Banks as financial advisers

A comparative study in English and German law

A thesis submitted in Trinity Term 1998 to the Faculty of Law in conformity with the requirements of the degree of D. Phil.

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The law is stated as at 1 August 1998.

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Abstract

This thesis deals with law concerned with the role of banks as their customers' financial advisers in England and Germany.

At present, the law related to financial advice in England and Germany appears to be a motley conglomerate of isolated concepts and lines of authority which fail to form a homogenous body of rules capable of guiding those who are involved in the banking business.

Recent developments such as the 'misselling' of pension funds and other investment products have undermined consumer confidence in the financial services industry and have raised the question whether the present legal concepts can still be seen as adequate means to protect the interests of consumers.

This thesis argues that the duties of banks which assume the role of their customers' financial adviser should be extended so as to ensure that only those financial products are sold to customers which are positively suitable to their individual needs. Furthermore, it is argued that banks which provide their customers with investment advice should disclose to them any substantial conflict of interest on their part.

Additionally, the duties of lenders should also be increased. This thesis maintains that, in certain circumstances, there should be an obligation on the part of a lender not to grant a loan to a financially inexperienced consumer. Furthermore, it is argued that - with regard to third party guarantees involving substantial financial risks for the guarantor - a lender should be under the obligation to ensure that the guarantor receives independent legal advice before signing the guarantee agreement.

On a more general level, this thesis calls for the development of a partnership between banks and their customers and regards it as the law's task to counterbalance existing inequalities of bargaining powers between banks and their customer to further the forming of such a partnership. It also supports the idea of informal conflict resolution systems such as the Banking Ombudsman Scheme.

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Germany:

AGBG	§§ 1, 9, 11
Auslandsinvestitionsgesetz	§ 12
BGB	§§ 119, 138, 242, 249, 254, 607, 662, 666, 675, 676, 765, 766, 818, 823, 826, 831, 833, 1618a
Börsengesetz	§§ 45, 46, 53
Grundgesetz	article 2
HGB	§§ 1, 346
Hypothekenbankgesetz	§§ 11, 12
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Richtlinien für die Bewertung von Sicherheiten im Personalkreditgeschäft (Sparkassengesetz Rheinland-Pfalz)	§ 6
StGB	§ 263
Wertpapierhandelsgesetz	§§ 2, 31, 32, 34, 35, 37a
Wertpapierverkaufsprospektgesetz	§ 13

Table of Abbreviations

AC	Law Reports, Appeal Cases (Decisions of the House of Lords and Privy Council from 1891)
AG	Amtsgericht (lowest local court in Germany)
AGBG	Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (Standard Contract Terms Act)
All ER	All England Law Reports
APR	annual percentage rate
BGB	Bürgerliches Gesetzbuch (German Civil Code)
BGH	Bundesgerichtshof (Federal Court of Justice in Civil and Criminal Matters)
BGHZ	Entscheidungen des Bundesgerichtshofs in Zivilsachen (Decision of the Federal Court of Justice in Civil Matters)
BJIB & FL	Butterworths Journal of International Banking and Financial Law
BVerfG	Bundesverfassungsgericht (Federal Constitutional Court)
C & FL	Credit & Finance Law
CA	Decisions of the English Court of Appeal
Ch. Div.	Law Reports, Chancery Division (from 1891)
CLJ	Cambridge Law Journal
Com LR	Commercial Law Reports
DC	Divisional Court
Die Bank	German Banking Journal
EGCS	Estates Gazette Case Summaries
FIMBRA	Financial Intermediaries, Managers and Brokers Associations
FLR	Familiy Law Reports
FSA	Financial Services Authority
FSO	Financial Services Ombudsman
FTLR	Financial Times Law Reports
HGB	Handelsgesetzbuch (German Commercial Code)
HL	Decisions of the English House of Lords
HLR	Housing Law Reports
ICLQ	International and Comparative Law Quarterly
ICR	Industrial Case Reports
IMRO	Investment Management Regulatory Organisation
JBL	Journal of Business Law
KB	Law Reports, King's Bench (1901-52)
KCLJ	King's College Law Journal
LG	Landgericht (German Regional Court)
Lloyds Rep.	Lloyds Law Reports
LQR	Law Quarterly Review

MLR	Modern Law Review (English Law Journal)
NCC	National Consumer Council
NLJ	New Law Journal
Nott.LJ	Notthingham Law Journal (English Law Journal)
NJW	Neue Juristische Wochenschrift (German Law Journal)
NSWLR	New South Wales Law Reports
OFT	Office of Fair Trading
OLG	Oberlandesgericht (German Regional Court of Appeal)
OJLS	Oxford Journal of Legal Studies
PIA	Personal Investment Authority
QB	Law Reports, Queen's Bench (1891-1901; 1952-)
RG	Reichsgericht (German Imperial Court)
RGZ	Entscheidungen des Reichsgerichts in Zivilsachen (Decisions of the German Imperial Court in Civil Matters)
SIB	Securities and Investments Board
SFA	Securities and Futures Authority
SRO	self-regulating organisation
StGB	Strafgesetzbuch (Criminal Code)
StVG	Straßenverkehrsgesetz (Road Traffic Act)
TLR	Times Law Reports
VuR	Verbraucher und Recht (German Law Journal)
WLR	Weekly Law Reports
WM	Wertpapier-Mitteilungen (German Law Journal)
ZBB	Zeitschrift für Bankrecht und Bankwirtschaft (German Law Journal)
ZIP	Zeitschrift für Wirtschaftsrecht (German Law Journal)

Chapter One:

Introduction

One and a half centuries ago, in the English case *Foley* v *Hill*, the House of Lords described a banker's trade as[1]:

> to receive money, [...] becoming debtor to the person who has lent or deposited with him the money.

Undoubtedly, banking has seen great change within the last 150 years. Nowadays, banks offer far more than loans to their customers. They issue credit and debit cards, operate cash machines, manage their customers' portfolios of shares, write references and may even act as their customers' trustees or executors. Banking via the telephone or internet is also gaining ground. Furthermore, the traditional boundaries between banking and insurance services have come down. 'Bankassurance', the amalgamation of the formerly strictly seperated areas of insurance and banking, has become the buzzword of the financial services industry of today. Quite naturally, alongside these structural changes in the financial services sector, there has been a sharp increase in the number and complexitiy of financial products on offer. In Germany, for example, an investor has currently the choice between no less than 2,700 different investment funds[2]. Not surprisingly, consumers find it difficult to choose between the financial products on the market. In a survey carried out by the National Consumer Council in Britain in 1994, one fifth of the respondents stated that they were 'not at all' or 'not very confident'



[1] [1848] II HLC 28 (HL), at p.44 in: The English Reports (Full Reprint) Volume 9, 1002, at p. 1008.
[2] *Frankfurter Allgemeine*, 13 October 1997, at p. 36.

when choosing where to invest a sum larger than their monthly pay[3]. Moreover, nearly a third of them said that they were 'not at all' or 'not very confident' in choosing a personal pension[4].

This shows that there is a great demand among consumers for financial advice. Today, many customers turn to their banks for advice not only with regard to rather 'traditional' banking matters such as loans, mortgages or personal guarantees but also in areas of 'modern' banking such as investment in shares and unit trusts. Experts predict that, for example, the private investment market alone will grow ten per cent per year over the next five years. This means that within the next five years the money invested by private customers will double[5]. In Germany, it is said that within the next decade DM 2,600 bn will be handed on from one generation to the next[6]. This will require banks to be able to advise customers not only on investment strategies but also to assist them in complex tax matters on succession.

However, judging from recent developments in the financial services sector, one may have doubts about the banks' ability to meet this demand for high quality financial advice. Within the last decade, the courts in England and Germany have increasingly been confronted with cases involving bank customers claiming that they had been given incorrect financial advice by their banks. In the UK, the so-called 'pensions misselling scandal' undermined consumer confidence in the financial services industry. It is estimated that in the late 80s and early 90s no less than 500,000 consumers were sold unsuitable pension products causing them a loss of £4bn[7]. Moreover, mortgage lending

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[3] National Consumer Council, *Consumer Concerns 1994 - A consumer view of the personal financial services: The report of a Mori Survey* (London 1994), at p. 10.
[4] *ibid*, at p. 10.
[5] The Banker, 'Care for a slice?', Volume 12, 1995, at p. 56.
[6] Lang, Volker, *Aufklärungspflichten bei der Anlageberatung* (Stuttgart 1995), at p. 17.
[7] *Financial Times*, 14 May 1997, at p. 12.

appears to be another trouble spot in the British banking business. Every year on average 50,000 houses are repossessed by building societies and banks in the UK[8]. Mortgage complaints were the most frequent type of complaints requiring full investigation by the British Banking Ombudsman Office for the period 1994-95[9]. In many of these cases it turned out that mortgages had been underfunded due to miscalculations made by the bank[10]. The banks also often failed to explain to their customers the basic nature of mortgage agreements.

In Germany, the country's highest civil court's well publicized ruling in the *Bond-Urteil*[11] highlighted significant shortcomings in the German banking sector with regard to advice in private investment matters. According to a very recent survey carried out by *Stiftung Warentest*, a respected consumer organisation, the standard of German banks' investment advice still needs to be improved significantly[12]. The financial advice provided by no less than 50% of the tested banks were rated by the consumer organisation as *mangelhaft* (inadequate) or sehr *mangelhaft* (very inadequate). In Germany, it was also mortgage lending and private investment matters that accounted for most of the complaints dealt with by the Ombudsman Office of the German private banks in 1992-93[13]. These, from a consumer's point of view, disappointing developments in the area of financial advice in the recent past has prompted me to undertake research in this field. The main question which is discussed in this thesis is whether the law should intervene to help solving the obvious shortcomings in today's banking business practice related to financial advice. Can the present legal concepts which define a bank's duties with regard to financial advice still be seen as adequate and

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[8] *Financial Times*, 1 February 1996, at p.8.
[9] The Banking Ombudsman Office, *Annual Report 1994/95* (London 1995), at p. 14.
[10] *ibid*, at p.14/15.
[11] BGH (06.07.1993) NJW 1993, 2433.
[12] Stiftung Warentest, *Finanztest*, Volume 12, 1997, at p. 12.
[13] Hoeren, Thomas, 'Der Bankenombudsmann in der Praxis', NJW 1994, 362, at p. 363.

up-to-date? What can be done to prevent the misselling of financial products? Are the present calls for more governmental regulation and supervision justified? What roles should so-called extra-legal institutions such as the Ombudsman Schemes play? Are statutory codes of practice which set standards for the providers of financial services necessary in order to safeguard the interests of consumers?

The aim of this work is find at least some answers to these very difficult and complex questions. At present, banking law in England and Germany appears to be a motley conglomerate of isolated concepts and lines of authority which fail to form a homogenous body of rules capable of guiding those who are involved in the banking business. This thesis seeks to contribute to the development of conceptionally and practically convincing solutions to the complex legal and socio-economic problems caused by recent trends in modern banking business. In order to achieve this goal, a comparative approach is taken.

However, in my view, the feasibility of the comparison of theoretical legal concepts is limited. Sometimes, legal concepts are nothing but products of certain structural deficiencies in a legal system and they are (mis-)used by the courts to reach a solution which appears to them fair and reasonable in the individual circumstances of the case. The differences and similarities of the 'solutions' offered by the English and German law will be analysed with a view to find out about the policy reasons lurking behind these 'solutions'. It will be seen that not infrequently doctrines and principles are used to disguise value-based arguments as legal points. Particular attention will be focused on how convincingly the English and German legal systems solve the complex practical

problems in the area of financial advice. Thus, both country's legal systems' concepts are analysed and evaluated 'from the outside, not only from within'[14].

As rules often present only 'a surface image of a legal system'[15] and there is 'much law to be found beyond the rules'[16] attention is focused on the socio-economic context of the bank/customer relationship. In my opinion, the emphasis of a comparative work should be on the practical results produced by the legal systems which are compared[17]. This means that particular attention is to be paid to the interdependence of rules and concepts on the one side, and, business practices and customs on the other. With a view to take also into account the different 'mentalités'[18] of the legal frameworks as well as the usages in the banking business in Germany and England this thesis reflects the perceptions of practioners, regulators and consumer groups.

In order to achieve this goal, the 'black letter law' of both jurisdictions have been used only as a starting point for this work. In addition, as this work is intended fo be a comparison of 'living law' I decided to gain an insight into the practical aspects of banking through completing interships with Deutsche Bank in Frankfurt/Main (Germany) and Lloyds Bank in Abingdon (Oxfordshire). During my time the Business Banking Centre of the Abdingdon branch of Lloyds Bank I was able to sit in on a number of customer interviews and join in several of the branch's managers' internal meetings. Moreover, I had the chance to 'shadow' for a couple of days one of the bank's consultants who advises the bank's clients on pension and investment matters and whose salary is partly linked to commissions.

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[14] Pound, Roscoe, *The Spirit of the Common Law* (Boston 1921), at p.212.
[15] Legrand, Piere, 'European Legal Systems are not converging' (1996) 45 ICLQ 52, at p. 60.
[16] *ibid*, at p. 60.
[17] See also the idea of the 'principle of functionality' in Zweigert/Kötz, *An Introduction to Comparative Law* (2nd edn. Oxford 1987), Volume 1, at p. 31.
[18] Legrand, Pierre, 'European Legal Systems are not converging' (1996) 45 ICLQ 52, at p. 60.

Additionally, in the course of my two month long stay with the legal department of Deutsche Bank in Frankfurt I had the opportunity to obtain an insight in the variety and complexity of legal problems which can arise in an ordinary bank/customer relationship. Moreover, I could discuss with some of the bank's experts the economic implications of rules and regulations in the banking sector.

Through these internships as well as a result of my theoretical work, I found out about the importance of public and 'semi-public law' in the area of a bank's duties as its customer's financial adviser. In England and Germany there is a great number of specific and often comprehensive statutory provisions which define the role of banks which sell certain financial products to their customers. Furthermore, there are important rules set by statutory or self-regulatory bodies which impose duties upon banks which act as financial advisers. Thus, I decided to conduct interviews with representatives from English and German regulatory bodies[19]. In this context, I would like to express my gratitude to Mr. Tony Holland, Principal Ombudsman of the Personal Investment Authoriy (PIA), Mr. Andrew Whittaker of Financial Services Authority (FSA), and Dr. Thorsten Pötzsch of the *Bundesministerium der Finanzen* (Federal Ministry of Finance) who took their time to talk to me.

Especially in England, banking supervision is particularly complex. An ordinary High Street bank in England is currently under the supervision of at least four different bodies[20]. However, this is going to change soon. In 1999, one single supervisory body for the UK's financial services industry, the so-called 'Financial Services Authority'

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[19] For a detailed list of interviews, see Appendix VIII.

[20] These are the Investment Management Regulatory Organisation (IMRO), the Personal Investment Authority (PIA), the Securities and Furutres Authority (SFA) and the Securities and Investment Board (SIB).

(FSA), will take up its business and should thereby help to streamline banking supervision in the UK. In Germany, the rules and regulations for the financial services industry are also in a state of flux. Currently, the German government appears to come up with more and more detailed pieces of legislation in the area of banking supervision every two or three years[21].

Moreover, another new trend in the area of banking is discussed in this thesis. In the early 90s, the banking industry in England and Germany introduced so-called 'Banking Ombudsman Schemes'. These schemes offer so-called extra-legal conflict resolution to bank customers. Attention is focused on the way these schemes operate and how useful their work is for the consumer. The number and type of complaints which are handled by these schemes also serve as an indicator for the biggest trouble spots in the today's banking practice. In order to obtain an insight into the work of the German and English Ombudsman Schemes I conducted interviews with senior staff from both institutions. At this point, I would like to thank Mrs. Bernadette Zawal-Pfeil of the German Banking Ombudsman as well as Mrs. Jane Hingston of the English Banking Ombudsman Office for taking their time to answer my (numerous) questions.

In addition, I interviewed with Mrs. Mary Sullivan of the Citizen's Advice Bureau's Money Advice Unit (London) and Mr. Hartmut Strube of the *Verbraucher-Zentrale* (consumer organisation) of the federal state of Nordrhine-Westfalia in Düsseldorf.

Beside this introduction, this thesis consists of further five chapters. Chapter Two contains an introduction to the general legal concepts used in English and German law

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[21] See the sequence of so-called *Finanzmarktförderungsgesetze* (Codifications for the Furtherance of the Financial Services Industry in Germany) within the last decade.

with regard to a bank's liability for financial advice. Chapters Three and Four deal with the exact scope of the advisory duties of banks with a view to selected areas of their business activities, namely lending and private investment. In Chapter Four the focus is also on the regulatory context. Here, the rules of regulations and methods of supervision of the financial services industry in England and Germany are analysed and compared. Additionally, the role and impact of Banking Ombudsman Schemes in England and Germany are discussed in Chapter Five.

The final chapter, Chapter Six, contains an analysis of the conceptual approaches taken by German and English law with regard to the role of banks as financial advisers and then continues by making a comparision and evaluation of the practical results achieved by the two legal systems. Furthermore, in this chapter suggestions are made which may help to improve and refine the English and German law related to financial advice provided by banks to their customers.

Finally, it may be stressed that one finds at the end of this thesis several appendices which contain translations of the most important provisions of those German codifications such as the German Civil Code and the relatively new Securities Trading Act which are of particular relevance for the subject matter of this piece of research work.

Chapter Two:

The general legal concepts in English and German law with regard to a bank's liability for financial advice

A. English law

(1) The legal nature of the bank/customer relationship in English law

In England, there has never been and there still is no codified definition of the legal nature of the ordinary bank/customer relationship. However, common ground is that this relationship is of a contractual nature. There are writers who favour the idea of one single general 'banking contract' which should be seen as basic to all transactions which is then amended by several specific contracts which arise only as they are brought into being in relation to specific transactions or banking services[22].

According to another point of view, the bank/customer relationship should rather be seen as a 'sui generis contract' incorporating elements of specific, already existing and well established different types of contracts such as that of debtor and creditor[23]. Although both ideas may be appealing from an academic point of view, neither are in line with the actual development of banking law in England. In the past, English courts have been constantly defining and re-defining the legal relationship between banks and

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[22] Hapgood, Mark, *Paget's Law of Banking* (11th edn. London 1996), at p. 110.
[23] Ellinger/Lomnicka, *Modern Banking Law* (2nd edn. Oxford 1994), at p. 110.

their customers by taking into account the constantly changing usages and customs in the banking trade. A very good example of this rather pragmatic approach taken by the English judiciary is the following statement of Salmon J. in the decision in *Woods* v *Martins Bank Ltd.*[24]:

> In my judgment, the limits of a banker's business cannot be laid down as a matter of law. The nature of such a business must in each case be a matter of fact and accordingly, cannot be treated as if it were a matter of pure law'.

Considering the above mentioned statement, one finds that the English judges have not opted for the concept of a contract sui generis of a general banking contract. Instead, they adopted a rather cautious step-by-step approach. Taking the debtor/creditor relationship as a contractual foundation, they added to it tailor-made separate contractual concepts whenever this was necessary to set up another legal framework to cater for new developments in the banking business such as cheques, standing orders, direct debit. Thus, one may be inclined to define today's bank/customer relationship as a conglomerate of several different contracts accumulated over the last 150 years which also mirrors the steady expansion of the services offered by banks to their customers. However, at this point, it should nevertheless be pointed out that the most important single contractual agreement between bank and customer still is the contract of loan.

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[24] [1959] 1 QB 55 (QB Div.), at p. 70.

(a) Bank/customer relationship as a conglomerate of various contractual agreements

In the ordinary bank/customer relationship this fundamental contract of loan is usually complemented by a number of other contractual agreements between the customer and the bank. One of the most important of these 'annexed contracts' is the customer's right to draw a cheque against his or her account with the bank. A cheque is seen as an order of the customer addressed to the bank to pay out of the customer's money in the bank's hands the amount of the cheque to the payee thereof. Thus, it is said that where a customer is given a chequebook by his or her bank the ordinary debtor/creditor relationship is thereby supplemented by the additional contractual relationship of agency. In this 'annexed' contract of agency the customer is viewed as the principal and the bank as the agent[25].

Moreover, within the framework of the ordinary bank/customer relationship the bank is commonly placed under a significant number of contractual obligations. First, there are the primary contractual obligations such as the obligation for the bank as debtor to pay back the customer's money out of his or her account on the customer's demand. Secondly, there are a number of secondary contractual obligations for a bank. Among these secondary obligations are, for example, a bank's obligation of secrecy[26]. In *Tournier* v *National Provincial and Union Bank of England*[27] it was held that it was an implied term of the contract between a banker and its customer that the bank will not divulge to third parties, without the consent of the customer, any information relating to the customer acquired through the keeping of the customer's account, unless the bank is compelled to do so by order of a court, or the circumstances give rise to a public duty of

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[25] per Lord Atkinson in *Westminster Bank Ltd* v *Hilton* [1926-27] 43 TLR 124, at p.126 (HL).
[26] Hapgood, Mark, *Paget's Law of Banking* (11th edn. London 1996), at p. 120.
[27] [1924] 1 KB 461 (CA).

disclosure, or the protection of the bank's own interests require it. Furthermore, a bank acting for its customer as a non-gratutious agent is under the contractual obligation[28] to exhibit such a degree of skill and diligence as is appropriate to the performance of the agency agreement which has concluded between them[29]. However, it is interesting that in English banking law there is no general contractual obligation for a bank to advise its customers on their financial transactions. Neither is there a general contractual duty on the part of the bank to look after its customers' financial affairs.

(b) No general contractual obligation on the part of the bank to advise a customer

For example, in a situation where a bank customer walks into his or her bank, asks for a loan to buy a house and explicitly seeks advice with regard to the feasibility of the purchase. English law would not - given that later a loan agreement is reached between the bank and the customer - put the bank under a *contractual* primary or secondary obligation to render financial advice to the customer. Moreover, English law also opposes the idea that when a customer openly seeks financial advice from the bank and is subsequently rendered financial assistance by the bank that then this results in the (tacit) conclusion of a separate 'contract to advise' between bank and customer[30]. English law's reluctance to offer a contractual solution in advice cases may be partly explained by the doctrine of consideration. According to this doctrine, a contract is only then binding and enforceable, if it is either made by deed or where both parties provide

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[28] It may also be stressed that in *Henderson* v *Merrett Syndicates Ltd* [1994] 3 All ER 506 (HL) the House of Lords confirmed that, in these situations, a professional agent's duty of care can be of a contractual and/or tortious nature.

[29] Chitty, *Chitty on Contracts* (27th edn. London 1994), Volume II: Specific Contracts, at p. 68 (para. 31-105); see also the decision in *Commonwealth Portland Cement Company Ltd* v *Weber, Lohmanns & Co Ltd* [1905] AC 66 (PC).

[30] See decision in *Woods* v *Martins Bank Ltd.* [1959] 1 QB 55 (QB Div.).

each other with 'something which is of some value in the eye of the law'[31]. Against the background of this doctrine English courts appear to view advice given by a bank to a customer as something of a supplementary character, something provided for free and therefore not substantial enough to form the core of a separate contract equivalent to the German notion of *Beratungvertrag* (a specific form of a contract for the supply of advice). Furthermore, although one may find that inroads[32] have already been made upon another of English law's quasi-sacrosanct doctrines, privity of contract which stipulates that a contract cannot confer rights arising under it on any person except the parties to it[33], one may be inclined to say that the doctrine of consideration is unlikely to be changed in the near future.

Furthermore, English law is also not eager to find an implied term in an ordinary bank/customer relationship which obliges the bank to provide its customer with advice on a specific transaction. A good example for English law's general reluctance to acknowledge implied contractual terms is the statement made by Bingham LJ[34] in the ruling in *Marcan Shipping (London) Ltd.* v *Polish Steamship Co.* (*'The Manifest Lipkowy'*)[35]:

> [...] a term will be implied only where it is necessary in a business sense to give efficacy to a contract, or where the term is one which the parties must obviously have intended.

When considering case law in this area of banking law, one finds that English courts tend to refrain from recognising implied terms which would place the bank under a duty

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[31] *Thomas* v *Thomas* (1842) 2 QB 851 (QB Div.), at 859; in: English Reports (Full Reprint) Volume 114, 330, at p. 333.
[32] See The Law Commission Report No.242: *Privity For The Benefit Of Third Parties* (July 1996 London); and the decision in *White* v *Jones* [1995] 1 All ER 691 (HL).
[33] Treitel, G.H., *The Law of Contract* (9th edn. London 1995), at p. 534.
[34] As he then was.
[35] [1989] 2 Lloyds Rep. 138 (CA), at p. 143.

to advise its customer. Decisions such as in *Schioler* v *Westminster Bank Ltd*[36] and *Redmond* v *Allied Irish Banks Plc*[37] indicate that English judges do not even consider the idea that such an implied term was necessary to 'give efficacy' to ordinary transactions such as the taking of deposits or contemplate that a banking-related contract is 'incomplete'[38] without such an implied term..

Additionally, English law does not know any general contractual duty on the part of the parties to the contract to disclose specific information to each other in the course of (pre-) contractual negotiations. The reason for this is said to be the liberal assumption, which dates back to the nineteenth century, that dealings between equal and equally knowledgeable parties do not require them to disclose to each other any information[39]. Nonewithstanding, English law requires one to refrain from making misleading statements in the course of pre-contractual negotiations. This area of the law is generally described as the law of misrepresentation.

(c) The notion of misrepresentation

In English law, a misrepresentation is generally defined as a false statement of fact which is addressed to the party misled and which is material inducement to entry into the contract[40]. According to the provisions of section 2 (1) and (2) of the Misrepresentation Act 1967, a misled party may then be able to rescind the contract or claim damages or to do both. If a misleading statement obtains contractual force, the representee is entitled

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[36] [1970] 2 QB 719 (QB Div.).
[37] [1987] 2 FTLR 264 (QB Div.).
[38] *Liverpool City Council* v *Irwin* [1927] AC 239 (HL).
[39] Cranston, Ross, *Principles of Banking Law* (Oxford 1997), at p. 220.
[40] Chitty on Contracts, *General Principles* (27th edn. London 1994), Volume I, at p. 334.

to rescind the contract or recover damages for breach of contract[41]. However, in this paragraph, the focus shall be on those statements and representations which are made in the course of contractual negotiations. The reason for this is that, in today's banking practice, this pre-contractual stage has become one of the main sources of dispute between banks and customers in the area of financial advice. Nowadays, the issue of misrepresentation typically occurs with regard to the banks' advertisements and in the course of negotiations between the banks' so-called 'mortgage specialists' or 'investment experts' and their customers.

A misrepresentation is generally described as a statement of fact as distinct from a statement of opinion, of intention, or of law[42]. In practice, however, especially the distinction between a statement of opinion and a statement of fact is often difficult to make. The decisions in *Bisset* v *Wilkinson*[43] and *Esso Petroleum Co Ltd* v *Mardon*[44] may show how thin the dividing line between a statement of fact and a statement of opinion can be. In *Bisset* v *Wilkinson*, a vendor of a farm in New Zealand told a prospective purchaser that, in his judgment, the land could carry 2,000 sheep. In fact, it could not carry that many sheep and the buyer sought to rescind the contract for misrepresentation. His action failed because the Privy Council found that the vendor's statement did not constitute a statement of fact but of opinion. This view was primarily based on the Privy Council's finding that[45]:

> In ascertaining what meaning was conveyed to the minds of the now respondents [i.e. buyers] by the appellant's statement as to the two thousand sheep, the most material fact to be remembered is that , as both parties were aware, the appellant had not and, so far as appears, no other person had at any time carried on sheep-farming upon the unit of land in

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[41] Treitel, G.H., *The Law of Contract* (9th edn.London 1995), at p. 326.
[42] Chitty, *Contracts* (27th edn. London 1994), Volume 1, at p. 334.
[43] [1927] AC 177 (PC).
[44] [1976] QB 801 (CA).
[45] per Lord Merrivale [1927] AC 177 (PC), at p. 183.

> question. That land as a disctinct holding had never constituted a sheep-farm.

On the other hand, in *Esso Petroleum Co Ltd* v *Mardon*, the Court of Appeal found that a petrol company's forecast with regard to the annual throughput of a petrol filling station constituted a statement of fact. In this case, the petrol company Esso told a prospective tentant of a petrol station which was in the process of construction that the throughput of petrol at the station was likely to reach 200,000 galllons per year. Later, the local authority refused planning permission for the petrol pumps to front onto the main road. Instead, the only access to the petrol pumps had to be from a side street resulting in the fact that the pumps could not be seen from the main street.

Despite this significant change in the lay-out of the petrol station Esso's representative, who had had 40 years' experience in the petrol trade, told the defendant in good faith that the initial estimation of an annual throughput of 200,000 gallons remained valid. Relying on this statement, the defendant signed a three year lease agreement and invested heavily in the station and also incurred a bank overdraft to operate it. Esso's forecast turned out to be false. At the end of the first 15 months of operation only 78.000 gallons of petrol had been consumed and the defendant had made a considerable loss in running it. Esso sought to repossess the station and to recover money owed to them by the defendant.

The defendant counterclaimed for damages for breach of contract and negligent misrepresentation. The Court of Appeal distinguished this case from the ruling in *Bisset* v *Wilkinson* on the grounds that in the Esso case the plaintiff petrol company's representee possessed much greater knowledge and skill than the defendant Mardon[46]:

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[46] [1976] QB 801 (CA), at p. 818 A-D.

> Now I would quite agree with Mr. Ross-Munro [i.e. counsel for Esso] that it was not a warranty - in this sense - that it did not *guarantee* that the throughput *would* be 200,000 gallons. But, nevertheless, it was a forecast made by a party - Esso - who had special knowledge and skill. [...] They knew the facts. They knew the traffic in the town. They knew the throughput of comparable stations. They had much experience at their disposal. They were in a much better position than Mr Mardon to make a forecast.
>
> It seems to me that if such a person makes a forecast, intending that the other should act on it and he does act on it - it can well be interpreted as a warranty that the forecast is sound and reliable in this sense that they made it with reasonable care and skill. [...]
> It is very different from the New Zealand case where the land had never been used as a sheep farm and both parties were equally able to form an opinion as to its carrying capacity.

It maybe concluded from both decisions that where the representor has greater knowledge than the representee the courts appear to be more likely to infer that his or her incorrect statement constituted a statement of fact and therefore also a misrepresentation. However, it should also be noted that the decision in *Esso Petroleum Co Ltd* v *Mardon* it was not ruled that there was a contractual duty on the part of Esso to give correct advice. Instead, the judges stressed that Esso was under a (tortious) duty of care when making a statement concerning the estimated annual throughput of petrol at the planned station.

In other words, this case was primarily decided not on the issue of misrepresentation but on the tort of negligence. Interestingly, the Court of Appeal stressed that the misrepresentation made by Esso also constituted a negligent breach of a duty of care on the part of the petrol company. In his speech in this ruling, Lord Denning pointed out that[47]:

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[47] [1976] QB 801 (CA), at p. 820 C-F.

> It seems to me that *Hedley Byrne*[48], properly understood, covers this particular proposition: if a man, who has or professes to have special knowledge or skill, makes a representation by virtue thereof to another - be it advice, information or opinion - with the intention of inducing him to enter into a contract with him, he is under a duty to use reasonable care to see that the representation is correct, and that the advice, information or opinion is reliable.
>
> If he negligently gives unsound advice or misleading information or expresses an erroneous opinion, and thereby induces the other side into a contract with him, he is liable in damages. [...]
>
> Applying this principle, it is plain that Esso professed to have - and did in fact have - special knowledge or skill in estimating the throughput of a filling station. They made the representation - they forecast a throughput of 200,000 gallons - intending to induce Mr Mardon to enter into a tenancy on the faith of it. They made it negligently. It was a 'fatal error'. And thereby induced Mr Mardon to enter into a contract of tenancy that was disastrous to him. For this misrepresentation they are liable in damages.

This statement focuses attention on the way English courts tend to deal with cases related to liability for incorrect advice or information which has been provided by professionals to their customers. Considering the leading judgments in this area, one finds that English courts rarely decide these cases on the ground of misrepresentation alone. In most situations, they find that the incorrect statement by the professional did not only amount to a misrepresentation but also to a breach of the professional's duty of care to make the relevant statement with due care and skill.

This is especially the case in the bank-related decisions in *Woods* v *Martins Bank*[49], *The Royal Bank Trust Co (Trinidad)* v *Pampellonne*[50] and *Verity* v *Lloyds Bank Ltd*[51]. All of these cases dealt with incorrect statements made by banks to their customers and all of these judgments in these cases centred on the question of whether there was a negligent

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[48] *Hedley Byrne & Co Ltd* v *Heller Partners Ltd* (*'Hedley Byrne'*) [1964] AC 465; this case is discussed in greater detail below.
[49] [1959] QB 55.
[50] [1987] 1 Lloyds Rep. 218 (PC).
[51] *The Independent* (4 September 1995), (Transcript); see also (1995) 8 C & FL 38 (QB Div.).

breach of duty of care on the part of the bank. Thus, one needs to take a closer look at the law of negligence to assess its impact on the law related to a bank's liability for financial advice.

(2) Liability of banks for financial advice given directly to customers - in England a domain of the law of tort

Taking into consideration the most recent case law in the area of banking[52], one may say that the legal question of a bank's liability for financial advice is mainly influenced by the law of tort and equity. Cases involving a bank's liability for its advice given directly to a customer without simultaneously affecting the interests of a third person centre almost exclusively on the tort of negligence.

(a) The tort of negligence

Negligence is a specific tort which gives rise to an action for damages. Liability in negligence is generally based on a failure to exercise that care which the circumstances demand[53]. Therefore, one may say that what amounts to negligence depends on the facts of the individual case. More than 50 years ago, Lord Wright showed great foresight when he stated in the decision in *Hay (or Bourhill)* v *Young* that[54]:

> [...] negligence is a fluid principle, which has to be applied to the most diverse conditions and problems of human life. It is a concrete, not an abstract idea. It has to be fitted to the facts of the particular case.

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[52] *Barclays Bank Ltd.* v *O'Brien* [1994] 1 AC 180 (HL); *CIBC Mortgages* v *Pitt* [1994] 1 AC 200 (HL); *Henderson* v *Merett Sydicates Ltd.* [1995] 2 AC 145 (HL); *Verity* v *Lloyds Bank Ltd.*, *The Independent* (4 September 1995) (Transcript) and (1995) 8 C & FL 38 (QB Div.).
[53] Halsbury's *Laws of England* (4th edn. London 1997), Volume 33, at p.421 (para.601).
[54] [1943] AC 92 (HL), at p. 107.

Today, the tort of negligence is still viewed as one of the most dynamic and rapidly changing areas of liability in English common law[55]. Generally speaking, the tort of negligence is based on the following four main requirements: duty of care, breach, causation and damages[56].

(aa) Duty of care:

Due to the fact that the tort of negligence has the potential for a very wide application, English courts have developed the concept of the duty of care to limit its scope[57]. The defendant must owe a duty of care in relation to the general class within which the plaintiff and the type of damage that has arisen fall before there can be any question of liability to the plaintiff in question. Generally speaking, the concept of duty of care is based on the following three requirements: proximity, foreseeability and the requirement that the imposition of the duty is 'fair, just and reasonable' in the circumstances of the case.

The concept of duty of care was most prominently shaped and defined by the House of Lords in the decision *Donoghue* v *Stephenson* (*'Donoghue'*)[58]. In this case dealing with a physical injury Lord Atkin developed the famous 'neighour rule'. According to this rule one must take reasonable care to avoid acts or omissions which one can reasonably foresee would be likely to do harm to your neighbour. Since *Donoghue*, English courts have continuedly been asked to apply the gist of the 'neighbour rule' to cases where banks gave financial advice to its customers.

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[55] Markesinis/Deakin, *Tort Law* (3rd edn. Oxford 1994), at p. 65.
[56] Markesinis/Deakin, *Tort Law* (3rd edn. Oxford 1994), at p. 65.
[57] Halsbury's *Laws of England* (4th edn. London 1997), Volume 33, at p. 421 (para. 601).
[58] [1932] AC 562 (HL).

The greatest difficulty judges face when applying the neighbour rule to bank/customer situations is to define when the customer is the bank's neighbour, or, in other words, when their relationship is sufficiently close to give rise to such a duty on part of the bank. A duty of care is usually given when there is a sufficient degree of proximity between the defendant bank and the plaintiff to lead to a 'special relationship' imposing a duty of care on the bank. On the one side, the courts have held that the mere existence of the bank/customer relationship does not automatically lead to a duty of care on the part of the bank. For example, in *Goldsworth* v *Brickell* Nourse LJ stated that[59]:

> [...] a banker, being a person having pre-existing and conflicting interest in any loan transaction with a customer, cannot ordinarily be trusted and confided in so as to come under a duty to take care of the customer and give him disinterested advice.

On the other side, the judges also stressed that if a bank explictly advertises to offer financial advice to customers and subsequently actually renders advice to them such a proximity between bank and customer is established so as to give rise to a duty of care on part of the bank.

Thus, one may be inclined to say that the question of proximity is rather a casuistic issue than a question of law. How difficult it can be to decide whether there is a sufficiently close relationship between bank and customer can be shown by the decisions in *Woods* v *Martins Bank ('Woods')*[60], *Hedley Byrne & Co Ltd* v *Heller & Partners Ltd ('Hedley Byrne')*[61], *The Royal Bank Trust Co. (Trinidad)* v *Pampellonne ('Pampellonne')*[62] and *Verity* v *Lloyds Bank Ltd ('Verity')*[63]. In *Woods* the defendant bank was very interested

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[59] [1987] 1 Ch. 378 (CA), at p. 405.
[60] [1959] 1 QB 55 (Ch. Div.).
[61] [1964] AC 465 (HL).
[62] [1987] 1 Lloyds Rep. 218 (PC).
[63] *The Independent* (4 September 1995), (Transcript) and (1995) 8 C & FL 38 (QB Div.).

in acquiring the custom of a wealthy young man with no real business experience and offered to be its financial adviser. The bank's brochures contained statements such as[64]:

> We have six district head offices with boards of directors and general managers, so that the very best advice is available through our managers virtually on your doorstep.
> [...]
> You may consult your bank manager freely and seek his advice on all matters affecting your financial welfare. All these advantages are yours as the possessor of a bank account, current or deposit, and in these difficult days, when financial problems of one kind or another always seem to be cropping up, it is a great comfort to know that you have an impartial friend whose help you may seek without obligation.

Referring to these statements and the factual evidence that the bank actively sought the custom of the plaintiff, the court held that there was a sufficient 'proximity' to impose a duty of care upon the bank to advise the plaintiff with due care and skill. The decision in Woods was not only confirmed but also extended by the House of Lords' ruling in *Hedley Byrne & Co Ltd* v *Heller & Partners Ltd* (*'Hedley Byrne'*)[65].

In this case, the plaintiffs asked their bankers to inquire into the financial stability of Easipower Ltd, a company the plaintiffs did business with. The plaintiffs' bank contacted the defendants which were Easipower's bankers and asked for a reference. The defendant bank negligently gave favourable references but stipulated that these references were 'without responsibility'. In reliance on the references, the plaintiffs entered into a contract with Easipower Ltd which resulted in a loss of £17,000 when Easipower Ltd. failed to pay. The House of Lords held that although there was no contractual or fiduciary relationship between the plaintiffs and the defendant bank that

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[64] [1959] 1 QB 55, at p. 70/71.
[65] [1964] AC 465 (HL).

the defendant bank owed the plaintiffs a duty of care. In this decision, Lord Reid stated that a duty of care would be imposed where[66]:

> the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstances required, where it was reasonable for him to do that and where the other gave information or advice when he knew or ought to have known that the inquirer was relying on him. I say 'ought to have known' because in questions of negligence we now apply the *objective standard*[67] of what the reasonable man would have done.

Hedley Byrne extended the ruling in *Woods* in so far as it was held that a duty of care could arise even if there was no contractual relationship between the plantiffs and the defendant bank. In contrast, in *Woods*, the court viewed the contractual relationship between the bank and the plaintiff as essential when holding the bank liable for its advice to the plaintiff. In *Woods*, the bank actively sought the custom of the plaintiff. To the contrary, in *Hedley Byrne* there was even no direct contact between the plaintiff and the defendant bank let alone a conclusion of a contract.

Nevertheless, it was ruled that the defendant bank owed the plaintiffs a duty of care. In *Hedley Byrne*, the duty was imposed on the defendant bank because there was held to be a specifically close relationship between the defendant bank and the plaintiffs. In his speech, Lord Reid also stressed that a duty of care would arise in a situation where a bank made a statement to a customer where the bank assumed responsibility for its statement[68]:

> A reasonable man, knowing that he was being trusted or that his skill and judgment were being relied upon, would, I think, have three courses open to him. He could keep silent or decline to give the information or advice sought; or he could give an answer with a clear qualification or that he accepted no responsibility for it or that it was given without that reflection

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[66] *ibid*, at p. 486.
[67] Emphasis added.
[68] *ibid*, at p. 486.

> or inquiry which a careful answer would require: or he could simply answer without any such qualification.
>
> If he chooses to adopt the last course he must, I think, be held to have accepted some responsibility for his answer being given carefully, or to have accepted a relationship with the inquirer which requires him to exercise such care as the circumstances require.

In *Hedley Byrne*, it was held that the defendant bank did in fact owe a duty to the plaintiff but successfully 'escaped' liability due to the disclaimer clause it had used when making the statement in question. Furthermore, it is interesting to note that the field of application of the ruling in *Hedley Byrne* (the so-called 'Hedley Byrne principle') has itself been extended by the House of Lord's recent decision in *Henderson* v *Merrett Syndicates Ltd* (*'Henderson'*)[69] in such a way that it may impose liability not only for negligent misstatements by professionals but also liability for any form of negligent service by professionals[70].

Henderson concerned an action brought by underwriting members of Lloyd's (so-called 'names') against their underwriting agents and managing agents in an attempt to recoup at least part of the great losses they had suffered. In this case, the House of Lords stressed not only that there can be concurrent liability in contract and tort but also ruled that the member's agents owed a duty of care toward the names, whether 'direct' or 'indirect'. Direct names belong to a syndicate which is managed by the members' agents themselves. In contrast, in the case of indirect names the members' agents delegate their mandate to sub-agents which usually belong to another syndicate.

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[69] [1994] 3 All ER 506 (HL).

[70] per Lord Steyn in *Williams* v *Natural Life Health Foods Ltd and Mistlin* [1998] 2 All ER 577 (HL), at p. 581f: ' in Henderson's case it was settled that the assumption of responsibility principle enunciated in Hedley Byrne case is not confined to statements but may apply to any assumption of responsibility for the provision of services'.

Unlike in *Hedley Byrne*, the agents' 'assumption of responsibility' was not based on a specific statement made by them but on the general nature of the relationship between the underwriting agents and the names. In *Henderson*, the mere fact that the agents held themselves out to offer professional financial services to their clients was, in the eyes of the Law Lords, sufficient to create a Hedley Byrne-like 'special relationship' between them. In this context, it may be pointed out that this latest extension of the Hedley Byrne principle has been criticized as 'unleashing another overarching general principle [...] capable of opening the floodgates to a host of inappropriate claims'[71].

However, on the other hand, there are also decisions where the courts found that the relationship between the bank and its customer was not close enough to establish a duty of care. For example, in *The Royal Bank Trust Co. (Trinidad)* v *Pampellonne* (*'Pampellonne'*) the Privy Council held that the passing on of a credit report and general information about a company to a customer interested in investing in this company does not result in a duty of care on part of the bank. In this case a bank manager had written to the customer[72]:

> All our reports indicate that this company may be regarded as trustworthy for its ordinary business engagements. We trust that this information will assist you in making up your mind as to the deposit.

Furthermore, the bank manager had also orally informed the customer about the substance of a credit report on another company as well as handed to him brochures and other literature about a company the customer was interested in. The very fact that the Privy Council was split[73] on the question of whether the bank was under a duty of care

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[71] Hodgson, John, 'Hedley Byrne - A New Sacred Cow?', (1995) 4 Nott. Law Journal 4, 1, at p. 25.
[72] [1987] 1 Lloyds Rep. 218, at p. 220 (PC).
[73] Three judges held that the defendant bank was under no duty of care whereas the other two judges saw the defendant bank under a duty to advise the plaintiff with due care and skill.

shows how controversial the interpretation of factual evidence can be. Nowadays, banks try to (mis-)use the ruling in *Pampellonne* in order to avoid liability. They argue that they only provide 'information' but no 'advice' to their customers, and, thus, when giving information this would (automatically) mean that they do not assume any responsibility for their assistance to their customers.

A very good example of this point of view is the provisions of the Mortgage Code[74] and the Banking Code[75] which deal with mortgage lending. Both codes have been drawn up voluntarily by the UK banks and building societies to set minimum standards of banking practice to be followed by those banks and building societies which subscribed to them. The provisions concerning mortgage lending are as follows:

> *3. Helping you to choose a mortgage*
> 3.1. Choosing a mortgage may be your most important financial commitment. There are three levels of service which may be provided and we will tell you which we offer at the outset. These are:
>
> *(a) advice and a recommendation* as to which of our mortgages is most suitable for you. When giving advice, we will take care to help you to select a mortgage to fit your needs by asking for relevant information about your circumstances and objectives.
> Our advice will also depend on your particular requirements and and on the market conditions at the time. The reasons for the recommendation will be given to you in writing before you complete your mortgage. [...]
>
> *(b) information on the different types of mortgage product* we offer so that you can make an informed choice of which to take;
>
> *(c) information on a single mortgage product only*, if we only offer one mortgage product or if you have already made up your mind.
>
> Before you take out your mortgage, we will confirm, in writing, the level of service given.

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[74] The Council of Mortgage Lenders, *The Code of Mortgage Lending* (London 1 July 1997).
[75] The British Bankers' Association, *The Banking Code* (London 1 July 1997).

In my view, it is especially complicated to draw the line between the provision of 'advice' (service level 'a') and 'information on the different types of mortgage product' (service level 'b') because the provision of 'information' on the different types of mortgage products automatically requires an explanation or the main repayment methods (repayment or interest only), insurance policies and additional costs and fees. A good example of how difficult it can be to qualify a bank's service as 'advice' or 'information' may be seen in the following fictitious dialogue between a mortgage adviser and a prospective customer which can be seen as typical of how mortgage interviews are nowadays conducted[76]:

> *Customer:* 'I am planning to buy a house. I need a mortgage loan of £70,000. What do you offer?'
>
> *Bank's 'Mortgage Adviser':* We offer repayment and interest only mortgages. Do you know the difference between them?'
>
> *Customer:* 'Yes, I am interested in a repayment mortgage.'
>
> *Bank's 'Mortgage Adviser':* 'Ok, basically, we offer three different types of repayment mortgages. There are mortgages combined with variable, fixed or capped interest rates.
>
> Variable means that the interest rate you are charged varies according to the market situation. As a result, your monthly instalments may go up or down.
>
> Fixed-interest rate mortgages have a fixed interest rate. Here, your monthly instalment always stays the same for the whole duration of the loan regardless what market rate does.
>
> Finally, a capped interest rate is a mixture of both other forms. It is flexible but there is a specified limit to which the interest rate can rise.'
>
> *Customer:*'What do you think is the best choice for me?'.
>
> *Bank's 'Mortgage Adviser':* I would say that this depends very much on your personal preferences.
>
> Fixed interest rate mortgages have the advantage that you know exactly what you have to pay every month. Variable interest rates can be cheaper

[76] This fictitious interview is based on the experience I gained through an internship with Lloyds Bank's Abingdon branch in March 1998.

> but also be more expensive for you, depending on the market situation. However, I have noticed that there is currently a trend among our customers to go for fixed rate mortgages.
>
> At the moment, interest rates are relatively low, but it is generally expected that they will rise in the near future. From this point of view, a fixed interest rate looks very good. We can offer a 7,19% fixed rate mortgage for loans up to £100,000. Personally, I find this is a very competitive rate.
>
> *Customer:* 'Yes, that sounds good.'
>
> *Bank's 'Mortgage Adviser':* 'Ok. May I ask you some questions about your financial situation then?'
>
> *Customer:* 'Sure.' [...]

In this example, the bank involved would very likely deny that its employee provided the customer with 'advice'. In contrast, the customer would probably have the impression that the bank's 'mortgage adviser' recommended to him or her a fixed interest rate mortgage[77]. Without doubt, there is a need for more precise criteria to decide in which circumstances a bank's service qualifies as provision of 'information' or 'advice'. In my view, in a banking context, information should be defined as being characterised by a strong objective element. Information may be described as a neutral statement of facts or law. For example, the mere description of the features of a financial product constitutes information. Advice, in contrast, has a distinctive subjective feature. The provision of advice may be defined as subjective interpretation and evaluation of certain facts. Contrary to someone who simply passes on information, the advisor assesses facts, draws a conclusion from this assessment which then forms the basis of his or her advisory statement.

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[77] In this context, it may be stressed that - especially in the area of telephone banking - conversations between the banks' employees and customers are taped. These recordings may be used in court to establish whether a bank assumed the role of its customer's financial adviser.

One may argue that, according to these definitions, the assistance given by banks can never qualify as 'information' because it is never 'neutral' due to the fact that banks typically promote only those financial products which belong to their own product range and do not mention any products of their competitiors even if those may be more suitable for the customer. In my opinon, this is beside the point. Here, the question is whether a specific statement of a bank qualifies as information or advice and not whether the bank should be under a duty to disclose certain facts to the customer in (pre-)contractual negotiations. This means that, in this context, a bank's description of one of its financial products can still be seen as 'neutral' information although no references are made to a competitor's similar product.

It may be summarized that English law lacks a set of criteria according to which a bank may be seen to be under a duty of care when assisting a customer in his or her financial affairs. It may also be stressed that, in my view, banks should not be allowed to escape liability for their statements by repetitively stating that they provide only 'information'. This simply does not reflect the reality of their business practices. If banks intend only to inform their customers, why do they provide their employees with these fine sounding titles such as 'mortgage advisor' or 'investment specialist'? In my opinon, the word 'adviser' does connote to the customer the fact that somebody with more skills than himself or herself undertakes to steer him or her in the right direction. It also implies trust coupled with skill, training and a professional approach to the customer's individual needs and interests.

Of course, each case should be dealt with individually. However, the general rule ought to be that where a bank does not only provide its customers with mere figures and facts about its products but also actively directs their attention to specific products by means

of argumentation this should qualify as 'advice'. Additionally, one may also take a look at the decision in *Hedley Byrne*. In *Hedley Byrne*, it was decided that a bank could be held liable for its statements although there was no direct contact between the defendant bank and the recipient of the statement which was made by this bank. If liability can be established in these circumstances, then this relationship between a bank which not only advertises to give 'mortgage advice' but also goes further and actively directs its customer's attention to a specific product by means of persuasion, then the relationship between the bank and its customer ought be seen as 'proximate' enough to give rise to a duty of care on the part of the bank.

Furthermore, the decision in *Hedley Byrne* could also be used to oppose to the banks' argument that where a bank provides only information there is no assumption of responsibility on the part of the bank. In this context, it should be pointed out that in his speech in this ruling Lord Reid did not differentiate between the terms 'advice' and 'information' when developing the notion of 'assumption or responsibility'[78]. Thus, it may be argued that, in certain circumstances, the provision of information can also lead to a duty of care on the part of a bank.

Applying all this to the above mentioned fictitious mortgage interview, one should come to the conclusion that this interview that the service provide by the bank's 'mortgage adviser' actually constituted advice because the 'mortgage adviser' followed the customer's request for a subjective and evaluating statement ('What is the best choice for me?') by directing the customer's attention to one specific product ('At the moment, interest rates are relatively low, but it is generally expected that they will rise in the near future. From this point of view, a fixed interest rate looks very good.'). Banks may find

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[78] per Lord Reid in *Hedley Byrne & Co Ltd* v *Heller & Partners Ltd* [1964] AC 465 (HL), at p. 486.

this harsh but they should be reminded of the fact that the question of whether a bank is liable for its assistance does not depend entirely on the issue of whether the bank is under a duty of care. Similarly relevant is the topic of the actual scope of this duty of care and whether the bank actually breached its duty. Taking these further two points into consideration when assessing the above mentioned fictitious mortgage interview, one would, given that the mortgage adviser's recommendation of fixed interest mortgages was economically plausible, no negligence liability of the bank could be established.

Furthermore, it is good to see that English courts appear to place more emphasis on the way which banks choose to advertise their services when deciding whether they assume the role of their customers' financial advisor. A good example of this is the decision in the unreported case of *Verity* v *Lloyds Bank plc* (*'Verity'*)[79]. In *Verity*, the plaintiffs developed the idea to buy and renovate a house in order to sell it for a profit. There were given by the defendant bank a pamphlet called *'Starting Your Own Business'* which stated that:

> Your bank manager will help you decide how much you can really afford to invest. Every business needs a margin of safety against the unforeseen [...] We don't help only with money. Our advice is tailor-made, confidential and free.

Inspired by the pamphlet, the plaintiffs approached a branch manager of the defendant bank with their plan and showed him their calculations. The bank's manager consulted his superiors, carried out an external and internal inspection of the house in question and told the plaintiffs that their project was 'viable'. In fact, the calculations made by the plaintiffs, who had no substantial business or renovating experience, were significantly

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[79] *The Independent* (4 September 1995), (Transcript) and (1995) 8 C & FL 38 (QB Div.).

flawed. Relying on the bank's statement, the plaintiffs went ahead with their renovation project that subsequently failed resulting in a considerable loss to them. By referring to the bank's brochure *'Starting Your Own Business'* the judge held that the defendant bank acted as the plaintiffs' financial adviser. He stressed that the bank had not only advertised that it would provide 'tailor-made advice' to customers, but also checked the plaintiffs' calculations and encouraged them by stating that their project was 'viable'. All this, the court said, amounted to the provision of 'advice' by the defendant bank. In my opinion, the ruling in *Verity* is a step in the right direction. It remains to be seen whether the higher courts will follow on this road.

However, the issue of 'proximity' is only one requirement within the concept of duty of care. In addition to 'proximity', it must also be ascertained that it was foreseeable for the defendant bank that carelessness on its part was likely to cause damage or loss to the plaintiff and that the imposition of a duty of care must be fair, just and reasonable in the circumstances of the case.

Foreseeability

For a start, attention may be drawn to the fact that the test of foreseeability is - much to the confusion of foreign lawyers - used in at least two different settings in the field of negligence. First, the test of reasonable foresight has been applied to the question of whether a duty of care exists. Secondly, once a breach of an established duty of care has been ascertained, the test of foreseeability is used to deal with the legal issue of remoteness of damage[80]. Here, foreseeability shall be discussed in relation to the

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[80] per Lord Russell in *Hay (or Bournhill)* v *Young* [1943] AC 93 (PC), at p. 101:
'In considering whether a person owes to another a duty a breach of which will render him liable to that other in damages for negligence, it is material to consider what the defendant ought to have

question of whether there is a duty of care. The gist of the 'reasonable man' test in relation to the existence of a duty is whether the defendant - at the time of his or her material conduct - must have contemplated that his or her behaviour was likely to cause damage or loss to the plaintiff. Nowadays, however, it is argued that the relevance of the test of foreseeability has diminished considerably. Recent decisions such as *Spring* v *Guardian Assurance*[81] (*'Spring'*), *Henderson* v *Merrett Syndicates Ltd.*[82] (*'Henderson'*), *Marc Rich & Co AG* v *Bishop Rock Marine Co Ltd*[83] (*'Marc Rich'*) and *White* v *Jones*[84] (*'White'*) appear to indicate that the notion of proximity and the requirement that the imposition of a duty of care must be fair, just and reasonable have gained weight at the cost of the issue of foreseeability[85].

In the area of negligence liability for misstatements the general guidelines laid done in the ruling in *Hedley Byrne* may still be seen as good law. Taking into consideration the more recent rulings in *Caparo Industries plc* v *Dickman*[86] (*'Caparo'*) and *Henderson* one may say that the test of foreseeability has become intertwined with the concept of 'assumption of responsibility' on the one side, and, on the other side, with the notion of 'reasonable reliance'. First, foreseeability can be ascertained where a professional assumes responsibility for his or her statement and realises or ought to realise that it is likely to be the basis upon which the recipient of that statement intends to act[87]. Secondly, foreseeability is also likely to be established where a plaintiff can reasonably

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contemplated as a reasonable man. This consideration may play a double role. It is relevant in cases of admitted negligence (where the duty and breach are admitted) to the question of remoteness of damage, i.e. to the question of compensation or to culpability, but it is also relevant in testing the existence of a duty as a foundation of the alleged negligence, i.e. to the question of culpability not to compensation'.

[81] [1994] 2 All ER 129 (HL).

[82] [1994] 3 All ER 506 (HL).

[83] [1995] 1 AC 211 (HL).

[84] [1995] 1 All ER 691 (HL).

[85] Hodgson, John, Hedley Byrne - A New Sacred Cow?, (1995) 4 Nott. LJ 1, at p. 3.

[86] [1990] 2 AC 605 (HL).

[87] See especially the decisions in *Esso Petroleum Co Ltd* v *Mardon* [1975] QB 801 (CA) and *White* v *Jones* [1995] 1 All ER 691 (HL).

rely on a professional's statement or conduct[88]. In practice, the courts appear to draw upon arguments deriving from both concepts when reaching a decision on the question of whether a defendant should be held liable for a negligent misstatement. However, in most cases related to a bank's financial assistance given to one of its customers foreseeability can typically be ascertained with reference to both concepts. In today's banking practice, a customer either seeks the bank's assistance with a view to a specific financial matter or the customer is approached by the bank in the course of one of the bank's sales initiatives. In both cases there is typically a direct contact between the bank`s employee and the customer.

In my view, if - in the course of such a meeting between the bank's employee and the customer - the employee makes a statement of an advisory character, the employee can generally be expected to foresee that his or her statement may be relied upon by the customer and may form the basis of the customer's financial arrangements. Taking especially the decisions in *Woods* and *Verity* into account, one may say that English courts have held that the greater the bank's involvement in the customer's financial affairs and the more detailed the bank's knowledge of the customer's plans and goals, the higher the probability is that it 'ought to have known' that the customer would rely on its advice and that carelessness on its part was likely to result in causing loss to its customer.

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[88] See especially the rulings in *Caparo* v *Dickman* [1990] 2 AC 605 (HL) and *Henderson* v *Merret Syndicates* Ltd [1994] 3 All ER 506 (HL).

Fair, just and reasonable

The third and last stage of the concept of duty of care is the test of whether, according to the circumstances of the individual case, it is fair, just and reasonable to impose a duty of care on the defendant bank. Considering decisions such as *Hill* v *Chief Constable of West Yorkshire*[89] and *Marc Rich & Co AG* v *Bishop Rock Marine Co Ltd*[90] (*'Marc Rich'*), it may generally be said that the issue of reasonableness has become the main battleground for the parties who cross their swords in court in negligence-related disputes.

On the one side, there are the banks claiming that it would be unreasonable to place them under too strict duties of care. One of their main arguments is the famous 'floodgates' issue. They propose that any extension of a bank's liability for financial advice would open the floodgates of litigation. Consequently, a rise in the number of court cases would automatically lead to a sharp increase in the banks' costs which would subsequently result in higher fees for the customers. Additionally, banks like to dig out the old Common law notion of 'caveat emptor'[91]. They argue that in the end it is the customer's own responsibility to decide whether the offered product suits his or her individual needs. Moreover, banks maintain that it would not be fair to impose a duty of care on banks as regards to their advice because this advice would be rendered to their customers for free.

On the other side, consumer protection groups often point out that banks offer free financial advice to attract customers in order to enhance their business. Where banks

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[89] [1989] AC 53 (HL).
[90] [1995] 1 AC 211 (HL).
[91] This Latin phrase may be translated as 'Let the buyer beware'; see also: Martin, Elizabeth, A. (Editor), *A Dictionary of Law* (3rd edn. Oxford 1994), at p. 57.

quite immodestly describe themselves as 'financial experts' they should reasonably be expected to live up to the degree of expertise they claim to possess. Consumer protection groups also reject the 'floodgates' argument by saying that banks tend to misuse this issue to protect their selfish interests. One should approach the issue of litigation and costs from a broader prespective. The fact that in Britain no less than 50,000 homes are repossessed every year[92] should make one think about the quality of financial advice offered by banks to customers in the area of mortgages. A stricter duty of care for banks would consequently result in a greater degree of caution and skill among banks in order to avoid litigation. This, in turn, would subsequently lead to a better service provided to customers and the number of repossessions would fall. However, on the other hand, stricter rules and more extensive duties for banks may also produce negative effects. It cannot be denied that stricter duties for mortgage lenders may also cause them to adopt a more restrictive lending policy which then, in turn, lead to a drop in the number of purchases of private homes.

Consumer associations also often stress that there is a significant inequality of bargaining power between customers and their banks. They argue that it would be unreasonable to assume that the bank/customer relationship is one of 'partnership' with equal business experience and financial resources. In fact, they maintain that banks are in a much stronger position due to their expertise and money. Banks should be prevented from any abuse of their naturally much stronger bargaining position let alone from getting away with poor standards of service. Banks should always be made aware of their social responsibility. From an observer's point of view, one may be tempted to say that the floodgates argument is often overstated. Of course, cases such as *O'Brien* and *Verity*,

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[92] *Financial Times*, 1 February 1996, at p.8.

which were both portraited by the media as 'consumer-friendly', have led to an increase in claims brought by customers against their banks which referred to these decisions.

However, there has been no 'flooding' so far. For example, there has been no significant increase in 'Verity-type complaints' to the British Banking Ombudsman Scheme in 1995-96[93]. Furthermore, the most recent English case law in the area of banking appears to show the judges' determination to prevent any kind of 'flooding' by taking a rather restrictive approach when applying *O'Brien* and *Verity* to new cases. Rulings such as the decision in *Barclays Bank plc* v *Sumner*[94] show that judges still prefer to base their views on facts instead of pure policy.

Finally, one may question the applicability of the 'caveat emptor' rule to the selling of today's financial products. Ordinary products such as food, furniture or even a car can usually be visually inspected by the consumer. Financial products are different. They are invisible, and the language which is used to describe them is often very complex. As has been stated above, in a survey carried out by the the National Consumer Council in Britain in 1994, nearly a third of the respondents stated that they were 'not at all' or 'not very confident' in choosing a personal pension[95]. This figure reflects the fact that many consumers find it more and more difficult for consumers to understand the nature of today's financial products. This problem should be recognised by banks. Due to the complexity of modern mortgage loans or personal pension plans the 'caveat emptor' rule should not be applied to financial products of today. Of course, this does not mean that banks ought to turn into charitable organisations with a mission to educate consumers,

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[93] The Banking Ombudsman Scheme, *Annual Report 1995-96* (London 1997), at p. 29.
[94] [1996] EGCS 65 (CA); this case will be dealt with in greater detail below in Chapter Three, Part B, I.
[95] National Consumer Council, *Consumer Concerns 1994 - A consumer view of the personal financial services: the report of a Mori Survey* (London 1994), at p.10.

but they may be requested to develop a better understanding of their customers' needs. Banks should also view the calls for higher standards in their business practices not as a threat but as an opportunity to acquire a better knowledge of their customers and their individual financial requirements.

(bb) Breach of Duty

Assuming that a bank is seen as being under a duty of care, it is then held liable in negligence, only if it is also established that the bank breached this duty. Breach of duty is generally defined as a failure to conform to the standard of care applicable to the defendant in the circumstances. For professionals this means that they are expected to exercise that level of skill that can reasonably be expected of an ordinary member of their profession. The decision in *Woods* shows that English courts do not hestitate to embark on scrutinizing every technical detail of the defendant bank's rendered advice. In *Woods*, Salmon J. dealt with great care and expertise with the bank's recommendation to its customer to invest in preference shares of one single private company which was also a customer of the the defendant bank.

Salmon J. ruled that the bank had negligently given wrong advice to the plaintiff. The judges also regarded the bank's recommendation as involving a very high risk for the plaintiff because it had caused the plaintiff to invest almost two thirds of all his disposable income in one single form of investment. Additionally, the bank was found to have failed to disclose to the customer the poor financial standing of the company in which he had been told to invest.

The ruling in *Woods* may serve as a warning to banks that courts nowadays have the self-confidence to bother themselves with complex financial matters in order to determine in which circumstances a bank failed to fulfil its duty of care as a financial adviser[96].

Additionally, in *Verity*, Taylor J. made another important point that may have some impact on the future law in regard to a bank's standard of care when giving financial advice. He held that if a bank decides to act as its financial adviser, it could be expected to exercise the standard of skill not only of an ordinary banker but also that standard of care of other professionals who primarily give that sort of advice, i.e. accountants[97].

According to this view, when a bank acts as a financial adviser in matters normally dealt with by another profession, typically by accountants, the bank can be judged against the standard of care that is expected of that profession. This profession's standard might even be higher than that usually expected of a bank within its own domain, i.e. banking. However, it remains open whether this rather strict attitude towards banks is to be emulated by higher English courts. At this point, it may be pointed out that the precise scope of a bank's duties as its customer's financial adviser are specifically discussed in Chapter Three and Four of this thesis. In these chapters, particular emphasis is placed on the the advisory duties of banks with regard to general lending and private investment matters.

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[96] This decision is to be discussed in greater detail in Chapter Four, A. (1).
[97] *Verity* v *Lloyds Bank plc, The Independent* (4 September 1995) (Transcript) and (1995) 8 C & FL 38 (QB Div.).

(cc) Causation

Assuming that it is established that a bank breached its duty of care when giving advice to a customer, it must finally be ascertained that its carelessness caused the customer's loss. In general, the test of causation is two-fold. First, there is the so-called *'but-for-test'*. This test requires that the loss sustained by the customer would not have been suffered but for the relevant act or omission of the bank. It is very common that banks argue in court that the customer would have made the same investment regardless of the bank`s advice. However, many judges tend to refer to the closeness of the bank/customer relationship to determine whether the bank's behaviour actually induced the customer to make a specific transaction causing the loss in question.

The general rule is that the less experienced a customer is in financial matters, the more likely it is that he relied on the bank's 'expert assistance'. In these situations, judges tend to take a very close look at the actual fabric of the bank/customer relationship. Not seldom, they find that the customers do not have any experience in financial affairs and are totally dependent on the bank's assistance. For example, in *Woods*, Salmon J. rejected such a claim by the defendant bank by stating that[98]:

> It is argued that, even had [the bank manager] advised the plaintiff against making any investment in B.R. Ltd, and against giving the guarantee, the plaintiff would still have acted as he did.
> The plaintiff did not strike me as being an over-confident young man or one who would not take advice. I think that he had just enough sense to realise that he was no match for [another adviser], and I am certain that he relied entirely on [the bank manager's] advice to protect him in his financial dealings.

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[98] [1959] QB 55 (QB Div.), at p.73.

However, it is quite obvious that the issue of causation cannot depend on the 'but-for-test' alone because otherwise a bank's liability could be extended indefinitely. Customers could argue that they based all kinds of their transactions on the bank's advice, even if these transactions were totally unrelated with the specific advice given by the bank or where carried out a substantial period of time after the bank's statements.

Thus, in order to limit a defendant's liability English law knows the *'test of remoteness of damage'*. The main task of the test of remoteness is to ascertain whether the plaintiff suffered damage of a kind that is recognised by the law as recoverable[99]. In general, loss is seen as recoverable if it is the natural, foreseeable and probable consequence of the wrongdoer's act. In this respect, one of the most controversial points is the question of the 'shelf life' of a bank's advice on a specific financial matter. The courts are quite often confronted with a situation where a bank advised a customer on a particular investment, and, after some time elapsed, the customer used the bank's advice again as basis of another transaction resulting in a loss. In *Pampellonne*, the court made it very clear that a bank's financial advice can always be reasonably relied upon within a very short period close to the date the advice was rendered. In this case Lord Goff stated[100]:

> Any sensible investor [...] must realize that, if advice is given regarding investments, it is given in the light of the circumstances prevailing, and that such circumstances may change.

Thus, one may conclude that the more time passes between the bank's financial statement and the customer's investment the more likely it is that the customer's sustained loss is later viewed by the court as too remote.

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[99] Charlesworth/Percy, *Negligence* (9th edn. London 1997), § 4-01, at p. 301.
[100] *The Royal Bank Trust Co. (Trinidad) Ltd.* v *Pampellonne and Another* [1987] 1 Lloyds Rep. 218 (PC), at p. 226.

(dd) Type and measure of recoverable damages

In English law, damages may be either compensatory or non-compensatory. Non-compensatory damages are further divided into contemptuous, nominal and exemplary damages. In general, in the area of banking only compensatory damages are of practical relevance. Compensatory damages are designed to compensate the plaintiff for damage or loss caused by the defendant. The basic principle behind them is that, so far as possible, the plaintiffs should be put into the position they would have enjoyed if the tort had never been committed (as opposed to contract damages, which generally try to put the plaintiffs in the position they would have enjoyed if the contract had been performed as agreed).

In the area of banking, since the decision in *Woods*, it has been established that economic loss is recoverable in action for damages by a customer against his or her bank based on a bank's negligent financial advice. Then, in *Hedley Byrne*, it was held that economic loss was also recoverable in negligence where there was no contractual relationship between the defendant bank and the plaintiff. The method of of assessment of the compensating is called *restitutio in integrum* in English legal terminology[101]. In the area of a bank's liability in negligence for its financial advice, the loss will usually be calculated by comparing the financial position the plaintiff or customer was in before the bank`s negligent conduct, with his or her position after its occurrence.

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[101] It may be noted that the same phrase has a different meaning in German legal terminology. In German law, restitutio in integrum means 'restitution in kind' whereas in English law, it stands for total reparation.

In *Banque Bruxelles Lambert SA* v *Eagle Star Insurance Co Ltd*[102] (*'Banque Bruxelles'*) the House of Lords confirmed the importance of the connection between the breach of the defendant's duty of care and the plaintiff's sustained loss. This case concerned the question of the scope of the liability of valuers for their negligent property valuations. In this decision Lord Hoffmann stressed that a person who negligently gives incorrect information can be held responsible only for the consequences which are directly caused by the fact that the information is wrong[103]:

> A duty of care which imposes upon the informant responsibility for losses which would have occurred even if the information which he gave had been correct is not in my view fair and reasonable as between the parties[104].

In this case the House of Lords linked the scope of recoverable damages to the type of the defendant's duty of care. In cases where the defendant's duty is simply to give information with due care and skill the defendant's liability is limited to the foreseeable consequences of the information being wrong. On the other hand, in situations where the defendant's duty is to advise the plaintiff as to what course of action he or she should take the defendant 'will be responsible for all the foreseeable loss which is a consequence of that course of action having been taken'[105].

Transferring this ruling into the area of banking, one may say that the wider concept of the above mentioned two different types of recoverable damages applies to most advice-related banking cases. Considering decisions such as *Woods* and *Verity*, one may say that in an ordinary action against a negligent financial adviser a customer is usually

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[102] [1996] 3 WLR 87 (HL).
[103] *ibid*, at p. 95E.
[104] This statement by Lord Hoffmann shows how much emphasis the courts nowadays lay on the policy issue of 'fair and reasonable'. In my opinion, in the situation which is discussed by Lord Hoffmann in this statement liability could also have been ruled out by using the less complex 'but-for-test'.
[105] per Lord Hoffmann, *ibid*, at p. 95F. For a more detailed discussion of the implications of this ruling please see: Stapleton, Jane, 'Negligent Valuers and Falls in the Property Market', (1997) 113 LQR 1.

entitled to recover all the money lost when relying on the bank's negligent financial advice.

For example, in *Woods*, the plaintiff successfully claimed the full amount of his lost investments. Furthermore, even if a customer took out a loan to finance an investment that was negligently recommended by the bank and subsequently resulted in a loss, he or she would not only be freed from paying back the loan but would also be entitled to be compensated for any interest already paid to the bank with regard to this loan.

However, where a bank stated that a specific investment could make a profit of 10% per annum and later the whole invested sum is lost, the customer would only be entitled to claim the sum lost, but not the profit he or she hoped to make. Moreover, a customer who falls victim to a bank's negligent advice is expected to take reasonable steps to mitigate any loss. The defendant bank will not be liable for compensatory damages in respect of any losses that could have been averted by such steps. Additionally, in actions for negligence English courts do not award damages for anguish and vexation arising out of the bank's negligent advice. Generally speaking, English law does only award damages for emotional distress in two cases. First, in situations where the vexation was caused by breach of a contract whose object was to provide peace of mind or freedom from distress. Secondly, in a action in tort for personal injury a court can award damages to compensate the plaintiff for any pain, shock or suffering[106].

