Primeo Fund v HSBC: Cayman Islands Court of Appeal dismisses Primeo's appeal

In a judgment delivered on 13 June 2019, the Cayman Islands Court of Appeal ("**CICA**") dismissed the appeal by Primeo Fund (in Official Liquidation) ("**Primeo**"), a Madoff feeder fund, against the 2017 judgment of the Grand Court which had dismissed Primeo's claims valued in excess of US $2 billion against its administrator and custodian, Bank of Bermuda (Cayman) Ltd ("**BBCL**") and HSBC Securities Services (Luxembourg) S.A. ("**HSSL**").[1] The CICA's judgment, which runs to 184 pages, addresses numerous issues that will be of interest to funds industry participants.

In dismissing Primeo's appeal, the CICA (Beatson, Birt and Field JJA) upheld the central finding by the first instance judge (Jones J) that Primeo is barred from recovering any loss it suffered in its capacity as a shareholder in two other Madoff feeder funds which are, as a matter of law, the proper plaintiffs in respect of any such loss. Any loss suffered by Primeo was therefore "reflective" (i.e. inseparable from the general loss suffered by the company) and therefore barred by the rule against the recovery of reflective loss. Significantly, the CICA confirmed the broad ambit of the rule against reflective loss, which not only guards against the risk of double recovery (i.e. recovery by a company and its shareholder or creditor from the same defendant in respect of the same loss) but also prevents such a shareholder or creditor *"scooping the pool"* by bringing its own competing claim against a defendant, where the company's claim has a real prospect of success.

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

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

Upon Madoff's arrest in 2008, Primeo entered liquidation but it was not until 2013 that the joint official liquidators of Primeo sued the Respondents for the alleged losses suffered by Primeo as a result of the Madoff fraud.

As against the custodian, Primeo alleged that HSSL breached its contractual duties concerning the appointment and supervision of BLMIS as its sub-custodian, and that HSSL was in any event strictly liable for the wilful default of BLMIS. As against the administrator, Primeo alleged that BBCL breached its obligations to maintain Primeo's books and records and determine its net asset value ("**NAV**") per share. Primeo alleged that, had the Respondents complied with their obligations, Primeo would have withdrawn its investments with BLMIS prior to the fraud being uncovered and reinvested the proceeds elsewhere, generating a significant profit.

First instance decision

During a twelve-week trial in 2016/17, Mr Justice Jones QC heard 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. In its judgment delivered in August 2017, the Grand Court dismissed Primeo's claims in their entirety, on the following grounds:

- **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 plaintiffs 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). Further, it made no difference that Primeo had not been a shareholder in Herald and Alpha when it first invested with BLMIS; what mattered was the economic reality at the time the plaintiff brought its claim.
- **Causation:** Primeo failed to prove that any breach of duty by the Respondents had caused its losses. In other words, even if the Defendants had acted as they should have done, the Court was not persuaded that the directors of Primeo would have withdrawn its investments from, and ceased to invest 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 HSSL could be held strictly liable because Primeo's loss did not flow from any wilful default of BLMIS in its capacity as sub-custodian.
- **Limitation:** Causes of action accruing prior to 23 February 2007 were 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 BBCL, as administrator, by 75{92e447aa5ae4509d19f58c4a2ed7ec0dbb286610ae15b33d823e9409689b2d4a} on account of Primeo's contributory negligence since Primeo was *"to a very substantial degree, the author of its own misfortune"*.

Primeo appealed against the Judge's dismissal of its claims, and the Respondents sought to uphold the first instance judgment on additional grounds (seeking to overturn certain adverse findings at first instance).

CICA judgment

Reflective Loss

Grounds of appeal

Primeo appealed the Judge's decision on reflective loss on two principal grounds:

- First, that the rule against reflective loss did not apply since Primeo was not a shareholder in either Herald or Alpha at the time it invested directly with BLMIS (the "**timing question**"), and that it was irrelevant that it later became such a shareholder.
- Secondly, that the Judge applied the wrong test when assessing the merits of the company's claims: the Judge held that to engage the rule it sufficed that Alpha and Herald's claims had "a real prospect of success", whereas Primeo contended that the Court should apply a more stringent merits threshold by asking whether, on the balance of probabilities, the company's claims were *"likely to succeed"* – if not, the shareholder's claim should be allowed to proceed (the "**merits test question**").

