

IN THE GRAND COURT OF THE CAYMAN ISLANDS

FINANCIAL SERVICES DIVISION

Cause No. FSD 30 of 2013 (AJJ)

BETWEEN :

PRIMEO FUND (In Official Liquidation)

Plaintiff

And

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

Defendants

In Open Court

Appearances: Mr. Tom Smith QC, Mr. Richard Fisher and Mr. Robert Amey instructed by Mourant on behalf of the Plaintiff

Mr. Richard Gillis QC, Mr. William Willson, Mr. Toby Brown and Mr. Simon Gilson instructed by Campbells on behalf of the Defendants

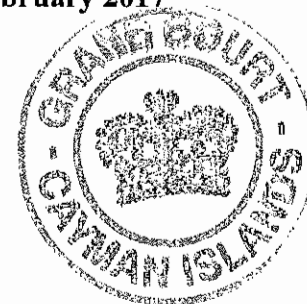
Before : **The Honourable Mr. Justice Andrew J. Jones QC**

Heard:: **7 to 12 November, 15 to 24 November and 28 November to 15 December 2016, 9 to 27 January and 13 to 21 February 2017**

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Judgment Delivered: 23 August 2017

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JUDGMENT

A. General Introduction

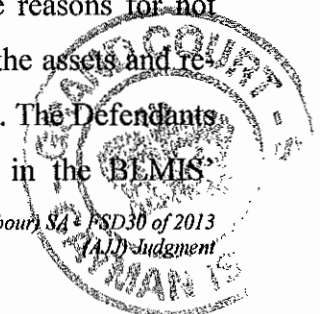
1. The plaintiff in this action, Primeo Fund (In Liquidation) (“Primeo”), was one of many hedge funds, the so-called “Madoff feeder funds”, whose assets were placed on a managed account with Bernard L. Madoff Investment Securities (“BLMIS”) which turned out to have been the world’s largest and most enduring Ponzi scheme. Primeo, now acting by its official liquidators, brings this action to recover damages of about US\$2 billion for breaches of contract against its former administrator, Bank of Bermuda (Cayman) Limited (“BoB Cayman”), and its former custodian, HSBC Securities Services (Luxembourg) SA (formerly known as Bank of Bermuda (Luxembourg) SA) which I shall refer to as “BoB Lux” and “HSSL” depending on the context. The Bank of Bermuda group (“BoB”) was taken over by HSBC Bank Plc (“HSBC”) in February 2004.

2. Primeo claims that, upon a true construction of the custodian agreement made on 19 December 1996 (“the 1996 Custodian Agreement”), HSSL is strictly liable for the negligent or wilful breaches of duty committed by BLMIS in its capacity as sub-custodian. In addition, Primeo claims damages against HSSL on the footing that it was in breach of its own duties in connection with the appointment and on-going supervision of BLMIS as its sub-custodian. HSSL’s case is that BLMIS held the assets credited to the managed account as custodian directly for Primeo and that the sub-custody agreements were made for “credit purposes only” and were not intended to take effect in accordance with their terms and, even if BLMIS was appointed as sub-custodian, the express terms of the 1996 Custodian Agreement excluded liability for the safekeeping of the assets held by BLMIS.

3. Primeo claims damages against BoB Cayman for breach of the second administration agreement made on 19 December 1996 (“the Second Administration Agreement”) pursuant to which it was responsible for maintaining its books and records and

determining the NAV per share as at the last day of each month. The performance of the administrator obligations by BoB Cayman was largely delegated to BoB Lux pursuant to a delegation agreement. At the core of the administration claim is a dispute about the role of independent fund administrators and the nature and extent of BoB Cayman's contractual obligations in relation to the determination of the NAV per share. Primeo contends that it was an implied term of the contract that the administrator would exercise the reasonable care and skill to be expected of a reasonably competent independent fund administrator which would require that information received from BLMIS be reconciled with information received from an independent source. The Defendants' case is that, on a true construction of the Second Administration Agreement, BoB Cayman was entitled to rely upon the information provided to it by or on behalf of Primeo and that there was no obligation to obtain confirmation from an independent source. In any event, it is exonerated from liability unless it was "grossly negligent" or in "wilful default".

4. Primeo also contends that it was an implied term of both the 1996 Custodian Agreement and the Second Administration Agreement that the Defendants would advise Primeo if in the circumstances they were unable to discharge properly their duties and explain their reasons for not being able to do so (referred to as the "advising duty") and exercise reasonable care and skill to ensure that any reports issued to Primeo were accurate and included all the information of which it was aware or ought to have been aware, which would be necessary to enable Primeo to evaluate whether the Defendants were performing their duties (referred to as the "reporting duty"). The Defendants say that there is no proper basis for implying these duties into the contracts and, in any case, deny that they would be in breach.
5. Primeo's causation hypothesis is that the Defendants ought to have concluded that, in the light of BLMIS' business model, they were unable to perform their contractual duties and, having informed Primeo of their concerns about BLMIS and the reasons for not being able to perform their obligations, Primeo would have withdrawn the assets and re-invested elsewhere, thereby avoiding the eventual loss of its investments. The Defendants contend that Primeo well understood the operational risks inherent in the BLMIS



business model and would have continued to have placed assets (directly or indirectly) for investment by Mr. Bernard L Madoff (“Madoff”) in any event. Even if Primeo can make out its case on causation, the Defendants say that it was the author of its own misfortune and that any award of damages should be substantially reduced by reason of its own contributory negligence.

6. Finally, even if Primeo can establish all the elements of its case in respect of duty, breach, causation and loss, the Defendants contend that its loss is reflective of the losses suffered by two other Madoff feeder funds, Herald Fund SPC (“Herald”) and Alpha Prime Fund Limited (“Alpha”). With effect from May 2007, substantially the whole of Primeo’s assets were invested in shares issued by Herald and Alpha and it said that the losses claimed against HSSL by Primeo are not separate and distinct from the losses claimed against HSSL by Herald and Alpha, with the result that Primeo’s claim in this action should be barred by the rule against recovery of reflective loss.

B. The Madoff Ponzi Scheme

7. In order to put the issues raised in this action into their proper context, it is necessary to describe the nature and extent of the Madoff Ponzi scheme which first came to light on 11 December 2008. The evidence before the Court comprises an expert report prepared by Louis J. Freeh (“Judge Freeh”) which is based upon information gathered from numerous public sources, including the report of the Office of Investigations of the Securities and Exchange Commission (referred to as “the OIG Report”)¹ and the Dubinsky Report². Judge Freeh is a lawyer who began his career as a special agent of the Federal Bureau of Investigation. He served as an assistant US Attorney for the Southern District of New York and in 1991 was appointed as a judge of the US District Court for the Southern District of New York. In 1993 he was appointed as Director of the Federal

¹ Securities and Exchange Commission, Office of Investigations’ Report No. OIG-509 entitled *Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme*, published on August 31, 2009.

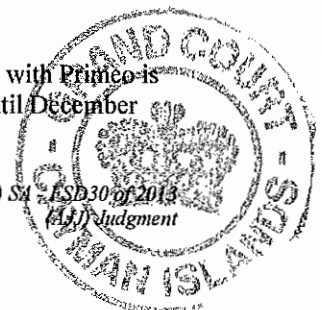
² The expert evidence of Bruce G. Dubinsky dated 26 January 2012 and prepared for the purposes of an action before the US District Court for the Southern District of New York between Irvin H. Picard, Trustee for the Liquidation of Bernard L. Madoff Securities LLC as plaintiff and Saul B. Katz et al. as defendants.

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Bureau of Investigation and served in this office until 2001. Following a period as general counsel for a national bank, Judge Freeh established his own business as a risk management consultant. In these various capacities, he has acquired enormous experience of investigating, prosecuting and adjudicating upon serious financial fraud matters. He has provided the Court with a description of Madoff's business and an analysis of his fraud which I found to be both authoritative and helpful.

8. The events giving rise to this claim began at the end of 1993, by which time Madoff was already a well-known and respected figure in New York's financial services industry. His securities business had been founded and registered with the Securities and Exchange Commission ("SEC") as a broker-dealer in 1960. He established his business as a sole proprietorship under the name Bernard L. Madoff Investment Securities and it was not incorporated until 1 January 2001, whereupon he became the company's sole shareholder and director. I shall refer to it as "BLMIS" without distinguishing between the sole proprietorship and the company. It was one of the five original broker-dealer members of Nasdaq Stock Market and from 1979 Madoff served on the National Association of Securities Dealers ("NASD") committee that helped create an electronic trading platform linking the regional stock exchanges with the New York Stock Exchange ("NYSE"). Madoff served as a director of numerous industry bodies. From 1985, he served four consecutive terms on NASD's Board of Governors. He was Chairman of Nasdaq's Board of Directors from 1991-1993. He was also appointed by the SEC to several of its committees, including (in September 2000) the Advisory Committee on Market Information.
9. Four of those who have given oral evidence to this Court met Madoff at BLMIS' office in New York at various times. Mr. Peter Fischer ("Mr. Fischer")³ met him in the early 1990s at a time when he was employed by Österreichische Länderbank AG. Dr. Stefan

³ Mr. Fischer was Group Treasurer of Bank Austria between 1987 and 1998. His only involvement with Primeco is that he served as one of the Bank Austria nominees on its board of directors for about three years until December 1998 when he left the bank's employment.



Zapotocky (“Dr. Zapotocky”)⁴ met him in the latter part of 1993 in connection with the initial selection of investment managers for Primeo. Mr. Nigel Fielding (“Mr. Fielding”)⁵ met Madoff three times. He first met him briefly in 2000 and later had two relatively lengthy meetings in July 2002 and again in March 2004 for the purposes of conducting due diligence on behalf of BoB Lux. Mr. Brian Pettitt (“Mr. Pettitt”)⁶ met Madoff three times. He had a relatively lengthy due diligence meeting with him in April 2005 and two shorter meetings in February 2007 and November 2008. The last of Mr. Pettitt’s meetings took place only about 3 weeks before Madoff admitted his fraud. All of these witnesses were experienced industry professionals when they met Madoff and they were all impressed with him. Their reaction was not unusual and is a reflection of the fact that Madoff had established a reputation as a capable and successful businessman whose integrity was generally taken for granted by those who dealt with him, including the SEC’s examiners and investigators.

10. BLMIS was engaged in three distinct areas of business, namely market making, proprietary trading and investment management. The market making and proprietary trading was a real business engaged in genuine securities trading activity on a very large scale. BLMIS developed a reputation as a big, successful player in the market and by the 1990s it is widely believed that at least 10% of all the trades on the NYSE were conducted through BLMIS. In 2006, Madoff claimed that BLMIS was conducting 15% of

⁴ Mr. Zapotocky was employed by Bank Austria as head of its Securities Division. As such, he was responsible for managing Bank Austria’s investment banking operations which included capital markets, asset management and brokerage. He was a director of Primeo from inception until leaving the employment of Bank Austria in 2000, when he became joint CEO of the Vienna Stock Exchange. In 2003, he participated in the promotion of another Madoff feeder fund called Alpha Prime Fund Limited which is described in paragraphs 89-92 below. Dr. Zapotocky is still a director of Alpha.

⁵ Mr. Fielding was employed by BoB Lux in various capacities from March 1999 onwards. He played an important role in the events relevant to this action and served as a director of Primeo from August 2000 to October 2006.

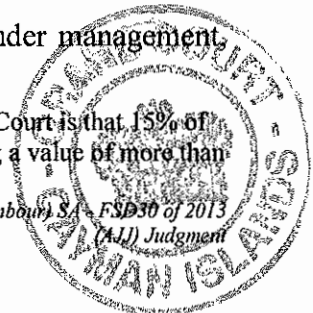
⁶ Mr. Pettitt was employed by HSBC Bank Plc in London and served as Head of Network Management for HSS in which capacity he played a role in connection with Primeo after the BoB Group was taken over by HSBC Bank Plc. in 2004.

the annual total trade volume of the US equity market.⁷ This business was conducted from offices at 885 Third Avenue, New York in which several hundred were employed. Based upon the financial information filed with the SEC, Madoff appeared to be a highly successful and extremely wealthy businessman with a net worth of hundreds of millions of dollars.

11. In contrast to its market making and proprietary trading business, BLMIS' investment advisory business was wholly fictitious. It never engaged in any securities trading or investment management activities on behalf of its clients at all. It was run from an entirely separate and self-contained office on the 17th floor of 885 Third Avenue (known as "House 17") where Mr. Frank DiPascali ("Mr. DiPascali") and a loyal team of up to 20 staff, acting under Madoff's supervision, conducted what is now considered to be the largest and most remarkable Ponzi scheme of all time. It is, I think, important to emphasize that the "Madoff fraud" was actually a team effort. Without a loyal and highly capable team of co-conspirators, it would not have been possible to carry on a Ponzi scheme on this scale, without detection, for as long as three decades. Mr. DiPascali pleaded guilty to various fraud charges and gave evidence against his fellow employees, eleven of whom either pleaded guilty or were convicted of various charges connected with the fraud. His evidence to the US District Court leads to the conclusion that this was a highly sophisticated fraud and it goes a long way towards explaining how Madoff avoided detection for so long in spite of three examinations and two investigations by the SEC and two fraud risk reviews conducted by KPMG.
12. BLMIS was registered with the SEC as a broker-dealer for some 48 years, but it avoided registering as an investment adviser under the Investment Advisers Act 1940 apparently on the basis that it was not charging fees to its clients and had fewer than 20 of them. When finally required to register in August 2006, BLMIS claimed to have 23 customer accounts with \$11.7 billion of assets under management. As late as 2008, Madoff was still claiming to have just 23 customer accounts with \$17.1 billion under management.

⁷ The First KPMG Report records Madoff as having said this. If true, the evidence before the Court is that 15% of the NYSE trade volume would amount to an average of more than 500,000 trades a day, having a value of more than \$10 billion.

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whereas in fact there were over 4,900 active customer accounts with a reported \$68 billion under management.

13. Madoff's team of dishonest staff included two computer programmers who developed customized software designed to record fictitious transactions and generate false trade confirmations, statements, management reports and IRS 1099 Forms. This was a closed circuit system run in House 17 which was entirely separate from the system used in the main office (known as "House 5") where genuine transactions were recorded and processed. These programs were able to generate tens of thousands of fake trade confirmations every month and allocate a pro rata share of them to each customer account. They were able to verify that the prices reflected in the fictitious trades were within the actual trading price range for those securities on the day in question.
14. BLMIS maintained an account (number 0646) with the Depository Trust Company ("the DTC")⁸ through which actual trades transacted by House 5 were settled, but no securities trades were ever transacted for any of the House 17 clients, including Primeo. The customized software generated replicas of customer position statements from the DTC, populated with fictitious holdings to make it appear that BLMIS actually had custody of the securities reflected on the trade confirmations and month end statements sent to its clients. These fake DTC position reports were highly convincing and successfully deceived both SEC examiners/investigators and KPMG forensic accountants.
15. An essential member of Madoff's team of co-conspirators was Mr. David Friehling ("Mr. Friehling"). He was a certified public accountant who carried on business in Rockland County, New York as a sole practitioner under the firm name of Friehling & Horowitz, CPA, P.C. ("F&H").⁹ F&H was engaged as BLMIS' auditor over a long period of time, but Mr. Friehling subsequently admitted that he had never in fact performed any real

⁸ The DTC is the world's largest securities depository. It serves as a clearing house in the United States for the settlement of securities trades and performs custody and related services for its participating banks and broker-dealers.

⁹ The OIG Report indicates that F&H's personnel comprised just Mr. Friehling and a secretarial assistant. Jerome Horowitz had retired and was living in Florida.

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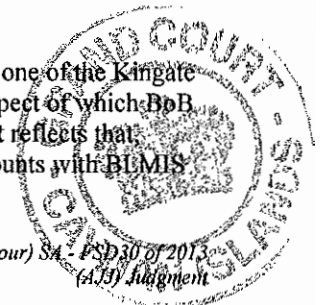
audit work at all. He merely lent his firm's name to a series of false audit opinions, internal control reports and other documents which were in fact produced by Madoff's own staff. In order to avoid subjecting the firm to the American Institute of Certified Public Accountants' ("AICPA") peer review program, Mr. Friehling claimed that F&H was not performing audit work for any clients at all. In November 2009, he pleaded guilty to filing false audit reports for BLMIS and filing false tax returns for Madoff.

16. On any view, the Madoff fraud was highly sophisticated and 'successful' in the sense that it continued, undetected, for almost three decades. Judge Freeh's conclusions included the following statement --

In my experience in federal investigations, prosecutions, litigation (and in the area of fraud in general), I have never seen such a sophisticated, elaborate infrastructure and operation for deceit and deception that served to protect an underlying fraud scheme of such mammoth proportions – worth billions and billions of dollars – all of which was devised and orchestrated by a man of such apparent integrity and achievement. This was an historic fraud.

17. Madoff's personal reputation was closely linked with BLMIS' high profile and apparently successful market making and proprietary trading business and tended to obscure the fact that his investment advisory business was not universally well regarded. In May 2001, *MAR/Hedge* published a report entitled *Madoff tops charts; skeptics ask how*. This report was based upon the published results of four Madoff feeder funds¹⁰ and it questioned their unusually consistent returns (lack of volatility), the secretive nature of Madoff's operations and the reasons for not charging any investment management fees. The report contains some highly critical comments about BLMIS' investment advisory business together with some rather unconvincing explanations from Madoff. For example, when asked why he did not charge management fees, he is quoted as saying "We're perfectly happy making the commissions" by trading for the funds. In a

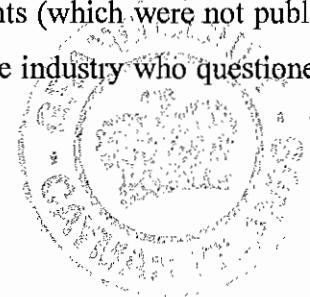
¹⁰ The funds are (1) Fairfield Sentry Ltd, (2) one of the funds managed by Tremont Partners, (3) one of the Kingate Funds (in respect of which BoB Ltd was custodian) and (4) Thema International Fund Plc (in respect of which BoB Group companies acted as custodian and administrator). Documentary evidence before the Court reflects that, collectively, the managers responsible for these funds placed over US\$9 billion on managed accounts with BLMIS commencing in the early 1990's.



subsequent article published in *Barrons*, it was pointed out that the fees which would normally be charged on a \$6 billion fund generating 15% annual returns would add up to \$240 million a year which Madoff was forgoing for no apparent reason. The fact that Madoff did co-operate with the author of the *MAR/Hedge* report no doubt helped maintain his credibility, but the report's concluding paragraphs reflect adversely on the standing of BLMIS' investment advisory business. It states –

Still, when the many expert skeptics were asked by MAR/Hedge to respond to [Madoff's] explanations about the funds, the strategy and the consistently low volatility returns, most continued to express bewilderment and indicated they were still grappling to understand how such results have been achieved for so long.

18. The OIG Report states that between June 1992 and December 2008 the SEC received six substantive complaints concerning Madoff's hedge fund operations which should have led to questions about whether he was actually engaged in any legitimate trading. One such complaint was received from a "respected Hedge Fund Manager" identifying numerous concerns about Madoff's strategy and purported returns and questioning whether Madoff was actually trading options in the volume he claimed. In fact, BLMIS was not engaged in any real options trading at all. The complainant noted that BLMIS' purported strategy and returns were not duplicable by anyone else. The Plaintiff's investment expert, Mr. Tim Thompson ("Mr. Thompson")¹¹, described the equity-like returns with bond-like volatility purportedly produced by Madoff 's investment strategy as "the holy grail" which is unachievable in the real world. Although Madoff eventually attracted as much as \$25 billion from a large number of hedge fund managers (the so called "Madoff feeder funds"), the existence of these complaints (which were not public knowledge at the time) is evidence that there were others in the industry who questioned whether the "holy grail" really was being achieved.



¹¹ Mr. Thompson is a highly experienced investment banker currently employed as a senior advisor to GLC Advisors & Co., LLC, based in New York. He was engaged by the Plaintiff to give expert evidence on investment management issues.

19. In conclusion, it is clear that Madoff was a well-known and respected figure on Wall Street long before he was introduced to Primeo's promoter in 1993 and he continued to maintain this image until the end. BLMIS' market making and proprietary trading business was a very large, respected and apparently profitable business. However, from the mid-1990s, its investment advisory business was the subject of increasing skepticism amongst some in the hedge fund industry who could not understand how the Madoff feeder funds, including Primeo, were able to achieve equity-like returns with bond-like volatility. Madoff's business model was also the subject of criticism, not least amongst executives of BoB (and, later, HSBC), some of whom even commented that it *could* conceal a Ponzi scheme. However, in spite of the red flags,¹² there is no evidence that any of those involved with Primeo actually believed or seriously suspected that BLMIS was in fact a huge Ponzi scheme.

C. Establishment of Primeo Fund

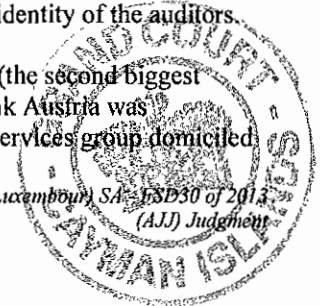
Role of Bank Austria and Mrs. Sonya Kohn

20. Primeo was promoted, marketed and managed by Bank Austria AG ("Bank Austria") which was (and still is) the largest banking and financial services business in Austria.¹³ Its Securities Division comprised a number of business lines including the largest brokerage business in Austria and a substantial asset management business which had assets under management of about 300 billion Austrian schillings as at 31 December 1992, then the equivalent of about US\$25.25 billion. It also had a custodian business which was operated as part of its Securities Division until the mid-1990s when it was separated for regulatory reasons.

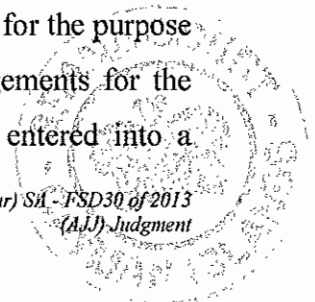
¹² The red flags included the unique business model and obsession with confidentiality; the implausibly consistent investment returns; the implausibly high level of options trading; the fee structure; and the identity of the auditors.

¹³ Bank Austria was the product of the merger in 1991 of Österreichische Länderbank AG (the second biggest commercial bank in Austria) and Zentralsparasse (the biggest savings bank in Austria). Bank Austria was subsequently taken over and became part of the UniCredit Group, a banking and financial services group domiciled in Italy.

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21. The investment products then offered by Bank Austria included around 150 domestic investment funds mostly denominated in Austrian schillings. In 1993, it was decided to enlarge this product range to include an alternative investment fund which would provide its European client base with an exposure to the US equity market. For this purpose, Bank Austria turned for advice to Mrs. Sonja Kohn (“Mrs. Kohn”). She was proprietor of an investment advisory business called Euovaleur Inc. (“Eurovaleur”) which had offices in New York and Vienna. She had known Madoff since the late 1980s and, by the time Bank Austria went to her for advice, she had already introduced Madoff to a Swiss investment firm called Genevalor, Benbassat et Cie (“Genevalor”). It established two hedge funds called Lagoon Investment Limited (“Lagoon”) and Hermes International Fund Limited (“Hermes”) in 1992. Lagoon established a managed account with BLMIS through which three sub-funds placed assets under management. Both these funds appointed The Bank of Bermuda Limited (“BoB Ltd”) as custodian (which in turn appointed BoB Lux as sub-custodian). BoB Lux was also appointed administrator for Lagoon and sub-administrator for Hermes (Hermes’ administrator was BoB Limited until October 2003, and Management International (Bermuda) Limited thereafter).
22. At this time, the head of Bank Austria’s Securities Division was Dr. Zapotocky, whom Mrs. Kohn had known for a numbers of years. In 1993, he travelled to New York to meet Mrs. Kohn who introduced him to a number of investment managers with whom the proposed new fund might make investments, including BLMIS. He met with Madoff during the course of this visit. His evidence is that he was “truly impressed by the size of [Madoff’s] business and his knowledge” and that the decision to include BLMIS amongst the managers with whom the proposed new fund would invest was made at this time.
23. Having already met certain BoB Lux executives through Hermes/Lagoon, Mrs. Kohn introduced them to Bank Austria. A fee proposal for acting as custodian and administrator was sent to Mrs. Kohn on 23 September 1993. She arranged a meeting, which was held at Bank Austria’s office in Vienna on 12 November 1993, for the purpose of introducing the relevant people and discussing administrative arrangements for the proposed fund. On the same day, Mrs. Kohn’s company, Eurovaleur, entered into a



formal consultancy services agreement with Bank Austria. In addition to Mrs. Kohn, the meeting was attended by Mr. Austin J. O'Connor ("Mr. O'Connor")¹⁴ and Mr. J. Christopher Wilcockson ("Mr. Wilcockson")¹⁵ on behalf of BoB Lux and Dr. Zapotocky, his then assistant Dr. Werner Kretschmer ("Dr. Kretschmer") and various others on behalf of Bank Austria.

24. Of those present at this meeting, only Dr. Zapotocky has given evidence in this trial. He said that Bank Austria relied on Eurovaleur and BoB Lux for advice about how to structure the new fund which was to be Primeo. He said that Primeo was "not structured by Bank Austria". It is inherently improbable that Bank Austria would rely upon BoB Lux, as the proposed custodian and administrator, for advice about how to structure its own fund. BoB Lux's call report of the meeting suggests that the Bank Austria team had been working on the project for some time and that the structure of the fund had already been determined by this stage. Dr. Zapotocky also said that Bank Austria selected BoB as a service provider "because of evidence that they already had know-how in connection with [BLMIS]". Again, it seems inherently improbable that Bank Austria would have engaged BoB Lux merely because its Dublin affiliate had a pre-existing knowledge of one particular investment manager out of the 10-15 managers with whom Primeo was intending to invest.
25. Under the heading "Formation Services", BoB Lux's Fee Schedule provided for "A fee of US\$10,000 for reviewing the Offering Memoranda, assisting with the preparation of agreements, liaising with lawyers and accountants and generally assisting with the launch of the Fund." The contemporaneous documentary evidence reflects that Bank of Bermuda (New York) Limited had provided Mrs. Kohn with some generic advice in June 1993, including advice about listing hedge funds on the Irish and Luxembourg stock exchanges. BoB Lux did in fact review Primeo's Offering Memorandum and drafted the

¹⁴ Mr. O'Connor was the managing director of BoB Lux from 1992 to 1998. He served as a director of Primeo from 24 January 1994 until 15 July 1996.

¹⁵ Mr. Wilcockson became a director of BoB Lux with effect from 2 January 1998 and was Managing Director from 2008 until 2011. He was Global Head of Global Fund Services (GFS) for the BoB Group. He never served as a director of Primeo.

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administration and custodian agreements, but there is no documentary evidence which supports Dr. Zapotocky's assertions that BoB Lux had any role in the determination of Primeo's structure.

26. Dr. Kretschmer was not called to give evidence, but written summaries (rather than verbatim transcripts) of the evidence given by him in various proceedings in Austria have been admitted pursuant to hearsay notices. There is nothing in his evidence which supports Dr. Zapotocky's assertions about BoB's role in the establishment of Primeo. In his evidence to Judge Wagner given on September 15, 2010, Dr. Kretschmer said that he had been entrusted by his boss, Dr. Zapotocky, with co-ordinating the establishment of Primeo "sort of as project manager" but he made no reference to BoB at all. I formed the view that Dr. Zapotocky's evidence about BoB Lux's role in the establishment of Primeo is not reliable. It is not supported by the contemporaneous documentary evidence. 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.

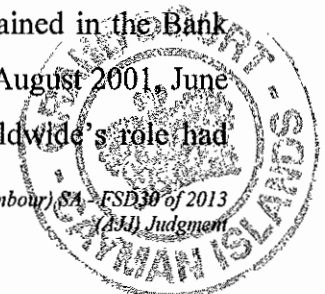
Role of BA Worldwide Fund Management, Ltd

27. BA Worldwide Fund Management, Ltd ("BA Worldwide") was incorporated on 29 September 1993 as the special purpose vehicle through which Bank Austria would manage and market Primeo. It was incorporated in the British Virgin Islands for tax reasons but its business was carried out by staff working from Bank Austria's offices in Vienna. Throughout the first 10 years of its existence, managing and marketing Primeo appears to have been BA Worldwide's only business. By an Advisory Agreement dated 15 December 1993, BA Worldwide was appointed as Primeo's investment advisor and by a Sub-Advisory Agreement made on 1 January 1994, BA Worldwide appointed Eurovaleur as sub-advisor. Although described as an "adviser", BA Worldwide's actual role, as described in the Offering Memorandum, was to "provide investment advice and management decisions" subject to the overall direction of Primeo's board of directors, all

of whom were initially Bank Austria employees. I reject the suggestion that it merely had a marketing function.

28. The original managing director of BA Worldwide was Dr. Kretschmer. As such, he was the senior Bank Austria executive responsible for the day to day management of Primeo. From 1995, he was assisted by Dr. Ursula Fano (“Dr. Fano”) who had joined the Securities Division with no prior relevant experience as an asset manager. In her evidence given to an Austrian court in 2009, she said “Initially my responsibility was to assist Dr. Kretschmer. Only afterwards did I gradually familiarize myself with the transactions, eventually becoming a hedge fund specialist.” She succeeded Dr. Kretschmer as managing director of BA Worldwide in 2000, although she was already performing a management role in respect of Primeo before taking up this appointment. Dr. Zapotocky sought to downplay her role by characterizing her as a “secretary” or “clerk”. I do not accept this evidence. Even if this is an accurate description of her original role in 1995, it is clear from the documentary evidence that she acquired an important managerial role in relation to Primeo at least from the year 2000 onwards. The fact that Dr. Fano was able to earn (in addition to her salary from Bank Austria) consultancy fees of €800,172 in 2007 and €1,058,782 in 2008 “primarily from two management companies of investment funds – in connection with the establishment and structuring of funds, performance management control and administrative activities” is wholly inconsistent with the notion her role in connection with Primeo was not managerial.

29. Those former Bank Austria employees who gave evidence, namely Dr. Zapotocky, Mr. Fischer and Mr. James O’Neill (“Mr. O’Neill”), all sought to distance Bank Austria (and themselves) from Primeo and to emphasize the roles of the BoB group companies. In their capacities as directors of Alpha, which is currently suing HSSL, Dr. Zapotocky and Mr. Fischer have a personal interest in the outcome of this case. Their evidence that BA Worldwide essentially only performed a marketing function is inherently improbable. It is also inconsistent with the description of its business activities contained in the Bank Austria internal audit reports. Whilst the reports in evidence are dated August 2001, June 2003 and August 2006, there is no reason to suppose that BA Worldwide’s role had



materially changed since the time that Dr. Zapotocky and Mr. Fischer were involved in the mid 1990s. Apart from selecting and appointing the other professional service providers, these reports describe its role as preparing offering memoranda, selecting the investments and investment strategies, monitoring investment performance, instructing auditors, monitoring subscriptions and redemptions, cash management and conducting plausibility checks on the monthly NAVs prepared by the administrator. BA Worldwide also performed its own due diligence which involved Dr. Fano visiting BLMIS's office twice a year from 2000 onwards.

Attribution of knowledge

30. It is important for the purposes of this case to identify those persons whose knowledge is properly attributable to Primeo. The UK Supreme Court reviewed the law on attribution in *Bilta (UK) Limited (In Liquidation) v. Nazir (No.2)* [2015] UKSC 23, in which it endorsed the approach previously taken by Lord Hoffmann in *Meridian Global Funds Management Asia Ltd v. Securities Commission* [1995] 2 AC 500 and held that -

In most circumstances the acts and state of mind of its directors and agents could be attributed to a company by applying the rules of the law of agency, but ultimately the key to the question of attribution was always to be found in considerations of context and the purpose for which the attribution was relevant; that where the purpose of the attribution was to apportion responsibility between a company and its agents so as to determine their rights and liabilities to each other, the result would not necessarily be the same as it would be in a case where the purpose was to apportion responsibility between the company and a third party;

In *Sagicor General Insurance (Cayman) Ltd v. Crawford Adjusters (Cayman) Ltd* [2011] 1 CILR 130, Henderson J. adopted this approach and said –

Where an individual represents the “directing mind and will” of the company, his intention or state of mind should be attributed to the company. The individual concerned need not be the central directing mind and will but may instead be the person whose functions within the company lead in all the circumstances to the conclusion that his actions or state of mind must be regarded as that of the company. This will usually depend upon the particular task or duty under consideration.

31. In general a company is deemed to have notice of anything of which any of its directors obtains knowledge in the course of performing his duties. This is so because the law attributes to the company the mind and will of the person(s) who manage and control its acts. Until May 2007, Primeo was ultimately controlled by Bank Austria which held (through a wholly owned subsidiary) all of the Founder Shares which carried all the voting rights. It arranged for Primeo's board of directors to comprise a number of Bank Austria Group employees. It also arranged for HSSL to be represented on the board, but the knowledge of those directors nominated by HSSL will not be attributed to Primeo for the purpose of considering its claims against the Defendants themselves.
32. Primeo's directors performed the high level supervisory role normally performed by non-executive directors of hedge funds. Day to day managerial control rested with BA Worldwide until 25 April 2007 and thereafter with Pioneer Alternative Investment Management Limited ("Pioneer")¹⁶. During this period, Mr. O'Neill and Mr. Hannes Saleta ("Mr. Saleta") were directors of both BA Worldwide and Primeo.¹⁷ After Pioneer took over the role of investment adviser, two of its most senior executive directors also served as directors of Primeo. In these circumstances, the knowledge of the investment advisers and their directors should be imputed to Primeo. It follows, in particular, that the knowledge of Dr. Fano should to be imputed to Primeo, firstly in her capacity as managing director of BA Worldwide and, from 25 April 2007 onwards, in her capacity as a director of Primeo.
33. Unlike Dr. Kretschmer and Dr. Fano (acting through BA Worldwide), I think that Mrs. Kohn's role (acting through Eurovaleur) was a purely advisory one. By its terms, the Sub-Advisory Agreement made on 1 January 1994 between Eurovaleur and BA Worldwide does not provide for BA Worldwide to delegate the performance of any of its functions to Eurovaleur. Whilst Mrs. Kohn was an influential voice, I do not think that

¹⁶ By 2007, BA Worldwide and Pioneer were both wholly owned members of the UniCredit Group.

¹⁷ Mr. O'Neill was managing director of Bank Austria (Cayman) Limited and Mr. Saleta was an employee of a Bank Austria group company in Vienna.

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her knowledge should be imputed to Primeo because it cannot be said that she had any actual decision making role.

D. BLMIS' Business Model and Investment Strategy

34. The business model adopted by Madoff in respect of his investment management business was unique in that BLMIS acted in a triple capacity as broker-dealer, investment manager and custodian. Normally these functions would be performed either by three wholly independent entities or by separate subsidiaries of one of the large banking and financial services groups, acting behind strictly controlled Chinese walls. In the case of BLMIS, these three functions were not only carried out through a single legal entity, they were actually performed by a team of about 20 staff working in a single office without any departmentalization.
35. The investment strategy purportedly adopted by BLMIS on behalf of Primeo Select (and its other clients) is described in Primeo's April 2007 Offering Memorandum (at page 8). This statement does not appear in earlier versions of the Offering Memoranda but Mr. Thompson, the plaintiff's investment expert, agreed that it does fairly reflect the investment strategy (purportedly) adopted throughout the relevant period. It is summarized as follows -

The strategy utilized by [BLMIS] is called "split-strike conversion" and entails –

- (a) purchasing a basket of thirty (30) to sixty (60) large capitalization 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 dollar 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.*

36. Primeo Select was as an absolute return fund with a hedging strategy. There is nothing unusual about the split-strike conversion strategy as such, but Madoff claimed to have a unique methodology which justified keeping BLMIS's role as investment manager

absolutely confidential. Pioneer attempted to describe his methodology in its last Primeo Fact Sheet (October 2008) as follows –

The key driver behind Primeo Select's robust resilience in times of markets stress is the underlying manager's proven asset allocation strategy: when the manager believes market conditions are unfavourable for the split-strike conversion strategy, the manager shifts its allocation to a portfolio of short-dated U.S. Treasury Bills. As soon as the manager believes that favourable market conditions have returned, the allocation is shifted back into the split-strike conversion strategy to capture opportunities once again.

In fact, BLMIS almost invariably reported that it had bought and sold the entire equity portfolio within each month, so that the month end statements reflected only a portfolio of Treasury Bills. A further consequence of this methodology is that Primeo's brokerage commission expense (charged at 4 cents per share) was very high.¹⁸

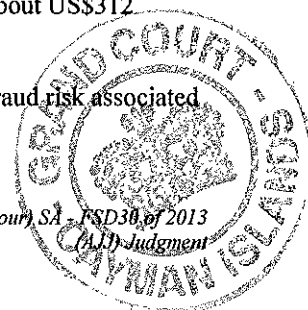
37. The First KPMG Report¹⁹ sets out the way in which this investment strategy was implemented. BLMIS had discretionary power to buy and sell securities and enter into options on behalf of its clients without reference to their investment advisers/managers. Trading on behalf of Primeo was done without reference to BA Worldwide or receipt of a proper instruction from BoB Lux as custodian. BLMIS purported to execute block trades with market counterparties which were settled through its account with the DTC in the case of the US equity stocks or its account with Bank of New York ("BNY")²⁰ in the case of US Treasury Bills. The bulk trades were then allocated, as agency trades, to each of the clients, as reflected on BLMIS's trade blotter. From the clients' perspective, BLMIS made the investment decision in its capacity as investment manager; it then executed the trades with itself in its capacity as broker-dealer; and finally held the securities itself in its capacity as custodian. Any cash was held in BLMIS's own account with JP Morgan Chase Bank NA ("JP Morgan") co-mingled with both other clients' cash and its own

¹⁸ For example, in the year ended 31 December 2002 (when Primeo Select had gross assets of about US\$312 million), it paid US\$3,272,904.96 to BLMIS by way of commission.

¹⁹ The report dated 6 February 2006 commissioned by HSBC for the purpose of analyzing the fraud risk associated with BLMIS, the details of which are discussed in paragraphs 125 to 132 below.

²⁰ BNY acts as a custodian of Treasury Bills as agent of the US Department of the Treasury.

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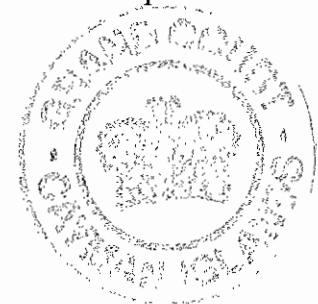


cash. Madoff represented to BoB Lux, initially in a written *Sub-Custodian Due Diligence Questionnaire* completed in July 2002 and thereafter in a number of due diligence meetings, that client assets were held in a segregated account (#0646) at the DTC, separate from BLMIS's proprietary assets. This was untrue. In fact, BLMIS only ever had one account with the DTC.

38. The result of employing this business model was that all of Primeo Select's invested assets were in fact held in the custody of BLMIS. The securities were not entered into the custody records maintained by BoB Lux's Global Custody Department (using software called *Trustware*) and were therefore not reflected in the monthly holdings reports issued to BA Worldwide. Trade confirmations were generated by BLMIS in respect of each purchase and sale of securities. These were sent by mail or fax (several days after the transaction date) to the Alternative Accounting & Valuation department of BoB Lux ("A&V") and were then entered into its client accounting records (using software called *Geneva*). Month end position statements were also generated by BLMIS and sent to A&V which then reconciled them with the accounts which had been generated from BLMIS' own trade confirmations. Because BLMIS insisted upon performing the triple function of investment manager, broker and custodian, its clients' other professional service providers were left in the position of having to rely upon single source information. BLMIS' unique business model was essential for the purposes of running a Ponzi scheme but this is of course one of the reasons why it was (and still is) conventional practice for the core functions involved in the management of hedge funds to be segregated amongst multiple independent professional service providers. Primeo, like all the other Madoff feeder funds, accepted the uniquely high operational risk inherent in BLMIS' business model as the price to be paid for Madoff's uniquely consistent investment performance and they did so for almost 20 years.

E. Factual Chronology – 1994 to 2008

The 1994 Brokerage Agreements



39. Primeo placed funds for investment by BLMIS from its inception. The initial sum of US\$1 million was transferred by BoB Lux's Global Custody department to BLMIS on 23 December 1993. The instruction reflects that it was originally intended that the account would be established in the name of BoB Lux on behalf of Primeo. BLMIS sent a set of printed standard form agreements to BoB Lux's Global Custody department which forwarded them to Bank Austria on 5 January 1994, indicating a willingness to sign them on behalf of Primeo subject to receiving confirmation of Bank Austria's acceptance of the terms and conditions. In the event, the Customer Agreement, Option Agreement and Trading Authorization (referred to collectively as "the 1994 Brokerage Agreements") were executed by Dr. Zapotocky and Dr. Peter Scheithauer ("Dr. Scheithauer")²¹ in their capacity as directors on behalf of Primeo whose address was stated to be its registered office in the Cayman Islands. BoB Lux added its name/address stamp to each of these documents. The choice of law clause in the Customer Agreement was completed by inserting the laws of Austria. BLMIS then set up account number 1FN060 on its books in the name of *Primeo Fund* ("the 1FN060 Account"). Dr. Zapotocky and Dr. Scheithauer also signed an IRS Form W-8 confirming Primeo Fund's foreign status and beneficial ownership of the account for US tax purposes.
40. Based upon the 1994 Brokerage Agreements, BLMIS managed Primeo's funds in accordance with its established business model. No investment management agreement was ever executed. Nor was any custodian agreement executed until 2002 when BLMIS entered into a sub-custody agreement with BoB Lux. BLMIS did not charge any investment management fee or any custody fee. The only fee ever charged to Primeo was a brokerage commission of 4 cents per share, which actually translated into a relatively high annual expense for Primeo because Madoff's investment methodology purportedly involved buying and selling a portfolio of S&P500 stocks every month.

***Restructuring of Primeo's Participating Shares in January 1996
Establishment of the Primeo Global and Primeo Select***

²¹ Dr. Scheithauer was a director of Primeo from inception until May 2000 during which time he was Head of Bank Austria's International Division.

