The retro effect

A look at how practitioners should respond to the retrocession crisis in Liechtenstein

By Martin Hermann

Abstract

- In 2020, the Supreme Court of Liechtenstein found that clients of Liechtenstein banks are entitled to third-party payments (retrocessions) that were made to banks in connection with client relationships.

- In 2022, the Liechtenstein parliament changed the limitation period for these claims retroactively from 30 to three years in favour of Liechtenstein banks and asset managers. The following article provides an overview of recent developments in Liechtenstein jurisprudence and legislation on the subject of retrocessions and discusses the consequences of these developments for trustees and board members of Liechtenstein fiduciary structures.[1]

1 This article draws on a previous article by the author and co-author Dr Helmut Schwärzler, which was published in the *Liechtenstein Law Journal* (LJZ) in December 2022; Schwärzler/Hermann, '*Organhaftung in Liechtenstein – Entwicklungen und aktuelle Herausforderungen für Stiftungsräte im Zusammenhang mit Retrozessionen*', LJZ 4/22, p.273.

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Over several decades, banks and asset managers in Liechtenstein have benefited from third-party payments that are typically intended to compensate recipients for initiating, maintaining and expanding client relationships.

Such payments are made, for example, by financial product providers to banks when they acquire financial instruments on behalf of their clients, when they recommend such instruments to their clients or for the simple fact that their clients remain invested in these instruments over a prolonged period. In other instances, banks themselves take on the role of third-party payers when they reward asset managers for retaining clients with them and referring new clients to them.

The terms used to describe these kinds of payments received by banks and asset managers include commission fees, retrocessions, kickbacks, distribution remunerations, portfolio maintenance commissions, *disagios* or referral fees. Although European lawmakers generally refer to them as 'inducements',[2] Liechtenstein lawmakers decided to adopt the term 'contributions' (*Zuwendungen*).[3] Ordinary citizens and media outlets in Liechtenstein are usually not familiar with either of these terms. They typically refer to these payments as 'retrocessions' or 'retros'.[4]

Although third-party payments may take various shapes depending on the circumstances and the parties involved, they usually have at least two elements in common, which is that they are founded on and drawn directly from the client's financial investment.

Nonetheless, the reality is that for a long time banks and asset managers have refused to pass these payments on to their clients. Up until 2004, third-party payments were not even mentioned in contractual documents. In 2004, banks and asset managers started to make reference to these payments in general terms and conditions (GTC), but the standard phrases adopted did not give clients sufficient basis to understand the existence, nature and amount of these payments. A typical clause from this period read as follows: 'The Client accepts that any remuneration and compensation, such as commissions and portfolio payments, which are paid to the Bank by third parties may be retained by the Bank and considered as additional remuneration.'

> ***'For a long time banks and asset managers refused to pass these payments on to their clients'***

Later clauses were more extensive, but they all failed to address at least one of the main deficiencies of previous clauses in that they did not inform clients comprehensibly on the amount of these payments, which is not a minor issue by any means, since third-party payments can make up a significant portion of the overall costs of investment services. In the author's experience, they may account for up to 0.75 per cent of invested assets per annum.

THE PROBLEMS WITH RETROCESSIONS AND THE EUROPEAN RESPONSE

There are two major problems associated with third-party payments.

First, such payments, if not properly disclosed, disguise the true costs of financial services offered and prevent clients from being able to make informed investment decisions. Second, third-party payments provide an incentive for banks and asset managers to make decisions that further their own financial interests but are not necessarily in the best interest of their clients.

