



In The Supreme Court of Bermuda

CIVIL JURISDICTION

2014: No. 66

COMMERCIAL COURT

BETWEEN:-

**(1) KINGATE GLOBAL FUND, LTD
(In Liquidation)**

**(2) KINGATE EURO FUND, LTD
(In Liquidation)**

Plaintiffs

-and-

**PRICEWATERHOUSECOOPERS
(A Firm)**

Defendant

RULING

(In Chambers)

Date of hearing: 9th and 10th October, 2014

Date of ruling: 4th November 2014

Mr Delroy Duncan and Ms Nicole Tovey, Trott & Duncan Limited, for the Plaintiffs

Mr John Riihiluoma and Mr Martin Ouwehand, Appleby (Bermuda) Limited, for the Defendant

Introduction

1. The Plaintiffs were investment companies which acted as “feeder funds” to Bernard L Madoff Investment Securities LLC (“Madoff Securities”), an investment company established and operated by the notorious fraudster Bernard L Madoff. The vast majority of monies raised by the Plaintiffs were transferred to Madoff Securities for investment on the Plaintiffs’ behalf. In fact Mr Madoff was running a Ponzi scheme and none of the monies were invested. Upon Mr Madoff’s arrest in December 2008 the Plaintiffs collapsed and were placed in liquidation.
2. The Defendant was appointed as auditor for the First Plaintiff from 1999 to 2008 and for the Second Plaintiff from 2000 to 2008. The Plaintiffs allege that, had the Defendant done its job properly, from March 2000 onwards the Plaintiffs would not have paid any monies to Madoff Securities. The amount transferred by the Plaintiffs to Madoff Securities after that date and not recovered is well in excess of US\$ 1 billion.
3. The Plaintiffs claim damages to be assessed for breach of contract, negligence, negligent misstatement, and wilful misconduct, together with interest and costs. The amount claimed, which covers various heads of loss in addition to that of monies paid to Madoff Securities and not recovered, is likely to be very substantial.
4. The Plaintiffs filed and served a statement of claim dated 21st February 2014. This weighed in at 1130 paragraphs and 366 pages. The Plaintiffs’ case with respect to each of the audit years 1999 through to 2007 was set out in nine sections: one section for each audit year. There was also a section

containing an introduction and overview. Although there were others, those are the sections with which we are chiefly concerned.

5. By a summons dated 10th April 2014 the Defendant applied to strike out the statement of claim pursuant to Order 18, rule 19(1) of the Rules of the Supreme Court 1985 (“RSC”) on the grounds that in breach of RSC Order 18, rule 7(1) it was not confined to a statement in summary form of the material facts upon which the Plaintiffs relied; it contained evidence and argument and/or was prolix and would thereby embarrass and/or delay the fair trial of the action; or that it was otherwise an abuse of process.
6. The summons came on for hearing before me on 4th June 2014. After a full day’s hearing Mr Ouwehand had completed his submissions for the Defendant but Mr Duncan had yet to begin his submissions for the Plaintiffs. The matter was adjourned part heard. The Court made some provisional observations about the pleading. The parties agreed that prior to the date of the resumed hearing they would engage in dialogue to see whether the Defendant’s concerns about the statement of claim could be resolved by its voluntary amendment.
7. By cover of a letter dated 6th August 2014, and following further correspondence between the parties, the Plaintiffs served a proposed amended statement of claim, now running to 416 pages, which sought to address various concerns raised by the Court and the Defendant. Eg the introductory section contained a new paragraph, numbered 19A, which set out in summary form the facts and matters relied on to support the Plaintiffs’ allegations of wilful misconduct. I shall proceed on the basis that the Plaintiffs’ case is as pleaded in the proposed amended statement of claim.
8. Further correspondence between the parties followed. This included a request from the Defendant by letter dated 5th September 2014 for further and better particulars of the proposed amended statement of claim.
9. At the resumed hearing on 9th and 10th October 2014 the Defendant did not pursue the strike out application but instead sought, in respect of each audit

year, an order for the further and better particulars which it had requested in correspondence. They were as follows:

- (a) details of each and every one of the individuals who is alleged to have known the matters expressed to have been known by the Defendant in paragraphs 19A.1 – 4 and in those paragraphs of Sections F to N of the Draft Amended Statement of Claim which make corresponding allegations of knowledge;
- (b) details of each individual:
 - (i) alleged to have had an “awareness ... that they were not performing a competent audit but were acting in breach of duty, committing widespread and serial failures in every audit year” (as alleged in paragraph 19A.5);
 - (ii) alleged to have been “recklessly indifferent to (1) the Madoff fraud risk, (2) their adherence or otherwise to standard and conduct which they knew were expected and required for a competent audit, (3) whether the performance of audit work by them was in accordance with their duties to the Plaintiffs, and thereby (4) whether their conduct was in breach of duty” (as alleged in paragraph 19B);
 - (iii) alleged to have acted with wilful misconduct;
- (c) details of each act or omission of each of the above individual/s which is alleged to have constituted a breach of contract, negligent misstatement and/or negligence and when each such act or omission occurred;
- (d) details of each fact or matter relied upon by the Plaintiffs in support of the allegations made against the individual/s specified in paragraphs (b) and (c), to the extent those facts or matters do not consist of the allegations referred to in paragraph (a) above. Where such facts or matters consist of:
 - (i) a document, then it must be described and a copy of it produced;

- (ii) a written communication, then the details ought to include the date it was sent, the persons between whom it was sent, and any record of it or a description of what it contained;
 - (iii) an oral communication, then the details ought to include the date it took place, whether it took place in person or by telephone, and any record of it or a description of the words used.
- 10. The request is framed in this way rather than by reference to particular paragraph numbers in the statement of claim because the alleged shortcomings identified in the pleading are said to be systemic. Mr Ouwehand referred the Court to a number of specimen passages in the statement of claim in order to make good this criticism.

The law

- 11. Pleadings are governed by RSC Order 18. RSC Order 18, rule 7(1) provides that facts not evidence must be pleaded:

Subject to the provisions of this rule, and rules 7A, 10, 11 and 12, every pleading must contain, and contain only, a statement in a summary form of the material facts on which the party pleading relies for his claim or defence, as the case may be, but not the evidence by which those facts are to be proved, and the statement must be as brief as the nature of the case admits.

- 12. Rules 7A, 10 and 11 are not material. Rule 12 deals with particulars of pleading. The relevant part provides:

(1) Subject to paragraph (2) [which is not material], every pleading must contain the necessary particulars of any claim, defence or other matter pleaded including, without prejudice to the generality of the foregoing words—

- (a) particulars of any misrepresentation, fraud, breach of trust, wilful default or undue influence on which the party pleading relies; and

(b) where a party pleading alleges any condition of the mind of any person, whether any disorder or disability of mind or any malice, fraudulent intention or other condition of mind except knowledge, particulars of the facts on which the party relies.

.....

(3) The Court may order a party to serve on any other party particulars of any claim, defence or other matter stated in his pleading ... on which he relies, and the order may be made on such terms as the Court thinks just.

(4) Where a party alleges as a fact that a person had knowledge or notice of some fact, matter or thing, then, without prejudice to the generality of paragraph (3), the Court may, on such terms as it thinks just, order that party to serve on any other party—

(a) where he alleges knowledge, particulars of the facts on which he relies, and

(b) where he alleges notice, particulars of the notice.

(5) An order under this rule shall not be made before service of the defence unless, in the opinion of the Court, the order is necessary or desirable to enable the defendant to plead or for some other special reason.

13. Thus a statement of claim should contain the material facts, ie the facts which are necessary as a matter of law to prove the plaintiff's case. They should be as concise as the circumstances of the case permit while containing sufficient detail to inform the defendant of the nature of that case. The degree of particularity necessary will depend on the particular facts of the case. Where a fact averred is a conclusion drawn from primary facts, eg that the defendant was in wilful default, both the conclusory fact and the primary facts on which it is based should be pleaded. Where the defendant requires further information to understand the case it has to meet, the Court will order the plaintiff to provide further and better particulars of the case. However excessive particulars can obscure rather than clarify the issues and the Court should be astute to avoid ordering particulars which are not really required. See Intercontinental Natural Resources Ltd v Conyers Dill &

Pearman [1982] Bda LR 1, CA (“Intercontinental”), *per* da Costa J at paras 103 – 111 and 141; applied in Focus Insurance Company Limited v Hardy and others [1992] Bda LR 25, CA (“Focus”), *per* Roberts P at 14 – 15; McPhilemy v Times Newspapers Ltd [1999] 3 All ER 775, EWCA, *per* Lord Woolf MR at 793 b – c; and Three Rivers District Council v Governor and Company of the Bank of England [2003] 2 AC 1, HL (“Three Rivers”), *per* Lord Hope at paras 49 – 50.

