Focus on fraud and asset tracing: asset recovery claims by victims of fraud

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As part of Ogier's ongoing series of articles on fraud and asset tracing, we will now look at a number of recovery claims that victims of fraud have brought against their service providers. This is important because often in the context of a fraud case, the main wrongdoer may have disappeared or have dissipated all of the assets, leaving the victim of fraud (or any office holders appointed over the entity) with no other avenue of recovery.

1. **Auditors** – There are a number of Cayman Islands cases [1] considering auditor negligence (although they are all decisions concerning strike-out applications brought by defendant auditors seeking to have the claims dismissed at an early stage of the proceedings, and so do not substantively determine the defendant's liability, but are useful in providing guidance as to the relevant tests to be applied). One of the purposes of an audit is to check the financial health of the entity being audited, and in agreeing to take on this work, auditors assume certain duties. If a victim of fraud has been caused loss that might have been avoided or minimised had an auditor detected the fraud, then the victim may potentially have a claim against that auditor. In the Cayman Islands, an auditor will be prima facie liable for economic loss suffered by a plaintiff if it can be shown that the auditor issued a report containing negligent misstatements in the knowledge that the recipient (now plaintiff) would rely on it in its business dealings, that the plaintiff did in fact rely on it, and that the plaintiff suffered consequential detriment as a result. [2] Potential plaintiffs should bear in mind any cap on liability in the auditor engagement terms. Also, depending on the fact pattern, it is possible that the auditor may seek to rely on the illegality defence (for further details on the application of this defence, see our recent briefing Assistance to the creditors of insolvent fraudsters? the modern illegality defence to the rescue)

2. **Legal advisors** – Similar to the above, legal advisors are fiduciaries and will also owe duties of care to their clients. For example, breach of duty by inadvertence or negligence may give

rise to Grand Court's summary jurisdiction to require compensatory payment by an officer of court: *Att. Gen. v. Carbonneau* (Grand Ct.), 2003 CILR 129. Depending on the fact pattern, a party who has suffered loss could consider whether there is any cause of action against their former legal advisor.

3. **Directors (individual or corporate)** – Liquidators of an insolvent Cayman Islands company were able to bring on behalf of the company successful claims in for breach of duty against directors in *Weavering Macro Fixed Income Fund Limited v Peterson et al* [2011 (2) CILR 203]. Directors' duties in the Cayman Islands are largely common law based rather than statutory, and include duties such as to exercise reasonable care, skill and diligence and to the duty to act bona fide in what they consider to be the best interests of the company. However, those duties are owed by the directors to the Company and not to shareholders or other stakeholders and so the principle of reflective loss [3] may mean that shareholders are not able to sue directly (although in certain circumstances, a Company's shareholders can enforce duties owed to the Company (by derivative action)). As a practical point, whether it is likely to be possible to make recoveries in any director claim could depend on whether there is a D&O insurance policy in place (and if it is a fraud claim then, entirely dependent on the fact pattern, bear in mind that this may mean the insurance does not respond).

4. **Custodians** – The Cayman Islands Court of Appeal and then the Privy Council *(Primeo Fund (In Official Liquidation) v Bank of Bermuda and another* [4]*)*, recently considered (among other things) a claim against a custodian. A custodian is a separate legal entity which typically would hold assets on behalf of a fund in a Cayman Islands structure. The *Primeo* case related to a fund which had made losses due to the Madoff fraud, and was a decision on claims made by that fund against certain other third party service providers. These were claims against the custodian (a Luxembourg entity) of the fund, where it was claimed that: (i) the custodian had breached various duties under the Custodian Agreement, (ii) by appointing the fraudulent Madoff entity as its sub-custodian it was liable for the negligence or wilful breach of duty of that sub-custodian (this was referred to as the strict liability claim against the custodian), and (iii) it had breached various implied duties. At first instance, Justice Jones made some helpful observations as to the scope of the duties of a custodian (although he ultimately dismissed the claims due to (among other things) the principle of reflective loss, his decision was upheld by the Court of Appeal but was overturned by the Privy Council on the scope of the reflective loss principle, addressed in more detail in our previous briefing: Cayman Islands' Privy Council clarifies reflective loss principle). Jones J noted that in that case it was an implied term of the custodian agreement that the custodian would exercise the care and skill to be expected of a reasonably competent global custodian, and that it owed continuing duties to satisfy itself about the suitability of the sub-custodian [5], although each case will turn on its own facts.

