

3 Stone Buildings Seminar – 18 November 2008
Law and the Management of Risk

Securitisations – Risk and the Financial Expert
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A. Introduction: What is a securitisation?

1. A securitisation involves using the income stream from a portfolio of cash generating assets to repay the principal and pay interest on marketable bonds (the “securities” from which the procedure derives its name). The company which owns the assets (the “Originator”) transfers the benefit of the income stream to a special purpose vehicle (the “Issuer”), whose business is solely to receive the cash generated. In order to raise the cash required to acquire the receivables from the Originator, the Issuer issues bonds to investors in return for payment. A trustee for the bondholders is granted security over the assets. The cash received by the Issuer from the income stream is used to pay the bondholders the sums due to them under the terms of the bonds.
2. The credit rating of the bonds will be higher than that of the Originator. Amongst other things, the Issuer is isolated from the risks of the Originator’s business. And its credit rating can be further enhanced by means of credit derivatives and other devices. Consequently, the bonds provide (in theory) a relatively safe form of investment for the bondholders and, at the same time, the interest paid by the Issuer will be considerably less than the Originator’s cost of borrowing. Thus the Originator obtains, in effect, the present value of its future cash flows, but discounted on a basis which is less than the interest it would pay on a traditional loan.
3. The cash generating assets can be all kinds of things: credit card receivables, receivables from leases of real property or goods, and so on. The most common type of securitisation involves mortgage loans; and the US market in such debt, particularly that related to so called sub-prime

borrowers, has played the central role in the ongoing credit crunch.

4. Many different specialist skills are required in structuring a securitisation. For example:-

- (1) The “Arranger”, which has overall organisational control, will normally be an investment bank which charges a handsome fee for the service, as well as often benefiting from providing bridging loans to the Originator whilst the securitisation is set up.
- (2) Some process of determining the present value of the future income stream will be required, which might involve a number of different skills, depending on the nature of the underlying assets, including e.g. property valuation and financial modelling.
- (3) The rating agencies (Standard & Poor’s, Moody’s and Fitch) must also be involved to determine the appropriate rating for the various classes of bonds to be issued. The rating agencies are normally paid by the Arranger, yet their function is to provide a measure of the relative reliability of financial instruments which will be relied on by investors. This generates an obvious potential for conflicts of interest.

5. The issue which this paper addresses is the extent to which these financial experts take any risk of having to pay damages to investors if the securitisation fails. It is concerned, in particular, with whether such parties might incur liability by virtue of statements made in the prospectus, often called an “Offering Circular”, issued to inform investors about the transaction.

B. The regulatory regime

6. The current regulatory regime in relation to prospectuses is derived from the Prospectus Directive of 4 November 2003 (Council Directive (EC) No. 2003/71) and the Regulation of 29 April 2004 (Commission Regulation (EC) No. 809/2004) which deals with the required content of prospectuses. Apart from the direct effect of the Directive as a matter of European law, these EU provisions have been given effect in English law by means of:-

- (1) Amendments to Part VI of the Financial Services and Markets Act 2000 (sections 72 to 103);
 - (2) The Prospectus Regulations 2005 (SI 2005/1433), which came into force on 1 July 2005; and
 - (3) A new section within the FSA Handbook containing Listing Rules, Disclosure and Transparency Rules and Prospectus Rules.
7. In the case of many securitisations, the Offering Circular is likely to be exempt from these regulations because the offer of securities is being made only to “qualified investors” or to fewer than 100 people other than qualified investors (see sections 86(1)(a) and (b) of FSMA). “Qualified investors” include legal entities authorised or regulated to operate in the financial markets and entities whose corporate purpose is solely to invest in securities (Article 2.1(e) of the Prospectus Directive).
 8. If the regulations apply, one of the most important rules is that certain people or entities are expressly determined to be “responsible” for the prospectus (FSA rule 5.5.4). These include the Issuer of the securities and any person “*who accepts, and is stated in the prospectus as accepting, responsibility for the prospectus.*”
 9. Section 90 of FSMA gives an investor a statutory right to compensation from any person “responsible” for the prospectus, if he has suffered loss as a result of any untrue or misleading statement in the prospectus or the omission of any matter required to be included. In addition to the statutory compensation, section 90(6) of FSMA provides that the section “*does not affect any liability which may be incurred apart from this section.*”
 10. If the securitisation is exempt from the regulations, the statutory right to compensation obviously does not apply. But the regulations still have some relevance because prospectuses are, in practice, frequently drafted as if they were intended to comply with them. In particular, they tend to contain wording along the following lines:

“The Notes will be obligations of the Issuer only and will not be guaranteed by, or be the responsibility of, any other person.

