

Credit Crunch Proceedings

Debt-trading and the credit crunch

In all the current commentary concerning the credit crunch and the selling of American mortgage-backed securities, or so-called ‘toxic debt’, the potential liability for fraudulent misrepresentation, both in the criminal and civil law, has largely been ignored, or the analysis has been skirted over. This may be because it has been assumed that there is little or no possibility of anyone being fixed with such liability. This article will examine this proposition and the difficulties with any such proceedings, and the circumstances in which it might be possible to bring proceedings successfully.

First, though, who are the potential targets for any litigation? The first and most obvious are the traders who sold or on-sold the packaged securities. It is not difficult to imagine that they may have made representations either as to the nature or the safety of the investments they were selling. Second could be the banks themselves, either vicariously liable for representations made by their employees in the course of their employment, or as issuers of such securities. Another potential target could be the ratings agencies, for the representations they made as to the quality of the investments and their volatility.

It seems, as will be set out in detail below, that criminal proceedings, whilst possibly attractive to the general public, are unlikely for a number of reasons to get off the ground. The most likely targets in civil proceedings are either the ratings agencies, or the issuers of the securities who provided information to the ratings agencies about them in order for the ratings agencies to form a view on the investments. This is not to say, of course, that bringing a civil claim any way preclude reporting suspected criminal activity, and in some circumstances there may be an obligation to do so.

Re-kindling our legal articles for those working in tax, William Christopher, McGrigors, considers how legal action might be taken against parties involved in the debt-trading that apparently led to the ‘credit crunch’

Whether criminal or civil, each case will of course turn on its facts. It may require a whistleblower to come forward to shed light on the processes within either the banks or the ratings agencies to make it possible for any such claims to be brought. This has been thrown into sharp relief by the report in the press recently that Lord Foulkes has written to the Financial Services Authority (FSA) in relation to information he has received from RBS insiders that non-executive directors were pressurised into not asking questions about the financial state of the bank. He has asked that an investigation is undertaken into whether investors or depositors were misled about the banks’ exposure to bad debts.

Criminal offences

It is highly likely that public opinion would be firmly behind the prospect of someone being held to be criminally liable for the current financial crisis. There are criminal offences which could potentially apply to the selling of these securities. First there is the Financial Services and Markets Act 2000 (FSMA) and in particular s 397. This states:

‘397. Misleading statements and practices.

‘(1) This subsection applies to a person who

‘(a) makes a statement, promise or forecast which he knows to be misleading, false or deceptive in a material particular;

‘(b) dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise; or

‘(c) recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular.

‘(2) A person to whom subsection (1) applies is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made) ‘(a) to enter or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement; or ‘(b) to exercise, or refrain from exercising, any rights conferred by a relevant investment ...’

Similar offences are created by the more recent Fraud Act as follows:

‘1 Fraud

‘(1) A person is guilty of fraud if he is in breach of any of the sections listed in subsection (2) (which provide for different ways of committing the offence).

‘(2) The sections are

‘(a) section 2 (fraud by false representation),

‘(b) section 3 (fraud by failing to disclose information), and

‘(c) section 4 (fraud by abuse of position).’

All of these offences are committed if the act is carried out with the intention of either making a gain for the defendant or another, or causing loss to another.

However, despite these offences being available to prosecuting authorities, there are several reasons why the criminal law might not provide effective awareness for redress.

First, and probably most important, there is the difficulty caused by the high standard of proof in criminal proceedings, which is that the offence must be proven beyond reasonable doubt. This can be a high hurdle in much simpler offences than those set out above, which of course concern an area of business which was apparently considered to be difficult to understand by many of those involved in it, let alone a jury. It is likely to prove fatal to successful prosecutions of these offences, particularly in the context of the complex area of securitisation and the selling of collateralised debt obligations.

Second is public policy. The FSA would probably have to bring a prosecution, certainly in relation to the offences under FSMA. The FSA is a creature of the tripartite regulation regime (together with the Bank of England and HM Treasury) brought in by the current government, whose remit was light-touch regulation. It could be said that we are where we are today as a result of the last 10 years of such regulation. The activity in relation to the packaging of these securities was well known and widespread, and the Government was content to regulate the market with the lightest of touches whilst it was making large returns for the banks, and thus to the Government's coffers through taxation. This may well lead the FSA (or indeed the Serious Fraud Office) to conclude that to bring any prosecutions would not be in the interests of public policy. Indeed the FSA has not to date demonstrated any huge appetite to bring any such proceedings since FSMA came into force. In fact only one case has been brought in the last eight years. Since the credit crunch began, no upsurge in FSA activities in this area can be identified. However, if the FSA did decide to prosecute, investors could be compensated under the criminal compensation regime as part of sentencing on a conviction being obtained. This is in fact what occurred in the one case which has reached the courts and which resulted in convictions.