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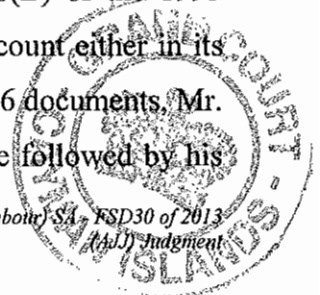


41. Primeo was originally launched as a fund of funds, having a single share class, and an initial capital of US\$19 million, of which US\$10 million was subscribed by Bank Austria itself. Its shares were listed on the Irish Stock Exchange. The original asset allocation, approved by a written resolution of the board of directors signed on December 20, 1993, comprised the sum of US\$1 million placed on the managed account with BLMIS together with equity investments in 19 investment funds, companies and partnerships. The first year of Primeo's operations reflected a negative investment performance with its NAV having declined to US\$17.29 million (US\$8.78 per share). BLMIS performed relatively well, with the result that the percentage of the invested assets attributable to the managed account increased from 5.26% at inception to 7.96% as at the 31 December 1994 financial year end. In its second full year of trading, Primeo's investment performance improved in that the NAV per share increased from US\$8.78 to US\$9.38, but the total NAV actually declined by a small amount because redemptions exceeded subscriptions by a substantial margin. Again, BLMIS produced a positive investment performance and, as at the 31 December 1995, the amount credited to the managed account represented 9.50% of Primeo's total NAV.
42. In December 1995, it was decided, on the advice of Mrs. Kohn, to restructure Primeo by dividing its participating shares into two classes which would constitute two sub-funds, each having a different investment strategy. The participating shares in issue as at 1 January 1996 were converted into Series A shares and the assets attributable to them were invested as a multi-manager fund of funds. These shares continued to be listed on the Irish Stock Exchange. On 1 March 1996, 184,000 Series B shares were issued at US\$10 per share and the whole of the proceeds was placed with BLMIS for investment in accordance with Madoff's split-strike conversion strategy. These shares were not listed on the Irish Stock Exchange. Bank Austria switched part of its proprietary investment by redeeming Series A shares and re-subscribing for Series B shares on the March and May redemption dates for total value of US\$2.2 million. In this way, Primeo was converted into two sub-funds and in October 1996 they were re-named as Primeo Global (being the fund of funds) and Primeo Select (being the single manager fund).

43. By 31 December 1996, Primeo's total NAV had increased to about US\$26.22 million of which about US\$11.83 million was attributable to Primeo Global and US\$14.39 million was attributable to Primeo Select. Thereafter, Primeo Select consistently outperformed Primeo Global with the result that the NAV of Primeo Global declined whilst that of Primeo Select increased. By 31 December 1998, Primeo Global's NAV was down to about US\$2.58 million and Primeo Select's NAV was up to about US\$106.32 million. With effect from 30 April 2001, Primeo Global was closed to new investors and the outstanding shares were compulsorily redeemed for a total amount of about US\$2.28 million. As at the 2001 year end, Primeo Select had about US\$285 million credited to its managed account with BLMIS and a total NAV of just under US\$279 million.

The 1996 Brokerage Agreements

44. The restructuring of Primeo into two sub-funds led to the execution of a new set of BLMIS standard form account documentation. A Trading Authorization was executed on 29 February 1996 and a Customer Agreement and an Option Agreement were also executed, probably on 11 March 1996. I refer to these agreements collectively as "the 1996 Brokerage Agreements". An IRS Form W-8 BEN was executed, probably on 11 March 1996, and there is also an unsigned BLMIS account information form. The 1994 and 1996 Brokerage Agreements were executed on identical BLMIS printed standard form documents. The only difference is that the governing law clause in the 1996 Customer Agreement contains a selection of Luxembourg law, whereas the 1994 Customer Agreement is expressed to be governed by Austrian law.
45. The 1996 Brokerage Agreements were executed by Mr. O'Connor who was at that time a director of BoB Lux and also a director of Primeo. Under Clause 6(B) of the 1993 Custodian Agreement, BoB Lux had authority to open a brokerage account either in its own name on behalf of Primeo or in Primeo's name. On each of the 1996 documents, Mr. O'Connor wrote *Primeo Fund Class 'B'* on the customer/signature line followed by his



signature. Each document bears the BoB Lux name/address stamp. BLMIS established a new account numbered 1FN092 on its books in the name *Primeo Fund - Class 'B'* (“the 1FN092 Account”). For the reasons explained in paragraphs 142 to 145 below, I have come to the conclusion that the customer under the 1996 Brokerage Agreements continued to be Primeo (not BOB Lux acting on behalf of Primeo) and that the legal owner of the new 1FN092 Account was Primeo.

The 1996 Offering Memorandum

46. The issue of new share classes also required that a revised offering document be issued and filed pursuant to the Mutual Funds Law. The revised Offering Memorandum is dated January 1996 and was re-issued in November 1996 to reflect a change of name from Series A and B to Primeo Global and Primeo Select. It stated that –

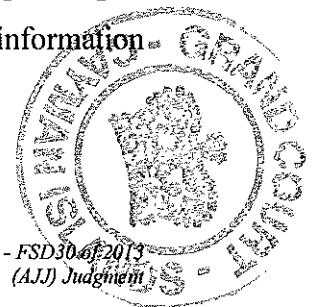
The Fund will utilize [BA Worldwide] (which may select one or more Managers) in managing the Primeo Fund Select Shares. (Page 3 of the November version).

For funds invested in Primeo Fund Select Shares, the Fund will reduce risk through diversification in U.S. - equity investments. It is expected that funds will be invested in highly liquid U.S. listed equities, including those in Standard & Poors 500 Index and which have a correlation to such index, and in equity options. The portfolio will typically have approximately 20-30 highly liquid positions in U.S. equities and will have positions in related options. (Page 4 of the November version).

The 1996 Offering Memorandum did not disclose the board of directors’ actual intention that Primeo Select would be a single manager fund with all of its assets placed on a managed account with BLMIS. It is significant that Primeo’s board of directors and its investment advisers, BA Worldwide and Eurovaleur, were always willing to accommodate Madoff’s insistence upon extreme confidentiality, to the extent that BLMIS’ actual role as the investment manager of Primeo Select was never disclosed in any of its Offering Memoranda. Nor did the Offering Memoranda disclose that any manager might perform the triple function of investment manager, broker and custodian. Mrs. Kohn even tried to persuade Primeo’s professional service providers to refrain from mentioning Madoff and BLMIS by name in their internal correspondence.

The 1996 Custodian and Administration Agreements

47. Primeo's original class of shares had been listed on the Irish Stock Exchange since 1994. The effect of the restructuring was that the existing shares (re-named Primeo Global) continued to be listed and in November 1996 the board resolved to make application for the new Primeo Select shares to be listed. In order to comply with the amended listing rules (which were published on 29 November 1996 and came into effect from 1 January 1997), it became necessary to make certain amendments to the 1993 Custodian and Administration Agreements and new agreements were executed on 19 December 1996.
48. The 1996 Custodian Agreement is in substantially the same terms as the previous agreement except that it includes a new Clause 16(B) dealing with the appointment and on-going supervision of sub-custodians. It is clear from a letter sent on 13 December 1996 from BoB Ltd's legal department in Bermuda to Dr. Fano that this clause was included in the new agreement for the purpose of conforming with the Irish Stock Exchange's requirements.
49. The new listing rules also required that the administrator and custodian of an investment fund be separate legal entities. For this reason, the 1996 Administration Agreement is made with BoB Cayman which simultaneously entered into a delegation agreement with BoB Lux, the result of which was that BoB Lux continued to perform practically all of the same work, but did so as sub-administrator for BoB Cayman. In these circumstances, it is not disputed that the knowledge of BoB Lux should be imputed to BoB Cayman. The terms of the 1996 Administration Agreement differ from the previous one in two material respects. First, Clause 9.2 relieves the administrator from liability in the absence of "gross negligence or wilful default" whereas the previous exculpatory provision applied in the absence of "negligence or wilful breach of duty". Second, Clause 9.5 imposes upon the administrator an obligation to use reasonable endeavours to verify pricing information supplied by the investment adviser.



50. An application to list the Primeo Select shares was made to the Irish Stock Exchange but the board subsequently resolved, at its meeting on 12 June 1997, not to proceed. The reason for this decision is not stated in the board minutes, but an e-mail written over two years later (on 5 August 1999) by Dr. Fano to Mr. David Bailey (“Mr. Bailey”)²² tends to suggest that it was related to Madoff’s insistence that BLMIS’s name should not be disclosed in the Offering Memorandum as the investment manager. Mr. Bailey said in evidence that this was in fact the reason why the application was not pursued. This decision is indicative of Primeo’s increasing reliance upon BLMIS for its investment performance. It is also indicative of the directors’ willingness to accept the risks inherent in BLMIS’s business model, including Madoff’s insistence upon an extreme degree of confidentiality.

Marketing Primeo’s shares in Austria

51. Both the Primeo Global and Primeo Select shares had been marketed in Austria since June 1997 when a public offering first took place. In 1999 there were discussions involving Mr. Bailey, Dr. Fano and Dr. Kretschmer about the possibility of transferring Primeo’s legal domicile to Luxembourg and converting it into a UCITS fund²³ which could then be registered and marketed in Germany.

52. On 10 February 1999 Mr. Bailey wrote to Dr. Fano and Dr. Kretschmer setting out a short explanation of the basic steps required to re-domicile Primeo to Luxembourg. Under the heading ‘Impact on the Existing Funds’, he suggested that BA Worldwide might take the opportunity to terminate Primeo Global since its NAV of US\$2.5 million was relatively small compared with Primeo Select (about US\$106 million as at 31 December 1998). As regards Primeo Select, he said –

²² Mr. Bailey was a client relationship manager employed by BoB Lux. He was responsible for the Bank Austria relationship and served as a director of Primeo from January 1998 until August 2000 when he left the employment of BoB.

²³ UCITS is the acronym for “Undertaking for Collective Investment in Transferable Securities”. It refers to European Directive 85/611/EEC dated 20 December 1985 which set up a single regulatory regime across the European Union for open-ended funds investing in transferrable securities (such as those supposedly owned by Primeo) with a view to defining high levels of investor protection.

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As you are aware all of the assets of the Select fund are maintained via Madoff. This includes both the management and custody of the assets. Under the terms of Luxembourg law it is necessary to appoint a Luxembourg domiciled Custodian. The Bank may be able to appoint the entity used by Madoff as our "sub-custodian", although this is subject to the identity of that entity and receipt of due diligence information. There will need to be regular reconciliation between two sets of records which could increase administration charges.

It is apparent from this statement that Mr. Bailey did not consider BoB Lux to have any custodial responsibility in respect of the assets held on the managed accounts.

53. In the event, as recorded in Mr. Bailey's call report in respect of the Primeo board meeting held on 13 October 1999, it was decided not to re-domicile Primeo to Luxembourg because the Austrian tax advantages associated with a Cayman Islands fund were more valuable to Bank Austria than the marketing capabilities of a Luxembourg UCITS fund. An alternative mechanism for establishing the right to market Primeo Select in Germany was to list its shares on the Munich Stock Exchange which the board resolved to do on 15 September 2000.

The 2001 Offering Memorandum

54. Sometime around the beginning of 2001, it was decided to issue a new class of Euro denominated shares in respect of Primeo Select which was then divided into two sub-funds called *Primeo Select Fund* and *Primeo Select Euro Fund*. This decision required that a revised Offering Memorandum be issued and filed with the Cayman Islands Monetary Authority ("CIMA").²⁴
55. It was also decided that Primeo Global would be closed to new investors with effect from 1 February 2001 and its outstanding shares were compulsorily redeemed on 30 April 2001. From this point onwards, Primeo was a pure Madoff feeder fund but this fact was never disclosed in its Offering Memoranda. The Global sub-fund ceased to exist in the

²⁴ CIMA was established in 1996 and performed functions in respect of mutual funds previously performed by the Inspector of Banks and Trust Companies.

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sense that it had no assets and liabilities but no steps were taken to terminate the Global share class with the result that it continued to be described in the 2001 Offering Memorandum and subsequent revisions. No new shares were ever again issued but the Global share class was not actually terminated until April 2007.

56. The issue of a Euro denominated share class was not associated with any change in the investment strategy. Therefore, from 1 May 2001 onwards, Primeo became a single manager fund with the whole of its invested assets placed on its managed account with BLMIS. The 2001 Offering Memorandum stated (at page 3) that “The Select Fund has been, since inception, managed by one Manager through a managed account, with all assets of such series in one managed account.” It did not identify the Manager as BLMIS.
57. A new statement was included (twice) in the 2001 Offering Memorandum in relation to the operational risks associated with this managed account. An entirely new paragraph was included in the Risk Factor section, as follows (on page 4) –

Managed Accounts.

The Fund may allocate certain money to investment managers running managed accounts. In such a case, the Administrator and the Custodian receive statements of the managed account as well as transaction slips for every security transaction only. Any loss arising as a result of an investment in a managed account will be borne by the Shareholders.

58. This language was repeated, *verbatim*, in that section of the Offering Memorandum which describes the custodian and administration agreements (on page 13). As amended, the description of the 1996 Custodian Agreement is as follows -

Pursuant to a custodian agreement dated December 19, 1996 the Custodian agrees to act in such capacity in accordance with the Articles of Association and the terms of such Agreement (the “Custodian Agreement”). Inasmuch as the Advisor selects Investment Companies and Managers to invest Fund’s assets, the Custodian’s primary function will be to hold the indicia of ownership in such Investment Companies or Managers. The assets of the Fund will be held by the Custodian in a segregated account in the name of the Fund and unavailable to third party creditors of the Custodian in the event of insolvency, except that the Fund may allocate certain money to investment managers

running managed accounts. In such a case, the Administrator and Custodian receive statements of the managed account as well as transaction slips for every security transaction only. Any loss arising as a result of an investment in a managed account will be borne by the Shareholders.

I have underlined the new words added in 2001 to qualify the statement as it appeared in the previous edition.

59. The formulation of this new statement about the effect of the 1996 Custodian Agreement and the associated risks for investors, reflects a compromise agreed between Dr. Fano and Mr. Jim Hughes (“Mr. Hughes”), a lawyer employed by BoB Ltd in Bermuda. In an e-mail transmitted on 21 February 2001, Mr. Hughes originally proposed that the following paragraph be included in the list of Risk Factors –

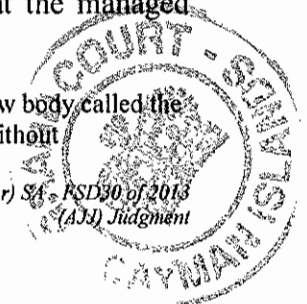
Managed Accounts. The Fund may allocate certain money to investment managers running managed accounts. A managed account is a commingled account held in the name of the investment manager in which funds of all investors using that manager are pooled. Unlike an investment fund, the Fund will not receive shares or any other form of title, but will simply be entitled to a pro rata share in the contents of the account. There will be no investment capable of being held by the Custodian on behalf of the Fund, and the Custodian will not be involved in providing custody for the assets held in the managed account. Any loss as a result of an investment in a managed account will be borne by the shareholders.

He proposed that the last two sentences also be added, as an exception, to the description of the 1996 Custodian Agreement.

60. This statement was not acceptable to Dr. Fano, apparently because the Austrian Federal Ministry of Finance (“the FMA”),²⁵ which then had a regulatory responsibility in respect of investment funds, thought that it would be inconsistent with the requirement that the assets of a fund marketed in Austria must be held by a custodian bank subject to European Union regulation, in this case BoB Lux. It was suggested that the managed

²⁵ In 2002 the functions previously performed by the Ministry of Finance were transferred to a new body called the Financial Markets Authority. For present purposes it is convenient to use the expression “FMA” without distinguishing between the Ministry and the Authority.

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account could be treated as a sub-custody account. This was rejected by Mr. Hughes who repeated that the Global Custody Department did not have custody of any securities credited to the BLMIS managed account. He said in an e-mail on 20 June 2001 that –

Madoff could not be described as any kind of sub-account to the account of the Fund at BOB because they are an investment manager not a subcustodian. I do not see how I can accept anything less than the last proposal ... 'except that the Fund may allocate certain monies to investment managers running managed accounts. In such a case, the Custodian will not be liable for the assets held in the managed account' Anything less would be incorrect and misleading.

61. Dr. Fano responded by stressing that “BoB has a double function as administrator and custodian of Primeo and it is difficult for me to understand that in one room BoB has all the information and in the other room not.” At this point, Mr. Hughes relaxed his position and accepted Dr. Fano’s re-formulation, apparently without any further discussion, and this is what appears in the final version of the 2001 Offering Memorandum.
62. The conclusions to be drawn from this episode are limited by the fact that the only evidence before the Court comprises the e-mail exchanges between Mr. Hughes and Dr. Fano, which reflects only part of the story. I have not seen the correspondence between Dr. Fano and the FMA. Nor have I had the benefit of evidence from any of the individuals involved. However, as I said during the course of Mr. Gillis’ closing submissions, it is clear that Primeo and BoB were trying to have it both ways. Dr. Fano was trying to satisfy the FMA that BoB Lux did have a duty as custodian in respect of the managed account assets which was capable of being satisfied by receiving and recording the trade confirmations and monthly statements in the accounting records maintained by the A&V department. Mr. Hughes was trying to record the fact, as he saw it, that BoB had excluded liability under the terms of the 1996 Custodian Agreement for loss arising in connection with the assets held on the managed account which, from this point onwards, would likely be the whole of Primeo’s invested assets.
63. Neither of them could have been under any illusion that these objectives were inherently incompatible. Dr. Fano understood the BLMIS business model. She knew that BLMIS in

fact had custody of the assets and she knew that BoB Lux considered that it did not have any duty, or had excluded liability for breach of any duty, in respect of the managed account assets. It is not known what Dr. Fano told the FMA but, by accepting her formulation, Mr. Hughes must have understood that BoB Lux was being held out as having some kind of custodial responsibility in respect of the managed account assets. This does appear to have been the basis upon which FMA granted authorization to market Primeo Select Euro shares in Austria.

64. An officer of the FMA, Ms. Andrea Mörtl, gave evidence about this matter in December 2011, April 2012 and October 2012 in connection with two proceedings pending before the Vienna Commercial Court and a proceeding before the Vienna Regional Court. Written summaries of her evidence (together with English translations) were produced during the course of the trial. She said (at the first hearing) that the FMA had not understood that BoB Lux considered that it had excluded liability for the managed account assets. She saw the last sentence of the risk warning – “Any loss arising as a result of an investment in a managed account will be borne by the Shareholders” – as relating to the market risk and did not interpret it as limiting the custodian bank’s liability. However, she also said (at the second hearing) “If you ask me whether I had approved Primeo or another fund, had the prospectus stated that there is a custodian bank but it is not liable, then I would probably say yes.”
65. Both Dr. Zapotocky and Mr. O’Neill also suggested that they understood the risk warning as relating to market risk rather than operational risk. I do not attach any weight to this evidence. Dr. Zapotocky left the employment of Bank Austria in March 2000, more than a year before this Offering Memorandum was issued, and there is no reason to suppose that he ever applied his mind to it except in the context of the current litigation. Similarly, Mr. O’Neill had no involvement with the production of this Offering Memorandum. He was not appointed as a director of Primeo until two years later, in June 2003.
66. By definition, the market risk associated with an asset is unrelated to the operational risk associated with the account to which the asset is credited. Viewed objectively, there is no



doubt in my mind that a prospective investor would have understood that the risk warning contained in the 2001 Offering Memorandum under the heading ‘Managed Account’ relates to the operational risk associated with the managed account. To the extent that the Offering Memorandum contains any warning about market risk, it is to be found under the heading ‘Performance’.

The 2002 Sub-Custody Agreement

67. The establishment of the Primeo Select Euro Fund gave rise to a foreign exchange risk. On 31 January 2001, BoB’s Credit Committee approved Primeo’s application for a US\$50 million foreign exchange facility. It also approved an US\$500,000 unadvised overdraft facility. The application was prepared by BoB Lux’s client relationship manager and recorded that “the facility is to be cash collateralized; Bank of Bermuda does not have custody of the assets of the Select Fund as they are held at broker in New York.” This point was repeated in a subsequent renewal application made on 12 December 2001.
68. At the time of the renewal application, BoB Lux was represented on Primeo’s board of directors by Mr. Fielding who was then the Deputy Global Head of Client Services for Global Fund Services (“GFS”) with responsibility across all the various jurisdictions in which BoB carried on a fund administration and custody business. In March 2002 he reviewed a similar credit proposal submitted on behalf of Thema International Fund Plc (“Thema”), a UCITS fund which had been administered by Management International (Dublin) Limited (“BoB Dublin”) in Ireland since 1996 and also maintained all of its invested assets in a managed account with BLMIS. Its custodian was Bermuda Trust (Dublin) Limited (“BTDL”) which had appointed BoB Ltd as sub-custodian and BoB Ltd had in turn appointed BLMIS as its sub-custodian.²⁶ The credit committee agreed to grant an overdraft facility to Thema on terms that this sub-custody agreement (executed on 1 July 1996) would be amended to the effect that BLMIS would not make a free delivery or

²⁶ In order to comply with the UCITS regulations, a fund must have a qualified custodian established in the European Union. This requirement was met in the case of Thema by having BTDL, a qualified custodian, enter into a chain of sub-custody agreements through which it has a custodial responsibility for the assets held by BLMIS on the managed account.

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transfer of cash or securities without the prior written approval of BoB Ltd, thereby improving the bank's security position. A letter of amendment was executed on 9 May 2002.

69. Mr. Fielding's evidence is that he decided that a similar sub-custody agreement should be put in place in relation to Primeo for the same purpose of strengthening BoB Lux's credit default protection by giving it a right of free delivery in respect of the managed account assets then held by BLMIS as custodian for Primeo. In order to achieve this result, he would need to obtain the agreement of both BLMIS and Primeo. He thought this arrangement would be advantageous for Primeo, because it would facilitate future lending on a larger scale without tying up excessive amounts of cash. He was also seeking to standardize the contractual arrangements relating to those BoB Group clients which then had managed accounts with BLMIS, namely Lagoon, Primeo and Thema.
70. Mr. Fielding met with Dr. Fano on 16 May 2002. BA Worldwide was at that time considering the possibility of establishing a Luxembourg domiciled UCITS fund which would invest with BLMIS and the principal purpose of the meeting was to discuss whether it would be possible to operate a managed account in accordance with Madoff's business model and at the same time comply with the UCITS regulations. As the prospective administrator and custodian, BoB Lux was involved in this exercise. The A&V department conducted a lengthy review of the Madoff's investment strategy and trading activity to ascertain whether or not it would meet the UCITS Part I investment restrictions. Mr. Fielding became aware of BA Worldwide's plan at this meeting and recognized that another potential advantage of establishing a sub-custody relationship between BoB Lux and BLMIS was that any new Luxembourg domiciled UCITS fund promoted by Bank Austria could simply be added to the schedule of companies to which the agreement related. Mr. Fielding's evidence is that he explained to Dr. Fano that he was planning to visit Madoff in New York for the purpose of putting to him the proposal to enter into a sub-custody agreement for the purpose of enhancing BoB Lux's security position. She had no objections and there were in fact good reasons why she would have agreed with the proposal.



71. In the meantime, the BoB Group's relationship with BLMIS had been discussed at a GFS Board meeting which took place on 13/14 May 2002. The minutes record that –

[Mr. David Smith²⁷] raised the question of meeting Madoff group. The existing relationship needs clearing up with segregation of assets. [Mr. Smith] would rather lose the business than continue as it is organized today. [Mr. Wilkinson²⁸] to visit in June. [Messrs. Smith/Wilkinson] to have a way forward by the end of June. If the relationship remains then GFS needs to have new controls in place. The prospectus must state that the custody is with Madoff or that there is no custodian. It may be possible to have Madoff appointed as sub-custodian.

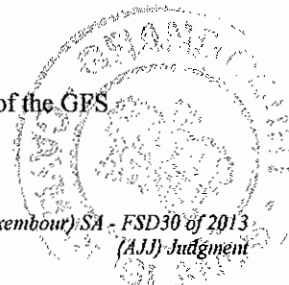
It is reasonable to infer that this minute reflects a discussion about the BLMIS relationship generally. It appears to reflect a concern that the prospectuses (being the 2001 Offering Memorandum in the case of Primeo) held out BoB Group companies as the custodian whereas in fact the whole of the invested assets were in the custody of BLMIS. Mr. Fielding was not at this meeting but his proposal to have BLMIS appointed as sub-custodian of BoB Lux appears to have been one of the possible solutions considered by the GFS Board for addressing at least part of their concern about the BLMIS relationship.

72. There is no evidence that Mr. Wilkinson did visit Madoff in June 2002 (as suggested in the board minute) but, having secured Dr. Fano's approval, Mr. Fielding met with Madoff at BLMIS's office on 17 July 2002. He was accompanied by Mr. Fergus Healy, a lawyer based in the BoB Group's New York office. The purpose of this meeting was to perform a custody due diligence exercise and secure Madoff's approval to the new arrangement whereby BLMIS would become sub-custodian of BoB Lux in respect of the assets then held for Primeo and Lagoon directly. The meeting lasted for about two hours. It was essentially an information gathering exercise. Madoff was asked questions about BLMIS, its business and operating procedures and he completed a BoB standard form

²⁷ Mr. David Smith was a BoB Group executive based in Dublin, but he was not a member of the GFS Management Committee.

²⁸ Mr. Brian Wilkinson was the Head of Sales and Head of GFS, Dublin.

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Sub-Custodian Due Diligence Questionnaire. Mr. Fielding's evidence is that he was told by Madoff that client assets were held in a separate account at the DTC. Madoff provided them with 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 F&H.

73. However, no steps were taken by Messrs. Fielding or Healy to verify any of the information provided by Madoff. Had they done so, they might have discovered that BLMIS had only one omnibus account with the DTC in which proprietary and client assets were co-mingled (or would have been co-mingled, had they in fact existed). Mr. Fielding said that he did speak to Primeo's auditors about F&H and says that he received some assurance about the firm's status, as was perhaps to be expected as they were at this time relying upon audit work performed by F&H.

74. Mr. Fielding was impressed with Madoff and his subsequent call report prepared for the GFS Board described the meeting as a "positive" one. He reported back to Bank Austria and, having secured its approval of the new arrangement, sent a letter to Madoff on 26 July 2002 in which he stated –

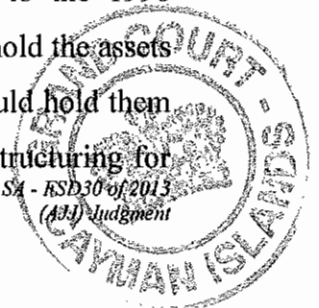
We have confirmed with Bank Austria and [Genevalor] that they have no objection to the account name with you being re-designated to include Bank of Bermuda (Luxembourg) S.A.

He also sent with this letter the draft sub-custody agreement which was approved and signed on behalf of BLMIS. It is dated 7 August 2002. One of the signatories on behalf of BoB Lux was Mr. Wilcockson. The *Primeo Fund - Class B* account was re-designated on BLMIS' books as *Bank of Bermuda (Luxembourg) S.A. Special Custody Account for Primeo Fund*.

75. This evidence leads me to the conclusion that there was a common intention amongst the parties that the pre-existing custody arrangement established pursuant to the 1996 Brokerage Agreements 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 BoB Lux. I accept that Mr. Fielding initiated this restructuring for

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credit purposes but BoB Lux could only obtain a right to call for free delivery of the assets by becoming custodian of those assets under the 1996 Custodian Agreement. Whilst BoB Lux was thereby assuming additional obligations, they were not entirely new obligations in that the BoB Group already had custodial obligations in respect of the assets credited to Thema's managed account with BLMIS. There is also evidence that Mr. Fielding saw some merit in standardizing the arrangements in respect of all three of the group's hedge client funds.

76. From Madoff's perspective, there was no reason to oppose the restructuring. Commercially, it made no difference to BLMIS. In terms of risk management, it did not matter whether its safekeeping obligation was owed to Primeo or to BoB Lux. In terms of fee income, the restructuring made no difference because BLMIS was not receiving any custody fee as such and would continue to receive the same brokerage commission in any event. Since BLMIS was not advancing credit to Primeo, there was no commercial disadvantage in being sub-custodian for BoB Lux.
77. From the perspective of Bank Austria and its clients, the restructuring was advantageous in a number of ways. It would confirm that BoB Lux was performing a real role as custodian and therefore resolve any further doubt about BA Worldwide's ability to market Primeo in Austria. It benefitted Primeo, because it would reduce or eliminate the need to put up cash collateral. In terms of fee expense, it was neutral. There would be no saving in the commission paid to BLMIS, nor would there be any increase in the fees paid to BoB Lux because it was receiving a composite fee which was not geared to the value of the assets held in custody. It was advantageous to Bank Austria because, having secured Madoff's approval to the restructuring, it would be straightforward to add any new UCITS fund to the sub-custody agreement.
78. I do not accept Mr. Fielding's evidence that the 2002 Sub-Custody Agreement was executed *solely* for credit purposes and that it was never intended to change the pre-existing arrangement whereby BLMIS held the assets as custodian for Primeo. I have come to the conclusion that his evidence on this subject is not credible. I accept that he

was motivated by a desire to improve BoB Lux’s security position, but the idea that he would do so through the mechanism of a sub-custody agreement rather than a pledge agreement, if this was his sole purpose, makes no commercial sense whatsoever. I find it difficult to imagine how he could sensibly explain the mis-use of a standard form sub-custody agreement in this way to Dr. Fano and Madoff, let alone BoB’s legal department. His written and oral evidence is unsupported by the contemporaneous documentary evidence. In particular, there is no hint in Mr. Fielding’s letter to Madoff dated 26 July 2002 that the attached sub-custody agreement was not intended to take effect in accordance with its express terms and that BLMIS would somehow be constituted as sub-custodian for BoB Lux only in the event that Primeo was to default on its obligations under the foreign exchange and overdraft facilities. Mr. Fielding’s evidence is also inconsistent with the parties’ post contract conduct. BoB officers repeatedly described BLMIS as its sub-custodian in respect of both Primeo and Lagoon. In 2005 Mr. Fielding himself permitted BoB Lux to issue a custody confirmation to Primeo’s auditors in respect of the assets held in custody by BLMIS, which he could only have done because he considered BLMIS to have been properly appointed as BOB Lux’s sub-custodian. Mr. Fielding’s evidence to this Court is also inconsistent with his witness statement made for the purpose of the Thema proceedings²⁹ in which he said “In or around July 2002, I called Mr. Madoff and explained that I wanted to visit BLMIS for due diligence purposes and to make arrangements for a sub-custody agreement with [BoB Lux] in relation to Primeo and [Lagoon]”. This statement is not qualified in any way to explain that it was really only proposing to enter into a sub-custody agreement for “credit purposes” and that it would not serve any custody purpose as such.

The GFS Board’s decision to engage KPMG – September/October 2002

79. In September 2002 there was a further high level discussion amongst members of the GFS Board about the risk inherent in the BLMIS business model and how that risk might be addressed from BoB’s perspective. This particular discussion appears to have been

²⁹ The action commenced in the Irish High Court between Thema International Fund Plc as plaintiff and HSBC Institutional Trust Services (Ireland) Limited as defendant. The action was settled in 2013 after the trial commenced but before any witnesses were called to give evidence.

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initiated by Mr. Tom Young (the Credit and Risk Manager for BoB Dublin) who addressed various questions to Mr. Fielding about the Thema/BLMIS relationship in an e-mail sent on 19 September 2002. He asked if it would be possible to obtain independent verification that the assets of Thema were segregated from the other assets held by BLMIS. He also asked about BLMIS's audited financial statements and the standing of F&H. In his reply, which was copied to members of GFS, Mr. Fielding fully agreed that it would make sense for each of the funds to have "audit certification of those assets" but he felt that this was a matter for their auditors. He said that "a fund auditor worth his salt would be doing this as a matter of course". His conclusion was that the "The [sub-custody] review is finished and signed off for this year and I do not intend do more unless the GFS Board supports it, risk versus cost versus relationship, etc."

80. Mr. Wilkinson (to whom Mr. Fielding reported) disagreed. He thought that GFS ought to obtain confirmation of asset segregation independently of whatever verification procedures were being undertaken by the auditors. He asked for comment from other members of the GFS Board.³⁰ Mr. David Smith agreed, as did Mr. Paul Smith.³¹ By 1 October 2002, the GFS Board had informally decided to ask KPMG (not F&H) to undertake audit procedures in order to provide independent confirmation of the assets held by BLMIS for all three of the clients, including Primeo. Mr. Fielding's response was somewhat unenthusiastic, but Mr. Paul Smith's position was very clear. He said,

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. Lets tell him so and get on with it with his support. If we continue to pussy foot around him we will get nowhere."

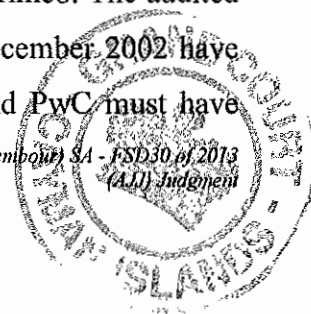
Counsel for the Plaintiff places considerable reliance upon the fact that the GFS Board decision was made, but never communicated to Primeo or acted upon.

³⁰ The GFS Board was actually a global management committee, but it was referred to as a "board" by the witnesses.

³¹ Mr. Paul Smith was Global Head of Global Fund Services and, after the BoB Group was taken over by HSBC, he became Global Head of Alternative Investment Funds, based in London. He was not employed by HSSL.

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81. It is unclear why this decision was not implemented. Apart from Mr. Fielding, none of those involved have given evidence. Mr. Fielding acknowledged the risk inherent in the BLMIS business model but, based upon the due diligence work which he had performed, he did not believe that it was a significant risk. This no doubt explains why he did not himself initiate any steps to implement the decision. Responsibility for discussing the matter with Genevalor (on behalf of Lagoon and Thema) rested with Mr. Wilkinson but there is no evidence about what, if anything, was ever agreed with them. Mr. Fielding did not raise the matter with BA Worldwide (on behalf of Primeo) and relied upon Mr. William (Bill) Jones (the Head of Legal, Compliance and Risk) to make all the necessary arrangements. There is no evidence that Mr. Jones ever communicated with Dr. Fano about this matter, although he did agree to meet Madoff on 2 December 2002. In the event, the meeting never took place and KPMG was never engaged.
82. The available evidence about this episode leads me to the conclusion that the GFS Board's decision (which was never recorded in any written minute) was simply overtaken by events. If KPMG had been engaged, my assumption is that they would have been instructed to perform whatever audit procedures they thought appropriate for the purpose of confirming the existence of the assets held by each of the three funds on their respective managed accounts as at 31 December 2002. The stated intention was that this work should be done irrespective of whatever work was planned to be done by the auditors. Primeo's auditor of record was the Cayman Islands firm of Ernst & Young which delegated performance of the audit fieldwork to the Ernst & Young firm in Luxembourg. For present purposes, it is sufficient to call Primeo's auditor "E&Y" without distinguishing between the two firms. Lagoon's auditor was also E&Y. Thema was audited by the Irish firm of PricewaterhouseCoopers ("PwC"). In fact, E&Y engaged F&H to perform audit procedures for this purpose in respect of Primeo and it is reasonable to infer that it must have adopted the same procedure in respect of Lagoon. What audit procedures were undertaken by PwC in respect of Thema is not known. On 28 March 2003, E&Y issued an unqualified audit opinion in respect of Primeo. The audited financial statements of Lagoon and Thema for the year ended 31 December 2002 have not been put in evidence, but it is reasonable to infer that E&Y and PwC must have



issued unqualified opinions, probably around the same time, otherwise subsequent events might well have taken a very different course. Engaging KPMG (as opposed to F&H) had obvious merit but, having failed to do so in conjunction with the audit work, it seems to me that it was almost inevitable that the GFS Board decision would fall off the agenda. Once unqualified audit opinions had been issued by E&Y and PwC, it would have been difficult for BoB to justify engaging KPMG (even at its own expense) to re-perform a critical part of the audit work which must already have been performed (in one way or another) to the satisfaction of two leading audit firms.

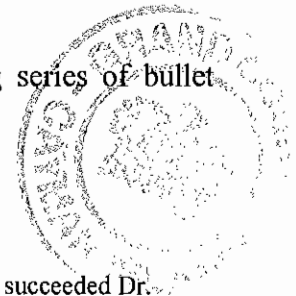
Bank Austria's Internal Audit Review of Primeo – June 2003

83. Given the size of Primeo's balance sheet as at 31 December 2002, Bank Austria's risk management procedures required that it be subject to an internal audit review. As part of this exercise, BoB Lux was asked to make a presentation to the internal auditors, which it did in May 2003. When arranging for this presentation to be done, Dr. Fano conveyed the message that the internal auditors were questioning BoB Lux's suitability to be acting as custodian. As a result, a large part of the written presentation prepared by Mr. Fielding and Mr. Germain Birgen ("Mr. Birgen")³² deals with the financial status of the BoB Group and has been redacted. However, the presentation also deals with the internal auditors' questions about the Primeo/BLMIS relationship. It is wholly unsurprising that Bank Austria's internal auditors identified and were concerned about the risks inherent in the BLMIS business model. Mr. Fielding recalled that the oral presentation was quite long – at least an hour and possibly as long as half a day. In addition to the internal auditors, Mr. Alfred Simon ("Mr. Simon")³³ was present at the meeting. He was chairman of Primeo's board of directors at this time. Dr. Fano was not present.

84. The written presentation describes the Madoff relationship in a long series of bullet points spread over 8 pages. These points include the following –

³² Mr. Birgen was General Manager of BoB Lux from March 2002 to 2004.

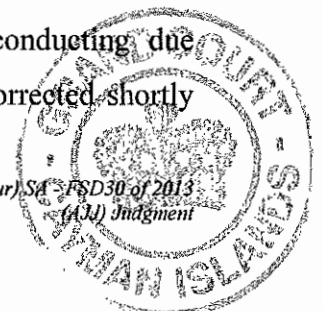
³³ Mr. Simon was a senior general manager at Bank Austria and head of asset management. He succeeded Dr. Zapotocky as chairman of Primeo's board of directors in May 2000 and continued in this capacity until 25 April 2007.



- *Appointed as a sub-custodian of [BoB Ltd] and [BoB Lux]*
(This statement is not qualified in any way)
- *Assets are held with [BLMIS] when our client appoints [BLMIS] to their fund, e.g. by opening a Trading Account*
- *Primeo Fund has an account with [BLMIS] covering the trading and securities and options since 1996*
- *The [BoB] sub-custodian agreements with [BLMIS] only allow securities or cash to be transferred on a free basis under an instruction duly authorized by [BoB] authorized personnel*
- *The Fund Manager or Adviser is expected to perform initial and regular due diligence on [BLMIS] in relation to the Trading Account*
(BA Worldwide did in fact carry out regular due diligence, for which purpose Dr. Fano visited Madoff twice a year with effect from 2000)
- *[BoB] personnel carry out regular due diligence on [BLMIS] in relation to the sub-custodian arrangements*
(This statement was true in the sense that it reflected the general practice relating to network sub-custodians and was not misleading in that this practice was going to be applied to BLMIS).
- *[BoB] completed its most recent due diligence on [BLMIS] in the 3rd quarter of 2002*
(This statement was ambiguous in that it could be interpreted to mean that BLMIS had been the subject of more than one due diligence review whereas, in fact, the July 2002 review was the first one to have been conducted).
- *No material issues arose during [BoB] sub-custodian due diligence review on [BLMIS]*
(This statement reflects the conclusion reached by Mr. Fielding as a result of his July 2002 review)

85. Mr. Fielding's attempt, in the course of his cross-examination, to explain away and qualify the first bullet point about having appointed BLMIS as sub-custodian is wholly unconvincing. Bank Austria was being told that BoB had entered into the 2002 Sub-Custody Agreement and was entitled to assume that BoB intended that the agreement would be binding and enforceable in accordance with its express terms.

86. The internal auditors mistakenly thought that BoB Lux had been conducting due diligence on BLMIS on a quarterly basis. This misunderstanding was corrected shortly



afterwards. When asked for copies of the quarterly due diligence reports, Mr. Birgen replied by e-mail on 17 June 2003 that -

BOB is NOT performing a quarterly due diligence on Madoff. As Nigel explained in Vienna, the due diligence procedure is regular but not on a quarterly basis; The last one performed was done by [Mr. Fielding] in fall 2002.

When asked by Dr. Fano for a copy of the July 2002 report, Mr. Fielding said (in an e-mail on 27 June 2003) that it was BoB Lux's policy not to disclose such reports and he went on to clarify the frequency with which reviews were performed, as follows -

I confirm that our normal cycle for a full due diligence review of agents is every two years, unless operational problems are encountered that lead to an early review Madoff currently falls in the two year review group and there are no day to day operational issues.

87. The internal auditors' report was issued on 11 June 2003 ("the BA Internal Audit Report"). It identified a number of issues which needed to be addressed. Firstly, it drew attention to the absence of any written investment management agreement between Primeo and BLMIS and the absence of any written investment guidelines or restrictions. Secondly, it stated that the 1996 Custodian Agreement excluded liability (under Clause 6(B)) for the BLMIS managed account which led to a recommendation that legal advice be taken in respect of any consequential liability on the part of Bank Austria. Thirdly, it made the point that "[BA Worldwide] relies almost exclusively on information from the manager in the review of transactions and positions". It is clear that the internal auditors understood perfectly well that BoB Cayman was relying upon a single source of information for the purposes of determining Primeo's NAV. It was in this context that the internal auditors recommended obtaining the due diligence reports from BoB. It seems to me that the internal auditors' response to the problem of single source reporting was much the same as Mr. Fielding's. They appear to have been content for BA Worldwide (and by inference BoB) to rely upon conducting on site due diligence reviews designed to establish the overall integrity of BLMIS's operations. They did not recommend the adoption of any procedure which would enable BoB, whether in its capacity as custodian

or administrator, to obtain information from an independent source. It may be that they simply accepted that, for commercial reasons, this would not be possible.