Furthermore, according to the provisions of The Law Reform (Contributory Negligence) Act 1945 a plantiff's damages can be reduced to take account of his or her contributory negligence. It is up to the defendant to prove that the plaintiff failed to take

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[106] See *Hayes* v *James & Charles Dodd (a firm)* [1990] 2 All ER 815, at p.824a/b (CA).

reasonable care for its own interests or contributed to the damage done. However, taking the decisions in *Woods*, and, especially in *Verity*, into account, one may me inclined to say that the issue of contributory negligence is of limited practical relevance to cases related to financial advice given by banks. Of course, banks often argue in court that the customers' conduct contributed to the loss incurred. For example, in *Verity*, the defendant bank stressed the fact that it was the plaintiffs who had drawn up the calculations that finally led to the failure of their renovation project.

In his ruling, Taylor J. rebuffed this point by emphazising that the fact that the plaintiffs were financially inexperienced was not an argument against, but *for* their action against the bank[107]. He stressed that the defendant bank after having assumed the role as the plaintiffs' financial adviser and knowing that its customers were absolutely inexperienced in financial affairs could not simply sit back and rely on their customers' calculations. The bank could reasonably be expected to look through the figures. In *Verity*, the plaintiffs' calculations were significantly flawed to an extent that any brief check would have shown that the plaintiffs' project could never have made any profit.

(3) Banks as trustees

Additionally, it should be mentioned that banks also offer to their customers to act as their trustees. In Britain, many investment funds and pension schemes are constituted under a trust deed. The economic importance of investment funds is impressive. In 1997, there were 1,100 fund management firms including portfolio managers, pension

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[107] *Verity* v *Lloyds Bank plc, The Independent*, (4 September 1995), (Transcript), at p.37 and (1995) 8 C & FL 38 (QB Div.).

fund managers, unit trust managers and trustees, investment trust managers which had a total of more than £1,225 billion of funds under their management[108]. However, despite the great economic significance of investment trust and pension funds, the role of banks as investment trustee can only be briefly discussed here because of the restrictions as to the scope and extent of this work.

Generally speaking, a trust is usually defined as a relationship recognised by equity which arises where property is vested in (a person or) persons called the trustees which those trustees are obliged to hold for the benefit of other persons called beneficiaries (or cestuis que trust)[109]. The holder of the property is the trustee, and the beneficial owner is the cestui que trust. The interests of the beneficiary will ususally be laid down in the instrument creating the trust, but may also be implied or imposed by law.

The advantages of investment trusts are two-fold. First, trust funds are earmarked for the beneficiaries of the trust and secured against the eventuality of the trustee's insolvency[110]. The creditors of trustees have no claim upon trust funds. Secondly, trustees owe their beneficiaries several wide-ranging duties which are intended to safeguard the beneficiaries' interests.

On the one hand, there are the duties which are established by the trust deed itself. If the trustee fails to fulfil these duties, this constitutes a breach of trust resulting in the trustee's liability to the beneficiaries to the beneficaries. Additionally, the relationship between trustee and beneficiary is defined as fiduciary[111]. This means that a trustee is

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[108] Securities Investments Board, *An Introduction to the SIB* (London 1997), at p. 24.
[109] Hanbury/Martin, *Modern Equity* (15th edn. London 1997 by Martin, Jill E.), at p. 45.
[110] Page/Ferguson, *Investor Protection* (London 1992), at p. 18.
[111] Halsbury's *Laws of England* (4th edn. London 1995), Volume 48, at p.248 (para.501).

generally placed under a range of special duties which normally exceed to a considerable extent those duties which are tpyically imposed by ordinary contractual agreements. For example, a trustee ought not to place him- or herself in a position in which his or her private interest and his or her duty as a trustee may conflict.

In *Cowan* v *Scargill*[112] it was held that the duty of trustees is to exercise their powers in the best interests of the present and future beneficiaries of the trust and the interests of the beneficiaries must always be paramount to the trustee's own interests. Furthermore, in the decision *Re Whitely*[113] the so-called 'prudent man rule' was developed. According to this rule, a trustee who is responsible for making investments for the trust is under a duty to conduct the business of the trust with the same care an ordinary prudent man would take in the management of his own affairs. However, attention should be drawn to the fact that English courts have ruled that a higher standard of diligence and knowledge can be expected from professional and paid trustees. For example, in the case of *Barlett* v *Barclays Bank Trust Co. (No.1)*[114], it was stated by Brightman LJ that:

> I am of opinion that a higher duty of care is plainly due from someone like a trust corporation which carries on a specialised business of trust management. A trust corporation holds itself out in its advertising literature as being above ordinary mortals.
>
> With a specialist staff of trained trust officers and managers, with ready access to financial information and professional advice, dealing with and solving trust problems day after day, the trust corporation holds itself out, and rightly, as capable of providing an expertise which it would be unrealistic to expect and unjust to demand from the ordinary prudent man or woman who accepts, probably unpaid and sometimes reluctantly from a sense of family duty, the burdens of a trusteeship.
>
> Just as, under the law of contract, a professional person possessed of a particular skill is liable for breach of contract if he neglects to use the skill and experience which he professes, so I think that professional corporate trustee is liable for breach of trust if loss is caused to the trust fund

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[112] per Sir Robert-Megary V-C, [1984] 2 All ER 750 (Ch.Div.), at p. 760.
[113] per Lindley LJ, (1886) 33 (Ch.Div.) 347, at p. 355.
[114] [1980] 515 (Ch.Div.), at p. 534.

> because it neglects to exercise the special care and skill which it professes to have.

In 1961, the Trustee Investments Act came into force stipulating the conditions in which trustees are entitled to make investments. Under the Act permitted investments by trustees are divided into two classes, i.e. so-called 'narrower-range' investments and 'wider-range' investments.

Narrower-range investments include National Savings products, government and local authority stock, UK corporate debentures, buildings societies deposits, and mortgages. Wider-range investments include ordinary company shares quoted on the Stock Exchange and unit trusts. Generally speaking, trustees are empowered to invest half the trust fund in wider-range investments, the remaining half being confined to the narrower-range. Trustees making investments under the 1961 Act are also requested to obtain and consider proper expert financial advice. However, in practice, the Trustee Investments Act 1961 is not of great significance because the provisions of the actual trust instrument prevail over the provisions under the Act. As a result, it is said that most modern trust deeds give powers of investment much wider than those set out in the Act[115].

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[115] Page/Ferguson, *Investor Protection* (London 1992), at p. 22.

(4) Disclaimers

Up to 1977, a bank could exclude or limit liability for negligent advice by simply using express disclaimer clauses stating that its advice was given 'without responsibility'[116]. Today, disclaimers are governed by the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations 1994.

(a) Unfair Contract Terms Act 1977

Section 2 (2) of the Unfair Contract Terms Act 1977 deals with clauses in relation to exclusions of liability for damage other than death or personal injury and states that a person acting in course of business cannot exclude or restrict his or her liability for negligence except in so far as the term or notice satisfies the requirement of 'reasonableness'. This means that the question of whether a contractual party can effectively exclude or limit liability for its conduct depends on the so-called 'test or resonableness'. Section 11 (1) of the Act defines the requirement of resonableness as:

> that the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been known to or in the contemplation of the parties when the contract was made.

Furthermore, in reference to any other non-contractual documents it is stated in section 11 (3):

> In relation to a notice (not being a notice having contractual effect), the requirement of reasonableness under this Act is that it should be fair and reasonable to allow reliance on it, having regard to all the circumstances obtaining when the liability arose or (but for the notice) would have arisen.

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[116] per Lord Reid in: *Hedley Byrne & Co.Ltd.* v *Heller & Partners Ltd.* [1964] 1 AC 465 (HL), at p. 492/493.

In *Smith* v *Eric S. Bush*[117] the House of Lords had to deal with the issue of disclaimer clauses. In this case, the plaintiff applied to a building society for a mortgage to assist her in purchasing a house. The building society instructed the defendants, a firm of surveyors and valuers, to carry out a visual inspection of the house and to report on its value and any matter likely to affect its value.

The report was paid for by the building society which passed the cost on to the plaintiff by charging her an 'inspection fee'. The building society also provided the plaintiff with a copy of the report. The report stated that no essential repairs were necessary. The plaintiffs relied on it and purchased the house. The valuer had negligently failed to point out in his report that two chimneys of the house were not adequately supported. Later, one of these chimneys collapsed.

The plaintiffs brought an action for damages in negligence. The valuers defended themselves by referring to a disclaimer clause in the building society's mortgage application form stating that the surveyor's report would be supplied without any acceptance of responsibility on the building society's or the valuer's part[118]. The House of Lords found that the defendant valuers owed the plaintiff a duty of care and failed to fulfil their duty. Furthermore, they ruled that the disclaimer used by the building society did not satisfy the requirement of reasonableness provided by sections 2 (2) and 11 (3) of the Unfair Contract Terms Act 1977. The judges based their view on the fact that the plaintiff and not the building society paid for the valuer's report and on the inequality of the bargaining power of the valuers and the plaintiff. Not surprisingly, the issue of

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[117] [1990] 1 AC 831 (HL), at p. 846C.
[118] *ibid*, at p. 842D.

insurance and insurability played an important role in this decision. Referring to this topic, Lord Griffiths stated[119]:

> We are dealing in this case with a loss which will be limited to the value of a modest house and against which it can be expected that the surveyor will be insured.
>
> Bearing the loss will be unlikely to cause significant hardship if it has to be borne by the surveyor but it is, on the other hand, quite possible that it will be a financial catastrophe for the purchaser who may be left with a valueless house and no money to buy another [...] it may result in a few more claims but I do not think so poorly of the surveyor's profession as to believe that the floodgates will be opened.

Thus, the court found that it was more just to deny a surveyor, in the circumstances of the case, the right to exclude liability rather than allowing the whole of the risk to fall upon the one unfortunate purchaser. However, Lord Griffiths also stressed that there must also be situations where professionals must be able to exclude or, at least limit, their liablitiy[120]:

> With very large sums of money at stake, prudence would seem to demand that the purchaser obtain his own structural survey to guide him in his purchase and, in such circumstances with very much larger sums of money at stake, it may be reasonable for surveyors valuing on behalf of those who are providing the finances either to exclude or limit their liability to the purchaser.

Applying these principles to banking, one may argue that banks should generally be entitled to exclude or limit their liability for their financial advice. This view may be based on the fact that banks, in contrast to valuers, usually provide their customers with advice for free. However, one need also to consider that in almost all cases involving financial advice there is some kind of consideration moving from the customer to the

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[119] *ibid*, at p. 858H-859A/B.
[120] *ibid*, at p. 859H-860A.

bank. For example, banks and building societies charge application fees for any loans granted.

Furthermore, the inequality of the bargaining power of the bank and the customer should be taken into account. Banks have much more experience in financial affairs than their customers who often rely entirely on any advice given to them by the banks. Nevertheless, it appears that a rather flexible approach to the test of reasonableness caters best for the banks' as well as the customers' interests. One the one side, banks which offer to act as their customers' 'financial experts' in order to attract customers should, generally speaking, not be allowed to exclude or drastically limit their liability. On the other side, any opening of the floodgates of litigation should be avoided.

Where customers have sufficient expertise or can be deemed to possess enough expertise to handle their financial affairs independently, banks should be entitled to use disclaimer clauses. For example, there are areas such as the field of discount-broking where banks mainly provide their customers with the mere technical means to carry out their own financial transactions. There, exclusions or limitations of liability are more likely to be seen by the courts as 'reasonable'.

(b) The Unfair Terms in Consumer Contracts Regulations 1994

The Unfair Terms in Consumer Contracts Regulations 1994 implemented the EU Directive 93/13 EEC on Unfair Terms in Consumer Contracts. The Regulations apply to any contract between a seller or supplier of services and a consumer (meaning a natural

person not acting in the course of business). Its core provision, section 5 (1), states that an unfair term is not binding on the consumer. Section 4 (1) defines an unfair term as:

> [...] any term which contrary to the requirement of good faith causes significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer.

In Schedule 3 of the Regulations, there is an illustrative list of terms which may be regarded as unfair. According to paragraph 1(b) of this list, a term may be unfair if it has the object or effect of:

> inappropriately excluding or limiting the legal rights of the consumer vis-à-vis the seller or supplier or another party in the event of total or partial non-performance or inadequate performance by the seller or supplier of any of the contractual obligations, including the option of offsetting a debt owed to the seller or supplier against any claim which the consumer may have against him.

However, this list is only of an indicative character. This means that according to section 4 (2) of the Regulations the unfair nature of any must must always be established against the whole background of the specific circumstances of each individual case. Thus, one may say that the exemplary clause 1(b) may be just seen as a means to attract the courts' particular attention to the fairness of disclaimer clauses used in consumer contracts. One may also argue that the test of 'fairness' as laid down in the Unfair Terms in Consumer Contracts Regulations 1994, equals the test of 'reasonableness' introduced by the Unfair Contract Terms Act 1977. In a consultation document on the implementation of the Directive on Unfair Terms in Consumer Contract, the British Department of Trade & Industry admitted that the concept of unfairness was likely in most cases to lead to a result very similar to that of the test of reasonableness in the Unfair Contract Terms Act

1977[121]. However, in this paper, the Department also emphasized that the two tests were not the same[122]:

> The Department has concluded therefore that it would be inconsistent with the proper implementation of the Directive to treat the concept of fairness as equivalent to the existing test of reasonableness in the [Unfair Contract Terms] Act.

Nevertheless, it remains to be seen how English judges will interpret the relationship between these two codifications. One may be inclined to say that the test of reasonableness should be treated as 'lex specialis' to the test of unfairness. This view may be based on the fact that the test of unfairness consists of three complex requirements: contrary to the requirements of good faith, causing a significant imbalance in the parties rights and obligations, and to the detriment of the consumer. In contrast to this, section 2 (2) of the Unfair Contract Terms Act 1977 does only speak of the 'requirement of reasonableness'.

Finally, attention may also be drawn to disclaimers with regard to the management of investment trusts. In general, at common law there is nothing to stop a trust deed excluding the trustee's liability for breach of trust or for breach of a duty of care[123]. However, with regard to authorised unit trusts, which have a considerable market share in the private investment business in Britain, section 84 of the Financial Services Act 1986 declares void any trust deed provision 'in so far as it would have effect of exempting the manager or trustee from liability for every failure to exercise due care and diligence in the discharge of his functions in respect of the scheme'.

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[121] Department of Trade and Industry, *Implementation of the EC Directive 93/13/EEC on Unfair Terms in Consumer Contracts - A Further Consultation Document* (September 1994), at p. 3.
[122] *ibid*, at p. 3.
[123] Page/Ferguson, *Investor Protection* (London 1992), at p. 20.

B. German Law:

(1) The legal nature of the bank/customer relationship in German law

In common with English law, German law does not have codified definition of the legal nature of the ordinary bank/customer relationship. However, it is generally accepted that this relationship is of a contractual nature and is governed by the provisions of the German Civil Code (*Bürgerliches Gesetzbuch*, or BGB for short). According to one point of view, the relationship between bank and customer is based on a *Bankvertrag*, i.e. one single banking contract containing all sorts of contractual obligations deriving from different agreements separately reached between bank and customer[124]. Nevertheless, German courts have rejected this notion of a single *Bankvertrag*. They have continuedly ruled that the bank/customer relationship is to be seen as a conglomerate of several different contracts. The most basic and most important of these separate contracts between bank and customer is the contract of debtor and creditor (§ 607 BGB) which is concluded when the customer opens an account with the bank.

In German law, the provision of financial advice is also typically dealt with in a contractual context. There are two main contractual concepts which define the bank's duties as a financial adviser. First, there is the concept of *Positive Vertragsverletzung* (violation of collateral contractual obligations). According to this concept, a bank may either be placed under a primary or a collateral obligation to render correct and complete advice to a customer[125]. German courts often combine the concept of *Positive Vertragsverletzung* with the notion of *Beratungsvertrag* (a contract to supply advice; §§

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[124] Baumbach/Duden/Hopt, *HGB*, (28th edn. 1989), (7) Bankgeschäfte I 3, at p. 1180.
[125] For further explanation of this concept, see Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume 1, at pp.418.

662, 675 BGB). A *Beratungsvertrag* is a contract whose very object is the provision of advice. Nevertheless, the concept of *Positive Vertragsverletzung* is also applied by courts in situations where the judges hold that a specific contract between bank and customer, for example an ordinary loan agreement, contains an additional, i.e. collateral contractual obligation on the part of the bank to advise the customer on the nature and the risks of the transaction.

Secondly, there is the concept of *Culpa in contrahendo* which states that, in certain circumstances, a bank may be under a pre-contractual obligation to warn its prospective customers about the risks involved in transactions[126]. In short, *Culpa in contrahendo* is a doctrine under which a party can be liable for negligently causing damage to another during contractual negotiations. Under this doctrine the mere opening of negotiations intended to lead to a contract creates a special relationship between the parties by virtue of the law rather than by agreement between the parties[127]. This relationship imposes on both parties special duties of care.

In contrast to this, German tort law is of much less practical relevance. The main reason for this is that § 823 I BGB, the central provision of German tort law, offers compensation only for the infringement of specific absolute rights such as the right of life, health and property but not for one's pure economic loss. As in most advice-related cases pure economic loss is often the only type of loss suffered by customers, not many claims are successfully based on § 823 I BGB.

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[126] For further reading on this concept, see Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume 1, at p. 64.

[127] Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume 1, at p. 64.

(2) Liability of banks for financial advice to customers - in German law within the domain of the law of contract

As already mentioned above, a bank's liability for financial advice is mainly centred on the contractual concepts of *Beratungsvertrag*, *Positive Vertragsverletzung* or the pre-contractual notion of *Culpa in contrahendo*. However, when taking a look at the provisions of the German civil code (BGB) one comes across a rather misleading paragraph. § 676 BGB states that[128]:

> A person who gives advice or a recommendation to another is not bound to compensate for any damage arising from the advice or the recommendation, without prejudice to his responsibility resulting from a contract or delict.

At the first glance, one is quite naturally tempted to conclude from this paragraph that banks are exempt from any liability for advice. In fact, the most important part of this paragraph is 'hidden' at the end of the provision, i.e. 'without prejudice to his responsibility from a contract or delict'. This means that an adviser can actually be held liable for advice if other contractual or tortious provisions of the German civil code say so. This 'loophole' in § 676 BGB has been used by German courts to develop, in a rather unscrupulous defiance of the wording of § 676 BGB, the concept of *Beratungsvertrag*, a contract whose very object is the supply of advice. In fact, the concept of *Beratungsvertrag* has become the backbone of today's law concerning a bank's liability for its financial advice to customers.

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[128] Note that all translations of German texts are provided by the author unless where stated otherwise.

(a) The concept of 'Positive Vertragsverletzung' combined with the notion of 'Beratungsvertrag'

Under the concept of *Positive Vertragsverletzung* combined with the notion of *Beratungsvertrag*, a bank is under a primary contractual obligation to provide its customer with sound advice. According to rulings of Germany's highest civil courts', a *Beratungsvertrag* is established in the following circumstances[129]:

> (i) The bank and the customer must have expressly or tacidly agreed that the bank advises the customer in financial matters;
>
> (ii) both plaintiff and defendant must have the intention to be legally bound by this agreement, but it is not necessary that the customer pays the bank for its advice.

(aa) Contractual agreement between bank and customer concerning the supply of advice and the 'hurdle' of intention to be legally bound

First, there must be a contract between bank and customer leading to an agreement concerning the supply of advice. The ruling of Germany's highest civil court, *Bundesgerichtshof*, in BGH NJW 1993, 2433 ('*Bond-Urteil*')[130] may serve as an example to show in what circumstances German courts are likely to infer a *Beratungsvertrag*. In this case, the plaintiffs, a married couple, had current accounts with the defendant bank for more than 20 years. During that period they also had been investing their savings in high interest time deposit accounts and German government bonds. Both forms of investment are generally regarded as very safe. All these investments were arranged through the defendant bank. In March 1989, the plaintiffs

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[129] BGH (04.03.1987) BGHZ 100, 117; BGH (16.10.1990) NJW 1991, 352.
[130] BGH (06.07.1993) NJW 1993, 2433; this decision is also widely known as *Bond-Urteil*.

approached the defendant bank concerning a new investment of DM 20,000. The defendant bank's 'special investment adviser' recommended the plaintiffs an investment in bonds issued by the Australian Bond Group. The bank's expert did not explain to the plaintiffs the nature and risks attached to this investment, but he assured the customers that there was 'no currency risk' when buying these bonds.

In reliance on the expert's advice, the plaintiffs invested DM 20,000 in the Bond Group. In 1990, the Bond Group went into receivership and the plaintiffs' bonds became worthless. The plaintiffs claimed damages for breach of contract. They argued that the bank gave them negligent advice. At first, the court turned to the question of whether there was a *Beratungsvertrag* between bank and customer. The court stated that[131]:

> If a customer approaches his bank in order to obtain some advice on an investment matter, this can be seen as an offer by the customer to the bank to conclude a contract to supply advice. If the bank then discusses with the customer the subject matter, such a contract is tacitly concluded.

It is, especially from an English lawyer's point of view, interesting to notice that the court also stressed that there is no requirement of consideration to move from the customer to the bank to create the contract of advice between them. Of course, the judges also said that the fact that there is no remuneration for the bank is of some relevance in defining whether the bank had an intention to be legally bound by its advice.

As already mentioned above, in German law it is a requirement for the conclusion of any contract that both parties to it must have the intention to be legally bound by the agreement. Thus, the fact that a bank is not (directly) paid by the customer for its advice, can be an indicator for the bank's lack of intention to be bound by the advice.

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[131] BGH (06.07.1993) NJW 1993, 2433.

However, in BGH NJW 1986, 180 the highest German civil court ruled that the bank's intention can be construed if the bank provided advice that was[132]

> obviously of great importance to the recipient and was to be used by him as basis for his significant decisions and undertakings

Furthermore, the court stressed in this decision that[133]:

> This inference [of the bank's intention to be legally bound] can especially then be made if the person giving advice possesses special expertise and has an economic self-interest in the subject matter.

Applying these principles to the factual evidence in the BGH NJW 1993, 2433, the court ruled that there was a *Beratungsvertrag* concluded between the bank and the plaintiffs. The judges stressed that there was a long-standing relationship between the bank and the plaintiffs and that the bank knew that the plaintiffs were inexperienced in financial matters. Additionally, the bank was also aware of the fact that the sum of DM 20,000 represented a large part of their life's savings.

It was also obvious to the bank that the plaintiffs would rely entirely on its advice when deciding on how to invest their money, especially as the couple had done so many times before. The court also pointed out that it was irrelevant that it was the plaintiffs who approached the bank concerning the investment and not the other way round. Additionally, the judges emphasized that the bank had a significant economic self-interest in the transaction because the bank recommended an investment that was included in the bank's portfolio scheme especially designed to attract stock-market investments by private customers.

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[132] BGH (17.09.1985) NJW 1986, 180, at p. 181.
[133] *ibid*, at p. 181.

In contrast to this ruling, it was held in BGH WM 1990, 1990 ('Landrat-Fall')[134] that a bank's intention to be legally bound by its advice cannot be inferred in situations where a bank makes a statement in relation to a financial matter in a 'social setting'. In this case, a new hospital was built in the district of D. On Thanksgiving Day (*Erntedankfest*), the first part of the new hospital was opened to the public. During the ceremony, Dr. K, a high district official was by chance introduced to the chief executive of the defendant bank which was involved in the financing of the project.

Dr. K. told the chief executive about 'concerns among the building companies involved in the project about the financing of the project'. He stressed that he would like to know about the future of the project in case 'someone may be held politically responsible'. The bank executive assured Dr. K that there was no problem with the financing of the hospital project. He also emphasized that Dr. K could pass this information on to the concerned building companies. Dr. K told the building companies about his conversation with the defendant bank's executive. Relying on this, the plaintiffs continued delivering building material to the H-company that run the hospital project. Not much later, the H-company collapsed. As a result, the plaintiffs lost DM 300,000.

The plaintiffs brought an action against the defendant bank based on a breach of contract. They argued that there was a contract of advice concluded between the bank and the district official and that this contract also had 'protective effect' on all the companies involved in the project. The court held that no contract to supply advice was concluded between the bank and the district official as the bank's statement was made in a 'purely social context'. This could especially be concluded from the whole setting of the meeting between the bank executive and the district official. They met accidently at

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[134] BGH (16.10.1990) WM 1990, 1990.

the Thanksgiving Day celebrations. It was also obvious to the district official that the bank director could not be regarded as giving him an answer based on extensive reseach in the matter. The bank executive simply made a comment on the future of the project at the top of his head. Thus, even from the district official point of view, it was clear that the bank did not want to be bound by its statement.

Additionally, in an obiter dictum statement, the court pointed out that a contract to supply advice could typically only then inferred if the bank knows details of the individual investment made by the inquirer. A request for general information on an unspecified subject matter could not lead to a *Beratungsvertrag*, let alone to a contract of advice having 'protective effect' on third parties. Thus, it may be summarised that under the concept of *Beratungsvertrag* the background of the situation in which a bank makes a statement concerning a financial matter is extremely important. If the bank's statement can reasonably be interpretated as a business comment based on careful consideration, it is likely that a contract of advice can be concluded between the bank and the inquirer. Another important point is the bank's economic self-interest in the subject matter.

(b) The concept of 'Positive Vertragsverletzung' in connection with a bank's collateral contractual obligation to advise and warn the customer

As already mentioned above, there are also situations where a bank is under a collateral contractual obligation to provide its customer with sound advice or to warn him or her about risks involved in a specific transaction. With regard to the field of banking, the

general requirements for a bank's liability for a breach of such a collateral contractual obligation are:

> (i) the existence of an exceptionally close contractual relationship between bank and customer giving rise to a bank's collateral duty to advise or to warn the customer;
>
> (ii) an intentional or negligent breach of the collateral obligation by the bank or its employees;
>
> (iii) causation of recoverable loss.

The main question of this test is whether there is such a close contractual relationship between bank and customer to put the bank under a supplementary obligation to advise or warn the customer. In general, German courts ruled such a relationship is only established if[135]:

> a special relationship of trust has come into existence between bank and customer where the adherence to the principle of good faith has become a much more prominent factor than in other relationships between ordinary contractual parties.

In BGH NJW 1995, 2218[136], it was held that a bank that grants a loan to a customer for his or her investment project can, in certain circumstances, be under a collateral contractual obligation to warn the customer about the risks involved in the investment. In this case, the plaintiff invested DM 141,000 in a housing project run by the P-company. The defendant bank granted the plaintiff a loan of DM 125,000 for his investment. The bank took the plaintiff's share in the property rights in the housing project as security for the loan. Initially, the contractual arrangement was such as to ensure that the plaintiff's investment would be forwarded by the defendant bank to the P-company only on the completion of the project. Later, the P-company, whose main

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[135] BGH (28.04.1954) BGHZ 13, 198, at p. 200.
[136] BGH (30.05.1995) NJW 1995, 2218.

creditor was also the defendant bank, asked the defendant bank for more money. The bank suggested to the plaintiff to change the contractual arrangement so that the P-company could get access to the plaintiff's money that was, at that time, still held in a special notary account. Simultaneously, the defendant bank demanded from the P-company to transfer to it all its claims against investors, including the claim against the plaintiff. The plaintiff agreed to the change of the contract and the P-company and used the plaintiff's money for the project.

Not long after, the P-company went bankrupt. Subsequently, the bank brought an action against the plaintiff claiming back the money 'paid' to him under the loan agreement. The plaintiff refused to do so and counterclaimed damages for breach of contract. The court held that the defendant bank was - in the circumstances of the case - under a collateral contractual duty to warn the plaintiff about risks involved in changing the original contractual arrangements. The judges stressed that in the original contract the plaintiff's investment was safe because the P-company was supposed to obtain the plaintiff's money only on the condition that the project would be finished.

In contrast to this, under the redrafted contractual agreement his investment was not secured at all. Under this new set-up, the defendant bank was not only the plaintiff's creditor with regard to the loan but also had obtained from the P-company the 'counterclaim' against him concerning the investment of DM 125,000. Thus, the court held that the bank was in a conflict of interest, because in this situation the bank was effectively in the powerful position to 'orchestrate' transactions made between the plaintiff and the P-company in a way that would suit its own interests best. Therefore, the judges pointed out that the bank was obliged to inform the plaintiff about the

consequences of changing the original agreement. As the defendant bank had failed to do so, the plaintiff was held to be entitled to damages for breach of contract.

In contrast to this, in OLG Köln WM 1995, 1268[137] it was ruled that a bank is generally not under a collateral contractual obligation to look after a surety's financial interests. In this case, the plaintiff bank granted a loan of DM 200,000 to the B-company in which the defendant had an interest. The defendant stood surety for this loan. The B-company was also a debtor to the D-company. The defendant stood also surety for this second loan. Later, the B-company collapsed. The D-company made the defendant pay to it DM 225,000 under the second surety agreement. Furthermore, the plaintiff bank brought an action against the defendant claiming DM 100,000 under their surety contract. The defendant refused to pay this sum arguing that the plaintiff bank failed to keep him informed about the deteriorating situation of the B-company in the period before its collapse.

Moreover, he stressed that since the plaintiff bank and the D-company had a business relationship they should have informed each other about the decline in the financial standing of the B-company. he emphasized that if they had told each other about their experience with the B-company, they both would have stopped lending money to it. Thus, much smaller debts would have been accumulated by the B-company. This, in turn, would have benefitted him being a surety for B-company's debts. The court rejected the defendant's arguments by stressing that[138]:

> a creditor is generally under no obligation to look after a surety's financial affairs [...] the contract of suretyship between the defendant and the plaintiff bank did not result in any obligation on the part of the bank to

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[137] OLG Köln (03.11.1994) WM 1995, 1268.
[138] *ibid*, at p. 1269.

> ensure that the surety will not be made to pay under another suretyship agreement the plaintiff entered into with another creditor.

Thus, it may be summarized that a bank is only in exceptional circumstances placed under a collateral obligation to warn its customers about risks involved in a specific transaction. Indicators of the existence of such a collateral obligation are a closer than usual business relationship between bank and customer, a significant degree of trust and confidence vested by the customer in the bank, and the bank's exposure to a conflict of interest. Given that these points are ascertained in the individual facts of the case, a bank can be seen as owing to the customer an obligation to advise him or her on the nature and the risks of a specific transaction.

(c) The concept of 'Culpa in contrahendo'

Furthermore, under the concept of *Culpa in contrahendo* a bank can be under a pre-contractual obligation to advise a prospective customer on the nature and the risks of a transaction. A bank can be held liable under this concept if:

> (i) there is a special pre-contractual relationship of trust and confidentiality between the bank and the prospective customer giving rise to an obligation on the part of the bank to warn the prospective customer of risks involved in the transaction;
>
> (ii) the bank intentionally or negligently fails to fulfil this obligation;
>
> (iii) recoverable loss is caused.

Under this concept, the main question is to establish that there is a relationship of trust and confidence between bank and prospective customer. It is generally said that such a relationship of trust arises if:[139]

> there is an intensified social contact between the prospective customer and the bank which gives rise to a feeling of mutual trust and confidence and an understanding that both of them will take all reasonable steps not to cause any harm or loss to the other.

The decision in OLG Karlsruhe WM 1995, 747[140] may serve as an example to show in which circumstances a bank is under a pre-contractual obligation to warn a prospective customer. In this case, the defendant bank advertised a loan scheme under which private individuals could buy 'the house of their dreams without any capital'. The plaintiff asked the bank for a loan under this scheme. The bank sent one of their 'financial experts' working on a freelance basis for them to the plaintiff.

The expert arranged for the plaintiff to open two savings accounts with the defendant bank. Furthermore, the defendant bank assisted the plaintiff in finding an appropriate piece of land where the house should be built. Relying on the expert's assurance that everthing was allright with regard to the financing of the project, the plaintiff was about to purchase this piece of land. To the bank's knowledge, the plaintiff arranged a meeting with a notary who was to certify the contract of sale for the land. In fact, the financing of the plaintiff's project was not given the green light by the bank. The plaintiff purchased the land but failed to pay for it. The seller sued the plaintiff for the purchase price. In turn, the plaintiff claimed damages from the bank under the concept of *Culpa in contrahendo*.

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[139] Palandt-Heinrichs, *BGB* (56th edn. München 1997), § 276 Rdn. 65-68, at p. 340/341.
[140] OLG Karlsruhe (11.01.1995) WM 1995, 747.

The court held that the defendant bank was liable for damages under the concept of *Culpa in contrahendo*. The judges stressed that a relationship of trust was established when the plaintiff entered into negotiations with the defendant bank. In its advertising campaign the bank had explicitly targetted first-time buyers who usually have very little or no experience in financial matters. Additionally, the bank claimed to possess special expertise in arranging financing for housing projects. Thus, the plaintiff could trust in the bank's competence and statements.

When the banks' expert assured the plaintiff that everything was fine with the financing of the project, it was not unreasonable for the plaintiff to enter into a contract of sale for a piece of land. Knowing that the plaintiff was about to purchase a piece of land and that the financing was in fact not secured, the bank was under a pre-contractual obligation to warn her about the risks involved in entering into a purchase agreement. The judges also decided that the bank would be held responsible under § 278 BGB for its expert's conduct because he was acting on behalf of the bank. Thus, it was ruled that the plaintiff was entitled to damages.

It may be concluded than, in general, a bank is only in special circumstances under a pre-contractual obligation to warn a prospective customer about the risks involved in a transaction. Such special circumstances tend to arise if there is a substantially intensified business contract between bank and the prospective customer inducing the prospective customer to place a significant degree of trust and confidence in the bank's conduct and statements.

(d) A bank's duties arising under the concepts of 'Beratungsvertrag', 'Positive Vertragsverletzung' and 'Culpa in contrahendo'

In BGH NJW 1993, 2433 ('Bond-Urteil') it was ruled that if there is a *Beratungsvertrag* concluded between bank and customer the bank is under the primary contractual obligation to provide the customer with 'correct, sound, understandable, and comprehensive advice'[141]. In this decision concerning investment advice, the *Bundesgerichtshof* came up with the requirement that a bank's advice must be *anlegergerecht* (suitable for the customer) as well as *anlagegerecht* (adjusted to the nature of the subject matter of the investment). The court stressed that[142]:

> The contents and extent of the [bank's] primary obligation to give advice are dependent on several factors which, on the one side, are related to the personality of the customer and, on the other side, refer to the object of the investment [...]
>
> The relevant factors concerning the customer are his expertise in investment matters and his readiness to take risks [...] With regard to the object of the investment, the advice given must include all features and risks that have or are likely to have an impact on the decision to be made by the customer.

The judges even said that, if a bank does not know enough about its customers experience in investment matters or his investment goals, it must actively seek this information from its customers. Furthermore, it was also said that the bank must inform its customers about all general risks of a transaction such as changes in the stock market as well as specific risks like fluctuations in interest and exchange rates.

Interestingly, a very similar type of duty is imposed on banks by the courts where the banks are found to be under a collateral or pre-contractual obligation to advise or warn

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[141] BGH (06.07.1993) NJW 1993, 2433, at p. 2433.
[142] *ibid*, at p. 2433.

a customer with regard to a specific transaction. Actually, in legal practice, the question of on which conceptual ground a plaintiff customer's claim for damages against a defendant bank can be based is of little relevance. In fact, there are many cases where even Germany's highest civil court did not bother to name the basis for a plaintiff's successful action against a bank. In these decisions the judges preferred to simply state that the plaintiff's action succeeded because 'the bank violated its general duties to inform and warn the customer of the nature and the risks involved in the disputed transaction'[143].

There is even a decision by a lower court in which the judge had no scruples to say that the plaintiff's action could be successfully based on 'either the concept of *Positive Vertragsverletzung* or the concept of *Culpa in Contrahendo*[144]. One may dare say that this approach does not further the cause of clarity and certainty in the law. However, one's criticism should also take account of the fact that this conceptual imprecision does not cause any ambiguities in practice because both concepts grant the same remedy to a successful plaintiff, i.e. reliance damages which limit the plaintiff's compensation to the loss incurred through the plaintiff's reliance on the defendant's conduct[145].

Finally, it may be pointed out that the exact scope of the duties of banks with regard to their roles as financial advisers are discussed in detail in the following chapters which focus on the area of general lending and private investment matters.

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[143] BGH (28.04.1992), NJW 1992, 2146, at p. 2147-48; BGH (29.05.1978) NJW 1978, 2547, at p. 2547-2548.
[144] AG Frankfurt/Main (06.03.1995) WM 1995, 700, at p. 700; emphasis added.
[145] For further reading on this issue, see Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume 1, at pp. 637.

(e) Breach of a (pre-)contractual duty

Generally speaking, a bank breaches its primary, collateral or pre-contractual duty to give advice if its advice is either incorrect, unsound or incomprehensible. Furthermore, according to § 276 BGB, the bank must have negligently or intentionally failed to fulfil this duty. The test of negligence is an objective one[146]. However, for banks the test of negligence is slightly stricter than for any other natural person. Under § 1 of the German Commercial Code (*Handelsgesetzbuch* or for short HGB) banks are viewed as 'businesses'[147]. This means that, pursuant to § 347 (1) HGB, banks generally must apply to all its activities the standard of care and diligence of a '*ordentlichen Kaufmanns*' (prudent merchant). This stricter standard of care is that level of skill that can reasonably be expected of an ordinary banker in the position of the defendant bank.

Nevertheless, in Germany, there exists no equivalent to the British Bankers' Association's 'Code of Practice' which lays down what is seen by British banks as good practice in banking in Britain. In Germany, there are only the *Standesrichtlinen der Deutsche Vereinigung für Finanzanalyse* (rules of conduct of the profession of independent investment analysts) which have been voluntarily drawn up by a body representing independent investment analysts. However, the provisions of this code of conduct contain only rather general statements such as that an analyst must avoid any conflict of interest and must keep him- or herself always informed about the most recent developments in the stock-market. This means that German court, in contrast to their English counterparts, cannot refer to a code of conduct when defining what standard of

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[146] Palandt-Heinrichs, *BGB* (56th edn. München 1997), § 276 BGB Rdn. 15, at p. 333.

[147] It should be stressed that § 1 and § 2 of the HGB have been changed. Under the new provisions anyone who carries on a commercial enterprise is regarded in law as a merchant unless his or her business does not - due to the nature and scope of the business - require to be organized in a commercial manner. These changes have become effective on 1 July 1998.

care could be expected of a bank that assumed the role of its customer's financial adviser. The exact scope of the duties of banks which act as their customers' financial adviser is discussed in the Chapter Three and Four of this thesis. These chapters deal with the duties of banks with regard to not only general lending but also private investment matters.

(f) Causation

Generally speaking, it must be ascertained that the defendant's breach of his or her primary, collateral or pre-contractual obligation caused the loss sustained by the plaintiff. The German law of causation is often described as being divided up into the following two tests[148]:

(i) *Haftungsbegründende Kausalität* (causation establishing the defendant's liability;

(ii) *Haftungsausfüllende Kausalität* (causation defining the scope of the defendant's liability).

(i) Haftungsbegründende Kausalität

The concept of *Haftungsausfüllende Kausalität* is used to find out whether the defendant's conduct resulted in the infringement of exactly that right of the plaintiff that is protected by the provision on which the plaintiff bases his or her claim for damages[149]. For example, in an action for damages under the tortious provision of § 823 I BGB the plaintiff must prove that the defendant's conduct led to violation of at least one of the

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[148] Palandt-Heinrichs, BGB (56th edn. München 1997), Vorbem. v § 249 Rdn.55-56, at p. 256.
[149] For further reading on this topic, see Markesinis, B.S., *The German Law of Obligations* (3rd edn. Oxford 1997), Volume 2, at pp. 99.

absolute rights named in this provision (such as health, freedom or property). As already mentioned above, pure economic loss is not protected in § 823 I BGB. Thus, if the plaintiff can only prove that economic loss was suffered as a result of the defendant's misconduct this means that under the concept of *Haftungsbegründende Kausalität* the defendant's action does not 'cause' or establish any liability under § 823 I BGB.

However, most claims brought in cases involving a bank's liability for financial advice are based on the doctrines of *Positive Vertragsverletzung* and *Culpa in contrahendo* which offer protection against pure economic loss. Thus, the concept of *Haftungsbegründende Kausalität* is not a great hurdle to take for a plaintiff who brings a claim for damages under *Positive Vertragsverletzung* or *Culpa in contrahendo.*

(ii) Haftungsausfüllende Kausalität

In contrast, the concept of *Haftungsausfüllende Kausalität* is of great importance for all claims for damages brought in cases involving a bank's liability for financial advice. According to this concept, the scope and nature of the loss suffered by the plaintiff must be attributable to the infringement of the very same right that is protected by the provision giving rise to the plaintiff's claim for damages.

In order to deal with this complex issue, German law has developed another three concepts which are called *Aquivalenztheorie* (theory of equivalence), *Adäquanztheorie* (theory of adequancy) and *Lehre vom Normzweck* (scope of the rule-theory)[150]. In a banking context, the concept of *Lehre vom Normzweck* is most important[151]. It says that

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[150] Palandt-Heinrichs, *BGB* (56th edn. München 1997), Vorbem v § 249 Rdn. 57-65., at pp. 261-262.
[151] For further information on the other two concepts please see Markesinis, B.S., *The German Law of Torts* (3rd edn. Oxford 1997), at pp. 95-108.

damages for harm or loss are recoverable only if the harm or loss is within the protective purpose of the norm awarding the compensation[152]. The rationale behind this concept is to lay emphasis on the legislative, social and economic purposes of the rule and to keep the liability within reasonable and predictable limits.

This means that in order to determine what damages are recoverable in advice-related cases one must take a look at the general idea behind the concepts of *Positive Vertragsverletzung*, *Beratungsvertrag* and *Culpa in contrahendo*. The scope of these concepts is that a bank that concluded a contract to supply advice to its customer must take all reasonable steps to protect its customer from any avoidable loss in relation to the transaction the advice is given on. In other words, there is a sphere of responsibility created by the bank's involvement in its customer's transaction. If the bank then fails to fulfil its duty to give sound advice the customer can recover all those losses that fall into this sphere of responsibility.

Thus, in BGH NJW 1993, 2433 ('Bond-Urteil') it was held that the plaintiffs were entitled to recover the whole sum they lost (i.e. DM 20,000) when they relied on the bank's wrong advice to invest in shares of the Bond Group, as the court held that this loss was inside the sphere of the bank's responsibility. However, the court also ruled that the plaintiffs were not entitled to claim any hypothetical profits they might have made if their investment in the Bond Group had turned out to be successful.

The judges argued that the scope of the concept of *Positive Vertragsverletzung* with regard to investment advice is to warn customers of risks that may result in losses but not to guarantee them any specific profits. Instead, the court held that the plaintiffs

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[152] Brox, Hans, *Allgemeines Schuldrecht*, (21st edn. München 1993), at p. 198.

could only recover a loss of profits determined by reference to the average interest rate of an ordinary savings account. In another decision, BGH NJW 1992, 1223[153], this approach was explained by the following argument:

> capital is typically not left idle, but reinvested at at least the average interest rate available.

(g) Type and measure of recoverable damages

In German law, the provisions of §§ 249 BGB define the damages to be awarded to plaintiffs. These provisions state that the plaintiffs' recoverable damages are determined by a comparison of their present economic situation with their (hypothetical) position if the loss incurring event had not happened (so-called *Differenzhypothese*)[154]. With regard to the damages granted for breach of contract, this means that the plaintiff is to be put in the position he or she would have been in if the contract had been performed as agreed. Furthermore, in actions for breach of contract economic loss is recoverable. In cases related to negligent financial advice the plaintiff is usually compensated for the full amount lost through his or her reliance on the bank's wrong advice. Moreover, § 252 BGB states that a plaintiff who was exposed to a breach of contract can also claim loss of profits.

However, as already mentioned above in BGH NJW 1993, 2433 Germany's highest civil court made it clear that, in advice-related cases, the compensation for loss of profit is limited to the kind of profit the plaintiff would have made if he or she had been given

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[153] BGH (02.12.1991) NJW 1992, 1223.

[154] For further reading on this topic, see Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume 1, at pp. 630.

suitable advice. In BGH NJW 1993, 2433 this that if the financially inexperienced plaintiff couple had been provided with suitable advice they would have put their money in an ordinary savings account. Thus, their compensation for loss of profit was restricted to the (relatively small) profit they would have gained through this sort of investment.

Nevertheless, in my opinion, there can also be situations where the compensation for loss of profit should be more substantial. For example, where a conservative investor is incorrectly advised by his or her bank to invest in high-risk derivatives instead of purchasing standard stocks, he or she should be entitled to claim damages for the lost profit which he or she would have made if he or she had invested in the standard stocks.

Moreover, it should also be noticed that § 254 I BGB states that a plaintiff's damages can be reduced to take account of his or her contributory negligence. According to this provision, a plaintiff is generally under the obligation to mitigate any loss sustained. On the other side, it was also held in BGH NJW 1993, 2433 that a bank, due to the principle of 'good faith' (§ 242 BGB), could - as in the final result in English law - not use the plaintiffs' inexperience in financial matters to 'prove' their contributory negligence. This view was mainly based on the argument that a customer can reasonably assume that the bank's advice is sound and does not have to double-check it. However, on the other hand, in the already above mentioned decision in OLG Karlsruhe WM 1995, 747 it was held that the plaintiff's damages were to be reduced by 50 per cent due to the plaintiff's contributory negligence.

In this case, the defendant bank whose employee had indicated to the plaintiff that she would be granted a mortgage loan although the bank's management had actually not given the green light for the loan did not contact the plaintiff although it knew that the

plaintiff had already made an appointment with a notary to conclude a contract concerning the purchase of a piece of land. Here, the court found that the plaintiff should have used greater care when buying the piece of land. She should have obtained a written statement from the defendant bank saying that the bank was prepared to finance the project before entering into a contract for the purchase of the land.

Furthermore, the court drew attention to the general principle that under the concept of *Culpa in contrahendo* a plaintiff is only entitled to be compensated for the loss which results from the plaintiff's reliance on the defendant's conduct. In other words, the plaintiff is not put in the position he or she would have been in if the contract had been agreed or performed as agreed. Applying this principle in OLG Karlsruhe WM 1995, 747, the judges held that the plaintiff was not be entitled to get her project financed by the bank as it was envisaged, but was 'only' awarded damages which were then also reduced by 50 per cent due to her contributory negligence.

(h) Disclaimers

When German financial institutions enter into business relations with their customers they usually agree with their customers, from the beginning, to have their standard contract terms applied to their contractual relations. As a matter of practice, the customer is asked to sign a special sheet on which he acknowledges that he has taken notice of them. This practice also applies to cases where the bank and customer conclude a contract to supply advice.

In these situations, there often already exist other contractual relationships between bank and customer where the bank's standard contract terms have already been incorporated. Thus, it is argued that - when concluding the contract to supply advice - bank and customer also agree tacitly to incorporate the bank's general conditions into this *Beratungsvertrag*. In Germany, the area of standard contract terms is governed by the *Gesetz zur Regelung der Allgemeinen Geschäftsbedingungen* (Standard Contract Terms Act or AGBG for short). According to § 1 of this Act, standard contract terms are defined as:

> terms which have been settled in advance for use in an indefinite number of contracts and which one party (the user) presents to the other party at the conclusion of the contract.

In relation to disclaimer clauses, § 9 and § 11 No.7 AGBG are of particular importance. Pursuant to § 11 No.7 AGBG, a disclaimer clause is void to the extent that it excludes any liability of a financial institution in its banking relationship with a non business person as defined under § 1 HGB either for its own gross negligence or for the gross negligence of any person employed by it. Another prohibition on a financial institution's excluding its liability results from § 9 AGBG which reads that[155]:

> § 9 (1):
> Provisions in standard contract terms are void if they unreasonably disadvantage the contractual partner of the user contrary to the requirements of good faith.
>
> § 9 (2)
> In case of doubt, a provision is unreasonably disadvantageous if
>
> 1. it is irreconcilable with essential, basic principles of the statutory provisons from which it deviates, or
>
> 2. essential rights or duties arising from the nature of the contract are restricted to a degree which jeopardises the attainment of the purpose of the contract.

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[155] Translations are taken from Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume I, at pp. 908.

Applying § 9 AGBG to disclaimer clauses used by banks to exclude liability for 'simple' negligence, German courts have continuedly ruled that such clauses are void if they refer to situations where cardinal obligations of the parties have been violated[156]. For example, in BGH NJW 1993, 335[157] it was held by the *Bundesgerichtshof* that a research laboratory for construction material testing's clause excluding liability for 'simple' negligence with regard to its research and testing was void under § 9 (2) No.2 AGBG. The court based its decision on the view that[158]

> a user of standard contract clauses is not entitled - even not against a business person [as defined in § 1 HGB] - to exclude through standard contract terms liability for that kind of contractual obligations which are essential for the mere realisiation of the object of the contract itself and where the other contractual party can reasonably rely upon the performance of these obligations.

Thus, in relation to disclaimer clauses used by banks in connection with contracts to supply advice, one may say that German courts could find them void if they excluded the bank's liability for 'simple' negligence. The jugdes may hold the view that the main and 'cardinal' obligation arising on the part of the bank in these contracts is to give sound advice and that an exclusion of liability for this advice could otherwise render the contract meaningless. However, one should notice that this question has yet not been decided by the Germany's highest courts. Furthermore, it is interesting to notice that new general business conditions of German private banks and savings banks do not include any disclaimers excluding liability for the bank's conduct any more[159]. Additionally, it may be mentioned that the provisions of the AGBG by and large meet the requirements established by the EU 93/13 EEC Directive on The Unfair Terms in

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[156] Palandt-Heinrichs, *BGB* (56th edn. München 1997), § 9 AGBG Rdn. 29, at p. 2398.
[157] BGH (11.11.1992) NJW 1993, 335.
[158] *ibid*, at p. 335.
[159] For example see: Deutsche Bank, *General Business Conditions* (Version of January 1993).

Consumer Contracts[160] so that only minor changes[161] to the AGBG have been imposed by the Act of 19 July 1996 which incorporated the provisions of the Directive into German law.

(3) Liability of banks for financial advice to customers - in Germany limited business for tort law

As already mentioned above, German tort law is not of much practical importance for cases where banks give wrongful advice to their customers. The main reason for this is that § 823 (1) BGB, the central provision of German tort law, offers compensation only for the infringement of specific absolute rights such as the right of life, health and property but not for one's pure economic loss[162]. As in most advice-related cases pure economic loss is the only type of loss sustained by the customers, not many claims are successfully made based on § 823 (1) BGB. Furthermore, § 823 (1) BGB is also of not much help to a plaintiff who gave his property as a security for a loan granted by the bank to finance his or her investment project. Although § 823 (1) BGB grants compensation for any unlawfully obtained charge on one's property[163], this would in most cases not be of much comfort to the plaintiff. In these situations, it is necessary that the defendant bank unlawfully obtained the charge on the house, meaning without justification for its infringement of the plaintiff's property rights in the house.

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[160] Schimansky/Bunte/Lwowski-Bunte, *Bankrechts-Handbuch* (München 1997), Band 1, § 5 Rdn. 79, at p. 100.
[161] § 12 AGBG has been modified and § 24a AGBG has been introduced into the AGBG.
[162] For further explanation of the principles of German tort law, see Markesinis, B.S., *The German Law of Obligations* (3rd edn. Oxford 1997), Volume 2, at pp.35.
[163] RG (07.07.1917) RGZ 90, 394, at p. 399.

In general, the plaintiff's consent to the mortgaging of his or her property is seen as sufficient justification for the infringement of the plaintiff's property rights. However, German law says that a person's consent to the infringement of his or her rights is only then valid if the person fully understands the nature of this infringement[164]. It is often argued by a plaintiff that he or she did not understand the nature and the consequences of a particular investment recommended by the bank and secured against a charge on the plaintiff's home.

Assuming that, in this case, the bank actually gave the plaintiff wrongful advice with regard to the investment, this would usually still not entitled the plaintiffs to a claim for damages under § 823 (1) BGB. The reason for this is that the bank would often rightly argue that even if the plaintiff did not fully understand the consequences of the recommended investment, he or she perfectly understood the nature and implications of an ordinary mortgage on his or her house.

Thus, the plaintiff's consent to the charge on his or her house was valid in the meaning of § 823 (1) BGB. Moreover, it is generally very unlikely that a plaintiffs suceeds in bringing a claim for damages against a bank under § 823 (2) BGB (breach of statutory duty) in connection with § 263 StGB (fraud) or a similar criminal offence because, in practice, there is often no evidence of any fraudulent behaviour on the part of the bank or its employees[165]. Additionally, it is very unusual that a court awards damages to a bank customer under § 826 BGB. Under this provision a customer can claim damages if the bank intentionally and against the principle of good faith caused loss to the

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[164] BGH (14.11.1995) NJW 1996, 777, at p. 779.

[165] For further reading on the topic of liability for breach of a statutory duty, see Markesinis, B.S., *The German Law of Obligations* (3rd edn Oxford 1997), Volume 2, at pp.890.

customer[166]. Again, in practice, there is often no evidence of a bank's intention to cause loss to a customer. Furthermore, § 831 (1) S.2 BGB is of great advantage for a bank. According to this provision, a bank can - in cases where one of its employee gave wrongful advice to the customer - avoid liability by proving that it selected and supervised the employee with due care and skill.

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[166] For further explanation of § 826 BGB, see Markesinis, B.S., *The German Law of Obligations* (3rd edn. Oxford 1997), Volume 2, at pp. 894.

C. Comparison

English and German law take very different conceptual approaches with regard to a bank's liability for its financial advice to customers. In England, a customer is most likely to base his or her action against a bank on the tort of negligence. In contrast, a German customer's claim is most likely based on the (pre-)contractual concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung*. Thus, one may be inclined to ask which of the two approaches should be preferred.

In the course of one's quest for an answer to this question, one finds that the supremacy of tort over contract in English law, and, on the other side, the dominance of contract over tort in German law, is the prearranged result of an unfair competition between the two concepts in both systems. In England, the success of the tort of negligence is due to the structural shortcomings of contract law whose scope is considerably limited by the doctrines of consideration and privity and the flexibility of the tort of negligence after the landmark ruling in *Donoghue*. In Germany, contract's dominance is founded on a crucial 'flaw' in the central tort law provision in the Civil Code, § 823 (1) BGB. This provision does not grant an action for the recovery of pure economic loss. Thus, German judges have to resort to contractual remedies which do allow compensation for this type of loss.

Furthermore, in both jurisdictions legal concepts are not regarded as sacrosanct by the courts. If it is deemed necessary, judges feel free to expand or even cross the boundaries of long established concepts. As a good example of the judiciary's disrespect for theoretical conceptualism may serve the German courts' circumvention of the provisions

of § 676 BGB. § 676 BGB[167] stipulates that, in principle, there is no liability for advice. However, in cases where professional advisers made negligent statements to their customers the German judges felt it unjust to exempt these professionals from liability for their negligent conduct.

In defiance of the intentions of the legislator, the courts turned § 676 BGB on its head by transferring the exception clause in this provision, which states that an adviser can then be held liable for advice 'if other contractual or tortious provisions of the German civil code say so', into the general rule. With the help of this creative 're-interpretation' of § 676 BGB, the courts de facto introduced liability for incorrect advice which is negligently given by professionals.

Similarly, in England, the House of Lords broke new ground with its ruling in *Hedley Byrne & Co Ltd* v *Heller & Partners Ltd*[168] (*'Hedley Byrne'*). In this case the House of Lords found that someone who represents to possess special skills can be held liable for his or her negligently given incorrect statement if it is foreseeable that the statement is relied upon by a recipient of this statement. Additionally, the judges ruled that economic loss is recoverable in an action for damages concerning a negligent misstatement by a professional.

Moreover, in *Henderson* v *Merrett Syndicates Ltd*[169] (*'Henderson'*) the House of Lords ruled that the so-called Hedley Byrne principle is applicable not only to misstatements of professionals but also to the negligent provision of any type of service. This has

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[167] § 676 BGB: A person who who gives advice or a recommendation to another is not bound to compensate for any damage arising from the advice or the recommendation, without prejudice to his responsibility resulting from a contract or delict.
[168] [1964] AC 465 (HL).
[169] [1994] 3 All ER 506 (HL).

provoked opposition from some academic writers. The House of Lords is criticized for its alleged undertaking to 'erect the Hedley Byrne principle into a virtual panacea for professional failings'[170]. It is also argued that the latest extension of the Hedley Byrne principle is 'capable of opening the floodgate to a host of inappropriate claims'[171].

Interestingly, academics in Germany and England accuse the legal profession in both legal system of relying on fiction instead of facts when establishing a basis for the imposition of liability for a professional's negligent misstatement. In England, critics say that the Hedley Byrne principle of 'assumption of responsibility' is nothing but a fictitious concept which is used to justify the conclusion that a duty of care is to be imposed[172]. In Germany, writers argue that judges just 'invent' a *Beratungsvertrag* (contract to supply advice) between a defendant professional adviser and a plaintiff customer in order to make the contractual remedies accessible to the plaintiff.

Indeed, it is fiction that a bank either willingly undertakes to accept responsibility for a professional statement or is eager to enter into a contract with a customer to supply him or her with advice. If one walked into a High Street bank today and asked a so-called 'mortgage adviser' whether he or she assumes responsibility for a recommendation made to a customer, the adviser would almost automatically reply that customers are only given non-binding information. This clearly shows the limits of legal concepts in the area of today's banking.

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[170] Hodgson, Roy, 'Hedley Byrne - A New Sacred Cow?', (1995) 4 Nott. Law Journal 1, at p. 25.
[171] ibid, at p. 25.
[172] Hepple, Bob, 'Negligence: The Search for Coherence' in: *Current Legal Problems 1997* (1997 Oxford), 69, at p. 88.

Considering all this, one may be tempted to say that the function of legal concepts in this area of the law has been reduced to serve as vehicles for the implementation of certain policy considerations. In fact, there are statements by judges which seem to support this view. For example, in *Williams* v *Natural Health Foods Ltd* Lord Steyn admitted that the present state of English contract law may need to be reformed[173]:

> Coherence must sometimes yield to practical justice [...] It may become necessary for the House of Lords to re-examine the principles of consideration and privity of contract. But while the present structure of English contract law remains intact the law of tort, as the general law, has to fulfil an essential gap-filling role.

However, in my opinion, this approach is very traditional, if not unimaginative. Especially, the English law's position on the doctrine of consideration should be reviewed. The view that the fact that banks claim to offer their advisory services to their customers for 'free' should not automatically result in the presumption that this lack of direct remuneration negatives any consideration moving from the bank to the customer. In my opinion, more attention should be paid to the underlying economic factors concerning the provision of financial advice by banks to their customers. Banks are no altruistic institutions.

Whenever they offer 'free' advice to a customer, this is done with the clear intention to to induce the customer to enter into a contract with the bank. This contract then stipulates that some form of consideration, typically a commission fee or a general service charge, moves from the customer to the bank. Thus, in my view, the provision of advice should be viewed in the general context of the contractual arrangements made between the bank and its customer. From a practical point of view, the advice given by the bank is logically and economically closely linked with the subsequent formal

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[173] [1998] 2 All ER 577 (HL), at p. 584e.

conclusion of the contract. Therefore, the consideration provided by the customer for the bank's services should 'overarch' to the pre-contractual advisory service given by the bank.

Such a wide interpretation of the doctrine of consideration could lead to the invention of a new type of contract in English law, i.e. the contract to supply advice. This new form of contract could then be used to give the provision of professional advice a clearer conceptual framework. It could help to curb the much criticized expansion of the Hedley Byrne principle in the law related to negligent misstatements by professionals.

In Germany, the disappointment with the concepts of *Beratungsvertrag*, *Culpa in contrahendo* and *Positive Vertragsverletzung* has prompted some academics to come up with a relatively new theoretical concept called *Berufshaftung* (vocational liability). Under this concept, liability is entirely linked to the professional duties of the defendant. The mere fact that the defendant has a specific occupation automatically places him or her under certain obligations which apply to all persons who have the same job[174]. Additionally, supporters of this concept argue that the law regarding liability for professional services should, in principle, contain the same remedies as the law which applies to the sellers of goods.

While the scope and extent of this work do not allow for a detailed analysis and discussion of the advantages and disadvantages of this theoretical concept, it can be stated that the courts refer more and more often to generally accepted standard business practices when reaching a decision as to whether a defendant professional adviser should be held liable for his or her statements. The decisive question often is whether the

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[174] Hirte, Heribert, *Berufshaftung* (1996 München), at pp. 485-493.

defendant professional adviser meets the requirements of what is regarded as 'good practice' in his or her profession. This current development may indicate that civil law loses its grip on the issue of a bank's liability for its financial advice to customers. As it will be shown in the following chapters, there is a trend towards turning civil law concepts into vehicles for implementing duties of banks acting as financial advisers which are imposed by specific legislation concerned with the supervision and regulation of the financial services industry. In this way, a new level of interdependence between civil law and regulatory standards is reached.

Chapter Three:

A bank's advisory duties in general lending matters

Introduction

Lending plays a dominating role in today's retail banking business. In Britain, in the mid-90s the total lending to private individuals even outweighed loans which were granted to commercial enterprises[175]. Mortgage lending is by far the most important type of private lending in the UK. In 1996, mortgage loans accounted for no less than 42% of all outstanding lending to Britain's private sector[176]. In Germany, consumer lending also plays a dominating role in today's private banking. Since 1970, the average annual increase in consumer lending has been 11,5 per cent. In 1997, the overal outstanding consumer loans amounted to no less than DM 400bn[177].

Private lending is also an area where many complex legal problems arise. Often, these issues are summarized under the title 'lender liability'. In fact, this term can be misleading. On the one side, there are indeed situations where a lender can be held liable to a borrower with regard to the granting or running of the loan. For example, where a bank persuaded one of its financially inexperienced customers to borrow a large amount of money in order to speculate on the stock market, this may result in the bank being held liable for the loss incurred by the customer. There is also a discussion about the

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[175] The British Bankers' Association, *Annual Report 1996-97* (London 1997), at p. 29.
[176] *ibid*, at p. 29.
[177] Singer, Reinhard, 'Aufklärungspflichten (und Sittenverstöße) im Konsumkreditgeschäft', ZBB 3/1998, 141, at p. 141.

question of whether a bank should be under a general duty to inquire for what purposes a borrower requires the money.

Additionally, especially in Germany, it is argued that banks possess a moral obligation to adopt a rather strict policy in relation to the granting of loans to customers. It is said that banks should not encourage customers to take out loans which they may not be able to pay back. Consumer associations are particularly critical of the so-called 'sub-prime lending' business. Sub-prime lending is a specific type of lending where loans are granted to individuals whose bad credit records typically prevents them from obtaining any lending from High Street banks.

On the other side, there are also many situations where the bank acted incorrectly but the customer's remedy is not, strictly speaking, 'liability'. Instead, in such cases, the borrower's remedy is of a rather defensive nature such as a right to have a transaction set aside. In England, for example, a loan as well as a security attached to it, may be rendered unenforceable by undue influence, unconscionability or duress. In Germany, a loan agreement or a security can be held unenforceable under § 138 BGB and/or § 242 BGB if it violates the *Treu und Glauben* principle (good faith).

In this area, there is also the sensitive issue of third party securities. Third party securities often lead to complex legal problems because there is the risk that the debtor misrepresents facts or puts undue pressure on the third party to make the third party enter into the security agreement with the creditor. In these cases, the crucial question is in which circumstances should a bank be prejudiced by the main debtor's misconduct. In Britain, especially within the last couple of years, there has been an increase in litigation with regard to charges over matrimonial homes. In these cases the question arose in

which circumstances a spouse could have such a charge over the family home set aside against the bank because of the alleged exercise of undue influence or misrepresentation by the partner.

As the legal issues arising in connection with private lending are particularly complex, this chapter will be divided into the following three main parts. First, in Part I, the issue of a bank's duties as lender towards a borrower will be addressed. Secondly, in Part II, the bank's role in third party security cases will be examined. Part III contains a comparison of the English and German legal concepts discussed in the first two parts.

PART I:

A bank's duties in English and German law in relation to lending matters

A. English law

(1) No general duty for the bank to advise on the prudence of the borrowing

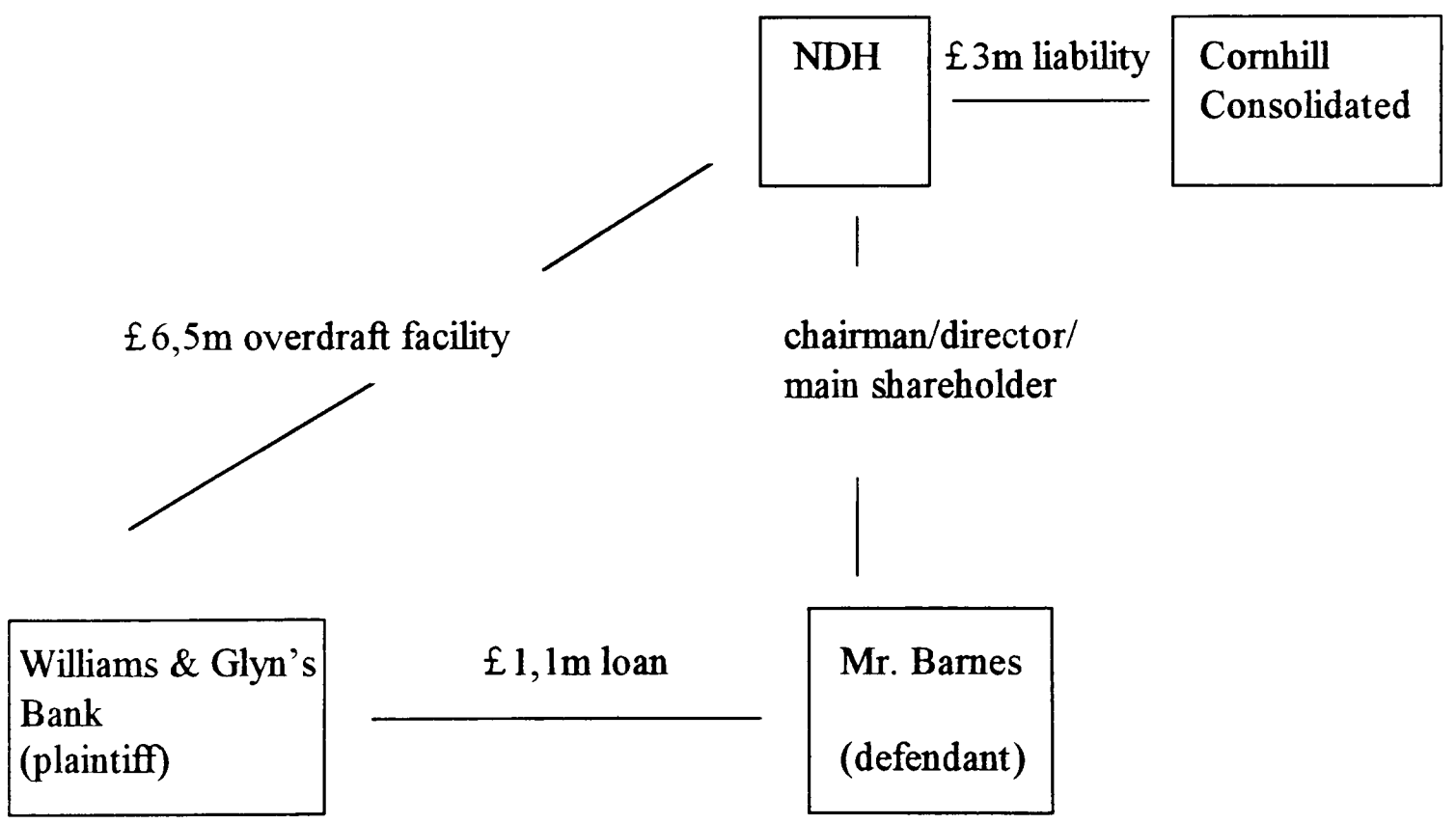
First, it should be emphasized that in English law a bank is generally not under any contractual or tortious duty to advise on the feasibility of private or commercial projects for the purpose for which it is asked to lend money. If a bank checks the details of the borrower's project with a view to decide whether or not to grant the loan, it does that for its own purposes as lender, and not for the benefit of the proposed borrower[178]. Generally speaking, English courts seem to be reluctant to recognise implied terms in an ordinary contract of loan and to place a bank under a contractual or tortious duty to advise the borrower on the prudence of the borrowing.

This attitude may be shown by the decision in *Williams and Glyn's Bank Ltd* v *Barnes*[179]. In this case, Mr. Barnes, the defendant, was the chairman, director and main shareholder in Northern Development Holdings ('NDH'). NDH was a property developer whose principal clearing bank was the plaintiff bank. In July of 1972, at Mr. Barnes' request, the plaintiff lender increased NDH's overdraft from £2,5m to £6,5m. Although the bank felt at the time that NDH's financial needs should be met by an increase in the company's equity base rather than an increase in borrowings on

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[178] Cranston, Ross , *Principles of Banking Law* (Oxford 1997), at p. 220.
[179] *Williams and Glyn's Bank Ltd* v *Barnes* [1981] Com LR 205 (QB Div.).

overdraft, it did not insist, or advise, on NDH undertaking any further equity financing. Moreover, since 1971, NDH had also raised money under a system of revolving acceptance credits which centred on a company called Cornhill Consolidated. In October 1972, the bank granted to Mr. Barnes a personal loan of £1m to enable him to buy more shares in NDH. This personal loan was secured by Mr. Barnes' shares in NDH which were held by the bank as chargee. During 1973, there was a slump in the building trade. The plaintiff bank refused to increase NDH's overdraft limit from £6,5 to £14m. In addition, in 1973, Cornhill Consolidated collapsed and NDH found itself liable to pay £3m on bills of exchange which it had drawn or accepted, although it had borrowed only £1,5m on them.



The bank agreed to lend NDH £3m to meet the bills on terms of a facility letter. In addition, the bank lent £100,000 to Mr. Barnes personally. By June 1974, NDH failed to meet its obligations towards the plaintiff bank and other creditors. In July 1974, there was a moratorium agreement, but in November 1974 other lenders party to this

agreement terminated the moratorium. In February 1976, the bank issued a writ against Mr. Barnes claiming repayment of its loans amount to £1,1m, plus interest. Mr. Barnes admitted the loans and, subject to extensive defences and counterclaims he raised, that they were due. NDH was not a party to the action.

First, Mr. Barnes tried to found his counterclaims on arguing that the bank breached its contractual or tortious duties towards NDH which also affected his loan of £1m. This was rejected by the court which stated that even if the bank breached any duty towards NDH it did not negatively affect the loan agreement between the bank and Mr. Barnes. Furthermore, even the fact that Mr. Barnes was the major shareholder in NDH did not count[180]. Obiter, Gibson J. also found that the bank in fact did not breach any duties, contractual or tortious, towards NDH. He rejected Mr. Barnes' argument that there was a 'relationship of confidentiality' between the bank and NDH to give rise to any special 'fiduciary' duties. Furthermore, taking the decision in *Hedley Byrne & Co Ltd* v *Heller & Partners Ltd*[181] into account, Gibson J. also pointed out that there was no evidence in this case that the bank did assume the role of NDH's financial adviser. Secondly, the judge refused to follow Mr. Barnes' view that the plaintiff bank did owe him a duty to advise him on the prudence of borrowing the £1m even if the bank knew or should have known that the borrowing was imprudent[182]:

> [...] no duty in law arises upon the Bank either to consider the prudence of the lending from the customer's point of view, or to advise with reference to it. Such a duty could arise only by contract, express or implied, or upon the principles of responsibility and reliance stated in Hedley Byrne, or in cases of fiduciary duty.
> The same answer is to be given to the question *even if the Bank knows or ought to know that the borrowing and application of the loan, as intended by the customer, are imprudent*[183].

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[180] *ibid*, at p. 207.
[181] [1964] AC 465 (HL).
[182] *ibid*, at p. 207.
[183] Emphasis added.

