

Banking - Switzerland

Recent rulings on banks' duty of care in advisory relationships

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The Federal Supreme Court recently rendered two decisions regarding banks' duties of care and fidelity in the distribution of financial products.

The court confirmed its established case law, but provided interesting insights into particular issues linked to the distribution of capital-protected structured products within the framework of an advisory relationship.

First ruling

The client invested part of his wealth in a capital-protected structured product issued by a Dutch subsidiary of the Lehman Brothers group, and guaranteed by the parent company of the group. The product was distributed in Switzerland by the defendant bank.

The client had concluded an advisory agreement with the bank and claimed to have given specific instructions to it, according to which he wanted no US-related investment in his portfolio due to his hostility to US policy.

Given the differences between the bank's and the client's interpretations of the instructions, the Supreme Court applied its theory of the so-called 'principle of trust' and sought to establish the meaning that the addressee of the instructions could and should give on the basis of all the circumstances.

The court concluded that the bank was entitled to understand that the instructions applied only to direct investments (US securities or investments in US dollars), as it was not possible to check whether any investment made by, for example, a fund and its sub-funds would exclude US securities. Such a check would also have exceeded the limits of an advisory agreement. In support of its view, the court added that the client had purchased units of collective investment schemes that were partly invested in the United States shortly after having given his instructions.

Hence, the bank could sell to the client the structured product in question denominated in Swiss francs and issued by a Dutch company, even though the product was guaranteed by a US entity.

The court thus confirmed the first instance ruling. Examining whether the bank had a disclosure duty based on the advisory agreement, the lower court had found that the bank had no duty to draw the client's attention to the issuer risk. The bank was entitled to consider that this long-term client, who had chosen the most risky profile, was aware of the issuer risk. The client's claim was therefore dismissed.

Due to the poor quality of the appeal, the Supreme Court dismissed most of the arguments invalid for formal reasons.

Second ruling

A company claimed approximately Sfr3 million from its bank for the losses it incurred in buying a structured product issued by the Lehman Brothers group.

The claimant based its claim on the contractual duties arising from the advisory agreement concluded with the bank and the regulatory duties to which the bank was subject as a securities dealer (Article 11 of the Federal Act on Stock Exchanges and Securities Trading). The claimant considered that the bank had a disclosure and information duty, as well as a duty of care and a duty to warn in relation to the investment. In particular, the claimant considered that the bank had a duty to inform it of

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the issuer risk and the risks related to a US investment bank.

The court stated that the scope and content of the contractual duties depend on the type of the contractual relation between the client and the bank. There are basically three types of contractual relations with regard to the execution of stock exchange transactions in favour of a client:

- the asset management agreement;
- the advisory agreement; and
- the deposit agreement.

The contractual duties of disclosure and information are the most comprehensive under the framework of an asset management agreement, while in the case of an advisory agreement they must be assessed based on the particulars of the case and the client's experience and knowledge. In this case, the bank and the client had concluded an advisory agreement.

Under Article 11 of the act, the bank must inform the client of the risks connected with a type of transaction, taking into account the client's business expertise and professional knowledge. However, the bank has no duty to inform of particular risks linked to a specific transaction (eg, as required by the European suitability test). The court interprets Article 11(2) of the act as stating that a bank acting as a securities dealer must inform the client only of unusual risks, and it may assume that the client knows the usual risks linked with the purchase, sale and holding of securities. In particular, the solvency risk regarding the issuer and the interest rate risk must be regarded as usual risks.

With respect to regulatory duties, the court observed that the issuer risk is not different in the case of structured products as it is, for example, for a simple bond, as structured products often comprise a bond element and a derivative element. The issuer risk applied to the bond element and the product was therefore subject to a similar risk.

The court also rejected the claimant's argument that the product was supposed to be 'capital protected' because the fact sheet of the product clearly indicated what these terms meant (reimbursement of the capital by the issuer).

The bank had also proposed to explain in further detail the function of the structured products in question to the claimant, but the claimant did not make use of this. The court held that the claimant had sufficient knowledge and expertise in the field of bonds and securities to understand the risks connected with a structured product.

The fact that the issuer was a US investment bank, and not regulated as banks in Europe are, was also irrelevant. There was no general risk connected with a type of transaction, but rather a specific risk of this concrete and particular transaction, therefore it could not be considered under the Swiss concept of the regulatory duties of a securities dealer.

With respect to contractual duties, the same considerations apply. The court also added that the claimant was unable to demonstrate why and how the US regulatory status of investment banks would impact negatively on its investments, especially in an *ex ante* assessment (ie, before the collapse of the Lehman Brothers group).

Finally, the court concluded that the Lehman Brothers products did not contradict the investment profile of the claimant. The claimant had never contested the portfolio statements in which the products appeared from 2005 to 2008. In addition, a duty of the bank to warn the claimant in March 2008 at the latest was denied by the court. As a rule, the bank could not have been held to have a duty to monitor the client's investment and warn the client under an advisory agreement unless such actions had been specifically agreed with the client and the bank had been paid for them.

Only in exceptional circumstances where the bank, although bound by an advisory agreement, has developed a special trust relationship with the client, may it have to monitor the risks and warn the client. However, this means only that the bank is in contact with the client and must examine its file, and that obvious problems become apparent.

The court did not see any such exceptional situation here, as the common knowledge of the financial situation of the Lehman Brothers group at the beginning of 2008 was that they were making huge profits and were well rated by the rating agencies. The collapse of the group came as a surprise to everybody, hence no duty to warn could be identified.

Even the fact that the bank had hired a former Lehman Brothers chief financial officer in July 2008 was insufficient to show that the bank had known the true situation of the Lehman Brothers group and had a duty to warn the client.

Comment

The two rulings confirm the Supreme Court's established case law and show that investors must be able to demonstrate that the bank had certain duties before proving that the conditions of the bank's liability were fulfilled.

In both cases, the claimants were often vague; several arguments were rejected by the court for a lack of legal precision or because they pertained to facts rather than law.

The second ruling provides interesting insights into the categorisation of the risks that a bank must disclose to its clients when selling financial products, and reaffirms that Switzerland does not acknowledge the suitability test among the regulatory duties of a securities dealer.

It remains to be seen whether the treatment of the issuer risk as a usual risk will hold true in the future. These cases should certainly strengthen the vigilance of financial players, and potentially the legal duties imposed on them.

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