Primeo Board Meeting – 23 June 2003

88. The internal audit review was conducted for the benefit of Bank Austria and, as one would expect, the report itself was not disclosed to Primeo’s directors as such, although all except Mr. Fielding might have seen it in their capacity as Bank Austria employees. Certainly, Mr. Simon had it in his capacity as head of the Asset Management Division and Dr. Fano had it in her capacity as president of BA Worldwide. She took the lead in raising its findings with Primeo’s directors at the meeting on 23 June 2003. The minutes record that she mentioned the absence of any agreement with Madoff relating to investment strategy and then went on to deal with the issue of BLMIS’s multiple functions as follows -

Bank Austria also identified that they had to totally rely on Madoff for information regarding the Fund due to his position as both Manager and Broker of the account. Dr Fano advised that this did not provide Madoff with any access to fees and the general management of the Fund is done by Bank Austria. Dr. Fano emphasized that this would never change, as Madoff did not wish to work with any other broker due to the possibility of exposing his tactics within the market. Confirmation of transactions was also an issue without an independent broker counter party. Mr Fielding reminded the board that Madoff supplies detailed statements of all activity, that the firm is registered with the SEC and has clean audit opinions.

Mr. Fielding was cross-examined on the basis that he wrongly gave Bank Austria/Primeo a generally reassuring message, both at the presentation in May and at the board meeting in June, when in fact he knew, but failed to disclose, that the GFS Board had been sufficiently concerned that it had decided to take the highly unusual step of employing its own auditors, KPMG, to carry out procedures to obtain independent confirmation about the existence and segregation of its clients’ assets. In my judgment, this allegation is not made out by the evidence. By the time of the presentation to the internal auditors in May and the Primeo board meeting in June 2003, the GFS Board decision had already been overtaken by events and dropped. There is no evidence that the GFS Board formally



changed its mind, but this may simply reflect the fact that it never made a formal decision in the first place, or at least one that was recorded in a written minute or resolution. I do not criticize Mr. Fielding for failing to tell Primeo's board about a decision which was no longer relevant in the sense that it was not going to be implemented. I do criticize BoB for failing to take the opportunity to review its operating procedures and ask itself (a) whether the "most effective safeguards available" had been implemented in respect of BLMIS' custody of the assets and/or (b) whether there was any means by which it could reconcile its accounts to information obtained from an independent source.

Establishment of Alpha Prime Fund Limited – launched in June 2003

89. Alpha was launched as a Madoff feeder fund on 1 June 2003. Dr. Zapotocky's evidence is that it was not promoted by Bank Austria but, even if this is right, Bank Austria played a substantial role in its promotion and subsequent management and was represented on its board of directors by Dr. Fano. Nominally, Alpha's promoter and investment manager was a special purpose vehicle called Alpha Prime Asset Management Ltd ("APAM"), the beneficial ownership of which is surrounded in mystery. Dr. Zapotocky's evidence is that he 'assumes' that APAM is a "self-owning entity" although he admitted that he is entitled to receive a fee equivalent to 25% of its profits. APAM delegated the performance of its duties as investment manager to BA Worldwide and so Dr. Fano must have been responsible for the day to day management of Alpha. BoB Ltd was appointed as Alpha's custodian and administrator pursuant to agreements made on 12 March 2003 but the performance of its duties was delegated to BoB Lux and Mr. Fielding was appointed as its representative on Alpha's board of directors. Alpha entered into a customer agreement, option agreement and trading authorization with BLMIS in the same terms (except for choice of law) as Primeo's 1996 Brokerage Agreements. The other initial directors of Alpha were Mrs. Kohn and Dr. Zapotocky, who was at that time employed as CEO of the Vienna Stock Exchange.
90. It is unclear why Alpha was structured differently from Primeo. However, the fact that Bank Austria was willing to participate in the promotion and launch of a new Madoff

feeder fund suggests that it must have been comfortable with the operational risks inherent in the BLMIS business model. The BA Internal Audit Review was issued in June 2003 – the same month that Alpha’s business was launched. The discussion about BLMIS and its business model which took place at the Primeo board meeting on 23 June 2003 was equally applicable to Alpha.

91. E&Y was appointed as Alpha’s auditor. Its audited financial statements for the period ended 31 December 2003 reflect that it had attracted about US\$4.6 million (or its equivalent) in subscriptions by the year end. Its NAV was only about US\$3.6 million because part of this subscription money is reflected on the balance sheet as a liability because it was received at or immediately before the year end and the shares were not actually issued until 2 January 2004. Of this US\$4.6 million of subscription money, Primeo provided the equivalent of about US\$1.8 million. By 31 December 2004, Primeo had subscribed the equivalent of about US\$24.7 million for shares in Alpha.
92. The custodian agreement between BoB Ltd and Alpha differed from the Primeo agreement in a number of respects. In particular, Clause 15(F) of the Alpha agreement provided that –

The Company acknowledges that when an investment is made in a managed account there will be no asset capable of being held by the Custodian and, in the absence of fraud, dishonesty, negligence or willful default on the part of the Custodian, the Custodian shall not be responsible for any loss arising in respect of a deposit of assets in a managed account.

Nor did the Alpha agreement contain a provision equivalent to Clause 16(B) of Primeo’s 1996 Custodian Agreement.

Establishment of Primeo Executive Fund – launched in November 2003

93. The Primeo Executive sub-fund was launched on 1 November 2003 with both US\$ and Euro share classes. It was described in the revised Offering Memorandum and associated Fact Sheets as a fund of funds which would be invested in US equities and index options.



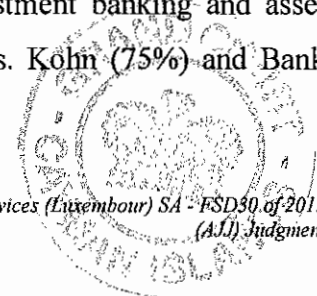
In economic reality, it was another single manager fund which placed its invested assets with BLMIS indirectly. By 31 December 2004, Primeo Executive had an NAV of about US\$51.6 million, split approximately equally between shareholdings in Alpha and Herald.

Mr. Fielding's second due diligence visit to BLMIS's office – 3 March 2004

94. A second due diligence meeting visit took place at BLMIS's office in New York on 3 March 2004. On this occasion, Mr. Fielding attended with Mr. Wilcockson. A copy of the *Sub-Custodian Due Diligence Questionnaire* completed in July 2002 was sent to Madoff in advance of the meeting. They were shown BLMIS's trading floor and went through the questionnaire with Madoff. He made some amendments and signed it. Mr. Fielding's evidence is that he re-confirmed with Madoff that proprietary assets and clients' assets were held in separate accounts with the DTC. If any attempt had been made to verify this statement, HSSL might have discovered that BLMIS in fact had only one DTC account. No call report was made, but Mr. Fielding's note (annotated on a copy of the fax transmitted to Madoff on 26 February 2004) records that the result of this meeting was "perfectly satisfactory". In the absence of any evidence to the contrary, I infer that Mr. Wilcockson must have reached a similar conclusion.

Establishment of Herald Fund SPC – launched in April 2004

95. Herald was incorporated in the Cayman Islands in March 2004 as a segregated portfolio company although only one portfolio (called Herald USA Segregated Portfolio One) was ever funded. BoB Lux was appointed as custodian and administrator pursuant to agreements dated 29 March 2004. Herald entered into a customer agreement, options agreement and trading authorization with BLMIS in the same standard forms as those entered into with Primeo and Alpha. Nominally, Herald was promoted, managed and marketed by a special purpose vehicle called Herald Asset Management Limited, but its functions were delegated 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 by Mr. Saleta.³⁴ Herald soon became a major part of Bank Medici's business.

96. Herald's business as a Madoff feeder fund was launched on 1 April 2004 with practically the whole of its invested assets placed on the managed account with BLMIS. By 31 December 2004, Primeo Executive had subscribed the equivalent of approximately US\$24 million for shares in Herald. Herald was successful. In spite of having the same investment strategy and investment performance as Primeo, it attracted new subscriptions at a far higher rate than Primeo. By 31 December 2006, Herald's NAV was approximately US\$737 million.
97. Both Herald and Alpha issued US\$ and Euro denominated share classes, with the result that they had both established foreign exchange and unadvised overdraft facilities with HSSL. In September 2004, the relationship manager responsible for all three funds arranged for a new sub-custody agreement to be entered into between HSSL and BLMIS ("the 2004 Sub-Custody Agreement"). It superseded the 2002 Sub-Custody Agreement and its only purpose was to add Alpha, Herald and another new fund called Square One Fund Limited to the list of funds to which it applied. I do not accept the assertion that this sub-custody agreement was entered into for "credit purposes only". As far as Primeo is concerned, it did not make any change to its pre-existing contractual arrangement.

Primeo Board Meeting – 14 May 2004

98. On 14 May 2004, Primeo held a board meeting in Madrid. The board then comprised Mr. Fielding and four Bank Austria employees including Mr. O'Neill. He was appointed to the board of Primeo with effect from 2 June 2003 and served for nearly four years, but he only ever attended three meetings on 14 May 2004, 29 April 2005 and 9 June 2006. I formed the view that Mr. O'Neill's evidence is unsatisfactory and needs to be treated with caution. Apart from attending these meetings, his involvement with Primeo was minimal and he was so far removed from the decision making process that little weight

³⁴ Mr. Saleta was a Bank Austria group employee who was a director of BA Worldwide. He was also a director of Primeo from 3 January 2005 until 25 April 2007.

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can be attached to much of his evidence. His judgmental observations on the discussion arising out of the BA Internal Audit Report which took place at the 23 June 2003 board meeting is a case in point. He was not present at this meeting and did not see the report until more than ten years later when preparing his evidence for this case.

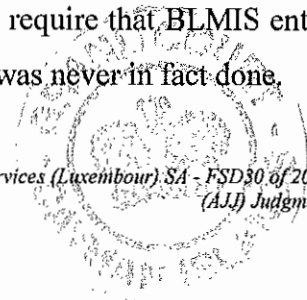
99. It was normal practice for board meetings to be tape recorded and the recording would then be used by BoB Lux for the purposes of preparing the minutes of the meeting. In this case the first draft of the minutes included several paragraphs which reflected further discussion of matters arising out of the BA Internal Control Report which had been discussed at the previous meeting on 23 June 2003. These paragraphs were removed from the final version of the minutes, as subsequently approved, but there is no dispute that the following extract does reflect what was discussed –

Madoff's Gentleman's Agreement initiated an open discussion with the Board. The lack of an investment contract and objective confirmations raised concern regarding the proof securities were really there and if transaction slips provided by Madoff were valid and had actually been executed. Additionally, Dr Fano highlighted Madoff's technique of booking trades on his own private account, which caused concern within Bank Austria. Mr Fielding responded by advising the Board that [BoB Lux] receive confirmation from Madoff every time a trade was made including the total positions. Mr Fielding added that Bank Austria should be confident of the fact that Madoff was regulated by the United States Authorities, Securities Exchange Commission ("SEC"), and that all investment restrictions were being met. Additionally, Madoff was being audited. The security of trades being made elsewhere should be considered a risk and that Madoff should be restricted to the US markets only. Alternatively, it was suggested that Dr Fano should provide the Board with a list of non-Nasdaq Funds and that if Madoff wished to expand his invest[ment] criteria into these alternative Funds, approval at Board level should be sought.

...

The Chairman noted the comments and suggestions and advised the Board to seek a legal opinion and requested [BoB Lux] to provide copies of agreements entered into with Madoff for review prior to making any formal decision.

The "formal decision" referred to a decision whether or not to require that BLMIS enter into a formal written investment management agreement. This was never in fact done.

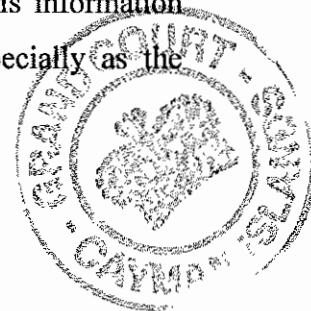


100. The fact that Mr. Fielding made no reference to the earlier decision of the GFS Board to engage KPMG was unsurprising bearing in mind that it had been overtaken by events more than a year beforehand and was not now going to be implemented. He was cross-examined on the basis that, because he personally thought that the view expressed by members of the GFS Board was misplaced, he presented Primeo's board with an entirely reassuring perspective which was unjustified. In response, Mr. Fielding made the point that the GFS Board's concern with BLMIS's business model was one of principle. He said –

I don't think the GFS Board had a concern that something was actually going wrong. They had identified that there could be a risk. I'd been to BLMIS twice, with Fergus Healy, I'd been with Chris Wilcockson, Dr. Fano had been. We'd all concluded that everything was fine.

The evidence does not support the assertion that Mr. Fielding either intended to mislead Primeo's directors or that he did in fact mislead them in any way. The BLMIS business model and its inherent risks were well known and understood by all concerned. There had been no material operational problems which had prevented NAVs from being issued by all three clients in a timely manner and the auditors of all three clients continued to issue unqualified opinions, most recently in respect of the 31 December 2003 financial statements. Everyone present at the board meeting must have recognized that the BLMIS business model did not meet industry standards about segregation of duties and necessarily involved a relatively high risk of fraud or error, yet Bank Austria had participated in the launch of another Madoff feeder fund just a few weeks beforehand. If Mr. Fielding had told the meeting that the GFS Board had been sufficiently concerned about the risk, back in October 2002, that it decided to instruct KPMG to perform audit procedures on BLMIS's books and records, it is difficult to see why this information would have had any particular impact upon the Board's thinking, especially as the decision had not been implemented.

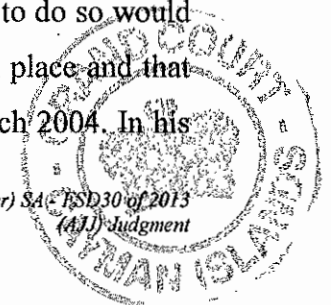
The audit of Primeo's 2004 financial statements



101. On 11 February 2005, the E&Y audit manager wrote to HSSL asking for a meeting in relation to all its audit clients which had managed accounts with Madoff. E&Y wished to discuss various aspects of the managed accounts, including the booking of the account transactions in the HSBC system and the controls in place. On 21 February they met with Mr. Birgen and Mr. Saverio Fiorino (“Mr. Fiorino”)³⁵ in respect of Primeo and they met with Mr. Robert Nespolo of Genevalor in respect of Hermes/Lagoon two or three days later. (Thema’s investment manager would not have been involved in this discussion because its auditor was PwC).
102. The internal e-mail exchanges amongst the HSSL executives reflect that E&Y were concerned about a number of related matters common to all three of their clients. They were concerned about Madoff’s investment strategy and questioned how he was able to generate regular profits even when markets were bad. They were concerned about segregation and whether the assets really existed. The reliability of F&H was a concern. They did not understand why BLMIS’s compensation was so low and how it could make so much money on transaction/brokerage commissions only.
103. To put these concerns into context, it is relevant to bear in mind that the managed account assets were not recorded in the custody records maintained by HSSL’s Global Custody Department (using the software called *Trustware*), with the result that the custody holdings reports and the related audit confirmations reflected that no assets were held by HSSL on behalf of Primeo Select. As at 31 December 2004, the only asset recorded in the custody records on behalf of Primeo Select was a holding of 49,560 units in a money market fund. The confirmation generated by the Custody Department issued to E&Y on 11 February 2005 therefore stated that these units were the only asset held in custody for Primeo Select. It made no reference to the assets held on the BLMIS managed account because they were not recorded in the custody records. However, the managed account assets were recorded on the accounting records maintained by HSSL’s A&V department (using the software called *Geneva*).

³⁵ Mr. Fiorino was the Head of Global Fund Services and subsequently Alternative Fund Services for HSSL from 2003 to 2008 and is still employed by HSSL.

104. E&Y had previously relied upon the year end statements issued by BLMIS. In addition, in respect of the four years from 2000-2003 inclusive, E&Y had engaged F&H to carry out an audit of the statement of movements in net assets held on the Primeo Select managed account and, presumably, exactly the same instructions were given in respect of E&Y's other clients. F&H purported to have carried out audits in accordance with auditing standards generally accepted in the United States and issued unqualified opinions addressed to E&Y that the BLMIS statements presented fairly, in all material respects, the net assets of Primeo Select for each of these four years. In February/March 2005, E&Y was questioning whether it could continue to rely upon F&H to perform this audit work. Instead, E&Y was proposing to visit BLMIS and conduct the work themselves, which would of course require Madoff's consent and co-operation. The e-mail correspondence reflects that E&Y were considering the possibility of resigning or issuing qualified opinions if they were unable to perform this work with satisfactory results.
105. Sometime in early March 2005, it was brought to the attention of E&Y that HSSL had entered into the 2004 Sub-Custody Agreement. In the absence of any evidence from E&Y, it is impossible to know exactly how or when it came to their attention, but the e-mail sent to Mr. Fiorino on 14 March 2005 tends to suggest that E&Y had not previously seen the 2002 Sub-Custody Agreement. In any event, having seen the 2004 Sub-Custody Agreement, the writer of this e-mail (whose name has been redacted) said "I assume that it will be possible to obtain a custody confirmation from HSBC for the positions held within the Madoff account as at 31 December 2004 – is this correct?"
106. Mr. Fiorino referred this request to Mr. Fielding, with copies to Messrs. Wilcockson and Birgen. He pointed out that, historically, E&Y had relied upon the BLMIS confirmations which had not been counter-signed by HSSL. He went on to say that he did not see any reason why HSSL should not sign a custody confirmation and that failing to do so would be in conflict with the fact that the 2004 Sub-Custody Agreement was in place and that due diligence had taken place in respect of BLMIS in July 2002 and March 2004. In his



reply on 15 March 2005, Mr. Fielding pointed out that the sub-custody agreement had been in place much longer and that the current one was simply the latest revision done for the purpose of adding new funds to the list. He agreed that a custody confirmation should be issued. He said –

I would also add that any such custody confirmation is not [just] for Madoff, it should be [a] custody confirmation issued by HSSL for all assets in our custody for the relevant funds. It should be in the standard format for custody confirmations generally issued by HSSL and it would [be] that HSSL had already successfully reconciled the sub-custodian holdings to [the] statement at [the] relevant date.

Having thus secured Mr. Fielding's agreement and in the absence of any response from either Mr. Wilcockson or Mr. Birgen, Mr. Fiorino gave instructions for a 'standard custody confirmation' to be issued in respect of all the relevant funds, including Primeo. He instructed his staff that, before issuing the confirmations, they should confirm that all Madoff trades were recorded in the accounting records maintained by the A&V department on its *Geneva* system and properly reconciled with the statements.

107. The confirmation in respect of Primeo was issued on 5 April 2005, but it was not in fact in the standard form. It is a carefully crafted letter which related only to the assets on the BLMIS managed account. It states as follows –

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

The attachment comprises a *Position Appraisal Report Summary* for the period end date of 31 December 2004 generated from A&V department's *Geneva* accounting system. This report reflects the securities held on the BLMIS managed account based upon the information contained in the trade confirmations received from BLMIS. It lists an investment in a money market fund and US Treasury Bills having a book cost and market

value of about US\$415.3 million. The confirmation letter is signed by Ms. Nathalie Baelen. She initialed the attached report and applied HSSL's name/address stamp.

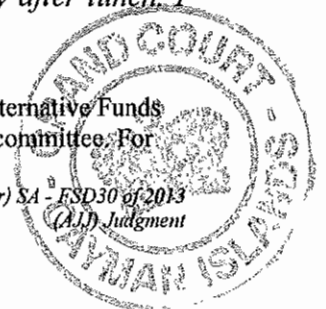
108. The original custody conformation sent to E&Y on 11 February 2005 related only to Primeo Select. On 7 April 2005, HSSL sent another composite confirmation (also signed by Ms. Baelen) relating to both Primeo Select and Primeo Executive. This confirmation is in the same standard format as the 11 February one and the attachment comprises a report generated from the Custody Department's *Trustware* system which states that the only securities held by HSSL in custody are the shareholdings held for Primeo Executive. It does not refer to the assets held on the BLMIS managed account for Primeo Select.
109. Contrary to the case now advanced on behalf of HSSL, to my mind the confirmation letter issued to E&Y on 5 April 2005 constitutes unequivocal evidence that HSSL did consider itself to be custodian in relation to the assets held by BLMIS pursuant to the 2004 Sub-Custody Agreement. The person responsible for issuing this confirmation was Mr. Fiorino in his capacity as Head of Alternative Fund Services ("AFS") for HSSL.³⁶ He was also a signatory to the 2004 Sub-Custody Agreement. It is perfectly clear from the contemporaneous documentary evidence that he considered HSSL to be custodian of the managed account assets held by BLMIS and saw no reason why a custody confirmation should not be issued. He is still employed by HSSL but was not called to give evidence.
110. Of those involved in the decision to issue this confirmation, only Mr. Fielding gave evidence. When shown the e-mail containing his advice to Mr. Fiorino, he said "I'm going to call it a rather inglorious email". He tried to suggest that, given his managerial position, it was really not his responsibility and he failed apply his mind to Mr. Fiorino's question. He said –

Because I was the Chief Admin Officer of AFS, quite a long way from this, and you can see what happens here. [Mr. Fiorino] writes to me in the morning. I reply after lunch. I

³⁶ Following the BoB Group's acquisition by HSBC, its global funds services business became Alternative Funds Services ("AFS") within HSBC Securities Services ("HSS") which also had a global management committee. For present purposes, AFS was simply the successor of GFS.

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(A.J.) Judgment



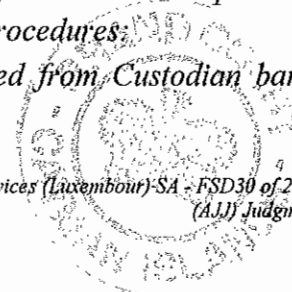
obviously want to get this thing off my desk. I probably don't give it a lot of thought, and I'm probably slightly irritated that he's bringing it to me, because I'm kind of going, "[Mr. Fiorino], take this to your line, take it to [Mr. Birgen] and [Mr. Wilcockson]". But probably without thinking it through. "If you want to do custody confirmations, okay, but make sure that you've reconciled the custody records".

Mr. Fielding now asserts that he never at any time believed that HSSL owed any safekeeping or supervisory obligation to Primeo arising out of the sub-custody agreements. However, Mr. Fielding must have understood that Mr. Fiorino was proposing to issue custody confirmations precisely because he thought that HSSL did owe a custodial responsibility to Primeo which, by reason of having entered into the sub-custody agreements, included assets in the custody of BLMIS. Mr. Fiorino was seeking Mr. Fielding's advice because he must have known that he was the person originally responsible for putting the 2002 Sub-Custody Agreement in place. The explanation now given by Mr. Fielding for having told Mr. Fiorino to proceed with issuing standard custody confirmations is that he "clearly didn't think it through". Even though the original decision to enter into the 2002 Sub-Custody Agreement was motivated by his desire to improve HSSL's security, all those concerned in the execution of both the 2002 and 2004 Sub-Custody Agreements (including Mr. Fielding himself) must have understood that they were creating custodial obligations on the part of HSSL and I do not believe that they intended not to do so.

111. The letter issued on 5 April 2005 does not say, in terms, that BLMIS held the assets listed in the attached report as sub-custodian for HSSL, but Mr. Fiorino knew that E&Y were seeking a "custody" confirmation and would rely upon this letter for audit purposes as evidence of the existence of these assets. Unsurprisingly, E&Y's Summary Review Memorandum dated 20 April 2005 reflects that they did in fact rely upon it for this very purpose. It states –

We obtained audit assurance that the securities in the Madoff Investment Corporation broker account existedby carrying out the following audit procedures:

- *Receipt of independent confirmation of ownership received from Custodian bank, HSBC Luxembourg S.A.*



If Mr. Fiorino had thought, for whatever reason, that BLMIS did not in fact hold the assets as sub-custodian for HSSL pursuant to the 2004 Sub-Custody Agreement, he would not have given instructions for this letter to be issued.

112. Mr. Quintus was not involved in the decision to issue this custody confirmation but he was called to give evidence about the way in which HSSL's global custody business operated generally. His witness statement made no mention of this custody confirmation but he was asked about it in the course of his cross-examination. He was quite clear that a custody confirmation ought not to have been issued because the managed account assets were not recorded in HSSL's custody records. He considered that issuing the 5 April letter based upon information recorded in the accounting records maintained by A&V "was not the right thing to do".

BLMIS due diligence review (April 2005) and the subsequent decision to instruct KPMG to conduct a fraud risk review (September 2005)

113. Following the takeover of the BoB Group by HSBC Holdings Plc., the credit approval and sub-custody functions previously performed in Luxembourg and Dublin were centralized and transferred to HSBC Securities Services ("HSS") in London. As a result, the Madoff related hedge funds came to the attention of Ms. Christine Coe ("Ms. Coe") and Mr. Brian Pettitt ("Mr. Pettitt"). Ms. Coe had become the Chief Risk Officer for HSS in November 2004 and Mr. Pettitt was Head of Network Management with responsibility for selecting, engaging and thereafter supervising the HSS global network of sub-custodians. Sometime at the beginning of 2005, in the context of dealing with one or more credit applications, Ms. Coe asked Mr. Pettitt to conduct a sub-custodian due diligence review in respect of BLMIS. At Mr. Fielding's suggestion, Mr. Pettitt arranged to meet with the relevant HSSL executives in Luxembourg in order to educate himself about the clients and their relationship with BLMIS before going to meet Madoff in New York.
114. The due diligence review proposed to be carried out by Mr. Pettitt coincided with the discussion with E&Y about its proposal to carry out audit work at BLMIS's office.



However, Mr. Fielding did not tell Ms. Coe and Mr. Pettitt about E&Y's concerns and the possibility that they might resign as auditors if they were unable to perform this work with satisfactory results. Mrs. Kohn (who controlled Herald through her majority ownership of Bank Medici AG and advised Primeo and Alpha through Eurovaleur) is reported to have thought that the proposed review was not a good idea. There was positive resistance from Genevalor (as investment manager of Hermes and Lagoon) which threatened to move its business to another service provider if HSBC persisted with this proposal. Mr. Fielding made the point that all sub-custodians are subject to review and it is a matter for the custodian, in this case HSSL, to decide when to carry out a review. In an e-mail addressed to Mr. Paul Smith, Mr. Wilcockson and Mr. Birgen, he said –

Partly I think this is a matter of getting the correct spin. All sub-custodians are subject to periodic review and this is our call as we appoint the sub-custodian, it is not client specific.

As I recall Madoff holds assets as our sub-custodian for funds promoted by Genevalor, Bank Austria, Bank Medici and Square One. Also, we provide credit to nearly all these funds relying on collateral rights over the assets. These clients asked us to be custodian and take the risk in addition to providing credit and they wanted us to appoint Madoff as our sub-custodian; they can't expect us to do no due diligence or review.

This e-mail was sent by Mr. Fielding on 15 March 2005, the day after he had sent the e-mail to Mr. Fiorino telling him that he should issue a custody confirmation to E&Y in respect of these same clients. In spite of what he wrote in two separate e-mails on consecutive days, Mr. Fielding's evidence is that he did not then believe, and still does not believe, that BLMIS held any assets as sub-custodian for HSSL. I do not find this evidence to be credible.

115. Mr. Pettitt's meetings with the HSSL executives in Luxembourg eventually took place on 21 March 2005. During the day he met with various people including Mr. Fielding, Mr. Wilcockson and Mr. Fiorino. The record of the meeting reflects that all aspects of the clients' relationship with BLMIS were discussed. In particular, Mr. Pettitt learned that BLMIS acted in a triple capacity as investment manager, broker and sub-custodian. He

said that this concentration of function was something which HSBC would “have shied away from”. The meeting note also records that Mr. Fielding “believes that Madoff has only one account at the DTC which, if true, means that they may be mixing client and proprietary trading assets”.

116. Shortly after this meeting, on 23 March 2005, Mr. Wilcockson followed up with an e-mail to Ms. Tanya Nystrom who was the Head of Fund Administration for AFS in New York. She was to accompany Mr. Pettitt at the meeting with Madoff. Mr. Wilcockson explained –

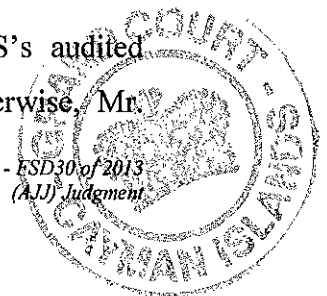
In the case of two locations – Bermuda and Luxembourg – there are sub-custody agreements where the bank appoints Madoff as sub-custodian. It is these appointments that [Mr. Pettitt] is looking at most as Madoff is outside the Bank’s standard sub-custody network. This is further complicated by the fact that some of the funds have credit facilities, mostly FX lines, and of course the assets are not strictly in our control.

Mr. Wilcockson clearly believed that BLMIS was acting as sub-custodian for HSSL.

117. Mr. Pettitt and Ms. Nystrom met Madoff for about 90 minutes on 1 April 2005. A questionnaire was sent to Madoff and had been completed in advance of the meeting. The substance of the meeting is recorded in a call report. Madoff stated in the questionnaire that “Proprietary assets are kept in separate accounts from client assets”. The call report records Madoff as having advised that “they maintain complete segregation of client and proprietary assets at DTC.” Mr. Pettitt was provided with the account number for what he understood to be the client account at DTC but no steps were ever taken to verify that BLMIS did have two DTC accounts. In fact, it only ever had one account. Mr. Pettitt’s overall conclusion, as stated in his call report, was that -

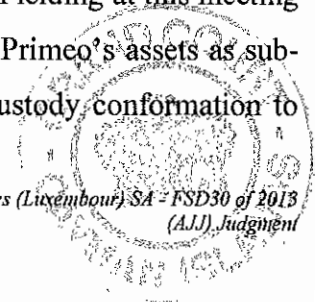
From the discussion, responses and documentation it appears that the assets are appropriately segregated and that the company exerts adequate control over its clients’ assets and meets their regulatory responsibilities.

The only supporting documentation provided to Mr. Pettitt was BLMIS’s audited financial statements and an internal control report issued by F&H. Otherwise, Mr.



Pettitt's conclusion was based entirely upon the answers provided to him by Madoff, both in writing and orally at the meeting. Mr. Pettitt's evidence is that his conclusion about BLMIS was based solely on his perception of Madoff as a man of standing and good reputation. It has to be said that Mr. Pettitt was not alone in this regard. Many others, including a succession of SEC examiners and investigators, were content to accept Madoff's word without taking any steps to verify what they were being told.

118. Mr. Pettitt clearly conducted this meeting on the basis that he was carrying out a sub-custody due diligence review. There were two relevant sub-custody agreements. The 2004 Sub-Custody Agreement between BoB Lux and BLMIS related to Primeo, Lagoon, Alpha, Herald and Square One. The sub-custody agreement between BTDL and BLMIS executed in 1996 related to Thema. Mr. Pettitt's evidence is that he would have read them at the time. It was put to him that their terms are essentially the same. He could not recall but agreed that they are broadly the same. He agreed that Thema's assets were held by BLMIS as sub-custodian for BTDL but insisted that he understood Primeo's assets to be held by BLMIS, not as sub-custodian for BoB Lux, but as custodian for Primeo. He said that he first learned this from Mr. Fielding (apparently at the meeting on 21 March 2005) when he was told that the 2004 Sub-Custody Agreement (and its predecessor) was entered into only "for the purposes of credit". His evidence about the effect of the 2004 Sub-Custody Agreement is inconsistent with the contemporaneous documentary evidence. It is also inconsistent with the understanding of Mr. Wilcockson and Mr. Fiorino who were also present with Mr. Pettitt at the same meeting in Luxembourg on 21 March 2005. The contemporaneous documentary evidence makes clear that their understanding of what Mr. Fielding said at the meeting is quite different from Mr. Pettitt's understanding as now explained to the Court. It is clear from Mr. Wilcockson's e-mail, written just two days later, that he did not distinguish between Thema and the other funds. He thought that BLMIS was holding all of their assets as sub-custodian for BTDL/BoB Lux. Likewise, nothing could have been said by Mr. Fielding at this meeting to change Mr. Fiorino's understanding that BLMIS was holding Primeo's assets as sub-custodian for HSSL, otherwise he would not have issued the custody confirmation to



E&Y two weeks later. I did not find Mr. Pettitt's evidence about his understanding of the effect of the 2004 Sub-Custody Agreement to be credible.

119. Mr. Pettitt's conclusion about BLMIS was the subject of discussion at a sub-custodian review meeting on 13 May 2005. The minutes of this meeting are not in evidence but it appears from the transcript of counsel's opening in the Thema proceeding (in which the minutes were produced) that Mr. John Gubert ("Mr. Gubert"), the Global Head of HSS, expressed the view that BLMIS' procedures were not acceptable. The inference is that Mr. Gubert disagreed with the conclusion expressed in Mr. Pettitt's call report. The result was that Ms. Coe produced a Discussion Document on the subject dated 23 May 2005. She made essentially the same points about BLMIS' flawed business model that had been made by others over the years. It is a notable feature of this story that all the industry professionals involved with BLMIS appear to have recognized that its business model was highly unusual, did not comply with accepted hedge fund industry standards about segregation of functions and therefore gave rise to a high risk of fraud or error. In her Discussion Document, Ms. Coe questioned the value of the due diligence performed by Mr. Pettitt because it did not involve an audit of the end to end process flow to confirm the integrity of the whole trading activity. She also questioned the extent to which F&H's internal control reports could be relied upon and concluded that "The key to this in my view, is the need for an independent control review. If we had the equivalent of a SAS70³⁷ carried out by a major firm, I think that we could get comfortable."

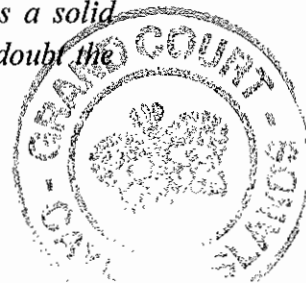
120. Mr. Gubert agreed with Ms Coe's proposal. In an e-mail dated 30 May 2005 he said –

It strikes me that the firm has reasonable capital (US\$450m for BLMIS), has a solid reputation but that we have a flawed process. Although there is no reason to doubt the integrity of the Group, the reality is that:

we do not have full control of assets or real time sight of transaction flows

³⁷ This refers to an in-depth examination of a professional service provider's accounting and internal control procedures by an independent accounting firm in accordance with the guidelines contained in the Statement of Auditing Standards (SAS) No.70. This standard was in force throughout the period of Primeco's trading life. It was superseded by a new standard in 2011.

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*the transactions are all internal to the family firms and there is no proof of best execution or even actual execution
the audit is undertaken by a firm that is not on our recognized list of auditors*

We appoint BLMIS as our sub custodian and expect them, according to the documentation, to exercise the duty of care expected of a reasonable professional sub custodian for hire. We appoint them from Dublin and appear to have a fiduciary duty to the underlying investors. The reality is that if we had concerns we would need to call on BLMIS to deliver the appropriate value to us.

I cannot countenance this process – and I appreciate it is a major money earner – unless we can adopt the process common in banking in the USA where liens (other than absolute title and possession) are adopted. Under that process we – or our delegate – could arrive unannounced at the client office to assess that all security was in place as advised. I appreciate Madoff does not like external “intrusion” and am willing for this to be undertaken by our auditors (at our cost). If this cannot be done, then we should exit the relationship.

Ms. Coe said that she drafted part of this e-mail. She said that she deliberately conveyed a stark message in order to get the attention of the relevant decision makers which would be necessary to secure approval for commissioning an independent review at HSBC’s expense.

121. This e-mail also reflects a belief that BLMIS had been appointed as sub-custodian in respect of all the clients. The Discussion Document does likewise. No distinction is made between Thema, which was a UCITS fund administered in Dublin, and the non-UCITS funds (including Primeo) administered in Luxembourg. However, Ms. Coe’s evidence to this Court is quite different. She explained, in the clearest possible way, her belief that Thema’s assets were held by BLMIS as sub-custodian pursuant to the sub-custody agreement made when the fund was established in 1996, whereas the assets of the other funds (including Primeo) were not held by BLMIS as sub-custodian for HSSL. Her evidence is that the 2002 and 2004 Sub-Custody Agreements had been executed solely for the purpose of securing the credit advanced to these funds. She said that she did not make this point in her statement in the Thema proceeding because it was not relevant to do so in that case. Ms. Coe comes across as a very capable businesswoman. She is very

articulate. She made the argument in a more compelling way than Mr. Fielding and Mr. Pettitt but, at the end of the day, it seemed no less contrived.

122. Ms. Coe was responsible for engaging KPMG. She decided not to instruct them to carry out an SAS70 review (even though she would normally expect a sub-custodian to produce an SAS70 report) because it would merely confirm that appropriate internal control procedures are in place and that trades are being executed in accordance with those procedures. She said that a SAS70 would not have identified whether the trading was real and she therefore decided to engage specialist forensic accounts to conduct a detailed review, tailored to the BLMIS business model, and designed specifically to identify whether any fraud was being perpetrated. She did not consider instructing KPMG to carry out an audit of the assets recorded as being held by BLMIS on behalf of the clients (as at any particular month end) in the way E&Y had instructed F&H to do. To the extent that confirming the existence of the assets would involve obtaining evidence from third parties outside of BLMIS, she said that the two KPMG engagement partners “both agreed with me that that was never going to happen”. This point was the subject of lengthy cross-examination. It was put to her that the instructions to KPMG left out the key issue. I accept her evidence that she did impress upon KPMG that they were to do whatever they considered necessary to satisfy themselves about the integrity of BLMIS’s trading operations and the existence of the assets, but she must have understood that this was subject to the important caveat that they would not attempt to obtain corroborating evidence directly from independent third parties. KPMG did not agree to undertake any audit procedures and it was not engaged to express an opinion about the existence of the assets. It was engaged to conduct a fraud risk review. Ms. Coe was entitled to expect that KPMG’s findings would help HSBC to make a more informed judgment about the integrity of BLMIS’s operations, including the existence of its clients’ assets, but the terms of the engagement letter were such that she was never going to receive anything equivalent to an audit opinion.

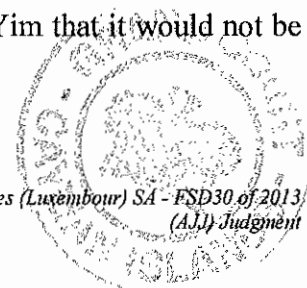
123. The engagement letter was signed by KPMG on 8 September 2005. It states -



You wish us to undertake a review in order to assist you in identifying the fraud risks that may arise as a result of HSBC, as custodian, placing funds of up to eight HSBC clients for investment with [BLMIS] in New York. We understand that HSBC owes these clients a fiduciary duty of care concerning safeguarding of their assets as primary custodian.

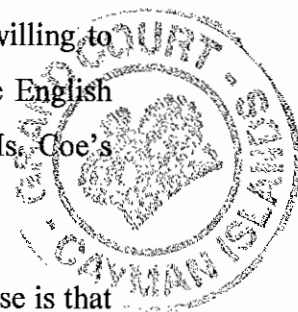
This statement reflects KPMG's understanding of what Ms. Coe had told them about the roles of the HSBC group companies and is contained in the original draft letter sent to her for review on 26 August. She sent the draft to Mr. Fielding (and others) for comment. He did in fact propose an amendment to a reference about obtaining client consent. He said (in an e-mail on 26 August) "As Madoff is contracted as a sub-custodian to us I don't believe we specifically need client consent, though clearly their support and understanding is important in this situation". His proposed amendment is reflected in the final letter dated 8 September which was then agreed and counter-signed by Ms. Coe on 11 October 2005. Once again, this letter reflects an understanding on the part of the HSBC group companies that BLMIS held assets as sub-custodian in respect of all the clients, not just Thema.

124. On 25 October 2005, one of the KPMG engagement partners, Mr. David Yim ("Mr. Yim") sent an e-mail to Ms. Coe outlining the work which they proposed to perform on-site at BLMIS's office in New York. The list included "Obtaining and reviewing corroborative evidence to support the existence and accuracy of reported trades" and "Obtain and review records of segregated client accounts maintained for clients contracted with HSBC for evidence of existence". I do not accept the argument of counsel for the Defendants that this work plan is evidence that KPMG were instructed to perform assurance or audit work. He misses the point that this work plan is talking about reviewing records and corroborative evidence *obtained from BLMIS*. For example, KPMG did review the daily DTC participation reports which do constitute corroborative evidence of the existence of the clients' assets, but the documents they saw were forgeries obtained from BLMIS. KPMG were not instructed to obtain reports *directly* from the DTC because it was agreed between Ms. Coe and Mr. Yim that it would not be possible to do so.



The First KPMG Report

125. KPMG on-site review began at BLMIS' office in New York on 7 November 2005 and lasted for four days. Mr. Pettitt happened to be in New York at the time and had dinner with the two engagement partners, Mr. Yim and Mr. David Luijernink ("Mr. Luijernink") after the second day's work on 8 November 2005. In an e-mail sent to Ms. Coe the following morning, Mr. Pettitt reported that "They seem impressed with Bernie and are generally happy. They have tracked trades through to the market side and are happy that spot checks have shown the audit trail to be as expected".
126. Shortly after the KPMG team returned to London, Ms. Coe arranged what she called a "de-briefing session" with Mr. Yim and Mr. Luijerink. The meeting took place at her office sometime in November before they delivered a draft report to her on 7 December 2005. She said that the meeting was preceded by a telephone conversation with Mr. Yim and she recalls him having said something to the effect that "We've done the all work, all looks OK, happy with everything". There is no call report or other documentary evidence of what was said at this meeting. Ms. Coe's evidence is that it was a critical meeting and that she is still, eleven years later, very clear about what was said. She is adamant that Mr. Yim expressed, in positive terms, his view that nothing untoward was going on at BLMIS. She specifically recalls having opened the meeting with the question "Is Bernie at it?" and having been told by Mr. Yim "Absolutely not". Mr. Yim was unwilling to attend and give evidence to this court but he was required by an order of the English court to give written answers to interrogatories based upon the content of Ms. Coe's witness statement.
127. Mr. Yim's written answers are carefully drafted. The general tenor of his response is that he cannot "fully recall what was said at the meeting" but he may have said (subject to the caveats set out in the subsequent report) that "we had not found any evidence while visiting BLMIS that it was engaged in any type of fraud or financial impropriety (as distinct from providing any assurance that BLMIS was not so engaged)". Ms. Coe's evidence is that he went further and expressed the positive opinion that he was satisfied



about the existence of the assets and the validity of the trades. In my judgment, neither Mr. Yim nor Ms. Coe have given entirely reliable evidence about what was said at this meeting. In the light of Ms. Coe's evidence and what Mr. Yim said three years later when reporting upon the outcome of his second review of BLMIS, I do not accept his written answers as constituting a fair and frank summary of what he said at the meeting. On the other hand, I conclude that Ms. Coe must have exaggerated the extent of the assurance expressed by Mr. Yim, otherwise she would surely not have accepted his report without commenting on the fact that its content is so different from what was allegedly said at the meeting.

