IN THE COURT OF APPEAL OF THE CAYMAN ISLANDS
ON APPEAL FROM THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION

CICA (CIVIL) APPEAL No. 21 of 2017
(FORMERLY CAUSE NO FSD 30 of 2013 – AJJ)

BETWEEN:

PRIMEO FUND (IN OFFICIAL LIQUIDATION)

APPELLANT

-AND-

(1) BANK OF BERMUDA (CAYMAN) LIMITED
(2) HSBC SECURITIES SERVICES (LUXEMBOURG) SA

RESPONDENTS

In Open Court

Appearances:	Mr Tom Smith QC, Mr Richard Fisher and Mr Robert Amey instructed by Mr Peter Hayden, Mr Jonathon Milne and Mr Jonathan Moffatt of Mourant on behalf of the Appellant. Mr Richard Gillis QC, Mr William Willson, Mr Toby Brown and Mr Simon Gilson instructed by Mr Andrew Pullinger, Mr Shaun Tracey and Mr Hamid Khanbhai of Campbells on behalf of the Respondents.
Before:	The Hon Sir Richard Field, JA; The Hon Sir Michael Birt, JA; and The Rt. Hon Sir Jack Beatson, JA.
Heard:	**26 - 30 November 2018 and 3 - 7 December 2018**
Draft Judgment Circulated:	**14 May 2019**
Judgment Delivered:	**13 June 2019**

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JUDGMENT

Sir Richard Field, JA

I. INTRODUCTION

1. This is the judgment in the appeal of the Primeo Fund ("Primeo") from the decision of Justice Andrew Jones QC ("the judge") sitting in the Grand Court. The judge dismissed Primeo's claims for damages against both Respondents as the administrator and custodian of investments in a managed account with Bernard L Madoff Investment Securities LLC ("BLMIS"), owned and controlled by Mr Bernard Madoff, whose trading business turned out to have been wholly fictitious and which became insolvent. The Respondents have raised a number of matters by way of cross-appeal and Respondents' Notice. The judgment that follows is the judgment of the Court to which all three members have contributed.

2. Primeo is an investment fund. It was incorporated in the Cayman Islands on 18 November 1993 and registered as an exempted company under the Companies Law. It is now in official liquidation. It was promoted, marketed and managed by Bank Austria AG ("Bank Austria").

3. Primeo's claims for breach of contract, and negligence are briefly summarised at [65] below and the judge's findings at [66] – [67] below. In narrating the factual background below and the judge's findings more fully we have drawn liberally from the judge's comprehensive judgment to which we are indebted.

II. THE CONTRACTUAL FRAMEWORK

(a) The 1994 Brokerage Agreements

4. In January 1994, Primeo signed a package of agreements ("the 1994 Brokerage Agreements") with BLMIS consisting of a Customer Agreement, an Option Agreement and a Trading Authorisation. The management account BLMIS opened for Primeo was numbered 1FN060. There was no separate investment management agreement. Under the 1994 Brokerage Agreements, BLMIS had complete discretion to buy and sell investments for Primeo without reference to either Primeo or Primeo's Investment Adviser. From

2001 down to 9 May 2007 virtually the whole of Primeo's invested assets were held directly in the managed account operated by BLMIS.

(b) The 1996 Brokerage Agreements

5. In March 1996 replacement brokerage agreements ("the 1996 Brokerage Agreements") were concluded between Primeo and BLMIS consequent on the restructuring of Primeo into two sub-funds, Primeo Global and Primeo Select. For all practical purposes, the terms and effect of the 1996 Brokerage Agreements were the same as under the 1994 Brokerage Agreements, although BLMIS established a new account for Primeo numbered 1FN092. Primeo Global did not invest with BLMIS and was closed in 2001.

(c) The Herald Transfer

6. On 1 May 2007, Primeo ceased to invest directly through BLMIS but instead did so indirectly through Herald Fund SPC ("Herald") to whom it assigned its rights under its managed account with BLMIS valued at US$465,824,061 in consideration for the issue of shares by Herald having an equivalent subscription price based on Herald's NAV for 30 April 2007 (this assignment and related issue of shares are hereinafter referred to as "the Herald Transfer"). The funds invested with BLMIS by Herald were invested through managed account arrangements on the same terms as Primeo's 1996 Brokerage Agreements.

(d) The 1993 Custodian and Administration Agreements

7. On 20 December 1993, Primeo concluded an administration agreement ("the 1993 Administration Agreement") and a separate custody agreement ("the 1993 Custodian Agreement") with the Second Respondent, then called Bank of Bermuda Luxembourg SA ("BoB Lux"). As a result of the acquisition of the Bank of Bermuda Group ("BoB Group") by HSBC Holdings plc on 18 February 2004, the Second Respondent changed its name to HSBC Securities Services (Luxembourg) ("HSSL"). We therefore refer to the Second Respondent as "R2".

8. Clause 16(B) of the 1993 Custodian Agreement permitted R2 as the Custodian to appoint:

> *"such agents, sub-custodians and delegates as it might think fit to perform in whole or in part any of its duties and discretions ... provided ...the Custodian will at all times remain responsible to the Company for any acts or omissions of any such person or persons... as if such acts or omissions were those of the Custodian, but will not be liable for any loss occasioned by reason only of the liquidation, bankruptcy or insolvency of such person."*

(e) The 1996 Custodian Agreement

9. On 19 December 1996, Primeo concluded new agreements (respectively "the 1996 Administration Agreement" and "the 1996 Custodian Agreement"). The custodian appointed under the 1996 Custodian Agreement remained BoB Lux, but the Administrator appointed under the 1996 Administration Agreement was the First Respondent, the Bank of Bermuda (Cayman) Ltd. (hereafter "R1"). This was because it was a requirement under the new listing rules of the Irish Stock Exchange that the administrator and custodian of an investment fund be separate entities. However, simultaneously with signing the 1996 Administration Agreement, R1 concluded a delegation agreement with BoB Lux, with the result that R2 was both Sub-Administrator and the Custodian of Primeo.

10. The 1996 Custodian Agreement is governed by the law of the Cayman Islands and included a new Clause 16(B). This conferred on the Custodian the power to:

> *"appoint such agents, sub-custodians and delegates as it might think fit."*

and provided that:

> *"the Custodian will use due care and diligence in the appointment of suitable sub-custodians and must be satisfied for the duration of the sub-custody agreements as to the ongoing suitability of the sub-custodians to provide custodial services to the Company [Primeo] ...[and] will require the sub-custodian to implement the most effective safeguards available under the laws and commercial practices of the sub-custodian's*

> *jurisdictions in order to ensure the most effective protection of the Company's assets. Subject thereto the Company has agreed to indemnify the Custodian from all liabilities of whatsoever nature which may be [in]curred by it in performing its obligations under the Custody agreement other than those liabilities resulting from fraud, negligence or wilful breach of duty on the part of the Custodian or any agent appointed by it ...*"

11. The duties imposed by the underlined words are referred to in the judgment as "*the appointment and ongoing supervision duties*".

12. To the extent relevant, Clause 16(E) of the 1996 Custodian Agreement provides:

> "*The Custodian shall not, in the absence of negligence or wilful breach of duty on the part of the Custodian or any agent, delegate or sub-custodian, be liable to the Company ... for any act or omission in the course of or in connection with the services rendered by it hereunder or for any loss or damage which the Company may sustain or suffer as a result or in the discharge by the Custodian of its duties hereunder or pursuant hereto.... The Company agrees to indemnify the Custodian from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements of any kind or nature whatsoever (other than those resulting from the negligence or wilful breach of duty on the part of the Custodian or any agent appointed by it) which may be imposed on, incurred by or asserted against the Custodian in performing its obligations or duties hereunder.*"

13. Clause 6 (A) imposed on the Custodian a duty, subject to sub-paragraphs (B) and (C) to "*... record and hold in a separate account in its books all Securities received by it from time to time and shall arrange for all Securities to be deposited in the Custodian's vault or otherwise be held by or to the order of the Custodian as it may think proper for the purpose of providing for the safekeeping thereof.*"

14. Clause 6 (B) deals with the opening of broker accounts. It allows the Custodian:

> "*upon receipt of Proper Instructions [to] open accounts with brokers or other intermediaries ... [and to] make ... arrangements concerning the trading authorisations ...*"

It also provides that:

"The Custodian shall not be responsible for the safekeeping of Securities or cash deposited with or remaining in any such account or accounts and will not be liable for any loss occasioned by reason of the liquidation, bankruptcy or insolvency of such broker or other intermediary."

15. Clause 6 (C) provides:

> "(i) *The Custodian shall on receipt of Proper Instructions, deliver Securities or cash into a segregated account or accounts in the name of [Primeo] at Bank Austria AG or at such other institution as the Board of Directors may determine from time to time, for the purpose of direct investment management by such institution."*

And:

> "(ii) *The Custodian shall not be responsible for the safekeeping of Securities or cash deposited or remaining in such accounts and will not be liable for any loss occasioned by reason of the liquidation, bankruptcy or insolvency of such institution."*

16. Clause 9 requires the Custodian: (i) to register all Securities in respect of which registration shall be necessary and to hold the Securities of [Primeo] by physical possession or in book entry form by a foreign depository with the registration of Securities; (ii) to identify Securities held by it as being held for the account of [Primeo]; (iii) require each agent, sub-custodian and delegate referred to in Clause 16(B) to identify Securities held by such agent, sub-custodian or fiduciary for the account of the Custodian.

(f) The 1996 Administration Agreement

17. The 1996 Administration Agreement referred to R1 as "*the Bank*" and to Primeo as "*the Company*". Under this agreement, the Bank was appointed to provide a Secretary and act as Registrar and Accountant for the Company. Clause 4 sets out some 19 duties to which the Bank was subject. Clauses 4 (xvii) and (xviii) provide:

> *"(xvii) subject to clause 9 [Rights of the Bank], [the Bank shall] determine in the name and on behalf of the Company on each valuation day the share prices in accordance with the Articles and in accordance with the information supplied to it by the Investment Adviser, the Company and the Custodian.*

(xviii) keep the accounts of the Company and such financial books and records as are required by law or otherwise for the proper conduct of the financial affairs of the Company all in accordance with the information supplied to it by the Investment Adviser, the Company and the Custodian."

18. Clause 9.2 relieves the Bank from liability for any act or omission in the course of or in connection with the services rendered under the agreement in the absence of "*gross negligence or wilful default on the part of the Bank or its servants, agents or delegates*".

19. Clause 9.5 imposes on the Bank the obligation "*to use reasonable endeavours to verify pricing information supplied by the Investment Adviser*".

It also provides that where:

> "*it may not be possible or practicable for the Bank to verify such information ... the Bank shall not be liable for any loss suffered by the Company ... by reason of any error in the calculation of the Share Prices resulting from any inaccuracy in the information supplied by...*"

the Investment Adviser, or any connected person thereof (including a connected person who is a broker, market maker or other intermediary).

(g) The 2002 and 2004 Sub-Custody Agreements

20. For convenience we deal with these agreements between R2 and BLMIS at [31] – [38] and [49] below after setting out the background to them.

III. THE FACTUAL BACKGROUND

(a) Primeo's Investment Advisers

21. In sequence of appointment, Primeo's Investment Advisers were BA Worldwide Fund Management Limited ("BA Worldwide") (appointed 15 December 1993); Eurovaleur Inc ("Eurovaleur") (as sub-adviser to BA Worldwide) (appointed 1 January 1994); and Pioneer Alternative Asset Management Limited ("Pioneer") (appointed to supersede BA Worldwide and Eurovaleur on 25 April 2007). Day to day managerial control of Primeo rested with the Investment Adviser. BA Worldwide was incorporated by Bank Austria. From February 2000 to April 2007 its managing director was Dr Ursula Fano ("Dr Fano"). The judge held that Dr Fano played an important managerial role in relation to Primeo. Eurovaleur was owned by Mrs Sonja Kohn ("Mrs Kohn") who advised Bank Austria in relation to the establishment of Primeo having previously introduced other hedge funds to BLMIS.

(b) BLMIS's triple function business model and single source reporting

22. At all material times, it was generally known that, in respect of its investment management business, BLMIS acted in a triple capacity as broker-dealer, investment manager and custodian. It was also generally known that BLMIS settled purchases and sales of securities through the Depository Trust Company ("the DTC") in New York, held investments made in US Treasury Bills with the Bank of New York ("BNY"), and held cash with JP Morgan.

23. Thus, when BLMIS purchased securities from a third party market participant, the securities would be settled into its DTC account and when BLMIS sold securities to an institutional investor there would be no movement on its DTC account because BLMIS would be on both sides of the transaction. Accordingly, no settlement notification would be generated by the DTC. It followed that, given BLMIS's discretionary authority to buy and sell investments for Primeo without reference to Primeo or its Investment Adviser, the only documentary evidence of trades available to R2 as Custodian and Sub-Administrator and R1 as Administrator was what was provided by BLMIS in the form of individual trade confirmations and month-end statements. R2 and R1 were therefore

faced with the problem of "*single source reporting*", the single source being BLMIS, whereas the administrators and custodians of non-BLMIS investment funds whose investments were traded by entities separate and independent from the fund's management could look to these independent entities for confirmation of the assets of the fund.

(c) BLMIS's purported split strike investment strategy

24. BLMIS purported to operate a so-called "*split-strike conversion*" investment strategy that entailed: (a) purchasing a basket of thirty (30) to sixty (60) large capitalisation S&P 100 stocks, which together account for the greatest weight of the index and therefore, when combined, present a high degree of correlation with the general market; (b) selling out-of-the-money S&P 100 index call options representing a similar amount of the underlying index equivalent to the dollar amount of the basket of shares purchased; and (c) purchasing out-of-the- money or at-the-money S&P index put options in the same dollar amount. This was combined with the following asset allocation strategy: when the manager believed the market conditions were unfavourable for the split-strike conversion strategy it shifted its allocation to a portfolio of short-dated U.S. Treasury Bills. As soon as the manager believed that favourable market conditions had returned, the allocation was shifted back into the split-strike conversion strategy to capture opportunities once again. In fact, BLMIS purported to liquidate every client's entire holding of securities every month investing the proceeds in Treasury Bills until purchases of securities resumed in the market in accordance with the split-strike strategy.

(d) The GFS Board meeting on 13/14 May 2002

25. The Board of the Bank of Bermuda's Global Fund Services division ("GFS") had responsibility across all the jurisdictions in which the Bank of Bermuda carried on its fund administration and custody business. At a GFS Board meeting on 13/14 May 2002, there was a discussion about the BoB Group's relationship with BLMIS. It was thought that the relationship needed clearing up in respect of the segregation of assets. One participant, Mr David Smith, a BoB Group executive based in Dublin, said he would

rather lose the business than continue as it was organised presently; if the relationship remained, GFS needed to have new controls in place.

26. A visit to BLMIS by Mr Brian Wilkinson, Head of Sales and Head of GFS Dublin was proposed.

(e) Mr Nigel Fielding's meeting with Dr Ursula Fano on 16 May 2002

27. On 16 May 2002, there was a meeting between Mr Fielding and Dr Fano. Mr Fielding at this time was Deputy Global Head of Client Services for GFS and represented R2 on Primeo's Board of Directors. As we have stated, Dr Fano was Managing Director of Primeo's Investment Adviser, BA Worldwide, from February 2000 to April 2007.

28. By this time, Mr Fielding had decided that it would be a good idea if R2 and BLMIS executed a sub-custody agreement, one of the advantages of which would be to enable R2 to call upon BLMIS to deliver securities held by BLMIS in the managed account as security for a foreign exchange facility and for a US$250,000 overdraft facility granted by R2 to Primeo.

29. At the meeting, Mr Fielding learned from Dr Fano that BA Worldwide was considering the possibility of establishing a Luxembourg domiciled UCITS fund which would invest with BLMIS and he recognised that another potential advantage of establishing a sub-custody relationship between R2 and BLMIS was that any new Luxembourg domiciled UCITS fund promoted by Bank Austria could be added to the list of companies to which the agreement related. Mr Fielding testified that he explained to Dr Fano that he was planning a visit to put to Mr Madoff the idea of a sub-custody agreement enhancing R2's security position and Dr Fano had no objection to this proposal.

(f) Mr Fielding's meeting with Mr Madoff on 17 July 2002

30. On 17 July 2002, Mr Nigel Fielding, then Deputy Global Head of Client Services for GFS and a director of Primeo and Mr Fergus Healy, a lawyer based in the BoB Group's New York office, met Mr Madoff. The purpose of the visit was to perform a custody due diligence exercise and secure Mr Madoff's approval to a new arrangement whereby BLMIS would become sub-custodian of R2 in respect of assets then held for Primeo and for another fund, Lagoon Investment Ltd ("Lagoon"), directly. Mr Madoff agreed to the proposal of a sub-custody agreement. He was asked about BLMIS's business and operating procedures and completed a BoB Group standard form *Sub-Custodian Due Diligence Questionnaire*. Mr Madoff told Mr Fielding that client assets were held in a separate account at the DTC and provided copies of BLMIS's audited financial statements for the year ended 31 October 2001 and an Independent Auditor's Report on Internal Control issued by BLMIS's auditors, Friehling & Horowitz ("F&H").

(g) The 2002 Sub-Custody Agreement

31. On 7 August 2002, R2 and BLMIS executed the proposed sub-custody agreement ("the 2002 Sub-Custody Agreement") which is governed by the law of Luxembourg.

32. Clause 2 of the 2002 Sub-Custody Agreement provides:

> *"The Bank (BoB Lux) hereby appoints the Sub-Custodian (BLMIS) as sub-custodian for the Bank in respect of the Property[1] delivered to, to the order of, or otherwise acquired by the Sub-Custodian pursuant to this Agreement to hold in safe custody and/or administer Property upon the terms and conditions hereinafter contained and the Sub-Custodian hereby accepts such appointment from the date hereof until its appointment shall be terminated as hereinafter provided."*

33. Under Clause 5, BLMIS was obliged to receive and keep segregated and safe Property delivered to it under the agreement and under Clause 6 to transfer, exchange or deliver Securities only on receipt of Proper Instructions.

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[1] Cash, bullion, coin, precious metals, Securities and any other form of investment or property of any description.

34. Under Clause 7, BLMIS was obliged to open and maintain within the custodial account a Cash Account from which it was, upon receipt of Proper Instructions from R2, to effect disbursements inter alia in connection with the purchase of Securities.

35. Clause 10 (a) provided that BLMIS shall supply R2 at such reasonable intervals as R2 may require a written statement which lists all Property held in, or credited to the Account … together with a full account of all receipts and payments made and other action taken by the Sub-Custodian pursuant to the agreement.

36. Under Clause 11, BLMIS was obliged to exercise the same standard of care that it exercised over its own assets or at least the degree of care expected of a prudent professional Sub-Custodian for hire and was to be liable to R2 for any loss suffered by it as a result of BLMIS's fraud, negligence or wilful default.

37. One of the reasons for the 2002 Sub-Custody Agreement was the wish of the BoB Group, which had granted Primeo a US$50 million foreign exchange facility and a US$500,000 unadvised overdraft facility, to strengthen R2's credit default protection by having a right of free delivery in respect of assets held by BLMIS for Primeo.

38. Upon the execution of the 2002 Sub-Custody Agreement, the 1FN092 Account was re-designated in the name of "*Bank of Bermuda (Luxembourg) S.A. Special Custody Account for Primeo Fund*".

(h) Mr Young of BoB Dublin raises the question of independent verification of Thema's and Primeo's assets and Mr Fielding's response thereto

39. On 19 September 2002, Mr Tom Young (the Credit and Risk Manager for BoB Dublin) asked Mr Fielding in an email if it would be possible to obtain independent verification that the assets of Thema International Fund PLC ("Thema") were segregated from the other assets held by BLMIS. Thema was another Madoff feeder fund. Mr Young also asked about BLMIS's audited financial statements and the standing of F&H. Mr Fielding felt that these were matters for the auditors. Mr Brian Wilkinson (to whom Mr Fielding reported) disagreed. He thought that GFS ought to obtain confirmation of asset segregation independently of the verification procedures being undertaken by the

auditors. Mr David Smith and Mr Paul Smith (Global Head of GFS) agreed with Mr Wilkinson.

(i) The decision of the GFS Board to instruct KPMG to undertake audit procedures to provide independent confirmation of Primeo's assets held by BLMIS

40. As a consequence of the GFS Board's concern about the lack of evidence beyond assurances from Mr Madoff that BLMIS was segregating Primeo's assets, the GFS Board informally decided sometime before 1 October 2002 to ask the accountancy firm KPMG to undertake audit procedures to provide independent confirmation of the assets held by BLMIS for Primeo and two other clients of the BoB Group, Thema and Lagoon. Mr Paul Smith's response to this decision was as follows:

> *"I don't feel we should mislead Madoff. We have a problem with him. He is the manager, broker and custodian to his accounts. In today's world this is a red flag. We need to address it. Let's tell him so and get on with it with his support. If we continue to pussyfoot around him we will get nowhere."* (emphasis added)

41. In the event, this decision was not implemented. In the view of the judge, it was overtaken by events including in particular the issue of an unqualified audit opinion by the Cayman Islands firm of Ernst & Young ("EY") in respect of Primeo on 28 March 2003.

(j) R2 's presentation to the Bank of Austria's internal auditors

42. In May 2003, R2 made a written and an oral presentation to Bank Austria's internal auditors who were concerned about BLMIS's business model.

(k) Bank Austria's internal auditors' report

43. On 11 June 2003, Bank Austria's internal auditors issued a report identifying a number of issues arising from Primeo's investments with BLMIS including the fact that Primeo's investment adviser, BA Worldwide, was relying upon a single source of information, BLMIS, for the purposes of determining Primeo's NAV. This concern was reported to Primeo's Board at its meeting on 23 June 2003.

44. In the same month, Alpha Prime Fund Limited ("Alpha") was launched as a new Madoff feeder fund. Although the ownership of the promoter and investment manager was, as the judge put it, surrounded in mystery, Bank Austria played a substantial role in its promotion and subsequent management and was represented on its board of directors by Dr Fano. BoB Limited was appointed as custodian and administrator and it delegated these duties to R2. The appointed investment manager delegated its duties to BA Worldwide with the consequence that Dr Fano would have been responsible for the day to day management of Alpha. Mrs Kohn was an initial director of Alpha.

(l) Mr Fielding's due diligence meeting with BLMIS

45. On 3 March 2004, Mr Fielding, who at this point was Global Head of Business Services for GFS, held a due diligence meeting at BLMIS's office in New York during which he went through a Sub-Custodian Due Diligence Questionnaire. Mr Fielding testified at the trial that he reconfirmed with Mr Madoff that proprietary assets and clients' assets were held in separate accounts with the DTC.

46. In April 2004, Herald was established in the Cayman Islands as a further Madoff feeder fund. It was promoted, managed and marketed by a special purpose vehicle which delegated its functions to Bank Medici AG, a small investment banking and asset management business established in 1994 and owned by Mrs Kohn (75%) and Bank Austria (25%). Bank Austria was represented on Herald's board of directors. R2 was appointed as custodian and administrator of Herald.

(m) The meeting of Primeo's Board on 14 May 2004

47. The concern raised in the report of Bank Austria's Internal Auditors was further discussed at the meeting of Primeo's Board held on 14 May 2004. Mr Fielding was a director of Primeo and attended this meeting. The first draft of the minutes of the meeting recorded that the lack of both an investment contract with BLMIS and objective confirmations raised concerns regarding the proof that securities were really there and if transaction slips provided by Mr Madoff were valid and had actually been executed. Mr Fielding advised the Board that R2 received confirmation from Mr Madoff every time a

trade was made and added that Bank Austria should be confident from the fact that Mr Madoff was regulated by the US Securities Commission and BLMIS was being audited.

48. By then (see [7] above) R2 had changed its name from BoB Lux to HSBC Securities Services (Luxembourg) S.A.

(n) The 2004 Sub-Custody Agreement

49. On 8 September 2004, a Sub-Custody Agreement was concluded between R2 and BLMIS relating to Primeo, and other clients of R2 that were invested in BLMIS, including Lagoon and Herald. This agreement ("the 2004 Sub-Custody Agreement"), whose terms were identical to those contained in the 2002 Sub-Custody Agreement, superseded the latter agreement.

(m) EY consider resigning if they are unable to conduct the audit work previously done by F&H

50. On 21 February 2005, EY met with representatives of R2 to discuss the following concerns EY had about Mr Madoff: how he was able to generate regular profits even when markets were bad; whether the assets attributed to Primeo really existed; and the reliability of BLMIS's auditors, F&H, on whom EY had relied in respect of its previous four yearly audits of Primeo to carry out an audit of the statement of movements in net assets held on the Primeo Select managed account. At this meeting EY said they were proposing to visit BLMIS to conduct themselves this audit work previously done by F&H and were considering the possibility of resigning or issuing a qualified audit opinion if they were unable to perform this work satisfactorily.

(o) R2 issues custody confirmations of Primeo's assets held in the BLMIS managed account

51. In the knowledge that there was a sub-custody agreement between R2 (now called HSSL) and BLMIS, EY, as Primeo's auditors, enquired by email on 14 March 2005 of a Mr Fiorino of R2 whether "*it would be possible to obtain a custody confirmation from HSBC for the positions held within the Madoff account as at 31 December 2004 ...?*" This enquiry was passed on to Mr Fielding who confirmed in an email dated 15 March

2005 that such a custody confirmation should be issued by R2 for all assets in its custody for the relevant funds. On 5 April 2005, a custody confirmation letter in respect of Primeo was issued by R2 to EY in relation to the assets on the BLMIS managed account. It was in the following terms:

> *"Further to our custodian letter dated February 11, 2005, please find attached additional extract regarding the Primeo account held with Madoff."*
>
> *"This extract contains details of the fund's assets held by Madoff. It has been signed by an appropriate signatory of [HSSL] and i[s] to be taken into account in conjunction with the original letter of February 11, 2005."*

52. It was BLMIS's practice to report to its investment fund clients that the assets held at the end of each month and at the year-end were in the form of US Treasury Bills and cash. The attachment to R2's letter dated 11 February 2005 consisted of a report relating to the securities held on the BLMIS managed account based not on any independent confirmations but solely on information contained in the trade confirmations received from BLMIS. The report listed an investment as at 31 December 2004 in a money market fund and US Treasury Bills having a book cost and market value of about US$415.3 million. It was signed by a Ms Baelen and bore R2's name and address stamp. It was issued solely on the basis of the authority of Mr Fiorino in his capacity as Head of Alternative Fund Services ("AFS"), AFS being the successor of GFS upon the acquisition of the BoB Group by HSBC Holdings Ltd.

53. Thereafter, for the audit years 2005 and 2006, R2 issued similar custody confirmations to EY in respect of Primeo's account held with BLMIS based solely on information provided by BLMIS. As R2 understood, EY relied on these confirmations when issuing as Primeo's auditors unqualified audit opinions on Primeo's annual financial statements. Thus, in their Summary Review Memorandum dated 20 April 2005 EY stated:

> "[W]*e obtained audit assurance that the securities in the Madoff investment corporation broker account existed ... by carrying out the following audit procedures:*

- *Receipt of independent confirmation of ownership received from the custodian bank, HSBC Luxemburg SA."*

As a result of the custody confirmations R1 in the capacity of Primeo's administrator also continued to calculate Primeo's monthly NAV pursuant to Clause 4.1 (xvii) of the 1996 Administration Agreement on the basis of information that did not come from an independent source but from BLMIS.

(p) The due diligence review conducted by Mr Pettitt of HSS

54. Following the takeover of the BoB Group by HSBC Holdings plc, HSBC Securities Services ("HSS") in London decided at the beginning of 2005 that a Mr Pettitt, Head of Network Management, should conduct a sub-custodian due diligence review in respect of BLMIS. Mr Pettitt met with the R2 executives in Luxembourg on 21 March 2005 when he learned that BLMIS acted in a triple capacity as investment manager, broker and sub-custodian. He also became aware that Mr Fielding believed that Mr Madoff had only one account at the DTC which, if true, meant that BLMIS may be mixing client and proprietary trading assets.

55. Mr Pettitt met Mr Madoff on 1 April 2005. Mr Madoff stated in a questionnaire that had been sent ahead of the meeting that proprietary assets were kept in separate accounts from client assets. He also stated at the meeting that BLMIS maintained complete segregation of client and proprietary assets at the DTC. Although he was provided with a number for what he was told was BLMIS's client account at DTC, Mr Pettitt took no steps to verify that BLMIS did indeed have a client account as well as a proprietary account with the DTC. Despite this lack of enquiry, Mr Pettitt's overall conclusion following the meeting with Mr Madoff was that from discussions, responses and documentation it appeared that the assets were appropriately segregated and that BLMIS exerted adequate control over its clients' assets and met its regulatory responsibilities.

(q) The reaction of Mr Gubert (Head of HSS) to Mr Pettitt's conclusion following his due diligence review

56. Mr John Gubert, Global Head of HSS disagreed with Mr Pettitt's conclusion. This led to Ms Christine Coe, HSS's Chief Risk Officer, producing a Discussion Document in which

she noted BLMIS's flawed business model and questioned the value of the due diligence performed by Mr Pettitt because no audit of the end-to-end process flow had been carried out. She also questioned the extent to which F&H's internal control reports could be relied on. In her view, what was needed was an independent control review. Mr Gubert agreed. He was of the opinion that unless HSS could adopt a process similar to the right of a lienor to arrive unannounced at the lienee's office to assess that all security was in place as advised, R2 should exit the relationship with Primeo.

(r) HSBC engages KPMG to conduct a fraud risk review

57. In September 2005, KPMG were engaged by HSBC to conduct a fraud risk review of BLMIS. KPMG were not instructed to carry out an audit of the assets recorded as being held by BLMIS. Ms Coe and the two KPMG partners who were to undertake the work agreed '*that this was never going to happen*' because of Mr Madoff's attitude to secrecy. It was understood that the review would not include the deployment of any audit procedures, including the obtaining of corroborating evidence directly from independent third parties. KPMG were not engaged to express an opinion about the existence of assets; they were only engaged to conduct a fraud risk review. The KPMG on-site review took place in early November 2005. They undertook an in-depth review of BLMIS's books and records including documents apparently from third parties such as BNY, JP Morgan and the DTC. Nothing was found that aroused any suspicion of impropriety. In their report, KPMG made it clear that they had relied on information provided by HSBC and BLMIS and had not independently verified this information.

(s) Pioneer is appointed as Investor Adviser to Primeo

58. Pioneer was appointed as Investor Adviser to Primeo in April 2007 as a result of the fact that Bank Austria had become a subsidiary of the UniCredit Group. Dr Fano ceased to have any managerial responsibility for Primeo but was retained as a consultant by Pioneer and was appointed a director of Primeo. Pioneer's nominees were appointed to the Board of Directors of Primeo in place of the Bank Austria nominees. It was following the appointment of Pioneer as investment adviser that the Herald Transfer took place on 2 May 2007.

(t) KPMG's second fraud risk review

59. In April 2008, KPMG carried out another fraud risk review of BLMIS at the request of R2. This was after the Herald Transfer and followed a further sub-custodian agreement made between R2 and BLMIS relating to Herald as well as other clients. As they had done during the first fraud risk review, KPMG, having been provided with what appeared to be prints of relevant DTC documentation, traced selected trades from R2 client statements to the block trades settled through BLMIS's DTC account. Again, KPMG found nothing to suggest any kind of impropriety.

(u) The telephone conference between R2 and KPMG after the collapse of Bear Sterns

60. KPMG's report on this second fraud risk review was not delivered until 8 September 2008. Before this date, in mid July 2008, Bear Sterns collapsed. In the aftermath of that collapse there was a telephone conference in the course of which one of the KPMG partners who had conducted the two fraud risk reviews, Mr Yim, briefed HSBC's Structured Finance Group about KPMG's findings from the second review. Mr Yim said that although KPMG had been able to trace trades through BLMIS's books, the problem was they were limited to internally created records. Mr Madoff had refused to allow KPMG to see information on BLMIS's DTC terminal. Those participating in this call recognised that BLMIS could be a Ponzi scheme, but no-one thought it was in fact such a scheme. Mr Yim said that there was nothing on the trading side which suggested that anything significant was amiss. The report was in broadly the same terms as the first KPMG report.

(v) Mr Madoff confesses to his massive Ponzi scheme

61. On 11 December 2008, Mr Madoff confessed that BLMIS had for years been a huge Ponzi scheme. At all material times to this appeal, BLMIS's trading business had been wholly fictitious. It had engaged in no securities trading or investment management for its clients whatsoever. The scheme had been run from the 17th floor of BLMIS's offices where staff, at Mr Madoff's bidding, created through the use of two customised computer programs huge numbers of false documents to give the appearance of trades being

conducted on behalf of clients, including the documents that appeared to have come from the DTC that were provided to KPMG for their work during the two fraud risk reviews in which they traced selected trades from R2 client statements to the block trades settled through BLMIS's DTC account. The assurances that Mr Madoff had given to Messrs Pettitt and Fielding and KPMG that BLMIS kept proprietary assets in separate accounts from client assets were brazen lies. The truth was that BLMIS held unsegregated accounts with DTC and BNY.

62. The lengths to which BLMIS was able to go in order to fool visiting accountants can be seen from the evidence of Mr Frank Dipascali given in criminal proceedings in the Southern District Court of New York on 2 December 2013. Mr Dipascali was one of the key co-conspirators with Mr Madoff. He refers to a visit by KPMG on behalf of HSBC bank and it seems he was probably referring to either the first or second visits by KPMG which we have just described.

63. Mr Dipascali explained that they forged a whole lot of documents in anticipation of the visit with a view to satisfying KPMG about the trades that had been undertaken and the allocation of assets to particular clients. However, they had picked month end dates on the assumption that this was the most likely date for KPMG to choose.

64. As it turned out, the representative from KPMG insisted on selecting a random date which Mr Dipascali gave as 17 April. Mr Dipascali told the representative that he would arrange for these documents to be produced and telephoned down to his colleagues asking them to produce the relevant documents. They understood that this was an instruction to forge documents in relation to that date. They undertook this task, but the difficulty was that the 500 pages or so of forged documents were warm because they were hot off the printer. Mr Dipascali explained how his colleagues placed the documents in the fridge to cool them down and threw them around a little to make them appear old documents before Mr Dipascali, after a space of about an hour and a half, produced them to KPMG.

IV. OUTLINE OF THE CLAIMS, THE JUDGE'S FINDINGS, AND THE SCOPE OF THE APPEAL

(a) The Claims

65. The insolvency of BLMIS caused huge losses to Primeo totalling hundreds of millions of US dollars. At trial, Primeo brought claims against R2 under the 1996 Custodian Agreement and R1 under the 1996 Administration Agreement. The principal claim under the 1996 Custodian Agreement (which has been referred to as the 'strict liability claim') was a claim that under that agreement, R2 was liable for the losses caused by BLMIS's breach as R2's sub-custodian whereby it used the funds sent by Primeo to BLMIS for investment in Mr Madoff's Ponzi scheme. The other claims both under the 1996 Custodian Agreement and the 1996 Administration Agreement were for the failure of R2 and R1 to take steps that they ought to have taken to verify the assets BLMIS purportedly held for Primeo, steps which had they been taken would have led to Primeo withdrawing or reducing its investments held in the managed account with BLMIS and thereby avoiding the losses caused by BLMIS's insolvency.

(b) The judge's findings

66. The judge found that in respect of a number of these claims, Primeo had established a breach of contract and/or negligence but went on to conclude that Primeo had no grounds for recovering the damages sought for various reasons including: (i) the failure of Primeo to establish that the breach of contract and/or negligence caused the loss complained of; (ii) Primeo had suffered no recoverable loss on any of the claims because the loss for which it was seeking damages was reflective of the loss that had been suffered by Herald within the principles enunciated by the House of Lords in ***Johnson v Gore Wood & Co (a firm)*** [2002] 2 AC 1; and (iii) the claims were statute barred.

67. The judge also held that if Primeo had established an entitlement to the damages, its recovery would have been reduced by 75% by reason of its contributory negligence.

(c) The scope of the appeal

68. There is no appeal in respect of claims where the judge held that no breach of duty or negligence had been established, although Primeo seeks to overturn the judge's finding that R1 was not grossly negligent prior to April 2005.

69. Primeo's appeals are against the judge's findings that, notwithstanding the establishment of a claimed breach of contract and/or duty, there is no entitlement to recover the damages claimed in respect thereof for the reasons the judge gave.

70. The Respondents cross-appeal against some of the judge's findings that there was a breach of contract and/or duty.

71. We turn now to relate the judge's findings on Primeo's claims that are challenged on appeal other than his findings on causation, reflective loss, limitation and contributory negligence which will be dealt with separately when dealing with the appeals against those findings.

V. THE JUDGE'S FINDINGS ON PRIMEO'S STRICT LIABILITY AND NEGLIGENCE CLAIMS

(a) Primeo's strict liability claim for breach of the 1993 Custodian Agreement and/or the 1996 Custodian Agreement

72. Primeo claimed that R2 were strictly liable under Clause 16(B) of the 1993 Custodian Agreement and Clause 16(B) of the 1996 Custodian Agreement for the breach of duty by BLMIS as R2's sub-custodian in using the funds it received from Primeo for investment in BLIMIS in the operation of the Ponzi scheme. The losses flowing from BLMIS's breach of duty were said to be the net amount of cash placed with BLMIS and dissipated in the Ponzi scheme after credit for actual recoveries received during the period from the inception of the 1993 Custodian Agreement to 1 May 2007 when the Herald Transfer took place and BLMIS's role as sub-custodian came to an end. If it were held that BLMIS was not R2's sub-custodian until the conclusion of the 2002 Sub-Custody Agreement, the period for the recoverable losses would start from the conclusion of that agreement, again ending on 1 May 2007.

73. As already noted, under clause 16(B) of the 1993 Custody Agreement, R2 (BoB Lux/HSSL) remained liable for any acts or omissions of any person it appointed as an agent, sub-custodian or delegate. Clause 16(B) of the 1996 Custody Agreement, however, was differently worded. The relevant wording of the new clause is set out in [9] above. Pursuant to this wording, Primeo agreed "*to indemnify the Custodian from all liabilities of whatsoever nature which may be [in]curred by it in performing its obligations under the agreement <u>other than those liabilities resulting from fraud, negligence or wilful breach of duty on the part of the Custodian or any agent appointed by it</u>*". (emphasis added)

74. As also previously noted in [12] above, Clause 16(E) exonerated the Custodian from liability for any act or omission in the course of or in connection with the services rendered under the agreement, subject to a carve out in respect of "*negligence or wilful breach of duty on the part of the Custodian or any agent, delegate or sub-custodian...*".

75. Clause 16(E) also conferred on the Custodian an indemnity against any and all liabilities, obligations etc. imposed or incurred or asserted against the Custodian in performing its obligations under the agreement, subject to a carve out in respect of liabilities resulting from the negligence or wilful breach of duty on the part of the Custodian or any agent appointed by it.

76. Primeo was put to proof that at all material times, BLMIS was R2's sub-custodian rather than Primeo's custodian.

77. In light of the fact that BLMIS, consistently with its triple function business model, purported to buy and sell securities for its clients by executing block trades with market counterparties which were then allocated as agency trades to each of its clients, it was common ground between the parties that BLMIS at all times had custody of assets beneficially owned by Primeo. The question was whether BLMIS held those assets as custodian for Primeo or as sub-custodian for R2.

78. Primeo submitted in closing that BLMIS was R2's sub-custodian continuously from the inception of the 1993 Custodian Agreement down to the Herald Transfer. If this were wrong, BLMIS became R2's sub-custodian on the execution of the 1996 Brokerage Agreements; and if this were wrong, BLMIS became a sub-custodian of R2 when the 2002 Sub-Custody Agreement was concluded. If BLMIS had been R2's sub-custodian continuously prior to the conclusion of the 2002 Sub-Custody Agreement, it continued to hold that position after that agreement was executed.

79. The judge found that until the execution of the 2002 Sub-Custody Agreement, BLMIS held the assets attributed to Primeo as custodian for Primeo and not as sub-custodian for R2.

80. In the judge's view, it was clear that the 1993 Customer Agreement was between BLMIS and Primeo, not R2 acting as Primeo's agent. This agreement had been executed by Primeo's directors in the name of Primeo Fund and BLMIS opened the managed account IFN-060 in its books in that name, Primeo Fund.