Taking all this into consideration, one may conclude that, in ordinary circumstances, a bank is under no duty to advise a customer on the prudence of the borrowing. However, there can also be situations where the bank is under a duty to advise its customer on the feasibility of the requested lending[184].

(2) Tortious duty to advise on borrowing only in special circumstances

A good example for a situation where a bank assumed responsibility for its advice on customer's lending is the decision in the Australian case *Lloyd* v *Citicorp Australia.* In this decision it was held by the Australian Supreme Court that a bank can be under a duty to draw a borrower's attention to unusual risks involved in a specific loan transaction.

In this case the defendant bank promoted to the plaintiff customer, a farmer, a foreign currency loan by stressing that it was particularly advantageous to him because of the low interest rate of such a loan. The bank did not mention to the plaintiff the risks involved in such a loan, especially the danger of fluctuations in the exchange rate. Later, the plaintiff suffered severe losses after a sharp fall in the Australian Dollar. The court ruled that the bank was under a duty to explain this risk to the plaintiff but failed to do

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[184] In this context, attention may also be drawn to the recent ruling in *Platform Home Loans Ltd* v *Oyston Shipways Ltd* [1998] 3 WLR 94 (CA). In this case the Court of Appeal found that the imprudence of a lender in deciding whether to make a loan for the purchase of a property at all is capable of amounting to contributory negligence so as to reduce the liability of a valuer to the lender for the consequences of the valuer's negligent overvaluation of the property which serves as a security for the loan. However, it remains to be seen whether this decision on the issue of a lender's contributory negligence with regard to the lender's claim for damages against a negligent property valuer may lead to a modification of the principle laid down in *Williams and Glyn's Bank Ltd* v *Barnes* which is concerned with the topic of a lender's liability towards a borrower.

so. The judges also stressed that the scope of the duty on the part of the bank as a lending advisor[185]:

> will vary with the known commercial experience of the client. It seems to me likely that the advice to be given to the treasurer of a multi-national incorporation in relation to dealing in foreign currencies will be minimal compared to that required to be given to a farmer in western New South Wales who, to the knowledge of the adviser, is entering the foreign exchange market for the first time.

In *Verity*, the notion of 'assumption of responsibility' was applied to a case where a customer asked a bank for advice on a loan matter. In this decision, the plaintiffs applied to the defendant bank for a loan. They showed the branch manager of the defendant bank their calculations concerning their plan to buy and renovate a house in order to sell it for a profit. The bank's manager carried out an external and internal inspection of the house in question, consulted his superiors, and told the plaintiffs that their project was 'viable'.

The judge found that the defendant bank had assumed the role of the plaintiff's financial adviser. In doing so, he laid particular emphasis on the bank's brochure 'Starting Your Own Business' which was given by the bank to the plaintiffs before they approached the bank with their loan application. In this brochure it was stated that 'your bank manager will help you decide how much you can really afford to invest [...] We don't help only with money. Our advice is tailor-made, confidential and free'[186]. Taking this decision into account, one may be tempted to say that some banks should be aware of the possible consequences of their advertisements. Nowadays, when one walks into a bank in England, one's attention is immediately drawn to signs offering to one the services of

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[185] per Rogers J., *ibid*, at p. 288G.
[186] *Verity* v *Lloyds Bank plc*, *The Independent* (4 September 1995) (Transpcript); also noted in: (1995) 8 C & FL 38.

the branch's 'Mortgage Adviser' or 'Loans Specialist'. Moreover, it is not uncommon to find in bank brochures which are aimed at small business owners statements such as[187]:

> [...] if you're thinking about setting up your own business, you can rely on B. to help you all the way [...] B. Business Account [gives you] access to a wide range of support services and introductions to business banking experts within the B. Group.

Although one can correctly argue that as a matter of contract law these signs and statements should be regarded as mere invitations to treat and therefore do not necessarily become part of any contractual agreements reached between the bank and the customer, they are nevertheless of some legal significance. In court, these signs and statements may also serve as an evidentiary facts when the judges need to decide whether a bank actually assumed the role of its customers financial or commerical adviser or not. In this respect, one may even argue that a bank which advertises to give 'advice' is unlikely to hesitate to actually provide 'advice' when being approached by a customer who had been attracted by such advertisments.

One may even take one further step. One may maintain that there should be a presumption that a bank which advertises to provide services of 'advisory character' typically provides 'advice' to customers and that this presumption may only then be successfully rebutted if the bank can produce documentary evidence that shows that no advice was actually given to the customer.

In my view, this is not too much to ask of banks and building societies. In the area of mortgage lending, the vast majority of lenders have already adopted the policy of stating

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[187] Barclays Bank, *Starting a business? - Let Barclays work for you* (London 1997).

to customer in writing what kind of service they have been provided. In line with the provisions of The Mortgage Code, a voluntary code of conduct drawn up by the Council of Mortgage Lenders, there are three different levels of service. First, there is the provision of information on a specific mortgage product. Secondly, there is information on the different types of mortgage products offered by the lender. Finally, at the highest level of service, there is advice and recommendation as to which of the lender's mortgage products is seen by the lender as most suitable for the customer. This recommendation is usually put in writing in a so-called 'reason-why-letter'. In this letter, the lender briefly states the reasons for recommending a specific mortgage product to the borrower.

As already mentioned abover in Chapter Two, there is a danger that banks misuse this three-tier-system by maintaining that they only give 'information' although they in fact provide 'advice' to their customers. Moreover, the practice of writing 'reason-why-letters' may even provide banks with an additional opportunity to impose their point of view upon the customer by misstating facts in the letter. Thus, one may suggest that in order to give this reason-why-letter any evidentary relevance, this letter ought to be signed by the customer who should be entitled to demand from the bank to make changes to it if it does not give an correct account of what has been said during the meeting between the bank's representative and the customer.

However, in general, one may say that the main problem area in lending appears to be in the field of lending to small businesses. The *Verity* case may serve as an example for the fact that banks are regularly approached by their small business customers who do not only want financial but also commercial advice. In such situations, a bank manager must be aware that his or her statements as to the feasibility of the customer's business may

be relied upon by the customer and may result in the bank being sued by the customer for negligent commercial advice. Thus, from a bank's point of view, the bank manager should either refrain from making any recommendations on the commercial side of the transaction in question or apply that standard of care that can reasonably be expected of an ordinary bank manager but also of an ordinary accountant or management consultant in the bank manager's position. In this context, it should be noted that in *Verity*, Taylor J. stressed that[188]

> If a bank manager undertakes to give financial advice to customers, then it seems to me that he must expect to be judged by the same standards as those applicable to other professionals who give financial advice, such as Mr Chilton Taylor [an accountant who was an expert witness in *Verity*].

Considering all this, one may still be surprised by the way English banks advertise their services to small business customers. One may wonder whether the banks are either unaware of the law in this area or deliberately ignore their legal departments' warnings in order to keep or increase their market share in the lucrative small business lending market. Obviously, the latter seems to be more likely. Furthermore, one may also say that banks which hold themselves out to be financial advisers take a carefully calculated risk. They can be deemed to be aware of the risk in law of being held liable for their negligent advice but they appear to rely on the fact that, in practice, the actual chance of being sued by a a small business customer who went bankrupt as a result of the bank's incorrect advice is limited. Usually, small business customers whose enterprises fail cannot afford to take the financial risks involved in legal proceedings against the bank.

However, attention should be drawn to the fact that the decisions in *Williams & Glyn's Ltd* v *Barnes*, *Hedley Byrne* and *Verity* were all characterized by a commercial setting.

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[188] *Verity* v *Lloyds Bank Plc*, *The Independent* (4 September 1995) (Transcript), at p. 35; see also (1995) 8 C & FL 38, at p. 39.

Most private lending cases can be distinguished from them on the grounds that the banks' customers did not ask their banks for commercial advice. However, in my view, this does not necessarily mean that banks do not owe any duties to their non-commercial customers. Where a bank advertises to help their customers with their financial affairs or to provide 'specialist mortgage advice' and then in the course of a meeting with the customer actually assumes - under the Hedley Byrne principle - the role of its customer's financial advisor, it is under a tortious duty of care to provide the advice with due care and skill.



This leaves the question of what is the exact scope of the duty of a bank which assumed the role of its customer's advisor in lending matters. In my opinion, the most fundamental duties of an 'advisory lender' can be found in the provisions of the British Banking Association's Banking Code which deal with lending. This voluntary code of conduct sets standards of good banking practice which are followed by banks and building societies which have suscribed to it[189]. Section 3.13. of this Code states that[190]:

> All lending will be subject to our assessment of your ability to repay. This assessment may include:
>
> - taking into account your income and commitments;
> - how you have handled your financial affairs in the past;
> - information obtained from credit reference agencies and, with your consent, others, for example employers, other lenders and landlords;
> - information supplied by you, including verification of your identity and the purpose of the borrowing;
> - credit assessment techniques, for example credit scoring;
> - your age;
> - any security provided.

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[189] Currently, all major High Street banks and building societies have subscribed to this Code.
[190] The British Bankers' Association, *The Banking Code* (London 1 July 1997).

It should be pointed out that this section is very carefully worded. It does not state that a bank must take these points into consideration. Instead, it states in an explanatory way that these points may be taken into account when a bank decides on a customer's loan application. In my view, the emphasis ought to be different. A bank which has decided to act as its customer's advisor in lending matters, ought to be under a duty to consider these points when advising the customer. Furthermore, another disadvantage of the Code is that it only binds its subscribers. This leads to the general question of the benefit of voluntary codes of conduct for the financial services industry. It has been argued that the UK government should introduce a statutory code of conduct for mortgage lenders[191].

Indeed, the relatively high number of 50,000 repossessions of family homes per year in Britain[192] as well as the fact that the most frequent type of complaints requiring full investigation by the British Banking Ombudsman Office in 1994-95 concerned mortgage lending, do not cast a favourable light on the UK's mortgage lenders. In the 80s, negative equity became a serious problem for many British home owners. At the height of the property boom in the mid-80s, house buyers were given loans which amounted to 90% or more of the value of the property they purchased. After a sharp fall property prices in 1988-89, they were all left with negative equity, meaning that their houses were worth less than the amount of their mortgages.

Even in 1996, there were still 2,5m property owners, actually a quarter of all mortgage holders, with insufficient equity in their houses to move[193]. Even today, it is still possible

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[191] See speech of David Hatch, Chairman of the National Consumer Council at the 9th Annual Conference of the Money Advice Liaison group on 25 November 1997 in London.
[192] *Financial Times*, 1 February 1996, at p. 8.
[193] *The Sunday Times*, 27 October 1996, at p. 17.

for first-time buyers to obtain a 100% loan. In fact, the Scottish Widows Bank offers a 110% loan to self-employed individuals who need the extra money for their businesses[194].

In contrast to this, in Germany, most house buyers do not obtain a loan which exceeds more than 60% of the value of the property which is being purchased with the loan. The reason for this is that the German *Hypothekenbanken* (mortgage banks[195]) and the *Sparkassen* (savings banks), which are the market leaders in the field of mortgage lending[196], are by law compelled to adopt a restrictive lending policy. § 11 of the *Hypothekenbankgesetz* (Mortgage Banks Act) stipulates that a mortgage bank can only grant a loan amounting up to three fifths of the value of the property. One of the main reasons behind this restrictive provision is investor protection. *Hypothekenbanken* are a specific type of banks whose business is by law limited to two sectors. On the one side, they issue and sell so-called *Pfandbriefe* (mortgage bonds) to investors. On the other side, they grant loans to the purchasers of properties. In order to protect the investors, the mortgage bonds by law must be backed up by first mortgages over properties which are purchased with the help of he loans granted.

The provisions concerning mortgage lending for Germany's regionally-based *Sparkassen* are similar. For example, § 6 of the *Richtlinien für die Bewertung von Sicherheiten im Personalkreditgeschäft* (guidelines for the acceptance of securities in the private lending business) in the federal state of Rhineland-Palatinate[197] state that a *Sparkasse* can only grant a loan which does not exceed 60% of the value of the purchased property. In this

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[194] *Financial Times*, 2 May 1998, at p. 3.
[195] *Hypothekenbanken* are a specific type of banks which issue so-called *Pfandbriefe* (mortgage bonds) which - by law -must be backed up by first mortgages over properties.
[196] *Hypothekenbanken* and *Sparkassen* had a share of 66,7% of the mortgage lending market in 1996; see Verband deutscher Hypothekenbanken, *Jahresbericht 1996* (Bonn 1997), at p. 48.
[197] Ochmann/Dietrich, *Sparkassengesetz in Rheinland-Pfalz* (6th edn. Heidelberg 1994), at p. 102.

context, attention may also be drawn to the fact that mortgage banks and savings banks are also bound to take a more conservative approach than their British counterparts when assessing the value of the properties in question[198].

As Germany's High Street banks such as Deutsche Bank, Dresdner Bank and Commerzbank generally[199] do not fall under the scope of the *Hypothekenbankgesetz*, they enjoy greater freedom when making their mortgage lending decisions. However, due to the strict provisions of the German *Kreditwesengesetz* (Banking Act) with regard to the minimum reserves of banks, German private banks have voluntarily adopted a policy of not granting mortgage loans which account for more than 80% of the value of the purchase property. Furthermore, it should be noted that, in contrast to Britain, the mortgage complaints filed with the German Banking Ombudsman do not relate to the issue of negative equity but to the issue of premature repayment of mortgage loans[200].

Considering this, one may argue that British mortgage lenders should adopt a more restrictive mortgage lending policy. For example, the Mortgage Code could contain a provision which stipulates that a mortage loan shall not exceed 90% of the value of the property which is bought with the help of the loan. Undoubtedly, this would help to reduce the numbei of repossessions in Britain because banks would not give loans to customer without some capital. On the other side, there could also be negative effects. A more restrictive lending policy could result to fewer purchases of private homes in Britain.

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[198] Thomas, Matthias, 'Immobilienwertbegriffe in Deutschland and Großbritannien', Die Bank , Heft 6, 1995, 263, at p.268: the German *Beleihungswert* of a property is decribed as being considerably lower than the English equivalent, i.e. the so-called 'Forced Sale Value'.

[199] Some German private banks have subsidiaries which are *Hypothekenbanken*. The lending done by these subsidiaries is regulated by the *Hypothekenbankgesetz*. On the other hand, some *Hypotheken-banken* have subsidiaries which are private banks whose lending does not fall under the restrictive provisions of the *Hypothekenbankgesetz*.

[200] Bundesverband deutscher Banken, *Fünf Jahre Ombudsmann* (Köln 1997), at p. 18.

Today, only 39% German households own a home or a flat. In contrast, in the UK 68% households live in their own property[201]. Of course, there are other factors which may also be seen as a cause for the significantly lower number of privately owned property in Germany. For example, German houses are typically more expensive than British homes. The average three-bedroom house costs DM 500,000 (approx. £170,000) in Germany. This means that, on average, a German needs to spend nine annual salaries to purchase a home whereas a British has to spend 'only' five annual salaries to acquire a similar home in the UK[202]. However, beside this cost argument, the German banks' restrictive lending policy can also be seen to be a cause of the lower number of privately owned properties in Germany. For most young Germans who wish to purchase property the main obstacle is still the banks' unwillingness to grant a loan unless the borrower can come forward with a substantial upfront payment.

All this should be taken into account when one makes suggestions for changes to the present British mortgage lending practice. One may ask the question whether there is sufficient political support for a more restrictive lending policy to be adopted by mortgage lenders because it would automatically result in fewer people being able to buy houses.

Additionally, banks often argue that a more restrictive lending policy constitutes an over-protective, if not paternalistic, approach which would deny a whole class of would-be buyers of homes. They also maintain that today's borrowers take an 'informed choice', suggesting that customers know exactly the financial and legal implications of their conduct. In my view, the 'informed consumer' is a myth. In practice, many

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[201] *Frankfurter Allgemeine Zeitung*, 20 April 1998, at p. 15.
[202] *Frankfurter Allgemeine Zeitung*, 11 August 1997, at p. 17.

consumers do not even understand the most basic features of complex financial products such as mortgage lending products. For example, according to a survey carried out by the National Consumer Council, only one in five consumers finds that the information currently provided on financial services products is clear and easy to understand[203]. In my opinion, customers who are given unclear or even incomprehensible information cannot be said to take an 'informed choice'. Additionally, some consumers turn a blind eye to the risks involved in extensive borrowing. They can be very naive when it comes to assessing the risks attached to a mortgage. Sometimes, borrowers do not want to contemplate the idea of what will happen if they lose their jobs or if there is a slump in the property market. Not surprisingly, this approach can lead to great disappointments.

One of the most typical disappointments in this context of extentive mortgage borrowing is the problem of negative equity. In 1996, no less than 2,6m property owners in the UK are not able to move homes due to having insufficient equity in their homes[204]. Taking all this into account, one can argue that the UK's mortgage lenders may review their lending practices. In my view, the idea of adopting a policy of granting loans only up to an amount of 90-95% of the value of the property which is bought with the help of the loan appears to be worth considering.

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[203] National Consumer Council, *Consumer Concerns 1994 - A consumer view of the personal financial services: The Report of a Mori Survey* (London 1994), at p. 10.
[204] *The Sunday Times*, 27 October 1996, at p. 17.

(3) No duty for a bank to refrain from granting a loan to a customer

Furthermore, beside the issue of assumption of responsibility by a bank, there is the question of whether there can be situations where a bank is under a duty to refrain from granting a loan to a customer. First, it may be stressed that in English law there is no such general duty because it would conflict with the notion of freedom of contract. However, there are cases where the law regards certain loan agreements as (partly) unenforceable. The most prominent example of this is section 137 of the Consumer Credit Act of 1974. Section 137 (1) states that 'if the court finds a credit bargain extortionate it may reopen the credit agreement as to do justice between the parties'. According to section 138 (1) of the Act a credit bargain is extortionate if it:

> (a) requires the debtor or a relative of his to make payments (whether unconditionally, or in certain contingencies) which are grossly extortionate, or
>
> (b) otherwise grossly contravenes ordinary principles of fair dealing.

In practice, however, English courts seem to be rather reluctant to interfere with consumer credit agreements which contain onerous terms for borrowers. For example, in *A. Ketley Ltd* v *Scott*[205] it was held that an interest rate of 12 per cent for a three month loan, which equals a nominal annual rate of no less than 48%, is not extortionate in the sense of the sections 137 and 138 of the Consumer Credit Act.

Moreover, certain business practices in the UK's so-called 'sub-prime lending' market appear to be morally questionable. A good example of the methods which are used in this area of financial services is the business activities of a company which is called Crazy George's. Crazy George's is a chain of shops which sells household goods

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[205] [1981] ICR 241 (Ch. Div.).

ranging from televisions and washing machines to upholstery and beds. The company operates a so-called 'New Buy Scheme' which offers a credit facility to customers who - due to their poor credit records - are unable to buy or rent products from other retailers.

The typical Crazy George's customer pays weekly instalments. The company only accepts cash payments which means that its customers have to come to visit their shops in person to pay the instalment once a week[206]. If a customer fails to pay there is a £2 penalty charge. The current APR rate charged by Crazy George's is 29,9 per cent. In other words, a CD player with a cash price of £407,45 purchased on the 'New Buy Scheme' by 156 weekly payments of £5,79 (which includes £3,76 for the repayment of credit and £2,03 optional service cover) would cost no less than £903,24.

Considering these figures, one may find that it is extremely expensive to be poor. Moreover, taking into account that the typical customer of Crazy George's is on low income or state benefits or a single parent on income support living in council accommodation[207] one may question the legitimacy of this form of business. In my view, as Crazy George's clearly targets unemployed consumers who are in a desperate financial situation to make a very significant profit. In my opinion, this should make one re-consider whether there should, in exceptional circumstances, a duty on the part of a lender to refrain from granting a loan to a customer.

However, the recent decision of the Court of Appeal in *Credit Lyonnais Bank Nederland NV* v *Burch*[208] (*'Burch'*) appears to show that the awareness among the

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[206] Presentation given by Steve Fell, National Debt Manager of Crazy George's, at the 9th Annual Conference of the Money Advice Liaison Group on 25 November 1997 in London.
[207] Fell, Steve, National Debt Manager of Crazy George's, 'Creditor Profile: Crazy George's' in: *Money Advice*, Issue 46 (June 1997), at p. 23.
[208] [1997] 1 All ER 144 (CA).

English judiciary for the protection of consumer interests may be increasing. In *Burch*, it was held that a bank's failure to realise that its customer is unable to meet the obligations under the contractual agreement reached between the bank and the customer may result in the unenforceability of the contract. In this case, the Court of Appeal held a third party security given by a 18 year old employee provided for the benefit of her employer unenforceable. The judges found that the bank was not only fixed with the misconduct of the employer but also stated that the terms of the guarantee agreement were so disadvantageous to the young employee that they 'shocked the conscience of the court'[209].

Although one must concede that the decisive issue in this case was the question of whether the bank was fixed with the main debtor's misconduct towards the guarantor, it is remarkable that the courts paid also much attention to the issue of unconscionability of the agreement. Considering the significant amount of caselaw developing from the landmark decision in *Barclays Bank Plc* v *O'Brien ('O'Brien')*[210], one may dare predict that there will be more rulings dealing with situations where banks should - at the time of the conclusion of the contract in question - have realised that the obligations imposed by this contract upon the customer were so onerous that the bank could not reasonably expect the customer to meet them. Thus, one may argue that the discussion about third party securities may easily take a different turn in England which could also affect the topic of a bank's general duties in loan matters.

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[209] per Millet LJ, *ibid*, at p. 152j.
[210] [1994] 1 AC 180 (HL).

B. German Law

(1) No general duty for the bank to advise on the prudence of the borrowing

First, it may be stressed that in German law a bank is generally under no contractual or tortious obligation to advise a borrower on the feasibility of the transaction for the purpose for which it is asked to lend money[211]. The main reason behind this general principle is the notion of freedom of contract. Briefly speaking, it is widely viewed as the borrower's own responsibility to decide whether to borrow money and to how to use it.

Furthermore, it is said that it is up to the borrower to compare the lending services and conditions offered by banks competing in the credit market. Borrowers are also expected to realise that any bank acts - to some degree that is generally accepted - for its own economic benefit[212]. Moreover, it is argued that a borrower can generally be expected to be able to assess his or her financial capacity and needs by him- or herself[213].

Additionally, the fact that a bank carries out a feasibility study as part of its own internal procedures does not generally lead to a duty on its part towards a potential borrower. For example, a bank's checking of the creditworthiness of a prospective borrower under § 18 *Kreditwesengesetz* (Banking Act) or a bank's assessment of the maximum sum to which property can function as a security for a loan according to § 12 *Hypothekenbankgesetz* (Mortgage Banking Act) do not automatically lead to an

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[211] Kümpel, Siegfried, *Bank- und Kapitalmarktrecht* (Köln 1995) Rdn. 2.125, at p. 61.
[212] Siol, in: Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Volume I, Rdn. 13, at p. 790.
[213] See OLG Frankfurt/Main (20.06.1996) WM 1998, 337, at p. 339.

obligation of the bank towards its customer to advise him or her on the feasibility of the lending[214].

In this context, the decision in OLG Köln WM 1997, 472[215] may serve as an example to describe how reluctant German courts can be to place a bank under an obligation to warn a borrower about the risks of a loan arrangement. In this case it was held that the plaintiff bank which granted a loan to the defendant couple for the renovation of their home was under no duty to check the feasibility of their building project. The couple presented the bank with a detailed list of their financial situation and a report drawn up by their architect.

Relying on the defendants' own statements as well as on the architect's figures, the bank granted them the requested loan. Subsequently, it turned out that the architect's report understated the real costs of their project. Moreover, the couple separated and their income decreased significantly so that they failed to meet their obligations. The bank successfully brought an action for possession of the couple's property.

The court found that only in exceptional cases a bank was under an obligation to advise a borrower on the feasibility of a loan. The judges stressed that the separation of the couple and the subsequent fall in their income were general risks which belonged to the sphere of the defendants and for which the bank did not carry any responsibility. Furthermore, the court pointed out that the fact that the architect's report proved to be inadequate could not be held against the bank[216]:

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[214] Siol, in: Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Volume I, Rdn. 15, at p. 790.
[215] OLG Köln (12.07.1996) WM 1997, 472.
[216] *ibid*, at p. 473.

> The plaintiff [bank] cannot be blamed for the fact that the [architect's] report turned out to be unrealistic. The obligations of a bank would be extended too far if, in the context of a loan agreement, one required it to scrutinize the details of a report on the renovation of a property which was presented to it by the borrower. It is primarily up to the borrower and property owner to safeguard his own interests.

Moreover, in OLG Saarbrücken WM 1995, 54[217] it was held obiter that a bank was generally under no duty to warn a financially not inexperienced borrower even if it was aware that the borrower's transaction contained a unusually high risk. In this decision, the plaintiff bank granted the defendant borrower a loan of DM 20,000. The agreement reached between the bank and the customer described the transaction as a 'loan application for the purpose of a purchase'. In fact, the defendant deposited the sum with a small firm called EVP specializing in private investment schemes. The contract he entered into with EVP stipulated that the profits gained by the defendant's investment would be used to pay back the loan to the plaintiff bank.

Soon after this, EVP went bankrupt and no more instalments were being paid to the plaintiff bank. The bank terminated the loan agreement and requested the defendant to pay back the loan. The defendant argued that the bank had known about his investment plans and had failed to warn him about the high risks involved in this transaction.

The court rejected the defendant's arguments by stressing that he failed to prove that the bank had knowledge of the purpose for which he obtained the loan. The fact that the documentation of the agreement reached between the bank and the defendant was headed 'loan application for the purpose of a purchase' turned out to be crucial in this case. The judges found that this title strongly supported the bank's argument that it had reason to assume that the defendant would use the money for the purchase of a

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[217] OLG Saarbrücken (25.10.1994) WM 1995, 54.

consumer good but not for speculating on the stock market. However, beside this question of burden of proof, it is probably more interesting to note that in their ruling the judges, obiter, emphasized that[218]:

> [...] even if the bank had complete knowledge [of the borrower's true intentions], liability under the concept of *Culpa in contrahendo* would be extremely unlikely; because it is primarily the borrower's own business to decide for what he uses the loan and, therefore, one would not assume that a bank was under a duty to prevent the borrower from risky transactions with a third party.
>
> A bank's duty to advise can naturally only exist in connection with an agreement that is reached with the bank itself, otherwise the scope of a bank's obligations would be boundless.

Taking this statement into consideration, one may conclude that German courts appear to be rather reluctant to impose on banks a duty to warn and inform borrowers on the feasibility of a loan arrangement unless the bank leaves its rather static position as traditional money lender and progesses to assume a more active role either as a financial intermediary between the borrower and a third party or as the borrower's investment adviser.

(2) Duty to warn and advise on the borrowing only in special circumstances

However, a bank may be under a duty to warn or advise a borrower on the implications of a loan agreement if one of the following cases can be established:

(a) the borrower is financially significantly inexperienced

(b) the bank has knowledge of concrete facts which are not accessible to the customer (*Konkreter Wissensvorsprung*)

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[218] *ibid*, at p. 54.

(c) the bank functions not only as lender but also as a 'match-maker' between the borrower and a third party

(a) Financially significantly inexperienced borrower

As already mentioned above, a bank is typically not under an obligation towards a prospective borrower to inquire about his or her financial experience and capacity. However, if the bank realises that its customer has a very limited understanding of the financial matter in question, it may be under a duty to explain not only the nature but also the risks of the proposed loan arrangement. In the extreme case, this duty can also oblige the bank to refuse to grant a loan to a financially inexperienced borrower if the bank, based on the information received from the borrower, reaches the conclusion that the envisaged transaction would pose an unacceptable risk for the borrower.

For example, in BGH WM 1997, 662[219] a bank was held liable where it had persuaded a financially inexperienced customer to take out a loan for the purpose of stock market speculations. In this case, in 1985, the plaintiff, a jewellery dealer, approached the defendant bank for advice on the investment of DM 80,000. Following the recommendation of the bank's investment adviser, the plaintiff bought shares of several companies listed at the German stock market. In June 1987, the bank's investment adviser told the plaintiff that 'if you want to make real money, you must risk much more' and suggested to him to take out a loan of DM 1 million for the purpose of stock market speculations. The plaintiff's property was supposed to serve as security for the loan.

[219] BGH (28.01.1997) WM 1997, 662.

The plaintiff accepted the bank's offer and signed a document that stated that the sum lent to him would be used 'for the purchase of fixed interest bonds and German standard shares'. In fact, on the recommendation of the bank's adviser, the plaintiff purchased shares and bonds carrying a much higher risk. In autumn 1987, there was a sharp fall in the stock market and simultaneously a significant rise in the interest rates. The plaintiff was forced to sell its shares at a loss of DM 626,000. The bank brought an action for possession of the plaintiff's property, the plaintiff a counterclaim against the bank for damages. The court found that the bank had provided the plaintiff with inadequate advice when it had recommended to him to engage in stock market speculations on loan[220]:

> The defendant, through its investment adviser, induced the holder of a deposit account, that was carefully built up by his own steady contributions, to take out a loan exceeding his own financial capacity by far in order to finance stock market speculations recommended by the investment adviser.
>
> Whilst the bank had a guaranteed income generated through interest payments as well as commission fees related to the plaintiff's stock market transactions, the failure of the plaintiff's investment was almost certain in the event of rising interest rates and falling share prices.
>
> Under these circumstances, the defendant should not have recommended to the - according to the findings of the lower court - *inexperienced*[221] plaintiff stock market speculations on credit.

Considering this decision, one may be inclinced to state that it is contradictory to the ruling in OLG Saarbrücken WM 1995, 54 where it was held obiter that a bank, even if it knew about the risks involved, was under no duty to discourage a borrower from taking out the loan for the transaction in question. However, there is one difference between these two rulings. In OLG Saarbrücken WM 1995, 54 the court regarded the defendant as having sufficient financial expertise to be able to assess the risks he was taking. In

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[220] *ibid*, at p. 663.
[221] Emphasis added.

contrast to this, in BGH WM 1997, 662 the judges found that the customer was not able to understand the dangers of the transaction he was being talked into by the bank.

Furthermore, in BGH WM 1997, 662 the bank undertook to recommend to the borrower a certain type of investment whereas in OLG Saarbrücken WM 1995, 54 the bank had not provided the borrower with any specific recommendation as to how to use the money. Nevertheless, both decisions highlight how difficult it often is to draw the line in these cases. The fact alone that in BGH WM 1997, 662 the court viewed the plaintiff as 'inexperienced' although he was a well established jewelry dealer cast a shadow over the stringency of the line of argumentation taken by Germany's highest court and, above all, undermine the need for a greater need for predictability of its rulings in this area of the law[222].

(b) The bank having knowledge of concrete facts which are not accessible to the customer ('Konkreter Wissensvorsprung der Bank')

Nowadays, banks tend to acquire a detailed knowledge of their customers' financial affairs. This may lead to situations where they can be in a very good position to judge the prospects of one of their borrower's projects. However, as already mentioned above, there is usually no duty to scrutinize the feasibility of the purpose for which the borrower requires the money. Nevertheless, if the bank comes across specific facts that indicate that the project for which its borrower requests a loan is doomed to fail, it may be under a duty to discourage its customer from going ahead with his or her plans. For

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[222] For a more detailed discussion of the duties of a banks towards financially inexperienced borrowers see Singer, Reinhard, 'Aufklärungspflichten (und Sittenverstöße) im Konsumentenkreditgeschäft', ZBB 3/1998, 141, at pp. 144-146.

example, if a bank is aware of the fact that a business partner of its customers is about to go bankrupt, then the bank may be obliged to inform its customer about this.

For example, in BGH NJW 1991, 693[223] the plaintiff was interested in investing in a construction a property development undertaken by C-company. The plaintiff authorized the C-company to 'take all necessary steps in relation to the investment including the application for a loan'. Acting upon this authoriziation, the C-company successfully applied in the name of the plaintiff to the defendant bank for a loan of DM 42,000 to finance the plaintiff's investment. The defendant bank granted this loan, although it knew that the C-company, which it had given a loan of DM 60 million, was on the verge of bankruptcy.

The court found that, considering the bank's detailed inside knowledge of the state of affairs of the C-company, the bank was under an obligation to inform the plaintiff about the poor financial standing of the C-company. Furthermore, the judges stressed that the bank's duty to disclose the actual financial situation to the plaintiff was not set aside because of the bank's duty of secrecy owed to its other debtor involved in the transaction, i.e. the C-company. In this case, the court held that the bank could have simply told the C-company, which approached it for a loan for the plaintiff, that it was not prepared to grant a loan to the plaintiff unless the C-company disclosed its poor financial situation to him[224].

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[223] BGH (27.11.1990) NJW 1991, 693.
[224] *ibid*, at p. 694.

(c) Bank functioning not only as lender but also as a 'match-maker' between borrower and a third party

Banks which have detailed understanding of their customers' financial affairs also often do not hesitate to use their knowledge to act as 'match-makers' between them. For example, they bring together a customer who seeks money with another of them who wants to invest money. In these situations, there arises the question to what extent a bank should be obliged to inform the investor about the financial standing of the borrower and the risks involved in the transaction.

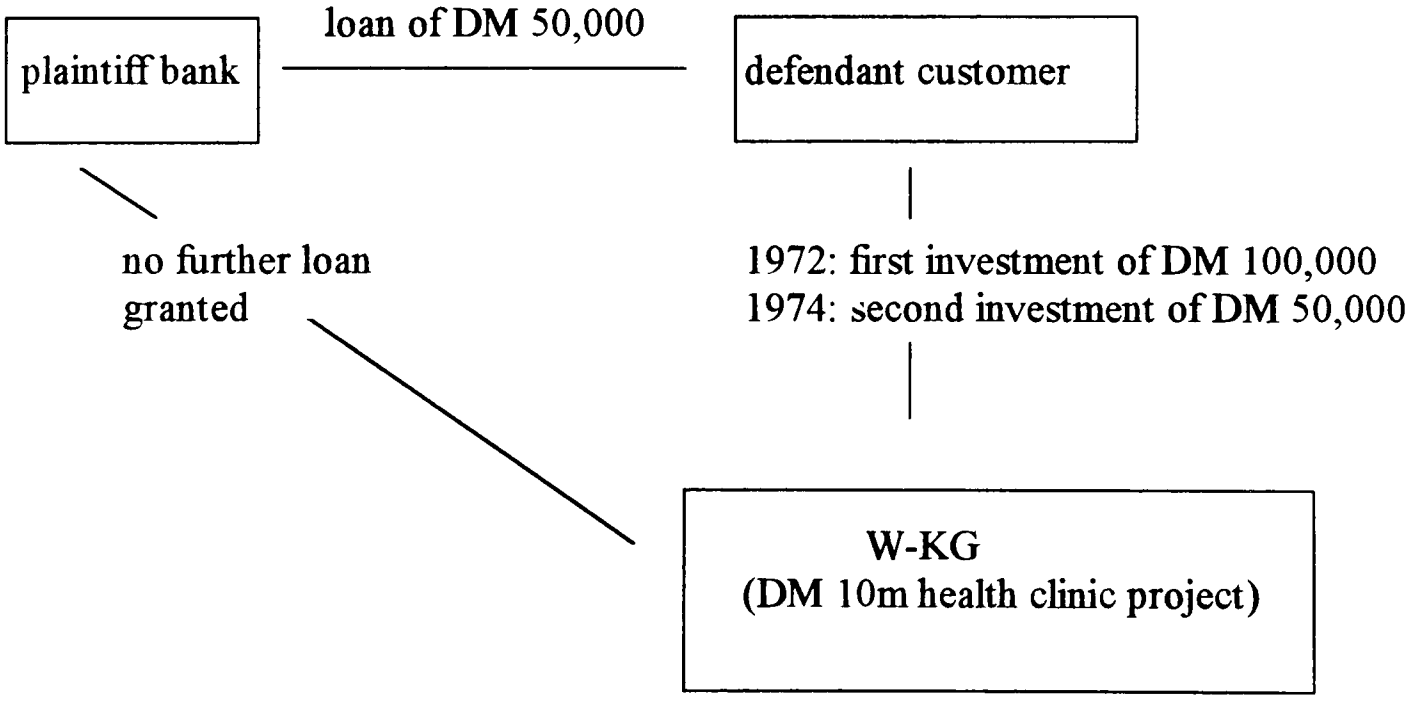
A good example of the legal issues typically coming up in these cases is the decision in BGH NJW 1978, 2547[225]. In this case, in 1972, the defendant invested DM 100,000 in a company called W-KG. This company was involved in the construction of a health clinic costing DM 10 million. The company's project was financed by the plaintiff bank's loan of DM 6 million and further four million Deutschmarks coming from private shareholders.

In 1973, the W-KG faced severe financial difficulties. At a shareholder meeting the plaintiff bank's representatives stated that the bank was not prepared to extend W-KG's loan facilities and made it clear that at least further DM 1,4 million were needed to enable W-KG to finish its project. The bank also offered to give out loans to the shareholders to finance their further investments in the W-KG. At the meeting, the shareholders agreed to accept the bank's offer under the condition that the loans were only then to be transferred to the W-KG if it was ascertained that the project would be

[225] BGH (29.05.1978) NJW 1978, 2547.

finished. In February 1974, the defendant applied to the plaintiff bank for a loan of DM 50,000.

In March 1974, the plaintiff bank told him that it accepted his application and would 'immediately transfer the sum of DM 50,000 to the W-KG'. At this time, the bank knew that the shareholders' loan applications amounted in total to DM 700,000, i.e. only half of what was needed to rescue the project. Only one month later, in April 1974, the plaintiff bank terminated all loan agreements with W-KG resulting in the company's collapse. Subsequently, the plaintiff bank brought an action against the defendant demanding him to pay back the loan of DM 50,000.



In its decision, the court stressed that a bank was generally under no obligation to warn its customers about risks involved in the transactions they enter into with each other. However, the judges also pointed out that a bank can, in exceptional circumstances, be under a pre-contractual or collateral obligation to look after its customers' financial interests.

In BGH NJW 1978, 2547 the court held that the plaintiff bank did not only act as a 'money transfer facility' but also became involved in the decision-making process of its customers. Moreover, the plaintiff bank was the main creditor of the W-KG. Therefore, the bank had a substantial economic interest in the subject matter of the transaction made between its customers. Additionally, the bank's representatives had appeared at the W-KG's shareholder meeting recommending to the shareholders to invest more money into the company. Thus, the judges held that:[226]

> Considering the economic interests of all parties concerned, and especially the fact that the bank recommended the shareholders to take out loans to be used to support the W-KG, the bank was under a duty to look after its customers' financial interests to a much greater extent than usual.

The court ruled that, in this case, the bank failed to fulfil pre-contractual as well as collateral obligations. First, the bank did not meet its obligation under the concept of *Culpa in contrahendo* to warn the defendant appropriately about the extremely high risks involved in any further investement in W-KG. Secondly, the bank breached its collateral obligation according to the concept of *Positive Vertragsverletzung* to look after the defendant's economic interests when transferring the loan of DM 50,000 to the W-KG although it was not secured that the W-KG could actually finish its building project. As a result of the bank's misconduct the defendant was entitled to a counterclaim against the bank for damages. The court awarded the defendant damages equalling the bank's claim of DM 50,000 so that the bank's action brought against the defendant was rejected.

Another example for this view taken by the courts is the more recent decision in BGH WM 1990, 921[227]. In this case, in 1981, the plaintiff took out a loan of DM 155,000

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[226] *ibid*, at p. 2547.
[227] BGH (24.04.1990) WM 1990, 921.

from the defendant bank to become a partner in a construction project run by the T-KG. There was a very close business relationship between the T-KG and the defendant bank, a cooperative local bank. The T-KG was member of the defendant bank, holding a share of DM 300,000. Furthermore, the defendant bank had previously granted several substantial loans to the T-KG. In 1981, the T-KG owed to the bank DM 1.3 million. In addition, the defendant bank granted the T-KG another loan totalling DM 3.8 million without which the T-KG would not have been able to start with its new construction project. In 1985, the T-KG went bankrupt, the construction project collapsed and the defendant bank terminated the loan agreement with the plaintiff. The plaintiff brought a counterclaim for damages.

The court found that the defendant bank violated its pre-contractual duties under the concept of *Culpa in Contrahendo* by failing to inform the plaintiff about the financial standing of the T-KG in 1981. The judges stressed that in situations where 'a lending bank is exposed to a considerable conflict of interest due to its role as creditor to the construction company as well as creditor to individual investors'[228] it is under a duty to warn a borrower about the risks of this project.

Referring to the facts of the case, the court found that in 1981, the defendant bank had - through its position as creditor of the T-KG - a very detailed knowledge of the poor financial standing of the T-KG. At that time, the T-KG was practically insolvent. The realisiation of the new construction project of T-KG depended entirely on the provision of a DM 3,8 million loan given by the defendant bank to the company. Furthermore, the bank knew that, at this stage, the T-KG had not found enough investors to guarantee the

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[228] *ibid*, at p. 922.

completion of the project. All this, the court found, the bank was obliged to disclose to plaintiff but failed to do so.

Taking all this into account, one may summarize that where a bank acts as a 'match-maker' between a borrower and a third party it it is likely to be placed under pre-contractual or collateral obligations to warn its customers about risks involved in such a transactions if[229]

> (i) the bank is involved in the decision-making process of its customers and this involvement becomes apparent to outsiders
>
> (ii) the bank itself has a not unsubstantial economic interest in the transaction
>
> (iii) the bank has detailed knowledge not only of its customers' financial affairs but also of the project for which the money is borrowed and makes use of this knowledge to its own benefit.

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[229] See Siol in: Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Bank I, Rdn. 28-29, at p. 793.

PART II:

Third party securities

Especially in the field of traditional banking, it is quite common that a bank is asked to advise, often on the very same matter, two or more of its customers between whom there is a strong family or emotional tie. Typically, such cases involve a wife, who, as result of her husband's unfair pressure or misrepresentations, provides third party loan security (usually over the matrimonial home) to a creditor for her husband's business borrowings. In this situation, there regularly arises the question of what circumstances necessitate a bank's warning its customers about the risks involved in the matter.

A. English law

(1) The equitable concepts of undue influence and misrepresentation

Under the English law's concepts of undue influence and misrepresentation the person who has been induced to enter into an agreement by undue influence or misrepresentation by the other contractual party is entitled to have the agreement set aside *against the wrongdoer*. However, in these husband/wife cases the situation is different. There, the bank itself is not involved in the exercise of undue influence or the misrepresentation of facts. It is the plaintiff's partner who applies undue influence or misrepresents facts to induce the plaintiff to enter into an agreement with the bank.

Thus, in these situations the crucial question is which of the 'innocent' victims (the surety or the creditor) should pay for the partner's misconduct[230].

(a) Actual undue influence

Actual undue influence is generally defined as any kind of improper pressure not amounting to duress due to a lack of physical violence. *Bank of Credit & Commerce* v *Aboody* (*'Aboody'*)[231] gives a good example of what in English law is seen as actual undue influence exercised by one spouse against another. In this case, the plaintiff, Mrs. Aboody, was an Iraqi educated in Baghdad in a very traditional way. At the age of seventeen a marriage was arranged for her and she subsequently moved to Britain. Her husband went into business and she became nominally a director and secretary of Eratex Ltd., the family business. She did not understand the business and it was routine for her to sign whatever her husband asked her to sign in relation to Eratex Ltd.

At some point Mr. Aboody applied for a substantial loan for the family business. The bank insisted on a charge over the matrimonial home that was solely owned by Mrs. Aboody. The bank also wanted Mrs. Aboody to obtain independent advice before signing the required documents. Thus, the bank arranged for Mrs. Aboody to see a solicitor on the bank's premises. Mr. Aboody, however, told his wife that she had to go to the bank to have her signature witnessed by a solicitor. He did not mention that the solicitor would provide her with advice. When the solicitor tried to discuss the matter with her she stated that she only came to sign the documents and did not need any advice. Whilst their meeting went on, Mr. Aboody burst into the room uninvited and in a

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[230] Fehlberg, Belinda, 'The Husband, the Bank, the Wife and Her Signature - the Sequel' (1996) 59 MLR 675, at p. 675.
[231] [1990] 1 QB 923 (CA).

high state of excitement and shouted at the solicitor: 'Why the hell don't you get on with what you are paid to do and witness her signature?'. There followed a scene which so distressed Mrs. Aboody that she was reduced to tears and signed the document[232].

In *Aboody*, the court held that the husband's conduct amounted to actual undue influence. Nevertheless, the judges ruled that the wife was not entitled to have the charge over the family home set aside against the bank because the charge was not a 'manifest disadvantage' to her as she profitted from her husband's company, too. In the more recent decision in *CIBC Mortgages plc* v *Pitt* (*'Pitt'*)[233] the requirement of a 'manifest disadvantage' was dropped. In this case, Mr. and Mrs. Pitt applied for a loan from their bank telling the bank that they would use the money to purchase a holiday home. In fact, the loan was used (to the knowledge of the wife) by her husband, who had exercised actual undue influence upon his wife to make her sign the documents, for the purpose of his stock market speculation. In *Pitt*, the House of Lords held that if actual undue influence is exercised by one partner it is not necessary to show that the relevant transaction was manifestly disadvantageous to the other partner who wants to have it set aside against the bank. In this ruling Lord Browne-Wilkinson stressed that[234]:

> Actual undue influence is a species of fraud. Like any other victim of fraud, a person who has been induced by undue influence to carry out a transaction which he did not freely and knowingly enter into is entitled to have that transaction set aside as of right [...] I therefore hold that a claimant who proves actual undue influence is not under the further burden of proving that the transaction induced by undue influence was manifestly disadvantageous: he is entitled as of right to have it set aside.

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[232] [1990] 1 QB 923 (CA), at p. 952A/B.
[233] [1994] 1 AC 200 (HL).
[234] *ibid*, at p. 209B.

(b) Presumed undue influence

Generally speaking, the presumption of undue influence arises where there is a very special relationship between the parties. In short, the concept of presumed undue influence says that an agreement reached between parties is deemed - in certain circumstances - to have been entered into by one party under the undue pressure exercised by the other party. This presumption may then be rebutted by showing that the transaction was entered into 'only after full, free and informed thought about it'[235].

There are two types of presumed undue influence. Both give rise to a fiduciary duty of care on the part of the stronger party. First, there is a status-based[236] presumption of undue influence ('class 2A'[237]). There are certain well established types of relationships which automatically give rise to a the presumption of undue influence. Among these are the relationships between parent and child, doctor and patient, solicitor and client, and trustee and beneficiary[238]. However, it must be emphasized that the ordinary bank/customer relationship does not belong to this category of status-based presumption of undue influence.

Secondly, there is a fact-based[239] presumption of undue influence ('class 2B')[240]. Here, it is open to the plaintiff to establish facts which create such a relationship of 'confidentiality and trust'. In the area of banking, it must be stressed that such a relationship of trust and confidentiality does not usually exist in the ordinary bank/customer relationship. To give rise to such a relationship of confidentiality there

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[235] per Lord Evershed MR in: *Zamet* v *Hyman* [1961] 3 All ER 933 (CA), at p. 938C.
[236] Southern, David 'The Liability And Duties Of Banks to Private Customers', (1996) BIJB 224, p. 225.
[237] per Lord Browne-Wilkinson in: *Barclays Bank Plc* v *O'Brien* [1994] 1 AC 180 (HL), at p.189F-G.
[238] per Nourse LJ in: *Goldsworthy* v *Brickell* [1987] 1 All ER 853 (CA), at p. 865d.
[239] Southern, David, 'The Liability And Duties Of Banks To Private Customers', (1996) 5 BJIB & FL 224, at p. 225.
[240] per Lord Browne-Wilkinson in: *Barclays Bank Plc* v *O'Brien* [1994] 1 AC 180 (HL), at p.189G-H.

must be a significant element of inequality of bargaining power between bank and customer in addition to a distinct lack of business experience on the side of the customer. The leading case in this area, *Lloyds Bank Ltd* v *Bundy*[241] (*'Bundy'*), may serve as an example to show what is required to establish such a relationship of confidentiality. In this case, the defendant, an elderly farmer, and his only son, had been customers of the plaintiff bank for many years. The son's company developed an overdraft and he asked his father to give a guarantee for this overdraft.

After consulting his solicitor, the father gave a guarantee of £5,000 and agreed to have a charge of £3,500 on his farm. Three years later, the son's company needed more money. The son visited the defendant together with the defendant bank's manager, Mr. Head, who had with him a further guarantee and a further charge ready for signature. Mr. Head stated that the bank had given serious thought as to whether they could continue to support the son's company. But that the bank were prepared to do so if the father gave a guarantee of the company's account a amounting to £11,000 and to give the bank a further charge of £3,500. On hearing the proposal, the father said that he was 100 per cent behind his only son. He signed the documents presented to him by the bank manager. The father said later in evidence[242]:

> I always thought Head was genuine. I have always trusted him [...] No discussion how business was doing that I can remember. I simply sat back and did what they said.

Only a couple of months later, after a receiving order had been made against the son, his company ceased to trade. The bank insisted on the sale of the house and brought proceedings to evict the father. At first, the court had to determine whether there was a

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[241] [1975] 1 QB 326 (CA).
[242] *ibid*, at p. 336B.

relationship of trust and confidentiality between the father and the bank that could give rise to special duties on the part of the bank. Lord Denning M.R.felt it was necessary to state the general principle that in the vast majority of cases a customer who signed a bank guarantee or a charge could not get out of it[243]. However, in *Bundy*, the court ruled that there was such a relationship of confidentiality between the bank and Mr. Bundy.

The judges stressed that the *Bundy* case had to be assessed in the light of the general background of the relationship between them that had built up over years and in the course of which the senior officials of this country bank branch had become trusted councillors of Mr. Bundy. The court also said that such a situation was not uncommon in provincial and country branches of banks where trust was often placed because of a combination of status, goodwill and knowledge.

In addition, the prominent role of the bank in the crucial family meeting where the father was persuaded to sign the documents prepared by the bank were of great significance. Sir Eric Sachs characterized Mr. Bundy's situation at this meeting as follows[244]:

> The situation was thus one which to any reasonably sensible person, who gave it but a moment's thought, cried aloud Mr. Bundy's need for careful independent advice.

In *Bundy*, the judges ruled that the defendant bank was under a duty to disclose to the customer that there was a conflict of interest and not to make any uncovenant profit at the expense of the the customer. In fact, the court described the bank's duty towards Mr. Bundy as 'fiduciary'[245]. However, this terminology used by the court might be

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[243] *ibid*, at p. 336F.
[244] *ibid*, at p. 345D.
[245] per Sir Eric Sachs, *ibid*, at p. 345G.

criticized as misleading because, in this context, an English lawyer would be inclined to associate with 'fiduciary duties' the law of trust or agency. In English law, a trustee is generally under fiduciary duties towards a beneficiary. A trust is commonly defined as a situation where a person has property or rights which he holds or is bound to exercise for or on behalf of another or others, or for the accomplishment of some particular purpose or particular purposes[246].

As in the *Bundy* case the bank's position could clearly not be compared with that of a trustee or agent, the phrase 'fiduciary duties' should not have been used by the court in this case. Instead, the judges should have rather resorted to more neutral terminology such as 'special duties' to describe the obligations arising on the part of the defendant bank in this case. The court also stressed that the defendant bank could have fulfilled these 'special duties' if it had suggested to Mr. Bundy to seek independent legal advice to enable him to make a decision after 'full, free and informed thought'. As the defendant bank failed to do so, the judges held that Mr. Bundy was entitled to have the guarantee and charge set aside against the bank.

To sum up, one may say that situations where a bank is placed under 'special duties' are very rare. Only in exceptional cases where there is an extraordinarily close relationship between the bank and the customer such 'special duties' may arise. Furthermore, English courts appear anxious to limit the scope of these 'special duties'. For example, in *Bundy* Sir Eric Sachs emphasized[247]:

> [...] it seems necessary to point out that nothing in this judgment affects the duties of a bank in the normal case where it is obtaining a guarantee, and in accordance with standard practice explains to the person about to sign its legal effect and the sums involved.

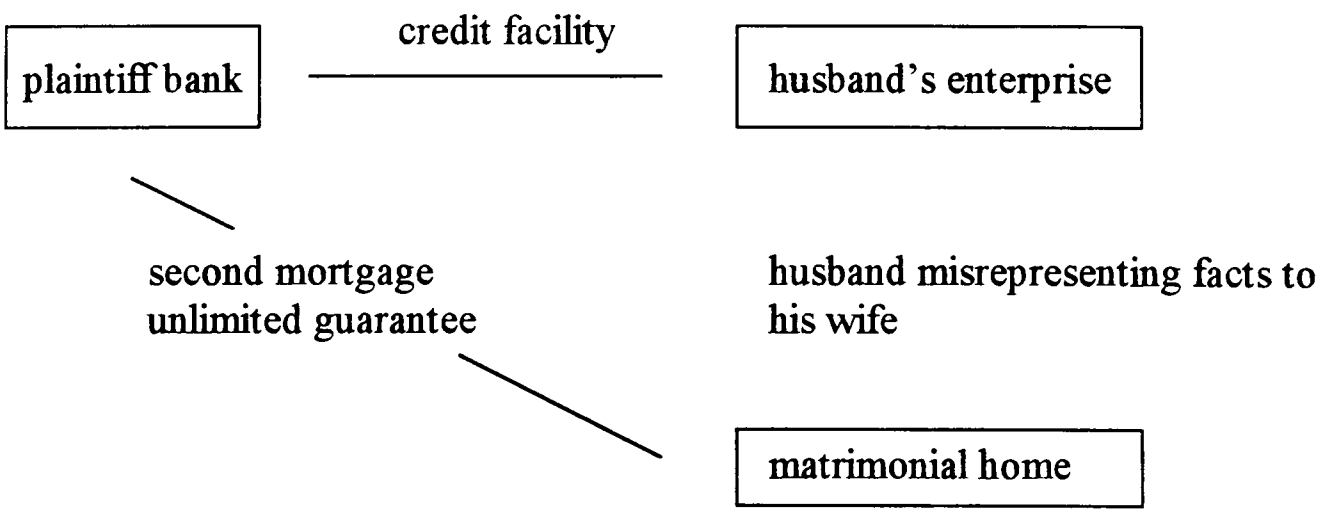
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[246] Halsbury's Laws of England (4th edn. London 1995), Volume 48: Trusts, Para 501, at p. 248.
[247] *ibid*, at p. 347C-D.

> When, however, a bank, as in the present case, goes further and advises on more general matters germane to the wisdom of the transaction, that indicates that it may - not necessarily must - be crossing the line into the area of confidentiality so that the court may then have to examine all the facts including, of course, the history leading up to the transaction, to ascertain whether or not that line has, as here, been crossed.

However, in cases where a bank is placed under 'special duties' it can usually fulfil its duties by disclosing the conflict of interest to the customer and suggesting him or her to seek independent legal advice. Nonetheless, it ought to be stressed that the ruling in *Bundy* was very exceptional. In *Bundy*, in contrast to the more recent decision in *Barclays Bank plc* v *O' Brien*[248] (*'O'Brien'*), the court found that there existed a relationship of trust and confidentiality directly between the bank and the customer.

In *O'Brien*, the situation was different. In this case, there was no relationship of confidentiality between the bank and the wife who signed the legal charge over a matrimonial home but between the husband and the wife. Here, the crucial legal question in *O'Brien* was whether the bank was prejudiced by the husband's misconduct toward his wife with regard to the transaction in question.



[248] [1994] 1 AC 180 (HL).

In this case, the first and the second defendant, husband and wife, agreed to execute a second mortgage of their matrimonial home as security for overdraft facilities extended by the plaintiffs bank to a company in which the husband, but not the wife, had an interest. The husband falsely told his wife that the charge on the house was to secure only £60,000 that even this liability would be released in a short time when the house was remortgaged. In fact, the documents signed by the couple guaranteed the payment and discharge of 'all monies and liabilities now and hereafter due owing or incurred by [the husband's company]'. In short, it was an unlimited guarantee.

First, the judges considered whether the husband's conduct constituted a misrepresentation. In English law mispresentation is defined as a false statement of fact made by one party to a contract to mislead and induce another party to enter into the contract. There are three types of misrepresentation: fraudulent, negligent and innocent. The court found that the husband's statement was a false statement of fact material enough to induce the wife to sign the documents. Furthermore, the court ruled that in this case the husband's misprepresentation was also intended to be acted upon by the wife. Thus, the House of Lords found that the husband's overall conduct constituted fraudulent misrepresentation. Taking all the decision in *O'Brien* as well as other subsequent decisions into account, one may summarize that the following four main requirements must be fulfilled to have a third party security set aside against a bank for misrepresentation or undue influence:

> (i) it must be established by the plaintiff that his or her partner[249] exercised undue influence or misrepresented facts;
>
> (ii) the bank must be linked with the partner's wrongful conduct either on the basis of the actual knowledge, the 'agency theory' or the 'doctrine of constructive notice';

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[249] In *Barlcays Bank plc* v *Rivett* [1997] 29 HLR 893 (CA) the Court of Appeal expressly confirmed that the O'Brien principle applies equally to either husband and wife.

> (iii) in cases of misrepresentation and presumed undue influence it must also be ascertained that the transaction was 'manifestly disadvantageous' to the plaintiff;
>
> (iv) the bank must have failed to take 'reasonable steps' to inform the plaintiff about the risk involved in the transaction in question.

(i) Exercise of undue influence or misrepresentation by the partner

It must be proved by the plaintiff that he or she was exposed to actual or presumed undue influence or misrepresentation by his or her partner when entering into the agreement with the bank. English law does not view the relationships between husband and wife or cohabitees belonging to the category of 'status-based' presumption of undue influence ('class 2A') where a fiduciary duty automatically arises. Thus, it is open to the pressured partner to establish facts which create a 'relationship of confidentiality' giving rise to a 'fact-based' presumption of undue influence ('class 2B'). In *O'Brien*, Lord Browne-Wilkinson stated in which circumstances such a relationship of confidentiality can arise in a marriage[250]:

> [...] it should be emphasized that in any particular case a wife may well be able to demonstrate that de facto she did leave decisions on financial affairs to her husband thereby bringing herself within Class 2(B) i.e. that the relationship between husband and wife in the particular case was such that the wife reposed confidence and trust in her husband in relation to their financial affairs and therefore undue influence is to be presumed.

Thus, one may summarize that a relationship of confidentiality may typically be established between spouses or cohabitees where one party deals (more or less) exclusively with financial matters concerning both, one partner has no interest in these matters and has complete confidence in the other's dealings and simply signs everything when being told to do so. This approach taken by English courts has been criticized as

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[250] [1994] 1 AC 180 (HL), at p. 190D.

requiring a wife who gave third party security 'to fit herself within a stereotype of the down-trodden and uninformed housewife'[251] in order to enhance the prospects of her action against a bank.

(ii) The bank's link with the partner's misconduct

It must also be established that there was some kind of link between the bank and the partner's wrongful conduct. This link can be ascertained in the following three ways: actual knowledge, the agency theory and the doctrine of constructive notice.

Actual knowledge

If the bank has actual knowledge of the partner's wrongful behaviour it is fixed with it. Furthermore, in *Aboody*[252] it was also held that a bank could be fixed with the actual knowledge of a solicitor it had instructed to give independent legal advice to the partner who had been exposed to the other partner's misconduct. In *Aboody*, the bank had arranged for a meeting between a solicitor and the plaintiff on the bank's premises. There, the solicitor witnessed the exercise of actual undue influence by Mr. Aboody against his wife, the plaintiff. The court found that since the solicitor had been instructed by the bank, there was a contract concluded between the bank and the solicitor and the bank had informed the solicitor about the background of the transaction in question, the bank was fixed with the solicitor's knowledge of the husband's misconduct.

The judges stressed that the bank had asked the solicitor to assist them in this transaction and expected the solicitor to report to them any circumstances that could

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[251] Fehlberg, Belinda, 'The Husband, the Bank, the Wife and Her Signature - the Sequel', (1996) 59 MLR 675, at p. 679.
[252] *Bank of Credit and Commerce International S.A.* v *Aboody* [1990] 1 QB 923 (CA).

make it unsafe for the bank to rely on the legal charge signed by the plaintiff. The solicitor failed to do so, but this did not speak against the bank being fixed with his knowledge. The bank had relied on his services and therefore had to bear the consequences of this reliance[253].

Furthermore, in *Steeples* v *Lea*[254] it was also held that a plaintiff lender whose solicitor realised or ought to have realised that actual undue influence was being exercised on the a surety was fixed with his solicitor's (constructive) knowledge. In this case, the defendant, Mrs. Lea, a 51 year old widow, agreed to offer her home as security for a £60,000 loan granted by the plaintiff to her employer, a Mr. Hamilton. In the course of the pre-contractual negotiations between the plaintiff and Mr. Hamilton the plaintiff was very surprised to hear that the defendant, only being a junior employee of Mr. Hamilton, was prepared to stand surety for a loan which he himself would not dream making without security. Additionally, at a meeting between the plaintiff's solicitor, a Mr. Ory, and the defendant Mr. Hamilton was also present. At this meeting, Mr. Ory told the defendant that as a result of the transaction she could lose her home. The events following this statement by Mr Ory are very vividly described and interpreted by Millet LJ in this decision[255]:

> When he warned the defendant that if she signed the document she stood to lose her home she turned to Mr. Hamilton for advice; and only after their whispered conversation did she decide to proceed. It is self-evident that Mr. Hamilton allayed her fears; and did so in sufficiently strong terms that she declined the services of a solicitor. In my opinion it was open to the judge to infer that Mr. Hamilton obtained the execution of the mortgage by the actual exercise of undue influence practised in Mr. Ory's presence; that Mr. Ory was thereby fixed with notice; and that since he was the plaintiff's solicitor acting in the very same transaction, his notice should be imputed to the plaintiff.

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[253] *ibid*, at p. 975 C-D.
[254] [1998] 1 FLR 138 (CA).
[255] *ibid*, at p. 147H.

Agency theory

A bank is also fixed with a partner's illegal behaviour if the partner acted as the bank's agent in procuring the other partner to sign the documents. In English law, agency is usually described as a fiduciary relationship which exists between two persons, one of whom expressly or impliedly consents that the other should act on his or her behalf so as to affect his or her relations with third parties and the other of whom similarly consents so to act or so acts[256]. The one on whose behalf the act or acts are to be done is called the principal. The one who is to act is called the agent. Typically, the relationship of agency arises out of agreement between principal and agent.

Although it is quite common that in cases involving a couple the bank hands documents over to the husband to present them to his wife for signature, since *O'Brien* this is usually not seen in English law as creating the relationship of agency between bank and husband. This view is mainly based on the argument that the bank does only intend to use the husband as a messenger. The bank typically intends to be in full control of all dealings and, above all, does not want to be bound by any representations made by the husband. Furthermore, in most of these situations, the principal debtor, usually the husband, is normally more concerned with his position than the bank's interests. In order to obtain the loan from the bank, he seeks to procure the support of the surety. In so doing he is acting for himself not for the creditor[257].

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[256] Bowstead/Reynolds, *Agency* (16th edn. London 1996 by Reynolds, F. M. B.), at p. 1 (para. 1-001).
[257] See speech by Lord Browne-Wilkinson in: *Barclays Bank* v *O'Brien* [1994] 1 AC 180 (HL), at p. 194A.

Doctrine of constructive notice

Thirdly, a link between bank and the partner's misconduct can also be based on the doctrine of constructive notice. In short, a bank is seen as having - in law - notice of the partner's inappropriate behaviour if the circumstances of the individual case are such as to put the creditor on inquiry as to the circumstances in which the plaintiff agreed to stand surety. Thus, it is not the bank's actual knowledge of the conduct of the parties involved which is relevant but whether the situation is such as to make the bank reflect upon the circumstances in which the surety 'agrees' to sign the documents. In *O'Brien*, Lord Browne-Wilkinson described in which circumstances a bank is put on inquiry as follows:

> Therefore, in my judgment a creditor is put on inquiry when a wife offers to stand surety for her husband's debts by the combination of two factors: (a) the transaction is on its face not to the financial advantage of the wife; and (b) there is a substantial risk in transactions of that kind that, in procuring the wife to act as surety, the husband has committed a legal or equitable wrong that entitles the wife to set aside the transaction.

In practice, the most fundamental requirement is that there exists an emotional or other close relationship of which the bank is aware. Moreover, the transaction in question must not 'on its face' be to the surety's advantage and therefore creating a risk that the partner would exercise undue pressure to induce the other partner to enter into the agreement.

(iii) Manifest disadvantage

In *O'Brien*, the House of Lords held that the wife's signature under a surety to secure the debts of a company in which she had no stake and which was solely owned by her husband was mainfestly disadvantageous to her. In contrast to this, in *CIBC Mortgages*

plc v *Pitt* (*'Pitt'*) the House of Lords stated that in cases involving actual undue influence exercised by a husband it is not necessary for the wife to prove that the transaction was to her manifest disadvantage. In *Pitt*, the wife nevertheless lost her case against the bank because the bank did not have either actual notice of the husband's misconduct nor did the husband act as its agent. Furthermore, it was held by the Law Lords that there was nothing 'on the face' of the transaction that had to put the bank on inquiry. The court stressed that, the bank could reasonably conclude that a loan for the purchase of a holiday was not likely to carry the risk of the husband exercising undue influence upon his wife.

How difficult it can be to decide whether (in cases involving presumed undue influence) a specific transaction is disadvantageous to a spouse or partner is shown by the decision in *Goode Durant Administration* v *Biddulph*[258]. In this case, Mr. and Mrs. Biddulph entered into a joint loan for a property development project undertaken by a company run by Mr. Biddulph. The matrimonial home served as a security for the loan. As Mrs. Biddulph had very little business experience and had complete confidence and trust in her husband's activities, Rich J. held that the presumption of undue influence was raised. However, the bank's main defence was that the transaction was not 'manifestly disadvantageous' to Mrs. Biddulph. The bank based its argumentation on the fact that Mrs. Biddulph had a direct interest in the company on the basis of her 2,5 per cent shareholding in and on her position as a director of the company.

Despite these facts, the court held that the loan agreement was a manifest disadvantage to the wife by stressing that the surrounding circumstances had also to be taken into consideration. Rich J. laid particular emphasis on the fact that Mrs. Biddulph was in fact

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[258] [1992] 2 FLR 551 (Ch. Div.).

not involved in the running of the company and was treated by both her husband and the bank as a 'mere automatic part of the transaction'[259].

On the other side, in the decision in *Equity and Law Life Assurance Society plc* v *Grath*[260] it was ruled that a guarantee given by a wife to secure the liabilities of a company operated jointly by her and her husband was not mainfestly disadvantageous. Here, the wife was more involved in the business of the company and knew about its financial standing. In this case, the judges held that the fact alone that the wife did not play a decision-making role in the company but was only engaged in the day-to-day running of the business was not a reason for the bank to be put on inquiry.

Furthermore, in *Barclays Bank plc v Sumner*[261], the judge also emphasized that in these husband/wife cases the question was whether the potential direct financial benefit to the wife through the company had to be compared with her potential liability as to put a reasonable lender on notice of the possibility that the wife had been induced to enter into a manifestly disadvantageous transaction. He held that a unlimited guarantee signed by a wife to secure the loans of a company in which she and her husband had equal shares was not 'manifestly disadvantageous' to her.

Thus, it may be summarized that the test of 'manifest disadvantage' is still to be applied from the perspective of looking at the surety's position from the creditor's point of view, but it also includes the 'widely acknowledged fact that a discrepancy often exists in family businesses between formal position and real power'[262].

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[259] [1992] 2 FLR 551 (Ch. Div.), at p. 555.
[260] (Transcript) 9 May 1996 (CA).
[261] [1996] EGCS 65 (Ch. Div.).
[262] Fehlberg, Belinda, 'The Husband, the Bank, the Wife and Her Signature - the Sequel', (1996) 59 MLR 675, at p. 681.

(iv) The bank's failure to take 'reasonable steps'

Even after a bank is fixed with actual or constructual knowledge of the partner's misconduct, it can eliminate the danger of having the transaction set aside by taking 'reasonable steps' to inform or get the pressured partner informed by someone else about the risk involved in the transaction. In *O'Brien*, Lord Browne-Wilkinson described the 'reasonable steps' to be taken by a bank as follows[263]:

> However for the future in my judgement a creditor will have satisfied these requirements if it insists that the wife attends a *private meeting*[264] (in the absence of the husband) with a representative of the creditor at which she is told of the extent of her liability as surety, warned of the risk she is running and urged to take independent legal advice.

However, since the ruling in *O'Brien*, the question of whether a bank which accepts a third party security is entitled to rely on a solicitor's statement to the effect that the person giving the security has been duly advised as to the implications of the transaction has been the focal point of interest in several recent decisions. For example, in *Banco Exterior Internacional* v *Mann* (*'Mann'*)[265] the Court of Appeal held that a bank accepting a third party security was entitled to rely on a solicitor's statement that the person giving the security was duly advised as to the transaction even though the solicitor was the main debtor's solictor.

In this case, the plaintiff bank offered a loan of £175,000 to B-Ltd, a company owned by Mr. Mann. The offer was conditional on a second charge of a matrimonial house jointly owned by Mr. and Mrs. Mann. The bank also demanded from Mr. Mann that the nature of the charge was to be explained to his wife by a solicitor. Thus, Mr. Mann passed the loan documents on to the company's solicitor Mr. Rochman. The solicitor

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[263] [1994] 1 AC 180 (HL), at p. 196H.
[264] Emphasis added.
[265] [1995] 1 All ER 936 (CA).

wrote to Mrs. Mann explaining the effect of the charge. Then, Mr. and Mrs. Mann attended Mr. Rochman's office where they signed the relevant documents.

The solicitor subsequently wrote a letter to the bank certifying that he had explained to Mrs. Mann the nature of the documents signed by her. Later, when the company went into liquidation, the bank sought an order for possession of the matrimonial home. The Court of Appeal ruled that although Mr. Mann exercised undue influence upon his wife, Mrs. Mann could not have the charge over the matrimonial home set aside because the bank was not fixed with actual or constructive notice of the husband's misconduct. The judges held that the bank was entitled to rely on the solicitor's statement that Mrs. Mann was duly advised as to the consequences of the charge. In this decision, Morritt LJ stressed that the bank could reasonably rely on the solicitor's statement[266]:

> It was a matter for Mr. Rochman to decide whether he was able to do so without any conflicting duty or interest. In my view, the bank was entitled to rely on the fact that Mr. Rochman undertook the task as showing that he was sufficiently independent for that purpose.

In addition, Sir Thomas Bingham MR pointed out that it could be expected of an ordinary solicitor to handle situations where he or she was asked to advise persons having different interests on one particular matter[267]:

> Was it reasonable to expect a solicitor, in explaining the nature and effect of the document, to give appropriate advice? In my view, it was. It is an ordinary incident of a solicitor's duty to explain the obvious potential pitfalls of legal transactions to those about to take part in them, and there is no clear dividing line between explanation and advice.
>
> If the certifying solicitor did his job with reasonable competence, as the bank was entitled to expect, Mrs. Mann would appreciate quite clearly that if the worst happened she could lose her rights in the house and that it was for her to decide whether she was willing to take that risk or not.

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[266] *ibid*, at p. 944h.
[267] *ibid*, at p. 950c-d.

Furthermore, in *Midland Bank plc* v *Serter* (*'Serter'*)[268] the Court of Appeal made it clear that a solictior instructed by a husband to give his wife advice on a transaction was not, when giving this advice, acting as the husband's or the bank's agent. In this case, Mr. Serter needed security if he was to continue his membership of Lloyds and for that purpose sought guarantees from the plaintiff bank. As security for the guarantees the bank required a second charge over the matrimonial home jointly owned by him and his wife, the defendant. Mr. Serter instructed his solicitor Mr. Colley to explain the charge to his wife and to witness her signature to the charge. The solicitor prepared two documents for Mrs. Serter. One was the charge, the other a letter stating that she was explained the nature and the consequences of the charge. On receipt of the certificate, the bank executed the guarantees required by Lloyds.