The Issuer accepts responsibility for the information contained in

this document. To the best of the knowledge and belief of the Issuer (having taken all reasonable care to ensure that such is the case), the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information. The Issuer accepts responsibility accordingly.”

11. An important issue which arises in English law is the impact of such wording on the potential liability of parties other than the Issuer for misstatements in the Offering Circular.

C. Liability under the common law

12. There are four principal ways in which the liability of a party other than the Issuer might be argued to arise in connection with the publication of an Offering Circular:-

- (1) As a result of a fraudulent misrepresentation;
- (2) Under section 2(1) of the Misrepresentation Act 1967;
- (3) As a result of negligent misstatement (see *Hedley Byrne v Heller* [1964] AC 465); and
- (4) As a result of a “freestanding” duty of care owed to investors as a result of the role played by the defendant in the transaction (by analogy with the kind of claims considered in *Henderson v Merrett* [1995] 2 AC 145).

13. Leaving fraud aside, there is likely, in practice, to be a fair degree of overlap between the other three legal bases for a claim. The considerations applicable to a claim in deceit are, to some extent, distinct and are not the focus of this paper.

The Misrepresentation Act

14. Section 2(1) of the 1967 Act provides:

“Where a person has entered into a contract after a

*misrepresentation has been made to him **by another party thereto** and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made that the facts represented were true.”*
(emphasis added)

15. The principal advantage of a claim based on this provision is that it is not necessary to establish a duty of care. The principal disadvantage is that the misrepresentation has to have been made by the other party to the contract. Thus, in the case of an investor purchasing securities, there can only be liability under the Act for a misstatement in the Offering Circular if the party from whom the investor purchased the bonds can be said to have made the relevant statement in the Offering Circular.
16. If the vendor was itself merely an investor which was selling the bonds on in the aftermarket, the Act is unlikely to be of assistance to a purchaser who was misled by the Offering Circular, since the vendor cannot be said to have made any statement by means of it (unless, of course, as a result of something he has said or done, the vendor has repeated or affirmed the statements made in the Offering Circular).
17. But even if the vendor was, for example, the Arranger of the securitisation, there will be a real issue as to whether any statements in the Offering Circular can be regarded as statements made by the Arranger. Given the statement commonly found in Offering Circulars to the effect that the Issuer is responsible for its contents, it might be said that the Arranger made no statements through the Offering Circular at all.

Negligent Misstatement / Duty of Care

18. Related problems arise in relation to a claim based on negligent misstatement or a freestanding duty of care. In *Customs and Excise Commissioners v Barclays Bank plc* [2007] 1 AC 181 the House of Lords underlined the importance of the “assumption of responsibility” test when considering the existence of a duty of care, whilst accepting that such a test is not necessarily decisive. As Lord Hoffmann said (at page 198), the

“*assumption of responsibility*” test can provide useful guidance in certain kinds of case:

“For example, in a case in which A provides information to C which he knows will be relied upon by D, it is useful to ask whether A assumed responsibility to D ... Likewise, in a case in which A provides information on behalf of B to C for the purpose of being relied upon by C, it is useful to ask whether A assumed responsibility to C for the information or was only discharging his duty to B ... Or in a case in which A provided information to B for the purpose of enabling him to make one kind of decision, it may be useful to ask whether he assumed responsibility for its use for a different kind of decision ... In these cases in which the loss has been caused by the claimant’s reliance on information provided by the defendant, it 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).”

19. If the information being supplied in the Offering Circular is expressly stated to be the responsibility of the Issuer, does that preclude the possibility that someone else might have assumed responsibility to investors for that information? In circumstances where there is a dispute as to whether responsibility was assumed by one party (e.g. the Arranger) as opposed to another entity (e.g. the Issuer), the question is whether the claimant could reasonably rely on an assumption of responsibility by the defendant.¹

20. As we have seen, the purpose of identifying the Issuer as responsible for the information is to comply with the regulatory provisions potentially leading to liability under section 90 of FSMA. That section expressly preserves liability arising in other ways. The Issuer is, by design, a vehicle with no existence independent of the securitisation. The Issuer will inevitably have relied on third parties to provide the information in the Offering Circular: it is unlikely to have had any staff of its own to do so. Furthermore, the Issuer has no assets other than the cash-flows intended to

¹ This is the test applied by Lord Steyn in *Williams v Natural Life Health Foods Ltd* [1998] 1 WLR 830 (at page 837) in circumstances where the claimant alleged that a company director, rather than the company, had assumed responsibility: arguably a more extreme case than an allegation that an arranger or lead manager is liable for statements in an Offering Circular.

pay the sums due under the terms of the bonds. If the cash-flows are insufficient to do that, it is unlikely that the liability of the Issuer, under section 90 or otherwise, will be of any comfort to an investor.

