Feature

**KEY POINTS**

- The German Supreme Court's reasoning for not applying *Ille Papier v Deutsche Bank* in a recent case concerning a cross currency swap is questionable.
- It means that customers, once their risk profile has been established, and provided the "usual profit margin" (initial negative market value) for the bank counterparty is not too large, are on their own.
- The court has concluded that a "usual profit margin" is acceptable in swaps even, it would seem, when derived from secretly shifting the odds.

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# *Ille* revisited? The German Supreme Court's difficulties with its own jurisprudence

Derivatives – Warren Buffet's "Weapons of Mass Destruction" – continue to preoccupy European courts. In this article Professor Julian Roberts considers a recent Supreme Court decision which calls into question the approach launched in *Ille Papier v Deutsche Bank.*

## INTRODUCTION

In 2011, in the case of *Ille Papier v Deutsche Bank*, the German Supreme Court (Bundesgerichtshof – BGH) handed down a judgment which seemed to initiate a new approach to settling disputes over financial derivatives.[1] The court said that the interest rate swap at issue was, in law, a bet, and in view of the "particular circumstances" arising from that, the bank should have obtained the customer's consent before shifting the odds of the bet for its own benefit.

This decision threatened to destroy the business model for selling derivatives to retail customers, and was not welcomed by the banks. After a long period in which they staved off further BGH decisions by settling any dispute that got that far, a case presented itself which appeared to give scope for persuading the Supreme Court to modify its view. The decision in this case has recently been handed down and it does indeed call into question the approach launched in the earlier *Ille* case.

## FACTS OF THE CCS CASE

The recent case concerned a "Cross Currency Swap" involving Turkish Lira against the Swiss Frank. The parties were a 48-year-old businessman from Nuremberg and his local savings bank (Sparkasse). The case proceeded on the footing that the claimant had gained "not inconsiderable" experience of "similar capital investments" in partnership with his accountant, and had concluded at least one previous "corresponding deal" on his own responsibility.[2] He was held to have initiated the contested deal himself.

Sparkasse procured the swap from Landesbank Baden-Württemberg (LBBW), which was the contractual counterparty. It involved notionals of CHF 795,000 and TRY 900,735. These were to be exchanged after three years, with the bank paying Turkish Lira and the customer paying Swiss Franks. There was also a provision for "interest" on these notionals, to be paid quarterly during the currency of the swap.

The attraction of the swap for the customer lay in the fact that the "interest" payments received by him, at 15.66 per cent p.a. (on the TRY notional), were significantly higher than his own payments, at 3.6 per cent p.a. on the CHF.

The risk, of course, lay in the exchange rate, and indeed the TRY/CHF rate was already plummeting at the date of inception and continued on the same path thereafter. This unhappy deal was eventually closed out by Sparkasse three weeks prior to maturity, at a price of €289,000; the customer's net loss on the whole deal was €180,000.

In the lower courts, the customer argued that he was not adequately informed about the risks of the deal and – invoking the *Ille* decision – that the bank did not tell him about the negative market value priced in at inception.

## VIEW OF THE COURTS

The courts (there were hearings at three levels in all) responded by saying that the CCS was a relatively straightforward product. It would not have been necessary for the customer to know about the initial negative value, since that only represented a "usual profit margin". The claimant was an unreliable witness; in fact he had plenty of experience, and, taking that into account, the defendant bank had informed adequately about the risk.

The decision in *Ille*, said the lower courts, would only have been relevant if (as in that case) the bank had deliberately constructed a product which:

- had a market value such that it could be sold onwards immediately; and
- was complex in order to conceal this fact from the client.

These factors, if both present, would have introduced a conflict of interests and thus militated against the bank's advisory duties (which German Courts regularly imply into these situations). But because the CCS purchaser was only being exposed to a "usual profit margin", and the risk was evident anyway, *Ille* could not assist him; the bank had advised adequately.

The problem with this is that, in *Ille*, the Supreme Court explicitly emphasised that the level of a swap's initial market value, and whether or not it exceeded a "usual profit margin", was irrelevant – a customer did not have to anticipate charges procured by shifting the odds, and if any were present, they had to be agreed.

