Developments

Case Note—Judgment of the *Bundesgerichtshof* (Federal Court of Justice of Germany) of 22 March 2011: Passion to Inform—BGH Expands Banks' Advisory Duties

By Jean David Jansen[*]

Abstract

In February 2011, a *Bundesgerichtshof* [BGH—Federal Court of Justice] decision caused a great media echo. The court convicted Germany's largest bank to pay about half a million Euros in damages for the breach of advisory duties. In the aftermath of the financial crisis, banking law evolved fast in German courts. The recent decision raises new questions concerning the advisory duties of a bank, when offering financial products to its clients. The article gives an insight to various factual backgrounds, which, as financial products of today, are somewhat complex. Another interesting aspect to this case is that there are numerous decisions of lower courts that dealt with the same product as the BGH did. The ruling is considered to be far-reaching and groundbreaking. This case note will look into the question how far this is true.

A. Introduction

In an attention-getting decision the *Bundesgerichtshof* [BGH—Federal Court of Justice]—Germany's highest court of appeals – convicted Deutsche Bank to pay about half a million Euros ($ 700,000) in damages to a mid- tier producer of hygiene products for bad performance in the disclosure of information.[1] The immense public interest in the decision can be traced back to the fact that there were several private companies and public communities that had entered into interest swap contracts that were identical with, or similar to the contract in dispute. In most cases, those engagements had caused immense losses for the contract holders. In the case of public communities, the decision was also politically explosive as communities gambled millions of Euros of taxpayers' money with

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[1] *See* Bundesgerichtshof [BGH- Federal Court of Justice], Reference Number (Ref. No.) XI ZR 33/10 (Mar. 22, 2011), available at: http://juris.bundesgerichtshof.de/cgibin/rechtsprechung/document.py?Gericht=bgh&Art=pm&Datum=2011&Sort=3&nr=55748&linked=urt&Blank=1&file=dokument.pdf (last accessed: 4 July 2011).

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those contracts.[2] This led to a flood of lawsuits against the concerned banks. The count after 11 appeal-decisions[3] was 7:4 for the financial institutions. With this somewhat surprising decision, the development peaked out. Since some of the higher courts of appeal had qualified the concerned swap-contract offered by the bank as a gamble in a similar case,[4] it is now less surprising that the bank runs a casino in Las Vegas, Nevada.[5]

Due to public interest, the press had reported the case previously. As a critical sideline, one of the defendant bank's representatives advanced the argument that this judgment would lead to another financial crisis. However, he qualified this statement after the judgment was rendered. The plaintiff's lawyer expected the proceedings for damages to equal a total amount of 1 billion Euros. While the practical importance of the decision is evident, the legal findings reflect an increase in the advisory duties the court holds banks obliged to.

The following note will first present the facts of the case (B), followed by a short overview of the necessary legal background of banking law (C). Subsequently, the findings of the BGH will be presented and evaluated (D). The case note will analyze how far the reach of banks' informational duties extends, according to the new BGH decision, and how this might affect the banking landscape in Germany (E). As aspects of community law are not of concern in this case, they are not commented on in this note.[6]

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[2] *See* Bund der Steuerzahler Deutschland (Tax Payers Association), *Schwarzbuch des Bundes der Steuerzahler - Die öffentliche Verschwendung (*Tax Payers Association's Black Book – The Public Waste) 29 (2008). Available at http://www.steuerzahler.de/files/15735/Schwarzbuch2008.pdf (last accessed: 4 July 2011).

[3] *See Oberlandesgericht* [OLG-Regional Higher Court of Appeal] Naumburg, Ref. No. 2 U 111/04 (Mar. 24, 2005), 17 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT (ZBB) 360-367 (2005); OLG Bamberg, Ref. No. 4 U 92/08 (May 11,2009), 30 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1082-1097 (2009); OLG Frankfurt, Ref. No. 23 U 76/08 (Jul. 29, 2009), 30 ZIP 1708 (2009); OLG Celle, Ref. No. 3 U 45/09 (Sep. 30, 2009), 30 ZIP 2091; OLG Frankfurt, Ref. No. 23 U 24/09 (Dec. 30, 2009), 31 ZIP 316 (2010); OLG Frankfurt, Ref. No. 23 U 175/08 (Dec. 30, 2009), 31 ZIP 921-925 (2010); OLG Koblenz, Ref. No. 6 U 170/09 (Jan. 14, 2010), 22 ZBB 153 (2010); OLG Stuttgart, Ref. No. 9 U 164/08 (Feb. 26 2010), 22 ZBB 162 (2010); OLG Frankfurt, Ref. No. 23 U 230/08 (Aug. 4, 2010), 31 ZIP 1637 (2010); OLG Stuttgart, Ref. No. 9 U 148/08 (Oct. 27, 2010), 31 ZIP 2189 (2010); OLG Hamm, Ref. No. 31 U 121/08 (Nov. 10, 2010), 11 ZEITSCHRIFT FÜR BANK- UND KAPITALMARKTRECHT (BKR) 68 (2011).

[4] *See* OLG Stuttgart 9 U 164/08, *supra* note 3, at 210; OLG Frankfurt, 23 U 175/08, *supra* note 3, at margin number 72.

