ALLEN & OVERY

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Trust trumps it all?

Speed read

On 13 April 2017, the Court of First Instance delivered its judgment in *Zhang Hong Li and another v DBS (Hong Kong) Ltd and others*, HCCL 2/2011. This judgment is a much awaited one. The claim is for recovery of losses to investments arising from the 2008 global financial collapse and it canvasses many issues and findings. This briefing only focuses on some of them. This case is different from the many other claims against financial institutions in the wake of the financial crisis: the investments were made and losses are said to have been suffered by a family trust.

Family trust

According to the judge (Bhawarney, J.), the claims were based not on a "mis-selling" of investment products claim, but primarily on alleged breaches of trust and fiduciary duties and dishonest assistance. The judge found against the relevant trustee for breach of trust and the relevant corporate nominee director of the investment vehicle for breach of directors' duties. The judge ordered equitable compensation for the losses suffered by the trust.

Parties

In 2005, Zhang Hong Li (**Li**) and his wife Ji Zhengrong (**Ji**) set up a family trust with the help of DBS Bank. It was for succession planning and estate duty purposes. The trust structure is typical in the private banking world. Zhang and Ji were the settlors. Investments were to be held by a BVI company, Wise Lords Ltd. Shares of **Wise Lords** are the trust asset.

Wise Lords sole shareholder was Nautilus Trustees Asia Ltd (formerly DBS Trustee HK (Jersey) Ltd) (**DBS Trustee**), a Jersey entity. Its sole director was DHJ Management Ltd (**DHJ**), a DBS entity incorporated in BVI. As is typical in the trust industry, another DBS entity in Hong Kong provided administration, operational and secretarial support services, in Hong Kong, to DBS Trustee in Jersey. That entity was found to be DBS Trustee's agent.

Wise Lords maintained a private banking account with DBS Bank (Hong Kong) Ltd (**DBS Bank**), through which investments were carried out. Wise Lords was served by one key relationship manager of the bank (**RM**). As would be expected, the RM had a close connection and frequent contact with Ji.

Zhang, Ji, Wise Lords and new trustees of the trust (replacing the DBS Trustee given the litigation) were the plaintiffs. The defendants included DBS Bank, DBS Trustee, DHJ, and other DBS employees and entities. DBS Bank and relevant DBS entities played three roles: (a) banker of Wise Lords; (b) trustee of the trust; and (c) director of Wise Lords.

It is significant that Ji was appointed as investment advisor to Wise Lords. It is a common arrangement for family trusts that settlors act as investment advisors of the trusts. Further Ji was authorised by Wise Lords to (a) execute investment transactions, (b) operate Wise Lords bank accounts, and (c) negotiate and draw on overdraft facilities. Effectively, she was Wise Lords authorised trader.

Astute and experienced investor

The judge found Ji to be:

(a) an astute and experienced investor, in many respects well informed;

(b) not an investor who blindly followed any recommendations given to her;

(c) with clear views as to what directions and regions she did or did not favour;

(d) disinclined to make investments without the necessary information or knowledge; and

(e) not hesitant to make it clear to the bank that she could and did resort to services of other banks, using that as leverage.

Investments and overdrafts

Between 2005 and 2008, Ji executed over 500 investment transactions for Wise Lords account. The bulk, some 340, comprised trades in mutual funds. Overall, these trades had generated handsome profits. The judge found that by May 2008, Ji had become disenchanted with mutual funds, thinking that the U.S. market was going to into a deep recession, which would affect the global economy, in turn affecting mutual funds. She redeemed most of Wise Lords mutual fund holdings, and switched her focus to investing heavily in foreign currencies, particularly AUD and EUR, currency-linked notes, and, ultimately, currency decumulators, with increasing leverage.

Between 2006 and 2008, Wise Lords overdraft facility was gradually increased from USD10m to USD100m. The judge found that Ji had strongly and repeatedly pressed the bank to increase the credit line, and that the RM had helped support the last few applications for increases by exaggerating to the bank Zhang's and Ji's assets and income.

By August 2008, Wise Lords portfolio comprised over AUD122m deposits (purchased in 11 tranches on just six trading days in July and August 2008), currency-linked notes for USD20m (linked to AUD and EUR) and some EUR deposits, against a USD96m overdraft. The portfolio had grown substantially in a short time against leverage.

