NewsLetter LL

Information by the Law Offices of Lutz Rechtsanwälte

Deposit Guarantee in Switzerland in Bankruptcies of Banks

How safe are our bank deposits? As it is nearly every day that we are given bad news about banks collapsing, it seems justified to question whether one's assets – to which banks that are still considered safe have access - are, indeed, still safe.

Thomas Reimann

The Current Legal Situation

Based on the report and proposals of the Expert Commission Schaerer, dating back to the year 2000, and based on the respective proposals of the Federal Council and the decisions of Parliament, the new provisions of the Bank Act (BankG) concerning the deposit guarantee were put into force and effect on 1 July 2004. In addition, on 1 August 2005 the new Ordinance on Bankruptcies of Banks (BKV) of the Federal Banking Commission (FBC) came into force and includes provisions concerning the deposit guarantee and complements the Federal Act on Debt Enforcement and Bankruptcy (SchKG). Contrary to practices of other countries (keyword: state guarantee) the Swiss deposit guarantee regarding banks is based on the following principles:

- Firstly, according to art 37b of the Bank Act (BankG) the law provides for a so-called **bankruptcy privilege**; the preferential payment of account deposits with the insolvent bank is guaranteed to a maximum amount of CHF 30,000 per customer and creditor, respectively; and
- **Small deposits** of a maximum amount of CHF 5,000 will be paid out directly out of the bankrupt estate; and

- Based on art 37h BankG a **self-regulation** system for institutes subject to the BankG shall effectively ensure that the liquidity required to repay the privileged deposits is actually available and ready for the repayment to creditors as soon as reasonably possible (no later than three (3) months after the collapse of the bank and waving any set-off against counterclaims).

However, the deposit guarantee provided on the basis of the self-regulation system in terms of art 37h BankG for the benefit of bank customers is not without limitation and is subject to the following restrictions:

- The banks and stock brokers with privileged deposits to whom the BankG applies are only obligated to jointly hold an additional liquidity of CHF 2 billion, the amount of which is apportioned to the claims reported as privileged. Moreover, according to art 37h para 3 lit b

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BankG the maximum limit of the deposit guarantee system is set at an aggregate amount of CHF 4 billion (initial amount was CHF 1 billion).

What really happens in an emergency?
If a bank or stock broker domiciled in Switzerland becomes bankrupt all claims of an account holder against the insolvent institution generally fall within the 3rd class of claims as specified by the Federal Act on Debt Enforcement and Bankruptcy (SchKG) and will be satisfied only subsequent to the prior-ranking classes. The bankruptcy as such is administered by the supervisory authority of banks pursuant to the bankruptcy proceedings for banks and not according to SchKG. With regards to the deposit guarantee the BankG provides for the following privileges for bank customers:

1. Small Deposits
Insofar as they are contactable, depositors in terms of art 37b BankG with an aggregate matured claim of CHF 5,000 or less shall be satisfied as quickly as possible separately from the schedule of claims and excluding any possibility of set-off.

2. Privileged Deposits
According to art 37b BankG deposits which are not in bearer form, including medium-term notes ("Kassenobligationen") which are deposited with the insolvent institution in the name of the depositor, shall be allocated, up to an amount not exceeding CHF 30,000 per creditor to the 2nd class pursuant to art 219 para 4 SchKG. Privileged deposits in terms of art 37b BankG especially include savings accounts, medium-term notes, fixed deposits, call money as well as provident accounts of the 3A pillar. For this type of deposits and claims the privilege only applies to the maximum amount of CHF 30,000 in the bankruptcy of the bank, and thus only once per creditor or bank customer. All of the deposits or claims of the respective customer against the insolvent bank will be added, and the privilege of a maximum of CHF 30,000 may only be claimed once, even if the customer holds several different accounts with the insolvent bank.

3. Valuables in Custody Accounts
Generally there is no risk involved for a customer with securities deposits: those assets do not form part of the bank's bankrupt estate but will be segregated from the estate as set out in art 37d BankG (subject to the claims of the bank against the depositor). Assets of this kind, such as bonds, shares, collective investment scheme units or exchange trade funds (FTS) belong to the deposit holder and will be surrendered to him in the event of the insolvency of the bank. Although securities held in such custody accounts may sharply decrease in value, they are not directly affected by the bankruptcy of the bank with which the securities are deposited. However, problems might arise where fiduciary deposits are made with third-party banks: In the event that the third-party bank faces insolvency, it is the creditor who generally bears the risk.