[5] *See* Handelsblatt, *Deutsche Bank verzockt sich in Las Vegas* (Deutsche Bank Gambles Away in Las Vegas)(2010), available at http://www.handelsblatt.com/unternehmen/banken/deutsche-bank-verzockt-sich-in-las-vegas/3367324.html (last accessed: 4 July 2011).

[6] *See,* for community law-specific issues, Marlen Träber, *AG Report*, 53 DIE AKTIENGESELLSCHAFT 356-358 (2008); *AG Report*, 55 DIE AKTIENGESELLSCHAFT 238-240 (2010).

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B. Factual Background

I. Case Facts

At the beginning of 2005, both opposing parties agreed to a Constant Maturity Spread Ladder Swap ("CMS Swap") after two advisory meetings. The claimant company's founder, director, and procurator (the latter who held a Masters degree in economics), also served as its representatives. The product presentation included a large number of documentary materials. The leading intention for the contract was to optimize the plaintiff's interest charge from existing interest swaps. The plaintiff had already closed these interest-swap-agreements in July 2002 with another bank. As these contracts did not work well and showed a negative market value of about 125,000 Euros each, *Deutsche Bank* recommended a CMS Swap to optimize the interest charges.

According to the contract, the defendant bank was obliged to pay a static interest rate of 3% for the whole contract period *per annum,* on a principal amount of 2 million Euros (about 2.8 million US Dollars). The plaintiff was committed to pay a static interest rate of 1.5% for the first year and a variable interest rate equal to the following formula for the last 4 years of contract duration:

> *Particular interest rate of the previous payment period* <u>*plus (+)*</u> *3* <u>*times (x)*</u> *[strike* <u>*minus (-)*</u> *(CMS10* <u>*minus (-)*</u> *CMS2)]*

The minimum rate of 0.0% (the so-called *floor*) was so that a negative duty of interest payment was contractually excluded. Thus, the bank's obligation also could not expand beyond 3.0%. The *strike* rates for subsequent years were set to the following: 1,0% for the second, 0.85% for the third, 0.7% for the fourth and 0.55% for the fifth years of the duration of the contract. The CMS10 and CMS2 are the median interbank swap rates for 10 and 2 years, as per the Euro Interbank Offered Rate (EURIBOR). In regular market circumstances, the CMS10 is higher than the CMS2, ensuring that the spread remains positive. Consequently, the higher the spread, the lower the holder's interest obligation. In contrast, a lower spread increases the interest rate that the holder has to pay. In case of an interest inversion, the spread becomes negative so that it is not subtracted from the strike, but added to it. Financial markets previously experienced such an exceptional interest inversion only 4 times since 1967.[7] According to the contract, both parties had the first right to termination first after three years of duration, and only for the payment of the current market value of the swap contract. The payments were terminated every 6 months.

[7] *See* OLG Bamberg, *supra* note 3, at margin number 197.

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The presentation materials provided by the bank noted under the title of "risks" that if the spread decreased strongly, the holder would have to pay more interest than was received. The risk of loss was stated as "theoretically unlimited."

On the day the CMS Swap was signed by the parties it had a negative market value of 4%, which equated the holder's payment to 80,000 Euros. After the claimant contested the contract because of fraud, it also paid the release amount conditionally, in order to dissolve the contract, and then sued the bank for repayment of its suffered losses.

II. How a CMS Spread Ladder Swap Works

The facts described above are what an objective spectator without special knowledge about derivatives would recognize. For an introduction to the legal issues that are faced in this case it is required to explain how a CMS Swap works. This issue is something the German courts experienced as well, when being confronted with the first lawsuits. It turned out that many erred in comprising the mechanisms of this financial product.[8]

The CMS Swap is a highly complex kind of interest swap. Two parties exchange cash flows, one at a static and the other at a variable interest rate, on a virtual and thus not really invested principal amount.[9] This fantastic product name has been derived from the formula the holder's interest obligation is calculated with.[10]

Whereas the formula for the holder's interest rate requires only the basic arithmetic operations and can be solved with the help of a calculator,[11] the effects and risks of this formula are hard to estimate and require complex mathematical and stochastic risk models. Some courts did not even recognize the difference between solving the formula with the help of a calculator and calculating the risk for a 5-year-period of contract-duration.[12]

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[8] *See* Johannes Köndgen & Klaus Sandmann, ***Strukturierte Zinsswaps vor den Berufungsgerichten: eine Zwischenbilanz*** *(*Structured Interest Swaps in courts of appeal, an Interim Result*)*, 22 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT (ZBB) 77, 78 (2010), with special emphasis on "profund ignorance."

[9] *See* PETER CLOUTH, PRAKTIKERHANDBUCH WERTPAPIER- UND DERIVATEGESCHÄFT,(Handbook of Securities and Drivates Business) at margin number 1002 (Jürgen Ellenbeger *et. al*. eds., 2010), about interest swaps in general.

[10] *See* this article, at Section B. II. 4.

[11] *See* Julian Roberts, *Finanzderivate als Glücksspiel? Aufklärungspflichten der Emittenten* (Financial Derivates as a Gamble? Duties to inform for Issuers), 48 DEUTSCHES STEUERRECHT (DStR) 1082-1086, 1082 (2010).