CICA judgment on reflective loss – policy factors

The CICA judgment contains a detailed exposition of the law on reflective loss, citing numerous authorities including the recent English Court of Appeal judgment in *Garcia v Marex Financial Ltd.*[2] The judgment identifies the policy rationale underlying the rule, highlighting in particular: (i) the need to preserve company autonomy (including to promote settlements) and avoid prejudice to minority shareholders and other creditors; and (ii) the need to avoid double recovery from the defendant by the shareholder and the company. The judgment explains that the scope of the rule is broad, despite its potentially harsh consequences. Specifically, the application of the rule does not depend upon there being a risk of double recovery, even though that is an important policy factor. Indeed, the rule may apply even if the company's claim is time-barred, such that there is no longer any risk of double recovery, or if the company has settled its own claim at an undervalue.

Citing recent case law, the CICA emphasised the need to respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders, and prevent a party from recovering compensation for a loss which another party has suffered. This is consistent with contemporary jurisprudence, including *Garcia v Marex Financial Ltd.* The CICA added that, where the company is in or near insolvency, the prejudice that would result if unsecured creditors could sue directly would be a breach of both the principle of collective insolvency and the *pari passu* rule. In other words, a shareholder or a creditor cannot "scoop the pool" by bringing its own competing claim against a defendant, where the company's claim has a real prospect of success.

CICA decision on reflective loss

Applying these principles, the CICA dismissed Primeo's arguments on both the timing question and the merits test question.

On the timing question, the first part of Primeo's argument (the "**capacity point**") was that the principle only

applies where a plaintiff is in substance claiming in its capacity as a shareholder or a creditor for a diminution in the value of its shares in the company or its claim against the company. The second aspect (the "**pure timing point**") was that, by definition, a plaintiff cannot claim in that capacity for losses incurred before it was a shareholder in the company and (as in respect of some of the losses claimed by Primeo) before the company in which it later became a shareholder was incorporated.

However, the CICA held that the effect of the authorities is that the operation of the bar does not depend on the capacity in which the plaintiff brings the proceedings, but rather on whether the plaintiff's loss would be made good if the company were successfully to pursue its claims.

On the pure timing point, the statements in case law relied on by Primeo focussed on "*the loss claimed*" and whether the plaintiff would have been "*made whole*" and its loss "*made good*" if the company had not been deprived of its funds by the wrongdoer or had enforced its rights against the wrongdoer. However, the object is to ascertain whether the loss claimed is one which "*would be made good*" if the company had enforced its rights. This has to be tested at the time the plaintiff's claim is made.

On the merits test question, the CICA rejected Primeo's suggested balance of probabilities test for gauging the strength of the company's claim; that test was unsupported by authority and impractical. For example, the merits of the company's claim would have to be determined in proceedings to which the company would generally not be a party.

On the facts, the CICA found no reason to interfere with the Judge's findings that the claims brought by Alpha and Herald against HSSL and other HSBC defendants (notably in Luxembourg) had a real prospect of success.

In reaching its conclusion on reflective loss, the CICA also rejected Primeo's submission that Primeo should simply give credit for recoveries received by Primeo from Herald or Alpha; the CICA confirmed that is not how the law operates where a claim is reflective.

The CICA's findings on reflective loss were dispositive, resulting in the wholesale dismissal of Primeo's appeal. Nonetheless, the CICA went on to address (*obiter*) in its judgment many of the other issues that were the subject of Primeo's appeal and/or the Respondents' cross-appeal, as summarised below.

Custodian claim

In short, the CICA upheld the Judge's findings that:

- BLMIS was not HSSL's sub-custodian prior to August 2002 (rather, BLMIS was a direct custodian to Primeo) and so HSSL had no liability for Primeo's funds invested with BLMIS prior to that date.
- BLMIS was HSSL's sub-custodian after August 2002, because the Sub-Custody Agreement made between HSSL and BLMIS in August 2002 was effective to appoint BLMIS as sub-custodian in respect of Primeo's assets held at BLMIS, since it amounted to an "*implied tri-partite agreement*" between HSSL, BLMIS and Primeo to do so.
- HSSL was strictly liable for the wilful default of BLMIS in its capacity as sub-custodian post-August 2002

(however, the CICA overturned the Judge's finding that BLMIS was not in wilful default as sub-custodian, and therefore that there was no loss for which HSSL was strictly liable; see below).

- HSSL also breached its contractual duties to ensure (i.e. in this case, to recommend to Primeo) that the most effective safeguards were in place in relation to the sub-custodian to ensure the protection of Primeo's assets. In particular, HSSL should have recommended that BLMIS:
  - establish a separate securities account with the central securities depository in New York, The Depository 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 an arcane DTC reporting system known as the Institutional Delivery System (the "**ID System**"); and
  - establish a separate account with the Bank of New York ("**BNY**") for treasury bills that BLMIS purported to hold for Primeo (which also never in fact existed).