It is for these two reasons that third-party payments are largely prohibited under EU law since the introduction of *Directive 2004/39/EC* (MiFID I) in 2007.[5] Article 26 of

2 See, e.g., art.26 of *Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive* (OJ 2006 L 241, p.26), incorporated into the *Agreement on the European Economic Area* (the Agreement) by *Decision of the EEA Joint Committee No 21/2007 of 27 April 2007* (LGBl. 2008 No 106)
3 See, e.g., art.8c (8) of the *Banking Act* (BankG) (LGBl. 1992 No 108) and Annex 2 sec. III. lit. A of the *Asset Management Ordinance* (VVO) (LGBl. 2005 No 289)
4 See, e.g., Hannes Matt, '*Retrozessionen sind noch immer ein sehr lukratives Geschäft, Liechtensteiner Volksblatt*', 22 June 2022; Dorothea Alber, '*Streitfrage um «Retros» bei Staatsvermögen entbrannt: Die Regierung hat die Verjährungsfristen für Retrozessionen gesenkt. Gab es solche Provisionen auch bei öffentlichen Geldern*?', *Liechtensteiner Vaterland*, 20 April 2022
5 *Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC* (OJ 2004 L 145, p.1), incorporated into the Agreement by *Decision of the EEA Joint Committee No 65/2005 of 29 April 2005* (LGBl. 2007 No 143)

Directive 2006/73/EC[6] (MiFID Implementing Directive) stipulated that:

> *'investment firms are not regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if in relation to the provision of an investment or ancillary service to the client, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit'.*

These payments and benefits were permissible only if they:

- improved the quality of the investment service provided;
- did not impair compliance with the duty of the investment firm to act in the best interests of the client; and
- were disclosed to the client prior to the provision of the relevant investment or ancillary service.[7]

The introduction of *Directive 2011/61/EU* (MiFID II)[8] in 2018 brought further restrictions to the regime of third-party payments. In the context of portfolio management and independent investment advice, third-party payments were banned altogether except for minor non-monetary benefits.[9] In the context of other investment services and ancillary services, the previous conditions (quality improvement, no conflict of interest, prior disclosure) were maintained and further strengthened.[10]

THE EFFECTS OF MiFID I AND II IN LIECHTENSTEIN

As a contracting party to the *Agreement on the European Economic Area* (the Agreement),[11] Liechtenstein was obliged to implement the MiFID provisions into national law.

Questions as to whether this incorporation was done correctly were already raised by courts in 2020.[12] Moreover, in 2022, the European Free Trade Association (EFTA) Surveillance Authority initiated infringement proceedings against Liechtenstein for incorrect transposition of MiFID II provisions.[13] These proceedings are still pending.

Regardless of this, it should be noted that the introduction of MiFID had no major impact on the way Liechtenstein financial service providers dealt with third-party payments in practice. Most banks and asset managers continued to accept third party-payments without proper disclosure and despite apparent conflict of interests after 2007, and some of them still hold onto this illegal business model today.

Public authorities have done little or nothing to limit the excesses of third-party payments. The Financial Market Authority (FMA), the Liechtenstein agency responsible for monitoring compliance and sanctioning non-compliance with MiFID regulations, has turned a blind eye to the problem. To the knowledge of this author, not a single financial service provider was ever fined for illegal receipt of third-party payments. The Liechtenstein government has gone even further to protect the interests of banks and asset managers. In 2007, it prepared a Bill that established that clients would automatically waive rights regarding third-party payments under certain conditions.[14] Further, in 2022, it pushed parliament to change the limitation periods for claims against banks and asset managers pertaining to third-party payments from 30 years to three years.[15] Both legislative changes led to massive encroachments on clients' rights and helped to legitimise the old practice with regard to third-party payments.

COURT DECISIONS ON RETROCESSIONS

In 2020 and 2021, the Supreme Court of Liechtenstein (the Court) issued three landmark decisions on the topic of retrocessions against a major Liechtenstein bank.[16]

In these decisions, the Court found that banks and clients are in a typical agent-principal relationship where the agent (the bank) is obliged to pass on to the principal (the client) any advantage that it obtains in connection with the execution of the mandate. Building on this, the Court

