Liability for Unsuitable Advice on Investment Funds (Austria)

By

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Introduction

The recent financial market crisis has destroyed the capital of many investors to an unforeseen extent. In many cases, small investors have lost their entire savings. It therefore did not come as a surprise that, with some delay, a wave of lawsuits by disappointed investors has broken upon Austrian courts. Thus, many recent decisions of the Austrian Supreme Court deal with the law relating to unsuitable investment advice. Some of these decisions provide helpful clarification on legal issues such as the adequate form and extent of compensation and the required standard of proof.

In the light of these decisions, this article describes the information requirements related to the distribution of shares in investment funds and outlines the requirements for and the extent of damage claims due to non-compliance with these requirements.

Information requirements related to the distribution of investment funds

Information requirements for investment companies

Prospectus requirement pursuant to the Investment Fund Act

In Austria, shares in an investment fund may—in accordance with EU law requirements—only be offered, if a simplified prospectus and a full prospectus were published one working day before the offer at the latest (s.6 para.1 of the Austrian Investment Fund Act (IFA)).[1] This prospectus requirement applies to public and non-public offers.[2]

Both the simplified prospectus, which is addressed to the typical small investor, and the full prospectus must include the information necessary for investors to make an informed assessment of the investment proposed to them, and in particular, of the risks attached thereto. To meet this requirement, the full prospectus has to include comprehensive and detailed information on the investment company, the investment fund and the depository bank, as specified in Annex A Sch.A, to the IFA. The simplified prospectus, on the other hand, only has to include, in summary form, the much less detailed information specified in Annex E Sch.E, to the IFA.

Pursuant to IFA s.21, both types of prospectus have to state in which kinds of assets the funds may invest. Under certain conditions, the IFA provides for additional specific information obligations (e.g. in case the fund invests in derivatives).

Pursuant to the IFA, the prospectus has to be updated continuously: Material changes of the legal and factual circumstances, which may influence the evaluation of the shares, have to be published immediately.[3]

The prospectus requirement set out in the IFA applies only to investment companies. Thus, the requirement does not apply to investors in funds who transfer their shares to other investors on the secondary market.[4]

Contractual information obligations

The legal relationship between the investment company and the investor is referred to as "investment agreement" (*Investmentvertrag*). In essence, this agreement qualifies as a mandate agreement pursuant to s.1003 of the Austrian Civil Code which obliges the investment company to carry out—for the account of the investors—the legal transactions and legal acts necessary for the administration of the fund. The investment company is not obliged to bring about a particular result, however it is, as follows from IFA s.3, obliged to apply the diligence of a prudent business manager.[5]

An obligation of the investment company to inform the investor of the fund and especially of the risks attached to it arises, according to civil law principles, from the pre-contractual relationship preceding the investment agreement. The prospectus requirement pursuant to the IFA (see above) specifies, albeit not exhaustively, these pre-contractual obligations. Thus, non-compliance with the prospectus requirement gives rise to damage claims *ex contractu*.[6]

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[1] An exception applies to "special funds" (s.6 para.7 IFA) for which—instead of a prospectus—individual advice and a comprehensive agreement is required. Shares in special funds may, pursuant to the fund provisions, not be held by more than 10 investors all of which have to be known to the investment company (s.1 para.2 InvFG).

[2] M. Oppitz, "Das Investmentgeschäft" in P. Apathy, G. Iro and H. Koziol (eds), *Österreichisches Bankvertragsrecht*, Vol.VI, 2nd edn (Vienna: Springer, 2007), p.310.

[3] Austrian Investment Fund Act (IFA) s.6 para.2.

[4] C. Pállfy, in H. Macher et al. (eds), *Investmentfondsgesetz Kommentar* (Vienna: Springer, 2008) s.6 margin No.11.

[5] M. Oppitz, "Das Investmentgeschäft" in P. Apathy, G. Iro and H. Koziol (eds), Österreichisches Bankvertragsrecht, Vol.VI, 2nd edn (Vienna: Springer, 2007), p.302.

