Primeo Fund v HSBC: Grand Court rules that Madoff feeder fund was "the author of its own misfortune"

In a landmark judgment of the Grand Court of the Cayman Islands delivered on 23 August 2017 in *Primeo Fund (in Official Liquidation) ("**Primeo**") v Bank of Bermuda (Cayman) Ltd ("**BBCL**") and HSBC Securities Services (Luxembourg) S.A ("**HSSL**"),*[1] Mr Justice Jones QC dismissed the claim brought by Primeo, a Madoff feeder fund, against its custodian and administrator seeking damages of approximately US$2 billion. Following a twelve-week trial, the Judge found that Primeo was "*to a very substantial degree the author of its own misfortune*". Even though the defendants were found to be liable to Primeo in respect of the defendants' own acts or omissions as well as, in the case of the custodian, for the wilful default of BLMIS in its capacity as sub-custodian, Primeo failed to establish the relevant causal link between such acts or omissions and the loss that was allegedly suffered. Primeo's claim also failed on other grounds including limitation and because it infringed the rule against reflective loss. Notwithstanding the dismissal of the claim, the case illustrates the risks of providing services to funds that have an abnormal business model and provides guidance to fund service providers, particularly custodians and administrators, concerning the scope of their obligations.

Background

Primeo, a Cayman Islands investment fund, was established and managed by Bank Austria. From 1993 until December 2008, Primeo invested with Bernard L Madoff Investment Securities LLC ("**BLMIS**"), the company through which Bernard Madoff perpetrated his infamous Ponzi scheme.

BLMIS's 'holy grail' of equity returns with bond-like volatility came with strings attached: Madoff insisted upon BLMIS performing the triple functions of investment manager, broker, and *de facto* custodian to its clients. Many institutional investors were willing to accept this concentration of responsibilities (and therefore risk) in exchange for the stellar returns that Madoff was apparently able to generate consistently for decades.

In 2003, Primeo began investing some of its funds with BLMIS indirectly, through two other Madoff feeder funds: Alpha Prime Fund Ltd ("**Alpha**") and Herald Fund SPC ("**Herald**"). Following an *in specie* transfer on 1 May 2007, all of Primeo's investments with BLMIS were indirect, through Primeo's shareholding in Herald and Alpha.

Primeo appointed BBCL and HSSL as its administrator and custodian respectively (together, the "**Defendants**") at a time when both of those entities were part of the Bank of Bermuda group of companies, which was subsequently acquired by HSBC in 2004.

Upon Madoff's arrest, Primeo entered liquidation but it was not until 2013 that the liquidators of Primeo sued the

Defendants for the alleged losses suffered by Primeo as a result of the fraud.

Claims and defences

As against the custodian, Primeo alleged that HSSL breached its contractual duties concerning the appointment and supervision of BLMIS as its sub-custodian. As against the administrator, Primeo alleged that BBCL breached its obligations in connection with the maintenance of books and records for Primeo, and in determining the net asset value ("NAV") per share at the end of each month. In his judgment, Mr Justice Jones QC observed that *"at the core of the administration claim is a dispute about the role of independent fund administrators"*. Primeo alleged that, had the Defendants complied with their obligations, Primeo would have withdrawn its investments with BLMIS prior to the fraud being uncovered and reinvested elsewhere.

The Defendants denied they had breached their contractual obligations to Primeo. The Defendants contended further that Primeo was well aware of the risks associated with BLMIS and that it would have continued to invest with BLMIS in any event. The Defendants argued that Primeo was in any case not the proper claimant for the loss because Primeo's losses were merely reflective of the losses suffered by Herald and Alpha, in which Primeo was a shareholder at the time of Madoff's arrest. The Defendants also argued that Primeo's claim was time-barred insofar as it sought to recover losses arising from a cause of action which accrued prior to 20 February 2007 (*i.e.* six years prior to the issue of the writ by Primeo against the Defendants). If Primeo succeeded in making out its claim for damages, the Defendants argued that a very substantial reduction would have to be made to reflect the contributory negligence on the part of Primeo.