6 Above, note 2.
7 art.26(b)(i) and (c) of MiFID Implementing Directive
8 *Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC* and *Directive 2011/61/EU* (OJ 2014 L 173, p.349) (MiFID II), incorporated into the Agreement by *Decision of the EEA Joint Committee No 78/2019 of 29 March 2019* (LGBl. 2019 No 318)
9 See art.12 of *Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits* (OJ 2017 L 87, p.500), incorporated into the Agreement by *Decision of the EEA Joint Committee No 85/2019 of 29 March 2019* (LGBl. 2019 No 319)
10 Above, note 9, at art.11.
11 The Agreement (LGBl. 1995 No 68)
12 Decision of the Court, 4 September 2020, 09 CG.2018.166
13 bit.ly/3HZT3dl (accessed on 2 February 2023)
14 See § 1009a of the *General Civil Code* (ABGB) (LGBl. 2007 No 272)
15 See § 1489a (2) of the *General Civil Code* (ABGB) (LGBl. 2022 No 167)
16 Decisions of the Court, 4 April 2020, 02 CG.2019.58; 6 May 2021, 15 CG.2018.219; 15 December 2021, 09 CG.2018.166, LJZ 2022, p.73

'The government, however, asserts that questions concerning the statute of limitations for civil claims are a matter for national law only and can, therefore, be changed by parliament at any time'

held that the defendant must surrender to its client all third-party payments that it received in connection with the client relationship. The defendant invoked waiver clauses regarding the surrender of third-party payments, which were included in the GTC of 2004, 2007 and 2010, but the Court considered them to be invalid, as they did not state whether the defendant would actually receive third-party payments nor what the amount of such payments would be. Finally, by way of *obiter dictum*, the Court also maintained that claims for the surrender of third-party payments are subject to a limitation period of 30 years.

The defendant bank challenged all three Court decisions by filing complaints with the Constitutional Court of Liechtenstein (*Staatsgerichtshof,* the Constitutional Court), but all three complaints were dismissed in March 2022.[17] Instead, the Constitutional Court fully validated the findings of the Court, stating that the defendant should have at least provided its clients with bandwidths of third-party payments prior to the provision of investment services.

Finally, a decision of the EFTA Court also supported the rulings of the Court. The EFTA Court is sometimes referred to as the 'little brother' of the Court of Justice of the European Union. Its competences lie in the interpretation and enforcement of EU law for the three EFTA members, Liechtenstein, Iceland and Norway. In its decision on third-party payments, the EFTA Court concluded that a generic disclosure that merely refers to the possibility that an investment firm might receive third-party payments and which does not place the client in a position to calculate the amount of third-party payments provided to the investment firm is not sufficient under EU law.[18]

NEW LAW REGARDING RETROCESSIONS

The three Court decisions mentioned above prompted an immediate reaction by the Liechtenstein government. It issued a new draft Bill to radically reduce the statutory period of limitation for clients' claims regarding information and surrender of third-party payments against financial service providers like banks and asset managers.[19] This new draft Bill was later adapted slightly and then passed by parliament on 7 April 2022.[20] Even though not explicitly stated, the purpose of this Bill was clearly to protect banks and asset managers from high recovery claims by clients.

The new Bill contains a relative three-year limitation period and an absolute ten-year limitation period for claims for information and surrender of third-party payments against financial service providers. The ten-year limitation period starts when a specific third-party payment is made. Regarding the relative three-year limitation period, the wording of the Bill states that it starts when the client 'becomes aware' of third-party payments. According to legislative materials provided by the government, the phrase 'becomes aware' is to be interpreted such that it only requires the service provider to inform the client (for example, in the GTC), that it may receive third-party payments in the future.[21] As explained above, this is precisely what Liechtenstein banks and asset managers have done in the past and what was considered inadmissible by the Court, the Constitutional Court and the EFTA Court. The government, however, asserts that questions concerning the statute of limitations for civil claims are a matter for national law only and can, therefore, be changed by parliament at any time.[22]

The new law entered into force on 1 June 2022 and, according to transitional provisions, it will also apply retroactively, i.e., to claims pertaining to third-party payments

17 Decisions of the Constitutional Court, 12 March 2022, StGH 2020/089; 28 March 2022, StGH 2021/045; 28 March 2022, StGH 2021/099, LES 2022, 127 = GE 2022, 158

