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UPDATE

Primeo v HSBC: Cayman Court of Appeal considers service provider claims

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On 13 June 2019, following a 10-day appeal hearing at the end of last year, the Cayman Islands Court of Appeal (the CICA) handed down its ruling in Primeo Fund v Bank of Bermuda (Cayman) Ltd & Anr - Appeal 21 of 2017 (the Judgment). The Judgment considers the claims being advanced against HSBC group companies in their roles as administrator and custodian to Primeo Fund (in Official Liquidation) (Primeo), a Madoff feeder fund. The claims have been made good, subject to the question of reflective loss which Primeo's liquidators are now considering appealing to the Privy Council.

At first instance, Mr Justice Jones QC (the **Trial Judge**) held that Bank of Bermuda (Cayman) Limited (**BoB Cayman**) and HSBC Securities Services (Luxembourg) SA (**HSSL**) (together, **HSBC**) breached various ongoing duties in their dual capacities as administrator and custodian to Primeo, and also that HSSL was strictly liable for the theft of the cash invested with Bernard L Madoff Investment Securities (**BLMIS**). However, notwithstanding these findings, no damages were awarded because the Trial Judge held that Primeo had not suffered any loss when paying cash over to BLMIS, that HSBC had not caused the losses through its breaches of duty and that Primeo's losses were reflective of losses suffered by other Madoff feeder funds into which Primeo had subsequently switched its Madoff investments. Our briefing on the Grand Court judgment is here.

Primeo appealed certain findings and HSBC filed an extensive cross-appeal seeking to challenge, amongst other things, the factual findings that HSBC was strictly liable for the losses, owed relevant duties under the administration and custodian agreement and had breached those duties.

Executive summary

Primeo's appeal largely succeeded with the CICA holding that Primeo suffered loss when paying cash over to BLMIS and that HSBC had caused Primeo's losses by breaching its duties as both administrator and custodian. The CICA also held that Primeo's claims were not time barred for limitation purposes and reduced the deduction for contributory negligence from 75% to 50%. HSBC's cross-appeal was largely rejected save in relation to contributory negligence where the CICA found that the deduction should be applied to the custodian claim as well as the administrator claim, but not to the strict liability claim.

The only remaining hurdle to recovery for Primeo's stakeholders, who are principally small Austrian investors who lost their savings through the Madoff fraud, is the rule against reflective loss. The CICA adopted a broad interpretation of the principle and their approach is discussed in greater detail below. The precise boundaries of the principle remain unclear and the UK Supreme Court is due to hand down a judgment on the subject later this year, which may shed further light on the scope of its application.

Alongside the reflective loss analysis, the Judgment contains some useful guidance as to how the courts will approach service provider claims and will be of interest to directors, managers, investors, service providers and their advisors. We set out more detailed commentary in respect of each of the CICA's main findings below.

Strict liability and relevant loss

The Trial Judge accepted that HSSL is strictly liable for the acts of BLMIS as its sub-custodian, but held that Primeo suffered no relevant loss as a result of any wilful default by BLMIS because, he said, Primeo realised the full reported value of the assets by switching to an indirect investment through Herald Fund SPC on 1 May 2007 (the Herald transfer).

The CICA concluded that, under the Custodian Agreement, HSSL owed a duty of safekeeping in respect of Primeo's cash. On each occasion when Primeo advanced cash to BLMIS, instead of receiving a chose in action against an honest and solvent broker for the value of the cash invested, the CICA held that Primeo merely received a chose in action against a fraudulent Ponzi scheme. Primeo, therefore, suffered an immediate actual loss on each occasion it advanced cash to BLMIS.

The CICA also agreed with Primeo that the Trial Judge should have asked himself whether the Herald transfer conferred a benefit on Primeo that nullified the losses Primeo had already suffered as a result of the breaches of the duty to keep cash safe. The CICA concluded that the answer to that question should have been "no" because, by the Herald transfer, Primeo did not improve its previous position. Rather than having a direct chose in action against the fraudulent Ponzi scheme, after the Herald transfer Primeo had a chose in action against Herald but the value of that chose in action was directly referable to the fraudulent Ponzi scheme in which Herald had invested all its assets.