81. The 1996 Brokerage Agreements were governed by Luxembourg law. The judge found that under Luxembourg law, if the wording of a contract is unclear, ambiguous, inconsistent or plainly uncommercial, the words are interpreted consistently with the parties' intentions, including their subjective intentions if these have been communicated to the other party. The 1996 Brokerage Agreements were executed in the name of "*Primeo Fund Class B*" and this was the name BLMIS gave to the new managed account No.1FN-092. The words "*Class B*" reflected the fact that the 1996 Brokerage Agreements were concluded because of Primeo's decision to establish two share classes A and B with the Class B shares being held in a fund wholly invested in BLMIS. In the opinion of the judge, the name of the account was consistent with the common intention of the parties to establish the account in the name of the Primeo Fund, referencing the Class B sub-fund. A handwritten annotation on an informal BLMIS opening document relating to the new account Primeo Fund – Class B stating:

> *"New foreign acct – waiting for acct papers (This acct has same "owner" of Primeo Fund Acct#1FN060 but will be a new acct, for acct'g purposes)"*

was admissible evidence of the parties' common intention and tended to show that the new account was an additional account established for the existing customer, Primeo. The fact that the documents bore the R2 name/address stamp did not point to an intention to open the account in the name of R2. This was the business address which would in any event have been applicable whether the account was in the name of Primeo Fund – Class "B" or in the name of R2 for Primeo Fund – Class "B".

82. The judge rejected an argument that BLMIS was a sub-custodian of R2 by virtue of the clauses of the 1993 Custodian Agreement under which Primeo appointed R2 its Custodian and agreed to deliver to the Custodian all securities and cash owned by it and empowered the Custodian to open accounts with brokers or intermediaries in its name on behalf of Primeo.

83. Although Primeo had agreed to deliver all securities to R2, it had in fact not done so. Instead, whilst all cash subscriptions had been delivered to R2, cash was then transferred under Clause 5(A)(g) of the 1993 Custodian Agreement to BLMIS on the basis it would be managed on a discretionary basis and that the securities would be held in the custody of BLMIS. Accordingly, cash was not transferred to settle purchases of securities which would then be settled into R2's custody via its network sub-custodian, Brown Brothers Harriman or Citibank. This was why securities held by BLMIS for Primeo were not recorded in R2's custody records and the "holding reports" issued to BA Worldwide did not include the assets held by BLMIS on the managed accounts. Thus it was that by January 1996, there was an established course of dealing and understanding between Primeo (acting by BA Worldwide which in turn took advice from Eurovaleur), BLMIS and R2, that BLMIS would perform the triple functions of investment manager, broker and custodian. Read in isolation, the terms of the 1993 Custodian Agreement tended to suggest that Primeo would not have intended to appoint BLMIS as a second custodian but the established course of conduct existing at the time of the 1996 Brokerage Agreements were executed pointed to the opposite conclusion.

84. The judge also rejected Primeo's argument that no "*Proper Instructions*" as defined in the 1993 Custodian Agreement[2] were given by Primeo to R2 requiring it to appoint BLMIS a custodian of Primeo. Mrs Kohn sent a fax to Mr Wayne Chapman of R2 on 21 January 1995 asking for the "*signed account opening papers*" for the 1996 Brokerage Agreements to be sent to BLMIS by fax and the originals to be sent by messenger. The judge found it was to be inferred that Mrs Kohn was authorised by Primeo to send this fax in light of the fact that the A and B shares restructuring project had been discussed by the Primeo Board the day before the fax was sent and at the next Primeo Board meeting on 15 January 1996 Mrs Kohn had made a presentation in favour of the restructuring project.

85. The judge also rejected the submission that it was to be inferred from the fact that it was R2 rather than BA Worldwide that gave withdrawal instructions to BLMIS in respect of both the 1FN060 and 1FN092 accounts after execution of the 1996 Brokerage Agreements that R2 must necessarily have been doing so in its own right as the account holder. In the judge's view, R2 could equally have been acting on behalf of Primeo, on instructions from BA Worldwide. The accounts in the name of Primeo having been established, it could be inferred from the parties' conduct that BLMIS acted on instructions received from R2 on behalf of Primeo as the account holder.

86. R2 submitted that Clause 5 of the Customer Agreement (one of the three agreements constituting the 1994 and 1996 Brokerage Agreements) supported the view that BLMIS was constituted custodian for Primeo. Clause 5 provided:

> *"Without abrogating any of the Broker's rights under any other portion of this Agreement and subject to any indebtedness of the Customer to the Broker, the Customer is entitled, upon appropriate demand, to receive physical delivery of fully paid securities in the Customer's account."*

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[2] "Proper Instructions shall mean written instructions from the Company or the Investment Adviser in respect of any of the matters referred to in this Agreement signed in the name of the Company or the Investment Adviser by such one or more Directors of the Company or the Investment Adviser as their respective Boards of Directors may from time to time have authorised, or any other person or persons duly authorised to sign by the Board of Directors of the Company or the Investment Adviser".

87. Responding to this submission, the judge noted that the background to Clause 5 was the entitlement of BLMIS under the applicable US law and regulations to hold assets as custodian for its customers and he accepted the expert evidence of Mr Vinella, Primeo's custody expert, that the clause "*is standard boilerplate language typically found in any brokerage agreement, the purpose of which is to establish that if the broker has in its possession physical certificates (free of any lien), then the customer is entitled to require that they be handed over.*" The judge went on to say that this evidence was not particularly helpful where, as here, the form has been used as part of a package intended to document BLMIS's triple function and was expressed to be governed by Luxembourg law. Mr Schmitt, a joint expert witness on Luxembourg law, had been of the view that Clause 5 assumed that the broker (here BLMIS) may hold the customer's assets in its custody and the clause could be construed by a Luxembourg court as implying custodial duties on the part of BLMIS *vis-à-vis* Primeo. In the judge's view, given the triple function actually performed by BLMIS in respect of the 1FN060 Account in the previous two years and the fact that the parties must have intended the 1FN092 Account to be operated in the same way, the Customer Agreement was to be construed as implying a safekeeping obligation on the part of BLMIS.

88. The judge further found that the parties to the 1996 Brokerage Agreements contemplated that BLMIS would continue to act in a triple capacity (broker, investor, custodian) in the same way regarding the new account as it had in respect to account 1FN060, namely, as custodian for Primeo. After the execution of those agreements, R2 continued not to record the assets credited to either of the 1FN060 or 1FN092 accounts in its custody records and continued to issue holdings reports to BA Worldwide which reflected the fact that these assets were not held in its custody. This was post contract conduct that tended to support the conclusion that the 1996 Brokerage Agreements were intended to constitute BLMIS as custodian of the assets of Primeo, rather than sub-custodian for R2.

89. The judge next considered the effect of the 2002 Sub-Custody Agreement. As already recorded, this agreement was governed by Luxembourg law.

90. The judge accepted the evidence of the three experts on Luxembourg law, Mr Trevisan, Mr Schmitt and Mr Fayot, that under Article 1919 of the Luxembourg Civil Code, custodian and sub-custodian contracts are contracts *in rem* which do not give rise to safekeeping and restitutionary obligations unless and until a remittance of the assets has taken place which, in a case of dematerialized securities, as was the position here, occurs when the appropriate book entries are made by both the custodian and sub-custodian. No such remittance had taken place between R2 and BLMIS because the assets recorded on the 1FN092 account were in fact fictitious. The experts also agreed that if BLMIS owed pre-existing safekeeping duties to Primeo, the 2002 Sub-Custody Agreement was null and void because it would purport to have the effect of creating conflicting obligations by requiring BLMIS to hold the same assets to the order of two different principals.

91. However, the judge went on to hold that the 2002 Sub-Custody Agreement was part of an implied tripartite agreement by which the custody arrangements relating to the managed account assets were restructured. He said that all three experts agreed with the proposition that the fact that no valid *in rem* obligation arose under the agreement did not necessarily mean that the contract was wholly invalid: it was still capable of giving rise to ancillary *in personam* obligations that were not dependent upon a remittance of assets, such as a duty of supervision of the assets and in respect of the good standing of the broker, BLMIS. Mr Fayot described such an agreement as a "*framework agreement.*"

92. The judge found at [75] that there was a common intention amongst the parties that the pre-existing custody arrangement should be restructured, such that BLMIS ceased to hold the assets credited to the 1FN092 Account as custodian for Primeo and thereafter would hold them as sub-custodian for R2. From Mr Madoff's perspective there was no reason to oppose the re-structuring since BLMIS was not advancing credit to Primeo. From Bank Austria's perspective, the restructuring was advantageous in that it would confirm that R2 was performing a real role as custodian and it benefitted Primeo because it would reduce the need to put up cash collateral to secure the foreign exchange and overdraft facilities provided by BoB.

93. The judge further said in [159] of the judgment:

> *"Primeo gave its prior consent to the execution of the 2002 Sub-Custody Agreement and therefore by, necessary inference, agreed that BoB Lux would become custodian of the assets pursuant to the 1996 Custodian Agreement and that BLMIS would in future owe its safekeeping duty to BoB Lux, whereupon it would be released from the duty previously owed to Primeo under the 1996 Brokerage Agreement."*

94. The Respondents argued, relying on the evidence of Mr Fielding that the 2002 Sub-Custody Agreement was executed solely for credit purposes and was never intended to change the existing arrangement whereby BLMIS held the assets as custodian for Primeo, that there had been no meeting of minds as required by Luxembourg law that the 2002 Sub-Custody Agreement should give rise to any form of custody agreement. The judge rejected this argument. In his view, the idea that Mr Fielding would improve R2's security position through a sub-custody agreement rather than a pledge agreement, if this was the sole purpose, made no commercial sense. Further, Mr Fielding's evidence was not supported by the contemporaneous documentary evidence. For example, there was no mention in Mr Fielding's letter to Mr Madoff dated 26 July 2002 that the sub-custody agreement attached thereto was not intended to take effect in accordance with its express terms and that BLMIS would somehow be constituted as sub-custodian for R2 only in the event that Primeo was to default on its obligations under the foreign exchange and overdraft facilities. Although it was an agreed fact that R2 did not record the managed account assets in its custody records as a result of executing the 2002 Sub-Custody Agreement, the evidence of the parties' post contract conduct taken as a whole pointed overwhelmingly to the conclusion that they did regard BLMIS as the sub-custodian of R2. BoB officers repeatedly described BLMIS as R2's sub-custodian in respect of Primeo and Mr Fielding stated in a written presentation made to Bank Austria in May 2003 in unqualified terms that BLMIS had been appointed as sub-custodian by BoB Ltd and by R2 and he repeated this statement at the Primeo Board meeting on 14 May 2004. Further, the notes to R2's audited accounts for the years ended 31 December 2004 to 2006 all stated that R2 had appointed "*a broker/dealer investment firm*" (meaning BLMIS) as sub-custodian of the assets held by BLMIS to hold the assets of Primeo Select. Most importantly, from 2005 onwards, R2 issued custody confirmations to Primeo's auditors

(with Mr Fielding's approval) which it could only have done because it regarded itself as custodian of the assets held by BLMIS as its sub-custodian.

95. The judge went on to hold that R2 was estopped from denying that BLMIS was in fact R2's duly appointed sub-custodian in respect of the assets held on the managed accounts. The estoppels in question were estoppel by convention and estoppel by representation. Estoppel by convention arose where parties to a transaction act on an assumed state of facts or law, the assumption being either shared by them both or made by one and acquiesced in by the other. The effect of the estoppel was to preclude a party from denying the assumed facts or law if it would be unjust to go back on the assumption; see *Republic India v Indian Steamship Co Ltd* [1998] AC 878 at 913E-G. The judge said that following the execution of the 2002 Sub-Custody Agreement, there clearly was a shared assumption between Primeo and R2 that BLMIS was holding the assets as sub-custodian for R2 even though the operating procedures remained unchanged.

96. Citing Handley, *Estoppel by Conduct and Election*, 2nd Ed at 1-006, the judge set out the constituent elements of estoppel by representation: a statement or other conduct amounting to a representation of fact; its communication to the representee; the representee's justifiable belief in its truth and his alteration of position in that belief; an attempt by the representor to contradict his representation; and prejudice to the representee as a result of his alteration of position if the contradiction of the representation is permitted. He went on to hold that there was estoppel by representation arising out of explicit representations made by R2 to Primeo on multiple occasions both orally and in writing that R2 considered itself to be Primeo's custodian and to have appointed BLMIS as its sub-custodian.

97. The judge said that in the case of both types of estoppel, there had been detrimental reliance arising out of the issue by R2 of custody confirmations to EY in connection with the 2004, 2005 and 2006 audits, with Primeo relying through its auditors upon the confirmations to its detriment because, in the absence thereof, EY would not have issued the unqualified opinions they did issue without performing other audit procedures with satisfactory results.

98. The judge held that BLMIS was in wilful breach of duty as R2 's sub-custodian in that it was operating a Ponzi scheme and on that basis he proceeded to deal with a number of submissions advanced by R2 on the construction of Clause 16(B) and (E) of the 1996 Custodian Agreement. He rejected R2's first submission that Clause 16(B) applied only to the appointment of "*network*" sub-custodians, i.e. custodians who have been pre-approved as potential sub-custodians by R2 through a bilateral agreement. The answer to this contention was that R2 was estopped from denying it owed duties under Clause 16(B) in consequence of its appointment of BLMIS as its sub-custodian.

99. He also rejected a second submission that the inclusion in Clause 16(B) of duties as to effective safeguards and the suitability of a sub-custodian indicated that it was not the contractual intention to impose liability for the default of a sub-custodian, for what would be the point of making provision for these duties if the Custodian was in any event liable for the default of a sub-custodian. The judge gave two reasons for rejecting this second submission. He held first that the effective safeguards and suitability duties were introduced specifically to meet the requirements of paragraphs 2.36 and 2.37 of the Irish Stock Exchange's new listing rules, these being requirements whether or not the Custodian is strictly liable for the default of a sub-custodian. Secondly, the imposition of on-going effective safeguards and suitability duties was not inconsistent with an intention to make the Custodian liable for the defaults of the sub-custodian.

100. R2's third submission was that the Custodian was entitled to be indemnified under Clauses 16(B) and 16(E) for any liability resulting from the fraud, negligence or wilful default of a sub-custodian and therefore it had the defence of circuity of action to Primeo's strict liability claim. This submission was premised on the exceptions to the indemnity conferred in Clause 16(B) and (E) being fraud, negligence of wilful default of an "*agent*". In R2's submission, the word "*agent*" connotes a status different from a "*delegate*" or "*sub-custodian*", these latter expressions appearing alongside "*agents*" in the first part of Clause 16(B) and in the carve-out from the exoneration from liability conferred in the opening part of Clause 16(E).

101. The judge rejected this third submission, holding that the postulated interpretation of these clauses involved an internal inconsistency between the exoneration from liability and the indemnity in Clause 16(E). In his view, the indemnities only applied to liabilities incurred by the Custodian in performing its duties itself; they refer to "*agents*" because the Custodian could use an agent whilst performing the duties itself whereas the appointment of a delegate or sub-custodian necessarily involves the duties being performed by the delegate or sub-custodian. On the true construction of Clauses 16(B) and (E), R2 is made liable for the wilful breach of duty on the part of BLMIS as its sub-custodian.

102. The losses for which Primeo sought compensation at trial under its strict liability claim on the basis that BLMIS was R2's sub-custodian from the inception of the 2002 Sub-Custody Agreement down to the Herald Transfer were the losses flowing from the misuse of its cash by BLMIS in furtherance of the Ponzi scheme during this period. The damages claimed for these losses were the net amount of cash placed with BLMIS and dissipated in the Ponzi scheme after credit for actual recoveries received.

103. Adopting Lord Nicholls's observations as to relevant loss in *Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd* (No.2) [1997] 1 WLR 1627, at p. 1631D-G, the judge held that the relevant loss was that which flowed from BLMIS's default, not that which flowed from Primeo's decision to place funds with BLMIS for investment, either directly or indirectly. BLMIS's obligation as sub-custodian was to deliver securities or pay cash equivalent to that recorded on its books, as reflected in the monthly statements. In the absence of a default by BLMIS in performing this obligation, there could be no relevant loss and throughout the relevant period, BLMIS had met the obligation, albeit by dishonestly misusing or misappropriating clients' funds under its control. There was a risk that payments made by BLMIS might become the subject of claw-back claims in subsequent bankruptcy proceedings, but this risk fell on R2 from the inception of the 2002 Sub-Custody Agreement, not on Primeo, and R2 would not be entitled to be indemnified under Clause 16(B) of the 1996 Custody Agreement in respect of a claw-back claim. Even if it could be said that Primeo suffered an actual measurable loss when

it placed funds with BLMIS, this was not the relevant loss for which R2 could be made strictly liable under Clause 16(B).

104. When as part of the Herald Transfer, BLMIS, acting on R2's instructions, transferred the total holding standing to the credit of Primeo's managed account to Herald's managed account, BLMIS fulfilled its obligation as R2's sub-custodian and there was no relevant loss for which R2 was liable. Even if Primeo suffered an actual measurable loss on 2 May 2007 when it subscribed for shares in Herald, this was not a loss for which R2 was strictly liable under Clause 16(B). The result would have been the same if BLMIS had paid out in cash which Primeo had then invested in Herald or in any other way.

105. Under the Settlement Agreement made on 12 November 2014, the BLMIS Trustee agreed that Herald was entitled to make a customer's claim in the liquidation on the basis that it had acquired all Primeo's rights which for the purpose of this claim were valued at US$149,753,024. Primeo had therefore suffered no loss by reason of any default on the part of BLMIS for which R2 could be made responsible.

(b) Primeo's claim for breach by R2 of its appointment and supervisory duties under Clause 16(B) of the 1996 Custody Agreement

106. As the judge put it in [178] of the judgment, the core claim made by Primeo under this heading was that R2 was in breach of the duty it owed as a reasonably competent custodian in appointing and continuing the appointment of BLMIS as its sub-custodian without requiring (or at least recommending) that BLMIS establish: (a) a separate account with the DTC and/or make use of the DTC's Institutional Delivery System (referred to as the ID System); and (b) establish a separate account with BNY, in each case for the benefit of Primeo or the HSBC Group clients collectively.

107. The judge held that R2 was in breach of the duty it owed to Primeo given that the GFS Board had been aware since at least May 2002 of the unusually high operational risks arising from BLMIS's unique triple function business model of broker, investment manager and custodian and from the dominance over its affairs of a secretive owner who controlled the business. The GFS Board were aware in particular that the only evidence

R2 had as to the assets that BLMIS should be holding for Primeo were individual trade confirmations from BLMIS reflecting the purchase and sale of securities in which no independent party had participated and the month end statements that showed holdings in Treasury Bills and cash in apparent conformity with BLMIS's split-strike conversion investment strategy liquidating every client's entire holding of securities every month and investing the proceedings in Treasury Bills.

108. The judge also found that a Mar/Hedge article published in May 2001, which questioned how BLMIS was able to maintain such consistently high returns, why BLMIS did not charge investment fees and Mr Madoff's secretiveness, was indicative of the way a reasonably competent custodian would likely approach the appointment of BLMIS as a sub-custodian.

109. In reaching the conclusion that R2 was in breach of the postulated duty, the judge accepted the evidence of Primeo's expert on custody issues, Mr Peter Vinella, in preference to that of the Respondents' expert, Mr Joseph Belanger. In the course of his evidence, Mr Vinella described as a "*pretty nightmarish scenario*" the fact that the only documentary evidence available to R2 was generated by BLMIS.

110. On the basis of expert evidence on the operations of the DTC given by Mr Joseph P. Denci on behalf of Primeo, the judge held that, faced with the risks posed by BLMIS's business model, a reasonably competent custodian would have required BLMIS to open a sub-account at the DTC in the name of BLMIS but designated for either Primeo or all of R2's clients investing with BLMIS. Once opened, agency trades between BLMIS and Primeo (acting through BLMIS as investment manager) would be settled into this separate DTC account with the result that the DTC would issue a settlement notification in respect of the trade which could be sent directly to R2 by SWIFT message or through the ID System pursuant to an instruction from R2 to BLMIS that this be done. Similarly, BLMIS could have been instructed to request a month end holdings statement be issued by the DTC, with a copy sent directly to R2 through the ID System. The existence of a separate account would also have enabled the auditors to view its contents directly by using the Participant Terminal System ("PTS") in BLMIS's office.

111. The judge also held that it would have been possible without requiring BLMIS to establish a separate sub-account with the DTC to use the ID System so that R2 could obtain notifications directly from the DTC. The ID system is an electronic communication facility between institutional investors and brokers that provides for (a) the allocation of trades, (b) the addition of standing instructions, (c) the electronic distribution of trade confirmations and (d) the electronic distribution of settlement notifications. If it had been set up R2 would have received a notification directly from the DTC as an "*interested party*" whenever BLMIS identified part of a bulk trade as being allocated to Primeo. In this way R2 would receive evidence directly from the DTC confirming that an actual trade had taken place and that the securities or cash had been settled into BLMIS's account.

112. The judge further held in respect of BLMIS's month end and year end statements showing Treasury Bills and cash, that it would have been straightforward for BLMIS to establish a separate account with BNY in its own name designated for each of Primeo and the other BoB clients so that BLMIS could then have instructed BNY to issue monthly statements directly to R2 and also confirm the year end balances directly to the auditors. And in respect of un-invested cash held for Primeo by BLMIS in its operating account maintained with JP Morgan, such cash could have been held in a separately designated account or sub-account, thereby enabling R2 to receive statements directly from the bank. In so holding, the judge relied on the evidence of Mr Gilbert T Schwartz, the jointly appointed US banking law and practices expert, who confirmed that there was no regulatory or practical impediment to setting up both a custody account with BNY and a bank account with JP Morgan in this way.

113. The judge noted that these last arrangements would not necessarily have prevented Mr Madoff from defrauding HSBC's clients. However, they would have enabled R2 to confirm that the requisite value of the Treasury Bills did actually exist as at each month end, thus making it more difficult for Mr Madoff to perpetuate his Ponzi scheme.

114. The judge observed that on various occasions during the relevant period, many BoB executives and, later, HSBC executives, considered the unique risks presented by BLMIS's business model, but they never actually did anything about it other than carry out routine custody due diligence reviews and commission the KPMG fraud risk reviews. In spite of talking about the problem of single source reporting on many occasions, the individual executives never applied their minds to ways in which confirmatory information could be obtained from independent sources. Even if they knew little about the detailed procedures in New York relating to exchange traded securities and Treasury bills, they had ready access to the expertise of the Global Custody Department of BoB and later, HSBC, which in turn had access to the expertise of their network of sub-custodians, including Brown Bros Harriman and Citibank in New York.

115. The judge concluded that R2's failure to recommend to Primeo that BLMIS open the aforesaid accounts at the DTC, BNY and JP Morgan and/or make use of the ID System was negligent and a breach of R2's continuing contractual duties under Clause 16(B). In the particular circumstances of the case, R2 could not require BLMIS to do anything without the consent of its client, Primeo. Accordingly, it was the failure to make the recommendation that constituted the negligence and breach of contract.

(c) Primeo's claim that R1 was grossly negligent in the way in which calculated an accurate NAV pursuant to Clause 4.1 (xvii) of the 1996 Administration Agreement

116. Primeo had to establish that R1 had been grossly negligent by reason of the wording of Clause 9.2 of the 1996 Administration that relieves the Bank, i.e. R2 from liability for any act or omission in the course of or in connection with the services rendered under the agreement in the absence of "*gross negligence or wilful default on the part of the Bank or its servants, agents or delegates*".

117. The judge adopted the following observations of Mance J in *Red Sea Tankers Ltd v Papachristidis ("The Ardent")* [1997] 2 Lloyd's Rep. 547 at p. 586 on what is comprehended by the concept of gross negligence:

> *""Gross"negligence is clearly intended to represent something more fundamental than failure to exercise proper skill and/or care constituting*

negligence. But, as a matter of ordinary language and general impression, the concept of gross negligence seems to me capable of embracing not only conduct undertaken with actual appreciation of the risks involved, but also serious disregard of or indifference to an obvious risk."

118. The judge held that R1's core duties under the 1996 Administration Agreement of producing the accounts and performing NAV calculations required the exercise of an independent professional judgment. He found that the 1996 Administration Agreement contained an implied term that in performing the NAV calculations pursuant to Clause 4.1(xvii) of the 1996 Administration Agreement R1 must exercise the care and skill of a reasonably competent mutual fund administrator carrying on business in the Cayman Islands. The accounting records maintained by R1 (acting by its delegate, R2) were very largely based on the individual trade confirmations sent by BLMIS. (The only other items on the balance sheet were receivables and payables relating to subscriptions, redemptions and operating expenses and the balances on the bank accounts maintained with R2.) Thus, in financial terms, the books and records maintained by R1 and the accounts it generated as at each valuation day were almost entirely dependent upon information received from BLMIS. These accounts were reconciled with the month end statements received from BLMIS as part of the process of determining the total NAV. The key issue was whether R1 had been guilty of gross negligence in satisfying itself about the existence of the assets credited to Primeo's managed account by reconciling two streams of information received from BLMIS alone in the circumstances of BLMIS's unique triple function business model that involved single source reporting from BLMIS itself.

119. In deciding whether R1 had been guilty of gross negligence, the judge proceeded to consider the concerns R1 and R2 had had over the problem of single source reporting and the steps that had been taken in response thereto.

120. He held that the failure of the GFS Board to implement its decision made in October 2002 to engage KPMG to perform audit procedures in respect of its clients' balance sheets did not constitute gross negligence. In his view, this decision was overtaken by events. After the issue by EY of an unqualified audit opinion in respect of Primeo on 28 March 2003, it would have become very difficult indeed for R1 to insist on having

KPMG re-perform part of the work which, by necessary implication, had already been done by F&H to the satisfaction of EY. The evidence did not lead to the conclusion that BoB disregarded or was indifferent to the obvious risks or that it went ahead and prepared further NAV calculations conscious of the fact that it was doing so in breach of duty or being reckless in the sense of not caring whether or not it was acting in breach of duty. The evidence tended to suggest that the GFS Board never reconsidered the matter and was simply careless in failing to ensure that its decision was implemented before it was overtaken by events. Its carelessness did not amount to gross negligence or wilful default.

121. The judge next considered the discussion of the matters arising out of the report by Bank Austria's internal auditors at the meeting of Primeo's board on 23 June 2003. The judge found that Mr Fielding failed to make a useful contribution on the issue of single source reporting because he wrongly believed the problem was for the auditors and not R1 and because he thought the risks associated with BLMIS were acceptable. Mr Fielding failed to mention the decision of the GFS Board to instruct KPMG to carry out audit procedures in respect of Primeo and the other two clients invested in BLMIS because he did not agree with it and anyway it had been overtaken by events. In the judge's view, whilst Mr's Fielding's approach was complacent, it did not lead to the conclusion that R1 had been grossly negligent or in wilful default of its duties.

122. Turning to the discussion of the same issues at the next Primeo Board meeting on 14 May 2004, the judge noted that whilst the single source reporting problem had been discussed further, BLMIS had continued to operate satisfactorily and on 29 April 2004, EY had issued another unqualified opinion. He concluded that whilst the continued failure to address the problem of single source reporting at the 14th May 2004 Board meeting was negligent, there was no basis for finding that the lack of attention to the issue at the 14 May 2004 Board meeting could be properly characterised as gross negligence.

123. The judge then considered the issue by R2 to EY on 5 April 2005 of the custody confirmation of the positions held within the BLMIS managed account as at the year-end. EY's request on 14 March 2005 for such a confirmation had followed the discussion

between R2 and EY on 21 February 2005 at which EY had raised numerous concerns about Mr Madoff including whether the assets attributed to BLMIS really existed and the reliability of BLMIS's auditors, F&H. During the meeting EY had indicated that they were proposing to visit BLMIS to conduct the audit work previously done by F&H themselves and were considering the possibility of resigning or issuing a qualified audit opinion if they were unable to perform this work satisfactorily.

124. In the view of the judge, Mr Fielding's approach that R1 was entitled to rely on the auditors to do the work necessary to verify the existence of the assets became wholly untenable once he agreed to provide EY with the 5 April 2005 custody confirmation. Without this confirmation, EY would have insisted on auditing the balances on the BLMIS statements, failing which they might have issued a qualified opinion or resigned. Mr Fielding was the ultimate decision maker concerning the issue of the custody confirmation and the manner in which he had dealt with the matter was grossly negligent. By his own admission, he had failed to apply his mind to the issue.[3] He was indifferent to the obvious risk of continuing to prepare and issue NAVs without the comfort of an unqualified audit opinion based upon supposedly independent work performed by F&H. And he had continued in this way, knowing that EY were unwilling to rely on F&H's work and knowing that R2 had taken no steps to perform its duties under Clause 16(B) of the 1996 Custodian Agreement. This all constituted a serious disregard of the risks associated with relying solely upon the information supplied by BLMIS. The custody confirmation was issued on 5 April 2005, the audit opinion was issued on 29 April 2005 and the NAV for the April valuation was issued on 2 May 2005.

125. R2 had continued to issue custody confirmations in respect of the 2005 and 2007 audits without having recommended that any steps be taken to implement any of the available safeguards applicable to the manner in which BLMIS purportedly performed its safekeeping duties under the 2004 Sub-Custody Agreement. Although it was reasonable

[3] When dealing with Mr Fielding's role in the issue of the 5 April 2005 custody confirmation in [110] of the judgment, the judge related that when at trial Mr Fielding was shown the email of 15 March 2005 he sent to Mr Fiorino who had referred to him EY's request for a custody confirmation, Mr Fielding said, "I'm going to call it a rather inglorious email" and tried to suggest that, given his managerial position, it was really not his responsibility and he failed to apply his mind to Mr Fiorino's question whether EY's request for a custody confirmation should be met.

for R2 to take some comfort from KPMG's report following the first fraud risk review, the fact that KPMG found no evidence tending to suggest any kind of impropriety did not justify this continuation of an inherently flawed procedure. Moreover, R1 (acting by R2) had failed to implement KPMG's most pertinent recommendation that it undertake a periodic review at BLMIS in accordance with a list of specified measures and enquiries.

126. The judge further held that R1 was grossly negligent in respect of the NAVs issued for Primeo after the Herald Transfer in 2007 because the work done by R2 in respect of Herald in this period was flawed for exactly the same reasons as the work done in respect of Primeo prior to May 2007 and this was known or ought to have been known by R1 in its capacity as administrator of Primeo. The second fraud risk review did not provide any justification for the continuation of this grossly negligent process. Whilst KPMG had not found any evidence of fraud, those who had participated in the discussion with KPMG on 17 July 2008 recognised that the operational risk associated with BLMIS was uniquely high and it *could* be a Ponzi scheme.

VI: THE ROLE OF AN APPELLATE COURT IN RELATION TO FINDINGS OF FACT.

127. Many of the submissions of both parties involve challenging findings of primary fact and inferences drawn from primary findings of fact. In their written and oral submissions, the parties referred to the limitations on the ability of an appellate court to interfere with the trial judge's findings of primary fact and the inferences he drew from such findings. In this connection we are bound to observe however that their submissions appeared at times to lose sight of the fundamental truth underlying Lord Hoffmann's oft-quoted statement in *Biogen Inc. v Medeva Plc* [1997] RPC 1 at 45. He stated:

> *"[T]he need for appellate caution in reversing the judge's evaluation of the facts is based upon much more solid grounds than professional courtesy. It is because specific findings of fact, even by the most meticulous judge, are inherently an incomplete statement of the impression which was made upon him by the primary evidence. His expressed findings are always surrounded by a penumbra of imprecision as to emphasis, relative weight, minor qualification and nuance ... of which time and language do not permit exact expression, but which may play an important*

> *part in the judge's overall evaluation. It would in my view be wrong to treat [Benmax v. Austin Motor Co. Ltd* [1955] A.C. 370*] as authorising or requiring an appellate court to undertake a de novo evaluation of the facts in all cases in which no question of the credibility of witnesses is involved. Where the application of a legal standard such as negligence or obviousness involves no question of principle but is simply a matter of degree, an appellate court should be very cautious in differing from the judge's evaluation".*

128. Where there is a clash in the oral or documentary evidence about the facts, the exercise carried out by the judge is an evaluative one, in which appropriate respect needs to be given to the decision of the judge. There is, however, a spectrum of appropriate respect, depending on the nature of the decision of the lower court, and caution by appellate courts is not confined to cases in which a factual finding turned on the credibility or reliability of oral evidence. In *EI Dupont De Nemours and Co v ST Dupont (Note) (CA)* [2003] EWCA Civ. 1368, [2006] 1 WLR 2793 at [94] May LJ stated that decisions of primary fact reached after an evaluation of oral evidence and purely discretionary decisions lie at one end of the spectrum. The evaluation of the factors and of disputed evidence is very much the province of the first instance judge who has heard evidence and is in a better position to assess it. Circumspection by an appellate court is also appropriate because the evaluative process is often a matter of degree upon which different judges can legitimately differ: see *Assicurazioni Generali SpA v Arab Insurance Group* [2002] EWCA Civ. 1642, [2003] 1 WLR 577*per* Clarke LJ at [16].

129. Inferences drawn from the primary facts and what May LJ described as "*multi-factorial decisions often dependent on inferences and analysis of documentary material*" are further along the spectrum. Evaluations of the application of a legal standard such as negligence which does not involve a question of principle but only a matter of degree fall into this category. Although an appellate court will be more willing to interfere with them, they are to be accorded considerable respect: as well as the last two sentences of the extract from Lord Hoffmann's speech in *Biogen* we have set out above, see e.g. *Allied Maples Group v Simmons & Simmons* [1995] 1 WLR 1602, 1610; *Six Continents Retail Ltd. v Carford Catering Ltd* [2003] EWCA Civ. 1790 at [19] – [21] *per* Laws LJ; *Floyd v*

John Fairhurst & Co [2004] EWCA Civ. 604, [2004] PNLR 41, at [56], *per* Arden LJ, and *Cox v Transco Plc* [2006] EWCA Civ. 127 at [16] *per* Gage LJ.

130. Even in situations (for instance concerning inferences and assessments of hypothetical counter-factuals) in which courts have stated they would be more willing to revisit the decision below, they are cautious of doing so where that decision is an evaluation of the facts. This is seen from the result in the *Allied Maples* case where the judge's assessment of the witnesses was supported by evidence and from *McClurg v Chief Constable of the RUC* [2009] NICA 37. In *McGlurg's* case Kerr LCJ stated (at [43]) that the appellate court was in as good a position as the trial judge to conduct its own analysis and reach its own conclusions. But at [55] borrowing Clarke LJ's words in *Assicurazioni Generali* he stated 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*". In the light of Clarke LJ's statement, particular respect to the trial judge's evaluation should be accorded where it involves a "*predictive*" element, and there is more than one possible "*right*" answer.

VII: THE CHALLENGE TO THE FINDING THAT BEFORE THE 2002 SUB-CUSTODY AGREEMENT BLMIS WAS R2'S CO-CUSTODIAN AND NOT A SUB-CUSTODIAN

131. In paragraph 10 (2) of its Amended Memorandum of Grounds of Appeal, Primeo pleads to the Respondents' cross-appeal against the judge's finding that BLMIS was R2's sub-custodian after the 2002 Sub-Custody Agreement. By that plea it is contended that the judge should have held that BLMIS was R2's sub-custodian from the inception of the 1994 Brokerage Agreements and that the 2002 Sub-Custody Agreement merely formalised a pre-existing sub-custody arrangement. As we have seen, this contention ("the para 10 (2) contention") was advanced at trial but was rejected by the judge.

132. In the Annex to Primeo's skeleton argument, Primeo invites this Court "*if necessary*" to uphold the judge's finding that BLMIS was R2's sub-custodian following the 2002 Sub-Custody Agreement on the additional grounds advanced by way of the para 10 (2) contention. However, at the hearing of the appeal Primeo relied on the para 10 (2)

contention not merely as an additional ground for the judge's finding but also in support of a submission that, even if the 2002 Sub-Custody Agreement had never been concluded, the judge should have found that BLMIS was R2's sub-custodian from the outset and was entitled to damages under Clause 16(B) of the Custodian Agreement for the period from the inception of the 1994 Brokerage Agreements down to the Herald transfer.

133. On behalf of Primeo, Mr Smith QC argued that since under Clause 2 of the 1993 Custodian Agreement, R2 was to be custodian of "*all Securities and cash owned by [Primeo]*" it was impossible to find, as the judge had done, that BLMIS was a co-custodian alongside R2. Mr Smith further submitted that an entity could be treated as having been appointed a sub-custodian under Clause 16(B) of the 1993 and 1996 Custodian Agreements where, as here, it had acted as a de facto sub-custodian in permanent custody of 100% of Primeo's assets in performing the functions of the Custodian (R2). In Mr Smith's submission, there was no evidential justification for the judge's conclusion that the terms of the 1993 Custodian Agreement - that at first blush tended to suggest that Primeo could not have intended to appoint BLMIS as a co-custodian - were displaced by an established course of conduct between the parties.

134. In support of this latter contention, Mr Smith relied on an extensive list of evidential points that in large part had been advanced by Primeo at trial to persuade the judge to reach the conclusion that BLMIS had acted as R2's sub-custodian and had not acted as a custodian of Primeo.

135. Mr Smith placed reliance both on Primeo's Offering Memorandum that named R2 as custodian with no mention of any other custodian and on a letter sent by R2 to BA Worldwide in December 1996 for onward transmission to the Austrian regulator, the Financial Markets Authority, stating that it was the custodian bank for Primeo, the purpose of the letter being to comply with an Austrian requirement that the fund's assets be held by a custodian separate from the investment manager. In Mr Smith's submission, if BLMIS had been acting as custodian rather than as sub-custodian, it would not have been lawful to market Primeo's shares in Austria. Accordingly, it was to be inferred from

the decision of Primeo's Board to market Primeo in Austria and from the entry into the 1996 Brokerage Agreements on 29 February 1996 that the parties believed and intended that R2 was the only "*custodian bank*" in respect of Primeo.

136. Reliance was also placed on Primeo's application for registration under the Cayman Islands Mutual Funds Law in which, in answer to a request for details of the fund's custodian, R2 alone was listed and on the fact that at the time the 1996 Custodian Agreement was concluded, Primeo intended to seek a listing of its Select shares in Ireland where the Irish Stock Exchange Rules required a separation of functions between the custodian and investment manager.

137. It was also submitted that it was to be inferred from a letter sent by R2 to BLMIS on 23 December 1993 asking BLMIS to open an account in the name of "*Bank of Bermuda (Luxembourg) SA Re: Primeo Fund*" that the intention was that R2 would be the account holder *vis-à-vis* BLMIS and this was how the managed account was operated. Further, none of the documents constituting the 1994 and 1996 Brokerage Agreements, namely the Customer Agreement, the Option Agreement, and the Trading Authorisation that were sent to Primeo for signature purported to appoint BLMIS as Primeo's custodian. Moreover, deposits were made directly into the managed account by R2 rather than Primeo and R2 would make requests to BLMIS to redeem investments having received prior authorisation from Primeo with redemption proceeds being paid by BLMIS into R2's account at Citibank in New York. In addition, all of Primeo's audited financial statements from the accounts for the year ended 31 December 1998 to 31 December 2001 expressly named R2 as the custodian and this continued post 2002 and R2's fee under the Custodian Agreements assumed that it was custodian of all of Primeo's assets including those held in the managed account.

138. Mr Smith also relied on: (i) an email dated 30 May 2002 from Mr Fielding to Dr Fano, (ii) Dr Fano's reply to Mr Fielding dated 30 July 2002; and (iii) an email from Mr Fielding to the GFS Board dated 26 July 2008. In the first of these emails, Mr Fielding was discussing the possibility of a fund like Primeo investing in BLMIS under UCITS regulations. The last sentence reads:

> *"Some tightening up of the custody and sub-custody arrangements between ourselves and Madoff would also be need (sic) to comply with UCITS Part 1 regulations ...".*

In the second email, Dr Fano says:

> *"A serious problem would be, however, BoB Lux' reinforcement of responsibility as custodian – I would have to check this issue (very cautiously) with Madoff first, in order to know how far he could go (if he would like at all ...)"*

139. In the third email, Mr Fielding is reporting to the GFS Board on his meeting with Mr Madoff on 17 July 2002. The opening sentence of the 2nd bullet point reads:

> *"NF noted that for the various accounts open in relation to clients of the bank (Primeo) that have been running for some time we found they are documented inconsistently. In particular, for the accounts relating to BOBLUX (Primeo) there is account opening documentation between Madoff and the fund but does not appear to be documentation between Madoff and the bank [R2] though the bank is custodian to the relevant funds. BLM agrees re putting this in order assuming the agreements are not substantially different from the one in place with BOBL/BTDL."*

140. Mr Smith contended that these emails clearly evidence an understanding that BLMIS had in fact been R2's sub-custodian from the outset and it was necessary to formalise this relationship by the conclusion of a sub-custody agreement between BLMIS and R2.

141. It was further argued that the judge was wrong to place the reliance he did on the fact that the parties must have known that BLMIS was acting in a triple capacity. BLMIS had always acted in this way even after the conclusion of the 2002 Sub-Custody Agreement. The judge also erred in attaching too much weight to the facts that: (a) prior to August 2002, there was no formal sub-custody agreement in place between R2 and BLMIS; (b) cash had been transferred to BLMIS via R2 and not directly from Bank Austria; and (c) R2 had failed to record that it had custody of the management account assets. The judge was in error on these matters because: (i) the fact that securities were held in BLMIS's actual custody tells one nothing about the capacity in which BLMIS was holding those

securities; (ii) by parity of reasoning, the absence of a formal co-custody agreement between BLMIS and Primeo supports the proposition that BLMIS was not Primeo's co-custodian; (iii) the transfer of cash to BLMIS from R2 suggests a contract between R2 and BLMIS, not BLMIS and Primeo; and (iv) R2 continued to fail to record the securities held by BLMIS on its custody systems even after the conclusion of the 2002 Sub-Custody Agreement.

