
[51] *White v Jones* [1995] 1 All ER 691, 716-717.
[52] *White v Jones* [1995] 1 All ER 691, 717.
[53] [2000] 1 WLR 1921.
[54] Both the three stage test outlined by Lord Bridge and the observations of Lord Oliver were endorsed: [2000] 1 WLR 1921, [12]-[13].

about indeterminacy of liability arising as a result of recognizing a duty owed to a third party because there was only one identifiable third party – the Law Society – to whom a duty was said to be owed.

Assumption of responsibility redux

In *Customs and Excise Commissioners v Barclays Bank plc*[55] the House of Lords again considered recovery for pure economic loss due to negligence. The House of Lords held that a bank owed no duty of care to a third party to take reasonable care to comply with the terms of a freezing injunction granted to the third party against one of the bank's customers. Lord Bingham considered the many decisions on the question of an auditors' liability to third parties and noted that they contain statements that are difficult to reconcile.[56] He ultimately concluded that the Court ought to focus on 'the detailed circumstances of the particular case and the particular relationship between the parties in the context of their legal and factual situation as a whole'.[57]. Similarly, Lord Hoffmann observed that there are different kinds of factual situations and these call for different considerations. In all of these cases, where loss has been caused by the claimant's reliance on information provided by the defendant:[71]

> [I]t is critical to decide whether the defendant (rather than someone else) assumed responsibility for the accuracy of the information to the claimant (rather than to someone else) or for its use by the claimant for one purpose (rather than another).

The answer to that question does not depend on what the defendant intended but rather depends upon 'what would reasonably be inferred from his conduct against the background of all the circumstances of the case.' [72] Lord Hoffmann observed that '[i]t is equally true to say that a sufficient relationship will be held to exist where it is fair, just and reasonable to do so'.[73] Courts will have regard to the reality of the economic relationship between the parties and the nature of the markets in which they were operating.[74] Thus the question as to whether or not a duty of care is owed to a third party and the scope of that duty depends on the nature of the relationship between the parties, as construed objectively, and the purpose of the communication.

In *MAN Nutzfahrzeuge AG v Freightlinger Ltd*[76] the Court of Appeal considered an auditor's liability vis-à-vis s third party. The facts of the case were as follows: the claimant suffered loss in connection with the sale of ERF; ERF's financial controller had made fraudulent statements

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[55] [2006] UKHL 28, [2006] 4 All ER 256.

[56] *Customs and Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, [4]. Similarly, Lord Mance observed that a review of the authority 'confirms that there is no single common denominator, even in cases of economic loss, by which liability may be determined': *Customs and Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, [93].

[57] *Customs and Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, [8].

[71] *Customs and Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, [35].

[72] *Customs and Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, [35].

[73] *Customs and Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, [36].

[74] Lord Hoffmann (at [36]) pointed to *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] BCLC 18, 24 where he identified some relevant considerations.

[76] [2007] EWCA Civ 910, [2008] 2 BCLC 22.

as to the accuracy of the ERF accounts in the course of negotiations for the sale of ERF by Freightliner's predecessor to the claimant. The defendants were the auditors of ERF and Freightliner sought to recover from the auditors the loss it had suffered loss as a result of incurring a liability in damages to the claimant in connection with the sale of ERF. Chadwick LJ (with whom Dyson LJ and Thomas LJ agreed) applied the analysis from *Caparo* and *Customs and Excise Commissioners v Barclays Bank plc*.[77] Chadwick LJ held that it was foreseeable by the auditors that Freightliner would rely on the accuracy of the accounts in its dealings with the claimant but it was not foreseeable that the participation of ERF's financial controller in the course of negotiations would cause Freightliner to incur liability to the claimant. Freightliner's loss was the direct result of the financial controller's dishonesty rather than the inaccuracy of the accounts themselves and the auditors owed no duty in respect of that kind of loss.[78] The Court of Appeal noted that, as held in *Caparo*, mere foresight (that a third party would rely on a statement and could suffer loss in doing so) is not enough to give rise to a duty of care to that third party.[82] Something more is required: often an assumption of responsibility.[83] The Court must consider the purpose for which the statement or communication were made and that purpose must be judged objectively. The question to be asked by the Court is:[84]

> … whether a reasonable person in the position of the claimant would conclude from the circumstances in which the statement was made or communicated to him that the purpose for which the statement was made or communicated to him included protecting him from a type of loss which he suffered in reliance on the statement.

Thus, again, we see that in order to determine whether or not a duty of care is owed to a third party and the scope of that duty, the Court must consider the purpose of the communication made to the third party and that purpose must be construed objectively.

Most recently, this issue was considered last year in *Barclays Bank plc v Grant Thornton UK LLP.*[85] In that case, the bank (together with a second bank) provided a loan facility to a hotel group. The terms of the facility required the hotel group to provide audited accounts to the bank. The auditors were engaged by the hotel group's parent company as auditors to carry out the statutory audit of the parent company and its subsidiaries and to provide financial statements to enable the hotel group to fulfil its obligations under the loan facility. The report included a disclaimer of any assumption of responsibility vis-à-vis third parties and the case turned on this point.[86] However, Cooke J made a number of observations as to the outcome if there had been no disclaimer. Cooke J observed that the purpose for which a statement is