128. The final version of the report is dated 16 February 2006 ("the First KPMG Report"). The introductory section sets out its limitations which accord with the terms of the engagement letter. It states as follows –

We have relied on information provided by HSBC and [BLMIS] personnel and have not independently verified that information.

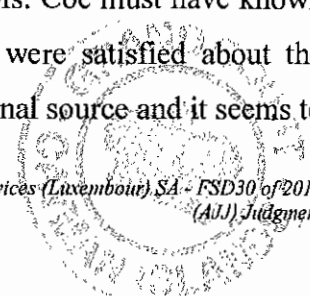
We were not required to review portfolio performance at [BLMIS], nor have we conducted an audit of client assets.

KPMG has not conducted an audit as part of its work, whether statutory or otherwise of HSBC, [BLMIS] or the information provided.

129. The first point made by KPMG under the heading 'Major Findings' merely re-confirmed the problem inherent in BLMIS's business model -

Asset ownership: Independent and external confirmation as to ownership of individual HSBC client assets cannot be made. [BLMIS] undertakes bulk trades and then allocate these assets on a proportional basis within [BLMIS] to individual client accounts. [BLMIS] produce a 'Client Confirmation' for each asset transaction other than for transactions to buy or sell Options and Fidelity funds.

To this extent, the report re-confirmed the existence of a problem which had been known, both to HSSL and its clients, from inception. For this reason, Ms. Coe must have known that KPMG would not express a positive opinion that they were satisfied about the existence of the assets without obtaining evidence from an external source and it seems to



me inherently unlikely that Mr. Yim would have expressed this opinion orally when he was not prepared to state it in writing.

130. The second ‘Major finding’ concerned internal controls as follows –

Internal controls: The controls tested by KPMG during the course of the on-site work were found to be in place. However, they may not prevent fraud or error occurring on client accounts, if management staff at [BLMIS] either override controls or undertake activities where appropriate controls are not in place.

The risk of internal controls being overridden or transactions being undertaken outside the control system is inherently high in any business which is owned, controlled and managed by one dominant individual. All those concerned must have understood that BLMIS was the classic case in which this risk existed and it is in fact exactly what happened. It was Madoff who instigated and managed the Ponzi scheme.

131. These are the key findings. Having regard to the scope limitations agreed with KPMG, no more positive findings about the existence (or non-existence) of the assets could have been expected, but it is important to focus on the nature and extent of the work done as described in Section 4 and Appendix B of the report. KPMG conducted an in-depth review of BLMIS' books and records and saw the documentation which they would have expected to see, including documents apparently generated and received from third parties such as BNY, JP Morgan and the DTC. What Mr. Yim must have said at the meeting is that this work produced a satisfactory result in the sense that KPMG did not come across any evidence or suspicious circumstances tending to suggest to them that the trading reflected in BLMIS's books and records had not taken place or that the results of the trading had been manipulated or that the reported assets might not exist. Put simply, nothing occurred or was found which aroused any suspicion on the part of KPMG. The report itself did not provide HSSL with a positive result in the form of an opinion that the assets existed but it seems to me that it was reasonable for Ms. Coe and her colleagues to take comfort from the absence of a negative result, in the sense that KPMG found no evidence tending to suggest any kind of impropriety.



132. HSBC was in fact reassured by the outcome of the KPMG review. On 13 March 2006, Ms. Coe prepared a draft of a letter intended to be sent to Madoff by Mr. Paul Smith. The draft, as reviewed and amended by Mr. Fielding, stated –

I am pleased to confirm that HSBC has now received the final Controls Review Report undertaken by KPMG on our behalf in relation to the appointment of [BLMIS] as our sub-custodian for specified clients.

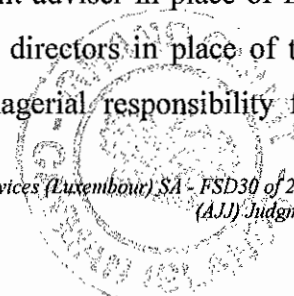
The actual letter sent to Madoff was not put in evidence but it was sent and I infer that its terms could not have been materially different from this draft. In addition to writing to Madoff, Mr. Paul Smith also wrote to Mrs. Kohn on 15 March 2006 in similar terms –

Sonya, just a quick note to tell you that our custody due diligence review on Bernard Madoff's business in New York is now complete and we have written to Bernard to confirm that we are happy to continue with him as a duly appointed sub-custodian. There are a few minor issues that we need to tidy up between us but these are insignificant."

It is reasonable to infer that Mrs. Kohn passed this information on to Dr. Fano on behalf of Primeo.

The appointment of Pioneer as investment adviser (25 April 2007) and the in specie subscription for shares in Herald (2 May 2007) ('the Herald Transfer')

133. In April 2007, various changes were made to the operation of Primeo as a result of the fact that Bank Austria had become a subsidiary of the UniCredit Group, a large multi-national banking and financial services group domiciled in Italy. Bank Austria's alternative investment business was transferred to Pioneer, another UniCredit Group subsidiary which had a large, well-known asset management business based in Dublin. On 25 April 2007, Primeo's Founder Shares (which carried all the voting rights) were transferred to Pioneer which then appointed itself as investment adviser in place of BA Worldwide and its nominees were appointed to the board of directors in place of the Bank Austria nominees. Dr. Fano ceased to have any managerial responsibility for



Primeo but she was retained as a consultant by Pioneer and was appointed (for the first time) to Primeo's board of directors. Pioneer also arranged for Primeo to enter into a contract with Maples Finance Limited (a licensed trust company and mutual fund administrator carrying on business in the Cayman Islands) for the provision of independent directorship services, pursuant to which Mr. Michael Wheaton was appointed to Primeo's board of directors.

134. Pioneer took the decision to reorganize Primeo Select's investments by terminating the managed account with BLMIS and instead subscribing for shares in Herald. This reorganization was achieved by assigning Primeo's rights under its managed account (having a reported value of US\$465,824,061 as at 1 May 2007) to Herald in consideration for the issue of shares by Herald having an equivalent subscription price based upon its NAV for 30 April 2007. Thus, the 1996 Brokerage Agreements were terminated and Primeo ceased to have any contractual relationship with BLMIS. Counsel have referred to this transaction as "the Herald Transfer".
135. The commercial result of this transaction is that, with effect from 2 May 2007 until the end of its trading life, Primeo was indirectly exposed to BLMIS through shareholdings in Herald and Alpha which were themselves single manager funds wholly invested with BLMIS through managed account arrangements on the same terms as Primeo's 1996 Brokerage Agreements. Herald paid an investment management fee calculated at 2% of its NAV, but its investment manager rebated the equivalent of 1.7% to Primeo so that the net annual cost of this transaction to Primeo's investors was only 30 basis points.

The second KPMG fraud risk review – April 2008

136. On 23 January 2008, a further sub-custodian agreement was concluded between HSSL and BLMIS. It related to Lagoon/Hermes, Alpha, Herald and a new UCITS fund established by Bank Medici called Herald (Lux). Another fund called Senator Fund SPC was added to the agreement in April. At about the same time, HSBC decided to instruct KPMG to conduct a second fraud risk review in respect of BLMIS. Ms. Coe was in charge of the exercise and the KPMG team was again led by Messrs. Yim and Luijterink.



The engagement letter was executed on 19 March 2008 and was in large part identical to the 2005 letter except that it included an additional instruction which stated – ‘Perform limited testing on a sample basis of the existence and accuracy of recording transactions executed by Madoff on behalf of HSBC’. However, as on the first occasion, KPMG’s work was limited to reviewing BLMIS’ books and records. It was not instructed to obtain (or attempt to obtain) corroborating evidence directly from the DTC, BNY or any trade counterparties in order to verify information contained in BLMIS’ records and reported to its clients. If Ms. Coe did tell Mr. Yim that “they should do whatever they considered necessary to satisfy themselves about these matters”, she did not intend that KPMG should seek to obtain confirmations from third parties, nor was it interpreted in this way by Mr. Yim. They both proceeded on the assumption that it would not be possible to obtain information directly from any third parties.

137. The work commenced at BLMIS’ office on 14 April 2008 and continued over several days. On 23 April 2008, Ms Coe met Messrs. Yim and Luijerk at her office in London to discuss their initial findings. There are inconsistencies in Ms. Coe’s written evidence about what was said at this meeting. In her Primeo witness statement, she said (at paragraph 174) –

KPMG’s unambiguous feedback was that they had satisfied themselves based upon a thorough review as to the integrity of BLMIS’s operations, the validity of the trades that they had tested and the existence of the relevant client assets. Mr. Luijerk confirmed during this meeting that KPMG had been able to reconcile the cash passing through the Fidelity account... and at paragraph 175 ... neither I nor KPMG could see how it would realistically be possible for Mr Madoff to cover up a fraud, given in particular the forensic testing that KPMG had employed.

The corresponding part of Ms. Coe’s Thema witness statement is quite different. It says (at paragraph 99) -

KPMG’s feedback that day was that they had satisfied themselves about an outstanding issue regarding the Fidelity account. I could not see how it would have been possible for Mr Madoff to cover up a fraud, given in particular the forensic testing that KPMG had employed.

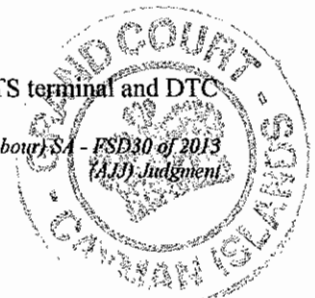
There is no mention in the Thema statement about KPMG being satisfied about the integrity of BLMIS' operations, the validity of trades and the existence of client assets.

138. KPMG's second report was not actually produced and delivered to Ms. Coe until 8 September 2008. In the meantime, on 17 July 2008, a telephone conference call was set up for the purposes of briefing HSBC's Structured Finance Group about KPMG's findings. The reason for doing so was that HSBC's proprietary assets then included an exposure to BLMIS of around US\$1 billion arising out of derivative transactions for which the Structured Finance Group was responsible. The call was not arranged for the purpose of discussing KPMG's findings with HSSL. The attendees were Mr. Yim and Mr. Luijerink on behalf of KPMG, Ms. Coe and Mr. Pettitt on behalf of HSS and Mr. Steven Phan and various others calling in from London, New York and Hong Kong on behalf of the HSBC Structured Finance Group. To put the meeting into context, it should be remembered that Bear Sterns had just collapsed, there was extreme volatility in the financial markets and many US broker-dealers and other market participants were facing severe liquidity problems.
139. This call was recorded and the transcript provides a reasonably reliable record of what was said. Mr. Yim explained the BLMIS business model and made the point that KPMG's work was limited to the examination of BLMIS' own books and records. He said that they had been able to trace the selected trades through BLMIS' books, as on the first occasion, but said that the problem is that they were only seeing internally created records. He explained having traced trades from the HSSL client statements to the block trades settled through BLMIS' DTC account and having seen prints of the relevant DTC documentation, but he also said that Madoff would not let them see the information on BLMIS's DTC terminal (which are referred to as "PTS" terminals)³⁸. (Madoff could never have allowed KPMG to have access to the terminal because it would have enabled them to discover that the prints were forgeries). The participants on this call recognized

³⁸ The expression 'PTS' refers to the DTC's 'Participant Terminal System'. The expressions PTS terminal and DTC terminal are synonymous.

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(AJJ) Judgment



that BLMIS *could* be a Ponzi scheme but no one expressed a suspicion or belief that it was in fact a Ponzi scheme. Ms. Coe described its business model as a “unique situation”. She recognized the need for a separate DTC account to be established in which to hold the HSBC clients’ assets. Mr. Yim made the obvious point (which had been made three years previously) that “The key thing is we need to test the existence of the actual trade because the only way you’re going to be able to verify that this is not just an elaborate fraud”. However, Mr. Yim also expressed his “personal opinion” that “There’s nothing on the trading side which suggests that anything is significantly amiss.” The major findings contained in the written report dated 8 September 2008 are practically the same as those recorded in the first report.

F. The Custody Claim

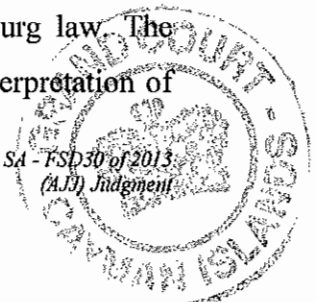
Introduction

140. The Plaintiff’s case is that BoB Lux was appointed, pursuant to the 1993 and 1996 Custodian Agreements, as custodian generally with the result that it had a safekeeping duty in respect of all of Primeo’s assets including those which were managed by BLMIS. Further, it is alleged that BoB Lux breached its duties under the terms of the 1996 Custodian Agreement in respect of the appointment of BLMIS as sub-custodian in 2002 and, thereafter, breached its on-going supervisory duties. BoB Lux’s case is that the assets managed by BLMIS did not fall within BoB Lux’s custody obligations and that the 2002 Sub-Custody Agreement (and the subsequent renewals) were not valid and effective in accordance with their terms in that they were executed solely for the purpose of providing BoB Lux with security and were not intended to change the pre-existing contractual relationship whereby BLMIS held the assets as custodian for Primeo.
141. An essential part of the BLMIS business model, insisted upon by Madoff, was that it would act in the triple capacity of investment manager, broker and custodian. Primeo’s investment advisers and directors understood the operational risk inherent in this model but accepted it as the price to be paid for the benefit of Madoff’s consistent investment performance. It is common ground between the parties that BLMIS did in fact have

custody of assets beneficially owned by Primeo from the inception of its business until 1 May 2007. The first issue to be decided is whether BLMIS held those assets as custodian for Primeo or as sub-custodian for BoB Lux. The analysis of this issue naturally falls into two stages. The first stage is the period from inception to 7 August 2002, being the date on which the 2002 Sub-Custody Agreement was executed. The second stage is the period from 7 August 2002 to 2 May 2007 when Primeo ceased to have any managed account with BLMIS, having assigned its rights to Herald. Having regard to the way in which the Plaintiff puts its case, it is also relevant to consider the stage from 2 May 2007 onwards, when the whole of Primeo's invested assets comprised shares in Herald and Alpha which were registered in the name of HSSL as custodian.

BLMIS as custodian for Primeo – the period from inception to 7 August 2002

142. The 1994 Brokerage Agreements were executed by Dr. Zapatocky and Dr. Scheithauer on behalf of Primeo. To my mind it is clear that the counterparty to the Customer Agreement is Primeo (as pleaded by the Plaintiff), not HSSL acting as agent on behalf of Primeo. There is evidence that BoB Lux anticipated that the managed account would be established in its name on behalf of Primeo, but this is not what in fact happened. The Customer Agreement was executed in the name of *Primeo Fund* by its directors and BLMIS therefore opened a managed account (the 1FN-060 Account) on its books in the name of *Primeo Fund*. The address given for Primeo is its registered office in the Cayman Islands but the agreements are also stamped with BoB Lux's name/address stamp, being the business address of the custodian and administrator to which correspondence relating to the account should be addressed. The 'customer' to whom the Customer Agreement applies was Primeo and the legal owner of the 1FN-060 account was Primeo.
143. The 1996 Brokerage Agreements were executed as a result of the decision to establish two share classes, one of which (the Class B shares) would constitute a sub-fund wholly invested with BLMIS. They are expressed to be governed by Luxembourg law. The applicable principles of Luxembourg law relating to the formation and interpretation of



contracts have been explained by three expert witnesses and are not in dispute. As regards the formation of a contract, Article 1108 ff of the Luxembourg Civil Code requires –

(i) the consent of each of the parties who obligate themselves, (ii) the parties' capacity to enter the contract, (iii) a definite object for which the parties agree to contract and (iv) a licit cause [ie consideration] for the parties' obligations.

When construing a contract, the Luxembourg court is seeking to establish the shared intention of the parties at the time of entering into the contract. The Defendants' expert, Mr. Franz Fayot ("Mr. Fayot"), summarized the principles of interpretation which will be followed where the contract is unclear or ambiguous in the following way –

*a. The Court would seek to identify the objective and subjective intention of the parties.
b. In doing so, the Court would be presented with factual and expert evidence, and it would take account of any relevant facts (including the prior and subsequent conduct of the parties, and general market practice) as well as the contractual wording itself.
c. The Court will give effect to the natural words of the contract, unless the wording is unclear, ambiguous, inconsistent or plainly uncommercial. In such circumstances, the Court will depart from the literal words, and instead interpret them consistent with the parties' intentions, in the relevant commercial context.*

The expert witnesses are agreed that the Luxembourg court would take into account the subjective intention of the parties. Since the court is seeking to establish the shared intention of the parties, the subjective intention of one party can only be relevant if it has been communicated to the other party. The court would take into account evidence of both pre-contract negotiations and post-contract conduct.

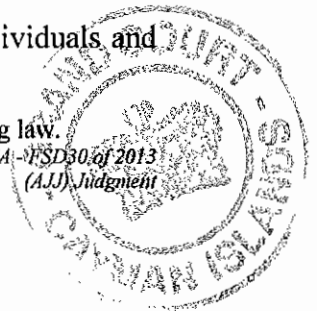
144. The 1996 Brokerage Agreements were executed in the name of *Primeo Fund Class 'B'* and BLMIS therefore opened the new managed account (the 1FN-092 Account) on its books in the name of *Primeo Fund - Class 'B'*. However, counsel for the Plaintiff argues that the manner in which the documents were executed by Mr. O'Connor (who was a director of both BoB Lux and Primeo at that time) leads to some ambiguity about the identity of the 'customer'. There was power under Clause 6(B) of the 1993 Custodian Agreement for BoB Lux to open a brokerage account either in the name of Primeo or, in

its own name on behalf of Primeo. The Plaintiff's expert on Luxembourg law, Monsieur Fabio Trevisan ("Mr. Trevisan") argued that BoB Lux should be treated as the 'customer', principally because *Primeo Fund - Class 'B'* is the description of a share class/sub-fund and is not a legal entity. I do not accept this argument. The name itself is consistent with the conclusion that the common intention of the parties was to establish the account in the name of Primeo Fund, referencing the Class B sub-fund.

145. The existing 1FN-060 Account had been opened in the name of Primeo and there is no evidence from which to infer any intention to change the existing arrangement and open the new account in the name of BoB Lux on behalf of Primeo (for its Class B share class). The handwritten annotation on an internal BLMIS account opening document relating to the new account entitled *Primeo Fund – Class B* states "New foreign acct – waiting for acct papers (This acct has same 'owner' of Primeo Fund Acct #1FN060, but will a new acct, for acct'g purposes)." Mr. Fayot and Mr. Alex Schmitt ("Mr. Schmitt")³⁹ agree that this is evidence which can properly be taken into account for the purpose of determining the parties' common intention. It tends to support the conclusion that the new account was intended to be an additional account established for the existing customer, namely Primeo. The fact that the documents bear the BoB Lux name/address stamp does not point to an intention to open the account in the name of BoB Lux. It is merely the business address which would be applicable in any event, whether the account is in the name of *Primeo Fund - Class 'B'* or in the name of *BoB Lux for Primeo Fund - Class 'B'*. The name/address stamp was applied to the 1994 Brokerage Agreements for the same reason.

146. I now turn to the question of whether the 1996 Brokerage Agreements create a custody relationship between BLMIS and Primeo but, before considering the arguments advanced by counsel, it is relevant to make two important preliminary points. First, the 1996 Brokerage Agreements comprise a collection of printed standard form documents which are obviously inadequate for the purpose of documenting the three functions in fact performed by BLMIS. The Customer Agreement is designed for use by individuals and

³⁹ Mr. Schmitt was jointly appointed by the parties to give expert evidence on matters of Luxembourg law. 170823 In the matter of *Primeo Fund and Bank of Bermuda (Cayman) Limited (1) HSBC Securities Services (Luxembourg) SA* FSD30 of 2013 (A.J.J.) Judgment



appoints BLMIS as broker-dealer, but the evidence of the Plaintiff's custody expert, Mr. Peter Vinella ("Mr. Vinella") is that it would normally sit alongside a securities trading agreement which is missing in this case. He also suggested that the Trade Authorization (which gave BLMIS a discretionary authority to buy and sell securities) would normally relate to an investment management agreement, which is also absent in this case. Finally, there is no custody agreement as such. The absence of any investment management agreement and custody agreement means that the usual provisions for the payment of fees are also missing. Second, by the time the 1996 Brokerage Agreements were executed, the business relationship between BLMIS and Primeo had already existed for two years based upon exactly the same contractual documents. The printed forms used in 1994 and 1996 are the same. The only difference is that the blank contained in the choice of law clause in the Customer Agreement has been filled in differently. In 1994 the parties chose Austrian law whereas in 1996 they chose Luxembourg law. Notwithstanding the inadequacy of these standard forms and the ambiguity arising out of their use, Primeo knew in 1996 how the contracts would in fact be performed by BLMIS. By January 1996, BA Worldwide must have known that BLMIS was acting in a triple capacity in respect of the 1FN060 Account and must have understood and agreed that it would continue to act in exactly the same way in respect of the new 1FN092 Account. This is an important factual circumstance to be taken into account, as a matter of Luxembourg law, in determining the shared intention of the parties.

147. Counsel for the Plaintiff makes a number of arguments. First, he makes the point that BoB Lux (acting by Mr. O'Connor) could only have executed the 1996 Brokerage Agreements pursuant to the authority conferred by the 1993 Custodian Agreement which contemplates that there will be only one custodian. The relevant clauses state as follows

2. The Company HEREBY APPOINTS the Custodian to be and the Custodian HEREBY AGREES to act as custodian of the Company in accordance with the Articles and the terms and conditions hereinafter contained from the date hereof. The Company agrees to deliver to the Custodian all Securities and cash owned by it, and all payments of income, payments of principal or capital distributions received by it with respect to the Securities.

6(B). *The Custodian shall upon receipt of Proper Instructions,⁴⁰ open accounts with brokers or other intermediaries in its name on behalf of the Company or in the name of the Company and may make such arrangements concerning the trading authorisations and other forms of authority with respect to such account or accounts as it deems advisable. 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.*

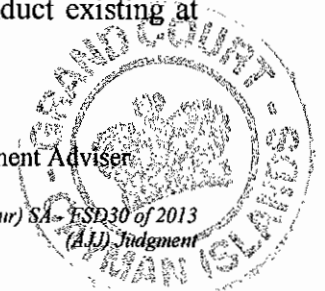
16(B). *In performing its duties hereunder the Custodian may appoint such agents, sub-custodians and delegates as it might think fit to perform in whole or in part any of its duties and discretions....*

148. Whilst Primeo agreed that it would deliver *all* Securities to BoB Lux, it had not in fact done so. All cash subscriptions were delivered to BoB Lux, but cash was then transferred to BLMIS pursuant to Proper Instructions given under Clause 5(A)(g) which meant that it ceased to be held in BoB Lux's custody. Cash was transferred to BLMIS on the basis that it would be managed on a discretionary basis and that the Securities would be held in the custody of BLMIS. As at January 1996, there was no sub-custody agreement in place between BoB Lux and BLMIS. Cash was never transferred under Clause 5(A)(a) to settle purchases of Securities which would then be settled into BoB Lux's custody (via its network sub-custodian in New York which would have been either Brown Brothers Harriman or Citibank). It follows that the securities held by BLMIS were not recorded in BoB Lux's custody records and that the 'holdings reports' (which identified the Securities held in its custody) issued to BA Worldwide did not include the assets held by BLMIS on the managed accounts. By January 1996, there was an established course of dealing and understanding amongst Primeo (acting by BA Worldwide which in turn took advice from Eurovaleur), BLMIS and BoB Lux, that BLMIS would perform the triple functions of investment manager, broker and custodian. Read in isolation, the terms of the 1993 Custodian Agreement tend to suggest that Primeo would not have intended to appoint BLMIS as a second custodian but the established course of conduct existing at

⁴⁰ "Proper instructions" is defined by Clause 1(a) to mean instructions from Primeo or the Investment Adviser signed in the name of Primeo or the Investment Adviser by a director or an authorised signatory.

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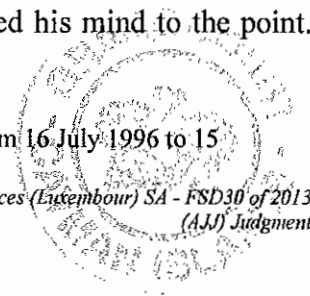
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the time the 1996 Brokerage Agreements were executed points to the opposite conclusion.

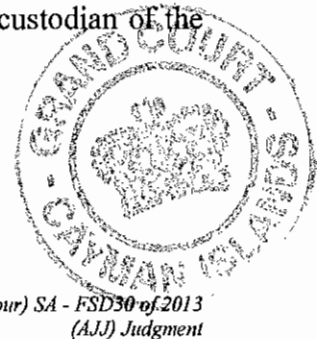
149. Counsel for the Plaintiff argues that no Proper Instructions were issued to BoB Lux requiring that it appoint BLMIS as a custodian. The 1996 Brokerage Agreements were executed consequential upon the directors' decision to restructure Primeo into two sub-funds represented by Class A shares and Class B shares. This project was discussed by the board of directors at its meeting on 20 December 1995. On the following day, Mrs. Kohn sent a letter by fax to Mr. Wayne Chapman⁴¹ at BoB Lux asking him to send the "signed account opening papers" (which must mean the 1996 Brokerage Agreements) to BLMIS by fax and forward the originals by messenger. Mrs. Kohn participated in the next board meeting on 15 January 1996 when she made a presentation about the project. The formal decision is contained in a unanimous written resolution dated January 1996. Neither the board minutes nor the formal written resolutions say anything about entering into a new set of agreements with BLMIS. However, given Eurovaleur's role as sub-investment adviser and the fact that the restructuring was being done on Mrs. Kohn's advice, it is reasonable to infer that she was in fact authorized to instruct BoB Lux to execute the 1996 Brokerage Agreements and BoB Lux appears to have accepted her fax dated 21 December 1995 as constituting a Proper Instruction. If, on their true construction, the 1996 Brokerage Agreements had the effect of appointing BLMIS as custodian (and investment manager), then it seems to me that BoB Lux did receive a Proper Instruction to make these appointments, albeit not one which said so expressly.
150. The Plaintiff's counsel sought to place some reliance upon the oral evidence of Mr. Bailey who was BoB Lux's client relationship manager for Bank Austria from 1995 to 2000. He was asked technical questions about his understanding at the time (now up to 20 years ago) of the basis upon which BoB Lux gave instructions to BLMIS to withdraw funds from the managed account. His initial answer was simply "As administrator and custodian" which suggests to me that he had never really applied his mind to the point.

⁴¹ Mr. Chapman was an employee of BoB Lux who served as a director of Primeo from 16 July 1996 to 15 December 1997.



He then agreed with counsel's leading questions that, in giving instructions to BLMIS, BoB Lux was exercising its rights as custodian of the managed account. He had said exactly the opposite in his witness statement which may well reflect his response to equally leading questions from the Defendants' lawyers. In all fairness to Mr. Bailey, I think that he was being asked technical questions about a subject which fell outside his expertise and I attach no weight to any of his evidence, both written and oral, on this point.

151. The fact that BoB Lux (as opposed to BA Worldwide) gave withdrawal instructions to BLMIS in respect of both the 1FN060 and 1FN092 Accounts after the execution of the 1996 Brokerage Agreements does not lead me to the conclusion that it must necessarily have been doing so in its own right as the accountholder. It could equally well have been doing so on behalf of Primeo, on instructions received from BA Worldwide. Having established the accounts in the name of Primeo, Clause 6(B) of the 1993 Custodian Agreement permits BoB Lux to make such arrangements concerning trading authorization and forms of authority as it deems desirable. Whilst the arrangements are not documented, it can be inferred from the parties' conduct that BLMIS acted on instructions received from BoB Lux on behalf of Primeo as the accountholder.
152. Prior to the execution of the 1996 Brokerage Agreements, the assets credited to the 1FN060 Account were not recorded by BoB Lux in the custody records maintained by its Global Custody Department. Following their execution, BoB Lux continued not to record the assets credited to either of the 1FN060 or 1FN092 Accounts in its custody records. It continued to issue holdings reports to BA Worldwide which reflected that these assets were not held in its custody. BA Worldwide never questioned the accuracy of these holdings reports. This is post contract conduct which tends to support the conclusion that the 1996 Brokerage Agreements were intended to constitute BLMIS as custodian of the assets for Primeo, rather than sub-custodian for BoB Lux.



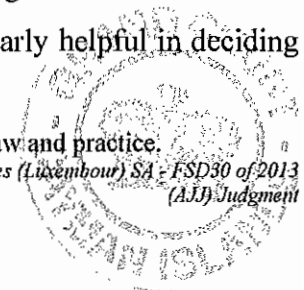
153. In support of his argument that BLMIS was constituted custodian for Primeo, the Defendants' counsel placed heavy reliance upon Clause 5 of the Customer Agreement which states that –

5. Without abrogating any of the Brokers'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.

154. By way of factual background, it is relevant to bear in mind that BLMIS was permitted under the applicable United States law and regulations to hold assets as custodian for its customers. The evidence of Mr. Don J. Andrews ("Mr. Andrews")⁴², the jointly appointed expert on US securities law, is that an SEC registered broker-dealer can be a 'qualified custodian' for the purpose of holding client assets for its investment advisory clients subject to complying with the 'financial responsibility rules' contained in the Securities and Exchange Act, the custody rules contained in the Investment Advisers Act 1940 and certain New York State laws. His evidence is that BLMIS was in fact carrying on business as an investment adviser at all material times and was therefore subject to the provisions of the 1940 Act even though it was not registered as such with the SEC until August 2006. In fact, it is now known that BLMIS was a Ponzi scheme and failed to comply with these rules in multiple ways but, for present purposes, the relevant point is that the applicable law and regulation would have permitted BLMIS to act as custodian for Primeo or sub-custodian for BoB had it been carrying on its business honestly.

155. Mr. Vinella said that, in his experience, Clause 5 of the Customer Agreement 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. I accept this evidence. If the printed standard form had been used in its proper context and expressed to be governed by New York law, it seems clear to me from its language that Clause 5 would be interpreted in this way. However, this evidence is not particularly helpful in deciding

⁴² Mr. Andrews gave evidence as the single jointly instructed expert on US securities law and practice.
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the issue in the present case where the form has been used as part of a package intended to document BLMIS's triple function and is expressed to be governed by Luxembourg law. Mr. Schmitt expressed the view that Clause 5 could be construed by a Luxembourg court as implying custodial duties on the part of BLMIS vis-à-vis Primeo. Clause 5 assumes that the broker (in this case BLMIS) may hold the customer's assets in its custody. 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 to be operated in the same way, I conclude that the Customer Agreement must be construed as implying a safekeeping obligation on the part of BLMIS.

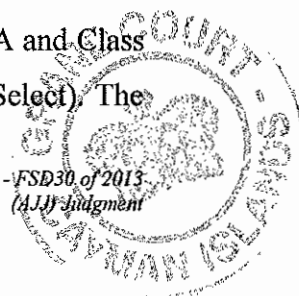
156. This was the conclusion reached by Mr. Schmitt. In answer to a question from me, he explained it in this way –

Mr. Schmitt: ...I have an agreement with my broker and I instruct my broker to invest and I sent him money and he keeps these securities on an account at – one of my accounts on his books. Okay, obviously the common intention of the parties is not that my broker should be, let's say, the custodian in the very classical sense, the intention is that he should buy securities for me. As long as he doesn't transfer them out of his possession, he's acting as a custodian, an ancillary- an implied custodian, an equitable custodian or something like that...

Judge: So the broker has an obligation of restitution?

Mr. Schmitt: Yes.

157. It seems to me that this analysis has to be right. The only question is whether the duty is owed to Primeo or to BoB Lux. The evidence leads to the conclusion that it was owed to Primeo. The 1FN060 Account was established in 1994 in the name of Primeo. The account holder was Primeo. The account was operated by BLMIS on the basis that it would perform the triple function of investment manager, broker and custodian and, by January 1996, this had become the established course of dealing between the parties. The 1996 Brokerage Agreements were entered into for the purpose of giving effect to the restructuring of Primeo's capital into two sub-funds represented by the Class A and Class B shares (which were subsequently re-named as Primeo Global and Primeo Select). The



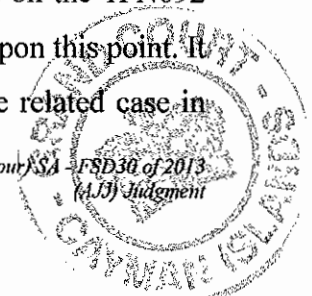
common intention of the parties was that a new account should also be established in the name of Primeo on the basis that the existing 1FN060 Account would become referable to the existing shares (now classified as Class A shares) and that the new 1FN092 Account would be referable to the Class B shares. There is no evidence of an intention to change the rights and obligations of the parties or to change the manner in which the accounts would be operated. The evidence leads to the conclusion that the common intention of the parties was that BLMIS would continue to perform the triple functions on behalf of Primeo as its customer, with the result that the parties must have intended that BLMIS would hold the assets credited to both accounts as custodian for Primeo. It follows, pursuant to Clause 6(B) of the 1993 Custodian Agreement, that the assets credited to these managed accounts fell outside the custodial responsibility of BoB Lux until 2002 when it was decided to restructure the arrangements. It also follows that I reject the argument that there was an un-written sub-custody agreement between BoB Lux and BLMIS during the period from 1994 to 2002.

BLMIS as sub-custodian for BoB Lux – the period from 7 August 2002 to 2 May 2007

158. The next question is whether this contractual relationship was changed on 7 August 2002 when the 2002 Sub-Custody Agreement was executed and the 1FN092 Account was re-designated in the name of *Bank of Bermuda (Luxembourg) S.A. Special Custody Account for Primeo Fund*. The Defendants' case is that, as a matter of Luxembourg law, this agreement is not valid and enforceable in accordance with its terms and did not have the effect of constituting BLMIS as sub-custodian of the assets, with the result that BoB Lux's duties under Clause 16(B) of the 1996 Custodian Agreement were not engaged. In support of this conclusion, counsel puts forward four arguments although I think that the first two are really different aspects of the same point.
159. First, it is agreed amongst the Luxembourg law experts that if BLMIS owed pre-existing safekeeping duties to Primeo, as I have found that it did, then the 2002 Sub-Custody Agreement would be 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. A second aspect of the same point is that if BoB Lux was not already custodian of the assets, as I have found that it was not, then it would have been impossible for it to appoint BLMIS as its sub-custodian. The answer to both these points is that the 2002 Sub-Custody Agreement was part of an implied tri-partite agreement by which the custody arrangements relating to the managed account assets were restructured. Mr. Trevisan agreed that, as a matter of Luxembourg law, a three-party agreement can be implied. 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 Agreements.

160. Second, it is agreed amongst the Luxembourg law experts that a remittance or delivery of assets is required to perfect any custody or a sub-custody agreement. This was not done. The fact that BLMIS recorded the assets in its books in the name of BoB Lux for Primeo is not good enough. For this reason, counsel for the Defendants is right that the 2002 Sub-Custody Agreement did not give rise to a valid and enforceable obligation of safekeeping and restitution but the expert evidence establishes that it was still capable of giving rise to valid and enforceable ancillary obligations which are not dependent upon any remittance of assets.
161. Mr. Schmitt explained that, under Article 1919 of the Luxembourg Civil Code, custodian and sub-custodian agreements are contracts *in rem* which do not give rise to safekeeping and restitutionary obligations unless and until a remittance has taken place. In the case of dematerialized securities, a remittance occurs when the appropriate book-entries are made by both the custodian and the sub-custodian. Even if BoB Lux had recorded the assets in its custody records (or is treated as having done so by recording the assets in the accounting records maintained by its A&V department), there would still have been no remittance as a matter of Luxembourg law, because the assets recorded on the 1FN092 Account were in fact fictitious. The Luxembourg lawyers are all agreed upon this point. It is also the basis upon which the Luxembourg District Court decided the related case in



favour of HSSL.⁴³ However, the fact that no valid *in rem* obligation of restitution arose under the 2002 Sub-Custody Agreement does not necessarily lead to the conclusion that the contract is wholly invalid because it is still capable of giving rise to ancillary *in personam* obligations which are not dependent upon a remittance of assets. All three experts agree with this proposition.

162. Mr. Fayot explained the point in this way –

Mr. Smith: *So a custodian agreement may, for example, impose a supervisory or monitoring obligation ... on the custodian, and that's something that arises out of the terms of the contract, it's not necessarily dependent on the remittance of assets, is it?*

Mr. Fayot: *That's absolutely right, and that's actually the traditional conception of fund custody in Luxembourg, which was more one of supervision of the assets and of the counterparties with whom the Fund was engaging rather than safekeeping of assets.*

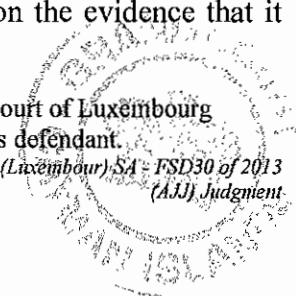
He described such an agreement as a 'framework agreement' to distinguish it from a perfected 'custodian agreement' in respect of which there has been a remittance of assets.

Mr. Schmitt was asked if there was no remittance, is there anything that can be supervised, to which he answered 'Yes, you could supervise the good standing of the broker', by which he meant BLMIS. It follows that even though the 2002 and 2004 Sub-Custody Agreements did not take effect as custodian agreements, they could still take effect as valid framework agreements insofar as there are ancillary contractual obligations which are not dependent upon a remittance of assets.

163. The Defendants' third argument is that there was no common intention or 'meeting of the minds' to create any custody agreement and that the sole object of executing the 2002 and 2004 Sub-Custody Agreements was to improve BoB Lux's security by creating a right of free delivery without at the same time constituting it as custodian of the managed account assets. For the reasons set in paragraph 78 above, I do not accept Mr. Fielding's evidence on this subject. Counsel relies, in particular, upon his evidence that he told Madoff that the execution of the 2002 Sub-Custody Agreement would have no operational effect from BLMIS' point of view. He also relies upon the evidence that it

⁴³ Judgment delivered on 22 March 2013 in Case #121 355 pending before the District Court of Luxembourg between Herald Fund SPC as plaintiff and HSBC Securities Services (Luxembourg) SA as defendant.

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had no operational effect from BoB Lux's point of view, at least to the extent that it still did not record the assets in the custody records maintained by its Global Custody Department. I accept that Mr. Fielding must have made it clear to Madoff that executing the 2002 Sub-Custody Agreement would have no operational effect in the sense that BLMIS would still be required to perform its triple function. From BLMIS' point of view, changing the party to whom it owed its safekeeping duty would have a legal effect, but it would not have any operational effect in the circumstances of this case. However, I do not believe that Mr. Fielding explained and agreed with Madoff that BLMIS would enter into a standard form sub-custody agreement with BoB Lux on the basis that BLMIS would somehow continue to owe its safekeeping obligation to Primeo and that the sub-custody agreement would take effect, if at all, when BoB Lux decided that it needed a free delivery of assets for credit purposes.

164. It is an agreed fact that BoB Lux did not record the managed account assets in its custody records as a result of executing the 2002 Sub-Custody Agreement but, taken as a whole, the evidence of the parties' post contract conduct points overwhelmingly to the conclusion that they *did* regard BLMIS as BoB Lux's sub-custodian. For example, the formal written presentation made by Mr. Fielding and Mr. Birgen to Bank Austria in May 2003 stated in unqualified terms that BLMIS had been appointed as sub-custodian by BoB Ltd and by BoB Lux. The document does not draw any distinction between these appointments or suggest that the BoB Lux appointment was made for "credit purposes only" and did not create any real custodial relationship. Mr. Fielding repeated the point at the Primeo board meeting on 14 May 2004. Most importantly, from 2005 onwards, HSSL 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. The notes to the audited financial statements for the years ended 31 December 2004 to 2006 all state that HSSL had appointed a 'broker/dealer investment firm' (meaning BLMIS) as sub-custodian to hold the assets of Primeo Select. As a member of the board (until October 2006), Mr. Fielding ought to have taken steps to correct this statement if he had really thought that it was not literally true.



Estoppel by convention

165. This evidence also leads to the conclusion that HSSL is estopped from denying that BLMIS was in fact HSSL's duly appointed sub-custodian in respect of the assets held on the managed accounts. There is no dispute between the parties about the legal principles giving rise to an estoppel by convention or an estoppel by representation.
166. An estoppel by convention may arise 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 an estoppel by convention is 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. India Steamship Co. Ltd* [1998] AC 878 at 913E-G. Following the execution of the 2002 Sub-Custody Agreement, there clearly was a shared assumption between Primeo and BoB Lux that BLMIS was holding the assets as sub-custodian for BoB Lux even though the operating procedures remained unchanged. In order for an estoppel by representation to arise there must have been 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 were permitted. See: *Hanley, Estoppel by Conduct and Election*, 2nd Edition, at 1-006. Explicit representations were made to Primeo, on multiple occasions, both orally and in writing, that HSSL considered itself to be custodian and to have appointed BLMIS as sub-custodian.
167. It is also clear to my mind that there was 'detrimental reliance' in connection with the issue by HSSL of custody confirmations to E&Y in connection with the 2004, 2005 and 2006 audits. The meaning of 'detrimental reliance' was explained by Akenhead J. in *Mears Limited v. Shoreline Housing Partnership Limited* [2015] EWHC 1396 in the following way at paragraph [51] –

A key element of an effective estoppel by convention will be unconscionability or unjustness on the part of the person said to be estopped to assert the true legal or factual position. I am not convinced that 'detrimental reliance' represents an exhaustive or limiting requirement of estoppel by convention although it will almost invariably be the case that where there is detrimental reliance by the party claiming the benefit of the convention it will be unconscionable and unjust on the other party to seek to go behind the convention. In my view, it is enough that the party claiming the benefit of the convention has been materially influenced by the convention.

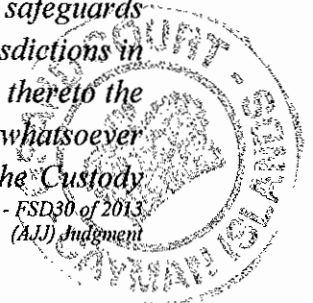
I would hold that Primeo relied, through its auditors, upon the custody confirmations to its detriment because, in their absence, E&Y would not have issued the opinions without performing other audit procedures with satisfactory results. This result was detrimental to Primeo. Therefore, I would hold that HSSL is estopped from denying that it did owe duties under Clause 16(B) in respect of the assets held on the BLMIS managed account with effect from August 2002.