142. It was also contended that the wording of Clause 5 of the Customer Agreement, being in the nature of a boilerplate provision, did not operate to appoint BLMIS as custodian of Primeo and the Luxembourg law evidence on Clause 5 had simply been to the effect that where a broker holds securities purchased for a client the obligation on the broker is not inconsistent with BLMIS being R2's sub-custodian because R2 operated all the rights in respect of the broker's account as Primeo's agent.

143. Finally, it was argued in Primeo's written submissions that the judge had erred in declining to accept the evidence given in cross-examination by Mr David Bailey that it was R2 (not Primeo) who opened the managed account at BLMIS and that R2 was the custodian of the managed account on behalf of Primeo. Mr Bailey had been a director of Primeo from 1998 – 2000 and was Primeo's relationship manager with R2 in the period 1995 – 2000.

144. We are not persuaded by Mr Smith's submissions. In our view, the judge was well entitled to reach the conclusions he came to for the reasons he gave. In our judgment, if BLMIS was appointed R2's sub-custodian pursuant to Clause 16(B) of the Custodian Agreements this could only have been as a result of an appointment under which BLMIS unequivocally accepted that it held the assets in the managed account to R2's order rather than to the order of its investor/customer - Primeo - and in our opinion the evidence fell well short of compelling a finding that there had been such an appointment.

145. In contrast to the position as between R2 and BLMIS, there were express written agreements constituting the 1994 and 1996 Brokerage Agreements between BLMIS and Primeo and in our judgment, the following findings made by the judge are unassailable: -

(i) the managed accounts were opened in favour not of R2 but Primeo, BLMIS's counterparty to the Brokerage Agreements;

(ii) although all cash subscriptions were delivered to R2, cash was then transferred to BLMIS pursuant to Proper Instructions given under Clause 5(A)(g) of the relevant Custodian Agreement to be managed on a discretionary basis with the Securities being held in the custody of BLMIS;

(iii) cash was never transferred under Clause 5(A)(a) of the 1993 and 1996 Custodian Agreements to settle purchases of Securities which would then be settled into R2's custody;

(iv) BLMIS owed an implied custodial duty to Primeo in respect of assets held in the managed accounts;

(v) it was the intention of the parties in respect of the 1996 Brokerage Agreements that BLMIS would continue to perform its triple functions, including that of custodian of Securities purchased for the managed account, with the consequence that, pursuant to Clause 6(B) of the Custodian Agreements, assets credited to the managed accounts fell outside the custodial responsibility of R2 but were the custodial responsibility of BLMIS down to the 2002 Sub-Custody Agreement;

(vi) it was to be inferred from the parties' conduct that BLMIS acted on withdrawal instructions received from R2 acting as agent on behalf of Primeo as the account holder and not on its (R2's) own behalf;

(vii) Primeo, acting by Mrs Kohn, had given R2 Proper Instructions under the 1996 Custodian Agreement to appoint BLMIS as a custodian for Primeo;

(viii) the conclusion that the 1996 Brokerage Agreements were intended to constitute BLMIS as custodian of the assets of Primeo, rather than sub-

custodian for R2 is supported by the continuation after the execution of the 1996 Brokerage Agreements of the prior practice whereby: (a) assets credited to the 1FN060 Account were not recorded by R2 in the custody records maintained by its Global Custody Department; and (b) the issuance of holdings reports to BA Worldwide which reflected that these assets were not held in R2's custody; and

(ix) no weight should be attached to the evidence given by Mr Bailey in cross examination on the ground that his answers were given to leading questions of a technical nature that were outside his expertise.

146. We would also observe that the fact that Mr Fielding and Dr Fano might have thought that BLMIS may have been a de facto sub-custodian prior to August 2002 adds no or only the slightest support for the assertion that BLMIS accepted an appointment as R2's sub-custodian on terms that it would hold the assets in the managed account on behalf of R2 rather than on behalf of Primeo, its counterparty to the Customer Agreement, the Option Agreement and the Trading Authorisation Agreement.

147. We accordingly reject Primeo's challenge to the judge's finding that BLMIS was a custodian *vis-à-vis* Primeo and not a sub-custodian of R2 from the inception of the 1994 Brokerage Agreements to the inception of the 2002 Sub-Custody Agreement.

VIII: R2'S APPEAL AGAINST THE FINDING THAT IT BECAME CUSTODIAN UNDER AN IMPLIED TRIPARTITE AGREEMENT UNDER WHICH BLMIS OWED ITS SAFEGUARDING DUTY TO IT AND NOT TO PRIMEO

148. As recorded at [91] – [92] above, in concluding that there was a tripartite agreement whereby R2 became custodian of BLMIS's managed account assets and BLMIS became R2's sub-custodian of those assets, the judge found that: (i) there was a common intention amongst the parties that the custody arrangement prior to the 2002 Sub-Custody Agreement should be restructured so that R2 would henceforth hold the assets credited to Primeo's managed accounts as custodian for Primeo with BLMIS holding the assets as

sub-custodian for R2; and (ii) Primeo gave its prior consent to the execution of the 2002 Sub-Custody Agreement and therefore, by necessary inference, agreed that R2 would become custodian of the assets pursuant to the 1996 Custodian Agreement and that BLMIS would in future owe its safekeeping duty to R2, whereupon it would be released from the duty previously owed to Primeo under the 1996 Brokerage Agreement.

149. Despite amending its pleading several times, Primeo did not plead the tripartite agreement found to have existed by the judge. Instead, Primeo only advanced a case based on the aforesaid tripartite agreement in its written closing. Until this point, Primeo's case had been that BLMIS had been R2's sub-custodian under the 1993 and 1996 Custodian Agreements and that the 2002 Sub-Custody Agreement simply regulated the terms on which sub-custody services were provided by BLMIS.

(a) The Respondents' procedural irregularity submission

150. The first ground of appeal advanced by Mr Gillis QC for the Respondents under this heading is that it was procedurally unfair for the judge to accept Primeo's unpleaded contention that the 2002 Sub-Custody Agreement was part of a tripartite agreement between Primeo, R2 and BLMIS by which R2 became custodian under the 1996 Custodian Agreement of all of Primeo's assets and BLMIS owed its safekeeping duty to R2 as R2's sub-custodian.

151. In its oral closing, R2 objected to Primeo being allowed to rely on this unpleaded contention. Mr Gillis submitted to the judge that Mr Fielding would have given much greater evidence as to his explanation to Dr Fano of the purpose and effect of the proposed sub-custody agreement and would have said that Dr Fano did not consent to a transfer to R2 of Primeo's right under the Brokerage Agreements to have delivery of the assets from BLMIS. In paragraph 111 of the Respondents' Defence, it was pleaded that the 2002 Sub-Custody Agreement was ineffective because it was interfering with Primeo's contractual right to call for delivery of the Securities held in the managed account. In paragraph 28 of its Reply, Primeo had pleaded that the Brokerage

Agreements did not constitute BLMIS a custodian of Primeo and so the 2002 Sub-Custody Agreement did not interfere with Primeo's rights.

152. When making Primeo's oral closing submissions in reply, Mr Smith QC did not apply for leave to amend Primeo's pleading. His line was that in advancing the tripartite agreement contention, Primeo was *"pointing out the implications of the defendants' own argument and evidence, namely, that the 2002 Sub-Custody Agreement had a credit purpose, and it was entered into with Primeo's consent"*.

153. In addition to the prejudice relied on by the Respondents when submitting to the judge that Primeo should not be permitted to advance its new case on the tripartite agreement, Mr Gillis submitted on appeal that the Respondents were prejudiced in that, had that case been known before trial, the Respondents would have: (i) cross-examined those witnesses who had been directors of Primeo, namely, Dr Zapatocky, Mr Fisher and Mr O'Neill, to elicit evidence that Dr Fano had no authority from Primeo to change its custody arrangement; (ii) cross-examined Mr Fielding challenging any suggestion that Dr Fano agreed on Primeo's behalf that BLMIS should cease to owe the pre-existing duty of delivery as custodian to Primeo of the assets in the managed and instead owe that duty to R2 ; and (iii) called expert evidence on Luxembourg law as to how, if at all implied agreements can arise under Luxembourg law and in particular how such agreements can be implied that vary written agreements (the 1996 Brokerage Agreements) to satisfy requirements for prior written consent of the Broker (BLMIS) and writing signed by the Broker as stipulated in Clauses 2 and 4 in the 1996 Brokerage Agreement governed by Luxembourg law.

154. When expressing the findings recorded in [148] above, the judge made no reference to the Respondents' contention that it would be procedurally unfair for Primeo to be allowed to advance its unpleaded case of a tripartite agreement. In our judgment, the judge was entitled on the evidence to make these findings and he did not act unfairly in doing so.

(b) The purpose of the 2002 and 2004 Sub-Custody Agreements

155. The Respondents' case below in respect of the 2002 and 2004 Sub-Custody Agreements was that the joint intention of those agreements was *solely* to attempt to give R2 additional protection in the event of a credit default in respect of credit arrangements provided by R2 to its clients, including Primeo.

156. In support of this case, the Respondents relied on paragraph 81 of Mr Fielding's witness statement in which he recalled explaining to Dr Fano before proceeding with the 2002 Sub-Custody Agreement that he planned to visit BLMIS and to present Mr Madoff with such a proposed agreement for the purpose of enhancing R2's position in relation to credit provided by R2 to it; and he did not recall Dr Fano expressing any objections to the proposed meeting or agreement between R2 and BLMIS.

157. Mr Fielding also said in evidence that he could not have gone to BLMIS to propose a sub-custody agreement without first having first consulted the client, Primeo.

158. Also, as noted at [138] above, Mr Fielding, in an email dated 30 May 2002 to Dr Fano, said: "*Some tightening up of the custody and sub-custody arrangements between ourselves and Madoff would also be need (sic) to comply with UCITS Part 1 regulations …,*" to which Dr Fano replied: "*A serious problem would be, however, BoB Lux' reinforcement of responsibility as custodian – I would have to check this issue…*"

159. In addition, it was Mr Fielding's evidence that Dr Fano was effectively responsible for the day-to-day management of Primeo and acted as Primeo's general manager; the Primeo directors would normally look to Dr Fano for her advice and guidance when it came to making key decisions. It was this evidence which was the basis for the judge's finding that Dr Fano's knowledge should be imputed to Primeo in her capacity as managing director of BA Worldwide. Thus, in telling Dr Fano of the proposed sub-custody agreement, Mr Fielding was effectively telling the management of Primeo.

160. In its opening submissions at the trial, Primeo case's in relation to the 2002 Sub-Custody Agreement was that it could only be explained on the basis that it was understood and

intended that R2 was the custodian in respect of the BLMIS assets and was therefore entitled to appoint BLMIS as its sub-custodian.

(c) A permissible variation of Primeo's pleaded case?

161. We accept Primeo's submission that the judge's findings were a permissible "*variation, modification or development*"[4] of Primeo's pleaded case and not something which was new, separate and distinct from what had been pleaded. As Slade LJ stated in *Alan Taylor v Doncaster Metropolitan Borough Council* (CA, unreported, 1 November 1989):

> "In many circumstances it would no doubt defeat the ends of justice for a court to reject the claim of a plaintiff which appeared to be well founded in law and on the basis of the evidence as to fact which had emerged at the trial, merely because the facts as ultimately established did not precisely correspond with the facts as pleaded. In some circumstances the court may further be justified in taking the view that to require the plaintiff to seek leave to amend his pleading at a late stage in the trial, as the price of acceding to his claim, may be a purposeless formality, if it is obvious that the application would have to be granted."

162. Given the evidence of Mr Fielding as to Dr Fano's role as general manager of Primeo, we find there is nothing in the Respondents' submission that if the tripartite agreement had been pleaded they would have been able to call evidence to show her lack of authority to agree to the 2002 Sub-Custody Agreement. We also accept Primeo's submission that the Respondents' point that they were denied the opportunity of cross-examining Primeo's witnesses as to their awareness of Clause 11 of the Advisory Agreement is a bad one. This clause provided that "*Nothing contained herein shall be construed to create the relationship of agent and principal or a joint venture or partnership between the parties hereto...*" The witnesses' subjective knowledge of this provision is nothing to the point. The question is whether the clause prevented Dr Fano from acting as Primeo's agent in agreeing to the execution of the 2002 Sub-Custody Agreement. We accept Primeo's submission that Mr Fielding and Dr Fano proceeded on the basis that she had authority to agree to the execution of the 2002 Sub-Custody Agreement and this overrides the labelling of the relationship between Primeo and BA Worldwide in Clause 11. We also

4 See *John G Stein & Co v O'Hanlon* [1965] AC 890 per Lord Guest at 909 E.

agree with the submission that the Primeo Board were not in a position where they could dispute that Primeo had consented to the 2002 Sub-Custody Agreement given that the Board became directly aware of the agreement and did not disavow it or question its validity.

163. As to the Respondents' contention that they were denied the opportunity of seeking the views of the experts on Luxembourg law as to the requirement for writing in Clauses 2 and 4 of the 1996 Brokerage Agreements, we accept Primeo's submission that the 2002 Sub-Custody Agreement itself, executed as it was by BLMIS, satisfies the requirement that BLMIS provided its written consent to the arrangements provided for in that agreement.

IX: R2'S APPEAL AGAINST THE FINDING THAT IT WAS ESTOPPED FROM DENYING THAT IT OWED DUTIES UNDER CLAUSE 16(B) OF THE 1996 CUSTODIAN AGREEMENT

164. The Respondents contend that the judge was wrong to find that R2 was estopped from denying that it owed duties under Clause 16(B) of the 1996 Custodian Agreement in respect of the assets held on the BLMIS managed account with effect from August 2002.

165. Mr Gillis first argued that the judge did not find any detrimental reliance prior to 2005 and only found detrimental reliance in relation to the 2005 Custody Confirmation and the subsequent Custody Confirmations. It followed, submitted Mr Gillis, that the judge erred in finding an estoppel founded in August 2002.

166. Mr Gillis next contended that the judge failed to make it clear that detrimental reliance and therefore the issue of unconscionability is to be assessed at the point that the estopped party seeks to resile from the convention or representation. What the judge should have done was to have considered detriment at the time in 2005 that R2 first argued that BLMIS was not the custodian of the BLMIS assets and on that basis he should have compared what did happen and what would have happened if the representation had not been made. Adopting this approach, the judge should have taken

into account his findings on causation in respect of damages claimed under the Administration Claim which were that if no Custody Confirmations had been issued, either EY would have issued unqualified audit opinions or, if no clean opinion was issued, Primeo would have reinvested its funds with another Madoff feeder fund.

167. Mr Gillis' next argument was that the judge had erred in not addressing the nature and extent of the "*convention*" or belief that could be reasonably based on the relevant representation. What the judge should have done was to take into account his findings as to Primeo's state of knowledge at the time of the 2005 Custody Confirmation in April 2005 as to a number of matters listed in paragraph 510 of the Respondents' skeleton argument, including: (a) EY knew that R2 had not reconciled the BLMIS statements with information derived from an independent source; (b) Primeo knew that R2 was relying on single source reporting; and (c) Primeo knew EY was relying on the Custody Confirmations and that R2 had no means of independently verifying the contents of those confirmations as long as the BLMIS business model remained unchanged. It was submitted that if these findings had been taken into account, it was difficult to see how the parties could have shared a common understanding that the Clause 16(B) duties were engaged because such a belief is irreconcilable with Primeo's knowledge that R2 could not and had not performed its duties under that provision.

168. Proceeding on the basis that the judge held that the shared assumption he found was evidenced by the Custody Confirmations and the Notes to the annual financial statements indicating that R2 had appointed the broker/dealer investment firm managing Primeo's assets (BLMIS) as sub-custodian, Mr Gillis submitted that this evidence did not constitute an adequate basis for the judge's findings on the estoppel. The Notes to the accounts had been inserted by the auditors, not Primeo, and the only relevant statement in the 2005 Custody Confirmation was the representation that BLMIS was R2's sub-custodian (the "status representation").

169. The Respondents' next argument was that the estoppel did not impose strict liability, this being a question of the construction of Clause 16(B). Finally, it was submitted that there was no injustice or unconscionability in R2 seeking to escape liability on the custody

claim because, as a matter of strict legal analysis, BLMIS was never R2's sub-custodian. There was no evidence that at the relevant time Primeo believed that R2 was strictly liable for BLMIS or was under the onerous most effective safeguards duty. The estoppel claim was therefore an opportunist attempt to take the benefit of a non-existent right which was not known about at the time.

170. We are not persuaded by any of the submissions advanced by the Respondents in challenging the judge's finding that R2 was estopped from denying that it owed duties under Clause 16(B) in respect of the assets held on the BLMIS account with effect from August 2002.

171. The judge's articulation of the law in respect of estoppel by convention and by representation is beyond challenge and there was ample evidence to support his finding that the shared understanding of Primeo, R2 and BLMIS was that, following the execution of the 2002 Sub-Custody Agreement, R2 rather than BLMIS, was to be custodian of the assets held in the BLMIS managed accounts and that BLMIS was to be R2's sub-custodian. In this connection, we refer in particular to the issue of the 5 April 2005 confirmation letter to EY on R2's behalf with the approval of Mr Fielding which, as the judge found, clearly evidences that R2 considered itself to be custodian in relation to the assets held by BLMIS pursuant to the 2004 Sub-Custody Agreement (which was on identical terms to the 2002 Sub-Custody Agreement). We also refer to Mr Fielding's statement to Primeo's Board at a meeting on 14 May 2004 that R2 received a controlled report on all of Mr Madoff's activities as R2 had appointed Mr Madoff as Sub-Custodian.

172. There was also further ample evidence to support the judge's conclusion that "*[e]xplicit representations were made to Primeo on multiple occasions both orally and in writing, that R2 considered itself to be custodian and to have appointed BLMIS as sub-custodian.*"

173. We accept Mr Smith's submission that whatever may be the position in respect of estoppel by representation, a conventional estoppel is enforced if it would be unjust or unconscionable to allow one party to go back on the shared understanding on which they

have carried on their dealings. This was the view of Lord Steyn (with whom the rest of the House was in agreement) in *Republic of India v India Steamship Co* [1998] AC 878, at 91E-G:

> *"an estoppel by convention may arise where parties to a transaction act on an assumed state of fact or law, the assumption being either shared by them both or made by one and acquiesced in by the other. The effect of an estoppel is to preclude a party from denying the assumed facts or law if it would be unjust to go back on the assumption."*

174. We also accept Mr Smith's submission that the parties having entered into the 2002 arrangements and regulated their subsequent dealings on the basis of the shared assumption that R2 was the Custodian, and BLMIS was its sub-custodian in respect of the BLMIS assets (as the judge found), it would be detrimental to Primeo, or unjust, if R2 was now permitted to resile from that assumption because Primeo would have lost the opportunity of the protection of having had a custodian and sub-custodian in place in respect of the BLMIS assets.

175. Mr Smith rightly accepted that the question of unconscionability in the case of conventional estoppel and detrimental reliance in the case of estoppel by representation is to be assessed at the time the estopped party resiles from the conventional understanding or representation relied on by the other party. In addition, we accept his submission that it was fully open to the judge to find for the purposes of estoppel by representation that Primeo had relied on the Custody Confirmations to its detriment because, in their absence, EY would not have issued the audit opinions they did without performing other audit procedures with satisfactory results. We reject Mr Gillis' submission that when assessing detrimental reliance, the judge should have conducted the same enquiry he undertook when deciding whether the damages claimed under the Administration Claim were caused by the established breaches of the 1996 Administration Agreement. Mr Gillis was able to cite no authority that supported this submission and we can see no justification for the approach he advocated. The relevant representations were directed at the question whether R2 was Custodian in respect of the BLMIS assets with BLMIS as its sub-custodian. Accordingly, even if it were appropriate to conduct a general causation

analysis, the question would be whether, but for the representations, Primeo would have sought the appointment of a Custodian in respect of the BLMIS assets and we agree with Mr Smith's contention that the answer to that is that it would have done because it was important that Primeo had an independent custodian bank responsible for its assets in order to meet this regulatory requirement for shares in Primeo to be sold to investors in Austria and the similar requirement in the Irish Listing Rules.

176. We also think that there is very considerable force in Mr Smith's submission that Primeo has an unanswerable case that it relied to its detriment when accepting after the 2002 Sub-Custody Agreement that R2 replaced BLMIS as the custodian of the BLMIS assets because Primeo thereby lost the opportunity of protecting its interest by appointing another custodian. As Lord Sumption observed in *Kelly v Fraser* [2013] 1 AC 450 at [17]:

> *"A common form of detriment, possibly the commonest of all, is that as a result of his reliance on the representation, the representee has lost the opportunity to protect his interest by taking some alternative course of action. It is well established that the loss of such an opportunity may be a sufficient detriment if there were alternative courses available which offered a real prospect of benefit, notwithstanding that the prospect was contingent and uncertain ..."*

We accordingly reject Mr Gillis' submissions that the judge erred in finding detrimental reliance and that the estoppel arose from August 2002 rather than from the time in April 2005 when Primeo relied on the first Custody Confirmation.

177. Turning to the Respondents' submission that the judge's finding as to the assumption shared by Primeo and R2 was flawed because he did not take into account his findings that Primeo knew the matters listed in paragraph 510 of the Respondents' skeleton, including R2's reliance on single source reporting and the lack of any means independently to verify the Custody Confirmations, none of these matters is inconsistent with the shared assumption and representation by R2 that from the time of the 2002 Sub-Custody Agreement, it rather than Primeo, was the Custodian in relation to the managed accounts assets and BLMIS was R2's sub-custodian.

178. We are equally unimpressed with the Respondents' argument that there was no evidential basis for a finding of estoppel based on: (a) the 2005 Custody Confirmation; and (b) the Note in Primeo's financial statements that "[t]*he custodian bank had appointed this broker/dealer investment firm (BLMIS) as the sub-custodian to hold and maintain the assets of Select*". In our judgment, it is beyond argument that the 2005 Custody Confirmation confirmed to EY the BLMIS assets and was issued by R2 plainly in its capacity as Primeo's Custodian. As the judge found (and was fully entitled to find) this was clear evidence of a representation by R2 that it was the Custodian in relation to the BLMIS assets.

179. As to the Note in Primeo's audited financial statements, the Respondents seek to contend that this adds little to the custody confirmation evidence because the evidence at trial indicated that the Notes were likely to have been inserted by the auditors. In fact, the judge made no finding that the Notes were inserted by the auditors, but in any event, we agree with Primeo's submission that even if he had, it would not detract from the cogency of the evidence constituted by the Notes. This is because the financial statements were prepared by R2, then approved by Primeo's Board and then sent to investors and filed with the Cayman regulator.

180. The Respondents contend that in [169] of the judgment, the judge held that R2 was estopped from denying that it was strictly liable for the acts and omissions of BLMIS. We agree with Mr Smith that what the judge was saying is that R2 was estopped from denying that it owed any duties under Clause 16(B). This finding was well open to the judge to make. It followed inexorably from his unimpeachable finding that R2 was estopped from denying that it was Primeo's custodian of the BLMIS assets and BLMIS was its sub-custodian.

181. Finally, we are unmoved by the Respondents' submission that there is no unconscionability or injustice in R2 contending that Clause 16(B) is not engaged. As Primeo submitted, the requirement for unconscionability or injustice is satisfied by the fact that, in circumstances where Primeo relied on R2 being its custodian for the BLMIS assets, it would be unjust for R2 to be permitted to resile from that position thereby

depriving Primeo of the benefit of having had a Custodian in place (including to be able to sue that Custodian for any breach of duty). R2 freely entered into the 1996 Custodian Agreement with Primeo, freely entered into the 2002 Sub-Custody Agreement with BLMIS and represented to Primeo that it had appointed BLMIS as its sub-custodian and was Custodian of the BLMIS assets. There is in our view no injustice in R2 taking the contractual consequences from these actions.

182. In their written submissions, the Respondents argue that the judge was wrong to find that the Framework Agreement engaged Clause 16(B) of the 1996 Custodian Agreement. In light of the fact that we have upheld the judge's decision that R2 is estopped from denying that it owed duties under Clause 16(B) of the 1996 Custodian Agreement in respect of the assets held on the BLMIS managed account with effect from August 2002 it is unnecessary to deal with this submission and we decline to do so.

X: THE STRICT LIABILITY CLAIM

(a) Primeo's Appeal against the finding that the loss claimed under clause 16(B) was not the relevant loss and therefore not recoverable

183. Primeo appeals against the judge's finding that the loss claimed under Clause 16(B) of the 1996 Custody Agreement in respect of BLMIS's misappropriation of the funds sent to Primeo, namely the amount of cash placed with BLMIS and dissipated in the Ponzi scheme after credit for actual recoveries received, was not the relevant loss and was therefore not recoverable.

184. In [172] of the judgment, the judge observed: "*It is not disputed that BLMIS was conducting a fraudulent Ponzi scheme at all material times and that it wilfully breached its duties as sub-custodian by misappropriating and/or misusing Primeo's money and covering up its fraud by issuing false statements of account.*" The Respondents have mounted no cross-appeal against this finding.

185. As we have seen, the judge went on to hold that Primeo had suffered no recoverable loss in consequence of BLMIS's breach of duty. As narrated in [103] and [104] above, the judge's reasoning for this conclusion was as follows. The relevant loss was that which

flowed from BLMIS's default, not that which flowed from Primeo's decision to place funds with BLMIS for investment, either directly or indirectly. BLMIS's obligation as sub-custodian was to deliver securities or pay cash equivalent to that recorded on its books, as reflected in the monthly statements. BLMIS met this obligation by paying cash from time to time in accordance with instructions received from R2, albeit by dishonestly misusing or misappropriating client funds under its control. In the absence of a default by BLMIS in performing this obligation, there could be no relevant loss and throughout the relevant period, BLMIS had met the obligation, albeit dishonestly misusing or misappropriating clients' funds under its control. When as part of the Herald Transfer, BLMIS, acting on R2's instructions, transferred the total holding standing to the credit of Primeo's managed account to Herald's managed account, BLMIS fulfilled its obligation as R2's sub-custodian and there was no relevant loss for which R2 was liable. Even if Primeo suffered an actual measurable loss on 2 May 2007 when it subscribed for shares in Herald, this was not a loss for which R2 was strictly liable under Clause 16(B). The result would have been the same if BLMIS had paid out in cash which Primeo had then invested in Herald or in any other way.

186. Primeo submitted on appeal that the judge should have found that Primeo suffered actual loss every time that cash transferred by R2 to BLMIS *qua* sub-custodian was misappropriated by BLMIS for use in the Ponzi scheme thereby giving rise to a right to damages measured by the amount of cash so transferred less any recoveries made. This was the argument that Primeo had advanced below in its written and oral closings, to which the Respondents made no objection on any pleading ground. Nor was such an objection raised by the Respondents in their written appeal submissions although in a footnote it was asserted that misappropriation of cash had never been the basis of Primeo's strict liability claim and an attempt to make such an allegation was struck out on 16 December 2015.

187. Mr Smith submitted that the judge's view that there had been no recoverable loss because BLMIS's had performed its only obligation as sub-custodian which was to deliver cash and securities when called upon to do so was wrong. On the judge's analysis, BLMIS did not commit a breach in respect of the misappropriation of cash until December 2008,

when the fraud was discovered and BLMIS was unable to satisfy the redemption requests made on it. In Mr Smith's submission, the judge had failed to take into account the Custodian's obligation to keep safe Primeo's cash and securities as expressly provided for in clauses 6, 9 and 16 of the 1996 Custodian Agreement and clauses 5-7 and 11-12 in the 2002 Sub-Custody Agreement. By perpetrating a massive Ponzi scheme and misapplying client monies (including Primeo's), BLMIS was plainly acting unlawfully, and in breach of its safekeeping duties throughout the relevant period.

188. Mr Gillis argued that there was no obligation of safekeeping in respect of securities or cash under the 1996 Custodian Agreement and in any event the claim for failing to keep safe cash had been struck out. In respect of securities, there was no safekeeping obligation because the BLMIS assets consisted only of personal rights to have delivered the securities or their equivalent value or cash as stated in BLMIS's statements of account and the obligation to keep such rights was no more than the promise to pay in accordance with the statements of account. When pressed to identify what breach the judge must have had in mind when he held there was a wilful breach by BLMIS when it misappropriated the cash, Mr Gillis argued that it was open to BLMIS to sit on cash so the breach was not the failure to acquire genuine securities but the issuance by BLMIS of a false statement purporting to record what securities had been acquired following the receipt of cash that had been sent to be invested. He further submitted that the loss that fell within BLMIS's duty was not the loss caused by BLMIS's insolvency because BLMIS was only accepting responsibility for the truth of its statements to Primeo and not in respect of its trading with other clients from 1993.

189. In the course of his oral submissions, Mr Gillis informed the Court that a claim in respect of the management of cash under Clause 5 of the 1996 Custodian Agreement had been struck out of Primeo's Re-Re-Amended Claim on the ground that the Court could not for limitation reasons grant leave to amend to plead a new cause of action that did not arise out of the same or substantially the same facts which had been previously pleaded. Primeo's first pleaded case against R2 was for breach of its obligation to keep Primeo's securities safe. The Respondents argued that this claim did not arise out of the same or

substantially the same facts that had been pleaded previously. The judge agreed. In his view, a cash management function was completely different from a securities custodial function. The judge's strike out order read: "*The following amendments that were included in the Re-Re-Amended Statement of Claim .... are hereby struck out ... (1) The alleged breaches by the Second Defendant of alleged duties regarding safekeeping, holding and dealing with cash (paragraphs 43C, 43L, 43N, 84(1) and in relevant part paragraphs 6A, 43O, 83(1) and 83(2).*"

190. Mr Gillis argued that paragraph 83(2) covered Mr Smith's strict liability actual loss submission. This paragraph reads as follows with the words struck out underlined:

> *"Breaches of duty by the Second Defendant*
>
> *83 The Second Defendant breached the duties which it owed to the Plaintiff, as set out in paragraphs 73 to 76, 43 to 434 above, in the following respects:*
>
> *(1) ...*
>
> *(2) The Second Defendant failed or failed to use reasonable care and skill to deal with the Plaintiff's cash which was deposited with or delivered to the Second Defendant (including any deposited with or delivered to BLMIS acting as the Second Defendant's sub custodian and/or nominee) in accordance with the terms of the Custodian Agreement and where cash was disbursed for the purposes of acquiring securities to ensure that such securities were received and held in accordance with Clause 9 of the Custodian Agreement;"*

191. Whilst in consequence of paragraph 84(3)[5] of the Re-Re-Amended Statement of Claim, paragraph 83(2) was an allegation of strict liability, it was not, in our view, an allegation of cash misappropriation in breach of Clause 6(A) of the 1996 Custodian Agreement, which, as we shall come to, was the case advanced by Primeo below and on appeal. For this reason and in light of the fact that the Respondents failed to raise this pleading point below either in their written and oral closing submissions that came after those of Primeo

5 "The conduct of BLMIS in relation to the matters pleaded above was negligent and/or amounted to a wilful breach of duty and, accordingly, the Second Defendant is liable for the conduct of BLMIS in failing to discharge the duties of the Second Defendant under the terms of the Custodian Agreement."

or in their written appeal submissions, we reject Mr Gillis' contention that it is not open to Primeo to argue that it suffered actual loss each time BLMIS misappropriated cash sent for investment.

192. Aside from his strike out argument, Mr Gillis argued that there was in any event no duty to keep cash safe under the 1996 Custodian Agreement. Under Clause 5(A) of that agreement, the obligation on the Custodian was to open and maintain a bank account or accounts in the name of the Company (Primeo) and to hold in that account or accounts all cash received by it from and for the account of Primeo; no obligation of safekeeping was engaged. Instead, there was simply the normal debtor/creditor relationship between bank and customer.

193. Mr Smith submitted that there was a duty on the Custodian under Clause 6(A) of the 1996 Custodian Agreement to keep cash safe. That clause provides that subject to sub-clauses 6(B) and 6(C) (which are not relevant for present purposes), the Custodian shall record and hold in a separate account in its books all Securities received from time to time. Included in the definition of Securities are "*bank deposits*". BLMIS was not a bank. As the judge found, it held its cash through accounts with JP Morgan and on a straightforward reading of Clause 6(A), the safe keeping duty it provides for applied to the cash held on deposit with JP Morgan.

194. Mr Smith made a similar point in respect of the 2002 Sub-Custody Agreement under which R2 appointed BLMIS as Sub-Custodian in respect of the Property delivered to, to the order of, or otherwise acquired by the Sub-Custodian pursuant to this Agreement to hold in safe custody. Property is defined to mean *cash*, bullion, coin, precious metals and Securities.

195. We agree with Mr Smith's submissions and find that R2 and therefore BLMIS owed a duty of safekeeping in respect of cash under Clause 6(A) of the 1996 Custodian Agreement and we further find that this must be the basis of the judge's finding that BLMIS wilfully breached its duties as sub-custodian by misappropriating and/or misusing Primeo's money.

196. We are also of the view that, as submitted by Mr Smith, the judge erred when dealing with the question of recoverable loss by proceeding on the basis that BLMIS's sole obligation as sub-custodian was to deliver securities or pay cash equivalent to that recorded in its books. As we have held, R2 and therefore BLMIS also had a duty to keep cash safe under Clause 6(A) of the 1996 Custodian Agreement and it was this duty that was breached when BLMIS misapplied the cash sent via R2 for investment.

197. Mr Smith argued that each time cash sent for investment was misappropriated for use in the Ponzi scheme, Primeo there and then suffered an actual loss in that it had bargained to receive rights against a legitimate custodian and securities broker (BLMIS) who held the actual asset, but it received rights of a lesser value because they were not backed by a legitimate securities business but a fraudulent Ponzi scheme. In Mr Smith's submission, this analysis was completely in accord with the reasoning of the House of Lords in *Nykredit (No. 2)*.

198. *Nykredit (No. 2)* was the follow-on from the earlier decision of the House of Lords that the measure of damages in a claim by a lender who advanced money on the security of property that had been negligently overvalued by the defendant valuer was the difference between the incorrect value ascribed to the security by the valuer and the true value of the property at the date of valuation. Loss attributable to a fall in the market of the property was not a recoverable loss because it is not a loss in respect of which the valuer's duty of care was owed. The lender's claim had been in tort and what the House was concerned with in *Nykredit (No. 2)* was the date from which interest on the damages should run, this being the date on which damage caused by the valuer's negligence was first suffered.

199. Lord Nicholls first took what he described as a simple case such as where a purchaser buys a house which has been negligently overvalued or which is subject to a local land charge not noticed by the purchaser's solicitor. Had he known the true situation the purchaser would not have bought and he suffers damage as soon as he completes because he has parted with his money and received in exchange property worth less than the price he paid for it.

200. Lord Nicholls then turned to deal with the more difficult case where, as a result of negligent advice, property is acquired by a lender as security. Here, in one sense the lender may suffer loss because if he had known the true position he would not have advanced the loan. But in another sense, he may suffer no loss because the borrower may not default or if he does the security may be of sufficient value to cover the indebtedness. In such a case, the first step in determining if the lender has sustained a measurable loss is to identify the relevant measure of damages, which in a case of this kind is the difference between the plaintiff's position if the defendant valuer had fulfilled his duty of care and the plaintiff's actual position. Where the plaintiff would not have entered into the lending transaction if a correct valuation had been given, the measure is the difference between the plaintiff's position if he had not entered into the transaction and his position under the transaction. This calls for a basic comparison between (a) the amount of money lent by the plaintiff which he would still have had in the absence of the loan transaction, plus interest, and (b) the value of the rights acquired, namely the borrower's covenant and the true value of the overvalued property.

201. Lord Nicholls's judgment continued at 1632 B to 1633 H:

> "*The basic comparison gives rise to issues of fact. The moment at which the comparison first reveals a loss will depend on the facts of each case. Such difficulties as there may be are evidential and practical difficulties, not difficulties in principle.*
>
> *Ascribing a value to the borrower's covenant should not be unduly troublesome. A comparable exercise regarding lessees' covenants is a routine matter when valuing property. Sometimes the comparison will reveal a loss from the inception of the loan transaction. The borrower may be a company with no other assets, its sole business may comprise redeveloping and reselling the property, and for repayment the lender may be looking solely to his security. In such a case, if the property is worth less than the amount of the loan, relevant and measurable loss will be sustained at once. In other cases the borrower's covenant may have value, and until there is default the lender may presently sustain no loss even though the security is worth less than the amount of the loan. Conversely, in some cases there may be no loss even when the borrower defaults. A borrower may default after a while but when he does so, despite the overvaluation, the security may still be adequate*

It should be acknowledged at once that, to greater or lesser extent, quantification of the lender's loss is bound to be less certain, and therefore less satisfactory, if the quantification exercise is carried out before, rather than after, the security is ultimately sold. This consideration weighed heavily with the High Court of Australia in Wardley Australia Ltd. v. Western Australia (1992) 109 A.L.R. 247. But the difficulties of assessment at the earlier stage do not seem to me to lead to the conclusion that at the earlier stage the lender has suffered no measurable loss and has no cause of action, and that it is only when the assessment becomes more straightforward or final that loss first arises and with it the cause of action...

I recognise that in practice the basic comparison may well not reveal a loss so long as the borrower's covenant is performing satisfactorily. For this reason there is little risk of a lender finding his action statute-barred before he needs to resort to the deficient security. But it would be unwise to elevate this practical consideration into a rigid proposition of law."

202. Lord Hoffmann said at 1638 H – 1639 D:

"Proof of loss attributable to a breach of the relevant duty of care is an essential element in a cause of action for the tort of negligence. Given that there has been negligence, the cause of action will therefore arise when the plaintiff has suffered loss in respect of which the duty was owed. It follows that in the present case such loss will be suffered when the lender can show that he is worse off than he wold have been if the security had been worth the sum advised by the valuer. The comparison is between the lender's actual position and what it would have been if the valuation had been correct.

There may be cases in which it is possible to demonstrate that such loss is suffered immediately upon the loan being made. The lender may be able to show that the rights which he has acquired as lender are worth less in the open market than they would have been if the security had not been overvalued. But I think that this would be difficult to prove in a case in which the lender's personal covenant still appears good and interest payments are being duly made. On the other hand, loss will easily be demonstrable if the borrower has defaulted, so that the lender's recovery has become dependent upon the realisation of his security and that security is inadequate. On the other hand, I do not accept Mr. Berry's submission that no loss can be shown until the security has actually been realised. Relevant loss is suffered when the lender is financially worse off by reason of a breach of the duty of care than he would otherwise have been. This is, I think, in accordance with the decisions of the Court of Appeal in UBAF v. European American Banking Corporation [1984] Q.B.

713 and First National Commercial Bank Plc. v. Humberts [1995] 2 All E.R. 673."

203. Mr Smith contended that Primeo's case fell within Lord Nicholls's first "*simple*" category. The value of the right actually received by Primeo in exchange for the cash was manifestly less than the value of the bargained for right that ought to have been received. Instead of a right to have delivered by BLMIS the resulting assets as reported monthly to Primeo, Primeo received choses in action against a fraudulent Ponzi scheme which carried no assurance that Primeo would receive anything back since the fraud could have been discovered at any time.

204. Mr Smith sought to draw support for his actual loss argument by reference to the decision of the Privy Council on a Canadian appeal in *Solloway v McLaughlin* [1938] AC 247. Here, the plaintiff had instructed his stockbroker to purchase 7000 shares in a particular company on margin, and deposited with the broker 3500 shares in the same company as margin. He received a contract note showing that the purchase had taken place. The 7000 shares were purchased by the broker and then unknown to the plaintiff used to complete purchases made by the broker in a shorting exercise when the shares had fallen in value. As shares in the company fell in value, the client was obliged to post a further 10,500 shares and $8000 cash margin. These deposited shares were also used to complete further sales made by the broker as the price fell further. Following this, the broker was purportedly holding 21,000 shares for the client (the 7000 originally purchased, 3500 deposited by way of margin initially, and the 10,500 deposited by way of further margin). The plaintiff then closed his account, paying an additional $42,000 to his broker and receiving delivery of 21,000 shares. Included in the sum paid was the price invoiced for the 7000 shares. The plaintiff subsequently discovered the fraudulent dealings carried on by the broker and commenced proceedings, including a claim for the repayment of the sum he had been charged for the purchase of the 7000 shares. The broker's defence was that the client had suffered no damage because he had received just as many shares back as he had deposited and paid for. Lord Atkin held that the broker did not have to deliver the very same shares he had purchased for the plaintiff but he had to get in equivalent shares. He also held that the disposal of the deposited shares amounted to conversion and

the client on each occasion on which the shares were sold had vested in him a right to damages for conversion which was to be measured by the value of the shares of the date of the conversion. As to the consequences of the broker's delivery of equivalent securities upon the client's demand, Lord Atkin said at page 258:

> *"How, then, is his position affected by the fact that, not knowing of the conversion, [the plaintiff] received from the wrongdoer, and has retained the very goods converted or their equivalent it? It appears to the Lordships that the only effect is that he must give credit for the value of what he has received at the time he received it, and that the damages are reduced by this amount."*

205. So far as concerns the purchase of the 7000 shares and the delivery back of the same number of shares, Lord Atkin held that due to the broker's fraud, he was not entitled to enforce an indemnity in respect of the cost of their purchase with the result that the plaintiff could recover the price he had paid in respect of those shares but had to give credit for the value of the 7000 shares that at the date they were delivered to him.