4. Own Products of the Insolvent Bank
In respect of products offered by the insolvent bank itself the situation is different: shares, bonds and structured products issued by the insolvent bank in its own capacity could become worthless if the institution goes bankrupt. In contrast, collective investment schemes of the bank are protected as special property and do not form part of the bankrupt estate but are separated.

Is the Deposit Guarantee in Switzerland Adequate?
The privileged amount of up to CHF 30,000 per customer described by law and currently ensured by the deposit guarantee, however, is limited to the maximum aggregate amount of CHF 4 billion: this actually provides protection for 134,000 customers of an insolvent bank to the amount of CHF 30,000 each. This cover may be considered sufficient where smaller and medium-sized institutions are involved, whereas if several and, even simultaneous bankruptcies of banks occur and/or in the event of the bankruptcy of a large institution in Switzerland this deposit guarantee will no longer suffice. Accordingly, it is understandable that in view of the current financial crisis the demand for state guarantees within Switzerland as well as abroad, is on the increase.

Solution with the Cantonal Banks and Raiffeisenbanks?
The Cantonal Banks as well as Raiffeisenbanks which are structured as cooperative societies are generally subject to the same principles concerning the deposit guarantee as set out above. In respect of the Cantonal Banks (Zürcher Kantonalbank amongst others) which are vested with a state guarantee, the protection of the bank customers is enhanced by the guarantee that rescues the respective Cantonal Bank from bankruptcy all together. With regards to the Raiffeisenbanks which are organized as

cooperatives, an additional reserve liability of the members of the cooperative, providing additional liability coverage besides the default guarantees, may help avoid possible losses for the bank customer. In light of this, it is more than understandable if especially the Cantonal Banks which are vested with a state guarantee as well as the Raiffeisenbanks are currently recording a considerable influx of new customers.

Conclusions and Consequences

In these troubled times there is no absolute security and banks are still appropriate depositors of assets, regardless of whether or not all banks deserve praise for being good administrators. The call for an additional state guarantee is understandable and an increase of the current maximum amount of CHF 30,000 per customer to CHF 50,000 or CHF 100,000, as currently under political discussion, is absolutely necessary. Whoever lacks trust in the swift implementation thereof may be advised to distribute his privileged deposits across multiple banks.

Open Questions in Connection with Remunerations Deriving from the Distribution of Investment Funds

The Swiss financial industry annually pays remunerations in billions to investment fund managers, distributors and management of investment schemes. Amongst others such remunerations are intended to stimulate the sale of investment scheme products. However, such remuneration schemes can provide false incentives which, in certain constellations, may be disadvantageous for the investors. How such remunerations should be handled is a topic which has lead to controversial disputes between lawyers as well as supervisory authorities.

Rolf Kuhn

In many countries, Switzerland included, investment funds' operations are a lucrative business. Various stakeholders, who are integrated in the actual value creation chain, share in the income generated by the investment scheme industry. Besides the producers of financial products and investment scheme managers, the brokers also form part of this circle. Brokers are remunerated by the producer or the institution responsible for the investment scheme for selling collective investment scheme units. In many instances these units are offered by the institution to its own customer base. These institutions are often banks and asset managers who have access to a wide customer network that might be interested in purchasing financial products.

In one of the recently published Green Papers of the Federal Banking Commission the Commission states that in April 2008 the Swiss fund market achieved a volume of CHF 525 billion. On average, this volume generates management fees of CHF 6.2 billion. A conservative estimate suggests that half of this sum is paid to distribution partners as remuneration for their sales.