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[77] *MAN Nutzfahrzeuge AG v Freightlinger Ltd* [2007] EWCA Civ 910, [2008] 2 BCLC 22, [56]-[59].
[78] *MAN Nutzfahrzeuge AG v Freightlinger Ltd* [2007] EWCA Civ 910, [2008] 2 BCLC 22, [42, [54]-[59].
[82] *MAN Nutzfahrzeuge AG v Freightlinger Ltd* [2007] EWCA Civ 910, [2008] 2 BCLC 22, [56].
[83] *MAN Nutzfahrzeuge AG v Freightlinger Ltd* [2007] EWCA Civ 910, [2008] 2 BCLC 22, [56].
[84] *MAN Nutzfahrzeuge AG v Freightlinger Ltd* [2007] EWCA Civ 910, [2008] 2 BCLC 22, [35] and [37].
[85] [2015] EWHC 320 (Comm), [2015] 2 BCLC 537.
[86] Cooke J held that while it is possible for auditors to owe duties to third parties a person could not be taken to have assumed responsibility in circumstances where it was specifically negative by him (i.e. by expressly disclaiming responsibility), nor would it be fair, just and reasonable to impose upon a person the very duty that the disclaimer purports to negative: *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [52], [41], [49].

made or communicated must be judged objectively (as set out in *MAN Nutzfahraeuge AG v Freightliner)*.[91] The auditors anticipated that the non-statutory reports would be forwarded to the bank (indeed the reports stated as much) and anticipated that the bank would rely on the reports in the context of the facility.[92] Thus in the absence of any disclaimer, it was clearly arguable that a duty of care would exist as between the auditors and the bank if the threefold approach were adopted with the requisite proximity and foreseeability.[93]

What can we take from this? First, the purpose of the statement is central to determining the existence and scope of a duty owed to third parties. The central question, when considering a negligent misstatement by a rating agency, will be for what purpose did the rating agency communicate the rating and does that purpose include protecting the claimant from the type of loss suffered. The purpose of audit reports – particularly given the statutory context – is to inform the company and shareholders and to allow them to exercise their rights in those respective capacities. The recent case of *Barclays Bank plc v Grant Thornton UK LLP* is interesting because it expressly leaves open the possibility that an auditor could owe a duty of care to a third party in respect of a non-statutory report where that report was prepared for the purpose of providing information to the third party (a similar approach to that taken in *Law Society v KPMG Peat Marwick*). Secondly, English Courts are far more willing to recognize a duty of care where the object of the duty is determinate. Turning to a rating agency, whether or not it owes a duty of care to a third party (a specific individual or a class) will depend upon the Court's characterization of the purpose of ratings and thus whether or not the rating agency can be said to have assumed responsibility towards a third party, and, if so, in respect of what kind of loss. The fact that the rating agency foresaw that a third party might rely on the rating and suffer loss will not be sufficient to ground a duty of care to that third party. It remains an open question, under English law, whether a claim against a rating agency made by a third party who suffered loss in relying upon on a negligent misstatement by that rating agency would succeed.

Australian breakthrough? ABN AMRO Bank v Bathurst Council

Let us turn to recent developments in the Australian context where such a claim against a rating agency has succeeded. In the 2014 Australian case of *ABN AMRO Bank v Bathurst Council,*[94] the Federal Court considered the position of a ratings agency that had negligently issued a flawed rating for a 'grotesquely complex' financial product, with strong suspicions that it had messed up the calculations. The agency, Standard and Poor, had relied heavily on the risk models provided to it by the issuer ABN AMRO, and had failed to devise its own robust and independent testing systems. It had also accepted the data provided to it by the issuer, which turned out to be tainted. Suspecting that both data and model were problematic, and discovering some crass calculative errors of its own, the Standard and Poor executives had nonetheless stood by their public rating of the issued products as AAA investment grade, though they strongly suspected that this assessment could not be justified. There was good evidence that Standard and Poor had feared reputational loss if they owned their mistakes and revised the rating, and also that they did not want to lose the business of ABN AMRO as

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[91] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [52].
[92] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [54].
[93] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [50]-[54].
[94] [2014] FCA FC 56.

a lucrative client. Another financial intermediary, LGFS, stood in a fiduciary relationship with a raft of local councils as their financial adviser and broker. LGFS induced those clients to buy the ABN AMRO issues, professionally advising the clients that these were safe investments fit for purpose, but failing to reveal that LGFS as intermediary wanted to offload the large stock of ABN AMRO securities it had procured for onward sale in order to reduce its own exposure and realize its profits. The supposedly AAA-rated issues declined precipitously in value and the councils sued each of Standard and Poor, ABN AMRO, and LGFS. The three defendants – ratings agency, issuer, and intermediary/broker – were held to be jointly and severally liable, under common law tort duties and additionally under statutory duties to avoid misleading and deceptive conduct. Standard and Poor was liable because it knew full well that the purchasing councils relied on its professional skill as a ratings agency where the councils lacked the capacity to analyse the issuer's securities; moreover Standard and Poor knew that the councils were entirely reliant on its rating and due to regulatory requirements needed that rating to be able to enter that very market. The issuer who had set up the ratings agencies knowingly with incorrect information could also be said to have an accessorial liability for the flawed rating, or alternatively could be subject to a coordinate liability under the doctrine of equitable contribution. LGFS was further in breach of its own fiduciary duties to the claimant councils, but could in turn recover in cross actions against the issuer and ratings agency who had misled LGFS as well. A defence of contributory negligence by the councils who might have tested the investment products themselves or sought their own professional advice was rejected, and strongly worded exclusion clauses by the ratings agency denying legal liability to reliant third parties were held to be ineffective.

The case is of high significance, not only for its results, but for the detailed and lucid forensics offered up in some four thousand paragraphs of judgment by the primary judge Jagot J, and the careful parsing of doctrine by the Full Federal Court, led here by Jacobson J. Four further observations may be made. First, Jacobson J in an earlier case had upheld the contractual exclusions of liability by an investment bank in dealing with a sophisticated client in a case of fiduciary advice in a hostile merger, and is regarded as a skilled commercial judge well attuned to the business world. Secondly, this case was the first judgment in the common law world to shine a searching light into the techniques of the ratings agencies and to find liability for inadequate work causing loss. Thirdly, the findings of the Federal Court were based on both common law and statutory duties, and it is wrong to suppose (as many English commentators have tried) that the result emerges solely from a local statutory context. Finally, it may be that the arguments mounted and information exposed in this massively detailed case helped precipitate the major settlements in New York and California some six months later in early 2015.