206. Mr Smith submitted that the position in respect of the deposited shares in *Solloway v McLaughlin* was closely analogous to that in the present case where BLMIS effectively misappropriated Primeo's assets in breach of contract. He went on to submit that the position in respect of the 7000 shares was even more closely analogous in light of Lord Atkin's observation that the plaintiff had a right to delivery of the equivalent shares. In our judgment, Mr Smith gains some general support from *Solloway v McLaughlin* but, as he recognised, the case in respect of the deposited shares was one in conversion of property in which the plaintiff had a proprietary interest, whereas Primeo's interest in the assets held in its account by BLMIS was a contractual right to the delivery of equivalent securities or their market value and an amount of cash equivalent to that recorded in Primeo's statement of account, at least until BLMIS became insolvent in which event Primeo, along with BLMIS's other clients, would be entitled to a pro rata share of the fund of cash and securities which would be segregated from BLMIS's general estate.

207. As to Mr Smith's contention that the claim in respect of the 7000 shares was even more analogous to the instant case, we agree with Mr Gillis's submission that this argument is

not well founded. The claimant in *Solloway v McLaughlin* never claimed for the failure of the broker to get in equivalent shares and never sought delivery of the 7000 shares prior to settling the account rendered by the broker. Instead, he sued for the return of the price he had paid for the 7000 shares which he was awarded because the fraudulent broker was not entitled to an indemnity for the purchase price but the plaintiff had to give credit for the value of the 7000 shares as at the date they were delivered to him by the broker.

208. Mr Gillis sought to argue that Primeo's use of hindsight was impermissible when applying the *Nykredit (No. 2)* approach to determine when actual loss has been suffered. In his submission, the following passage in Lord Nicholls's judgment would make no sense if one can have recourse to hindsight when determining whether there was loss when the lender advanced the loan and received in return the borrower's covenant and the property conveyed by way of security.

> *"More difficult is the case where, as a result of negligent advice, property is acquired as security. In one sense the lender undoubtedly suffers detriment when the loan transaction is completed. He parts with his money, which he would not have done had he been properly advised. In another sense he may suffer no loss at that stage because often there will be no certainty he will actually lose any of his money: the borrower may not default. Financial loss is possible, but not certain. Indeed, it may not even be likely. Further, in some cases, and depending on the facts, even if the borrower does default the overvalued security may still be sufficient."*

209. We reject this submission. Lord Nicholls is not making a point about hindsight here. He is saying that at the time of entry into the transaction, the lender may suffer no loss because there is no certainty that the borrower will default, and this is a point which arises equally whether you use hindsight or not. We also note that in a later passage of his judgment at 1633 C, Lord Nicholls appears to contemplate resort to information that has become available since the completion of the transaction:

> *"I can see no necessity for the law to travel the commercially unrealistic road. The amount of a plaintiff's loss frequently becomes clearer after court proceedings have been started and while awaiting trial. This is an everyday experience. There is no reason to*

think that the approach I have spelled-out will give rise to any insuperable difficulties in practice. In their practical conduct of litigation courts are well able to ensure that assessment of damages are made in a sensible way."

210. Mr Gillis's submission is also contrary to the decision of the Court of Appeal in *DNB Mortgages v Bullock & Lees* [2000] PNLR 427. Here, the appellant ("DNB") brought proceedings against the respondent valuers for negligently over valuing a house on the security of which DNB advanced £136,000 on 5 February 1990. When this mortgage finance had first been applied for in August 1989 by the mortgagors, Mr and Mrs Fitzgerald, Mr Fitzgerald (who was the sole earner of the two) was employed as a producer by Sky Television on a salary of £40,000 per year. DNB's first mortgage offer was made in October 1989 but it was not taken up by the Fitzgeralds. However, they accepted a second offer from DNB in February 1990 for the same amount. By this time, Mr Fitzgerald had ceased to be employed by Sky Television and was operating a new business venture on a self-employed basis which did not prosper. Mr Fitzgerald paid the monthly mortgage payments until the end of January 1991, after which no further payments were made. On 3 February 1992, he was adjudicated bankrupt.

211. DNB's claim against the valuers was issued on 8 May 1996. By this time the claim in contract was manifestly statute barred and the defendants contended that the claim in tort had also been started too late. The issue was therefore whether DNB had suffered actionable loss before 8 May 1990, at which time Mr Fitzgerald was performing his covenant and £140,000 was owed.

212. The judge at first instance had regard to the fact that Mr Fitzgerald had ceased to work for Sky Television by the time the mortgaged transaction had been completed, although this was unknown by DNB at the time. He also took Mr Fitzgerald's bankruptcy and his statement of affairs into account when deciding that the value of Mr Fitzgerald's covenant to pay was not worth more than £10,000. He went on to hold that the value of the mortgaged property at 8 May 1990 was £130,000 and concluded that DNB had suffered loss before 8 May 1990.

213. In the course of giving the lead judgment of the Court of Appeal, Robert Walker LJ (as he then was) said:

> *"The value of the covenant*
>
> *... [I]t is not entirely clear how the borrower's covenant is to be valued. It was unnecessary for the House of Lords to go into the point, since Nykredit's borrower was a single-asset company and was in default from the inception of the transaction. In their speeches both Lord Nicholls and Lord Hoffmann show some inclination to treat the various mortgages as marketable securities to be valued on an open market basis. Lord Hoffmann referred in terms (at p.1639, in a passage already cited) to the open market, and Lord Nicholls (at p.1633) referred with approval to a submission made by counsel about a prospective buyer inspecting the loan book of a commercial lender. (Mr Denman's evidence was that a prospective buyer of a loan book would not attempt to evaluate every covenant and would be concerned only with non-performing loans disclosed in any sample.)*
>
> *However, Lord Nicholls and Lord Hoffmann both pointed out that no loss may be apparent so long as a covenant is performing satisfactorily: see at pp.1633 and 1639 respectively, in passages already cited. In Saamco itself Lord Hoffmann made the same point more vividly ([1997] AC at p.220, in a paraphrase of leading counsel's argument which Lord Hoffmann was however accepting on this particular point "The court was not obliged to take the borrower to be the prosperous tycoon which everyone thought him to be at the date of the valuation but could have regard to the fact that he had afterwards been shown to be a fraudulent bankrupt."...*
>
> *There is therefore some degree of tension, in Nykredit (No. 2), between the approach of valuing the mortgagor's covenant as part of a bundle of rights comprised in a marketable security (and to be valued as the market would have valued it at the time, without hindsight) and the approach of valuing it on fundamentals (that i[s], on the objective evidence, available when the case is heard, of the true state of affairs at the valuation date).*
>
> *In Nykredit (No. 2) either approach led to the same result. In this case the two approaches might lead to different results. So far as they would lead to different results, I consider that the mortgagor's covenant had to be valued on the evidence available to the deputy judge, restricted though it was, as to the true facts. Apart from [the expert] Mr Denman's passing reference to what a hypothetical purchaser of DNB's*

mortgage book might have done, the deputy judge had no evidence on which to found an `open market' valuation; and the requisite valuation is of Mr Fitzgerald's covenant on its own, not as a tiny component of an entire loan book. Moreover an enquiry into the true facts is in line with the conclusion which the House of Lords reluctantly reached in Cartledge v Jopling, that the steel dressers' causes of action had accrued when they were first affected by the insidious disease, even though no one knew about it. Since then the Latent Damage Act 1986 has redressed that injustice, and (as Lord Nicholls noted in Nykredit (No. 2) at p.1633G) s.14A of the Limitation Act 1980 would generally be available where the loss on the basic comparison was revealed only at a late stage. It is also in line with Lord Nicholls' general observation (at p.1633D) that "within the bounds of sense and reasonableness the policy of the law should be to advance, rather than retard, the accrual of a cause of action."

The deputy judge extracted from Nykredit (No. 2) the conclusion that "in practice the basic comparison may well not reveal a loss so long as the borrower's covenant is performing satisfactorily. It must therefore be a question of fact in each case at what stage the basic comparison shows a loss." Here he was doing his best to follow the guidance given by the House of Lords and it is reasonably clear, from the way in which he proceeded, that he was enquiring into the actual facts of the particular case, rather than attempting an 'open market' approach.

The deputy judge had written reports from, and saw and heard, the two experts as to credit. Their brief agreed statement recorded that "It was agreed that any assessment of the value of the borrowers' covenant must be based on available evidence relating to the financial circumstances of the borrowers. Based upon the evidence seen, it was not possible to attribute any specific value to the borrowers' covenant as at the material time. Not agreed: It was possible to say that the covenant had some unspecific value at the material time."

[T]he deputy judge did not comment on the evidence of the credit experts. But he must have had the statement of affairs in mind, since he had earlier in his judgment referred to the unsecured debts of £45,000 as at Mr Fitzgerald's bankruptcy. He had also referred to the second charge which was granted to Nationwide in March 1990. It would have been helpful if the deputy judge had made plain that it was on that evidence, together with Mr Fitzgerald's lack of salaried employment after January 1990, that he based his conclusion that it was most improbable that the value of the covenant, at 8 May 1990, exceeded £10,000 (which amounted to a finding, on the balance of probabilities, that it was less than £10,000.

> *Nevertheless the deputy judge's conclusion was justified by the evidence before him..."*

214. In our judgment, it is clear from the decision of the Court of Appeal in *DNB Mortgages v Bullock and Lees* that hindsight can be resorted to when comparing (a) the amount of money lent by the plaintiff which he would still have had in the absence of the loan transaction, plus interest, and (b) the value of the rights acquired, namely the borrower's covenant and the true value of the overvalued property.

215. In our view, the loss claimed for in respect of BLMIS's misappropriation of the cash, namely the cash misappropriated less all recoveries received by Primeo, is loss in respect of which BLMIS's duty to keep cash safe was owed.

216. Further, putting on one side for the moment the effect of the Herald Transfer, we find that Primeo did indeed suffer actual loss each and every time money sent by Primeo via R2 to BLMIS for investment was misappropriated for the reasons advanced by Mr Smith. The determination whether a loss has been suffered involves in the first place a comparison of the value of what the plaintiff ought to have received compared with the value of what he in fact received. This is clear not only from the speeches of Lord Nicholls and Lord Hoffmann in *Nykredit (No. 2)* but also from Lord Walker's speech in the later decision of *Law Society v Sephton* [2006] 2 AC 543 at [45] where he accepted the correctness of three "*transaction cases*" referred to by Savile LJ in *First National Commercial Bank plc v Humberts* [1995] 2 All ER 673, at 679 where it was held that loss had been suffered as a consequence of the negligence of a professional adviser where the plaintiff "*ended up with a package of rights less valuable than he was entitled to expect.*"

217. In our opinion, the value of the right actually received by Primeo in exchange for the cash was manifestly less than the value of the bargained for right that it ought to have been received. Instead of a right to have delivered by BLMIS genuine resulting assets as reported monthly to Primeo, Primeo received choses in action propped up by a fraudulent Ponzi scheme. It follows that, upon misappropriation of the money, Primeo suffered an

immediate actual loss measured by the value of the money misappropriated with credit being given for all recoveries received.

218. It further follows that the honouring by BLMIS of all the requests for redemption made in the relevant period is beside the point. In any event, in our judgment the honouring by BLMIS of redemption requests whilst it was operating a massive Ponzi scheme robbing Peter to pay Paul is not to be equiperated with what Lord Nicholls and Lord Hoffmann referred to as the "*satisfactory performance of the borrower's covenant*" in *Nykredit (No. 2)*.

219. We turn now to Primeo's challenge to the judge's finding that the effect of the Herald Transfer was that BLMIS met its obligations so that as at 1 May 2007 there was no relevant loss for which R2 was liable under Clause 16(B). In the judge's view, this result would have been the same if BLMIS had paid out cash which Primeo had then invested in Herald or in any other way.

220. It will be recalled that the Herald transfer was achieved by the assignment of Primeo's rights under its managed account with BLMIS with a reported value of US$ 465,824,061 to Herald in consideration for the issue of shares by Herald having an equivalent subscription price.

221. We agree with Mr Smith's submission that the question the judge should have asked was 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, and the answer that should have been given was "*no*" because by the transaction Primeo did not improve its previous position. Instead, it swapped a direct exposure to loss resulting from the receipt of a chose in action propped up by a Ponzi scheme, to an indirect exposure to the same loss, the chose in action now sitting as an asset on Herald's balance sheet on which the value of Primeo's shares in Herald was dependant. Here again, the judge's error stemmed from his conclusion that the only duty owed by the Custodian and BLMIS was to pay out when requested in accordance with the chose in action represented in its

account with Primeo, whereas R2 and hence BLMIS also owed and had been in breach of a duty to keep safe the cash transferred by Primeo via R2 to BLMIS for investment.

222. Mr Smith sought to advance not only a claim for damages measured by the cash misappropriated less all recoveries received. He also sought to advance a claim on appeal for the difference between the value of the BLMIS assets for which he said R2 assumed a custodian responsibility when it became Custodian of those assets following the 2002 Sub-Custody Agreement, and their actual value, less any recoveries. At trial, it was Primeo's primary case that R2 had been Custodian of the BLMIS assets with BLMIS as its sub-custodian from the inception of the 1994 Brokerage Agreements and that R2 was liable on a safekeeping basis for the loss in value of the BLMIS assets. However, Mr Smith did not advance below a specific safekeeping damages case tailored to apply to the hypothesis that R2 only became Custodian of the BLMIS assets and BLMIS its sub-custodian from 7 August 2002.

223. In our judgment, it would not be right to allow Primeo to seek to enlarge its recovery in the manner sought on appeal. Whether Primeo had a safekeeping claim based on custodial responsibility assumed by R2 after 7 August 2002 was a matter to be decided at the trial on such evidence as was relevant to this issue. Such a case not having been advanced below, we hold that Primeo cannot advance it in this appeal.

224. In the period 7 August 2002 to 2 May 2007, Primeo's redemptions exceeded its subscriptions by a total of US$25.25 million. Faced with these figures, Primeo submitted first that the "*first in, first out*" methodology derived from *Clayton's Case* (1817) 1 Mer. 572, 15 RR 161 where there has been a running account between the parties should be applied in the calculation of the damages due on its strict liability claim, so that it can be determined whether Primeo must give credit for sums remitted back to Primeo by R2 against credits to the account made prior to 7 August 2002 or credits made to the account post 7 August 2002. In addition, Primeo submitted, citing *Seymour v Pickett* [1905] 1 KB 715, that where a plaintiff is owed two (or more) debts, and receives payment, the plaintiff is entitled to appropriate the payment as it sees fit.

225. Whether the rule in *Clayton's Case* should be applied in the calculation of Primeo's damages depends on whether there was indeed a running account between Primeo and BLMIS. Mr Smith submitted that the broker/custody account numbered "*IFN092*" in March 1996 operated as a running account because BLMIS delivered funds in partial satisfaction of the overall debit balance shown on the account in the sense that they were referable to the running account in BLMIS's books, but were no specific part of it. He also suggests that the judge regarded the broker/custody account as a running account when he said in [175] of the judgment: "*As at 1 May 2007, the reported balance standing to the credit of Primeo's Select's 1FN092 Account was US$465,824,061.*"

226. The Respondents strongly resist the proposition that the rule in *Clayton's Case* should be deployed in the calculation of Primeo's damages on the strict liability claim. They submitted that *Clayton's Case* is inapplicable in an ordinary damages claim based on a comparison between the plaintiff's financial position and the position it would have been had the contract been performed as promised. They also submitted that: (i) *Clayton's Case* is displaced by an implied intention to the contrary and neither Primeo, R2 nor BLMIS intended that investments/redemptions would be allocated on a "*FIFO*" basis; (ii) the rule would not apply because this is not a case where there was an unbroken or running account; and (iii) the application of *Clayton's Case* would cause injustice because it could render R2 liable for all pre-2002 losses associated with BLMIS when R2 was not the Custodian of the BLMIS assets.

227. If the overall outcome of this appeal were that Primeo had established an entitlement to damages on its strict liability claim, there would be an order that the damages were to be assessed by a judge sitting in the Financial Services Division of the Grand Court. Since we are not in a position to decide if the broker/custody account was a running account or whether the application of *Clayton's Case* would be contrary to the parties' intentions, or whether in the circumstances of this case Primeo is entitled to appropriate redemption payments as it sees fit, the question as to appropriation in general and whether the rule in

Clayton's Case was to apply would be referred to the judge assigned to deal with the assessment of damages.

(b) The Respondents' appeal against the judge's interpretation of Clause 16(B) of the 1996 Custodian Agreement

228. The Respondents argue that the judge misconstrued Clause 16(B). In their submission, on its true construction Clause 16(B) was not engaged following the formation of the implied tripartite agreement found by the judge because the clause has no application where an entity ("a triple function broker") that has the three functions that BLMIS had – broker, investment manager and custodian – was used as a sub-custodian by the Custodian. In short, Clause 16(B) only applies where the Custodian appoints as sub-custodian a Network Sub-Custodian with whom the Custodian has a bi-lateral and not a tri-lateral relationship with the sub-custodian and the client. It is submitted that Clause 16(B) assumes that the Custodian has both choice of and control over the Sub-Custodian appointed, which was not the case with the appointment of BLMIS because R2 had no effective choice over the appointment and no control over BLMIS following the appointment.

229. The Respondents contend there are findings made by the judge that strongly support this construction. These were: (a) the judge's conclusion in [193] when dealing with R2's failure to make recommendations in respect of the most effective safeguards obligation under Clause 16(B) that "*it was not within the power of [R2] ... to ... do anything without the agreement of the client...*"; and (b) the judge's findings in [163], [215], [309], [319] that the implied tripartite agreement was based on the common understanding that there would be no operational change post-August 2002.

230. In paragraph 454 of their written appeal submissions the Respondents list what they say are the critical factors of the factual matrix in the light of which Clause 16(B) must be construed. In brief, these factors are: the 1996 Custodian Agreement was executed to assist with the intended listing on the Irish Stock Exchange; at the time of the execution of the agreement BLMIS was performing the aforesaid triple functions; there were two active sub-funds, Select and Global; it remained Primeo's intention to have the option of

investing in different funds and different strategies; and R2 had Network Sub-Custodians for the US market.

231. The Respondents further submit that it made no commercial sense for Clause 16(B) to apply where the Custodian had no choice in the appointment of the sub-custodian or control over the appointee. The clause that was entirely apposite for a triple function broker was Clause 6(B).

232. In *Ennismore Fund Management Ltd v Ferris Consulting Ltd* [2016] UKPC 9, a Cayman Islands appeal, the Privy Council applied the English principles of contractual construction as articulated by Lord Neuberger in *Arnold v Britton* [2015] AC 1619 at [14]:

> *"When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to 'what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean', to quote Lord Hoffmann in Chartbrook Ltd v Persimmon Homes Ltd [2009] UKHL 38, [2009] AC 1101, para 14. And it does so by focussing on the meaning of the relevant words, in this case clause 3(2) of each of the 25 leases, in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions. In this connection, see Prenn [1971] 1 WLR 1381 at pp 1384-1386 and Reardon Smith Line Ltd v Yngvar Hansen-Tangen (trading as HE Hansen-Tangen) [1976] 1 WLR 989, 995-997 per Lord Wilberforce Bank of Credit and Commerce International SA v Ali [2002] 1 AC 251, para 8, per Lord Bingham of Cornhill, and the survey of more recent authorities in Rainy Sky [2011] 1 WLR 2900, per Lord Clarke of Stone-cum-Ebony JSC at paras 21-30."*

233. In our judgment the findings of the judge relied on by the Respondents for their inconsistency argument are not in fact inconsistent with the interpretation upheld by the judge which was that Clause 16(B) applied in accordance with its terms following the appointment of BLMIS as R2's sub-custodian.

234. Further and in any event, we think that the Respondents' construction gives insufficient weight to the words used in Clause 16(B): "*In performing its duties hereunder the Custodian may appoint such agents, sub-custodians and delegates as it might think fit ...*". In our view there is no justification for construing these words so as to exclude the appointment of a "*triple function broker*" such as BLMIS.

235. The Respondents also appeal against the judge's finding that the effect of Clauses 16(B) and 16(E) was to render R2 strictly liable for the wilful breach of duty of BLMIS as R2's sub-custodian. It was submitted that the objective bystander would not have thought that R2 intended to accept strict liability for a sub-custodian in a trilateral relationship because where there is such a relationship it does not lie within the power of the Custodian to implement changes. He can merely request them; he cannot insist on them.

236. Next it is submitted that the judge should have had regard to the fact that Clause 16(B) in the 1996 Custodian Agreement omitted the words in the 1993 version that clearly imposed strict liability.

237. Then it was submitted that since Clause 16(B) imposed an ongoing supervisory duty and an ongoing effective safeguards duty, it must have been the intention of the parties not to impose strict liability because this would be a redundant provision, given those duties. The Respondents argued that when dealing with this submission below the judge misdirected himself by holding that the supervisory and effective safeguards duties were only in the clause in order to comply with a mandatory requirement contained in the Irish listing rules. It is said that this was a misdirection because the effect of the Irish listing requirements was only to require the imposition of the supervisory and effective safeguards duties where strict liability was not imposed.

238. Finally, it was argued that since Clauses 16(B) and 16(E) refer to agents, sub-custodians and delegates, "*agent*" in Clauses 16(B) and 16(E) does not include "*sub-custodian*", with the result that R2 is entitled to the indemnities conferred by those clauses and

therefore has the defence of circuity of action, the carve out from the indemnities applying only to breaches by an agent and not a sub-custodian.

239. The judge held that this last construction of the two clauses was plainly wrong because it involved interpreting the exoneration provision and indemnity provision in a way that was internally inconsistent. In his view, it was clear that the indemnities only apply to liabilities incurred by the Custodian in performing its duties itself and they refer to agents because the Custodian could use an agent whilst still performing the duties itself, whereas the appointment of a delegate or sub-custodian necessarily involves the duties being performed by the delegate or sub-custodian.

240. On appeal, the Respondents submitted that the judge had impermissibly read down the indemnities and was wrong to suggest that something done by a sub-custodian was not the performance of the Custodian's obligations under the Custodial Agreement.

241. We are unpersuaded by any of the arguments advanced by the Respondents. In our opinion, it is plain that Clause 16(B) imposes both strict liability and the supervisory and effective safeguards duties, whether or not the inclusion of the latter two duties is explained by a particular interpretation of the Irish listing rules and regardless of the fact that the 1993 Custodian Agreement had expressly provided for strict liability. We also find the Respondents' argument that R2 was entitled to the indemnities conferred by Clauses 16(B) and 16(E) because the carve outs therefrom use the expression "agent" in contradistinction to "*sub-custodian*" and "*delegate*" to be wholly unconvincing. In our view, it is plain that the indemnities in Clause 16 (B) and Clause 16 (E) only apply to liabilities resulting from the performance by R2 itself and thus the reference therein to "*agent*" but not to "*sub-custodian*" or "*delegate*" is because a custodian may use an agent whilst still performing the duties imposed on him, whereas the appointment of a delegate or sub-custodian necessarily involves the performance of those duties by another person. (i.e. the delegate or sub-custodian).

X: PRIMEO'S CLAIM THAT R2 WAS ITSELF IN BREACH OF CLAUSE 16(B) OF THE 1996 CUSTODIAN AGREEMENT

(a) The terms of the agreement

242. As stated earlier, as well as the strict liability claim, Primeo claimed that R2 was itself in breach of its obligations under Clause 16(B) of the Custodian Agreement. For convenience we repeat the relevant parts of Clause 16(B):-

> *"In performing its duties hereunder the Custodian may appoint such ... sub-custodians .. as it might think fit to perform in whole or in part any of its duties and discretions ... The Custodian will use due care and diligence in the appointment of suitable sub-custodians and must be satisfied for the duration of the sub-custody agreements as to the ongoing suitability of the sub-custodians to provide custodial services to the Company. The Custodian will require the sub-custodian to implement the most effective safeguards available under the laws and commercial practices of the sub-custodian's jurisdictions in order to ensure the most effective protection of the Company's assets. ..."*

243. Clause 16(E) goes on to provide that:-

> *"The Custodian shall not, in the absence of negligence or wilful breach of duty on the part of the Custodian..., be liable to the Company ... for any act or omission in the course of or in connection with the services rendered by it hereunder or for any loss or damage which the Company may sustain or suffer as a result or in the course of the discharge by the Custodian of its duties hereunder of pursuant hereto ...".*

244. Clause 16(B) in effect imposes two specific obligations on the custodian in connection with the appointment of a sub-custodian. First, the custodian must use due care in the appointment of a sub-custodian and must be satisfied for the duration of any sub-custodian's appointment as to the ongoing suitability of the sub-custodian. This was referred to by the judge at [170] as the '*ongoing suitability duty*'. The second duty is that the custodian must require the sub-custodian to implement the most effective safeguards available in the laws of the sub-custodian's jurisdiction in order to ensure the most effective protection of the company's assets. The judge referred to this as the '*most effective safeguards duty*'. The two together were referred to as the '*ongoing supervisory duties*'.

245. Primeo contended that R2 had acted in breach of the ongoing supervisory duties in that it failed to take certain precautionary steps which a reasonably competent custodian would have taken.

(b) The expert evidence

246. As set out at [109] above, the judge heard evidence from two experts on custody issues generally. Primeo called Mr Vinella and R2 called Mr Belanger. Mr Vinella gave evidence to the effect that a reasonably competent global custodian could be expected to adopt either or both the solutions put forward by Mr Denci, the expert on DTC operations. Mr Belanger on the other hand, supported by Mr Wiener, said that such procedures were not at the time (and were still not) adopted as a matter of normal commercial practice by global custodians. R2's failure to adopt them could not therefore lead to the conclusion that it had fallen short of the required standard and had not behaved as a reasonably competent global custodian would.

247. The judge rejected the point put forward on behalf of R2: see our summary at [110] and [111] above. He accepted that it would not have been normal practice for a custodian to put in place procedures which would enable it to reconcile a sub-custodian statement directly to the DTC or BNY and that a custodian would normally reconcile to the statements, confirmations or other information received from the broker or investment manager. However, he pointed out that this was not possible in the case of BLMIS because it was performing all three functions. He held that if the application of the normal practice to an abnormal business model produced an abnormal result with potentially unacceptable consequences, as it did in the case of BLMIS, the reasonably competent custodian would look for an alternative operating procedure and this R2 had failed to do.

248. As set out at [106] – [115] above, the judge held that R2 was in breach of the most effective safeguards duty and the ongoing suitability duty under Clause 16(B) by failing to recommend that BLMIS be required to (a) establish a separate account at the DTC in which to hold Primeo's securities and/or to make use of the ID system and (b) establish a

separate account or sub-account with BNY in which to hold Primeo's US Treasury bills ("the Available Safeguards").

(c) R2's challenge to the judge's decision

249. As part of the Respondents' notice, R2 contends that the judge was wrong to find that it was in breach of its ongoing supervisory duties under Clause 16(B) in failing to recommend to Primeo that BLMIS be required to introduce the Available Safeguards.

250. In support of that contention, Mr Gillis reminded us of the applicable test for professional negligence as established in the leading cases of *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582 and *Maynard v West Midland Regional Health Authority* [1984] 1 WLR 634. He cited the observation of Lord Scarman in *Maynard* at 639:-

> *"... I have to say that a judge's "preference" for one body of distinguished professional opinion to another also professionally distinguished is not sufficient to establish negligence in a practitioner whose actions have received the seal of approval of those whose opinions, truthfully expressed, honestly held, were not preferred. If this was the real reason for the judge's finding, he erred in law even though elsewhere in his judgment he stated the law correctly. For in the realm of diagnosis and treatment negligence is not established by preferring one respectable body of professional opinion to another. Failure to exercise the ordinary skill of a doctor (in the appropriate speciality, if he be a specialist) is necessary."*

251. We were also referred to the judgment of Bingham LJ in *Eckersley v Binnie & Partners* (1988) 18 Con. L.R 1. Bingham LJ dissented on the facts, but the majority did not disagree with his statement of the law on the standard of care: see (Russell LJ at 67 with whom Fox LJ agreed). Bingham LJ stated at 80:-

> *"From these general statements it follows that a professional man should command the corpus of knowledge which forms part of the professional equipment of the ordinary member of his profession. He should not lag behind other ordinarily assiduous and intelligent members of his profession in knowledge of new advances, discoveries and developments in his field. He should have such awareness as an ordinarily competent practitioner would have of the deficiencies in his knowledge and the limitations on his skills. He should be alert to the hazards and risks*

> *inherent in any professional task he undertakes to the extent that other ordinarily competent members of the profession would be alert. He must bring to any professional task he undertakes no less expertise, skill and care than other ordinarily competent members of his profession would bring, but need bring no more. The standard is that of the reasonable average. The law does not require of a professional man that he be a paragon, combining the qualities of polymath and prophet.*" (emphasis added)

252. Mr Gillis submitted first that the judge had fallen into the error envisaged by Lord Scarman when he said at [179] that he had *"come to the conclusion that Mr Vinella's opinions should be accepted in preference to those of Mr Belanger ....".* He had therefore applied the wrong test.

253. We do not consider that he applied the wrong test. It is true that he expressed himself in terms of preferring Mr Vinella's evidence but that observation has to be read in the context of the evidence and the arguments before him. It is clear from the list of issues to be addressed by the experts (which had been agreed by the court) that they were to opine on how the reasonably competent global custodian would have acted in the circumstances of the case. In other words, they had been asked to opine upon the correct question. This is confirmed at [179] of the judgment where the judge said:-

> *"Both Mr Vinella and Mr Belanger have the expertise and experience necessary to express opinions about what is to be expected of a reasonably competent global custodian in the circumstances of this case...".*

254. Similarly, at [183] the judge said:-

> *"... I accept Mr Vinella's evidence that a reasonably competent global custodian could be expected to adopt this course in the particular circumstances arising out of BLMIS's business model."*

255. Thus, in saying that he preferred the views of one expert over another, the judge was saying that he agreed with that expert's opinion as to what the reasonably competent global custodian should or should not have done.

256. Furthermore, it is clear from the judgment as a whole that the judge has the right test in mind. For example he said at [178] that:

> *"The key issue is whether a reasonably competent global custodian would have made, and thereafter continued, the appointment without requiring (or at least recommending) that (a) BLMIS establish a separate account with the DTC and/or make use of its [ID] System and (b) establish a separate account with BNY, in each case for the benefit of Primeo or the HSBC group clients collectively."*

257. There are numerous other references in this section of the judgment to the test being what is to be expected of a reasonably competent global custodian in the circumstances of the case; see for example [180], [181], [188] and [189].

258. Secondly, Mr Gillis submitted that the reasons which the judge gave for preferring the evidence of Mr Vinella to that of Mr Belanger were unsatisfactory.

259. The judge gave three reasons for this preference. The first was that Mr Belanger had failed to recognise that a reasonably competent global custodian would be concerned about the obvious red flags hanging over BLMIS, namely its unique business model with its concentration of different functions, the fact that it was controlled by one dominant individual who refused to allow its name to be disclosed in its clients' offering documents and the fact that it was audited by a small firm (F&H) which would lack both the independence and resources to conduct a proper audit. The second reason was that Mr Belanger had not taken sufficient account of the challenge presented to the custodians of Madoff feeder funds because of the BLMIS business model and had accordingly failed to address the way in which they might reasonably be expected to meet the challenge. He had not effectively addressed the question as to whether the approach adopted by R2 met the standards to be expected of a reasonably competent global custodian in the particularly high-risk circumstances presented by the BLMIS business model. Thirdly, the judge held that Mr Belanger had over-emphasised the notion that BLMIS was a "*client- imposed custodian*"; the fact that this was so did not limit R2's responsibility for supervising its sub-custodian.

260. Mr Gillis submitted that each of these reasons was unsatisfactory because the judge had not focussed on the right question. Thus he had not focussed on whether the average

custodian would be negligent for failing to recognise the red flags or failing to assess the situation as particularly high risk requiring different measures.

261. Thirdly, Mr Gillis submitted strongly that the judge had erred in saying that the reasonable average custodian would have recommended the introduction of the Available Safeguards. He pointed out that these were not used by custodians in commercial practice. Mr Belanger, an expert, was not even aware that the ID System could have been used to provide information to third parties such as R2, and none of the contemporaneous regulatory or industry material recommended that custodians employ the Available Safeguards. They were not recommended by KPMG in its review nor were they considered, let alone recommended, in the OIG report on the Madoff fraud prepared by the SEC in 2009 after the event. In short, the judge had imposed too high a standard in finding that the failure to recommend the Available Safeguards to Primeo amounted to a breach of Clause 16(B).

262. It was and is not disputed that R2 can only be liable to Primeo for a breach of the ongoing supervisory duties if it fell below the standard required of a reasonably competent global custodian. It was an evaluative finding by the judge as to whether this was so. In these circumstances, as Lord Hoffmann made clear in the passage from *Biogen* quoted at [127] above, an appellate court should be very cautious in differing from the judge's evaluation.

263. We can detect no flaw in the judge's approach. As set out at [253] above, we consider that he asked himself the right question. The reasons which he gave for preferring Mr Vinella's evidence to that of Mr Belanger seem to us to be perfectly coherent and sensible and he had the advantage of seeing and hearing the two experts give evidence. The real question is whether he imposed too high a standard in holding that it was negligent not to recommend the Available Safeguards despite the fact that they were not normally used.

264. The judge was fully aware of the submissions strongly made to him by R2 that these were not normal precautions and dealt with this fully at [188] – [189]. In short, he accepted that these procedures were not adopted as a matter of normal commercial practice by global custodians but said that he did not find this argument compelling because it missed the point that BLMIS's business model was unique and created operational risks which were not addressed by normal procedures.

265. In our judgment, having applied the right test, the judge reached a conclusion which was reasonably open to him having regard to the facts of the case and the arguments submitted to him. There are no grounds upon which we could properly interfere with his evaluation of the position and we therefore uphold his finding that R2 was in breach of the ongoing supervisory duties in Clause 16(B) by failing to recommend the Available Safeguards.

XII: THE ADMINISTRATION CLAIM AGAINST R1

(a) The question under appeal

266. As we have described at [17] – [19] above, the 1996 Administration Agreement required R1 to calculate on each valuation day the NAV upon which Primeo and its shareholders could properly rely for the purposes of transacting subscriptions and redemptions. It was not disputed that it was an implied term of the Administration Agreement that, in calculating NAV, R2 had to exercise the care and skill of a reasonably competent mutual fund administrator carrying on business in the Cayman Islands. However, by virtue of Clause 9.2 of the Agreement, R1 would only be liable to Primeo for any act or omission in connection with its services under the Administration Agreement if it was guilty of gross negligence or wilful default.

267. Primeo claimed that R1 was at all material times grossly negligent in calculating NAV on each valuation day. The judge held (see [122] – [124] above) that, although R1 was negligent from October 2002 onwards, it was not guilty of gross negligence until 2nd May 2005, being the first valuation day after the point when R2 first issued custody confirmations on 5th April 2005.

268. Both parties challenge the findings of the judge. Primeo contends that he should have found R1 to have been grossly negligent from October 2002 onwards whereas R1 contends that it was not grossly negligent even after 2nd May 2005. R1 also contends that it was not negligent before 2nd May 2005.

(b) The judgment below

269. We appreciate that we have already summarised the judge's findings at [118] – [126] above, but before turning to the parties' submissions, we think it would be helpful to elaborate certain aspects of the judge's decision.

270. The judge first considered the position prior to the issue of custody confirmations in April 2005. He found (see [118] above) that the Administration Agreement was subject to the usual implied term that R1 would exercise the care and skill which was to be expected of a reasonably competent fund administrator. The function under Clause 4.1(xvii) of the Agreement was to calculate an accurate NAV upon which Primeo and its shareholders could properly reply for the purposes of transacting subscriptions and redemptions. He agreed that administrators were not expected to perform audit procedures but they were concerned to satisfy themselves that the published NAV was accurate. It involved the exercise of professional judgment.

271. He said that there were two aspects to the calculation of an accurate NAV. The first was the pricing of assets. This would be done by reference to independent pricing services and it was agreed that there was no criticism of the work done by R1 in this case to satisfy itself about the reasonableness of the pricing reported by BLMIS. The second aspect was the verification of the existence of assets by the process of reconciliation. He said that the key issue in this case was whether, in the circumstances arising out of the BLMIS business model, a reasonably competent administrator could have satisfied itself about the existence of the assets by reconciling two streams of information received from BLMIS alone.

272. On this, he heard from two fund administration experts. Primeo called Ms Tanya Beder and R1 called Mr William Fleury. The judge stated at [200] that he considered that Mr Fleury's approach to the issues was fundamentally flawed because he was unwilling to recognise that the BLMIS business model presented R1 with a unique challenge. The judge found that an administrator normally satisfies itself about the existence of the assets reflected in the fund's balance sheet by reconciling information received from two or more independent service providers. Mr Fleury said it was common for administrators to rely upon single source reporting in cases where, for example, a large international banking group such as UBS promoted its own in-house investment products, in which event all the various service providers would be likely to be subsidiaries within the same group. But the judge held that this was different from the BLMIS model because, in the case of a large international group, the in-house fund would be marketed as such and therefore the investor would know that all the various functions were being performed by related parties. Furthermore, the various functions would be performed by different subsidiaries carrying out their own separate business in different offices subject to management controls which would not be easily overridden. The administrator would thus be likely to receive information from multiple sources, albeit related party sources.

273. The judge agreed with Ms Beder that that business model was wholly different from BLMIS where all three functions were carried out by a single company wholly owned by one dominant individual.

274. Unfortunately, the judgment does not record what Ms Beder said R1 should have done in such circumstances. However, reference to her report shows that she considered that, once an administrator had specific concerns about the matter, the reasonably competent administrator would have shared those concerns with the client (i.e. Primeo) in order to see how the matter could be addressed.

275. The judge referred to the fact that R1 (through R2) did indeed have such concerns. These manifested themselves in the GFS Board decision in October 2002 and the discussions (at which Mr Fielding was present) at the board meetings of Primeo in June 2003 (following

the Bank Austria Internal Audit Report) and the meeting on 14th May 2004. Having noted that this had to be set against the fact that BLMIS had met all redemption requests and EY had issued unqualified audit opinions, the judge nevertheless held that the failure of R1 to address the problem of single source reporting was negligent; but it could not properly be characterised as constituting gross negligence: see our summary at [120] – [122] above.

276. The judge held, however, that the position changed once R2 issued custody confirmations in April 2005: his reasons (which we summarised at [123] – [124] above) were that until then, R1 had the comfort that there was an unqualified audit opinion from EY based upon supposedly independent audit work performed by F&H. However, from 2005 R1 (through R2) knew that EY were no longer willing to rely on the work of F&H and were instead relying on custody confirmations provided by R2. But, R2 was relying on nothing more than information provided by BLMIS. The judge held that continuing in this way knowing that EY was unwilling to rely upon F&H's work and knowing that R2 had taken no steps to obtain independent confirmation of the existence of the assets constituted a serious disregard by R1 of the risks associated with relying solely upon information supplied by BLMIS and constituted gross negligence.

277. The judge held that this gross negligence continued even after receipt of the first KPMG report. Although that report found no evidence tending to suggest fraud or impropriety, it did not justify continued reliance upon single source reporting.

278. The judge went on to hold that, given that R2 was custodian and administrator of Herald and knew that Herald custody confirmations were being issued in the same manner for Herald, it remained grossly negligent of R1 to calculate the NAV for Primeo after May 2007 simply by reference to the NAV of Herald. He held that the same was true in respect of Primeo's shareholding in Alpha.

279. Although the judge did not articulate in this section of his judgment exactly what R1 should have done if acting as a reasonably competent administrator, it is clear from [258] of the judgment that he considered that a reasonably competent administrator would give

notice of its intention to resign, explain its reasons for doing so and discuss the matter with BA Worldwide as investment advisor to Primeo.

(c) Was there gross negligence before April 2005?

280. Primeo submits that the judge should have found R1 to have been grossly negligent from October 2002 onwards rather than only from April 2005. Mr Smith referred to the statement of Mance J in *Red Sea Tankers* quoted at [117] above and said that there was an obvious risk in respect of which R1 had shown serious disregard or indifference. He relied in particular on the decision of the GFS Board in October 2002 to instruct BoB's own auditors to undertake an independent audit confirmation of the existence of the assets purportedly held by BLMIS. This showed that R2 was aware of the obvious risk of single source reporting.