[6] Pállfy, in H. Macher et al. (eds), *Investmentfondsgesetz Kommentar* (Vienna: Springer, 2008) s. 6 margin No.18.

Information obligations of investment agents

Information obligations arising from the investment agreement between the investment company and the investor

Investment agents undertake to distribute or broker investments for entities offering those investments.[7] The conclusion of investment agreements, too, is often initiated by investment agents (e.g. banks, insurance agents).

Investment agents may themselves be subject to the pre-contractual information obligations arising from the investment contract between the investment company and the investor (see above). According to Austrian case law that requires that the investment agent has a "distinct own commercial interest" in the conclusion of the investment agreement (such interest can follow from a commission promised by the investment company) or that "he has influenced the negotiations exploiting a particular position of trust he enjoyed with his counterpart".[8]

Irrespective of these requirements for a personal liability of the investment agent under an "agreement between others", actions of the investment agent which run contrary to the investment company's obligations under the investment agreement may give rise to damage claims against the latter since an investment agent will usually qualify as a "vicarious agent" of the investment company.[9]

Information obligations arising from a direct legal contractual relationship between the investment agent and the investor

According to the case law, an "information agreement" (*Auskunftsvertrag*) is tacitly concluded between the investment agent and a (potential) investor:

> "if the circumstances of the case—with respect to the public's perception and the requirements of trade—justify the conclusion that the investment agent on the one hand and the investor on the other hand want to make the provision of information a subject matter of contractual rights and obligations."

This can be assumed:

> "if it is obvious that the person seeking information considers making a particular investment decision and the investment agent or investment advisor intends to further the conclusion of the intended deal."[10]

An information agreement obliges the investment agent:

> "to provide correct and complete information about all factual circumstances which are of particular importance for the investment decision of the interested person".[11]

The extent of the information obligations "depends largely on the circumstances of each individual case, especially on the nature of the customer and on the character of the investment project".[12] Thus, under information agreements investment agents are usually obliged to inform customers about the risks attached to the investment.[13]

Information obligations pursuant to the Securities Supervision Act

Section 40 of the Austrian Securities Supervision Act (SSA) provides for comprehensive information obligations of banks and other legal entities, which render "investment services in the securities field":

> "A [provider of investment services in the securities field] has to provide his customers in a comprehensible way with adequate information. This information must enable the customers to understand the type of investment service, the risks attached to it and the particular type of financial product proposed so that the customers can take investment decisions on a sound basis."

Section 40 SSA goes on to clarify that these information obligations include, inter alia, information on the service provider and his services, on the proposed financial product, on costs and ancillary costs and on the proposed investment strategies.

The provisions of the SSA, which implement Directive 2004/39 on markets in financial instruments (MiFID),[14] are mainly of a regulatory nature. However, according to the majority of Austrian legal commentators, s.40 SSA and comparable provisions of the SSA are also relevant in civil law. Some argue that usually (unless agreed otherwise) they become part of the obligations of the investment agent under the information agreement with the investor (see above), provided such agreement is actually concluded (so called "effect theory" [*Auswirkungstheorie*]). Others take the view that the stated provisions qualify as "protective laws" (*Schutzgesetze*) which—next to their regulatory function—aim at directly protecting the assets of individuals. If s.40 SSA did indeed qualify as a protective law, its infringement by an investment agent would thus give rise to damage claims of the investor even if no

[7] OGH May 26, 2004, 3 Ob 13/04i.
[8] H. Koziol and R. Welser, *Grundriss des Bürgerlichen Rechts*, 13th edn (Vienna: Manz, 2007), Vol.II, p.19.
[9] Civil Code s.1313a.
[10] OGH November 24, 2010, 9 Ob 5/10s.
[11] OGH January 21, 1999, 8 Ob 259/98s; H. Koziol, "Das Emissionsgeschäft" in P. Apathy, G. Iro and H. Koziol (eds), *Österreichisches Bankvertragsrecht*, 2nd edn (Vienna: Springer, 2007), Vol.VI, p.62.
[12] OGH May 26, 2004, 3 Ob 13/04i.
[13] OGH November 24, 2010, 9 Ob 5/10s.
[14] Directive 2004/39 on markets in financial instruments [2004] OJ L145/1.

information agreement was concluded between them (damage claims ex delicto).[15] So far, the Austrian Supreme Court has not commented on the question of whether s.40 SSA qualifies as a protective law or not.