18 Judgment of the EFTA Court, 15 July 2021, E-14/20
19 Report and motion of the government to the Parliament of the Principality of Liechtenstein concerning the amendment of the *Civil Law Mediation Act*, the *Code of Civil Procedure*, and the *General Civil Code* of 28 September 2021 (BuA 2021/74)
20 See § 1489a (2) of the *General Civil Code* (LGBl. 2022 No 167)
21 Statement of the government to the Parliament of the Principality of Liechtenstein on the issues raised on the occasion of the first reading concerning the amendment of the *Civil Law Mediation Act*, the *Code of Civil Procedure* and the *General Civil Code* of 8 March 2022 (BuA 2022/29), p.13
22 Above, note 22, at p.14.

that were already paid before 1 June 2022, beginning with 1 June 2023.[23]

This means that clients will have to take care of their claims for information and surrender of third-party payments against banks and asset managers until 30 May 2023. After that date, most of these claims will be subject to the new statute of limitations and will, therefore, become time barred.

More specifically, clients who have not taken any action by 30 May 2023 will lose claims for information and surrender of third-party payments spanning 27 years (in cases where the three-year limitation period applies) and 20 years (in rare cases where the ten-year limitation period applies). This consequence of the statute of limitations can only be prevented by filing a lawsuit against the recipient of third-party payments (bank/asset manager) with the Princely District Court in Liechtenstein (*Fürstliches Landgericht*) or by obtaining a written confirmation of waiver to plea statute of limitation by the bank/asset manager before 30 May 2023.

In summary, therefore, the new law constitutes a radical retroactive limitation of clients' claims for information and surrender of third-party payments. Whereas, in 2021, the Court found that clients are entitled to information and surrender of third-party payments received by banks and asset managers for the past 30 years, the new law will effectively reduce these claims from 30 years to three years (or, in a few cases, to ten years).

CONSEQUENCES FOR TRUSTEES AND BOARD MEMBERS OF LIECHTENSTEIN FIDUCIARY STRUCTURES

The developments in jurisprudence and legislation outlined above carry opportunities and risks in equal measure.

On the one hand, clients of Liechtenstein banks and asset managers have a right to information and surrender of third-party payments made in connection with the client relationship. This pertains to any kind of client, be it a natural or a legal person. Therefore, trustees and board members of fiduciary structures may request banks and asset managers to disclose and surrender third-party payments received by them in connection with the trust or the fiduciary structure during the past 30 years. On the other hand, however, trustees and board members of Liechtenstein fiduciary structures may run the risk of liability if they fail to take care of their claims for information and surrender of third-party payments before they expire on 1 June 2023.

According to the Liechtenstein *Law on Persons and Companies* (*Personen- und Gesellschaftsrecht*, the PGR), the administration of a legal entity must ensure preservation of the capital and the maintenance and success of the entity within the framework of its legal obligations and the available possibilities.[24] It must carefully manage and promote the business of the entity and it will be liable for the observation of the principles of careful business management and representation.[25] Article 182(2) of the PGR establishes the 'business judgment rule', which provides that members of the administration shall act in accordance with these principles if their business decisions are not guided by interests beyond those of the business and if the members of the administration could reasonably expect to be acting on the basis of appropriate information for the benefit of the legal person.

It follows from this that trustees and board members of Liechtenstein companies may have a legal obligation to take care of claims regarding third-party payments on behalf of their clients before they expire on 1 June 2023. Trustees and board members of Liechtenstein companies should therefore request disclosure and surrender of third-party payments from banks and asset managers as soon as possible and seriously consider filing a civil lawsuit (to compel disclosure and surrender of third-party payments) in case banks and asset managers do not comply with this request.

SCOPE OF LIABILITY FOR TRUSTEES AND BOARD MEMBERS OF FIDUCIARY STRUCTURES

Trustees and board members of Liechtenstein fiduciary structures may be held liable for the entire damage caused by their negligence. If, for example, claims for third-party payments lost by a Liechtenstein trust or company amount to CHF 1 million, then the responsible trustee or board member may also be held liable to pay damages in this amount to the injured party, i.e., the company or, in the case of trusts, the settlor or beneficiaries. Such liability claims against trustees and board members are also subject to limitation periods that, depending on the circumstances, can be three, ten or even 30 years.