281. He said that R2 had shown serious disregard of or indifference to that obvious risk because they had done nothing pursuant to the decision of the GFS Board. They had simply let the matter drop. There was no valid reason for not proceeding with the independent audit work. The email exchanges within R2 prior to the GFS Board decision showed that the decision to instruct KPMG was reached partly because it was considered inappropriate to rely on Primeo's auditors and it was not known exactly what verification processes those auditors had undertaken. Mr Smith submitted that it was therefore no answer to say that R2 did not proceed with the independent audit work because EY had produced an unqualified audit opinion in respect of Primeo's 2002 accounts.

282. We have no hesitation in rejecting Primeo's submission that we should overturn the judge's finding that R1 was not guilty of gross negligence prior to April 2005. We would summarise our reasons as follows:-

(i) Although the words of Mance J in *Red Sea Tankers* are of assistance, they should not be treated as if in a statute. In our judgment, gross negligence means simply 'very great', 'extreme' or 'flagrant' negligence. As Lord Upjohn put it in *Rondel v Worsley* [1967] 1 AC 191 at 287, one is only guilty of gross negligence '*by*

some really elementary blunder'; see also *Purves v Landell* (1845) 12 Cl & F 91, 8 ER 1332 at 1335 with its reference to something which upon its face shows '*gross ignorance of the ABC of his profession…*".

(ii) The fact that the GFS Board had decided that it would take the precaution of instructing its own auditor to investigate but did not then proceed with this does not necessarily mean that it was grossly negligent for R1 to have continued to calculate NAV on the basis of single source reporting from BLMIS. The problem of single source reporting was an inevitable consequence of the BLMIS business model and this was well known to the board of Primeo and its advisers.

(iii) The GFS Board decision shows that R2 was aware of the risks of the BLMIS business model but, as the judge found, it was entitled to take account of the fact that EY had regularly produced clean audit opinions and did so again in respect of the 2002 accounts, that BLMIS had always met redemption requests satisfactorily and that Mr Fielding's due diligence visit in 2002 had not thrown up any specific issues.

(iv) In summary, establishment of gross negligence requires 'very great', 'extreme' or 'flagrant' negligence and we do not think any criticism can be levelled at the judge for finding that R1's conduct did not reach that high threshold prior to April 2005. It was very much an evaluative finding for the judge to make and we do not consider that there are any proper grounds for an appellate court to overturn that finding.

283. Contrary to Primeo, R1 submits that the judge erred in finding that it had even been guilty of ordinary negligence prior to April 2005. The judge accepted that the calculation of NAV involved a matter of professional judgment. Mr Gillis submits that the judge was wrong to find that reliance on single source information was something which no competent administrator would have done. He pointed to the fact that everyone (i.e. the board of Primeo and its investment adviser) knew that R1 would have to rely on single source information because that was the whole basis of the BLMIS investment model;

and that EY knew exactly the basis upon which R1 was calculating NAV because, as part of their audit of Primeo, they inspected the books and records of R1/R2 in Luxembourg, and yet they produced unqualified audit opinions in relation to Primeo. Furthermore, even Ms Beder had not suggested that it was negligent of R1 to rely on single source information prior to 2002 (when R1 actually first had concerns as shown by the GFS Board decision). He submitted that, putting these matters together, the judge clearly erred in finding R1 to have been negligent prior to April 2005 by calculating NAV on single source information and not alerting Primeo to its concerns.

284. These were forceful submissions by Mr Gillis but we see no need further to lengthen this judgment by dealing with that aspect. It makes no difference to the outcome as, under the terms of the Administration Agreement, R1 is only liable if gross negligence is proved. The points which Mr Gillis has made can be considered as part of the background to the issue to which we turn next, namely whether gross negligence after April 2005 is established.

(d) Was R1 grossly negligent after April 2005?

285. R1 appeals by Respondents' notice against the judge's finding (see our summary at [123] – [125] above) that it was grossly negligent from April 2005 onwards.

286. The key change in April 2005 was the introduction of the custody confirmations issued by R2 (see [51] – [53] above). This followed an approach from EY indicating that, for the purposes of auditing Primeo's accounts, they were no longer prepared to rely upon audit work undertaken by F&H in relation to Primeo's assets with BLMIS. Following that approach, R2 agreed to provide custody confirmations but these were based entirely upon the information received from BLMIS.

287. Mr Gillis accepted during the course of the hearing that R1's conduct in continuing to prepare NAV on the basis of single source information from BLMIS in circumstances where it could no longer rely on the audit by EY to the same extent (because it knew that EY was relying on the custody confirmations which in turn relied solely on single source

information from BLMIS) was negligent, but submitted that it did not reach the high threshold necessary to establish gross negligence.

288. He submitted first that there was no 'obvious risk' because R1 was still reasonably entitled to rely upon an unqualified audit opinion from EY. As the judge found, EY knew the basis on which the custody confirmations had been given, namely that R2 was not conducting any independent verification, yet they remained satisfied and were able to produce an unqualified audit opinion that Primeo's accounts represented a true and fair view. The position after April 2005 was therefore not materially different, from R1's perspective, from the earlier period and R1 was entitled to take significant comfort from the unqualified audit opinion.

289. Secondly, even if there was an obvious risk, there was no 'serious disregard'. Far from disregarding the risk of single source reporting, Mr Fielding had paid active regard to the risk. It was simply that, like all those involved (including BA Worldwide as the investment adviser, Eurovaleur, the directors of Primeo and EY), he had concluded that on balance it was acceptable. The case was one of a mistaken risk assessment rather than serious disregard of an obvious risk.

290. Thirdly, this was not a case where R1 had been indifferent to this risk. On the contrary, the decision to commission the first KPMG report in December 2005 showed that it (through R2) was far from indifferent to the risk and it was willing to incur substantial expenditure at its cost to advise on the level of risk.

291. Fourthly, Mr Gillis submitted in his skeleton argument that the judge's finding of gross negligence from April 2005 onwards was procedurally unfair because this was not the way Primeo had put its case. Primeo had not suggested a dramatic change in the position from April 2005 onwards. R1 had been deprived of the opportunity to make submissions or call evidence on the significance (or otherwise) of the custody confirmations.

292. In his oral submissions, Mr Gillis summarised the points which he wished to make in support of his assertion that, even if negligent, R1 could not be viewed as being grossly negligent as follows:-

(i) EY had signed an unqualified audit opinion for the previous nine years knowing that there was only single source information from BLMIS.

(ii) Whatever concerns EY might have had about F&H did not cause EY to re-open or qualify its prior year accounts.

(iii) EY had been in contact with Bank Austria and Bank Medici during March 2005 regarding their concerns and Ms Kohn was being invited to speak to Mr Madoff.

(iv) EY knew the basis upon which R2 was providing the custody confirmations, yet regarded that as being sufficient for its purposes.

(v) Mr Fielding conducted two due diligence visits at the office of BLMIS, one in July 2002 and a second one in March 2004 and had come away satisfied.

(vi) Mr Pettitt conducted a further due diligence visit a matter of days before the first custody confirmation was issued on 5th April 2005.

(vii) Primeo's directors and investment adviser knew about the BLMIS triple function and the fact that R1 was relying on single source information. The judge had found that BA Worldwide and the directors of Primeo had equivalent knowledge of BLMIS and its business model to that of the Respondents (see the judgment at [215] and [240]).

(viii) Dr Fano performed twice yearly due diligence on her visits to BLMIS and had done so since 1998.

(ix) Ms Kohn, who was the 'gate-keeper' to Mr Madoff and had a long and special relationship with him, was content with the arrangements for calculating NAV from a single source.

(x) Mr Fielding thought that the risks associated with BLMIS were acceptable. As the judge found, this was a view shared by many others including Dr Fano, Dr Kretschner, Mr Simon and other directors of Primeo.

(xi) No one at R1 and R2 actually suspected fraud or impropriety on the part of BLMIS and it is not alleged that they should have done. It was simply that they acknowledged the theoretical possibility.

(xii) The approach taken by R1 had to be considered in the light of Mr Madoff's Wall Street reputation. He was SEC regulated and he was a depositary at the DTC. In essence he was at the heart of the financial settlement system and was a man with an impeccable reputation.

293. Putting all these matters together, said Mr Gillis, it was a matter of professional judgment on the part of R1 whether it was satisfactory to continue with single source reporting for calculating NAV and whilst it might be said to be a negligent decision after April 2005, it could not be said that R1 had made some really elementary blunder such as to constitute gross negligence.

294. Mr Gillis further submitted that even if, contrary to his primary submission, R1 was grossly negligent from April 2005, it could not continue to be so after receipt of the KPMG report in February 2006. KPMG found no evidence of fraud. R1 was entitled to take this into account when considering whether it was willing to continue to rely on single source reporting. It could not be said that it was disregarding an obvious risk. It had instructed accountants who had found no evidence of fraud.

295. We think that R1 has placed undue weight upon the exact words used by Mance J in *Red Sea Tankers*. It has therefore spent time considering whether there was 'serious disregard' or 'indifference' to an 'obvious risk'. This is reflected in the submission that, because Mr Fielding had considered the risk of single source reporting but had decided that, in the particular circumstances, it was acceptable, he could not therefore be guilty of gross negligence as he had not disregarded the risk. We do not accept that submission.

A person may consider a matter and think about it but then reach a decision which is negligent or even grossly negligent. It is the failure to take the steps which a reasonably competent administrator would take which constitutes negligence (or gross negligence), not necessarily the failure to think about it.

296. In ***Peterson v Weavering Macro Fixed Income Fund Limited (in liquidation)*** [2015] (1) CILR 45, this Court quoted with approval at [94] the observation of Sir Robin Auld in the Privy Council in *Spread Trustee Co Limited v Hutcheson* [2012] 2 AC 194 at [117] when he said:-

> *"On the plain meaning of the words, and as a matter of logic and common sense, the terms 'negligence' and 'gross negligence' differ only in the degree of seriousness of the want of due care they describe. It is a difference of degree, not of kind ..."*

That accords with our observation at [282(i)] above.

297. It is an evaluative judgment by the trial judge as to whether the degree of negligence displayed is of such a high level that it can properly be described as 'gross'. Different judges may have a different view as to exactly where, in a particular case, the boundary line between negligence and gross negligence occurs and, as Lord Hoffmann made clear in *Biogen*, this Court should only interfere where the trial judge has clearly erred in his evaluation.

298. In our judgment, despite Mr Gillis' forceful submissions, the judge's finding of gross negligence after April 2005 cannot be faulted. Prior to that date, R1 had been able to derive some comfort from the fact that, even though they knew that R1 was relying on single source information from BLMIS when calculating NAV, EY regularly issued an unqualified audit opinion which by definition meant that they were content that the NAV as at 31st December of each year gave a true and fair view of Primeo's financial position. In reaching that opinion, EY had been relying on audit work in respect of Primeo's assets with BLMIS supposedly performed by F&H.

299. However, all that changed in 2005. R1 was informed by EY that they were no longer content to rely upon the work undertaken by F&H and were minded to resign unless they

could themselves undertake audit work at BLMIS. R2 then agreed to provide the custody confirmations in writing and EY relied on these confirmations to satisfy themselves that the assets of BLMIS existed as per the confirmations. R1 knew that the custody confirmations were based entirely on information provided by BLMIS. It also knew that EY were no longer willing to rely on work done by F&H. In those circumstances, it was entirely open to the judge to find that the level of negligence of R1 in continuing to prepare NAV on the basis of single source information from BLMIS without taking any steps to address the matter was sufficient to constitute gross negligence. The one element which had given some form of comfort earlier, namely the audit opinion of EY based on the work supposedly undertaken by F&H, had disappeared and it was or should have been obvious to R1 that the calculation of NAV was now wholly dependent on information provided by BLMIS. The audit opinion of EY no longer provided any legitimate comfort.

300. We also conclude that the judge was entitled to find that matters did not change following receipt of the first KPMG report in 2006 (or the second report in 2008). It was understood by all concerned that the work undertaken by KPMG would be confined to documents produced by BLMIS. There was to be no checking from independent sources. That was also the case in respect of the second KPMG report and we were referred to a conference telephone call in July 2008 between representatives of KPMG and R2 in which the point was made strongly by KPMG that everything was based on BLMIS's records. The KPMG representative made clear that the only way in which one would be able to establish that it was not just an elaborate fraud would be to test the existence of the actual trades by obtaining independent evidence. Whilst, as the judge said, R1 was entitled to draw some comfort from the fact that KPMG had not discovered any evidence of fraud in the course of preparing either the first or second report, their work did not address the underlying problem of establishing whether the assets existed and therefore did not assist on the question of whether it continued to be grossly negligent to rely solely on information from BLMIS.

301. Mr Gillis did not develop the procedural point referred to at [291] above in his oral submissions and accordingly we were not alerted to any specific further submissions or

evidence which the Respondents might have made or adduced had they been aware of the significance which the judge would place on the change of position in April 2005. The position before the judge was that Primeo was alleging that R1 had been grossly negligent in relying on single source reporting from at the latest 2002 (being the date of the GFS Board decision). It is not surprising therefore that in those circumstances Primeo did not place weight on any change of position in 2005. However, the judge rejected Primeo's submission that R1 had been grossly negligent throughout the period and considered that, whilst it had been negligent prior to issue of the custody confirmations, it had not been grossly negligent. In our judgment, that was a permissible modification or development of the case put by Primeo; it is not a ground for this Court to intervene.

302. We should mention one final point. In the Respondents' notice, it was contended at para 8(k) that the judge had erred in finding that R1 continued to be grossly negligent after the Herald transfer. However, the point was not mentioned in the written submissions of either party, nor was it touched upon in oral submissions. We have accordingly not considered it further.

XIII: CAUSATION

(a) The questions for decision

303. Having found that R2 was in breach of the ongoing supervisory duties under clause 16(B) of the Custodian Agreement from August 2002 and that R1 was in breach of the Administration Agreement by being grossly negligent in relation to calculating NAV from April 2005, the judge had to go on to decide whether these breaches had caused loss to Primeo. Both breaches consisted of omissions by the relevant Respondent. The judge therefore had to consider what would have happened – and in particular what Primeo would have done – if the Respondents had not been negligent (or grossly negligent in the case of R1). This can only be a matter of inference to be determined from all the circumstances. Although the question is a hypothetical one it is clear that, where the issue is relevant, a plaintiff must still prove on the balance of probabilities that he would

have taken action which would have avoided the loss; see *Allied Maples Group v Simmons and Simmons* [1995] 1 WLR 1602 at 1610G.

304. Primeo claimed loss under three headings. First, it said that, had the Respondents performed their duties properly, Primeo would have withdrawn its existing investments from BLMIS at the relevant time ("the Withdrawal Claim"). Secondly, it said that in addition or alternatively to that claim, it would have ceased to place any further investments under management with BLMIS (the "No Further Investment Claim"). Thirdly, it said that having withdrawn the investments from BLMIS, it would have reinvested those funds with another investment manager and would have made profits (the "Future Profits Claim"). We should add for the sake of completeness that Mr Smith said during the course of the appeal that Primeo was no longer pursuing the Future Profits Claim but that is not relevant to the matters which we have to determine on this appeal.

305. The judge considered the issue of causation by reference to three different points in time, namely August 2002, April/May 2005 and February/April 2007. The parties have done likewise in their submissions to us. We shall also consider each in turn.

(b) August 2002 causation

306. This is the point very shortly after the 2002 Sub-Custody Agreement was executed. The issue of causation in this period relates to R2's breach of the Custodian Agreement by not recommending to Primeo that BLMIS be required to introduce the Available Safeguards. The judge proceeded on the basis that R2 should have made this recommendation to Primeo; that BLMIS would have refused to introduce the Available Safeguards having no alternative to do so because their implementation would have seriously impeded the operation of the Ponzi scheme; and that R2 would then have either resigned or sought to re-negotiate the terms of the Custodian Agreement so as to exclude any liability of R2 for the assets with BLMIS. As the judge said, the crucial question then was how Primeo's directors would have reacted in that situation.

307. The judge began by noting at [247] that BoB Group acted as custodian and administrator of three Madoff feeder funds at this time, namely Primeo, Thema and Lagoon. The judge thought it inherently improbable that BoB would treat these clients differently and accordingly BoB would be recommending that all three introduce the Available Safeguards.

308. He noted that at this time, apart from Mr Fielding, Primeo's board of directors was comprised wholly of Bank Austria group employees. Mr Simon was both chairman of the board and head of Bank Austria's asset management division and the judge considered it fair to regard him as the key decision-maker. The persons to whom the board would have turned for advice were Mrs Kohn and Dr Fano. The judge noted that none of these people had been called to give evidence as to how they would have responded to a situation where Mr Madoff was refusing to introduce the Available Safeguards and R2 was proposing to resign as custodian unless the terms of its contract were renegotiated to exclude liability for assets held by BLMIS as sub-custodian.

309. The judge also noted the following points:-

(i) The Bank Austria internal report took place the following year and the subsequent board meeting showed that the directors were willing to accept the relatively high operational risk associated with BLMIS's business model. There was no reason to think that their attitude would have been any different in 2002.

(ii) Primeo was wholly dependent upon BLMIS's unique investment performance and it was also very profitable for Bank Austria and for Mrs Kohn. Any new investment manager would have had a very different and inferior performance history to Mr Madoff as no-one could match his uniquely consistent performance. In the circumstances the judge considered that the circumstantial evidence tended to suggest that Bank Austria and Primeo's board of directors would have worked hard to avoid having to appoint a new investment manager.

(iii) One alternative would be to appoint a new custodian who would not take the same attitude as R2. An alternative solution would be to renegotiate the terms of the Custodian Agreement to make it clear that R2 had no responsibility for the managed account assets with BLMIS. From Bank Austria's perspective, this would have been an attractive solution to the problem although it might have been forced to accept that Primeo's shares could not be marketed in Austria.

310. The judge summarised his conclusions at [254] as follows:-

> *"In the absence of evidence from any of those who would actually have made the decision, I am not satisfied, on the balance of probabilities, that the Plaintiff has proved its withdrawal hypothesis. If BoB Lux had recommended in August 2002 that BLMIS be required to (a) establish a separate account at the DTC for Primeo (or, more likely, all three BoB clients) and/or make use of the ID System and (b) establish a separate account(s) at BNY, and Madoff had refused to do so, this ought to have raised a red flag in the minds of Primeo's directors. However, the circumstantial evidence (including what happened subsequently) points to the conclusion that they were firmly committed to Madoff and I am not able to infer that they would have decided to terminate the BLMIS relationship in these circumstances."*

311. Although he does not specifically say so, [254] read with [253] must mean that he found that Primeo would therefore have renegotiated the Custodian Agreement to exclude any liability of R2 for the assets with BLMIS.

312. Primeo submits that the judge's decision was clearly wrong and that this Court should interfere. Mr Smith referred to *Allied Maples* at 1610 where Stuart-Smith LJ, when discussing the situation of where causation turns on an assessment of what would have happened in a hypothetical counter-factual situation said:-

> *"Since this is a matter of inference, this court will more readily interfere with a trial judge's findings than if it was one of primary fact."*

313. We agree that this is so but, as set out at [130] above, even in such cases an appellate court should be cautious in revisiting the decision below and should only interfere where

the trial judge has exceeded the generous ambit within which reasonable disagreement is possible.

314. We would summarise Mr Smith's key criticisms of the judge's finding as follows:-

(i) The judge conflated the Future Profits Claim with the Withdrawal Claim and the No Further Investment Claim. The issue of what Primeo would have done following withdrawal is relevant to the Future Profits Claim but not to the other two. The judge wrongly considered and took into account what Primeo might have done following any withdrawal from BLMIS.

(ii) The judge did not consider the No Further Investment Claim separately from the Withdrawal Claim as he should have. Faced with a refusal by Mr Madoff to agree to the Available Safeguards and with a custodian wishing to resign as a result, the board would at the very least be likely to have placed a hold on further investment with BLMIS until the problem had been resolved. The judge therefore should have found that, even in the unlikely event that Primeo had maintained its existing investments with BLMIS, it would not have placed any further sums with BLMIS for investment.

(iii) The judge agreed that Mr Madoff's refusal to agree to the Available Safeguards ought to have raised a red flag in the minds of Primeo's directors. The judge also found that, if BLMIS was genuine, there was no good reason for Mr Madoff not to agree to the Available Safeguards. Therefore, it was illogical in those circumstances for the judge to find that the board would nevertheless have continued with BLMIS.

(iv) The fact that, as the judge found at [249], the directors were willing to accept the high operational risk associated with BLMIS's business model and, by necessary inference, must have given credence to Mr Madoff's reasons for insisting that it would not be changed, did not mean that, faced with a custodian who was so concerned about the position that it was proposing to resign because of Mr

Madoff's refusal to agree to the Available Safeguards, the board would not consider that it was no longer willing to accept the operational risks. It was highly unlikely that the directors would simply ignore the concerns being expressed by a professional custodian.

(v) Although the judge was correct to say that no evidence had been called from those who would actually have made the decision in 2002, Primeo had called evidence from three directors, namely Dr Zapotocky (who had been a director from December 1993 to May 2000), Mr Fischer (who had been a director from December 1996 to December 1998) and Mr O'Neill (who was a director from June 2003 to April 2007). They had all given evidence which, to a greater or lesser extent, was supportive of Primeo's case that, if matters could not be satisfactorily resolved, it would have withdrawn the investment from BLMIS. The judge did not address their evidence in the context of August 2002 causation.

(vi) As the judge pointed out at [253], amending the Custodian Agreement to remove R2's responsibility in respect of the BLMIS assets could well have meant that Primeo's shares could not be marketed in Austria. Although, as a result of the evidence of an officer of the Austrian Federal Ministry of Finance ("FMA") in other proceedings referred to at [64], there was possibly some doubt as to whether it would in fact have prevented such marketing, the fact remained that, as set out by the judge at [59] – [62] the board and its advisers, particularly Dr Fano, were of the view that marketing in Austria would not be possible if R2 had no responsibility for the BLMIS assets. That made it even less likely that the board would have agreed to modify the Custodian Agreement as suggested.

315. ***Discussion and Conclusion:*** Notwithstanding Mr Smith's submissions, we are of the clear view that the judge's decision on causation in August 2002 was one which was reasonably open to him and is not one with which an appellate court should interfere. We would summarise our reasons for so concluding as follows, (references in square brackets being to paragraphs in the judgment below):-

(i) There was an equivalence of knowledge between the parties in that Primeo and BoB had the same knowledge and understanding of BLMIS and its business model. In particular Primeo and its investment adviser BA Worldwide knew that BLMIS performed a triple function and understood the operational consequences: [308].

(ii) However, like all the other Madoff feeder funds, Primeo accepted the uniquely high operational risk inherent in BLMIS's business model as the price to be paid for Mr Madoff's uniquely consistent investment performance and they did so for almost 20 years [38]. This extended to the fact that Primeo's directors and its investment advisers were willing to accommodate Mr Madoff's insistence on extreme confidentiality, even to the extent of agreeing that the name of BLMIS should not be disclosed in Primeo's Offering Memorandum: [46] and [50].

(iii) Further evidence of this is to be found in the BA Internal Audit Report of June 2003. It made the point that (through its investment adviser) Primeo was relying exclusively on information from BLMIS. This topic was discussed at the board meeting of 23rd June 2003 and again on 14th May 2004 as summarised at [43], [47], and [94] above. It is clear from the second meeting in particular that the board was aware there was a concern as to whether the securities were really there and whether the transaction slips provided by Mr Madoff had actually been executed.

(iv) Despite this, it was only very shortly after the BA Internal Audit Report that Bank Austria was involved in the promotion and launch of Alpha, another Madoff feeder fund.

(v) Bank Austria was also involved in the launch of another Madoff feeder fund in April 2004, namely Herald. It owned 25% of Bank Medici AG with the other 75% being owned by Mrs Kohn. The investment management and promotion activities in relation to Herald were all delegated to Bank Medici AG.

(vi) In October 2007, Pioneer's global head of operational risk management prepared a report for Pioneer in the context of Herald. It described the BLMIS business model and the operating procedures of R2 (in its capacity as custodian and administrator of Herald) in terms which are the same as the procedures applicable to Primeo prior to the Herald transfer. In passing, it stated that there was a great degree of opacity and mystery around Mr Madoff and that transparency, as far as trading flows, processes or counterparties were concerned, was '*nil*'. It referred also to the non-segregation of assets and generally expressed a number of concerns about BLMIS/Herald which were very similar to the concerns expressed by R2 in relation to Primeo, including the statement that it did not consider that Bank Medici/Herald offered a safe operational platform. Despite this, Pioneer, as adviser to Primeo, procured the Herald transfer and did not raise any concerns with Herald or its custodian or administrator.

(vii) We acknowledge that the matters mentioned at (iii) – (vi) all post-dated August 2002, but in our judgment the attitude of Bank Austria, the investment advisers (namely BA Worldwide and then Pioneer) and the directors of Primeo at those times are strongly indicative of what their attitude would have been in August 2002.

(viii) Dr Fano carried out her own due diligence and attended Mr Madoff's office in New York twice a year from 2000 onwards and Mrs Kohn was described as the 'gatekeeper' to Mr Madoff. Dr Fano was the managing director of BA Worldwide and the judge held that her knowledge (together with that of BA Worldwide and Pioneer) should be imputed to Primeo. Mrs Kohn was the proprietor of Eurovaleur and had been a key individual advising Bank Austria on the establishment of Primeo. She was also heavily involved in the establishment of Alpha and Herald. She was described by the judge at [33] as being '*an influential voice*'.

(ix) The investment performance had been remarkable and Bank Austria and the advisers were making handsome profits from Primeo (not least because BLMIS did not charge an investment management fee).

(x) There was accordingly in our view ample evidence upon which the judge could properly conclude that Bank Austria, Primeo and its advisers were firmly committed to Mr Madoff despite their knowledge of the risks involved and that Bank Austria and Primeo's directors would have worked hard to avoid anything which meant that BLMIS ceased to be Primeo's investment manager.

(xi) So what changed in August 2002 in this counter-factual situation? R2 would not have been telling Primeo anything new when communicating that it was concerned about relying solely on BLMIS for information as to the existence of the assets. Primeo and its advisers were already well aware that this was the situation and were accepting of it. What would be new would be that Mr Madoff had refused to agree to the Available Safeguards and that R2 was minded to resign as a result unless amendments were made to the Custodian Agreement to carve out any responsibility of R2 for the assets with BLMIS. Mr Gillis and Mr Smith both agreed during the course of oral submissions that, although there are references in the judgment and in the skeleton arguments to the possibility of finding another replacement custodian, given the likelihood that any such custodian acting as a competent custodian would have similar concerns to R2 and therefore seek similar terms, the real issue was whether Primeo would have agreed to amend the Custodian Agreement to exclude any responsibility of R2 for assets held with BLMIS as sub-custodian. The choice of the directors would therefore have been between agreeing such an amendment or withdrawing the funds and terminating the relationship with BLMIS.

(xii) In this respect, it is relevant that, as set out in the judgment at [92], the Custodian Agreement between BoB Limited and Alpha contained a provision that when an investment was made in a managed account (i.e. with BLMIS) there would be no asset capable of being held by the custodian and that, in the absence of fraud,

dishonesty, negligence or wilful default on the part of the custodian, the custodian would not be responsible for any loss arising in respect of assets in a managed account. Furthermore, the Alpha custodian agreement did not contain a provision equivalent to clause 16(B). Together with Mrs Kohn, Bank Austria was involved in the establishment and promotion of Alpha, and there was considerable commonality of key decision makers between Primeo and Alpha. Thus Mrs Kohn and Dr Fano were directors of Alpha and BA Worldwide was its delegated investment manager. Dr Zapotocky was also a director of Alpha having been a director of Primeo. This suggests that the board of Primeo, consisting substantially of Bank Austria employees and advised by BA Worldwide and Eurovaleur would not have been averse to the introduction of a similar clause into the Custodian Agreement carving out responsibility for the assets placed with BLMIS.

(xiii) Furthermore, the BA Internal Audit Report indicated that the internal auditors were of the view that R2 had already excluded liability for securities placed with BLMIS and recommended obtaining a legal opinion on the matter. There was no evidence before the judge that any legal opinion had ever been obtained, which suggests that Bank Austria/BA Worldwide/Primeo were not unduly concerned at the thought that R2 had excluded liability for assets with BLMIS. This further supports the view that, faced with a choice between losing the advantage of being managed by BLMIS or agreeing a carve out clause with R2, the board of Primeo, advised no doubt by BA Worldwide, would have chosen the latter.

(xiv) We accept, as did the judge, that agreeing to such a clause might cause marketing difficulties in Austria, although the position was not wholly clear. Whilst there was evidence that the directors thought that Primeo's shares could not be marketed in Austria with such a provision, there was evidence from an officer of the FMA in other proceedings that there was some doubt as to whether it would in fact have prevented such marketing. Furthermore, there does not appear to have been any evidence before the judge as to whether the shares in Alpha were marketed in Austria. Be that as it may, the judge clearly took this into account

and it cannot be said to be an unreasonable view to consider that, even if faced between a choice of not being able to market in Austria or losing the ability to be managed by BLMIS, Primeo would have chosen the former.

(xv) We accept, as Mr Smith submitted, that the judge did not separate out the Withdrawal Claim and the No Further Investment Claim from the Future Profits Claim. But we do not think that matters. Ultimately he asked himself the right question, which was whether Primeo would have terminated the BLMIS relationship (i.e. withdrawn). In answering that question it was relevant to consider what Primeo would have done if it had withdrawn from BLMIS because clearly any board of directors would not withdraw without giving some consideration to the steps which it might take following any such withdrawal? Consideration of what might follow any withdrawal was therefore not wholly irrelevant.

(xvi) We also accept that the judge did not consider separately the Withdrawal Claim and the No Further Investment Claim but in the circumstances we do not see this as material. Having found that Primeo would not have withdrawn its investment from BLMIS, but would instead have agreed a carve out provision in the Custodian Agreement, it is hard to see why the board would have ceased further investments.

(xvii) We do not consider the judge's failure to refer to the evidence of Dr Zapotocky, Mr Fischer and Mr O'Neill casts any doubt on his decision, although it would have been preferable had he done so. In the first place, none of them was a director in 2002 which is the relevant time for considering how Primeo would have acted. Secondly, he had clearly concluded that he could place little reliance upon the evidence of any of them. In the context of the role of R2 in the establishment of Primeo, the judge held at [26] that Dr Zapotocky's evidence was not reliable. He said "*Dr Zapotocky admitted having a personal interest in the outcome of this litigation and came across as an advocate, determined to present a case against BoB/HSBC whenever the opportunity arose. In the*

absence of corroboration, I have treated Dr Zapotocky's evidence with caution." In the same context he also formed an adverse impression of Mr Fischer concluding that he had a personal interest in the outcome of the case and that his evidence about the role of BA Worldwide was '*inherently improbable*' at [29]. Mr O'Neill became a director in June 2003 and the judge considered his evidence in relation to April/May 2005 causation. The judge records at [265] that, by his own admission, Mr O'Neill knew relatively little about Primeo at the time he served on its board of directors. He apparently gave evidence to the effect that he and (so far as he was aware) the other directors did not know that BLMIS's multiple roles meant that R2 was not in a position to confirm the existence of Primeo's assets with information from any independent source. Mr O'Neill said that if they had known about this and the concerns expressed by R2 executives, the board of Primeo would have taken steps to redeem the assets held by BLMIS. His evidence was clearly wholly inconsistent with all the other available evidence as to the knowledge of Primeo and its advisers about BLMIS's multiple roles and the reliance on single source information and it is not surprising that the judge concluded that he was unable to attach any weight to Mr O'Neill's evidence that the board would have taken steps to redeem the assets held by BLMIS.

(xviii) As stated earlier, Primeo bears the burden of proving on the balance of probabilities that it would have withdrawn the funds from BLMIS rather than negotiate a carve out in relation to BLMIS assets in the Custodian Agreement. Whilst it is not essential for a plaintiff to provide direct evidence of what it would do in a counter-factual situation and the question may be determined as a matter of inference, a court is certainly entitled to take into account that there is no direct evidence of a plaintiff's likely reaction if the plaintiff has failed to give evidence on the point. As the judge pointed out, none of the directors at the material time, nor any of the key advisers such as Dr Fano or Mrs Kohn gave evidence on this point and there was accordingly no direct evidence on behalf of Primeo as to how the key decision makers at the time would have responded.

316. Putting all these matters together, we conclude that there was ample evidence to justify the judge's decision and we uphold his finding that Primeo fails on causation as at August 2002 on the basis that Primeo has not shown on the balance of probabilities that, if R2 had not been negligent in the manner described earlier, Primeo would have withdrawn its investment with BLMIS and/or would not have invested any further monies.

(c) April/May 2005 causation

317. As already described, the situation changed in April 2005. Until then, EY had been producing audited accounts of Primeo, partly in reliance upon audit work (purportedly) undertaken on its behalf by F&H. However, in early 2005, EY indicated that it was no longer content to rely on work undertaken by F&H and that either it needed itself to undertake the necessary audit work at BLMIS or it would be minded to resign. In the face of this, R2 decided to issue the custody confirmations despite the fact that in doing so it was relying entirely on information provided by BLMIS. The judge held that, if they had not been negligent, R1 and R2 would have indicated an intention to resign at this time and would have explained to Primeo and BA Worldwide why they were resigning.

318. At [259] the judge summarised the steps which formed the basis of the way in which Primeo put its case on causation:-

(i) If R2 had not issued the custody confirmation (which was not itself a breach of contract but was a consequence of the breach of duty in not considering and then recommending the Available Safeguards), EY would have insisted upon having access to BLMIS in order to perform their own audit procedures designed to confirm the existence of the assets with BLMIS.

(ii) Mr Madoff would not have allowed this to happen.

(iii) In those circumstances EY would have threatened to resign.

(iv) Faced with the possibility of being unable to comply with its statutory duty to file audited financial statements to 30th June 2005, Primeo would have had no real option but to terminate the relationship with BLMIS and withdraw its assets.

319. The judge went on to consider each of these steps in turn. He agreed with (i). He then went on to consider (ii), namely whether Mr Madoff would have refused to allow EY to have access to BLMIS. The judge dealt with this at [261] and concluded that Mr Madoff might well have allowed such access to happen. He pointed out that it would be difficult for Mr Madoff to explain why he would not allow EY to do the very same work which F&H had (purportedly) done in prior years and that it would be explained to him that, in the absence of performing that work, EY would not issue an audit opinion with the result that Primeo and all the other BoB clients might be forced to terminate their managed accounts. This would have placed pressure on him to agree. Furthermore, said the judge, the scenario would not have been materially different from the one which occurred later in the year when Mr Madoff was persuaded to allow KPMG to conduct the first of its fraud risk reviews. In this connection he held that, from Mr Madoff's perspective, allowing EY to perform audit work might not have appeared any more risky than allowing KPMG to perform a fraud review, not least because, being an audit at year end, Mr Madoff would have known in advance what documents would need to be forged for EY's purposes whereas the KPMG review would involve selecting random transactions for review. For these reasons, the judge held that he was not persuaded that Mr Madoff would have refused to give EY access to BLMIS's books and records.

320. The judge went on at [262] to acknowledge that the causation analysis then became much more speculative because it turned on the outcome of the hypothesis that EY were given access to BLMIS and allowed to perform audit work at its offices. He said there were a range of possible outcomes. Mr Madoff's team might have successfully deceived EY, as they did later deceive KPMG, in which case an unqualified audit opinion would have been issued even in the absence of any custody confirmation from R2. In that event, Primeo would not have withdrawn from BLMIS. On the other hand, EY might have attempted to obtain a confirmation directly from BNY which might have led to the

exposure of the Ponzi scheme. In that event, BLMIS would have been liquidated and Primeo would have had no opportunity to withdraw its funds. Within those two extremes there was a possibility that EY would have come away from BLMIS with an inconclusive result but without actually suspecting the existence of any fraud or impropriety.

321. The judge held that, in order to establish its withdrawal hypothesis, Primeo needed to show that EY would not have issued an audit opinion by 30th June 2005 as per step (iii). The judge concluded at [263] '*In my view there is insufficient evidence from which to infer that, in the absence of a custody confirmation from HSSL, no audit opinion would have been issued.*'

322. He went on to hold at [266] that, if EY had issued an unqualified audit opinion, Bank Austria and Primeo's board would have sought to persuade R2 and R1 to remain as custodian and administrator by including appropriate exculpatory provisions in the contracts.

323. He concluded at [267] in the following terms:-

> *"In conclusion, I am not satisfied on the balance of probabilities that, but for the breaches of contract which occurred in April/May 2005, Primeo would have terminated its managed account, redeemed its shareholdings in Alpha and Herald, obtained an unqualified audit opinion from E&Y and then re-invested the proceeds in some other way. The assumption is that if E&Y (or some other approved auditor) had received a bank confirmation in respect of the cash, albeit not as at the balance sheet date, it would have issued an unqualified opinion. Even if this is right, the evidence does not lead to the conclusion that the directors would have re-launched Primeo with an entirely new investment strategy. More likely, they would have re-invested in one or more of the other Madoff feeder funds which had not engaged any HSBC companies as custodian or administrator, thus avoiding any risk of mass redemptions."*

324. We agree with the submissions of both counsel that this is not an easy paragraph to interpret. The judge is dealing with a number of matters in a very compressed form, including, it would seem, the Future Profits Claim. However, the key findings of the judge en route to that paragraph were that Primeo had failed to show that Mr Madoff

would have refused to give EY access and had also failed to show that, even if he had, no audit opinion would have been issued. It is clear that in reaching these conclusions, he was considering the matter on the balance of probabilities.

325. ***Discussion and Conclusion:*** In our view, the judge erred in law in applying a balance of probability standard to the hypothetical actions of Mr Madoff and EY. That is because, where there has been negligence consisting of an omission (as in this case) and where the plaintiff's loss depends on the hypothetical actions of a third party, he is entitled to succeed if he can show that there was a real or substantial, rather than a speculative, chance that the third party would have acted in a way which avoided the loss to the plaintiff.

326. The leading case is *Allied Maples* (supra). We think it is useful to quote from the judgment of Stuart-Smith LJ as it sets the position out very clearly at 1609 - 1611:-

> *"In these circumstances, where the plaintiffs' loss depends upon the actions of an independent third party, it is necessary to consider as a matter of law what it is necessary to establish as a matter of causation, and where causation ends and quantification of damage begins.*
>
> *(1) What has to be proved to establish a causal link between the negligence of the defendants and the loss sustained by the plaintiffs depends in the first instance on whether the negligence consists of some positive act or misfeasance, or an omission or non-feasance. In the former case, the question of causation is one of historical fact. The court has to determine on the balance of probability whether the defendant's act, for example the careless driving, caused the plaintiff's loss consisting of his broken leg. Once established on balance of probability, that fact is taken as true and the plaintiff recovers his damage in full. There is no discount because the judge considers that the balance is only just tipped in favour of the plaintiff; and the plaintiff gets nothing if he fails to establish that it is more likely than not that the accident resulted in the injury.*
>
> *Questions of quantification of the plaintiffs' loss, however, may depend upon future uncertain events. For example, whether and to what extent he will suffer osteoarthritis, whether he will continue to earn at the same rate until retirement, whether, but for the accident, he might have been promoted. It is trite law that these questions are not decided on a balance of probability, but rather on the court's assessment, often expressed in*

percentage terms, of the risk eventuating or the prospect of promotion, which it should be noted depends in part at least on the hypothetical acts of a third party, namely the plaintiff's employer.

(2) If the defendant's negligence consists of an omission, for example to provide proper equipment, give proper instructions or advice, causation depends, not upon a question of historical fact, but on the answer to the hypothetical question; what would the plaintiff have done if the equipment had been provided or the instruction or advice given? This can only be a matter of inference to be determined from all the circumstances. The plaintiff's own evidence that he would have acted to obtain the benefit of or avoid the risk, while important, may not be believed by the judge, especially if there is compelling evidence that he would not. ...

Although the question is a hypothetical one, it is well established that the plaintiff must prove on balance of probability that he would have taken action to obtain the benefit or avoid the risk. But again, if he does establish that, there is no discount because the balance is only just tipped in his favour. In the present case the plaintiffs had to prove that if they had been given the right advice, they would have sought to negotiate with Gillow to obtain protection. ...

(3) In many cases the plaintiff's loss depends on the hypothetical action of a third party, <u>either in addition to action by the plaintiff, as in this case, or independently of it</u>. In such a case, does the plaintiff have to prove on balance of probability, as Mr Jackson submits, that the third party would have acted so as to confer the benefit or avoid the risk to the plaintiff, or can the plaintiff succeed provided he shows that he had a substantial chance rather than a speculative one, the evaluation of the substantial chance being a question of quantification of damages?
Although there is not a great deal of authority, and none in the Court of Appeal, relating to solicitors failing to give advice which is directly in point, I have no doubt that Mr Jackson's submission is wrong and the second alternative is correct." (emphasis added)

327. Stuart-Smith LJ went on to say at 1614:-

"*In that case* [*Davies v Taylor* [1974] AC 207] *the court was not concerned to distinguish between causation and quantification of loss. But, in my judgment, the plaintiff must prove as a matter of causation that he has a real or substantial chance as opposed to a speculative one. If he succeeds in doing so, the evaluation of the chance is part of the assessment of the quantum of damage, the range lying somewhere between something that just qualifies as real or substantial on the one hand and near certainty on the other. I do not think that it is helpful to seek to lay*

down in percentage terms what the lower and upper ends of the bracket should be."