In finding a common law tort liability the Full Federal Court noted that: Standard and Poor knew that the rating of the notes it provided to ABN AMRO would be published in Australia and to potential purchasers; Standard and Poor authorized publication; and the entire purpose of the arrangement between Standard and Poor and ABN AMRO was to obtain a rating was to enable the marketing of the product with the rating by inviting reliance from prospective purchasers.[95] Facts such as these make this case significantly different from *Caparo*. That said, questions about the indeterminacy of the class to which a rating agency

[95] See *ABN AMRO Bank v Bathurst Council* [2014] FCA FC 56, [1357].

owes duties would likely arise in the English context: English Courts have proven far more resistant to recovery for pure economic loss than Australian Courts and the cases in which the Courts appear willing to recognize a duty of care owed to a third party who suffers economic loss in reliance on a negligent misstatement appear (thus far, at least) to be limited to circumstances where there is one (or two) specific third party to whom the duty is said to be owed.[96] It seems unlikely (although not impossible) that an English Court would be willing to hold that a financial institution owed a duty of care to an indeterminate class of third parties, such as potential investors. That said, it is not the case that English law requires that the defendant know the identity of the third party in order to owe a duty to them.[97] We shall return to the exclusion clause issues in this important case, *ABN AMRO Bank*, shortly after concluding the question of primary tort liability.

Excluding or weakening Caparo: other jurisdictions

The principle in *Caparo* has had a mixed reception outside of England. The High Court of Australia had initially embraced the *Caparo* principle,[98] but the three-stage approach taken in *Caparo* is no longer the law in Australia.[99] Indeed in *Sullivan v Moody*, the High Court pointed to some of the dangers of the *Caparo* approach: first, that judges and practitioners will seek to give the *Caparo* approach 'a utility beyond that claimed for it by its original author' and, secondly, that 'the matter of foreseeability (which is often incontestable) having been determined, the succeeding questions will be reduced to a discretionary judgment based upon a sense of what is fair, and just and reasonable as an outcome in the particular case'.[100] The English case law subsequent to *Caparo* seem to bear out some of these concerns (in particular, the observations of some English Courts that the outcomes of decisions seem correct although the statements of principle within those decisions may not be reconcilable). That said, English Courts have provided further guidance since these observations by the High Court of Australia, and in doing so the Courts have emphasized that the focus must be on the purpose of the communication made to the third party, as construed objectively.

New Zealand has taken a different approach to that taken in England (and Australia). In *Scott Group Ltd v McFarlane*[101] the New Zealand Court of Appeal held that *prima facie* a duty of care arises if it were in the reasonable contemplation of the alleged wrongdoer that carelessness on their part may be likely to cause damage to the person who has allegedly suffered it.[102] Thus the New Zealand Court of Appeal appears to take a foreseeability-based approach. The *Scott Group* decision had been followed in the England decision of *JEB*

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[96] See, for example, Cooke J's comments in *Barclays Bank plc v Grant Thornton UK LLP* and the outcomes in *White v Jones* and *Law Society v KPMG Peat Marwick*.

[97] In *Hedley Byrne v Heller* the inquiry was made and the response received via an intermediary bank which suggests that the defendant need not know the claimant's identify. See discussion in Winfield & Jolowicz, [11.25].

[98] See *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241, 250-252 per Brennan CJ, 257-258 per Dawson J, 260 per Toohey and Gaudron JJ, 276-286 per McHugh J.

[99] See *Perre v Apand Pty Ltd* [1999] HCA 36; (1999) 198 CLR 180 at 193-194 per Gleeson CJ; 210-21 per McHugh J, 302 per Hayne J; noted in *Sullivan v Moody* [2001] HCA 59; (2001) 207 CLR 562.

[100] *Sullivan v Moody* [2001] HCA 59; (2001) 207 CLR 562, [49].

[101] [1978] 1 NZLR 553.

[102] See also discussion of the position in New Zealand by McHugh J in *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241, 278.

Fasteners Ltd v Mark Bloom & Co[103] (which predated *Caparo*). Woolf J (whose decision was subsequently affirmed by the Court of Appeal[104]) observed that the appropriate test with regards to the auditor's liability is: [105]

> … whether the defendants knew or reasonably should have foreseen at the time the accounts were audited that a person might rely on those accounts for the purpose of deciding whether or not to take over the company and therefore could suffer loss if the accounts were inaccurate.

However, this approach is unlikely to be followed in England nowadays. In *Caparo* Lords Bridge and Oliver both distinguished *JEB Fasterners* on the basis that a duty of care arose in that case because the information had been provided for a specific purpose. Lord Bridge expressly stated that he did not agree with the conclusion in *JEB Fasterners* that duty could be derived from foreseeability alone (although he accepted that the particular facts of the case might have been sufficient to give rise to a duty of care given that the auditors actually knew of the specific purpose for which the plaintiffs intended to use the accounts).[106]

The main reason that the New Zealand approach is not persuasive in the English (or Australian) context is that it is based on an interpretation of Lord Wilberforce's decision in *Anns v Merton London Borough Council* that has been rejected in England (and Australia).[107] In *Anns* Lord Wilberforce set out a two-stage enquiry for determining whether or not there is a duty of care. At the first stage – at which the Court determines whether or not there is a prima facie duty of care – Lord Wilberforce required only a consideration of whether harm was foreseeable thereby equating the proximate relationship with foresight and nothing more.[108] In *Caparo* Lord Oliver noted that while the *Scott Group* case had been accepted in a number of cases in the United Kingdom (including *JEB Fasterners*), those cases had accepted the *Anns* approach of establishing a test of proximity that depended upon the foreseeability of harm alone,[109] and that as the *Anns* approach was no longer good law in England, these cases were not convincing authority.[110] Lord Oliver concluded that the Court of Appeal in New Zealand favoured a more extensive view of the circumstances from which the essential relationship between plaintiff and defendant may be inferred in a negligent misstatement case than the United Kingdom.[111]