Decision

After hearing evidence from more than 25 factual and expert witnesses including three of Primeo's former directors and a number of experts in the fields of custody and fund administration, Mr Justice Jones QC dismissed Primeo's claim in its entirety, on the following grounds:

- Causation: Primeo failed to prove that any breach of duty by the Defendants had caused its losses. In other words, even if the Defendants had acted as Primeo alleged they should have, the Court was not persuaded that the directors of Primeo would have decided to withdraw the investments placed with BLMIS and would have ceased to invest further with BLMIS. Although the custodian was also found to be strictly liable for any wilful default of BLMIS in its capacity as sub-custodian, there was no loss for which the Defendants could be held strictly liable. Primeo's loss did not flow from any wilful default of BLMIS *qua* sub-custodian. Following the *in specie* transfer on 1 May 2007, BLMIS was no longer sub-custodian to Primeo; Primeo held only shares in Herald and Alpha, and they were in the custody of the custodian, HSSL.
- Reflective Loss: The rule against reflective loss operated to bar the recovery of any of Primeo's alleged loss, because Primeo was seeking to recover losses suffered by way of a diminution in the value of its shareholdings in Herald and Alpha. As a matter of law, Herald and Alpha were the proper claimants in respect of those losses, and any recoveries obtained by Herald and Alpha would flow to Primeo as a shareholder. In arriving at this conclusion, the Court determined that the appropriate standard against which to assess the merits of the claims by Herald and Alpha against HSSL was that such claims have 'a real prospect of success' (as opposed to being 'likely to succeed' as contended by Primeo).
- Limitation: Causes of action accruing prior to 23 February 2007 are time-barred under the Limitation Law.

This covered almost all claims arising from breaches that occurred while Primeo invested *directly* with BLMIS, as opposed to indirectly through Alpha and Herald.

In any case, the Judge determined that he would have reduced any damages awarded against the administrator by 75% on account of Primeo's contributory negligence.

Although Primeo's claim failed on several bases, the Judge's findings and observations concerning the roles and responsibilities of administrators and custodians will be of significant interest to the funds industry in the Cayman Islands and abroad.

Custodian: Breach of Duty

The Judge found that during the years 1993 to 2002, the custodian was not responsible for investments placed by Primeo with BLMIS. Rather, BLMIS was the legal as well as *de facto* custodian of Primeo's assets placed with BLMIS for investment.

However, in August 2002, the custodian entered into a Sub-Custody Agreement with BLMIS (the **"2002 Sub-Custody Agreement"**), which was governed by Luxembourg law. The validity, purpose, scope and effect of the 2002 Sub-Custody Agreement were vigorously contested.

The Judge found that the 2002 Sub-Custody Agreement was effective to appoint BLMIS as the sub-custodian in respect of Primeo's assets held at BLMIS, because it amounted to an "*implied tri-partite agreement*" between HSSL, BLMIS and Primeo to do so.

It followed, according to the Judge, that from August 2002 the custodian had contractual duties to use due skill and care in the appointment of any sub-custodian, to assess the ongoing suitability of the sub-custodian, and to ensure that the most effective safeguards were in place in relation to the sub-custodian to ensure the protection of Primeo's assets. The Judge found that the custodian was in breach of these duties.

The key issues were whether a reasonably competent global custodian would have made, and then continued, the appointment of BLMIS without requiring (or at least recommending) that BLMIS:

1. establish a separate securities account with the central securities depository in New York, the Depositary Trust Company (**"DTC"**), for Primeo's benefit rather than accepting that Primeo's securities would (purportedly, because they never in fact existed) be held in BLMIS's single omnibus client account at DTC and/or make use of a DTC reporting system known as the Institutional Delivery System (the **"ID System"**); and
2. establish a separate account with the Bank of New York (**"BNY"**) for treasury bills that BLMIS claimed to hold for Primeo (which also never in fact existed).