328. In that case, the Court of Appeal held that the plaintiffs had shown on the balance of probabilities that, in the counter-factual situation where the defendant solicitors had given non-negligent advice, they would have sought to negotiate with Gillow (the counterparty to the contract which the plaintiffs had entered into). It also held (by a majority) that there was a real or substantial chance that Gillow would have agreed a different term in the contract if requested to do so. The matter was therefore remitted to the judge for determination of the percentage chance as a matter of quantification of damages.

329. The approach in *Allied Maples* was approved by Lord Nicholls and Lord Hoffmann in *Gregg v Scott* [2005] 2 AC 176 and, since the hearing of this appeal, the principle established in it has been affirmed by the Supreme Court of the United Kingdom in *Perry v Raleys Solicitors* [2019] UKSC 5, [2019] 2 WLR 636. We think it helpful to quote short extracts from the judgment of Lord Briggs (with whom the other members of the court agreed):-

> *"[15] The assessment of causation and loss in cases of professional negligence has given rise to difficult conceptual and practical issues which have troubled the courts on many occasions.*
>
> *[16] Commonly, the main difficulty arises from the fact that the court is required to assess what if any financial or other benefit the client would have obtained in a counter-factual world, the doorway into which assumes that the professional person had complied with, rather than committed a breach of, his duty of care. The everyday task of the court is to determine what, in fact, happened in the real world rather than what probably would have happened in a what-if scenario generally labelled the counter-factual. Similar difficulties arise where the question of causation or assessment of damage depends upon the court forming a view about the likelihood of a future rather than past event.*
>
> ...
>
> *[20] For present purposes the courts have developed a clear and common-sense dividing line between those matters which the client must prove, and those which may better be assessed upon the basis of the evaluation of a lost chance. To the extent (if at all) that the question*

whether the client would have been better off depends on what the client would have done upon receipt of competent advice, this must be proved by the claimant upon the balance of probabilities. To the extent that the supposed beneficial outcome depends upon what others would have done, this depends upon a loss of chance evaluation.

[21] This sensible, fair and practicable dividing line was laid down by the Court of Appeal in [Allied Maples] ..."

330. Mr Gillis submitted that a company's auditor (EY in this case) should not be regarded as an independent third party for these purposes. He admitted that he was unable to point to any authority in support of this proposition and we unhesitatingly reject it. Auditors exercise their own professional expertise; they are not under the direction or control of the company or its directors. They are independent of the company.

331. The consequence is that there were two independent third parties in this case whose possible actions were relevant for purposes of causation when considering the counter-factual world, namely BLMIS (or Mr Madoff) and EY. Their actions would be relevant to the key issue of whether EY would have produced a clean audit opinion in the absence of the custody confirmations. In our judgment, there is undoubtedly a real or substantial (rather than speculative) chance that EY would not have produced a clean audit opinion in the counter-factual world. Mr Madoff might have refused them access. In that event, it seems likely that they would not have produced an unqualified audit opinion. Alternatively, as the judge indicated, Mr Madoff might have allowed EY to have access. In that event, an assessment has to be made as to the prospects of EY not producing an unqualified audit opinion. When referring to an audit opinion in this context, we mean an opinion issued despite the fact that Primeo retained its investment in BLMIS. We shall refer to this as a 'pre-withdrawal audit opinion' to distinguish it from an audit opinion given after a withdrawal as described at [339] below.

332. Mr Gillis submits that the loss of chance point is not open to Primeo in this appeal. He points out that it was not pleaded, that it was not raised before the judge and that it did not even feature in the grounds of appeal. The point made its first appearance in Primeo's skeleton argument for this appeal. Even then, the point was only taken as an alternative to Primeo's primary submission that the matter had to be determined on the

balance of probabilities. The latter point is certainly correct. Even during this appeal Mr Smith submitted that the question of whether Mr Madoff would have let EY attend at BLMIS's office was a binary question to which a yes or no answer had to be given on the balance of probabilities. Reverting to the submission of Mr Gillis, he said that the only reference to loss of a chance before the judge had been in the different context of whether BLMIS had sufficient money for Primeo to have in fact been able to withdraw its investment. That is why there is no reference to loss of a chance in relation to causation in the judgment. The judge was simply not addressed on the point. Mr Gillis submits therefore that it is too late now for Primeo to take the point.

333. On the basis of the material to which we have been referred, we accept that the loss of a chance point in relation to causation was not taken by Primeo until its skeleton argument for this appeal. However, we do not think that that prevents the point being taken now. This was not a failure to plead a cause of action. The correct approach to causation in a counter-factual situation is a matter of law and it is not generally necessary to plead matters of law. Furthermore, it is well-established law, having been clearly laid down in *Allied Maples* as long ago as 1995. There has at all times been a clearly identified issue as to causation such that the counter-factual situation had to be considered on the hypothesis that the Respondents had not breached their contracts. It was incumbent upon the judge to apply the correct law when considering questions of causation and quantification in those circumstances and it is equally incumbent upon this Court to apply the correct law.

334. In this respect, *Allied Maples* itself is of interest. The case appears to have been fought at first instance on the basis that the plaintiffs had to prove on the balance of probabilities that Gillow, the third party, would have agreed to a variation of the terms of the contract. The judge found that it probable that they would have. It would seem that even before the Court of Appeal, the arguments were made on the same basis; thus Mr Jackson for the appellants was arguing that the judge was wrong to find on a balance of probabilities that Gillow would have agreed a variation. It was the Court of Appeal itself which raised the issue of whether that was the correct approach. The court went on to consider the law

and to hold that the judge had applied the wrong approach and that the question of what Gillow would have done in a hypothetical situation should be assessed by reference to the loss of a chance rather than on a balance of probabilities. The court proceeded to apply the correct law despite the fact that this had not been raised in the court below or in the Court of Appeal until raised by the court itself. We consider the position to be similar in the present case.

335. The court made clear in *Allied Maples* at 1614, that the judge hearing the quantum issue would be free to fix the percentage chance at such figure as he thought fit having heard the evidence then produced and was not bound in any way by the fact that the trial judge at the causation hearing had assessed the prospects of Gillow as third party agreeing the variation at more than 50%, (because he had found it proved on the balance of probabilities). The same would be true in this case. The judge dealing with quantification of damage would not be bound by the conclusion of the judge at [263] that the prospects of EY not producing an unqualified pre-withdrawal audit opinion were less than 51% and the parties would be free to adduce such evidence as they thought fit on the percentage chances of this being the case.

336. The failure to apply the correct approach of loss of a chance when considering whether EY would have issued an unqualified pre-withdrawal audit opinion in the absence of the custody confirmations will only be significant if it might affect the judge's overall conclusion that Primeo had failed to prove a causative loss. This is because the final step in the causation exercise is to assess on the balance of probabilities what Primeo would have done (i) if EY had produced an unqualified pre-withdrawal audit opinion and (ii) if EY had not. If the answer is that Primeo would have done the same whether or not EY produced an unqualified pre-withdrawal audit opinion, the error in failing to apply the loss of a chance approach to this issue would make no difference.

337. As to (i), the judge held at [266] that if an unqualified pre-withdrawal audit opinion from EY was obtained, Primeo would not have withdrawn but would have negotiated an amendment to the contracts with the Respondents in order to include appropriate

exculpatory provisions. The position would effectively have been no different from that in 2002. For the reasons set out in relation to the 2002 causation, we consider that to be a reasonable finding which is not vulnerable on appeal.

338. As to the situation in (ii), the judge appears to have accepted at [263] that, in the absence of an unqualified pre-withdrawal audit opinion, Primeo would have had no choice but to terminate the managed account with BLMIS and withdraw the funds. In our judgment, this was clearly a correct finding.

339. The judge dealt with what Primeo would have done following any withdrawal at [267], which we have quoted at [323] above. As already stated, it is a difficult paragraph to follow but, when read with the judge's summary at [331] it seems reasonably clear that the judge held that, following a successful withdrawal of funds from BLMIS, Primeo would have reinvested the funds in one or more other Madoff feeder funds which had not engaged any HSBC companies as custodian or administrator. In reaching this conclusion, the judge assumed that, following a successful withdrawal of the cash balance, EY (or some other approved auditor) would have accepted the existence of that cash (albeit it not at the balance sheet date) as evidence that the assets reflected in the balance sheet must have existed as at 31 December 2004 and would therefore have given an unqualified audit opinion at this stage. We would refer to this as a 'post-withdrawal audit opinion'.

340. Despite the need to be cautious in overturning an evaluative finding of this nature by a trial judge, we consider that the judge's finding falls outside the reasonable band of decisions open to him. We would summarise our reasons as follows:-

(i) There was no evidence from any representative of EY or any expert audit evidence. There was therefore no evidence as to whether an auditor would issue an unqualified audit opinion in circumstances where it could not ascertain the existence of the company's assets as at the balance sheet date but was satisfied that at a later date there was an equivalent amount of cash. In the absence of such

evidence it must therefore be a matter of pure speculation as to whether or not an auditor would give such an opinion. There was certainly no evidence upon which the judge could properly find on a balance of probabilities that such an audit opinion would have been forthcoming. In the absence of an unqualified post-withdrawal audit opinion, Primeo would not realistically have been able to continue to operate.

(ii) Even if such a subsequent audit opinion was obtainable, one has to consider the position in which the directors would have found themselves. In the first place, as in 2002, they would be faced with a custodian (and now also an administrator) saying that they were concerned because they could not obtain satisfactory evidence that the assets existed; that Mr Madoff had refused to agree to the Available Safeguards (for which refusal there would be no apparently good reason); and that the custodian and the administrator were going to resign unless their contracts were amended so as to exclude any responsibility on their part for the existence of the assets with BLMIS.

(iii) But the situation now would be worse. Whereas in 2002, the directors would have been able to draw comfort from the fact that Primeo's auditors were providing an unqualified opinion which carried the implicit assurance that the assets shown at the balance sheet date existed, their auditors would now be telling them that they had been unable to satisfy themselves as to the existence of the assets because Mr Madoff was refusing them access and/or despite having been granted access, they had been unable to obtain any satisfactory confirmation as to the existence of the assets. Their auditors accordingly would have told them that they would be unable to issue an unqualified pre-withdrawal audit opinion.

(iv) Even allowing for Bank Austria/Primeo's enthusiasm for Mr Madoff, we find it less than probable that, in these circumstances, having withdrawn the assets from BLMIS, the directors would nevertheless immediately reinvest the funds with BLMIS despite their custodian, their administrator and their auditors all saying that they had been unable to verify that the assets really existed. We consider a

contrary conclusion to be outside the band of decisions reasonably open to the trial judge.

341. In these circumstances, the judge's error in not applying the loss of chance approach as to whether, by reference to the hypothetical actions of Mr Madoff and/or EY, a clean pre-withdrawal audit opinion would have been obtained, becomes very significant. If such an audit were to be obtained, Primeo's claim would fail for the reasons given by the judge, which we have upheld; Primeo would not have withdrawn its funds from BLMIS. If, on the other hand, an unqualified pre-withdrawal audit opinion were not obtained, Primeo would, on the balance of probabilities, have withdrawn its funds from BLMIS and would not have reinvested in some other Madoff feeder fund.

342. It would therefore be necessary at a hearing on quantification of damage for the judge to determine the chances of an unqualified pre-withdrawal audit not being obtained. As stated in *Allied Maples*, this assessment would be a matter of quantification not causation. If, simply by way of example, the judge were to conclude that there was a 40% chance of EY having been unwilling to produce a clean pre-withdrawal audit opinion in the counter factual world, so that Primeo would have withdrawn its funds from BLMIS, Primeo would be entitled to recover 40% of the damages it would have recovered on a full recovery basis.

343. Much of the hearing before us was devoted to submissions on whether the judge was reasonably entitled to find that, on the balance of probabilities, Mr Madoff would not have refused EY access to BLMIS and/or that EY would not have failed to issue an unqualified pre-withdrawal audit opinion. In view of our ruling that the judge applied the wrong test and that these aspects should be resolved by reference to loss of a chance rather than on the balance of probabilities, we do not think it necessary or appropriate to consider these submissions further. It would be a matter for the judge at any hearing on the quantification of damage to consider these matters by reference to loss of a chance.

344. We should add that we have considered whether the loss of a chance approach should also affect the outcome of the 2002 causation argument. That is because the 2002

causation involves, as part of the exercise, a finding that Mr Madoff would have refused to allow the introduction of the Available Safeguards. As he is an independent third party, the likelihood of such a refusal should have been assessed by reference to the loss of a chance approach rather than on a balance of probabilities. However, it is clear from the judgment that Primeo and the Respondents agreed that Mr Madoff would have refused. If the judge had followed the correct approach, he would therefore have been entitled to find that there was a 100% chance that Mr Madoff would have refused to implement the Available Safeguards. The error in approach therefore makes no difference to the outcome of the 2002 causation argument.

(d) 2007 Causation

345. The judge held at [268] that the causation analysis in respect of the breaches of contract which occurred in February/March/April 2007 was essentially the same as that applicable to the breaches in 2005. He held that Primeo had failed to prove its case on causation for the same reasons as in 2005.

346. In their written submissions, neither party sought to distinguish the position in 2007 from 2005. In his oral submissions, Mr Smith confirmed that he agreed with the judge's observation at [268] that the analysis on causation in 2007 was the same as in 2005. Similarly, Mr Gillis did not seek to address us on any specific matter relating to 2007 causation.

347. In the circumstances our finding in relation to 2007 causation is the same as in relation to 2005.

(e) Conclusions on causation

348. In summary:-

(i) We uphold the judge's finding in relation to 2002 causation, namely that Primeo has not proved on the balance of probabilities that it would have withdrawn its

investment with BLMIS and accordingly its claim (other than its strict liability claim under clause 16(B)) fails on causation.

(ii) In relation to both 2005 and 2007, the judge, through no fault of his own, applied the wrong legal test when considering whether EY would have issued an unqualified pre-withdrawal audit opinion in the absence of the custody confirmations. That was to be assessed on a loss of chance basis by reference to the possible reactions of Mr Madoff and EY in a counter-factual situation rather than, as the judge did, on a balance of probabilities. We overrule the judge's finding that, even if Primeo had withdrawn its funds from BLMIS following the lack of a clean pre-withdrawal audit opinion from EY, it would nevertheless have reinvested the money with one or more Madoff feeder funds which had not engaged BoB companies as custodian or administrator. In our judgment, on the balance of probabilities, Primeo would have withdrawn its investment from BLMIS in the absence of an unqualified pre-withdrawal audit opinion and would not have reinvested with one or more other Madoff feeder funds in such circumstances.

(iii) Accordingly, the issue would fall for decision as a matter of quantification of damages by reference to the chances of EY not issuing an unqualified pre-withdrawal audit opinion thereby causing Primeo to withdraw its funds from BLMIS.

349. We should add finally that, in the event of any hearing taking place as to the quantification of damages, it may become relevant to consider whether BLMIS would have been in a position to pay the amount which Primeo (and the other feeder funds of which the HSBC Group were custodians or administrators) sought to withdraw. This is touched upon by the judge at [280] of the judgment but it would be open to the parties to bring forward any additional evidence on this point should they think fit.

XIV: REFLECTIVE LOSS

(a) The questions for decision

350. The judge stated at [281]-[300] that Primeo's claims against R1 and R2 would have been barred because any loss suffered by it is reflective of loss in fact being claimed, or capable of being claimed either by Herald or by Alpha and is not separate and distinct from their loss. It was, he held, irrelevant that at the time Primeo's causes of action arose against R1 and R2 it was not a shareholder in either Herald or Alpha (**"the timing question"**). He also held that to engage the principle it sufficed that Alpha and Herald's claims against R1 and R2 had "a real prospect of success", and that a more stringent "merits" threshold that on the balance of probabilities a claim is likely to succeed, was not required (**"the merits test question"**). Primeo's appeal is against the judge's conclusion on these two questions.

351. The next three sections of this part of our judgment summarise the principle barring reflective loss, the material factual and procedural background, and the judgment below. Our consideration of the two questions for decision is preceded by a discussion (at [376] - [395]) of the rationale and justifications of the principle. For the reasons given at [396] - [426] we dismiss Primeo's appeal on the timing question and, for the reasons given at [427] - [441] we dismiss its appeal on the merits test question.

(b) The principle barring reflective loss

352. The principle, sometimes referred to as the reflective loss or the "*no reflective loss*" rule or principle, applies in the Cayman Islands: see *Xie Zhikun v XiO GP Ltd* CICA (Civil) Nos. 15 and 16 of 2017 handed down on 14 November 2018 in which the English authorities were considered and applied. The principle is derived from the decision of the English Court of Appeal in *Prudential Assurance Co. Ltd. v Newman Industries (No 2)* [1982] Ch 204 and was confirmed and explained by the House of Lords in *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1. It applies where a company and a shareholder both have a claim against a defendant arising out of the same facts. Under it a claim will generally not lie by any shareholder where all or part of the shareholder's loss is not separate and distinct from the loss to the company and can be seen as mimicking or reflecting the loss caused to the company by the wrongdoer, and the shareholder's rights

will be satisfied, if at all, through the company's recoveries against the defendant: see *Prudential v Newman* at 222-3 and the formulation in Gower, *Principles of Modern Company Law* 10th ed., 2016, eds. Davies and Worthington 17-34.

353. In *Johnson v Gore Wood* Lord Bingham (at 35F -36A), in a passage set out by the judge and closely analysed in the submissions to us, distilled three propositions from the authorities:

> *"(1) Where a company suffers loss by a breach of duty caused to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by any shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss.*
>
> *(2) 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 (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding.*
>
> *(3) 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."*
>
> (paragraph breaks added)

354. Lord Goff, Lord Hutton and Lord Millett agreed with these propositions. At 64C-G and 66, Lord Millett also identified the policies that justify the rule (on which see [382] ff below). At 67 he stated that the principle also applied to:

> *"payments which the company would have made if it had had the necessary funds <u>even if the plaintiff would have received them qua employee and not qua shareholder</u> and even if he would have had a legal claim to be paid".* (emphasis added)

355. It is axiomatic (see Lord Bingham's proposition (2) in *Johnson v Gore Wood* set out at [353] above and Lord Millett at 62C) that the reflective loss principle cannot operate where the company has no claim against the wrongdoer, and the only claim is that of the shareholder, or where the shareholder has no claim and the only claim is that of the company. In some cases, it will be clear whether the company has or does not have a claim against the same wrongdoer for the same loss as the plaintiff has sustained but in other cases, such as this, while it is possible to say that in principle the company has a cause of action, there is uncertainty about its prospects of succeeding.

356. We discuss the rule, the policies underlying it, and the way it has developed since *Johnson v Gore Wood* at [376]ff below. At this stage, since one of the issues between the parties is whether the rule concerns causes of action or certain types of loss, we observe that although there are references in the cases to the no reflective loss rule barring a shareholder's claim, there are also references (for example in the decision of the English Court of Appeal in *Gardner v Parker* [2004] EWCA Civ.781, [2004] 2 BCLC 554 at [49]) to it not being concerned with barring causes of action **as such**, but with barring recovery of certain types of loss.

(c) The material factual and procedural background

357. The facts material to the two questions for decision by us can be summarised as follows. Between January 1994 and May 2007 Primeo invested directly in BLMIS. It used two categories of participating shares, Primeo Select and Primeo Global (which was closed in 2001), which effectively functioned as sub-funds. From 2 May 2001, Primeo Select became a single manager fund with the whole of its invested assets placed on its managed account with BLMIS. By the end of 2002, its investment in BLMIS exceeded $300 million. In November 2003, another sub-fund, Primeo Executive, was launched.

358. For the reasons given at [9] above, under the 1996 agreements R1 was appointed as Primeo's administrator. Under the simultaneous agreement between R1 and R2 under which R1 delegated the performance of its administration duties to R2, R2 was not to be liable to R1 or Primeo in the absence of negligence or wilful breach of duty, and R1

agreed to indemnify R2 for any loss caused by R1's performance of those duties caused other than by negligence or wilful breach of duty on the part of R2. The effect of the clause exonerating R2 in the absence of negligence or wilful breach of duty is that, where, as in this case, R2 was negligent it would be liable to R1 for any loss caused by R2's negligent performance of those duties. Thus, although not the mirror of the provision in the delegation agreement under which R1 agreed to indemnify R2, the effect is that R1 would be made good for such liabilities and losses and the ultimate liability would fall on R2.

359. It was only in 2003 and 2004 that Alpha and Herald were respectively incorporated and launched as single manager Madoff feeder funds wholly invested with BLMIS through managed account arrangements. Alpha was incorporated under the laws of Bermuda on 1 March 2003. Its custodian agreement dated 12 March 2003 was with the Bank of Bermuda Ltd, a Bermudian entity. The Bank of Bermuda Ltd delegated performance of its custodian duties to R2 in a sub-custodian agreement dated 12 March 2003. The sub-custodian agreement provided that R2 was not to be liable to the Bank of Bermuda Ltd in the absence of fraud, dishonesty, negligence or wilful default by R2, and the Bank of Bermuda Ltd agreed to indemnify R2 for any loss caused other than resulting from matters for which R2 is liable. In a case, such as this, where R2 is negligent, the effect is in substance the same as the effect under the 1996 agreements described in the last paragraph.

360. The judge found at [89] and [295] that Alpha's Administration Agreement was with the Bank of Bermuda Ltd and that Bank of Bermuda Ltd had delegated performance of its duties under that agreement to R2 under an agreement made the same day. However, it was the Respondents' case that pursuant to a novation agreement on 2 January 2007, Bank of Bermuda Ltd was replaced by another Bermudian entity, HSBC Institutional Trust Services (Bermuda) Ltd, with R2 continuing to act as sub-administrator[6]. Mr Smith, on the other hand, submitted in oral argument that Alpha's Administrator was Management International (Bermuda) Ltd, but he did not suggest that R2 was not the

[6] See footnote 7 of the Respondents' Note, "The Merits Of Alpha's Claim".

sub-administrator at all material times[7]. Indeed, it was common ground on the pleadings (see para 16 (1) of the Re-Re-Amended Statement of Claim and para 114 (b) of the Re-Amended Defence) that at all material times R2 was the sub-administrator and the sub-custodian of Alpha. In a letter to the Court from Primeo's solicitors dated 27 May 2019 after the draft judgment had been sent to the parties it was contended for the first time that R2 was not Alpha's sub-administrator because Bank of Bermuda Ltd had had no power to appoint R2 as sub-administrator. In our view this contention was made too late and we accordingly proceed on the basis set out in the pleadings that at all material times R2 was the sub-administrator of Alpha.

361. Primeo Executive first invested in Alpha in November 2003 and in Herald in November 2004, some eight months after they were launched. By the end of 2004 it had invested some $51 million split equally between Alpha and Herald: see judgment at [89], [91], [95] – [96]. It appears from a table provided by Primeo during the hearing that as the beginning of May 2007 the withdrawal value of these investments was $56.3 million, some 10.8% of the total withdrawal value of Primeo's investments in BLMIS including its direct investments. The position in relation to Primeo Select was that before 2 May 2007 it was not a shareholder in either Alpha or Herald: see judgment at [286] and [288], albeit those paragraphs relate to March 2007, the date on which the judge assumed the causes of action arose.

362. Following the Herald Transfer (described at [6] above) all Primeo's investments in BLMIS were held indirectly in shares issued by Herald (97.5%) and Alpha (2.5%) registered in the name of R2 as custodian and administrator.

363. Primeo commenced these proceedings on 20 February 2013. Alpha and Herald had commenced proceedings against R2 in Luxembourg in 2009. Herald's claims, commenced on 3 April 2009, are for restitution in respect of securities and cash, and breaches of duty under the custodian agreements, statute, and the law of tort. Save for the claim for the restitution of the securities, which was dismissed by the Luxembourg court

[7] See Transcript D2, p.109, lines 12-18; D9, p.50, lines 5-7.

in March 2013, Herald's claim has yet to be determined. Appeals by both R2 and Herald in respect of the decision concerning the claim for the restitution of the securities are pending. The reports of Mr Trevisan and Mr Fayot, respectively Primeo and Rs' Luxembourg experts, state that Herald's claim for restitution has no prospect of success. As to its other claims, both experts considered the contract claim has a real prospect of success but were unable to put it higher than that. Rs' expert also considered the tort claim has a real prospect of success, but Primeo's expert disagreed.

364. Alpha's claims in Luxembourg are for breach of contract and in tort. In 2011 Alpha made cross-claims in proceedings brought by the BLMIS trustee in the US Bankruptcy Court against parties including R2 which were dismissed on jurisdictional grounds in December 2016. At the hearing before us, we were informed that an appeal was then pending. On 28 November 2014 Alpha issued proceedings in Bermuda against a number of parties including R2 and HSBC Bank plc, but at the time of the hearing before us, had not served them.

(d) The judgment below

365. The judge summarised what he called the reflective loss principle and set out the passage from Lord Bingham's speech in *Johnson v Gore Wood* which we have set out at [353] above and Lord Millett's explanation in that case of the underlying policy considerations, on which see [382] ff below). He stated (at [281]) that "*the reflective loss principle holds that where a company suffers loss caused by a breach of a duty owed to it, only the company can sue in respect of that loss and no action lies at the suit of a shareholder suing in that capacity to make good a diminution in the value of the shareholder's shareholding where that merely reflects loss suffered by the company.*"

366. The application of the principle to the hedge fund industry was considered by the judge (at [284]) to be unlikely to cause difficulty in the case of "*a typical master/feeder structure*". This is because ordinarily the professional service provider, in this case R2, will owe the same duty to the master fund, here Alpha and Herald, and the feeder fund, here Primeo, and the feeder fund will be barred from suing the service provider because it

will not suffer a loss which is separate from that of the master fund. The judge stated (at [285]) that although Primeo, Alpha and Herald were not set up as master/feeder structures they acquired the essential economic characteristics of such structures. This, he said, was because the whole of Primeo's assets comprised shares in Alpha and Herald and, in substance it used the same administrator and custodian as Alpha and Herald: see the explanation at [358] – [359] above in relation to the delegation and indemnity agreements made in 1996 and 2003.

367. ***The "timing" question:*** The basis of the judge's decision on the timing question was his analysis of two scenarios. The scenarios assumed (see judgment at [286] - [289]) that R1 and R2 were in breach of the duties owed to Select, Executive, Alpha and Herald and that the causes of action against them arose in March 2007 when Executive was wholly invested in Alpha and Herald but Select was not a shareholder of either company. They also turned on the fact that from 2 May 2007, the date of the Herald Transfer, Primeo became (in respect of what had been the Select managed account) a material shareholder in Herald and Alpha, and that these proceedings were commenced on 20 February 2013.

368. The first scenario assumed that BLMIS's Ponzi scheme had been discovered before Primeo Select's investment in Herald. The judge stated that here the application of the principle is uncontroversial: it would apply to a claim by Primeo Executive. It is not said but is clearly implicit that the principle would not apply to a claim by Select. The second scenario assumed the scheme was discovered after Select's investment in Herald and Select wished to claim that but for the breach it would have redeemed its shares in Herald.

369. The judge stated that, if the principle does not apply against Select in the second scenario, R2's total exposure would be increased from a total of $1.5 billion to a total of $2 billion because Select's claim would be for its AUM but its AUM would also be a component in Herald's AUM.[8] For the reasons given by Lord Millett in *Johnson v Gore Wood* (at 62F-G and see [382] ff below), the judge considered that to be an unjust result. If the

[8] The acronym is not defined in the judgment. We understand it to be a reference to "assets under management".

shareholder were allowed to recover there would either be double recovery from the wrongdoer or the shareholder would recover at the expense of the company, other shareholders, and creditors. Justice to the defendant required the exclusion of one claim or the other; and the protection of the company's other shareholders and creditors required the company to be the entity allowed to recover.

370. The judge rejected Primeo's submission that the risk of any double recovery would be dealt with by the plaintiff shareholder waiving so much of his claim as has already been paid to the company. He agreed with the statement of Costello J in the Irish High Court decision of *Alico Life International Ltd v Thema International Fund Plc* [2016] IEHC 363 that the bar on recovery of reflected loss is one of principle and, its application cannot be overcome in this way.

371. The analysis of the two scenarios and the increase in R2's total exposure was said by the judge (at [289]) to illustrate why he considered that the application of the reflective loss principle is not dependent upon the plaintiff being a shareholder at the time the cause of action arose. "[W]*hether or not any particular loss is reflective of the company's loss has to be determined on the basis of the factual circumstances existing at the time the claim is made*" because the reflective loss principle does not bar the shareholder's cause of action but only "*claims for those heads of loss which are reflective of the company's loss*".

372. On the basis of the factors we refer to at [367] above, the judge decided (at [289]) that Primeo's loss of investment claim against R1 and R2 is reflective of Alpha and Herald's claims and those claims were capable of being barred if the merits test was met.

373. ***The "merits test" question***: The question arises in the present case because both the relevant companies, here Herald and Alpha, and Primeo have a cause of action against the wrongdoer, here R1 and R2. Does it suffice as the judge held (at [294] and [300]), that Herald and Alpha's claim has "*a real prospect of success*" or is it necessary as Primeo submitted that Herald and Alpha's claim must be one which on the balance of probabilities "*would succeed if they brought it*".

374. The judge referred to and relied on to the statement of HHJ Rich QC sitting in the High Court in *Perry v Day* [2004] EWHC 3372 (Ch.), [2005] 2 BCLC 405 at [24] at a trial that followed Rimer J's refusal to strike out the claim: [2004] EWHC 1398 (Ch.). HHJ Rich stated that "*since the limb of the principle ... applies only when the loss caused identically to the company and to the shareholder arises from breach of separate duties owed to them each, it seems to me to follow necessarily that the company's claim must at the relevant time be a real claim with at least some prospect of success*". Primeo relied on *Shaker* v Al-*Bedrawi* [2002] EWCA Civ. 1452, [2003] Ch. 350 where Peter Gibson LJ giving the judgment of the English Court of Appeal stated at [83] that what must be established is "*not merely that the company has a claim ... but that such claim is available on the facts*". It also relied on the statement by Rimer J in *Perry v Day* that the court "*must at least be satisfied on the evidence whether or not the company had a claim which was likely to succeed*": [2004] EWHC 1398 (Ch) at [65]. The judge in this case accepted HHJ Rich's interpretation that in the factual context of *Shaker's* case the reference to availability was "*a reference to whether, on the facts, the company had a cause of action, not the likelihood of such a claim being successfully pursued*": see [2005] 2 BCLC 405 at [25]. As to Rimer J, who had described his view as "*provisional*", the judge in this case said that HHJ Rich's decision was made after full argument at the trial.

375. The judge stated that the experts on Luxembourg law (whose positions we summarise at [363] above) agreed that Herald's breach of duty claim against R2 has a "*real prospect of success*". He considered the factual circumstances of the claims by Alpha and Herald to be practically the same as those relating to Primeo's claim ("the shareholder claim") and the merits of the shareholder claim and the company claims to be "comparable" although not identical: see judgment at [299] – [300]. He stated that it could not be assumed that his finding against Primeo on loss and causation was an indication that the Luxembourg and Bermuda courts would reach the same conclusion because the decision makers who would be the relevant witnesses are different.

(e) Discussion

376. ***Introduction:*** The reflective loss principle was described as "*perplexing*" by Neuberger J in *Humberclyde Finance Group Ltd. v Hicks* [2001] All ER (D) 202 at [33] and, notwithstanding the decision of the House of Lords in *Johnson v Gore Wood,* by Arden LJ as requiring further clarification: *Johnson v Gore Wood (No. 2)* [2003] EWCA Civ. 1728 at [162]. The fact that its application has the consequence of denying a plaintiff what would otherwise be his right to sue has led to it being seen as "*an exclusionary rule*" and might be taken as an indication of caution as to the ambit of the principle. In *Shaker* v Al-*Bedrawi* [2002] EWCA Civ. 1452, [2003] Ch. 350 at [83] it was stated that the onus is on the defendant to establish its applicability. In *Freeman v Ansbacher Trustees* [2009] JLR 1 at [97(i)] (Jersey) it was said that it should be "*confined to those circumstances where it is clearly applicable*", and in *Jefcoate v Spread Trustee Company Ltd.* 31 October 2014 at [375] (Guernsey) that it should "*be applied cautiously, and only in the cases where it ought, according to its rationale, clearly to be invoked*".

377. Notwithstanding these indications favouring caution as to the ambit of the principle, the way the principle was stated in *Johnson v Gore Wood* and the variety and nature of the policy justifications identified for it in that case means that it does not follow that the principle is narrow. One illustration of this is the treatment by the House of Lords of the approach of the New Zealand Court of Appeal in *Christensen v Scott* [1996] 1 NZLR 273. That court had held that the principle does not apply to cases where D's breach of duty is one owed to P even where his loss flows from loss suffered by a company in which P is a shareholder through a similar breach of duty owed to the company. The House of Lords rejected that approach and gave the rule/principle a wider scope. Developments by English courts since the decision in *Johnson v Gore Wood* are to the same effect. They also emphasise the narrowness of the scope of the exception to the principle recognised in *Giles v Rhind* [2002] EWCA Civ. 1428; [2003] Ch. 618, where the wrongdoer's conduct has prevented or disabled the company from pursuing such cause of action as it has.

378. The foundations for the width of the principle and for the restrictive approach to the *Giles v Rhind* exception may lie in Lord Millett's speech in *Johnson v Gore Wood.* Indeed, in his judgment in the Final Court of Appeal of Hong Kong in *Waddington v Chan Chun*

Hoo Thomas [2009] 4 HKC 381 at [88], with which the other members of the Court agreed, Lord Millett stated that *Giles v Rhind* was wrongly decided and should not be followed in Hong Kong. Notwithstanding this and other criticism of the exception established in *Giles v Rhind* e.g. by Professor Charles Mitchell in his "*Shareholders' Claims for Reflective Loss*", (2004) 120 LQR 457 at 472 it continues to apply in England: see *Webster v Sandersons Solicitors* [2009] EWCA Civ. 830, [2009] 2 BCLC 542. But in *St Vincent European Partner Ltd v Robinson* [2018] EWHC 1230 (Comm) at [97] Males J (as he then was) observed that there is hardly any other case in which it has been applied, although *Perry v Day* [2004] EWHC 3372 (Ch.), [2005] 2 BCLC 405 discussed at [374] above is such a case.

379. The ambit of the principle was considered in two decisions in 2018. The first is *Carlos Sevilleja Garcia v Marex Financial Ltd.* [2018] EWCA Civ. 1468, [2018] 3 WLR 1412 ("*Garcia's* case"). In that case the English Court of Appeal, after discussing the policies underlying the principle, held that it applied to claims by unsecured creditors who are not shareholders of the relevant company in the way foreshadowed by Arden LJ in *Johnson v Gore Wood (No. 2)* [2003] EWCA Civ. 1728 at [162] and Neuberger LJ in *Gardner v Parker* [2004] EWCA Civ. 781, [2004] 2 BCLC at [70] – [71]. In the 2011 edition of his *Principles of Corporate Insolvency Law* at 14-20 n 125, Sir Roy Goode described this as paralleling the principle barring individual shareholders and Primeo accepted (skeleton argument, paragraph 97) the logic of applying the principle to unsecured creditors of the company who are not shareholders because "*it is difficult to see why the principle should apply in relation to a claim for in substance the diminution in value of one type of right against a company (a shareholding) but not to a claim for in substance the diminution in value of another type of right (a creditor claim)*". In *Garcia's* case the Court of Appeal granted permission for an appeal to the United Kingdom Supreme Court *inter alia* (see Lewison LJ at [71]) to enable that Court to consider the coherence of the law in the current state of the authorities.

380. The second decision is that of this Court in *Xie Zhikun v XiO GP Ltd*, [352] above. The Court held that there is a serious issue to be tried that the reflective loss principle does not

reach the case where the shareholder does not sue to recover a loss but seeks an injunction to prevent one arising in the future. Rix JA (at [95]) commented that, in the light of *Garcia's* case, the doctrine seemed *"to be extending wider and wider"*.

381. Primeo emphasised the distinction between the conditions that are required for the reflective loss principle to be engaged and the policy justifications for the bar where the principle is engaged. The conditions in effect operate as jurisdictional bars. Primeo submitted that one of the conditions is the requirement that a plaintiff be a shareholder at the time the loss is suffered so that the loss is claimed in its capacity as a shareholder. Its case is that a plaintiff who was not in the category of "*shareholder*" when the breach of duty occurred, and the loss was suffered, is not in reflective loss territory. This approach has the effect of downplaying to some extent the significance of the policy justifications in determining the ambit of the principle. The cases we have considered, however, show close attention to the rationale and justifications of the reflective loss principle in determining its ambit. We consider that this is also required for the determination of the two questions before us, in particular the timing question.

382. ***The rationale and justifications of the principle***: The fullest discussion of this is to be found in the speech of Lord Millett in *Johnson v Gore Wood* at 62E-G and 66F-67B although see also Lord Bingham at 36B-D. The very helpful and succinct summary of them by Flaux LJ in *Garcia's* case makes it unnecessary extensively to set out Lord Millett's words. At [32], Flaux LJ stated that four aspects or considerations justifying the rule emerge from the authorities, in particular from Lord Millett's speech. Adding paragraph breaks and the underlined words, and omitting Flaux LJ's cross-references to other paragraphs of his judgment, the four policy justifications are:

> *"(i) the need to avoid double recovery by the claimant and the company from the defendant: see per Lord Millett at 62E-F...;*
>
> *(ii) causation, in the sense that if the company chooses not to claim against the wrongdoer <u>or to settle a claim for less than it might have done</u>, the loss to the claimant is caused by the company's decision not by the defendant's wrongdoing: see per Lord Millett at 66D-F <u>[quoting Hobhouse LJ in Gerber Garment Technology</u>*

Inc v Lectra Systems Ltd [1997] RPC 443, 47], and Chadwick LJ in Giles v Rhind at [79];

(iii) the public policy of avoiding conflicts of interest particularly that if the claimant had a separate right to claim it would discourage the company or the wrongdoer from making settlements: see per Lord Millett at 66F-G, ... and

(iv) the need to preserve company autonomy and avoid prejudice to minority shareholders and other creditors. The point about company autonomy is made by Lord Bingham at 36C and Lord Millett at 66H-67A ... and the point about protecting minority shareholders and other creditors is made by Arden LJ at [162] in Johnson v Gore Wood (No 2) ...."

383. The first of these considerations, (i), was identified as an important policy concern in *Johnson v Gore Wood.* Lord Millett stated (at 62E-F) that neither "*double recovery at the expense of the defendant*" nor recovery by the shareholder "*at the expense of the company and its creditors and other shareholders*" was permitted. There are also many references to the need to ensure that there is no double recovery in the speeches of Lord Hutton and Lord Cooke. In *Peak Hotels and Resorts Ltd v Tarek Investments Ltd* [2015] EWHC 3048 (Ch.) Birss J, in what may be an unreserved judgment, stated at [32] – [33] that "*what emerges clearly from* [the] *authorities is that the rule on reflective loss is concerned with double recovery*", and that "*even if the claimant shareholder has a cause of action him or her or itself, that shareholder cannot recover for loss which is reflective because it would be double recovery*". Birss J's statement, however, needs qualification.

384. The principle is not rooted simply in the avoidance of double recovery and may apply even where there is no prospect of that. The examples include: where the company has declined or failed to bring its claim (*Prudential Assurance v Newman* at 223E&F); there is some defence to the company's claim; the company has settled the claim at an undervalue (see *Johnson v Gore Wood per* Lord Bingham at 35G, the last sentence of proposition (1) set out at [353] above); or where the company's claim is statute barred (*Kazakhstan Kagazy Plc v Arip* [2014] EWCA Civ. 381, and *Norcross v Georgallides* [2015] EWHC 1290 (Comm) at [65] *per* Hamblen J). See also *Day v Cook* [2001] EWCA Civ. 598, [2002] 1 BCLC 1 at [38] *per* Arden LJ and proposition (4) of Neuberger LJ's

statement of the principles in *Gardner v Parker* [2004] EWCA Civ. 781, [2004] 2 BCLC 554 at [33] [9], repeated in the judgment of the court (Lord Clarke MR, Arden and Lloyd LJJ) in *Webster v Sandersons Solicitors* [2009] EWCA Civ. 830, [2009] 2 BCLC 542 at [37].

385. This suggests that, even if preventing the risk of double recovery is an important policy concern, it is not the primary concern. Interestingly, Lord Bingham, in his analysis in *Johnson v Gore Wood* did not refer to it. It is also to be noted that in the decision of this Court in *Xie Zhikun v XiO GP Ltd* Rix JA observed at [48] that Flaux LJ's last consideration, (iv), the need to preserve company autonomy and avoid prejudice to minority shareholders and other creditors, might be said to be the first consideration. The force of this perceptive observation becomes more apparent when the other justifications listed by Flaux LJ are examined.

