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UPDATE

Make no mistake: Cayman Courts will uphold contractual arrangements

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The Cayman Islands Grand Court has now provided guidance on the role of the law of common mistake in the context of investments in Ponzi schemes. In so doing, the Court ruled in favour of Primeo Fund (in Official Liquidation), holding that its US$463 million dollar in specie subscription in Herald Fund SPC (in Official Liquidation) was not void for mistake.

Whilst all cases involving issues of mistake will be highly fact-sensitive, the Court's ruling demonstrates that, similar to the approach in other English common law jurisdictions, the Cayman Courts will be slow to override an investor's contractual rights. This approach reflects the importance of upholding commercial contracts and providing certainty.

The Facts

Primeo was incorporated in 1993 and, until 2007, invested directly in Bernard L Madoff Investment Securities LLC (**BLMIS**), through Primeo's custodian, HSBC Securities Services (Luxembourg) SA (**HSSL**). Herald also invested directly in BLMIS through its custodian, HSSL, from 2004.

For the purposes of determining the mistake argument, it was agreed between the parties that, at all material times, BLMIS acted as sub-custodian, broker and investment manager with respect to the monies that each of Primeo and Herald invested with BLMIS through HSSL. It was also agreed that, at all material times, the contractual arrangements that existed between BLMIS and, respectively, Primeo and Herald, were substantially the same.

BLMIS maintained an account with the Depository Trust Company (the **DTC**) in the United States, which serves as a clearing house and is the world's largest securities depository. BLMIS purported to hold the securities it was purportedly trading for clients, including Primeo and Herald, in its DTC account. The securities were purportedly held in blocks and registered in the name of a DTC nominee, rather than in the names of BLMIS' underlying clients, although they were segregated in the statements sent by BLMIS to Primeo and Herald.

In May 2007, Primeo decided to restructure its investment and invest in BLMIS through Herald, rather than directly. The restructuring could have been achieved by Primeo redeeming its investment in BLMIS and using those proceeds to subscribe for shares in Herald. However, in the event, Primeo and Herald agreed that Primeo should transfer its investment in BLMIS to Herald in return for the issue of shares in Herald (the **In Specie Subscription**).

On 11 December 2008, Madoff confessed that BLMIS was an elaborate fraud. On 23 July 2013, upon the petition of Primeo, liquidators were appointed over Herald.

The 'Mistake'

The Additional Liquidator asserted that both Primeo and Herald intended that the consideration for the In Specie Subscription was to be the legal and beneficial ownership of the 'actual shares, options, US treasury bills, cash, and any other type of securities reflected in the BLMIS account statement as being held on

behalf of Primeo'. Since the actual shares and securities purportedly held by BLMIS never existed, the Additional Liquidator claimed that there was a common mistake as to the existence of the subject matter and, as a result, the In Specie Subscription was void.

Primeo's response was that it did not have any legal or beneficial entitlement to the underlying securities; those rights were vested in the DTC nominee. Primeo had rights against BLMIS under the various contractual arrangements, but in the relevant context those rights were limited to rights to delivery of equivalent securities and/or the payment of the value of the assets held on behalf of Primeo in its BLMIS Account. Primeo submitted that these rights, which formed the consideration for the In Specie Subscription, had been validly transferred to Herald and, accordingly, there was no common mistake as to the existence of the subject matter. It followed that Herald's complaint simply related to the value of the rights transferred, or the adequacy of the consideration, and Primeo claimed that Herald had assumed this risk by failing to demand an appropriate warranty from Primeo.

At trial, after reading the parties' detailed written submissions and hearing from the Additional Liquidator's Leading Counsel, Mr Justice Jones QC found in Primeo's favour without requiring Primeo to make any oral submissions.

The Law

The Court's decision is unsurprising. In dismissing the Additional Liquidator's claim, the Court followed long-established principles well known to English common law.

The Court found that the first question which it must ask itself is whether the risk under the contract has been allocated, relying on the dicta by Steyn J (as he then was) in *Associated Japanese Bank (International) Ltd v Crédit du Nord SA* [1989] 1 WLR 255:

'Logically, before one can turn to the rules as to mistake, whether at common law or in equity, one must first determine whether the contract itself, by express or implied condition precedent or otherwise, provides who bears the risk of the relevant mistake. It is at this hurdle that many pleas of mistake will either fail or prove to have been unnecessary. Only if the contract is silent on the point, is there scope for invoking mistake.'

Accordingly, as a matter of Cayman Islands law, the law of mistake will have no application where risk has been allocated by the parties, either expressly or impliedly. It is only if this question is answered in the negative that the Court will look to see whether there has been an actionable mistake.

Again following the position under English common law, the Court held that in order for a mistake to be actionable, five elements must be present:[1]

1. as between the parties, a common assumption as to the existence of a state of affairs;
2. no warranty by either party that that state of affairs exists;
3. the non-existence of that state of affairs is not attributable to the fault of either party;
4. the non-existence of the state of affairs must render the performance of the contract impossible; and
5. the state of affairs may be the existence, or a vital attribute, of the consideration to be provided or circumstances which must subsist if performance of the contractual venture is to be possible.

If any one of these elements is not present, the mistake will not render the contract void. In this case, the Court accepted Primeo's argument that Herald had assumed the risk in relation to the value of the consideration and therefore the doctrine of common mistake did not apply and the Additional Liquidator's claim failed even before the application of the five elements test.

The Court also found that, in any event, the mistake as to the adequacy of the consideration received did not render the contract impossible to perform and therefore at least one of the five elements was not present. A mistake as to the adequacy of the consideration will rarely, if ever, result in a contract being void.

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[1] See *Great Peace Shipping Ltd v Tsavliris Salvage International Ltd* [2003] QB 679

Conclusion

The Court's decision is one of a number of recent authorities which demonstrates the Cayman Court's adherence to the principles of commercial certainty and the sanctity of contractual arrangements. The Judge noted that '[t]he common law attaches importance to the sanctity of contracts and to the related principles that contracts should be enforceable with predictability and certainty. One aspect of this is that once a contract has been entered into by the parties then the circumstances in which the law will be prepared to treat that contract as void and ineffective by reason of a common mistake on the part of the parties are very limited.'

This clear statement should provide comfort to investors that the Cayman Court will not seek to override contractual rights, unless there is a very clear legal basis for doing so.

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