However, as noted above, the CICA held that the Judge erred in finding that BLMIS did not act in wilful default of its obligations as sub-custodian. The Judge had reached that conclusion on the grounds that: (i) BLMIS's duty as sub-custodian was to return Primeo's funds to it upon request; and (ii) BLMIS had done so, in particular via the Herald Transfer. However, the CICA found that BLMIS, as sub-custodian, was under a safekeeping duty that extended beyond the mere return of Primeo's funds, and that BLMIS breached that safekeeping duty each and every time it misapplied Primeo's cash for the purposes of the Ponzi scheme. Therefore, BLMIS was in constant wilful default of its obligations as sub-custodian, Primeo suffered a loss upon each cash transfer being made to BLMIS, and HSSL would have been strictly liable for those losses had Primeo's claim not been dismissed on reflective loss grounds.

The CICA also overturned some of the Judge's other findings with respect to causation, contributory negligence and limitation, as discussed briefly below.

Administrator claim

The CICA declined to make any finding upon BBCL's cross-appeal against the Judge's ruling that it had been negligent throughout the years 1993 to 2005 for producing Primeo's NAV on the basis of single source data received from BLMIS (albeit in different capacities). The CICA adopted this position because it considered the matter was of no practical importance because the contractual standard for imposing liability on BBCL was gross negligence.

The CICA dismissed BBCL's cross-appeal against the Judge's finding that it had been grossly negligent during the years 2005 to 2008 for producing Primeo's NAV on the basis of single source data despite knowing that Primeo's auditors, Ernst & Young ("**EY**"), were by that stage relying upon custody confirmations given by HSSL.

Causation

Primeo formulated its case based upon the need for it to establish causation at certain dates (2002, 2005 and 2007), claiming that if the Respondents had acted in accordance with their duties, Primeo would at each stage

have withdrawn its investments from BLMIS and made no further such investments. At first instance, the Judge found that Primeo had not proven its causation case at any point in time, and that this was a further reason why its claim would fail.

On appeal, the CICA upheld the Judge's finding with respect to causation in 2002. However, the CICA overturned the Judge's findings with respect to causation in 2005 and 2007, on the basis that the Judge had applied the wrong legal test. The Judge had, upon the invitation of Primeo, applied a "balance of probabilities" test to questions such as whether in 2005/2007: (i) BLMIS would have permitted access to EY as part of its audit of Primeo; and/or (ii) EY would have given a clean audit of Primeo; and/or (iii) Primeo would nevertheless have reinvested its funds with another Madoff feeder fund, even if it had withdrawn its direct BLMIS investments. However, the CICA held that the applicable legal test was the "loss of chance" test which involves an assessment of whether there is a real or substantial chance of such eventualities occurring.

Contributory negligence

The CICA upheld the Judge's finding that contributory negligence was available as a defence to the claim against BBCL for breach of the administration agreement, but overturned the Judge's finding that it was not available as a defence to HSSL for breach of the custodian agreement. In each case, the CICA set the percentage of Primeo's contributory negligence at 50{92e447aa5ae4509d19f58c4a2ed7ec0dbb286610ae15b33d823e9409689b2d4a}.

Limitation

The CICA upheld the Judge's finding that the administrator claim was time-barred insofar as the causes of action accrued prior to 20 February 2007 (i.e. six years prior to the commencement of the litigation). However, the CICA overruled the Judge's finding that Primeo's pre-20 February 2007 strict liability custodian claim was statute-barred. The rationale for this decision was that, for limitation purposes, BLMIS is to be treated as the agent of HSSL and accordingly the deliberate concealment by BLMIS of its fraud is to be attributed to HSSL, such that no time bar arises.

Conclusion

The CICA judgment contains a clear, principled and comprehensive dismissal of Primeo's claims on the ground that they contravene the rule against the recovery of reflective loss. It highlights once again the need for litigation to be commenced by the correct plaintiffs. In other respects, however, the judgment of the CICA contains mixed findings, upholding the first instance judgment in many respects but overruling it in others. On any view, the judgment is an important one for the jurisdiction, the broader funds industry and Madoff litigants, addressing a number of novel legal issues.

Campbells represented the successful HSBC Respondents. The factual and legal issues raised in these proceedings are complex and go well beyond the scope of this brief advisory note. Should you have any questions, or wish to discuss any aspect of this important judgment, please contact the authors.

[1] [2017 (2) CILR 334]. For our client advisory about the first instance judgment, see.
[2] [2018] EWCA Civ 1468. This judgment has been appealed to the UK Supreme Court, and judgment is expected later this year.

Hamid Khanbhai
Consultant

hkhanbhai@campbellslegal.com

Andrew Pullinger
Partner

+1 345 914 5865
apullinger@campbellslegal.com

Shaun Tracey
Counsel

+1 345 914 5862
stracey@campbellslegal.com