For all of the above reasons it is probably unlikely that many criminal proceedings would be successful, and criminal charges would probably not be brought in many cases. Civil law, with its lower standard of proof (on the balance of probabilities, rather than beyond reasonable doubt), may prove to

be a more fruitful environment in which to consider proceedings.

Deceit or fraudulent misrepresentation

What are the possibilities of civil liability for fraudulent misrepresentation or deceit being established? The elements of the tort of deceit are:

- X makes a representation to Y
- X knows the representation is false, or has no honest belief in its truth, or is reckless as to whether or not it is true
- X intends Y to rely on the representation
- Y does rely on the representation
- Y is caused loss and damage as a result of such reliance.

The advantages of a claim in deceit

Some important points to note in relation to this tort are the following.

- It is not necessary to show there is a duty of care existing between the person making the representation and the person relying on it, just that a representation was made by one, to the other. This can include a representation to a class of people which includes the person relying on it.
- Where the representation is an opinion, there is also 'always an assertion that the maker does indeed hold that opinion' (*Brown v Raphael* [1958] Ch 636). Where a representation of opinion is made by a professional man, with more knowledge than the person to whom the representation is made, there is also an implied representation that he genuinely believes there are reasonable grounds for holding that opinion.
- It is not necessary to show there was an intention to induce Y into entering into a contract with X, just an intention that Y would rely on the representation which caused him loss.
- Finally, if liability can be established the damages which can be recovered are all those which are caused by the deceit, whether foreseeable or not.

Those then are the advantages of attempting to bring civil proceedings for deceit. There are, however, also significant difficulties in doing so.

The difficulties of a claim in deceit

Before examining the difficulties in each of the elements of the tort, it is worth noting that an allegation of fraud carries with it some additional hurdles. Despite the lower standard of proof in civil proceedings, if an allegation of fraud is made it must be properly particularised and based on reasonably

credible material which, without more, establishes a *prima facie* case of fraud. There is also a higher burden as to the cogency of the evidence. The court works on the assumption that the more serious the allegation, the less likely the event is to have occurred, therefore the more proof there needs to be that it has occurred.

Taking first the position of a trader in the trade of a security (and the trader's employer, as any representation is likely to be found to have been made in the course of the trader's employment) and leaving aside for the moment the potential that the position may be different for a trader of the securities in the bank which issued them, as opposed to an investment bank dealing with them in subsequent trades, the position may be as follows. A trader may make a representation to another as to the quality of the investment he is seeking to trade, a representation which transpires to be unfounded. He may well intend the prospective purchaser to rely on the representation he makes and the purchaser may indeed rely upon it (although see below). This is likely to cause loss to the investor.

However, the very difficult element to prove will be the state of the trader's mind, namely whether he knew that the representation was false, or whether he had no honest belief in its truth, at the time the representation was relied upon and loss was caused.

The seller is likely to resist an allegation on any one or more of a number of grounds. Most obviously he could point to the rating of the securities by the rating agency as evidence that he did hold an honest belief that any representation based on this rating was true. On a more general note it is difficult to see how a trader could have the requisite lack of honesty. Mere carelessness is not sufficient. To prevent a false statement being fraudulent there must always be an honest belief in its truth – Lord Hershell in *Derry v Peek* (1889).

There is also a difficulty with the element of reliance and, linked with it, causation. Whilst there may be an intention of the seller that the buyer will rely on the representation, the courts may be reluctant to find that the representation did operate on the mind of the buyer so that he acts in a certain way. The courts have in the past, particularly in the recent case of *JP Morgan Chase Bank v Springwell Navigation Corp* [2008]

EWHC 1186 (Comm), demonstrated that they are reluctant to interfere in dealings between sophisticated investors. This may be the case in the circumstances described, unless an element of dishonesty can be shown. If an investor would have bought the security regardless of the representation made to him, the requisite reliance is not proved, neither could it be said that the misrepresentation caused the loss.