Often the amount and occurrence of such distribution remunerations are correlated to the turnover achieved by the sale of fund units, i.e. the more units a distributor is selling the higher his remuneration will be. Accordingly, a remuneration system of this type also acts as an incentive scheme. The system provides motivation for the distributor to sell as many units as possible. However, oftentimes there is also a contractual re-

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lationship between the distributor and his customers. Depending on how the contract with the customer is fashioned the distributor may also be obliged to protect the interests of the customer, prioritizing them above his own profit interests. An incentive scheme inherently leads to a conflict of interests. The distributor could tend to sell products to his customers which might not optimally meet a customer's needs, for instance, because the product exceeds the customer's level of risk acceptance.

In the aforementioned Green Paper the Federal Banking Commission dealt with the question of how such conflicts of interest should be addressed. On the one hand it appears necessary to make the remunerations paid transparent to the investors. The investor can then see for himself whether there might be a possible conflict of interest. In addition, the conflict of interest can, of course, be countered by organizational measures, e.g. the customer consultant and investment advisor is not told for which fund his employer, the bank, receives a sales remuneration. In essence, this ensures neutral advice. The organization of the internal wage plan also plays an important role in this context. A bonus system that is linked to the sale of a certain products can result in undesirable consequences. In this regard, too, a balanced control can reduce the potential negative consequences of an incentive scheme.

Apart from organizational measures the Swiss Code of Obligations provides for a principle which is supposed to serve as an adjustment factor for conflicts of interest of that kind. Art. 400 para 1 CO provides that the agent has to return everything that he received in connection with the execution of the mandate. The provision proposes that in the end the agent does not have an incentive to surrender to any other interests than to those of his principal. If the agent knows everything he received from a third party must eventually be returned, he has no interest in generating such third-party benefits.

In legal doctrine the effect this provision has on the remunerations in connection with the fund distributions has been heavily debated for a fairly long time: the opinions as to whether or not such sales remunerations should be surrendered to the investor differ widely. On the one hand it has been held that the sales remunerations were a compensation for expenses the bank incurred in connection with the distribution of units. Hence, the customers were not entitled to them. Others were of the opinion that the remunerations linked to the sales were indeed acquired in connection with the orders placed by a customer and that those remunerations were subject to the obligation of returning income in terms of the abovementioned provision and therefore ultimately had to be surrendered to the investor.

It is not clear which of the views is the correct one. The Federal Court has yet to decide this matter. The Federal Banking Commission has not subscribed to any view in its Green Paper but has merely pointed out that they do not wish to anticipate a decision which would be within the powers of the Federal Court. It is of interest to monitor the continuation of the discussion. If the return were approved it would constitute a sensitive interference with the current value creation chain. The model as practiced today would be selectively infiltrated by certain participants, i.e. the distributor would suddenly be coerced to allow a drain-off of considerable assets out of the self-contained value creation chain. It is therefore unlikely that a court will allow such an intervention and it is probable that an obligation to surrender possession would be denied. On the other hand, the discussion concerning remunerations in the financial industry, especially in connection with the international financial crisis has flared up again. Further, incorrect incentive systems and a lack of control mechanisms are considered to be one of the sources for this crisis. The demand for state regulation is noticeably increasing – whether legitimate or not. Therefore it may well be possible that in the course of the current discussions the model currently in practice will become subject to fundamental change. Further, against this backdrop it must be assumed that the investment fund industry, too, is facing fundamental changes. ■

Effective Instruments against Unfair Business Practices

In the context of the planned amendment of the Act on Protection against Unfair Competition (UWG) it is intended that specific flaws in the current law will be eliminated. Notably, the "directory swindles", unfair snowball systems and improper general business terms and conditions shall be combated.

Roger Meier

The explanatory report on the amendment of the UWG identifies flaws in the applicable law on three different levels: laws governing certain business practices, those in law enforcement and those regarding the price transparency of services. In the area of unfair business practices which will have to be renewed, "directory swindles", unfair snowball systems and improper general business terms and conditions (GTCs) are the primary issues:

Directory Swindle

Of prevalence is the abuse of covert conditions of offers for registrations of any kind which are of little or no use. The victims are mostly SMEs, freelancers or administrative bodies. Generally known are the offers that are disguised as invoices and are intended to make the addressee believe that a contract was already concluded. However, in reality the contract is only concluded, sometimes for the duration of several years, upon payment of that invoice. Popular targets of such schemes are new trademark or company owners who are contacted shortly after publication of the new trademark or company and who sometimes believe that by settling the invoice, they had paid the official charges in connection with that publication.