These findings reflect a common sense approach. HSBC had sought to argue that by meeting redemptions from time to time, by misappropriating cash from other investors, BLMIS was meeting its obligations, and HSSL could not therefore be liable for its sub-custodian's fraud. That argument was rejected by the CICA.

The CICA's findings on strict liability highlight the risk of delegating the performance of important functions to third parties without appropriate checks, balances and oversight.

Duty and breach

At first instance, the Trial Judge held that HSBC owed and breached various ongoing duties as administrator and custodian to Primeo prior to Madoff's arrest in December 2008. Such breaches by HSBC included: adopting grossly negligent NAV calculation procedures; failing to give any consideration or make any recommendations to Primeo in relation to safeguards which were readily available and, if implemented, would have been effective to safeguard Primeo's assets; and failing to ensure that BLMIS was and/or remained suitable to act as sub-custodian.

HSBC lodged an extensive cross-appeal against the findings that it owed duties and had breached them. The CICA dedicated a section of its judgment to setting out the role of the appellate court and the need to be cautious in interfering with findings made by the Trial Judge based on an evaluation of the facts. The CICA summarised the position by quoting Clarke LJ's observations in *Assicurazioni Generali* stating that, where an appeal court is considering an evaluation of the facts, it should only interfere where the trial judge "*has exceeded the generous ambit within which a reasonable disagreement is possible*".

Applying that test, the CICA rejected HSBC's cross-appeal and upheld the Trial Judge's findings on the duties that were owed and the breaches of those duties. Similarly, the CICA formed the view that the Trial Judge's finding of gross negligence could not be faulted.

The CICA agreed with Primeo that HSBC had not done anything to address the underlying issue of establishing whether the assets purportedly held by Madoff existed. There were readily available safeguards which HSBC could and should have recommended to Primeo, and not doing so was negligent. BLMIS was the investment manager, broker and sub-custodian on his accounts, and that unique business model was essential for the purposes of the Ponzi scheme. This is, of course, one of the reasons why it was (and still is) conventional practice for the core functions of hedge funds to be segregated amongst multiple independent professional

service providers. As the CICA and Trial Judge observed, if presented with an unconventional scenario like the BLMIS model, professional service providers are expected to consider the risks and how to address them in order to perform their duties to the requisite standard, which may include having to recommend additional safeguards that may not be required in the usual case. The CICA's finding acknowledges that the service provider is being retained and paid for its expertise in a particular area and the client should have the benefit of that specific expertise.

Causation

Despite the need to be cautious in overturning an evaluative finding by a Trial Judge, the CICA considered that the Trial Judge's findings on causation fell outside the range of findings that were reasonably open to him.

The Trial Judge held that Primeo had not established that HSBC's serious breaches of contract were an effective or dominant cause of Primeo's lost investments. The CICA held that Primeo was entitled to succeed if it could show that there was a real or substantial, rather than speculative, chance that a third party would have acted in a way that caused the loss to be avoided. The CICA focused on the fact that from 2005 HSSL improperly issued custody confirmations to the auditors, EY, confirming the existence of the assets purportedly held by BLMIS, in circumstances where HSSL had taken no steps whatsoever to verify the existence of those assets and in fact shared the concerns held by the auditors as to whether the assets existed. The wrongful issue of the custody confirmations was the only basis on which EY was able to give clean audit opinions, which allowed Primeo to continue operating and investing with BLMIS. The CICA concluded that there is undoubtedly a real chance that EY would not have produced clean audit opinions had HSSL not issued the custody confirmations.

The CICA overruled the Trial Judge on the basis that it was not probable that the directors would have found a way to continue investing with BLMIS in circumstances where the custodian, administrator and auditors were all indicating that there was a serious issue because they were unable to verify that the assets purportedly held by BLMIS actually existed.