In 1992, when the bank's demands for payments were not met, it claimed possession of the house. In her counterclaim the wife sought a declaration that the charge was not binding on her on the ground that her signature had been procured by undue influence. The Court of Appeal rejected her counterclaim and ruled that the bank was entitled to rely on the solicitor's certificate stating that the wife was properly advised as to the nature of the charge. The Court also rebutted the wife's argument that the solicitor failed to advise her properly and therefore the bank was fixed with the solicitor's inadequate advice by stating that[269]:

> [...] a solicitor, like any other agent, may be instructed specifically to act for a party for one particular purpose in relation to a transaction, but not to act for him generally for other purposes.
>
> Thus it is only knowledge which he acquires when carrying out that part of the transaction in which he is instructed to act as agent which is to be imputed to the party who for that purpose is his principal [...]

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[268] [1995] 1 FLR 1034 (CA).
[269] *ibid*, per Glidewell LJ, at p. 1046H-1047C.

> The evidence shows that Mr. Colley was the agent of the bank to register the security, but there is no evidence that he was expressly appointed to take any antecedent step. In the ordinary way in advising Mrs. Serter as he did he was either acting for her, or was acting for her husband and advising her in pursuance of what he properly perceived to be his general professional duty.
>
> The bank, as [the bank's counsel] submits, was entitled to believe that he acted in one or other of theses capacities. In neither capacity was what he knew to be imputed to the bank.

This view that a bank could reasonably rely on a solicitor's statement that he or she duly advised a person giving a third party security as to the risks involved in such a transaction has been confirmed by the recent rulings in *Bank of Baroda* v *Rayarel* (*'Rayarel'*)[270], *National Westminister Bank plc* v *Beaton*[271] (*'Beaton'*) and *Barclays Bank plc* v *Thomson* (*'Thomson'*)[272]. In in fact, in *Thomson*, the Court of Appeal went one step further. In this case, the court held that a bank could rely on a solicitor's statement *even if the solicitor did not explain the relevant transaction sufficiently to a person giving the security* for the benefit of another.

In *Thomson*, the respondent wife was the owner of a property that was used as the family home. The wife agreed to mortgage the property to enable her husband's business to obtain overdraft facilities from the plaintiff bank. The bank instructed the husband's solicitors Gwyn James & Co. to act on its behalf in obtaining the wife's signature on the legal charge and registering it. The solicitors also acted for the wife in the transaction. They explained to the wife the full content of the legal charge and certified to the bank that they had done so and that she was aware of what she had signed. However, the solicitors failed to explain that the charge was unlimited in effect, in respect of both

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[270] [1995] 2 FLR 376 (CA).
[271] [1998] 30 HLR 99 (CA).
[272] [1996] NLR 1778 (CA).

amount and period. The bank later demanded repayment of the overdraft and, when their demand was not met, claimed possession of the property.

The wife claimed that she had signed the charge as the result of her husband's undue influence and that the bank had actual or constructive notice of this as they were acting as the bank's solicitors and agents, not hers. Again, the Court of Appeal rejected the wife's arguments by holding that the solicitors did not act as the bank's agent and that the bank was entitled to rely entirely on the solicitors' statement[273]:

> I can see no good reason whatever why a bank, perhaps conscientiously instructing solicitors to give independent advice to a signatory who might otherwise go unadvised, should thereby be disabled from relying on the solicitors' certificate that such advice has been properly given. The contrary argument founded on the agency principle is wholly artificial and to my mind now discredited.

In my view, however, the Court of Appeal's ruling in *Thomson* appears to have taken the *O'Brien*'s concept of 'reasonable steps' one step too far when holding that a bank could rely on a solicitor's statement even if the solicitor did not properly explain the risks involved to a person giving the third party security. It should be noticed that in *O'Brien* it was originally held by Lord Browne-Wilkinson that the creditor himself should inform the wife about the risk involved in the transaction[274]:

> However for the future in my judgment a creditor will have satisfied these requirements if it insists that the wife attend a *private meeting*[275] (in the absence of the husband) with a representative of the creditor at which she is told of the extent of her liability as surety, warned of the risk she is running and urged to take independent legal advice.

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[273] [1996] NLR 1778 (CA), at p. 1778.
[274] [1994] 1 AC (HL) 180, at p. 196H.
[275] Emphasis added.

This view was very sensibly based on the idea that the bank is in fact mostly suited to explain to the wife the commercial risk attached to the transaction because it has first-hand knowledge of the main debtor's financial standing. After *O'Brien*, the Court of Appeal in its rulings in *Mann*, *Rayarel* and *Thomson*, has consistently moved away from this 'original' view and allowed the banks to 'delegate' this duty to inform the guarantor, mortgagor or surety to a solicitor. At first, this seemed to be a convincing development because it was apparently in line with the requirements of today's banking business and the solicitors' task to 'oil the wheels of business'[276].

In fact, this digression from the 'original' decision in *O'Brien* meant a significant procedural improvement for banks. They were now allowed to avoid any direct contact with a surety or guarantor which might lead to unpleasant questions being asked by the sureties or guarantors. Instead, banks now can conveniently hand the relevant documents to the main debtor kindly requesting him or her to present them a 'suitable' surety or guarantor.

This pro-creditor approach naturally invites main debtors to misstate the financial standing of their business affairs to the prospective surety or guarantor. These misled guarantors or sureties then find themselves bound by their agreements reached with the banks because the banks can comfortably pretend their innocence by relying on the solicitors' statements certifying that the guarantors and sureties have been advised as to the legal effects of the signed documents (*Mann*). The fact that the security giving persons have not been told anything about the financial background of the transactions is seen by the judges as insignificant.

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[276] See trial judge's statements cited by Hirst LJ in: *Bank of Baroda* v *Rayarel* [1995] 2 FLR 376 (CA), at p. 382H.

Furthermore, this view encourages main debtors to ask their solicitors to draw up 'certificates' stating that the sureties or guarantors were duly advised although, in fact, the main debtor persuaded the surety or guarantor to sign the documents (*Serter*). Thus, one may be tempted to say that the judges should either go back to '*O'Brien*-basics' and place the burden of informing the surety or guarantor directly on the creditor or, at least, hold banks vicariously liable for any negligent advice given by solcitors they have instructed to assist them in the transaction.

Furthermore, it is argued that a creditor accepting third party security should ensure that the person giving the security has actually received 'truly' independent advice. This means that the solicitor rendering the advice should work only for the surety or guarantor and not also advising the bank or the main debtor on the very same subject matter.

Additionally, it is maintained that the following alternative to the House of Lords' concept of 'reasonable steps' should be imposed upon banks which accept third party securities and which want to avoid the setting aside of a third party security[277]:

> There must be reasonable grounds to believe that
>
> (i) the creditor requested that the surety be seen in the absence of the debtor by an adviser who acted for the surety alone,
>
> (ii) that the creditor supplied the surety or his or her adviser with the debtor's loan application and the creditor's offer of facility, and
>
> (iii) that the creditor has confirmation from the adviser that the surety was advised in accordance with the O'Brien reasonable steps.

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[277] *ibid*, at p. 689.

Additionally, it may be also be emphasized that the argument that a surety or guarantor who has been inadequately warned about the risks by his or her solicitor could alternatively bring a claim for damages against the solicitor[278] is not convincing. This view misses the crucial point that the surety's or guarantor's main goal is to avoid the loss of possession and ownership of the property which has been given as a security to the bank. Thus, in practice, a claim for damages against the solicitor cannot be seen as a real alternative to an action against the bank to have the charge over the property set aside in equity.

However, on the other side, the ruling in *Credit Lyonnais Bank Nederland NV* v *Burch* (*'Burch'*)[279] gives some ground to believe that the English courts may take a more consumer-orientated approach in the near future. In this case it was held that in special circumstances the bank's mere suggestion to the customer to seek independent advice is not sufficient. In *Burch*, the judges ruled that the security agreement was so extremely disadvantageous to the surety, actually bordering on an unconscionable bargain, that the bank had to ensure that the surety *actually received* independent advice.

In this case, Ms. Burch was a junior employee of a company controlled by Mr. Pelosi with whom she had close but not emotional links. On his request, she gave a unlimited security for an increase in the overdraft facility of Mr. Pelosi's company to £270,000 pounds having no interest in the company either as a shareholder or as director. In his judgment Milett LJ stressed that[280]

> The transaction was not merely to the manifest disadvantage of Miss Burch; it was one which, in the traditional phrase, 'shocks the conscience

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[278] See Giliker, Paula, 'Maintaining the Balance between Victims of Undue Influence or Misrepresentation and Mortgagees' (1996-97) 7 KCLJ 108, at p. 111.
[279] [1997] 1 All ER 144 (CA).
[280] *ibid*, at p. 152h-j.

> of the court'. Miss Burch committed herself to a personal liability far beyond her slender means, risking the loss of her home and personal bankruptcy, and obtained nothing in return beyond a relatively small and possibly temporary increase in the overdraft facility available to her employer, a company in which she had no financial interest. The transaction gives rise to grave suspicion. It cries aloud for an explanation.

Furthermore, Nourse LJ made it absolutely clear that - emphasizing the exceptional circumstances of this case - the bank had to ensure that Ms. Burch actually obtained independent legal advice in order not be fixed with any notice of undue influence exercised by Mr. Pelosi against her[281]:

> It was at the least necessary that she should receive such advice. That is because the first thing an independent solicitor would have done, on looking at cl[ause] 2 of the draft legal charge, was to inquire as to the extent of [Perlosi's company's] current borrowings and the current limit and, on receiving the answers, to advise Miss Burch that she should not on any account enter into a transaction in that form.

Moreover, attention should also be drawn to the recent ruling in *Cooke* v *National Westminister Bank Ltd*[282] (*'Cooke'*). In this case the Court of Appeal held that where a bank has knowledge of the fact that a guarantor shows reluctance to sign a guarantee agreement for the benefit of a third person and has asked a firm of solicitors to provide independent legal advice to this guarantor, the bank must obtain confirmation from the solicitors stating that this legal advice has actually been given to the guarantor in order to avoid to be prejudiced with constructive notice of the third person's exercise of undue influence upon the guarantor.

In *Cooke* the defendant bank asked the plaintiff's husband, Mr. Chris Cooke, to provide the bank with additional security for a loan which the bank had granted to a business

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[281] *ibid*, at p. 152b.
[282] *Cooke* v *National Westminister Bank Ltd*, *The Times Law Reports*, 27 July 1998, and also *The Times*, 27 July 1998 (Transcript).

whose director was Mrs. Sheila Cooke but which was de facto solely owned and managed by Mr. Cooke. Following the bank's request, Mr. and Mrs. Cooke signed a joint guarantee agreement with regard to the debts of Mr. Cooke's company and also executed a second charge over the family home which was jointly owned by the couple. In court, it was alleged by Mrs. Cooke that her husband had exercised undue pressure to make her sign these agreements.

However, in *Cooke* the decisive question was whether the defendant bank could be regarded as being prejudiced with 'constructive notice' of the husband's exercise of undue influence. The Court of Appeal ruled that the bank had such constructive notice because it knew that Mrs. Cooke's had been reluctant to sign a guarantee in the past and therefore ought to have been put on inquiry as to the circumstances in which she signed the guarantee later. In fact, the defendant bank's internal records contained the following statement[283]:

> Whilst Sheila Cooke accepts her role as a Director of the Company she is not over anxious to give the Guarantee on the grounds that she would not wish to put at risk her own assets which amount to some 80,000 of SEQ which she feels is her children's inheritance and not part of Chris Cooke's business world.

Furthermore, in a letter to the firm of solicitors which witnessed the signing of the guarantee documents by Mr. and Mrs. Cooke, the bank's manager explicitly requested the solicitors to 'ensure that seperate legal advice is administered to Mrs. Cooke'[284] and asked them to confirm to him in writing that such advice had been given to her. The solicitors never confirmed that independent legal advice had been provided to Mrs. Cooke and the bank did not insist on obtaining this confirmation from the solicitors.

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[283] *Cooke* v *National Westminister Bank Ltd, The Times*, 27 July 1998, (Transcript).
[284] *Cooke* v *National Westminister Bank Ltd, The Times*, 27 July 1998, (Transcript).

Thus, the Court of Appeal found that the defendant bank was affected by constructive notice of Mr. Cooke's exercise of undue influence through its failure to satisfy itself that Mrs. Cooke's signature had been properly obtained.

Nevertheless, it remains to be seen whether the rulings in *Burch* and *Cooke* will lead to a re-consideration of the *O'Brien* principle. Especially, the decision in *Burch* may also mark the starting point of a new era for the notion of unconscionability[285]. The ruling in *Burch* can also be seen as another example of how the line between the concepts of undue influence and unconscientious behaviour gets more and more blurred. This development towards an alignment of both notions has been criticized by some writers[286]. However, in my view, it appears to reflect the fact that the problems which typically arise in these cases concern issues which can be dealt with under both concepts.

Furthermore, the ruling in *Burch* has also had a significant impact on the drafting of the new Banking and Mortgage Lending Codes of Conduct. The new Codes which came into force on 1 July 1997, i.e. one year after the Court of Appeal's ruling in *Burch*, contain a provision dealing with third party securities. This provision stipulates that a lender which accepts a third party security is obliged to encourage a prospective guarantor to seek independent legal advice. Additionally, the Codes state that banks and mortgage lenders which have subscribed to the Codes do not ask their private customers for unlimited guarantees any more[287].

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[285] Chen-Wishart, Mindy, 'The O'Brien Principle and Substantive Unfairness' (1997) CLJ 61, at p. 70; Tjio, Hans, 'O'Brien and Unconscionability' (1997) LQR 10, at p. 16.

[286] See Birks/Yin, 'On the Nature of Undue Influence' in: Beatson/Friedmann (ed.), *Good Faith and Fault in Contract Law* (Oxford 1995), at pp. 57-97.

[287] The British Bankers' Association, *The Banking Code* (London 1 July 1997) and The Council of Mortgage Lenders, *The Code of Mortgage Lending Practice* (London 1 July 1997).

B. German law

(1) No general duty for a bank to explain the nature of a security to the person providing the security

First, it may be pointed out that, in Germany, the law concerning the duties of a bank that accepts a third party security has mainly been developed with regard to guarantees. However, the principles laid down by the courts in relation to guarantees are usually applied to any other forms of third party securities such as charges over properties or assumptions of other persons' debts[288]. Thus, here, the focus will be on third party guarantees. In German law, creditors are under no general duty to explain to a guarantor the nature and the risk of a guarantee. It is widely said that the considerable risks atttached to a guarantee are widely known to the general public[289]. Furthermore, it is viewed that the fact that under § 766 BGB any contract of guarantee must be in writing functions as a clear warning to even financially inexperienced persons so to prevent them from being rushed into entering such an agreement[290].

In Germany all contracts, including the contract of guarantee (*Bürgschaft*, § 765 BGB), are governed by the principle of *pacta sunt servanda*, meaning that once a contract has been entered into both parties must keep their promises. However, one major qualification to this principle can be found in § 119 (2) BGB. Under this provision a party is entitled to have a contract declared void if the party is in error as to 'those characteristics of a person or thing which are regarded in business as essential'[291]. Thus,

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[288] Siol in: Schimansky/Bunte/Lwowksi, *Bankrechts-Handbuch* (München 1997) Band I, Rdn. 63, at p. 800.
[289] BGH (22.10.1987) NJW 1988, 3205, at p. 3206.
[290] BGH (10.10.1957) BGHZ 25, 318, at p. 320.
[291] § 119 (1) A person who, when making a declaration of intention, is in error as to its content, or did not intend to make a declaration of such content at all, may rescind the declaration if it may be assumed

a guarantor may argue that the financial standing of the main debtor belonged those characteristics of a person regarded in business as essential. If the bank then turns to the guarantor demanding payment under the guarantee contract the guarantor may then say that the contract of guarantee ought to be declared void under § 119 (2) BGB based on the ground that he or she was in error about the main debtor's financial position when entering into the guarantee agreement with the creditor.

However, it is generally accepted among German lawyers that § 119 (2) cannot be applied to guarantee contracts as this would fundamentally contradict the very object of any agreement of guarantee whose main goal is, of course, that the guarantee provides the creditor with security in case the main debtor fails to pay back the loan[292]. Only in exceptional circumstances may a bank come under a (pre-)contractual obligation to inform the guarantor about specific risks that are involved in a guarantee. For example, if a bank gets to know that the main debtor is on the verge of bankruptcy just before the the guarantor is about to sign the guarantee agreement, it is under a duty to disclose this fact to the prospective guarantor provided that it has the impression that the guarantor is not aware of this situation. However, in practice, such situations seem to be very rare.

For example, in BGH NJW 1988, 3205[293] the plaintiff's bank manager was present at a meeting between the principal debtor and the guarantor where the principal debtor assured the guarantor that it was unlikely that the bank would approach him under the guarantee. Although the bank knew that this statement made by the principal debtor was of a rather optimistic nature, the court found that the bank was under no duty to

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that he would not have made it with knowledge of the facts and with reasonable appreciation of the situation; (2) An error as to the content of the declaration is regarded in the same way as an error as to those characteristics of a person or thing which are regarded in business as essential.

[292] Münchener Kommentar-Kramer, *BGB - Allgemeiner Teil*, Band 1, (2nd edn. München 1984), § 119 Rdn. 111, at p. 848.

[293] BGH (22.10.1987) NJW 1988, 3205, at p. 3206.

intervene and tell the guarantor its more pessimistic evaluation of the principal debtor's financial standing.

Interestingly, in the context of guarantees, the courts' focus of attention has recently been not so much on a bank's contractual duties towards a guarantor but rather more on the question of the unconscionability of such an agreement, especially in situations where there is a strong family or emotional tie between the main debtor and the guarantor.

(2) § 138 BGB and third party securities

Under § 138 BGB a contractual agreement that is regarded by the courts as an *sittenwidrig* (contra bonos mores) is void. Within the last four years, there have been a good number of decisions on the issue of guarantees given by children for the benefit of their parents. The controversy about this topic led even to one of the rare occasions where the *Bundesverfassungsgericht* (Federal Constitutional Court) overruled decisions made by the *Bundesgerichtshof* (Federal Court of Justice) on this matter[294].

[294] In principle, the *Bundesgerichtshof* is regarded as Germany's highest court with regard to civil law matters. Only where it is argued that a provision of the private law or a ruling of a court fails to comply with the *Grundrechte* (fundamental constitutional rights) the *Bundesverfassungsgericht* can be asked to decide on this constitutional matter.

(a) Guarantees given by children for the benefit of their parents

The *Bundesverfassungsgericht* told the civil law experts of the *Bundesgerichtshof* quite bluntly that they had failed to consider the impact of the concept of *Privatautonomie* (freedom of contract), which is protected under article 2 (1) of the German Constitution, on guarantee agreements where one party plays a very dominating role. In these situations, according to the *Bundesverfassungsgericht*, the law must intervene for the benefit of the 'structurally disadvantaged' party. Thus, it was held by the Bundesverfassungsgericht that a child's guarantee for the benefit of his or her parents can be void if[295]:

> (i) the parents exercised undue pressure on the child to provide a guarantee;
>
> (ii) the child is inexperienced in financial matters and has no own economic interest in his or her parents' activities;
>
> (iii) the bank knew or ought to have known that the parents exercised undue pressure on the child;
>
> (iv) the child's obligations under the guarantee are so significant that if the guarantee agreement would be seen as valid the child would have to make payments to the bank for almost the rest of his or her life.

For example, in BGHZ 125, 206[296] the defendant's parents applied to the plaintiff bank for a loan of DM 2,3m for their property development project. The plaintiff bank made it clear that it would not grant this loan unless the parents presented them a person to act as a guarantor for them. The parents 'persuaded' their 23-year-old son to sign an unlimited guarantee agreement with the bank. The son was a member of the Germany Army earning DM 1,500 a month. Not long after, the parents' project collapsed and the bank asked the son to pay to them DM 500,000 under the guarantee agreement. The

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[295] BVerfG (19.10.1993) NJW 1994, 36.
[296] BGH (24.02.1994) NJW 1994, 1278 ('Lebenstraumfall').

court felt it necessary to stress the principle that guarantee agreements were void only in exceptional circumstances. Unfairness could not be easily established in guarantee contracts as guarantees are in themselves not agreements characterized by equal rights of guarantee and guarantor. Under a guarantee contract one party would be granted a right whereas the other party would not usually gain anything in return for it. Nevertheless, the court said that a guarantee could generally be held void if[297]

> the guarantee agreement is of that kind that the sum secured exceeds the guarantee's resources to a very great extent resulting in a significant inequality between the contractual partners and where, additionally, the guarantor's decision is impaired by his or her inexperience or by the bank's or a third person's undue pressure.

Applying this principle to the facts of the case, the judges held that [298]

> there was an extreme discrepancy between the scope of the guarantee and the sons's resources; [the bank] could not seriously expect that the son would ever be able to repay them a loan amounting to millions of Deutschmark.

Furthermore, the court stressed that the parents violated the provisions of § 1618a BGB which says that 'Parents and children are obliged to support each other and to respect each others interests'. The judges interpretated this as placing the parents under a duty *not* to ask their children to act as a guarantor for them as this would almost automatically put them under strong moral pressure to please their parents out of a natural feeling of gratitude towards their parents.

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[297] BGH (24.04.1994) NJW 1994, 1278, at p. 1279; see also Markesinis/Lorenz/Dannemann, *The German Law of Obligatons* (Oxford 1997), Volume I, at p. 189 (with a translation of the very similar case BGH (24.02.1994) NJW 1994, 1341, as case 33 at p. 232.

[298] *ibid*, at p. 1279.

The court also held that a bank could generally be fixed with the parents' misconduct if the bank had explictly asked for a third party security and the parents said that their child would be prepared to act as a guarantor for them and [299]

> the bank either knew of the undue pressure exercised by the parents on the child or deliberately turned a blind eye to this fact.

Applying this principle to the facts of the case, the judges ruled that the bank was aware of the great danger that the parents would put their son under pressure as their project depended on his signature under the guarantee document. As the bank failed to draw the son's attention to the severe consequences of this guarantee agreement, it could be assumed that the bank did not care whether the parents actually exercised undue influence upon their son and simply decided to turn a blind eye to the entire problem.

Thus, the court held that the guarantee was void under § 138 (1) BGB. However, it should be emphasized that the judges also stressed that they would have decided differently if the son had had a substantial economic interest in their parents' project[300]. This question of the relevance of the guarantor's economic interests in the loan being granted to the main debtor came up in the decision in BGH NJW 1997, 940[301]. In this case, the 24 year old defendant was asked by his father who owned a small business to act as a guarantor for a loan of DM 187,000 that was to be granted to the father's business by the plaintiff bank. The defendant, who was registered as managing director of this business, agreed and signed the guarantee agreement with the plaintiff bank. Later, when the father's business collapsed, the bank turned to the son who protested that the guarantee agreement was void under § 138 BGB.

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[299] *ibid*, at p. 1280.
[300] *ibid*, at p. 1280/1281.
[301] BGH (05.12.1996) NJW 1997, 940.

The court rejected the defendant's argument that the guarantee agreement was void because it exceeded his financial capacity. The judges stressed that the son had a substantial financial interest in the father's business because he was employed by the company as managing director. Furthermore, the court said that the son, who was about to finish his studies of law at the time when he gave the guarantee, would have good prospects of earning an above average income in the near future that would enable him to meet his father's obligations[302].

In a more general statement, the court also emphasized that the mere fact that the scope of the guarantee exceeded the financial capacity of the guarantor was not enough to invalidate a guarantee agreement. Additionally, there had to be established some improper behaviour either on the part of the father or the bank itself. In this case, the court found the son capable of assessing the nature and the risks of the guarantee stressing the fact that he had been studying law for three years before he signed the guarantee agreement.

This decision may also serve as an example for a recent change in the approach taken by the courts now. After the landmark ruling of the *Bundesverfassungsgericht* in BVerfG NJW 1994, 36[303] in 1993, there appeared to be tendency among judges not to enforce any guarantee agreements simply on the basis that there was a significant discrepancy between the sum guaranteed and the actual financial capacity of the guarantor. More recent decisions of Germany' higher courts seem to indicate that the mere fact that the guarantor may not be able to meet the obligations under the guarantee does not, on its

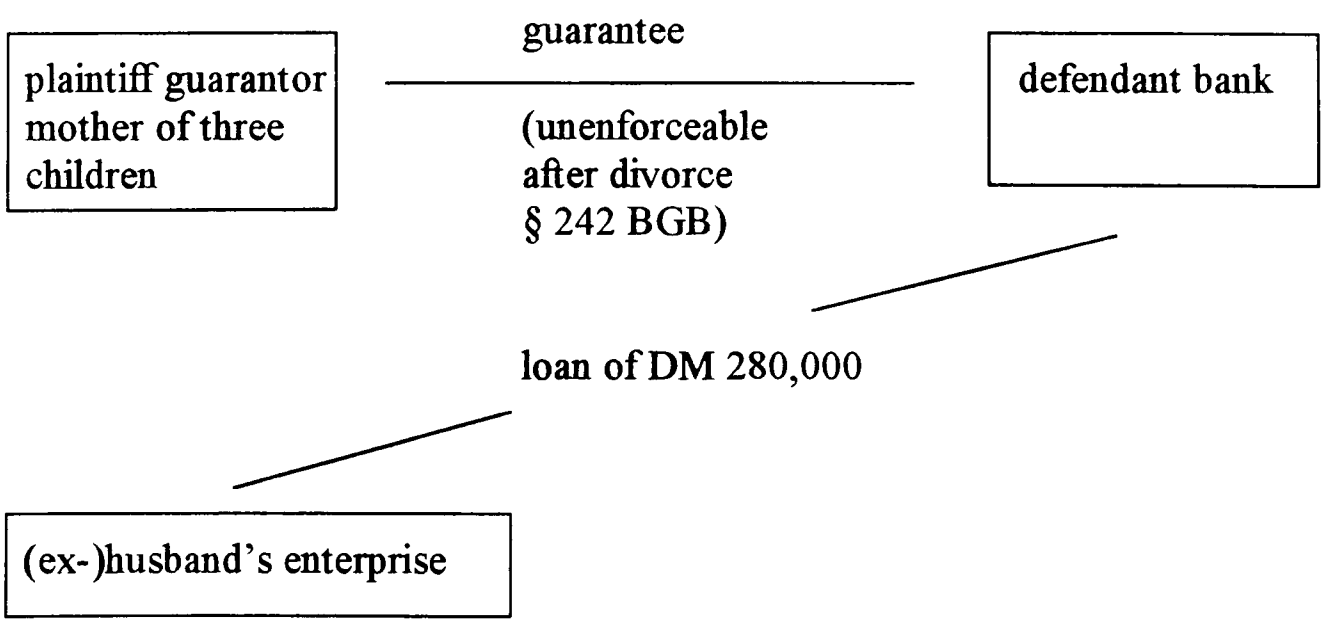
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[302] *ibid*, at p. 940; here, the author, being a lawyer himself, cannot resist the temptation to comment that the judges overestimated the current general job and income prospects for lawyers in Germany to a not insignificant extent.
[303] BVerfG (19.10.1993) NJW 1994, 36.

own, invalidate the guarantee agreement. Instead, it is now stressed that there also must be some improper conduct on the part of the main debtor or the bank itself to result in the unenforceability of the guarantee under § 138 BGB[304].

(b) Guarantees given by spouses for the benefit of their partners

First, it may be said that the principles concerning the validity of guarantees given by children for their parents can also generally be applied to situations where spouses act as a guarantor for their partners. However, there are some differences in how the law deals with the notorious husband/wife situations. First, the courts may apply to these cases not only § 138 BGB but also the concept of *Wegfall der Geschäftsgrundlage* (collapse of the foundation of the contract) which is based on § 242 BGB. The reason for this is that in some husband/wife cases it is often much harder to prove that the spouse acting as a guarantor does not have an economic interest in the partner's business. For example, in the case BGHZ 128, 230[305], the plaintiff guaranteed a loan of DM 280,000 that was granted by the defendant bank to a business run by her husband.



[304] See BGH (23.01.1997) WM 1997, 467 and OLG Köln (25.02.1997) WM 1997, 1095.
[305] BGH (05.01.1995) BGHZ 128, 230.

The plaintiff was a mother of three young children and did not work, and had no experience in business matters. Subsequently, the plaintiff got divorced from her husband. Later, the ex-husband's business collapsed. The defendant bank asked the plaintiff to pay the bank DM 50,000 under the guarantee agreement. The plaintiff brought an action against the defendant bank demanding to have the guarantee agreement declared void under § 138 (1) BGB.

The court held that the guarantee agreement was not void under § 138 (1) BGB because the defendant bank initially had a legitimate interest in having the plaintiff as a guarantor. The judges pointed out that in business there had been established a fraudulent habit among husbands running small businesses, according to which business assets were transferred from the husband's business to his wife just before the business went insolvent. Through this 'fiddling with the assets' the banks' securities on the business would de facto be rendered worthless. Thus, the court held that, in these situations, banks have a legitimate interest in requiring that the wife be guarantor of the liabilities of her husband's business debts. Moreover, the judges found that it could typically be assumed that a wife had an economic interest in her husband's business, especially in cases where the business was the family's only source of income.

However, then, the judges turned to the principle of *Wegfall der Geschäftsgrundlage* (collapse of the foundation of the contract)[306]. Under this concept, a contract may become unenforceable if there is a substantial change in the foundation of the contract to such an extent that insisting on its performance would be contrary to the principle of *Treu und Glauben* (good faith; § 242 BGB)[307]. In this context, the 'foundation' of a

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[306] See also Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume 1, at pp. 615.
[307] Palandt-Heinrichs, *BGB* (56th edn. München 1997), § 242 Rdn. 113, at p. 237.

contract is generally defined as a set of circumstances which, without becoming express contractual terms, had been regarded by at least one party as essential for the conclusion of the contract and whose express inclusion into the contract could not have been rejected by the other party without being in breach of the principle of *Treu und Glauben.*

In the event of the collapse of this 'foundation' of the contract, the contract may either be adapted to the new circumstances or become unenforceable. In most cases, the courts prefer to adjust the the contract to the changed situation in order to enforce at least part of what the parties had orginally agreed upon. However, where the contract cannot be rescued, the court usually gives the party which is sued for performance under the contract the defence of *Unzulässige Rechtsausübung* (abuse of a legal right) under § 242 BGB. Relying on this defence, the party being sued can refuse to perform its obligation without breaching any contractual or tortious obligations. In return, the party being entitled to this defence cannot ask for performance by the other party either.

In BGHZ 128, 230 the court emphasized that sole function of the wife's guarantee was to prevent her husband from 'fiddling with the business assets'. As the wife had no other resources of her own, the guarantee was of no other additional and independent economic value to the bank. The bank had been aware of this and the judges held that, if the wife had demanded to incorporate a term into the contract stating that the purpose of the guarantee was to prevent any concealment of assets by the couple, the bank would not have been able to reject this demand without being in breach of the *Treu und Glauben* principle (good faith). Thus, the judges concluded, that this purpose became the 'foundation' of the guarantee agreement.

Therefore, after the divorce, the bank had no legitimate interest in having the 'poor' ex-wife to act as a guarantor for the substantial debts of the ex-husband's business. There was no longer the danger that the husband might transfer any of his business' assets to his ex-wife. Therefore, the 'foundation' of the guarantee agreement between the bank and the wife collapsed after the divorce and the ex-wife was entitled to the defence of *Unzulässige Rechtsausübung* (abuse of a legal right). This meant that the guarantee became permanently unenforceable[308]. However, the court also emphasized that it would have decided differently if the wife had been 'rich' and her resources had been, right from the beginning, meant to serve as an additional security for the bank's loan granted to the husband's business.

This last issue was then touched upon by the decision in BGH WM 1997, 467[309]. In this case the bank argued that it had regarded the guarantor's prospects of an inheritance as essential when granting a loan to the main debtor. In BGH WM 1997, 467 the plaintiff bank granted a loan of DM 74,000 to the defendant's husband, who worked as a insurance agent, for the purpose of 'car repairs'. Part of the sum was also used for the couple's household. The defendant signed a guarantee agreement securing the entire business relations between her husband and the bank. Later, the couple separated. Soon after, the husband failed to repay the loan and the bank turned to his ex-wife.

First, the defendant ex-wife argued that the guarantee was void under § 138 (1) BGB because it exceeded her financial capacity. She stressed that, when signing the guarantee documents, she, being a mother of two little children, had neither an income of her own nor any savings. This was rejected by the court which reiterated that a discrepancy

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[308] See also the decision in OLG Karlsruhe (05.06.1997) WM 1997, 2122.
[309] BGH (23.01.1997) WM 1997, 467.

between the sum guaranteed and the guarantor's financial strengh rendered the agreement void only if the guarantor had additionally been exposed to improper conduct by the main debtor or the creditor when entering into the contract. According to the findings of the court in this case, the wife could not prove that she had been subject to such undue pressure[310].

Secondly, the ex-wife maintained that the foundation of the guarantee contract had collapsed after her separating from her husband. This was strongly disputed by the bank. The bank emphasized that it had regarded the wife's prospects of inheriting her parents' property as the basis on which it entered into the guarantee agreement with her. The bank claimed that it had not given the loan to her husband if it had not received a guarantee from her which also covered her prospects of inheriting her parents' house. Thus, the bank argued, the guarantee agreement had to be interpreted as remaining in force even after the breakdown of the marriage.

On the one hand, the court stressed it was generally possible to widen the scope of a guarantee so as to cover any future accessions of property by the guarantor including an inheritance. However, on the other side, the judges also found that such a wide interpretation of a wife's guarantee was atypical. Therefore, it could not automatically be seen as a founding term of any ordinary guarantee agreement to which any guarantor would have to agree to avoid a breach of the good faith principle. This meant that only if a bank made it clear to the guarantor that the guarantee was to include any future accession of property by the guarantor, such a term could become the 'foundation' of a guarantee agreement[311]. Referring to the facts of this case, the judges ruled that the bank

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[310] *ibid*, at p. 468.
[311] *ibid*, at p. 469-470.

had failed to prove that it had made it clear to the wife that it regarded her prospective inheritance as an additional essential security for the loan granted to her husband. Thus, the bank could not bring a claim under the guarantee against her after the marriage broke down because the guarantee had become unenforceable.

Furthermore, attention should be drawn to the recent decision in BGH WM 1997, 2117[312]. In this case the *Bundesgerichtshof* (Federal Court of Justice) modified its approach towards guarantees given by spouses. Prior to this ruling, the court used to hold that a guarantee given by a 'poor' spouse for the benefit of his or her partner's enterprises was not void under § 138 (1) BGB provided that the reason for the guarantee agreement was to prevent any concealment of assets of the business by the couple in the event of a bankruptcy of the partner's enterprise. In BGH WM 1997, 2117 the court digressed from this view and found that the bank's legitimate interest in preventing any 'fiddling with the assets' alone does not 'rescue' a guarantee agreement which is characterized by an 'extreme discrepancy between the scope of the liability under the guarantee on the one side, and, on the other, the actual financial means of the guarantor'[313].

In this case the plaintiff bank granted several loans totalling DM 900,000 to the defendant's fiancé who ran a carpentry business. There was already a charge over all the fiancé`s business assets when he applied to the plaintiff bank for an extension of his line of credit. Thus, the bank asked him to come forward with an additional security. He presented to the bank the defendant who agreed to sign an unlimited guarantee to secure all present and future liabilities arising in the business relationship between the bank and

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[312] BGH (18.09.1997) WM 1997, 2117.
[313] *ibid*, at p. 2118.

the fiancé's enterprise. At the time of the conclusion of this guarantee agreement, the defendant was employed by her fiancé's company and earned a monthly salary of DM 3,500.

Later, the fiancé's business went bankrupt. The bank brought an action against the defendant asking her to pay them the oustanding loan of DM 300,000. The court found the guarantee void under § 138 (1) BGB because there was an extreme discrepancy between the scope of the defendant's liability under the guarantee and her financial means. The judges stressed that[314]:

> such an extreme discrepancy is established where the income of the guarantor which is subject to seizure is not sufficient to cover a quarter of the total of the main debtor's liability within five years after the conclusion of the guarantee agreement.

In this case, the defendant's annual income which was subject to seizure amounted to DM 20,000. This meant that the defendant would have been able to pay the plaintiff bank 'only' DM 100,000 within the five years after the conclusion of the guarantee agreement. As this sum accounted for no more than 11 per cent of the main debtor's outstanding loan at the material time, the court ruled the guarantee to be void under § 138 (1) BGB.

Attention may be focused on the fact that this ruling appears to be similar to the English decision in *Credit Lyonnais Nederland NV* v *Burch*[315] (*'Burch'*) where a guarantee of an employee was also held unenforceable because the guarantor had been subject to undue influence by the main debtor and where the terms of the guarantee were also found to be unconscionable by the Court of Appeal. Taking into account both rulings, one may be

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[314] *ibid*, at p. 2118.
[315] [1997] 1 All ER 144 (CA).

inclined to say that there seems to be a growing awareness among the English and German judiciary for consumer interests in the area of third party securities.

(c) Guarantees given by a sibling for the benefit of another sibling

Finally, it may also be mentioned that in the recent decision in BGH WM 1998, 239[316] Germany's highest civil court extended the principles on the validity of guarantees given by spouses for their partners and those of children for their parents to guarantees given by one sibling for the benefit of another. In this case the defendant agreed to act as a 'woman of straw' for her brother's business activities. At her brother's request and in order to enable him to make tax savings, she became one of the two principal shareholders of a limited company called SF-GmbH. This company was founded by the defendant's brother and his business partner with the help of a DM 100,000 loan which was granted to them by the plaintiff bank. The defendant herself had no financial interest in the SF-company.

For example, in a separate agreement with her brother and his business partner it was stipulated that she would keep all profits which were generated by the SF-GmbH as a trustee[317] for her brother and his business partner. The plaintiff bank had knowledge of all these facts. Furthermore, the defendant, a 26 year old woman with a relatively modest monthly income of DM 2,300, signed a unlimited guarantee which was meant to function as a security for a DM 1,2m loan which was granted by the plaintiff bank to the SF-GmbH. Later, the SF-GmbH defaulted and the plaintiff bank asked the defendant to

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[316] BGH (18.12.1997) WM 1998, 239.

[317] German law does not have a legal concept which is congruent with the English notion of 'trust'. However, the nearest equivalent in German law to the English law's trust is the concept of 'Treuhand'.

pay DM 600,000 under this guarantee. The defendant counterclaimed that her guarantee was void under § 138 (1) BGB because there was an extreme discrepancy between the scope of the guarantee and her actual financial means. Additionally, she argued that the principles laid down by the *Bundesgerichtshof* (Federal Court of Justice) with regard to guarantees given by spouses and children should be applied to guarantees of siblings.

First, the court stated that the personal ties between siblings are usually not as close and prone to the exercise of undue influence as those relationships between spouses and partners or between children and their parents. Secondly, however, the judges also stressed that, in special circumstances, the relationship between siblings can be similarly proximate[318]:

> In the individual circumstances of the case between siblings there may also exist similarly proximate personal ties or even a relationship characterised by dependence.
>
> In this case, such a [sibling] guarantor can be entitled to the same level of protection which is granted by the law to guarantors who are spouses, partners or financially inexperienced children [of the main debtor].
>
> However, in such a situation the guarantor needs to establish that the factual situation was such as to enable the bank to realise that there existed such a [similarly proximate] relationship. If necessary, the guarantor must also produce evidence of this.

In this particular decision, the *Bundesgerichtshof* referred this case back to a lower court to establish whether the facts of the case were such as to conclude that the relationship between the defendant and her brother was sufficiently close to make the guidelines on guarantees of spouses and children applicable to this specific case. Taking this ruling into account, banks may be tempted to complain that the 'floodgates' of litigation have been opened.

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[318] *ibid*, at p. 240.

Indeed, it appears to be likely that Germany's highest civil court will soon be confronted with cases where it is asked to decide whether the principles concerning the validity of guarantees which are given by spouses, children or siblings can also be applied to other relationships which are characterised by very close personal ties such as, for example, the relationships between grandparents and their grandchildren, the personal bonds between cousins or even the relationship between employers and their employees.

Moreover, considering all these decisions, one may summarize that, in German law, the problematic issue of third party securities is mainly not dealt with in the field of a bank's contractual or tortious duties but in terms of the unconscionability of the agreement reached between creditor and guarantor. In this respect, the provisions of § 138 and § 242 BGB, both founded on the principle of *Treu und Glauben* (good faith), play a crucial role. The reason for this may be that the courts find these concepts better adaptable to the permanently changing banking practice than any other contract or tort based solutions. Additionally, it appears that the courts have recently adopted a tendency to prefer to apply the concept *Wegfall der Geschäftsgrundlage* (collapse of the foundation of the contract) over § 138 BGB, especially in cases related to guarantees given by spouses.

The advantage of the notion of *Wegfall der Geschäftsgrundlage* over § 138 BGB is that this concept provides the judges with even more freedom. In contrast to § 138 BGB where the judges have to reach a clear cut decision whether a contract is void or not, the concept of *Wegfall der Geschäftsgrundlage* offers them the opportunity to uphold and alter a contract although it may be significantly flawed.

PART C:

Comparison

In English and German law there is no general duty on the part of a lender to advise a borrower on the feasibility of his or her lending. Only in exceptional circumstances where the lender assumes the role of the borrower's financial adviser the lender may be under a duty to warn the borrower of particular risks which are attached to the transaction in question. This is typically the case where the lender undertakes to adopt a role which exceeds the normal functions of an ordinary money lender, for example, where the lender acts as a kind of 'match-maker'[319] between the borrower and a third person who seeks to invest money or encourages a customer to take out a loan for the purpose of speculating on the stock market.

Generally speaking, this approach can be welcomed because it is in line with the notion of freedom of contract which plays an important role in both jurisdictions. Additionally, from a commercial point of view, it appears to be sensible to say that, in principle, lender and borrower cannot be expected to look after each other's affairs. Nevertheless, it may be stressed that this view is based on the assumption that there is a kind of equality of bargaining power between lender and borrower. In practice, however, the lender is typically in a much stronger economic position than the borrower. Thus, the question arises whether a lender, in certain circumstances, should be under a duty to refrain from granting a loan.

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[319] See decision in BGH (29.05.1978) NJW 2547.

Especially with regard to the area of so-called 'sub-prime lending' the imposition of such a duty appears to be worth considering. Sub-prime lenders target specifically individuals whose bad credit records prevent them from any borrowing from ordinary lenders such as High Street banks.

The business practices of the English sub-prime lender and retailer 'Crazy George's' may serve as an example of this morally questionable from of lending. As already mentioned above, Crazy George's is a chain of shops which sells household goods and offers a credit facility to its customers who - due to their bad credit records - are unable to buy or rent products from other retailers. The current APR rate charged by Crazy George's is 29 per cent. The typical customer of Crazy George's is a 23 year old unemployed single parent who lives on state benefits[320]. A customer who has a 'disposable income'[321] of £50 per week is granted by Crazy George's a credit facility of £15[322].

In my view, this form of lending should not be allowed because the sub-prime lender exploits financially inexperienced and unemployed consumers who are in a desperate financial situation. The dominant economic position of a sub-prime lender should be counterbalanced by a duty on the part of the sub-prime lender to refrain from granting a loan to specific customers in certain circumstances.

For example, in my opinion, a lender should be obliged not to grant a 'sub-prime' loan which is used for the purchase of consumer goods where the repayment of this loan

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[320] Presentation given by Steve Fell, National Debt Manager of Crazy George's, at the 9th Annual Conference of the Money Advice Liason Group on 25 November 1997 in London.
[321] Usually state benefits.
[322] Presentation given by Steve Fell, National Debt Manager of Crazy George's, at the 9th Annual Conference of the Money Advice Liason Group on 25 November 1997 in London.

would account for more than 20 per cent of the weekly or monthly disposable income of the debtor. Furthermore, it is worth considering whether there should be limit for the price of consumer products which are sold on the basis of a 'sub-prime' loan. For example, in my view, the 'sub-prime loan price' of a consumer product should not be more than twice the cash price of the very same product.

In addition, the issue of mortgage loans appears to be particularly problematic in England. Every year, on average 50,000 homes are repossessed by banks and building societies in the UK[323]. This raises the question of whether the present lending practices of UK banks and building societies are too lax. In the UK, even first-time buyers can obtain a mortgage loan which amounts to 100 per cent of the value of the property which is purchased with the help of the loan. Considering that the property market is traditionally subject to substantial fluctuations, this can easily expose borrowers to the risk of negative equity. In the UK, 2.5m owners of private homes - this is no less that a quarter of all mortgage holders, had insufficient equity in their home to move to a new home in 1996[324]. Thus, in my view, it is questionable whether 100 per cent mortgage loans are suitable for all types of house buyers in the UK.

In contrast, in Germany, statutory provisions stipulate that most mortgage lenders are not entitled to grant private loans which exceed two thirds of the value of the property which is purchased with the help of the loan. Furthermore, due to strict rules regarding the evaluation of private properties negative equity is not a significant problem in the German property market[325]. In fact, many German house buyers manage to repay their

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[323] *Financial Times*, 1 February 1996, at p. 8.
[324] *Sunday Times*, 27 October 1996, at p. 17.
[325] Thomas, Matthias, 'Immobilienwertbegriffe in Deutschland und Großbritannien', Die Bank, Volume 6, 1995, 263, at p. 268.

loans earlier than stipulated by the loan agreements[326]. Thus, one may be tempted to argue that the UK's mortgage lenders should adopt a more restrictive lending policy.

On the other hand, one may also point out that the introduction of stricter mortgage lending practices in the UK would probably lead to a considerable reduction in the purchases of private property in Britain. In Germany, where there is a stricter mortgage lending policy in place, only 39 per cent of all households live in their own four walls. In contrast, in the UK, no less than 68% of all households own property[327]. Correspondingly, the question arises whether the present mortgage lending policy in Germany is not too strict because, in practice, it denies a considerable proportion of the society access to the ownership of private property.

Furthermore, the second main trouble spot related to lending matters is the area of third party securities. Third party securities often lead to complex legal problems because there is the risk that the main debtor misrepresents facts or puts undue pressure on the third party to enter into some form of security agreement with the creditor.

Generally speaking, one can say that the English law's emphasis is on how the creditor can be fixed with the main debtor's misconduct. In contrast, in Gemany, the focus is more on the issue of unconscionability. In my view, the English law's approach is flawed because it is, in principle, based on the assumption that the mere provision of a warning to the person who gives the third party security is sufficient to ascertain the enforceability of a third party security. This concept does not take into account that the true nature of the problems behind a third party security. Cases such as *Steeples* v *Lea*[328]

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[326] Bundesverband deutscher Banken, *Fünf Jahre Ombudsmann* (Köln 1997), at p. 18.
[327] *Frankfurter Allgemeine Zeitung*, 20 April 1998, at p. 15.
[328] [1998] 1 FLR 138 (CA).

and *Banco Exterior Internacional* v *Mann*[329] clearly show that even if a financially inexperienced guarantor is provided with an adequate warning of the risks he or she often nevertheless decides to give the security. Thus, a concept whose main objective is to ensure that a guarantor obtains access to information about the risks of the guarantee can only work in circumstances where the handicap of the disadvantaged guarantor is mainly grounded on a deficit of information. However, in most third party security situations the guarantor's freedom of choice is not infringed through a lack of knowledge of the risks of the guarantee but impaired by the exposure to undue pressure resulting from the close family or emotional ties between the debtor and the guarantor[330]. Usually, a guarantor is aware of the fact that what he or she is signing can get him or her into severe trouble but he or she is simply unable to resist the immense emotional or other pressure exercised by the principal debtor.

Additionally, in contrast to their English counterparts, German courts seem to focus more attention on the economic reasons underlying the bank's request for a third party security. German judges are likely to question the feasibility of a guarantee agreement. A good example of this are cases involving guarantees which are jointly given by couples where one of the spouses does not earn an income of his or her own. In these situations, German courts tend to declare the guarantee unenforceable[331] with regard to the liability of the non-earning spouse in the case of a break-up of the marriage. In their rulings, the judges point to the economic reasoning behind a joint guarantee agreement.

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[329] [1995] 1 All ER 936 (CA).

[330] See also Singer, Reinhard, 'Aufklärungspflichten (und Sittenverstöße) im Konsumentenkreditgeschäft', ZBB 3/1998, 141, at p. 147.

[331] For example, in *BGHZ 128, 230*, the court applied the priciple of *Wegfall der Geschäftsgrundlage* (collapse of the foundation of the contract) and found a guarantee agreement unenforceable under § 242 BGB (good faith) after the break-up of the marriage.

Such a joint gurantee is typically requested by a bank to prevent the couple from concealing assets of the business in the event of a bankruptcy of the enterprise which is typically owned by only one of the spouses. There is the danger that the spouse who owns the enterprise transfers all the assets of the business to the other spouse with a view to frustrate the bank's later bankruptcy proceedings. In this set of facts, the courts usually find that, after the break-up of the marriage, this danger of 'assets fiddling' ceases to exist so that the bank does not have a legitimate economic interest in having the non-earning divorcee as a guarantor any more.

Moreover, it was held in *BGH WM 1997, 2117*[332] that even in situations where the bank has a legitimate interest in preventing a couple from concealing assets the guarantee is void under § 138 BGB if there is an extreme discrepancy between the scope of the liability under such a guarantee on the one side, and, on the other, the actual financial means of the guarantor. In this decision, Germany's highest civil court came up with a clear rule stating that a guarantee is void[333]:

> [...] where the income of the guarantor which is subject to seizure is not sufficient to cover a quarter of the total of the main debtor's liability within five years after the conclusion of the guarantee agreement.

If this principle had been applied by the English Court of Appeal in *Credit Lyonnais Bank Nederland NV* v *Burch*[334] ('Burch'), the outcome would have been crystal clear. Without any need to inquire about the factual circumstances surrounding the conclusion of the guarantee agreeement in question, the unlimited guarantee which was given by the 18 year old defendant employee with a modest annual income of £12,000-14,000 to secure a £270,000 loan granted to her employer would have been declared void.

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[332] BGH (18.09.1997) WM 1997, 2117.
[333] *ibid*, at p. 2118.
[334] [1997] 1 All ER 144 (CA).

However, on the other hand, the present German law with regard to the safeguarding of the interest of financially inexperienced providers of third party securities also leaves much room for improvement. At the moment, the main provision which offers some protection for consumers is § 766 BGB. It stipulates that all guarantee agreements must be in writing. The legal requirement of writing is meant to indicate to consumers the far-reaching consequences of a guarantee. Nonewithstanding, in my view, German law should adopt the English law's so-called 'O'Brien principle'[335]. Under this principle, lenders are obliged to recommend to guarantors who have a family or otherwise very close relationship with the main debtor to seek independent legal advice before entering into the guarantee agreement. Additionally, German banks should also voluntarily adopt their English counterparts' policy not to accept unlimited guarantees any more[336].

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[335] See *Barclays Bank* v *O'Brien* [1994] 1 AC 180 (HL).
[336] See The British Bankers' Association, *The Banking Code* (London 1 July 1997).

Chapter Four:

Banks as advisers on investment matters

Introduction

Only a decade ago, private investment usually centred on 'safe' saving accounts and pension funds. Nowadays, people increasingly look for more lucrative - and more speculative - ways of making their money work for them. Investing in bonds and all kinds of investment funds is no longer reserved for a very small portion of society. In fact, in 1995, analysts predicted that the private client market in the UK will grow ten per cent per year over the next five years[337]. This means that within the next five years the money that is invested by private customers will more than double.

In Germany, it is estimated that until the year 2000 land property, shares, bonds and savings accounts worth no less than 2,600 billion Deutschmark will be handed on from one generation to another[338]. Without doubt, these developments in the private investment sector have created an immense demand for financial advice by banks. At the same time, fierce competition in banking business has led to a high number of closures of bank branches. 'Lean management' and 'down sizing' are terms more and more often heard in the banking industry. In Britain, the number of employees in the banking sector

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[337] The Banker, 'Care for a slice?', Volume 12, 1995, at p. 56.
[338] Lang, Volker, *Aufklärungspflichten bei der Anlageberatung* (Stuttgart 1995), at p. 17.

has dropped from 450,000 in 1990 to 365,000 only five years later[339]. 'Direct Banking' by telephone, fax and via the Internet is rapidly gaining ground[340].

However, the banks' struggle for greater efficiency appears to be in contradiction with their customers' also strong demand for 'tailor made' financial advice. It is exactly this two-way development in banking, 'lean' and 'direct' banking on the one side, and the customers' call for 'customer tailored' and 'individual' advice on the other, that poses a great challenge to bankers and lawyers to develop conceptually as well as practically convincing solutions to the complex legal problems occasioned by these new circumstances.

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[339] Britisch Bankers' Association, *Annual Report 1994/95* (London 1995), at p. 27.
[340] Banking World, 'Direct Banking gathers pace', August 1990, at p. 41.

A. English law:

English law relating to the duties of banks as financial advisers in the area of investment may be described as a conglomerate of common law, specific legislation such as the Financial Services Act 1986 and several codes of conduct set up either by statute or voluntarily by bodies within the financial services industry itself. Generally speaking, one may say that the Common law with its mainly tort-based decisions may still function as the starting point when one tries to give an overview of the law related to liability for investment advice.

(1) Common law duties of banks acting as investment advisers

As already mentioned above in Chapter Two, English law, in contrast to German law, does not know the notion of a specific contract for the supply of advice. Instead, English law tends to apply tort law where a bank undertakes to provide its customer with financial advice. First, it should be pointed out that in this chapter the emphasis will not so much be laid upon the circumstances in which a bank is under a duty of care but the focus will rather be on the scope of this duty once it is established. In this respect, the relatively old decision in *Woods* v *Martins Bank Ltd*[341] ('*Woods*') can still be used as a good illustration of how English courts establish and assess a bank's duty as its customer's investment adviser.

In *Woods*, the defendant bank's manager had actively sought the custom of the plaintiff who was a relatively wealthy young man with almost no business experience and offered

[341] [1959] 1 QB 55 (Ch.Div.).

him to act as his financial adviser. The plaintiff agreed and, on the manager's recommendation, the plaintiff, at three different occasions between 1950 and 1952, purchased for the total sum of £10,500 preferences shares in a company called B.R. Ltd which was another customer of the defendant bank. At each of these occasions, the bank's manager assured the plaintiff that B.R. Ltd. was financially sound although this was not the case. Later, the company became insolvent and the plaintiff lost his money.

The court found that the defendant bank had been under a duty of care towards the plaintiff and had acted in breach of this duty when recommending him to invest in B.R. Ltd. In reaching this conclusion, the judges laid particular emphasis on the issue of '*unsuitability of the product*' recommended by the defendant bank and the bank's '*failure to disclose a conflict of interest*'.

The judges found the defendant bank's recommendation to the plaintiff to purchase preference shares for £10,500 as unsuitable because: (i) this meant that the customer would spend almost two thirds of all his disposable income in one single form of investment, and, (ii) this investment in preference shares of a private company with a poor financial record was obviously not in the interest of the plaintiff who had made it clear to the bank that he wanted a safe investment.

Additionally, it is interesting to notice that, in *Woods*, the court did not hesitate to scrutinize the general advantages and disadvantages of an investment in preference shares[342] in great detail. In this case Salmon J. stated that[343]:

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[342] Preference shares are generally desribed as a special type of shares which usually carry the right to a fixed percentage dividend, e.g. 10% of the nominal value, before ordinary shareholders receive anything. Holders of preference shares also have the right to the return of the nominal value of their shares before ordinary shareholders (but after creditors); see Martin, Elizabeth A., 'A Dictionary of Law' (4th edn. Oxford 1997), at p. 431.

> There are two requirements for any preference share: (i) that the money invested shall be safe; and (ii) that the stipulated interest shall be paid.
>
> Any ordinarily prudent and competent bank manager, especially the bank manager of a commercial branch, should know that before advising the investment of money in the preference shares of any company, let alone a private company, he should be able to see from the balance-sheet figures that the financial position of the company is strong enough to ensure that the investor's capital is safe and from the trading history of the company that the interest would be paid.
>
> I cannot imagine that any ordinarily prudent and competent bank manager, on the facts and figures which the defendant [bank's manager] had before him, could have advised the plaintiff to make any investments in prefence shares of this company, whatever the supposed yield had been [...].

First, this statement shows that, nowadays, courts view themselves as competent to inquire about the feasibility of transactions recommended by a bank acting as its customer's investment adviser. Secondly, it is noticeable that, in *Woods*, the court also based its ruling against the defendant bank on the fact that the bank failed to disclose to its customer a conflict of interest on its part. With regard to this matter, Salmon J. stressed that[344]:

> It seems to me to be plain that in the circumstances of this case [the defendant bank's manager] ought never to have advised the plaintiff at all - certainly not without making a full disclosure to the plaintiff of the conflicting interests between the plaintiff and the defendant bank and the plaintiff and the defendant bank's other customers concerned.

On the other hand, it should also be stressed that, in the past, English courts were often rather reluctant to find that a bank which assisted one of its customers with an investment decision actually assumed the role of the customer's adviser resulting in a duty of care on the part of the bank. A good example of this rather restrictive approach

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[343] [1959] 1 QB 55 (Ch.Div.), at p. 66.
[344] [1959] 1 QB 55 (Ch.Div), at p. 73.

is the decision of the Privy Council in *The Royal Bank of Canada* v *Pampellonne*[345] ('*Pampellonne*'). In this case, Mr. Pampellonne's attention was drawn to a finance company called Davies Investment Ltd.

Mr. Pampellonne approached the appellant bank's manager and requested him to investigate this firm for him. The manager sent him letter including a brochure issued by Davies Investment Ltd. In this letter to Mr. Pampellone, the bank's manager, reyling on a contemporary credit report received by the bank about this firm, stated that this company was 'trustworthy'[346].

In reliance on this letter the plaintiff invested a sum totalling T$ 43,000 in Davies Investment Ltd. of which T$ 16,000 were lost when subsequently the company failed. The Pampellonnes brought an action for damages against the bank arguing that the bank had given them negligent advice. The Privy Council rejected the Pampellonnes' claim. Referring to the findings of the trial judge that the appellant bank agreed to do no more than to provide the plaintiffs with 'information'[347] on Davies Investment Ltd., the bank was only under a duty to pass on this information correctly to the Pampellonnes[348]. This duty, the judges found, was duly fulfilled by the appellant bank.

However, in my opinion, it appears to be questionable whether this ruling can still be seen as reflecting correctly today's business practices in modern private banking. Nowadays, all High Street banks compete intensively for the custom of wealthy individuals and owners of successful small enterprises. In their glossy brochures the

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[345] [1987] 1 Lloyds Rep. 218 (PC).
[346] [1987] 1 Lloyds Rep. 218 (PC), at p. 220.
[347] For a more detailed discussion of this matter see above in Chapter Two, A. (2) (a).
[348] *ibid*, per Lord Goff at p. 225.

banks advertise that they can provide 'expert advice' and encourage customers to see their 'mortgage or pension plan specialists'. Thus, in my view, the approach taken by the court in *Pampellonne* does not appear to be justifiable anymore. Where a customer, encouraged by these brochures and statements, approaches a bank with a request to 'investigate' a specific company the customer is interested in, then this should leave the bank with the following two options: (a) either it refuses to fulfil the customer's request and thereby risk losing this customer , or, (b) it provides him with the advice on the matter knowing of the risk of liability but thereby ensuring this customer stays with the bank. Nevertheless, the duties of a bank opting for the latter approach should not be prohibitive. This bank should be entitled to refer to and rely on reports of commonly recognised credit agency when giving the requested assistance.

Not surprisingly, banks argue that a customer who obtains such investment advice for free could not reasonably expect that the bank wants to be held liable for its statements. This is, in my opinion, a short-sighted approach. This view does not take into consideration that typically customers who have a long-term business relationship with their bank approach their bank for investment advice. As a result of the bank's recommendation, the advised customer usually places an order with the bank which then earns the bank some sort of commission or premium. Thus, in my view, the banks' argument that a lack of consideration by the customer for the bank's assistance would justify that the bank is not the customer's financial adviser and, therefore, not under a duty of care does not take into account the actual economic background of the typical bank/investor relationship.

A similar, in my view, more realistic approach to this matter has also been taken by Taylor J. in *Verity* v *Lloyds Bank Ltd.* ('*Verity*').[349] In this case the plaintiffs approached the defendant bank with a request for advice on the feasibility of their business venture. The bank received and agreed to check the plaintiffs' business plan. Additionally, it inspected the property they wanted to develop. After all this, the bank told them that their project was 'viable' and granted them the requested loan.

In my view, there is no difference in the bank's role in *Verity* and *Pampellonne*. In both cases the bank was asked by one of its customers to comment on the feasibility of a specific nvestment the customer was interested in. However, the fact that, in my opinion, in *Pampellonne* the bank should have been under a duty of care towards its customer, would not have resulted in a different outcome of this case. The reason for this is that in *Pampellonne*, in the end, the bank did not fail to fulfil this duty of care because it was entitled to refer to and rely on a credit report of a well respected credit agency when commenting on the financial status of the finance firm in question.

Nonwithstanding, things might be different if, in a case such as *Pampellonne*, the bank is asked to comment on the safety of an investment which belongs to the range of standardized financial products recommended by this bank to its customers. In such a situation, the bank would be under a duty to use its more detailed knowledge of its own products as well as the findings of its own investment experts and analysts in addition to general credit reports when answering a customer's question about the safety and suitability of this investment.

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[349] *The Independent* (4 September 1995) (Transcript), and (1995) 8 C & FL 38.

However, if, in the circumstances of the case, it is established that a bank has assumed the role of its customer's investment adviser and, therefore, owes him or her a duty of care, it is generally accepted that the bank must exercise the skill and care of any other ordinary investment adviser in its position[350]. Nonwithstanding, in *Verity*, Taylor J. went further and ruled that a bank which assumes the role of its customer's investment adviser could be expected to exercise that standard of skill applicable to other professionals who primarily give that sort of financial advice that is requested in the circumstances of the case, i.e. accountants[351]. This aspect appears to have been overlooked in the discussion sparked off by the *Verity* ruling in September 1995. According to this statement, when a bank acts as a financial adviser in matters normally dealt with by another profession, typically by accountants, the bank can be judged against the standard of care that is expected of that profession. This profession's standard might even be higher than that usually expected of a banker in his or her domain, i.e. banking. However, it remains open whether this rather strict attitude towards banks is to emulated by higher English courts.

Furthermore, in this context, attention should also be drawn to the fact that all major UK High Street banks own subsidiaries which offer special advisory services to a carefully selected class of their customers. For example, Lloyds TSB Group owns a subsidiary called 'Lloyds Private Banking'. If the portfolio of a customer of an 'ordinary' Lloyds TSB Group branch exceeds a certain amount, presently around the sum of £100,000, he or she is 'transferred' to Lloyds Private Banking arm[352]. There, the customer is called a 'client' and is offered advice not only on purely financial matters

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[350] *Woods* v *Martins Bank Ltd.* [1959] 1 QB 55 (Ch.Div.), at p. 71.
[351] *The Independent* (4 September 1995) (Transcript).
[352] Interview with Simon Donlevy, Private Banking Executive (PBE) and 'Relationship Manager' with Lloyds Private Banking/Abingdon Branch on 11th March 1998.

such as portfolio management but also on related issues of taxation, wills and general inheritance matters. Lloyds Private Banking also operates special tax and trust departments with a view to provide its clients with expert advice which is meant to cover all aspects of its clients' financial affairs.

Furthermore, a so-called 'Relationship Manager' of Lloyds Private Banking looks after the client. During regular 'fact-find meetings' the Relationship Manager inquires about the financial objectives of the client. The average 'client' of Lloyds Private Banking is male, over 50 years old, self-employed or earns a very high salary. His or her portfolio is worth £150,000. The typical customer is usually too busy to look after his or her own financial affairs and is happy to delegate this task to the bank which usually asks for an annual service charge of one per cent of the value of the portfolio. At these meetings, the Relationship Manager and the client agree on a set of guidelines according to which the bank is requested to manage the client's portfolio. For example, a client may requests the bank that his or her portfolio should consist of 25 per cent gilts, 45 per cent quities and 35 per cent bonds. Typically, the portfolio management contract between the bank and the client stipulates that the bank has 'full discretion' in the day-to-day running of the client's portfolio provided that it adheres to the general instructions given by the client.

However, it should be stressed that the 'full discretion' clause does *not* have the effect that the bank may not be under a duty to exercise due care and skill with regard to the managing of the client's portfolio. In this context, attention should be drawn to the ruling in *Henderson* v *Merrett Syndicates Ltd.*[353] ('*Henderson*'). In this case the House of Lords had to decide whether Lloyd's' underwriting agents owed a duty of care in tort

[353] [1994] 3 All ER 506 (HL).

towards their customers who were direct and indirect names of Lloyd's. The contractual agreements between the underwriters and the names stated that the underwriting agents had 'absolute discretion' in respect of the underwriting business conducted on behalf of the names. However, in his speech Lord Goff stressed that this clause did not mean that the underwriting agents did not have to use due care and skill in the exercise of their functions as managing agents[354]:

> However, it appears to me, as it did to the judge, that in the present context the words used cannot have the effect of excluding a duty of care, contractual or otherwise. Clear words are required to exclude liability in negligence; and in the present case the words can, and in my opinion should, be directed towards the scope of the agents' authority. No doubt the result is that very wide authority has been vested in the agents; but the suggestion that the agent should as a result be under no duty to exercise due skill and care in the exercise of his function under the agreement is, in the present context, most surprising.

Finally, one may be inclined to stress that decisions such as *Woods*, *Pampellonne* and especially *Verity* can only function as the foundation for the law related to the conduct which can be expected of investment advisers. All these decisions were mainly concerned with advice with regard to quite straightforward types of investment. In *Verity*, for example, the customers asked the defendant bank for its view on a small business venture in the area of property development. Modern investment business has become very complex so that it gets more and more difficult for judges, who are usually no experts in the futures or derivatives market, to decide whether a specific form of investment a bank recommends is suitable for the customer's interests.

Furthermore, nowadays, specific legislation such as the Financial Services Act 1986 as well as the codes of conduct which have been drawn up under this legislation play a dominating role in defining the standard of care which can expected of an investment

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[354] *ibid*, at p. 523a-b.

adviser in the UK. Nevertheless, the decisions in *Woods*, *Pampellonne*, *Henderson* and *Verity* are still of great importance because most parts of this specific legislation including the various codes of conduct have an administrative character. In other words, neither the specific legislation nor the codes of conduct automatically grant an investor who has suffered loss through a firm's violation of a provision of the specific legislation or a code of conduct a civil right of action against the firm. This means that in cases where a customer is not given a right of action under the specific legislation or code of conduct, he or she must resort to the 'ordinary' law or tort by arguing that he or she suffered loss caused by the bank's negligent investment advice. However, in the context of such a claim, the provisions of the FSA and the codes of conduct become very important. In these situations, those provisions would be used by the courts to ascertain whether the defendant bank was under duty of care, and, if so, whether the bank breached its duty.

(2) Duties of a bank as an investment adviser under the Financial Services Act 1986

The Financial Services Act 1986 regulates the carrying on of investment business in the UK. According to Schedule 1, Part I of this Act, 'investments' in the meaning of the Act are defined as to include stocks and shares, debentures, certificates of deposit, government securities, warrants, unit trusts, options, futures and the like. However, a bank's deposit taking and lending activities are not included in this definition. These activities are at present still regulated by the Banking Act and the Buildings Societies Act.

Furthermore, by section 1 (2) Financial Services Act 1986, invesment business means 'the business of engaging in one or more of the activities which fall within the principles in Part II of Schedule 1 and are not excluded by Part III of that Schedule'. Schedule 1, Part II and III define investment business as 'buying, selling, subscribing for or underwriting investments or offering or agreeing to do so, either as principal or as an agent'. Additionally, the 'managing, or offering or agreeing to manage assets belonging to another person' as well as 'the giving or offering or agreeing to give, to persons in their capacity as investors or potential investors advice on the merits of their purchasing, selling, subscribing for or underwriting an investment, or exercising any right conferred by an investment to acquire, dispose of, underwrite or convert an investment' qualifies as investment business under the Act.

According to section 47 (1) of the Act it is an offence to make a misleading, false or deceptive statement or dishonestly conceal any material facts and thereby induce another person to enter or refrain from entering into an investment agreement. Moreover, under section 47 (2) of the Act the offence is also committed even if there is no proof of dishonesty or recklessness but it is a defence if one proves that one reasonably believed that one's act or conduct would not create an impression that was false or misleading.

Furthermore, it is interesting to notice that a breach of the provisions of section 47 Financial Services Act by an authorised investment adviser may also lead to the loss of authorisation but there is no express right to damages for a misled or deceived investor[355]. Section 62 of the Act, which confers a civil right of action in respect of a contravention of certain rules and regulations laid down in chapter five of the Act, does

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[355] Lomnicka/Powell, *Encyclopaedia of Financial Services Law* (London, Release 43, November 1997), Volume I, Part II, at p. 2-132.

not include a reference to section 47. Thus, it is generally accepted that a breach of section 47 does not entitle to a claim under section 62 but may give rise to an action in common law, for example in deceit, misrepresentation or negligence[356].

(a) The old structure of supervision and regulation of the financial services industry in the UK

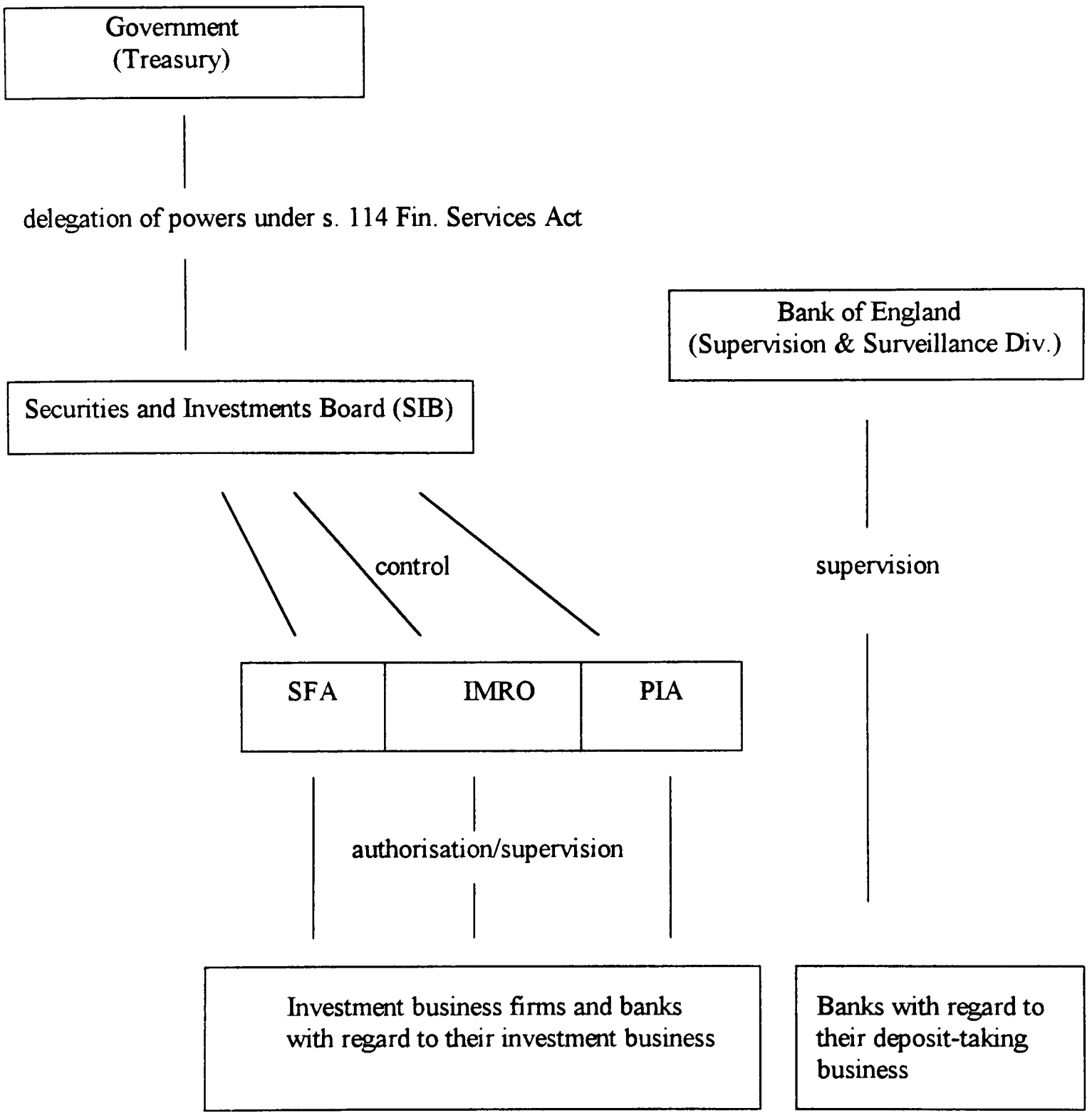
Until very recently, under section 114 of the Financial Services Act 1986 important rule-making functions were delegated to the Securities and Investments Board ('SIB'). The SIB is a regulatory body whose members are appointed jointly by the Secretary of State and the Govenor of the Bank of England. Under section 114 of the Financial Services Act the Secretary of State/Treasury had delegated its rule making powers under section 48 Financial Services Act 1986 to the SIB. In practice, this meant that the SIB drew up and polices its codes of conduct for the financial services industry.