14. A person will be liable for wilful misconduct if he deliberately acts or omits to act: (i) knowing and appreciating that such act or omission is wrong in the sense of being in breach of duty; or (ii) recklessly, ie knowing and appreciating the risk that the act or omission may result in loss, but regardless of the consequences or when in all the circumstances the act or omission is otherwise unreasonable. See Intercontinental, *per* da Costa J at para 113; and TNT Global SpA v Denfleet International Ltd [2007] 1 CLC 710, EWCA, *per* Waller LJ at paras 8 to 11. In the statement of claim the Plaintiffs have used the phrase “*reckless indifference*” to characterise the mental state accompanying the second type of wilful misconduct.
15. Wilful misconduct is far beyond even gross negligence. See Forder v Great Western Railway Co [1905] 2 KB 532, KBD, *per* Lord Alverstone CJ at 535 to 536. But it falls short of fraud or wilful dishonesty, although it may consist of conduct which happens also to be dishonest or fraudulent. See, by parity of reasoning, Focus, where the court considered the meaning of the analogous concept of wilful default in the unamended section 98 of the Companies Act 1981. This retained the common law position that a company could not exempt an officer or auditor of the company from any liability attaching to him on grounds of wilful negligence, wilful default, fraud, or dishonesty. Roberts P noted at page 11 that:

“wilful negligence” and “wilful default” must indicate conduct which is not, and so falls short of, fraud or dishonesty. If it were not so, the reference to fraud and dishonesty would be redundant.

16. For that reason the cases on fraud and dishonesty to which I was referred are of limited assistance. In particular, I reject Mr Ouwehand's submission that Lipkin Gorman v Karpnale Ltd [1989] 1 WLR 1340, EWCA, *per* May LJ at 1350F – 1352G and 1355B – E, is authority for the proposition that the rules applicable to pleading fraud apply to any case involving “*want of probity*” if “*want of probity*” is taken to include wilful default. As used by May LJ, “*want of probity*” has the narrow sense of a concept, akin to dishonesty, which is necessary to give rise to a constructive trust.
17. The defendant to a claim for wilful misconduct is nonetheless entitled by reason of RSC Order 18, rule 12(1) to particulars of (i) the conduct alleged to be wilful (by analogy with the requirement to provide such particulars with respect to an allegation of wilful default) and (ii) the facts relied upon to establish the requisite state of mind. The amount of detail necessary will depend upon the facts of the case. However I accept that, *per* Lord Hope in Three Rivers at para 51, the more serious the allegation of misconduct the greater the need for particulars to be given.
18. The purpose of the particulars is to give the defendant rather than its witnesses notice of the plaintiff's case, even though the witnesses may be the subject of the allegations of misconduct. I do not accept Mr Ouwehand's submission that the judgment of da Costa J in Intercontinental at para 141 is authority for the proposition that where serious allegations are made against reputable professionals the purpose of particulars is to inform witnesses who may not also be parties of the allegations against them: the reputable professionals of whom the learned judge spoke were all respondents.
19. It is not a proper ground for striking out the allegation that the particulars may be found, after trial, to amount not to wilful default but merely to negligence. See, by parity of reasoning with allegations of dishonesty and fraud, Three Rivers, *per* Lord Steyn at para 1; Lord Hope at paras 53 – 55 and Lord Hutton at 125. Lord Hobhouse at para 161 and Lord Millett at paras 184 and 186, both dissenting, took a different view: whether they would have done so with allegations of wilful misconduct rather than dishonesty is a matter of speculation.