[12] *See* OLG Celle, *supra* note 3, at margin number 35, 36; OLG Frankfurt 23 U 230/08, *supra* note 3, at margin number 57; LG Wuppertal, Ref. No. 3 O 33/08 (Jul. 16, 2008), 62 WERTPAPIERMITTEILUNGEN – ZEITSCHRIFT FÜR

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The *Oberlandesgericht* [OLG—Regional Higher Court of Appeal] Stuttgart was the first court to show impressively how even minimal differences in the spread development can make the distinction between profit and very high loss for the holder.[13] This is caused by a combination of various factors described below.

1. The Spread

A spread describes the difference between two interest rates. One such fundamental difference is that the spread can become negative. As the spread was a key-figure and multiplier for the holder's interest rate, it had a big impact on the risk scheme. The holder was left to predict both the continuing development of two interbank market interest rates, as well as an opinion about the future development of the spread. This seems to be a logical structure, and is easy to understand. Furthermore, the bank made its estimation concerning the development of the spread into to a decisive element of the consulting meetings. The bank's employees said that they expected the spread to grow in the future. This in fact, would have meant a beneficial development for the holder.

2. The Effect of Record Dates

According to the contract, the interest rate for a particular payment period is based on the values of CMS10 and CMS2 on a specific day at a specific time. Consequently, it is not sufficient for the holder to simply have an idea of the spread's tendency (up or down) for the next 5 years. Rather, a projection of the spread's value for each of the 8 days of record at a specific time, for five consecutive years must be provided. This is incomparable with a rough estimation of the market's development, because future special events must also be considered, even if they have no sustainable influence on the rate's development, and turn out to be a spontaneous reaction of the rate exclusively. This effect is catalyzed by the *ladder* structure.[14]

WIRTSCHAFTS- UND BANKRECHT (WM) 1637, at margin numbers 85, 107 (2008); LG Ulm, Ref. No. 4 O 122/08 (Aug. 22, 2008), 29 ZIP 2009, at margin numbers 91, 101 (2008).

[13] *See* OLG Stuttgart 9 U 164/08, 9 U 148/08, *supra* note 3.

[14] *See* this article, at Section B. II. 4..

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3. Volatility of the CMS Value

The issue of record dates becomes even more severe in combination with the volatility of the CMS-values, i.e. with a high degree of fluctuation of rate experiences. Even if the holder has the right idea of the tendency, the value can differ strongly from its tendency by the time the record is taken. The holder's interest rate for a particular period then depends on this "snapshot," i.e. what brings the swap contract close to a gamble. This volatility cannot be considered without highly complex calculating models.[15] Thus, it seems to be impossible for a mid tier business to run a department that provides the manpower and know-how that these forecasts require.

4. The Ladder Structure

As the interest rate of the preceding payment-period is added to each subsequent one, the interest curve is recursive.[16] Thus, the holder's obligation not only depends on the present height of the spread, but also on the chronological order of its development. One could say that it accelerates increases, whereas decreases are delayed, creating a sort of *memory effect*.[17] This is why the spread is called a *ladder* swap.[18] This structure is comparable to the steps of a ladder, as the interest rate for one period always has the preceding rate as its starting point.

The effect of the ladder structure is not as simple as it may seem. In particular, the holder's commitment depends on the path the rate takes to a specific end value. In its calculations, the OLG Stuttgart showed that there were two scenarios where the start and end values of the spread were the same, but each followed a separate path in between. The difference in developments was crucial for the final result, whether it was profit or loss.[19] Thus, it is evident that an idea of the tendency of the spread's value is irrelevant to the holder with respect to risk estimation.

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[15] *See* OLG Stuttgart. 9 U 164/08, *supra* note 3; OLG Stuttgart 9 U 148/08, *supra* note 3, at margin number 55; Köndgen & Sandmann, *supra* note 8, at 78.

[16] Köndgen & Sandmann, supra note 8, at 79.

[17] *See* BGH, *supra* note 1, at margin number 29; OLG Bamberg, *supra* note 3, at margin number 111; OLG Koblenz, *supra* note 3, at margin number 43.

[18] *See* OLG Bamberg, Reference No. 4 U 92/08, at margin numbers 24, 111 (May 11, 2009); Köndgen & Sandmann, *supra* note 8, at 78; An alternate view is presented here: Reinhold Roller, Thomas Elster & Jan Christoph Knappe, *Spread-abhängige* (Spread Dependent) *Constant Maturity (CMS) Swaps* 5 ZBB 345, 347 (2007) are of the opinion that the name is based on the strike's decrease during the contract duration.

[19] *See* OLG Stuttgart 9 U 164/08, *supra* note 3; BKR, *supra* note 15, at 208, 213; *see* also Köndgen & Sandmann, *supra* note 8, at 80-81, who give an example for such a scenario.