The SIB's functions included the recognition of self-regulating organisations ('SROs') which in turn regulated the carrying on of investment business of their members[357]. Until very recently, there were three SROs: the Securities and Futures Authority ('SFA'), the Personal Investment Authority ('PIA') and the Investment Management Regulatory Organisation ('IMRO'). The titles of these organisations were broadly descriptive of the type of investment business which they covered.

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[356] Lomnicka/Powell, *Encyclopaedia of Financial Services Law* (London, Release 43, November 1997), Volume I, Part II, at p. 2-132.
[357] Cresswell/Blair/Hill/Wood, *Encylopaedia of Banking Law* (London, Issue 39, July 1997), Volume I, at p. A 501.

Outline of the old structure of banking and investment business supervision in the UK:



The Securities and Futures Authority (SFA) regulated about 1,000 firms involved in all the organised city investment markets - i.e. the stock market, eurobond, financial futures, commodity futures markets - and also corporate finances specialists and off-market traders[358]. The Investment Management Regulatory Organisation (IMRO) regulated about 1,100 fund management firms including portfolio managers, pension

[358] The Securities and Investments Board (SIB), *An Introduction to the SIB* (London 1997), at p. 25.

fund managers, unit trust managers and trustees, investment trust managers and managers of unregulated collective investment schemes. In January 1997, IMRO firms had a total of more than £1,225 billion of funds under management[359].

The Personal Investment Authority (PIA) regulated about 4,000 firms, including independent products or act for private investors in relation to such products. It was the main regulator of firms advising on and arranging deals in the life assurance and personal pensions, friendly society investments, unit trusts and investment trust savings schemes[360]. Many banks were members of more than one organisation because their business activities fell into the scope of more than one of these bodies[361].

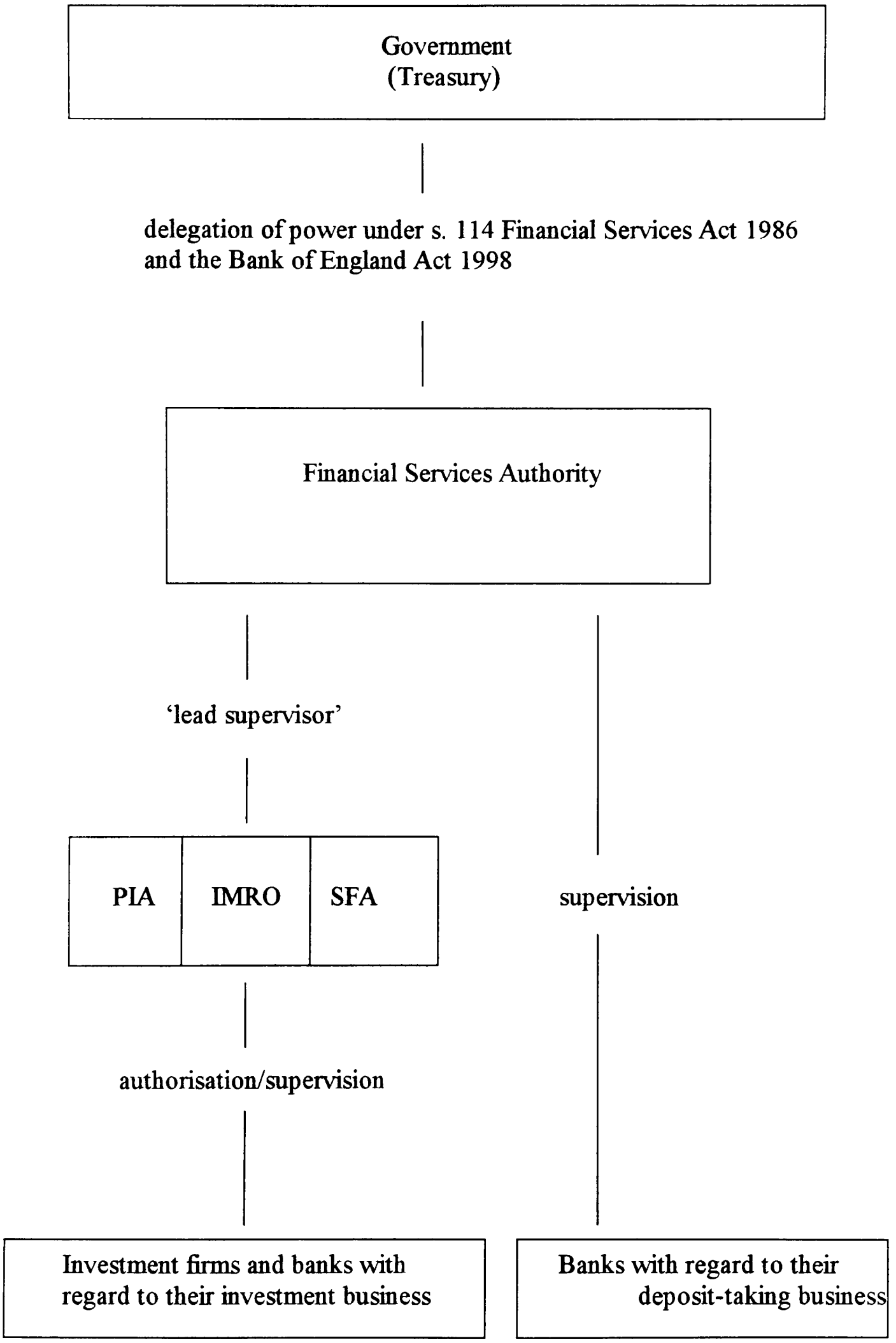
(b) The present and future structure of the supervision and regulation of the financial services industry in the UK

However, all this has changed recently. Through the Bank of England Act 1998, a new supervisory and regulatory body called the 'Financial Services Authority' ('FSA') has been created. The FSA is - in corporate and legal terms - the Securities and Investments Board ('SIB') renamed. It is meant to become the new single regulator for the entire financial services industry in the UK. The new regulatory body is to acquire its full range of responsibilities in two stages[362].

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[359] *ibid*, at p. 24.
[360] *ibid*, at p. 24.
[361] Blair/Allison/Palmer/Richards-Carpenter, *Banking and the Financial Services Act* (London 1993), at p. 15-16.
[362] Financial Services Authority, *Financial Services Authority - An Outline* (London October 1997), at p. 5.

Outline of the present structure of banking and investment business supervision in the UK (i.e. as with effect from the 1st June 1998):



First, with effect from the 1st June 1998, the FSA has taken over from the Bank of England the task of supervising banks and wholesale money market institutions with regard to their deposit-taking business[363]. Moreover, under several interim arrangements, the FSA is currently preparing itself for the incorporation of the presently still operating self-regulating bodies such as PIA, IMRO and SFA. For the time being, the FSA's role is restricted to function as a 'lead supervisor' for the still existing SROs. This means that, for the time being, PIA, IMRO and SFA retain their responsibilities for the authorisation and regulating of their member firms.

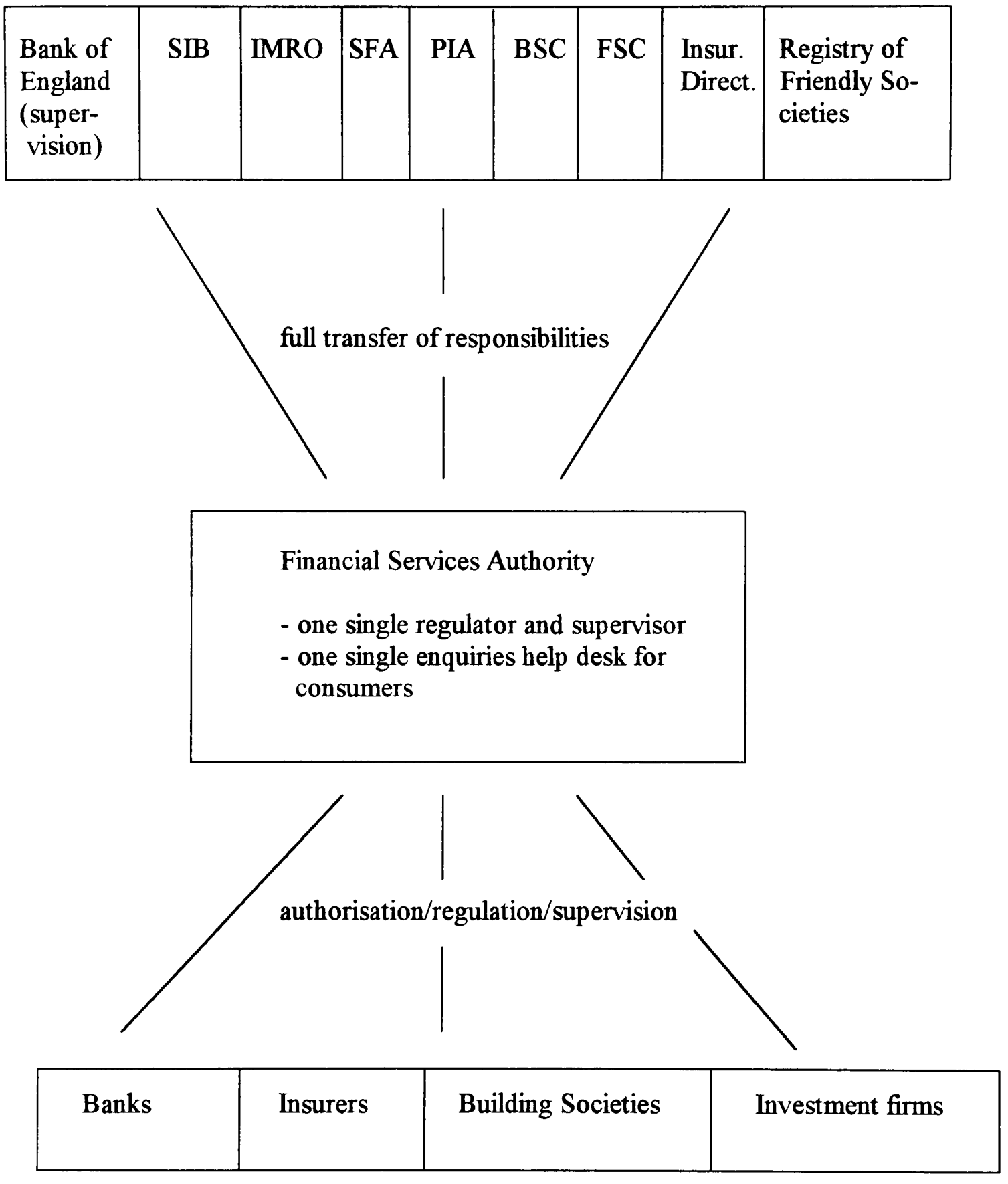
However, this is all going to change soon with the enactment of the proposed 'Financial Services and Markets Bill' in 1999. This piece of legislation is meant to create a new statutory regime under which the FSA will, in broad terms, acquire the regulatory and registration functions which are currently exercised by the self-regulating organisations ('SROs'), the Department of Trade's Insurance Directorate ('ID'), the Building Societies Commission ('BSC'), the Friendly Societies Commission ('FSC') and the Registry of Friendly Societies ('RFS')[364]. The FSA will also be given responsibility for the authorisation of firms currently authorised to do investment business by virtue of their membership of a Recognised Professional Body ('RPB') such as, for example, the Law Society or the Chartered Institute of Accountants[365].

In July 1998, the government published the bill in draft. Early introduction of the bill in Parliament might lead to enactment in 1999. This may result in the FSA acquiring the full range of its powers in late 1999 or early 2000[366].

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[363] *ibid*, at p. 5.
[364] *ibid*, at p. 5.
[365] Fisher/Bewsey, *The Law of Investor Protection* (London 1997), at p. 28.
[366] Interview with Mr. Andrew Whittaker, Deputy Counsel to the Board, Financial Services Authority on 25th June 1998 in London.

Outline of the future structure of banking and investment business supervision in the UK (i.e. from commencement of the proposed financial regulation bill in 1999/2000):



With the establishment of the FSA as one single supervisory and regulatory body for the entire financial services industry, Britain is breaking new ground. The new FSA is going to employ about 2,000 staff and its budgeted expenditure for 1998-99 is said to be no

less than £66,8m[367]. It is said that no other country in Europe has such an integrated system of supervision of financial services[368].

One of the main reasons behind the establishment of FSA has been the criticism over the handling of the pension mis-selling scandal in the UK. To many financial institutions the different regulators had seemed to be competing with each other and failing to cooperate[369].

However, with the establishment of the new single regulator for the entire financial services industry, this is meant to change. The new FSA is intended to function as a 'one-stop-shop' regulator and supervisor to enhance the regulatory system in ways which benefit both firms and consumers[370]. The recently elected British government wants the FSA to become a 'world-class regulator'[371]. It remains to be seen whether this ambitious goal can be achieved.

(c) A bank's investment advice and the Codes of Conduct

Beside the field of supervision, the other practically very important task of the above mentioned institutions is producing regulations for the UK's financial services industry. Under the provisions of the Finanical Services Act 1986, the 'old' SIB as well as the

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[367] Financial Services Authority, *Financial Services Authority - Plan & Budget 1998-99* (London 1998)
[368] Interview with Andrew Whittaker, Deputy Counsel to the Board, Financial Services Authority on 25th June 1998 in London.
[369] Graham, George, 'A leap into the dark' in: The Banker/Financial Times, International Banking in London (27 November 1997), at p. 12.
[370] Financial Services Authority, *Financial Services Authority - Plan & Budget 1998-99* (London February 1998), at p. 11.
[371] Financial Services Authority, *Financial Services Authority - An Outline* (London October 1997), at p. 4.

SROs produced a set of Codes of Conduct which remain in force until the proposed Financial Services and Markts legislation empowers the new FSA to come up with its own draft for new codes of conduct for the financial services industry.

For the time being, there is a three-tier system of rules of conduct in today's UK investment business. First, there are the ten 'Principles' of the SIB. These Principles are directly applicable to all financial services firms irrespective of which SRO they belong to. Secondly, there is the the SIB's 'Core Conduct of Business Rules' and the 'Financial Services (Conduct of Business) Rules 1990'. The 'Financial Services (Conduct of Business) Rules 1990 apply only to investment firms which are not SRO members but are directly regulated by the SIB.

The SIB's forty 'Core Conduct of Business Rules' were originally designated to apply to all investment businesses whether they were directly authorised by the SIB or authorised by a SRO. However, the 'Financial Services (Dedesignation) Rules and Regulations 1994' dedesignated[372] the Core Rules and revoked the IMRO and SFA commencement orders which made the Core Rules applicable to their member firms [373]. As a result, the Core Rules are no longer[374] directly applicable to SRO members. They only apply to those investment businesses which are authorised by the SIB itself. However, it should be pointed out that the Core Rules have been incorporated into the SROs' own rule books which make up the third tier of the conduct rules for the UK's investment businesses.

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[372] With the exemption of Core Rule 36 and 40.
[373] Lomnicka/Powell, *Encyclopaedia of Financial Services Law* (London, Release 43, November 1997), Volume I, Part IIIA, at p. 5-204/131.
[374] With the exemption of Core Rule 36 and 40.

Due to the restrictions as to the scope of this work, it is not possible to mention and discuss the very detailed rules of conduct which have been issued by all three SROs, i.e. IMRO, PIA and SFA. However, it is safe to say that the SIB's Principles, Core Conduct of Business Rules and the Financial Services (Conduct or Business) Rules 1990 constitute the foundation stones of these SROs rules. The principles and the core rules deal with the most important problems in today's investment business. The supplementary rules laid down by the SROs are primarily meant to elaborate and adapt them to the specific type of transactions and dealings in those sectors of investment business which are regulated and supervised by the SFA, IMRO and PIA[375].

(3) The ten 'Principles' of the SIB

With the help of its ten Statements of Principle the SIB has sought to set general standards of conduct required by persons authorised by the SIB to undertake investment business. Investment business in the meaning of the FSA is defined in section 1 (2) of the FSA by reference to Schedule 1 to that Act. It includes the dealings in investments as they are defined in section 1 FSA and services related to investments such as the arrangement of investments, managing of investments, advice on investments, and establishing of collective investment schemes.

This means that the ten SIB Principles do not apply to investments or advice on a matter that is not related to investments in the sense of section 1 of the FSA. In this respect, Schedule 1 to the FSA, Part II, paragraph 24 explicitly states that 'advice given in the

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[375] Cresswell/Blair/Hill/Wood, *Encylopaedia of Banking Law* (London, Issue 39, July 1997), Volume I, at p. A 527.

course of carrying on any profession or a business not otherwise constituting investment business' does not qualify as advice on investment business in the sense of the FSA[376]. It follows that, for example, a bank's advice on a loan for a small business venture is not covered by the Principles. In other words, cases such as *Verity* where a bank's customer requested the bank's opinion on the customer's plan for an investment in a small property development on credit would not be covered by the SIB's Statements of Principle.

As mentioned above, these Principles are directly applicable to all SRO members and firms which are directly regulated by the SIB. A breach of these principles does *not* give in itself rise to liability under section 62 FSA, but can lead to the SRO taking disciplinary action against the investment firm concerned. For example, the SIB or a SRO can withdraw, suspend or terminate a firm's authorisation. It is said that, in practice, the threat of disciplinary action is generally sufficient to 'persuade' a firm to compensate an investor who has suffered loss[377].

The ten SIB principles may be described as being of a rather general nature. They request investment firms to observe high standards of integrity, fair dealing and to act with due skill care and diligence. Due to the restrictions as to the scope and extent of this thesis, only the most relevant principles with regard to investment advice may be discussed here.

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[376] Blair/Allison/Palmer/Richards-Carpenter, *Banking and the Financial Services Act* (London 1993), at p. 39.
[377] Cresswell/Blair/Hill/Wood, *Encylopaedia of Banking Law* (London, Issue 39, July 1997), Volume I, at p. A 524.

Principle 4: Information about customers

> A firm should seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfil its responsibilities to them.

This principle is also known as the *'know your customer'* rule. Under this rule the investment firm is required to obtain from its customers information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfil its responsibilities to its customers.

Where a customer is unwilling to give this information to the firm the firm can nevertheless provide the customer with the requested investment services or advice. However, this does not automatically mean that, in this situation, the firm is under no duties at all. Rule 16 (1) of The Core Conduct of Business Rules, the so-called suitability rule, is generally interpreted as placing the firm under the obligation to consider the information it already has about its customer when providing its services to him or her[378]. Furthermore, it is argued that principle 4 does not apply to the providers of so-called 'execution-only' business, i.e. firms which offer their investment services per fax, telephone or the internet because they do not give any advice on specific investments to their customers[379].

Principle 5: Information for customers

> A firm should take reasonable steps to give a customer it advises, in a comprehensible and timely way, any information needed to enable him to make a balanced and informed decision. A firm should similarly be ready to provide a customer with a full and fair account of the fulfilment of its responsibilities to him.

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[378] *ibid*, at p. 13 footnote 9.
[379] *ibid*, at p. 12.

This principle is about disclosure and accountability. Generally, it is said that the investment firm must disclose to the customer information which enables him or her to reach an informed investment decision. The information which is given to the customer must be correct, comprehensive, timely and comprehensible. It should be to the nature of the investment as well as to the financial implications of the transaction. Moreover, the more the customer relies on the skill and judgment of the adviser, the more explanation will be needed[380]. The second requirement of principle 5, i.e. accountability, is seen as more 'customer-driven'. This means that a firm must, at the customer's demand, be able to provide him or her with a full and fair account of the material transaction.

Principle 6: Conflicts of interest

> A firm should either avoid any conflict of interest arising or, where conflicts arise, should ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act, or otherwise. A firm should not unfairly place its interests above those of its customers and, where a properly informed customer would reasonably expect that the firm would place his interests above its own, the firm should live up to that expectation.

Principle 6 is generally regarded as the most complex of all ten principles. The first part of this principle offers to firms two ways of handling a conflict of interest. The first option is to avoid any conflict of interest arising. The second is to undertake to 'manage' the conflict. This is to be achieved by ensuring that there is fair treatment to all the firm's customers[381]. Normally, the disclosure of the existence of conflict is seen as sufficient. If the customer knows that the firm has a stake in the matter, he or she will usually be able to assess the situation and what is best for his or her interest. It is said

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[380] *ibid*, at p. 16.
[381] *ibid*, at p. 18.

that the principle appears to be neutral between the two options, and does not establish a hierarchy between them so long as it achieves a fair result[382].

The second part of the principle requires a firm not to place its own interests unfairly above those of its customers. This means that a firm ought not engage in any trading in its own interest on the basis of its knowledge of the customer's orders with a view to make extra profits (so-called front, parallel or counter running). This principle may also be seen as a more specific form of the general common law duty of agents not to use their position to acquire a benefit for themselves at the expense of their principals[383].

The legal nature of the SIB's Statements of Principle may be summarized as a form of indirect investor protection rules because the Principles do not grant investors any civil rights against a firm which breaches them. However, with the Principles the SIB has set a uniform (minimum) standard of conduct for firms and individuals involved in the investment business. Furthermore, breaches of the Principles can result in disciplinary action by the SIB or the SROs. Additionally, the Principles may also serve as guidelines for the courts when they are asked to decide whether a certain conduct by an investment firm was in breach of its common law duty of care towards its customer irrespective of the question of whether this the material investment matter is covered by the Principles or not.

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[382] *ibid*, at p. 20.
[383] Cranston, Ross, *Principles of Banking Law* (Oxford 1997), at p. 203.

(4) The Core Conduct of Business Rules

Whereas the SIB's Statements of Principle are of a rather general nature, the SIB's Core Conduct of Business Rules are more specific. As already mentioned above, the core rules (with the exception of rules 36 and 40) do apply only to investment firms which are directly regulated by the SIB[384]. In other words, investment firms which are regulated by one of the SROs do not fall under the core rules. However, the core rules have been - with some derogations - incorporated into the SROs's own rulesbooks and thereby they apply to SRO members by virtue of contract of membership which includes the SRO rules[385].

It should be pointed out that the forty Core Conduct of Business Rules cover a wider range of issues than the Principles and they distinguish between two types of customers, i.e. private customers and non-private customers. Generally, the core rules generally apply to all types of customers. However, there are two exceptions to this rule. First, some core rules state that they are applicable only to dealings with a specific type of customers (e.g. private customers). Secondly, the application of some core rules may be restricted to provisions made by the SROs' rulebooks provided that these 'exemptions' meet the requirements of core rule 39. In short, core rule 39 enables a SRO to draw up a provision stating that someone who would normally be viewed as a private customer can be treated as a non-private customer provided that he or she has sufficient understanding of the legal consequences of this, and has been provided with a written warning and has given his or her consent.

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[384] Cresswell/Blair/Hill/Wood, *Encyclopaedia of Banking Law* (London Issue 39 July 1997), Volume I, at p. A 526.
[385] Lomnicka/Powell, *Encyclopaedia of Financial Services Law* (London, Release 32, February 1995), Volume II, Part V, Chapter IIIA, at p. 5-204/131.

Generally speaking, the stricter standard of conduct applies to dealings with private customers, the more relaxed to tradings with non-private customer. A private customer is defined as any individual who is not acting in the course of carrying on investment business[386]. This means that all natural persons investing for themselves but not by way of business are covered. Furthermore, it is notable that breach of the Core Conduct of Business Rules, unlike the Principles, give rise to civil law liability. If a core rule is breached, an aggrieved investor can bring a claim in civil law for damages under section 62 FSA[387].

Clearly it would be inappropriate to list here all forty core rules. Instead, the focus will be on those core rules which are most important for a defining an investment adviser's duties towards a customer.



Core Rule 4: Polarisation

1. A firm which advises a private customer on packaged products must either:
(a) be a product company or its marketing group associate or
(b) do so as an independent intermediary.

2. A firm which is a product company or its marketing group associate must not advise private customers to buy packaged products which are not those of the marketing group.

3. A firm which acts as an independent intermediary in advising a private customer on packaged products must act as an independent intermediary whenever it advises private customers on packaged products in the course of regulated business.

4. But where a firm acts as an investment manager for a customer, the core rules on polarisation does not prevent the firm from advising the customer on any packaged product.

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[386] Blair, Michael, *Financial Services - The New Core Rules* (London 1991), at p. 44.
[387] Blair, Michael, *Financial Services - The New Core Rules* (London 1991), at p. 44.

In essence, this rule obliges an investment firm which advises private customers on so-called 'packaged products' (i.e. interests in collective investment vehicles such as life assurances or unit trusts) to 'polarise'. This means that an investment adviser must be either a company representative or a marketing group associate representing the interests of only one product company or an independent intermediary acting as an agent for the investor and surveying the whole market in order to find the most suitable investment product for the investor[388]. Furthermore, it may be pointed out that subsection 4 of this rule disapplies the polarisation principle where a firm acts as an 'investment manager' for a customer (i.e. where a firm manages an account or portfolio in the exercise of discretion). In such a case, the firm is free to decide whether it restricts its advice to its own financial products or also advises on packaged products offered by any other investment firm[389].

In practice, the polarisation rule has led to the development of a two-class system of financial advice in today's private customer banking business. In the area of the so-called 'bread and butter' banking business such as consumer and mortgage loans as well as personal pensions plans, the UK's High Street banks have adopted a 'one product company' approach. This means that in the field of ordinary banking matters every High Street bank makes it clear to its customers that they advise only on their own financial products but not on any products of other providers of financial services.

On the other side, all major High Strees banks have also established subsidiaries which specialize in portfolio management for wealthy customers. The business activities of

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[388] Blair/Allison/Palmer/Richards-Carpenter, *Banking and the Financial Services Act* (London 1993), at p. 118.
[389] Lomnicka/Powell, *Encyclopaedia of Financial Services Law* (London, Release 32, February 1995), Volume II, Part 5 (5-249AD), at p. 5-204/137.

these subsidiaries usually fall under sub-section 4 of Core Rule 4 so that these subsidaries are free to give advice not only on their bank's but also on other banks' financial products. For example, Lloyds TSB's private banking arm is not held to sell only Lloyds TSB's own products to its customers. This means that if a certain financial product in which the customer of this subsidiary is interested, for example a specific private pension plan, is offered on more favourable terms by a rival of Lloyds TSB Group, Lloyds' private banking arm buys this product on the customer's behalf of this rival[390].

One may be inclined to argue that the existing two-class system in today's banking business in the UK is morally questionable because it denies the vast majority of bank customers truly impartial advice. However, in my view, this criticism does not take into account the underlying economic considerations of the approach which is currently taken by the High Street banks. It appears that banks find that, at present, due to a lack of sufficient profit margins with regard to the investments typically made by less wealthy customers it is not feasible for them to function as an 'independent financial adviser' for all of their customers.

In my view, the question of whether banks should be obliged to offer impartial advice to all of their customers may be left to be solved by the market forces. In my opinion, the ever growing competition between banks will eventually force banks to offer to their customers not only a broader range of financial products including a selection of products of their rivals but also to provide independent advice to a much wider spectrum of their customers.

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[390] Interview with Simon Donlevy, Private Banking Executive (PBE) and 'Relationship Manager' with Lloyds Private Banking/Abingdon branch on 11 March 1998.

However, in the meantime, the emphasis should rather be laid on requesting banks to provide their customers with as much correct and complete information as they need to reach an 'informed decision' when purchasing financial products. Additionally, it should be emphasized that the fact that an investment firm calls itself an 'independent financial adviser' ('IFA') does not, in practice, mean that the advice which is given by this firm is entirely free from any self-interest of this firm. For example, it is argued by the present PIA Ombudsman that many of today's so-called independent financial advisers are - in the strict sense - not independent at all[391]. It is maintained that today's independent financial advisers obtain commission fees for every sale of a financial product in which they act as an intermediary between the customer and the provider of the financial service requested by the customer. As long as there are significant discrepancies between the extent of commission payments which are made by different providers of financial services (especially insurance companies and investment funds) to the independent financial advisers, there exists a conflict of interest for every independent financial adviser. Thus, it is argued by the PIA Ombudsman that the independent financial advisers should take fees from their customers instead of earning their money 'indirectly' through commission payments.

However, this suggestion is viewed as unrealistic by members of the financial services industry[392] because it would not take into consideration the fact that today's consumers are not used - and therefore also not prepared - to pay a fee for financial advice which, at present, is provided for 'free' to them.

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[391] See speech given by Mr. Tony Holland, Principal Ombudsman of PIA at the conference on 'Regulations under Review' on 15 October 1997 in London.

[392] See speeches made by representatives of the UK's financial services industry at the conference on 'Regulations under Review' on 15 October 1997 in London.

Core rule 10: Customer's understanding

> A firm must not recommend a transaction to a private customer, or act as a discretionary manager for him, unless it has taken reasonable steps to enable him to understand the nature of the risks involved.

This rule imposes a duty on the firm to take reasonable steps to ensure that the customer understands the nature of the risks of the transaction. This rule (impliedly) stipulates that a recommendation is given only after consulting the customer and explaining to him or her the transaction and its risks. Moreover, in this context, attention should be drawn to the fact that this rule has been significantly extended by the SIB itself in its 'Conduct of Business Rules 1990'[393]. Part Three, rule 3.01 (1) explicitly says that the firm must obtain from its private customer 'such facts about his personal and financial situation as may be expected to be relevant to the proper performance of those services in accordance with these rules'. This requirement for a firm to make inquiries specifically with regard to the personal and financial affairs to the customer is not contained in core rule 10. On the other hand, Part Three, 3.01 (2) grants a relatively wide exemption to this obligation. Part Three, 3.01 (2) stipulates that a firm is not under the obligation to inquire about the personal and financial situation of a customer if this customer is either a market counterparty, an execution-only customer, a professional or experienced investor.

The conduct of several stock broker firms and building societies with regard to the misselling of so-called 'home income plans' in the 80s in the UK may serve as a good example of a contravention of core rule 10. Home income plans were offered especially to elderly home owners who had already paid off the whole or the greater part of earlier mortgage loans. The purpose of these plans was to raise a loan which was secured by a

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[393] It may be pointed out that these 'Conduct of Business Rules 1990' only apply to those investment firms which are directly regulated by the SIB.

mortgage on the property and a large proportion of the capital raised by this loan was invested in an equity linked single premium bond. The balance, after the deduction of fees and costs of the mortgage, was made available to the investor for his or her personal needs. Provided that the investment bond performed sufficiently well to meet the interest payments on the mortgage loan when they fell due, without depreciating the captial invested, all would be fine. There was, however, an inevitable risk that, if the return from the investment and/or the value of the property fell, and the mortgage interest rates increased, the income form the bond would not service the mortgage loan. The capital invested would then diminish at an increasing rate which in the end meant that the investor had to sell his or her home. In many cases, elderly investors were not informed about this risk. A very good illustration of the questionable business practices at that time is the experience of Mr. Veniard, a party to the legal action in the decision in *Regina* v *Investors Compensation Scheme Ltd, ex parte Weyell*[394].

In 1987. at the age of 72, Mr. Veniard was approached by Mr. Doerr, a partner of Aylesbury Associates, a firm of stock brokers which specialized in home income plans. From the information given to him by Mr. Doerr, Mr. Veniard understood that the plan would be for him to obtain a loan of £60,000 secured by a mortgage on his home which he jointly owned with his wife. Of this loan, £8,000 would be used to pay off an existing mortgage loan. Aylesbury would then invest and manage the balance in such a way as to enable them to meet all the interest payments on the mortgage and pay Mr. and Mrs. Veniard an income of £200 per month. Mr. Doerr said that though investments could go down, they always went up again; averaging over the year Aylesbury Associates could guarantee a return of at least 20 per cent on the investment. Mr. Doerr did not

[394] [1994] QB 749 (DC).

warn Mr. and Mrs. Veniard that there was a risk to their home nor did he tell them about the fees or commission his firm would be paid if they entered into a home income plan. Mr. Doerr arranged for the Veniards the mortgage loan with the Cheltenham & Gloucester Building Society and the Veniards signed a power of atttorney appointing Mr. Doerr and his partner Ms. Wilkins to invest and manage at their discretion the net proceeds of the mortgage loan. In 1988 and 1989, when Mr. and Mrs. Veniard withdrew cash from the plan Mr. Doerr also failed to explain to them that cash withdrawls from the plan automatically lead to a significant decrease in the income generated by their investments and therefore, in the end, could put their home at risk if the investment income was not sufficient to serve the mortgage payments anymore.

In November 1990, Aylesbury Associates got into financial difficulties and stopped the payments made on behalf of the Veniards to the building society. Two years later, the stock broker firm collapsed. The Veniards lost all their investments placed with Aylesbury Associates and therefore could not repay their mortgage loan. They had to sell their house and filed an application for compensation from the Investors Compensation Scheme Ltd, a rescue fund which was set up by the Securities and Investment Board (SIB) in 1988. The Scheme steps in when problems arise and clients of an investment firm, which is authorised by one of the self-regulatory organisations such as the the Investment Management Regulatory Organisation (IMRO), the Personal Investment Authority (PIA) and the Securities and Futures Authority (SFA), stand to lose money they invested[395]. The Scheme is funded by a levy, to which investment firms authorised by the SIB, IMRO, PIA and SFA contribute.

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[395] The Investors Compensation Scheme, *Annual Report 1996-97* (London 1997), at p.2.

In *Regina* v *Investors Compensation Scheme Ltd, ex parte Weyell* the Divisional Court, found - when deciding whether the Veniards were entitled to compensation under the Scheme - that they were given negligent advice by Aylesbury Associates[396]:

> [...] by failing to warn to warn the Veniards in those reports of the increasing risk to their fund and thus to their home, and by not warning them of the increase in this risk resulting from their withdrawls of cash from the fund in 1988 and 1989, Aylesbury were in breach both of the implied duty to use reasonable skill and care in their contract with the Veniards and of rule 4.3.2. of the FIMBRA rules[397].

Taking into consideration that according to a survey carried out by the National Consumer Council about one third of all consumers are 'not at all' or 'not very confident' about choosing where to invest a sum larger than their monthly pay[398], it may be argued that banks as their customers' investment advisers ought to take extra care when explaining to their customers their often very complex investment products.

> *Core rule 15: Customer's rights*
>
> (1) A firm *must not, in any written communication or agreement, seek to exclude*[399] or restrict any duty or liability to a customer which it has under the Act, or under the regulatory system.
>
> (2) Similarly, unless it is reasonable to do so in the circumstances, a firm must not, in any written communication or agreement, seek to exclude or restrict:

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[396] per Glidewell LJ and Cresswell J [1994] QB 749 (DC), at p. 768C.

[397] FIMBRA stands for 'Financial Intermediaries, Managers and Brokers Regulatory Association'. FIMBRA was amalgamated with another self-regulatory body called ''Life Assurance and Unit Trusts Regulatory Organisation (LAUTRO) into the 'Personal Investment Authority' (PIA) in 1994. FIMBRA Rule 4.3.2 resembles the SIB's Core Rule 10 and states that:
'Subject to rule 4.3.3, a member [of FIMBRA] shall not act as a discretionary portfolio manager on behalf of a client unless the member has taken all reasonable steps to satisfy itself that the client has a reasonable understanding of the risks to which he will be exposed in connection with the management of the portfolio having regard to: (a) the investment objectives set out in the client agreement; (b) the extent of the discretion conferred on the member by the client agreement; and (c) the extent to which the client is relying on the member to supply expertise which the client does not possess [...]'.

[398] National Consumer Council, *Consumer Concerns 1994 - A consumer view of the personal financial services: The report of a Mori Survey* (London 1994), at p. 10.

[399] Emphasis added.

> a. any other duty to act with skill, care and diligence which is owed to a private customer in connection with the provision to him of investment services in the course of regulated business; or
>
> b. any liability owed to a private customer in connection with regulated business for failure to exercise the degree of skill, care and diligence which may reasonably be expected of it in the provision of investment services in the course of that business.
>
> (3) A firm must not seek unreasonably to rely on any provision seeking to exclude or restrict any such duty or liability.

Paragraph 1 of this core rule prohibits any firm from seeking to exclude or restrict duties or liabilities to a customer under the FSA or the rules laid down by the SROs. The main objective of paragraph 2 of this rule is to make the 'reasonableness test' of the Unfair Contract Terms Act 1977 (indirectly) applicable to investment business agreements[400]. Section 1 (2) of this Act in connection with Schedule 1, No.1 (e) disapplies the Act to 'any contract so far as it relates to the creation or transfer of securities of or any right or interest in securities. Thus, the direct application of this Act to securities contracts is not possible. Nonwithstanding, with the help of core rule 15 (2) the ideas attached to the Unfair Contract Terms Act 1977 become applicable to securities contracts. In practice, this means that any exclusion or restriction of duties and liabilities of a firm is subject to a test which is meant to run along the lines of the provisions of the Unfair Contract Terms Act 1977. Paragraph 3 of the rule is meant to encourage firms not to behave unreasonably in relying on exclusion clauses[401].

> *Core rule 16: Suitability*
>
> (1) A firm must take reasonable steps to ensure that it does not in the course of regulated business or associated business:
>
> a. make any personal recommendation to a private customer of an investment or investment agreement; or

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[400] Blair, Michael, *Financial Services - New Core Rules* (London 1991), at p. 92.
[401] Blair, Michael, *Financial Services - New Core Rules* (London 1991), at p. 93.

> b. effect or arrange a discretionary transaction with or for a private customer or, subject to any exceptions contained in the rules of an SRO of which the firm is a member, any other customer;
>
> unless the recommendation or transaction is suitable for him having regard to the facts disclosed by that customer and other relevant facts about the customer of which the firm is, or reasonably should be, aware.
>
> (2) But where, with the agreement of the customer, a firm has pooled his funds with a view to taking common management decisions, the firm must instead take reasonable steps to ensure that the transaction is suitable for the fund, having regard to the stated investment objectives of the fund.

This rule is probably the most important of all forty rules. Unfortunately, the rule does not define what 'suitable' means in the context of an investment. According to one view[402], suitability rests somewhere between two extremes on the spectrum running from 'not suitable' to 'positively and indisputably the most suitable available'. Furthermore, it is argued that the more important the transaction is for the customer, the more the definition moves to the more exacting end of the spectrum. Moreover, attention should be drawn to the fact that the issue of suitability has also been regulated in the rulebooks of the SFA, IMRO and PIA. The SFA rule on suitability may serve as an example for the general policy of the SROs to elaborate and adapt the SIB's Principles and Core Conduct or Business Rules to the specific characteristics of the type of investment business which is regulated and supervised by them. The SFA suitability rule contains the provisions of SIB's core rule 16 plus the following paragraph:

> A firm which acts as:
> (a) an investment manager for a private customer; or
> (b) a discretionary investment manager for a non-private customer,
> must ensure that the customer's portfolio or account *remains suitable*[403], having regard to the facts disclosed by that customer or other relevant facts about the customer of which the firm is, or reasonably should be, aware.

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[402] Blair, Michael, *Financial Services - New Core Rules* (London 1991), at p. 94.
[403] Emphasis added.

In summary, this third paragraph places an investment firm which is regulated and supervised by the SFA not only under the general SIB-based duty to ensure that the recommended investment or portfolio *is* suitable but also under the SFA-related obligation to ascertain that the customer's investment or portfolio *remains* suitable. In other words, this means, for example, that where a SFA-regulated firm has recommended to a private customer a specific derivative transaction for the purpose of hedging against a risk to which the customer is exposed, the transaction will only remain suitable while the customer remains exposed to that risk[404].

The following case which has recently been dealt with by the Personal Investment Authority Ombudsman may serve as an example of the provision of unsuitable investment advice. In this case[405], a 19 year old employee approached an investment firm with the intention of obtaning protection against long term illness. He also mentioned as his second priority to make some long term savings. The investment firm did not offer so-called 'stand alone' critical illness cover or such a cover linked to an otherwise pure investment contract. Instead, the firm sold the young man a policy where the premium was apportionated as to approximately 50 per cent to investment, 30 per cent to life cover and 20 per cent critical illness cover. The investor was not told of the proportions in which his premium was being appropriated to the various benefits.

The PIA Ombudsman Bureau decided that the policy was a missale because it was unsuitable for the specific needs which were explicitly stated by the investor to the investment firm. Due to the fact the investor stressed that he did not need life cover, 30

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[404] Whittaker, Andrew, *Financial Services: Law and Practice*, Volume III (London, Issue 57, August 1997), E 2472, at p. E 2229A.
[405] See Personal Investment Authority Ombudsman Bureau, *Annual Report 1996-97* (London 1997), at p. 47.

per cent of his premium was being wasted. The PIA Ombudsman Bureau also emphasized that only 50 per cent of his premium was being put towards investment even after the charges had been met, with the result that the investment return was likely to be poor at least in the medium term[406].

However, in my view, it remains questionable whether these suitability rules as at present drafted are sufficient. Taking into consideration that many banks and other financial services providers aggressively advertise themselves as 'investment specialists' or 'stock market experts', one should require them to live up to their own promises. It does not appear to be appropriate to accept advice from them which is only just 'suitable'. In my opinion, one can reasonably expect that their expert advice must be 'positively suitable'. For example, a customer who asks a bank for advice on a 'very safe investment' should not just be referred to the bank's own products in that category, i.e. a savings account. In this situation, the bank ought rather to inquire whether government bonds, which usually offer a higher interest rates than the bank's standard savings accounts, are more suitable for this customer. This problem has also been addressed by the PIA. In a draft guidance on factfinding the PIA deals with the issue of limited product ranges. In section 18 of this draft guidance, it is stated that[407]:

> Product providers with limited product ranges must take care to ensure that they *recommend a product only where it is positively suitable, not just where it is the least unsuitable from the range*[408]. If a customer's need cannot be met by a product from within the range, then *no product recommendation should be made*[409]. In such cases, a referral to an IFA [Independent Financial Adviser] should be made.

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[406] *ibid*, at p. 47.
[407] Personal Investment Authority Ombudsman Bureau, *Annual Report 1996-97* (London 1997), at p. 32.
[408] Emphasis added.
[409] Emphasis added.

In my opinon, this paragraph summarizes very well what should constitute 'suitable advice' in the area of investment business. In other words, where a bank, or any financial services provider, assumes the role of its customer's financial adviser, it ought to be required to recommend only those products which are positively suitable, not just those which are the least unsuitable from the range of products offered by this bank or financial services provider.

> *Core Rule 22: Best execution*
>
> (1) Where a firm deals with or for a private customer, it must provide best execution.
>
> (2) A firm must also provide best execution where it fulfils an order from a non-private customer.
>
> (3) A firm may rely on another person who executes the transaction to provide best execution, but only if it believes on reasonable grounds that he will do so.
>
> (4) For the purposes of the core rule on best execution, a firm provides best execution if:
> a. it takes reasonable care to ascertain the price which is the best available for the customer in the relevant market at the time for transactions of the kind and size concerned; and
>
> b. unless the circumstances require it to do otherwise in the interests of the customer, it deals at a price which is no less advantageous to him;
> and in applying the core rule on best execution, a firm should leave out of account any charges disclosed to the customer which it or its agent would make.
>
> (5) The core rule on best execution does not require a firm to provide best execution on a purchase of a life policy or on a purchase from the operator of a regulated collective investment scheme of units in the scheme.

This rule stipulates that a private customer must always get best execution whether the firms acts as principal or agent. For other customers, best execution must only then be made available where an order is fulfilled by the firm. Best execution means that the firm must take reasonable care to ascertain the keenest price at the time and must then deal at

a price which is no less advantageous than that[410]. Paragraph 4 (a) and (b) of the rule contain important qualifications including the obligation to make an effort to establish the best price for a transaction of the kind in the relevant market at the time. The technical term 'relevant market' is left undefined but as world markets in at least major stocks are becoming more and more accessible nowadays, the care which can be expected of firms will reflect this trend[411].

Core Rule 26: Churning and switching
(1) A firm must not:
a. make a personal recommendation to a private customer to deal; or
b. deal or arrange a deal in the exercise of discretion for any customer;
if the dealing would reasonably be regarded as too frequent in the circumstances.

(2) A firm must not:
a. make a personal recommendation to a private customer to switch within a packaged product or between packaged products; or
b. effect such a switch in the exercise of discretion for a private customer;
unless it believes on reasonable grounds that the switch is justified from the customer's viewpoint.

The aim of the first paragraph of this core rule is to require firms to resist the temptation to earn extra commission by making recommendations or dealings on a discretionary basis too frequently. Paragraph (2) of the rule imposes a prohibition on a variety of churning whether from one packaged product to another or, for example, within a life policy or as between the 'spokes' of an umbrella fund[412]. Churning is a widely recognised problem not only with the retailing of life insurance and other packaged investment products (what is also called 'twisting') but also in the area of securities trading and portfolio management.

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[410] Blair, Michael, *Financial Services - New Core Rules* (London 1991), at p. 110.
[411] Blair, Michael, *Financial Services - New Core Rules* (London 1991), at p. 110.
[412] Page/Ferguson, *Investor Protection* (London 1992), at p. 293.

In the area of life policies, churning occurs when an intermediary prevails upon the investor to surrender his or her existing life policy, or allow it to lapse, and to take out a new policy instead. Particularly in the case of regular premium policies, the long term nature of the product and the poor surrender values attaching to early encashment means that such a course of action is rarely in the interests of the investor[413]. Churning with regard to portfolio management occurs where a firm misuses its discretionary powers to buy and sell stocks in the name of the customer too frequently.

(5) The FSA's plans for a 'Handbook of rules and guidance'

The new Financial Services Authority is currently drafting a new single rulebook which is meant to regulate the business activities of the entire financial services industry in the UK. This 'FSA Handbook' is intended to embrace both regulatory statements (e.g. business conduct and captial adequancy rules) and matters of process (e.g. authorisation, complaints and interventions)[414].

However, it should be pointed out that this 'FSA Handbook' will not become enforceable before the enactment of the proposed 'Financial Services and Markets Bill' in 1999/2000. This piece of legislation will provide the FSA with the power to make rules for the financial services industry[415]. It is expected that the Bill will also empower the FSA to decide which sanction to attach to any particular rule. Moreover, it is

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[413] Page/Ferguson, *Investor Protection* (London 1992), at p. 293.
[414] Financial Services Authority, *Designing the FSA Handbook of rules and guidance* (London April 1998), at p. 4.
[415] *ibid*, at p. 12.

planned that this legislation will create a right of action for 'private persons' with regard to breaches of the rules which are going to be listed in the 'FSA Handbook'[416].

In my view, the idea of drafting one single rulebook for the entire financial services industry can only be welcomed. There is no doubt about the fact that the present co-existence of numerous different codes of conduct is confusing. A single rulebook will create a greater degree of transparancy and accessability of the rules for consumers. Furthermore, the intention to provide consumers with a right of action for damages with regard to breaches of the rules which are included in the 'FSA Handbook' would also be a significant step forward for the protection of consumers interests in the UK.

(6) Duties of a bank acting as an investment trustee

Finally, the duties of a bank acting as a trustee in the field of investment business should be mentioned briefly. As already mentioned above in Chapter Two, many investment funds and pension schemes are constituted under a trust deed. Trustees are obliged to exercise their powers in the best interests of the present and future beneficiaries of the trust and the interests of the beneficiaries must be always paramount to the trustee's own interests.

However, as the duties of trustees have already been discussed in detail in Chapter Two[417], here, the relevance of trust law with regard to the issue of investment fraud may

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[416] *ibid*, at p.13.
[417] See Chapter Two, A. (3).

be described. Today's investment fraudsters often use very sophisticated methods in order to misapply funds. Typically, persons other than the fraudster handle or assist in handling the misapplied funds, either at the time of misappropriation or during the money laudering process[418]. Third parties, such as banks, stockbrokers, solicitors and accountants are potentially exposed in this regard. Where misapplied funds have been handled by a third party or a third party has assisted in the handling of the funds, the third party may become personally liable as a so-called 'constructive trustee' to an investor who suffered a loss as a result of the misappropriation[419].

However, due to the restrictions as to the scope and extent of this work, this aspect of the law cannot be discussed here in detail. It may only be pointed out that in the recent decisions in *Polly Peck International plc* v *Nadir and others (No.2)*[420] and *Royal Brunei Airlines Sdn Bhd* v *Philip Tan Kok Ming*[421] it was held that a third party, although it may not be an accomplice to a fraudulent scheme, may be held liable if it either 'knowingly assisted' the fraudster or 'knowingly received' misapplied funds[422].

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[418] Fisher/Bewsey, *The Law of Investor Protection* (London 1997), at p.377.
[419] *ibid*, at p. 377.
[420] [1992] 4 AER 769 (CA).
[421] [1995] 2 AC 378 (PC).
[422] For further reading on this matter see Fisher/Bewsey, *The Law of Investor Protection* (London 1997), at pp. 377-392.

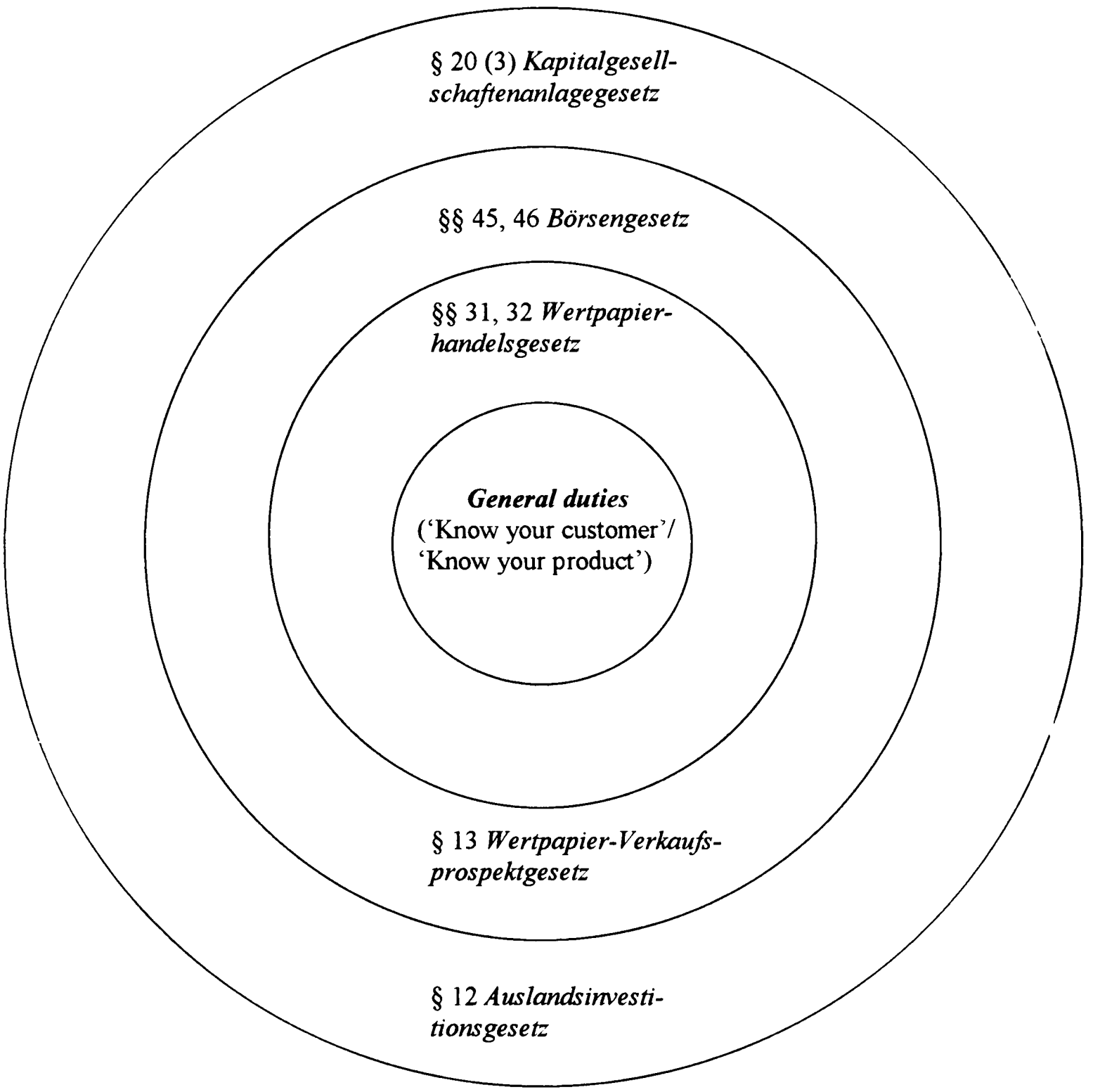
B. German law:

One of the most striking features of the German law in relation to advice on investments is that it is a motley conglomerate of long established case law and relatively new codifications. On the one side, there are the case law based concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung*. On the other side, there exists comprehensive specific legislation such as the *Wertpapierhandelsgesetz* (Securities Trading Act) and the *Börsengesetz* (Stock Exchange Act). However, the legal nature and the precise structure of the concepts of *Positive Vertragsverletzung* and *Culpa in contrahendo* have been extensively described in Chapter Two. And so, in this chapter, as with English law, the focus will be on the precise scope of the duties of banks arising in the field of financial advice.

In general one may describe the German law on financial advice as a system of concentric circles, each of them containing certain duties for banks. At the core, there are those duties which must be fulfilled with regard to any kind of advice on any form of investment.

In the next rings of the concentric circles, there are those duties which are added if a bank gives advice on all dealings in securities and derivates. These duties are especially laid down by the *Wertpapierhandelsgesetz* (Securities Trading Act). The next outer ring contains further duties which are imposed on banks by the *Börsengesetz* (Stock Exchange Act) and the *Wertpapierverkaufs-Prospektgesetz* (Securities Sales Prospectus Act). They apply to anyone trading in bond warrants. The outer most ring includes

duties that are imposed on banks that are involved in the running of investment management companies or investments abroad.



In order to define a bank's duties concerning its financial advice to customers, one always needs to start from the most inner circle which contains those obligations that apply to all types of investment recommendations. Then, on the way to the periphery, more and more duties are added until the ring of the circles is reached which includes that set of obligations that applies to the very specific character of the investment matter the bank gives advice upon. However, in this context, it should also be stressed that these duties do not exclude each other. One may rather describe them as being supplementary to each other[423]. For example, this means that a bank can simultaneously be under the general duty to provide so-called *anleger- und anlagegerechte Beratung* (advice according to the 'Know your customer' and 'Know your product' rules) and under more specific duties under §§ 31, 32 *Wertpapierhandelsgesetz* or the §§ 45, 46 *Börsengesetz*.

Furthermore, it is interesting to notice that the most basic duties of the most inner circle have been developed solely by case law. Due to a lack of specific legislation in this field in the past the *Bundesgerichtshof* has been developing a skeleton of duties of banks towards their customers in this area. In addition to this, the court has also mapped out the duties of a bank that advises its customers on stock market investments. In fact, this case law on stock market tradings has also had a very significant impact on the obligations laid down by the *Wertpapierhandelsgesetz* which was enacted in 1994. It is argued that the §§ 31, 32 of the *Wertpapierhandelsgesetz*, which contain general and specific codes of conduct for banks dealing in any forms of securities, are nothing else

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[423] However, there is one exception to this general assumption: The statutory duties laid down under §§ 45, 46 *Börsengesetz* and § 13 *Wertpapierverkaufs-Prospektgesetz* are generally interpreted as overriding the civil duties of the case law based duties under the so-called concept of *Prospekthaftung im engeren Sinne* (civil prospectus liability in the strict sense). See below under (c) (aa).

but the enactment of guidelines that have been drawn up by the *Bundesgerichtshof* in this area of the law within the last decade[424].

In order to obtain an overview of the complex German law on bank's duties with regard to their financial advice to their customers, one may start off with a description of the most general duties for banks, or, in other words, the content of the most inner circle.

(1) The scope of a bank's general duties as its customer's investment adviser (*Bond-Urteil*)

As already mentioned above in Chapter Two, a bank can be under a pre-contractual or contractual duty to render correct, complete and understandable advice to its customers. Under the concept of *Culpa in contrahendo* a bank is under a pre-contractual obligation to give sound advice where there has been an 'intensified social contact' established in the course of negotiations between the bank and its (prospective) customer. Furthermore, according to the concept of *Positive Vertragsverletzung*, a bank can either be under a primary or collateral obligation to provide to its customers sound advice.

However, in practice, the issue of the actual scope of a bank's duties is decisive. The scope of these general duties of banks have been laid down by the *Bundesgerichtshof* in its decision in the well known above mentioned *Bond-Urteil*[425] with precision and clarity that is being missed in many other rulings by lower court with regard to this matter.

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[424] Lang, Volker, *Aufklärungspflichten bei der Anlageberatung* (Stuttgart 1995), at p. 54-55.
[425] BGH (06.07.1993) NJW 1993, 2433.

In this case[426] which concerned financially inexperienced plaintiffs who were recommended by their bank to invest most of their savings in a high risk Australian bonds the court held that a bank's investment advice must be *anlegergerecht* (suitable for the customer) as well as *anlagegerecht* (adjusted to the nature of the subject matter of the investment). Moreover, the court stressed that[427]:

> The *contents and extent of the [bank's] primary obligation*[428] to give advice are dependent on several factors which, on the one side, *are related to the personality of the customer and, on the other side, refer to the object of the investment*[429] [...] The relevant factors concerning the customer are his expertise in investment matters and his readiness to take risks [...] With regard to the object of the investment, the advice given must include all features and risks that have or are likely to have an impact on the decision to be made by the customer.

The judges even said that, if a bank does not know enough about its customers' experience in investment matters or his investment goals, it must actively seek this information from its customers. Furthermore, it was also said that the bank must inform its customers about all general risks of a transaction such as changes in the stock market as well as specific risks like fluctuations in interest and exchange rates.

(a) Anlegergerechte Beratung (Know your customer)

In the *Bond-Urteil* the *Bundesgerichtshof* ruled that a bank must ensure that its advice given to its customers suits the individual needs of the customer. This means that the bank must get to know not only the customer's expertise and experience in investment matters but also his investment goals. Furthermore, the bank is obliged to inform itself

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[426] See above Chapter Two, B. (2) (a).
[427] BGH (06.07.1993) NJW 1993, 2433, at p. 2433.
[428] Emphasis added.
[429] Emphasis added.

about the general financial situation of the customer and what kind of risks he or she is prepared to take. In order to obtain this information the bank may either use already acquired knowledge in the course of an often long established business relationship or it must actively seek the required information from the customer.

In German banking practice it has become common for banks to request a customer interested in investment matters to fill out standard forms containing questions related to the customers' financial affairs[430]. For example, the customers are asked what kind of investments they made in the past, what is there disposable income, whether they have any debts and how they would describe their investment strategy.

However, in practice, it has turned out that a significant number of customers are very reluctant to provide their banks with complete and detailed information about their financial situation. Partly, this reluctance can be explained by the fact that the customers do not want their bank to know virtually everything about their finances (i.e. that they also have accounts or deposits with rival institutions)[431]. Additionally, some customers fear that the taxman may get hold of these assessment forms and may ask unpleasant questions concerning their income tax declarations[432]. On the other side, some banks have also been criticized[433] for misusing these standard forms in order to obtain

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[430] Furthermore, under § 31 (2) No.1 *Wertpapierhandelsgesetz* banks are also requested to ask their customers who want to invest in the stock market about their financial situation and their preferred investment strategy.

[431] This view was expressed by many representatives of German private banks and discount brokers at the seminar 'Discount Broking und die §§ 31 ff. WpHG' organized by the legal journal 'Wertpapiermitteilungen' on 22 May 1996 in Frankfurt/Main (Germany).

[432] Considering the number of raids on well-known banks carried out by the German inland revenue offices and public prosecutors in recent years, one may view this fear as not totally unsubstantiated.

[433] Schwark, Eberhard, 'Die Verhaltensnormen der §§ 31 ff WpHG' in: *Das Zweite Finanzmarktförderungsgesetz in der praktischen Umsetzung - Bankrechtsstag 1995*, Schriftenreihe der Bankrechtlichen Vereinigung e.V., (Köln 1996), Volume 7, at p. 115-116.

information from their customers that is not needed for the investment matter in question.

The general rule laid down in the *Bundesgerichtshof*s decision in the *Bond-Urteil* is that the less experienced the customer the more information about his or her envisaged investment the bank must provide to him or her. In the *Bond-Urteil* the judges stressed that the bank was aware of the fact that the plaintiff couple had been investing their money always in a very conservative way (savings accounts and government bonds) avoiding any risks of total loss.

Thus, the bank's recommendation to them to switch to an investment including much higher risks such as the purchase of foreign bonds had to be accompanied with a clear and detailed warning on the risks.

In the *Bond-Urteil* the bank's investment adviser said little more than that the deal did not constitute any currency risks. Although this statement in itself was correct, the judges stressed that it was nevertheless misleading because the bank's manager did not say anything about the general risk of bond issues such as the risk of a total loss in case of the insolvency of the bond issuing company. Thus, in the *Bond-Urteil* the *Bundesgerichtshof* ruled that the defendant bank failed to give the plaintiff couple sound and complete advice.

On the other side, in LG Hannover WM 1996, 1575[434] it was held that where a customer expressly or impliedly presents him- or herself to have experience in stock market trading, the bank is under no obligation to inform him about risks even if he

[434] LG Hannover (22.03.1996) WM 1996, 1575.

purchases through the bank high risk bonds. In this case, the plaintiff telephoned the defendant bank, demanded to speak to the branch manager and requested that he should sell him warrants issued by certain Japanese companies listed at Tokio Stock Exchange. The plaintiff told the manager the warrants identification numbers and spelled to him the name of the issuing Japanese companies. The bank carried out the plaintiff's order. Later, the plaintiff lost DM 44,000 when there was a sharp fall in the Japanese stock-market.

The court rejected the plaintiff's claim for damages arguing that there was no *Beratungsvertrag* concluded between the plaintiff and the defendant bank. Moreover, the judges also found that the bank was under no pre-contractual obligation (i.e. *Culpa in contrahendo*) giving rise to any duty to warn the plaintiff about the risks involved in the purchase of warrants issued by foreign companies. The judges stressed that the fact that the plaintiff was able to precisely tell the defendant bank the warrants identifications numbers as well as the names of the issuing Japanese companies gave the bank reason to assume that he was experienced in stock market dealings.

Furthermore, it was pointed out that the bank's records of the plaintiff's securities deposit account showed that the plaintiff had previously placed orders for the purchase of warrants. Moreover, the judges stressed that the bank was not involved in creating any risk for the plaintiff by interfering in any way with the plaintiff's decision to invest his money. It is interesting to note that in its ruling the court actually used the technical term *Gefährdungstatbestand* (set of facts giving rise to potential dangers) when discussing the bank's role in this case[435]. This technical term is normally used either in

[435] LG Hannover (22.03.1996) WM 1996, 1575, at p. 1576.

criminal law in connection with involuntary manslaughter or negligently causing bodily harm or in civil law with regard to strict liability.

In the BGB, there are only very few provisions under which a defendant can be held strictly liable. One of these rare provisions is § 833 S.1 BGB[436]. Under this provision, a keeper of an animal can be held strictly liable for any damage caused by this animal. Generally speaking, in German law strict liability applies only to an activity that is permitted even it creates a substantial risk to other members of the general public[437]. However, in return for 'legalising' this dangerous activity, the person undertaking and benefitting from this activity must be prepared to compensate anyone suffering harm or loss as a result of this activity irrespective of whether this person was at fault or not when undertaking this activity.

Considering all this, it is surprising to see a court using a term typically applied to strict liability cases in a banking context. One may even say that the use of the phrase *Gefährdungstatbestand* by the court in LG Hannover WM 1996, 1575 was 'technically' inappropriate because, in this case, the claim was based not on a strict liability provision but on the fault-based concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung*. Furthermore, no bank is very likely to find it agreeable that German judges drew an analogy between a bank's provision of run-of-the-mill financial advice and and situations where strict liability typically applies such as the operating of nuclear power plants or chemical industry production sites.

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[436] Strict liability can also be established under § 231 and § 701 BGB.

[437] In German law, strict liability is typically imposed by specific legislation. For example, § 7 *Strassenverkehrsgesetz* (Road Traffic Act), § 1 *Produkthaftungsgesetz* (Product Liability Act), and § 1 of the *Umwelthaftungsgesetz* (Environment Liability Act).

Furthermore, in BGH NJW 1996, 1744[438] it was held that where a customer brings his or her own professional adviser to the talks with the bank, the bank is not obliged to provide the customer with detailed information about the nature and risks of the investment the customer is interested in. The bank can (rightly) assume that the customer's interests are sufficiently safeguarded by the customer's own personal professional adviser.

(b) Anlagegerechte Beratung (Know your product)

In the *Bond-Urteil* the *Bundesgerichtshof* also emphasized that the bank's advice relating to the customer's envisaged investment must include correct and complete information with regard to all those features and risks that may be of considerable relevance for the customer's decision on the investment. The judges stressed that the bank is obliged to inform the customer not only about the general risks of a certain investment matter such as the present state of the economy or general trends on the stock market. In addition to this, the bank is also obliged to inform the customer about the specific risks which depend on the individual characteristics of the envisaged investment.

Additionally, the court ruled in the *Bond-Urteil* that the scope of the bank's duty is influenced by the fact of whether the bank recommends to the customer a product that is part of its own range of investment products or just offers to assist the customer in

[438] BGH (27.02.1996) NJW 1996, 1744.

buying any financial product available on the market. In the *Bond-Urteil*, the judges stressed that[439]:

> The customer who entrusts himself to a bank because of the bank's claim to possess special expertise is entitled to conclude from the fact that the bank included a certain financial product in its range of investment products that the bank itself considers this product as advantageous.

The court also held that a bank must keep itself informed about any suggested products as well as general changes of the economy and on the stock market. In doing so, banks are obliged to study at least the most important national and international publications. Moreover, it was also pointed out that if the bank recommends the purchase of a foreign financial product, for example, foreign DM bonds or shares of a company listed on a foreign stock exchange, the bank must keep itself up to date about these products by monitoring foreign newspapers and journals.

Indeed, the judges stressed that where a bank recommends a foreign investment its duty to provide the customer with complete and correct advice is more comprehensive than where it sells a national product because the customer's access to information about the foreign investment is much more limited[440].

Moreover, attention should be drawn to the fact that banks cannot avoid liability for incorrect advice by arguing that the company they recommended to their customers was properly listed the German stock market. In the *Bond-Urteil*, it was held that the mere listing on the German stock market is no indicator for such a company's financial standing[441]. The judges stressed that the test applied by the public body responsible for

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[439] BGH (06.07.1993) NJW 1993, 2433, at p. 2433.
[440] *ibid*, at p. 2433.
[441] BGH (06.07.1993) NJW 1993, 2433.

admissions to the German stock market is primarily based on formal points such as the completeness of the documents required for an application[442] and could therefore not be seen as any reliable statement as to this company's financial affairs[443].

Additionally, the court also emphasized that the fact that a company's application for a listing had to include an auditor's report was not relevant because these reports were often drawn up several months before the filing of the application[444]. For this reason, these reports could not give any up to date information on the company's standing.

It should also be noted that the German courts - like their English counterparts[445] - often do not hesitate to scrutinize the feasibility of certain investments recommended by banks. For example, in AG Frankfurt/M. WM 1995, 700[446] the court held that the bank must inform the customer about the kind of investment that is most suitable for his or her investment goal despite the fact that the bank may earn less commission if the customer chooses to put his or her money into this investment.

In this case, the plaintiff's father, who was authorised by his son to handle his son's financial affairs, turned to the defendant bank for financial advice. He told the bank that he would like to invest his son's money '*without any risk*'. The defendant bank's financial adviser recommended the plaintiff's father to purchase for DM 45,000 shares of a pension fund owned by the bank. After one year, the plaintiff had to sell these shares at a loss of DM 5,000. The plaintiff sued the bank for damages arguing that the

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[442] According to §§ 36, 38 *Börsengesetz* (Stock Market Act), any company which wants to be listed on the German stock market must apply for a listing to a supervisory body.
[443] *ibid*, at p. 2434.
[444] *ibid*, at p. 2434.
[445] See the decision in *Woods* v *Martins Bank Ltd* [1959] 1 QB 55 (Ch.Div.).
[446] AG Frankfurt/Main (06.03.1995) WM 1995, 700.

bank had not sufficiently explained to his father the risks involved in the purchase of shares of a pension fund.

The court found that the bank had indeed failed to warn the plaintiff's father about the dangers of investing in a pension fund. The court stressed that, according to the facts of the case, the plaintiff's had made it absolutely clear to the bank's employee that he wanted invest his son's money without any risks. Then, the court looked at the nature of investments in pension funds and concluded that[447]:

> The pension fund recommended by the bank has a quoted market value which is being fixed on a daily basis and which can change permanently, it can go up or, as it happended in this case, down [...] This means that there is always an economic risk attached to the investment in a pension fund [...] The bank's employee should have explained to the plaintiff's father the precise risks involved in the purchase of shares of a pension fund, and, if the plaintiff's father insisted on an entirely safe form of investment, he should have recommended him to buy savings bonds issued by the government of the Federal Republic of Germany.

One should draw attention to the practical concequences of this ruling. In today's banking business it is quite common for (German) banks to recommend only their own financial products to their customers even if other banks or institutions may offer more attractive forms of investments. The main reason for this habit is that the banks would like to keep the customer's money 'on the premises' to make a double profit. First, the bank can charge a commission for its service. Secondly, the bank may make an easy profit by 'channelling' the customer's money in forms of investment that may not necessarily provide him with the best returns available on the market. In short, some banks try to use the customer's inexperience to maximize their profits.

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[447] *ibid*, at p. 700-701.

However, it remains to be seen whether the approach taken by the AG Frankfurt/Main will be accepted by the higher courts. On the other hand, the banks' opinion on this matter also carries some weight. Banks often view themselves as unfairly treated when they are criticized for their policy of recommending their own financial products to customers instead of mentioning their competitors' offers which may be more suitable for their customers. Banks argue[448] that no one expects a car dealer who sells only cars of the make X to inform prospective buyers of the better mileage per gallon of a car that is manufacured by Y. Thus, they say, why should a bank be obliged to mention to its customers anything about its rivals' offers?

Moreover, the above mentioned decision in BGH NJW 1997, 662[449] gives also a good impression of in which circumstances a German court is likely to find that a certain financial product is 'unsuitable' for a customer's individual needs. In this case, the plaintiff, the owner of a jewellery shop, sought the defendant's advice concerning the investment of a sum of DM 80,000. The defendant bank's investment specialist told him that if he wanted to make 'real money' he had to invest substantially more. In July 1987, the investment specialist persuaded the plaintiff to take out a loan of DM 1 million with a flexible interest rate to buy shares. As a result of the stock market crash in autumn 1987, the plaintiff's acquired shares lost substantially in value. In 1991, the bank terminated the loan agreement and asked the plaintiff to pay back the oustanding debt of DM 626,000.

The court ruled that the bank was entitled to only one third of this sum because the bank violated its contractual obligations under the *Beratungsvertrag* (contract to supply

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[448] This point of view was shared by many bankers whom I met during my internship with Deutsche Bank in Frankfurt/Main in July/August 1996.
[449] BGH (28.01.1997) WM 1997, 662.

advice) concluded between the plaintiff and the bank. The judges viewed the bank's recommended investment stragegy as unsuitable to the finanically inexperienced plaintiff because, at the time of the investment, it was rather unlikely that the plaintiff would make any significant profits. In the summer of 1987, shares prices remained stagnant whereas there was a rise in interest rates. Thus, the plaintiff's proceeds from his shares would have had to be exceptional in order to pay for the rising interest on his loan, let alone to make a substantial profit. Therefore, the plaintiff's whole investment contained a high risk. However, with reference to § 254 (1) BGB, the court also held that there was contributory negligence on part of the plaintiff reducing his claim for damages by one third.