Damage claims due to an infringement of investment fund related information obligations

Conditions precedent to damage claims

Under Austrian law, a damage claim requires: (i) damage in a legal sense; (ii) causation; (iii) wrongfulness; and (iv) fault.

Damage

Pursuant to the Austrian Civil Code any legal disadvantage, thus any new situation which is legally less desirable than the previous one qualifies as a damage. Thus, a damage does not necessarily require an economic loss that is measurable by money. If a customer was interested in a secure investment, the acquisition of risky securities is, according to the caselaw, in itself a damage in a legal sense (so called "real damage").[16]

In practice, the occurrence of a real damage is relevant for the limitation of action: Damage claims become time-barred after three years following the day on which the real damage and its author became known to the claimant,[17] but no later than after 30 years following the occurrence of the real damage.[18] A securities-related real damage, for instance, would be regarded as known if the market value of an investment, which was advertised as secure, falls significantly and the investor learns about this slump through a portfolio statement.[19]

The "calculational damage", which determines the amount of the damage claim, is the difference between the current value of the investor's assets and the hypothetical value these assets would have if the investor had been informed properly (for the determination of the calculational damage see below).

Causation

A damage claim of an investor also requires that the infringement of information obligations by the investment company or the investment agent was causal for the acquisition of the undesired shares. If the customer had taken the same investment decision even with proper information, such a causal link would be missing.

Wrongfulness

As shown above, the wrongfulness of providing insufficient information on an investment fund can result from non-compliance with the prospectus requirement of the IFA, from an infringement of information obligations of the SSA or from an infringement of contractual or pre-contractual obligations.

Liability for a wrongful act can only arise with respect to damages the infringed obligation seeks to avoid ("illegality link" (*Rechtswidrigkeitszusammenhang*)). From this it follows that an investment company and an investment agent are not liable for a loss which occurs due to the materialisation of a risk other than the risk they wrongfully omitted to inform the investor about. Thus, the investment company and an investment agent are not liable for the materialisation of a risk the investor was properly informed about or of a risk which was not subject to an information obligation.

Fault

The investment company or the investment agent must infringe the information obligation culpably. As a rule (slight) negligence, thus "a failure to apply due diligence", is sufficient. Since investment companies and investment agents qualify as "experts" within the meaning of s.1299 Civil Code, the required standard of diligence is not determined by the diligence of an average person, but by the diligence usually applied by persons who render the same kind of services.

If the infringement of a contractual information obligation is established, fault is assumed pursuant to s.1298 Civil Code. Thus, the investment company or the investment agent has to prove that it or he did not infringe this obligation culpably.

Form and extent of compensation (calculational damage)

According to Austrian case law, the form of compensation depends on whether the investor still holds the undesired shares or not. As long as the investor holds the undesired shares, he is entitled either to the provision of the desired securities (hypothetical alternative investment) or to the amount of money representing the current value of the hypothetical alternative investment *both in return for the handing over of the undesired shares*. If the value of the desired securities has fallen since the acquisition of the undesired shares (until the end of the evidence procedure before the court of first instance), the investor may be awarded less than the invested purchase price or even less than the current value of the undesired shares.[20]

[15] C. Wendehorst, "Anlageberatung, Risikoaufklärung und Rechtswidrigkeitszusammenhang" (ÖBA, 2010), p.562.
[16] M. Ramharter, "Aktuelle Fragen der Anlageberatungshaftung" (Zak, 2009), p.403.
[17] Civil Code s.1489.
[18] Civil Code s.1478.
[19] Ramharter, "Aktuelle Fragen der Anlageberatungshaftung", 2009, p.403.
[20] P. Leupold and M. Ramharter, "Anlegerschaden und Kausalitätsbeweis bei risikoträchtiger hypothetischer Alternativanlage" (ÖBA, 2010), p.718.