Contrast the portfolio at that date with the position three months before: Wise Lords did not hold any AUD deposits, just USD4.7m deposits and some USD52m worth of currency-linked notes, against loans of USD19m.

It was in July and August 2008 when Ji made substantial purchases of AUD that AUD began its decline against USD. The purchases incurred losses given the currency mismatch (against USD borrowing) and leverage. The judge found that despite the worrying AUD situation and repeated

warnings from the bank, Ji remained bullish and resisted unloading Wise Lords long positions at anything less than break-even point. What Ji did instead was to execute "decumulators" for AUD76m and EUR6m.

"Decumulator" was a product which would allow the investor to sell AUD against USD at weekly fixings (for 1/52 of the total AUD committed) at a fixed strike rate (better than the market rate prevailing at the time of entering into the decumulator), provided that the AUD rate did not drop below a specified floor rate against USD at the time of the fixing. If the AUD rate was higher than the floor rate, then the fixing at strike would provide some reprieve. If the AUD rate dropped below the floor level, then the investor would only receive the fixing in AUD without interest.

The judge found that decumulators did not function as a hedge against the AUD exposure, because if the AUD rate continued its decline below the floor rate, then the investor would be unable to quickly liquidate the AUD76m committed to the decumulators (funded by Wise Lords AUD deposits): the investor would only receive weekly in AUD, 1/52 of the total AUD committed which the investor could convert at current market rate and the balance would remain locked up. The judge found that the ability to liquidate AUD was deactivated if AUD was to sharply decline further, when protection was most needed.

Instead of being an effective hedge, decumulators were found to exacerbate the currency risks in the portfolio. It is noteworthy that the judge also found that Ji was sufficiently informed of the operation and risk features of the decumulators.

In fact the judge found that the RM and the bank's product specialist had:

(a) cautioned Ji about long positions in AUD;

(b) in June 2008, suggested that Ji could sell half of the current holding, then of AUD43m and take a profit;

(c) alerted Ji to the risk of a possible USD rebound and a fall of AUD;

(d) offered other exit strategies for unloading or closing the long AUD positions, and to help control Wise Lords currency exposure;

(e) suggested that Ji should consider investing a smaller sum in decumulators and with a shorter tenor than one year, because of the risk of lock-up; and

(f) suggested that Ji should adopt other strategies to help control Wise Lords' currency exposure.

However, the judge found that Ji was not impressed by these suggestions, and that she wanted to be able to sell Wise Lords substantial holdings of AUD only at the rate she wished and was willing to take substantial risks to do so.

Bank's role in the investments

What about the bank's role (as banker, not trustee or director) in these investments? The judge found that the RM and her team were very eager to increase transaction volume in Wise Lords' account so that they could enjoy higher bonuses, and were more than happy to recommend products to Ji.

The judge accepted, though, that from a contractual standpoint, any recommendations from the RM and her team were not to be considered investment advice. Importantly, he found that there was no question of the RM and her team pushing Ji to conduct investment transactions that she herself did not wish to undertake or fully independently consider.

No common law or contractual duties of care owed or assumed by bank to advise or ensure suitability of investments

All claims against DBS Bank and its staff, including the RM as banker, were dismissed. The judge found that no statutory or common law duties were owed or assumed by DBS Bank to (a) Zhang, (b) Ji or (c) the trust. There was no banker-customer contract between the bank and them.

The only banker-to-customer relationship was one between Wise Lords and the bank. The contractual terms made it clear, and the judge accepted, that the relationship between Wise Lords and the bank was *not advisory* but concerned *transaction execution only*. The bank did not assume either contractual or common law duties of care to advise or ensure suitability of investments for Wise Lords. The judge found that the SFC Code was not incorporated into the contract between the bank and Wise Lords.

The RM was found to have exaggerated to DBS Bank, Ji's and Zhang's assets to support increasing credit facilities to Wise Lords. However, according to the judge, that was a wrong to the bank, not to any of the plaintiffs. In any case, no loss was caused to the plaintiffs as a result of the increased facilities. The judge found that Wise Lords suffered losses not from the grant of increased facilities, but from substantial purchase of AUDs in July and August 2008 and the purchase of currency decumulators, although the purchases were partly funded by overdrafts.