The Trial Judge's conclusions illustrate the difficult position office holders are in when trying to prove the causation element of breach of contract claims. The Trial Judge required evidence on causation from witnesses of fact, notwithstanding that the causation analysis involved looking at a hypothetical scenario rather than matters which had actually happened. The Primeo liquidators had gone to great lengths to obtain evidence from former directors, which the Trial Judge then rejected. The CICA's approach, which involved considering the facts and drawing appropriate inferences from them, should make it easier for office holders to prove causation.

Limitation

The proceedings against HSBC were issued by Primeo on 20 February 2013. In the Cayman Islands, as in England, an action founded upon a breach of contract cannot usually be brought more than six years after the date upon which the cause of action accrued. Accordingly, HSBC asserted that any claims which accrued prior to 20 February 2007 are time-barred.

The Trial Judge and CICA agreed that there were periodic breaches by HSBC and fresh causes of action after 20 February 2007 (including a custody confirmation issued on 23 February 2007 and the striking of monthly NAVs), such that limitation issues did not prevent recovery in this case. However, the limitation issues may be relevant to the quantum of the claims. Primeo had therefore argued that certain statutory exceptions to the general rule applied in this case.

In relation to its strict liability claim against HSSL, Primeo argued that, for limitation purposes, BLMIS' acts should be attributed to HSSL. BLMIS deliberately concealed facts from Primeo, and HSSL was strictly liable for the acts of BLMIS. Accordingly, Primeo asserted that time did not begin to run until Primeo could, with reasonable diligence, have discovered the fraud or the concealment (i.e. time began to run when Madoff was arrested on 12 December 2008). As that was *after* 20 February 2007, the CICA agreed that no part of Primeo's strict liability claim is statute barred.

Primeo also argued that, in relation to the claims for breach of administration and custody duties, HSBC acted recklessly and that was the equivalent of deliberately breaching their duties for limitation purposes. If Primeo was correct, it would mean that the limitation period for the breach of duty claims would be extended in a similar way to the strict liability claim. The Cayman Limitation Law is based on the UK Limitation Act 1980. Prior to 1980, it was clear that recklessness was sufficient to extend the limitation period. Furthermore, one of the leading text books, *Clerk & Lindsell on Torts*, expresses the view that the new legislation preserved and confirmed the case law that recklessness suffices.

The CICA concluded that, notwithstanding the position prior to 1980, it was difficult to construe the words "deliberate commission of a breach of duty" as including recklessness. The CICA summarised the test as one of active concealment and clear intention. Although HSBC was found to have been indifferent to obvious risk and acted in a way that showed a serious disregard of the risks associated with the BLMIS model, the CICA held that this was not enough to extend the limitation period.

Contributory negligence

The Trial Judge had concluded that Primeo's damages against BoB Cayman, as administrator, should be reduced by 75%.

Primeo appealed against that decision, arguing that contributory negligence did not apply at all because it had engaged an apparently competent professional to carry out skilled activities. Primeo submitted that it was entitled to trust service providers, such as HSBC, to do their job properly and comply with their contractual obligations. Primeo argued that the fund structure sought to allocate risk and HSBC should not be able to shift that contractual allocation of risk back on to Primeo.

The CICA determined that, in the light of BoB Cayman's status as a professional administrator and the tasks assigned to it by the contract, attributing 75% of the fault to Primeo was well outside the range of outcomes reasonably open to the Trial Judge. However, the CICA concluded that Primeo was independently at fault and negligent in appointing and retaining BLMIS in a tripartite capacity and in failing to conduct its own adequate due diligence on the custody arrangements, notwithstanding the contractual allocation of that risk to the custodian. Therefore, the CICA formed the view that Primeo is 50% at fault and that any damages awarded should be reduced accordingly.

The Trial Judge had held that Primeo's claim against HSSL, as custodian, was not subject to a defence of contributory negligence. However, the CICA concluded that HSSL's liability arises from a contractual obligation, which is in substance the same as the tortious obligation to exercise reasonable skill and care. Therefore, the CICA held that HSSL can also rely on the defence of contributory negligence.