However, whereas the above mentioned decisions give one the impression that German law related to a bank's duties as its customer's investment adviser is characterized by at least some common features one may be disillusioned by the more recent decisions of several different courts dealing with the missale of so-called 'Fokker bonds'. All of these recent cases were concerned with recommendations which were made by German banks to their private customers in 1993 and 1994 to purchase bonds issued by the Dutch Fokker Group.

In the early 1990s, the Fokker Group, a producer of small and medium-sized airplanes, got into serious financial difficulties. In April 1993, the Fokker Group was taken over by the Dutch state and the German Dasa AG, a subsidiary of the large German industrial group Daimler-Benz AG. Dasa AG and the Dutch state became the majority shareholders of the Fokker Group. At that time, financial analysts produced contradictory reports on the economic standing of Fokker. On the one hand, even after the engagement of Dasa AG, some analysts viewed Fokker as requiring substantial

restructuring and reorganisation. On the other hand, in autumn 1993, other investment specialists described Fokker's financial standing as 'satisfactory'. This view was mainly based on the fact that Fokker was being backed up by the financially very potent Dasa AG/Daimler-Benz AG.

However, in January 1996, Dasa AG/Daimer-Benz AG suddenly pulled out of the Fokker Group driving it into insolvency. As a result, the bonds of thousands of German private investors became worthless. Many of these small investors sued their banks which had recommended them to buy Fokker bonds. This led to a significant number of rulings by lower and higher German civil courts on this matter. Unfortunately, some of these rulings contradict each other.

On the one side, there are the decisions of lower courts such as the rulings in AG Nordhorn WM 1997, 1700[450], LG Berlin WM 1997, 1422[451], LG Hamburg WM 1997, 1423[452], LG Osnabrück WM 1998, 381[453] and LG Duisburg WM 1997, 574[454]. In all these ruling banks which had recommended Fokker bonds to their usually financially inexperienced customers in 1993/94 were not held liable for losses which their customers suffered after the Fokker Group became insolvent in 1996.

For example, in LG Duisburg WM 1997, 574 the judges ruled that the defendant bank's advice to the plaintiff investor to purchase Fokker bonds in January 1994 was not only *anlegergerecht* (suitable for the customer's needs) but also *anlagegerecht* (adjusted to the nature of the subject matter of the investment). The court based its ruling mainly on

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[450] AG Nordhorn (23.06.1997) WM 1997, 1700.
[451] LG Berlin (24.04.1997) WM 1997, 1422.
[452] LG Hamburg (16.05.1997) WM 1997, 1423.
[453] LG Osnabrück (23.12.1997) WM 1998, 381.
[454] LG Duisburg (05.02.1997) WM 1997, 574.

the fact that the defendant bank, when making its recommendation, referred to the reports issued by independent financial analysts including an established Dutch investment bank in autumn 1993 in which the financial standing of the Fokker Group was described as 'sound'.

Furthermore, attention should also be drawn to the fact that the judges stated in their ruling that, in January 1994, the defendant bank was not even obliged to inform the plaintiff about the theoretical possibility of Fokker becoming insolvent. The court argued that[455]:

> The banks' duty to advise would be extended too far if they were being requested to warn about the merely abstract possibility of a bond issuer's insolvency provided that there are no clear indications for the materialization of this risk.

This view has been severely criticized by higher courts in the more recent decisions in OLG Braunschweig WM 1998, 375[456] and OLG Nürnberg WM 1998, 378[457]. For example, in OLG Nürnberg WM 1998, 378 the court had to decide whether the defendant bank was liable for its recommendation to purchase Fokker bonds in October 1993 to a customer who inquired about a 'safe' investment. In this case the judges questioned already whether company bonds are - in principle - *anlegergerecht* (suitable) for a conservative private investor because of the risk that the issuer of the bond may become bankrupt[458].

The judges found that the question of whether company bonds are suitable for conservative investors 'cannot be decided in general terms but depends on the individual

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[455] *ibid*, at p. 575.
[456] OLG Braunschweig (04.12.1997) WM 1998, 375.
[457] OLG Nürnberg (28.01.1998) WM 1998, 378.
[458] *ibid*, at p. 379.

facts of the case'[459]. Taking into account of the facts of this case, the court held that the defendant bank's recommendation of Fokker bonds was not suitable because the bank failed to mention the special financial circumstances of the Fokker Group when it advised the plaintiff in April 1993:

> The defendant [bank] breached its advisory duty because it failed to explain to the plaintiff not only the general risk of the bond issuer becoming insolvent but other relevant facts concerning the issuer [...]
>
> The defendant [...] should especially have pointed out that, early in 1993, even before the founding of Fokker Holding which was owned by Dasa AG (which was backed by the Daimler-Benz AG) and the Dutch state, the bond issuer Fokker AG was in a financially very difficult situation, in fact, it was a 'Sanierungsfall' [in such a poor condition that it required urgent substantial restructuring and refinancing measures] and that the crisis of the Fokker AG was mainly due to the general developments in the aviation industry in which the Fokker AG was doing business in [...]
>
> All this shows that, in 1993, the bond issuer was by far not a sound enterprise.

In my view, only the approach taken by the OLG Nürnberg with regard to the missale of Fokker bonds appears to be in line with the guidelines which were laid down by the *Bundesgerichtshof* in the well-known *Bond-Urteil*. In its ruling in the *Bond-Urteil*[460], the *Bundesgerichtshof* made it clear that a bank is obliged to explain to an inexperienced customer all risks relevant for the customer's investment decision.

It is rather unconvincing to view the possibility that the bond issuer becomes insolvent as not material for the customer's decision as to whether to purchase bonds. In fact, in many cases the danger of the bond issuer's insolvency is, next to the exchange rate risk, the only main matter of concern for a potential investor. Even if at the time of bank's

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[459] *ibid*, at p. 379.
[460] BGH (06.07.1993) NJW 1993, 2433.

advice the possibility of the bond issuer becoming insolvent is only remote, this remote risk needs to be mentioned by the bank to a financially inexperienced customer.

There is always a relatively high probability that a safety-orientated inexperienced customer who is told that there is only an abstract of possibility of losing his entire investment may decide against such an investment. Of course, in situations similar to the Fokker cases, a bank's duty should not be too onerous. A standard warning drawing the customer's attention to the fact that his or her savings could be lost if the bond issuer became insolvent would have been enough. Just remaining silent was, in my view, clearly not sufficient in this set of facts.

Some of the above mentioned decisions may tend to give the impression that the area of financial advice has become something of a minefield for banks. Indeed, there are reports that many banks prefer to recommend more and more only standard products involving very low risks[461]. In an attempt to avoid liability, it has also become common among German banks to hand over to their customers brochures describing the nature and risks of stock market dealings[462]. These brochures have been drawn up by the Geman private bankers' association and the German cooperative and public credit institutions. In fact, the word 'brochures' is not quite accurate. They may rather be described as books. One of them contains no less than 120 pages. Not surprisingly, only very few customers seem to bother to wade through them before making an investment decision[463].

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[461] *Frankfurter Allgemeine Zeitung* (17 August 1995), at p. 11.
[462] These brochures are called *Basisinformationen über die Vermögensanlage in Wertpapieren* (Basic information about investments in shares and bonds) and *Basisinformationen über Börsentermingeschäfte* (Basic information about futures trading).
[463] *Frankfurter Allgemeine Zeitung* (17 August 1995), at p. 11.

Nevertheless, German courts generally say that it is sufficient for banks to provide their customers with these brochures in order to fulfil their (pre-)contractual duties towards their customers[464]. However, in BGH WM 1997, 811[465] it was held that the individual facts of a case may require the bank to may have to do more than just giving out these brochures.

In this case, the plaintiffs, two Turkish citizens working in Germany, approached the defendant, a fellow national also living in Germany, for financial advice. The defendant financial adviser offered to assist them with their financial affairs by making investments on the stock market in return for a 25% share in any profits gained. The plaintiffs agreed and gave the defendant authority over their accounts which held a total of DM 210,000. In April 1989, the defendant started placing orders for the purchase of bonds and warrants in the name of and on account of the plaintiffs. After the defendant had already started investing the plaintiffs's money, the plaintiffs received a brochure informing them about the nature and risks of trading in bond warrants[466]. Both plaintiffs signed a document stating that they had received this brochure.

In 1990, the defendant invested all of the plaintiffs' savings in one single Japanese bond warrant. After initial profits, everything was lost. The plaintiffs brought an action for damages against the defendant. They argued that the defendant failed to fulfil his contractual duty to explain to them the risks involved in trading bond warrants. The defendant replied that the plaintiffs were sufficiently warned about the risks because they received the brochure.

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[464] BGH (14.02.1995) NJW 1995, 1554.
[465] BGH (11.03.1997) WM 1997, 811.
[466] This brochure was called *Verlustrisiken bei Börsenterminschäften* (Risks related to the trading of bond warrents).

The court rejected the defendant's point by stating that, according to the factual circumstances of the case, the mere handing over of the brochure was not enough to provide the plaintiffs with proper advice on the purchase of a high risk bond warrant. The judges emphasized that, generally speaking, a bank's duties with regard to the sale of bond warrants were two-fold: First, according to § 53 (2) S.1 *Börsengesetz* (Stock Exchange Act) banks were required to supply a customer with written information about the general nature and risks of bond warrants. Secondly, in addition to this, the bank had to inform and warn a customer with regard to his or her individual needs, knowledge and experience.

In this case, the court found that, considering that both plaintiffs were workers having absolutely no experience in any kind of stock market dealings, the defendant was under the duty to provide them with detailed information about the risks of bond warrants. Furthermore, the judges pointed out that[467]:

> The brochure with its abstract and standardized warnings is here neither sufficient to provide the customer with advice suitable for his individual needs [*anlagegerecht*] nor does it explain all the relevant features and risks inherent in the exact type of investment in question [*anlagegerecht*].
>
> The plaintiffs are Turkish workers lacking any knowledge and experience in bond warrants trading. They should have been informed - in way understandable to them - about the fact that the defendant intended to invest their entire savings in highly speculative stock market dealings, the nature and risks of bond warrants, and that investing all money in one single bond warrant is extremely risky.

The court ruled that the plaintiffs could claim from the defendant all the money lost by his dealings. The judges also stressed that a plaintiff bringing an action against a bank does not have to establish that he would not have made the investment if the bank had advised him or her correctly. This means that if a bank violated its duties to advise it can

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[467] *ibid*, at p. 812.

only avoid liability if it manages to prove that the plaintiff would have made the transaction in question even if it he or she had been properly advised by the defendant bank[468].

In practice, this often means that the bank has the very difficult task of showing that the plaintiff was such a stubborn and ignorant person who would simply have refused to listen to any sensible advice. In BGH WM 1997, 811 the judges found that if the plaintiff had been openly told about the risks involved in investing all money in one single bond warrant, they, undoubtedly, would have backed off from the deal[469].

It may be summarized that the German law related to a bank's liability for incorrect investment advice is a motley conglomeration of contradictory decisions which consequently leads to the introduction of a significant element of randomness into this area of the law. Only the recent rulings in OLG Nürnberg WM 1998, 378 and in BGH WM 1997, 811 can be seen as (cautious) steps in the right direction. However, it remains to be seen whether other courts will follow these decisions. Thus, for the time being, one main feature of the present German law related to investment advice is a considerable degree of unpredictability, a feature of which the German judiciary certainly cannot be proud.

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[468] *ibid*, at p. 813.
[469] *ibid*, at p. 813.

(c) The bank's general duties arising under a Vermögensverwaltungsvertrag

Another area where the general principles of the ruling in the *Bond-Urteil* are of particular importance is the field of portfolio management. From a bank's point of view, private customer portfolio management is one of the most lucrative sectors of today's banking business. Due to the often very substantial sums which are invested for the customers, commission fees are a major source of revenue. In 1997, German investment firms looked after their private customers portfolios which had a total value of no less than DM 1040 bn[470].

The usual legal framework in the area of portfolio management is a so-called *Vermögensverwaltungsvertrag* (contract concerning the management of a customer's portfolio) a contract for serviced that is typically concluded between a bank and its customer. This contract is governed by the provisions of §§ 662, 675 BGB. Under the terms of this contract, the bank undertakes to manage its customer's portfolio in return for a commission fee[471].

The bank's primary contractual obligation under such a *Vermögensverwaltungsvertrag* towards its customer is to manage the customer's funds in line with the directions given by the customer. However, it should be stressed that the banks do not guarantee any profits but they promise to undertake to try to make a profit for the customer through its activities. Some customers give their banks 'full discretion' to handle their money. However, typically, customers provide their banks with guidelines according to which

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[470] *Frankfurter Allgemeine Zeitung*, 17 February 1998, at p. 29.

[471] The *Vermögensverwaltungsvertrag* is generally characterized as a so-called *entgeltlicher Geschäftsbesorgungsvertrag* (contract for services by which one party undertakes for a consideration to look after the interests of the other party); see Palandt-Thomas, *BGB* (56th edn. München 1997), § 675 Rdn.6, at p. 793.

their portfolios should be managed by the banks. For example, very cautious customers want their banks to invest their money only in government bonds and other fixed interest rate schemes. More adventurous investors ask their banks to focus on shares, options or even derivatives.

(aa) The bank's primary obligation under a Vermögensverwaltungsvertrag

The recent ruling in BGH WM 1998, 21[472] may serve as an illustration of the extent and scope of a bank's primary obligation under a *Vermögensverwaltungsvertrag* to manage its customers's portfolio according to the customer's instructions. In this case, in 1987, the plaintiff, an Iranian entrepreneur, entered into a *Vermögensverwaltungsvertrag* with the defendant bank. The plaintiff deposited DM 500,000 with the defendant bank. In a letter, which was written in English, the plaintiff gave the bank the following instructions as to how the bank should manage his portfolio:

> 1. The portfolio should be based on German stocks and cash (in DM).
> 2. Up to twice the value of the sums available in my account, stocks could be bought, i.e. up to a maximum amount of DM one million, presently.
> [...]
> 5. The sum invested for purchasing of each single stock should not exceed DM 50,000.

Between 1987 and 1992, the defendant bank conducted no less than 140 purchases and 130 sales of securities on behalf of the plaintiff. In this period, the bank's managing of the plaintiff's portfolio included several severe breaches of the above mentioned guidelines. For example, the defendant bank violated guideline number one, which stipulated that only German stocks could be bought, no less than thirty times which

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[472] BGH (28.10.1997) WM 1998, 21.

resulted in the exposure of the plaintiff's portfolio to significant currency risks. Additionally, twenty-five times the defendant bank breached guideline number 5, which stated that no single investment ought to exceed the sum of DM 50,000. In one case, the defendant bank invested DM 123,000 in options coupons which were not traded at the stock markets at all. This particular transaction constituted a breach of not only guideline number one but also a violation of guideline number five.

The court regarded the 'guidelines' which were given by the plaintiff to the bank as binding upon the bank and found that the bank had breached them on many occasions. Moreover, the judges stressed that it was irrelevant that the plaintiff brought his claim for damages years after the bank's first breaches of the guidelines had occurred. The court pointed out that a customer who concluded a *Vermögensverwaltungsvertrag* with a bank was not obliged to check the individual statements of account which are provided by the bank on a regular basis. In this respect, the judges found, the customer's obligations under a *Vermögensverwaltungsvertrag* differed from those under an ordinary giro account arrangement under which a customer is expected to check the bank's statements of account regularly[473].

The court based this view on their interpretation of the nature of a *Vermögensverwaltungsvertrag*. This contract is characterized by the fact that the customer delegates all administrative tasks which are linked with his or her portfolio to the bank which, in return, obtains a fee from the customer for its services. Thus, the judges held that the plaintiff's inactivity after the receipt of the bank's statements of accounts could not be interpretated as the customer's approval of the bank's prior incorrect and negligent portfolio management activities.

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[473] *ibid*, at p.23.

Furthermore, a bank is under two additional collateral obligations once it has entered into a *Vermögensverwaltungsvertrag* with a customer. First, it is under the general duty to handle its customer's portfolio with due care and skill to protect the customer's financial interests. Secondly, there is the bank's duty under § 666 BGB to provide its customer with 'all necessary information' concerning the management of the portfolio.

(bb) The bank's collateral obligation under a Vermögensverwaltungsvertrag

Generally speaking, this collateral duty on the part of a bank under a *Vermögensverwaltungsvertrag* to apply due care and skill when managing the customer's portfolio is very similar to the bank's primary obligation to follow the customer's instructions as to how the customer's portfolio should be operated.

This collateral duty to handle the customer's portfolio with due care and skill obtains practical importance mainly in cases where the guidelines which were drafted by the parties are not precise enough and require some interpretation. A good example of such a case is the decision in LG Nürnberg-Fürth WM 1996, 1579[474]. In this case the plaintiff entered into a *Vermögensverwaltungsvertrag* with the defendant bank in June 1994. He transferred DM 800,000 to a special trading account with the defendant bank. The terms of the contract stipulated that securities and holdings in foreign currencies should not exceed a level of 70% of the overall value of the portfolio. The contract documents also described the customer's investment policy as 'growth orientated' and with a 'priority in securities'.

[474] LG Nürnberg-Fürth (03.04.1996) WM 1996, 1579.

The bank explained in detail to the plaintiff the risks involved in trading in securities. Nevertheless, the plaintiff stated that he generally agreed that the bank could invest in securities listed in the so-called emerging markets in Asia which typically carried higher risks than European securities. In late June 1994, the defendant bank bought on behalf of the plaintiff 250 shares of the German manufacturer 'Klöckner-Humboldt-Deutz AG' ('KHD') for DM 37,000. In Janurary 1995, these shares were sold at a loss of DM 10,000. After being informed about this loss, the plaintiff immediately terminated the contract and brought an action for damages against the defendant bank arguing that the bank had breached its collateral duty to use due care and skill when managing the plaintiff's portfolio.

First, the judges took a look at the guidelines laid down by the plaintiff for the bank. The court found that the bank had not breached any of the guidelines set out by the terms of the contract concluded between the bank and the plaintiff. The share of securities in the plaintiff's portfolio had not exceeded the limit of 70% at any time. Additionally, the actual percentage of holdings in foreign currencies had not been higher than 10%.

Secondly, the court considered the plaintiff's argument that the defendant bank did not use due care and skill when purchasing shares in 'KHD' in June 1994. Analysing various reports in newspapers and stock market magazines dating from June 1994, which all viewed 'KHD' as a sound business venture, the court found the bank's decision to acquire shares of this company flawless. Thus, the judges held that the purchase of shares in 'KHD' did not exceed the level of risk the bank had been entitled to take under the provisions of the *Vermögensverwaltungsvertrag*.

Moreover, the court stressed that, when entering into the *Vermögensverwaltungs-vertrag*, the plaintiff had explicitly agreed to take those risks that were typical of investments in securities. As in this case one of these typical risks materialized, the plaintiff could not expect to be compensated for his loss by the defendant.

In addition to this, the court held that the defendant bank had successfully excluded liability in this case. The bank had used a general contract term which exonerated the bank from liability except for gross negligence and intent. The court ruled that banks were generally entitled to use such clauses in connection with a *Vermögensverwaltungs-vertrag*[475].

(cc) The bank's collateral obligation under § 666 BGB

The other main collateral obligation under a *Vermögensverwaltungsvertrag* is the bank's duty under § 666 BGB to provide the customer with 'all necessary information' concerning the management of the portfolio. It is said that under this provision a bank must, without being specifically asked to do so by the customer, to inform the customer about all relevant changes to the portfolio. This means that a bank is obliged to inform its customer especially in case there has been a substantial decrease in the value of the customer's portfolio. For example, in BGH WM 1994, 834[476] it was held that a bank violated this obligation because it failed to report to its customer a loss amounting to 21% of the original value of the customer's portfolio.

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[475] *ibid*, at p. 1580; see also: LG Stuttgart (13.11.1996) WM 1997, 163, at p. 164.
[476] BGH (29.03.1994) WM 1994, 834.

It may also be pointed out that in BGH WM 1994, 834 it was stressed obiter that banks must disclose not only actual but also so-called 'book losses' if they are substantial. On the other hand, it is also argued that a bank is not always obliged to disclose every loss made in the course of the handling of a customer's portfolio. There are situations where there may be a loss caused through one single transaction but where the overall performance of the portfolio is still satisfactory. In such a case, the bank is not required to report this single loss to its customer[477].

The most important question in this context is to define when a loss is substantial enough to put the bank under the duty to disclose it to the customer. This is said to depend heavily on the customer's individual investment objectives. If the customer has explicitly asked the bank to avoid any investments carrying any significant risks, a loss exceeding 5% may be seen as substantial enough to be reported to the customer. On the other hand, where a customer told the bank to trade in standard shares the loss may need to amount to 15% or more in order to put the bank under the obligation to disclose that loss to its customer[478].

Additionally, there is, especially in cases where the *Vemögensverwaltungsvertrag* between the bank and the customer was concluded and a few years have passed since, the question of how to assess the performance of a customer's portfolio. It is argued that the basis on which the performance of the portfolio is measured should be the figures of the last disclosure of facts made by the bank to the customer. Usually, banks report to their customers at the end of every year. Furthermore, the disclosure of the loss must be without any unnecessary delay, unequivocal and easy to understand.

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[477] Schäfer, Frank, 'Vereinbarungen über Benachrichtigungspflichten in Vermögensverwaltungsverträgen', WM 1995, 1009, at p. 1011.
[478] *ibid*, at p. 1011.

In BGH WM 1994, 834 it was also held that the defendant bank could not successfully rely on a standard contract clause under which it exonaterate itself from the duty to inform its customers about any substantial losses. The court found that such a clause was invalid under § 9 *Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen* (Standard Contract Terms Act) because it would otherwise deprive the customer of its main contractual rights and thereby contradict the main objectives of the *Vermögensverwaltungsvertrag* concluded between the bank and the customer.

Taking all this into consideration, one may conclude that a bank's liability with regard to the managing of a customer's portfolio depends much on what has been agreed upon by the parties when entering into the *Vermögensverwaltungsvertrag*. The courts seem to lay great emphasis on what kind of risk the customer has agreed to take and what the customer's investment objectives are when ruling whether the bank's actual decisions made in the course of running the portfolio could give rise to a successful claim for damages against the bank.

However, in my opinion, the courts should also draw more attention to the pre-contractual negotiations between customers and banks in the field of portfolio management. It is one thing to give a customer's written investment guidelines a quasi-sacrosanct status. It is another to ensure that the customer is well-informed when drafting these guidelines. Thus, in my view, the courts should emphasize that, in the area of portfolio management, banks are not only obliged to strictly adhere to investment guidelines which are given to them by their customers but are also under a prec-contractual duty to provide them with information and assistance when the guidelines are being drafted by the customers.

(2) A bank's general and specific duties under the §§ 31, 32 *Wertpapierhandels-gesetz*

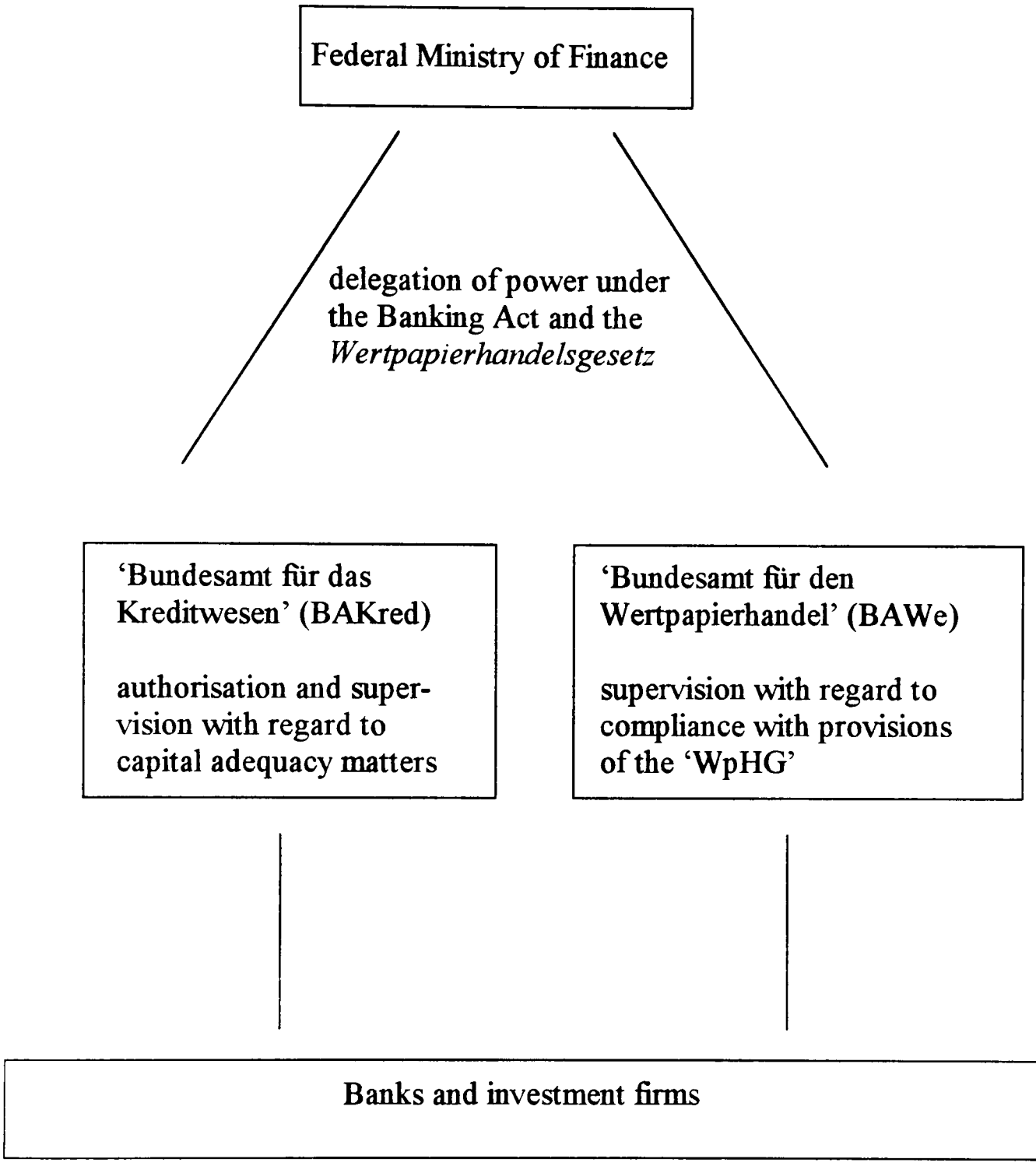
In addition to a bank's general duties, there are further obligations for banks which are involved in the trading of securities and other investment products. Coming back to the above mentioned model of 'concentric circles of duties', one may say that these additional duties form a second circle to the core duties as mapped out by the *Bond-Urteil*. These duties of this second ring are imposed by the provisions of the *Wertpapierhandelsgesetz* (Securities Trading Act or WpHG for short) and are supplementary to the the core duties. The relatively new *Wertpapierhandelsgesetz*[479] regulates insider trading, publicity requirements of companies listed on the stock market, and established the *Bundesamt für den Wertpapierhandel* (Federal Office for the Supervision of Securities Tradings in Germany or BAWe for short).

Furthermore, the 'WpHG' lays down a code of conduct for banks and any kind of businesses involved in the offering, selling and brokering of sales and purchases of securities, derivatives as well as the trading of voting rights in listed companies. The Act's main provisions in relation to financial advice are the §§ 31, 32 'WpHG'. They contain 'general' and 'specific' rules of conduct for so-called 'investment firms', i.e. companies or firms dealing with securities including banks, and came into force in January 1995.

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[479] The *Wertpapierhandelsgesetz* (Securities Trading Act) was designed to implement three EC Directives dealing with the area of financial services. These three Directives are the Council Directive 88/627 of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of, the Council Directive 89/592 of 13 November 1989 coordinating regulations on insider dealing, and the Council Directive 93/22 of 10 May 1993 on investment services in the securities field.

Outline of the present structure of banking and investment business supervision in Germany:



Additionally, the Federal Office for the Supervision of Securities Tradings, exercising its powers under § 35 section 2 'WpHG', issued a Directive which is meant to explain and interpret in greater detail the duties of securities services companies under §§ 31, 32 'WpHG'[480].

[480] 'Richtlinie des Bundesaufsichtsamtes für den Wertpapierhandel gemäß § 35 Abs.2 des Gesetzes über den Wertpapierhandel (WpHG) zur Konkretisierung der §§ 31 und 32 WpHG für das Kommissions-, Festpreis- und Vermittlungsgeschäft der Kreditinstitute' (Directive of the Federal Office for the Supervision of Securities Trading based on § 35 (2) of the Securities Trading Act concerning the definition of the the duties of financial services firms under §§ 31, 32 WpHG).

At this point, one should explain the relationship between the duties of investment firms under §§ 31, 32 'WpHG' and the Directive of the 'BAWe' on the one side, and the duties as they were laid down by the decision in the *Bond-Urteil*, on the other. Generally speaking, the main difference between them is that the duties under §§ 31, 32 'WpHG' and the Directive are public law duties whereas the *Bond-Urteil* based duties are civil law obligations[481].

In other words, the duties under §§ 31, 32 'WpHG' and the Directive form only an official standard code of professional practice. This means that the provisions of the 'WpHG' and the Directive only apply within the relationship of the Federal Office for the Supervision of Secutities Tradings and the firms regulated by it. They have no direct application to the civil law relationship between the investment firms and their customers[482]. Nonetheless, they have a significant impact on the civil law duties of securities services companies towards their customers because the duties laid down by the §§ 31, 32 'WpHG' and the Directive are used within the civil law concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung* in order to define the standard of care that can reasonably be expected of securities services companies.

In fact, many terms used by the legislator in the §§ 31, 32 *Wertpapierhandelsgesetz* had already been developed by the *Bundesgerichtshof* in its earlier decisions on topics related to the financial services sector such as the landmark ruling in the *Bond-Urteil*. Thus, it is also said that the statutory *public law*[483] rules of conduct established by §§

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[481] Schwark, Eberhard, 'Die Verhaltensnormen der §§ 31 ff. WpHG' in: *Das Zweiter Finanzmarktförderungsgesetz in seiner praktischen Umsetzung - Bankrechtstag 1995*, Schriftenreihe der Bankrechtlichen Vereinigung, (Köln 1996), Volume 7, 109, at p. 120-121.
[482] Balzer, Peter, 'Anlegerschutz bei Verstößen gegen die Verhaltenspflichten nach §§ 31 ff. Wertpapierhandelsgesetz (WpHG)' ZBB 3/97, 260, at p.268.
[483] Emphasis added.

31, 32 *Wertpapierhandelsgesetz* are a kind of re-definition of the *civil law*[484] principles already developed by the *Bundesgerichtshof* within the framework of the concepts of *Positive Vertragsverletzung* and *Culpa in contrahendo* as well as under the provisions of the §§ 383, 384 of the *Handelsgesetzbuch* (German Commercial Code)[485]. This means that there is a considerable degree of 'overlap' between case law based duties and the public law obligations established under the §§ 31, 32 *Wertpapierhandelsgesetz* and the Directive. However, it should be noted that the §§ 31, 32 'WpHG' and the provisions of the Directive apply only where primary or secondary securities services in the meaning of § 2 (3) and (3a) 'WpHG' are provided.

There is, therefore, a certain degree of interdependence between the §§ 31, 32 *Wertpapierhandelsgesetz* and the provisions of the Directive on the one hand, and the concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung*, on the other. The §§ 31, 32 *Wertpapierhandelsgesetz* as well as the provisions of the Directive do not offer any direct remedies for investors against investment firms. This means that an investor who claims that the investment firm has violated any of the provisions of the §§ 31, 32 *Wertpapierhandelsgesetz* or the Directive must base its claim either on the civil law concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung*, or else on the law of delict (i.e. §§ 823-853 BGB). § 823 (2) BGB states that anyone violating a statutory provision which protects not only the interests of the general public but also of invididuals can be liable for damages[486]. The §§ 31, 32 *Wertpapierhandelsgesetz* are generally viewed as having protective effect for individuals[487]. Thus, a violation of §§

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[484] Emphasis added.
[485] Kümpel, Siegfried, 'Die allgemeinen Verhaltensregeln des Wertpapierhandelsgesetzes' WM 1995, 689, at p. 689.
[486] See Chapter Two.
[487] Stafflage, Axel, *Die Anlageberatung der Banken* (Berlin 1996), at p. 24.

31, 32 *Wertpapierhandelsgesetz* and/or the Directive can result in liability under § 823 (2) BGB.

As already mentioned above, the duties laid down in §§ 31, 32 *Wertpapierhandelsgesetz* and the Directive are very similar to the judge made obligations developed within the scope of the concepts of *Culpa in contrahendo* and *Positive Vertragsverletzung*. This means that, generally speaking, any violation of the §§ 31, 32 *Wertpapierhandelsgesetz* or the Directive leads to liability under those concepts.

(a) § 31 WpHG: General rules of conduct

§ 31 of the 'WpHG' is divided into two sections. Section 1 places an investment firm under two duties which are often described as the most fundamental duties of financial institutions. These are the duty to act in the customer's interest and the duty to undertake to avoid a conflict of interest when dealing with the customer's order. Section 2 contains two further main duties of securities services companies. First, an investment firm is obliged to obtain information from a customer about his or her knowledge of and experience in securities dealings, about his or her investment objectives and financial situation. Secondly, on the basis of the information received from the customer, the firm is under a duty to provide the customer with 'appropriate information' on the dealings he or she is interested in.

(aa) § 31 (1) No.1 Wertpapierhandelsgesetz: Duty to act in the customer's interest

According to § 31 (1) No.1 *Wertpapierhandelsgesetz*, a bank, when offering its financial services to a customer interested in securities, must use 'skill, care and conscienciousness' and must 'act in the customer's interest'. This obligation is generally seen as congruent with the long established duties of banks arising under the §§ 383, 384 of the *Handelsgesetzbuch* (German Commercial Code). These provisions of the *Handelsgesetzbuch* state that anyone acting as a commission agent must apply the skill and care of a diligent merchant and must act in the principal's interest. With regard to most securities transactions, banks act as their customers' commission agents. Thus, the §§ 383, 384 *Handelsgesetzbuch* do apply to banks carrying out their customers' orders related to securities tradings.

The gist of § 31 (1) No. 1 *Wertpapierhandelsgesetz* is that the customer's interests must prevail over the bank's own interests. Furthermore, under § 31 (1) No.1 a bank must always carry out its customer's orders on the most favourable terms and as quickly as possible. However, this does not prevent a bank from implementing and using cost efficient ways such as the 'bundling' of orders when dealing with its customers' requests concerning the purchase and sale of securities[488].

Additionally, it is said that § 31 (1) No.1 prohibits a bank to charge exceptionally high commissions and fees. In this respect, it may be stressed that the test concerning a bank's remuneration under § 31 (1) No.1 *Wertpapierhandelsgesetz* is much stricter than the general notion of an unconscionable bargain in the sense of § 138 BGB[489]. German

[488] Assmann/Schneider-Koller, *Wertpapierhandelsgesetz* (Köln 1995), § 31 Rdn. 60, at p. 438.
[489] Assmann/Schneider-Koller, *Wertpapierhandelsgesetz* (Köln 1995), § 31 Rdn. 16, at p. 420.

courts appear to be rather reluctant to apply § 138 BGB to situations where there is a discrepancy between the value of the consideration provided by the parties to a contract unless there is 'exceptionally significant disproportion of consideration and performance'[490]. The reason behind the courts' hesitation to apply § 138 BGB is another sacrosanct principle of German contract law, i.e. the principle of freedom of contract.

(bb) § 31 (1) No.2 WpHG: Duty to avoid a conflict of interest

According to § 31 (1) No.2 *Wertpapierhandelsgesetz* an investment firm must 'undertake to avoid any conflict of interest when dealing with its customer's order'. This provision of the *Wertpapierhandelsgesetz* may be said to cause the greatest practical problems in today's banking in Germany. Germany is characterized by what may be called a universal banking system. In such a system, all banks are entitled not only to assist companies with issuing shares but also to sell the very same shares to their private customers. There is no rule in German banking law that forbids banks from playing this dual role.

For example, one of Germany's largest private banks, 'Dresdner Bank', played a very important role in the privatisation of Germany's formerly state owed telecommunications group 'Deutsche Telekom' in 1996. 'Dresdner Bank' acted as the syndicate leader to promote the issue of the shares of 'Deutsche Telekom' in the stock market. Due to a high-profile and very successful advertising campaign, the admission of 'Deutsche Telekom' to the stock exchange attracted very much interest among private

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[490] Palandt-Heinrichs, *BGB* (56th edn. 1997, München), § 138 Rdn.25. at p. 119; see also Markesinis, *The German Law of Obligations*, Volume I, The Law of Contracts and Restitution: A Comparative Introduction' (Oxford 1997), at pp. 174.

investors in Germany. It has even been said that this event has been a turning point in Germany's private investment business. For the first time, people with virtually no experience in stock market dealings considered the purchase of shares of 'Deutsche Telekom'. About two milllion German private investors purchased over 260 million shares of 'Deutsche Telekom'[491]. No less than three million German households registered with the 'Aktien-Informations-Forum' (stocks information centre) established by the company and which was designed to provide financially less experienced individuals with general information on shares and stock market tradings.

In autumn 1996, shortly before the issue of the shares, many private individuals turned to their banks to ask them for advice whether to acquire shares of 'Deutsche Telekom'. Interestingly, nearly all the big German privately owned banks were part of the syndicate given the task to place the shares in the market. Thus, these banks were being confronted with the following conflict of interest: On the one hand, they were keen to please their corporate client 'Deutsche Telekom' with a successful and quick sale of the shares. On the other hand, their private customers approached them with the legitimate request to provide them with impartial and sound financial advice on the standing and prospects of 'Deutsche Telekom'[492].

For example, the private customer advisers of 'Dresdner Bank'[493] were asked by thousands of the bank's customers whether it was sensible to acquire shares of 'Deutsche Telekom'. In such a situation, the question arises whether the mere disclosure

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[491] Kröske, Joachim, 'Die Plazierung der T-Aktie - ein Erfolg', WM 1997, 409, at p.409.

[492] This issue was named as one of the typical conflicts of interest for German private banks by representatives of German banks at a seminar organized by the German legal periodical 'Wertpapiermitteilungen' on 'Informationspflichten und Haftungsfragen in der Anlageberatung und Vermögensverwaltung' on 19 September 1997 in Frankfurt/Main.

[493] It may be stressed that 'Dresdner Bank' is only referred to in an exemplatory way. In fact, nearly all major private and public German banks were involved in the admission of 'Deutsche Telekom' to the German stock market.

of the bank's own interests to its customers is sufficient to fulfil its obligation under § 31 (1) No.2 'to undertake to avoid a conflict of interest'.

Generally speaking, in my view, a mere disclosure of the conflict of interest is not enough because the disclosure of a conflict does not end the conflict. Thus, it can rightly be argued that, in such circumstances, the bank must either give its customers' interests strict priority or tell them that they cannot accept their orders because they could not guarantee that their interests were sufficiently safeguarded.

Ideally, in this situation, Dresdner Bank's investment advisers would have forgotten about who paid their salaries and who would give them commission for any of the bank's customers' share dealings and would have impartially informed the customers about the advantages and disadvantages of an investment in shares of 'Deutsche Telekom'.

On the other hand, it is also said that § 31 (1) No.2 does not mean to interfere with the process of bargaining between the investment firm/bank and the customer. In any free market system the interests of seller and buyer of services differ. Naturally, both sides to aim to reach an agreement whose terms are favourable to them. That is the very essence of any bargaining. Thus, it is maintained that the parties should be left alone to freely negotiate the conditions of the deal, especially the price and the type of the service to be provided. Instead, it is argued that § 31 (1) No.2 is only directed at preventing the bank from abusing its stronger bargaining position to misinform the customer or to manipulate a customer's order to his or her disadvantage[494].

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[494] Assmann/Schneider-Koller, *Wertpapierhandelsgesetz* (Köln 1995), § 31 Rdn. 26-27, at p. 422-423.

Another fertile ground for a conflict of interest on the part of German banks in the area of investment advice is the fact that German banks have an influential role as co-owners and creditors of nearly all 'blue chip' companies listed in the German stock market. For example, 'Deutsche Bank', Germany's largest private bank, has 24% of the shares of Daimler-Benz AG[495], which is the country's largest industrial conglomerate. 'Deutsche Bank' also has substantial stakes in the large German construction group 'Philip Holzmann' and in the world's largest reinsurance company called 'Münchner Rück'. In this sort of situation, banks are often open to criticism in providing their private customers with recommendations concerning the dealing in shares that have an advantageous effect on the companies the banks themselves have a stake in.

Moreover, there is also plenty of room for conflicts of interests in the area of voting rights which are usually attached to shares. Many customers ask their banks to safekeep their shares and bonds in a general account run by the bank which also contains shares and bonds belonging to other customers of the bank. Most customers authorize their banks to exercise in their name their voting rights at the shareholders' annual general meetings.

Consumer protection groups claim that banks misuse this authorisation. They argue that banks use their customers' votings rights to their own advantage instead of safeguarding the customers' interests[496]. Without doubt, the interests of banks and their customers can differ significantly. For example, a bank in its function as creditor of a listed company may prefer this company, which is its debtor, to pay a relatively small dividend to shareholders in order to be able to ensure that the company's debts owed to the bank

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[495] Lutter, Marcus, 'Macht der Banken' NJW 1995, 2766.
[496] *Frankfurter Allgemeine Zeitung* (21 August 1997), at p. 21.

will be paid back in time. Such a course of conduct may result in a bank's liability under the concept of *Positive Vertragsverletzung* based on the argument that the bank violated its collateral contractual duty of care towards its customer by putting its own interests above the customer's.

On the other hand, it should also be pointed out that banks which represent their customers at shareholders' meetings do ask their customers to provide them with instructions before these meetings are held. At present, only three per cent of the banks' customers do instruct their banks in regard to how the banks should exercise their voting rights[497]. Thus, some banks argue that there is, in practice, nothing that prevents shareholders from looking after their own interests. Furthermore, if all bank customers would provide their banks with detailed instructions how to vote at the annual general shareholder meetings this may lead to considerable technical problems.

Thirdly, there is the problem that some banks tend to recommend to their customers almost exclusively those investment funds which are owned or run by themselves. According to a survey carried out by the well known German consumer protection group 'Stiftung Warentest,' one third of all banks tested failed to provide sound financial advice, mostly because of their tendency to recommend only their own financial products[498].

Moreover, many investment advisers 'forget' to mention to their customers the possibility of purchasing government savings bonds without having to pay any transaction fees. As the sale of government bonds does not offer much scope for profits

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[497] Hammen, Horst, 'Das Vollmachtsstimmrecht der Banken in der Aktienrechtsreform' WM 1997, 1221, at p. 1223.
[498] *Frankfurter Allgemeine Zeitung* (17 August 1995), at p. 11.

for banks, they are not particularly keen on encouraging their customer to purchase any government bonds[499].

However, in AG Frankfurt/M. WM 1995, 700[500] it was held that a bank must draw its customer's attention to government savings bonds if - according to the customer's explicitly stated investment aims - these bonds are the most suitable form of investment for the customer. Nevertheless, it remains to be seen whether this pro-consumer approach will be accepted by the higher courts in Germany.

Furthermore, in this context, attention should also be drawn to the provisions of the rules of conduct of the 'Deutsche Vereinigung für Finanzanalyse und Anlageberatung' (German Association for Financial Analysis and Advice; 'DVFA'). The 'DVFA' is a private association with a membership of about 950 independent or employed financial analysts and advisers[501]. Section 2 (a) of the rules of conduct of this association states how employed financial analysts and advisers should deal with a conflict of interest when advising their employer's customers:

> Analysts [and advisers] are regularly employees of an institution which is engaged in capital markets dealings. In the course of their professional activities [analysts and advisers] ought to act independently and in the interest of the customers.
>
> There can exist a conflict of interest. With a view to solving this problem of conflicting interests, the general guideline is that analysts [and advisers] should - with regard to the key areas of their activities, especially concerning sale or purchase recommendations or equivalent dealings - be exempt from any specific, non-fact based and opinion-forming instructions by their employers.

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[499] Verbraucher-Zentrale NRW e.V., *Sparen und Geldanlage* (3rd edn. Düsseldorf 1996), at p. 97.
[500] AG Frankfurt/Main (06.03.1995) WM 1995, 700, at p. 700-701.
[501] *Frankfurter Allgemeine Zeitung* (8 June 1998), at p. 32.

In my view, the German legislator should include this provision - in some form - into § 31 (1) No.2 'WpHG' in an attempt to solve the problem that today many banks still tend to pressurize their employed advisers to recommend to customers only those financial products which belong to the banks' own product range.

(cc) § 31 (2) No.1 WpHG: Duty to obtain information from the customer

Under § 31 (2) No.1 *Wertpapierhandelsgesetz* the bank is also obliged to obtain information on what are the customers' objectives with regard to their investments. Generally speaking, this provision is meant to ensure that the bank has enough background information not only about their customers' financial standing but also about what risks they are prepared to take. Section 3.1 of the Directive of the *Bundesaufsichtsamt für den Wertpapierhandel* (Federal Office for the Supervision of Securities Trading) on the §§ 31, 32 'WpHG' defines this duty as follows:

> The investment firm must, *insofar as necessary*[502], ask the customer with regard to the following points:
>
> *(a) investment objectives*
> The investment firm is to question the customer about his investment objectives. The customer is especially to be asked about his interest in long term or short term forms of investment (e.g. for the purpose of his old age provision or education), single or recurrent returns (profits) and about the extent of his willingness to take risks.
>
> *(b) Knowledge or experience*
> The investment firm must also ask the customer of which forms of investments (e.g. debenture bonds, shares, investment certificates, derivatives) he has knowledge and in which of them he has already invested money in the past (extent, frequency and time).

[502] Emphasis added.

> *(c) Financial affairs*
> The investment firm must also ask the customer with reference to his financial affairs insofar as this is necessary with regard to his envisaged dealings, his investment objectives as well as his knowledge and experience. Insofar as the customer gives information on deposit accounts or derivatives dealings with other credit institutions, this information must also be taken into account by the firm.
> [...]
> No collection of information is necessary insofar as the investment firm has already sufficient knowledge of the customer's affairs.

It should be noted that the Directive does not stipulate a duty on the part of the customer to give the investment firm information about his or her experience or financial situation. Furthermore, it may be stressed that the last provision of this section which enables banks to refrain from asking a customer about his or her financial affairs and objectives has been included in the Directive after calls by German financial institutions for greater flexibility to cater for the individual needs of their customers whose experience and financial resources apparently differ significantly[503]. Not seldom banks stress that, for example, confronting a financially very experienced private client, possibly a managing director of a small but very successful software company, with a long list of questions about his or her knowledge of securities trading as well as his or her financial standing would not only come close to an insult to this customer but also undermine the trust and confidentiality on which their business relationship was founded[504].

Additionally, it should be pointed out that where an investment firm refrains from asking a customer about their knowledge, experience, investment objectives and financial affairs, it must be aware of the fact that this could turn out to be detrimental its position

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[503] This statement was made by representatives of private German banks at a seminar organized by the German legal periodical 'Wertpapiermitteilungen' on 'Informationspflichten und Haftungsfragen in der Anlageberatung und Vermögensverwaltung' in Frankfurt/Main on 19 September 1997.
[504] This viewpoint was taken by representatives of several large German private banks at a seminar organized by the German legal journal 'Wertpapiermitteilungen' on 'Informationspflichten und Haftungsfragen in der Anlageberatung und Vermögensverwaltung' in Frankfurt on 19 September 1997.

if a customer brings a claim against it arguing that the firm violated its duties under §§ 31, 32 'WpHG'. In such a court case the investment firm would have to resort to other means of documentation such as statements of current or deposit accounts or earlier securities dealings in order to prove that, in this specific case, the bank had sufficient knowledge of the customer's financial situation and investment objectives so that it was not necessary to bother him or her with any questions with regard to this matter.

However, in my view, the German *Bundesaufsichtsamt für den Wertpapierhandel* - when drawing up its guidelines on the §§ 31,32 'WpHG' - should have followed the UK's example of categorizing customers according to their level of experience in investment matters. The 'Core Rules' of the Securities and Investments Board '(SIB') do contain different sets of rules for different types of customers. In my opinion, the German counterpart of the SIB should also have produced a similar system of rules which link the level of information which is to be provided to the state of the customer's financial experience.

This lack of statutory categorization may be one reason for the fact that German banks have taken it into their own hands to 'pigeon-hole' their customers. In today's banking in Germany, it has become general practice that banks ask their customers to fill out a standardized questionnaire before they accept any orders by their customers. Such a questionnaire typically requests customers to state their income, their liabilites and what kind of experience they have with investments. In addition, the customers are asked to indicate whether they would prefer a form of investment that carries 'no', 'little', 'medium', or 'high' risks. Moreover, the banks want to know whether their customers are interested in a 'short-term', 'medium-term', or 'long-term' investment strategy.

The use of standardized questionnaires can be said to have been approved by the courts. In fact, in many cases the customers' statements concerning their goals and their financial situation have become crucial in many cases where customers sued their banks for incorrect financial advice. Whenever the courts found that a bank had recommended a form of investment that did not fit in with the customer's clearly stated investment policy, the defendant banks were held liable for incorrect advice[505].

There may be situations where a bank does not need to rely on its customers' self-assessments. Not seldom, banks are capable of getting a very accurate picture of their customers' financial standing just through looking into their own files. In this context, it should be pointed out that most Germans operate only one bank account[506] so that most German banks do have a fairly good overall impression of their customers' financial affairs.

Thus, it is argued that in a situation where a bank can easily access its customers' financial status, it can be held liable if it provides them with such financial advice that any ordinary bank in its position would not have given[507]. Furthermore, section 3.4 of the Directive says that where a customer refuses to give details about his or her financial status, the investment firm shall only then accept his or her order if the firm ascertains that it has offered the customer information on the investment before the transaction is carried out by the firm.

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[505] AG Frankfurt/Main (06.03.1995) WM 1995, 700; BGH (11.03.1997) WM 1997, 811.
[506] Jacob/May, 'Auch Banken müssen verkaufen', Die Bank, 1996, at p. 108.
[507] Schwark, Eberhard, 'Die Verhaltensnormen der §§ 31 ff WpHG' in: *Das Zweite Finanzmarktförderungsgesetz in der praktischen Umsetzung - Bankrechtstag 1995*, Bankrechtliche Vereinigung, (Köln 1996), Volume 7, at p. 117.

(dd) § 31 (2) No.2 WpHG: Duty to disclose all relevant information to the customer

Under § 31 (2) No.2 *Wertpapierhandelsgesetz*, an investment firm is obliged:

> to disclose to its customers all appropriate information that is relevant for the customers' interests, especially with a view to the nature and scope of the customers' envisaged transactions.

Furthermore, in section 3.2 of its Directive on the §§ 31, 32 'WpHG' the *Bundesamt für den Wertpapierhandel* laid down in detail what kind of information must be given by an investment firm to its customers who are interested in debenture bonds, shares, investment certificates, deriviatives or options warrants:

> *3.2.1. Information concerning debenture bonds*
> Information concerning the risks of debenture bonds should especially include information on the revenue, the credit rating, and, if necessary, the country risk, the price and interest rate risk, the insolvency risk, the currency risk as well as the termination and drawing rights risk.
>
> *3.2.2. Information concerning shares*
> Information regarding to shares should especially include information on the revenue (dividend), the price risk, the credit rating, the insolvency risk, the trade cycle risks as well as the currency risk.
>
> Information on risks with regard to shares which are not traded at a national or foreign stock exchange (e.g. US-American 'Penny Stocks') should contain information on the market (especially on the market liquitity) and the specific risk of loss of this form of investment as well as on the origin of the price statements, on the difference between bid and book price ('spread') and on the fees charged by the securities services companies involved in the execution of the order.
>
> *3.2.3. Information concerning investment certificates*
> Information on risks of investment certificates should include information on the composition of the funds, the investment strategy, the utilization of the revenue, the issuing price (issuing top up fee etc.), the price risk and the assessment procedures.
>
> *3.2.4. Information on derivatives and options warrants*
> Information on the risks of derivatives must especially contain information on the intrinsic value, the economic context and function of the products (particularly the importance of duration of premium, the type of execution, the leverage effect, the liquidity, the volatility of the markets

> and, if necessary, the standstill risk), the revenue, the price risk, the currency risk and the credit risk.

A good illustration of what kind of information ought to be given by a bank to an investor may the decision in BGH WM 1991, 315[508]. In this case the defendant broking house provided the plaintiff with a brochure in which the defendant described so-called 'Penny Stocks' to him.

'Penny Stocks' are relatively cheap shares which are issued by very young companies. These shares have a very small nominal value. Despite this, these shares are nevertheless sold at a price many more times higher than their nominal value because profits can be extraordinarily high in case these young companies become very successful very quickly. On the other side, there is also the risk of a total loss of one's investment in 'Penny Stocks' due to the relatively high number of insolvencies among young companies.

In the defendant's brochure 'Penny Stocks' were nevertheless described as a 'calculable risk' and their risks were downplayed through statements such as 'all stock market dealings are speculative and we cannot guarantee profits just as we cannot rule out losses'. The court found that the defendant broking house misled the plaintiff by creating - through its incomplete information - the false impression that an investment in 'Penny Stocks' were essentially not different from buying ordinary shares in the normal stock market.

The judges stressed that the defendant fell short of explaining that 'Penny Stocks' were particularly dangerous because they would often be sold by only one single broking house which would not only result in a buyer's limited opportunity to sell stocks at any

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[508] BGH (22.01.1991) WM 1991, 315.

time but also created the risk of total loss in case of insolvency of this single broker. The court also said that the defendant broker should have told its customer that the market for 'Penny Stocks' was particularly small so that prices could easily be manipulated either by brokers themselves or by individuals who held large numbers of shares[509].

Furthermore, in OLG Frankfurt/M WM 1996, 253[510] it was ruled that all the already above mentioned relevant information and warnings in relation to 'Penny Stocks' must be given to customers in a written form. The court found that only written information would enable inexperienced customers to assess the full scope of dangers of high risk investments. Additionally, the judges ruled that these warning were not to be hidden away in the small print.

All this may appear to place numerous and extensive duties upon investment firms. However, the courts also seem to be willing to take into account not only the need for sufficient customer protection on the one side, but also, on the other side, and the markets' demand for a quick, cost-sensitive and practical handling of orders what can also be seen as in the interest of the customer. For example, in LG Duisburg WM 1997, 574[511] it has been held that a bank's duty to inform its customers should be kept within reasonable and practicable limits. In this decision, it was ruled that a bank, when giving information to its customer on a specific investment, is typically not obliged to order its own specialists to undertake a detailed analysis of the company whose shares or bonds it is recommending but can instead refer to and rely on reports drawn up by widely respected and long established credit rating agencies such as Standard & Poor's or Moody's Investor's Service.

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[509] *ibid*, at p. 316-317.
[510] OLG Frankfurt/Main (28.06.1995) WM 1996, 253.
[511] LG Duisburg (05.02.1997) WM 1997, 574.

However, attention should be drawn to the fact that section 3.2 of the Directive of the 'Bundesamt für den Wertpapierhandel' also states that if an investment firm places its customers into specific risk categories this categorization is to be considered when carrying out orders and that:

> If, on consultation, the customer wishes to have one specific order executed which does not fall into his risk category, the order can be carried out if it is ensured that the customer has received the necessary information before the excution of his order.

In practice, this means that where an investment firm has placed a customer into a 'low risk category' this firm *must* refrain from carrying out this customer's order which does not fall into this 'low risk category'. For example, a firm's customer who has previously invested exclusively in very safe German government bonds and has therefore been classified by the firm as belonging to the 'low risk category' approaches the firm with a request to purchase high risk US Penny Stocks. In this situation, according to the provisions of section 3.2 of the Directive, the investment firm *must* reject this customer's order. Only after providing the customer with extra (written) information describing the nature and high risks of US Penny Stocks in detail, and, ideally, after obtaining the customer's signature under a document stating that the customer has been informed about the risks of US Penny Stocks, the firm can execute the customer's order.

In practice, however, problems arising in such cases are 'solved' by investment firms through the handing over or mailing of a brochure explaining on no less than 120 pages in great detail the nature and scope of all sorts of securities transactions. In my view, it remains questionable whether today's practice of many banks to provide their customers with this lengthy brochure is 'appropriate and understandable information' in the sense of § 31 (2) No.1 *Wertpapierhandelsgesetz*. Thus, not surprisingly, in BGH WM 1997,

811[512] it was held that the defendant financial adviser's mere handing out of a 120-page-long brochure on bond warrants was not enough to properly explain to its financially totally inexperienced customers the substantial risks of this form of investment. Although this case was mainly concerned with the duties of a financial adviser, the principles laid down in this ruling may nevertheless applicable to situations where *banks* deal with financially totally inexperienced customers.

(b) § 32 WpHG: Specific rules of conduct

(aa) § 32 (1) No.1 WpHG: Recommendation must be in accordance with customers' interests

§ 32 (1) No.1 *Wertpapierhandelsgesetz* stipulates that an investment firm must not recommend to its customers any investment that is not in line with its customers' objectives. In practice, this means that § 32 (1) No.1 *Wertpapierhandelsgesetz* does enlarge a security services firm's duties towards its customers. In contrast to § 31 (1) No.2 *Wertpapierhandelsgesetz* which requires firms to disclose all necessary *general information* on the investment matter to their customers, § 32 (1) No.1 *Wertpapierhandelsgesetz* goes further and asks investment firms to take their customes' *individual* interests into account when making a *recommendation* to them.

In this context, it may be of some help to try to explain the difference between the provision of information and the making of recommendations. Probably the most

[512] BGH (11.03.1997) WM 1997, 811.

common definition of the difference between information and recommendation. According to this view, the supply of information is defined as giving objective facts to the customers. In contrast to this, a recommendation is usually described as the presentation of a subjective point of view which is typically based on a detailed analysis of facts[513].

At this point, it should also be emphasized that no investment firm is obliged to make any specific recommendations to their customers under the provisions of the *Wertpapierhandelsgesetz*. § 32 (1) No.1 also only says that *if* a bank recommends to a customer a certain form of investment, then it is bound by the provisions of § 32 (2) 'WpHG' and the section 5.1 of the Directive on the §§ 31, 32 'WpHG'. It should be pointed out that section 5.1. of the Directive stipulates that an

> investment firm is not permitted to recommend to customers transactions of which it assumes or *should reasonably assume*[514] that it is disadvantageous to its customer's interests.

Referring to this provision, it can be said that an investment firm which recommends a certain transaction under can be expected to use that standard of skill and care that can reasonably be demanded from any other ordinary investment firm in its position.

Moreover, section 5.1 of the Directive states that an investment firm especially acts not in line with the customer's interests if its recommendation results in a unreasonably high number of transactions leading to costs for the customer which are unreasonably high in proportion to the capital employed and the profit gained. This type of misconduct is also widely known as 'churning' in the financial services sector. Additionally, section 5.1

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[513] Assmann/Schneider-Koller, *Wertpapierhandelsgesetz* (Köln 1995), § 32 Rdn.3, at p. 476-477.
[514] Emphasis added.

says that investment firms ought not misuse their position by recommending transactions to customers in order to influence the market price of certain financial products with a view to dealings by the firms themselves on their own behalf.

Interestingly, it is reported that the provisions of § 32 (1) No.1 'WpHG' in connection with section 5.1. of the Directive of the *Bundesamt für den Wertpapierhandel* have already had a restricting effect on the financial services providers' willingness to give recommendations to their customers. According to a survey carried out by the consumer protection association 'Stiftung Warentest', more and more financial institutions seem to refrain from recommending to their customers any specific financial products in order to avoid any risk of liability[515].

(bb) § 32 (1) No.2 WpHG: No recommendations to customers in order to enhance the bank's own interests

Under § 32 (1) No.2 *Wertpapierhandelsgesetz* investment firms are not allowed to recommend to their customers any investments with a view to enhance the firms' own trading profits. The aim of this provision is to safeguard the integrity of the capital market as such. Due to their experience and expertise financial services providers are often in a position where they can easily talk their customers into transactions which are in fact more beneficial to themselves than to their customers.

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[515] *Frankfurter Allgemeine Zeitung* (17.08.1995), at p. 11.

(cc) § 32 (1) No.3 WpHG: No front, parallel, or contra running

§ 32 (1) No.3 *Wertpapierhandelsgesetz* prohibits investment firms to undertake any transactions solely based on the knowledge of their customers' orders or the expectation of their customers' orders. This conduct is commonly called 'front, parallel or counter running'. Front and parallel running are generally defined as the purchase or sale of securities or derivatives by banks based on their knowledge of their customers' transactions and where this knowledge is used to earn an extra profit for the banks themselves[516]. Counter running is described as the deliberate placing of counter orders for those securities the bank's customer is interested in acquiring with a view to gain an extra profit for the bank through (mis-)using its own knowledge of the purchase or sale limits given by the customer.

Furthermore, section 5.2 of the Directive on the §§ 31, 32 'WpHG' also stipulates that where an investment firm is about to make a recommendation or to publish research results on one specific investment matter, the firm must refrain from any dealings closely related to this matter until its customers have had 'reasonable time to react'[517] to the new findings.

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[516] Assmann/Schneider-Koller, *Wertpapierhandelsgesetz* (Köln 1995), § 32 Rdn. 11, at p. 479.

[517] Section 5.2 of the Directive: '[...] Where the publication of written recommendations for customers or research results of the securities services firm or one of its associated companies are impending, no tradings in the affected securities or derivatives on one's own behalf are to be carried out before the customers had reasonable time to react. Such a reasonable time to react can usually be assumed if, at the time of the written recommendation to the customer, the information has been made to the interested public (*Bereichsöffentlichkeit*) by publication of the information through an electronic information processing system that is recognized by the stock exchanges and commonly used by credit institutions, listed companies and insurance companies'.

(c) §§ 31, 32 WpHG and the so-called 'execution only business'

In today's banking in Germany discount banks and discount brokers which offer financial services to consumers directly via telephone, fax or internet play a more and more significant role. Since 1994, more than a dozen of discount banks and brokers have been established in Germany[518]. Nearly all large German private banks now offer discount banking and broking services to their customers either through independent subsidiaries or on an 'in-house' basis, i.e. as part of their own product range. Generally, discount banking is seen as having great potential for growth and it has already become one of the most competitive markets in the financial services sector[519]. Moreover, it is estimated that direct banks and discount brokers will acquire up to seven or eight million customers until the year 2000[520].

Most of these discount banks and brokers do not operate a branch network. Usually, they offer to carry out their customers' orders at a significantly cheaper rate than 'normal' banks do. In 1995, when the *Wertpapierhandelsgesetz* came into force, there was an intensive debate whether, and if so, to what extent the provisions of the §§§ 31, 32 *Wertpapierhandelsgesetz* applied to the services offered by discount-brokers.

In May 1997, the *Bundesaufsichtsamt für den Wertpapierhandel* (Federal Office for the Supervision of Securities Trading), exercising its regulatory powers under § 35 (2) *Wertpapierhandelsgesetz*, ended this discussion by issuing a directive intended to specify

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[518] Lasch/Röder, 'Das Börsenangebot der Direktbanken' ZBB 4/95, at p. 342.
[519] *Frankfurter Allgemeine Zeitung* (30 April 1997), at p. 25.
[520] Raab, Hans-Jürgen, 'Direktbanken: Das Beratungskonzept' Die Bank, 1996, 280, at p. 280.

and clarify the conduct rules under §§ 31, 32 *Wertpapierhandelsgesetz*[521]. Section 3.6 of this Directive deals with the duties of discount brokers:

> Insofar as institutions trading in securities only carry out orders ('execution-only'), possibly through a separate distribution channel, in the individual case or generally, it must inform its customer about this fact at latest before it accepts the order.
>
> The *disclosure of information*[522] shall be subject to the knowledge and experience of the customer with regard to the type of transactions intended by the customer.
>
> Insofar as the institution provides the customer with information which exceed the disclosure of information which is stipulated in this section, for example, the provision of market reports, charts or analysis, it must make it clear to the customer that this information does not constitute any investment advice but is only meant to facilitate the customer's own decision on the investment.

First, it is interesting to notice that the *Bundesaufsichtsamt für den Wertpapierhandel* uses the term 'execution-only business' instead of the more commonly used phrase 'discount broking'. By choosing the expression 'execution-only business' the *Bundesaufsichtsamt für den Wertpapierhandel* appears to have adopted the view which is also taken by consumer protection groups that the term 'discount broker' is not be uniformly used in the German financial services market and therefore cannot serve as basis for a legal definition[523]. In fact, there are some financial institutions in Germany which do use the phrases 'direct' and 'discount' when advertising their services although they actually provide individual investment advice to their customers.

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[521] 'Richtlinie gemäß § 35 Abs.2 des Gesetzes über den Wertpapierhandel (WpHG) zur Konkretisierung der §§ 31, 32 WpHG für das Kommissions-, Festpreis- und Vermittlungsgeschäft der Kreditinstitute' of 26 May 1997 (Directive of the Federal Office for the Supervision of Securities Trading based on § 35 (2) of the Securities Trading Act concerning the definition of the the duties of financial services firms under §§ 31, 32 WpHG).

[522] Emphasis added.

[523] Interview with Mr. Hartmut Strube, Verbraucher-Zentrale NRW e.V. in Düsseldorf on 3 January 1997

One example of these institutions is the 'Advance Bank AG', which is a subsidiary of 'Vereinsbank', one of the house-hold names in Germany's private banking sector. In a recently published article, the managing director of Advance Bank AG described its bank as 'a direct bank of the third generation' which could offer besides the ordinary services of a direct bank the 'additional assets such as innovative products, first class service and, above all, objective financial investment advice and portfolio management'[524]. Furthermore, in the same publication, the bank's managing director also wrote[525]:

> Another field which functions to distinguish us from our competitors is [the area] of portfolio management, to be precise, objective portfolio management that is an essential part of the philosophy of the Advance Bank.
>
> The bank cooperates with the FERI Trust GmbH, which belongs to the Quant Group and is a research institute that provides [the Advance Bank AG] with advice on investment strategies and permanent analysis of the funds market.
>
> On this basis, [the Advance Bank AG] offers its customers a number of investment alternatives which can individually adjusted with regard to risk, profit and tax issues and may range from shares, government bonds and investment funds.
>
> Thus, the bank does not only resort to investment funds offered by the Vereinsbank but also makes selections from entire funds market.

This example clearly shows that the area of discount banking and broking is by far no homogenous market because some of so called 'discount' banks or brokers do actually offer individual and tailor-made investment advice to their customers. Furthermore, one should draw attention to the fact that the mere amount of the commission fees charged by so called discount brokers cannot serve as a reliable indicator whether an institution is a 'discount broker' or not because these fees vary considerably. In some cases, the

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[524] Raab, Hans-Jürgen, 'Direktbanken: Das Beratungskonzept', Die Bank 5/96, 280, at p. 280.
[525] *ibid*, at p. 281.

fees of the most expensive 'discount' brokers are between 100 and 228% above the commission charged by their cheapest competitors[526]. Considering all these points, one may even be inclined to plead that the phrase 'execution-only' should be interpreted in a very strict way so that it does only cover transactions where there is not any kind of advice given to the customer.

Secondly, it is interesting to notice that section 3.6. of this Directive also states that some information must be disclosed to customers even in the area of 'execution-only' business. This is clearly a setback to most discount brokers who favoured the view that they were under no obligations under §§ 31, 32 *Wertpapierhandelsgesetz* at all. Nevertheless, one should realise that it is also widely accepted that discount brokers can fulfil this obligation by simply posting to their customers a brochure published by the German private banks association which describes the nature and risks of dealings in securities in a very general manner. The effectiveness of burying the consumers under piles of brochures, which, as has been said above, can be as voluminous as 120 pages and which are usually not read by them, remains questionable.

However, on the other hand, it may also be pointed out that section 3.6 of the Directive contains the following provision which may be interpretated as detrimental to the idea of investor protection:

> Generally, the [discount broker] shall ask the customer about his or her knowledge and experience at latest before it takes the order. Statements concerning the customer's investment goals and financial standing are only then required if the [discount broker] either grants the customer a loan for the transactions planned or asks the customer for securities of credit.

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[526] Metz, Rainer 'Discount-Broker: Bankgeschäfte und technologische Veränderungen', VuR 1996, 183, at p. 186.

In practice, this provision is a (partial) exemption clause for the providers of 'execution-only' broking services with regard to the general duty to obtain information from customers about their financial situation. In my view, this partial exemption is contradictory to the general duty under § 31 (1) 'WpHG', which undisputedly[527] applies not only to 'ordinary' but also to 'discount' banks and brokers to 'carry out dealings in securities, as well as any supplementary services related to these dealings, with the required skill, care and conscienciousness and *in its customer's interest*[528]' In my opinion, it is hard to imagine how a financial institution which provides investment services to a customer can successfully act in his or her interest without knowing about the customer's general financial situation and investment strategy[529].

However, for the time being, the issue of the duties of discount brokers under the §§ 31, 32 *Wertpapierhandelsgesetz* remains a controversial topic. So far, there has been only one important court decision on this matter. In LG Köln WM 1997, 1479[530], a defendant discount broker used a general contract term which stated that:

> in order to offer favourably priced products the [defendant] refrains from providing any kind of advice [to the customer].

The court ruled that it was void because of a breach of § 9 (1) in connection with (2) No.1 'Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen' (General Contract Terms Act). According to this provision, a general contract term is regarded as void if it is 'incompatible with the fundamental policies forming the basis of the statutory regulation from which the term derivates'[531]. In its decision in LG Köln

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[527] Interview with Mr. Hartmut Strube, Verbraucher-Zentrale NRW e.V. in Düsseldorf on 3 January 1997 in Düsseldorf.
[528] Emphasis added.
[529] See also Reich, Norbert, 'Informations-, Aufklärungs- und Warnpflichten beim Anlagengeschäft', WM 1997, 1601, at p. 1604.
[530] LG Köln (12.06.1997) WM 1997, 1479.
[531] See above Chapter Two.

WM 1997, 1479 the court found the clause used by the defendant discount broker incompatible with the fundamental policies behind § 31 (2) *Wertpapierhandelsgesetz*[532]:

> [...] the renouncement of any kind of advice which is imposed on the customer by the defendant is unreasonable.
>
> This clause does not only seek to counteract any conclusion of an additional contract to supply advice between the defendant [and the customer] but also, even if this is not explicitly said, to exclude any liability for those situations where there would have been a duty for the defendant to advise or where there was - incorrect - advice actually being given by the defendant.

Additionally, the judges stressed that the clause was incompatible with the policy behind § 31 (2) *Wertpapierhandelsgesetz* because this provision requires discount brokers to supply their customers with information about the transaction in question. As the court viewed the supply of 'information' as an inseparable prerequisite for the provision of 'advice', the clause used by the defendant was meant to exclude liability not only for advice but also the provision of information. This wide scope of the disclaimer clause used by the defendant was, in the opinon of the judges, not in line with the general idea behind § 31 (2) *Wertpapierhandelsgesetz* which stipulated that the provision of information was one of the core duties of financial institutions offering their services to private investors[533].

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[532] LG Köln (12.06.1997) WM 1997, 1479, at p. 1480.
[533] *ibid*, at p. 1481.

(d) § 37a 'WpHG': Three year prescription period

Furthermore, attention should also be drawn to the new short prescription period for claims for damages which are based on a violation of the duties listed in §§ 31, 32 'WpHG'. This short prescription period was introduced by the recently enacted *Drittes Finanzmarktförderungsgesetz* (Third Act for the Furtherance of the Financial Markets)[534]. According to § 37a 'WpHG' a plaintiff's action for damages which is founded on a breach of the provisions of §§ 31, 32 'WpHG' in connection with the concepts of *Culpa in contrahendo*, *Positive Vertragsverletzung* or the tortious provisions of the §§ 823-831 BGB is barred by prescription within three years from the time at which the claim arose.