The Custodian's liability for the negligence or willful default of its sub-custodian – August 2002 to May 2007

168. Executing the 2002 Sub-Custody Agreement, as part of the implied tri-partite agreement, had the effect of engaging Clause 16(B) of the 1996 Custodian Agreement. Having appointed BLMIS as sub-custodian to perform part of its duties, the effect of Clause 16(B) and (E) is that HSSL remains liable to Primeo for the performance of those duties where either HSSL or its sub-custodian acted negligently or in wilful breach of duty. These clauses provide as follows -

16. (B) In performing its duties hereunder the Custodian may 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 (including in such appointment powers of sub-delegation). 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. Subject thereto the Company has agreed to indemnify the [C]ustodian from all liabilities of whatsoever nature which may be [in]curred by it in performing its obligations under the Custody

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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. The fees and other remuneration of any agent or delegate appointed by the Custodian shall be paid by the Custodian (except any fees or other remuneration as referred to in Clause 6 hereof) but any fees and other remuneration of sub-custodians shall be paid by the Company.

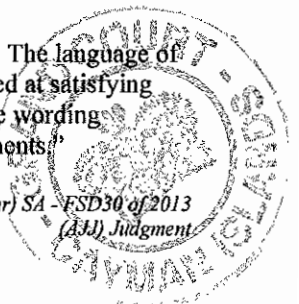
(E) The Custodian shall not, in the absence of negligence or wilful breach of duty on the part of the Custodian or any agent, delegate or sub-custodian, be liable to the Company or to any shareholder of the Company for any act or omission in the course of or in connection with the services rendered by 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 or pursuant thereto. 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.

169. HSSL seeks to avoid strict liability under Clause 16(B) in two ways. First, it is said that, as a matter of construction, Clause 16(B) applies only to the appointment of network sub-custodians in circumstances which give rise to a bi-lateral relationship between the custodian and sub-custodian. For the reasons which I have already explained, HSSL is estopped from denying that it owes any duties under Clause 16(B).
170. Second, it is said that on a true construction of Clauses 16(B) and (E), the 1996 Custodian Agreement does not impose strict liability upon the custodian. Read by itself, it may be said that Clause 16(B) does not expressly impose strict liability and counsel suggests that the imposition of ongoing supervisory duties (referred to as ‘the ongoing suitability duty’ and ‘the most effective safeguards duty’) points to the conclusion that the parties must have intended *not* to make the custodian liable for the defaults of its sub-custodian. It is suggested that these duties would be all but redundant if the Custodian is strictly liable for the defaults of its sub-custodians. The evidence clearly points to the conclusion that the ongoing suitability duty and the most effective safeguards duty were introduced into the 1996 Custodian Agreement specifically to meet the requirements of paragraphs 2.36

and 2.37 of the Irish Stock Exchange's new listing rules.⁴⁴ As such, it seems to me that these provisions would need to have been included whether or not the custodian was intended to be strictly liable for the defaults of the sub-custodian. In any event, I do not consider that the imposition of ongoing supervisory duties is inconsistent with an intention to make the Custodian liable for the defaults of the sub-custodian.

171. From the perspective of the Cayman Islands regulatory regime, it was open to Primeo to engage BoB Lux as custodian on whatever terms that the parties saw fit to agree. It was open to the parties to agree that BoB Lux would not have any liability for the defaults of the sub-custodians but they chose not to do so. The exoneration from liability contained in Clause 16(E) is expressly qualified so as to apply only in the absence of negligence or wilful default on the part of the sub-custodian and it cannot be disputed that BLMIS was in fact guilty of a wilful breach of duty. Counsel for BoB Lux seeks to avoid this result by relying upon the indemnity provisions contained in both Clause 16(B) and (E) by which the Custodian is indemnified in respect of all liabilities incurred in the performance of its obligations or duties "other than those resulting from the fraud, negligence or wilful breach of duty on the part of the Custodian or any agent appointed by it". Clause 16(B) distinguishes between delegates, sub-custodians and agents. On this basis, the argument is that the indemnity *does* apply to liabilities resulting from the fraud, negligence or wilful breach of duty on the part of a delegate or sub-custodian (as opposed to an agent) with the result that BoB Lux would be entitled to be indemnified in respect of its liability for the wilful default of BLMIS and, in effect, absolved from liability through circuitry of action. In my view this analysis is plainly wrong. It would involve interpreting the exoneration provision and the indemnity provision in a way which is internally inconsistent. In my view, it is 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

⁴⁴ The language of the ongoing suitability duty appears to have been taken directly from rule 2.36. The language of the most effective safeguards duty is not reflected in the rules, but it does appear to have been aimed at satisfying rule 2.37. By a letter dated 13 December 1996, BoB Ltd's legal department told Dr. Fano that "The wording regarding the appointment of sub-custodian should now conform to Irish Stock Exchange requirements."



appointment of a delegate or sub-custodian necessarily involves the duties being performed by the delegate or sub-custodian. On a true construction of Clauses 16(B) and (E), I conclude that HSSL is made liable for the wilful breach of duty on the part of BLMIS as its sub-custodian.

Did Primeo suffer a relevant loss for which HSSL is liable?

172. The next question is whether any relevant loss flowed from a breach of duty on the part of BLMIS for which HSSL is liable. 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. Mr. Smith's argument is that, for the purposes of strict liability under Clause 16(B), the appropriate analysis of Primeo's loss is perfectly straightforward. He says that the loss is simply the net amount of cash placed with BLMIS and dissipated in the Ponzi scheme during the relevant period. For these purposes the relevant period runs from 7 August 2002 (when the 2002 Sub-Custody Agreement was executed) until 1 May 2007 (when the Herald Transfer took place and BLMIS' role as sub-custodian came to an end). The Plaintiff's case is that HSSL is liable to make good this loss, subject to giving credit for the actual recoveries which it has received.
173. HSSL's case is that Primeo suffered no loss on its investments placed with BLMIS because, as a result of the Herald Transfer, it succeeded in realizing the full reported value of the assets recorded on its managed account as at 1 May 2007. It suffered loss only when, on 2 May 2007, it subscribed US\$465.8 million for shares in Herald which subsequently turned out to be worth less than their purchase price. Mr. Smith's response to this argument is that Primeo suffered an actual loss on each occasion that it placed cash with BLMIS for investment. It suffered loss because the value of the rights received (namely the contractual right to delivery of equivalent securities and/or cash recorded in

the managed account) was worth less than the amount paid because, unknown to Primeo, BLMIS was in fact insolvent at all material times. The resolution of this issue turns on identifying the *relevant* loss and determining when Primeo suffered this loss, if at all. See: *Nykredit Mortgage Bank Plc v. Edward Erdman Group Ltd (No.2)* [1997] 1WLR 1627, per Lord Nicholls at page 1631, letter D-G.

174. In its capacity as custodian, HSSL is not strictly liable under Clause 16(B) for all the consequences, even all the foreseeable consequences, which flowed from Primeo's decision to place funds for investment with BLMIS. As Mr. Gillis rightly said, HSSL is put in the position of a guarantor. Its obligation is to make good BLMIS' default in its capacity as sub-custodian (but not in any other capacity) to the extent that such default constitutes a negligent or wilful breach of duty. It follows that the relevant loss for the purposes of Primeo's strict liability claim is that which flows from BLMIS' default, not that which flows from Primeo's decision to place funds with BLMIS for investment, either directly or indirectly. BLMIS' 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 HSSL, albeit by dishonestly misusing or misappropriating the client funds under its control. In the absence of a default, there is no relevant loss for which HSSL can be strictly liable under Clause 16(B). Because BLMIS was carrying on a Ponzi scheme, there was always an inherent risk that the payments made by BLMIS might become the subject of claw-back claims in any subsequent bankruptcy proceeding but, with effect from 7 August 2002, this risk fell upon HSSL, not Primeo. As the recipient of the payment, the potential liability to repay BLMIS' trustee would fall on HSSL, but it would not be entitled to be indemnified under Clause 16(E) because the repayment obligation would arise as a result of BLMIS' wilful default in having made the original payment whilst insolvent. Even if it can be said that Primeo suffered an actual measurable loss when it placed funds with BLMIS, ~~this is not the~~ relevant loss for which HSSL can be made strictly liable under Clause 16(B).

175. The effect of the Herald Transfer is that BLMIS met its obligations and therefore, as at 1 May 2007, there was no relevant loss for which HSSL is strictly liable under Clause 16(B). On 27 April 2007, HSSL instructed BLMIS to transfer the total holding standing to the credit of Primeo's managed account to Herald's managed account. As at 1 May 2007, the reported balance standing to the credit of Primeo Select's 1FN092 Account was US\$465,824,061 and BLMIS duly carried out HSSL's instruction by debiting this amount to Primeo's account and crediting it to Herald's account. The holding in Primeo's account was valued by Herald at only US\$463,353,186.26 (as at 30 April 2007) because it did not take account of an additional sum of US\$2 million transferred to BLMIS close to the month end. On the basis of Herald's NAV for 30 April 2007, this equated to 371,604.1272 USD Class shares in Herald. On 9 May 2007, HSSL (as custodian for Primeo) sent an instruction to HSSL (as administrator of Herald) requesting it to make an investment of US\$463,353,186.26 in Herald for a dealing day of 2 May 2007. Additional shares were subsequently issued (also for the 2 May 2007 dealing day) in respect of the final credit balance received by Herald, comprising the additional US\$2 million plus some dividends and less some tax. In this way, Primeo assigned its contractual rights against BLMIS to Herald in consideration for the issue by Herald of shares having an equivalent value which was the reported value of the assets held by BLMIS as sub-custodian for HSSL as at 1 May 2007. BLMIS fulfilled its obligation by transferring the account balance to Herald in accordance with the instructions received from HSSL. There was no default and Primeo suffered no relevant loss for which HSSL is liable. It may be that Primeo suffered an actual measurable loss on 2 May 2007 when it subscribed for shares in Herald, but this is not a loss for which HSSL is strictly liable under Clause 16(B). The result would have been the same if BLMIS had paid out cash which Primeo then invested in Herald or in any other way.

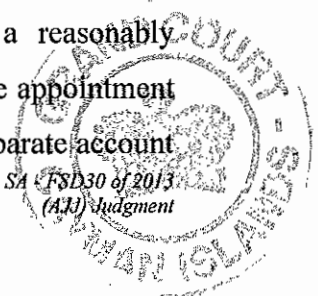
176. Following the revelation that BLMIS was a Ponzi scheme, Herald's additional liquidator challenged the validity of this transaction. Having characterized the consideration given by Primeo as the transfer of the legal and/or beneficial ownership of the actual securities and cash purportedly held by BLMIS as sub-custodian for HSSL, he asserted that, because these securities did not exist, there was a common mistake as to the existence of

the subject-matter of the share subscription agreement which rendered that agreement null and void. In a ruling made on 18 February 2016, I rejected this argument because it was based upon a mischaracterization of the nature of the consideration given by Primeo. The fact that BLMIS was operating a Ponzi scheme did not make it impossible for Primeo to validly assign its contractual rights as against BLMIS to Herald. Those rights did exist, the contract was performed and on 2 May 2007 Primeo did receive shares in Herald for which it contracted.

177. Although BLMIS was in wilful breach of its duties as sub-custodian in that it was operating a Ponzi scheme, it did in fact perform the repayment instruction received from HSSL in the manner stipulated by Primeo, with the result that Primeo did not suffer an actual loss on or before 1 May 2007. This result was subsequently recognized and given effect by the BLMIS Trustee pursuant to the Settlement Agreement made on 12 November 2014, by which he agreed that Herald was entitled to make a customer claim in the liquidation on the basis that it had acquired all Primeo's rights. For the purposes of this claim, the cash value of the rights acquired by Herald was agreed to be US\$149,753,024. The end result is that Primeo successfully assigned its rights against BLMIS for the full amount of the recorded value (approximately US\$465.8 million) as at 1 May 2007 and the performance by BLMIS of its repayment obligation in this manner has not been upset by the Trustee. It follows that Primeo has suffered no loss by reason of any default on the part of BLMIS for which HSSL can be made liable.

Breach by HSSL of its Clause 16(B) supervisory duties – August 2002 to May 2007

178. I now go on to consider whether HSSL is in breach of its own duties under Clause 16(B) in respect of the appointment and ongoing supervision of BLMIS as sub-custodian. The mere fact that BLMIS was already acting as Primeo's custodian immediately before its appointment (and re-designation) as BoB Lux's sub-custodian does not relieve BoB Lux from performance of these duties, but it must affect its approach in connection with the appointment and subsequent supervision. 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



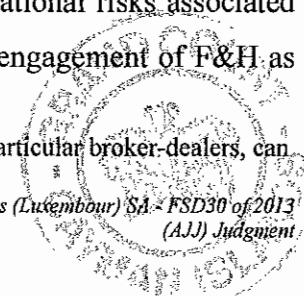
with the DTC and/or make use of its Institutional Delivery System (referred to as the ID System”)⁴⁵ and (b) establish a separate account with BNY, in each case for the benefit of Primeo or the HSBC Group clients collectively.

179. The parties engaged separate experts in respect of the custody issues generally. The Plaintiff called Mr. Peter Vinella (“Mr. Vinella”) who has 25 years experience in the financial services industry, including as the chief executive of the trust and fund administration affiliate of Wilmington Trust Company. He was employed as a senior executive at two major broker-dealers and also has wide experience as a consultant on a broad range of subjects including risk management and trade processing. The Defendants called Mr. Joseph P. Belanger (“Mr. Belanger”) who spent 26 years working for State Street Bank and Trust Company (“State Street”), one of the world’s largest global custodians. During the last 12 years of his employment, he was a Senior Vice President and Division Head which involved him having executive responsibility for three business units. In particular, from 2003 until his retirement in 2009, he was responsible for the State Street Cayman Offshore and Alternative Fund Services. 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, but I have come to the conclusion that Mr. Vinella’s opinions should be accepted in preference to those of Mr. Belanger for the following reasons.

180. First, Mr. Belanger has misunderstood the evidence about Madoff’s “stellar” reputation and failed to recognize that a reasonably competent global custodian would be concerned about the obvious red flags hanging over BLMIS. In my view the points made in the MAR Hedge article in May 2001 and the concerns actually expressed by members of the GFS Board in May and September 2002 indicate that Mr. Belanger is simply wrong and that the circumstances surrounding BLMIS at the material time would actually have heightened a custodian’s appreciation of the unusually high operational risks associated with this business. From a custodian’s perspective, I regard the engagement of F&H as

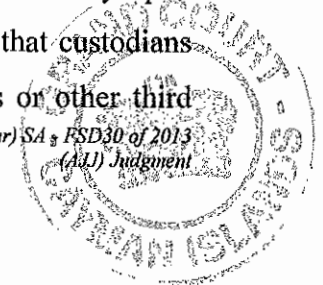
⁴⁵ The ID System was established by the DTC as a means by which its participants, in particular broker-dealers, can deliver electronic trade confirmations to their institutional clients.

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the single most important red flag which Mr. Belanger dismisses in his report (at paragraphs 183-4) on the basis that the firm must have been acceptable to the SEC. If BLMIS had been the subject of audits conducted by one of the major firms, this would have provided a custodian with a degree of assurance about the integrity of its operations, especially if the auditor conducted a SAS70 review in addition to an ordinary systems based audit of the financial statements. The engagement of F&H raises a red flag because the assumption must be that Mr. Friebling would lack both the independence and resources to conduct a proper audit, which leads to the suspicion that he might have been engaged by Madoff for this very reason. Mr. Belanger also failed to recognize, at least in his report, that the BLMIS business model was unique and did itself constitute a red flag. The examples he gives of hedge fund structures, such as those promoted by Bear Sterns and Lehman Brothers, in which there was a comparable concentration of functions bear no resemblance to BLMIS. These were public companies whose businesses were marketed in a transparent way. BLMIS was wholly owned and controlled by one dominant individual who deliberately obscured the existence of its investment advisory business, to the extent of failing to register it with the SEC and refusing to allow its name to be disclosed in its clients' offering documents. The OIG Report and the Mar/Hedge Article reflect that the view expressed by Mr. Paul Smith at this time was shared by others in the hedge fund industry and is indicative of the way in which a reasonably competent custodian would likely approach the appointment of BLMIS as sub-custodian. Mr. Belanger's failure to recognize the significance of the red flags hanging over BLMIS tends to undermine the credibility of his opinions.

181. Second, Mr. Belanger has not sufficiently taken account of the consequences of the BLMIS business model and, having failed to identify the unique challenge presented to the custodians of Madoff feeder funds, he has inevitably failed to address the way in which they might reasonably be expected to meet that challenge. His description of the way in which the global custody industry works is authoritative, helpful and substantially uncontroversial. It is not in dispute that a custodian is ordinarily entitled to rely upon information received from a fund's other professional service providers; that custodians do not normally seek to verify the existence of assets with depositories or other third



parties; and that custodians and administrators are ordinarily in a position to reconcile with information received from more than one service provider (even though the other service providers might be related parties). Mr. Belanger's failing is that he has not effectively addressed the question whether the approach adopted by BoB Lux meets the standards to be expected of a reasonably competent global custodian in the particularly high risk circumstances presented by the BLMIS business model. These risks were known to and understood by BoB Lux at the time it entered into the 1996 Custodian Agreement and at the time it entered into the 2002 Sub-Custody Agreement. I consider that Mr. Vinella's analysis of the issues to be more reliable because his has started from the realistic position (recognized by the GFS Board) that BLMIS' business model did not comply with accepted industry practice and gave rise to an inherently high risk of fraud or error.

182. Third, Mr. Belanger has over-emphasized the notion that BLMIS was a "client imposed custodian". This was not a case like Alpha and Herald in which BoB Lux was presented with a client-imposed arrangement which it must either accept as part of the overall contracted service model or alternatively turn down the business. In the case of Primeo, as at August 2002, BoB Lux was seeking to change an existing structure which had been in place, in its current form, since 1996. By appointing BLMIS as sub-custodian, BoB Lux assumed an obligation to perform the ongoing supervisory duties imposed by Clause 16(B) which it intended to discharge by conducting regular due diligence reviews beginning in July 2002. I accept that the appointment of BLMIS in these circumstances is wholly different from the appointment of a new network sub-custodian, but this is not a case in which the custodian contracted out of or limited its responsibility for supervising a sub-custodian imposed upon it by the client. I agree that responsibility for supervising BLMIS was shared, but not in the way suggested by Mr. Belanger. By Clause 2 of the Advisory Agreement, responsibility for monitoring BLMIS' performance in its capacity as investment manager rested with BA Worldwide. By Clause 16(B) of the 1996 Custodian Agreement, responsibility for supervising BLMIS in its capacity as sub-custodian rested with BoB Lux.

183. It is not in dispute that the applicable regulatory laws permitted BLMIS to act in the triple capacity of investment manager, broker and custodian. Subject to complying with the ‘financial responsibility rules’ contained in the Securities and Exchange Act, the custody rules contained in the Investment Advisers Act 1940 and certain New York State laws, it was permissible for BLMIS, in its capacity as a registered broker-dealer, to hold the assets of its investment advisory clients as custodian.⁴⁶ It could do so as custodian for Primeo or as sub-custodian for BoB Lux. A ‘qualified custodian’ must segregate its proprietary assets from its clients’ assets on its own books, but most of the experts agree that there was no legal or regulatory requirement that it should do so at the DTC level. The DTC rules permit its participants to establish multiple accounts but Mr. Jack Wiener (“Mr. Wiener”)⁴⁷ and Mr. Joseph P. Denci (“Mr. Denci”)⁴⁸ agree that, typically, its participants hold both client assets and proprietary assets in a single omnibus account.⁴⁹ However, participants can use a number of ‘segregation locations’⁵⁰ within their omnibus accounts for the purpose of segregating client and proprietary assets, but there is no requirement that they do so. This is simply an optional tool established by the DTC as a means by which its participants can meet their regulatory obligation to segregate clients’ assets. In spite of the fact that it clearly was not normal commercial practice for custodians to segregate assets by establishing separate accounts at the DTC (in respect of

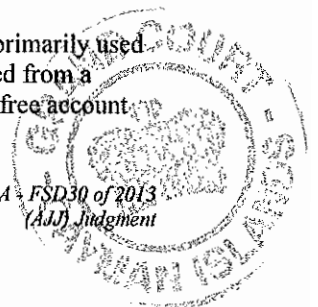
⁴⁶ Mr. Wiener’s evidence is that there were about 12,000 investment advisors registered with the SEC at the time when the Madoff fraud was discovered and that about 15% of them self-custodied their clients’ assets.

⁴⁷ Mr. Wiener was called by the Defendants to give expert evidence about the operations of the DTC. He is a lawyer and worked for the DTC for 17 years. He held the positions of Managing Director and Deputy General Counsel at the time he left its employment in 2005. He subsequently served as Managing Director of the Securities Industry and Financial Markets Association and currently practices as a consultant and has given expert evidence about the DTC on a number of previous occasions.

⁴⁸ Mr. Denci was called by the Plaintiff to give expert evidence about the operations of the DTC. He was employed by the DTC from 1987 to 1997 during which time he was involved in operating and marketing the ID System. Since then he has worked for a number of financial institutions on operations concerning their interaction with the DTC and is currently managing partner of a capital markets consulting firm specializing in regulatory and operation efficiency projects.

⁴⁹ During the relevant period 36% of DTC participants had more than one account. Today this figure is 46%.

⁵⁰ A ‘segregation location’ is an accounting designation within a participant’s stock record which is primarily used for the purpose of segregating client assets from proprietary assets. Most activities cannot be conducted from a ‘segregation location’ which means that a security must first be transferred to the participant’s general free account before any transaction can take place.



securities) and at BNY (in respect of US Treasury Bills) for their hedge fund clients, 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' business model. Mr. Denci said that it was common practice for broker-dealers with institutional clients to have multiple accounts with the DTC.

184. When BLMIS genuinely purchased securities from a third party market participant, the securities would be settled into its DTC account. When BLMIS (acting as broker) then sold a proportionate share of those securities to Primeo (acting by BLMIS as its investment manager), the transaction was recorded on BLMIS' books only. Because BLMIS was on both sides of the transaction, there would be no movement on its DTC account and therefore no settlement notification would be generated by DTC. Because BLMIS had a discretionary authority to buy and sell securities for Primeo without reference to BA Worldwide, no evidence was available from any independent source that the transaction had ever taken place. The only documentary evidence available to BoB Lux was generated by BLMIS and constituted the individual trade confirmations (reflecting the purchase/sale of securities in which no independent party had participated) and the month end statements. Mr. Vinella described this as a "pretty nightmarish scenario for a custodian" but the expert evidence of Mr. Denci establishes that it could easily have been overcome in two alternative ways.

185. First, by requiring BLMIS to establish a second account (or sub-account) at the DTC in the name of BLMIS, but designated for either Primeo or all of the relevant BoB clients, the agency trade made between BLMIS (as broker) and Primeo (acting by BLMIS as investment manager) would have been settled into the separate DTC account, with the result that the DTC would have issued a settlement notification in respect of this trade. The existence of a separate sub-account would have enabled BoB Lux to require that BLMIS instruct the DTC to send settlement notifications directly to BoB Lux, either by SWIFT message or through the ID System. Similarly, BLMIS could have been instructed to request a month end holdings statement be issued by the DTC, with a copy sent directly to BoB Lux through the ID System. In this way BoB Lux could have reconciled

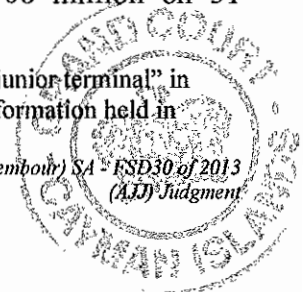
the month end holdings statements received directly from the DTC with the trade confirmations and month end statements received from BLMIS. The existence of a separate account would also have enabled the auditors to view its contents directly by using the PTS terminal located in BLMIS' office.⁵¹ It seems clear to me that the establishment of a separate account (either for Primeo or the BoB clients collectively) would have been an effective means of protecting the assets held by BLMIS without preventing it from performing its triple function.

186. Secondly, even without requiring BLMIS to establish a separate sub-account, it would have been possible to use the ID System so that BoB Lux 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. It was established by the DTC (and is now run by a company called Omgeo) as a cost saving way for brokers to deliver trade confirmations and settlement notifications to their clients electronically. During the relevant period, a high percentage of broker-dealers, including BLMIS itself, participated in the ID System. It could easily have been set up so that BoB Lux would receive a notification directly from the DTC as an 'interested party' whenever BLMIS identified part of a bulk trade as being allocated to Primeo. In this way BoB Lux 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.

187. BLMIS employed a split-strike conversion investment strategy but did so in a highly unusual way which purportedly involved liquidating every client's entire holding of securities every month and investing the proceeds in Treasury Bills. Throughout a long period up to the time of the Herald Transfer (2 May 2007), practically the whole of the assets reflected on Primeo's month end accounts and its audited annual financial statements were Treasury Bills, rising in value from about US\$108 million on 31

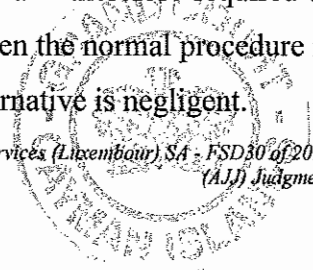
⁵¹ Mr. Denci explained that it would also have been possible to set up what he called a "PTS junior terminal" in HSSL's office (with the consent of BLMIS as the DTC participant) by which it could view information held in BLMIS's sub-account relating to Primeo and the other relevant clients.

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December 1998 to about US\$454 million on 31 December 2006. These Treasury Bills were purportedly held on BLMIS' omnibus account with BNY. It would have been perfectly straightforward for BLMIS to establish a separate account in its own name designated for each of Primeo and the other BoB clients. BLMIS could then have instructed BNY to issue monthly statements directly to BoB Lux and also confirm the year end balances directly to the auditors. Furthermore, to the extent that BLMIS must have held un-invested cash for Primeo from time to time in its operating account maintained with JP Morgan, such cash could also have been held in a separately designated account or sub-account, thus enabling BoB Lux to receive statements directly from the bank. Mr. Gilbert T. Schwartz ("Mr. Schwartz"), the jointly appointed US banking law expert, 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. These arrangements would not have interfered with BLMIS's triple function business model. Nor would they have necessarily prevented Madoff from defrauding HSBC's clients. However, they would have enabled BoB Lux to confirm that the requisite value of Treasury Bills did actually exist as at each month end, thus making it much more difficult for Madoff to perpetuate his Ponzi scheme.

188. The Defendants put forward various reasons why a reasonably competent global custodian could not have been expected to recommend the implementation of these apparently straightforward and effective safeguards. They are essentially permutations of the same theme based upon the evidence of Mr. Belanger and Mr. Wiener, which is that these procedures were not (and are not now) adopted as a matter of normal commercial practice by global custodians. Therefore, it is said that BoB Lux's failure to adopt any of them cannot lead to the conclusion that it fell short of what was to be expected of it. I do not find this argument at all compelling in the circumstances of this case because it misses the point, ultimately recognized by Mr. Belanger during his cross examination, that BLMIS' business model was unique. It created operational risks which were not addressed by the normal, commercially acceptable procedures and therefore required to be addressed by some other procedures. It seems to me that when the normal procedure is known to be ineffective, failing to apply a readily available alternative is negligent.



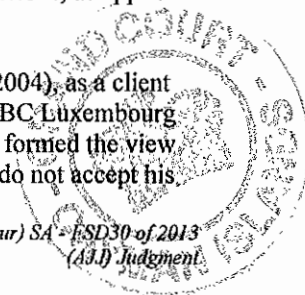
189. The fact that DTC participants are not required (either by regulation or the DTC rules) to maintain separate accounts for proprietary and client assets and typically do in fact hold both in single omnibus accounts also misses the point.⁵² DTC participants do not typically act in a triple capacity (through the same legal and economic entity) in the manner of BLMIS. It is (and was at the material time) normal practice for brokers to operate in a way which enabled their clients to receive trade confirmations through the ID System. BLMIS used this service for its legitimate House 5 business and I can see no good reason for refusing to use it in respect of its House 17 business. I accept the evidence of Mr. Belanger, Mr. Claude Quintus⁵³ and Mr. Pettitt that it is (and was at the material time) normal commercial practice for custodians to reconcile to the records of their sub-custodians. I accept that it would not have been normal practice for a custodian to put in place operating procedures which enable it to reconcile a sub-custodian's statements directly to the DTC and its bankers. The custodian would normally reconcile to the statements, confirmations or other information received from the broker or investment manager, but this was not possible in this case because BLMIS was performing all three functions. If the application of the normal practice to an abnormal business model produces 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 which is capable of producing the normal result. BoB Lux failed to do so.

190. On various occasions during the relevant period, many BoB executives and, later, HSBC executives, considered the unique risks presented by BLMIS' business model, but they never actually did anything about it other than carry out routine custody due diligence reviews and commission the in-depth KPMG fraud risk reviews. These reviews did not

⁵² It is not necessary for me to decide whether or not Mr. Andrews is right that the statutory provisions, as applied to BLMIS, would have required that it segregate client and proprietary assets at the DTC level.

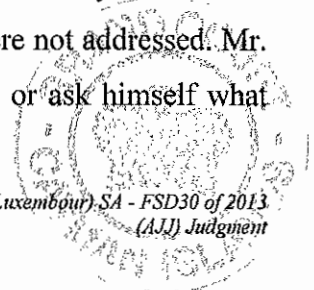
⁵³ Mr. Quintus was employed by HSSL in various capacities in the Treasury Department (1994-2004), as a client relationship manager (2004-2008) and Head of Custody (2008-2011). He is now employed by HSBC Luxembourg branch as a business manager. He gave evidence in an unhesitating and straightforward way and I formed the view that he was generally a reliable witness but he had relatively little involvement with Primeo and I do not accept his evidence about the purpose and effect of 2002 Sub-Custody Agreement.

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solve the problem. The GFS Board discussed the problem of single source reporting in September 2002 and identified the possibility of instructing KPMG to conduct audit procedures, but this was never done. Messrs. Fielding and Birgen ought to have addressed the issue in their presentation to Bank Austria's internal auditors in May 2003. Mr. Fielding again failed to offer any solution when the problem was discussed at the board meeting in June 2003. Nor did his second due diligence review conducted in March 2004 prompt any attempt to remedy the problem of single source reporting. It was discussed at the board meeting in May 2004 but Mr. Fielding again failed to offer any solutions. The matter ought to have been addressed at the time of Mr. Pettitt's sub-custody due diligence review in March 2005 and during the subsequent period leading up to the issue of the custody confirmation to the auditors on 5 April 2005. Perhaps most surprisingly, the First KPMG Report, issued in February 2006, did not prompt an attempt to implement any solutions to the lack of segregation and single source reporting.

191. Mr. Pettitt's next meeting with Madoff took place a year later, on 9 February 2007. This was not a regular due diligence review. The purpose of the meeting was to discuss and deal with the matters set out in an agenda sent to Madoff on 26 January 2007. Three subjects are listed. The first was to follow up on outstanding items from the First KPMG Report. The only point mentioned in the agenda is the implementation of new, consistent sub-custody agreements with each of the relevant HSBC subsidiaries in Luxembourg, Dublin and Bermuda. He reviewed the report at some length on the day before the meeting and asked Ms. Coe what matters she thought ought to be raised with Madoff but this did not prompt any consideration of the key issues. The second agenda item concerned the implementation of new service level agreements. This was never done in spite of the fact that, according to Mr. Pettitt, Madoff was not resistant to the idea. The third item was "to discuss the problems which our colleagues in the centres are currently encountering". It appears that the "problems" in question concerned the introduction of an electronic interface rather than the transmittal of hard copy documents by fax or mail. The key issues of lack of segregation and single source reporting were not addressed. Mr. Pettitt did not apply his mind to the requirements of Clause 16(B) or ask himself what



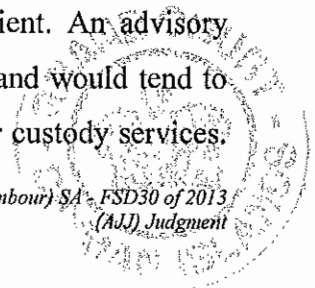
procedures could be put in place to safeguard the clients' assets without impinging upon BLMIS' business model and Madoff's extreme concern about confidentiality.

192. In spite of talking about the problem of single source reporting on many occasions, the individual executives never actually applied their minds to ways in which confirmatory information could be obtained from independent sources. Even if some of the individuals concerned, such as Mr. Fielding and Ms. Coe, knew little about the detailed procedures relating to the custody of exchanged traded securities and Treasury Bills in New York, they had ready access to the expertise of the Global Custody Departments of BoB and, later, HSBC, which in turn had access to the expertise of their network of sub-custodians, including Brown Brothers Harriman and Citibank in New York.
193. BoB Lux's failure to recommend to Primeo that BLMIS be required to establish a separate account at the DTC and/or make use of the ID System and establish a separate account or sub-account at BNY was negligent and constitutes a breach of its ongoing contractual duties under Clause 16(B). If BLMIS had been acting as sub-custodian on a standalone basis, then the failure to require it to implement these operational safeguards would itself constitute a breach of contract. If the sub-custodian refused, then it would have been the custodian's duty to terminate the contract and appoint a different sub-custodian. In the circumstances of this case, where the sub-custodial service provided to BoB Lux was part of an indispensable package of services provided to Primeo, it was not within the power of BoB Lux, at least as a practical commercial matter, to require that BLMIS do anything without the agreement of its client. In these circumstances, it is the failure to make the recommendation which constitutes the breach. Whether or not Primeo, acting through BA Worldwide and/or its directors, would have accepted and acted upon the recommendation is a separate issue which is addressed in the context of the parties' arguments on causation.

Breach by HSSL of its reporting and alleged implied advisory duties under the 1996 Custodian Agreement – period after 2 May 2007



194. Finally, I now turn to the period after 2 May 2007 when Primeo's managed account with BLMIS was closed following the Herald Transfer. The Plaintiff does not allege any breach of HSSL's safekeeping or supervisory duty in respect of the shares in Alpha and Herald which were held in its custody until 22 December 2010 when they were transferred into the name of Primeo itself. The Plaintiff's case against HSSL, as it relates to the period after 2 May 2007, is based upon the proposition that it was an implied term of the 1996 Custodian Agreement that HSSL would (a) advise Primeo if in the circumstances it was unable to discharge properly its duties and explain its reasons for not being able to do so (which counsel describes as "the advising duty") and (b) exercise reasonable care and skill to ensure that any reports issued to Primeo were accurate and included all the information of which it was aware, or ought to have been aware, which would be necessary to enable Primeo to evaluate whether HSSL was performing its duties (which is described as the "reporting duty"). In my judgment, there is no basis for implying advising and reporting duties into this custodian agreement for the following reasons.
195. First, I think that it would be inconsistent with the express provisions of the contract. HSSL's reporting obligation is set out in Clause 16(C). It is limited to delivering periodic accounts of receipts and payments and other actions taken pursuant to the agreement and lists of securities and cash held in custody. HSSL performed this obligation by delivering monthly transaction and holdings reports. The attempt to imply an additional reporting obligation contradicts Clause 16(F) which provides that HSSL shall be under no duty "to take any action other than as specified in this Agreement".
196. Second, it would be unusual to include an advisory duty and/or an extended reporting duty of this kind in a standard custody agreement made in the context of the Cayman Islands hedge fund industry. A custodian's reporting obligation is normally limited to factual information about the existence and value of the assets held for the client and the transactions executed upon proper instructions received from the client. An advisory function (which involves exercising judgment) is inherently different and would tend to attract a much higher level of remuneration than that normally paid for custody services.



It would be unusual to see an express advisory provision in a custody agreement which tends to suggest that it would not be right to imply it. (*Capita Ltd v. RFOB Group Ltd* [2016] 2 WLR 1429 at para.19).

197. Third, I am inclined to agree with counsel for the Defendants that if it is right to imply into this agreement a term to the effect that HSSL is under an obligation to advise its client about circumstances giving rise to its own current and prospective breaches of contract, then such a term would normally be implied into every similar service contract. No authority supporting this proposition has been put before the Court.
198. Fourth, I agree that the implication of a continuing duty to advise about circumstances giving rise to a breach of contract would make it inherently difficult for professional service providers to rely upon the Limitation Law because it could always be said the service provider is guilty of 'deliberate concealment' by failing to advise about a past breach.

G. The Administration Claim

Introduction

199. The claims against the 1st Defendant, BoB Cayman, arise under the Second Administration Agreement made on 19 December 1996 pursuant to which it was appointed to act as registrar and accountant of Primeo and to provide share issue and redemption services under the supervision of the Investment Adviser. Simultaneously, BoB Cayman entered into a Delegation Agreement whereby it delegated the performance of practically all of its duties to BoB Lux, but BoB Cayman retains the contractual responsibility for provision of the services to Primeo. The principal claim is that BoB Cayman breached its duty under Clause 4(xvii) in connection with its determination of Primeo NAV per share. Before turning to the terms of the contract, it is relevant to consider the role generally performed by independent hedge fund administrators.

The role of hedge fund administrators

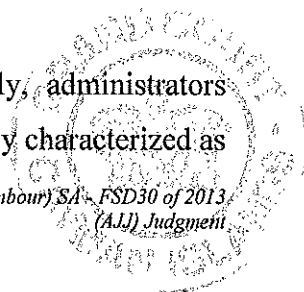


200. I have been referred to the *Guide to Sound Practices for Hedge Fund Administrators* published in September 2004 (“the 2004 AIMA Guide”) which I regard as authoritative evidence of what constituted best practice in the hedge fund administration industry during the relevant period from 1996 to 2008. It was published jointly by the Alternative Investment Management Association (“AIMA”) and the Dublin Funds Industry Association (subsequently re-named as the Irish Funds Industry Association) (“IFIA”) and was prepared by a working group drawn from members of both associations. I note that HSBC was represented on the working group by Mr. Wilkinson. Although not published until 2004, the expert witnesses agree that the 2004 AIMA Guide reflects best practice as it existed during the relevant period. Mr. William Fleury (“Mr. Fleury”), the Defendants’ administration expert, observed that the vast majority of the practices suggested in the 2004 AIMA Guide are the same as those prescribed in his former employers’ pre-existing procedures manuals. However, I bear in mind that the 2004 AIMA Guide is not the equivalent of auditing standards promulgated by the AICPA. It does not lay down “rules” or “standards” required to be adopted by members of AIMA. As stated in its introduction,

The Guide seeks to identify the best practice in hedge fund administration although, as befits an industry the size of the hedge fund administration industry, there will be differences between practices described herein and practices employed by individual hedge fund administrators. In this respect, the Guide should not be seen as a “benchmark” or standard against which to measure a hedge fund administrator’s performance but, rather, as an educational tool that describes what a typical hedge fund administrator will do.

In September 2009, AIMA and IFIA published a new edition of their guide which had been “revised to reflect various industry developments in areas such as valuations, tax and anti-money laundering”. It does not address any new developments relating to NAV calculation which might have a bearing on the issues raised in this case.

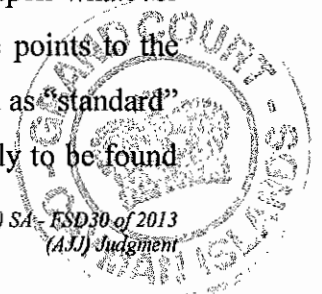
201. Hedge fund administrators provide a professional service. Typically, administrators provide a package of administrative services, some of which are properly characterized as



secretarial in nature but the core duties of producing the accounts and performing the NAV calculations require the exercise of an independent professional judgment. It is not the role of administrators to perform managerial and advisory functions. This is the role of the investment manager/adviser, in this case BA Worldwide and later Pioneer. BoB Cayman's function under Clause 4.1(xvii) of the 1996 Administration Agreement was to calculate (in a timely manner) an accurate NAV upon which Primeo and its shareholders could properly rely for the purposes of transacting subscriptions and redemptions. Administrators are not expected to perform audit procedures, but they are concerned to satisfy themselves that the published NAV is accurate. The existence of assets is verified by the process of reconciliation. The pricing of assets – in this case exchange traded securities - is verified by reference to independent pricing services such as Bloomberg. The experts agree that administrators would ordinarily proceed on the assumption that the information received from third party service providers, such as brokers, investment managers and custodians, is reliable but, as stated in the 2004 AIMA Guide (at section 3.3), reconciliations still need to be performed as the means by which the administrator can be satisfied about the completeness and accuracy of the information received. There is no criticism of the work done by HSSL to satisfy itself about the reasonableness of the pricing reported by BLMIS. The key issue in this case is 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 credited to Primeo's managed account by reconciling two streams of information received from BLMIS alone. There is a sharp difference of opinion between the expert witnesses on this issue.

Express terms of the Second Administration Agreement

202. The Mutual Funds Law does not seek to regulate the content of administration agreements and, subject to making appropriate disclosure in its offering document, it was open to Primeo to engage the services of BoB Cayman as administrator upon whatever terms and conditions might be agreed between the parties. The evidence points to the conclusion that the Second Administration Agreement can be characterized as “standard” in the sense that it contains express terms and conditions of a kind normally to be found



in administration agreements made between licensed mutual fund administrators and Cayman Islands domiciled funds and does not contain any express terms and conditions which either of the expert witnesses identified as unusual or peculiar to this particular case. There is some dispute between the parties about the true nature of the role typically performed by fund administrators, but neither party has suggested that the role of BoB Cayman under this administration agreement, on its true construction, is untypical.

203. The BoB Cayman's duties are listed in Clause 4.1. For present purposes, I need only recite sub-clauses (xiii), (xvii) and (xviii) which provide for the administrator to do the following things -

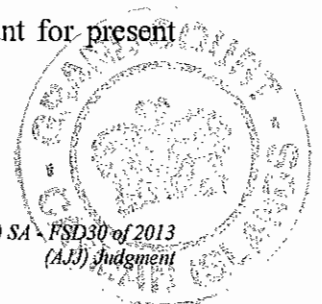
(xiii) arrange for a representative of [BoB Cayman] to attend at board meetings and general meetings of the Company when so required by the Company and prepare, agendas, minutes and other documents required at or in connection with such meetings;

(xvii) ... determine in the name and on behalf of the Company on each valuation day the share prices in accordance with the [memorandum and articles of association of the company] 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;

204. Clause 5 provides for the administrator to perform its duties subject to the control and review of the Investment Adviser and the directors and to comply with the reasonable and proper orders, directions and regulations received from the Investment Adviser or the directors. Clause 5 also provides that the administrator will faithfully serve the Company and use all reasonable endeavours to promote its interests.