Perhaps because of this, the Supreme Court took a different tack from the courts below. Although its own previous decision in *Ille* still stood, said the court, it did not apply in the instant case, because, given that the defendant savings bank was not the counterparty under the CCS, the prejudicial "conflict of interest" could never arise.

That said, however, the Supreme Court still confirmed the view of the courts below that the instrument was neither complex nor burdened with an excessive "negative market value", and would therefore not have engaged *Ille* in any event.

## DISCUSSION

There are various issues with this.

### No "conflict of interest"?

In the first place, the point as to whether the swap counterparty LBBW was, or was not, identical with the position of the advising bank, Sparkasse, was not taken in the lower courts. Without knowing the precise contractual relations between the defendant Sparkasse and LBBW it is hard to know whether the Supreme Court was correct in assuming that the former really was neutral with regard to the swap's value. Certainly it seems odd that, if Sparkasse was without any interest in the product, it was (according to the court judgments) nonetheless able and motivated to close it out and enforce the securities.

That apart, it is unclear why a conscientious adviser in the position of Sparkasse should be free of the duty to advise on unusual risks just because it is not directly the counterparty.

### "Usual profit margin"?

Second, the courts at all levels made much of the fact that – supposedly – the initial negative market value was no higher than a "usual profit margin".

The evidential basis for this is rather obscure. The claimant's application for a court expert to calculate the value was rejected, and the courts seem to have accepted the defendant bank's submission that it was charging no more than its "usual margin", simply because the claimant himself produced no evidence to the contrary. (Valuing deals like this can, of course, be expensive.)

This is disappointing because it leaves open what an acceptable "profit margin" might be. There appears to be a suggestion in the Supreme Court judgment that any margin is okay provided "the profit is not significantly eroded and the chances of winning are not significantly diminished" (para 38). This, of course, is a "how long is a piece of string?" position.

The lack of evidence as to the precise size of the "margin" is unsatisfactory in any event. A database enquiry suggests that the margin could, in fact, have been as high as 4.4 per cent, ie, in cash terms, CHF31,800. That initial "hit" is a not insignificant part of the eventual net loss, and puts quite a different perspective on the otherwise sensational 15 per cent enjoyed by the customer during the currency of the swap (ie, up to the point of the terminal exchange).

(It also rather calls into question what the defendant appears to have been saying about its costs. Certainly – given an appropriate database for calculating the price – the work involved in "structuring" this instrument would have been minimal.)

### No complexity?

The lower courts, backed up by the Supreme Court, all took the view that the Cross Currency Swap was not, in comparison with the interest rate swap in *Ille*, particularly complex. All it involved was the exchange of the notional sums at maturity, combined with quarterly "interest" payments leading up to that point – all of which were fixed in the contract. The *Ille* deal, by contrast, had involved rows of formulae and a changing basis of calculation in each one.

This, however, arguably misses the point.

It was not disputed that, owing to the "interest" payments, the customer would have been unable to value the CCS at inception by himself. Any instrument which does not have a readily available market price is, at least in terms of European legislation, "complex" (MiFID implementing directive 2006/73, Art 38), and there seems no good reason not to apply the same criterion to the instant case.

In any event, the "complexity" involved in assessing future risks does not lie primarily in whatever formula a particular financial instrument may use, but in the underlying market phenomena themselves. Despite the burgeoning arithmetic, the *Ille* swap was really only a bet on the relationship between two indices – namely two-year and ten-year swap rates. The same thing applies to the disputed CCS: it was concerned with the relationship between two currencies (or indeed three, given that the customer's domestic currency was the euro). The point is that these phenomena are complex in themselves, regardless of the payout formulae. The difficulty faced by weather forecasters is not in knowing what will happen if it rains, but the likelihood that it will rain at all.

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## ADVISING OR WAGERING?

The CCS judgment cites *Ille* at length (compare para 31) and does not purport to derogate from what was said there. The issue, however, is that in its new judgment the Supreme Court gives no indication that it sympathises with – or even recognises – the analytical basis of the earlier judgment. (Unresolved and unacknowledged disharmonies of this kind are more likely to occur within the German system, given that there is only ever one judgment, written by the "reporting" judge. The reporter in *Ille* was no longer the reporter in the recent case.)

