The Cum-Ex tax scandal - a fraud on the investor?

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The Cum-Ex scheme

The Cum-Ex files, as so called by the team of investigative reporters who uncovered the story,**[1]** is a tax fraud perpetrated by obtaining multiple capital gains tax refunds withheld on dividend distribution, even though the tax has only been paid once – or not at all. The masterminds behind the Cum-Ex fraud traded shares on the date of dividend distribution, so that multiple entities would appear to the tax authorities as owners of the same share and each claim a refund of the capital gains tax. Up until the Cum-Ex scheme was uncovered in 2011, it is said to have cost up to €55bn to European states, making it the biggest tax fraud of all time.**[2]**

On 24 September 2020, the European Securities and Markets Authority (ESMA) published the Final Report on its inquiry into Cum/Ex, Cum/Cum and withholding tax (WHT) reclaim schemes. This report aims at identifying gaps in relevant tax legislation and recommending best practices and potential solutions for the prevention, detection and prosecution of WHT schemes. Investigations are gaining momentum. It was revealed in October 2020 that the United Kingdom's financial regulator had decided to pursue Cum-Ex cases and was investigating 14 companies and six individuals in Denmark, Germany, France and Italy over their roles in the Cum-Ex scheme.**[3]** In March 2020, a German court issued a criminal conviction for tax evasion against two bankers who engaged in the Cum-Ex trade, and many such proceedings are still pending.**[4]**

In view of actions being taken by the public authorities, where does this tax fraud leave the investors who unknowingly invested in collective investment funds that engaged in Cum-Ex scheme strategies? These funds often described themselves as a risk-free investment: the funds did not rely on market fluctuations and merely relied on the upcoming reimbursement from the state. **[5]** But, in reality, the investment turned out to be extremely risky. When the German tax authorities uncovered the scheme, the repayments of taxes were withheld, and the funds engaged in the trades collapsed. Swiss bank J. Safra Sarasin found itself at the centre of various proceedings. In Germany, it was ordered to pay approximately €50m to an investor after having offered him an investment in the Luxembourg Sheridan fund, which engaged in the Cum-Ex scheme.**[6]**

Proceedings have also been brought in the Swiss courts, including against J. Safra Sarasin, again in respect of the same Luxembourg Sheridan fund. Notably, two claims brought by investors in the Luxembourg Sheridan fund went all the way to the Swiss Supreme Court, with opposite results.**[7]**

Factual background of the two Swiss civil cases

The Swiss Supreme Court ruled on the first of the two above-mentioned Cum-Ex trade cases in 2016,**[8]** and on the second in 2020.**[9]** Both cases are based on a very similar factual background. In early 2011, J. Safra Sarasin provided two of its clients – a Dutch company specialising in financial investments in the 2016 case, and a German company specialising in the sale and management of real estate in the 2020 case – with investments in the Luxembourg Sheridan fund.**[10]** This collective investment fund, which was independent of and unrelated to the bank, presented its strategy as 'short-term investment over dividend date' to 'take advantage of price inefficiencies due to dividend and corresponding taxation'. In fact, the fund's strategy was to exclusively carry out Cum-Ex trades.

While the Dutch client was well versed in financial instruments and was willing to invest, the German client was new to this field of investments, as it had previously only invested in real estate. Without providing a prospectus or explaining the mechanisms of the collective investment funds, the bank explained that the investor could expect an annual return of up to 12 per cent per annum of the invested money. This persuaded the German client to open an account with the bank in order to invest in the Sheridan fund. The Dutch client purchased shares of the Sheridan fund for €6.5m on 4 April 2011. The German client invested €998,000 in the same fund on 10 May 2011. In the summer of 2011, the German tax authorities refused to pay the tax refunds. There were no returns and the investments were effectively frozen. In January 2012, both clients were informed by the Sheridan fund management company that 10 per cent of the shares would be redeemed. They finally received respectively €728,910 and €111,914.69 from redemptions, and nothing more thereafter.

Each client sued before the Zurich commercial court to recover its full investments.**[11]** Both clients based their claims on similar grounds. They claimed damages for a breach of – allegedly concluded – advisory contracts. In addition, they both also claimed that the sales contracts for the shares were the result of a fraud within the meaning of Article 28 of the Swiss Code of Obligations (SCO), which provides that 'a party induced to enter into a contract by the fraud of the other party is not bound by it even if his error is not fundamental'. They each claimed on this ground that the contract had been rescinded and that the bank was obliged to repay the full investment.

Findings of the courts

In both cases, the courts found that the bank was well aware of the high risks associated with investments in the Sheridan fund, even though the Sheridan fund was independent of and unrelated to the bank.

The courts held that the investment risks were apparent from the prospectus and sales documentation of the Sheridan fund. The prospectus hinted at the possibility that there could be no tax reimbursement. This disclosure was deemed by the court to be an indication that the investment was a speculation on the legality of the practice, ie, on whether the request for tax reimbursement was lawful. Therefore, the legality of the fund was not a confirmed quality of the fund, but a speculative fact. Without ruling on the legality of the Cum-Ex practice, the Swiss Supreme Court hence found that the illegality of the practice was at least a risk associated with the contemplated investment in the Sheridan fund. From these findings of fact, the consequences were however different for each client.

Civil claim of fraud

The courts came to diverging conclusions on the question whether the clients had been induced to purchase the shares by a fraud of the bank.

In the 2016 case, the courts found that, since the stated investment strategy was to 'take advantage of price inefficiencies due to dividend and corresponding taxation', the claimant could not ignore that the profits would be obtained to the detriment of the national treasuries. The Swiss Supreme Court held that the client, who was a professional investor, should have enquired further as to the legality of the investment strategy if it wanted such legality to be a warranty. Since the bank's acts did not lead the client to believe that the legality of the fund was a certainty, no fraud was committed by the bank.