386. Consideration (ii), causation, has been criticised by Professor Charles Mitchell in his LQR article we refer to at [378] above. He stated (at [469]) that notwithstanding Lord Millett's enthusiasm for it, Hobhouse LJ's causation argument begs the question because it presupposes that the shareholder will suffer a reflective loss when the company decides not to pursue its remedy but does not explain why the shareholder cannot sue. In fact, Lord Millett accepted (at 66F) that there was more to the matter than causation, and that disallowance of the shareholder's claim in respect of reflective loss is driven by the policy factors reflected in considerations (iii) and (iv). This also shows the force of Rix JA's observation in *Xie Zhikun v XiO GP Ltd.*

387. As to (iii), Lord Millett's speech focussed on settlements made at the instigation of the company directors who brought the company's claim or those made at the instigation of the company's liquidator. The possibility of a shareholder action would make it difficult for the directors and the liquidator to settle the action and (see 66G) would effectively take the conduct of the litigation out of their hands. Where the directors are shareholders

[9] This was Blackburne J's formulation in *Giles v Rhind* [2001] 2 BCLC 582 at [27] as amended by two qualifications Neuberger LJ stated were expressed in the judgment of Chadwick LJ in that case: [2002] EWCA Civ. 1428; [2003] Ch. 618 at [61] and [62].

or creditors, they might additionally "be *placed in a position where their interest conflicted with their duty*" where settlement of the company's claim at less than its true value (or abandonment of that claim) would leave them with a claim *qua* shareholder or creditor which they can pursue against the wrongdoer in their own interest. The policy favouring settlements is equally applicable where the position is considered from the perspective of the wrongdoer. As Chadwick LJ stated in *Giles v Rhind* at [79], there is a "*need to avoid a situation in which the wrongdoer cannot safely compromise the company's claim without fear that he may be met with a further claim by the shareholder in respect of the company's loss*".

388. As to (iv), while it may, as Rix JA stated, combine two considerations, preservation of company autonomy and prejudice to minority shareholders and other creditors, the two are linked and were treated together in *Johnson v Gore Wood.* Lord Bingham (36C) considered that "*the court must respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders and ensure that a party does not recover compensation for a loss which another party has suffered*". We add 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": See Sir Roy Goode, *Principles of Corporate Insolvency Law, 4th ed.,* 2011 14-20 and Flaux LJ in *Garcia's* case at [37]. This consideration has been held not to be in play in the case of a secured creditor and *inter alia* for that reason, a claim by a debenture holder has been held not to be barred by the principle: *International Leisure Ltd. v First National Trustee Co. Ltd.* [2012] EWHC 1971 (Ch.), [2013] Ch. 346 at [42] – [44].

389. The link between the need to preserve company autonomy and avoid prejudice to minority shareholders and other creditors is also seen in Lord Millett's speech. He stated (at 62F-G) that "*protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder*" (emphasis added), and his reference (at 66G) to the control of the conduct of the litigation. The latter statement was made about proceedings brought by a liquidator, but it is also applicable to proceedings brought in the company's name by the directors.

390. The principle thus supports what Gower's *Principles of Modern Company Law*, 17-36 describes as the principle of centralised management of the company's assets through the board which Lord Millett considered was necessary to protect minority shareholders and other creditors. Because the justification for the principle is not confined to company autonomy, we respectfully disagree with the statement of Teare J in *Latin American Investments Ltd v Maroil Trading Inc* [2017] EWHC 1254 (Comm) at [14] that the principle of company autonomy is the underlying reason which justifies the reflective loss principle. In our judgment, if there is an "*underlying reason*", it is the need to avoid prejudice to minority shareholders and other creditors.

391. Arden LJ has pointed out in *Johnson v Gore Wood (No. 2)* at [162] that the *Giles v Rhind* exception to the reflective loss principle shows that "*the need for creditor and shareholder protection is not always an absolute consideration and can be displaced*". But those factors appear to have been accorded increased importance in the recent case law. That may be the explanation for the criticisms of making a distinction between a shareholder with one share who is a creditor, whose claim is barred and a creditor with no shares or who has sold his shares, whose claim is not barred as "*odd*" by Arden LJ in *Johnson v Gore Wood (No. 2)*, and as illogical by Neuberger LJ in *Gardner v Parker* [2004] EWCA Civ. 781, [2004] 2 BCLC 554 at [70] and by Flaux LJ in *Garcia's* case at [36].

392. The need to avoid prejudice to minority shareholders and other creditors is the explanation for the decision of the Court of Appeal in *Garcia's* case not to perpetuate what Flaux LJ (at [36]) described as "*the illogical and unprincipled distinction*". As we stated at [379] above, the court decided that the reflective loss principle applies to claims by unsecured creditors who are not shareholders of the relevant company. Flaux LJ (at [33]) stated that once it is recognised that the justification for the principle is not limited to company autonomy "*in the sense of the unity of economic interest between a company and its shareholders ... it is difficult to draw a principled distinction between a claim by a shareholder qua creditor ... and a claim by any other creditor who is not a shareholder*". He considered (at [36]) that the various justifications he had identified for

the principle (set out at [382] above) then come into play and (at [37]), that the need to avoid prejudice to other creditors applies "*with particular force to any creditor of a company, whether a shareholder or not because of the risk of "scooping the pool*" and bypassing or subverting the *pari passu* principle.

393. In *Garcia's* case Lewison LJ observed (at [71]) that "*no judge who has considered whether a shareholder creditor and a non-shareholder creditor should be treated differently for the purposes of the rule against reflective loss has answered that question 'yes'*". Neuberger and Arden LJJ considered that both should be barred by the principle. Waller LJ in *Giles v Rhind* considered that neither should be. His was a minority view and does not sit comfortably with Lord Millett's view that the principle applies in respect of payments which the company would have made if it had had the necessary funds "*even if the plaintiff would have received them qua employee and not qua shareholder and even if he would have had a legal claim to be paid*". He considered that claims for arrears of remuneration, expenses and pension contributions and for loss of future such payments should not be caught by the principle because they are not "*pure*" reflective loss and would have been recoverable by an employee or creditor of the company who was not a shareholder: see [2002] EWCA Civ. 1428; [2003] Ch. 618 at [40].

394. Primeo argued that *Gardner v Parker* and *Garcia's* case show that English law at Court of Appeal level has taken a wrong turn. In the appeal from *Garcia's* case, if the United Kingdom Supreme Court considers that the state of the authorities before the decision of the Court of Appeal is problematic, there appear to be two broad possibilities. The first would be to confirm that the principle applies to all reflective loss whether by a person who happens to be a shareholder or not. The second would be to confine the principle to those who are shareholders and to deal with the illogicality referred to by Arden, Neuberger and Flaux LJJ in some other way, possibly by linking the scope of the principle more closely to the "*proper plaintiff*" rule in *Foss v Harbottle* (1843) 2 Hare 461 or adopting the approach Waller LJ favoured in *Giles v Rhind.* On this last possibility, it may be necessary not just to reject the approaches in *Gardner v Parker* and *Garcia's* case, but also to revisit the rejection by the House of Lords in *Johnson v Gore Wood* of the approach of the New Zealand Court of Appeal in *Christensen v Scott* and

Lord Millett's application of the principle to payments received qua employee and not qua shareholder. That would result in a significant narrowing of the principle.

395. In this appeal we are concerned with the present state of the common law of the Cayman Islands. As seen, for example from the decision of this Court in *Xie Zhikun v XiO GP Ltd,* that closely tracks the position under the common law of England and Wales. Our discussion of the questions for decision, therefore analyses the present state of the English authorities.

396. ***The "timing" question:*** There are two limbs to Primeo's case that for the reflective loss principle to apply it is necessary that the plaintiff be a shareholder in the company at the time the cause of action accrued. The first limb (see skeleton argument 84(1)) has two aspects. The first aspect ("the capacity point") is 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") is 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 was incorporated. Primeo relied on the references in *Johnson v Gore Wood* by Lord Bingham in proposition (1) at 35F set out at [353] above to "*a shareholder suing in that capacity and no other*" and by Lord Millett at 61H to "*a shareholder suing as such*", and the judgment of Lewison LJ in *Mellor v Partridge* [2013] EWCA Civ. 477 at [32] – [33] (claims of three plaintiffs were "*not claims made as shareholders*" and the complaint of another is "*not that it suffered loss in its capacity as a shareholder*").

397. Primeo submitted that before the Herald Transfer on 2 May 2007 it was not a "*material shareholder*" in and had only "*a very modest exposure*" to Alpha and Herald through Primeo Executive's investments. That exposure was (see [361] above) 10% of the withdrawal value of all Primeo's investments in BLMIS, i.e. including its direct investments. Primeo submitted that except in respect of that exposure, losses it sustained from its investments in BLMIS before 2 May 2007 were not for a diminution in the value of any shares held by it in Alpha or Herald or any claim by it against them. Those losses

accrued before it was a shareholder and in the case of some of them before the companies were incorporated. In respect of those losses it is suing in its capacity as a contractual counterparty to R1 and R2 and not in the capacity of shareholder or creditor of Alpha or Herald.

398. There is an overlap between the pure timing point and the second limb of Primeo's case. The second limb ("the no change point") is that the nature of the loss suffered before the plaintiff becomes a shareholder cannot change just because the plaintiff subsequently becomes a shareholder. Recoverable losses that have been sustained before a plaintiff is a shareholder must by definition be separate and independent and within Lord Bingham's proposition (3) set out at [353] above. Their nature cannot change just because the plaintiff becomes a shareholder later. What, Mr Smith asked on behalf of Primeo, would the position have been if Herald had not engaged R2 as custodian and administrator so that its claim was against a different defendant to Primeo's claim?

399. Primeo also commented on the focus placed by the Respondents on whether Primeo's loss would be "*made good*" if the company successfully sued the wrongdoer. As is clear, in particular from *Prudential*, the principle was derived from the rule in *Foss v Harbottle* (1843) 2 Hare 461 and the rules governing derivative actions by shareholders. Primeo submitted that making whether a plaintiff's loss would be "*made good*" if the company sued successfully the central requirement for the operation of the principle would be to extend it radically.

400. ***(i) The capacity point:*** Although Primeo can legitimately draw some support for its position from the references in *Johnson v Gore Wood* to a shareholder "*suing in that capacity*" and "*as such*", we reject the submission that this is a condition required for the principle to be engaged. We have concluded that those references (and Lord Bingham's reference in proposition (1) to "*a diminution in the value of the shareholder's shareholding*" are descriptions of the typical scenario in which the principle applies rather than statements of one of the conditions for it to be engaged.

401. In *Johnson v Gore Wood* in the passage we set out at [354] above Lord Millett stated (at 67B) that the principle applied to bar a plaintiff in respect of payments which the plaintiff would have received qua employee and not qua shareholder and, "*even if he would have had a legal claim to be paid*", "*his loss is still an indirect and reflective loss which is included in the company's claim*". Only Lord Millett addressed this point directly. But it appears that Lord Bingham agreed with him. Dealing with the part of Mr Johnson's claim for diminution in the value of his pension relating to payments the company would have made into a pension fund for him, Lord Bingham stated (at 36H) "*I think it plain that this claim is merely a reflection of the company's loss and I would strike it out*".

402. Lord Bingham's reference in proposition (1) to "*a diminution in the value of the shareholder's shareholding*" does not show that it is necessary that the diminution took place while the plaintiff was a shareholder because, as discussed below, it is clear that the principle extends beyond diminution in the value of shares and includes all payments which the shareholder might have obtained from the company if it had not been deprived of its funds.

403. Disregarding any of the comments in later decisions, and focussing only on *Johnson v Gore Wood,* it is difficult to square the application of the principle to payments received qua employee rather than qua shareholder with a requirement that the plaintiff bring its claim in the capacity of shareholder. It is also somewhat artificial to regard a claim by a person in respect of a payment which he would have received "*qua employee*" as brought in the capacity of shareholder. We discuss at [416] ff below the later decisions, two of which, *Gardner v Parker* in 2004 and *Garcia v Marex Financial* in 2018, state that *Johnson v Gore Wood* is a binding decision which clearly rejects limiting the ambit of the principle to claims brought by a shareholder in his capacity as such.

404. The last decision we deal with in this section on the capacity point is the decision of the English Court of Appeal in *Mellor and others v Partridge* [2013] EWCA Civ. 477. Primeo argued that it shows that:

> *"The fact that a plaintiff's loss would be made good if the company in which he is a shareholder succeeded in its claim is a necessary condition for the reflective loss principle to operate, but it is not sufficient. If the plaintiff was not a shareholder in the company at the time his cause of action accrued, the reflective loss principle is not engaged".*

It maintained that the parallels with the present case are "*striking*" and that the Court of Appeal "*could not have been clearer*".

405. The claimants formed a company (Amor) to purchase Partridge Fine Arts plc (PFA) which later collapsed as a result of what the claimants alleged were serious breaches of duty by PFA's former directors and shareholders. The Court of Appeal allowed an appeal from a decision of Beatson J that certain of the claims be struck out as unsustainable because of the principle that a shareholder is unable to recover for reflective loss. Lewison LJ (with whom McCombe LJ and Sir Stephen Sedley agreed) considered (at [32]) that the principle did not apply to the facts because the first two claimants never became shareholders in the company and the third claimant only did so much later as part of a damage limitation exercise. The consequence was that "*their claims are not claims made as shareholders, and no part of their claim relates to the value of any shares*".

406. As to the claim by Amor, Lewison LJ said (at [33]) that Amor's complaint was "*not that it suffered loss in its capacity as a shareholder; but that it was induced to become a shareholder by misrepresentation*" and that "[a]*t the time when the misrepresentations were made it was not a shareholder*". He concluded that consequently any duty owed to Amor by the defendants "*was not a duty owed to a shareholder, but a duty owed to a prospective buyer of shares*".

407. We consider that *Mellor's* case is of limited assistance in resolving the question before us. First, it concerned an application to strike out, albeit one heard over two days. In *Johnson v Gore Wood* Lord Bingham (at 36) stated that, at the strike out stage any reasonable doubt must be resolved in favour of the plaintiff. In *Mellor's* case, Lewison LJ qualified what he said in the passages we quote at [405] – [406] above by saying (at [34]) "[a]*t the very least this is not a case in which there is no reasonable doubt*". It may be (see his summary of the approach to strike outs at [3]) that he simply thought the first

instance judge had been too robust at the strike out stage and that the case was one in which the nature of the claims warranted fuller investigation.

408. Secondly, after hearing full argument, in *Garcia's* case, in the passage set out at [419] below, Lewison LJ concluded 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 on whether the plaintiff's loss would be made good if the company were successfully to pursue its claims.

409. Thirdly, Lewison LJ may have overlooked the fact that, although the first two claimants in *Mellor's* case never became shareholders in PFA, they were indirect shareholders in it by virtue of their shareholding in Amor. In principle, where a plaintiff is a shareholder of a parent company and claims for loss that is reflective of loss suffered by a subsidiary of the parent, but would be made good through the parent, its claim should be barred. This is what occurred in the Hong Kong Court of Final Appeal decision in *Waddington v Chan Chun Hoo Thomas* [2009] 4 HKC 381 at [89] in respect of losses which were reflective of the losses allegedly suffered by a sub-subsidiary company, although (see [81]) the point had been conceded in that case.

410. Although our rejection of Primeo's "*capacity*" point significantly weakens its position on the timing question, it is not in itself fatal to it. We therefore turn to its "*pure timing*" point, which is closely linked to its "*no change*" point. For the reasons below, we consider that, in the circumstances of this case, neither assist Primeo.

411. ***(ii) The 'pure' timing point:*** In *Johnson v Gore Wood* there are statements by Lord Bingham and Lord Millett which point to the important factor being the type of loss that is being claimed. Is the loss claimed by the plaintiff the same loss as that suffered by the company as a consequence of the wrongdoing, or is it separate and distinct from the company's loss and caused by a breach of duty independently owed to the shareholder? These statements are also relevant to the "*no change*" point.

412. Lord Bingham stated (at 35G, proposition (1) at [353] above) that a claim would "*not lie by any shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss*". His proposition (3) is that a shareholder may sue to recover a loss separate and distinct from that suffered by the company caused by a breach of duty independently owed to the shareholder. Lord Bingham later stated (at 36C-D) that "*the object is to ascertain whether the loss claimed appears to be or is one which would be made good if the company had enforced its full rights against the party responsible, and whether ... the loss claimed is 'merely a reflection of the loss suffered by the company*".

413. There are three relevant statements in Lord Millett's speech. At 66C-D he stated that "[t]*he test is not whether the company could have made a claim in respect of the loss in question; the question is whether, treating the company and the shareholder as one for this purpose, the shareholder's loss is franked by that of the company.*" The paragraph immediately preceding what he said about payments received qua employee and not qua shareholder contains (at 66H) an important statement about the types of loss. He stated that:

> *"Reflective loss extends beyond the diminution of the value of the shares; it extends to the loss of dividends ... <u>and all other payments which the shareholder might have obtained from the company if it had not been deprived of its funds</u>."* (emphasis added)

414. Earlier, (at 64B) when rejecting a suggested distinction from *Prudential* that the principle did not apply because the defendant in *Johnson v Gore Wood* was in breach of a duty owed to the plaintiff personally and he had his own cause of action to recover his loss, he stated that the problem was that "*the plaintiff's own loss would be fully remedied by the restitution to the companies of the value of the misappropriated assets*".

415. These statements all focus 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. If, as Lord Bingham stated at 36D, quoted at [412] above, 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. We therefore agree with the judge (at [289] summarised at [371] above) that what is relevant are the factual circumstances that obtain at the time the claim is made. The argument that for the principle to apply it is necessary for a person to be a (material) shareholder at the time that person's cause of action accrues is inconsistent with according centrality to the type of loss because the application of the principle would be determined by examining how and when the plaintiff's cause of action arose rather than by the type of loss suffered and whether it would be made good.

416. It is against this background that in *Gardner v Parker* [2004] EWCA Civ. 781, [2004] 2 BCLC 554 Neuberger LJ stated (at [49]) that "*the rule against reflective loss is not concerned with barring causes of action as such, but with barring recovery of certain types of loss*" and see also at [33] propositions (1), (3) and (5). In *Garcia v Marex Financial Ltd.* [2018] EWCA Civ. 1468 at [27] – [28] Flaux LJ cited that passage, stated that it was part of the ratio in *Gardner v Parker* and that Knowles J had erred at first instance in focussing on the nature of the cause of action.

417. In *Gardner v Parker* Neuberger LJ applied the principle to a claim by BDC, a company which was both a shareholder in and a creditor of Scoutdale which was why the question that fell for decision in *Garcia's* case did not arise. The claim was for damages for breach of fiduciary duty by the defendant (BDC's majority shareholder) who was alleged to have procured a sale at an undervalue of an asset belonging to Scoutdale. The losses to BDC would have been made good if Scoutdale had enforced its rights against the defendant.

418. On the question of the capacity in which a loss is claimed, Neuberger LJ considered the statements of Lord Bingham and Lord Millett that we quoted at [412] and [413] above. He stated (at [70]) that it was clear from those observations and that aspect of the decision in *Johnson v Gore Wood* that the principle is not limited to claims brought by a shareholder in his capacity as such and would also apply to claims brought in his capacity as an employee of the company.

419. In *Garcia's* case, in a concurring judgment primarily addressing precedent, Lewison LJ stated (at [70]):-

> *"[T]he decision of the House of Lords in Johnson establishes that a claim brought by a shareholder, even if not in his capacity as such, is barred by the rule against reflective loss if the loss that he himself has suffered would have been made good by the restoration of the company's asset. Gardner establishes that this applies to a claim for repayment of a loan where the lender happens to be a shareholder in the company in question. Both these decisions bind us."*

420. ***(iii) The "no-change" point:*** We accept, as did R1 and R2, that the nature of a loss sustained which is separate and independent cannot change and become reflective of a company's loss just because the plaintiff later becomes a shareholder. But it follows from the authorities which focus on the nature of the loss and (see Lord Bingham at 36D referred to at [412] and [415] above) the need to ascertain whether the plaintiff would be made whole if the company had enforced its right that whether a loss is in fact reflective is to be tested and determined in the light of the circumstances that exist when the claim is made.

421. Moreover, this is not a case in which Primeo just happened to become a shareholder in Herald. There was a very direct link between the assets it transferred from its account at BLMIS to Herald's account and the shares that Herald transferred in exchange. The nature of the transaction between Primeo and Herald as assets moved from one account at BLMIS to another account there provides an additional explanation for why any loss incurred by Primeo before 2 May 2007 ceased to be separate and distinct.

422. There is further support for this conclusion in the policy justifications for the reflective loss principle. Primeo maintained that there is no question of it achieving double recovery as a result of its claim in these proceedings because it is required to give credit for sums actually received from Herald and sums it is likely to receive from it in the future. Although we consider that, with proceedings on foot by both Herald and Alpha in different jurisdictions, the risk of double recovery cannot be excluded, we do not rely on such risk. It is not necessary to do so because, as stated at [384] above, the authorities show that the principle is not rooted simply in the avoidance of double recovery and may

apply even where there is no prospect of that. But the justifications reflected in considerations (iii) and (iv) in *Garcia's* case apply because of the possibility of Primeo "*scooping the pool*" before the companies' claims, prejudicing other shareholders and creditors and because of the impact of these proceedings on R1 and R2's ability to settle the companies' claims.

423. Primeo also submitted that there were three other reasons that the reflective loss principle does not apply to Primeo's losses. The first is that Herald's losses arise from breaches that took place in later years than Primeo's and under a different agreement. The second is that it is merely a coincidence that both Herald and Primeo engaged the same custodian. Had Primeo engaged a different custodian, there could be no suggestion that any claim against its custodian referable to the period prior to the Herald Transfer was barred by the reflective loss principle. The third relates only to Primeo's administration claim against R1. Primeo argued that, as Herald had no claim against R1, any claim by Primeo against R1 for breach of its administration duties could not be reflective.

424. We do not consider that any of these points are answers to the applicability of the principle.

(a) The first two are inconsistent with the fifth proposition in Neuberger LJ's summary in *Gardner v Parker* [2004] EWCA Civ. 781, [2004] 2 BCLC 554 at [33] of the effect of the speeches in *Johnson v Gore Wood*, repeated in the judgment of the court in *Webster v Sandersons Solicitors* [2009] EWCA Civ. 830, [2009] 2 BCLC 542 at [37]. That states: "*provided the loss claimed by the shareholder is merely reflective of the company's loss and provided the defendant wrongdoer owed duties both to the company and to the shareholder, it is irrelevant that the duties so owed may be different in content.*"

(b) As to the third point, we accept Mr Gillis' submission that despite the apparent (legal) asymmetry, the effect of the delegation, exemption, exoneration and indemnity arrangements in the 1996 agreements (see [358] above), mean that in economic reality symmetry remained and the situation was within the ambit of the reflective loss principle. The effect of those arrangements was that R2 in fact did the

administration for both Primeo and Herald and that a claim by Primeo against R1 for breach of administration duties would in substance be passed through as a claim against R2 in negligence and/or wilful breach of duty. Accordingly, it would compete with claims against R2 by Herald potentially scooping the pool and extracting value or funds from Herald at the expense of other shareholders and creditors.

425. In the case of Alpha, if the Administrator (whether it was Bank of Bermuda Ltd, HSBC Institutional Trust Services (Bermuda) Ltd or Management International (Bermuda) Ltd) failed to take care in supervising the delegate, R2, and suffered loss by reason of the delegate's breach of duty, the Administrator would be liable to Alpha for breach of a common law duty to take reasonable care in the supervision of R2 but would have a claim over against R2 for breach of duty giving rise to the loss complained of by Alpha.

426. For these reasons we reject Primeo's appeal on the timing question and turn to the merits test question.

427. ***The merits test question*:** Two questions about the treatment by the judge of the merits of the claims by Alpha and Herald against R1 and R2 are raised by Primeo. The first is that the judge erred in holding that the test for determining whether the reflective loss principle is engaged is whether the company's claim has a realistic prospect of success. In its written submissions, Primeo submitted that on the authorities and as a matter of policy "*the correct merits test is whether, assuming that the facts alleged by the plaintiff are established, the company has a claim which would succeed if the company brought it*". At the hearing, in response to questions from us it accepted that the merits threshold was slightly different and lower. In a formulation which to some extent reflects that of Rimer J in *Perry v Day* that it must be shown that the company's claim "was likely to succeed", it maintained that what was required was a claim which, on the balance of probabilities, would succeed. The second question is that Primeo submitted that there was no basis on the evidence before him for the judge's conclusion that Herald has a good claim.

428. As to the authorities on the threshold required, Primeo relied on statements in the cases which it submitted showed that a court will bar a plaintiff shareholder only where the defendant demonstrates that the company has a claim which is "*available on the facts*". It placed particular reliance on the passage in *Shaker* v Al-*Bedrawi* which we quote in our summary of the judge's decision at [374] above which used these words, and which it submitted, contrary to the view of HHJ Rich QC mean something higher than a cause of action. It also relied on the statement in *Shaker's* case at [60] that the defendant "*had to satisfy the court that it was the inevitable conclusion from the facts which were admitted or agreed ... [that its conduct] ... was a breach of duty ... to [the company]*" and the explanation of *Shaker's* case by Neuberger LJ in *Gardner v Parker* at [40]. Neuberger LJ stated that *Shaker's* case was one in which, "*without a full trial, it could not be clearly established that the company was in fact entitled to recover the sums claimed by the claimant*".

429. Primeo also relied on the statement in *Johnson v Gore Wood* by Lord Millett at 61G-H that the principle applied "*if the company has a cause of action*" and the fact that Lord Bingham's propositions (1) and (2), see [353] above, are formulated by reference to the company having or not having a cause of action. It also referred to Lord Bingham's statement at 36C that "*the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation*".

430. As to policy, Primeo submitted that it follows from the fact that the principle is an exclusionary rule (see [376] above), that what would otherwise be a good claim by a plaintiff shareholder should only be barred where this is clearly justified. It argued that it is unjust to hold that a shareholder with a very strong claim against the defendant is not entitled to sue where the company's claim in respect of the same loss is arguable but unlikely to succeed. Uncertainties about a company's claim resulting from matters such as its claim being for a different cause of action and requiring proof of different facts to the plaintiff's or being governed by a different law should not be resolved by barring the plaintiff because the result might be that neither recover.

431. Some of the cases relied on by Primeo are only decisions reflecting the proposition that we described at [355] above as axiomatic, that the reflective loss principle cannot operate where the company has no claim against the wrongdoer. See the decisions of the English Court of Appeal in *Lee v Sheard* [1956] 1 QB 192, *George Fischer (Great Britain) Ltd v Multi Construction Ltd* [1995] BCC 310 and *Gerber Garment Technology Inc. v Lectra Systems Ltd* [1997] RPC 443, and to some extent the judgment of Arden LJ in *Day v Cook* [2001] EWCA Civ. 598, [2002] 1 BCLC 1 at [41]. They do not consider the threshold merits test.

432. The references in cases such as *Johnson v Gore Wood* and *Shaker's* case to the company having a "*cause of action*" do not in our judgment assist Primeo because, as Mr Gillis submitted, it is possible to have a cause of action without having a claim which the court believes will succeed. Lord Bingham's statement that the court "*must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation*" does provide some support for Primeo's position. But Lord Bingham's statement was made when addressing the position on a strike out application at which stage he also said that any reasonable doubt must be resolved in favour of the plaintiff shareholder. He was not addressing the threshold required after the matter has been fully explored at a trial such as the twelve week trial in the present case. There will be differences between the position at the earlier and the later stages, as illustrated by the differences (on which see [374] above) between the decisions of Rimer J and HHJ Rich in *Perry v Day*.

433. What of the statements of the English Court of Appeal in *Shaker's* case? We consider that in *Perry v Day* HHJ Rich was correct in stating that in the particular context of *Shaker's* case, the reference to a claim "*available on the facts*" is a reference to whether the Pennsylvania company (ANA Inc) had a claim rather than to how strong a claim which it did have in fact was or was likely to be. This is because although ANA would have had a claim under English law, whether it had any claim at all was governed by Pennsylvanian law, there was no evidence of Pennsylvanian law before the court, and it could not be assumed that law was the same as English law. This was also the view of Neuberger LJ in *Gardner v Parker* at [40] when, after the passage relied on by Primeo, he

stated that in *Shaker's* case it could not be determined that the reflective loss principle applied because "*it was unclear that the company had a claim for any loss suffered*". We have concluded that the authorities before the decision of HHJ Rich in *Perry v Day* are not decisive.

434. As to policy, it is true that the effect of the operation of the principle is to bar a plaintiff where the company may not in the event recover and thus "*make good*" the plaintiff's loss, and that appears to be a tough consequence. But as the cases referred to at [384] above show, this will be the position in other situations in which the company does not recover, for example, where the company does not pursue its claim, settles it at an undervalue (*Johnson v Gore Wood*) or where the claim becomes statute barred. In *Johnson v Gore Wood* the principle barred the claim for reflective loss even though (see 18H – 20B) the settlement expressly provided that subject to a cap of £250,000, whatever personal rights the plaintiff shareholder had against the defendant be preserved.

435. In *Johnson v Gore Wood* Lord Millett (at 66) stated that the policies Flaux LJ identified under consideration (iii) (see [382] above) justify barring the shareholder's claim in these circumstances. The relevance of these policy justifications to the determination of the threshold that has to be met in relation to the company's claim also reflects the fact that claims with a reasonable prospect of success, particularly in complex commercial litigation, are seen to have a value which can be realised and which the company should be entitled to realise. Setting the threshold at the level for which Primeo contends would make it difficult for the company to settle such claims and would increase the risk of an individual shareholder "*scooping the pool*" at the expense of other shareholders or creditors.

436. Requiring a claim to be one that is likely to succeed will also lead to a number of significant practical difficulties in all but the simplest of cases. First, the merits of a company's claim would have to be determined in proceedings to which the company is generally not a party. Save for *Barings plc v Coopers & Lybrand* [1997] 1 BCLC 427 and possibly *Shaker's* case the relevant company was not a party or before the court in the cases to which we were referred. In *Day v Cook* [2001] EWCA Civ. 598, [2002] 1 BCLC

1 at [42] Arden LJ stated that making the assessment is difficult where the company is not a party to the proceedings or where the shareholder is closely identified with the company. This may particularly be so since there is no requirement for the plaintiff and the company to have the same claim: see the fifth proposition set out in *Gardner v Parker* set out at [424] above. It may also be particularly difficult where, as in these proceedings, the plaintiff shareholder's claim comes before the court before the company's claim is particularised and before it is known what the evidence will be in it.

437. A final practical difficulty is that the court may have little assistance because the parties to a claim by a shareholder will have no incentive to argue that the company's claim will succeed. The plaintiff will not do so because that would bar its claim. The defendant will not do so because that would be to admit liability in another claim. At the hearing, the question of staying a shareholder's claim to await the outcome of the company's claim was briefly canvassed but there was no enthusiasm for it by either party.

438. Returning to *Perry v Day,* although what HHJ Rich QC said about the test was *obiter,* for the reasons given in our discussion, we consider that his conclusion that the test is that the company has a "*realistic*" claim rather than that it is "*likely to succeed*" is consistent with the authorities and indeed correct. The judge did not err in following him. We note that "*a realistic possibility*" was the term used by Males J in *St Vincent European Partner Ltd v Robinson* [2018] EWHC 1230 (Comm) at [78], albeit not as part of his decision in that case. For these reasons we reject Primeo's appeal on the threshold part of the merits test question.

439. Our rejection of Primeo's submissions on the threshold merits question means that the remainder of its case on this ground, that there was no basis on the evidence to conclude that Herald has a good claim against R2 falls away It was in any event not common ground that the claim was unlikely to succeed (see our summary of the position taken by the experts on Luxembourg law summarised at [362] above). The judge stated (at [299]) that "*the HSSL executives responsible for the provision of custody and administration services to Primeo were also responsible for Alpha and Herald*". He concluded that the circumstances of both claims are practically the same as those of Primeo's claim and that

the companies had a realistic prospect of success. It is clear in our view that, on the evidence before him, the judge was entitled to conclude this in the case of Herald's claim.

440. In the case of the merits of Alpha's claim, about which there is little in the written submissions, a wrinkle emerged during the hearing. As a result of a question by Birt JA consideration was briefly given to whether the judge had erred in proceeding on the basis that the factual circumstances of Alpha's claim are practically the same as those of Primeo's. This was because clause 15(F) of Alpha's custodian agreement with the Bank of Bermuda Ltd, which excluded the Bank of Bermuda Ltd from liability absent *inter alia* fraud, negligence and wilful default, differed from the terms of Primeo's custodian agreement with R2, which in clause 16(B) contain the "appointment", most "effective safeguards" and "ongoing suitability" duties. The judgment (at [92]) in fact sets out clause 15(F) and clause 16(B) is set at [22] and [242] above. We have, with the assistance of a useful note from R1 and R2 on the merits of Alpha's claim considered this. We have concluded that the overall effect of clause 16(B) in the light of the exonerating provisions in it and in clause 16(E) is that R2 is under no liability unless it is negligent (see also [493]-[494] below). For that reason, the absence of 16(B) in the Alpha custodian agreement makes no difference and the prospects of success against R2 are the same for Alpha as for Primeo, albeit under a different cause of action (see [495] – [496] below. We have also concluded that the terms of Alpha's administration agreement with its Bermudian administrator and the delegation, exoneration and indemnity provisions in it to which we refer at [359] above mean that that agreement is substantially the same as Primeo's administration agreement with R1. The passage from [299] of the judgment that we quote at [439] above may be an over-compressed reference to this but the fact that there is no reference at this point to the difference in the contractual position means this is unfortunately not clear. But, we have concluded that the evidence before the judge entitled him to conclude that Alpha had a realistic prospect of success.

441. For these reasons, we reject Primeo's appeal on the merits test question.

XV: LIMITATION

(a) Overview

442. The position is governed by the *Cayman Islands Limitation Law (1996 Revision)* ("*the Limitation Law*") which, as far as the provisions relevant to this appeal are concerned, is in identical terms to the Limitation Act 1980 governing the position in England and Wales. The judge held (see [302] – [303]) that R1 and R2's breaches of contract were not continuous. He rejected (see [306] – [311]) Primeo's submission that the extended period of limitation under section 37 of the Limitation Law applies because R1 and R2 deliberately concealed facts relevant to the causes of action and deliberately committed the breaches of duties alleged. Accordingly, the six-year period of limitation for actions based on contract in section 7 of the Limitation Law applied. Since these proceedings were commenced on the 20 February 2013 the judge found (at [330]) that Primeo's causes of action which accrued before 20 February 2007 were statute barred.

443. The material parts of section 37 of *the Limitation Law* provide (in identical terms to sections 32(1) and 32(2) of the English Act):

> *"(1) Subject to subsection (3), where in the case of any action for which a period of limitation is prescribed by this Law, either –*
> *(a) the action is based upon the fraud of the defendant;*
> *(b) any fact relevant to the plaintiff's right of action has been deliberately concealed from him by the defendant; or*
> *(c) ...*
>
> *the period of limitation does not begin to run until the plaintiff has discovered, or could with reasonable diligence have discovered, the fraud, concealment or mistake. References in this subsection to the defendant include references to the defendant's agent, and to any person through whom the defendant claims, and his agent.*
>
> *(2) For the purposes of subsection (1), deliberate commission of a breach of duty in circumstances in which it is unlikely to be discovered for some time amounts to deliberate concealment of the facts involved in that breach of duty."*

444. Clear and authoritative guidance as to a number of the principles applicable to sections 37(1)(a) and (b) and 37(2) can be found in decisions on the identically worded sections

32(1)(a) and (b) and 32(2) of the 1980 Act. The judge referred to the decision of the House of Lords in *Cave v Robinson* [2002] UKHL 18, [2003] 1 AC 384 in which Lord Scott at [60] distinguished positive acts of concealment and concealment by omission, and to two decisions of the English Court of Appeal: *AIC Ltd v. ITS Testing Services (UK) Ltd* [2006] EWCA Civ. 1601, [2007] 1 All ER (Comm) 667 at [326] – [327] and [427] and *Arcadia Group Brands Ltd v. Visa Inc.* [2015] EWCA Civ. 883, [2015] Bus LR 1362. We derive the following propositions from these decisions:

(i) The defendant must be under a duty to inform the plaintiff of the facts in question although, where it is clear that the defendant is under a duty, the plaintiff can concentrate on the commission of the breach of duty;

(ii) The defendant must know that it had such a duty;

(iii) Knowing of its duty, the defendant nevertheless decided not to reveal the facts in question to the plaintiff and to breach the duty;

(iv) The facts in question are relevant to the plaintiff's cause of action in the sense that they are facts without which the cause of action is incomplete; and

(v) Facts which merely improve prospects of success or which bear on a matter which is not a necessary ingredient of the cause of action but which may provide a defence are not facts relevant to the claimant's right of action.

(b) The questions for decision

445. Although Primeo's grounds of appeal and its written submissions on limitation are wide-ranging, we have only four questions for decision. They are: whether the breaches of the on-going suitability and most effective safeguards duties are "*continuing*" breaches; whether BLMIS was R2's "*agent*" within section 37(1), whether Primeo's claim was based on fraud, and whether a reckless breach constitutes the "*deliberate commission of a breach of duty*" within section 37(2), and, if so, whether the breaches in this case were reckless.

446. The remaining matters on which the judge is said to have erred include his findings (references in square brackets) that Primeo:

(i) was aware of the facts amounting to the relevant breaches and the facts necessary to plead the causes of action: [309];

(ii) must have known EY was relying on custody confirmations and there was no means of independently verifying these: [306];

(iii) did not commit the breaches deliberately: [310] - [311];

(iv) had not established the four positive acts of concealment on which it relied: [306]; and

(v) had not established concealment by omission because (see [194] – [198] and [307]) R2 was not under an implied duty to inform it that it was unable properly to discharge its contractual duties.

447. Primeo also criticized the judge's failure to deal with Primeo's arguments as to why the strict liability claim could not be statute barred, and the error of any implicit conclusion that the strict liability claim was not barred, and his failure to take into account the Rs' failure to call relevant witnesses. In the event, the submission that the breaches were deliberate was not pursued. The challenges to the findings of primary fact or evaluations made from such findings as to the conduct and knowledge of R1 and R2 were either not pursued or pursued with little vigour. Mr Smith was right not to do so.

(c) Continuous Breach of Contractual Duties

448. The judge decided at [302] – [304] that although the on-going suitability and most effective safeguards duties are "*continuing*" supervisory duties the breaches of them were not continuous but periodic. Primeo's submission that the judge erred has some force in the light of R2's duty "*to be satisfied for the duration of the sub-custody agreement*" of the "*ongoing suitability*" of the sub-custodian, and the analogy it drew from the examples

of a repairing clause in a tenancy agreement in *Bell v Peter Browne & Co* [1990] 2 QB 495, 501 and a reinsurance broker's duty to remit funds received to the underwriter in *Equitas Ltd v Walsham Bros & Co Ltd* [2014] PNLR 8. But the evidence of the experts which the judge accepted poses a significant hurdle to its argument that the duty and the breach is continuous rather than periodic. In the light of that evidence and the judge's acceptance of it, his use of the term "*continuing duties*" was unfortunate. However, for the reasons in the next two paragraphs, it is not necessary for us to decide whether he was wrong.

449. During the hearing Mr. Smith accepted that the continuous breach point does not arise on the facts if, as the judge found, there were breaches by R1 and R2 of the "*ongoing suitability*" and "*effective safeguards*" duties after 20 February 2007 but prior to the Herald Transfer, including one on 23 February 2007 when R2 issued a custody confirmation. This was because Primeo accepted that only losses after 20 February 2007 would be recoverable. Mr Gillis, however, argued that the judge erred in finding that there was a breach of those duties on 23 February 2007 when the custody confirmation was issued. Issuing the custody confirmation was only the consequence of an earlier breach which occurred on 9 February 2007 when a due diligence review visit was made to BLMIS and R2 did not consider the question of safeguards. We reject this argument and agree with Mr Smith that the continuous breach point does not arise on the facts.

450. We have concluded that, whether or not the breach was continuous, an alternative way of looking at the matter is that a periodic review was required. Accordingly, the judge did not err in having regard not only to the review meeting on 9 February 2007 which he said "*triggered*" the clause 16(B) duties, but also to the issuing of the custody confirmations on 23 February 2007. We reject Mr Gillis's submission that the breach lay only in the failure at the review meeting itself to consider suitability and whether any safeguards were required. That would have put R2 in breach even if after the meeting it gave careful and appropriate consideration to these questions. It also gives insufficient weight to the importance of the decision to issue the custody confirmations which, although not part of the original custodian agreement, R2 later agreed to issue as a result of concerns by EY.

