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Risk Disclosure Statements Save Barclays from Securities Fraud Suit

SCOTT S. BALBER AND STACEY TRIMMER

According to the authors, a recent federal court decision suggests that reckless investors were just as much at fault for the economic bubble that burst, as the financial institutions that packaged and sold risky securities.

The United States District Court for the Southern District of New York has dismissed a securities class action case against Barclays Bank PLC arising from its offerings of American Depository Shares. The court found that Barclays' disclosure of the risks associated with those securities was adequate, and thus, plaintiffs had failed to state a claim that defendants misled investors by improperly accounting for risky real estate business. The court further found that the plaintiffs lacked standing and failed to timely file the action.¹

THE OFFERINGS

The lead plaintiffs in this action were purchasers of securities in one or more of four separate offerings of American Depository Shares (the "Securities") issued by Barclays between April 2006 and April 2008 (the "Offerings") pursuant to two shelf registration statements and several prospectuses (the "Offering Materials"). The defendants included Barclays, several former Barclays' directors, and the investment banks that under-

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wrote the securities offerings. The plaintiffs asserted claims under Sections 11, 12(a)(2), and 15 of the Securities Act of 1933, which included allegations that defendants failed to disclose and write down mortgage-related assets during the Offerings and provided misleading descriptions of risk management practices.

Plaintiffs contended that during the time of the Barclays' four securities offerings between April 2006 and April 2008 — Series 2 in April 2006, Series 3 in September 2007, Series 4 in November 2007, and Series 5 in April 2008 — Barclays "held large amounts of risky mortgage-backed assets," including: (1) Alt-A mortgages and residential mortgage-backed securities ("RMBS") with par value of over £5 billion; (2) subprime mortgages and subprime RMBS with par value of over £6 billion; (3) gross exposure to risky mortgage-backed collateralized debt obligations ("CDOs") of approximately £5 billion; (4) commercial real estate related assets of approximately £8 billion; and (5) exposure to structural investment vehicles ("SIVs" and "SIV-lites") of £0.9-1.6 billion.

On account of these risky assets, plaintiffs claimed Barclays had total credit market exposure of greater than £36 billion. In addition, in late 2006 specialized indices such as ABX.HE and TABX.HE indicated that the value of RMBSs and CDOs began to decline substantially due to a rise in mortgage loan defaults. Thus, plaintiffs claimed that Barclays reasonably should have known that the value of Barclays' subprime/non-prime-backed RMBS/CDOs had declined significantly before the September 2007 Offering and should have disclosed it.

MOTION TO DISMISS

Barclays moved to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6). In support of that motion, Barclays asserted that it had in fact made adequate disclosures. For example, Barclays asserted that on November 15, 2007, it had strong results, especially in comparison to its competitors' substantial writedowns." In addition, Barclays pointed out that, on February 19, 2008, it publicly announced in its 2007 Annual Report that it had written down £1.6 billion on its CDO and subprime exposure. Then, in July 2008 Barclays released its 2008 interim results, which

disclosed Barclays' first-half net income declined 34 percent, "largely owing to a massive writedown of £2.8 billion in credit-related assets." The Series 2 and 3 Offering Materials disclosed that Barclays held over £13 billion and £18.7 billion of mortgage and other asset-backed securities. In addition, the Offering Materials cautioned investors by saying if certain risks were to materialize "Barclays' business, financial condition, and results of operations could suffer."

Plaintiffs opposed the motion by arguing that Barclays had boasted about its risk management practices in the Offering Materials by stating, for example, "the identification and management of risk remains a high priority and underpins all our business activity." The defendants countered that the Offering Materials also warned investors that "Barclays' risk-management system is designed to manage rather than eliminate the risk of failure to achieve business objectives."

THE COURT'S ANALYSIS

In their complaint, plaintiffs made several allegations based on Barclays' disclosures and alleged non-disclosures, including that (1) defendants failed to disclose and write down mortgage-related assets, (2) defendants failed to itemize mortgage-related assets, (3) defendants violated accounting and SEC requirements, and (4) defendants misleadingly emphasized its risk management practices. The court rejected each of these arguments.

First, as to Barclays' alleged failure to disclose and write down mortgage-backed assets, the court relied on prior case law establishing that "subjective opinions are only actionable under the Securities Act if a complaint alleges that the speaker did not truly have the opinion at the time it was made public." The court held that since the assets at issue here were not traded on an efficient market such as the New York Stock Exchange, the value of such assets is a subjective opinion. Therefore, a proper claim must "allege that Barclays did not truly believe its own valuation." Here, the complaint made no such allegations. Further, Barclays did offer "substantial risk disclosures regarding its valuations, such as: 'if any of these risks occurs, our business, financial condition, and results of operations could suffer...' and 'the profitability of Barclays businesses could be ad-

versely affected by a worsening of general economic conditions.”

Second, the court held plaintiffs’ claim that Barclays was required to itemize its mortgage-related assets into separate subcategories insufficient because the Second Circuit Court of Appeals has specifically found that such itemization is not necessary. In addition, “Securities Act Sections 11 and 12 do not require an offering participant to disclose information merely because a reasonable investor would very much like to know it.”

Third, the court found that plaintiffs’ claim that defendants violated accounting standards and SEC requirements failed because it contained only general allegations of non-disclosure and not specific allegations of how the accounting practices were improper.

Finally, plaintiffs’ claim that Barclays misleadingly emphasized its risk management practices also failed because Barclays only made general statements and also cautioned against risk. Moreover, plaintiffs did not allege that the descriptions of risk management processes were actually false or that those processes were not followed.

THE PROCEDURAL RULINGS

As an alternative ground for dismissal, the defendants asserted the plaintiffs lacked standing because they merely pled that they “bought securities issued pursuant to or traceable to” the Offering Materials. To have standing, a plaintiff must plead that it purchased directly from the defendant. While the court apparently saw merit in this argument, the court commented that this defect could have been easily cured, had the action not been dismissed on other grounds.

Further, the defendants asserted the plaintiffs’ claims were time-barred. The statute of limitations for Section 11 and 12(a)(2) claims is one year, and a claim accrues at the time of discovery or when discovery should have been made by reasonable diligence, which is also called inquiry notice. In this case, the court found that the plaintiffs had inquiry notice for the Series 2 and 3 Offerings on November 12, 2007, the date of the Trading Update that disclosed Barclays’ exposure. Even though the Trading Update contained “words of comfort from management,” a reasonable investor would have investigated the disclosures anyway. As to

the Series 4 Offerings, the plaintiffs had inquiry notice on February 19, 2008, when Barclays released the 2007 annual results. The action thus was untimely because the plaintiffs filed their initial complaint on March 12, 2009, more than one year after the dates of inquiry notice, which provided an alternative ground for dismissal.

CONCLUSION

Many commentators continue to be surprised that more criminal and civil liability has not been imposed on financial institutions as a consequence of the economic collapse and resulting deep recession. This case demonstrates the significant hurdles that plaintiffs face in imposing civil liability, as many financial institutions indeed made significant disclosures of risk — disclosures that many frenzied investors apparently failed to heed. This decision suggests that reckless investors were just as much at fault for the economic bubble that burst, as the financial institutions that packaged and sold risky securities.

NOTE

¹ *In re Barclays Bank PLC*, 2011 WL 31548 (S.D.N.Y. 2011).