21. Might it be said, in those circumstances, that it is reasonable for an investor to rely on parties other than the Issuer as having undertaken responsibility for the accuracy of the information in the Offering Circular? What if there is expert evidence to the effect that everyone operating in the securitisation market knows and expects that Arrangers make extensive checks of the information to be contained in the Offering Circular, knowing and intending that it is going to be relied on by investors?

IFE v. Goldman Sachs

22. So far as the writer is aware, there is no English authority dealing with these questions in the context of a securitisation.
23. There is, however, a recent authority dealing with similar questions in relation to a syndicated loan. In *IFE Fund S.A. v. Goldman Sachs International* [2007] 1 Lloyd's Rep. 264 (Toulson J) and [2007] 2 Lloyd's Rep. 449 (CA) Goldman Sachs was the Arranger of the syndicated loan, raising money to enable the Issuer, Autodis, to purchase shares in a company called Finelist. Goldman Sachs prepared a Syndicate Information Memorandum ("SIM") on which IFE relied in deciding to lend a €20 million share of the €257 million mezzanine facility which constituted part of the finance provided to Autodis. The SIM contained certain information prepared by Arthur Andersen.
24. After the SIM had been sent to IFE, Arthur Andersen produced further reports which, as the judge found, showed that the statements about Finelist's financial performance in the SIM were, or might have been, materially incorrect. On 30 May 2000, when it executed an agreement to loan €20 million, IFE was unaware of the further reports prepared by Arthur Andersen. In fact, Finelist's financial position was not as it appeared in its accounts and the information in the SIM was inaccurate.
25. IFE contended that Goldman Sachs had been obliged to reveal to it the further reports prepared by Arthur Andersen. IFE relied on (i) the Misrepresentation Act 1967, (ii) a claim for negligent misstatement and (iii) a claim under a "freestanding" duty of care to inform IFE about the

further reports.

26. A central issue in the case was the effect of an “Important Notice” under cover of which the SIM was provided to IFE. The notice stated that the information in the SIM had been obtained from various sources and that:

*“The Arranger [i.e. Goldman Sachs] has not independently verified the information set out in this Memorandum. Accordingly, **no representation, warranty or undertaking, express or implied, is made and no responsibility is accepted** by Goldman Sachs International ... as to or in relation to the accuracy or completeness or otherwise of this Memorandum ... Neither the Arranger, nor any of its respective directors, officers [etc.] shall be liable for any direct, indirect or consequential loss or damage suffered by any person as a result of relying on any statement contained in this Memorandum or any such other information.”*
(emphasis added)

27. The Important Notice also stated that:

“The information contained in this Memorandum should not be assumed to have been updated at any time subsequent to the date shown on the cover hereof ... The Arranger expressly does not undertake ... to advise any potential or actual participant in the Facilities of any information coming to the attention of the Arranger.”

28. The judge (Toulson J) dismissed IFE’s claim. He held that the effect of the Important Notice was that Goldman Sachs had not made any express or implied representation in the SIM. The Important Notice was not an exclusion of liability which could be reviewed under the Unfair Contract Terms Act 1977, but went to the scope of the representations being made, or of the duty of care. In the course of reaching these conclusions, the judge said:

“It would not be right to approach the SIM as if it were a document issued to members of the public unversed in financial matters and unlikely to have professional advice. It was a document issued to financially sophisticated entities operating in a specialist market. The structuring of syndicated mezzanine finance is a complex business, but one that is understood by its participants ...