We consider that there was a breach of the duties by R2 in not revisiting the need for safeguards and ongoing suitability immediately prior to the time it issued the confirmations. This included the confirmation issued on 23 February 2007 and, as the judge decided, a fresh cause of action accrued then which is not statute barred. We are therefore left with three questions for decision.

(d) The strict liability claim and section 37(1)

451. Primeo's primary case concerns its strict liability claim against R2 and whether for limitation purposes BLMIS's fraud and deliberate concealment is to be attributed to R2. It argued that the terms "*fraud*" and "deliberate concealment" in section 37(1)(a) and (b) include the conduct of an "*agent*" and that BLMIS was R2's "*agent*" for this purpose. As BLMIS, the sub-custodian, was fraudulent and deliberately concealed facts from Primeo, R2, the custodian, was strictly liable for the acts of BLMIS. Accordingly, time under a claim founded on section 37(1)(a) or (b) did not begin to run until Primeo could, with reasonable diligence, have discovered the fraud or the concealment. As that was after 20 February 2007 no part of Primeo's strict liability claim is statute barred.

452. Primeo complained that the judge did not address its arguments as to why the strict liability claim is a claim based upon fraud within section 37(1)(a) and was therefore not statute barred. R2's response was that the judge did not need to address them because he had dismissed the strict liability claim, and because Primeo's argument on this was not pleaded, was not open to Primeo, and was first raised in Primeo's oral closing submissions. R2 also submitted that it is not open to Primeo on appeal because the factual issues it raises (primarily on the nature of the relationship between BLMIS and R2 under Luxembourg law and inconsistency with Primeo's position in litigation with Herald that Herald was not BLMIS's agent) were not put to any of the witnesses at the trial. It would have been possible for the judge to deal with this briefly as he did with other questions, such as contributory negligence, but we reject R1 and R2's suggestion that he did not need to deal with it at all. We also reject their submission that the point is not open to Primeo on appeal because of the factual issues. It involves the meaning of section 37(1), and there appears to be no inconsistency with Primeo's position in its litigation with

Herald. In both disputes its position is that BLMIS is not the agent respectively of R2 and of Herald in the sense of having authority to contract on behalf of them with third parties.

(e) The meaning of "agent" in section 37(1)

453. The terms "*fraud*" and "*deliberate concealment*" in section 37(1)(a) and (b) include the conduct of an "*agent*". Primeo's case is that, in this context, the term "*agent*" is not limited to those who are given authority to contract on behalf of a principal with third parties but has an extended meaning and includes independent contractors. Before the judge and in its written submissions for this appeal, it primarily developed this argument in relation to section 37(1)(a). It argued that the fraud of BLMIS, the sub-custodian, engaged the section *vis-à-vis* R2 because BLMIS was in the position of R2's independent contractor. Its oral submissions focused on section 37(1)(b). It argued that BLMIS's deliberate concealment of facts as R2's independent contractor engaged the section *vis-à-vis* R2.

454. The question whether the term "*agent*" in section 32(1) of the 1980 Act (section 37(1) of the Limitation Law) includes an independent contractor depends on the effect of two decisions of the English Court of Appeal on which Primeo relied and which R2 sought to distinguish. *Applegate v Moss* [1971] 1 QB 406 and *King v Victor Parsons* [1973] 1 WLR 29 involved land which a developer had sold to the plaintiff contracting that "*he*" would erect a house on it which the developer then engaged a builder to build. In both cases, the foundations laid by the builder were seriously defective. When sued, the developers argued that the claims were statute barred, but the plaintiffs successfully relied on the predecessor to section 32 of the 1980 Act, section 26 of the Limitation Act 1939. That extended the period where the cause of action was based on the fraud or the concealment of the fraud "*of the defendant or his agent*". The Court of Appeal held that the builder was the developer's agent for the purpose of the statute.

455. R2 suggested that the reason the concept of agent may have been given an extended meaning in these cases was because they involved latent damage. It also submitted that they are distinguishable on a number of grounds and should, as stated in *Deane v Coutts* [2018] EWHC 1657 (Ch) at [136], be confined to their particular circumstances and not

be seen as establishing a principle. They concerned non-delegable duties, whereas clause 16(B) expressly provided for delegation by the custodian. They involved principals (the developers) who were in a position to control the independent contractor (the builders), whereas R2 was not in a position to control BLMIS. Moreover, *Applegate v Moss* is a case in which the developer had instructed the builder to depart from the plan and so he had the requisite knowledge. R2, however, did not know of or authorize BLMIS's conduct or concealment.

456. We reject R2's submissions. *Deane v Coutts* is of very limited assistance to R2 because, as Mr Gillis accepted, the individuals who had arranged finance for the claimant footballers were not agents of the defendant banks in any sense of that word. The context of *Applegate v Moss* and *King v Victor Parsons* might have been latent damage, but the decisions concerned the construction of statutory provisions which were not confined to such damage. In any event, BLMIS's fraud was concealed and, in some sense Primeo's damage can be seen as latent.

457. It is true that in *Applegate v Moss*, the judge had held that the developer must have given instructions to the builder to depart from the plan and change the foundations and Megaw LJ based his decision on the developer's knowledge. Edmund Davies LJ, however, considered (at 415) that the word "*agent*" in the statute embraced an independent contractor, and that it did not lie in the mouth of the developer to say that what was done by the builder was not done by his agent. Lord Denning MR stated (at 413) that even if the developer knew nothing of the builder's "*disgraceful*" work he had to take responsibility for it. In *King v Victor Parsons* Megaw LJ accepted (at 37) that the effect of the approach of the majority in *Applegate v Moss* was that the knowledge of the builder may be treated as the knowledge of the developer, whether or not the developer knew of the condition of the site. We consider this to be consistent with the policy underlying the statutory extension of the limitation period. Mr Gillis was unable to offer a justification for treating the knowledge of a person or entity which has a contractual task or part of a contractual task delegated to it but fraudulently conceals its breach as

attributable to the person or entity which delegated the task when the delegate is an agent but not when it is an independent contractor.

458. We have concluded that the word "*agent*" in section 32(1) of the 1980 Act includes an independent contractor and that is also its meaning in section 37 of the *Limitation Law*. The result is that in the case of Primeo's strict liability claim, BLMIS's deliberate concealment can be treated as R2's deliberate concealment, and time is extended pursuant to section 37(1)(b). Our conclusion on this point is in principle applicable to Primeo's appeal on section 37(1)(a) but that appeal turns on whether fraud has to be a necessary part of the cause of action for a claim to fall within that provision.

(f) Action based upon fraud within section 37(1)(a)

459. Primeo submitted that time should be extended because its action is based upon fraud and is therefore within section 37(1)(a). Primeo's skeleton argument (para. 204 n.55) stated that the fraud in question "*is clearly*" a fraud in the sense required in *Beaman v ARTS Ltd* [1949] 1 KB 550. Mr Smith accepted that, on other facts, Primeo might have had an action for breach of the safekeeping duties without alleging fraud but that was not so in this case. This claim is based on fraud because the fundamental building block to the claim is BLMIS's fraud. It is the means by which Primeo establishes that there was misappropriation of its assets and therefore the breach, and that it was wilful. We reject this surprising submission. There are clear statements in the authorities that an action is "*based upon fraud*" for this purpose only when, focusing on the generic cause of action rather than the particular facts alleged, fraud is an essential element of that cause of action. It suffices to refer to Lord Greene MR and Singleton LJ in *Beaman v ARTS Ltd* [1949] 1 KB 550 at 558 and 571 and to Waller LJ in *Barnstaple Boat Co Ltd v Jones* [2007] EWCA Civ 727 at [31]. See also *Chitty on Contracts* §29-083 and McGee, *Limitation Periods* 8th ed §20.009.

(g) Reckless breach and section 37(2)

460. The final question is Primeo's appeal against the judge's conclusion (at [310]) that a reckless breach of duty which is unlikely to be discovered for some time does not suffice

to constitute the deliberate commission of a breach of duty for the purposes of section 37(2). He concluded that Mr. Fielding's conduct in relation to the NAV calculations did not amount to wilful default and that Mr. Fiorno was not conscious that what he did was a breach. Accordingly, R1, although grossly negligent, was not wilfully in breach. The Judge also relied (at [311]) on the fact that the KPMG review, gave R2 some assurance that BLMIS was not a Ponzi scheme.

461. The judge referred to Lord Millett's statement in *Cave v Robinson* at [19] that reference to the 1939 Act and the cases on it was of limited value because sections 32(1)(b) and 32(2) of the 1980 Act were designed to clarify and, if necessary, change the law by removing all references to fraud and substituting the concept of "*deliberate concealment*". He also set out Mance LJ's statement in *Williams v Fanshaw Porter & Hazelhurst* [2004] EWCA Civ. 157, [2004] 1 WLR 1318, at [31] stating that "*Cave's case decided that the wording of section 32(2) ... requires a defendant not merely to have intended to do an act which constituted a breach of duty, but also to realize that the act involved a breach of duty*".

462. Primeo maintained its reliance on the view expressed in *Clerk & Lindsell on Torts* 22 ed at 32-23, albeit with no reference to *Cave v Robinson,* that the Limitation Act 1980 preserved and confirmed the case law on section 26 of the Limitation Act 1939 that recklessness suffices. Mr Smith submitted that neither *Cave v Robinson* nor *Williams v Fanshaw Porter & Hazelhurst* were dealing with recklessness which, under *Derry v Peek* (1889) 14 App. Cas. 337, 374, qualifies as fraud. *Cave's* case only dealt with whether conduct which was merely negligent sufficed. It held that it did not, and *Williams v Fanshaw Porter* followed it.

463. We have concluded that the judge did not err on this point. It is difficult to construe the words "*deliberate commission of a breach of duty*" in section 37(2) as including recklessness, particularly since this represented a move by the legislature away from the language of fraud into which recklessness has been held to fall. For that reason, cases such as *First Subsea Ltd. v Balltec* [2017] EWCA Civ. 186 in which Patten LJ at [64]

stated a breach of trust may be fraudulent where there has been recklessness do not assist because that case concerned section 21 of the Limitation Act 1980 which uses the language of fraud rather than "*deliberate commission*". We are also not assisted by the decision in *Westlake v Bracknell DC* (1987) 19 HLR 375 because that case pre-dates *Cave v Robinson.*

464. We consider that *Cave v Robinson* does decide that recklessness does not suffice for section 32(2) and therefore for 37(2). The contrast between the first and second sentences of [25] of Lord Millett's speech may appear to provide some support for the submission that the case does not address the position of recklessness because the contrast is between the position of those who take active steps to conceal a breach of duty after becoming aware of it or who are guilty of deliberate wrongdoing and the position of those who are unaware of their error or that they have failed to take proper care. But what Lord Millett said in the first sentence is:

> "*Section 32 deprives a defendant of a limitation defence in two situations: (i) where he takes active steps to conceal his own breach of duty after he has become aware of it; and (ii) where he is guilty of deliberate wrongdoing and conceals or fails to disclose it in circumstances where it is unlikely to be discovered for some time*".

If that is put together with Lord Millett's statement (to which we have referred at [459] above) about cases on the antecedent statute it is difficult to understand it as including recklessness. It is also very hard to fit recklessness into Lord Scott's statement at [60] that:

> "*If the claimant can show that the defendant knew he was committing a breach of duty, or intended to commit the breach of duty ... each would constitute, in my opinion, a deliberate commission of the breach ...*"

Moreover, Mance LJ's statement in *Williams v Fanshaw Porter & Hazelhurst* set out by the judge and at [459] above could not be clearer.

465. In view of our decision that recklessness does not suffice, it is not necessary to make a decision on Primeo's submission that the judge's findings are sufficient to mean that section 37(2) applies in this case. However, we do not consider that either in relation to

R1's breaches in respect of the NAV calculations or R2's breaches in respect of BLMIS's suitability and failure to consider whether the Available Safeguards were needed, the breaches were reckless. The Respondents were negligent and in certain respects grossly negligent. We do not, however, consider that a finding of gross negligence against R1 in the circumstances of this case satisfies the test for reckless breach applying the test that what is required is that the individual concerned subjectively appreciated that he or she might be committing a breach but decided to take the risk anyway; see *Weavering Macro Fixed Income Fund v Peterson* [2015] (1) CILR 45 at [95] – [109] *per* Chadwick P.

466. For these reasons we reject Primeo's submissions on this part of its appeal on limitation.

XVI: CONTRIBUTORY NEGLIGENCE

(a) Overview

467. In the light of the judge's other findings the issue of contributory negligence did not fall for decision and his judgment dealt with it fairly briefly at [312] – [319]. He held that the defence of contributory negligence applies to Primeo's claim against R1 for breach of its contractual obligations under the 1996 Administration Agreement in relation to the determination of the monthly NAVs and the reports delivered pursuant to that agreement. He held that Primeo was contributorily negligent, and that the appropriate deduction was to reduce the damages awarded against R1 by 75%. Primeo appeals against the finding that it was contributorily negligent and against the amount of the deduction. The judge held that the defence does not apply to Primeo's claim against R2 for breach of clause 16(B) of the 1996 Custodian Agreement. In their Respondents' Notice, R1 and R2 submit that the judge erred in so concluding.

468. As explained by the judge, the Cayman Islands legislation was intended to amend the common law applicable in the Cayman Islands in the same way as the common law of England had been amended by the Law Reform (Contributory Negligence) Act 1945. It is now contained in the *Torts (Reform) Law (1996 Revision),* section 8(1) of which provides:

> *"Where any person suffers damage as the result partly of his own fault and partly of the fault of any other person or persons, a claim in respect of that damage shall not be defeated by reason of the fault of the person suffering the damage, but the damages recoverable in respect thereof shall be reduced to such extent as the court thinks just and equitable having regard to the claimant's share in the responsibility for the damage".*

469. The judge determined the applicability of the defence of contributory negligence to Primeo's contractual claims using the threefold classification originally formulated by Hobhouse J in *Forsikringscktielskapet Vesta v Butcher* [1986] 2 All ER 488, at 508 ("*Vesta*"). The classification was approved and used by the Court of Appeal in that case and described as "*valuable*" by Neill LJ (see [1989] AC 852, 875) and is generally accepted in subsequent decisions. The three categories are:

> *"(1) Where the defendant's liability arises from some contractual provision which does not depend on negligence on the part of the defendant.*
>
> *(2) Where the defendant's liability arises from a contractual obligation which is expressed in terms of taking care (or its equivalent) but does not correspond to a common law duty to take care which would exist in the given case independently of contract.*
>
> *(3) Where the defendant's liability in contract is the same as his liability in the tort of negligence independently of the existence of any contract."*

470. Hobhouse J and the Court of Appeal held that the defence only applies to contract claims falling within category (3); and does not apply to those falling within category (1). Only Hobhouse J referred to category (2). He stated (at 509) that there was no binding authority on the point and appeared to leave the point open. The Law Commission of England and Wales concluded that the defence does not apply to category (2): see *Contributory Negligence as a Defence in Contract* Law Com No 219 (1993) §3.29. The Commission recommended (§§4.15, 4.23-25) that it should apply in such cases unless the contract excludes it expressly or by necessary implication.

(b) The judgment below

471. **Applicability of the defence:** The judge held that the defence applies to Primeo's claim against R1 in respect of the NAV calculations, because the claim is based on an implied term in the contract to exercise reasonable care and skill which is co-extensive with the tortious duty of care which arises from the fact that R1 can be regarded as holding the office of administrator under Primeo's articles of association and is thus within category (3) of *Vesta*.

472. As to Primeo's claim against R2 for breach of clause 16(B) of the 1996 Custodian Agreement, the judge held that the defence does not apply because the claim fell within category (1) of *Vesta.* We note that clause 16(B) (see [10] above) contains three duties. The first, "*the appointment duty*", expressly requires the custodian, i.e. R2, to "*use due care and diligence in the appointment of suitable sub-custodians*. The second, "*the ongoing suitability duty*", provides that R2 "*must be satisfied for the duration of the sub-custody agreements as to the ongoing suitability of the sub-custodians to provide custodial services to the Company*". The third, "*the most effective safeguards duty*" provides that R2 "*will require the sub-custodian to implement the most effective safeguards available under the laws and commercial practices of the sub-custodian's jurisdictions in order to ensure the most effective protection of the Company's assets*".

473. The judge stated that Primeo's submission that the "*ongoing suitability*" and "*most effective safeguards*" duties required R2 to be satisfied on objectively reasonable grounds did not necessarily lead to the conclusion that there is an implied term which would be co-extensive with a tortious duty of care. He stated this was because the provision in clause 16(B) that R2 will require the sub-custodian to implement the most effective safeguards "*is not the same as a duty to safeguard the assets in the manner to be expected of a reasonably competent global custodian*". The provision in clause 16(B) was analogous to the provision in *Barclays Bank Ltd v. Fairclough Building Ltd* [1995] QB 214 requiring the defendant roofing contractor to provide the best workmanship and to comply with any legislation applicable to the works which was held to impose a category (1) obligation.

474. ***Was Primeo contributorily negligent?*** In the case of Primeo's claim against R1 in respect of the NAV calculations, the judge concluded that Primeo was contributorily negligent. At [319] he stated that:

> *"[Primeo's] decision... to establish Primeo Select as a single manager fund on the basis that its investment manager would also be allowed to act as its broker and custodian did not comply with industry standards relating to segregation of duties. The relatively high operational risks inherent in the BLMIS business model were obvious. The circumstantial evidence suggests that BA Worldwide did not perform any due diligence in 1996 before advising the directors to make this decision. Restructuring the custodian arrangements in August 2002 ... did not result (and was not intended to result) in an operational change and the risks therefore remained unchanged. By this time, Dr. Fano ... was visiting BLMIS twice a year, but she accepted, as did the directors, that Madoff would not change his business model. The evidence suggests that she was concerned to avoid upsetting Madoff, with the result that the directors did not give any consideration to ways in which the operational risks could be mitigated whilst at the same time allowing BLMIS to continue with its multi-functional role. Even after the risk of single source reporting was brought to their attention by the BA Internal Control, the directors still made no attempt to overcome the problem. Pioneer's decision to restructure Primeo Select's investments through Herald did not alter its exposure to the operational risk associated with BLMIS, as was made clear by the Pioneer Report, but the new board did not act on its recommendations. Primeo's directors and investment advisers focused on Madoff's uniquely consistent investment performance and negligently failed to pay sufficient attention to the red flags and the high risk of fraud or error inherent in his business model."*

475. ***The extent of Primeo's contributory negligence:*** The judge stated that, had he found in favour of Primeo, for the reasons he gave in the passage we have set out in the preceding paragraph, he would have reduced the damages awarded against R1 by 75% because "*Primeo was, to a very substantial degree, the author of its own misfortune*".

(c) The appeal and cross-appeal

476. **The claim against R1 under the Administration Agreement:** Primeo's appeal against the finding that it was contributorily negligent in relation to this claim is based on the principle that that a person who has instructed and employed an apparently competent

professional to carry out skilled activities is not guilty of contributory negligence. It submitted that it was entitled to trust service providers such as R1 under the 1996 Administration Agreement to do their job correctly and meet their contractual obligations. Primeo argued that it was not foreseeable that R1 would not perform its administrative duties to the normal professional standard. Primeo was not contributorily negligent by failing to supervise R1, for example on determining NAV, or R2, for example on single source reporting. Mr Smith submitted that it was for R1, an experienced administrator, and not for Primeo to determine whether single source reporting was sufficient for the determination of NAV.

477. Primeo relied on a number of authorities. It criticised the judge for not dealing with any of these and for overlooking its submissions on this point. Before us it particularly relied on *Barclays Bank Ltd v. Fairclough Building Ltd* [1995] QB 214 and *Bollom (J W) & Co Ltd v Byas Mosley & Co Ltd* [2000] Lloyd's Rep IR 136, but also referred to *Becker v Medd* (1897) 13 TLR 313 and *Compania Naviera Maropan S/A v Bowaters Lloyd Pulp and Paper Mills LD* [1955] 2 Q.B. 68.

478. We have carefully considered these decisions and the submissions skilfully made about them by Mr Smith. We have, however, concluded that they do not assist Primeo in the circumstances of the present case. They are cases about the failure of a party to supervise a person who has been engaged to carry out specified functions or to guard against the failure of the person who has been so engaged to carry out his legal obligations. They do not address R1's pleaded case which does not rely on that but on Primeo's independent fault and negligence in appointing and retaining BLMIS as broker/custodian/investment manager; a failure to conduct due diligence; and a failure to act on the conclusions in the October 2007 report by its own investment adviser, Pioneer, to which we referred at [315(vi)] above. Primeo submitted that R1's response is flawed. Mr Smith maintained that the question is whether Primeo was under some form of duty which it breached so as to be contributorily negligent and R1 did not identify a legal duty which Primeo was said to have breached. We reject this. We consider that the authorities Primeo relied on do not

preclude a finding that on the facts found by the judge it was under a duty to take sensible measures with respect to risks which it had itself identified.

479. We deal with the authorities chronologically. In *Becker v Medd* the issue was whether the plaintiff's failure to read the statements of account sent to him by the defendant, which meant that he did not see that a fraudulent book-keeper (provided to the defendant by the plaintiff) had misappropriated a number of cheques, amounted to contributory negligence. It was held that it did not. Adapting Lord Esher MR's words at 314, the defendant in that case, who had undertaken the duty to pay money received from the sale of the plaintiff's eggs into the bank, to keep accounts, and to render monthly statements could not say that he had been negligent in the performance of the duty, but that the plaintiff was guilty of contributory negligence in not finding him out.

480. *Compania Naviera Maropan S/A v Bowaters Lloyd Pulp and Paper Mills LD* is also a very different case. The ship's owner was entitled to proceed on the assumption that the charterer had complied with the obligation to nominate a safe loading place notwithstanding the master's description of it as "*very dangerous*" because he received an assurance from the experienced pilot sent by the charterers. It was therefore not a case simply about a contracting party's entitlement "*to act in the faith that the other party to a contract is carrying out his part of it properly*" (Devlin J at 77 and see Singleton LJ at 88) but a case in which the contracting party has received reassurance from that party (via a representative, the pilot). In the present case, because of the concern not to upset Mr Madoff, Primeo and those involved, such as Dr. Fano did not consider ways in which the operational risks could be mitigated whilst at the same time allowing BLMIS to continue with its multi-functional role, let alone raise those matters with him and others at BLMIS.

481. In *Barclays Bank Ltd v. Fairclough Building Ltd* Beldam LJ stated (at 226-227) that, "*generally speaking, a person could be said to have acted prudently in his own as well as other's interests if to carry out skilled work he contracts with a reputable and experienced contractor of whose work and reputation he is aware*". It is important, however, to note that immediately before those words, Beldam LJ stated: "*if the conduct*

relied on consists of an omission to guard against the failure of another person to carry out his legal obligations", in order for it to be regarded as negligent, "*it must be established that experience shows such failure to be likely*" and the failure must be "*unreasonable in all the circumstances*". It may be that is the reason that Mr Smith emphasised his submission that it was not foreseeable that R1 would not perform its administrative duties to the normal professional standard. But those words also show that Beldam LJ was addressing the position of a failure to supervise or check the defendant's conduct rather than the position where there is an independent failure by a plaintiff.

482. In *Bollom (J W) & Co Ltd v Byas Mosley & Co Ltd.,* Moore-Bick J stated (at 152):

> *"When a person engages a professional man to provide specialist services the law will not ordinarily impose a duty on that person to take steps to protect himself against the negligence on the part of someone who has himself undertaken to act with all reasonable care and skill and care".*

This again is simply an example of the fact that a person is not under a duty to supervise a professional who has contracted to carry out specified functions. A paint manufacturer who had to settle an insurance claim for fire damage for less than the loss suffered because it had failed to switch on the alarm sued the broker who arranged the cover. The broker had informed the manufacturer that the policy contained an "*Alarms and Protections Clause*" but, in breach of duty, did not explain what that meant. The broker's defence that the manufacturer's failure to read the policy was contributory negligence did not succeed.

483. We therefore dismiss this part of Primeo's appeal.

484. **The claim against R2 under clause 16(B) of the Custodian Agreement:** R2 appeals against the judge's conclusion that Primeo's claim is not subject to a defence of contributory negligence. There are two limbs to its submissions that the judge erred in concluding at [317] that there was no implied term which would be co-extensive with a tortious duty of care.

485. The first limb is that the judge's conclusion is inconsistent with his conclusions as to the nature of the duty imposed by clause 16(B) in other parts of the judgment and the views of Primeo's expert custody witness, Mr Vinella. Mr Gillis referred to the judge's statement at [193] that R2's failure to recommend to Primeo that BLMIS be required to establish a separate account at the DTC, or to make use of the ID System and establish a separate account or sub-account at BNY "*was negligent and constitutes a breach of its ... duties under clause 16(B)*". He also referred to the judge's agreement with him (at [302]) that, on its true construction, the clause "*imports the standard of the reasonably competent global custodian*", and to [322] in the summary of the Court's findings where the judge stated that it was an implied term that in performing the continuing duties under the clause R2 would exercise the care and skill to be expected of a reasonably competent global custodian.

486. As to the expert evidence, Mr Gillis relied on the way Mr Vinella put the case in paragraphs 224 and 225 of his report. Mr Vinella did so in terms of what "*a reasonably competent custodian*" would have done. He stated such a custodian would have established separate sub-accounts at the DTC and JP Morgan and thus segregated Primeo's assets. Mr Gillis submitted that the judge's conclusion was inconsistent with this.

487. The second limb of R2's submissions is that the judge erred in saying at [317] that clause 16(B) of the custodian agreement required a specified standard to be achieved by R2 rather than merely that reasonable care be exercised in carrying out the contractual tasks. It submitted that this case was not analogous to *Barclays Bank Ltd v. Fairclough Building Ltd* where the contract directly imposed a specified and strict standard. It argued that, on the basis of the judge's findings, R2 was under a common law duty to exercise reasonable care independently of the custodian agreement. This was because, under the principle discussed in *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145, 182, 189-190, it is taken to have assumed responsibility to Primeo by acting as its professional custodian. This tortious duty has a different origin and function from R2's contractual duties under

clause 16(B) but Mr Gillis submitted that it was co-extensive with them and thus within category (3) of *Vesta.*

488. Mr Smith submitted that the "*most effective safeguards*" duty is not focussed on the standard of provision of the custodial services but on achieving a particular result. Its language obliges the custodian (R2) "*to* ***require***" the sub-custodian (BLMIS) "*to* ***implement***" the most effective safeguards. We have referred (at [470] above) to the fact that clause 16(B) imposes three different duties on R2 regarding sub-custodians. While the "*appointment duty*" expressly provides that R2 is to use "*due care and diligence*", the "*ongoing suitability*" and the "*most effective safeguards*" duties do not. The judge's language in other sections of the judgment, including the references in the paragraphs relied on by Mr Gillis to the standard of the reasonably competent global custodian, which, see [256] above, he described as the "*key issue*" on clause 16(B) was loose in the sense of running the elements in the three duties together. It does not, however, necessarily follow that because the "*appointment*" and "*ongoing suitability*" duties require R2 only to use "*due care*" that the "*most effective safeguards*" duty also does.

489. Mr Gillis can legitimately claim some support for his submission from the paragraphs of Mr Vinella's evidence to which he referred (and see also paragraphs 227 and 135-136) because they were phrased in terms of what "*a reasonably competent custodian*" would do. But it does not necessarily follow that the judge's conclusion is inconsistent with Mr Vinella's evidence. It is also important to note that in those paragraphs Mr Vinella also stated that what was required was a result. He stated that the custodian was obliged to take steps "*to require BLMIS to establish a sub-account at the DTC designated in the name of Primeo, or in the alternative [R2], in accordance with its obligation to ensure the 'most effective safeguards'*". Moreover, when referring to clause 16(B), with one exception Mr Vinella's evidence does so in terms of R2 being ***required to ensure*** BLMIS implemented strict segregation of assets at the DTC, JP Morgan, and BNY: see paragraphs 47, 82, 138, 167. For example, in paragraph 138 he stated that R2:

> "*... should have taken steps to ensure that a segregated sub-account was opened at the DTC to hold Primeo's assets and/or HSBC's assets.*

> *Ensuring a segregated sub – account was in my view a requirement under clause 16(B) of the Primeo Custodian Agreement (most effective safeguards)."*

Mr Vinella's only reference to clause 16(B) which uses the more qualified language of "*due care*" is in paragraph 89 and that does so in relation only to the "*appointment*" and "*ongoing suitability*" duties.

490. What is required in determining the nature of a defendant's contractual liability is to focus on the language of the contract as a whole. In order to determine whether the liability in contract falls within category (3) of *Vesta,* the liability in contract must be "*the same as* [the] *liability in the tort of negligence independently of the existence of any contract*". In this case, the breaches were predominantly of the "*most effective safeguards*" duty.

491. Ultimately the question turns on the construction of clause 16(B). Does the fact that it imposes three different duties and makes a clear distinction in the way the "*most efficient safeguards*" one is formulated, mean that that duty, unlike the "*appointment*" duty does not impose a duty that is co-extensive with the duty in tort? Taking the parts of clause 16(B) imposing a duty on R2 in isolation, Mr Smith's points have considerable force. But a focus on the language of the contract in order to determine the nature of a person's liability in contract must reflect the clause and the contract as a whole.

492. In the present case, clause 16(B) also provides that Primeo shall indemnify R2 from "*all liabilities of whatsoever nature which may be occurred by it in performing its obligations under the custody agreement other than those liabilities resulting from fraud, negligence or wilful breach of duty".* Moreover, clause 16(E), which we have set out at [12] above, provides that the custodian shall not, in the absence of negligence or wilful breach of duty on the part of the Custodian or any agent, delegate or sub-custodian, be liable". R2's liability in respect of the "*most efficient safeguards*" duty arises only where it has failed to take appropriate care.

493. In assessing whether R2's liability under clause 16(B) arises only because it has failed to take appropriate care, significant guidance is given by the indemnities in clauses 16(B) and 16(E). They both exonerate R2 as Custodian in respect of all liabilities other than those resulting from negligence or wilful breach of duty on the part of the custodian or any agent appointed by it, and, in the case of clause 16(E), negligence or wilful breach of duty on the part of any "*delegate or sub-custodian*". Clause 16(B) also excludes liability arising from fraud from the exoneration. These exonerating indemnities are what was described in *Smith v South Wales Switchgear* [1978] 1 WLR 165 at 168 and 172 as "*the obverse of an exempting clause*" and, like exemption clauses, the duty/liability imposing parts of 16(B) must be interpreted taking them into account: see Lewison, *The Interpretation of Contracts* 6th Ed., 2017 §12.15.

494. The effect of these provisions is that unless the custodian, here R2 or its agent, is negligent or in wilful breach of contract it is indemnified from all liabilities. We have concluded that this means that R2's liability arises only because it has failed to take appropriate care. Accordingly, notwithstanding what would otherwise appear to be the unqualified language and absolute terms of the most effective safeguards duty in Clause 16(B), that duty is in reality a duty to exercise reasonable skill and care in connection with the most effective safeguards.

495. We have considered whether, although R2's contractual duty under clause 16(B) is in reality a duty to exercise reasonable skill and care in connection with the most effective safeguards, it does not correspond to the common law duty of care which would exist independently of the contract. If so it would fall within category (2) of *Vesta,* and R2 could not rely on Primeo's contributory negligence as a defence. The view of leading commentators is that following the decision in *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145 it will be rare for a case to fall within category (2) rather than category (3): see *Chitty on Contracts* 33rd Ed., 2018, Ed Beale, §26-085 n. 490; Treitel, *The Law of Contract* 14th Ed. 2015, ed Peel, §20-125 n 793; Burrows, *A Restatement of the English Law of Contract* 2016, p 132. It is stated by Treitel, *op cit* that the effect of *Henderson v*

Merrett Syndicates Ltd in practice reflects the recommendation of the Law Commission to which we referred at [470] above.

496. We have concluded that R2's duty does not fall within category (2). For the reasons given at [492] – [494] above, the overall effect of clause 16(B) in the light of the exonerating provisions in it and in clause 16(E) is that R2 is under no liability unless it is negligent. Its liability thus arises from a contractual obligation which in substance is to exercise reasonable skill and care in connection with the most effective safeguards, and thus, for the reasons set out in the preceding paragraph, falls within category (3).

497. We therefore allow R2's appeal on this ground.

498. **The extent of Primeo's contributory negligence:** The judge held that Primeo's damages against R1 under the administration agreement be reduced by 75% because it was, to a large extent, the author of its own misfortune. Primeo appeals against that decision.

499. The principles governing the review by an appeal court of an apportionment of fault by a trial judge were discussed by the United Kingdom Supreme Court in *Jackson v Murray* [2015] UKSC 5, [2015] RTR 20. In summary, they are that, when determining the appropriate reduction, the court must have regard both to the blameworthiness of each party, and also the relative importance of each party's act in causing the damage, but no court can arrive at an apportionment that is demonstrably correct: [20], [27] and [46]. Lord Reed stated (at [27]):

> *"The problem is not merely that the factors which the court is required to consider are incapable of precise measurement. More fundamentally, the blameworthiness of the pursuer and the defender are incommensurable."*

The consequence is that apportioning blame is a rough and ready exercise essentially for the trial judge on which different judges might legitimately take different views on the appropriate reduction and an appellate court should only interfere where the judge has

gone wrong in principle, has misapprehended the facts, or is "*clearly wrong*": see [28], [29] and [45] - [46].

500. In *Jackson v Murray* Lord Reed stated (at [37]:

> "[E]*ven in the absence of an identifiable error, a wide difference of view as to the apportionment which is just and equitable, going beyond what Lord Fraser [in G v G (Minors: Custody Appeal) [1985] 1 WLR 647, 652] described as the generous ambit within which a reasonable disagreement is possible, can in itself justify the conclusion that the court below has gone wrong.*"

He took as an example *National Coal Board v England* [1954] AC 403, in which the House of Lords set aside a 50% apportionment and held that the damages should be reduced by only 25%. He stated that in that case Lord Reid observed at p 427 that it was not right to disturb the trial judge's apportionment lightly, but that "*the difference between holding the parties equally to blame and holding the one's share of responsibility to be three times that of the other is so substantial that we should give effect to it*".

501. The issue is thus whether the judge's decision to make a deduction of 75% fell outside the broad range of outcomes within which reasonable disagreement is possible. Primeo submitted that it is, that the judge plainly erred, and that we should undertake a fresh assessment. R1's response was that the judge was directed to the correct principles and applied them to the facts. He was entitled to conclude on the evidence and the submissions that Primeo was to a substantial degree the author of its misfortunes.

502. As to the errors, Primeo submitted that the judge did not give a satisfactory explanation as to why P was more blameworthy than R1. That is a submission about the reasons given rather than the underlying substance. The underlying substance is to be found in the second limb of this submission. Primeo submitted that R1 was more to blame because it is a professional service provider under a specific contractual obligation to monitor BLMIS and investments placed with BLMIS and with a particular responsibility to determine the monthly NAVs. It argued that the failures the judge identified at [319] of

his judgment which we have set out at [474] above as constituting negligence by Primeo applied with even greater force to R1.

503. Primeo also argued on the basis of Carnwath J's judgment in *British Racing Drivers Club Ltd v Hextall Erskine & Co (a Firm)* [1996] BCC 727, at 742 that the judge erred in attributing BA Worldwide's failings in relation to, for instance, due diligence, to Primeo. We do not consider that Primeo is assisted by *British Racing Drivers Club Ltd v Hextall Erskine & Co*. It concerned a scenario in which a decision that the defendant solicitors could rely on the contributory negligence of the directors of the plaintiff company would defeat the purpose of the statutory scheme in section 320 of the Companies Act 1985. Here there is no statutory scheme which would be defeated by attributing BA Worldwide's failings to Primeo. Moreover, there is no appeal against the judge's finding in [32] – [33] that the knowledge of BA Worldwide can be attributed to P as a matter of principle.

504. In resisting this part of Primeo's appeal, Mr Gillis submitted that what he described as the judge's primary findings on contributory negligence at [319] are succinct but comprehensive. He also sought to support those findings by findings of fact recorded in other parts of the judgment. We have said that, since the judge's other conclusions meant contributory negligence by Primeo did not fall for decision, it is understandable that at the end of a long judgment he dealt with the topic succinctly. That this is permissible if done appropriately is seen from *Jackson v Murray* where Lord Reed, when setting aside a finding by the Inner House of the Court of Session that a young girl who suffered personal injuries was 70% to blame, and replacing it with a finding that she was 50% to blame said only:

> *"As it appears to me, the defender's conduct played at least an equal role to that of the pursuer in causing the damage and was at least equally blameworthy." (at [43])*

505. The findings in other parts of the judgment that Mr Gillis relied on are that: (a) Primeo must be taken to know that it was not possible to verify independently the transactions and assets reported by BLMIS and that R1 and R2 were performing their services on the

basis of single source reporting: see [87] and [215]); (b) Primeo accepted the high operational risk inherent in BLMIS's business model: see [38]; and (c) Bank Austria participated in the promotion and formation of Alpha and Herald as new Madoff feeder funds in 2003 and 2004: see [95] –[96] and [100]. We accept R1's submission that the judge was entitled to make these findings. While a brief reference in [319], for example to "*the findings I made earlier*" might have been helpful, it is clear that the factors to which the judge refers in [319] relate to findings made earlier in the judgment.

506. We are conscious of the fact that the judge formed his view after a long trial involving many witnesses, of what Lord Hoffmann said in *Biogen Inc. v Medeva Plc* (see [127] above) about the need for caution in interfering with evaluative findings, and of the force of the points made on behalf of R1. Nevertheless, we accept Primeo's submissions.

507. We have concluded that in the light of R1's status as a professional administrator and the tasks assigned to it by the contract, attributing 75% of the fault to Primeo is well outside the broad range of outcomes within which reasonable disagreement is possible and is clearly wrong. We do so in the light in particular of the fact that R1 was performing a professional service and was given the specific task of monitoring BLMIS. It had particular responsibility for determining NAV and issuing NAVs and did so knowing that nothing had been done to verify the existence of assets. It did not make Primeo's Board aware of the concerns being expressed internally in R1 and HSBC about the concentration of functions and lack of transparency at BLMIS and that there was a risk that the assets did not exist. Indeed, at Board meetings in 2003 and 2004 Mr Fielding provided reassurance to Primeo's Board.

508. Bearing in mind that the factors which we are required to consider are incapable of precise measurement and the keenness of Primeo to invest wholly in BLMIS, we have concluded that R1's conduct played at least an equal role to that of Primeo in causing the damage and that it was at least equally blameworthy. In *Jackson v Murray* Lord Reed concluded (at [44]) that the view that parties are equally responsible for the damage suffered "*is substantially different from the view that one party is much more responsible than the other*" and that "[s]*uch a wide difference of view exceeds the ambit of*

reasonable disagreement and warrants the conclusion that the court below has gone wrong". For these reasons we would therefore allow this part of Primeo's appeal and would order that its damages against R1 be reduced by 50%.

XVII: Summary of Conclusions

509. For the reasons set out in the section on reflective loss above, Primeo's appeal against the dismissal of its claim for damages is dismissed.

510. However, many other points have been argued and we summarise below our conclusion on the key points.

511. We uphold the judge's decision that BLMIS was R2's sub-custodian from the date of the 2002 Sub-Custody Agreement but not before. We also uphold his decision as to the interpretation of Clause 16(B) of the 1996 Custodian Agreement and the fact that it was binding upon R2.

512. As to the strict liability claim, we uphold the judge's decision that R2 is strictly liable for the breach of duty by BLMIS but we overrule his conclusion that Primeo suffered no relevant loss as a result. In our judgment, Primeo suffered a loss every time money intended for investment was misapplied by BLMIS and the Herald Transfer did not extinguish such loss. Quantification of such loss would require a further hearing should that become necessary.

513. As to R2's own breach of the Custodian Agreement, we uphold the judge's finding that R2 was in breach of Clause 16(B) in failing to recommend the Available Safeguards.

514. As to the Administration Agreement, we uphold the judge's conclusion that R1 was not grossly negligent before April 2005 but was grossly negligent (and therefore liable) thereafter.

515. In relation to causation, our conclusions are as set out at [348].

516. As to limitation, we conclude as follows:-

(i) The strict liability claim is not time-barred because BLMIS is to be treated as the agent of R2 and accordingly its deliberate concealment is to be treated as that of R2 under Section 37(1)(b).

(ii) We uphold the judge's decision that the claims against R2 for its own breach of the Custodian Agreement and against R1 for breach of the Administration Agreement are time-barred in relation to any breaches which occurred before 20 February 2007.

517. As to contributory negligence, our conclusion is as follows:-

(i) We uphold the judge's conclusion that contributory negligence is applicable to the claim against R1 for breach of the Administration Agreement.

(ii) We overrule the judge's decision in relation to R2's own breach of the custodian agreement and hold that contributory negligence is applicable thereto.

(iii) We overrule the judge's assessment of the degree of contributory negligence and assess 50% as the appropriate figure.

518. However, for the reason as stated at [509] above, this appeal is dismissed.

Field, JA

Birt, JA

Beatson, JA.