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[103] [1981] 3 All ER 289.
[104] [1983] 1 All ER 583.
[105] [1981] 3 All ER 289, 296-297.
[106] *Caparo Industries Plc v Dickman* [1990] 2 AC 605, *625.*
[107] The *Anns* test as been rejected in England and Australia: see, for example, the comments of McHugh J in *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241, 279; see also the discussion of *Scott Group* by Lord Oliver in *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL). The *Anns* approach was overruled in *Murphy v Brentwood District Council* [1991] 1 AC 398 (UKHL). This was expressly noted by Lord Oliver in *Caparo*: *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 646 per Lord Oliver.
[108] See discussion in *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 645-646 per Lord Oliver.
[109] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 648-649 per Lord Oliver.
[110] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 649 per Lord Oliver, referring to the rejection of the *Anns* approach, including by Lord Wilberforce himself in *McLoughlin v O'Brian* [1983] 1 AC 410.
[111] *Caparo Industries Plc v Dickman* [1990] 2 AC 605 (UKHL) 646 per Lord Oliver.

The approach taken in Canada also differs from that taken in England (and Australia). In *Hercules Managements Ltd v Ernst & Young*[112] the Supreme Court of Canada held that whether auditors owe duty of care in respect of communications in their audit reports will depend upon: whether a prima facie duty of care is owed; and whether that duty, if it exists, is negative or limited by policy considerations. The Supreme Court embraced the reasoning in *Caparo* in that it held that auditors owe a duty of care regarding their audit reports only in respect of the purpose for which those reports were prepared.[113] The Court held that the point of the auditor's report was to provide information to shareholders so that they could oversee management; it was not to provide information so that shareholders could make personal investment decisions.[114] The Court observed that the auditors were unaware that their reports would be used for investment purposes and that if duty of care arose here there would be no logical reason to refuse to recognize duty of care in other cases where auditors reports used for purposes of which auditors had no knowledge. Thus the Court accepted that a prima facie duty of care arose but held that it was negated by policy considerations.

D. Credit ratings agencies: exclusions in the Anglo-Commonwealth common law

As we earlier noted, it is crucial to decide whether a credit ratings agency can invite serious reliance from a class of purchasers whilst integrating into the rating statement a disclaimer or exclusion of liability. This section investigates the resources of the common law to answer that question.

The courts have made clear that disclaimers can be effective across parts of tort law. Where the existence of a primary duty is dependent on the assumption of responsibility, one can avoid assuming responsibility by disclaiming responsibility (and thereby avoid assuming the duty in the first place) or one can limit the scope of what one has assumed responsibility for by limiting liability (and thereby define the scope of the primary duty) (see *Hedley Byrne & Co v Heller & Partners* and *Barclays Bank plc v Grant Thornton UK LLP*). It is also clear that contractual disclaimers are effective as between the parties to the contract (provided that they do not fall foul of the Unfair Contract Terms Act 1977 or similar statutory controls of oppressive bargains in other jurisdictions, which require that disclaimers be reasonable). It is, however, unclear (and acknowledged to be so by the Courts) whether a disclaimer in a contract between two persons is effective against a third party's claim in tort where that disclaimer is not addressed to the third party. The case law indicates that the existence of a disclaimer as between two contractual parties is relevant, but not determinative, of the existence and scope of a duty vis-à-vis a third party.

In contrast, limitations of liability may be chosen where the party seeking protection wishes to emphasize that the bargain is not imbalanced and oppressive in its primary consideration or exchange of valuable promises. Such limitations are less likely to be found outside contractual privity, as where a credit rating agency wishes to escape liability to purchasers who rely on its ratings.

[112] [1997] 2 SCR 165, 1997 CanLII 345 (SCC).
[113] *Hercules Managements Ltd v Ernst & Young* [1997] 2 SCR 165, 1997 CanLII 345 (SCC) [208].
[114] *Hercules Managements Ltd v Ernst & Young* [1997] 2 SCR 165, 1997 CanLII 345 (SCC) [206]-[208].

Primary and secondary duties

As the model best fitted to the cases, we argue that in tort *disclaimers* operate on the existence and scope of the primary duty; *limitations* on the secondary duty to do the next best thing if one breaches the primary duty.

To illustrate why this is so, consider the outcome in *Hedley Byrne & Co v Heller & Partners*. The claimants were concerned about the financial position of their client and so made enquiries of the client's bank (the defendant) as to the client's financial position. The bank stated that the client was 'considered good for its ordinary business engagements' and that the statement was made 'without responsibility'. In reliance on this statement, the claimants incurred loss (they placed orders on behalf of their client and their client defaulted upon them). The House of Lords held that the bank would have been liable for the claimants' loss but for the bank's disclaimer of responsibility. The outcome in this case makes sense if one thinks in terms of a rights-based model of tort law.[115] The claimant's right as against the bank was dependent upon the bank's assumption of responsibility to the claimant. As the existence of bank's duty depended upon an assumption of responsibility by it, a disclaimer of responsibility by the bank prevented that duty from arising in the first place.

The view that disclaimers operate on the primary duty is consistent with the fact that disclaimers are not effective in respect of many torts. This is because many rights protected by tort do not depend on an assumption of responsibility by the defendant. I have a right against you that you do not injure me negligently. The existence of my right – and hence your correlative duty not to injure me negligently – does not depend upon you assuming responsibility not to injure me negligently. And so the existence of the duty is not susceptible to a denial of assumption of responsibility.[117] Similarly, the view that disclaimers operate on the primary duty is consistent with the fact that disclaimers are effective in respect of contractual obligations. The contractual obligations owed by a contractual party depend on the voluntary assumption of those obligations and thus they are susceptible to disclaimers to the effect that one did not voluntarily assume a particular obligation.