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5. The Negative Market Value

The most confusing thing about the CMS Swap has been its negative market value. There have been a considerable number of incorrect assumptions about the facts behind this technical expression. For example, some courts have interpreted the negative market value as a kind of prepayment penalty.[20]

The negative market value of a swap contract is the balance of the objectively expected and probable variables, according to the mathematical and stochastic risk models applied by banks towards cash flows the parties are committed to.[21] In the case of a negative market value, the holder's commitment exceeds the bank's duty of payment, whereas in the case of a positive market value, it is the other way round. It is not a value designated by market participants,[22] but can be calculated objectively by the bank at any time, making it possible for the bank to rearrange the formula to form a negative market value, ultimately leading to a contract that is very likely to be a loss making one for the holder. [23]

The negative market value becomes relevant in two situations. First, the negative market value is the price that has to be paid to resolve the contract before the original contract duration has ended.

The second relevant situation is the bank's handling of the swap contract. According to the judgment of the OLG Stuttgart, the position the holder takes in a swap contract is one he would have be awarded for by professional players in financial markets.[24] The height of this award is equal to a negative market value. The bank "sells" these options after contracting with the client, and realizes the negative market value as its profit.[25]

[20] *See* OLG Celle, *supra* note 3, at margin number 41; OLG Frankfurt 23 U 230/08, *supra* note 3, at margin number 67.

[21] *See* OLG Stuttgart Reference No. 9 U 148/08, at margin number 67 (Oct. 27, 2010).

[22] *See,* erring in this assumption, OLG Celle, *supra* note 3, at margin number 41.

[23] *See* OLG Stuttgart, 9 U 148/08, *supra* note 3, at margin number 67.

[24] *Id*. at margin number 72.

[25] *Id*. at 23.

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6. Effect of the Bank's Right of Cancellation

In most CMS Swap-Agreements dealt with by the courts, the bank has a right of cancellation at any time, leading to a strong shift in risk towards the holder. First, the bank can stop a loss-creating business by cancelling the contract, when the spread develops badly for the bank. Second, it can avoid a loss that the client has made, by balancing this with a subsequent positive development. In other words, the client will most certainly not have the chance to balance a big loss at the beginning of the contract duration, as the bank will then cancel the contract to protect its profits.[26] It can be summed up that the client's idea of a well performing 5-year-investment is unrealistic because the bank will make use of its right to cancel the contract in this case.[27]

Whereas the contract documents only show a right of cancellation for the banks, in some cases the oral proceedings regarding the contract highlighted a similar stance for the holder as well. This applies to the case in point, as well. If the right of cancellation is given to both parties under equal conditions, it does not mean a risk shift. However, the question of why the contracts did not explicitly state such a right for the holder in addition to the bank remains.

C. Legal Background: German Private Banking Law

For the last couple of years, banks have experienced turbulent times in the markets as well as in courtrooms. First of all, it has always been a constant of jurisdiction that there be an implied advisory contract established when the bank and the client enter into a dialogue about a client's particular investment decision.[28] This advisory contract must be distinguished from a simple brokerage contract. Whereas the broker only has to repeat information correctly to the client, the adviser conducts an evaluation of the information given, and must issue a recommendation.[29] In the *Bond Decision* from 1993, the BGH decided that a bank is obliged to advise a customer in proportion to the client's interests and readiness to take risks ("*anlegergerecht"*). Further, it concluded that a banking institution must equate these factors to the financial product it recommends, all the while

[26] A detailed illustration is available through Köndgen & Sandmann, *supra* note 8, at 80-81.

[27] *See,* similarly deciding, OLG Koblenz, *supra* note 3, at margin number 49.

[28] *See* the recent decision, BGH, Ref. No. III ZR 193/05 (Jan. 11, 2007), 60 NEUE JURISTISCHE WOCHE (NJW) 1362, 1363 (2007).

[29] *See* Thorsten Seyfried, *in* BANK- UND KAPITALMARKTRECHT (Banking and Capital Market Law) at margin number 3.96 (Arne Wittig ed., 2010); Braun, Lang & Loy, *in* PRAKTIKERHANDBUCH WERTPAPIER- UND DERIVATEGESCHÄFT (Handbook of Securities and Derivates Business) at margin number 226 (Jürgen Ellenbeger *et. al*. eds., 2010); Heinz Georg Bamberger, *in* HANDBUCH ZUM DEUTSCHEN UND EUROPÄISCHEN BANKRECHT (HANDBOOK OF EUROPEAN AND GERMAN BANKING LAW) § 50, at margin number 29 (Peter Derleder *et. al*. eds., 2008).

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ensuring that they fit to the client's qualifications ("*objektgerecht"*).[30] This can be understood as a parallel to the U.S. banking law principles of "know your customer" and "know your merchandise."[31] The client's knowledge, willingness to take risks and the ultimate investment objective are pitted against more general risks, such as the status of the economy, the development of capital markets and risks concerning the specialties of a particular investment product. These are the major aspects an adviser must consider.[32] Hence, the bank is obliged to explore the customer's profile. This duty is codified in § 31 (4) of the *Wertpapierhandelsgeset*z (WpHG) (Securities Trading Act).[33]

Recently arisen issues concern so-called *kickbacks*. If a bank recommends a share in funds it has to disclose whether it received a commission from the funds company, as well, leaving it in a state of conflict. On the one hand, the bank is obligated to advise the client in accordance to the advisory contract, while on the other, it may not always be objective in its recommendations, because of its interest in potential commissions. This conflict of interests must be disclosed to the client in order to allow the latter to evaluate the worth of the bank's recommendation.[34] In this context, the question of whether the bank had to disclose its profit margins to the client was raised. For such a duty one can argue that it is not the fact *that* a commission is paid, but *how high* this commission is that gives the client an insight into the degree of the bank's interest collision.[35] This question plays a role in the recent decision as well.