205. Clause 7 sets out Primeo's duties of which only sub-clause 7.2 is relevant for present purposes. It provides that Primeo will –



7.2 procure that the Investment Adviser will with all reasonable expedition supply [BoB Cayman] with all such information as [BoB Cayman] may require to enable it to perform its duties hereunder;

206. The requirement to determine the NAV per share “in accordance with the information supplied to it by the Investment Adviser, the Company and the Custodian” means that the administrator is not required to conduct any form of audit in respect of Primeo’s balance sheet as at each valuation day. This phrase does not imply that the administrator was both entitled and required to determine an NAV on the basis of whatever information is made available by Primeo and/or the investment adviser. It does not imply that the administrator’s role in determining the NAV is a purely mechanical one and that it is relieved from the obligation to exercise the care and skill to be expected of a reasonably competent fund administrator. The preparation of financial statements and determination of NAVs are functions which require the exercise of professional judgment.

207. Clause 9.2 is a limitation of liability clause of a kind which is typically to be found in fund administration agreements. It provides that –

9.2 [BoB Cayman] shall not, in the absence of gross negligence or wilful default on the part of [BoB Cayman] or its servants, agents or delegates, be liable to [Primeo] ... 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 [Primeo] may sustain or suffer as the result or the course of the discharge by [BoB Cayman] of its duties hereunder ...

Gross negligence and wilful default

208. The meaning of “gross negligence” was explained by Mance J. in *Red Sea Tankers Ltd v. Papachristidis* (“*The Ardent*”) [1997] 2 Lloyd’s Rep. 547 as follows –

‘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.



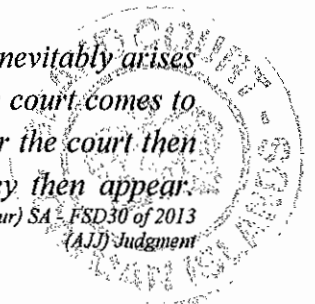
209. By comparison, in order to show that BoB Cayman acted in ‘wilful default’, Primeo must show either that (a) BoB Cayman was conscious that in doing the act complained of or omitting to do that which it is said that it ought to have done, it was acting in breach of duty or (b) BoB Cayman was recklessly careless in the sense of not caring whether its acts or omissions were or were not breaches of duty. See *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407 and *Weaving Macro Fixed Income Fund v. Peterson* 2015(1) CILR 45, para.83.
210. Clauses 9.4, 9.5 and 9.6 require BoB Cayman to verify pricing information received from the Investment Adviser or any ‘connected person’ as part of the process of determining Primeo’s NAV. What this means in the context of the present case, is that BoB Cayman was required to verify the information received from BLMIS about the prices at which it had bought and sold exchange traded securities by reference to one or more automated pricing services such a Bloomberg. The experts agree that this was (and still is) a service typically offered by administrators to funds such as Primeo.

The implied terms of the agreement

211. The applicable principles relating to the implication of contractual terms were recently restated by the UK Supreme Court in *Marks and Spencer plc v. BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2016] AC 742. For a term to be implied, it must be reasonable and equitable; it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; it must be so obvious that ‘it goes without saying’; it must be capable of clear expression; and it must not contradict any express term of the contract. In the circumstances of this case it is important to bear in mind the passage cited from Lord Bingham MR’s judgment in *Philips Electronique Grand Public SA v. British Sky Broadcasting Ltd* [1995] EMLR 472 at page 482 –

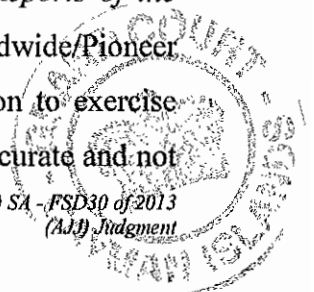
The question of whether terms should be implied, and if so what, almost inevitably arises after a crisis has been reached in the performance of the contract. So the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court then to fashion a term which will reflect the merits of the situation as they then appear.

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Tempting, but wrong. it is not enough to show that had the parties foreseen the eventuality which in fact occurred they would have wished to make provision for it, unless it can be shown either that there was only one contractual solution or that one of several possible solutions would without doubt have been preferred ...

212. I accept the Plaintiff's argument that the Second Administration Agreement is subject to the usual implied term that BoB Cayman will exercise the care and skill which is to be expected of a reasonably competent fund administrator, strictly speaking a reasonably competent licensed mutual fund administrator carrying on business in the Cayman Islands. Mr. Gillis' argument that the implication of this term is inconsistent with the existence of the limitation of liability contained in Clause 9.2 is wrong in principle and unsupported by any authority. As was pointed out by Neville J. in *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch. 425 at page 437, it cannot be said that a person is guilty of negligence, gross or otherwise, unless one can determine the extent of the duty which he is alleged to have neglected. The existence of a limit on liability does not affect or prevent the usual implication of an obligation to use reasonable care and skill.
213. Executives of BoB/HSBC expressed concerns about the risks associated with the BLMIS business model on a number of occasions over a period of years but these concerns were not shared with BA Worldwide and Primeo's directors. The existence of these concerns and the manner in which they were addressed is relevant to the question whether BoB Cayman exercised the appropriate care and skill in performing the NAV calculations. However, the Plaintiff now seeks to imply a term into the contract which would have the potential effect of making BoB Cayman's failure to communicate these concerns to Primeo into a breach of contract.
214. BoB Cayman's express reporting obligation is limited under sub-clause (xiii) to the provision of reports at the request of the investment adviser or the board and the evidence is that drafts of the *Reports of the Administrator* (and from 2005, the *Reports of the Custodian and Administrator*) were reviewed and discussed with BA Worldwide/Pioneer before being presented to the board. There must be an implied obligation to exercise reasonable care and skill to ensure that the content of any such reports is accurate and not



misleading. However, the implication of a duty to advise Primeo “if in circumstances it was unable to discharge properly its duties under the 1996 Administration Agreement (including advising as to the reason why it is considered that it is unable to discharge properly its duties)” bears the hallmarks of reverse engineering with the benefit of hindsight. Counsel has accepted that 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. The Plaintiff’s complaint is that BoB did not volunteer information or advice to Primeo about its own assessment(s) of the risks associated with BLMIS but, absent an implied term of the kind contended for by the Plaintiff, BoB Cayman had no contractual obligation to provide any risk management advice to Primeo at all. This was the function of the investment adviser. Imposing advisory duties upon BoB Cayman would not be reasonable and equitable. Nor is the implication of advisory duties, which would normally be the responsibility of the investment manager/adviser, necessary in order to give business efficacy to this administration agreement.

215. Nor do I accept that it is an implied term of Second Administration Agreement that BoB Cayman will “confirm independently the correctness of BLMIS’ information as to client assets and transactions”. It is not possible to imply a term in circumstances where the parties must have known that it was not capable of being performed. The parties must be taken to have known, as at December 1996, that it would not be possible to independently verify the transactions and the assets reported by BLMIS, so long as its existing business model remained unchanged. In these circumstances, it goes without saying that the parties would *not* have agreed to this term or, at least, not without agreeing upon a corresponding obligation that Primeo would first secure a change in BLMIS’ business model. If an officious bystander had proposed the inclusion of an express term to this effect, it seems to me that both Primeo and BoB would have said “of course not” because they both knew in December 1996 that persuading Madoff to make some operational changes would be a necessary pre-condition to its performance.

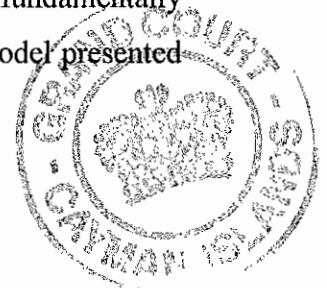
The parties’ fund administration experts



216. I am satisfied that both parties' fund administration experts have the necessary qualifications and experience to be able to give expert evidence about the general standards and practices to be expected of a reasonably competent administrator during the relevant period from 1996 to 2008. However, their experience is very different. The Plaintiff called Ms. Tanya Beder ("Ms. Beder"). Most of her experience has been gained in the capacity of consultant, although she held senior positions in two large asset management businesses from 1999 to 2006 when it would be fair to say that she was in the position of being a user (rather than a provider) of administration services. She has acquired a great deal of knowledge about the fund administration business as a result of providing consultancy services to asset management companies, but she has never worked for a fund administrator, except as a non-executive director of OpHedge Investment Services LLC. The Defendants called Mr. Fleury. In contrast to Ms. Beder, much of Mr. Fleury's career has been spent working at a high level with UBS Fund Services and Butterfield Fund Services, two well-known hedge fund administrators. He also acquired some knowledge of the practices of many other fund administrators as a result of performing hedge fund audits whilst employed by the Cayman Islands firm of PwC. Mr. Fleury has a direct, hands on experience of the fund administration business, whereas Ms. Beder has the broader experience one might expect of a consultant. Having read their respective reports and listened to them give oral evidence at some length, I came to the conclusion that Mr. Fleury's approach to the issues was fundamentally flawed because he was unwilling to recognize that the BLMIS business model presented BoB Cayman with a unique challenge.

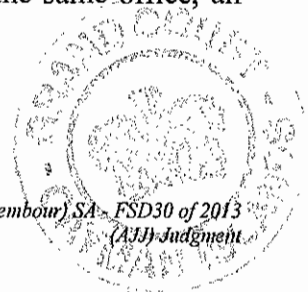
Verification of assets by means of reconciliation

217. In normal circumstances, a hedge fund administrator gets comfortable about the existence of the assets reflected on its client's balance sheet by reconciling information received from two or more independent service providers. Because Madoff insisted that BLMIS must perform the triple function of investment manager, broker and custodian and BA Worldwide appears to have bought into the idea that there was a legitimate business



reason for this practice, BoB Cayman found itself in the difficult position of having to rely upon a single source of information.

218. Mr. Fleury suggested that it was commonplace for administrators to rely upon single source reporting. On analysis, it is clear that the commonplace situation which he had in mind is in fact wholly different from the BLMIS business model. He had in mind the large international banking and financial services groups, such as UBS, which promote their own “in-house” branded investment fund products. In such a case, all the various service providers, including the administrator itself, are likely to be subsidiaries within the same group but this scenario is different from the BLMIS model in two respects. First, it is different in principle in that an in-house fund will be marketed as such and the investors will know that all the various functions are being performed by related parties. Second, an in-house fund is likely to be different operationally. Typically, the various functions of investment management, administration, brokerage and custody will be performed by different subsidiaries carrying on their own separate businesses in different offices, subject to management controls which are not easily overridden. The administrator will not be independent (or held out as such), but it is likely to receive information from multiple sources, albeit related party sources. I agree with Ms. Beder that this business model is wholly different from BLMIS. The whole point about the BLMIS business model is that three functions were (purportedly) carried out through a single company, wholly owned by one dominant individual who would have been in a position to override any internal controls. In fact, there was no attempt to departmentalize House 17. The entire operational process was managed by a small group of up to 20 people working together in one office. They were responsible for making the investment decisions; they were on both sides of the purchase and sale transactions; they were responsible for holding the resulting securities in co-mingled accounts at the DTC and BNY; and they performed all the back office functions. Trade confirmations and month end statements were generated by the same group of people out of the same office, all under the managerial control of Madoff.



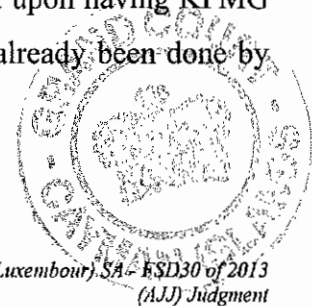
219. The evidence establishes that single source reporting of this sort was unique in the hedge fund industry, although it was not unique to Primeo. It applied to all the Madoff feeder funds, including Lagoon, Thema, Alpha and Herald which were also administered by BoB Dublin and BoB Lux. None of the expert witnesses, including Mr. Fleury, had ever come across any comparable business model. It seems to me that the relatively high risk of fraud or error inherent in the BLMIS model must have been manifestly obvious to all concerned, including the funds' promoters and investment managers/advisers.
220. Ms. Beder suggested that one possible response to the BLMIS business model would have been the issue of "qualified NAVs". This is a novel concept which I regard as a contradiction in terms. The NAV is determined and published as at each monthly valuation/dealing day as the basis upon which subscriptions and redemptions will be transacted. If a fund's administrator and directors conclude that it is impossible, impractical or inappropriate to determine an NAV which is reliable for this purpose, then the determination must be suspended. I think that counsel for Primeo accepted that there is no other alternative to issuing an unqualified NAV per share or suspending its determination. In fairness to Ms. Beder, I think what she really had in mind was that the risk warnings in Primeo's Offering Memoranda ought to have included a statement about the operational risk associated with the concentration of functions performed by BLMIS. There is obvious merit in this point, but it was the responsibility of the directors and is not relevant to the case against BoB Cayman.

Failure to implement the GFS Board decision to instruct KPMG

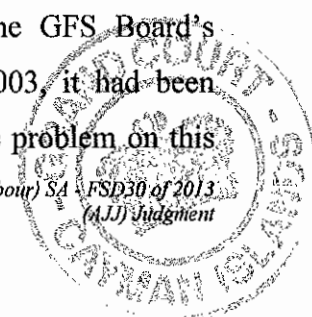
221. The Plaintiff relies upon the failure by the GFS Board to implement its decision (made in October 2002) to engage KPMG to perform audit procedures in respect of its clients' balance sheets (presumably as at 31 December 2002) as constituting the first breach of contract which amounts to wilful default or gross negligence. The relevant clients at this time were Lagoon, Primeo and Thema. Alpha and Herald were established later. As regards Primeo, by October 2002, it was a single manager fund, known as Primeo Select, with two share classes – one denominated in US\$ and the other in Euros. The whole of the invested assets (about \$294.4m and €46m as at 30 June 2002) were held on the

BLMIS managed account. In this regard, the accounting records maintained by BoB Cayman (acting by BoB Lux) were based upon the individual trade confirmations which BLMIS sent by air mail or fax 2 or 3 days after the trade date. The only other items on the balance sheet were the receivables and payables (relating to subscriptions, redemptions and operating expenses) and the balances on the bank accounts maintained with BoB Lux (about \$2.3m and €3.6m as at 30 June 2002). It follows that, in financial terms, the books and records maintained by BoB Cayman and the accounts which it generated as at each valuation day were almost wholly dependent upon information received from BLMIS. These accounts (and the underlying trade confirmations) were reconciled with the month end statements received from BLMIS as part of the process of determining the total NAV. Reconciling two streams of information received from the same source does serve some limited purpose, but it does not provide any real assurance as to the existence of the assets or the underlying trades.

222. The evidence (summarized in paragraphs 79-82 above) leads me to conclude that the GFS Board's decision was overtaken by events. To my mind, it cannot be said that the delay and ultimate failure to instruct KPMG to carry out any audit procedures, independently of whatever F&H might be instructed to do by E&Y (or PwC), constitutes gross negligence or wilful default on the part of BoB Cayman. Part of the reason for the decision was the Board's justifiable skepticism about F&H, but the fact that E&Y concluded that it could properly rely upon audit work performed by this firm is still a relevant consideration. The Board's decision ought to have been implemented in tandem with the audit work conducted by E&Y and PwC in January, February and March 2003. Since Madoff was willing to allow E&Y to instruct F&H, it would have been difficult for him not to allow BoB to instruct KPMG to do similar work. However, once the auditors had issued unqualified opinions (which E&Y did in respect of Primeo on 28 March 2003), it would have become very difficult indeed for BoB to insist upon having KPMG re-perform part of the work which, by necessary implication, had already been done by F&H to the satisfaction of E&Y.



223. The evidence before the Court does not establish that the failure to take the steps necessary to instruct KPMG, including consultation with the clients and securing Madoff's consent, leads 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. Only Mr. Fielding has given evidence about this subject. He disagreed with the Board's decision because he believed at the time that BoB Cayman was entitled to rely upon the auditors. He sought to distance himself from any responsibility for implementing the GFS Board's decision. The evidence tends to suggest that the 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 does not amount to gross negligence or wilful default.
224. Having decided (albeit by default) that Primeo's NAV would continue to be prepared on the basis of the information supplied by BLMIS without being reconciled to information received from any independent source, the next opportunity to review the matter arose in May and June 2003. BoB Lux made its presentation to Bank Austria's internal auditors in May. The BA Internal Control Report itself was not disclosed to Primeo's board of directors as such but Mr. Simon had it in his capacity as Head of the Asset Management Division and Dr. Fano had in her capacity as President of BA Worldwide. In any event, matters arising out of it were discussed at the board meeting on 23 June 2003. The evidence suggests two reasons why Mr. Fielding failed to say anything useful at the board meeting about the problem of single source reporting. First, he believed that it was a problem for the auditors rather than BoB Cayman. In this regard, his approach was wrong. Second, having personally met with Madoff and conducted an on-site due diligence exercise, he thought that the risks associated with BLMIS were acceptable. In this regard, it has to be said that his view must have been shared by many others, including Dr. Fano, Dr. Kretschmer, Mr. Simon and the other directors of Primeo. In these circumstances, it is unsurprising that he failed to mention the GFS Board's decision. He never agreed with it in the first place and, by June 2003, it had been overtaken by events. Whilst I think that Mr. Fielding's approach to the problem on this



occasion was complacent, it does not lead to the conclusion that BoB Cayman was grossly negligent or in wilful default of its duties.

225. The same issues were discussed again at the next board meeting held on 14 May 2004. In the meantime, no operational changes had taken place. In its capacity as custodian, BoB Lux had not recommended the implementation of any of the safeguards/operating procedures which could have provided some independent evidence about the existence and segregation of the assets held by BLMIS. Nor had the problem of single source reporting been addressed any further from the administrator's perspective. Various red flags continued to hang over BLMIS and were there for all to see. On the other hand, BLMIS had continued to perform satisfactorily. To the extent that it had been called upon to realize assets and remit funds for the purpose of meeting redemption requests, BLMIS had by this stage established a satisfactory track record going back for a decade. On 3 March 2004, Mr. Fielding had conducted another on-site due diligence review, with what he considered to be "perfectly satisfactory" results. On 29 April 2004, E&Y had issued another unqualified audit opinion. Whilst I consider that the continued failure to address the problem of single source reporting was negligent, there had been no material change of circumstances from which to infer that BoB's lack of attention to the issue (either at the 14 May board meeting or in the meantime) can properly be characterized as constituting gross negligence.

Issue of custody confirmations

226. The issue next came to the attention of Mr. Fielding in materially different circumstances summarized in paragraphs 101-112 above. In February 2005, E&Y wrote to HSSL expressing various concerns about BLMIS. In particular, E&Y questioned whether it could continue to rely upon audit work performed by F&H and suggested that it would need to perform the work itself, failing which it might resign. The resignation of E&Y would have had potentially serious adverse consequences for Primeo. In the event, this result was avoided because HSSL agreed to provide a custody confirmation to E&Y in respect of the assets held by BLMIS as sub-custodian, thus avoiding the need for E&Y either to engage F&H or do the work itself. From the perspective of BoB Cayman, as

administrator, this decision had serious consequences which were ignored by Mr. Fielding.

227. Mr. Fielding's view was that BoB Cayman was entitled to rely upon the auditors to do the work necessary to verify the existence of the assets. Whether or not his view was misguided, it became wholly untenable once he agreed to provide E&Y with a custody confirmation. The evidence points to the conclusion that, without this confirmation, E&Y would have insisted upon auditing the balances on the BLMIS statements, failing which it might have issued a qualified opinion or resigned. Having provided the key piece of audit evidence, HSSL (as BoB Cayman's delegate) gave up whatever justification it might have had for continuing to prepare NAVs based upon a single source of information. It became impossible for BoB Cayman to rely upon E&Y's unqualified audit opinion when the opinion was itself based (in a highly material respect) upon HSSL's own custody confirmation.

Breach of contract – conclusion – gross negligence

228. Responsibility for determining Primeo NAV per share rested with Mr. Fiorino, but I regard Mr. Fielding as the ultimate decision maker in this instance because I think that it is unlikely that Mr. Fiorino would have taken the decision without his support. The manner in which Mr. Fielding dealt with the matter was not merely negligent. By his own admission (recited in paragraph 110 above), he failed to apply his mind to the issue. 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 audit work performed by F&H. Continuing in this way, knowing that E&Y was unwilling to rely upon F&H's work and knowing that HSSL had taken no steps to perform its duties under Clause 16(B) of the 1996 Custodian Agreement, constituted a serious disregard of the risks associated with relying solely upon information supplied by BLMIS. The custody confirmation was issued on the 5th of April, the audit opinion was issued on the 29th and the NAV for the April valuation day was issued on the 2nd of May 2005. In the circumstances, the decision to recommend the issue of this NAV was a breach of contract

which constituted gross negligence within the meaning of Clause 9.2 of the Second Administration Agreement. It is not wilful default because Mr. Fielding was not conscious that what he was doing (or advising Mr. Fiorino to do) constituted a breach of duty.

229. HSSL continued to issue custody confirmations in respect of the 2005 and 2006 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. BoB Cayman continued to prepare and issue NAVs for each succeeding valuation day up to and including April 2007 without taking or attempting to take any steps to reconcile the information received from BLMIS with information obtained from an independent source. No steps were taken to remedy this situation in the intervening period, except for the first KPMG review.

230. Whilst I think that it was reasonable for HSSL to take some comfort from the First KPMG Report (for the reasons summarized in paragraph 131 above), the fact that KPMG found no evidence tending to suggest any kind of impropriety does not justify the continuation of an inherently flawed procedure. To the contrary, BoB Cayman (acting by HSSL) failed to implement KPMG's most pertinent recommendation which was that it should undertake a periodic review at BLMIS which should include –

Identifying and assessing risks and controls which may be relevant to the movement and control of client assets.

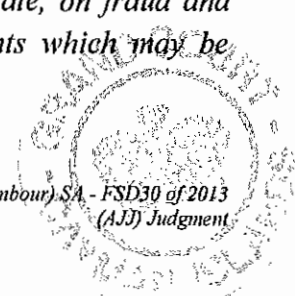
Review the internal audit and compliance reports, conflicts of interest documentation and any external reviews such as those conducted by US regulatory agencies.

Undertake on a periodic basis, independent confirmation of faxed client trading activity information as provided by [BLMIS], as faxes can be easily replicated or falsified in order to commit fraud.

Request [BLMIS] to provide compliance, Internal Audit and other review reports on a periodic basis.

Hold discussions with [Madoff] and other [BLMIS] staff, as appropriate, on fraud and operational risks and controls and discuss any prior period incidents which may be relevant to client accounts

Testing key controls by selecting client trades.



Apart from holding discussions with Madoff and reviewing F&H's Internal Control Reports as part of the periodic custody reviews, no attempt was made to implement any of these procedures. In my view, the fact that KPMG found no evidence tending to suggest fraud or impropriety does not justify the continuation of BoB Cayman's flawed process and its failure to act upon these recommendations tends to support my conclusion that it continued to act in breach of contract in a manner which was grossly negligent.

231. In principle, the decision to close the managed account and invest the whole of Primeo's assets in Herald represents a material change of circumstances from the administrator's perspective. The expert witnesses are agreed that an administrator of a fund of funds will rely upon the NAVs published by the underlying funds in which it is invested, unless there is some clear reason not to do so. Ordinarily, the administrator of a fund of funds would have no ability to "look through" the NAVs published by the underlying funds and neither Ms. Beder nor Mr. Fleury were aware of any case in which this had been attempted.⁵⁴ The Plaintiff's pleaded case merely asserts that BoB Cayman was grossly negligent after May 2007 for the same reasons that applied in the earlier period. In order to make good this allegation, the Plaintiff needs to prove that (a) BoB Cayman knew, or ought to have known, the basis upon which the Herald's NAVs were being prepared, (b) knew, or ought to have known, that Herald's NAV per share could not properly be relied upon for the purposes of determining Primeo's NAV, with the result that (c) in all the circumstances, BoB Cayman's reliance upon Herald's published NAV per share was grossly negligent.

232. HSSL was custodian and administrator of Herald. I assume that it was given authority (or, if it had asked, would have been given authority) to use the information obtained in that capacity for the purposes of determining Primeo's NAV. It follows that HSSL knew, and was properly entitled to know, the basis upon which Herald's NAV was being determined and that it was in a position to judge whether or not it was reasonable to rely

⁵⁴ Different considerations would apply if the underlying fund has suspended the issue of NAVs for whatever reason but this did not happen until December 2008.

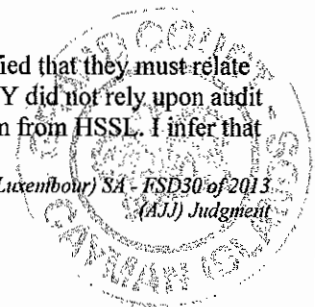
upon the published NAV per share for the purposes of determining Primeo's own NAV. The witness statement of Ms. Lucia Andrich ("Ms. Andrich") is focused on the work done for Primeo, but she does say that the same process and accounting procedures also applied to Herald and Alpha.⁵⁵ I am being asked to draw the inference that, if the work done on behalf of Primeo prior to May 2007 was grossly negligent, then the work done for Herald after May 2007 must have been equally negligent because all the relevant circumstances were the same and therefore BoB Cayman, as a reasonably competent administrator, would not have relied upon the result of that work for Primeo's purposes. The reliance upon single source reporting was common to both funds. Both funds engaged E&Y as auditor and the basis upon which the audit opinions were issued was the same. The evidence establishes that HSSL did issue custody confirmations to E&Y in respect of the audits of Herald's and Alpha's financial statements for the years ended 31 December 2006 and 2007.⁵⁶ The evidence discloses only one factor which might possibly differentiate the work done in respect of Herald and Primeo. The determination of Herald's NAV was subject to an element of review by Bank Medici and its work was subject to further review by Deloitte & Touche and a firm called Carne. The nature of this review work is described in the operational risk report dated 3 October 2007 and prepared by Mr. Vincent Vandembroucke ("the Pioneer Report") who was Pioneer's Global Head of Operational Risk Management. It concludes that these three levels of review added very little value because it was all based on the information sent by Madoff and only conducted *after* the NAV was released. For this reason, the fact that this review was conducted does not have a material bearing on my analysis.

233. The evidence leads to the conclusion that the work done by HSSL in respect of Herald after May 2007 was flawed for exactly the same reasons as the work done in respect of Primeo prior to May 2007. The same was true in respect of the work done for Alpha. This

⁵⁵ Ms. Andrich was employed as a manager in HSSL's A&V department from November 2004 until 2012. She managed a team of two fund accountants responsible for maintaining the books and records and performing the NAV calculations for Primeo, Alpha and Herald.

⁵⁶ The copies of the custody confirmations in evidence have been redacted, but I am satisfied that they must relate to Herald and Alpha. An e-mail exchange between E&Y and Mr. Fischer confirms that E&Y did not rely upon audit work performed by F&H in respect of the Alpha audit because it got a custody confirmation from HSSL. I infer that E&Y would have dealt with the Herald audit in the same way.

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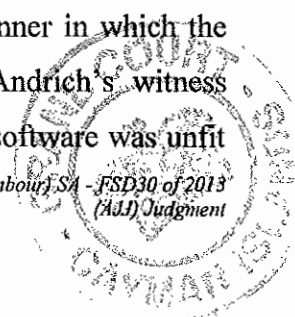


was known, or ought to have been known, to BoB Cayman in its capacity as administrator of Primeo. In my view, it follows that BoB Cayman was grossly negligent in respect of the NAVs issued for Primeo after 2007.

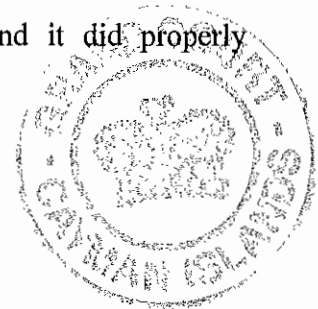
234. Next, I turn to the question whether the second KPMG review conducted in April 2008 provides any justification for the continuation of what I have found to be a grossly negligent process. The work done and the discussion about KPMG's findings is described in paragraphs 136-139 above. In short, this exercise produced no new information and the major findings recorded in the written report dated 8 September 2008 are practically the same as those reported three years earlier. KPMG had not found any evidence of fraud and Mr. Yim expressed the opinion that "There's nothing on the trading side which suggests that anything is significantly amiss" but those who participated in the discussion with KPMG on 17 July 2008 recognized that the operational risk associated with BLMIS was uniquely high and that it *could* be a Ponzi scheme. In my view, nothing emerged from this exercise which could justify the continuation of what I consider to have been a grossly negligent procedure for determining Primeo's NAV per share, even after May 2007.

Alleged breach of the books and records duty under sub-clause (xviii) of the Second Administration Agreement

235. Primeo also claims that BoB Cayman acted in breach of its duty under Clause 4(xviii) which counsel has referred to as "the books and records duty". In my view there is a fundamental distinction between the function of determining the NAV per share under sub-clause (xvii) and the function of maintaining the books and records under sub-clause (xviii). It is the distinction between the roles of the accountant and the bookkeeper. The expert witnesses were not specifically asked to address this distinction in their reports but it seems perfectly clear to me that the accountant's role requires the exercise of professional judgment, whereas the bookkeeper's role does not. To my mind, Primeo's case for breach of the books and records duty is unarguable. The manner in which the books and records were maintained, as described in Ms. Lucia Andrich's witness statement, is not criticized and there is no suggestion that the *Geneva* software was unfit



for purpose. The information received was all properly recorded and it was possible to produce accounts which were consistent with those books and records and to do so in a timely manner. Whether those accounts could properly be relied upon for the purpose of calculating and issuing an NAV per share, is an entirely different matter. BoB Cayman, in its capacity as accountant, was in breach of its NAV duty under sub-clause (xvii) but this does not necessarily lead to the conclusion that, in its capacity as bookkeeper, it must also be in breach of the bookkeeping duty under sub-clause (xviii). Recording the false information received from BLMIS in Primeo's books and records was not itself a breach of duty. The information contained in the trade confirmations was not manifestly wrong. The breach arises out of the reliance upon this information for the purposes of the NAV calculation in circumstances where it could not be reconciled with information from an independent source. I appreciate that the maintenance of Primeo's books and records and the calculation of the NAV per share was all part of an integrated process, but I think that the sub-clauses (xvii) and (xviii) give rise to fundamentally different duties which should not be conflated into a single composite duty. Notwithstanding that I have found BoB Cayman to have been grossly negligent in the manner in which the NAV per share was calculation was performed from April 2005 onwards, to my mind it did properly discharge its books and records duty throughout the entire period.



The Administrator's alleged advisory and reporting duties – the Reports of the Custodian and Administrator

236. I have concluded that, on a true construction of the 1996 Custodian Agreement, there is no implied “advising duty” or “reporting duty”. The Plaintiff contends that exactly the same terms are to be implied into the Second Administration Agreement. I reject this proposition, essentially for the same reasons as those applicable to the 1996 Custodian Agreement. The implication of such terms was not necessary to give business efficacy to the agreement. The role of administrator was not an advisory one and its reporting obligations were limited. Clause 4.1(xiii) of the Second Administration Agreement

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(recited in paragraph 195 above) provides that BoB Cayman shall (a) arrange for a representative of BoB Cayman to attend at board meetings when required to do so and (b) prepare agendas, minutes and other documents required in connection with board meetings. BoB Cayman's obligation was performed by BoB Lux, at least one of whose employees attended every board meeting throughout the relevant period. With effect from the board meeting held on 1 April 1998, the documents prepared for the directors (referred to as the "board pack") included a report, described as the *Report of the Administrator*. With effect from the meeting held on 29 April 2005, the scope of these reports was enlarged to include a section relating to custody and from this date onwards the reports are entitled *Report of the Custodian and Administrator*. The person responsible for preparing these Reports was Ms. Maryse Duffin ("Ms. Duffin") who has been Head of Corporate Secretarial Services at HSSL since 1988. The Reports are signed by the client relationship manager.⁵⁷

237. The content of the "board packs" was driven by the needs of the board as related to HSSL by the investment adviser – BA Worldwide until April 2007 and Pioneer thereafter. Ms. Duffin's evidence, which I accept, is that the Reports were generally prepared in conjunction with the investment adviser which would most probably have been sent a draft and asked to indicate whether it included the information which the board wanted to see. She would collect up the information from the relevant departments including the A&V department which supplied the financial summaries and supporting accounts. The form and content was based upon a template, with the result that some sections are repeated *verbatim* in successive reports. Ms. Duffin said that these Reports were not intended as the means by which information about any important high level issue, such as concerns about BLMIS' business model and the basis upon which the NAV calculations were being performed, would be conveyed to the directors. Actually, I think that this point is self-evident from the form of the Reports and the manner in which they were produced. It is also consistent with Mr. Fleury's description of the normal industry

⁵⁷ There are 12 Reports in total. The first four are signed by Mr. Bailey who was the client relationship manager for Bank Austria until September 2000. The next five reports, beginning in October 2002, are signed by Jillian Irvin. The April 2006 Report is signed by Filip Majen and the final three, from January 2008 onwards are signed by Catherine Huet.

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(A13) Judgment



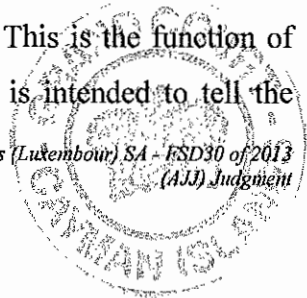
practice. In my view, there is no basis for imposing an advisory obligation or an extended reporting obligation which goes beyond that which was agreed by the express terms of the contract.

238. BoB Cayman's obligation was limited to providing the board of directors with reports on such matters as may be required and, in so doing, it must exercise reasonable care and skill so as to ensure that the content of the Reports is not inaccurate or misleading. The Plaintiff's case in this regard is that, from October 2002 onwards, these Reports were positively misleading and inaccurate because they did not describe the concerns expressed by members of the GFS Board at that time or disclose the decision to engage KPMG (which was not implemented) and/or state that the BLMIS business model meant that the NAV calculations were being performed on the basis of single source reporting. The final paragraph of each of these Reports comprises a statement under the heading "General Administration" in the following terms –

We are pleased to report that the administration of the Fund has progressed smoothly during the period under review and that as at [] there were no unresolved issues requiring the Board's attention.

The Plaintiff contends that this statement (which I shall refer to as "the General Administration statement") was inaccurate and misleading and that the circumstances in which it was made (and repeated) were such that BoB Cayman was grossly negligent. In my view this allegation is misconceived and plainly wrong for two reasons. First, it is based upon a misunderstanding of the nature and purpose of the Reports. Second, it fails to take account of the parties' common knowledge about BLMIS and the operational consequences of its business model.

239. Each report related to a specific accounting period and a high proportion of its content (and attachments) comprises simple factual information about the financial condition of company during the period under review and as at the latest valuation day. It does not contain any analysis or advice about the financial performance. This is the function of the investment adviser. The General Administration statement is intended to tell the



board that no administrative issue (not already addressed by the Board) has arisen since the last meeting which requires the Board's attention. There is no evidence to suggest that this statement is inaccurate in any way. The point about single source reporting did not arise in the period from 1 February 2000 to 31 October 2002. The problem had existed from the inception of Primeo's business. It was an inherent consequence of the BLMIS business model which was known to and understood by Primeo and its investment adviser. It would have served no useful purpose to repeat this point in each of these Reports.

240. The Report for the period 1 February 2000 to 31 October 2002 was presented to the board meeting held at BoB Lux's office on 5 December 2002. None of those present at the meeting have given evidence except for Mr. Fielding. There is no evidence from which to infer that Dr. Fano or any of the directors were misled in any way by the General Administration statement. The evidence about what took place at the next two board meetings in June 2003 and May 2004 is relevant and leads to the conclusion that these directors must have understood perfectly well that the General Administration statement was not intended to address the inherent structural problem which, by the time of the June 2003 meeting, had been addressed in the BA Internal Audit Report. The content of this report was discussed at length at this meeting and again at the May 2004 meeting. There is no suggestion in the minutes or any other contemporaneous document that the internal auditors had revealed anything which the directors did not already know about the BLMIS business model and its consequences. There is no contemporaneous evidence that any of the Bank Austria personnel present at either of these meetings, including Mr. O'Neill, criticized BoB for not having addressed the issue in its previous Reports, let alone criticized BoB for having misled them about the matter. Quite clearly, the reason for this is that the point about single source reporting was well understood by all concerned. If any of them had misunderstood the purpose and effect of the General Administration statement, they would surely have said so and would have questioned what the statement was supposed to mean. There is no evidence to suggest that anyone ever did so.



241. Senior executives of BoB/HSBC discussed the risks associated with BLMIS repeatedly over many years, sometimes in very critical terms, but they never actually came to the conclusion that BoB Cayman and HSSL should resign because the risk had become unacceptable. Neither BoB Cayman nor HSSL were under any contractual obligation to relate these internal discussions to their client. The General Administration statement contained in the Reports was not intended to encompass the problems inherent in the BLMIS business model and Primeo's directors and investment adviser were not misled in this regard. Had BoB Cayman and HSSL decided to resign, or threaten resignation absent some operating changes on Madoff's part, these Reports would not have been the vehicle for communicating such a decision to Primeo and its investment adviser.

H. Causation

Introduction

242. A plaintiff may only recover damages for a loss where the breach of contract was the effective or dominant cause of that loss. There must be a causal connection between the defendant's breach of contract and the plaintiff's loss such that the plaintiff would not have suffered the loss but for the breach of duty by the defendant (*Chitty on Contracts*, 31st Edition, 26-057; *Galoo v. Bright Grahame Murray* [1994] 1 WLR 1360). In circumstances where a number of factors combine to cause loss to a plaintiff, the defendant will still be liable if its breach of contract was *an* effective cause of the plaintiff's loss. It does not have to be the only effective cause or the most effective of multiple causes (*County Ltd v. Girozentrale Securities* [1996] 3 All ER 834). Nor does it matter if there are persons other than the defendant whose breaches of duty contributed to the plaintiff's loss.

243. The Plaintiff puts its case on the basis that if the Defendants had properly discharged their contractual duties, Primeo would have (a) terminated its managed account and withdrawn its investments placed directly with BLMIS, (b) redeemed its shareholdings in Alpha and Herald and (c) would not have invested any further funds with BLMIS, either directly or indirectly through any other Madoff feeder fund. Its total loss is said to

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be (a) the loss of its investment, being reported value of the investments as at the date of withdrawal/redemption (adjusted for subsequent investments/withdrawals and fees) and (b) the loss of profit, being the total net return (capital gain and income) which would have been earned on an alternative investment. Alternatively, Primeo claims the value of the Net Investments which is defined to mean the total cash amount paid to BLMIS (both directly and indirectly through Alpha and Herald) less the amount paid out (both directly and indirectly). As an alternative to the loss of profit claim, Primeo would seek an award of statutory interest on the amount of its lost investment. Finally, it is accepted Primeo must give credit for the actual value of its investments in Herald and Alpha, being the amount realized by selling shares in the post-liquidation secondary market and the amount of the distributions received in the liquidations of Herald and Alpha.

244. It follows that the Plaintiff must prove, on the balance of probabilities, that the directors at the relevant time would have taken these actions in the hypothetical circumstances which are postulated. Therefore, in commercial terms, the Plaintiff is seeking to prove that its directors would have closed Primeo Select and Executive (without compulsorily redeeming the investors and putting the company into liquidation) and then re-launched the fund with an entirely new investment strategy. It is not suggested that its directors would have engaged a new investment manager who would continue to pursue its existing split-strike conversion strategy.

245. Both the 1996 Custodian Agreement and the Second Administration Agreement create continuing duties in the sense that they are required to be performed periodically. BoB Cayman and HSSL breached these duties periodically during the period from August 2002 onwards. For the purposes of the causation analysis, it is sufficient to examine the consequences of the breaches which occurred in August 2002, April/May 2005 and February/March/April 2007.

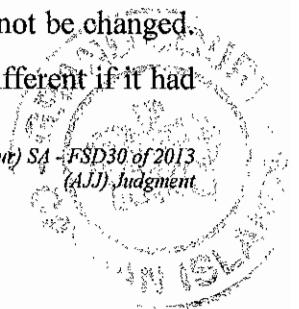
Causation analysis relating to the breach of Clause 16(B) – August 2002

246. BoB Lux was first in breach of its continuing duty under Clause 16(B) of the 1996 Custodian Agreement, from August 2002 onwards, when it failed to recommend to



Primeo that it require BLMIS to (a) establish a separate account at the DTC and/or make use of the ID System and (b) establish a separate account or sub-account at BNY. In principle, the implementation of these safeguards ought to have been perfectly straightforward. However, it is clear that Madoff would have had no alternative but to resist because their implementation would have seriously impeded the operation of his Ponzi scheme. Therefore, I have to consider how BA Worldwide, the board of directors and BoB Lux would have reacted in these circumstances.

247. It is also relevant to bear in mind that Primeo was one of three Madoff feeder funds for whom the BoB Group was acting as custodian and administrator at this time. Even if the terms of the custodian agreements with Primeo, Thema and Lagoon were not exactly the same, as a practical matter, the proposed safeguards must have been equally relevant to all three funds and it seems to me inherently improbable that BoB would want to treat these clients differently. This is relevant because it compounds the problem which would have faced Madoff and increases the likelihood that he would refuse to implement the proposed safeguards.
248. At the material time, apart from Mr. Fielding, Primeo's board of directors was wholly comprised of Bank Austria Group employees, namely Mr. Simon (chairman), Dr. Hans-Peter Tiefenbacher, Mr. Johannes J. Spalek and Dr. Karl E. Kaniak. Since Mr. Simon was both chairman of the board and head of the Bank Austria's Asset Management Division, it is probably 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. None of these people have been called to give evidence. Nor were the Plaintiff's liquidators able to obtain access to documents relating to Primeo in the possession of Bank Austria.
249. It is clear from the discussions that took place the following year in the context of the BA Internal Audit Report that these directors were willing to accept the relatively high operational risk associated with BLMIS's business model and, by necessary inference, must have given credence to Madoff's reasons for insisting that it would not be changed. There is no reason to suppose that the discussion would have been any different if it had



taken place in August 2002 in the context of BLMIS' appointment as sub-custodian and Madoff's refusal to implement the proposed safeguards. However, it would or should have been apparent to all concerned that these safeguards could have been implemented without interfering with BLMIS' business model. I find it difficult to see how he could sensibly resist the establishment of separate accounts at the DTC and BNY. Since he was in fact using the ID System for his House 5 brokerage business,⁵⁸ it would have been difficult to explain why it could not be used for the House 17 business. Madoff was known to have a "penchant for confidentiality" but Mr. Wiener's attempt to explain why the need for confidentiality could justify refusing to use the ID System was wholly unconvincing. It seems to me that, if faced with this dilemma, any reasonably competent custodian would either resign or seek to re-negotiate the terms of its contract. Then, the crucial question is how Primeo's directors would have reacted in this scenario.

