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Cum-ex: a game of high-stakes musical chairs

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On 23 September 2020, the Frankfurt District Court in Germany held that Deutsche Bank was not liable to compensate German private bank M.M. Warburg for its €167m tax bill in connection with cum-ex transactions. Why is this case relevant?

Coverage of cum-ex has only recently started to gain considerable traction globally. At the same time, litigation such as the case of Warburg against Deutsche Bank, along with other recent cases, might indicate that the 'cum-ex saga' may have moved to the next level: parties involved in cum-ex trading schemes are suing each other in order to recoup the costs.

This article looks at cum-ex transactions in light of the recent increase in litigation. It provides background on cum-ex schemes and highlights the complexity and magnitude of the issue.

M.M. Warburg's lawsuit against Deutsche Bank

In the lawsuit, which had been ongoing since 2018, Warburg was seeking for Deutsche Bank to reimburse its tax liabilities in connection with cum-ex transactions. Deutsche Bank acted as the custodian of ICAP in around 400 share transactions between 2007 and 2011 around the dividend date, in which ICAP had sold shares to M.M. Warburg. Warburg argued that Deutsche Bank, in its role as custodian bank for ICAP, should have transferred taxes to the tax authorities.

Deutsche Bank rejected the claim, arguing that Warburg knew that custodian banks never withheld and transferred money to tax authorities in connection with cum-ex schemes. The court followed Deutsche Bank's argument, setting out that Warburg is the original tax debtor and therefore has to bear the tax liability.

Warburg increased its claim several times during the proceedings up to the final amount of €167m (plus €21m in interest). This amount will be familiar to those following cum-ex: Warburg was ordered to pay €167m as part of the recent landmark decision on cum-ex by the Bonn District Court. In the criminal proceedings against two former London-based investment bankers regarding their role in cum-ex schemes, the Bonn District Court, as the first German court making a decision on this issue, held that cum-ex schemes had always been illegal and, as this should have been obvious to all participants, cum-ex transactions constituted serious tax fraud. The court issued suspended prison sentences for both defendants, and ordered Warburg to repay €167m, being the profits made from cum-ex transactions between 2007 and 2011.

It seems that the story may not end here for Warburg, with the next chapter of legal proceedings on the horizon. The bank has appealed the decision by the Bonn District Court ordering it to pay €167m. The case will next be heard before the German Federal Court of Justice. While the Frankfurt District Court rejected the claim against Deutsche Bank, it hinted that Warburg might be able to instead sue ICAP, the share seller. Warburg is said to be considering further courses of action against other parties.

Finally, Cologne prosecutors filed indictments in June 2020 with the Bonn

District Court against four present or former bankers of Warburg in connection with their roles in cum-ex schemes. While the admission proceedings are still pending, the case will almost certainly proceed. While the defendants in the first cum-ex trial before the Bonn District Court extensively cooperated throughout the proceedings and in turn received relatively lenient sentences, the four defendants in the present case have so far not cooperated or commented on the allegations.

Losses from cum-ex schemes are estimated to be a staggering €55bn. Only a few cases have been decided by the courts in criminal or civil proceedings so far, with appeals often still pending. With the number of individuals and firms under investigation reportedly reaching nearly 900, and a steady increase of pending and scheduled legal proceedings, more financial services providers may find themselves in a situation similar to that of Warburg.

What is cum-ex

While cum-ex as a topic is gaining global attention, details of how the schemes worked are still scarce. This makes it difficult for financial services firms to assess their possible exposure.

Shares with or without dividend entitlement. The term 'cum-ex' refers to the trading of shares with (cum) or without (ex) entitlement to dividend after a company has declared but not yet paid the dividend. Cum-ex schemes involved complex securities trading transactions in which multiple investors and institutions collaborated to ultimately receive multiple refunds of dividend withholding tax from tax authorities that had only been paid once. Cum-ex transaction patterns are similar to those of dividend arbitrage. However, while dividend arbitrage realises profits from hedging the difference in value between shares cum and ex-dividend, the sole purpose and profit of cum-ex schemes was to achieve duplicate re-payments of taxes only paid once.

Local schemes with global participants. Cum-ex schemes are said to have been operated mainly in Germany, and on a smaller scale in Denmark, the Netherlands, Austria, Belgium, France, and Italy. The schemes were set up from around 2002 and flourished between 2005 and 2012, when changes to the law in Germany put a stop to the schemes there. While the schemes were related to shares traded in those jurisdictions, participants are said to include funds, asset managers, private banks, and large financial institutions globally with many well-known institutions implicated.

How cum-ex schemes worked

Cum-ex schemes were developed based on an alleged loophole in German tax legislation based on the separation of the economic and legal ownership of shares. A typical cum-ex scheme involved at least three investors. In Germany, dividend tax was withheld and paid to the tax authorities at source, with institutional investors, which were tax exempt, able to reclaim the withheld tax through tax certificates issued by their custodian banks.

Using a combination of short-selling and over-the-counter equity trading transactions around the cum-ex date, the impression was created that two parties – the original holder of the shares and the party buying shares through a short-selling agreement from a third party – were entitled to tax refunds. As a result, both received tax certificates from the respective custodian bank, even though the tax was only paid once to the tax authorities. In addition to the direct share transactions, the parties would enter into various hedging instruments to protect themselves against share price fluctuations and to distribute the profits from the arrangement.

What to do next?

Cum-ex is not only complex, it also relates to transactions made typically eight or more years ago. It is only now, as criminal and civil cases come to courts, that the issue is gaining greater prominence outside the relevant jurisdictions. As more parties suffer losses as a result of repayment demands or court orders for repayment of profits, they may consider how to pass on some or all of those costs to other participants. A wider circle of financial services firms, with varying degrees of involvement in cum-ex, may therefore now face legal, financial and reputational risks.

It is essential for senior management teams and heads of legal and compliance to understand their organisation's exposure to potential claims and prosecution so that they can prepare to protect their organisation. This process often starts with an internal investigation in order to gain the necessary understanding to be able to proactively address any potential risks.

In this high-stakes game of musical chairs, when the music stops, the litigation begins. Make sure you are not left standing. ■

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