The courts were more indulgent with the client in the 2020 case. Both the Zurich commercial court and the Swiss Supreme Court ruled that the bank was aware that the German client misunderstood the risks entailed in the investment, and rather than informing its client, had comforted it in its belief that the investment was low risk. The Court further held that the bank knew that the client was not an experienced investor and that the client had no knowledge of the speculative strategy of the fund. There was no proof that a prospectus or any similar document had been provided to the client. In addition, since the client was precisely seeking investment advice from the bank, the Court found it irrelevant that a prospectus was or was not easily accessible. In conclusion, the courts held that the bank had committed a civil fraud within the meaning of Article 28 of the SCO by fraudulently inducing its client to invest in the fund. However, the German client had failed to invoke the rescission of the contract within the statutory one-year period from the date when the fraud was discovered, and could therefore not rely on the fraud to claim restitution of its investment.

Claim for contractual breach

With regard to the claims for damages for breach of contract, the courts found that the bank's duties differed in the two cases. In the 2016 case, the Dutch client had purchased the shares within an execution-only contract and, as a result, the bank had no specific duty to inform the client about the risks. On the other hand, in the 2020 case, both a share purchase and an advisory contract related to isolated transactions had been concluded between the bank and the German client. Therefore, only the German client was able to claim damages on the basis of an advisory contract.

Under Swiss law, advisory contracts impose an obligation to take account of the client's knowledge and experience when advising on investments.

The above-mentioned fraudulent behaviour of the bank in the 2020 case, through which the bank had failed to properly advise the client on the investment and had misled it into believing that the investment was low risk, constituted a breach of the bank's contractual duty under the advisory contract. According to the Swiss Supreme Court, it could be inferred from the fact that the German client's account with the bank had been opened solely for the purpose of the investment in the Sheridan fund that the German client would have not invested at all with the bank if the bank had not deceived him. The client was therefore entitled to obtain the full amount of the lost investment.

While the 2016 case was dismissed, and the bank's liability towards the Dutch client was excluded, the Swiss Supreme Court obliged the bank to pay €887,593.29 (plus five per cent interest from 31 May 2017) in damages to the German client in the 2020 case.

Outlook

The diverging conclusions as to the occurrence of civil fraud in the two cases can be explained by the Swiss Supreme Court's differential treatment in respect of professional clients as compared to retail clients. The Swiss Supreme Court held that a professional client must have been aware that the practice of the Sheridan fund was possibly illegal and therefore incurred high risks. Consequently, the same reasoning could be applied to banks that funnel money in collective investment funds practising the Cum-Ex strategy. Banks, with their expert knowledge, should be also deemed to have been aware of the potentiality of a fraud. This may well pave the way for prosecution and claims against Swiss banks – not only by investors but also by foreign states who lost billions in fraudulently claimed tax rebates on account of the Cum-Ex scheme.

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[1] 'The CumEx Files: a cross-border investigation', available at **https://cumex-files.com/en/**, accessed 14 May 2021.
[2] ibid.
[3] **Ellen Milligan** and **Jonathan Browning**, 'U.K. Regulator Investigating 14 Firms, 6 People in Cum-Ex Cases' (Bloomberg, 23 October 2020), available at **www.bloomberg.com/news/articles/2020-10-23/u-k-regulator-investigating-14-firms-6-people-in-cum-ex-cases**
[4] Philip Oltermann, 'Former London bankers convicted after Germany's "greatest tax robbery"' (The Guardian, 19 March 2020), available at **www.theguardian.com/world/2020/mar/19/former-london-bankers-convicted-after-germany-greatest-tax-robbery**
[5] Anne Michel, Maxime Vaudano and Jérémie Baruch, 'Comment des financiers européens ont soustrait 55 milliards au fisc' (Le Temps, 18 October 2018), available at **www.letemps.ch/economie/financiers-europeens-ont-soustrait-55-milliards-fisc**.
[6] Sönke Iwersen and Volker Votsmeier. 'Sarasin-Bank gibt im Millionenstreit mit Drogerie-Unternehmer Müller endgültig auf' (Handelsblatt, 15 November 2018), available at **www.handelsblatt.com/finanzen/banken-versicherungen/cum-ex/cum-ex-geschaefte-sarasin-bank-gibt-im-millionenstreit-mit-drogerie-unternehmer-mueller-endgueltig-auf/23637978.html?ticket=ST-251764-uY1rfWdLVn6GgnTArYgh-ap5**.
[7] 'Kläger gegen Privatbank Sarasin abgeblitzt' (Neue Zürcher Zeitung, 18 November 2016), available at **www.nzz.ch/wirtschaft/sheridan-fonds-klage-gegen-privatbank-sarasin-abgeblitzt-ld.129227**; 'Cum-Ex: Sarasin muss wegen Falschberatung von Clemens Tönnies zahlen' (JUVE-Steuermarkt, 3 August 2020), available at **www.juve-steuermarkt.de/nachrichten/namenundnachrichten/2020/08/cum-ex-sarasin-muss-wegen-falschberatung-von-clemens-toennies-zahlen-2**.
[8] Swiss Supreme Court decision 4A_308/2016, dated 28 October 2016.
[9] Swiss Supreme Court decision 4A_297/2019, dated 29 May 2020.
[10] As identified by the press articles under end note vi supra.
[11] Zurich Handelsgericht decision HG140077-O dated 6 April 2016; Zurich Handelsgericht decision HG170121-O dated 7 May 2019.