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UPDATE

Fairfield Sentry suffers setbacks in the BVI

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Fairfield Sentry Limited (**Fairfield**) was a BVI investment fund which had approximately 95 per cent of its assets invested in Bernard Madoff Investment Securities Ltd (**BLMIS**). Like many similarly affected funds, it went into liquidation following the discovery of the Madoff fraud.

Fairfield was placed into liquidation in July 2009. Shortly after the commencement of the liquidation, Fairfield's liquidators commenced 'clawback' claims against a number of Fairfield's investors who were paid redemption proceeds prior to the fund's demise. The liquidators sought to recover these redemption payments.

The liquidators' two principal arguments were:

1. That the payment of redemption monies was made by Fairfield under a mistake of fact, namely that it was not known that BLMIS was operating a Ponzi scheme and that Fairfield's investments in BLMIS were therefore lost from the date that they were invested and, as a consequence, its shares were virtually worthless.
2. That the contracts of redemption themselves were void on the grounds of common mistake, with the consequence that money paid under them by Fairfield could be recovered.

As discussed in further detail below, both arguments were rejected at both first instance and, more recently, on appeal.

The proceedings have been watched with interest by those in the insolvency profession, both in the BVI and the wider offshore world. The reason for this interest is that, quite often, liquidators appointed over offshore funds will find themselves faced with situations in which those funds have paid out redemption proceeds to investors, and subsequently it is revealed that the funds were insolvent, or (as here) the victims of a fraud at the time of such payments.

If liquidators are unable to pursue the statutory remedies available to them (eg to avoid preferences, or to recover dispositions at an undervalue), and there is doubt as to the state of knowledge of the investor receiving the payment (so as to found a constructive trust-based claim, or the like) then those liquidators may have cause to consider the common law claims available to them, which arguably may not require such knowledge.

There have been various suggestions as to the type of common law claims that might be brought in such situations. These have included claims founded upon the *ultra vires* status of the payments, with the result that the payments were made in circumstances amounting to a 'total failure of consideration', or alternatively claims that the redemption payments were paid pursuant to a 'mistake'.

However, the claims brought by Fairfield are the first well publicised attempts by liquidators to pursue such claims in practice. Unfortunately for Fairfield, its attempts to do so proved unsuccessful.

Fairfield v Bank Julius Baer and others – 16 September 2011[1]

The first decision of the BVI Court concerned Fairfield's primary claim that the monies were paid by Fairfield under a mistake of fact.

Rather than having a full trial upon this claim, the BVI Court first considered several preliminary issues. All but one were directed to various arguments as to the existence and effect of certificates from the fund's directors that may have had the effect of making the various Net Asset Value (NAV) calculations under which the redemption payments were made, binding and final on all parties. The Court held that no such certificates existed.

That cleared the way for the BVI Court to determine the preliminary issue going to the heart of whether a mistake claim could be brought under these circumstances, namely:

> 'Whether a redeeming Member of the [fund] in surrendering its shares gave good consideration for the payment by the [fund] of the Redemption Price and, if so, whether that precludes the [fund] from asserting that the money paid to that Member on redemption exceeded the true Redemption Price and as such is recoverable as to the excess from such redeeming Member.'

The Court held that the fund would not be able to recover a payment made by mistake in circumstances where it had received good consideration from the payee. In this situation, the consideration received by the fund was the surrender of the rights of the redeeming shareholder. The consequence was that it was not now open to the fund to recover the redemption price from its redeeming investors, simply because it calculated the NAV upon information (ie the value of the securities invested through BLMIS) which had subsequently proved unreliable for reasons unconnected with any of the redeeming investors.

The Court also commented that it did not see how the fund could recover the redemption price in circumstances in which *restitution in integrum* (ie the ability to restore the parties to their original positions) was not possible.

ABN AMRO v Fairfield– 10 October 2011[2]

The second decision of the BVI Court concerned the remaining, common mistake claim. After considering the way that this claim had been pleaded, along with whether or not he could now hear further argument from the parties in relation to this claim, Bannister J. considered whether this claim was strong enough to be allowed to continue to a full merits trial.

The learned judge considered some of the authorities on common mistake, including the observation of Lord Thankerton in *Bell v Lever Bros* that a common mistake will not avoid a contract unless it is related to something that both the parties must necessarily have accepted in their minds as an essential and integral element of the subject matter.

He then applied those principles to the facts before him, finding that the common mistake was that Fairfield had invested in BLMIS which (the Court assumed) Fairfield and the investor had believed to be genuine, but which turned out to have been run fraudulently. However, the Court held that this mistake had 'no impact whatsoever' upon the fund's ability to perform its obligation to make a redemption payment upon being served with a redemption notice by that investor.