250. By August 2002, Primeo Select had become a successful single manager fund which was wholly dependent upon BLMIS' unique investment performance. It was also particularly profitable for Bank Austria because it did not have to pay any investment management fees and BLMIS's brokerage commission was being born by the investors.⁵⁹ From Mrs. Kohn's perspective, the commercial pressure to maintain the BLMIS relationship must have been even greater because the fee income derived from Primeo, Lagoon and Thema was likely to have been highly material to Eurovaleur. Terminating the BLMIS account would necessarily involve closing Primeo Select unless BA Worldwide could have found a new investment manager who would pursue the same split-strike investment strategy. For the reasons explained by the Defendants' investment management expert, Mr. Alistair Lowe ("Mr. Lowe), it would have been very difficult indeed to do this because any new manager would have had a different and inferior performance history. No one could match Madoff's uniquely consistent performance.

⁵⁸ Given the huge daily volume of transactions, it would have been impossible for BLMIS to carry on its legitimate House 5 business without using the ID System.

⁵⁹ Primeo's audited financial statements for the year ended 31 December 2002 reflect that BA Worldwide earned fees of US\$5,779,156 of which US\$1,155,831 (20%) was payable to Eurovaleur pursuant to the Sub-Advisory Agreement. The custodian and administration fees payable to BoB for the same period were US\$328,040 and €78,532.

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251. The Plaintiff puts its case in a way which assumes that Primeo Select would be closed and the fund would be re-launched with a different investment strategy. Having regard to BA Worldwide's previous lack of success with Primeo Global, re-launching Primeo as a fund of funds would not have been an appealing prospect. The alternative was to find a new investment manager to pursue some different investment strategy which was compatible with Primeo's broadly stated investment objective. This is the way in which the Plaintiff's case is put. However, as the evidence of both Mr. Lowe and Mr. Thompson makes clear, the directors would have understood the consequential risk of mass redemptions. In the absence of any evidence from Dr. Fano, I find it difficult to see how BA Worldwide would have marketed the re-launch of Primeo with a new investment strategy and a new investment manager whose past performance could not have matched Madoff's uniquely consistent returns. The circumstantial evidence tends to suggest that Bank Austria and Primeo's board of directors would have worked hard to avoid proceeding in this way.

252. From Bank Austria's perspective, it seems to me that appointing a new custodian and administrator in place of the BoB Group companies might well have been commercially more attractive than appointing a new investment manager in place of BLMIS. As at August 2002, there were a number of other Madoff feeder funds which had been in existence since the early 1990s and were not dependent upon BoB Group companies as custodians or administrators. The evidence before this Court is that at least some of them had engaged large, reputable, well known service providers and it is reasonable to assume one or other of them might have been willing to take on additional Madoff related business⁶⁰ but I accept Mr. Fleury's evidence that, by 2002, there would have been fewer firms willing to do so than was the case a decade earlier.

⁶⁰ There were other Madoff feeder funds unconnected with BoB/HSBC group companies. The largest of these was probably Fairfield Sentry Ltd. The complaint in proceedings commenced in the US Bankruptcy Court by the BLMIS trustee reflects that it placed a total of US\$4.3 billion on its managed accounts commencing in 1990.

253. From the perspective of BoB Lux in its capacity as custodian, reverting to the *status quo ante* would have been a possible solution to this dilemma. The 2002 Sub-Custody Agreement could have been terminated. BLMIS could have been re-instated as custodian for Primeo in respect of the managed account assets. The 1996 Custodian Agreement and the Offering Memorandum could have been amended to make it clear that BoB Lux had no responsibility for the managed account assets. BLMIS might have been forced to accept a more transparent disclosure of its true role in the Offering Memorandum, albeit without mentioning its name. BoB Lux would have been required to adopt a more conventional approach towards the creation of security for its exposure under the foreign exchange and overdraft facilities. 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.
254. 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.

Causation analysis relating to the custody/administration breaches which occurred in April/May 2005

255. HSSL was in breach of Clause 16(B) of the 1996 Custodian Agreement in April 2005 when, following Mr. Pettitt's due diligence review, it again failed to make any recommendation or take any steps towards implementing the 'most effective safeguards'.

BoB Cayman was in breach of its duty to exercise reasonable care and skill when

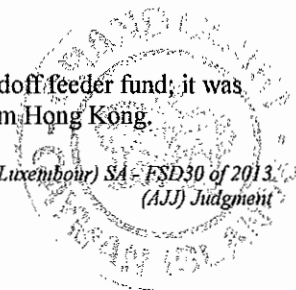
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performing the NAV calculations for the April 2005 valuation day. These breaches of duty are closely inter-linked. It became grossly negligent to continue issuing NAVs without conducting multi-source reconciliations because BoB Cayman (acting by HSSL) knew that E&Y's unqualified audit opinion in respect of the 2004 financial statements was based, to a material extent, upon the custody confirmation letter issued by HSSL on 5 April 2005. HSSL was in breach of Clause 16(B) because it failed to give any consideration to the implementation of the procedures which would have enabled it to verify the existence of the assets, which would in turn have justified issuing the custody confirmation to E&Y.

256. In summary, the scenario with which the Defendants were faced in Q1 2005 was as follows. E&Y were questioning whether they could continue to rely upon audit work performed by F&H and had raised the possibility of resignation unless they were able to perform the work themselves with satisfactory results. To the extent that it was possible for him to do so, Madoff would have resisted this proposal but the need to ask him never actually arose because HSSL issued the custody confirmation, albeit in circumstances where it ought not to have done so. This enabled E&Y to issue an unqualified audit opinion, but it also undermined BoB Cayman's ability to rely upon the opinion as a justification for performing NAV calculations without reconciling the information received from BLMIS with information obtained from an independent source. Faced with this situation, a reasonably competent custodian/administrator would have given notice of resignation (without having issued the custody confirmation) and explained its reasons for doing so to the board of directors.

257. HSBC could not have taken a decision to resign as custodian and administrator of Primeo in isolation. By April 2005, Alpha, Herald and Square One⁶¹ had been added to the list of Madoff feeder funds for which HSBC Group companies were acting. Mrs. Kohn was involved with at least five of these funds in an advisory capacity, acting through

⁶¹ There is very little evidence before the Court about Square One except that it was a Madoff feeder fund; it was an HSBC Group client; and it may have been domiciled in Hong Kong or administered from Hong Kong.



Eurovaleur.⁶² She was involved in the promotion and management of Herald (through her 75% ownership interest in Bank Medici). The commercial interests in Alpha are somewhat opaque, but she was a director and, like Dr. Zapotocky, she probably had a beneficial interest in its promoter/investment manager. BA Worldwide earned fees as sub-investment manager. Bank Austria had an interest in Herald through its 25% ownership interest in Bank Medici. Whilst there were some variations in the terms of the custodian and administration agreements, the HSBC Group companies would have been faced with the same problems in respect of all these clients, at least to the extent that they were audited by E&Y.⁶³ It is reasonable to infer that E&Y must have adopted the same position about the reliability of F&H in respect of all its audit clients. In these circumstances, it is difficult to see how any reasonably competent custodian/administrator could have justified terminating the relationship with Primeo, whilst continuing to act for its other Madoff feeder fund clients. The reasons for resigning would, almost certainly, apply equally to all of them.

258. I have concluded that BoB Cayman and HSSL were not under any legal duty to relay to Primeo their “concerns” about BLMIS’ business model but the suggestion that they could or would have resigned without explaining their reasons seems commercially unrealistic to me. The point about “tipping off” does not arise. HSSL did not suspect fraud or impropriety on the part of BLMIS and it is not alleged that it ought to have done so. The reasons why a reasonably competent custodian and administrator would have considered resignation in April 2005 are that (a) it was not possible for the custodian to implement readily available and effective custody safeguards and (b) the administrator could no longer properly rely on single source reconciliations if the auditor was not prepared to issue an unqualified opinion in the absence of a custody confirmation which the custodian was not in a position to issue. The causation analysis is not based upon the premise that, but for their breaches of duty, the Defendants would have become aware of facts and matters which would have lead them to make a report to the regulators. All the

⁶² Whether or not Mrs. Koln was involved with Square One is not apparent from the evidence.

⁶³ E&Y audited Primeo, Hermes/Lagoon, Alpha and Herald. PwC audited Thema. The identity of Square One’s auditor is not apparent from the evidence.

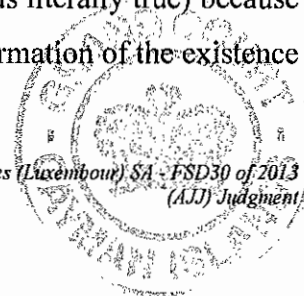
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expert witnesses gave evidence to the effect that a reasonably competent custodian/administrator would explain the reasons for resigning in the circumstances of this case. It seems to me that HSSL would have explained and discussed the matter with BA Worldwide before actually serving the formal 60 day notices of termination required by the contracts.

259. What changed in Q1 2005 is that E&Y lost confidence in F&H. The Plaintiff puts its causation analysis in the following way. First, it is said that HSSL ought not to have issued the custody confirmation letter dated 5 April 2005, without which E&Y would have insisted upon having access to BLMIS's books and records in order to perform their own audit procedures designed to confirm the existence of the managed account assets. Madoff would not have allowed this to happen. Therefore, E&Y would have threatened resignation. In these circumstances it would have been very difficult to find another auditor approved by CIMA which would be prepared to accept the engagement on terms that it would not have access to BLMIS's books and records or a custody confirmation from HSSL. Faced with the possibility of being unable to comply with the statutory duty to file audited financial statements with CIMA by 30 June 2005, the argument is that Primeo's board of directors would have had no real option but to solve the problem by terminating the relationship with BLMIS and withdrawing the assets. Implicit in this argument is the proposition that E&Y would then have relied upon the subsequent withdrawal of the cash balance (sometime prior to the 30 June deadline) as evidence that the assets reflected in the balance sheet must have existed as at 31 December 2004, thus enabling an unqualified audit opinion to be issued.

260. I agree with the proposition that HSSL ought not to have issued the 5 April 2005 custody confirmation letter. HSSL had no information from any independent source with which to corroborate or reconcile the year end statement received from BLMIS. For this reason, it issued a carefully crafted letter in terms different from its standard form custody confirmation which was inappropriate (even though its content was literally true) because HSSL knew that E&Y would rely upon it as an independent confirmation of the existence



of the assets reflected in the BLMIS statement when in fact HSSL had no independent evidence as to their existence. And, E&Y did in fact rely on it for this purpose.

261. The next leg of this argument is that Madoff would have refused to allow E&Y to have access to BLMIS' books and records. There is no direct evidence in support of this proposition because it appears that Madoff was never in fact asked the question. Neither Mr. Fielding nor Mr. Pettitt raised the matter with him. There is no evidence that Dr. Fano ever did so and it is inherently unlikely that the E&Y engagement partner would have contacted Madoff directly without going through her. The circumstantial evidence suggests that, if he had been asked, he might well have allowed it to happen. It seems to me that it would have been difficult for Madoff to explain why he would not allow E&Y to do the very same work which F&H had (purportedly) done in prior years. If it had been explained to Madoff that, in the absence of performing this work, E&Y would not issue an audit opinion with the result that Primeo and the other E&Y clients might be forced to terminate their managed accounts, he would have been under immense pressure to agree. This scenario would not have been materially different from the one which did in fact play out later in the year when Madoff was persuaded to allow KPMG to conduct the first of its fraud risk reviews. From Madoff's perspective, allowing E&Y to perform this audit work might not have appeared any more risky than allowing KPMG to perform wide ranging and potentially invasive systems review work. One material difference between these exercises is that Madoff would have known in advance precisely what documents would need to be forged for E&Y's purposes⁶⁴ whereas KPMG review would involve selecting random transactions for review. For all these reasons, I am not persuaded that Madoff would have refused to give E&Y access to BLMIS's books and records.

262. Having reached this conclusion, the causation analysis becomes much more speculative because it turns on the outcome of the hypothesis that E&Y is given access to BLMIS's books and records and allowed to perform audit fieldwork at its offices. There are a range

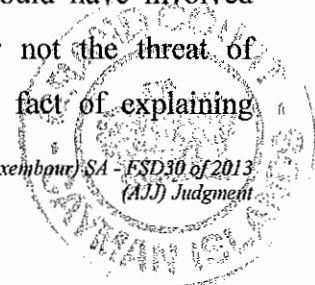
⁶⁴ The relevant asset on Primeo Select's balance sheet was US Treasury Bills having a cost price of US\$424,335,064. In order to verify the existence of this asset, Madoff would need to forge documents apparently emanating from BNY as well as internal documents reflecting the allocation of an aggregated holding of Treasury Bills amongst multiple clients.

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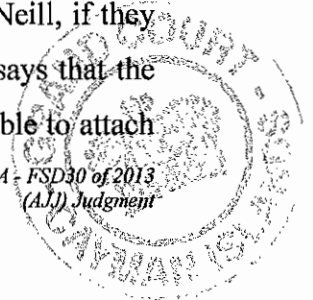
of possible outcomes. Madoff's team might have successfully deceived E&Y, as they did in fact deceive KPMG, in which case an unqualified audit opinion would have been issued without the need for any custody confirmation from HSSL. In this event, Primeo would have continued placing new money on the managed account. On the other hand, E&Y might have attempted to obtain a confirmation directly from BNY which might conceivably have led to the exposure of the Ponzi scheme. In this event, BLMIS would have been put into liquidation and Primeo would have had no opportunity to withdraw its funds or, at least, not without exposing itself to a claw-back claim. Within these two extremes, there is the possibility that E&Y would have come away from BLMIS with an inconclusive result, but without actually suspecting the existence of any fraud or impropriety which would need to be reported to the regulators.

263. If E&Y (or some other auditor approved by CIMA) had been willing to issue an unqualified audit opinion and continue in office as Primeo's statutory auditor, the board would not have considered terminating the BLMIS managed account simply because HSSL considered the operational risks associated with BLMIS to be unacceptable and was threatening to resign. More likely, it would have sought to persuade them to continue or find an alternative service provider for which purpose it might well have accepted the inclusion of exculpatory provisions in the custodian and administration agreements. In order to establish its withdrawal hypothesis in this scenario, the Plaintiff needs to show that E&Y (or some other auditor approved by CIMA) would not have issued an audit opinion by 30 June 2005 or within such extended period as might have been allowed by CIMA, in which case Primeo would have had no choice but to terminate the managed account. 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.
264. If E&Y had issued an unqualified audit opinion without having any custody confirmation, Primeo would not have withdrawn its investment from BLMIS or redeemed its Herald and Alpha shares. However, this scenario would have involved HSSL explaining its reasons for wanting to resign, whether or not the threat of resignation was withdrawn. The Plaintiff's case is that the mere fact of explaining



HSSL's "concerns" would have led Primeo's board of directors to terminate the BLMIS relationship and withdraw the managed account assets. This argument depends, to a material extent, upon the evidence of Mr. O'Neill who, by this time, had joined Primeo's board of directors in place of Dr. Tiefenbacher. Apart from Mr. Fielding, the board was still wholly comprised of Bank Austria Group employees. Mr. Simon was still chairman of the board and head of Bank Austria's Asset Management Division. Mrs. Kohn and Dr. Fano were still performing the same roles that they had done in August 2002. If HSSL had threatened resignation and/or sought to have explained its "concerns", it is reasonable to infer that these matters would have been discussed by the board at the meeting which was in fact scheduled for 29 April 2005, although the agenda items would have been very different from that which was actually discussed. In particular, without any custody confirmation, the outcome of E&Y's audit would still have been an open issue at this point in time.

265. The evidence leads me to the conclusion that Mr. O'Neill had practically no involvement with Primeo apart from attending three board meetings in May 2004, April 2005 and June 2006. He was managing director of Bank Austria's Cayman Islands subsidiary and, as such, removed from the decision making process relating to Primeo. In answer to the question: *Would you agree with this, that you were somewhat divorced from the decision-making process in relation to important issues impacting Primeo?*, he replied: *It appears that way, yes.* He was also a director of BA Worldwide, but no board meetings were ever held and his only role was to review and sign invoices as a means of demonstrating that the company was not tax resident in Austria. By his own admission, he knew relatively little about Primeo at the time he served on its board of directors and I formed the impression that his evidence to this Court was heavily influenced by a desire to distance himself from the matter. In summary, his evidence relating to the causation issue is that he and (so far as he was aware) the other directors did not know that BLMIS' multiple roles meant that HSSL was not in a position to confirm the existence of Primeo Select's assets with information from any independent source. According to Mr. O'Neill, if they had known about this and the concerns expressed by HSSL executives, he says that the board would have taken steps to redeem the assets held by BLMIS. I am unable to attach



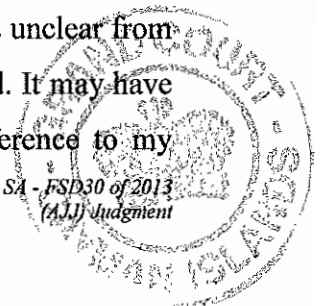
any weight to this evidence. At best, it reflects a surprising degree of ignorance on his part about Bank Austria's state of knowledge and tends to suggest that he would have had little or no influence on the decision making process.

266. Bank Austria understood the BLMIS business model and its implications perfectly well. In her evidence to an Austrian court, Dr. Fano said "We knew from the beginning that Madoff was also the sub-custodian". The fact that Mr. O'Neill was never sent a copy of the BA Internal Control Report and was not aware of the 2002 Sub-Custody Agreement until 2006 helps to explain his ignorance, but it also tends to support the conclusion that his influence in the decision making process would have been minimal. Bank Austria knew that E&Y was relying on audit work performed by F&H. On 6 May 2003, E&Y sent copies of the F&H audit reports for the years ended 31 December 2000, 2001 and 2002 to Dr. Fano at her request. She must have known that the audit opinion issued in April 2005 was in fact based upon the HSSL custody confirmation rather than F&H's audit work. If HSSL had refused to issue the custody confirmation, she would have been directly involved in the ensuing discussions with E&Y and Madoff and she would have lead the discussion at the board meeting, as she had done previously in June 2003. If HSSL (perhaps acting by Mr. Paul Smith or someone other than Mr. Fielding) had told the board that it had come to the conclusion that that it should resign as both custodian and administrator unless Madoff was willing to put in place the appropriate custody safeguards (which he would not have done), the ultimate outcome would, most likely, have turned on the response of the auditors. Unless and until it became apparent that an unqualified audit opinion would be unobtainable, Bank Austria and Primeo's board of directors would have sought to persuade HSSL to change its mind by offering to include appropriate exculpatory provisions in the contracts. At the same time, they would have sought to find alternative service providers and considered re-investing in one of the other Madoff feeder funds, such as Fairfield Sentry Ltd, which had not engaged any HSBC Group companies as their custodians or administrators. In this scenario, it seems to me inherently improbable that Mr. O'Neill would have persuaded (or even attempted to persuade) his Bank Austria colleagues to close Primeo Select and re-launch the fund with a new investment strategy.

267. 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.

Causation analysis relating to the custody/administration breaches which occurred in February/March/April 2007

268. The causation analysis in respect of the breaches of contract which occurred in February/March/April 2007 is essentially the same as that applicable to the previous breach. BLMIS' business model remained unchanged. The procedures employed by HSSL and BoB Cayman in their respective capacities as custodian and administrator remained unchanged. On 9 February 2007, Mr. Pettitt met with Madoff for the purpose of discussing various custody related issues which had been identified in the First KPMG Report. He failed to consider whether HSSL was in compliance with its 'ongoing suitability duty' and 'most effective safeguards duty' in circumstances which gave rise to a breach of Clause 16(B). The breach occurred on 23 February 2007 when HSSL issued another custody confirmation to E&Y in circumstances where it was still unable to verify the existence of the managed account assets by reconciling BLMIS' statements with information from any independent source. Again, E&Y acted on the confirmation without engaging F&H or attempting to perform their own audit procedures on BLMIS' books and records. E&Y issued an unqualified audit opinion on 5 April 2007. It is unclear from the documentary evidence when the 31 March NAV was actually published. It may have been on 12 April 2007, but if I am wrong about this, it makes no difference to my



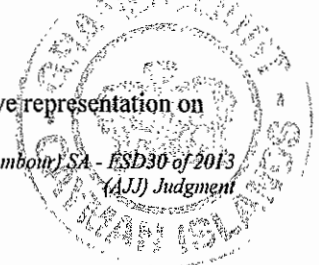
analysis. I also note that Primeo was in decline during this period in the sense that total redemptions exceeded total subscriptions by a substantial margin between April 2005 and April 2007.

269. At around this time, the composition of Primeo's board of directors was about to undergo a material change because it had been decided that managerial control of Primeo should to be transferred from BA Worldwide (in Vienna) to Pioneer (in Dublin), both of which were at this time wholly owned subsidiaries of the UniCredit Group. The HSBC Group companies had ceased to be represented on the board since Mr. Fielding's resignation on 3 October 2006.⁶⁵ The formal transfer of control from BA Worldwide to Pioneer did not take place until 25 April 2007, but there is e-mail correspondence which reflects Pioneer's involvement from at least mid-November 2006 onwards, although the board's formal resolution giving Pioneer to free access to Primeo's books and records was not passed until 16 March 2007. Dr. Fano continued to have day to day managerial responsibility until 25 April 2007 when she became a member of the board. The other new members were Mr. La Rocca (Pioneer's Chief Executive Officer), Mr. Murray (Pioneer's Chief Operating Officer) and an independent director. I approach the Plaintiff's withdrawal hypothesis on the basis that the relevant decision would have been made by the new board, albeit with input from Mr. Simon and possibly other members of the outgoing board. None of these people have given evidence except for Mr. O'Neill, but I think that his evidence about what would have happened in April 2007 carries no real weight at all.

270. The Plaintiff's withdrawal hypothesis is the same. But for the breaches of contract, it is said that BoB Cayman and HSSL, as a reasonably competent custodian and administrator, would have threatened resignation without issuing the custody confirmation on 23 February 2007, with the result that E&Y would not have issued an audit opinion without themselves performing audit procedures at BLMIS' office, which Madoff would not have allowed, and so it is said that the directors would have had no

⁶⁵ Mr. Fielding's resignation followed from a policy decision that HSBC would no longer have representation on the boards of directors of its hedge fund clients.

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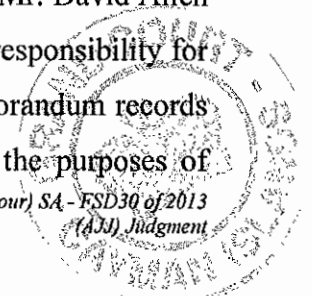
alternative but to terminate the managed account. This hypothesis assumes that Pioneer's plan to invest the whole of Primeo's assets in Herald and Alpha would have to be abandoned because those funds would have been in the same predicament as Primeo, with the result that Primeo Select and Primeo Executive would have been closed, the assets would have been withdrawn/redeemed in cash and an entirely new investment strategy would have been formulated. This hypothesis ignores the possibility that Pioneer might have conducted a "soft liquidation" of Primeo by compulsorily redeeming the investors and encouraging them to re-invest in an entirely new fund.

271. There is no evidence which makes the Plaintiff's 2007 causation analysis any less speculative than that applicable to 2005. If anything, the introduction of Pioneer into the equation makes it even more speculative. The decision to terminate the managed account and invest in Herald was made by the new board, based on Pioneer's advice. The reasons for this decision are stated to have been as follows –

1. *A clear barrier of limited liability at the Herald level is inserted between the investors in Primeo Select Fund and the Madoff managed account.*
2. *Herald is in a unique position to perform more comprehensive, insightful and complete ongoing review and due diligence on Madoff, given the long and special relationship between Sonja Kohn of Bank Medici AG and Bernie Madoff.*
3. ...
4. *[Pioneer] Dublin has negotiated a highly competitive management fee of 0.30% for all such assets invested in Herald. This compares very favourably with market rates for such investments.*

This suggests a desire on the part of Pioneer to distance itself from responsibility for monitoring a managed account with BLMIS.

272. There are two other pieces of documentary evidence before the court which shed light upon Pioneer's view of BLMIS and the operational risks associated with its business model. The first is a memorandum dated 7 December 2006 prepared by Mr. David Allen ("Mr. Allen"), a Pioneer officer who subsequently assumed day to day responsibility for Primeo. He became involved at least by mid-November 2006. His memorandum records a visit to Bank Medici's offices in Vienna on 6 December 2006 for the purposes of



performing operational due diligence in respect of Herald,⁶⁶ presumably in anticipation of re-structuring Primeo's investments. He spent about 4 hours at Bank Medici's office. His overall conclusion was –

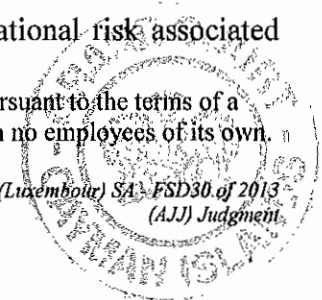
In summary I believe that the operational environment for Herald USA is appropriate given the nature of the fund managed. The procedures are in line with expectations for a Madoff feeder fund. He identified a few areas of concern and then said, ... In conclusion I would consider it a suitable operational environment.

273. The second document is the Pioneer Report dated 3 October 2007 and prepared by Mr. Vandembroucke who was Pioneer's Global Head of Operational Risk Management. This is a very detailed 36 page report which must have involved extensive research. He had a meeting at Bank Medici's office in Vienna on 5 September 2007, when he met Mrs. Kohn, other officers of Bank Medici and a representative of Deloitte & Touche which had been engaged to do review work in connection with Herald's NAV. It describes the BLMIS business model and the operating procedures of HSSL (in its capacity as custodian and administrator of Herald) in terms which are the same as the procedures which were applicable to Primeo prior to May 2007. The conclusions and recommendations are as follows –

Considering 1/ the current level of transparency at Madoff (trading flows, trading counterparties, matching and settlement of trades, non segregation of assets at the broker, compliance and risk controls, disaster recovery plan), 2/ the fact that the investment mandate of [Herald] is currently vague and does not give any [as]urance as to what is the strategy employed today and what the intentions of the Investment Manager are; 3/ the opacity of the legal documents which do not disclose the manager (Madoff) or the controlling/marketing agent (Bank Medici) and; 4/ the high level of fees compared to the peers and to the strategy (excluding any side letter), we do not consider that Bank Medici/Herald Asset Management offer a safe operational platform for an investment in Herald Fund SPC.

Apart from the point about fees⁶⁷ and the fact that Bank Medici's status was very different from that of Bank Austria, this assessment of the operational risk associated

⁶⁶ Bank Medici performed the investment management/advisory functions for Herald, pursuant to the terms of a sub-management agreement with Herald Assets Management Ltd, which was an SPV with no employees of its own.



with BLMIS/Herald is not dissimilar from the “concerns” expressed about BLMIS/Primeo by the HSBC executives, which the Plaintiff says ought to have been related to Primeo’s board of directors. By comparison, Mr. Allen’s earlier report appears to be rather superficial.

274. I ask myself if Primeo’s new board would have made the same decision on 25 April 2007 if the information contained in the Pioneer Report had been laid out for the directors? Would it have made any difference if Mr. Paul Smith had attended the meeting on behalf of HSBC and said this is exactly why HSSL is resigning as custodian and administrator of both Primeo and Herald? What if the E&Y engagement partner had attended the meeting and said that, in the absence of custody confirmations from HSSL, he would not be prepared to issue opinions in respect of either Herald or Primeo unless and until he is able to conduct audit procedures on BLMIS’ premises with satisfactory results? This is the scenario postulated by the Plaintiff.

275. I infer from the reasons given by the new board for terminating the managed account that, even at that time, Pioneer must have been more concerned than the old board about the operational risks associated with BLMIS, in spite of the reassuring report received from Mr. Allen which is actually focused on Bank Medici rather than BLMIS. On the other hand, the commercial problems associated with withdrawing/redeeming the BLMIS investments and re-launching Primeo with a new investment strategy would have been no different in April 2007 than in April 2005. The risk of mass redemptions would be the same. The net fee income at risk was far greater in 2007.⁶⁸ From a marketing perspective, it might have been easier for Pioneer to present a change in investment strategy than it would have been for BA Worldwide to do so. It is noteworthy that the formal notice to

⁶⁷ The fees charged by Herald were higher than those charged by Primeo.

⁶⁸ The gross fee income received by Pioneer/BA Worldwide from Primeo in the year ended 31 December 2007 was about US\$11.4 million. Pioneer was able to retain the full amount of the gross income (calculated at 2% of NAV) because (a) it did not have to pay 20% of its income to Eurovaleur as BA Worldwide had done and (b) Herald paid a management fee of 1.7% of NAV back to Primeo which meant that the net extra cost to Primeo for investing in Herald was only 30 basis points, which was sufficiently small that Pioneer could avoid discounting its own fees. The result was that Pioneer’s fee structure was even more profitable than that previously enjoyed by BA Worldwide.

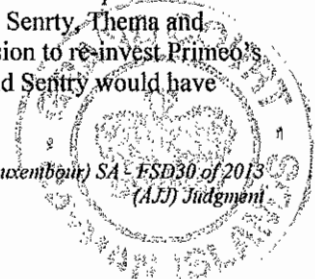
Primeo's shareholders dated 1 May 2007 and entitled *Notification of Recent Changes* talks about the appointment of Pioneer in place of BA Worldwide but makes no mention of the decision to terminate the managed account and subscribe for shares in Herald. The Fact Sheets published immediately after May 2007 continued to describe Primeo as a single manager fund with a managed account and make no mention of the fact that its assets actually comprised shares in Herald and Alpha.

276. In conclusion, I am not satisfied that the Primeo has proved its case on causation. The only real difference between the Plaintiff's withdrawal hypothesis as applied to 2005 and 2007 relates to the composition of the board of directors. In 2007, the decisions would have been made by the new board comprising Pioneer's executives, none of whom have given evidence. In spite of Mr. Allen's report, Pioneer must have had some concerns about BLMIS and its investment model, which was likely to have been at least part of the reason for terminating the managed account and investing in Herald. In substance, the instinctive concerns expressed internally by Mr. Paul Smith and other HSBC executives were not materially different from those later expressed in the Pioneer Report, yet Pioneer continued to maintain Primeo as a Madoff feeder fund until the very end. The circumstantial evidence suggests to me that Pioneer might well have re-invested in another Madoff feeder fund unrelated to HSBC and E&Y, rather than close Select and Executive and re-launch Primeo with an entirely new investment strategy which would not have the benefit of Madoff's uniquely consistent performance history.⁶⁹

277. Nor is there any evidence from which to infer that, if this scenario had played out the following year, the result would have been any different.

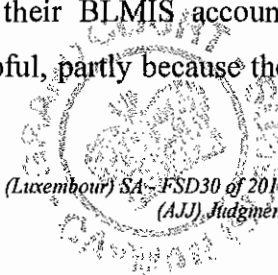
BLMIS' ability to pay the amount due to Primeo, both directly and indirectly via Alpha and Herald

⁶⁹ The evidence includes an undated document prepared by Pioneer entitled *Madoff Feeder Funds Operational Comparison*, which compares the operational risk factors associated with Kingate, Fairfield Sentry, Thema and Herald. Whether or not this exercise was performed specifically in connection with its decision to re-invest Primeo's assets is not entirely clear, but its content does suggest that the risks associated with Fairfield Sentry would have been no less acceptable than Herald.



278. Although it is not strictly necessary that I do so, I will address the Defendants' further arguments that, even if Primeo had sought to withdraw its investment with BLMIS, it would not have been able to do so because the Defendants would have notified the regulators and/or BLMIS would have been unable to pay. The point about notifying the regulators is misconceived for two reasons. First, the Plaintiff's withdrawal hypothesis is not predicated upon the assumption that, but for their breaches of contract, HSSL would have become aware of facts which would have triggered a reporting obligation. Second, there is no evidence that any HSBC Group company ever believed that BLMIS was in fact carrying on its business in a criminal manner, such that it should have made a report to any regulatory authority. A number of people speculated that that the structure *could* conceal a Ponzi scheme but nobody ever expressed the view that it was in fact a Ponzi scheme. In this regard, Ms. Coe, Mr. Fielding and Mr. Pettitt all said that they were reassured by the outcome of the KPMG reviews.

279. Whether or not BLMIS would have been able to honour Primeo's withdrawal instructions in the ordinary course of business depends upon a combination of (a) the total amount of withdrawal demands presented to BLMIS and (b) the total cash available as at the applicable payment dates which I will take to be 30 June 2005 or 30 June 2007. The relevant information about the amounts due to Primeo (both directly and indirectly via redemption of its shares in Herald and Alpha) can be extracted from its semi-annual unaudited financial statements. It would have been about US\$450 million on 30 June 2005 and about US\$530 million on 30 June 2007. However, for the purposes of this analysis, it is necessary to take into account the amounts due to any of the other HSBC group clients which would have decided to withdraw at the same time and for the same reasons, but the relevant financial statements have not been put into evidence. The only helpful evidence is an internal HSSL e-mail dated March 2005 which says that its clients (which would exclude Thema which was a client of BoB Dublin) then had a total of US\$1.2 billion placed with BLMIS. The table of clients and their BLMIS account balances contained in Ms. Coe's written evidence is not very helpful, partly because the



information is stated as at October/November 2008 and partly because it includes entities about which I have no other evidence at all.

280. The only evidence about BLMIS' financial condition comprises miscellaneous references to the aggregate balance on BLMIS' linked accounts maintained with JP Morgan (referred to as "the 703 Account"). The Dubinsky Report states (at paragraph 284) that "The total positive balances in the House 17 related accounts were approximately \$1.5 billion as of December 11, 2002". The Statement of Facts incorporated in the Deferred Prosecution Agreement made by JP Morgan on 6 January 2014 states (at paragraph 20) that "the 703 Account was, in fact, used by Madoff's investment advisory business, and achieves balances of well more than \$1 billion beginning in approximately 2005, and up to approximately \$5.6 billion by 2008". I infer that if Primeo was the *only* HSBC Group client to withdraw its funds on 30 June 2005 or 2007, BLMIS could and would have paid. If *all* the HSBC Group clients, including Hermes/Lagoon and Thema, had sought to withdraw their funds during Q2 2005, without re-investing in other Madoff feeder funds which were not HSBC clients, the evidence points to a BLMIS default. However, the evidence tends to suggest that BLMIS had relatively more cash available in Q2 2007 and that it would not have defaulted, especially if one or two of the funds in question had withdrawn cash, obtained bank confirmations for their auditors, and then immediately re-invested in another Madoff feeder fund. On balance, the evidence suggests to me that Madoff would have been able to avoid a default.

I. The Rule against Recovery of Reflective Loss

The reflective loss principle

281. The reflective loss principle holds that, where a company suffers loss caused by a breach of duty owed to it, only the company may 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.

This principle is derived from the decision of the English Court of Appeal in *Prudential Assurance Co. Ltd v. Newman Industries Ltd (No.2)* [1982] Ch. 204, in which the
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plaintiff (Mr. Bartlett) held shares in a company (Newman Industries Ltd) which had acquired two other companies. Mr. Bartlett brought proceedings against the vendor and two directors of Newman Industries in connection with the acquisition in which he made allegations of fraud and conspiracy. He sought to claim in a direct personal capacity, in a derivative action and in a representative capacity on behalf of all the shareholders. The Court of Appeal dismissed his personal claim on the basis that he had suffered no loss which was separate and distinct from the company's loss.

282. This principle was considered by the House of Lords in *Johnson v. Gore Wood & Co (a firm)* [2002] 2 AC 1. In that case, the plaintiff (Mr. Johnson) held all but two shares in a property development company called Westway Homes Ltd ("W Ltd"). He instructed the defendant, a firm of solicitors, on behalf of W Ltd in connection with a proposed purchase of land. The transaction went wrong and W Ltd commenced an action against the solicitors which was settled on the basis that the firm paid a substantial sum to W Ltd. Mr. Johnson then commenced his own separate action against the solicitors in which he asserted a personal cause of action arising out of the same transaction. The solicitors sought to strike the action out the ground, *inter alia*, that the claim was barred by the reflective loss principle. The House of Lords held that he was in principle entitled to recover in respect of any loss that was separate and distinct from W Ltd's losses but his claims for the diminution in the value of his company pension and his shareholding were struck out as being reflective of W Ltd's loss.

283. Having reviewed the authorities, Lord Bingham set out (at pages 35F-36A) the following propositions which he considered to be supported by them –

(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.

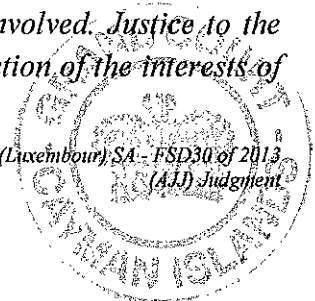
(2) Where a company has suffered loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding.

(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.

Lord Goff, Lord Hutton and Lord Millett agreed with these propositions. Lord Cooke also agreed but added that these three propositions are not comprehensive.

284. In the context of the hedge fund industry, the application of the reflective loss principle is unlikely to cause any difficulty in the case of a typical master/feeder structure where the master fund and offshore feeder fund both contract with the same set of professional service providers. Ordinarily, the professional service provider will owe the same contractual duty to the company (the master fund) and the shareholder (the feeder fund). In such a case, where the service provider is in breach of the duties owed to both the master fund and the feeder fund under separate contracts, it is clear that, ordinarily, the feeder fund will be barred from suing because it will not have suffered any loss which is separate and distinct from that of the master fund. Lord Millett explained the policy considerations underlying the reflective loss principle in the following way (at page 62E-F) –

In such a case the shareholder's loss, in so far as this is measured by the diminution in the value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; 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.

Application of the reflective loss principle in the present case

285. Primeo, Herald and Alpha were not set up as master/feeder structures. They were established as standalone funds by different (but related) promoters at different times and they were controlled by different investment managers/advisers. However, they acquired the essential economic characteristics of master feeder/structures. All three funds employed the same Madoff investment strategy (either directly or indirectly) in respect of the whole of their invested assets.⁷⁰ It follows that an investment in Primeo Select was in fact the economic equivalent of an investment in Herald. Likewise, an investment in Primeo Executive was in fact the economic equivalent of an investment in Herald and Alpha⁷¹ which were themselves the same. For all practical purposes an investment in any one fund (or sub-fund in the case of Primeo) was the economic equivalent of an investment in any of the others. This situation existed from the times when Alpha and Herald were first launched but, from May 2007 onwards, Primeo acquired some of the characteristics of a feeder fund in that (a) the whole of its invested assets comprised shares in Herald and Alpha⁷² and (b) it had engaged the same custodian and administrator, namely HSSL,⁷³ as the "master funds". Whilst the contracts are not identical, HSSL (and BoB Cayman in the case of Primeo) owed similar duties to all three of its clients and the factual circumstances giving rise to causes of action against them were the same in each case.

286. Primeo was not established as a segregated portfolio company. Its sub-funds were intended to be separate economic entities but they were not separate legal entities.

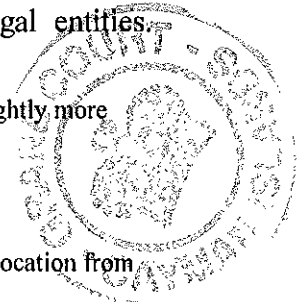
⁷⁰ The only slight distinction lay in the fact that their fee structures were not identical. Herald was slightly more expensive than Primeo.

⁷¹ Primeo Executive's assets comprised approximately equal shareholdings in Herald and Alpha.

⁷² Primeo Select was wholly invested in Herald. Taking the two sub-funds together, Primeo's asset allocation from May 2007 onwards comprised shares in Herald (97.5%) and Alpha (2.5%).

⁷³ Only Primeo had a contract with BoB Cayman, but I do not regard this as a material distinction for the purposes of analyzing the application of the reflective loss principle.

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However, for the purpose of applying the reflective loss principles to the facts (both actual and assumed) of this case, I found it helpful to assume, for the sake of argument, that Primeo Select and Primeo Executive were two separate companies (or alternatively two portfolios within a segregated portfolio company) and that they each had their own separate contracts with HSSL. For the purposes of this analysis, I am assuming that HSSL is in breach of the duties which it owes to Select, Executive, Herald and Alpha and that the factual scenario giving rise to the breaches applies to all four funds in the same way. All four funds therefore have their own causes of action against HSSL and I will assume for the purposes of this analysis that these causes of action arose in March 2007 at which point (a) Select was not a shareholder of either Herald or Alpha (b) Executive had the whole of its assets invested in the shares of Herald (50%) and Alpha (50%). Mr. Smith argues that, as a matter of law, the reflective loss principle cannot apply against Select because it was not a shareholder of either Herald or Alpha at the time the causes of action arose. Testing this proposition in the following alternative factual scenarios demonstrates why his argument must be wrong.

287. In scenario one, I assume that Madoff's Ponzi scheme comes to light in April 2007, which was shortly after the causes of action against HSSL arose. Inevitably, all four funds immediately suspend NAV and Select continues to have the whole of its assets placed on BLMIS managed account. The investment in Herald never takes place. Assume that all four funds commence proceedings against HSSL for breach of contract. In the cases of Select, Herald and Alpha, the causation hypothesis is that, but for the breach, they would have withdrawn their investment from BLMIS and re-invested in some other way. In the case of Executive, the hypothesis is that, but for the breach, it would have redeemed its shares in Herald and Alpha and re-invested elsewhere. They all claim the loss of their investments, together with consequential loss of profit. In this scenario, the application of the reflective loss principle is uncontroversial. It is clear that Executive's claim against HSSL is barred because it has no claim for a loss which is separate and distinct from the losses suffered by Herald and Alpha. In financial terms, if Select had a reported AUM of \$500m, Executive had \$100m, Herald had \$750m and Alpha had \$250m, Executive's claim is barred and judgments are given against HSSL for a total of

\$1.5 billion. By restoring the value of Herald's AUM, Executive is made whole and HSSL is not prejudiced by what would otherwise be a double recovery. From the point of view of the underlying investors in the four funds, the economic equivalence which existed prior to the discovery of Madoff's fraud is carried through into the liquidation of their respective funds.