Since 1 November 2007 § 31 (1) No. 2 of the WpHG contains a rule for the disclosure of conflict of interest, as long as this collision cannot be avoided.

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[30] *See* BGH, Ref. No. XI ZR 12/93 (Jul. 6, 1993), 46 NEUE JURISTISCHE WOCHE (NJW) 2433 (1993).

[31] *See* FRANK SCHÄFER, *in* HANDBUCH DES KAPITALANLAGERECHTS (Handbook of Investment Law) § 21, at margin numbers 19, 27 (Heinz-Dieter Assmann *et. al*. eds., 2007).

[32] *See* Heinz Georg Bamberger, *in* HANDBUCH ZUM DEUTSCHEN UND EUROPÄISCHEN BANKRECHT, *supra* note 28, § 51, at margin numbers 111-113 (; Ekkehard von Heymann & Hervé Edelmann, *in* HANDBUCH DES KAPITALANLAGERECHTS, *supra* note 30, § 4, at margin numbers 19-21; Ingo Koller, *in* KOMMENTAR ZUM WPHG § 31, at margin numbers 46-49 (Heinz-Dieter Assmann & Uwe H. Schneider eds., 2009) ; Martin Hannöver, BANKRECHTSHANDBUCH BAND II § 110, at margin number 31 (Herbert Schimansky *et. al*. eds., 3rd. Ed., 2007).

[33] Formerly codified in § 31 (2) S. 1. No. 1 WpHG (Securities Trading Act).

[34] *See* for the *Kick-back Decisions*: BGH, Ref. No. IX ZR 56/05 (Dec. 19, 2006), 60 NJW 1876 (2007); BGH Ref. No. XI ZR 510/07 (Jan. 20, 2009), 62 NJW 1416 (2009); BGH, Ref. No. III ZR 196/09 (Apr. 15, 2010), 31 ZIP 919-921 (2010).

[35] *See* BGH, Ref. No. IX ZR 56/05 (Dec. 19, 2006), 60 NJW 1876, 1878 (2007).

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D. The BGH's Findings and Evaluation

The BGH, in contrast to the preceding decisions, stated that it was irrelevant if a contract was void under § 138 BGB, not effective under § 307 (1) s.2 BGB or if it was voidable under § 123 BGB.[36] Rather, the court rather placed emphasis on various aspects of the advisory contract between parties.

I. Advice Equated to Customer Profile

Initially, the BGH discussed the question of whether the bank had advised the plaintiff to equate to a specific risk scheme. The main issue was whether the bank had explored the customer's profile diligently. The claimant stated that the bank had not, whereas the defendant bank claimed that it had not been obliged to do so.

The defendant bank argued that the claimant had already entered into two other interest swap agreements in 2002 with another bank, and thus knew the risks, and was willing to take them. Further, it was argued that more detailed advice had not been necessary, as the claimant had been represented by a procurator possessing a Master's degree in Economics.

The BGH did not subscribe to the bank's argumentation in these two aspects. In the court's opinion it might be true that the exploration of a customer's profile was no longer required if the bank actually knew of this from a long-term business relation, or from the customer's previous transactions. However, the two interest swap agreements the claimant closed in 2002 do not void the bank's duty to explore the risk profile. The bank could not assume a high-risk profile from these contracts, since they were not as complex as the offered CMS Swap, and the risks thus were not comparable.[37] The crucial difference in this case was that the risk of a potential loss was not unlimited for the claimant in the 2002 contracts.

Furthermore, in contrast to the OLG Frankfurt, the BGH stated that it was irrelevant that the claimant's representative had an academic education in Economics. The client's professional qualification was not sufficient to assume knowledge and experience with financial future transactions. Rather, it was proved that the client has gained this experience on his job, and working as a procurator at a mid-tier producer of hygiene products did not suggest the assumption for such an achievement. The BGH also made clear that the OLG Frankfurt erred in another aspect when assuming that the client's

[36] *See* BGH, *supra* note 1, at margin number 17; See, for these aspects in detail: Köndgen & Sandmann, *supra* note 8, at 88-93; *See* Reinhold Roller *et. al.*, *supra* note 17, at 360-362.

[37] *See* BGH, *supra* note 1, at margin number 26.

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personal knowledge was evidence about his willingness to take risks.[38] The product knowledge a client already has, thus does not affect the bank's duty to explore investment objectives.

This last aspect is interesting. In contrast to the BGH's finding, it can be argued instead that a customer who knows the character and risks of an investment product can also decide whether to take these risks, in order to reach his investment objective. However, the BGH's ruling is convincing in its result. Specific knowledge of one product does not accurately reflect knowledge about a whole range of products that may, under the circumstances, also be suitable to the investor's objectives. It is the duty of the advising bank to present all suitable alternatives to a client to ensure that the latter can make an informed decision. Therefore, the bank must know the customer's individual objectives and willingness to take risks, and cannot derive these merely from the client's knowledge concerning one specific product.