5. **Administrators** – In the *Primeo* case referred to above, claims were also brought against the administrator (Bank of Bermuda). In a fund context, the administrator is generally a separate legal entity that assists with the subscriptions of investors, and calculations of the Net Asset Value (**NAV**) of the underlying assets. In *Primeo,* the plaintiff alleged that the administrator had breached its obligations under the Administration Agreement in respect of calculating the NAV of Primeo; the keeping of Primeo's accounts and books and records; and failure to exercise reasonable skill and care in the performance of its functions. The claim against the administrator was also subject to the arguments on reflective loss up to the Privy Council level, [6] but Jones J again made some remarks as to the scope of duties which are still of relevance to potential claims against administrators. He held that in normal circumstances, a hedge fund administrator could be satisfied about the existence of assets reflected on its client's balance sheet by reconciling information received from two or more independent service provider, such that the resultant NAV could be considered reliable. However, if a fund's administrator and directors concluded that it was impossible, impracticable or inappropriate to determine a reliable NAV, the determination should be suspended. [7]

6. **Banks** – Following recent case law, in a scenario where money has been misappropriated by those with control over a victim's bank accounts, a claim may potentially arise against the victim's banks who effected any relevant transfers of money. The *Quincecare* duty [8] is that a bank owes a duty of reasonable skill and care to its customers when executing a customer's order, such that liability will arise where a bank executed an order knowing it to be dishonest, or shutting its eyes to obvious wrongdoing, or was reckless in failing to make sufficient enquires as to the appropriateness of the order. This duty was recently revisited by the UK Supreme Court in *Singularis v Daiwa Capital Markets Europe* [2019] UKSC 50 a claim brought by the Cayman Islands court appointed liquidators of one of the companies in the Saad group, against the London subsidiary of the Japanese investment bank and broker Daiwa. In that case the main fraudster Maan Al Sanea had instructed Daiwa to execute a series of transfers totalling approximately US$200m out of the account of Singularis to other entities. Once liquidators were appointed and they began investigating, they brought claims against Daiwa including in negligence for breach of the *Quincecare* duty of care (ie that in the circumstances, Daiwa should not have given effect to the payment instructions). The Supreme Court allowed the negligence claim against Daiwa, and in doing so rejected Daiwa's arguments on the illegality defence (with the Supreme Court finding, among other things, that denial of the claim would undermine the public interest in requiring banks to play an important part in uncovering financial crime and money laundering [9]) and causation (with the Supreme Court holding that the fraudulent instruction from Al Sanea to Daiwa gave rise to Daiwa's duty of care which Daiwa breached, thus causing the loss [10]).

Of course, the available claims will depend on the fact pattern and the contractual

arrangements in any specific case. If you have any questions, or need any assistance in relation to the issues discussed in this article, please feel free to contact the authors of this article or Ogier's broader Fraud and Asset Tracing team.

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[1] *In re Omni Securities Ltd (No 3)* [1998 CILR 275]; *Omni Securities Limited v Deloitte and Touche and Ors* [2000 CILR 102]; and *TCB Creditor Recoveries Ltd. v. Arthur Andersen LLP* [2008 CILR 486].

[2] *In re Omni Securities Ltd (No. 3)* [1998 CILR 275].

[3] The principle of reflective loss is that a shareholder in a company is prevented from suing a wrongdoer for the reduction in the value of shares or distributions when the loss suffered is a "reflection" of a loss sustained by the company (so it is a claim of the company against the wrongdoer). There is a recent UK Supreme Court decision on this important principle. For more information, read our briefings: Snapshot: reflections on loss and Cayman Islands' Privy Council clarifies reflective loss principle.

[4] [2019 (2) CILR 1] and [2021] UKPC 22, further background on the relevant facts is set out in our recent article covering this case in more detail: Cayman Islands' Privy Council clarifies reflective loss principle

[5] [2017 (2) CILR 334] at 342.

[6] The Cayman Islands Court of Appeal had held that *Primeo's* claims against its Administrator would be barred on the basis that the effect of certain contractual arrangements was that the Custodian was delegated the administration functions for both the feeder fund and *Primeo* with the result that a claim by *Primeo* against the Administrator would, in substance, be passed through as a claim to the Custodian. The Privy Council allowed the appeal on that point on the basis that if the reflective loss principle were to be applied in these circumstances, this would amount to a significant and unjustifiable extension of the rule and would ignore the relevance of the separate legal personalities of the Administrator and the Custodian.

[7] [2017 (2) CILR 334] at 345.

[8] Named after the case of *Quincecare Ltd* [1992] 4 All ER 363, where the duty was first recognised.

[9] *Singularis v Daiwa Capital Markets Europe* [2019] UKSC 50, at paragraph 17.

[10] *Ibid*, at paragraph 23.

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