In each case, Primeo argued that a reasonably competent custodian would have required or recommended those options, that, if they had done so, Primeo's directors would then have asked BLMIS to set up such separate accounts for Primeo, and that if BLMIS had refused to do so Primeo would have withdrawn its funds from BLMIS and stopped making further investments. The Judge accepted that a reasonably competent custodian would have made such recommendations, though (as discussed above) he rejected Primeo's causation arguments.

Separate Account at DTC or ID System

BLMIS purportedly executed large scale bulk trades for all of its investment clients on an omnibus basis, and then separate agency trades for each client's part of the bulk (*i.e.* the assets were purportedly segregated by BLMIS in its books and records, rather than at the DTC). A separate account at the DTC in the name of BLMIS, but designated for either Primeo or all of the custodian's clients, would have meant that the agency trade made between BLMIS (as broker) and Primeo (acting by BLMIS as investment manager) would have been settled into the separate DTC account, with the result that the DTC would have issued a settlement notification in respect of this trade, which the custodian could have required to be sent directly either by SWIFT message or through the ID System.

Alternatively, the ID System, without a separate DTC account, would have allowed the custodian to obtain trade confirmations and settlement notifications directly from the DTC. The Judge found that the custodian could have been set up to receive a notification directly from the DTC as an 'interested party' whenever BLMIS identified part of a bulk trade as being allocated to Primeo.

In either case, he held, there would have been independent confirmation of an actual trade taking place and settlement into BLMIS's account, as well as the possibility of reconciling confirmations and statements received from BLMIS with those received from DTC.

Separate Account at BNY

BLMIS's purported strategy involved investing in US treasury bills for a large part of the time, including at month-end as a means by which to protect the confidentiality of BLMIS's purported trading strategy, and timing the trading of US equities. The treasury bills were purportedly held in BLMIS's omnibus account with BNY. The Judge found that BLMIS could have established a separate account in its own name designated for each of Primeo and the custodian's other clients. BLMIS could then have instructed BNY to issue monthly statements directly to the custodian and confirm year-end balances directly to Primeo's auditors, Ernst & Young. The Judge found that there was no regulatory or practical impediment to doing so, and it would not have interfered with BLMIS's 'triple function' business model – nor necessarily prevented Madoff from defrauding the custodian's clients. However, it would have allowed the custodian to confirm the requisite value of treasury bills at each month end, making it more difficult for Madoff to perpetuate his Ponzi scheme.

Findings

The custodian argued, among other things, that these might have been possible options but they did not constitute normal commercial practice, so they could not have been *required* of a reasonably competent custodian, and that any failure to make such recommendations did not amount to negligence.

The Judge found that, although it was not (and is still not) normal commercial practice for custodians to segregate assets by establishing separate accounts at the DTC and at BNY for their hedge fund clients, in the particular circumstances arising out of BLMIS's business model, a reasonably competent custodian would have done so. BLMIS's performance of roles as broker, dealer, and *de facto* custodian introduced operational risks which were not addressed by the normal, commercially acceptable procedures. The Judge found that "*when the normal procedure is known to be ineffective, failing to apply a readily available alternative is negligent*".

In addition to liability for its own acts and omissions, the Judge also found that, under the Custodian Agreement, the custodian was strictly liable for any wilful default of BLMIS acting as sub-custodian. But from May 2007, BLMIS was no longer Primeo's sub-custodian. Primeo held only shares in Herald and Alpha, and they were held by the custodian. Accordingly, no loss flowed from any wilful default by BLMIS *qua* sub-custodian – and so there was no loss for which the custodian could be held to be strictly liable.

Administrator: Breach of Duty

The Judge held that an administrator's role did not extend to performance of managerial and advisory functions. Rather, the core duties were the production of accounts and determination of the NAV by the exercise of independent professional judgment. The Judge held that *"administrators are not expected to perform audit procedures, but they are concerned to satisfy themselves that the published NAV is accurate."* The existence of assets is verified by the process of reconciliation and the pricing of assets by reference to independent pricing services such as those provided by Bloomberg.