The German legislator's main reason for the introduction of this short prescription period was to adjust the limitation period for claims with regard to negligently performed securities services to today's business practices in the area of securities trading which are characterized by very rapid transactions[535].

However, in my view, this three year prescription period is too short. Especially in the field of portfolio management it can easily lead to unjust results. The already above mentioned[536] decision in BGH WM 1998, 21[537] may function as a good illustration of the disadvantages of a short prescription period. In this case, in 1987, the plaintiff investor entered into a contract with the defendant bank under which the bank was asked to manage the plaintiff's portfolio. The plaintiff also provided the bank with clear

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[534] This Act came into force on 1 April 1998.
[535] Pötzsch, Thorsten, 'Das Dritte Finanzmarktförderungsgesetz' WM 1998, 949, at p. 957.
[536] See above under B. (1) (c) (i).
[537] BGH (28.10.1997), WM 1998, 21.

instructions as to how the bank should invest his money. In 1992, i.e. five years after the contract had been concluded and the first transactions by bank on behalf of the plaintiff had taken place, the plaintiff had the impression that the defendant bank had been mismanaging his portfolio. He brought a claim for damages against the bank. The court ruled that the defendant bank, during this five year long period had committed dozens of serious breaches of the plaintiff's instructions when handling the plaintiff's portfolio. The plaintiff was awarded significant damages.

Under the new three year prescription period of § 37a 'WpHG' the plaintiff in BGH WM 1998, 21 would not have succeed with his claim with regard to those of the bank's negligently performed dealings which had taken place earlier than three years before he brought his claim for damages against the bank.

Taking this into account, the prescription period for actions for damages which are based on a bank's violation of its duties under §§ 31, 32 'WpHG' should be longer than three years. In my view, it would be more sensible to extend the prescription period to six years which is exactly the period of time for which a bank under § 34 (3) 'WpHG' is obliged to keep records of its securities transactions. Such a six year long prescription period would still be considerably shorter than the thirty year prescription period of § 195 BGB which applies to all civil law claims unless other more specific provisions say otherwise.

(3) A bank's special duties in relation to tradings in futures, options, derivatives and commodities under the *Börsengesetz*

In Germany, the *Börsengesetz* (Stock Exchange Act) imposes on banks additional duties in relation to tradings in futures, options, derivatives and commodities. The trading in this form of financial products is is defined as *Börsentermingeschäfte* (futures). *Börsentermingeschäfte* are generally described as contracts with regard to securities, fungible goods or currencies whose obligations are not to be fulfilled at the time of the agreement but at a later stage and on conditions which are set out precisely by the original contract. Another characteristic feature of these transactions is that there must also be a possibility to 'even up' the prinicpal transaction by reaching a second agreement that counters the effects of the original contract[538].

The main difference between ordinary trading in shares on the stock exchange and dealing in futures is the time element. When purchasing or selling 'ordinary' shares the transaction, delivery and payment must take place within two days after the agreement is reached. In contrast to this, in a deal involving futures typically a considerable period of time elapses between the agreement and the actual transaction. Indeed, it is this time factor that singles out this form of trading. Investors in futures try to make a profit from speculating on the future development of certain securities, goods or currencies. They acquire the right either to purchase or sell certain shares or goods at a fixed price at a specified time in the future. This right itself has a market value and can be sold to others.

In 1989, the Stock Exchange Act was changed to allow private individuals to obtain a special form of legal capacity called *Börsentermingeschäftsfähigkeit* which entitles them

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[538] Lang, Volker, *Aufklärungspflichten bei der Anlageberatung* (Stuttgart 1995), at p. 107.

to trade in futures (*Börsentermingeschäfte*). Today, under § 53 (2) S.2 *Börsengesetz* (Stock Exchange Act) private investors can trade in futures, options, derivatives and commodities after being thoroughly informed about the nature and the risks of these transactions. Additionally, according to § 53 (2) S.3 *Börsengesetz* private individuals must also confirm in writing that they have received this information.

Furthermore, it is interesting to notice that the *Börsentermingeschäftsfähigkeit* obtained by a private customer is limited in time. According to § 53 (2) S.4 *Börsengesetz* a customer who wants to keep the legal capacity to trade in futures must be informed a second time about the nature and risks of this form of investment within twelve months after being informed about this matter for the first time. However, after having received the information for a second time, the customer is capable of trading in futures for another three years.

In order to cater not only for their customers' call for information and advice but also to ensure efficient trading, banks and stock broking houses have come up with a brochure called *Wichtige Information über Verlustrisiken bei Börsentermingeschäften* (Important information concerning the risks in relation to trading in futures). It is common practice that before a customer places an order with a bank or stock broking house he or she signs a document stating that he or she has received this brochure.

Although this brochure is generally viewed by the judiciary as providing an accurate picture of the nature and the risks of trading in futures, in BGH WM 1997, 811[539] the court ruled that the mere handing out of the brochure is not sufficient in cases where a financially very inexperienced customer is interested in purchasing high risk bond

[539] BGH (11.03.1997) WM 1997, 811.

warrants. In this ruling, the judges also emphasized that, generally speaking, a bank's duties with regard to the sale of bond warrants were two-fold:

First, according to § 53 (2) S.1 *Börsengesetz*, banks are required to supply a customer with written information about the general nature and risks of bond warrants. Secondly, in addition to this, the bank must inform and warn a customer with regard to his or her individual needs, knowledge and experience. Appyling these principles to the facts in BGH WM 1997, 811, the court found that - taking into account that in this case both plaintiffs were workers having absolutely no experience in any kind of stock market dealings - the defendant was under the duty to provide them with detailed information about the risks of bond warrants. In the eyes of the judges, the mere handing out of the above mentioned brochure was not enough. Thus, they held the defendant liable for the losses suffered by the plaintiffs.

Moreover, in BGH WM 1996, 1214[540] it was held that where a bank recommended to its customer to take an 'active approach' in the handling of his deposit account containing futures and options the bank also had to point out to him that the greater the number of transactions done the less profits could be achieved. In this case, the plaintiff transferred DM 229,000 to the New York branch of the defendant bank with a view to trading in curriencies and US government bonds. Within six months after the transfer, the defendant bank charged him $ 62,000 for commission and fees.

Although a brochure that was handed over to the customer stated that 'profits can be reduced by commissions and fees' and that 'the commission fees rise with any increase in the number of transactions', the court found that the bank had failed to warn him properly about the impact of commissions and fees. The bank should have pointed out

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[540] BGH (14.06.1996) WM 1996, 1214.

more clearly that, when dealing with options, one can only then make a profit if the changes in the market prices are substantial enough to exceed the the costs of acquiring the option as well as the commission and fees charged by the bank[541]:

> The scope of the risks as well as the decrease in the chances of gaining a profit through an unusually high provision or unusually great number of provision payments must be pointed out clearly even to a cursory reader in an understandable and eye catching way that does not intend to cover up something.

If a customer is not properly informed about the nature and the risks of dealings in futures the customer does not obtain the legal capacity to trade in futures. Any transactions concerning futures this customer has entered into are non-binding[542] on the bank and the customer. In this situation, the general principles of the German law of restitution, the §§ 812-822 BGB, apply. This means that both sides, bank and customer, must return what they have received from each other in relation to the transaction in question.

However, it should be noticed that banks are barred from using the defence of § 818 (3) BGB which says that a party must not return the received enrichment if the party is not any longer enriched[543]. The reason behind this is that § 818 (3) BGB is meant to protect the interest of innocent parties who, being in good faith, spent sums they had received in a way they would normally not have done. As banks are generally expected to keep and re-invest any sums they receive, they are regarded as ineligible for this defence[544].

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[541] *ibid*, at p. 1215; see also OLG Düsseldorf (04.05.1995) WM 1996, 1488, at p. 1491.
[542] Non-binding but *not* void in the sense of § 134 BGB.
[543] The equivalent of this legal topic in English law is called 'change of position' in the law of restitution.
[544] Lang, Volker, *Aufklärungspflichten bei der Anlageberatung* (Stuttgart 1995), at p. 163-164.

In addition to this, the courts generally find that in situations where a customer has not obtained the *Börsentermingeschäftsfähigkeit* in the sense of § 53 (2) due to a lack of information provided by the bank, the customer is entitled to damages under the pre-contractual concept of *Culpa in contrahendo*. Thus, in short, it can be said that where a bank's customer is interested in dealing in futures, the bank must provide the customer with general information on this form of investment for two reasons: First, the provision of the information is a prerequisite for rendering the agreed transaction binding on both parties. Secondly, by giving this information the bank undertakes to avoid liability under the pre-contractual concept of *Culpa in contrahendo*.

(4) A bank's duties in relation to investment prospectuses

Nowadays, many forms of investments are offered to the general public by way of distributing prospectuses. First, one needs to define what should be regarded as a 'prospectus'. Generally speaking, a prospectus is defined as any means of advertisement that intends to inform and acquire the custom of investors and functions as a significant basis for their investment decisions[545].

Due to the restrictions as to the scope and extent of this thesis, only a brief outline of the German law as to pospectus liability can be given here. In German law, the technical term *Prospekthaftung* (prospectus liability) covers not only certain statutory provisions which define what a prospectus issued by a listed company must contain but also a civil law concept of *Bürgerlich-rechtliche Prospekthaftung* (civil law based prospectus

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[545] Von Heymann, Ekkehardt, 'Prospekthaftung bei Immobilienanlagen', Die Bank, 1992, 33, at p. 34.

liability) which has been developed by the courts to protect the interests of private investors. Thus, one may describe the German law as to prospectus liability as a 'dual track' system.

The most important statutory provisions in relation to prospectus liability are the §§ 45, 46 *Börsengesetz* (Stock Exchange Act), § 13 *Wertpapier-Verkaufsprospektgesetz* (Securities Sales Propectus Act), § 20 *Kapitalanlagegesellschaftengesetz* (Investment Management Companies Act), and § 12 *Auslandsinvestmentgesetz* (Foreign Investment Act). All these codifications are relatively new, except for the Stock Exchange Act.

(a) §§ 45,46 *Börsengesetz* and § 13 *Wertpapier-Verkaufsprospektgesetz*

According to §§ 36, 38 *Börsengesetz* a company which wants to sell its shares or bonds at the stock market must apply to the stock market authority for a listing at the stock market. This application must also contain a prospectus which describes the company's business, its assets and liabilities and must give an account of the company's overall financial situation. Under § 36 (2) *Börsengesetz* a company's application must be assisted by a registered bank. Usually, there is a syndicate of banks which assists a company with its application. Syndicate banks are also involved in the drafting of the prospectus.

Under §§ 45, 46 *Börsengesetz* a bank which belongs to such an underwriting syndicate can be held liable if the prospectus is incorrect, incomplete or misleading. In order to be held liable, a bank must either have known or must have been grossly negligent in failing

to realise that the prospectus was incorrect or must have been grossly negligent in not detecting that the prospectus was incomplete[546].

Finally, it may also be mentioned that the right to sue an issuer of a prospectus under §§ 45, 46 *Börsengesetz* only applies to situations where the prospectus promotes securities officially registered with the German stock exchanges. In addition, § 13 *Wertpapier-Verkaufsprospektgesetz* (Securities Sales Prospectus) extends this right also to cases where there is an incorrect, incomplete or misleading propectus advertising securities which are not registered but offered to the general public.

(b) § 20 *Kapitalanlagegesellschaftengesetz* and § 12 *Auslandsinvestmentgesetz*

The provisions of the *Kapitalanlagegesellschaftengesetz* (Capital Investment Management Companies Act) and the *Auslandsinvestmentgesetz* (Foreign Investment Act) protect the interests of private investors. They lay down criteria for prospectuses issued by companies which specialise in the area of funds management or investments abroad.

Although banks are typically not involved in the issuing of these prospectuses, § 20 (3) of the *Kapitalanlagegesellschaftengesetz* and § 12 *Auslandsinvestitionsgesetz* give investors a right of direct action against banks which are involved in the selling of investment bonds or certificates of fund management companies or companies which offer investments abroad. § 20 (3) *Kapitalanlagegesellschaftengesetz* gives a private

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[546] See decisions in OLG Frankfurt/Main (01.02.1994) ZIP 1994, 282 and OLG Frankfurt/Main (27.03.1996) WM 1996, 1216.

investor the right to claim invested money back from the bank that sold to him or her bonds of an investment management company whose prospectus was incorrect, incomplete or misleading provided that the bank knew or was grossly negligent in failing to detect the shortcomings of the prospectus.

Under § 12 (4) *Auslandsinvestmentgesetz* an investor can claim his or her money back from a bank which sold him or her a bond or certificate issued by a foreign investment firm given that the bank knew or should have known that the prospectus distributed by this foreign firm was incorrect, incomplete or misleading.

The aim of these provisions is to ensure that banks thoroughly check prospectuses of fund management companies and companies which offer investments abroad before they recommend their financial products to their own customers.

(c) The concept of *Bürgerlich-rechtliche Prospekthaftung*

The *Bürgerlich-rechtliche Prospekthaftung* (civil law based prospectus liability) may be described as a judge-made legal concept which is based on the notion of *Culpa in contrahendo*. Strictly speaking, there are two different types of *Bürgerlich-rechtliche Prospekthaftung* which differ significantly. First, there is the notion of *Prospekthaftung im engeren Sinne* (prospectus liability in the strict sense). Secondly, there exists *Prospekthaftung im weiteren Sinne* (prospectus liability in the wider sense).

(aa) Prospekthaftung im engeren Sinne

This form of civil law based prospectus liability is concerned with the liability of a person who can directly be linked with the process of issuing a prospectus which advertises any kind of investment. The most characteristic point about *Prospekthaftung im engeren Sinne* is that liability under this concept can be established without proving that there has been a so-called 'intensified social contact' between the defendant and the plaintiff investor.

In this respect, liability under this concept is much stricter than liability under the ordinary concept of *Culpa in contrahendo* where such a social contact is essential to bringing a successful claim. This means that under the notion of *Prospekthaftung im engeren Sinne* liability is typically not based on the plaintiff investor's individual reliance upon a personal contact with the issuer of the prospectus but on other objective factual circumstances.

The courts have developed a set of typified factual circumstances in which one may be held liable under the concept of *Prospekthaftung im engeren Sinne*[547]. Generally speaking, the courts have restricted the scope of liability under this concept to the following group of individuals: First, anyone who issues or drafts a prospectus or plays a dominating role in the running of the entire investment project which is presented in the prospectus can be held liable if the prospectus is incorrect. Secondly, individuals who appear to outsiders to have been considerably involved in the drafting of the prospectus and are being trusted because of their occupation or professional skills (i.e. accountants, lawyers and financial advisers) can also be held liable under this concept.

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[547] Von Heymann, Ekkehardt, 'Prospekthaftung bei Immobilienanlagen', Die Bank, 1992, 33, at p. 33.

(bb) Prospekthaftung im weiteren Sinne

Under the notion of *Prospekthaftung im weiteren Sinne* liability depends on the existence of an 'intensified social contact' between the investor and the defendant. Furthermore, *Prospekthaftung im weiteren Sinne* is only seen as an integral part of the general concept of *Culpa in contrahendo.*

Taking this into consideration, one may conclude that under the concept of *Prospekthaftung im weiteren Sinne* the crucial point is whether the bank assumed a role which exceeded the functions of an 'ordinary' creditor. Thus, whenever there are signs that the bank adopts a dual role as the financial adviser of a company running a special investment scheme as well as a creditor of prospective investors in this scheme, the bank runs the risks of liability under this concept. Generally, it may be said that the more active a bank is in acquiring investors for projects, the stricter its duties towards these investors become.

In practice, the concept of *Prospekthaftung im weiteren Sinne* is often applied to cases of relatively small scale local construction projects[548]. In such projects, banks are often asked by the company which runs the project to approach its customers to advertise the project. Companies are very keen on getting a bank's backing for their project because they know that many of the bank's customers rely heavily on their bank's recommendations. In such circumstances, investors view their bank often as a kind of guardian of the entire project because they assume that their bank has not only special expertise but also detailed insider knowledge of the nature and the feasibility of the project.

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[548] See decision in BGH (16.06.1992) NJW 1992, 2148.

Considering this, it may be said that it appears fair to impose duties upon a bank which assumes the role of a kind of intermediary or 'match maker' between a construction company and the investors because this dual role also provides the bank with the opportunity to reap double profits as the adviser and creditor not only of the company but also as creditor of the investors.

C. Comparison:

Today, it is still commonplace among banks in England and Germany to recommend to their customers only those financial products which belong to their own product range although products offered by other financial institutions are more suitable for their customers' individual needs. The glossy brochures which are handed out by banks to their customers typcially contain the following sentence, usually hidden in small print in a footnote[549]:

> The respresentatives of the A-Group can only provide advice on the life, pensions and unit trust products of the A-Group.

In this context, it is often argued by banks that it would be unreasonable to require them to inform a customer about the fact that a certain financial product of one of their rivals is more suitable for the customer than its own product. In this respect, it is maintained by the banks that no one expects a car dealer who sells only cars of the make X to tell prospective buyers of the better mileage per gallon of a comparable model which is manufactured by the Y-company.

However, in England, private investment advisers are bound by the so-called 'polarisation rule'. In short, this rule obliges a provider of financial services who advises private customers on so-called 'packaged products' (i.e. interests in collective investment vehicles such as life assurances or unit trusts) to 'polarize'. This means that an investment adviser must be either a company representative acting as an agent for the company or an independent intermediary acting as an agent for the private investor and surveying the whole market in order to find the most suitable investment product for the

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[549] For example, see Lloyds Bank plc, *Business Banking - Helping you get started* (London January 1998).

investor[550]. Additionally, in England and Germany, there is another rule which obliges investment firms only to recommend those financial products which are suitable for their individual needs[551].

Nevertheless, considering that a significant number of consumers depend on the advice which is given to them by their banks and that most banks still operate a policy of recommending only their own products the present suitability rules in England and Germany should be amended by the following provision with a view to establish a greater degree of protection for inexperienced private investors[552]:

> Product providers with limited product ranges must take care to ensure that they *recommend a product only where it is positively suitable, not just where it is the least unsuitable from the range*[553]. If a customer's need cannot be met by a product from within the range, then no product recommendation should be made. In such cases, a referral to an IFA [Independent Financial Adviser] should be made.

In my opinion, such an amendment is justified on the grounds that financial products are typically very complex and difficult to compare for the ordinary consumer. A car can be taken for a test drive, a personal pension plan can not.

In my view, in Germany, there is even a greater need for a better protection of private investors. In comparison with their English counterparts, German consumers have much less experience in stock market investments. For example, investments in shares make up no less than two thirds of the average portfolio of a private investor in the UK. In

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[550] See Securities and Investments Board, *The Core Conduct of Business Rules*, Rule Four.
[551] See with regard to England: Securities and Investments Board, The Core Conduct of Business Rules, Rule Sixteen, and, concerning Germany: see § 32 (1) No.1 *Wertpapierhandelsgesetz* (Securities Trading Act) as well as the general guidelines which have been laid down by Germany's highest civil court in BGH (06.07.1993) NJW 1993, 2433.
[552] See the draft guidance on factfinding issued by Personal Investment Authority Ombudsman Bureau, *Annual Report 1996-97* (London 1997), at p. 32.
[553] Emphasis added.

contrast, shares account for only 10 per cent of the investments made by the average German private investor[554]. Furthermore, the market of private pension schemes is underdeveloped in Germany. Only 5.8 per cent of the average income of a German pensioner results from occupational or private pension schemes. In contrast, in the UK, nearly a third of the average pensioner's income is based on private or occupational pension systems[555].

Moreover, with effect from the of 1 April 1998, the *Drittes Finanzmarktförderungs-gesetz* (Third Act for the Furtherance of the Financial Marktes) has introduced a new form of private pension scheme, the so-called *Altersvorsorge-Sondervermögen* (old age special funds), to the German private investment market. Mainly due to the growing doubts among consumers about the trustworthiness of the state-run pensions scheme in Germany, this new form of private pension is expected to be an exceptionally successful financial product. It is estimated that, within the next couple of years, every year one million of these new old age special funds contracts with an overall annual volume of DM 2.5bn will be sold to private investors[556].

Naturally, this extraordinarily dynamic development of the German private pension sector carries the great risk of resulting in a misselling scandal similar to the £11bn missale of private pensions in the UK in the late 80s where hundreds of thousands of consumers were advised wrongly to buy a personal pension rather than join or stay in their employer's scheme[557].

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[554] *Frankfurter Allgemeine Zeitung*, 15 May 1998, at p. 32.
[555] *Frankfurter Allgemeine Zeitung*, 23 May 1998, at p. 24.
[556] Stiftung Warentest, *Finanztest*, Volume 7, 1998, at p. 47.
[557] *Financial Times*, 4/5 July 1998, at p. 3.

Taking into consideration that the UK's pensions misselling scandal was mainly caused by a combination of poorly trained sales personnel hungry for commissions and a lack of experience in financial matters among consumers[558], one may be inclined to argue that the following precautionary steps should be taken to avoid a similar development in Germany. The requirements of suitability concerning the sale of the new old-age special funds should be explicitly regulated in the *Wertpapierhandelsgesetz*. In my view, financial institutions which intend to sell these new private pensions schemes should be obliged by law to adopt a policy concerning a conflict of interest which resembles the approach which is expected by the *Deutsche Vereinigung für Finanzanalyse und Anlageberatung* (German Association of Financial Analysis and Advice, 'DVFA') from its members who are independent or employed financial analysts and advisers. The code of conduct issued by this private association contains the following statement which suggests how employed financial analysts and advisers should deal with a conflict of interest when advising their employers' customers[559]:

> Analysts [and advisers] are regularly employees of an institution which is engaged in capital market dealings. In the course of their professional activities [analysts and advisers] ought to act independently and in the interest of the customers.
>
> There can exist a conflict of interest. With a view to solving this problem of conflicting interests the general guideline is that analysts [and advisers] should - with regard to the key areas of their activities, especially concerning sale or purchase recommendations or equivalent dealings - be exempt from any specific, non-fact based and opinion-forming instructions by their employers.

In my opinion, only such a strict rule can help to prevent a pensions misselling scandal in Germany. In this respect, attention should be focused on the fact that the events in the

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[558] Interview with Simon Donlevy, Private Banking Executive (PBE) and 'Relationship Manager' with Lloyds Private Banking/Abingdon branch on 11 March 1998.

[559] Deutsche Vereinigung für Finanzanalyse und Anlageberatung, *Standesrichtlinien* (Dreieich 1998), section 2 (a).

UK have shown that it is not the banks or insurance companies which have to foot the bill. It is the consumers who have to pay for the improper selling practices of the providers of financial services. In the UK, the lion's share of the £11bn of compensation payments which are to be made by insurers to the victims of the misselling is paid for by ordinary 'innocent' policyholders. For example, policyholders of the many mutual insurance companies in the UK are also co-owners of these companies. Their ownership status means that they are directly affected by the large compensations sums which have to be paid to the victims of the missales of these companies[560].

The same applies to customers of insurance companies which have shareholders and which offer to their policyholders so-called 'with profits funds'. The returns from these funds are usually split according to a ratio of 9:1 between policyholders and shareholders. Presently, the UK insurance industry plans to split the costs of the misselling of these 'with profits funds' pension policies likewise between policyholders and shareholders[561].

In order to avoid a misselling scandal in Germany, attention should also be paid to the following two points. First, the providers of these new old age special funds should be required to improve the training of their sales forces. Secondly, both the financial services industry and consumer rights groups should cooperate in order to improve the consumers' knowledge of the nature and risks of private pension plans. In this respect, a good example may be the policy of the UK's Financial Services Authority to support the lobbying for bringing financial matters into the National Curriculum in Britain[562].

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[560] *Financial Times*, 2 July 1998, at p. 11.
[561] *Financial Times*, 2 July 1998, at p. 11.
[562] Financial Services Authority, *Plan & Budget 1998-99* (London 1998), at p. 28.

Chapter Five:

Just agony aunts or efficient guardians of bank customers? - The role of the Banking Ombudsman Schemes in England and Germany

Introduction

In the last decade, the financial services industry in Germany and England has witnessed the introduction of various Ombudsmen schemes as vehicles for the informal resolution of grievances between the providers of financial services and their customers. The term 'ombudsman' comes from the Swedish phrase 'ombud' meaning commissioner or agent[563]. In Sweden, already in 1809, the office of the 'militieombudsmannen' was introduced as a parliamentary comissioner appointed to supervise and enforce the observance of laws and statutes concerned with national defense[564]. In the UK, the first Ombudsman was the Parliamentary Commissioner for Administration, appointed in 1967 with the task of investigating complaints of maladministration against government departments. In the private financial services sector, the first ombudsman to be established was the Insurance Ombudsman Bureau which was created in 1981[565]. Since then, half a dozen other Ombudsman offices have been established in Britain, either on a statutory[566] or voluntary basis. The four most important schemes are the Building Societies Ombudsman, the Banking Ombudsman, the Investment Ombudsman, and the

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[563] *The New Oxford English Dictionary*, Volume II (Oxford 1993), at p. 1993.
[564] *The Oxford English Dictionary*, Volume X (2nd edn. Oxford 1989), at p. 784.
[565] Morris, P.E., 'The Banking Ombudsman - five years on' (1992) Lloyd's Maritime and Commercial Law Quarterly, 227, at p. 227.
[566] For example, the Building Societies Ombudsman is statutory-based (see The Building Societies Act 1986) and the Insurance and Banking Ombudsmen were founded on a voluntary basis.

Personal Investment Ombudsman. In Germany, schemes for the extra-legal conflict resolution are mainly restricted to the area of public services. For example, there is a general parliamentary petition system and ombudsman schemes for the German Army, for foreigners living in Germany as well as an office whose task is to prevent any misuse of data. However, in the private sector, relatively few business areas know informal conflict resolution schemes. These business areas include dry-cleaners, radio and TV repair shops, architects and medical practitioners[567]. The first ombudsman scheme introduced in the area of financial services was the *Ombudsmann der privaten Banken* (Banking Ombudsman) for customers of Germany's private banks which became operational in 1992.

The practical relevance of the Banking Ombudsman schemes in England and Germany is indeed impressive. For example, from September 1996 until September 1997 the English Banking Ombudsman Scheme received 26,000 telephone enquiries and nearly 9,000 written complaints[568]. In Germany, the Banking Ombudsman Office registered 4,000 filed complaints in in the period between 1992 and 1997[569]. The relatively high scale of enquiries and complaints seems to imply that there is a significant number of customers who feel that their banks are either unable explain to them today's often rather complex banking matters, provide poor services to them or are even suspicious that the banks take the advantage of them. Generally speaking, there are the following two types of enquiries to the Banking Ombudsman Offices. First, there are bank customers who call the Ombudsman to seek simply independent confirmation of something the bank has said

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[567] Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Band I, at p. 33 Rdn.15.
[568] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997),at pp. 9-11.
[569] Bundschuh, Karl Dietrich, 'Erfahrungen mit dem Ombudsmannverfahren der Banken' ZBB 1/1998, 2, at p. 4.

to them. Secondly, there are customers who wish to make a specific complaint with regard to an individual banking matter.

There is little doubt that the great popularity of these schemes with customers is at least partly due to the fact that the services are provided free for the customers. When the service of the Banking Ombudsman was introduced in Germany in 1992, there were fears among the banks that the scheme would be confronted with a considerable number of unreasonable complaints[570]. However, these fears turned out to be unjustified. According to the Office of the German Banking Ombudsman, the number of unreasonably pursued or abusive complaints is very small[571]. Similarily, according to the Annual Report of the English Banking Ombudsman for 1996-97, there was only one unreasonably pursued claim out of a total of no less than 8,818 complaints in this period. Nevertheless, it should be mentioned that the running costs of the Ombudsman schemes are not very significant. In England, the budget of the Banking Ombudsman for 1997-98 amounts to £2,6 million[572]. Bearing in mind that it is the bank customers who in the end foot the bill insofar as the expenditures are passed on to them in the form of higher service charges, it nevertheless appears that this money is well spent. The average cost of the handling of a complaint is between £300-400, which is well below the costs of an ordinary court proceeding.

The mere existence of the schemes saves banks and customers considerable ligitation costs as well as contributes considerably to improving the relations between banks and

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[570] Interview with Mrs. Bernadette Zawal-Pfeil, Head of the *Kundenbeschwerdestelle* (Complaints Department) at the Office of the German Banking Ombudsman on 27 December 1996.
[571] Interview with Mrs. Bernadette Zawal-Pfeil, Head of the *Kundenbeschwerdestelle* (Complaints Department) at the Office of the German Banking Ombudsman on 27 December 1996.
[572] Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 2.

customers. In many cases, the fact alone that a customer can bring his or her problem to the attention of the Banking Ombudsman who then picks up the phone to get in contact with the senior management of the concerned bank usually works wonders. According to the Annual Report of the English Banking Ombudsman for 1996-97, although the number of complaints was 9,6% up in 1996-97, the number of conducted thorough investigations was 8,4% down because more cases were solved by way of conciliation[573].

However, it should not remain unmentioned that there is also suspicion of the actual motives of the banking industry for establishing Ombudsman schemes. In the UK, it is said that in the wake of the Financial Services Act of 1986 retail banks feared that a failure to reform grievance resolution procedures for their customers would result in the imposition of a more rigid statutory regime[574]. In Germany, the launch of the Banking Ombudsman Scheme in 1992 was also not given a particularly warm welcome by some consumer protection groups. Some consumer protection organisations were suspicious and thought that the scheme would be nothing more than 'a cheap publication relations exercise intended to boost the dented image of the private banks in Germany'[575]. However, despite these reservations with regard to the motives behind the Ombudsman Schemes consumer groups have come to the conclusion that the Ombudsman Schemes can profit banks and consumers alike. In England, the National Consumer Council (NCC') found in 1993 that[576]:

> Ombudsman scheme are a cheap and often informal alternative to the courts and, as we have described, have the potential to offer advantages to consumers and producers alike. [...] We hope that all ombudsman

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[573] *ibid*, at p. 13.
[574] Morris, P.E., 'The Banking Ombudsman - five years on', (1992) Lloyd's Maritime and Commercial Law Quarterly 227, at p. 229.
[575] Interview with Mr. Hartmut Strube, Verbraucher-Zentrale NRW, on 3 January 1997 in Düsseldorf.
[576] National Consumer Council, *Ombudsman Services - Consumers' views of the Office of the Building Societies Ombudsmen and the Insurance Ombudsman Bureau* (London 1993), at p. 81.

> schemes and the public or private sector funders that support them will see the benefits of improving the schemes and increasing public confidence in them.

Furthermore, in the meantime, the Banking Ombudsman Schemes in England and Germany have established good working relationships with the consumer groups in their countries. In England, the Citizens Advice Bureaux actively encourage consumers to contact the Banking Ombudsman in cases where they have problems with their banks[577]. In Germany, according to the German Ombudsman Office, many consumer groups have also started recommending to consumers who have problems with their banks to turn to the Banking Ombudsman[578].

On the other hand, especially in England, banks complain that the Ombudsman scheme suffers from the so-called 'M-25 effect', named after the constantly widened but nevertheless always overstrained motorway circulating London[579]. In other words, it is argued the Banking Ombudsman scheme would create problems it was originally designed to solve because its free service provided to bank customers would encourage persons to file a complaint who would otherwise not take any action against their banks. There is some statistical evidence to support this view. Within the period from 1990 to 1995, the number of telephone enquiries and complaints made to the Banking Ombudsman more then quadrupled from 4,237 to 18,667[580].

However, it can also be argued that the increase in the number of complaints and enquiries made to the Ombudsman is due to the greater awareness of the general public

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[577] Interview with Mrs. Mary Sullivan, Money Advice Support Unit, National Association of Citizens Advice Bureau-London Region on 23 July 1997.
[578] Zawal-Pfeil, Bernadette, 'Fünf Jahre Ombudsmann der privaten Banken' Die Bank, Volume 7, 1997, at p. 446.
[579] Southern, David, 'The Liabilities and Duties of Banks to Private Customers' (1996) 5 BJIB , 224, at p. 227.
[580] The Banking Ombudsman Scheme, *Annual Report 1994-95* (London 1995), at p. 4.

of the work of the Banking Ombudsman. According to a survey carried out by the Office of Fair Trading (OFT), in 1990 only 24% of all questioned consumers knew about the existence of the Banking Ombudsman Scheme[581]. Since then, the Banking Ombudsman has conducted various public relations campaigns to get a higher profile in Britain's public life. Moreover, banks have distributed more than 100,000 copies of the brochure 'The Banking Ombudsman Scheme: When and how we can help' to their customers[582]. Furthermore, one should always view the number of complaints in perspective. In 1996-97, UK banks handled more than 53 million personal accounts, 66 million credit and debit cards and 400,000 new mortgages[583]. Furthermore, in 1996, £150bn were deposited with the major British banking groups and £125bn lent by the banks to their customers on a mortgage basis[584] but not more than about 9,000 complaints were filed with the Banking Ombudsman by customers[585].



Additionally, the complaints actually made by customer are not unsubstantiated. This is shown by the fact that half of all complaints filed with the Ombudsmen are decided in the complainants' favour[586]. On the other hand, it cannot be denied that customers are influenced by media coverage of prominent consumer cases. A good example of this is the decision in *Verity* v *Lloyds Bank*[587] in September 1995. Almost all British newspapers reported on their frontpage on this case where a bank was found liable for negligent financial advice to customers. Within weeks of this ruling, the number of customer complaints related to lending matters made to the Banking Ombudsman increased significantly. The German Banking Ombudsman can tell similar stories.

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[581] National Consumer Council, *Ombudsman Services - Consumers' views of the Office of the Building Societies Ombudsmen and the Insurance Ombudsman Bureau* (London 1993), at p. 4.
[582] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 6.
[583] *ibid*, at p. 28.
[584] The British Bankers' Association, *Annual Report 1996-97* (London 1997), at p. 29.
[585] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 11.
[586] *ibid*, at p. 16.
[587] *The Independent*, 4 September 1995 (Transcript); (1995) 8 C & FL 38.

Whenever there is a case decided by German's highest civil court in favour of a bank customer, there is a sharp increase in the number of complaints filed by other customer who think their 'case' resembles exactly the subject matter which had been decided in the published ruling[588].

However, the goal of this chapter is to analyse not only the structure and practical impact of the Banking Ombudsman Schemes in England and Germany, but also the type of cases which they usually handle. Furthermore, controversial topics such as whether the independence of the English and German Ombudsman Schemes is sufficiently safeguarded and how both schemes deal with controversial questions such as whether a successful complainant should be compensated for expenses incurred for employing a professional adviser (i.e. a solicitor), or, whether there should be compensation for the inconvenience caused to complainant by the bank will be discussed.

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[588] Zawal-Pfeil, Bernadette, 'Fünf Jahre Ombudsmann der privaten Banken' Die Bank, Volume 7, 1997, 446, at p. 446.

A. The English Banking Ombudsman Scheme

As already mentioned above, in 1981, England's major insurance companies decided to set up and fund their own private ombudsman. It is understood that this had prompted the High Street banks to follow suit and institute the world's first Banking Ombudsman[589]. However, another main reason for the establishment of the Banking Ombudsman is said to have been the findings of a report published by the National Consumer Council ('NCC') on 'Banking Services and the Consumer' in 1983. In this survey, it was stated that although consumers were generally satisfied with the overall quality of the services provided by their banks, some one-third of them were not content with the manner in which their banks handled their complaints. This led the NCC to suggest that disputes between banks and their customers should not only been dealt with by the banks' internal grievance procedures but also by a specialist banking ombudsman office[590]. The Banking Ombudsman Office was finally established in 1986[591].

However, the banks' newly found interest in their customers problems with them was driven rather by self-interest than generosity. A good example of the strong idea of pragmatism dominating the banks' general attitude of banks toward their customers' problems can be found in the Annual Report for 1996-97 of the British Bankers' Association which contains the following suprisingly frank statement[592]:

> An important area of the BBA's Consumer & Retail work is promoting good practice in retail banking through the development of guidelines, standards and codes. *These expressions of self-regulation enhance the image of the industry and can forestall burdensome and rigid legislation*[593].

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[589] Morris, P.E., 'The Banking Ombudsman' (1987) JBL 131 (Part I) and 199 (Part II), at p. 131.
[590] National Consumer Council, *Banking Services and the Consumer* (London 1983), at p. 108.
[591] Interview with Ms. Jane Hingston, New Complaints Manager, The Office of The Banking Ombudsman on 4 February 1997 in London.
[592] The British Bankers' Association, *Annual Report 1996-97* (London 1997), at p. 20.
[593] Emphasis added.

Today, the main issues the English Banking Ombudsman Office has to deal with are matters related to lending, mortgages, interest charges, account errors, cash machines and securities for advances[594]. However, it should be pointed out that there are seven additional Ombudsman schemes which are concerned with complaints with regard to financial matters in England. The most important of them are The Building Societies Ombudsman Scheme, The Investment Ombudsman Scheme, The Insurance Ombudsman Scheme, and The Personal Investment Authority Ombudsman Scheme.[595].

Banking Ombudsman	Building Societies Ombudsman	PIA Ombudsman	Insurance Ombudsman	Invesment Ombudsman
retail banking	mortgage lending	insurance policies private investment	insurance policies	unit trusts personal equity plans
complaints against banks	complaints against building societies	complaints against firms regulated by PIA	complaints against insurance companies	omplaints against firms regulated by IMRO

The Building Societies Ombudsman is mainly concerned with mortgage lending. The Insurance Ombudsman Scheme deals with insurance policies and the Personal Investment Authority Ombudsman's task is to resolve complaints made in connection with the private investment business as well as insurance policies. The Office of the Investment Ombudsman is concerned with complaints related to trust and pension fund management[596]. However, in this chapter, the focus is on the role and function of the Banking Ombudsman Scheme because most problems arising in the relationship between

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[594] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 18.
[595] The remaining three are: The Personal Insurance Arbitration Service, The SFA Complaints Bureau and Arbitration Service and The FSA Direct Regulation Unit and Independent Investigator; The Financial Services Authority, *Consumer Complaints* (London December 1997), at p. 7.
[596] For more detailed information see: National Consumer Council, *Ombudsman - A Guide to Ombudsman Schemes in Britain and Ireland* (London 1997).

a bank and its private customer fall into the terms of reference of this Ombudsman scheme.

(1) Structure of The Banking Ombudsman Office in England

The Banking Ombudsman is registered as a private unlimited company with no share capital and which is financed by the member banks of the Scheme. The member banks are represented on the Board of this company.

Board of The Ombudsman Office

- consists of representatives of the member banks
- collects subscriptions from banks
- decides on the Terms of Reference
- confirms appointment of Ombudsman

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Council of the Ombudsman Office

- five independent and five bank appointed members
- appoints the Ombudsman
- makes suggestions for changes of the Terms of Reference

↓

Office of the Ombudsman

- 1 Principal Ombudsman and 2 Assistant Ombudsmen
- Complaints, Investigations and Administrative Departments
- 39 staff including solicitors and barristers

The main functions of the Board are to collect subscriptions from member banks and to decide on changes of the Scheme's 'Terms of Reference', which can be described as the Ombudsman's constitution.

The Board's power to change the Ombudsman' Terms of Reference clearly shows who is the master of the whole scheme. Mainly for this reason it has been has been argued that the scheme lacks 'water-tight independence guarantees for the Ombudsman'[597]. Nevertheless, in my view, this flaw in the legal structure of the Ombudsman scheme should not be overestimated.

More important is degree of actual trust and confidence of customers in the scheme. Here, the high numbers of enquiries and complaints speak for themselves. Customers do not seem to question the independence or impartiality of the Ombudsman. For example, according to a survey carried out by the National Consumer Council in 1993 on the consumers' view on the Insurance Ombudsman Bureau and the Buildings Socieites Ombudsman more than three quarters of all those who filed complainants with these schemes, whether successfully or not, would use these schemes again[598].

Furthermore, attention may also be drawn to the fact that recently the so-called 'British and Irish Ombudsman Association' has been founded. This body is a voluntary network of all existing public and private sector Ombudsmen including all above mentioned schemes. It is assumed that this body will be able to act as a 'powerful professional grouping able to support an Ombudsman whose independence is threatened'[599].

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[597] Morris, P.E., 'The Investment Ombudsman - A Critical Review' (1996) JBL 1, at p. 2.
[598] National Consumer Council, *Ombudsman Services - Consumers' views of the Office of the Building Societies Ombudsmen and the Insurance Ombudsman Bureau* (London 1993), at p. 60.
[599] Morris, P.E., 'The Investment Ombudsman - A Critical Review' (1996) JBL 1, at p. 3.

Secondly, there is the Council which consists of eight members. Five members are independent, three are representatives of banks. In 1997-98, among the independent members of the Council there are prominent individuals such as Trevor McDonald OBE, the main presenter of a popular TV news programme, and Maire Patterson CBE, director of the London School of Economics[600]. The Council is not involved in decisions on individual complaints. Its main function is to preserve the Ombudsman's independence and to keep the scheme under review.

Thirdly, there is the Office of the Ombudsman which is headed by one Principal Ombudsman and two Assistant Ombudsmen who are appointed by the Council. The Ombudsmen are responsible to the Council and must act within the Council's Terms of Reference. The Ombudsman Office itself has 39 staff, including 16 solicitors and two barristers. The Office is divided up into three departments: the Complaints Department, the Investigation Department and the Administration Department. The main function of the Office of the Ombudsman is to receive unresolved complaints about the provision of banking services rendered by member banks and 'to facilitate their satisfaction, settlement or withdrawl whether by agreement, by [...] making of recommendations or awards, or by such other means as seem expedient'[601].

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[600] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 34.
[601] The Banking Ombudsman Scheme, *Terms of Reference* (London January 1997), Paragraph 1, at p. 2.

(2) Complaints handling procedure

A complaint made to the Ombudsman Office is first dealt with by the Complaints Department. This department checks whether the complaint falls with the terms of reference of the scheme. This means that the service that is complained about by the customer must have been given within the UK by a bank which is a member of the scheme. Currently, 111 banks are members of the Ombudsman scheme, including all major High Street banks. Furthermore, the complaint must be concerned with a matter related to retail banking. In 1996-97, a quarter of the total of 8,818 filed complaints were found to be outside the rules of the Banking Ombudsman because they either related to issues which were dealt with by other Ombudsmen such as the Building Societies or the PIA Ombudsman or concerned general banking policies or legitimate commercial decisions on lending[602].

At this point, it should be mentioned that especially the power of the Ombudsman to turn back complaints by arguing that they concerned a legimitate commercial lending decision initially provoked criticism. It was argued that this provision of the Terms of Reference could be misused to get rid of troublesome complaints in the field of lending. However, in my opinion, this criticism is unjustified. First, the term commercial decision is clearly defined in the Terms of Reference as 'assessments of risk, of financial or commercial criteria'.

Furthermore, according to paragraph 16 (a) of the Terms of Reference state that the Ombudsman's restrictions as to complaints relating to commercial judgment in lending

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[602] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 12.

matters 'shall not preclude him from considering complaints about *maladministration*[603] in lending matters'. This provision entitles the Ombudsman to scrutinize the procedural quality of a commercial lending decision what is widely seen as a sufficient means of safeguarding against any irrational lending decision to be taken by banks whilst, at the same time, it protects the banks' legitimate right to define the parameters for its lending policies[604].

Additionally, it should be pointed out that the Ombudsman deals only with complaints from 'individuals' who are customers of a member banks. This means that only private customers of a bank, including partnerships and those who run businesses which are not incorporated and whose annual turnover does not exceed £1m, can file a complaint with the Ombudsman. Furthermore, the topic of the complaint must not or must not have been or must not be subject to any proceedings in or before any court, tribunal or arbitrator or any other independent conciliation body. Moreover, the complaint cannot contain a claim for a compensation amounting to more than £100,000.

Moreover, it must be ascertained that the complainant has followed the bank's internal complaints procedure through to the end. If the complaint is not resolved at this level, the bank is supposed to issue a letter stating that a 'deadlock' has been reached and that the customer has six months in which to bring a formal complaint to the Banking Ombudsman. Consumer groups are critical of this requirement of a 'deadlock letter'. They argue that banks would often not respond quickly enough to customer complaints and would misuse the 'deadlock letter' to block complaints[605].

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[603] Emphasis added.
[604] Morris, P.E., 'The Banking Ombudsman - five years on', (1992) Lloyd's Maritime and Commercial Law Quarterly 227, at p. 235.
[605] National Consumer Council, *Ombudsman Services - Consumers' views of the Office of the Building Societies Ombudsmen and the Insurance Ombudsman Bureau* (London 1993), at p. 9.

Furthermore, according to a survey carried out by the National Consumer Council in 1993 over 50 per cent of all customers of building societies and insurance companies who went through internal complaints procedures before turning to the Building Societies and Insurance Ombudsmen found that 'the internal complaints procedure was a complete waste of time'[606]. This considerable dissatisfaction of consumers with internal complaint mechanisms of financial services providers questions the feasibility of such schemes. Additionally, there are also grievance resolution schemes which do without this 'deadlock letter' hurdle. For example, the Code of Conduct of the Finance and Leasing Association, whose members are UK finance and leasing companies which offer hire purchase loans as well as leasing facilities, allows complaints against its member without asking for any 'deadlock letters'[607].

Bank		**Ombudsman complaints department**		**Ombudsman investigation department**
internal complaints mechanism 'deadlock letter'	➡	*test of elegiblity:* - retail banking matter - service provided by a member bank in the UK - matter not pending in a court case - claim not over £100,000	➡	- conciliation - investigation > formal decision by 'adjudicator' which can be asked to be reviewed by the Ombudsman ('final decision')

However, at present, in cases where a bank customer has unsuccessfully turned to his or her bank's internal complaints procedure but has nevertheless not been given the

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[606] National Consumer Council, *Ombudsman Services - Consumers' views of the Office of the Building Societies Ombudsmen and the Insurance Ombudsman Bureau* (1993), at p. 32.

[607] Presentation by Martin Hall, Director General, Finance & Leasing Association, at the Money Advice Liasion Group's 9th Annual Conference on 25 November 1997 in London.

deadlock letter, the Banking Ombudsman can, and in practice often does,[608] assist this customer. In this situation, the Ombudsman's Office usually contacts the concerned bank and sets it a time limit within which to either resolve the problem or issue a deadlock letter.

After having received the bank's deadlock letter, the Ombudsman Office explores whether there is scope to resolve it by conciliation. However, if the complaint is not resolved by conciliation, it will be passed to the Investigation Department for investigation. The Ombudsman Office may nevertheless decline to conduct an investigation if it thinks that the bank has already offered adequate compensation to the complainant. Moreover, it is interesting to notice that under paragraph 5 of the Terms of Reference the Ombudsman has the power to require a bank named in a complaint to 'provide any information relating to the subject matter of the complaint'.

Finally, it should be mentioned that under paragraph 20 of the Terms of Reference, the Ombudsman can - at the bank's request - cease to consider a complaint and declare it a so-called 'test case'. Such a move, which is entirely at the Ombudsman's (and not the bank's) discretion, leads to court proceedings and puts the bank under the obligation to pay the complainant's legal costs as well as to make interim payments to the complainant where this is deemed appropriate by the Ombudsman[609].

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[608] *The Banking Ombudsman Scheme*, 'Annual Report 1996-97 (London 1997), at p. 12.
[609] The Banking Ombudsman Scheme, *Terms of Reference* (London January 1997), at p. 7-8.

(3) Types of complaints and awards made

In 1996-97, 16% of all complaints and 9.9% of all investigations related to lending, 14.1% of the complaints and 19.1% of the investigations concerned mortgages. In contrast, only 0.9% of all complaints and 1.5% of all investigations dealt with investment matters. However, with regard to issues concerning investment matters one must realise that many complaints with regard to this area are not made to the Banking Ombudsman but the Personal Investment Ombudsman or the Investment Ombudsman. Especially the Personal Investment Ombudsman receives every year a significant number of complaints related to personal pensions, unit trust and investment trust savings schemes. For example, in 1996-97, the Personal Investment Ombudsman received 4,310 complaints, half of which contained allegations of the provision of unsuitable or incorrect advice by financial advisers[610].

Many complaints which are made to the Banking Ombudsman are resolved by the banks themselves once the Ombudsman becomes involved, either through the banks' 're-assessing' of the findings of its own internal complaints procedures or the Ombudsman's conciliation. Consequently, the number of cases the Ombudsman Office has to investigate is comparatively small. In 1996-97, 8,818 complaints resulted in 'only' 674 investigations. The adjudicators, who work in the Ombudsman's Investigation Department, conduct these investigations. They try to conciliate, and, where there is no successful conciliation, come up with a formal decision. Two-thirds of these formal decisions are accepted by both sides, the bank and the complainant. In one third of these decisions either the bank or the complainant asks the Ombudsman to review them and

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[610] Personal Investment Authority Ombudsman Bureau, *Annual Report 1996-97* (London 1997), at p. 24-25.

come to a final decision on the matter. At this point, it may also be pointed out that where such a review by the Ombudsman is being carried out, it takes on average about a further seven months until a final decision is reached. Not surprisingly, this delay is one of the main reasons for discontent with the scheme among complainants. In a survey carried out by the National Consumer Council on the customers' experience with the services offered by the Building Societies Ombudsman and the Insurance Ombudsman, 43 per cent of all those who had made a complaint with the Building Societies and 20% of all those who complained to the Insurance Ombudsman found that the Ombudsmen 'took an unreasonably long time to make a decision'[611].

In 1996-97, of all decisions taken either by the adjudicators or the Ombudsmen themselves half were decided in favour of the complainant and half of them were in favour of the banks[612]. Furthermore, in 1996-97, in 75% of all cases where a decision was made in favour of the complainant resulted in compensation higher than that previously offered by the bank. The compensation awarded in that period ranged from £21 to £90,000. Most awards were between £200 and £10,000 and the average award was £2,805. Additionally, it should be stressed that the Banking Ombudsman's awards may include compensation for the complainant's own time spent dealing with the bank and the Ombudsman Office itself. However, a complainant's expectations with regard to this form of compensation should not be too high. In the Ombudsman's 'Guidance Note: Compensation For Complainant's Own Time'[613] it is ominously stated that 'we expect a complainant to be reasonable and *robust*[614]'. In this note it is also said that if the

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[611] National Consumer Council, *Ombudsman Services - Consumers' views of the Office of the Building Societies Insurance Ombudsman Bureau* (London 1993), at p. 27.
[612] The Banking Ombudsman Scheme, *Annual Report 1996-97* (London 1997), at p. 16.
[613] The Office of The Banking Ombudsman, *Guidance Note: Compensation For Complainant's Own Time* (London July 1997).
[614] Emphasis added.

Ombudsman finds it appropriate to compensate a complainant for time spent with regard to the complainant this compensation is unlikely to exceed £10 per hour spent.

Even more restrictive is the view which the Ombudsman takes on the issue of compensation for the complainant's advisers' fees. Only in exceptional cases - where the Ombudsman is 'satisfied that the complainant would not have managed without the advisers' help' an award made may include an amount towards professional fees. the examples for such cases which are given by the Ombudsman Office include the following situations: the problem was particularly technical and complex, the complainant was suffering from some relevant disability, or the bank itself involved advisers[615].

In contrast to this, as we shall see, the idea of compensation for a complainant's adviser's fees is controversial in Germany. The German Banking Ombudsman categorically refuses to compensate a bank customer for his or her expenses for consulting an expert. It is argued that the main goal of the whole scheme was to offer fast and inexpensive resolutions and that the involvement of experts would unnecessarily slow down and increase the costs of the entire process. Furthermore, it is said that this would introduce a notion of legalism into a mechanism which was specifically designed to have an extra-legal character and to be pervaded by the idea of user-friendliness. Additionally, in England, other schemes such as the Investment Ombudsman Scheme imposes a ban on legal representation for either of the parties during the conciliation phase[616].

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[615] The Office of The Banking Ombudsman, *Guidance Note: Compensation For Advisers' Fees* (London July 1997).
[616] Morris, P.E., 'The Investment Ombudsman - A Critical Review', (1996) JBL 1, at p. 9.

Attention should also be drawn to the fact that the decisions and awards made by the English Ombudsman are binding for the complainant only if, within a month after the issue of the award, the complainant agrees to accept it in full and final settlement of the subject matter of the complaint. Moreover, a decision by the Ombudsman which has been fully accepted by the complainant cannot be rejected by the bank. Additionally, it should be stressed that the Ombudsman must observe any applicable rule of law or judicial authority but can nevertheless make awards which may exceed that what the complainant is 'legally' entitled to obtain. Paragraph 14 of the Terms of Reference states that[617]:

> In making any recommendation or award under these Terms of Reference the Ombudsman shall do so by reference to what is, *in his opinion, fair in all the circumstances*[618].

This provision gives the Ombudsman significant discretionary power and may lead to a bank losing its 'case' before the Ombudsman because the Ombudsman finds that, although the bank acted in accordance with the law, it behaved unfairly or unreasonably. This considerable discretionary power of the Ombudsman has been criticised as an 'opaque, highly individualistic system' which would leave room for misuse[619]. However, in my view, this criticism is misplaced because due to the fact that the Ombudsman is also obliged by the Terms of Reference to observe 'any applicable rule of law or relevant judicial authority', based on the notion of 'fairness' cannot lead to a decision taken by the Ombudsman which falls short of the requirements laid down by the law. Thus, per definition, any decision by the Ombudsman which is - wholly or partially - on the notion of fairness and reasonableness can only leave the customer better off than a decision by the Ombudsman which simply follows the law.

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[617] The Banking Ombudsman Scheme, *Terms of Reference* (London January 1997), at p. 4.
[618] Emphasis added.
[619] Morris, P.E., The Investment Ombudsman - A Critical Review, (1996) JBL 1, at p. 10.

Moreover, according to paragraph 14(b) of the Terms of Reference, the Ombudsman in making any recommendation or award 'shall have regard to general principles of good banking practices and any relevant code of practice applicable to the subject matter of the complainant'[620]. This provision may be described as the second tool of the Ombudsman which enables him to introduce the idea of fairness and reasonableness in his work. For the area of financial advice, which this work is intended to focus on, 'The Banking Code' and 'The Mortgage Code' are of particular importance.

(4) The 'Banking Code' and the 'Mortgage Code'

The Banking Code and the Mortgage Code are voluntary codes of conduct by banks and building societies in their relations with personal customers in the UK. They are an expression of existing practice which means that every bank or building society which has subscribed to the codes is obliged to adhere to their provisions. Both codes contain a number of so-called 'Key Commitments' which include rather general statements as to the conduct of business for all products and services provided to customers. The most important of these statements are the banks' and building societies' promises to act fairly and reasonably in all our dealings with the customer, to help the customer to choose a service or product to fit his or her needs, and, to help the customer to understand the financial implications of a mortgage, other borrowing, savings and investment products and card products[621].

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[620] The Banking Ombudsman Scheme, *Terms of Reference* (London January 1997), at p. 4-5.
[621] *The British Bankers' Association*, The Banking Code (London 1 July 1997), Paragraph 1; *The Council of Mortgage Lenders*, The Code of Mortgage Lending Practice (London 1 July 1997), Paragraph 1.

Furthermore, as already mentioned above in Chapter Two[622], the Codes contain more detailed provisions on fundamental issues such as mortgage lending and guarantees. Paragraph 3.1 of The Mortgage Code [623] deals with the issue of mortgage lending and states that mortgage lenders can offer three different types of mortgages:

> *(a) advice and a recommendation* as to which of our mortgages is most suitable for you. [...]
>
> *(b) information on the different types of mortgage products* we offer so that you can make an informed choice of which to take;
>
> *(c) information on a single mortgage product only*, if we offer only one mortgage product or if you have already made up your mind.

Furthermore, Paragraph 3.2. of the Mortgage Code stipulates that mortgage lenders must also provide borrowers with detailed (written) information on essential matters such as repayment methods, types of interests rates and additional insurance services. Overall, it can be said that these provisions place banks and buildings societies under considerable obligations to ensure that their customers fully understand the type of mortgage they are sold.

At the first glance, paragraph 3.1.(a) appears to be a very consumer-friendly provision because it obliges banks and building societies to recommend a mortgage which is 'most suitable' for the customer. However, when one reads the same paragraph more carefully, one soon notices the phrase 'which of *our* mortgages is most suitable for you'. In other words, under 3.1.(a) a bank or building society is only under a duty to recommend as to which mortgage of *their* product range is most suitable for the customer. This means that, according to paragraph 3.1.(a), a mortgage lender can

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[622] See above Chapter Two, A. (2) (a).
[623] See also: The British Bankers' Association, *The Banking Code* (London 1 July 1997), Paragraph 2.19.

recommend a mortgage which maybe the most suitable from its own products for the customer but which may otherwise not particularly suitable for the customer's needs.

In my view, this falls short of what should reasonably be expected of today's mortgage lending business. In my opinion, The Banking and Mortgage Codes should adopt an approach which is already taken by the PIA Ombudsman with regard to investment advice. In the PIA's Regulatory Update of September 1996 (Draft) the PIA proposes with regard to the investment business that[624]:

> Product providers [of investment products] with limited product ranges must take care to ensure that they recommend a product only where it is positively suitable, not just where it is the least unsuitable from the range.

Additionally, there is the question of whether the banks and building societies may rather be inclined to describe the services rendered to their customers as falling into category (b) or (c), which contain less obligations on their part, although they actually provided service which in fact could be rather be defined as belonging to class (a)[625].

In practice, it is difficult for customers to question the bank's or building society's statement as to what level of service has been provided. In this context, it should also be mentioned that there is no powerful enforcement body which polices the banks' and building societies' compliance with the Codes. There only exists an 'Independent Review Body for the Banking and Mortgage Code'[626] whose task is described as to 'monitor' compliance with the Codes. As this body has no direct enforcement power, it maybe described as a toothless 'watchdog' that can only bark but lacks any bite. A

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[624] Personal Investment Authority Ombudsman Bureau, *Annual Report 1996-97* (London 1997), at p. 32.
[625] See above Chapter Two.
[626] The British Bankers' Association, *The Banking Code* (London 1July 1997).

proper enforcement body could check on banks and building societies to ensure that they are honest and fair when it comes to stating what level of advice has been given to their customers.

Moreover, in this context, attention should also be focused on a significant flaw in the Codes. Both Codes are not drawn up by the Ombudsman schemes but by the British Bankers' Association and The Building Societies Association. The Ombudsmen may only come up with suggestions as to which provisions of the Codes they think should be changed. The decision on the content of the Codes, however, lies with the banks and the building societies. Another weakness of the Codes is that their provisions - except for the 'fairness and reasonableness test' and the creditors' self-restraint with regard to unlimited guarantees - do not go beyond that level of consumer protection which is already given by the law itself. A good example for this is the provision of the Banking and Mortgage Code which deals with the issue of guarantees:

> *3.1.4. Guarantees*
>
> If you want us to accept a guarantee or other security from someone for your liabilities, you may be asked to consent to the disclosure, by us, of your confidential financial information to the person giving the guarantee or other security or to their legal adviser. We will also:
>
> - *encourage them to take independent legal advice*[627] to make sure that they understand their commitment and the potential consequences of their decision. All the documents they will be asked to sign will contain this recommendation as a clear and prominent notice;
>
> - advise them that by giving the guarantee or other security they may become liable instead of or as well as you;
>
> - advise them of what the limit of their liability will be. *An unlimited guarantee will not be taken*[628].

[627] Emphasis added.
[628] Emphasis added.

This provision does not offer to a potential guarantor more protection than the law as it has been laid down by the English courts in the well known decisions in *Barclays Bank plc* v *O'Brien*[629], *CIBC Mortgages plc* v *Pitt*, *Credit Lyonnais Bank Nederland NV* v *Burch*[630] and *Barclays Bank plc* v *Thomson*[631]. In my view, the Codes should rather contain a provision which would oblige banks and buildings societies to *ensure* that - with regard to transactions involving significant financial risks - the guarantor has *actually received independent legal advice* before entering into the guarantee agreement with the lender.

Finally, it may be said that voluntary codes of conduct can only be as good as their acceptance by the consumers. If the consumers lose their trust and confidence in the codes and their grievance resolution schemes, they will resort to calls for statutory protection. It is unlikely that such calls would remain unheard by the new British Labour government which is more inclined to believe in statutory than voluntary regulation of the financial services than the previous government[632]. In the past, UK banks have been very successful in fending off any strict statutory regime but this might change soon if they fail to make some changes to the Banking and Mortgage Codes which would improve their customers' position.

Furthermore, the future of the English Banking Ombudsman is not entirely certain. In 1997, the new Labour government confirmed that a new single regulatory organisation, the Financial Services Authority, would take on supervision of building societies, banks and insurance companies. This development towards the establishment of one single

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[629] [1994] 1 AC 180 (HL).
[630] [1997] 1 All ER 144 (CA).
[631] [1996] NLR 778 (CA).
[632] See the British government's plans to establish one single regulator for the financial services industry; Chapter Four, A.(2) (b).

regulator for the provision of financial services has brought up the question of whether there should also be one single ombudsman for this sector.

(5) The plans for the introduction of a 'Financial Services Ombudsman'

According to a discussion paper published by the recently established Financial Services Authority (FSA), the British government intends to create a single Ombudsman scheme for the entire financial services industry in the UK[633]. This institution is to expected to be established under the proposed 'Financial Services and Markets Bill' which is meant to be enacted in 1999. This new institution is to be called 'Financial Services Ombudsman' (FSO). It is planned that it will be compulsory for investment firms, banks and building societies to be a member of this new single financial services Ombudsman scheme[634].

The main reason for the government's intention to establish one single Ombudsman scheme is said to be the confusion created by the existence of no less than eight different Ombudsman schemes for the financial services industry in the UK[635]. Currently, most consumers do not know to which of the schemes they should direct their complaints to. The key objective of the new FSO is to simplify the present structure of the extra-legal conflict resolution systems by reducing the number of the existing schemes. However, whilst it is planned that there should be only one single Ombudsman, this new scheme is generally expected to have separate departments relating to the different areas of business, namely investments, banking, mortgage lending, and insurance[636].

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[633] Financial Services Authority, *Consumer Complaints* (London December 1997), at p. 3-4.
[634] *ibid*, at p. 4 and p. 17.
[635] *ibid*, at p. 8.
[636] *ibid*, at p. 12.

Furthermore, it is said that these departments are likely to follow the lines of the existing schemes. This could have the effect that the present Banking Ombudsman Office might be incorporated - in some form or another - into the new FSO.

According to the FSA's discussion paper, the following changes to the present Banking Ombudsman scheme are likely to be made after the enactment of the financial regulatory reform bill[637]:

First, the present Banking Ombudsman will come under the wings of the FSO. Instead of being employed by the British Bankers' Association, the new head of the FSO's 'Banking Department' will be appointed by the FSA. Secondly, the FSA will replace the present Board and Council of the Banking Ombudsman Scheme with directors who will be appointed exclusively by the FSA. This is meant to secure the new scheme's full independence from banks which are expected to finance it. Thirdly, under the proposed legislation, the FSA will be empowered to create new terms of reference for the FSO's 'Banking Department'.

However, on the other hand, the FSA has also stated that the fundamental powers of the new FSO, respectively its 'Banking Department', will probably be very similar to those which are presently exercised by the Banking Ombudsman over its member banks. The new FSO is expected to be given authority to make awards which are binding upon banks up to the sum of £100,000. Moreover, additional awards for distress and inconvenience will be limited to £1,000[638].

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[637] *ibid*, at p. 23.
[638] *ibid*, at p. 19.

Nevertheless, the practically most relevant changes to the present system will be the compulsory membership for banks, the FSO's power to enforce awards as well as the FSA's right to draw up not only a new legal framework for the Ombudsman Scheme but also to lay down new rules of conduct for the entire financial services industry in the UK.

From my point of view, the British government's intention to break up the present conglomerate of eight different customer complaints mechanisms is to be welcomed. The current system can hardly be described as user-friendly. However, the Financial Services Authority may be well advised, when creating the new single Ombudsman scheme, to incorporate the present Banking Ombudsman Scheme instead of creating a completely new body. This would ensure that all the expertise and experience which has been gained by the present complaints handling system over the past twelve years could be used for the benefit of all parties concerned.

B. The German Banking Ombudsman Scheme

The establishment of the German Banking Ombudsman Scheme was initially prompted by a recommendation issued by the European Commission in 1990. In this recommendation the Commission asked the member states of the European Community to take measures to increase the degree of transparency in the area of cross-border money transactions. One of the Commission's suggestions included the idea to introduce independent complaints handling schemes whose task should be to protect the customers' interests. The *Bundesverband deutscher Banken* (Federal Association of German Banks) found that such a body whose powers were limited to cross-border transactions would not be of much help for customers[639]. Inspired by the success of the banking ombudsman schemes in Denmark, the Netherlands and the UK, the *Bundesverband deutscher Banken* established a complaints handling scheme which has the authority to deal with complaints made by private customers with regard to any matter related to any banking services provided by one of its 300 member banks.

Additionally, attention should also be drawn to the fact that there are two other important informal conflict resolution schemes in the German banking sector. First, there is the *Ombudsmann der deutschen Hypothekenbanken* (Ombudsman for German mortgage banks). This Ombudsman is concerned with complaints made against those banks whose commercial activities are limited to mortgage lending. Secondly, there is the complaints handling schemes of the *Sparkassen.* The *Sparkassen* are financial institutions which are owned by local authorities and whose scope of business is by law

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[639] Zawal-Pfeil, Bernadette, 'Ein Jahr Ombudsmann der privaten Banken', Die Bank 1993, Volume 10, 620, at p. 620.

restricted to a certain geographic area. Most *Sparkassen* have opted for the introduction of in-house complaints handling mechanisms[640].

Ombudsmann der privaten Banken	*Ombudsmann der Hypothekenbanken*	*Kundenbeschwerdestellen der Sparkassen*
complaints against private banks	complaints against mortgage banks	in-house complaints departments of regionally operating institutions

Only in some areas in Germany, umbrella associations which represent several *Sparkassen* operating in one particular area have introduced a single body which exclusively deals with complaints made against its members[641]. Furthermore, it should be pointed out that the fourth major type of Germany's financial institutions, the *Volks- und Raiffeisenbanken* (cooperative credit institutions) do not offer any informal complaints grievance resolution schemes to their customers. The cooperative banks argue that there was no need for such schemes because their customers were also their owners and the articles of association of cooperative banks would provide owners easy access to the Board of Directors of these banks[642].

Considering the fact that the majority of all Germans bank with either with *Sparkassen* or *Volks- und Raiffeisenbanken*, one may say that the idea of informal resolutions of grievances between banks and their customers is, to put it rather mildly, under-developed in Germany. However, the focus of this part of this chapter is on the work of

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[640] Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Band I, at p. 33 (Rdn.33).
[641] For, example, see Rheinischer Sparkassen- und Giroverband, *Verfahrensordnung der Kundenbeschwerdestelle bei dem Rheinischen Sparkassen- und Giroverband* (Düsseldorf 1997).
[642] Schwintowski/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Band I, at p. 33 (Rdn.17).

the Banking Ombudsman because this office is, for the time being, the only significant scheme for extra-legal conflict resolution in the German banking sector.

(1) Structure of the Banking Ombudsman Office in Germany

The German Banking Ombudsman is an integral part of the *Bundesverband deutscher Banken.* The Ombudsman's complaints handling department is actually in the same building as the headquarters of the private banks's association in Cologne. Currently, the Ombudsman scheme is headed by two Ombudsmen who were both appointed by the Board of Directors of the *Bundesverband deutscher Banken.* This Board contains only representatives from banks. In contrast to the English Banking Ombudsman, there is no 'buffer body' between this Board of Directors and the Ombudsmen. Furthermore, there the whole scheme is devoid of any means for input by consumer protection groups. The Ombudsmen are appointed for a period of three years and can be dismissed by the Board only for a 'good cause'[643].

Due to a lack of institutional guarantees for the independence of the Ombudsmen the customers' trust and confidence in the scheme depends entirely on the conduct and personality of these two Ombudsmen. At present, however, it is widely viewed that the banks have made a good decision to appoint two former senior judges as Ombudsmen. First, there is Dr. Leo Parsch, the former president of the Constitutional Court of Bavaria. The second Ombudsman is Karl Dietrich Bundschuh, a former judge and chairman of the second civil law senate of the *Bundesgerichtshof,* Germany's highest civil court. Both Ombudsmen are highly respected lawyers in Germany and no one

[643] In German: *aus wichtigem Grund.*

would question their impartiality. Nevertheless, this does not help to disguise the fact that the scheme is severely flawed because it fails to safeguard the independence of the Ombudsmen and does not allow for any input from independent sources such as banking experts or consumer protection groups.

Board of Directors of the *Bundesverband deutscher Banken*

- appoints both Ombudsmen
- draws up the *Verfahrensfahrensordnung* (terms of reference)

↓

Two Ombudsmen

- decide on eligibility and subject matter of complaints
- make awards which are binding for banks up to the amount of DM 10,000

↓

Kundenbeschwerdestelle

- makes enquiries about eligibility of complaints
- two lawyers and administrative staff

Additionally, the German Banking Ombudsman office includes a *Kundenbeschwerdestelle* (complaints department). The task of this *Kundenbeschwerdestelle* is to enquire

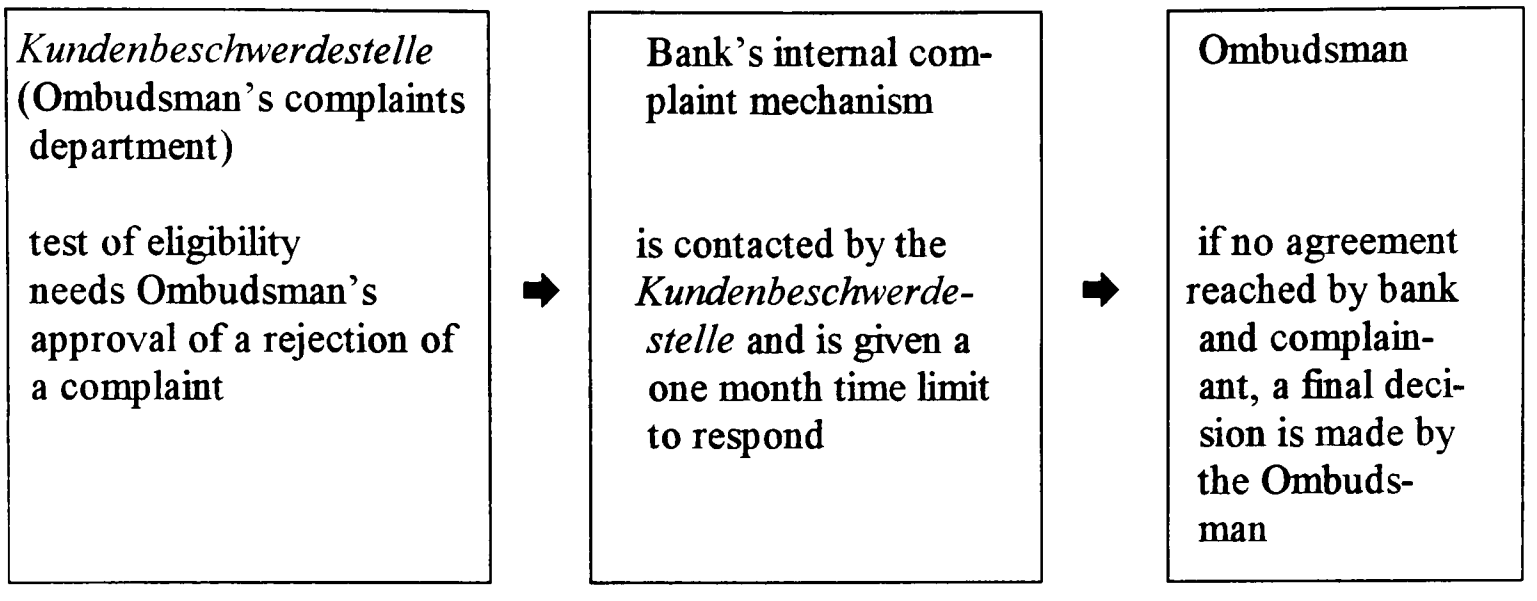
about the eligibility of a complaint. The decision on the eligibility of a complaint, however, can only be made by one of the Ombudsmen.