*Biog box*

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As we noted, the "particular circumstances" governing the decision in *Ille* were the fact that the bank and its customer were effectively entering into a wagering relationship with one another. The bank's shifting of the wagering odds in order to generate a "margin" was unacceptable, at least without the consent of the customer.

Even in *Ille*, however, this relatively straightforward analysis was overlaid by additional elements drawn from the Supreme Court's previous jurisprudence – namely, the implication of an *advisory* relationship into all banking encounters (except those where it was clearly ruled out). The problem with the wagering relationship, from this point of view, was that it created a "conflict of interest" which disturbed the advisory relationship.

This approach, however, left open the question of which was the primary root of the bank's duties. Does it lie in the structure of wagering contracts, or in the structure of advisory contracts? Arguing for the latter, defendant banks have pointed out that *all* commercial relationships involve a "conflict of interest" – why should that introduced by swaps be any different? The introduction of "wagering" into the analysis – at least in this view – does not alter or enhance that duty.

This is a position which *Ille* – at least implicitly – rejected. In being a wager, the swap in *Ille* was a different kind of contract from normal financial instruments. That was the "particular circumstance" from which the enhanced duties of advice flowed. Bettors don't engage in secret shifting of the odds, because to do so is incompatible with the duties under a *bet*, irrespective of any advisory duties which may or may not exist at the same time.

It seems clear from later *obiter* comments, and utterances of persons in the *cabinet* of the Supreme Court's banking senate, that the court – initially, at least – situated itself on the "wagering" side.[3] The latest CCS decision, however, puts that into question. The criteria for assessing fault in connection with derivative train wrecks – at least as far as that decision is concerned – revert to being the same as for any other financial instrument. That means, at least in terms of the Supreme Court's traditional jurisprudence, that customers, once their risk proclivities have been established, and provided the "usual profit margin" is not too outrageous, are on their own. *Caveat emptor!* (Or should it be *vae victis?*)

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## CONCLUSION

The CCS decision sits uneasily with previous jurisprudence. If the Supreme Court has now come to the conclusion that a "usual profit margin" is acceptable in swaps even when derived from secretly shifting the odds, then it should say so, and give reasons.

Beyond that, however, the recent decision appears uninformed. The basis for the modern derivatives trade is given by two parameters, namely market value and risk. Professional market participants invariably quantify both. Without that quantification, there would be no trade in derivatives. The quantification can be difficult and expensive, but the actual results are easy to understand. Risk is what, in a conventional bet, amounts to the stake – what I might lose if things go against me. And market value is the price I am paying – if any – for the chance of entering the wager.

As far as the latter goes, normally, only licensed casinos are allowed to charge a price for wagering. If anyone else does it, it would count as cheating. And even a casino, in shifting the odds on a game, does not do so secretly. It is very strange that anyone should believe this to be a legitimate business model for selling derivatives.

As it happens, there is probably a perfectly legitimate argument on behalf of Sparkasse in the CCS case. The simple fact is that the cross currency swap, despite being called a swap, is not a wager. The swap in the *Ille* case was a contract for differences, with no delivery of the underlying. That makes it a wager. The swap in the CCS case, by contrast, provides for physical exchange of the currencies. In that respect, it is a simple forward agreement, not a contract for differences. Contrary to what the courts appear to have assumed, and in contrast to the *Ille* swap, the cross currency swap did not bear unlimited risk. And the basic dimensions of its (limited) risk should have been apparent from the corresponding forward rates – which the customer should have asked for, even if he was unable to access them directly himself, and even if working out the "interest" element would have been more difficult.

In the event, the decision in the CCS case may be correct. The Supreme Court's reasoning, however, is disappointing. Fortunately, most of it probably counts as *obiter*. ■

1 BGH v 22.03.2011, Ille, XI ZR 33/10 Juris (11. Zivilsenat 2011).

2 OLG Nürnberg v 19.08.2013, 4 U 2138/12 Juris Para 15.

3 Schmieder, Anmerkung zu OLG Frankfurt 16 U 96/10.

*Further Reading:*

- Swaps, betting and the law [2014] 9 JIBFL 563.
- Should losses on payer swaps be recoverable? [2012] 11 JIBFL 680.
- LexisNexis Loan Ranger blog: Fraud, bribery, misrepresentation and corruption – derivatives contract set aside.