23 LGBl. 2022 No 167, sec. II and III

24 art.182 (1) PGR (LGBl. 2000 No 279)
25 art.182 (2) PGR (LGBl. 2008 No 220)

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The three-year limitation period starts when the damage and the damaging party became known to the injured party and it requires that the injured party can be reasonably expected to pursue such claims against the trustee or board member. According to Liechtenstein jurisprudence, the latter requirement is usually not met as long as the fiduciary structure is still represented by the liable board members.[26]

The ten-year limitation period starts when the damaging act occurred, i.e., when the trustee or board member of the fiduciary structure failed to pursue claims against banks and/or asset managers.[27] Since this failure constitutes an ongoing act that will last until 1 June 2023, i.e., when claims regarding third-party payments expire, it is the opinion of this author that the ten-year limitation period will only start on 1 June 2023.

The 30-year limitation period requires 'intentional infliction' of damage, which means that the person causing the damage must consider damage for the fiduciary structure to be possible and accept this potential outcome.[28] Trustees or board members of fiduciary structures may regularly fall under this prescription period if they know that claims against banks and asset managers could exist but still fail to take any action.

Interestingly, the law provides that the 30-year limitation period will apply to trustees and board members who are not supervised by the FMA, but it will not apply to local trustees and board members with a Liechtenstein trustee permit.[29] In the opinion of this author, this constitutes a discrimination of international trustees and board members, which can hardly be justified under constitutional law.

26 art.226 (1), the PGR (LGBL. 2022 No. 227); § 1489a (1), *General Civil Code* (LGBl. 2022 No. 167); decisions of the Court, 3 September 2009, 09 CG.2006.312, LES 2010, 73; 5 April 2001, 1 C 586/98-38; 7 January 2009, 1 CG.2006.303; Öhri, *Die Grundlagen der zivilrechtlichen Verantwortlichkeit der mit der Verwaltung und Geschäftsführung einer AG, Anstalt oder Stiftung betrauten Organe*, LJZ 4/2007, p.100
27 art.226(1), the PGR (LGBL. 2022 No. 227); § 1489a (1), *General Civil Code* (LGBl. 2022 No. 167)
28 The ten-year limitation period applies if the conditions for the three-year limitation period are met. Article 226 (1), the PGR (LGBL. 2022 No. 227), Öhri, in Heiss/Lorenz/Schauer, *Kommentar zum liechtensteinischen Stiftungsrecht*, 2nd edn., 2022, art.226, p.912.

CONCLUSION AND RECOMMENDATIONS

In light of the above, it is fair to say that Liechtenstein is currently undergoing a retrocession crisis.

For decades, Liechtenstein banks and asset managers have taken advantage of third-party payments that were withheld and kept secret from national and international clients. In 2020, the Court rendered this business model practically illegal and endorsed clients' rights to claim back third-party payments made in connection with client relationships.

In the immediate wake of these decisions, the government rushed to change the law with a view to protecting banks and asset managers from high recovery claims. The new law reduces the limitation period pertaining to claims for information and surrender of third-party payments from 30 to three years with retroactive effect as of 1 June 2023.

There can be no doubt that the new law was not well thought through. Not only does it fail to take into account the interests of thousands of vested clients integral in the establishment of Liechtenstein as an important financial centre but it also inadvertently places enormous pressure on trustees and board members of Liechtenstein fiduciary structures who, in order to avoid liability, have to assert claims for third-party payments against banks and asset managers within an extremely limited timespan before they expire on 1 June 2023.

Against this backdrop, this author recommends that trustees and board members take the necessary steps to prevent claims regarding third-party payments from expiring. Under Liechtenstein law, this requires filing a lawsuit against the recipient of third-party payments (bank and/or asset manager) with the Princely District Court in Vaduz or obtaining a declaration of waiver to plea statute of limitation, signed by the recipient of third-party payments, in both instances before 1 June 2023. Given the complexity of the subject matter, consulting a legal expert is advised. ■

29 See § 1489a (1), *General Civil Code* (LGBl. 2022 No. 167) (*lex specialis*)