Finally, the view that disclaimers in tort law operate on the primary duty is consistent with the approach taken in recent case law. In *Smith v Eric Bush (A Firm)*[118] the House of Lords held that a purchaser of a house could rely on a survey provided contractually to the vendor/finance provider, since the purchaser had provided the consideration for the survey and the surveyor knew very well that the survey would be relied upon by her and her alone to decide if the house was a sound purchase. In other words, the valuation of the house for the purpose of securing the loan and for the purpose of checking the soundness of the house for that particular purchaser were inextricably linked. The surveyor's exclusion of liability of the primary tort duty that arose by operation of law failed because the language of the Unfair Contract Terms Act 1977 was held to be effective to control exclusions of primary as well as secondary liabilities. In *Barclays Bank plc v Grant Thornton UK LLP*[119] by contrast Cooke J emphasized that a person could not be taken to have assumed responsibility where they

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[115] See for example Robert Stevens, *Torts and Rights* (Oxford, Oxford University Press, 2007) 34.
[117] Stevens, *Torts and Rights*, above, 34.
[118] [1990] 1 AC 831.
[119] [2015] EWHC 320 (Comm), [2015] 2 BCLC 537.

expressly asserted they were not assuming responsibility.[120] In other words, if a disclaimer of responsibility is effective, no primary duty grounded in the assumption of responsibility can arise. Similarly, Cooke J observed that it would not be fair, just and reasonable to impose upon a defendant the very duty that the disclaimer purported to negative.[121] An effective disclaimer would mean that no primary duty arose. Similarly, in *White v Jones* Lord Goff suggested that the assumption of responsibility towards the beneficiary by a solicitor when drafting a will would be subject to any term of the contract between the solicitor and the testator that might exclude or restrict the solicitor's liability to the testator.[122]

Disclaimers and third parties

In order to judge how disclaimers operate vis-à-vis third parties we may start with *Hedley Byrne v Heller*. This case shows us that where the defendant's duty arises from an assumption of responsibility towards the claimant, the defendant can exclude that duty by disclaiming the assumption of responsibility and addressing that disclaimer to the object of the duty that would otherwise arise. More difficult is the question whether a disclaimer in a contract between two persons is effective against a third party's claim in tort; in other words, where the disclaimer is not necessarily addressed, or addressed directly and mediately, to the third party. The law is unclear and most (although not all) recent decisions have declined to decide the issue.[123] The starting point in many of these cases is often seen to be the speech of Lord Brandon (with whom the other members of the House of Lords agreed) in *Leigh and Sillivan Ltd v Aliakmon Shipping Co Ltd*.[124] The House of Lords held that the plaintiff contracting buyers had no claim against the defendant ship-owners in tort for damage to the goods caused by bad stowage because at that time the goods were owned by the sellers. In passing, Lord Brandon suggested that an exclusion of liability provision in the contract between the sellers and the ship-owners would not provide 'an convincing legal basis for qualifying a duty of care' owed to a third party.[125]

Then in *Pacific Associates Inc v Baxter* Purchas LJ stated:[126]

> There can be no doubt of the force of Lord Brandon's [in *Aliakmon*] comment as it stands. However, with great respect to the learned and noble Lord the absence of a direct contractual nexus between A and B does not necessarily exclude the recognition of a clause limiting liability to be imposed on A in a contract between B and C, when the existence of that contract is the basis for the creation of a duty of care asserted to be owed by A to B. The presence of such an exclusion clause while not being directly binding between the parties, cannot be excluded from a general consideration of the contractual structure against which the contractor demonstrates reliance on, and the engineer

[120] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [41].
[121] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [49].
[122] *White v Jones* [1995] 1 All ER 691, 711.
[123] Noted most recently by Cooke J in *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [60].
[124] [1986] 2 All ER 145.
[125] [1986] 2 All ER 145, 155.
[126] *Pacific Associates Inc v Baxter* [1989] 2 All ER 159, 179.

> accepts responsibility for, a duty in tort, if any, arising out of the proximity established between them by the existence of that very contract.

The issue was then considered by Neuberger J (as he was then) in *Killick v PricewaterhouseCoopers* (*a firm*).[127] At issue in that case was whether an accountant appointed by the directors of a company to perform a valuation of the company's shares, thereby setting the price at which the shares owned by certain shareholders were to be compulsorily acquired, owed those shareholders any duty of care; and, if so, whether the accountant's liability towards those shareholders could be subject to a limitation clause in the contract between the company and the accountant; and, if so, whether the limitation clause satisfied the requirements of reasonableness in the Unfair Contract Terms Act 1977.[128] The claimants were not parties to the contract and so sued in tort.[129] Further, the claimants had not been aware of the limitation clause in the contract.[130] Neuberger J concluded that it was inappropriate to determine the effect of the limitation clause on the shareholders at this interlocutory stage. Nonetheless, Neuberger J considered the state of the law. The authorities canvassed by Neuberger J indicated that an exclusion or limitation of liability clause between two contract parties is not binding on a third party but will be relevant to the determination of whether the contractual party owes a duty to the third party and, if so, the scope of that duty.

