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Gross Negligence Revisited

***Primeo Fund (In Official Liquidation) and Bank of Bermuda (Cayman) Limited, HSBC Securities Services (Luxembourg) SA* (Cayman Islands Court of Appeal 13 June 2019).**

In recent years the conduct of professional service providers in the Cayman Islands has come under scrutiny by the courts in respect of their failure to prevent large scale investment fund frauds. This has included auditors, administrators and custodians, as well as persons serving as independent directors. A recurring issue in professional negligence litigation in the Cayman Islands is the scope of exculpatory and indemnity provisions which typically require proof of wilful neglect or default or gross negligence before liability can be established.

In *Weavering Macro Fixed Income Fund Limited (In Liquidation) -v- Peterson and Ekstrom* (the "Company"), the Company's articles of association protected directors from liability for conduct falling short of "wilful neglect or default". The Court of Appeal held[1] that in order to overcome this hurdle it was necessary for the Company to prove "*that the director made a deliberate and conscious decision to act or to fail to act in knowing breach of his duty: negligence, however gross, is not enough*."[2] The Court of Appeal also observed that for a director to be liable on the basis of being recklessly careless, in the sense of not caring whether his act or omission is or is not a breach of duty, he had (at the least) to suspect that his conduct might constitute a breach of duty in order for such conduct to constitute wilful neglect or default. The Court reversed the decision of the trial Judge and held that the facts did not support the Judge's inference in that case that the directors had consciously chosen not to perform their duties to the Company.

In *Primeo Fund (In Official Liquidation) and Bank of Bermuda (Cayman) Limited, HSBC Securities Services (Luxembourg) SA*[3] the Court of Appeal has recently had to consider the meaning of the common exclusion for acts and omissions falling short of "gross negligence". Primeo was an investment fund promoted, marketed and managed by Bank Austria AG, which invested its funds in a managed account with Bernard L Madoff Investment Securities LLC ("BLMIS") owned and controlled by the now long-term guest of the US Federal Bureau of Prisons, Bernard Madoff. It was a feature of the business model of BLMIS that it operated as investment manager, broker and custodian, and its trading strategy remained secret. The liquidators of Primeo brought claims against the Bank of Bermuda (Cayman) Limited, as administrators, and HSBC Securities Services (Luxembourg) SA, as custodian, for damages for breach of contract and negligence on the basis that, had they fulfilled their legal duties, Primeo would have withdrawn its funds from BLMIS prior to the discovery of the fraud and invested elsewhere. Ultimately the claims failed on the basis that the loss was not recoverable under the principle of "reflective loss", but the case provides some useful analysis of the gross negligence standard.

The Administration Agreement required the administrator to calculate NAV on each valuation day and it was not disputed that there was an implied term that such calculation had to be carried out using the care and skill of a reasonably competent mutual fund administrator carrying on business in the Cayman Islands. However, the Agreement excluded liability unless the Administrator was guilty of gross negligence or wilful default.

It was held by the trial Judge that although administrators were not expected to perform audit procedures, nevertheless they were required to satisfy themselves that the published NAV was accurate and that involved a matter of professional judgment. It involved both the pricing of assets, which would be done by reference to independent pricing services, and also the verification of the existence of assets by the process of reconciliation. It was this latter task that was at issue. The key question was whether in the circumstances arising out of the Madoff managed account business model a reasonably

[1] 2015 (1) CILR 45
[2] Paragraph [95]
[3] Unrep. 13 June 2019

competent administrator could have satisfied itself about the existence of assets by reconciling two streams of information received from BLMIS alone. The Judge held, after hearing expert evidence, that it could not.

However, the Judge found that although negligent, the administrator's failures did not constitute gross negligence until it became aware that, in simplified terms, the fund auditors, EY, had become unwilling to accept asset confirmations from BLMIS own auditors, and thereafter were relying upon the custodian's confirmations, which the administrator knew had not been independently verified. That constituted a serious disregard by the administrator of the risks associated with relying upon information supplied by BLMIS and amounted to gross negligence. These findings were upheld by the Court of Appeal.

The Court of Appeal re-affirmed that gross negligence means simply "very great", "extreme" or "flagrant" negligence[4] and approved the observation of Sir Robin Auld in the Privy Council in *Spread Trustees -v- Hutcheson* [5] that the terms "negligence" and "gross negligence" differ only in the seriousness of the want of care they describe – a difference of degree, not of kind.

The Court of Appeal pointed out that different judges may have different views as to exactly where in a particular case the boundary is to be drawn, and that the Appellate Court would only interfere with the assessment of the trial judge if it could be shown that he had clearly erred in his evaluation.[6]

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[4] Paragraph [282(i)]
[5] [2012] 2 AC 194 at Paragraph [117]
[6] Paragraph [297]