288. My alternative scenario is predicated on the assumption that Madoff's Ponzi scheme is not discovered until after Select has terminated its managed account and invested the whole of its assets in Herald in May 2007. At this point the reported AUM of the four funds is as follows – Select \$500m, Executive \$100m, Herald \$1250m and Alpha \$250m. I assume that all four funds commence their actions against HSSL in June. Their causes of action are the same and the causation arguments are the same. The only difference is that Select now puts its causation argument on the basis that, but for the breach, it would have redeemed its shares in Herald rather than withdrawn its investments from the BLMIS managed account. Economically, there has been no change. An investment in any one fund is still the economic equivalent of an investment in any of the others. However, Mr. Smith's submission is that the reflective loss principle applies as against Executive but not as against Select, because it was not a shareholder in March when its cause of action against HSSL arose. In financial terms, this would mean that judgments are obtained by Select for \$500m, by Herald for \$1250m and by Alpha for \$250m, which increases HSSL's total exposure to total of \$2 billion. For the reasons given by Lord Millett in *John v. Gore Wood*, this result is unjust and it is no answer to say that Select will give HSSL credit for whatever may be recovered from Herald after the commencement of the litigation, either by way of distribution in Herald's liquidation or by selling its shares in the post-liquidation secondary market. I agree with what Costello J. said in *Alico Life International Ltd v. Thema International Fund Plc* [2016] IEHC 363-

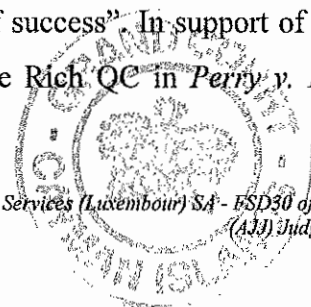
While the rule is designed to guard against double recovery, a shareholder cannot overcome the rule by waiving so much of his claim as has already been paid to the company in satisfaction of its claim. They refer to Humberclyde Finance Group Ltd v Hicks [2001] EWCH 700 (Ch). In that case Neuberger J. (as he then was) rejected the proposition that an agreement or a court order limiting the damages, a successful

shareholder could recover would obviate the danger of double recovery and thus avoid the mischief designed to be avoided by the rule. He pointed out at para.40 that the speeches of Lord Bingham and Lord Millett in Johnson v. Gore Wood indicate that: 'the rule that a shareholder cannot recover reflective loss is one of principle and it seems to me that Mr. Hicks cannot get around it by the sort of device proposed by [his counsel], even though that device has inherent practical attraction.'

289. This analysis illustrates why the application of the reflective loss principle is not dependent upon the plaintiff being a shareholder at the time the cause of action arose. The principle has to be applied to the claims actually made in the shareholder's action. If the shareholder claims in respect of a loss which is not separate and distinct from the company's loss and is in fact reflective of a loss suffered by the company, the claim should be barred. Whether or not he was a shareholder at the time when the cause of action arose is irrelevant. The reflective loss principle does not bar the shareholder's cause of action. It merely bars claims for those heads of loss which are reflective of the company's loss. Whether 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. In my view the Plaintiff's loss of investment claim against both Defendants is reflective of the claims of both Herald and Alpha and are capable of being barred. It is irrelevant that the Plaintiff would not have been able to put its case in exactly the same way, had it commenced its action in March or April 2007, prior to the termination of its BLMIS managed account.

The merits test issue

290. The reflective loss principle is based upon the premise that the company can recover and should recover the relevant loss. It is not sufficient merely to show that Herald and Alpha have causes of action against HSSL. There has to be some prospect of success and there is an issue between the parties about the correct criteria to be applied for this purpose.
291. Mr. Gillis submits that the correct test is "a real prospect of success". In support of this proposition, he relies in particular on the decision of Judge Rich QC in *Perry v. Day* [2005] 2 BCLC 405. In which he said at paragraph [24] –



The question whether the company had a claim must be determined at the date when the loss was identified. Unless the company had a claim at that date, there is no risk of double recovery, the avoidance of which is one of the principal justifications to rule against recovery of reflected loss. Since the limb of the principle whose application I am now considering 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 that necessarily that the company's claim must at the relevant time be a real claim with at least some prospect of success.

292. Mr. Smith submits that the test is that the company must have a claim “available on the facts” by which he means “a claim that, on the balance of probabilities, is likely to succeed”. This formulation of the test is based to some extent upon what Peter Gibson LJ said in *Shaker v. Al-Bedrawi* [2003] Ch. 350 –

As the 'Prudential' principle is an exclusionary rule denying a claimant what otherwise would be his right to sue, the onus must be on the defendants to establish its applicability. Further, it would not be right to bar the claimant's action unless the defendants can establish not merely that the company has a claim to recover a loss....., but that such claim is available on the facts.

This passage was cited to Judge Rich QC in *Perry v. Day*. His interpretation of what Peter Gibson LJ meant by a claim being “available of the facts” was as follows -

I agree with [counsel] that that reference to availability on the facts in the context of that judgment is a reference to whether, on the facts, the company had a cause of action, not the likelihood of such a claim being successfully pursued.

293. There were in fact two judgments in *Perry v. Day*. At an earlier stage in the proceedings, Rimer J. dealt with certain preliminary issues, one of which was whether the case should be struck out on the basis of the no reflective loss principle. It was decided that it would not be appropriate to rule finally on this issue without the benefit of all the relevant evidence and full argument on the question whether the company had been prevented from pursuing its claim by the defendant, acting in breach of fiduciary duty in his capacity as a director. Mr. Smith relies on what Rimer J. said about the merits test –

I recognize that when, in litigation such as this, the court has to determine whether the company has a claim against the wrongdoer, it is not concerned to conduct any sort of notional trial of the alleged claim. But, whilst I had no developed argument on this point, my provisional view is that it must at least be satisfied on the evidence whether or not the company had a claim which was likely to succeed, an exercise which involves considering not just the case which the company could have made, but the defences which could have been raised to it.

The full argument took place at the trial before Judge Rich QC who decided that the plaintiff's claim could proceed because the defendant had wrongly prevented the company from pursuing its own claim. This is an exception to the reflective loss principle recognized in *Giles v. Rhind* [2003] Ch 618. For this reason it was not actually necessary for Judge Rich QC to apply the merits test or make any decision about it.

294. It seems to me that the correct approach, consistent with what has been said in the various cases referred to by counsel in their written submissions, is that I would need to be satisfied that the company, Herald and/or Alpha, has a claim against HSSL with a real prospect of success.

Do the claims of Herald and Alpha have a real prospect of success against HSSL?

295. The factual circumstances giving rise to Herald's claims and Alpha's claims against HSSL are essentially the same as those that have given rise to Primeo's claims which leads me to question whether I need to apply a merits test at all. Herald entered into a custodian agreement and administration agreement with HSSL on 29 March 2004. Alpha entered into a custodian agreement and an administration agreement with BoB Ltd on 12 March 2003 and BoB Ltd delegated performance of its duties to BoB Lux pursuant delegation agreements made on the same day. All these agreements are based upon BoB Group standard forms; they are all written in English; and their terms are substantially the same as the Primeo agreements. The only material difference is that the Primeo and Alpha agreements are expressed to be governed by Cayman Islands law and Bermuda law (which is the same), whereas the Herald agreements are expressed to be governed by Luxembourg law. Herald and Alpha each entered into a set of agreements with BLMIS in

the same terms as the Primeo agreements.⁷⁴ The 2004 Sub-Custody Agreement relates to all three of Primeo, Alpha and Herald.

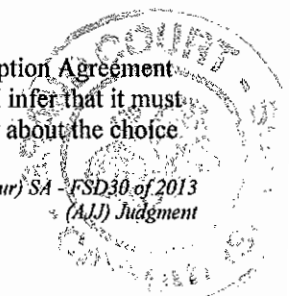
296. Because the Herald agreements are governed by Luxembourg law, the parties were given leave to call Luxembourg lawyers to opine on the merits of Herald's case on the assumptions that (a) Herald will particularize its breach of duty claim against Herald in the same or similar terms to Primeo's claims in this action and (b) Herald will establish the factual allegations pleaded in support of this claim. Herald commenced an action in 2009 against HSSL in the Luxembourg court in which it made restitution claims in the total sum of approximately US\$2 billion and an alternative claim for damages for breach of contract in the same amount. There are actually separate restitution claims in respect of securities and cash. The securities claim has been dismissed and is now subject to appeal. The cash claim has been stayed. The alternative breach of duty claim falls into three parts – breach of the custodian agreement, breach of certain statutory duties and tortious liability.

297. There was some slight difference of opinion between the Luxembourg lawyers, Mr. Fayot and Mr. Trevisan, about the merits of Herald's appeal against the dismissal of its restitution claim. For present purposes, it is sufficient to say that I agree with Mr. Trevisan that the restitution claims appear to have no reasonable prospects of success. However, they are agreed that (based upon the stated assumptions) Herald does have a real prospect of success in respect of its alternative breach of duty claims. They agree that the applicable Luxembourg law principles will enable Herald to put its case for the loss of its investment in the same way that Primeo has put its case in this action. They agree that claims for loss of profit and loss of a chance are recognized under Luxembourg law.

298. Alpha has issued three proceedings against HSSL. In 2009, it commenced proceedings in Luxembourg in which it claims US\$346 million for breach of contract and in tort. In

⁷⁴ The choice of law clause in the Herald Customer Agreement has been left blank. The Alpha Option Agreement and Trading Authorization are included in the evidence, but the Customer Agreement is missing. I infer that it must have been executed on the same printed form. In the absence of the document, there is uncertainty about the choice of law.

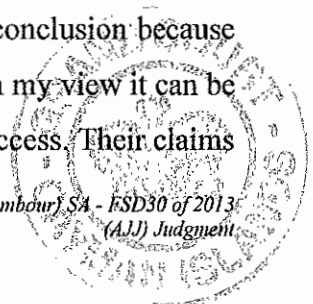
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2014, Alpha issued cross-claims against multiple parties including HSSL in proceedings pending in the United States Bankruptcy Court. Also in 2014, Alpha commenced an action in Bermuda against multiple parties including HSSL.

299. Having now heard all the evidence, it has become clear that the factual circumstances relating to the claims of Herald and Alpha (the company claims) are practically the same as those relating to Primeo's claim (the shareholder claim). In the case of Primeo the factual chronology stretches back to 1994, whereas Alpha and Herald were not incorporated until 2003 and 2004 respectively, but the factual circumstances giving rise to the breaches of contract, which occurred in 2005 and thereafter, in respect of Primeo are equally applicable to Alpha and Herald. Much of the evidence adduced in this action relates to all three funds. HSSL's decision to issue custody confirmations was made in respect of all three funds. E&Y's decision that it would rely upon those custody confirmations instead of seeking to conduct audit procedures at BLMIS' premises, related to all three funds. From HSSL's perspective, much of the evidence adduced in this action will be equally applicable to the defence of the Alpha and Herald claims. The HSSL executives responsible for the provision of custody and administration services to Primeo were also responsible for Alpha and Herald.

300. For these reasons, the merits of Primeo's claim and the claims of Herald and Alpha are comparable, but it cannot be said that they are identical, in particular in relation to the causation issue. Primeo, Herald and Alpha were related in various ways but they were not under common control. Their boards of directors were differently constituted. Assuming that the Luxembourg and Bermuda courts are likely to come to the conclusion that BoB Ltd/HSSL were in breach of their contractual duties to Herald and Alpha for the same reasons that I have found BoB Cayman/HSSL to have been in breach of their duties to Primeo, the overall merits of the companies' cases will turn on the causation issue. The fact that I have found against Primeo on this issue should not be taken as an indication that the Luxembourg and Bermuda courts will likely reach the same conclusion because the decision makers (who are the relevant witnesses) were different. In my view it can be said that the claims of Herald and Alpha have a realistic prospect of success. Their claims



are certainly no less meritorious than Primeo's claim. For these reasons, I would hold that Primeo's claims are barred by the rule against reflective loss.

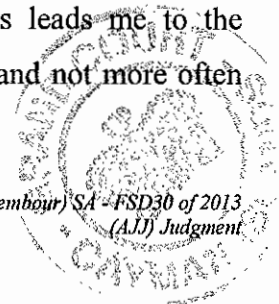
J. The Defendants' Limitation Defences

The Limitation Law (1996 Revision)

301. The Defendants rely upon section 7 of the Limitation Law pursuant to which actions founded upon breach of contract cannot be brought more than six years after the date upon which the cause of action accrued. The Plaintiff did not issue its writ until 20 February 2013 and so the Defendants' case is that no damage can be recovered for breaches occurring prior to 20 February 2007. The Plaintiff's response is twofold. First, it contends that the Defendants were in continuous breach of ongoing contractual duties with the result that it can recover damage caused after 20 February 2007, even though the original breach occurred much earlier. Second, it asserts that the Defendants deliberately concealed facts relevant to its causes of action within the meaning of section 37 of the Limitation Law.

Continuing breach of duty

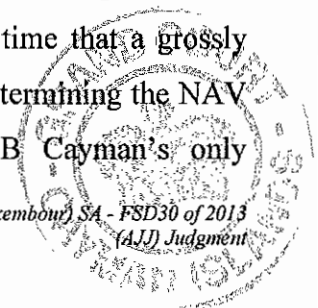
302. By its terms, Clause 16(B) of the 1996 Custodian Agreement creates continuing supervisory duties. I am satisfied that the 'ongoing suitability duty' and the 'most effective safeguards duty' are continuing duties but this does not necessarily imply that they are performable on a daily basis. I agree with Mr. Gillis that, on its true construction, Clause 16(B) imports the standard of the reasonably competent global custodian. Mr. Belanger and Mr. Vinella agreed that sub-custody due diligence reviews should be performed periodically and they did not criticize HSSL's policy of reviewing network custodians once every two years or annually if there was some particular reason to do so. The evidence of Mr. Fielding and Mr. Pettitt is that the same approach was adopted in respect of BLMIS, which was not a network sub-custodian. This leads me to the conclusion that these continuing duties are performable periodically and not more often



than annually, with the result that there can be no continuing breach in the sense that it occurred on a daily basis.

303. I have found that a breach of duty occurred in August 2002 when the ‘most effective safeguards’ duty was triggered by the execution of the 2002 Sub-Custody Agreement as part of the implied tripartite agreement amongst Primeo, BoB Lux and BLMIS. Further breaches occurred when sub-custody due diligence reviews were conducted by Mr. Fielding in March 2004 and by Mr. Pettitt in March/April 2005. They did not apply their minds to Clause 16(B) and failed to consider whether any safeguards, or any more effective safeguards, could or should be implemented. No review was conducted in 2006, either in connection with the custody confirmation issued to E&Y or at any other time. Subject to the concealment argument, any causes of action which accrued at these times would be statute barred. Mr. Pettitt did meet with Madoff on 9 February 2007 in circumstances which triggered the Clause 16(B) duties. He reviewed the First KPMG Report in preparation for the meeting but never raised the key issues of lack of segregation and single source reporting or considered how these problems might be overcome without interfering with Madoff’s (presumably legitimate) business model. Some two weeks later, on 23 February 2007, HSSL issued another custody confirmation to E&Y without anyone having considered whether there were any available safeguards which could be implemented without infringing upon BLMIS’ business model and Madoff’s extreme desire for confidentiality. A fresh cause of action accrued on this date which is not statute barred.

304. The analysis relating to the duty to determine the NAV per share under Clause 4.1(xvii) of the Second Administration Agreement is essentially the same, in that the duty arises monthly and has to be performed within 10 business days of each month end (which is the valuation day). Once it has been issued and acted upon for the purposes of transacting redemptions and/or subscriptions, a negligently determined NAV per share is not capable of being changed. A fresh cause of action arises each time that a grossly negligent NAV is issued. I have concluded that the procedure for determining the NAV became grossly negligent from April 2005 onwards, when BoB Cayman’s only



justification for relying upon single source reporting was undermined by the issue of the custody confirmation to E&Y. This procedure continued unchanged until April 2007 when Primeo ceased to have a managed account with BLMIS. Fresh causes of action accrued on the days when the NAVs were issued in March, April and May 2007 and are not statute barred. The causes of action accrued in respect of grossly negligent NAVs issued for valuation days up to and including 31 January 2007 are statute barred unless it can be established that there was concealment on the part of BoB Cayman within the meaning of section 37.

Deliberate concealment of a fact relevant to the cause of action

305. Section 37(1)(b) of the Limitation Law provides that if –

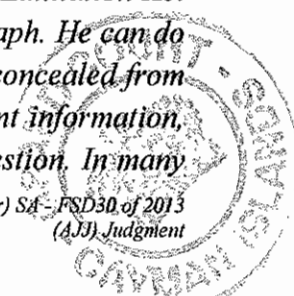
(1)(b) any fact relevant to the plaintiff's right of action has been deliberately concealed from him by the defendant the period of limitation does not begin to run until the plaintiff has discovered, or could with reasonable diligence have discovered the concealment.

Section 37(2) then provides that –

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.

These sections are the same as sections 32(1)(b) and section 32(2) of the English Limitation Act 1980. The leading authority on their interpretation is the decision of the House of Lords in *Cave v. Robinson Jarvis & Rolf* [2003] 1 AC 384 in which Lord Scott said (at paragraph 60) –

A claimant who proposes to invoke section 32(1)(b) in order to defeat a Limitation Act defence must prove the facts necessary to bring the case within the paragraph. He can do so if he can show that some fact relevant to his cause of action has been concealed from him either by a positive act of concealment or by a withholding of relevant information, but, in either case, with the intention of concealing the fact or facts in question. In many



cases the requisite proof of intention might be quite difficult to provide. The standard of proof would be the usual balance of probabilities standard and inferences could of course be drawn from the suitable primary facts but, none the less proof of intention, particularly where an omission rather than a positive act is relied on, is often very difficult. Section 32(2), however provides an alternative route. The claimant need not concentrate on the allegedly concealed facts but can instead concentrate on the commission of the breach of duty. If the claimant can show that the defendant knew he was committing the breach of duty, or intended to commit the breach of duty – I can discern no difference between the two formulations; each would constitute, in my opinion, a deliberate commission of the breach – then, if the circumstances are such that the claimant is unlikely to discover for some time that the breach of duty has been committed, the facts involved in the breach are taken to have been deliberately concealed for subsection (1)(b) purposes.

306. As to the four allegedly positive acts of concealment relied upon by the Plaintiff, it has not been established that any relevant facts were intended to be concealed or were in fact concealed. First, it has not been established that the General Administration statement contained in the *Reports of the Administrator* and *Reports of the Custodian and Administrator* for the periods from October 2002 onwards were misleading. This statement was not intended to encompass the problems inherent in BLMIS' business model and would not have been understood by Primeo's directors to mean that no such problems existed. Second, the custody confirmations issued to E&Y did not conceal any relevant facts. The content of the confirmations was literally true. They represented a statement that, in HSSL's judgment, based upon the available information, the assets did exist. The information available to HSSL and E&Y was the same and E&Y must have known that HSSL had not reconciled the BLMIS statements with information received from any independent source. Third, the evidence does not establish that Mr. Fielding positively concealed any relevant facts at the board meetings held in June 2003 and May 2004. He said nothing to dispute the points reported to have been made in the BA Internal Audit Report. He said nothing about the decision made in October 2002 to instruct KPMG to undertake audit work. By the time these meetings took place, the decision was no longer extant. It had been overtaken by events and dropped. I have found that BoB Cayman did not have any implied duty to advise. Fourth, the evidence does not establish that Mr. Fielding and Mr. Birgen said anything at the meeting in May 2003 to mislead

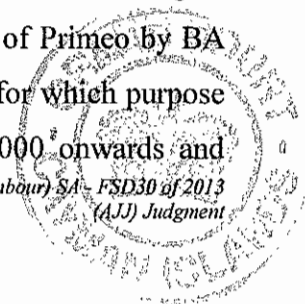
Bank Austria's internal auditors about the frequency with which sub-custodian reviews were being conducted in respect of BLMIS. There was a misunderstanding on the internal auditors' part, but it was subsequently corrected in e-mails written by Mr. Birgen and Mr. Fielding on 17 and 27 June 2003 respectively.

307. For the purposes of section 37(1)(b), there are four elements to proving concealment by omission. It must be established that (i) the defendant was under a duty to inform the plaintiff of the facts in question; (ii) the defendant knew that it had such a duty; (iii) knowing of its duty, the defendant nevertheless decided not to reveal facts in question to the plaintiff; and (iv) that the facts in question were relevant to the plaintiff's cause of action. See: the decision of the English Court of Appeal in *AIC Ltd v. ITS Testing Services (UK) Ltd* [2007] 1 All ER (Comm) 667, per Rix LJ at paragraphs [326] to [327] and per Buxton LJ at paragraph [427]. For the reasons which I have already explained, I am not persuaded that it was an implied term of either the 1996 Custodian Agreement or the Second Administration Agreement that the Defendants would advise their client that they were unable to properly discharge their contractual duties. The roles accorded to custodians and administrators in the hedge fund industry are not normally advisory ones. It was the duty of the investment manager/adviser to provide Primeo with risk management advice and to make managerial decisions about the suitability of BLMIS as its investment manager. It is quite clear that those BoB/HSBC executives who expressed concerns about BLMIS and its business model did not consider that they had any legal duty to share their opinions and risk management assessments with the client although, if the Defendants had decided to resign, then they would have been expected to explain their reasons for doing so.

308. Nor can it be said that the Defendants concealed by omission any facts relevant to the causes of actions which did arise. The English authorities on what is meant by a "fact relevant to a plaintiff's right of action" were reviewed by the Court of Appeal in *Arcadia Group Brands Ltd v. Visa Inc.* [2015] Bus LR 1362 which establishes the following principles. A fact relevant to a plaintiff's right of action is a fact without which the right (or cause) of action is incomplete, rather than a fact which merely improves a plaintiff's

prospect of success. In this case, counsel for the Plaintiff accepts that there was an “equivalence of knowledge” about BLMIS and the operational problems inherent in its business model. What Mr. Fielding failed to disclose was the “concerns”, by which is meant the opinions and assessments about the risk expressed in e-mail correspondence amongst themselves. Primeo and its investment adviser knew that BLMIS performed a triple function and understood the operational consequences. They did not know, for example, that Mr. Paul Smith had expressed the view that “In today’s world this is a red flag. We need to address it.” This is merely an expression of opinion about the significance of an agreed fact. The existence of such concerns is evidence which tends to support the Plaintiff’s case, but it is not a fact which needs to be proved as an essential ingredient of its cause of action.

309. At the end of the day, the concealment argument fails because Primeo was aware of the facts necessary to plead its causes of action for breach of Clause 16(B) of the 1996 Custody Agreement and for issuing NAVs in circumstances which constituted gross negligence. Primeo knew that BoB Lux was not in a position to cause BLMIS to implement any custody safeguards in August 2002 or at any time thereafter without changing BLMIS’s business model, at least to some extent, and this could not have been done without the active assistance and co-operation of Primeo. Therefore, Primeo must have known that BoB Lux had not taken any steps to comply with its ‘most effective safeguards’ duty under Clause 16(B). Primeo must have known that BoB Cayman was relying on single source information in respect of the NAV calculations long before the issue was raised in the BA Internal Audit Report. Primeo must have known that E&Y was relying on the custody confirmations issued by HSSL which was why the notes to the financial statements for the years ended 2004, 2005 and 2006 included the additional statement that HSSL had “appointed this broker/dealer as sub-custodian”. Primeo knew that HSSL would have no means of independently verifying the content of its confirmations so long as BLMIS’ business model remained unchanged. It should not be forgotten that due diligence was conducted on behalf of Primeo by BA Worldwide (part of the largest asset management business in Austria), for which purpose Dr. Fano visited BLMIS’ office in New York twice a year from 2000 onwards and



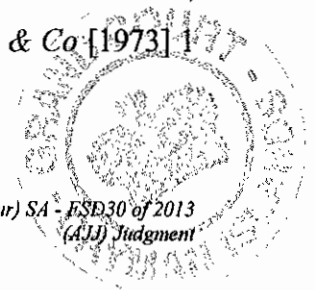
internal control reviews were conducted specifically in respect of Primeo from 2003 onwards. The evidence is that Dr. Fano understood the procedures employed by BoB Cayman and HSSL, but if she was in any doubt, she only had to ask.

Deliberate commission of a breach of duty

310. It is also claimed that the Defendants deliberately breached their duties with the result that they are deemed to have deliberately concealed from Primeo the facts relevant to its causes of action, by committing a deliberate *or reckless* breach of duty in circumstances where it was unlikely to be discovered for some time. Counsel for Primeo contends that for the purposes of section 37(2), a breach of duty which is committed recklessly is to be treated as if it had been committed deliberately. In support of this proposition, he relies upon the passage in *Clerk & Lindsell on Torts* (21st Edition) at paragraph 32.23 in which is said that the equivalent provision of the English Limitation Act 1980 “preserves and confirms the case law on s.26 of the Limitation Act 1939, according to which the start of the limitation period is postponed whenever the defendant has committed the wrong, knowingly or recklessly.” This proposition is not supported by any authority and I think that it is wrong. In *Cave*, Lord Millett referred to the old law under section 26 of the 1939 Act which required “concealed fraud” and stated (at paragraph 19) that –

Section 32(1)(b) and section 32(2) of the 1980 Act were designed to clarify and, if necessary, change the law by removing all reference to fraud and substituting the more appropriate concept of “deliberate concealment”. In such circumstances reference to the antecedent statute and case law is of limited value, since there can be no assumption that the later statute merely reproduced the pre-existing law. But in my opinion it can be referred to if it helps either to identify the mischief which the later statute set out to remedy or to explain why Parliament chose to adopt the particular language or drafting technique which it did when enacting the later statute.

Lord Millett went on to explain the meaning of “concealed fraud” under the 1939 Act, referring to the judgment of Lord Denning MR in *King v. Victor Parsons & Co* [1973] 1 WLR 29, 33-34. He then said (in paragraph 23) –



As I have explained, in enacting the 1980 Act Parliament substituted “deliberate concealment” for “concealed fraud”. This is a different and more appropriate concept. It cannot be assumed that the law remained the same. But reference to the old law explains why Parliament enacted section 32(2) and did not rely on section 32(1)(b) alone to cover the whole ground. With all reference to fraud or conscious impropriety omitted, there was an obvious risk that “deliberate concealment” might be construed in its natural sense as meaning “active concealment” and not as embracing mere non-disclosure. Section 32(2) was therefore enacted to cover cases where active concealment should not be required. But such cases were limited in two respects: first, the defendant must have been guilty of a deliberate commission of a breach of duty; and secondly, the circumstances must make it unlikely that the breach of duty will be discovered for some time.

I think that Lord Millett is clearly saying that a deliberate breach is required under the 1980 Act, rather than recklessness based upon the old case law on the meaning of “concealed fraud” under the 1939 Act. This conclusion is supported by the subsequent decision of the English Court of Appeal in *Williams v. Fanshaw Porter & Haelhurst* [2004] 1 WLR 3185 in which Mance LJ said (at paragraph 31) –

Cave’s case decided that the wording of section 32(2) – “deliberate commission of a breach of duty” – 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. In such a situation, if the circumstances make it unlikely that that breach of duty will be discovered for some time, the subsection (by its words “amounts to”) introduces a “legal fiction” that there has been “deliberate concealment of facts involved in the breach of duty”.

BoB Cayman was grossly negligent in the way in which it performed the NAV calculations in and after April 2005 but Mr. Fielding’s conduct did not amount to wilful default. He was not conscious of the fact that issuing a custody confirmation would undermine the only justification for performing the NAVs on the basis of single source information. Nor is there evidence from which to infer that the person actually responsible for issuing the NAVs, namely Mr. Fiorino, was conscious that what he was doing constituted a breach of duty.



311. Counsel for the Plaintiff placed some emphasis on an exchange of e-mails between Mr. Michael May and Mr. Russell Ford⁷⁵ which constitute their immediate response to news reports of Madoff's arrest. They said -

May: *Another case where all our suspicions were right.*

Ford: *Indeed, the beauty of hindsight.*

May: *Worse - we suspected but never pinned it down. Not even hindsight, just enough courage to walk away from what was not understood.*

Ford: *Always too afraid to lose the revenue, but the business should pay more attention to the view of Risk.*

These comments were written with the benefit of hindsight and do not suggest to me that HSBC believed that BLMIS was a Ponzi scheme. The contemporaneous evidence points to the opposite conclusion. There was sufficient concern to instruct KPMG to perform two fraud risk reviews but the result of these reviews actually provided HSBC/HSSL with some assurance that it was *not* a Ponzi scheme. To my mind this e-mail exchange does not tend to suggest that HSSL acted in deliberate breach of duty.

K. The Plaintiff's contributory negligence

Introduction

312. In the light of my findings on causation, this issue does not arise. However, if Primeo had made out its claim for damages, a very substantial reduction would have to be made to reflect Primeo's own contributory negligence.

Interpretation of the Torts (Reform) Law (1996 Revision)

313. Section 8(1) provides as follows --

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 damages

⁷⁵ At the material time Mr. Ford was Head and Mr. May was Deputy Head of HSS Operational Risk, based in HSBC Bank Plc's office in London.

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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.

The word “fault” ought to be defined in section 2 as follows –

“fault” means an act creating a liability in tort [or] which, prior to the operation of this Law, would have given rise to the defence of contributory negligence.

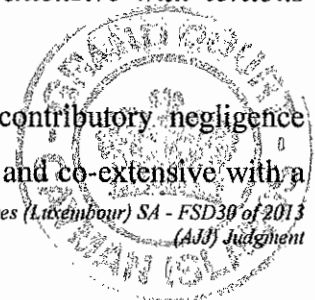
I say that it *ought* to be defined in this way because an analysis of the legislative history makes it clear that the word “or” was accidentally omitted from the text during the revision process which occurred in 1977. This accidental omission has been carried forward into subsequent revisions but it does not have the effect of changing the law as originally enacted.

314. The Law Reform (Contributory Negligence) 1964 (“the 1964 Law”) was gazetted in the following year and came into force (as Law 9 of 1965) on 15 June 1965. It was intended to amend the common law applicable in the Cayman Islands in exactly the same way that the common law had been amended in England by the Law Reform (Contributory Negligence) Act 1945. The 1964 Law defines the word “fault” as stated above. It was one of many laws which were “revised” in 1977 pursuant to the Law Revision Law (Law 19 of 1975). As part of this exercise, it was consolidated with the Fatal Accidents Law (Cap.54) and the Law Reform (Tortfeasors) Law 1964 (Law 8 of 1965) and re-issued under the title of the Law of Torts Reform Law (Revised). Unfortunately, the word “or” was missed out of the definition but the process of revision does not permit any substantive amendment of the law and so the revised version of the definition must still be interpreted in the original way as if the accidental omission had not occurred. Therefore, the Cayman Islands law should continue to be interpreted in the same way as the English statute upon which it is based.

Are the Defendants' contractual duties the same as and co-extensive with tortious duties?

315. It follows that the Defendants can rely upon their plea of contributory negligence provided that their liability for breach of contract is the same as and co-extensive with a

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liability which arises in tort independently of the existence of the contracts. Authority for this proposition is *Forsikringsaktieselskapet Vesta v. Butcher* [1989] AC 852 (CA) in which the English Court of Appeal addressed three categories of contractual duties in the following way. Category 1: where the defendant's liability arises from some contractual provision which does not depend on negligence on the part of the defendant. Category 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 the contract. Category 3: where the defendant's liability in contract is the same as and co-extensive with a liability under the tort of negligence independently of the existence of any contract. It is only in Category 3 cases that the defendant can seek to reduce the damages which would otherwise be payable on the ground of contributory negligence. The first issue to be decided is whether the claims fall into Category 1 as Primeo contends or Category 3 as contended by the Defendants.

316. The plaintiff's claims are pleaded as claims of professional negligence. By paragraph 40(1) and (2) of the Re-Re Amended Statement of Claim, the claim against BoB Cayman in respect of the NAV calculations is based upon it being an implied term of the contract to exercise reasonable care and skill. In my view this contractual duty is co-extensive with the tortious duty of care which arises from the fact that BoB Cayman can also be regarded as holding the office of administrator under Primeo's articles of association.⁷⁶ Sub-clause (xvii) of the Second Administration Agreement requires that NAV per share be determined "in accordance with the Articles" and I think it is clear that BoB Cayman owed a tortious duty of care which is co-extensive with the contractual duty, with the result that a plea of contributory negligence is available.

317. The position of HSSL as custodian is different. Custodians are not normally regarded as officeholders and the terms of Primeo's articles of association do not make any reference to there being a custodian. In relation to the 'ongoing suitability' and 'most effective

⁷⁶ Primeo's articles of association were amended and re-stated on more than one occasion but every version defines "the Administrator" as "the person, firm or corporation appointed and from time to time acting as administrator of the Company".

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safeguards' duties under Clause 16(B), it is alleged under paragraph 43P of the Re-Amended Statement of Claim that compliance requires that HSSL be satisfied on objectively reasonable grounds, but this does not necessarily lead to the conclusion that there is an implied term which would be co-extensive with a tortious duty to take care. The circumstances applicable to HSSL's Clause 16(B) duties are analogous to those considered in *Barclays Bank Ltd v. Fairclough Building Ltd* [1995] QB 214. This case concerned the breach of a building contract in which the relevant provision stated that 'Materials and workmanship shall be the best of their respective kinds and the work shall be executed and finished in an expeditious, efficient and workmanlike manner'. This is an illustration of a Category 1 case because it was held that, on its true construction, the contract required that the specified standard be achieved, not merely that reasonable care should be exercised in carrying out the work. Clause 16(B) provides that the custodian will require the sub-custodian to implement the most effect safeguards available under the laws and practices of the applicable jurisdictions. This is not the same as a duty to safeguard the assets in the manner to be expected of a reasonably competent global custodian. For this reason, I would hold that a plea of contributory negligence is not available to HSSL in respect of the claim under Clause 16(B).

318. I have rejected the Plaintiff's claims that a positive 'duty to advise' and 'duty to report' are to be implied into the 1996 Custodian Agreement and the Second Administration Agreement. In respect of the *Reports of the Administrator* and *Reports of the Custodian and Administrator* in fact delivered pursuant to the express terms of the Second Administration Agreement, there is an implied duty to exercise reasonable care and skill to ensure that they are accurate and not misleading. This is co-extensive with the tortious duty which would arise under the principles in *Hedley Byrne & Heller*. For this reason, it would have been open to BoB Cayman to assert a plea of contributory negligence.

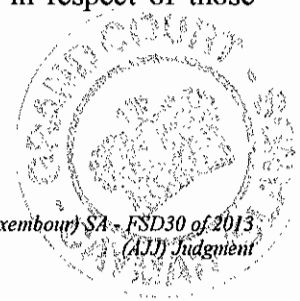
What would be the appropriate deduction for contributory negligence?

319. Primeo was, to a very substantial degree, the author of its own misfortune. Its directors were industry professionals. Their decision originally made in January 1996, to establish

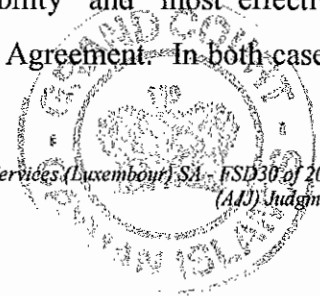
Primeo Select as a single manager fund on the basis that its investment manager would also be allowed to act as its broker and custodian did not comply with industry standards relating to segregation of duties. The relatively high operational risks inherent in the BLMIS business model were obvious. The 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, whereby BLMIS became sub-custodian of BoB Lux, did not result (and was not intended to result) in an operational change and the risks therefore remained unchanged. By this time, Dr. Fano had become President of BA Worldwide and 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. For these reasons, I would have reduced the damages awarded against BoB Cayman by 75%.

L. Summary of the Court's Findings

320. During the period up to 7 August 2002, the assets credited to Primeo's managed account were held by BLMIS as custodian for Primeo and, by virtue of Clause 6(B) of the 1996 Custodian Agreement, HSSL owed no safekeeping duty to Primeo in respect of those assets.



321. By virtue of entering into the 2002 Sub-Custody Agreement as part of an implied tripartite agreement concluded by and amongst HSSL, BLMIS and Primeo on 7 August 2002, HSSL became liable to Primeo under Clause 16(B) of the 1996 Custodian Agreement for the performance by BLMIS of its obligations as sub-custodian and the exoneration from liability under Clause 16(E) does not apply by reason of the fact that BLMIS was guilty of a wilful breach of duty. However, BLMIS performed its obligations in respect of HSSL's instructions to transfer the balance standing to the credit of Primeo's managed account as at 1 May 2007 to Herald, by reason of which Primeo suffered no relevant loss for which HSSL is liable.
322. HSSL owed continuing duties, arising under Clause 16(B) of the 1996 Custodian Agreement, to satisfy itself about the ongoing suitability of BLMIS as sub-custodian and to require BLMIS to implement the most effective safeguards available under the laws and commercial practices of New York. It is an implied term of the contract that, in performing these duties, HSSL will exercise the care and skill to be expected of a reasonably competent global custodian.
323. The fact that Primeo had already engaged BLMIS (in the triple capacity as investment manager, broker and custodian) and would continue to do so in any event, did not relieve HSSL from the obligation to perform the on-going supervisory duties expressly imposed by Clause 16(B), but it did mean that HSSL was not in a position to 'require' that BLMIS implement any particular operating procedure without first seeking and obtaining the consent and active co-operation of Primeo.
324. Having regard to BLMIS' business model and the operational risks inherent in its use, HSSL's failure 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, constituted a breach of its 'on-going suitability' and 'most effective safeguards' duties under Clause 16(B) of the 1996 Custodian Agreement. In both cases,

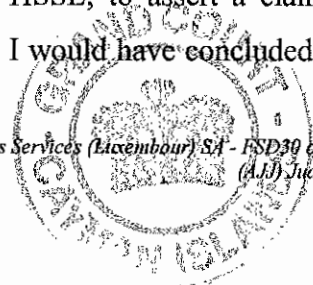


the safeguards would be equally effective if BLMIS had established the accounts for Primeo alone or for HSBC's relevant clients collectively.

325. On its true construction, Clause 16(B) created on-going duties which required periodic performance. HSSL was in breach of contract when it failed in August 2002, June 2003, March 2004, March/April 2005 and February 2007 to give any consideration or make any recommendations to Primeo about safeguards which were readily available and, if implemented, would have been effective to safeguard Primeo's assets.
326. On its true construction, it was an implied term of the Second Administration Agreement that BoB Cayman would exercise the care and skill which its to be expected of a reasonably competent fund administrator, but it is not an implied term of the contract that, for the purposes of determining Primeo's NAV per share, BoB Cayman was required to confirm independently the correctness of the information received from BLMIS.
327. BoB Cayman's reliance upon the fact that E&Y issued unqualified audit opinions in respect of Primeo's annual financial statements ceased to be justifiable from April 2005 onwards when the audit opinions were themselves based (to a material extent) upon custody confirmations issued by HSSL in circumstances where HSSL was itself unable to reconcile the information received from BLMIS with any information received from an independent source. The procedure adopted by BoB Cayman in April 2005 remained unchanged and was, in all the circumstances, grossly negligent, with the result that BoB Cayman is in breach of contract in respect of the NAV per share calculations performed in April 2005 and every month thereafter.
328. It was not an implied term of the 1996 Custodian Agreement or the Second Administration Agreement that HSSL/BoB Cayman would (a) advise Primeo if, in the circumstances, they were unable to discharge properly their duties and explain their reasons for not being able to do so and (b) exercise reasonable care and skill to ensure that any reports issued to Primeo would include all the information of which it was

aware, or ought to have been aware, which would be necessary to enable Primeo to evaluate whether the Defendants were performing their duties.

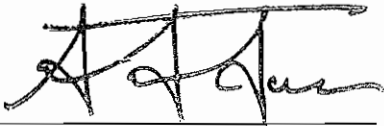
329. It was an implied term of the Second Administration Agreement that the content of any reports required from BoB Cayman would be accurate and not misleading but it is not established that the General Administration statements contained in the *Reports of the Administrator* and the *Reports of the Custodian and Administrator* were inaccurate or misleading or that Primeo was in fact misled by them.
330. Primeo's claims against the Defendants in respect of the breaches of contract which occurred prior to 20 February 2007 are statute barred. The breaches were not committed deliberately and there was no deliberate concealment of the breaches within the meaning of s.37 of the Limitation Law. The causes of action which accrued against HSSL at the earliest on 23 February 2007 (when the custody confirmation was issued to E&Y) and against BoB Cayman in respect of the February 2007 and subsequent NAV per share calculations are not statute barred.
331. Primeo has not established that the Defendants' breaches of contract were an effective or dominant cause of its lost investments. Its withdrawal hypothesis has not been proved. In all likelihood, even if HSSL had not issued any custody confirmations to E&Y and E&Y had been unable to perform audit procedures on BLMIS' books and records with satisfactory results, Primeo would still have continued with the same investment strategy by investing in the shares of one or more other Madoff feeder funds.
332. I would also hold that Primeo's claim for the loss of its investment (and consequential loss of profit on an alternative investment) is irrecoverable because it infringes the rule against reflective loss. The loss claimed by Primeo is not separate and distinct from the losses claimed, or capable of being claimed, by Herald and Alpha.
333. I would also hold that is open to BoB Cayman, but not HSSL, to assert a claim of contributory negligence. If I had found in favour of Primeo, I would have concluded that



its damages be reduced by 75% because it was, to a large extent, the author of its own misfortune.

334. For these reasons Primeo's claim is dismissed and I give judgment for the Defendants.

335. Subject to any submissions counsel may wish to make, I propose to make an order that the costs follow the event and that Primeo pay the Defendants' costs of the action, such costs to be taxed on the standard basis, if not agreed.



JUDGE OF THE GRAND COURT
THE HON MR. JUSTICE ANDREW J. JONES QC