But for the trust structure, the judgment would have ended here. Yet issues regarding the trust intervened.

Failures by trustee and director

The trust deed provided that the trust was allowed to engage in speculative investments and that DBS Trustee was under no duty to:

(a) diversify investments; or

(b) see that the value of the trust was preserved or enhanced in any way.

However, construing terms of the trust and relevant Jersey law, the judge found that DBS Trustee owed a duty to the trust to:

(a) take a high level and overarching supervisory role in respect of the trust assets;

(b) conduct regular monitoring; and

(c) ensure that the value of the trust was subject to appropriate controls, reviews, investment expertise and management.

How should this duty be reconciled with the fact that investments were made on a daily basis by Ji, as authorised trader for Wise Lords and as investment advisor?

The judge found that Ji's power to make investments was subject to DBS Trustee's and DHJ's power to:

(a) override Ji's decisions; or

(b) reverse transactions she conducted for Wise Lords.

This power was never exercised to reverse any of the over 500 investment transactions made. In practice, approvals to transactions and credit facilities were sought from and given by DHJ and DBS Trustee after the event.

The judge found that DBS Trustee did not query why, in July and August 2008, Wise Lords was acquiring so much AUD and how it was paying for them. Regarding the decumulators, DBS Trustee was found to have sought an explanation of what a decumulator was after approving two. It went on to approve the third when critical information about a decumulator's risks of a possible one-year lock-up was not given in internal approval applications addressed to DBS Trustee.

In the circumstances, the judge found that (a) DBS Trustee failed to discharge its supervisory duty owed to the trust (represented in the action by the new trustees), and (b) DHJ failed to discharge its fiduciary duty owed to Wise Lords, in approving, after the event:

(a) nine out of 11 purchases of AUD (worth USD83m out of USD96m) made by Wise Lords in July and August 2008;

(b) the increased credit facility (from USD58m to USD100m) obtained by Wise Lords in July 2008; and

(c) the three decumulators.

Outcome

Although, as mentioned above, all claims against DBS and its staff were dismissed, DBS Trustee and DHJ were found to be liable for a serious or flagrant degree of negligence, hence losing protection under exclusion and indemnity clauses in the relevant documentation. Equitable compensation was ordered, requiring further determination by the judge with help from experts. It is noted however, that the judge dismissed all dishonest assistance claims.

Comments

There appears to be no clear guidance in the judgment as to how the court worked out the quantitative thresholds for what amounted to unacceptable investments. The court did not find that DBS Trustee's and DHJ's approvals of the first USD13m objectionable, nor a facility of up to USD58m being granted. Further judicial guidance as to how and when the trustee's and the director's "power of reversal" should be exercised would be desirable.

Neither the trustee nor the director was party to any of the investments. The investments and facilities were binding between the bank and Wise Lords. Termination of the transactions and facilities, depending on timing, could have been at significant costs.

The trust documentation appears to have provided that the trustee should have consulted with Ji or Zhang on all matters relating to the trust, and that her recommendation should be final.

The following questions arise:-Is the expectation then that the trustee (and the director) should first have consulted with Ji about reversal, or even withheld approval? What if Ji were to disagree? One should not forget that Ji herself had a significant role as investment advisor and authorised trader of Wise Lords. The judgment does not discuss what duty and standard of care is owed by her to Wise Lords or to the trustee. In fact, it is quite unclear if that is in issue between the parties.

Conclusion

This judgment shows how professional trustees can face exposure for losses to trust assets arising from financial investments conducted by and on the advice of settlors qua investment advisors. The cause of action is not classic mis-selling, but breach of trust – failure in discharging a trustee's high level, supervisory duties over trust assets.

Depending on the settings of trust services offered by financial institutions, this judgment may justify revisiting:

(a) procedures for approval and rejection of investments;

(b) procedures for portfolio reviews;

(c) suitability criteria for appointing investment advisors; and

(d) importantly, contractual provisions for risk allocation between trustees (and other service entities) and settlors qua investment advisors.

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