The amendment would provide that in case of an offer for a new entry into a directory or company register it would have to be pointed out that the offer involves costs, and reference would have to be made to the duration of the contract, the total price thereof as well as the distribution and form of the publication. Furthermore, this information would have to be printed in marked letters in an easily identifiable place and in comprehensible language. The posting of invoices for a registration would be prohibited if no prior order had been made. The provision particularly relies on the principles developed by the Federal Court in connection with "offer-invoices" [Offertrechnungen] (BGE 129 IV 49 (E. 2.5), sic! 4/2003, 354 ff. 13) and was met with wide acceptance during the legislative consultation process.

Unfair Snowball Systems

The need for regulation of snowball systems has been widely acknowledged. Characteristically, snowball systems involve an investment of money or they seek a snowballing spread, such as the European Kings Club (EKC) which once made headlines. It is a mathematical truism that snowball systems (must) fail because of the finite number of participants. The current applicability of the Lottery Act to such snowball systems can only be explained historically, and it makes sense rather to include it in the UWG. The new Bill attempts to clarify how to discern between the frowned upon snowball systems and the permissible multi-level-marketing systems, and in art 3b it provides a list of (new) criteria. If any two of the criteria are met, it suggests that a prohibited snowball system is present. Since the UWG provisions are also sanctions, apprehension obviously arises that the control mechanism of professio iuris (presumption of law) will lead to a breach of the criminal law principle of legality [Legalitätsprinzip], and thus, sooner or later the Federal Court will temper the new art 3b UWG. The draft art 3b was met with general acceptance in the consultation process. However, many participants in the consultation process desired a more precise formulation, in particular with regard to the differentiation of unlawful snowball systems and permissible multi-level-marketing systems.

Abuse of GTCs

Art 8 of the present Bill provides that a person acts unfairly if he uses standard general terms and conditions which, in a manner that is inconsistent with good faith, considerably deviate from the directly or analogously applicable legal order or which allocate rights and obliga-

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tions in a manner that is contrary to the nature of the contract. Despite the wide consensus that the current formulation of the provision is unconvincing, the new reference to “good faith” is at least as much in need of interpretation as the current term “in a misleading manner”, but firstly clarification is needed as to the extent to which the practice regarding the old provision will also apply to the new one. Moreover, controversy exists concerning the introduction of an abstract judicial review. If one were to implement an abstract judicial review as suggested by the Federal Council, it would imply that a court could prospectively declare a contract or the GTCs it is based on as unfair even if the agreement corresponds to the free and congruent will of the parties but considerably deviates from dispositive law.

Conclusion

Whilst the new provision on “directory swindles” will clamp down on a vexatious business method, the revision of the snowball systems and the GTCs in the UWG are not yet fully persuasive. Already from a methodical point of view the shortcomings are serious; a penal provision that operates with a presumption of law is a constitutional violation, and the GTCs should fall under the Code of Obligations. In addition, the amendment regarding the content of the general terms and conditions received harsh criticism in the consultation process. Therefore, it is hoped that Parliament will know how to rectify the identified flaws. ■

Humor

At the height of a political corruption trial, the prosecuting attorney attacked a witness.

“Isn’t it true,” he bellowed, “that you accepted five thousand dollars to compromise this case?”

The witness stared out the window, as though he had not heard the question.

The prosecutor again blared, “Isn’t it true that you accepted five thousand dollars to compromise this case?”

The witness still did not respond.

Finally, the judge leaned over and said, “Sir, please answer the question.”

“Oh,” the startled witness said, “I thought he was talking to you.”

On a Personal Note

We have the pleasure to announce that Attorney lic.iur. **Christopher Tillman** LL.M., **Certified Specialist SBA Construction and Real Estate Law**, is appointed to teach for private and public constructing and real estate law in the Real Estate Development (Project Development) course as well as in the Real Estate Trustee course of the Swiss Real Estate Association (SVIT). Mr. Tillman is a member of the Chamber of Independent Consultants for Builders and Real Estate Property Owners (KUB) of SVIT. ■

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