In the end, the BGH found the appeal court's factual findings to be insufficient to provide a final answer to the question of a client's willingness, leaving this query explicitly unanswered.

II. Advice Equated to Investment Product

Following the BGH's decision, the CMS Swap has proved to be a risky product with a complex structure making the bank's advisory requirements very high. The risks of this "interest bet" can hardly be recognized by a consideration of the single mathematical operation the formula includes. Rather, it is the bank's obligation to show, in a comprehensive and obvious manner, that the loss risk is real and may be ruinous, and is not merely "theoretical."[39] In the case of a CMS Swap this includes detailed descriptions of all elements of the formula, as well as an understanding of their precise effects under different circumstances. Furthermore, the bank has to highlight the imbalances of chances and risks between the parties.[40] In the end, the client should have nearly the same knowledge as the advising bank to make a full-informed decision.[41]

Whether the bank meets these requirements in this case is left unanswered, as the factual findings are insufficient for the BGH once again. This is unfortunate. In this instance, the bank provided a lot of information material concerning the CMS Swap. It would have been

[38] *Id.* at margin number 25.

[39] *Id.* at margin number 29.

[40] *Id.*

[41] *Id.*

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interesting to know if this information had met the requirements of the BGH, particularly with respect to the expression "theoretical unlimited," which has been subject to controversy. As the bank used the same information documents in other cases, several courts had the opportunity to evaluate the quality of this expression. Some found this expression played down the real risks, and stated that the bank instead is obliged to define a "worst case scenario" by absolute figures.[42] Others stated that the risk warning could not be clearer[43] or that the expression implied a sufficient highlight of the loss risk.[44] The question is more than a fight for words. There are other imaginable situations in which a bank has to explain that a loss risk cannot be quantified. Therefore, a clarification would have been appreciated. The explanation that a risk is "real and ruinous" as suggested by the BGH does not seem to be an appropriate solution, since a specific qualification is still missing, and this expression might not be specific enough to serve as a warning for the client.[45] This *obiter* however, is a first step in the consideration of scientific findings of behavioral economics.[46]

III. The Disclosure of the Inevitable Collision of Interest

Another influential aspect of this case concerned the BGH ruling that the bank breached its advisory duty by failing to disclose the initial negative market value the contract had, at the time the parties agreed to it.[47] According to the factual findings, the contract had a negative market value of 4%, i.e. 80,000 Euros at that time. The BGH explicitly ascribed great importance to the swap agreement with regards to the negative market value, as this is the expression of a severe collision of interests on the bank's side.[48] Thus, this is not only a theoretical figure for the case, as the holder wished to terminate the agreement earlier, in keeping with the assumption of the preceding court.[49]

[42] *See* OLG Koblenz, *supra* note 3, at margin number 59.

[43] *See* OLG Hamm, *supra* note 3, at margin number 87.

[44] *See* OLG Frankfurt 23 U 230/08, *supra* note 3, at margin numbers 63-64.

[45] *See* also Jan Lieder, *Gesteigerte Beratungspflichten bei komplexen Anlageprodukten – Implikationen der "Zinswette"-Entscheidung des BGH* (Increased Advisory Duties for complex financial instruments – Implications of the Interest Bet Decision of the BGH), 3 Gesellschafts- und Wirtschaftsrecht (GWR) 175 (2011).

[46] *See* Lars Klöhn, *Untitled Case Note,* 32 ZIP 762, 764 (2011).

[47] *See* BGH*, supra* note 1, at margin numbers 31-38.

[48] *Id.* at margin number 31.

[49] *Id.* at margin number 81; *see also* OLG Frankfurt 23 U 175/08, *supra* note 3.

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The collision of interests is imminent due to the role of the bank in a swap agreement. Since the bank is the holder's adversary, the latter's loss is the former's benefit. Therefore, the bank's situation is ambivalent. On the one hand, it must be convinced that a product causes a loss for the client, but on the other, it must also advise the client of the same product to assure its own benefit. This is absolutely contrary to the duties arising from the advisory contract between bank and client. This defense of bank, namely that avoiding this interest collision by passing the agreement's chances and risks on to a third party, was not accepted by the court. The BGH stated that the bank was no longer interested in the development of the swap agreement because it had "sold" the contract to another party.[50] Yet this transaction was only possible because of the negative market value the bank had constructed by structuring the formula in a certain way. If market evaluated the holder's risk negatively at the closing time, this meant that it simultaneously also evaluated the bank's chances positively. This advantage could be sold by the bank.[51]

To complete the BGH's remarks, if the market evaluated the holder's chances positively, the bank would have had a disadvantage while evaluating its risks negatively. This would obligate the bank to pay a risk premium additionally when transferring the risks to another party.

For the BGH it is clear that because the bank benefits from the negative market value, i.e. from a client's disadvantage, the neutralism of the bank's recommendation is in jeopardy.[52] A customer would see the recommendation in a different light if he knew that the formula for his interest payment obligation was structured in a way that his chances were considered to be worse than the bank's chances by professional market participants.[53]

The duty to disclose was not deemed void because of the client's actual knowledge about the concept of negative market values from the 2002 contracts. It may be true that the bank notified the client that these contracts showed a negative market value when the parties entered into the CMS Swap, but this does not mean that the claimant actually knew that these swap agreements were usually closed with an initial negative market value.[54]

If the negative market value is the benefit the bank realizes by passing the contract's chances and risks on, the question of whether there is a general obligation for the bank to

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[50] *See* BGH*, supra* note 1, at margin number 35.

