Federal Court of Justice rules fund fee clause in general and special fund rules invalid

In its judgment of 5 October 2023 (case no. BGH III ZR 216/22), the German Federal Court of Justice (BGH) ruled market standard clauses in fund rules that, inter alia, provided for the deduction of a ‚flat fee of 1.5% p.a.' from the assets of an undertaking for collective investment in transferable securities (UCITS) by the management company to be invalid because such clauses were not clear and easy to understand for investors and therefore unreasonably disadvantageous. These challenged clauses were based partly on the samples provided by the German Investment Funds Association (BVI) that had been agreed on with the German Federal Financial Supervisory Authority. The judgment therefore potentially affects a significant number of fund providers operating in Germany that have used these or similar clauses at least to some extent in their own business. However, this judgment is also relevant to foreign fund providers who market their products in Germany. Besides the uncertainty as to what costs a fund may incur going forward if one of its fee clauses is invalid, there are also legal risks surrounding fees charged in the past.

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Investor lawsuit against management company's fee deduction

The judgment was handed down on the action brought by an investor against the management company of a UCITS investment fund. The investor demanded the repayment of distribution fees that the management company had deducted from the assets under management *inter alia* for the payment of retrocession fees. In its defence, the management company based its arguments on a clause in its ‚*Special Fund Rules*' that permitted it to deduct from the UCITS fund assets *‚[...] a daily flat fee of 1.5% p.a. of the value of the UCITS fund assets calculated based on its asset value as determined on an exchange-trading-day basis (see clause 18 of the „GFR") [...]'*. In addition, that *‚all-in-one*' fee was to cover all remuneration and refundable expenses owed to the management company, including for the fund management and administration, distribution costs and service fees.

For the purposes of calculating the *daily flat fee*, according to the cited clause 18 of the ‚*GFR*', ‚*the market values of the assets belonging to the UCITS fund are determined less any loans taken out and other liabilities (net asset value) and divided by the number of outstanding units*'. The amount so calculated then served as the fee assessment basis. While that determination was made ‚*on an exchange-trading-day basis*', the management company and the depositary were permitted to forego ‚*any determination of the value on public holidays that are exchange trading days, as well as on 24 and 31 December of any year*'.

BGH: remuneration periods and calculation methods unclear

The BGH also criticised that the clauses did not make explicitly clear to a well-informed investor at what intervals the management company was to receive the remuneration in question, nor the specifics of how it was to be calculated. The court therefore found them invalid pursuant to Sec. 307(1) sentences 1 and 2 of the German Civil Code (BGB).

Furthermore, the clauses did not sufficiently explain how the remuneration was to be calculated on days that were not exchange trading days. According to the judgment, it was unclear whether the per annum calculation was to be based on an average value or a value as of a record date, whether it be a day on which exchanges are open for trading or not. Moreover, the deduction clause identified the ‚*asset value*' as the relevant amount, but without clearly defining what that term meant. The court found that the term was unclear also because clause 18 of the ‚*GFR*', which is merely referenced using the qualifying abbreviation ‚*vgl.*' (‚see'), used the different term ‚*net asset value*', which gave rise to doubts as to whether the term was to be equated with ‚*asset value*'.

The BGH left the question unanswered whether a reference to an investment prospectus might dispel this uncertainty – the same as it did the questions regarding whether the clauses additionally violate either the rules of conduct obligations under Sec. 26 of the German Capital Investment Code (KAGB) or the transparency requirements under Sec. 162 KAGB or under what circumstances fund rules become part of an investment agreement if and when funds are merged.

Effects on fund providers uncertain

The BGH has set aside the appeals court judgment that dismissed the action and has sent the case back to the appeals court to be retried. That court must now determine whether the investor has a claim against the management company for the refund of the deducted distribution fees for lack of a valid deduction clause. The extent to which the management company might have a claim to the fees remains an unanswered question. In principle, pursuant to Sec. 306(2) BGB, the clause's invalidity now results in statutory provisions applying. Pursuant to Sec. 93(3) KAGB applied *mutatis mutandis* in conjunction with Sec. 670 BGB, a management company could demand reimbursement only of *necessary* expenses incurred for its services.

This judgment marks a continuation of the trend among courts and regulators to make more rigorous demands on the transparency of financial investment products' expense ratios. In principle, not even the managers of foreign funds, including Luxembourg UCITS, are immune to the possible consequences. Only recently, in March 2023, the BGH (case no. III ZR 108/202) ruled that the principle of monitoring consumer contracts (*AGB-Kontrolle*) applied to Luxembourg fund rules on the basis of Art. 6(1) of the Rome I Regulation.

Fund providers should check whether or not the fee clauses they have used or are using pose similar issues. The judgment is expected to lead to further court cases. Class actions such as representative actions brought by consumer associations or mass litigation waged by legal tech debt-collection providers are also conceivable.

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