4. The Investment Services Contract case

A had obtained partly as a present and partly as an inheritance several pieces of real estate and housing corporation shares entitling to the possession of three apartments. A concluded in May 1988 with a bank an oral agreement on asset management. The agreement contained the purchase of a share portfolio with a credit granted to the client by the bank. The loan arrangement was taken up on the bank's initiative and was strongly recommended by it to A. X Ltd., a company founded by A for another purpose was connected with this arrangement at the suggestion of the bank. A indicated to the bank his solid purpose and keen interest in keeping his inheritance undiminished and thus in the best possible asset management.

The loan granted by the bank for the said purpose amounted to 10 million FIM. The loan was according to the agreement to be invested in listed shares. The loan amount was deposited on a blocked account available only to the trustee and securities department of the bank. The bank took as a security for the loan the share portfolio that was object of the agreement, appraised at 70 per cent of the loan amount, the housing corporation shares inherited by A and four bearer papers of FIM 250.000 each mortgaged on the pieces of real estate obtained by A.

Later X Ltd bought in 1988 two of the apartments inherited by A at 2,9 million FIM which were taken from the loan assets deposited on the blocked account. After that the bank demanded as additional securities the housing company shares entitling A to the possession of his home as well as six bearer papers of FIM 250.000 mortgaged each on A's mentioned pieces of real estate.

X Ltd bought shares of housing corporations and real estate companies which were pledged in August 1989 to the bank as a security for an additional credit of 3,5 million FIM granted by it to the company the same day. Also A's personal guarantee up to FIM 600.000 was given as a security for the same credit.

The system functioned for about one year. Then came the deepening depression of the early 90's, and active investment functions were given up. As investment income rapidly decreased and became insufficient for the management of the credits, the bank terminated all A's loans and realized in the beginning of the 90's the share portfolio in order to get payment for the overdue interests and instalments. The prices thus obtained were remarkably below the purchase prices and the market and accounting values of the moment when the trade in the shares was given up.

A initiated legal proceedings against the bank and demanded primarily that it should be declared that the bank had taken without a written agreement a guarantee based responsibility for the economic result of the trade in shares that was carried on in the name of X Ltd and that in attending to the investment function the bank had by negligence caused the company damages specified in the action. Also A demanded that the company should be exempted from the responsibility for the credits granted to it by the bank and that the bank should set free the securities given for the credits.

In its decision the local court dismissed A's action and considered that there was no evidence in favor of a guarantee liability concerning the result of the investment activity and that it had not been proved that the bank would have mislead A or acted in a negligent manner in managing the share portfolio. The court of appeal confirmed the local court decision, with the additional argument that the plaintiff could not specify any individual acts of the defendant in attending to its contract duties that would have damaged A. The court of appeal also reasoned that the amount of the loss was not proved. The Supreme Court did not take the case under consideration; so the decision of the court of appeal gained legal force.

Please reconsider the case from the view of securities markets legislation, contract law and damages law. Take into account especially the regulations and guidelines of the Financial Supervision Authority pertaining to the securities markets. Those in force at the time of the commission given to the bank cannot be exactly traced, but consider e.g. those mentioned in the following, stemming from a little later years, or try to apply the current standards of the FSA to the case.

Among earlier standards of the FSA there is e.g. the Guideline (201.9) on agreements for safekeeping and administration of securities (including safe custody), book entry accounts and portfolio management, issued on 5 November 1996. In sect. 5.11 and 12 of the said guideline it is indicated, i.a., that an asset management agreement should contain no provision on guarantee responsibility of the asset manager, whose liability is limited to damages caused by negligence. However, the liabilities and duties of the parties should be defined exactly. The contract should indicate especially the profit expectations and risk level agreed upon by the parties.

The guideline of 1996 was formally not in force when the asset management agreement was made. Still the same principles, which are consistent with good practice of investment service firms, may be supposed to have prevailed already at that time. And a guideline (6.01) of the Financial Supervision Authority from 5 September 1983 concerning trustee operations of banks that was in force at the relevant time, contained a requirement that an agreement of the current type should be concluded in a literary form.

It may be added that by in the beginning of the 2000’s the debt burden of A to the bank approached 50 million FIM (due to unpaid interests) while the value of the share portfolio purchased to X Ltd at that time exceeded 270 million FIM (it contained plenty of Nokia.