The CICA's judgment could have a significant impact on litigation in the investment fund sector, where risks are contractually allocated to third party service providers. Implicit in the CICA's judgment is the proposition that directors may not be able to rely on advice received from professional service providers without conducting their own due diligence, even on risks specifically allocated to the professional service providers, before proceeding. There may also be a substantial risk of the courts finding contributory negligence at a later stage and reducing any award of damages against the service provider, leaving the fund and investors to bear the losses.

Reflective loss

The doctrine of reflective loss generally applies where a company and a shareholder both have a claim against the same defendant arising out of the same facts. Lord Bingham summarised the propositions behind the principle in *Johnson v Gore Wood* as follows:

(a) Where a company suffers loss by a breach of duty caused to it, only the company may sue in respect of that loss.

(b) Where a company has suffered loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it.

(c) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by a breach of duty independently owed to the shareholder, each may sue to recover the loss caused to it by the breach of duty owed to it but neither may recover loss caused to the other by the breach of the duty owed to that other.

The core policy justifications for the principle include: the avoidance of double recovery; the avoidance of conflicts of interest; the need to preserve company autonomy; and the need to protect minority shareholders / creditors. Although the propositions at (a) – (c) above only refer to shareholders, in more recent cases the reflective loss principle has been found to apply to claims brought by employees and creditors as well.

However, in other respects, the scope of the reflective loss doctrine remains unclear. A number of issues relating to reflective loss arose in this case, including the timing point and threshold point. The timing point concerned causes of action that Primeo maintained were fully accrued prior to the Herald transfer. Primeo argued that because these actions were fully accrued prior to the Herald transfer, the losses arising in relation to those causes of action could not be said to be reflective of loss suffered by Herald.

The threshold point concerned the merits test which should be applied in relation to the claims which were said to give rise to the application of the reflective loss principle, did they have to be likely to succeed or was it sufficient for them to be sufficiently arguable to avoid being immediately struck out? There were, however, also other issues because, for example, there were different defendants to the claims which were said to be reflective.

Had Primeo succeeded on any of the points relating to reflective loss, it would have recovered damages from HSBC, but the CICA found against Primeo on these points. The CICA held that it did not matter that Primeo's claims were fully accrued before the Herald transfer, because the time to consider whether the claims were reflective was when the claims were issued rather than when they accrued. The CICA also held that, notwithstanding that save for reflective loss Primeo had a good claim against HSBC, it should be prevented from pursuing that claim because Herald had a claim that was arguable and could survive an immediate strike out application. It further held that it did not matter that Primeo and Herald's causes of action were different, under different contracts governed by different laws and against different defendants, because there was a possibility that liability might nonetheless end up with HSSL and the claims were therefore reflective. In summary, whilst the CICA acknowledged that there were indications in some of the authorities which favoured caution as to the ambit of the reflective loss principle, the CICA adopted a broad view of the reflective loss principle.

It remains to be seen whether the broad approach adopted by the CICA is the correct approach to reflective loss. As in this case, if it does represent the position, it has the potential to operate harshly against plaintiffs. It may deprive a plaintiff with a good claim of any recovery purely on the basis that there is a company that has an arguable cause of action (but which is likely to fail) against different defendants which, in the unlikely event that it succeeded, could result in some kind of recovery for the plaintiff. The Supreme Court is due to hand down judgment in *Garcia v Marex* and this may help to clarify the position, although that case does not involve the same issues that arose here.

Comment

The breach, causation, strict liability and loss findings are likely to be helpful for funds bringing claims against their service providers. However, the parts of the judgment concerning limitation, contributory negligence and reflective loss illustrate that it can be very difficult to succeed on these kinds of claims. Liquidators are in a particularly challenging position in that regard, given that they generally have no contemporaneous knowledge of events and may struggle to gain access to witnesses and/or documents.

Primeo's liquidators are now considering a possible appeal to the Privy Council on at least the reflective loss issue. Mourant acts for the Primeo liquidators (Gordon MacRae and Eleanor Fisher of Kalo Advisors) in these proceedings and other related litigation.

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