This issue then arose for consideration in the first instance decision of Moore-Bick LJ in *MAN v Freightliner*.[137] Moore-Bick LJ considered a limitation of liability clause that limited the liability of E&Y (UK) to each company listed in the schedule to the engagement letter in respect of breach of contract or breach of duty or fault or negligence or otherwise arising out of or in connection to the engagement to a total of £2 million. [138] It was submitted by E&Y (UK) that even if it owed a duty to the third party claimant, its liability for any breach of that duty was limited to £2 million because the third party was aware that E&Y (UK) was only prepared to carry out work on that basis.[139] Again it was not necessary to decide the case on the limitation of liability point (and when the case went on appeal the Court of Appeal made no observations as to the effect of the limitation of liability clause). Nonetheless, Moore-Bick LJ reviewed the case law.[140] Moore-Bick LJ expressed a provisional view as to the appropriate approach.[145] It is important, he stated, to consider whether or not there were channels of communication between the defendant and the third party because 'the existence of a channel of communication provides an opportunity for the maker of the statement to exclude or restrict liability for errors'.[146] Moore-Bick LJ expressed the provisional view that, in cases where there is such a channel of communication, 'it is more appropriate to treat the existence

[127] *Killick v PricewaterhouseCoopers* (*a firm*) [2001] 1 BCLC 65.
[128] *Killick v PricewaterhouseCoopers* (*a firm*) [2001] 1 BCLC 65, 70.
[129] *Killick v PricewaterhouseCoopers* (*a firm*) [2001] 1 BCLC 65, 73.
[130] *Killick v PricewaterhouseCoopers* (*a firm*) [2001] 1 BCLC 65, 74.
[137] [2005] EWHC 2347 (Comm).
[138] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [407].
[139] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [408].
[140] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [410]: pointing to the obiter comments of Lord Brandon in *The Aliakmon*, the position of Purchase LJ in *Pacific Associates v Baxter*, and Lord Goff's observation in *White v Jones.*
[145] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [411].
[146] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [411].

and terms of the contract between A and B as part of the circumstances in which the relationship between A and C falls to be assessed.'[148] The Court must ask: whether the third party knew of the terms of the engagement letter; and, importantly, 'whether that letter and the terms of business when read together and in the context of the surrounding circumstances indicated clearly that E&Y (UK) intended to assume responsibility for the correctness of the audit statement only on limited terms'.[149] On the facts of this case, Moore-Bick LJ noted the absence of any significant degree of communication between the parties in relation to the use of the audited accounts by the third party and concluded (while emphasizing it was unnecessary to express a final view) that E&Y (UK) did not effectively restrict their liability.[150]

Most recently, the issue of disclaimers was considered in *Barclays Bank plc v Grant Thornton UK LLP.*[151] Briefly, the audit report included a disclaimer to the effect that the reports were made solely to the company's director for the purpose of assisting him to fulfil his duties under the terms of the loan facility and that the auditors did not accept or assume responsibility to anyone else. Barclays (who, together with another bank, were providing the facility) brought a claim against the auditors alleging they were negligent in failing to uncover a fraud (perpetrated by two employers in relation to the group's financial reports). The auditors relied on the disclaimer and applied for summary judgment. Barclays argued that the disclaimer was ineffective because it had not been brought sufficiently to their attention or because it did not satisfy the requirement of reasonableness under the Unfair Contract Terms Act 1977. Cooke J gave summary judgment for the auditors. He observed:[152]

> … it is a vexed question whether or not an auditor whose liability is capped to its client by reason of contract can rely on such a limitation against a third party to whom a duty of care is found to exist.

Cooke J pointed to detailed discussion of this issue (although without resolution) in *MAN v Freightliner* (at first instance)[153] and *Killick v PricewaterhouseCoopers* (*a firm*).[154] Cooke J stated:[155]

> Suffice it to say that it would be wholly unjust if the non-contractual entity could rely on statements made primarily to a client with a contractual limitation and assert responsibility on behalf of the auditor to it without any such limitation.

[148] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [411].
[149] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [411].
[150] *MAN Nutzfahrzeuge AGv Freightliner* [2005] EWHC 2347 (Comm) [411].
[151] [2015] EWHC 320 (Comm), [2015] 2 BCLC 537
[152] [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [60].
[153] *MAN v Freightliner* [2005] EWHC 2347 (Comm). The decision went on appeal where Court found that the loss suffered was not of the type that would be covered by any duty the auditor might have owed to the third party. The Court of Appeal did not consider the issue of the disclaimer, nor reflect upon Moore-Bick LJ's observations. See: *MAN Nutzfahrzeuge AG v Freightliner* [2007] EWCA Civ 910; [2008] 2 BCLC 22.
[154] *Killick v PricewaterhouseCoopers* (*a firm*) [2001] 1 BCLC 65.
[155] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [60].

While Cooke J declined to decide the point, he noted that the uncertainty surrounding the state of the law lent force to the auditor's argument that one of the purposes of a disclaimer was to avoid any such issues arising.[156] He stated that the outcome will depend 'on the reasonableness or otherwise of the disclaimer in all the circumstances of the case'.[157] The question is: 'whether a reasonable person in the position of Barclays could properly consider that [the auditor] was undertaking responsibility to it'; in other words, 'what a reasonable person would think [the auditor] was doing'.[158] On the facts of the case, Cooke J held that it was clear that the third party bank was aware that the auditors did not like undertaking responsibility to persons other than their clients and often sought to avoid it; and that the auditor had in fact sought to do so in this case.[159] Cooke J considered a variety of different factors to determine whether or not the disclaimer was reasonable.[160] Cooke J concluded that if the Court applied the test of whether, objectively, the defendants had assumed responsibility to the bank, a reasonable person in the bank's position would not consider there had been such an assumption of responsibility because the disclaimer was clear and obvious, the bank was a sophisticated commercial party, the bank was aware auditors did not like undertaking responsibility to persons other than their clients, the bank did not engage or pay the auditors for their reports and the auditors could not have been expected to do anything further to bring the disclaimer to the bank's attention.[161]

The Courts' obiter observations suggest that a disclaimer or limitation of liability between two contractual parties is relevant to, but not determinate of, the existence and scope of the duty that may be owed to a third party. The extent to which the contractual party communicated with the third party will be relevant to determining what (if anything) the contractual party assumed responsibility for vis-à-vis the third party. Finally, where the third party is a sophisticated commercial party, is aware of the disclaimer and the disclaimer serves a legitimate purpose, it seems likely that the disclaimer will be effective as against the third party.