After a sale of the undesired shares, the investor is entitled to "pure" money compensation (*reiner Geldersatz*). The Austrian Supreme Court has recently explained the calculation of this compensation as follows:

> "For the determination of the hypothetical current wealth of the investor, the concrete circumstances and agreements at the time of conclusion of the information agreement, especially the declared investment aims of the investor must be taken into account […]. It cannot be generally assumed that the investor would have chosen a totally risk-free investment if he had been informed properly […]; the amount of damages is determined on the basis of the proceeds of the sale [of the undesired shares] and the market value of the [hypothetical] alternative investment […]."[21]

As long as the investor holds the undesired shares, he is, according to the caselaw, not entitled to such pure money compensation. In this connection, the Austrian Supreme Court has held that the damage cannot be quantified before the sale of the undesired shares due to almost certain value fluctuations in the future.[22] Several legal commentators have criticised this differentiation between investors who still hold the undesired shares and those who do not, arguing that the investor must have the possibility to accept the character of the originally undesired shares (for the future) and to decide on keeping them. With such a decision the "illegality link" (*Rechtswidrigkeitszusammenhang*) between the insufficient information and future losses is, according to these commentators, cut off. As of the moment of the decision to keep the originally undesired shares, it would be the investor who bears the risk of future losses and stands the chance of future gains.[23] It remains to be seen whether the Supreme Court will follow to this opinion.

Burden of proof

According to the Austrian rules on the burden of proof, the investor must prove that the conditions precedent to a damage claim are met. Only with regard to the requirement of fault, Austrian law provides for a shift of the burden of proof to the author of the damage (provided that an infringement of contractual obligations is established by the claimant).

It may be difficult for the investor to establish that, with proper information, he would not have acquired the undesired shares. It may be even more difficult to establish which concrete alternative investment he would have chosen.[24]

In a very recent decision, the Austrian Supreme Court has relaxed the burden of proof for an investor:

> "The requirements for proving a merely hypothetical course of events are lower than the requirements for proving that a damage was directly caused through positive actions. The question how things would have developed if the author of the damage had acted properly can obviously not be answered with ultimate certainty as this course of events did not actually happen. Thus, the claimant only has to bring forward allegations [and evidence] that make the causation of a damage plausible. It is then for the defendant to establish that another course of events is more probable."[25]

Duty to mitigate

According to the case-law, the investor is under a duty to inform the author of the damage as soon as his knowledge of the relevant facts would enable him to bring a claim with reasonable prospect of success. This way the author of the damage is given the opportunity to satisfy claims right away. If the investor breaches the stated duty, damages he suffers after the time in which the author of the damage would have provably satisfied the damage claim are not (or only in part) to be compensated for.

Conclusions

The type and the extent of the damage claim depend on whether the investor still holds the undesired shares or not. As long as the investor still holds the shares, he is entitled to the provision of the desired securities (hypothetical alternative investment) or to the amount of money representing the current value of the hypothetical alternative investment (both) in return for the handing over of the undesired shares. After a sale of the undesired shares the investor is, according to the case-law, entitled to "pure" money compensation (*reiner Geldersatz*). The amount of compensation is based on the proceeds of the sale of the undesired shares and the market value of the hypothetical alternative investment.

The Austrian Supreme Court lightens the burden of proof for investors for proving that, with proper information, they would not have acquired the undesired shares and for proving which alternative investment they would have chosen.

[21] OGH January 28, 2011, 6 Ob 231/10d.
[22] OGH 8 Ob 123/05d in ÖBA 2006, 682.
[23] T. Schobel and R. Parzmayr, "Anlegerschaden und Schadensberechnung—Ausgleich für Trankaktionsschäden und Preisschäden durch Naturalrestitution und Geldersatz" (ÖBA, 2010), p.165.
[24] Leupold and Ramharter, "Anlegerschaden und Kausalitätsbeweis bei risikoträchtiger hypothetischer Alternativanlage" (ÖBA, 2010), p.718.
[25] OGH January 28, 2011, 6 Ob 231/10d.