Where there might be a case

What about where the trader making the representation has insufficient knowledge to form any opinion as to whether the ratings agencies have got it right? Is this sufficient for this element to be made out? Or, indeed, what about the situation where the trader actually thinks that the ratings agency has got it wrong but intends to rely on the agency's rating anyway, because he can sell the security and make money for himself and his employer? The latter situation may well provide the absence of an honestly held belief necessary to make out the tort of deceit.

It is also worth noting that the terms and conditions under which trades take place have not been litigated over. The courts have not had an opportunity to consider the terms and the disclaimers in them in the context of a claim in deceit concerning the trading of these securities.

What becomes apparent from the above analysis is that the role of the ratings agencies is an important one and investors do indeed rely on them to influence their decisions as to whether to buy a security or not. Ratings agencies, however, maintain that their ratings are not intended to be relied upon and disclaimers form a large part of their descriptions as to what a rating is and how they undertake it.

The disclaimers provide that ratings are opinions and are not statements of fact. They will state that they are not intended to amount to investment advice, neither are they recommendations to buy, hold or sell particular securities. They are issued, according to the disclaimer, in the understanding that investors will carry out their own study and evaluation of a particular security. They state that the ratings agency has no obligation to, and in fact does not, carry out any due diligence to check the accuracy of the information provided to it. Finally the ratings agencies state that they have relied on information provided to them by the issuers, who



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also pay for the ratings agencies to provide the ratings.

In these disclaimers the ratings agencies seek to deal with all of the elements of the tort of deceit. They are not making a representation about anything, it is an opinion anyway, they themselves have relied on information being accurately provided to them which they have not checked and they specifically do not intend anyone to

LEGAL CONCEPTS

If any readers feel they need guidance on a legal topic which is relevant to their tax work, or would like to write on a particular topic, could they please get in touch with the Editor at alison.lovejoy@lexisnexis.co.uk.

Topics already covered: *US Cartel Investigations* (850); *Extradition* (849); *Directors' Duties* (825); *Criminal Law* (821); *Leases Pts 1 & 2* (814, 816); *Freehold Land* (812); *Property Investment Vehicles* (807); *Land Law* (805); *Scottish Property Law* (792); *Memorandum & Articles of Association* (785); *Buyback of Shares* (775); *Contract Law Pts 1 & 2* (771, 772); *Employment Litigation* (763); *Termination of Employment* (758); *Standard Employment Documentation* (756); *Who Is An Employee?* (755); *Dividends* (746); *Financial Assistance* (744); *Accession and Community Law* (740); *Share Capital* (739); *Share Issues* (736); *Gilt Strips* (735); *Finance Leasing* (727); *Securitisation* (725); *Repackaging* (723); *Derivatives* (721); *Stock Loans and Repos* (720).

rely on it and investors should make their own enquiries. However, these disclaimers will not enable the party relying on them to limit liability for fraud.

There is also an inherent conflict of interest, as the agencies are being paid to provide the ratings at a certain level by the issuers. Further, does the trail of who has made a representation come back again to the issuer, who has provided information to the ratings agencies to enable them to rate their products whilst at the same time paying them for rating their products at a certain level?

If an issuer makes representations about the quality of the securities it wishes to have rated then, as it has more information about the strength of those securities backing the packaged debt, it will not only have to honestly believe the representations it makes, it will also represent that it *bona fide* believes that there are reasonable grounds for making the representation – see *Barings plc (in liquidation) v Coopers & Lybrand* [2002] EWHC 461 (Ch). If this is not the case, there may be sufficient grounds to allege deceit.

It would be incredibly interesting to see disclosure of documents which set out the in-house policies of ratings agencies and to establish whether they were followed. More interesting still would be to establish what the internal practices actually were in relation to the rating of CDOs.

Conclusion

There may well be circumstances in which it might be possible to bring an action in deceit. This view does come with certain limitations, though. No ratings agency has ever been sued in England and Wales, although a case was issued in the USA, in the Southern District of New York. It is not clear how this case is progressing. Any such proceedings in this jurisdiction will therefore be of a novel nature. An action against an issuer or a trader in deceit involving the rating and selling of these securities will be similarly unusual. It is not readily apparent whether circumstances exist which might give rise to a claim in deceit and the chances of succeeding in any such action will depend very heavily on someone coming forward to shed light on the practices involved.

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