Case Law Update: Misselling Financial Products

In a recent case, *Cassa di Risparmio della Repubblicca di San Marino SpA* ("**CRSM**") *v Barclays Bank Ltd* ("**Barclays**"), CRSM brought claims in fraud, negligent misrepresentation and breach of contract against Barclays arising out of a bespoke, synthetic CDO deal.

In a careful judgment, the Court has provided a clear summary of the legal principles which apply in CDO misselling claims. In particular, it has underlined that in deciding if a misrepresentation claim has become barred as a result of a contractual disclaimer, the effect of the disclaimer must be analysed closely and placed in context. Only if the disclaimer can fairly be said to exclude the precise representation which the claimant is alleging will the court find that claims based on that representation have been excluded. On the facts, however, CRSM failed to establish that Barclays was liable for its losses. The Court also rejected CRSM's claim that a discrepancy between the risks of investing in the Notes projected by Barclays' internal modelling and those implied by the AAA rating given to the Notes gave rise to a fraudulent misrepresentation.

Facts

In a vivid reminder of the way in which the financial markets embraced structured products during the boom, Barclays sold CRSM four sets of AAA rated, credit linked notes (the "**Notes**") in 2004/early 2005 with a total nominal value of €406 million. The Notes each had a maturity of 5 to 7 ½ years. In exchange for the principal value of the Notes, CRSM received a coupon of approximately Euribor + 0.95 %. The underlying purpose of the transaction was to provide financing for certain of CRSM's consumer finance subsidiaries, to which CRSM was unable to lend directly because of risk concentration limits prescribed by the Central Bank of San Marino.

The Notes had synthetic CDOs embedded in them giving exposure to a pool of reference assets through a portfolio CDS. The reference assets themselves were synthetic CDOs referenced to approximately 50 individual CDSs. The CDOs to which CRSM was directly exposed were colloquially known as "CDO squareds".

The Notes were restructured in 2005 as a result of which various reference entities were substituted and certain structural changes to the CDOs were made in an attempt to make them less risky. Notwithstanding the restructuring, massive losses were experienced.

CRSM's Claims

CRSM's central claim was that although Barclays had sold it the Notes on the basis of an agreed AAA rating which they intended CRSM to rely on and which CRSM did rely on, Barclays knew and intended, through its internal modelling, that the Notes had a probability of default equivalent to B rated instruments. CRSM further alleged that Barclays had deliberately structured the Notes in this way in order to maximise its profits.

Barclays' expert witness testified that this practice— known as "credit ratings arbitrage"—was widespread in the structured finance sector during the boom. In many claims litigated in the US courts, claimants have argued successfully that banks engaging in such practices were acting fraudulently. It will therefore be disappointing for claimants that the Court agreed with Barclays that, on the facts of this case, this aspect of CRSM's claim compared the incomparable. In particular, unlike the Notes' credit rating, the Court held that Barclays' internal projection of the risks associated with the

Notes was not concerned with default risk. Instead, its purpose was to derive a market price for the Notes in order to mark its books to market, to hedge against the risks associated with the Notes and for calculating notional profits.

In addition to arguing that CRSM had failed to establish its claims on the evidence, Barclays argued that CRSM's claims were defeated as a matter of contract by the terms and conditions of Notes and the disclaimers in the deal documentation. Here claimants may find themselves somewhat reassured. In particular, the Court noted that although contracting parties may agree that one party has not made any pre-contractual representations to the other, or that any such representations have not been relied upon, clear words will be necessary if a term is to be construed as having this effect. In an appropriate case a bank may also fail to exclude liability for misrepresentation where the misrepresentation relates to the effect of the documents themselves.

Conclusion

Overall this decision will be welcomed by the banks as the latest in a series of decisions in which the claims of investors in complex financial products have been dismissed. That said, claimants will draw comfort from the Court's clarification that misrepresentation claims will only be contractually excluded if the disclaimers relied upon by the bank use clear words. The key implication is that in claims where the evidence is stronger banks will find it difficult to rely on the disclaimers in their documents. What the case law also fails to convey is what is below the surface: where stronger claims have been made the banks have often been quick to settle for fear of setting unhelpful precedents, with the result that only the intrinsically weaker claims make their way to court, adding to the accumulation of precedents favouring the seller of those products.