Similarly, in the specialised world of syndicated finance there is everything to be said for leaving the participants to determine the respective responsibilities and risks of the sponsors, the debtor, the arranger and the investors, and for respecting their decisions. The SIM has to be read as a whole in order to see what a reasonable participant would understand was the scope of the responsibility undertaken by the arranger in relation to its contents.” (paras 52 and 53)

29. The Court of Appeal upheld Toulson J’s judgment. Waller LJ held that:-
- (1) In the light of the Important Notice, a claim based on a freestanding duty of care was hopeless: *“Nothing could be clearer than that [Goldman Sachs] were not assuming any responsibility to the participants”* (para 28).
 - (2) The claim based on negligent misstatement could not succeed if the claim under the Misrepresentation Act did not succeed (para 28).
 - (3) Thus, the principal questions were whether Goldman Sachs made any express or implicit representation of fact when providing the SIM to IFE and whether any such representation continued to be made on 30 May 2000 (paras 29 & 31).
 - (4) IFE could not establish the alleged representation by Goldman Sachs that it did not know facts rendering the information provided in the SIM inaccurate: such a representation was precluded by the Important Notice, which made it clear that Goldman Sachs had no obligation to check the information (para 34).
 - (5) Although it might otherwise have been possible for IFE to establish an implied representation that, as far as Goldman Sachs was aware, the reports and conclusions reflected Arthur Andersen’s view of Finelist as at the date of the SIM, it was impossible to do so in the light of the statement in the Important Notice that Goldman Sachs did not undertake to advise IFE of any information coming to its attention after the date of publication of the SIM (paras 35-37).
30. Gage LJ said that the only implied representation made by Goldman Sachs was, as the judge had found, that, in supplying the SIM, it was acting in good faith; in other words, it was not knowingly putting forward

information likely to mislead. That representation would only be untrue if Goldman Sachs actually knew that it had information which made the SIM unreliable, and this was tantamount to an allegation of dishonesty which had not been asserted (para 74).

D. Conclusions

31. Plainly, the wording of the Important Notice in the *IFE* case was very favourable to Goldman Sachs. In the context of a securitisation, it is not obvious that a statement that the Issuer is responsible for an Offering Circular would necessarily preclude an investor from establishing that the Arranger had made representations by means of it. Nor is it obvious that, where the Arranger is, in fact, making a representation from its own knowledge, a statement that it is not making a representation could be legally effective.
32. Rating Agencies, however, tend to include wide ranging disclaimers in their “New Issue Reports” which are provided to investors. Here is one to be found in very small print at the bottom of such a report in a case with which the writer was recently involved:

*“...All information contained herein is obtained by [the Agency] from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided ‘as is’ without warranty of any kind and [the Agency], in particular, **makes no representation** or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall [the Agency] have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of [the Agency] or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if [the Agency] is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY [the Agency] IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling...” (emphasis added)*

33. It seems unlikely, in the light of the *IFE* case, that any claim could be

mounted which could circumvent a disclaimer like this.

34. Perhaps more importantly, the *IFE* case does not greatly advance the debate as to whether an Arranger, valuer or other professional, who might not have the benefit of such a wide disclaimer, might owe a duty of care to investors. Certainly the purchasers of bonds issued in a securitisation are sophisticated investors who have the benefit of professional advice. But there is an important distinction to be made between:-
- (1) The risk that the investment might not perform as anticipated (e.g. because property values fall, thereby reducing the security available in relation to mortgage backed securities), which investors accept; and
 - (2) The risk that the existing facts stated in the Offering Circular turn out not to have been the case, which investors do not accept.
35. In the *IFE* case, Goldman Sachs had not attempted to verify any of the information in the SIM, and had made it clear that they had not. But an Arranger of a securitisation will normally carry out some degree of due-diligence in relation to the assets being securitised and is likely to undertake the financial modelling itself. Market participants know and expect the Arranger to undertake that role. And although the investors are likely to be sophisticated institutions, their business would cease to function if they attempted to carry out the kind of due-diligence which would be required to satisfy themselves that assets being securitised were correctly represented in the Offering Circular.
36. What if the Arranger produced a financial model which failed to calculate correctly (i.e. it was wrong as a matter of mathematics, rather than because assumptions had been made which turned out to be incorrect)? The investor can review the model, but will have nothing like the same time to do so as the Arranger. If the Arranger knows and intends that investors will rely on the model it has produced, why should it not owe a duty to investors to ensure that the model calculates accurately?
37. Given the significance of securitisations to the ongoing difficulties in financial markets, it is reasonable to assume that the Courts will have to grapple with some of these questions in the not too distant future. In the meantime, the writer makes no representations as to whether claims by investors are likely to succeed.