20. What count as adequate particulars of wilful default will depend upon the facts of each case and a decision on the facts of one case cannot be mechanically “read across” to apply to the facts of another, particularly if, as in Three Rivers, to which both parties made extensive reference in argument, the allegation is not one of wilful default but misfeasance in public office. However, the decision of Bannister J in Appleby Corporate Services (BVI) Limited v CITCO Trustees (BVI) Limited is illustrative of the standard of pleading that is likely to prove acceptable. The learned judge stated at para 21:

Mr Moverley Smith says that this is not what he calls a “proper” pleading of willful default. I accept, of course, that a claim alleging willful default must be properly particularised. It seems to me that this one has been. Sixteen acts, or elements, of alleged breach of trust are set out in paragraph 23 of the statement of claim. They include the matters which I have set out at paragraph [3] together with a considerable number of others which I do not think it is necessary for me to recite. This is not a case like RGI International Ltd v Synergy Classic Ltd [2011] EWHC 3166 where the defendant could not tell from the pleading what he was supposed to have done wrong (or to have omitted to do right). These specific breaches are said, in paragraph 25 of the statement of claim, to constitute or arise out of Citco's willful default. Leaving aside the circular “arise out of”, this is a plain allegation that what was done or omitted constituted willful default. It seems to me that an allegation (which, of course, remains to be proved) that trustees have sat back for two years and upwards watching some US\$5 million being wiped off the value of the fund of which they were supposed to be custodians, without taking any steps to arrest the decline or even inform the Settlor or any of the beneficiaries that it was taking place, is more than adequate as a pleading of willful default. Mr Moverley Smith complains that that (sic) there is no “material” enabling Appleby to make the pleading. It was never quite clear during the hearing what Mr Moverley Smith meant by this, but if he meant that the precise course of events or that the identities of the individuals alleged to have been at fault cannot presently be mapped or specified, or that Appleby does not give chapter and verse as to the thought processes from day to day of the persons with responsibility for these events, as Mr Moverley Smith appeared at times to suggest, then in my judgment the complaint is not

well founded. Citco is told in clear terms what it is alleged to have done wrong and that that conduct amounts to willful default on its part. That is a perfectly adequate pleading.

The Plaintiffs' pleaded case

21. Mr Duncan explained with great clarity the Plaintiffs' pleaded case on wilful default. He also explained several points which are not presently clear from the proposed amended statement of claim. This will need to be amended so that they are made clear.
22. Para 19 of the proposed amended statement of claim states the Plaintiffs' case is that, whether considered individually or cumulatively across audit years, the Defendant's audit failures constituted breaches of contract, negligent misstatement and/or negligence, in each case amounting to wilful misconduct.
23. At para 19A of the proposed amended statement of claim the Plaintiffs allege as their primary case that the Defendant conducted its audits with knowledge that its failings amounted to breach of duty. Paras 19A.1 – 19A.4 set out the material facts upon which the Plaintiffs rely to establish such knowledge.
24. At para 19B of the proposed amended statement of claim the Plaintiffs allege that in the alternative that the Defendant was not aware that it was acting in breach of duty, then, given its state of knowledge as pleaded at para 19A, it was recklessly indifferent to: (i) the Madoff fraud risk; (ii) its adherence or otherwise to standards and conduct which it knew was expected and required for a competent audit; (iii) whether the audit work which it performed was in accordance with its duties to the Plaintiffs; and thereby (iv) whether its conduct was in breach of duty.
25. Para 19C of the proposed amended statement of claim states that accordingly all allegations made in the body of the pleading as to the Defendant's wilful misconduct include, as the Plaintiffs' primary case, the allegation that the

Defendant acted knowingly in breach of duty and, as the Plaintiffs' alternative case, the allegation that the Defendant acted with reckless indifference.