(2) Complaints handling procedure

A complaint made to the Ombudsman is first dealt with by the *Kundenbeschwerdestelle*. This department checks whether the complaint is eligible to be considered by the Ombudsman. In order to be eligible a complaint must be made by a private customer of one of the private banks which are members of the *Bundesverband deutscher Banken*. Complaints from business customers are only accepted if they are related to cross-border money transactions in the meaning of the recommendation made by the Commission of the European Commission in 1990. Furthermore, the topic of a complaint must not or must not have been subject to any court proceedings. A complaint is also rejected if the complainant has already initiated a criminal proceeding with regard to the subject matter of the complaint.

Moreover, under section 2 (2) d) of the articles of association (*Verfahrensordnung*), the Ombudsman is entitled to turn down a complaint 'if it concerns a fundamental legal question which requires a decision of the highest civil courts'. In other words, if the Ombudsman thinks that a complaint raised a matter which is so controversial that it calls for a decision in principle, this is to be left to the courts. Thus, section 2 (2) d) can be interpreted as seeking to ensure that the German Ombudsman does not create new law, but rather applies the current law. Moreover, this section fails to contain a 'test case' rule which can be found in paragraph 20 of the English Banking Ombudsman's 'Terms of Reference'. Under paragraph 20 of the English Ombudsman's 'Terms of Reference',

the Ombudsman can declare a complaint a 'test case' which leads to immediate court proceedings and puts the bank under the obligation to pay the complainant's legal costs regardless the outcome of these proceedings.



However, probably the most controversial ground on which the Ombudsmen can reject a complaint is section 2 (2) e) of the articles of association of the Ombudsman scheme. According to this provision, a customer's complaint will not be considered if[644]

> it requires the taking and producing of evidence unless the required evidence can be provided by written documents.

This means that the Ombudsman can refuse to deal with a complaint of which he thinks that it involves thorough investigation. In practice, this provision is the most often cited reason for rejections of complaints by the Banking Ombudsman[645]. It is argued by the banks that any inquisitorial role assumed on the part of the Ombudsman would inevitably alter the whole purpose of the Ombudsman. The German Ombudsman Scheme was meant to produce fair, fast and cost-efficient remedies to bank customers.

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[644] Bundesverband deutscher Banken, *Der Ombudsmann der privaten Banken - Verfahrensordnung* (Köln July 1996), section 2 (2) e).

[645] Bundschuh, Karl Dietrich, 'Erfahrungen mit dem Ombudsmannverfahren der Banken', ZBB 1/1998, 2, at p. 4.

This objective, according to the banks, would be jeopardized if the Ombudsman was under a duty to investigate complaints[646]. In my view, this is not convincing. Without the power to ask banks to disclose all their files and to investigate complex matters the function of an Ombudsman is too limited. At present, the Ombudsman is unable to directly influence and actively promote any improvements in the banking industry's standard practice. Thus, in my opinion, the German Baking Ombudsman must have not only the right but also the duty to investigate the subject matter of a complaint.

However, where the *Kundenbeschwerdestelle* has ascertained that a complaint is eligible to be considered by the Ombudsman it usually contacts the internal complaints department of the bank concerned and gives it a month to produce a statement explaining the bank's view on the subject matter. In many situations, the problem is solved through negotiations between the bank's internal complaints handling system and the customer. Where no agreement is reached the *Kundenbeschwerdestelle* presents the complaint to the Ombudsman who then makes the final decision on the matter. Awards made by the Ombudsman in favour of the customer are binding for banks only up to the amount of DM 10,000[647]. In my view, there is no apparent reason for such a low limit. In practice, complaints related to a bank's alleged negligent advice in investment matters, which account for no less than 30 per cent of all complaints, the complainant often seeks compensation exceeding DM 10,000 by far. In contrast, the awards made by the English Banking Ombudsman are binding for banks up to an amount of £100,000.

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[646] Interview with Mrs. Bernadette Zawal-Pfeil, Head of the *Kundenbeschwerdestelle*, German Ombudsman office on 27 December 1996.
[647] Currently, approximately £3,400.

(3) Types of complaints and awards made

According to the German Banking Ombudsman, since the decision in the well known *Bond-Urteil*[648], many bank customers who suffered losses as a result of an investment turn to the Banking Ombudsman and claim that they had not been adequately informed and advised by their bank[649].

In the period between 1992 and 1995, 37 per cent of all complaints made to the German Banking Ombudsman concerned private investment matters such as financial advice related to the purchase of shares and bonds[650]. In these cases, typically there is a lack of documentation which makes it very difficult for the Ombudsman to find out whether incorrect advice has been given by the bank. The number of complaints which are rejected under section 2 (2) e) of the Ombudsman's articles of association ('need for the taking and producing of evidence') is remarkably high in this area[651].

Usually, the Ombudsman can only infer from the complainant's previous experience in the field of private investment whether the recommendation made by the bank was appropriate. Another problem arising in this area is the level of compensation that is claimed. In many cases, the complainants seek compensation exceeding the sum of DM 10,000 which is the limit up to which an award made by the Ombudsman is binding upon the bank[652]. In practice, however, the Ombudsman has already made awards

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[648] BGH (06.07.1993) NJW 1993, 2433.
[649] Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch* (München 1997), Band I, at p. 45, Rdn.50.
[650] Bundesverband deutscher Banken, *Fünf Jahre Ombudsmann* (Köln 1997), at p. 20.
[651] Inteview with Mrs. Bernadette Zawal-Pfeil, Head of the *Kundenbeschwerdestelle*, German Ombudsman office on 27 December 1996.
[652] Interview with Mrs. Bernadette Zawal-Pfeil, Head of the *Kundenbeschwerdestelle*, German Ombudsman office on 27 December 1996.

amounting up to DM 80,000 which have been accepted by the banks[653]. This fact adds to the reasons why banks should increase the present limit.

Lending issues are another major subject of complaints made to the Ombudsman. Between 1992 and 1995 matters related to lending made up 32 per cent of all complaints[654]. In the area of mortage lending, many complaints dealt with the issue of *disagio*[655]. In Germany, it is quite common that mortgage lenders grant loans with a deduction (*disagio*) of, for example, 5 per cent of the nominal value of the loan. This means that a borrower who has been granted a loan of £100,000 is actually handed over 'only' £95,000 by the bank. The rest (i.e. £5,000) is kept by the bank, partly as a fee for the arrangement of the loan and partly as an anticipated payment of the interest charged.

In recent years, interest rates for savings kept falling in Germany so that many German borrowers chose to use their savings to repay their mortgage loans prematurely assuming that they would be reimbursed for that part of the interest-related 'disagio' which had, in their eyes, not been used by the bank due to the premature repayment of the loan. In many cases the banks refused to repay any portion of the disagio. This caused resentment among borrowers and led to many court proceedings.

Finally, the *Bundesgerichtshof* ruled in 1996 that the banks had to reimburse borrowers for that part of the 'disagio' which had not been used by them due to the premature repayment of the loan and also laid down a formula according to which the scope of the reimbursement had to be calculated. Prompted by this decision, many borrowers filed

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[653] Interview with Mrs. Bernadette Zawal-Pfeil, Head of the *Kundenbeschwerdestelle*, German Ombudsman office on 27 December 1996.
[654] Bundesverband deutscher Banken, *Fünf Jahre Ombudsmann* (Köln 1997), at p. 20.
[655] *Disàgio* is Italian and maybe translated as uneasiness or inconvienience. In the area of banking this word has become a technical term for the type of loan described above.

complaints with the Ombudsman claiming that they had not been adequately reimbursed. In many of these cases, the Ombudsman's task was to explain this complex matter to the borrowers and to help to assess the exact amount that had to be repaid by the banks[656].

(4) Shortcomings of the German Ombudsman Scheme

There are a number of inadequacies with the German Ombudsman Scheme with regard to the issues of awards, investigative powers, scope of judgments and public accountability.

In contrast to his English counterpart, the German Ombudsman does not make any awards for inconvenience caused to the complainant by the bank's incorrect behaviour. Although one may agree with the banks' aim to keep down the costs of the Ombudsman scheme, this should not prevent the Ombudman from awarding compensation for distress caused by a bank's inacceptable conduct in exceptional cases. Such a form of compensation would be nothing but a 'recognition of the social reality that administrative bungling and unfair action [...] can cause [...] considerable upset and bother'[657] to customers.

Moreover, the Geman banks should consider whether, in certain circumstances, the Ombudsman should be entitled to grant compensation for the complainant's adviser's fees. For example, in situations where the subject matter is very complex so that the complainant needs to consult an expert because otherwise the bank would - due to its

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[656] Zawal-Pfeil, Bernadette, 'Fünf Jahre Ombudsmann der privaten Banken' Die Bank, Volume 7, 1997, 446, at p. 446.
[657] Morris, P.E., 'The Investment Ombudsman - A Critical Review' (1996) JBL 1, at p. 21.

in-house experts - gain an unfair advantage over the complainant, the complainant should be entitled to be compensated for the costs of this expert in the event of an award being made by the Ombudsman in his or her favour.

In contrast to his English counterpart, the German Banking Ombudsman does not have the power to investigate complaints thoroughly. In fact, the articles of association of the German Ombudsman state that a complaint will not be considered if[658]

> it requires the taking and producing of evidence unless the required evidence can be provided by written documents.

In practice, this provision is the most often cited reason for rejections of complaints by the German Banking Ombudsman[659]. In my view, this is unacceptable. Without the power to ask banks to disclose all their files to the Ombudsman and to investigate complex matters the work of an Ombudsman is too limited to guarantee a proper handling of bank customers' complaints.

I should also be pointed out that the German Ombudsman' terms of reference do not include a provision which resembles paragraph 14 of the 'Terms of Reference' of the English Banking Ombudsman and which states that the English Ombudsman 'shall [in making any recommendation] do by reference to what is, *in his opinion, fair in all the circumstances*[660]'. In my opinion, this is another major flaw of the German Banking Ombudsman Scheme because it unnecessarily restricts the scope of the activities of the Ombudsmen. One of the great advantages of the English Banking Ombudsman Scheme is the Ombudsman's power to make a decision against a bank even if this bank has

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[658] Bundesverband deutscher Banken, *Der Ombudsmann der privaten Banken - Verfahrensordnung* (Köln July 1996), section 2 (2) e).
[659] Bundschuh, Karl Dietrich, 'Erfahrungen mit dem Ombudmannverfahren der Banken' ZBB 1/1998, 2, at p. 4.
[660] Emphasis added.

fulfilled the requirements which are laid down by the law but has, at the same time, failed to act in a 'fair and reasonable' manner.

How insensitive some representatives of German banks are to the notion of fairness and reasonableness became apparent in the course of a discussion at a seminar organised by the legal journal 'Wertpapiermitteilungen' in Frankfurt in September 1997. Being told about the existence of the 'fair and reasonable' clause in the English Banking Ombudsman's Terms of Reference, one senior lawyer of a well known German private bank replied that there 'was no need for such a provision in the Geman Banking Ombudsman Scheme, because of § 242 BGB German law was per se fair and reasonable'[661].

Furthermore, attention should be drawn to the fact that according to section 4 (4) of the Ombudsman's articles of association, the Ombudsman is not obliged to give any explanation of his decisions. It is argued by the banks that this provision is essential to to keep down the costs of the scheme. In my view, however, a customer whose complaint has been accepted by the Ombudsman - which indicates that it is not unsubstantiated - should be entitled to request an adequate explanation of the reasons lying behind the Ombudsman's decision.

This is also a question of the public accountability of the Ombudsman. The requirement of written explanations of decisions would increase the transparancy of the Ombudsman scheme. It would also make it much easier for outsiders such as researchers and consumer groups to monitor the work of the Ombudsman. In general, there seems to be

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[661] Seminar on 'Informationspflichten und Haftungsfragen in der Anlageberatung und Vermögensverwaltung' organised by the legal journal 'Wertpapiermitteilungen' on 19 September 1997 in Frankfurt/Main.

an aura of secrecy about the German Banking Ombudsman Scheme. Not only is there no requirement of written explanations for his decisions but also no formal annual report on his activities is published by him. Only sporadically facts and figures about the the Ombudsman Scheme have been published by the Ombudsman or his senior assistants since the establishment of the scheme.

C. Comparison

The Banking Ombudsman Schemes are widely accepted by the consumers in England and Germany. However, in contrast to its English counterpart, the German Ombudsman Scheme for customers of Germany's private banks is riddled with significant structural flaws which undermine the credibility of the entire system.

First, the German Banking Ombudsman scheme lacks a so-called 'buffer body' between the scheme's Board of Directors and the two Ombudsmen. In England, the Ombudsman is appointed by an independent body which cointains representatives from consumer organisations and the media. In Germany, the Ombudsmen are directly appointed by the Board.

Secondly, the Geman Ombudsman's articles of association are not as consumer-friendly as the English Ombudsman's terms of reference. For example, the English Banking Ombudsman is expressly empowered to reach decisions not only along the lines of the applicable law but also to make a recommendation or award by 'reference to what is, in his opinion, fair in all circumstances'[662]. In contrast, the two German Banking Ombudsmen are expected to base their decisions on the rule of law alone. This emphasis on the legal aspects of the complaints is also shown by the fact that the association of Germany's private banks appointed two retired senior judges as Ombudsmen. Moreover, the English Banking Ombudsman can make awards which are binding upon banks up to the amount of £100,000. The limit up to which rulings of the German Ombudsman are binding is DM 10,000[663]. Additionally, the English Ombudsman can, in

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[662] The Banking Ombudsman Scheme, *Terms of Reference* (London January 1997), at p. 4.
[663] Currently, approximately £3,400.

contrast to his German counterpart, make awards for any distress or inconvenience caused by to the complainant by the bank. In exceptional circumstances, the English Ombudsman is also entitled to order a bank to compensate a customer for his or her costs for consulting an expert adviser such as an accountant or a lawyer.

Thirdly, it should be emphasized that, in contrast to England, there is no code of conduct of standard banking practice in Germany. For the time being, there is only the so-called *Verbraucherpolitisches Gesamtkonzept* (general consumer concept)[664] which has been drawn up by the *Bundesverband deutscher Banken.* This concept contains rather vague statements as to what the private banks' association regards as good banking practice. The two main objectives of this concept are 'transparency' and 'reasonableness'. Transparency is defined as an obligation on the part of the bank 'to inform the customer comprehensively and in an understandable way about products and their characteristics'[665]. The notion of reasonableness is described as the bank's duty to ensure that 'the rights and obligations arising from the contractual relationship between the bank and the customer must be fair to both parties'[666].

Although one must admit that these objectives do point in the right direction, much remains to be done to provide the German Ombudsman Scheme with the same powers and degree of independence as the English Banking Ombudsman. The British-Irish Ombudsman Association has named four main criteria which must be fulfilled by an informal grievance resolution scheme to be entitled to use the term 'Ombudsman' in the UK and the Republic of Ireland. These four criteria are: the power to investigate,

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[664] Bundesverband deutscher Banken, *Fünf Jahre Ombudsmann* (Köln 1997), at p. 24.
[665] *ibid*, at p. 24.
[666] *ibid*, at p. 24.

effectiveness, fairness and accountability[667]. From my point of view, the German Ombudsman would fail to fufil already the first requirement, i.e. independence. Maybe another glance across the Channel can provide some 'development assistance' to the German Banking Ombudsman Scheme. In the rules of the British And Irish Ombudsman Association independence is defined as follows[668]:

> Independence, for example, maybe achieved in several ways. Hence, in the private sector the body which appoints the Ombudsman and to whom the Ombudsman reports, can be regarded as independent, provided that those of its members who are representatives of organisations subject to the Ombudsman's jurisdiction, constitute a minority of the membership.

Beside the issue of independence, the German Banking Ombudsman's powers of judgment should be increased to the benefit of customers. For example, Ombudsman should be given the express power to make a decision against a bank even if the bank had acted within the limit of the law but thereby acted in a way that can be viewed as unfair and unreasonable. If the German banks do not make these changes to the current structure of the Ombudsman Scheme, whose reputation depends, at present, entirely on the acceptance and reputation of its two Ombudsmen, the work of the Ombudsman Scheme may be in danger of being compared rather to an agony aunt than to an earnest guardian of the cause of consumer interests.

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[667] British And Irish Ombudsman Association, *Rules and Criteria* (London May 1997), at p. 9.
[668] *ibid*, at p. 9.

Chapter Six:

Conclusion

Due to the introduction of specific legislation in the area of banking law the importance of general contractual or tortious concepts is diminishing in England and Germany. Especially with regard to the issue of a bank's liability for its financial advice to customers less and less emphasis is laid by the courts on the question of under which theoretical concept liability can be established. Instead, in their decisions, the judges focus attention on the issue of whether the defendant bank meets the requirements of what is regarded as 'good practice' in the financial services industry.

Civil law concepts appear to be turned into vehicles for implementing duties of banks acting as financial advisers which are imposed by specific legislation concerned with the supervision and regulation of the financial services industry. Specific legislation such as the Financial Services Act 1986 and the proposed Financial Services and Markets Bill in England as well as the *Wertpapierhandelsgesetz* in Germany become more and more important in the defining the duties of banks which assume the role of their customers' financial advisers.

It follows that the question of which of the two jurisdictions' different conceptual approaches, i.e. English law's preference for tort law or the dominance of contract law in Germany, appears to be more suitable for the protection of consumer interests is of

limited relevance. Instead, a comparison of the actual levels of consumer protection which are offered by the two legal systems appears to be much more useful.

Comparing the protection which is given by both jurisdictions to borrowers, one may come to the conclusion that the English law with regard to mortgage lending needs to be reformed. The fact that, in 1996, no less than 2.6m owners of private homes in the UK had insufficient equity in their homes to move to a new house[669], raises the question of whether there should be a statutory provision requesting banks and building societies to adopt stricter lending policies so that, for example, 100 per cent mortgage loans would no longer be offered to private borrowers.

Certainly, the introduction of a rule which stipulates that banks and building societies ought to be more restrictive with regard to their mortgage lending would help to reduce the cases of negative equity as well as the number of repossessions in Britain. On the other side, there would also what could be perceived as negative effects. A more restrictive lending policy would also result in fewer purchases of private homes in the UK.

In this context, the issue of mortgage lending may also serve as a good example of the limits of the goal of harmonizing the laws concerning consumer finance in Europe. Whereas - in the light of the rapid growth of telephone and internet banking - it appears to be sensible to consider the standardization of private investment products such as life assurance policies or savings accounts, harmonization in the area of mortgage lending seems to be much more difficult because one needs to pay particular attention to the

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[669] *Sunday Times*, 27 October 1996, at p. 17.

different 'mentalites'[670] of the borrowers and lenders in the countries involved. One may doubt whether there is sufficient political support in the UK for a more restrictive lending policy to be adopted by mortgage lenders because there is a strong tradition of private property ownership in Britain. No less than 68 per cent of all UK households live in their own property[671]. In contrast, in Germany, only 39 per cent of all households own a home or a flat[672].

Furthermore, in both countries, third party securities are a problematic issue. In my view, both legal systems should reconsider their present emphasis on the assumption that the mere provision of a warning to the person who gives the third party security is sufficient to ascertain the enforceability of a third party guarantee. This concept does not take into account the true nature of the problems behind a third party security. Banking practice clearly shows that even if a financially inexperienced guarantor is provided with an adequate warning of the risks he or she often nevertheless decides to give the security. Thus, a concept whose main objective is to ensure that a guarantor obtains access to information about the risks of the guarantee and is encouraged to seek independent legal advice can only work in circumstances where the handicap of the disadvantaged guarantor is mainly grounded on a deficit of information. However, in most third party security situations the guarantor's freedom of choice is not infringed through a lack of knowledge of the risks of the guarantee but impaired by the exposure to undue pressure resulting from the close family or emotional ties between the principal debtor and the guarantor.

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[670] Legrand, Pierre, 'European Legal Systems are not converging' (1996) 45 ICLQ 52, at p. 60.
[671] *Frankfurter Allgemeine Zeitung*, 20 April 1998, at p. 15.
[672] *ibid.*

Instead, the judiciary should base their judgments also on the feasibility of a guarantee agreement. For example, in German law a guarantee agreement is regarded as void under § 138 BGB if there is an extreme discrepancy between the scope of the liability under such a guarantee on the one side, and, on the other, the actual financial means of the guarantor. Such an extreme discrepancy is typically established where the income of the guarantor which is subject to seizure is not sufficient to cover a quarter of the total of the main debtor's liability within five years after the conclusion of the guarantee agreement[673].

Additionally, it may be argued that both jurisdictions should do more to protect the interests of private investors. Today, it is still commonplace among banks in England and Germany to recommend to their customers only those financial products which belong to their own product range although products offered by other financial institutions are more suitable for their customers' individual needs. Therefore, in my view, the present law in England and Germany concerning investment advice should be changed to ensure that a bank recommends a product only 'where it is positively suitable, not just where it is the least unsuitable'[674] from the bank's range of products. Furthermore, in this context, the suitability of a product should be based on the customer's personal financial situation and his or her experience in investment matters.

On the other hand, one should mention that the imposition of stricter duties upon banks in itself is not enough. In addition, consumers need to become more knowlegeable with regard to their financial dealings. In this context, one may be inclined to ask for a better cooperation between banks and consumer rights groups with a view to improve the

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[673] See decision of the Bundesgerichtshof in BGH (18.09.1997) WM 1997, 2117.
[674] See the draft guidance on factfinding issued by the Personal Investment Authority Ombudsman Bureau, *Annual Report 1996-97* (London 1997), at p. 32.

consumers' knowledge of the nature and risks of third party guarantees and investment products. In this respect, a good example may be the policy of the UK's Financial Services Authority to support the lobbying for bringing financial matters into the National Curriculum in Britain[675]. Moreover, informal conflict resolution systems such as the Banking Ombudsman Schemes should be further strenghened and their powers extended.

The times when the relationship between a bank and its customer was clearly defined in the tems of creditor and debtor are long gone.Today, the bank/customer relationship should be rather defined as a partnership and the law's task is, and will probably always be, to safeguard that the bank's economic superiority does not enable the bank to dominate this relationship.

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[675] Financial Services Authority, *Plan & Budget 1998-99* (London 1998), at p. 28.

APPENDIX I: Extracts from the German Civil Code (BGB)[676]

First Book - General Part
Third Section: Legal Transaction
Second Title: Declaration of intention

§ 119 [Recission due to error]

(1) A person who, when making a declaration of intention, is in error as to its content, or did not intend to make a declaration of such content at all, may rescind the declaration if it may be assumed that he would not have made it with knowledge of the facts and with reasonable appreciation of the situation.

(2) An error as to the content of the declaration is regarded in the same way as an error as to those characteristics of a person or thing which are regarded in business as essential.

§ 123 [Recission on grounds of fraud or threats]

(1) Whoever has been induced to make a declaration of intention by fraud or unlawfully by threats may rescind the declaration.

(2) If a third party was guilty of the fraud, a declaration which was required to be made to another person may be rescinded only if the latter knew or should have known of the fraud. Insofar as a person other than the one to whom the declaration was required to be made has acquired a right directly through the declaration, the declaration may be rescinded as against him if he knew or should have known of the fraud.

§ 133 [Interpretation of a declaration of intention]

In interpreting a declaration of intention the true intention shall be sought without regard to the declaration's literal meaning.

§ 134 [Statutory prohibition]

A legal transaction which violates a statutory prohibition is void, unless a contrary intention appears from the statute.

§ 138 [Legal transaction against public policy; usury]

(1) A legal transaction which is against public policy is void.

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[676] Translations are taken from Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume I, at pp. 817.

(2) A legal transaction is also void whereby a person exploiting the need, carelessness or inexperience of another, causes to be promised or granted to himself or to a third party in exchange for a performance, precuniary advantages which exceed the value of the performance to such an extent that, under the circumstances, the pecuniary advantages are in obvious disproportion to the performance.

§ 157 [Interpretation of contracts]

Contracts shall be interpreted according to the requirements of good faith, giving consideration to common usage.

Fifth Title: Agency, Power of Attorney

§ 179 [Liability of an unauthorized agent]
(1) Whoever has entered into a contract as agent is, if he has not given proof of his authority, bound to the other party at his choice either to carry out the contract or to compensate him, if the principal refuses to ratify the contract.

(2) If the agent did not know that he had no authority he is bound to compensate only for the damage which the other party has sustained by relying upon the authority; not, however, beyond the value of the interest which the other party has in the validity of the contract.

(3) The agent is not liable, if the other party knew or should have known of the lack of authority. The agent is also not liable if he was limited in his competency to enter into transactions, unless he had acted with the consent of his legal representative.

Second book - Law of Obligations
First Section Content of Obligations
First Title: Obligaton to perform

§ 241 [Content of obligation]
The effect of an obligation is that the creditor is entitled to claim performance from the debtor. The performance may consist of refraining from acting.

§ 242 [Performance according to good faith]
The debtor is bound to effect performance according to the requirements of good faith, giving consideration to common usage.

§ 249 [Compensation in kind]
A person who is obliged to make compensation shall restore the situation which would have existed if the circumstance rendering him liable to make compensation had not occurred. If compensation is required to be made for injury to a person or damage to a thing, the creditor may demand, instead of restitution in kind, the sum of money necessary for such restitution.

§ 250 [Compensation in money after laying down a period of notice]
The creditor may fix a reasonable period for the restitution by the person liable to compensate with a declaration that he will refuse to accept restitution after the expiration of the period. After the expiration of the period the creditor may demand the compensation in money if the restitution is not effected in due time; the claim for restitution is barred.

§ 251 [Compensation in money without laying down a period of notice]
(1) Insofar as restitution in kind is impossible or is insufficient to compensate the creditor, the person liable shall compensate him in money.

(2) The person liable may compensate the creditor in money if restitution in kind is possible only through disproportionate outlays. Expenditure resulting from the medical treatment of an injured animal is not considered disproportionate only because it considerably exceeds the value of the animal.

§ 252 [Lost profit]
The compensation shall also include lost profits. Profit is deemed to have been lost which could probably have been expected in the ordinary course of events, or according to the special circumstances, expecially in the light of the preparations and arrangements made.

§ 253 [Non-material damages]
For an injury which is not an injury to property, compensation in money may be demanded only as provided by law.

§ 254 [Joint debts]
(1) If any fault of the injured party has contributed to causing the damage, the obligation to compensate the injured party and the extent of the compensation to be made depends upon the circumstances, especially upon how far the injury has been caused predominantly by the one or the other party.

(2) This applies also even if the fault of the injured party consisted only in an omission to call the attention of the debtor to the danger of unusually high damage which the debtor neither knew nor should have known, or in an omission to avert or mitigate the damage. The provision of § 278 applies mutatis mutandis.

§ 276 [Responsibility for one's own conduct]
(1) A debtor is responsible, unless it is otherwise provided, for wilful conduct and negligence. A person who does not exercise ordinary care acts negligently. The provisions of §§ 827, 828 apply.

(2) A debtor may not be released beforehand from responsibility for wilful conduct.

§ 277 [Care exercised in one's own affairs]
Whoever is obliged to exercise only such care as he is accustomed to exercise in his own affairs is not relieved from responsibility for gross negligence.

§ 278 [Responsibility for persons employed in performing obligation]
A debtor is responsible for the fault of his legal representative and of persons whom he employs in performing his obligation, to the same extent as for his own fault. The provision of § 276 (2) does not apply.

Third title: Promise of performance for the benefit of a third party

§ 328 [Contract for benefit of a third party]
(1) A contract may stipulate performance for the benefit of a third party, so that the third party acquires the right directly to demand performance.

(2) In the absence of express stipulation it is to be deduced from the circumstances, expecially from the object of the contract, whether the third party shall acquire the right, whether the right of the third party shall arise forthwith or only under certain conditions, and whether any right shall be reserved to the contracting parties to take away or modify the right of the third party without his consent.

Fifth title: Loan

§ 607 [Essence of loan]
(1) A person who has received money or other fungible as a loan is bound to return to the lender what he has received in things of the same kind, quality and quantity.

(2) A person who owes money or other fungibles for an other reason may agree with the creditor that the money or the things shall be owed as a loan.

Tenth Title: Mandate

§ 662 [Essence of mandate]
By the acceptance of a mandate the mandatary binds himself gratuitously to take care of some matter for the mandator entrusted to him by the latter.

§ 663 [Duty of notification of refusal]
A person who is publicly appointed or has publicly offered himself for the care of certain kinds of matters is bound, if he does not accept a mandate relating to such affairs, to notify the mandator of his refusal without delay. The same rule applies if a person has offered himself to the mandator for the charge of certain kinds of matters.

§ 664 [Personal obligation; liability for assistants]
(1) In case of doubt the mandatory cannot transfer the execution of the mandate to a third party. If the transfer is permitted, he is responsible only for fault imputable to him in making such transfer. For the fault of an assistant he is responsible under § 278.

(2) In case of doubt the claim for execution of the mandate is not transferable.

§ 665 [Deviation from instructions]
A mandatary is entitled to derivate from the instructions of his mandator if, under the circumstances, he can assume that the mandator would approve of the deviation if he had knowledge of the state of affairs. Before making the deviation the mandatory shall give notice to the mandator and await his decision, unless there is danger in delay.

§ 666 [Accounting and duty to give information]
The mandatary is bound to give the mandator all necessary information; on demand to furnish information about the condition of the matter; and to render an account after the execution of the mandate.

§ 667 [Mandatary's duty to hand over]
A mandatary is bound to hand over to his mandator all that he receives for the execution of the mandate and all that he obtains from the charge of the matter.

§ 668 [Interest in money spent]
If the mandatary spends, for his own benefit, money which he has to account to the mandator or to spend for him, he is bound to pay interest upon it from the time of spending.

§ 669 [Duty to make advances]
The mandator shall on demand make advances to the mandatary for the expenses necessary for the execution of the mandate.

§ 670 [Reimbursement for outlays]
If, for the purpose of the execution of the mandate, the mandatary incurs any outlay which he may regard as necessary under the circumstances, the mandator is bound to reimburse him.

§ 671 [Revocation: notice]
(1) A mandate may be revoked at any time by the mandator, and terminated by notice at any time by the mandatary.

(2) The mandatary can give notice only in such manner that he mandator can make other arrangements for taking care of the matter, unless a serious cause exists for the premature notice. If he gives premature notice without such reason, he shall compensate the mandator for any damage arising therefrom.

(3) If a serious case exists the mandatary is entitled to give notice even though he has waived the right to do so.

§ 672 [Mandator's death or incompetency]
In case of doubt mandate is not extinguished by the death of the mandator, nor by his becoming incompetent to enter into legal transactions. If the mandate is extinguished, and if there is danger in delay, the mandatary shall continue to take care of the matter entrusted to him until the heir or the legal representative of the mandator can make other arrangements; the mandate is to such extent deemed to be continuing.

§ 673 [Death of mandatary]
In case of doubt a mandate is extinguished by the death of the mandatary. If the mandate is extinguished, the heir of the mandatary shall, without delay, notify the mandator of the death, and shall, if there is danger in delay, continue to take care of the matter until the mandator can make other arrangements; the mandate is to such extent deemed to be continuing.

§ 674 [Fiction of continuation]
If a mandate is extinguished other than by revocation, it is, nevertheless, deemed to be continuing in favour of the mandatary until he knows or ought to know of its extinction.

§ 675 [Taking care of a matter for valuable consideration]
The provisions of the §§ 663, 665 to 667, 672 to 674 and, if the person bound has the right to give notice without observance of any term of notice, the provisions of § 671 (2) also apply mutatis mutandis to a contract of service or a contract for work which has for its object the taking care of a matter.

§ 676 [No liability for advice or recommendation]
A person who gives advice or a recommendation to another is not bound to compensate for any damage arising from following the advice or the recommendation, without prejudice to his responsibility resulting from a contract or delict.

Eigtheenth title: Guaranty

§ 765 [Essence of guaranty]
(1) By a contract of guaranty, the guarantor binds himself to the creditor of a third party to be responsible for the fulfilment of the obligation of the third party.

(2) A guaranty may also be assumed for a future or conditional obligation.

§ 766 [Written form of declaration of guaranty]
A written statement of the declaration of guaranty is necessary for the validity of the contract of guaranty. Where the guarantor fufils the principal oblgiation the defect of form is cured.

§ 767 [Extent of guaranty liability]
(1) The extent of the principal obligation at any time determines the obligation of the guarantor. This applies also, in particular, where the principal obligation is altered by the

fault or default of the principal debtor. The obligation of the guarantor is not increased by any legal transaction entered into by the principal debtor after the assumption of the guaranty.

(2) The guarantor is liable for the expenses of notice and legal action which must be paid by the principal debtor to the creditor.

§ 768 [Defences of guarantor]
(1) The guarantor may raise all defenses available to the debtor. If the principal debtor dies the guarantor may not avail himself of the fact that the heir has only a limited liability for the obligation.

(2) The guarantor does not lose a defense by reason of the fact that the principal debtor has waived it.

§ 771 [Claim for prior execution against principal debtor]
The guarantor may refuse to satisfy the creditor, the claim of the creditor against the principal debtor is transferred to him. The transfer may not be enforced to the detriment of the creditor. Defenses of the principal debtor arising from a legal relationship existing between him and the guarantor remain unaffected.

(2) Co-guarantors are liable to each other only under § 426.

Twenty-fifth Title: Delicts

§ 823 [Duty to compensate for damage]
(1) A person who, wilfully or negligently, unlawfully injures the life, body, health, freedom, property or other right of another is bound to compensate him for any damage arising therefrom.

(2) The same obligation is placed upon a person who infringes a statute intended for the protection of others. If, according to the provisions of the statute, and infringement of this is possible even without fault, the duty to make compensation arises only in the event of a fault.

§ 826 [Wilful damage contrary to public policy]
A person who wilfully causes damage to another in a manner contrary to public policy is bound to compensate the other for the damage.

§ 831 [Liablility for employees]
(1) A person who employs another to do any work is bound to compensate for any damage which the other unlawfully causes to a third party in the performance of his work. The duty to compensate does not arise if the employer has exercised necessary care in the selection of the employee; and where he has to supply apparatus or equipment or to supervise the work, has also exercised ordinary care as regards such supply or supervision, or if the damage would have arisen notwithstanding the exercise of such care.

(2) The same responsibility attaches to a person who, by contract with the employer, undertakes to take charge of any of the matters specified in (1)) sent.2.

§ 852 [Prescription]
(1) The claim for compensation for any damage arising from a delict is barred by presciption in three years from the time at which the injured party has knowledge of the injury and of the indentity of the person bound to make compensation, and without regard to such knowledge, in thirty years from the doing of the act.

(2) If negotiations about the compensation to be provided are pending between the person liable and the entitled person, prescription is suspended until one or the other refuses to continue with the negotiations.

(3) If the person bound to make compensation has acquired anything by the delict at the expense of the injured party, he is, even after the running of the period of prescription, bound to return it under the provisions relating to the return of unjust enrichment.

APPENDIX II: Extracts from the German Standard Contract Terms Act (AGBG)[677]

§ 1 [Essence of standard contract terms]
(1) Standard contract terms are terms which have been settled in advance for use in an indefinite number of contracts and which one party (the user) presents to the other party at the conclusion of the contract. It is immaterial whether these general contract terms are a part of the contract which is phyically separated from the main document or incorporated into the main document, as well as their extent, their typing style or of what kind the contract is.

(2) Insofar as the contractual parties negotiate terms individually, these terms are not seen as general contract terms in the meaning of this Act.

§ 8. Scope of control and content
§§ 9 to 11 apply only to provisions in standard contract terms stipulating regulations which deviate from, or supplement, statutory provisions.

§ 9 General clause
(1) Provisions in standard contract terms are void if they unreasonably disadvantage the contractual partner of the user contrary to the requirements of good faith.

(2) In case of doubt, a provision is unreasonably disadvantageous if
1. it is irreconcilable with essential, basic principles of the statutory provisions from which it deviates, or
2. essential rights or duties arising from the nature of the contract are restricted to a degree which jeopardises the attainment of the purpose of the contract.

§ 10 Void clauses subject to reasonableness test
In particular, the following provisions are void in standard contract terms
1. (Periods of time for acceptance and performance)
a provision by which the user reserves for himself unreasonably long or insufficiently determined periods of time for accepting or refusing to accept an offer or for effecting performance;
2. (Periods of grace)
a provision by which the user, contrary to § 326 subs. I BGB, reserves an unreasonably long or insufficiently determined period of grace for the performance which he is to effect;
3. (Reservation for terminating the contract)
the stipulation of the user's right to free himself from his obligation to perform without a reason which is objectively justified and named in the contract; this does not apply to continuing contracts;
4. (Reservation for amending the contract)

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[677] Translations taken from Markesinis/Lorenz/Dannemann, *The German Law of Obligations* (Oxford 1997), Volume I, at pp. 908.

the stipulation of the user's right to modify or to deviate from the promised performance, unless, when considering the interests of the user, such stipulation of modification or deviation is not asking too much of the other party;
5. (Constructive declarations)
a provision whereby a certain act or omission by the user's contractual partner is considered as a declaration made or not made by this party, unless
(a) the contractual partner is granted a reasonable period ot time to make an express declaration and
(b) the user undertakes to indicate specifically to the contractual partner the envisaged meaning of his conduct at the beginning of this period ot time;
6. (Constructive receipt of communication)
a provisions according to which a declaration by the user which is of particular significance is deemed to have reached the other party;
7. (Winding up of contracts)
a provision which entitles the user, in case one of the parties to the contract terminates the contract or gives notice of termination, to demand
(a) an unreasonably high remuneration for the use of a corporeal object, of a right, or for performance made or
(b) an unreasonably high reimbursement of expenditure;
8. (repealed)

§ 11 Void clauses not subject to reasonableness test
The following provisions are void in standard contract terms:
1. (Short-term price increase)
a provision which envisages a price increase for goods or services which are to be delivered or provided within four months after the conclusion of the contract; this does not apply to goods or services provided under continuing contracts;
2. (Rights to suspend performance)
a provision whereby
(a) the right to suspend performance which accrues to the contractual partner of the user under § 320 of the Civil Code (BGB) is excluded or restricted, or
(b) a right of retention belonging to the contractual partner of the user, to the extent that it arises from the same contractual relationship, is excluded or restricted;
3. (Prohibition of set-off)
a provision by which the contractual partner of the user is deprived of his entitlement to set-off with a claim which is undisputed or has become res judicata;
4. (Warning, fixing period)
a provision by which the user is exempted from his statutory obligation to warn the other party, or to fix a period of grace;
5. (Liquidated damages)
the stipulation of the user's right to claim liquidated damages or compensation for diminuition of value, if
(a) the stipulated lump sum exceeds the damage or diminuition of value to be expected for the provided cases in the ordinary course of events or
(b) the other party to the contract is not allowed to prove that no damage or loss of value has occurred, or that the damage or the loss amounts to considerably less than the lump sum;
6. (Penalty)
a provision whereby the payment of a penalty is promised to the user in cases of failure to take delivery, of delay in taking delivery, of late payment, or in case the other party withdraws from the contract;

7. (Liability for gross negligence)
an exclusion or limitation of liability for a damage which is based on a grossly negligent breach of contract by the user, or on a wilful or grossly negligent breach of contract by a statutory agent of the user, or by a person employed by the user for the performance of his obligation; this also applies to damage resulting from the violation of duties during contractual negotiations;
8. (Delay, impossibility)
a provision by which, if the user is in delay of performance, or if he is responsible for performance being impossible,
(a) the right of the other contractual party to withdraw from the contract is excluded or restricted or
(b) the right of the other contractual party to claim damages is excluded or restricted in violation of No.7;
9. (Partial delay, partial impossibility)
a provision which, if the user is in delay of part of his performance, or excludes the right of the other contractual party to claim damages for non-performance of the entire obligation, or to terminate the entire contract, if partial performance of the contract is of no interest to this party;
10 (Liability for defects)
a provision by which, for contracts for the supply of newly produced goods or services,
(a) (Exclusion and reference to third parties)
claims against the user for liability for defects including any rights for removal of defects or for delivery of a substitute are excluded in total or in regard of individual parts, are limited to providing claims against third parties, or made conditional on previous court litigation against third parties;
(b) (Limitation to removal of defects)
claims against the user for liability for defects are limited in total or in regard of individual parts to removal of defects or delivery of a substitute, unless there is an express reservation of the right of the other contractual party, once removal of defects or delivery of a substitute has failed, to claim reduction of the price or, unless the liability arises from the performance of building operations, instead to choose to terminate the contract;
(c) (Expenditure for removal of defects)
the obligation of a user who is liable for defects to bear the expenditure which becomes necessary for the purpose of removing defects, in particular costs for transport, journey, labour, and materials, is excluded or restricted;
(d) (Withholding removal of defects)
the user makes the removal of a defect, or the substitute delivery of a corporeal object free from defects, condititonal on previous payment of the entire price, or of a part of the price which, when considering the defect, is disproportionally high;
(e) (Cut-off period for notification of defects)
the user fixes for the other party a cut-off period for the notification of defects which are not obvious, whereby this period is shorter than the limitation period for statutory liability claims for defects;
(f) (Reduced limitation periods for liability for defects)
the statutory limitation periods for the liability for defects are reduced;
11. (Liability for breach of warranty)
a provision in a contract for sale, works, or goods to be manufactured, by which claims against the user for damages under §§ 463, 480 subs.2, § 635 of the Civil Code (BGB) for breach of warranty are excluded or restricted;
12. (Duration of continuing contracts)

in a contractual relationship, the object of which is the recurrent delivery of goods, or the recurrent provision of services or works by the user:
(a) a duration of the contract which binds the other contractual party for more than two years,
(b) a tacit extension of the contractual relationship for more than one year at a time which is binding on the other contractual party or
(c) a period of notice, burdening the other contractual party, in excess of three months before lapse of the initially envisaged, or tacitly extended, duration of the contract;
13. (Change of contractual partner)
a provision according to which, in contracts for sale, services or works, a third party will or can, in the user's place, take over the rights and duties arising from the contract, unless this provision
(a) indicates the third party by name, or
(b) grants to the other contractual party the right to withdraw from the contract;
14. (Liability of contracting agent)
a provision whereby the user burdens an agent who enters into the contract on behalf of the other contractual party,
(a) with the agent's own liability or guarantee, without an express and separate declaration to this effect or
(b) in cases of agents acting without authority, any liability exceeding what is envisaged by § 179 of the Civil Code (BGB);
15. (Burden of proof)
a provision by which the user changes the burden of proof to the disadvantage of the other contractual party, in particular by
(a) placing on this party the burden of proof for circumstances which are within the user's area of responsibility;
(b) making the other party acknowledge specified facts.
Letter (b) does not apply to acknowledgements of receipt which are signed separately;
16. (Form of notifications and declarations)
a provision whereby notifications or declarations, which must be made towards the user or a third party, are subjected to from requirements stricter than a written form, or to special requirements for effectuating receipt.

APPENDIX III: Extracts from the German Commcercial Code (HGB)

Book One
First section: Merchants

§ 1 [Merchant by virtue of type of business]
(1) A merchant within the meaning of this Code is a person who carries on a commercial enterprise.

(2) Every commercial undertaking qualifies as a commercial enterprise given that its nature and scope require the establishment of an organized business.

Book Three
First Section: General Provisions

§ 343 [The concepts of commercial transaction]
Commercial transactions are all transactions of a merchant which pertain to the carrying on of his trade.

§ 344 [Presumptions]
(1) Transactions undertaken by a merchant are deemed, when in doubt, as pertaining to the carrying on of his trade.
(2) All acknowledgements of debts signed by a merchant are deemed as signed in the course of trade, unless the contrary appears from the document.

§ 346 [Customs of merchants]
The customs and usages which obtain in commerce shall be taken into consideration among merchants in respect of the meaning and effect of acts and omissions.

§ 347 [Duty of care of an ordinary merchant]
(1) A person who, in respect of a transaction which is, as to himself, a commercial transaction, is under a duty of care to another person, must exercise the care of a prudent merchant.

(2) There is no effect on the provisions of the Civil Code, according to which the debtor is in certain cases, liable only for gross negligence or is required to apply only such degree of care as he usually applies in his own affairs.

APPENDIX IV: Extracts from the *Wertpapierhandelsgesetz* (Securities Trading Act)[678]

§ 1 Scope of Application

This Act applies to the provision of primary and secondary securities services [Wertpapierdienstleistungen and Wertpapiernebendienstleistungen], irrespective of whether these securities are listed at the stock market or not, money market instruments, derivatives as well as transactions aimed at changing the ownership of voting rights of stock market listed companies.

§ 2 Terminology

(1) Securities in the meaning of this Act are, even if there are no documents made out for them:

1. shares, certificates substituting shares, debenture bonds, participating certificates, options and
2. other securities which can be compared with shares or debentures, provided that they can be traded in a market.

Securities are also investment certificates which are issued by a investment management firm or a foreign investment trust.

(1a) Money market instruments in the sense of this Act are claims which do not fall under section 1 and are typically traded in the money markets.

(2) Derivatives in the meaning of this Act are

1. tradings in futures, either on fixed terms or on an optional basis, whose price depends directly or indirectly on
   a) the stock market or market price of securities,
   b) the stock market or market price of money market instruments
   c) the interests rate or other income or
   d) the stock market or market price of goods and metals
2. Currency future tradings which are traded in an organised market ('currency futures'), currency options, currency swaps, currency swap options, and currency futures options.

(3) Primary securities services [Wertpapierdienstleistungen] in the sense of this Act are

1. the acquisition and disposition of securities, money market instruments or derivatives in one's own name for the account of another,
2. the acquisition and disposition of securities, money market instruments or derivatives by way of trading for one's own account for another,
3. the acquisition and disposition of securities, money market instruments or derivatives in another's name for another's account,
4. the procurement or supply of dealings with regard to the acquisition or disposition of securities, money market instruments or derivatives.
5. the taking-over of securities, money market instruments or derivatives at one's own risk with a view to their placing or the acceptance of similar guaranties,
6. the discretionary management of portfolios of others consisting of several securities, money market instruments or derivatives.

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[678] Ammended according to the '3.Finanzmarktförderungsgesetz' of 27 March 1998.

(3a) Secondary securities services [Wertpapiernebendienstleistungen] in the meaning of this Act are
1. the safe-keeping and managing of securities for others, insofar as the Securities Deposit Act does not apply
2. the granting of credits or loans to others in connection with the execution of services related to securities which are provided by the firm which also grants the credit or loan,
3. the provision of advice with regard to investments in securities, money market instruments or derivatives,
4. the activities listed under section 3 No.1 to 4, insofar as their object are currency dealings and currency futures dealings which do not fall under section 2 No.2 and are related to primary securities services.

(4) Investment firms [Wertpapierdienstleistungsunternehmen] in the sense of this Act are credit institutions, providers of financial services and businesses which operate under § 53 (1) of the Banking Act which either offer only primary or primary as well as secondary securities services in a commercial manner or in a way that requires the setting up of a commercial business.

(5) An organised market in the meaning of this Act is a market which is regulated and supervised by bodies recognised by the government, which is been held regularly, and which is directly or indirectly accessible to the public.

§ 31 WpIIG: General rules of conduct
(1) An investment firm [Wertpapierdienstleistungsunternehmen] is obliged
1. to carry out primary and secondary securities services with the required skill, care and conscienciousness and in its customers' interests;
2. to undertake to avoid any conflict of interest and to ensure that, in case of unavoidable conflicts of interest, the customer's order is to be executed in such a way that the customer's interests are safeguarded.

(2) Such a firm is also obliged
1. to obtain from its customers information concerning their experience and expertise in the kind of securities trading that are the object of the services rendered by the firm to the customers, as well as in relation to the the objectives of these tradings and the customers' financial affairs;
2. to disclose to its customers all appropriate information
insofar as this is necessary for the safeguarding of the customers' interests with a view to the nature and the scope of the envisaged tradings. The customers are not obliged to meet the request for information under Sentence 1 No. 1.

(3) Subsections (1) and (2) also apply to companies which have their seat of business in a foreign country and which provide primary and secondary securities services towards customers whose ordinary residence or whose business management is within the country unless the primary securities services including related and supplementary services are exclusively rendered within a foreign country.

§ 32 WpIIG: Specific rules of conduct

(1) An investment firm or any of its associated companies is not permitted:

1. to advise customers of the firm dealing in securities the purchase or sale of securities or derivatives if and so far as the advice is not in accordance with the customers' interests;
2. to advise customers of the investment firm the purchase or sale of securities or derivatives for the purpose of the undertaking of dealings on the firm's or on its associated firm's own behalf in order to manipulate prices in a certain direction;
3. to undertake a purchase or sale of securities or derivatives on its own behalf based on the knowledge of a customer's order placed with the investment firm and which can result in disadvantages for the customer.

(2) The owners of an investment firm set up in the legal structure of a sole trader [*Einzelkaufmann*], and, in other securities services companies, persons who are by law or according to the firm articles of association entrusted with the running of the management of the business affairs and are entitled to represent the firm, and, employees of securities services companies who are in charge of trading with securities and derivatives, analysis of securities, or provision of investment advice, are not permitted:

1. to recommend customers of the investment firm the purchase or sale of securities or derivatives under the conditions listed in sub-section (1) No.1, or, for the purpose of undertaking dealings on their own or a third person's behalf in order to manipulate prices in a certain direction;
2. to undertake dealings on one's own or a third person's behalf based on the knowledge of a customer`s order with the firm dealing in securities to purchase or sell securities or derivatives and which can result in disadvantages to the customer.

(3) Sub-sections (1) and (2) also apply - under the conditions laid down in § 31 (3) - to companies whose seat is in a foreign country.

§ 37a Prescription concerning claims for damages

The claim of a customer against an investment firm for damages which is based on a breach of a duty to give information or on the provision of incorrect advice with regard to the supply of a primary or secondary securities service is barred by prescription in three years from the time at which the claim has arisen.

APPENDIX V: Directive of the Federal Office for the Supervision of Securities Trading of 26 May 1997 on §§ 31 and 32 'WpHG'[679]

1. Scope of application

This Directive illustrates the duties arising under §§ 31 and 32 'WpHG'. It applies to the securities services provided by the following securities services companies:
(a) credit institutions whose seat is within the country,
(b) branches of companies in the meaning of § 53 section 1 sentence 1 and § 53b section 1 sentence 1 of Banking Act in the version of 30 June 1993 (BGBl. I S.1082), amended through the Act of 28 September 1994 (BGBl. I S.1082), amended through the Act of 28 October 1994 (BGBl. I S.3210),
(cc) branches of companies which are given an equal status or are exempted according to a statutory instrument based on § 53c of the Banking Act.

This Directive also applies to companies having their seat in a foreign state and which offer securities services towards customers whose ordinary residence or whose business management is within the country, unless primary securities services including related and supplementary services are exclusively rendered within a foreign country.

Securities services in the meaning of this Directive are the transactions on a commission basis, dealings for one's own account for the benefit of others (Fixed Price Dealings), and procurement dealings, insofar as they relate to securities and derivatives in the sense of § 2 section 1 or 2 'WpHG'. Additionally, transactions where securities services companies pass their customers' orders on to other securities services companies are also covered, provided that the rendered services are not restricted to the mere forwarding of the orders.

According to § 37 section 1 'WpHG' this Directive does not bind
(a) companies which carry out securities services exclusively for their parent firm or their subsidiaries in the sense of § 1 section 6 and 7 of the Banking Act or for other subsidiaries of of their parent firm;
(b) the Federal Debt Administration, one of its Special Funds, the Debt Administration of one of the Federal States, a member state of the European Communities or a signatories to the Treaty on the European Economic Area, the German Federal Bank as well aas the central banks of theother member states or signatories.

This Directive does not apply to dealings which are done between two securities services companies in the stock market (see § 37 section 2 'WpHG').

2. General information to be given before the rendering of the securities services

2.1. Information on the firm

On demand, the investment firm has to provide the customer with information on the nature and scope of the offered securities services, especially on range of services available.

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[679] 'Richtlinie des Bundesaufsichtsamtes für den Wertpapierhandel gemäß § 35 Abs. 2 des Gesetzes über den Wertpapierhandel (WpHG) zur Konkretisierung der §§ 31 und 32 WpHG für das Kommissions-, Festpreis- und Vermittlungsgeschäft der Kreditinstitute'.

2.2. Information on costs and collateral securities ('margins')
Before the supply of the services, the investment firm has to enable its customer to obtain information on the calculation, extent and type of the costs, and to realise, where necessary, the need for collateral securities ('margins'), or the existence of other liabilities such as costs for statements of account or deposit account, and, explain them on demand. Particular attention must also be drawn to minimum fees.

If the investment firm arranges with brokers or other involved companies the partial reimbursement of third party costs which are billed to the customer as incurred expenses ('kick-back-agreements'), the investment firm has to inform the customer about the obligation under the commission arrangement to pay back these sums. Insofar as this information has not already been given when the business relationship was established, it must be provided before the supply of the securities services at the latest. The customer is also to be told, in an appropriate maner, about changes in the way prices are calculated.

2.3. Verification
The investment firm has to comply with the duties to inform as they are laid down in this section in such a way that its compliance can be verified trhough an inspection under § 35 section 1 or § 36 section 1 'WpHG'.

3. Collection of customer details and provision of adequate information
At latest before the placing of the order, the investment firm must, insofar as necessary, provide its customer with all appropriate information on the type of the envisaged dealings ('disclosure'), i.e. it must explain to the customer especially the nature and risks of single forms investment.

Insofar as the investment firm only executes orders ('execution-only'), either through a separate distribution channel or generally, in an individual case or commonly, meaning that the firm's disclosure is not followed by a recommendation taking into account its customer's personal situation, the customer must be informed about this fact explicitly at latest before the customer's order is executed. In these cases, the rules as set out in third part of this Directive apply subject to the provisions of 3.6.

3.1 Collection of information from the customer
The investment firm is obliged, insofar as necessary, to ask its customer about his investment objectives, his knowledge of and experience in specific forms of investment and about his financial situation. In this context, it must be pointed out to the customer that the giving of this kind of information, which is on a voluntary basis, is in the customer's own interest. The scope of the gathered information should be brought into line with the customer's interests as well as to the type and extent of his envisaged dealings.
No collection of information is necessary insofar as the investment firm has already sufficent knowledge of the customer's affairs. If, with a view to the provisons of this Directive, individual information on specific forms of investments is not required and it is only collected within the ordinary course of the business relationship for the purpose of streamlining business procedures, the customer must be informed about this beforehand. It must be safeguarded that the given information is exclusively used for the purpose of disclosure and advice to the customer unless the customer consents to any other use.

The disclosure undertaken by the investment firm are founded on the customer's statements. Therefore, the customer's attention is to be drawn to the fact that he should inform the investment firm about any substantial change in his affairs that form the basis for his statements. As soon as a change in the situation underlying the customer's statements is noticeable, the investment firm must approach and ask the customer again. With regard to derivatives and options, statements by customers are, insofar as necessary, to be obtained again within a period of three years.

The investment firm must, insofar as necessary, ask the customer with regard to the following points:

(a) investment objectives

The investment firm is to question the customer about his investment objectives. The customer is especially to be asked about his interest in long term or short term forms of investment (e.g. for the purpose of his old age provision or eduction), single or recurrent returns (profits) and about the extent of his willingness to take risks.

(b) Knowledge or experience

The investment firm must also ask the customer of which forms of investments (e.g. debenture bonds, shares, investment certificates, derivatives) he has knowledge and in which of them he has already invested money in the past (extent, frequency and time).

(c) Financial affairs

The investment firm must also ask the customer with reference to his financial affairs insofar as this is necessary with regard to his envisaged dealings, his investment objectives as well as his knowledge and experience. Insofar as the customer gives information on deposit accounts or derivatives dealings with other credit institutions, this information must also be taken into account by the firm.

With regard to the scope of these questions, the investment firm is to consider whether the envisaged dealings are to be paid for by the customers's own means or through loans and what kind of risks concerning loss, additional payments or other risks exist with regard to these transactions. Customers who use their own existing funds to invest in securities of issuers having a particularly high credit standing such as the bonds or special funds of the Federal Republic of Germany or the Republic's Federal States or equivalent bonds of member states of the European Economic Area, which are members of the Organisation for Economic Cooperation and Development (OECD) need not make any statements as to their financial situation.

3.2. Extent of the information[680]

At latest before the acceptance of the customer's order, the customer is, insofar as necessary and with regard to his statements, to be informed about the nature and risks of the forms of investment as well as other relevant facts, for example about the possibility of putting a limit on an order, especially in markets of low liquidity and a minimum number of orders. This can be done through standardised brochures.

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[680] The German term used in the Directive is 'Aufklärung' which could also be translated as 'disclosure' However, the phrase 'disclosure' appears to have a slightly different meaning in English in the context of financial services in the UK. In the UK., the word 'disclosure' usually seems to characterise a situation where one party is obliged to disclose facts that are (more or less) exclusively known to him or her to another party. In contrast to this, in the German Directive, the term 'Aufklärung' is meant to describe the duties of a securities services firm to explain to a (not very experienced) customer facts that are of common knowledge to professionals in the area of financial services.

The customer must be told that he has the right to give instructions concerning the execution of his order, especially with regard to at which stock exchange the transaction is to be completed.

On demand, and insofar as known to the investment firm, the firm must inform the customer at which stock exchange or in which markets the order is to be executed and which mediators, traders, market makers, depositary banks or clearing organisations are involved in the transaction. If there are specific risks concerning the involved parties or with regard to particular markets, especially with a view to insolvency or transactions, this must be disclosed to the customer by the investment firm. This particularly applies to cross border securities services.

The information must be correct, complete and unequivocal as well as structured and is to be presented in an appropriate manner. With regard to the content and form of the information, the investment firm shall take into account the customer's knowledge of and experience in the relevant form of investment. The information is to be repeated if this appears to be necessary, for example, if the customer does only show a limited trading activity.

If the customer's statements are used to place the customer into a specific risk category and he is told about this, then this categorisation is to be considered when his orders are being executed by the investment firm. Additionally, the customer must be told about the criteria which are used for the categorisation.

If, on consultation, the customer wishes to have one specific order executed which does not fall into his risk category, the order can be carried out if it is ensured that the customer has received the necessary information before the execution of his order.

3.2.1. Information concerning debenture bonds

Information concerning the risks of debenture bonds should especially include information on the revenue, the credit rating, and, if necessary, the country risk, the price and interest rate risk, the insolvency risk, the currency risk as well as the termination and drawing rights risk.

3.2.2. Information concerning shares

Information regarding to shares should especially include information on the revenue (dividend), the price risk, the credit rating, the insolvency risk, the trade cycle risks as well as the currency risk.

Information on risks with regard to shares which are not traded at a national or foreign stock exchange (e.g. US-American 'Penny Stocks') should contain information on the market (especially on the market liquitity) and the specific risk of loss of this form of investment as well as on the origin of the price statements, on the difference between bid and book price ('spread') and on the fees charged by the securities services companies involved in the execution of the order.

3.2.3. Information concerning investment certificates

Information on risks of investment certificates should include information on the composition of the funds, the investment strategy, the utilisation of the revenue, the issuing price (issuing top up fee etc.), the price risk and the assessment procedures.

3.2.4. Information on derivatives and options warrants

Information on the risks of derivatives must especially contain information on the intrinsic value, the economic context and function of the products (particularly the importance of duration of premium, the type of execution, the leverage effect, the liquidity, the volatility of the markets and, if necessary, the standstill risk), the revenue, the price risk, the currency risk and the credit risk.

If the customer is requested to bring a collateral security ('margin') for his envisaged transactions, he, on demand, must be informed in writing about the methods of how the collateral security is being calculated. In this respect, it must be disclosed to him which involved party demands the collateral security and in what form this security can be given (e.g. money, securities) and whether the investment firm asks for more securities than the stock exchange itself. Additionally, the customer must be told, if necessary, about his obligation to produce further means of collateral securities ('additional payments') where necessary. Furthermore, attention should be drawn to the possibility of the passing on of collateral securities to the material stock exchange or clearing organisation. The investment firm must also inform the customer in which circumstances he has the right to even up or liquidate a position. In this context, the customer is also especially to be told at which intervals the requirements for collateral securities are revised by the investment firm and what time limit the customer is granted to fulfil his obligation to present additional payments or to liquidate his position.

Moreover, the investment firm has to notify the customer in which forms the given collateral securities are usually administered and whether the customer is, provided that the market situation allows it, entitled to reduce a surplus of collateral securities.

3.3 Agency

If a customer is represented by an agent, the agent's knowledge of and experience in the form of investment in question is relevant in respect of the obligation to collect information and also with regard to the obligation to give appropriate information.

3.4 Procedure in cases where customers do not give information

The investment firm must undertake serious efforts to obtain the relevant information from the customer. Where a customer excercises his right to refrain from giving information, this must be documented by the investment firm. However, the possibility of not giving any information must not be part of a questionnaire used by the firm. In case a customer does not provide the requested information to the firm, the customer's specific order can be executed if it is ensured that the customer has been offered to to get information on the nature and risks of the forms of investments before his order is being accepted.

3.5 Procedure where the customers are unattainable

Where the customer is unattainable for the purpose of the provision of information to him and where the immediate execution of the order is obviously within his interests, it is sufficient if the relevant pieces of information are given to him without undue delay after the execution of his order.

3.6 Provisions for securities services companies which only execute their customers' orders ('execution-only')

If an investment firm only executes orders ('execution-only'), possibly through a separate distribution channel, individually or typically, it must inform its customer about this fact at latest before the acceptance of an order by him. The information that is to be

given to the customer must be brought in line with his knowledge of and experience in his envisaged forms of investment. Insofar as the firm provides the customer with information which exceeds the type of information regulated in this section, such as market reports, charts or analysis, it must make it clear to its customer that this information does not amount to the supply of investment advice but is only meant to facilitate the customer's own investment decision. At latest before the acceptance of the order, the investment firm typically has only to ask its customer about his knowledge and experience. Statements by the customer concerning his investment objectives and financial affairs are only then required insofar as the investment firm grants the customer a loan for the execution of his envisaged dealings or requests him to present collateral securities. In other respects, the rules of section 3 apply.

4.3 Execution in the customer's best interest

Orders must be executed in the customer's best interest. In this respect, those interests of the customer which are noticable to the investment firm are material. Orders, which are obviously not in the interest of the customer, must only then be carried out by the investment firm if it explains to the customer the risks of these orders before their execution. Insofar as there are no specific directions given by the customer, the investment firm has, with the standard of care usually exercised in the ordinary course of business, to undertake to obtain with a view to the costs the most favourable price on the most favourable market as it is defined by the provisions of § 10 Stock Exchange Act. If necessary, the investment firm must also inquire about the liquidity of the markets (e.g. so-called 'emerging markets').

In case the investment firm uses a third party for the execution of the order, it must exercise due care when selecting this third party in order to ensure the best excecution of the order.

The splitting up of one single order into several partial orders is only then allowed if this is economically feasible as well as in the customer's interest considering the thereby created extra costs. However, this does not apply where the customer explicitly requests the splitting up of the order.

With regard to orders which are passed on via an order routing systems of the respective stock exchange, it must be ensured that there are no delays caused by the forwarding of these orders. If delays cannot be avoided, other ways of communication (e.g. telephone or telefax) are to be used.

Where the investment firm agrees with the customer on a fixed price for a single transaction (dealing for one's own account or, as the case maybe, fixed price dealings), it must inform the customer about the fact that this agreement leads to the conclusion of a contract of sale. The price with regard to fixed price dealings is to calculated by periodical reference to the market price.

5. Not permitted dealings

5.1 Not permitted recommendations

The investment firm is not permitted to recommend to the customer a transaction of which it assumes or should reasonably assume that is disadvantageous to the customer's interests. Especially it must not recommend to the customer transactions which are not in line with his interests.

The customer's interest is especially impaired if the recommendations result in a unreasonably high number of transactions in his current or deposit account leading to costs which are unreasonably high in proportion to the capital employed and the profit gained.

The investment firm is also not permitted to recommend to the customer transactions in order to influence the price with a view to dealings in the firm's own account or in the account of one of the firm's associated companies in the sense of § 15 Company Act. Especially misleading influence on the forming of the customer's opinion or deceit of the customer (e.g. through fictitious transactions or arranged dealings) are not allowed.

5.2 Not permitted transactions on the firm's own behalf which are detrimental to the customer

The investment firm is not allowed to undertake transactions on its own behalf on the basis of the knowledge of or expectation of a customer's order and which can result in disadvantages to the customer (prohibition of front, parallel or counter running).

It is especially not permitted to acquire securities or derivatives with regard to a future recommendation in order to sell them with a profit after the recommendation. The same applies to sales. Where the publication of written recommendations for customers or research results of the investment firm or one of its associated companies are impending, no tradings in the affected securities or derivatives on one's own behalf are to be carried out before the customers have had reasonable time to react. Such a reasonable time to react can usually be assumed if, at the time of the written recommendation to the customer, the information has been made known to the interested public (so-called 'Bereichsöffentlichkeit') by publication of the information through an electronic information processing system that is recognised by the stock exchanges and commonly used by credit institutions, listed companies and insurance companies. There are exceptions to this rule in the following situations:

- there is obviously no substantial impact on the price or rate to be expected;
- the transactions are carried out as part of a 'market maker' activity;
- the transaction is made in order to execute a customer's order and where the investment firm neither acts as an adviser nor as a portfolio manager;
- the transaction is made in order to lay in a stock with a view to be able to accept orders after a publication and, thus, there is no influence on the price that is detrimental to the customer;
- the publication includes a reference to possible transactions on the firm's own behalf.

The provisons of the number 5.1 and 5.2 do not apply insofar as the investment firm has implemented sufficient organisational messures to ensure that such conflicts of interest are avoided.

APPENDIX VI: Extracts from the German Stock Exchange Act (BörsG)

§ 45 [Liability for incorrect prospectuses]
The purchaser of securities which have been admitted for exchange trading on the basis of a prospectus which contains incorrect or incomplete statements which are material to the evaluation of their value can demand from
1. those who have assumed responsibility for the prospectus as well as from
2. those who issued or caused the prospectus to be issued
jointly to take over the acquired securities at the purchase price - provided that this price does not exceed the initial issuing price - as well as the costs which are usually incurred by the transaction insofar as the purchase of the securities has been concluded within six months after the initial issuing of the securities.

APPENDIX VII: Glossary of German Legal Terms Used[681]

Adäquanztheorie	theory of adequancy
AGBG	Standard Contract Terms Act
Amtsgericht	lowest local civil court
anlegergerecht	suitable for the investor/customer
anlagegerecht	adjusted to the nature of the subject matter of the investment
Äquivalenztheorie	theory of equivalance
Auftrag	contract of mandate
aus wichtigem Grund	for a good cause
Auslandsinvestitions-gesetz	Foreign Investments Act
BAKred	Federal Office for the Supervision of Financial Institutions
Bankvertrag	(general) banking contract
BAWe	Federal Office for the Supervision of Securities Trading
Beleihungswert	forced sale value
Beratungsvertrag	contract for the supply of advice
BGB	German Civil Code
BGBl	Federal Law Gazette
BörsG	Stock Exchange Act
Bundesgerichtshof	Federal Court of Justice (in Civil and Criminal Matters)
Bundesverfassungsgericht	Federal Constitutional Court
Bürgschaftsvertrag	contract of guaranty
Culpa in contrahendo	pre-contractual liability
Darlehensvertrag	loan agreement
Einzelkaufmann	sole trader
entgangener Gewinn	lost profit
entgeltlich	for remuneration
Finanzmarktförderungs-gesetz	Act for the Furtherance of the Financial Markets
Gefährdungstatbestand	set of facts giving rise to potential dangers
Geschäftsbesorgungsvertrag	agency agreement
Geschäftsgrundlage	basis of the transaction
Grundgesetz	Basic Law
HGB	German Commercial Code
Hypothekenbank	mortgage bank
Hypothekenbankgesetz	Mortgage Banks Act

[681] Most translations have been taken from Markesinis/Lorenz/Dannemann, The German Law of Obligations (Oxford 1997), Volume I, at pp. 913.

Kapitalgesellschaftenan-lagegesetz	Capital Investment Management Companies Act
konkludente Annahme	tacit acceptance
Kreditwesengesetz	Banking Act
Kundenbeschwerdestelle	customer complaints department
Landgericht	Regional court
Lehre vom Normzweck	scope of the rule theory
Nebenpflicht	collateral obligation
negatives Interesse	reliance damage/interest
Oberlandesgericht	Higher Regional Court of Appeal
Ombudsmann	ombudsman
Pfandbrief	mortgage bond
Pflichtverletzung	breach of obligation
positive Vertragsverletzung	positive breach of contract
positives Interesse	expectation interest
Privatautonomie	freedom of contract
Produkthaftungsgesetz	Product Liability Act
Rechtsinstitut	legal institution
Rechtsmißbrauch	abuse of the law
Richtlinie	directive
Schlechterfüllung	faulty performance/positive breach of contract
Schriftform	written form
Schutzgesetz	protective statute
sittenwidrig	contra bonos mores
Sparkasse	savings bank
Strassenverkehrsgesetz	Road Traffic Act
Treu und Glauben	good faith
Umwelthaftungsgesetz	Environment Liability Act
unzulässige Rechtsausübung	abuse of the law
Verbraucher-Zentrale	consumer organisation
Verjährung	prescription
Vermögensverwaltung-	portfolio management
Vertrag	contract
Vertragshaftung	contractual liability
Vertrauenshaftung	reliance liability
Vertrauensinteresse	reliance interest
Vertrauensschaden	reliance loss
Wegfall der Geschäftsgrundlage	collapse of the foundation of the transaction
Wertpapierdienstleistung	securities service
Wertpapierdienstleistungs-unternehmen	investment firm

Wertpapier-Verkaufs-prospektgesetz	Securities Sales Prospectus Act
WpHG	Securities Trading Act

APPENDIX VIII: List of interviews made and conferences/seminars attended in the course of my research

I. Interviews:

(a) Interview with Dr. Thorsten Pötzsch, Referat VII B 5, Bundesministerium der Finanzen (Federal Ministry of Finance of Germany), on 16th December 1996 in Bonn/Germany

(b) Interview with Bernadette Zawal-Pfeil, Leiterin der Kundenbeschwerdestelle beim Ombudsmann der privaten Banken, on 27th December 1996 in Köln/Germany

(c) Interview with Hartmut Strube, Abteilung I/Verbraucherrecht/Finanzdienst-leistungen, Verbraucher-Zentrale Nordrhein-Westfalen on 3rd January 1997 in Düsseldorf/Germany

(d) Interview with Jane Hingston and Ian Pattison, The Office of the Banking Ombudsman, on 4th February 1997 in London/England

(e) Interview with Mary Sullivan and Stuart Davidson, Specialist Money Advisers, Citizen Advice Bureau, London Money Advice Support Unit, on 23rd July 1997 in London/England

(f) Interview with G.N. Johnson and S.Lloyd, Lloyds TSB Group, Legal Department, on 2nd September 1997, in London/England

(g) Interview with Anthony Holland, Principle Ombudsman of the Personal Investment Authority (PIA) on 2 October 1997 in London/England

(h) Interview with Dr. Thorsten Pötzsch, Referat VII B 5, Bundesministerium der Finanzen - Außenstelle Berlin (Federal Ministry of Finance of Germany) on 6th January 1998 in Berlin/Germany

(i) Interview with Simon Donlevy, Private Banking Executive, Lloyds Private Banking on 11th March 1998 in Abingdon (Oxfordshire)/England

(j) Interview with Mr. Andrew Whittaker, Deputy Director to the Board, Financial Services Authority on 25th June 1998 in London/England

II. Conferences/Seminars

(a) WM-Bankrechtsseminar on 'Discount-Broking und §§ 31 WpHG ff.' on 22th May 1996 in Frankfurt am Main/Germany

(b) WM-Bankrechtsseminar on 'Informationspflichten und Haftungsfragen bei der Anlageberatung' on 19th September 1997 in Walldorf-Mörfelden/Germany

(c) Money Marketing, 2nd Annual Conference on 'Regulations under Review' on 15 October 1997 in London/England

(d) Money Advice Liaison Group, 9th Annual Conference on 'Codes of Practice - Who are they Working For?' on 25th November 1997 in London/England

III. Internships

(a) Deutsche Bank, International Commercial Banking, Frankfurt/Main in July/August 1996

(b) Mini-pupillage with Ali Malek, QC, 3 Verulam Buildings, Gray's Inn, London in January 1997

(c) Lloyds Bank Abingdon Business Centre, Abingdon (Oxfordshire) in February/March 1998

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