[51] *Id.*

[52] *Id.* at margin number 36.

[53] *Id.*

[54] *Id.* at margin number 37.

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disclose their profits arises. The BGH comments on this sensible question as well. Confirming the precedent jurisdiction, BGH states that the conflict of interest caused by a bank offering its own products to its clients is so obvious that the former does not have to be subjected to the obligation to disclose.[55] In this case however, the judges saw a special constellation, namely the intentionally structured initial negative market value of a contract the bank recommended to the customer. This is, in contrast to the general intention of profit making, not recognizable to the customer.[56] Only a client who is aware of this conflict of interest can accurately estimate the recommendation's worth. There are three steps in which the BGH ruling can be summed up: First, the bank is conflicted because of the bet-like structure of an interest swap. According to the contract, the bank can only make a profit if the customer suffers a loss. Secondly, this conflict of interest is avoided by passing on this contractual position to another party. The bank's benefit does not depend on the swap's goals underlying anymore. Rather, it is the price the bank gets for the contract in a hedging transaction. This price equates the negative market value. To attain the goal of realization benefits through the close of a hedging transaction, the bank must ensure that the swap contract shows a negative market value. This is step three then. In order to close the hedging transaction shortly after the swap agreement is finished, the bank must arrange the market value to be negative at that time. This is done by a slight modification of the interest formula. In the end, the bank recommends a swap agreement as a promising investment, although professional mathematical simulation models show that the investment might be unprofitable for the client. However, this probable loss is fundamental for the bank's benefit. These facts should then be made visible to the investor.

No prophetic abilities are necessary to foresee that this BGH judgment will lead to much debate. There is a fine line between obvious and unobvious interest collisions. What can a customer seriously expect from a bank's recommendation in this case? Isn't the collision of interests always obvious when betting against the adviser? Assuming that the client is unclear about the exact workings of the swap, he will at least have understood that his/her benefit would be the bank's loss, and vice-versa. A bet is always an expression of the conviction to know a specific future development better or more precisely than the opponent. The party that is right gains the benefit, whereas the erroneous one makes a loss.[57] It cannot be denied that the average customer would perhaps think that it is not the brightest idea to bet on the future financial development of a spread between two interest rates with his bank. There is more than one indication that the bank might have the better idea of what is being placed at stake.

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[55] *Id.* at margin number 38.

[56] *Id.* at margin number 47.

[57] *See* MATHIAS HABERSACK, MÜNCHENER KOMMENTAR ZUM (Munich Commentary) BGB § 762, at margin number 7 (Kurt Rebmann *et. al.*, eds., 2009).

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This raises the question of whether the advisory contract between the bank und the customer is dissolved consensually when an interest rate bet becomes the subject of the dialogue.[58] This point of view however, cannot not be aligned with § 37e WpHG. It is the understanding that bank's transactions, which can be qualified as a gamble, are also subject to the duties under § 31 WpHG. With § 37e WpHG, the legislator implicitly allows the bank to offer gambles to their customers. Thus, its advisory duties are not affected by the fact that the transaction is a gamble. However, in the end one can agree with the BGH ruling. Crucial in this case is the unconditioned duty to disclose collision of interests. It is uncertain how far the dogmatic meaning of this ratio reaches.

IV. Assumption for Causation – Aufklärungsrichtiges Verhalten (advice-conform behavior)[59]

The plaintiff's director admitted that he never quite understood the agreement's mechanisms and that he only entered into it because he wanted the defendant's employee to close the deal. The BGH states that the "the customer's decision for the investment, without an understanding for it, is actually the expression of the exceptionally trustful relationship which makes the customer orient himself by the recommendation of "his adviser."[60] Based on this assumption, the BGH negated a contributory negligence under § 254 BGB of the customer, which is convincing.

Considering the plaintiff's statement, one may wonder whether the assumption that the investor would have refrained from entering into the contract if he was informed diligently is correct. This supposition is always applied in order to shift the burden of proof to the bank.[61] It seems to be the BGH's opinion that this assumption also assumes that the customer would have understood the mechanisms if he had been informed diligently. However, it is interesting to grant this shift concerning the burden of proof to a customer who explicitly says that he invested without understanding the product. In this context, it is important to remember that the investment decision is solely the customer's affair and cannot be made by the bank because it would then be seen as asset management than as some advisory function, [62] The customer who invests in the awareness of incomprehension

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[58] *See* Lars Klöhn, *supra* note 45, at 762, who similarly asks whether the rule that an advisory contract is conclusively closed is still appropriate, if the bank is required to subordinate its own interest to the customer's.

[59] In all cases concerning the liability for investment advisory, the jurisdiction assumes that the investor would have made the right decision if he was informed diligently.

[60] *See* BGH, *supra* note 1, at margin number 41.

[61] *See* BGH, *supra* note 1, at margin number 40 (with further references).

[62] *See* Heinz Georg Bamberger, *supra* note 28, § 50 at margin number 7.