As the Court commented, the fund's 'case on common mistake confuses (1) a shared mistaken assumption the truth of which is a necessary condition for the performance of a particular contract with (2) a shared mistaken assumption about the background against which it is expected that the contract will be performed. The former case will mean that no contract can, as a matter of law, be concluded. The latter will not.'

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[1] BVIHC (COM) 30/2010 and 7 other claims.

[2] BVIHC (COM) 30/2010.

The appeals[3]

Fairfield was granted leave to appeal, and its appeals were heard by the Eastern Caribbean Court of Appeal in January 2012. In upholding the earlier decisions of Bannister J, the Court of Appeal held that, notwithstanding the true value of the redeemed shares, those investors who redeemed their shares gave good consideration for the redemption proceeds they received, being the surrender of their shares, and thus had a complete defence to the claims levied against them by Fairfield.

Pereria JA, who delivered the Court's judgement on the point, noted:

> 'I agree with the [investors] that [the fund's] contractual obligations gave rise to a debt obligation whatever the value of the shares and the surrender of the rights to the shares by the [investors], in my view, having fully performed their part of the contract, gave good consideration which defeats [the fund's] restitutionary claim.'

She continued:

> 'I do not consider that the mistake here undermined the legal obligation placed upon [the fund] under the contract which required it to pay the redemption price by way of discharging its obligations on the redemption of the shares. The subject matter of the contract was the shares. The contract for the shares was with [the fund] and not with BLMIS, and therefore it mattered not what was the value of [the fund's] investment in BLMIS. This did not form part of the contract. It was [the fund] who had to determine the value of the payment for the redeemed shares but making that determination or having mistakenly so determined it, does not nullify the obligation to pay on redemption. The initial consideration was the subscription monies. I do not consider that it was of no value. The initial consideration was also fixed by reference to [the fund's] NAV. [the fund] clearly obtained something of value when it issued the shares pursuant to the Article 10 contract. On the payment of the redemption price [the fund] got precisely what it paid for - the shares. [the fund] was not carrying on a fraudulent Ponzi scheme. Indeed in the context of the subscription contract and Article 10 Sentry got all that it bargained for. This was not a contract where it can be said that the subject matter either did not exist, or ceased to exist or where the performance of the terms were impossible. It cannot be said that it was impossible for [the fund] to redeem or purchase the shares at a price to be fixed solely by [the fund]. Indeed the mistake as to [the fund's] NAV cannot be said to be a common mistake but [the fund's]. As was said by Lord Atkin in Bell v Lever Brothers, mistake as to a quality of the thing contracted for would not affect assent unless it was the mistake of both parties, and was as to the existence of some quality which made the thing without the quality essentially different from the thing as it was believed to be. The subscription contract was for the shares, and the redemption payment for the surrender of the shares and not for a specific value of any interest or investment in BLMIS.'

Accordingly, Fairfield's appeals were dismissed.

Appeals to the Privy Council

Fairfield and the investors each appealed to the Judicial Committee of the Privy Council, who heard the appeals on 18 and 19 March 2014. In a judgment given on 16 April 2014, the Privy Council confirmed the First Instance and Court of Appeal's ruling that the investors who redeemed their shares gave good consideration for the redemption proceeds they received. The Privy Council also overturned the lower courts' decision in relation to the question of certificates, holding that the documents relied upon by the investors did amount to certificates which had the effect of making the various NAV calculations binding and final on all parties. For a full explanation of the judgment of the Privy Council, please see our update 'Fairfield Sentry claims refused by the Privy Council'.

Conclusion

The decisions provide useful and timely guidance as to the limits upon a fund's ability to levy clawback claims against those investors to whom the fund has previously made redemption payments. The decisions will no doubt bear heavily on the minds of liquidators who have been appointed over investment funds

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[3] HCVAP 2011/041 and related matters.

over recent years, particularly those investment funds which, upon examination, appear to have had a record of publishing inflated NAVs during their lifetime. Although the consequences of upholding the good consideration defence may be seen as harsh – particularly for those investors who are left to 'carry the can' - the commercial consequences in not doing so would likely be far worse: the need for certainty in commercial transactions is paramount and, in the context of an investment fund, investors require certainty so to ensure that they need not be concerned with the affairs of a fund from which they have severed all ties. Had the Courts upheld Fairfield's claims, this commercial certainty would have been severely jeopardised, placing many investors in an unenviable position.

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