In restraint of exclusions – the use of mind states

The Federal Court of Australia had far less ambivalence in overruling an exclusion of tort liability to a non-contractual reliant party in the case of *ABN AMRO* discussed earlier. Read in its context, the disclaimer of liability to both purchaser and intermediary was ineffective because it was repugnant to the whole tenor of the agency's conduct; its rating could only have value if it was relied upon for its professional skill, otherwise it was worthless. The analysis was as follows:[162]

> Each Ratings Letter set out the rating assigned by S&P. Each contained a disclaimer … Again, a careful reader of the disclaimer will notice that each

[156] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [60].
[157] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [61].
[158] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [62].
[159] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [64].
[160] *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [65]-[88].
[161] See *Barclays Bank plc v Grant Thornton UK LLP* [2015] EWHC 320 (Comm), [2015] 2 BCLC 537, [40], [62]-[76], [89]-[91], [93].
[162] [2014] FCAFC 65, [612]-[613].

> Ratings Letter identifies what it is *not*. It is not "investment, financial, or other advice" and it went on to state that "you should not read and cannot rely upon the rating as such"… The rating was not advice. It was an expert opinion as to the creditworthiness or the credit risk of the [ABN AMRO-issued] notes. The words set out … are not a disclaimer to the effect that S&P accepts no responsibility for the function or task it was engaged to perform and that is not surprising. A disclaimer in those terms would render the rating devoid of content or meaning and, as the primary judge accepted …, would have rendered the rating content-less, futile and self-defeating.

There were further reasons to knock out the disclaimer. Standard and Poor had clearly held out its opinion as formed by professionals exercising due skill and care; and had rather downplayed the disclaimer of liability in their presentations to the clients. Yet all along the agency executives knew that the rating did not embody due reasonable skill and care, and therefore the publication of the rating to the purchasers was a misrepresentation of fact (i.e. that Standard and Poor purported to act with professional skill) made with a degree of recklessness or even deceit, and so was not caught by the disclaimer. The legal result of this analysis was to deny that through disclaimer a ratings agency could push the risks of loss from a faulty rating onto a purchaser known to be reliant, especially if the rating was suspected to be unsound. It is not clear if the disclaimer in this case would have failed in the presence of ordinary inadvertent negligence without the aggravating gross or reckless elements.

It thus seems likely that the common law does have resources to hold ratings agencies to account for poor quality ratings that cause harm, using the normal tools of private law analysis. Carefully reasoned common law judgments, in the Australian and American judicial traditions, have made that abundantly clear in the past few years. And the case-law expounded here suggests that this approach is compatible with English common law, despite divergences in doctrinal tradition.

E. Re-regulation in the EU and UK – in whose interests?

We may close by observing how the latest raft of statutory intervention in the EU and the UK may have muddied the waters. Indeed the new statutory norms could almost have been designed to throttle at birth the new common law developments in ratings agency liability. Whether this is a product of the public power of the ratings agencies in influencing government is a question worth asking.

The European Union passed fresh regulations and directives in 2010, 2011 and finally in 2013 restating the duties of credit rating agencies, and placing oversight within a new European Securities and Markets Authority.[163] The detailed rules can hardly be said to impose demanding new requirements on the ratings agencies such as to curb their profit taking. There is a requirement that sovereign debt ratings to be issued at set calendar dates and not in real time reaction to political events. There is a ban on blatant conflicts of interest, for example an agency rating an entity that owns 5% or more of that agency. There is a

[163] Credit Rating Agencies Regulation (CRA3), 462/2013, brought into UK law by Credit Rating Agencies (Civil Liability) Regulations 2013/1637.

requirement that all available ratings data (including fees charged) be published on a European Rating Platform to permit ready access and comparison. The meat of the new measures is the creation of a new civil claim where a rating agency 'infringes intentionally or with gross negligence the Credit Ratings Agency Regulation, thereby causing damage to an investor or an issuer'.[164] One would have thought this added little to existing legal liabilities, as the ratings agencies would already be liable for intentional i.e. deceitful practices. On closer scrutiny we shall see how even the addition of a gross negligence test is blunted through national interpretation and application that in effect reads down or eliminates the policy intent behind the rules.

The UK version of this law, the Credit Rating Agencies (Civil Liability) Regulations 2013, states the new liability rules for credit rating agencies as follows (all emphases added):[165]

> …
> 3 …an infringement shall be considered to have been committed intentionally by the credit rating agency if the senior management of the credit rating agency acted deliberately to commit the infringement.
>
> 4(1) …an infringement shall be considered to have been committed with gross negligence if the senior management of the credit rating agency were reckless as to whether the infringement occurred.
>
> (2) For the purposes of this regulation, the senior management of a credit rating agency are reckless if they act without caring whether an infringement occurs.
>
> 5…an infringement has an impact on a credit rating if it results in a different rating category being assigned to the issuer or the financial instrument of the issuer to which the credit rating relates.
>
> 6(1) …an investor reasonably relies upon a credit rating where—
>
> (a) the investor relies upon a credit rating when making an investment decision, and
>
> (b) that reliance is reasonable.
>
> (2) The test for whether the reliance is reasonable is the same as for whether it is reasonable for a person to rely on a statement for the purposes of determining whether the statement gives rise to a duty of care in negligence.

[164] European Commission, 'Stricter rules for credit rating agencies to enter into force', Brussels, 18 June 2013; for ESMA activity see eg https://www.esma.europa.eu/page/CRA-documents.
[165] Credit Rating Agencies (Civil Liability) Regulations 2013/1637. Glosses are offered by Andrew Wanambwa, 'Civil liability of credit rating agencies' (2014) 29(8) *Journal of International Banking Law and Regulation* 519;

7 …an investor shall be considered to have exercised due care if the investor took the care a reasonably prudent investor would have exercised in the circumstances.

