

May 23, 2008

Private Banks Must Beware Risk of Lawsuits Over Client Losses



Tom Burroughes
Deputy Editor in London

Private wealth managers must be vigilant for a raft of lawsuits from irate clients who have lost money amid the current market turmoil.

That is the stark warning from consultants and analysts who track and work in the wealth management industry. They say private banks and other institutions serving high net worth individuals and their families have barely begun to grasp the potential scale of lawsuits and complaints that could arise.

"It is a huge latent risk that they [private banks] have probably not fully appreciated," **Ray Soudah**, founder of consultancy **Millenium Associates**, told *WealthBriefing*. "They are happening in several places. The instance of lawsuits is underestimated by the market," he said.

Chris Ryan, a law professor at City University in London, agrees: "It would appear that people are losing money, left, right and centre and that leads people to think how they can recoup it. And that means legal proceedings. The impression I have got is that it is not high on the agenda (of private banks) unless something goes wrong. Maybe it needs to get a higher profile," he said.

Underestimating the risks of legal action would be a grievous mistake. At the start of this decade, when equity markets crashed, the London financial community was treated, for example, to the high-profile spectacle of Merrill Lynch Investment Managers, as it was then known, being sued by the pension fund of Anglo-Dutch conglomerate Unilever over alleged negligence due to disappointing investment returns.

It is possible that cases, even if they are not as well-documented as the Merrill-Unilever one, could hit wealth managers. For example, Citi, the US bank, is coming under pressure to bail out investors in one of its troubled hedge funds. Citi has reportedly started to ask private clients to accept a \$250 million compensation package in return for dropping legal claims against the bank. The problems stem from Citi's Falcon Strategies hedge fund, an investment vehicle that traded mortgages and other credit instruments. Thousands of Citi clients face heavy losses, media reports say. Other parties affected by this case include Wachovia, the US bank.

Meanwhile, according to Butterworths, the UK legal publisher, recent cases include that of Riyad Bank and other parties, which sued Ahli United Bank (UK) Ltd. The case, which appeared before the UK Court of Appeal in 2006, centred on the issue of whether Ahli United Bank had a duty of care, as defined under tort law, towards an investment fund that had been set up by Riyad Bank, Butterworths told *WealthBriefing*. The court ruled there was a duty of care.

There have been rumblings of concern that lawsuits will pick up because of the credit crunch. Last year, as the market turmoil began, Stephanie Jarrett, a partner at Baker & McKenzie, told the news service *Reuters* that an increasing amount of litigation for poor investment performance was likely and that bankers needed to be trained in how to deal with angry clients.

A number of consultants who look at the sector say that unless markets improve, lawsuits will increase as investors try to plug some of their losses. Markets have certainly been lacklustre overall: the Morgan Stanley Capital International World Index of developed countries' index shows a loss of 0.73 per cent since the start of the year. In some individual cases, portfolios based on specific markets would have been hit much harder: the MSCI Hong Kong index, coming after a year of strong performance for the Asian jurisdiction, is sunk deeply in the red, with a loss of -11.21 per cent, for example.

So some clients, particularly if they feel confident of proving negligence or a clear breach of contractual terms with their private banks, may reach for their lawyers, although high legal fees and the risk of losing could deter some from going ahead. A problem in measuring the scale of any volume of these suits, however, is that many cases do not make headlines because they get settled before reaching a court.

Another problem in finding out about the scale of such cases, analysts say, is that banks and complainants are shy of divulging that they are involved in disputes as rows about loss of assets typically are bad for a bank's image and embarrassing to a client. Publishers of legal cases typically only do so if a case leads to a significant and important ruling so many disputes simply fall under the radar.

Another reason why disclosure of cases is typically low is a fear of copy-cat lawsuits. "The banks are certainly not rushing to disclose them (lawsuits) because it may only encourage yet more lawsuits," Mr Soudah said. "There have been some lawsuits but usually, you won't hear about them as they take a long time to come through."

Even so, the scale of any lawsuits could be large, he said. To give some measure of how big legal actions may be, Mr Soudah said more money has been lost by institutional and professional investors than banks have written off - \$200 billion so far. "This is not widely documented," he said.

As if wealth managers did not have enough to worry about, the risk of lawsuits will prove an unwelcome distraction for private banks looking at how to protect clients' wealth.

The risk of being sued hinges on a number of factors, which cannot be easily mapped in advance. Much depends on the type of contract a client has with a wealth manager as well as whether the defendant in a case is a trust or some other entity.

Trustees are generally more vulnerable to lawsuits than bankers in general, particularly under Anglo-Saxon law. They are typically placed under tougher conditions of responsibility towards beneficiaries than is the case of bankers and their clients, so a trust can be potentially more vulnerable to a suit, argues **Philip Marcovici**, a partner of Baker & McKenzie based in Zurich.

"For my understanding, the risk (of being sued) is much higher to the extent that assets are held in trusts. Trustees are held to a high standard of care," he told *WealthBriefing*.

Millenium Associates' Mr Soudah explained how the risk of lawsuits can vary: "There are agreements that give banks all sorts of investment authorities...it (risk of being sued) depends on whether banks deviated from their mandate(s). In cases where they might not have exercised due care and attention or their fiduciary responsibilities, they may be at some legal risk but such (cases) will be difficult and onerous to prove."

Analysts point out that there are a number of mechanisms that private banks can use to protect themselves, such as indemnity insurance and legal agreements, known as waiver clauses, in which a client agrees in advance not to sue in the event of a loss. However, if there is a loss, clients will scrutinise every line of these agreements to see if any facts relating to such a clause are incorrect, which could render such waiver terms invalid.

The risk of lawsuits should not be exaggerated, however. If markets do stage a significant recovery in the next few months and restore clients' assets, then some of the anger at any poor performance may fade away. But private banks cannot afford to be complacent about the risk they may face, particularly as the rest of the world is adopting the US litigation habit.