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might confute the assumption that he would have acted differently if he had been informed sufficiently.[63]

E. Consequences of the Decision

I. Similar Bank Transactions

The BGH decision concerns a particular investment product, the CMS Swap. The decision is generally considered to have repercussions that reach far beyond the individual case.[64] This might be due to the fact that the same, or very similar contracts were closed more than a hundred times with different customers. However, it must be stated that the BGH left many questions explicitly open. Considering this, it will probably not be the last BGH ruling that concerns CMS Swaps. Furthermore, it brings up the question of how far this ruling can be generalized and applied to other bank transactions.

There are several financial transactions where a bank takes an opposing position in relation to the holder. Every time the bank is grantor, its interests oppose those of its clients. This situation is enhanced where the bank's profit depends heavily on mirroring the client's loss. This structure is present in every kind of swap agreement, whether it is interest or currency based.

Applying the ratio of the BGH's decision, the bank's particular advisory duty depends on its behavior. If the swap agreement is not passed on within a hedge, the bank only has to disclose that the recommendation for this can be made under the influence of its will to realize a profit. The bank then has to reveal that it can only give valid advice by harming itself. However, the question remains whether this collision is so unobvious that it must be disclosed.[65]

Otherwise, if the bank hedges the swap agreement, and therefore, constructs an initial negative market value by modifying the formula, it must disclose this negative value at the time the parties enter into the contract.

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[63] With a similar argument, *see* LG Frankfurt/Main, Ref. No. 2-19 O 435/09 (Oct. 25, 2010), 11 BKR 169, 172 (2011).

[64] LG Frankfurt/Main 2-19 O 435/09, *supra* note 62.

[65] *See* this article, at Section E. II.

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II. Dogmatic Scope – Disclosure of Conflict of Interest

A general duty to inform the client about profit margins or the content of hedging transactions cannot be derived from the ruling. This was not the first time that the collision of interests was the decisive aspect, demonstrating the continuity in the BGH's rulings in the last couple of years. The decision can be understood as a consequent advancement of *kick-back-jurisdiction*.[66]

A key aspect has always been the disclosure of a conflict of interests, and the BGH seems to establish a system of exceptions and counter-exceptions. The basic rule is that every conflict must be communicated to the client. So far, this is codified in § 31 (1) No. 2 of the WpHG. The most important exception is made for interest collisions, which are so obvious that it can be assumed that the customer is already aware of them. Examples are: the general profit motive when a bank is selling its own products,[67] or the profit motive of a free, i.e. not engaged by a bank, adviser who offers services without demanding an advisory fee from the client.[68]

The counter-exception is made when "special circumstances appear additionally."[69] The intentionally constructed negative market value is an example of such a situation. The reason behind this counter-exception is in contrast to the bank's general profit motive, as it is unrecognizable to the client.[70]

The criteria applied by the BGH are not fully convincing. The standard of obviousness has been criticized for being pseudo-empiric, as it is based on undisclosed assumptions about human information processing, and causes legal uncertainty, as one can usually be of differing opinions about the obviousness of the risks of investment products.[71] This can be argued even more for the criterion of "special circumstances" which, in the case of an obvious collision interest, are the ground for a counter-exception. A search for the similarities in the situations where the BGH assumed these "special circumstances" can be attempted. An example is a situation in which the customer knows that the bank wants to make a profit, but at the same time errs in his imagination of how the bank realizes this profit. In the case of a CMS Swap, the idea that the bank's profit would be generated by

[66] *See* the decisions referred to in note 33.

[67] *See* BGH, *supra* note 1, at margin number 38; BGH Ref. No. III ZR 196/09 (Apr. 15, 2010), 31 ZIP 919-921, at margin number 12 (2010).

[68] *See* BGH, *supra* note 34, at margin number 13.

[69] *See* BGH, *supra* note 1, margin number 38.

[70] *Id.*

[71] *See* Lars Klöhn, *supra* note 45, at 762, 763.

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the contract turned out to be an error, as the bank's profit was realized by "selling" the contract's chances to a third party. In the case of the sale of investment funds, the customer erred in his imagination that the bank's only source of profit would be the fee, which is charged by the bank for the general business relations. This implies a particular imagination of a bank's business, where some things are more obvious than others. What this imagination looks like and where the line between obvious and unobvious facts has to be drawn remains in the dark. Further, it is dissatisfying that the court, while assuming a customer's imagination, does not consider the variations between different groups of customers.

For example, while the *kick-back-decisions* concerned private banking customers, the CMS Swap was only offered to business clients. A normative evaluation of what a customer ought to expect and what is not realistic will, at the very at least, consider differences in the knowledge of a particular customer and the context in which the contract is closed.

It remains uncertain if this decision is an advancement of holders' rights. The phenomenon that less information can be more from other situations in capital markets is also known.[72] It also might be difficult to explain the effect of a negative market value to someone who is not interested, or simply not educated in a proper way, to understand contracts of this nature. Whether German banks will ever offer CMS Swaps again is questionable, as is the consideration of the reasonableness of such a recommendation in the first place.

[72] *See* Jan Lieder, *supra* note 44; Thomas M.J. Möllers & Eva Kernchen, *Information Overload am Kapitalmarkt (Information Overload on Capital Markets)*, 40 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 1-26 (2011).

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