The Judge made no criticism of the administrator in relation to satisfying itself about the pricing reported by BLMIS, because those prices matched the publicly available sources.

Although it was agreed between the expert witnesses that administrators would normally proceed on the assumption that information received from third parties is reliable, the key issue concerned whether, and if so how, an administrator must verify the *existence* of reported assets.

The Defendants' expert gave evidence that it was common for an administrator to rely on single-source reporting, especially during the period from 1993 to 2008. The administrator would "tie" to the custodian's statement, and in this case the *de facto* custodian was the broker, BLMIS. Therefore, it was not negligent of the administrator to rely upon BLMIS's monthly statements when calculating Primeo's NAV.

However, the Judge rejected that evidence. He accepted that might have been the case within large international banking and financial services groups, promoting their own 'in-house' branded investment fund products, but, in such a case, all the various service providers, including the administrator itself, were likely to be separate entities within the same group. An in-house fund would have been marketed as such, but in the case of BLMIS it was the same entity carrying out all of the functions.

The Judge found that single-source reporting in relation to a hedge fund with the characteristics of BLMIS was unique in the hedge fund industry. He found that the "*relatively high risk of fraud or error inherent in the BLMIS model must have been manifestly obvious to all concerned*". The Judge found the use of single-source reporting to be negligent but not *grossly* negligent (the contractual standard for imposing liability on the administrator) for the years 1993 to 2005, because during that period Primeo's auditors had been content to rely upon clean (but fraudulent) audit reports from BLMIS's auditors as evidence that Primeo's assets existed.

The Judge found that from 2005, however, this factor no longer assisted the administrator because Primeo's auditors began relying upon custody confirmations provided by the custodian (which confirmations had appended BLMIS's account statements).

The Judge found that the administrator's reliance upon information solely from BLMIS in these circumstances did not account for the risks of using single-source reporting. The administrator's preparation of Primeo's NAVs from 2 May 2005 onwards was therefore found to have been in breach of contract amounting to gross negligence.

Indirect investments

By May 2007, Primeo was only an indirect investor in BLMIS because its only assets were shares in Herald and Alpha. The Defendants argued that this meant the administrator had no duty to "look through" the published NAV of Herald and Alpha, but was entitled to rely upon those NAVs unless there was any obvious error (which there was not) for the purpose of calculating Primeo's NAV.

The Judge confirmed that there is ordinarily no obligation on administrators to "look through" the NAVs published by master funds. However, HSSL also provided custody and administration services to Herald and Alpha. The Judge inferred that the NAV calculations made in respect of Herald and Alpha after May 2007 were flawed for the same reason as for Primeo's beforehand. The Judge therefore found that the administrator's reliance on Herald and Alpha's published NAVs when producing Primeo's NAVs also amounted to gross negligence.

However, the Judge also ruled that, if Primeo had made out its claim against the administrator, he would have reduced any damages award by 75% on account of Primeo's contributory negligence: Primeo was largely the author of its own misfortune because its directors and investment advisers were well aware of the risks inherent in the BLMIS structure.

Conclusion

This judgment addresses a range of issues that will be of significant interest to fund directors and service providers. For industry professionals, the headline point is the serious risks to fund service providers posed by investment structures that are abnormal or high risk. The judgment also establishes that a fund service provider may have an obligation to recommend a course of action to its client to address abnormal risks, even when those risks are well-understood by the client, and that a failure to do so may amount to a breach of contract.

[1] Campbells represented the successful Defendants. The factual and legal issues raised in these proceedings are complex and go beyond the scope of this brief client advisory note. Should you have any questions, or wish to discuss any aspect of this judgment, please contact the authors below.

Hamid Khanbhai
Associate

+1 345 914 5834
hkhanbhai@campbellslegal.com

Andrew Pullinger
Partner

+1 345 914 5865
apullinger@campbellslegal.com

Shaun Tracey
Counsel

+1 345 914 5862
stracey@campbellslegal.com