8 …the test of causation in negligence applies for the purposes of determining whether an infringement caused damage.

…

10(1) If the claimant is an issuer and it, or a related third party, has entered into a contract with a credit rating agency to assign a credit rating in respect of such issuer or a financial instrument issued by such issuer, the court may consider the following factors, amongst others, to be indications that a limitation on liability is reasonable and proportionate—

(a) the limitation resulted from contractual negotiations between the issuer, or a related third party, and the credit rating agency;

(b) the price agreed between the issuer or a related third party and the credit rating agency reflects the extent of the limitation on liability;

(c) the credit rating agency gave the issuer a reasonable opportunity to submit additional factual information not previously available to the credit rating agency, or to clarify any factual inaccuracies regarding the proposed credit rating, before the credit rating was issued, and took account of those submissions or comments when finalising the credit rating;

(d) the limitation relates to losses which the credit rating agency could not reasonably have foreseen when it assigned the credit rating;

(e) the limitation relates to losses which no credit rating agency could reasonably insure against on a prudent commercial basis;

(f) the limitation relates to losses which no credit rating agency would reasonably be expected to have the resources to meet.

(2) The absence of a factor or factors in paragraph (1) does not indicate that a limitation on liability is unreasonable or disproportionate.

12(1) If the claimant is an investor the court may consider the following factors, amongst others, to be indications that a limitation on liability is reasonable and proportionate—

(a) the limitation resulted from contractual negotiations between the investor and the credit rating agency;

(b) the price agreed between the investor and the credit rating agency reflects the extent of the limitation on liability;

(c) there is no relationship of proximity between the credit rating agency and the investor;

(d) the limitation relates to losses resulting from unexpected or unusual uses of the credit rating;

(e) the limitation relates to losses which the credit rating agency could not reasonably have foreseen when it assigned the credit rating;

(f) the limitation relates to losses which no credit rating agency could reasonably insure against on a prudent commercial basis;

(g) the limitation relates to losses which no credit rating agency would reasonably be expected to have the resources to meet.

(2) The absence of a factor or factors in paragraph (1) does not indicate that a limitation on liability is unreasonable or disproportionate.

(3) A limitation of liability is not likely to be reasonable and proportionate if the credit rating agency fails to take reasonable steps to bring the limitation to the attention of investors.

13(1) The damages recoverable by an issuer in a claim … are—

(a) where the issuer, or a related third party, has entered into a contract with a credit rating agency to assign a credit rating in respect of such issuer or a financial instrument issued by such issuer, the damages recoverable by the issuer in accordance with that contract; or

(b) where there is no such contract, the increase in the financing costs of the issuer resulting from the affected credit rating.

14 The damages recoverable by an investor in a claim … are—

(a) where the investor enters into a contract with a credit rating agency to provide a credit rating, the damages recoverable by the investor in accordance with that contract; or

(b) where there is no such contract, the damages that would be recoverable by the investor if the investor had succeeded in a claim against the credit rating agency in the tort of negligence.

15(1) The common law principle that a claimant's damages may be reduced if the claimant fails to mitigate their loss applies to any damages ….

> (2) The provisions of the Law Reform (Contributory Negligence) Act 1945 apply to any damages..
>
> 16 No claim may be brought … after the expiry of the period of one year beginning with the date on which the claimant discovered the infringement, or could with reasonable diligence have discovered it.

These regulations add nothing to extant common law protection, but rather give a long list of reasons to limit or exclude the credit rating agencies' liability, a high bar for mens rea, a remarkably short one year limitation period, and directions to take into account the insurability and capacity to pay of the agency, i.e. its profitability under any new liability rules. Indeed the new regulations may even cut back the fledgling common law protections that do exist. At least one commentator has predicted that the statutory action will likely be a dead letter.[166] So far there are no reported civil claims under these laws. It is likely that the *ABN AMRO case* would have failed under this statutory regime.

One interesting feature of the new regulations seems to cut back rating agency liability but may also affect the agency's business model. The EU rule, executed aggressively in the UK instantiation, requires financial institutions to make their own internal risk assessments and not rely entirely on external ratings; mitigation and contributory negligence are examples of local vehicles used to cut back potential agency liability. This could turn out to be significant since issuers and purchasers have in the past paid for ratings in order to *replace* their own risk assessment with that of the credit rating agencies; if the law now sheets risk for poor assessment back to the head parties then responsibility for risk cannot be evaded by investment managers by pointing to their reliance on external ratings. In which case it will become unclear why it is valuable for the head parties to hire the ratings agencies in the first place, since the main point of the exercise is to remove market risk to a place where losses cannot be litigated against any responsible decision maker. It would be a delicious irony if the legislature, in purporting to institute fresh liabilities for ratings agencies to displace the common law whilst aiming in effect to shrink practical liability to vanishing point, ended up destroying the businesses they were trying to protect.

Sometimes principals need protection from law to save them from their agents; and some self-seeking agents have to be legally controlled to save them from themselves. Perhaps what we have seen in the story of rating agencies is a case of the common law haltingly reaching for decent solutions to the problems of finance after many false starts, only to be stymied at the last gate in this country by political intervention. The alternative story is that the local political sovereign in the United Kingdom (but not in Australia or the United States, or indeed the rest of the European Union) has curbed the development of new liabilities in the courts, in order to make space for a free market solution to the fraught problem of rating agency liability. It is too soon to tell. In time, both stories may turn out to be true.

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[166] Giorgio Risso, 'Investor protection in credit rating agencies' non-contractual liability: the need for a fully harmonised regime' (2015) 40 *European Law Review* 706.