26. Paras 81 – 83 of the proposed amended statement of claim identify the senior members of the audit team for each of the audit years.
27. Paras 96 – 107 of the proposed amended statement of claim set out the Defendant's duties pursuant to contract, tort and statute and under applicable accounting standards.
28. For each audit year from 1999 through 2007, the proposed amended statement of claim identifies six areas of audit responsibility. These are headed: (i) planning, fraud risk and materiality; (ii) inappropriate reliance on and failure to seek to obtain sufficient understanding and evidence of internal controls at Madoff Securities; (iii) inappropriate reliance on and failure to review the purported internal controls work of Friebling & Horowitz (which was the external auditor of Madoff Securities); (iv) failure to substantiate the existence of the Plaintiffs' investments and the occurrence of the Plaintiffs' investment transactions; (v) failure to question, investigate or have regard to Madoff Securities' questionable investment strategy and other indicia of potential impropriety; and (vi) failure to report and warn.
29. The proposed amended statement of claim identifies at the start of each audit year which members of the audit team were responsible for complying with the areas of audit responsibility. It doesn't state which individual is responsible for which area of audit responsibility because the Plaintiffs allege that the audit team was collectively responsible for all six areas. Within each of those areas the proposed amended statement of claim sets out the facts and matters which are relied upon to demonstrate that the Defendant knew the risks inherent in each area of audit work to be performed. It then sets out how the Defendant allegedly failed despite this knowledge to carry out the work that each area of audit responsibility required, and the consequences of that failure. The alleged failures in each area are related back to the duties set out at paras 96 – 107.

30. The Plaintiffs allege that the Defendant knew that it had a duty to perform each area of audit responsibility and had in many cases identified them. However it is alleged that the Defendant intentionally failed to carry out the work or had reckless disregard as to whether it was carried out.
31. As to paragraphs (a) and (b) of the particulars sought, Mr Duncan explained that references in the proposed amended statement of claim to the Defendant in each audit year are references to the senior members of the audit team for that year, as identified at paras 81 – 83 of the statement of claim and at the start of the sections of the pleading dealing with each audit year. Thus an allegation that the Defendant knew or was recklessly indifferent is an allegation that each of the senior members of the audit team for that audit year knew or was recklessly indifferent. This explanation is implicit in the statement of claim but needs to be articulated in express terms.
32. The Defendant's knowledge is alleged to include cumulative knowledge derived from past audits. Mr Duncan explained that each senior member of the audit team derived that knowledge from the audit file for the Plaintiffs, which they are alleged to have read. In any given audit year after 1999, some of the senior members of the audit team had audited the Plaintiffs in one or more previous audit years. It is alleged that those members retained the knowledge about the Plaintiffs which they had acquired in previous audits. The proposed amended statement of claim should set out, as explained by Mr Duncan, the material facts on which the allegation of cumulative knowledge is based.
33. As to paragraph (c) of the particulars sought, Mr Duncan submitted that due to the collective nature of the audit process the Defendant's request for details of each act or omission etc of each of the senior members of the audit team was inappropriate. He further submitted that, as reflected in the engagement letter for each audit year, the audit was conducted by a team and the senior team members were collectively responsible for the audit work and the final audit opinion. What was material were the breaches of duty, identified in the conclusion to each of sections dealing with one of the audit

years, for which each senior member of the team was on the Plaintiffs' case jointly responsible. I agree.

34. As to paragraph (d) of the particulars sought, I am satisfied that the facts and matters alleged against the senior audit team members have been adequately pleaded, as summarised by Mr Duncan in his overview of the Plaintiffs' case set out above.

Conclusion

35. The Defendant is entitled to the particulars requested at (a) and (b). I anticipate that they can be provided quite shortly. This can most conveniently be achieved by further amending the proposed amended statement of claim to include the material facts summarised at para 31 above. The further amendments should also state the material facts on which the allegation of cumulative knowledge is based, as summarised at para 32 above. I direct that within 14 days the proposed amended statement of claim should be further amended accordingly and served upon the Defendant.
36. For the reasons given above, the Defendant is not entitled to the particulars requested at (c) and (d). I note that had they been ordered, they might easily have run to another 400 pages, and would doubtless have elicited requests for yet further particulars. Had I been minded to order them, I should not have done so until after service of the defence, as they would not have been necessary or desirable to enable the Defendant to plead, and there would have been no special reason to order them beforehand.
37. I am satisfied that, subject to the further amendments to the proposed amended statement of claim mentioned above, the Defendant has adequate notice of the Plaintiffs' case. As Mr Ouwehand, who fought his corner with great skill, requested, I shall allow the Defendant until Friday 30th January 2015 to file its defence.

38. I shall hear the parties as to costs.

Dated this 4th day of November, 2014

Hellman J