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First Hong Kong misselling case of 2016 won by bank

The case of Li Kwok Heem John v Standard Chartered International (USA) Ltd [2016] HKEC 7 is the latest case in which the courts have dismissed claims of alleged misselling by banks. The bank denied it had made misrepresentations and relied on the terms within its account opening documents by which it said the plaintiff was not entitled to rely on advice or recommendations given by it. While dismissing the banks' arguments on so-called "contractual estoppel", the Court of First Instance found that the plaintiff had failed to prove negligence because the bank had conducted due diligence on the scheme with reasonable care and skill, judged in the light of what was known at the time.

The judgment is the latest in a long line of cases in which investors have failed to prove misselling by banks and other financial institutions.

Background

The plaintiff was a chartered accountant and former partner of PricewaterhouseCoopers. Through the introduction of Standard Chartered, the defendant bank, the plaintiff invested USD1.7 million in August 2005 in the Fairfield Sentry Fund (the Fund), which turned out to be one of the Ponzi schemes operated by Bernard Madoff.

The plaintiff lost his investment and brought an action against the bank for misrepresentation and breach of duty of care.

Misrepresentation

The plaintiff claimed that in a meeting in August 2005, the bank's representatives recommended that he place the proceeds of another fund he was liquidating into the Fund. The representatives handed him the Fund's fact sheet which stated that the Fund's investment objective was to achieve capital appreciation through consistent monthly returns. They described how the Fund had outperformed other investments over 15 years and described the Fund as a low risk investment with moderate returns that was suitable for the plaintiff.

The Court found that the bank had made these misrepresentations concerning the Fund to the plaintiff, and that the plaintiff had relied on these misrepresentations when making his investment. The misrepresentations were not actionable however, because the bank was not found to be negligent.

Key issues

- The non-reliance clauses in the client agreement did not protect the bank (unlike in other recent cases), as they did not cover the nature of the investment.
- The clauses were found to be unenforceable because they were unreasonable exemption clauses under the Control of Exemption Clauses Ordinance.
- Despite this, the bank was not negligent. It had done reasonable due diligence, judged by what was known at the time before the Ponzi scheme was discovered.

Negligence

The plaintiff pleaded that the bank had made the false representations negligently as it had failed to make reasonable enquiries on the truth or accuracy of the representations before making them to him.

The Court agreed that the Bank had assumed a duty of care under both the common law and the Supply of Services (Implied Terms) Ordinance when giving advice and recommendations on the Fund to the plaintiff.

The issue was whether the bank had reasonable grounds to believe and did believe up until the point at which the fraud was revealed (in December 2008), that the representations it had made were true.

The Court considered what the bank had done by way of due diligence. The bank had analysed the Fund's returns by comparing them against various benchmarks, including the S&P 100, deposit rates and other hedge funds. It had concluded that the Fund produced good, but not spectacular annual returns. Senior employees of the bank had had meetings and discussions with representatives of Fairfield Greenwich Limited (FGL), the Fund's investment manager, about its investment strategy and operations. The Bank had reviewed due diligence questionnaires prepared by FGL on the Fund and had studied twelve years of financial statements audited by PwC.

Although Mr Madoff rarely met with investors, the bank requested meetings with him every six months. When a meeting finally took place in April 2008, nothing about the meeting itself or the bank's follow-up enquiries aroused any suspicions.

The bank disagreed that any additional *"reasonable enquiry"* could have uncovered the Ponzi scheme. It was noted that Mr Madoff had honoured over three billion dollars in redemption requests from the Fund during the course of its existence.

The Court said the question was a narrow one of whether the bank was negligent in not discovering the Ponzi scheme. The standard to apply should be the industry standard prevailing at the time before the fraud was revealed.

The Court found that the bank had conducted its due diligence with reasonable care and skill. The bank had proved on a balance of probability that it had reasonable grounds to believe and did believe up to the time the fraud was discovered that the representations made to the plaintiff were true.

Contractual estoppel

The defendant argued the plaintiff was estopped from arguing that he had relied on any advice or representation or that the bank had assumed any duty of care in the plaintiff's purchase of shares in the Fund. The estoppel rose by virtue of his having signed terms in the bank's Business Conditions and Risk Disclosure Statement, both of which formed part of the account opening documents.

The Court found that the clauses relied upon by the bank did not provide it with a defence. The clauses covered investment activities that were high risk, and not investments such as the Fund which the bank had said was low risk.

In any event, the clauses in the Risk Disclosure Statement failed to satisfy the requirement of "reasonableness" under the Control of Exemption Clauses Ordinance (CECO). The bank had employed a team of investment advisers whose duty was to give advice and recommendations on investments to client. Any suggestion they were not giving advice was artificial.

The bank therefore could not rely on the provisions to exclude or restrict its liability to the plaintiff in relation to his purchase of shares in the Fund.

Analysis

This case has significant implications for legacy cases dealing with agreements in which banks gave investment advice to clients, but where the customer signed terms that suggested the trades were being done on an "execution-only" basis.

In previous cases, such as *DBS Bank (Hong Kong) Ltd v Sit Pan Jit*[1] and *DBS Bank (Hong Kong) Ltd v San-Hot HK Industrial Co Ltd*[2], non-reliance clauses in client agreements were found fairly to have characterised the relationship between the client and the bank and therefore could not be considered exemption clauses. Even if they were, the Court in those cases found that they satisfied the requirement of reasonableness under CECO.

1 (unreported, HCA 382/2009, [2015] HKEC 548)

2 [2013] 4 HKC1

The findings on contractual estoppel will however become academic in light of new reforms which will stop banks putting such clauses in client agreements.

The SFC last month notified a change to the Professional Investor Regime which requires financial intermediaries to ensure that any financial product solicited for sale or recommended to a client is reasonably suitable for the client, regardless of what is stated in the client agreement. Further information about the requirement – including the incorporation of a new clause which should enable investors to claim for damages where an intermediary sells or recommends products that are not reasonably suitable - can be found *here*.[3]

Even if banks can no longer use non-reliance clauses as a defence in misselling claims, the customer still has to prove negligence. This will depend on the facts of the case but may still prove a significant hurdle to recovery.

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[3] *SFC seeks to abolish non-reliance clauses with new suitability requirement* – Clifford Chance briefing December 2015

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