IN THE GRAND COURT OF THE CAYMAN ISLANDS

CAUSE NO. 258 OF 2006

IN THE MATTER OF THE COMPANIES LAW (2007 REVISION)

AND IN THE MATTER OF THE SPHINX GROUP OF COMPANIES (IN OFFICIAL LIQUIDATION) AS CONSOLIDATED BY THE ORDER THIS COURT DATED 6TH JUNE 2007

AND IN THE MATTER OF THE DPM APPEAL OF DPM MELLON LLC AND DPM MELLON LTD. (together "DPM") DATED 25TH MARCH 2008

IN CHAMBERS
BEFORE THE HON. CHIEF JUSTICE
Heard on the 30th September – 2nd October 2008
And on the 23rd February 2009

Appearances: Mr. R. Sheldon QC instructed by Mr. Alistair Walters and Mr. Guy Manning of Campbells for the applicants ("DPM")

Mr. T. Lowe QC instructed by Ms. Cherry Bridges of Ritch and Conolly for the Joint Official Liquidators of the SPhinX Group of Companies ("the JOLs")

Mr. A. Phillips QC instructed by Mr. Alan Turner of Turner & Roulstone for the Liquidation Committee of the SPhinX Group of Companies (in liquidation)

1. I have before me cross-applications by DPM and by the JOLs. By its application DPM seeks directions for the trial of certain preliminary issues in these proceedings. The JOLs on the other hand seek an order for a stay of these proceedings pending the outcome of related proceedings in New York, in the United States.

2. DPM contends that the preliminary issues should be determined before the stay is ordered, but otherwise does not oppose the JOLs' application.

3. The relevant background is as follows.

4. In December 2001, Plus Funds Group Inc. ("Plus Funds") entered into an exclusive licence with Standard and Poor's – a division of the McGraw-Hill group of companies ("S & P") – to create and market investment products designed to achieve returns consistent with the S & P Hedge Fund Index, a composite index measuring major hedge fund strategies. Several months later, Plus Funds created the SPhinX Funds Group of companies ("SPhinX" being an acronym for the S & P Index); a family of Cayman Islands hedge funds specifically designed to offer "full transparency" to investors, by making available to investors daily net assets value reports of investments on a real-time basis, with performance to be aimed at tracking the S & P Index.

5. DPM became the administrator of the SPhinX companies by virtue of Service Agreements struck in June 2004 ("the Service Agreements"). The Service Agreements are governed by the laws of the State of New York.

6. For a number of reasons including alleged fraud and mismanagement, the SPhinX funds failed and the SPhinX companies were placed into liquidation in 2006 with the JOLs appointed as liquidators.

7. The JOLs subsequently instituted proceedings in New Jersey (later consolidated with others in New York proceedings) on behalf of the SPhinX companies and as assignees of a number of other claims assigned by some 16 other entities or individuals who were investors in the SPhinX companies.

8. The JOLs' claim in the New York proceedings is for (i) some $263 million (plus interest) in damages said to have been suffered by the SPhinX family of hedge funds; (ii) the loss of business enterprise value and deepening insolvency damages suffered by SPhinX's promoter and investment manager, Plus Funds and (iii) damages suffered by the group of 16 investors who assigned their claims.

9. The damages are said to have arisen from the diversion of SPhinX's cash from protected, customer segregated accounts within respective SPhinX companies, to unprotected accounts held by Refco Capital Markets Ltd. ("RCM"), a Bermuda based entity of the Refco Group of brokerage firms which became enmeshed in the massive fraud perpetrated against his investors by Phillip Bennett, the President and CEO of the Refco Group. The New York claim therefore also pleads that Refco's crash in October 2005 resulted in the loss of the $263 million of SPhinX funds wrongfully deposited at RCM and led to the collapse of both the SPhinX Funds and Plus Funds.

10. A significant portion of the $263 million is said to be owed directly to SPhinX Managed Futures Fund SPC ("SMFF"), a Cayman Islands entity and one of the number of the Cayman Islands SPhinX companies administered by DPM.

11. As pleaded in the New York proceedings, a central and crucial component of SPhinX's business plan was the use of segregated portfolio companies ("SPCs") incorporated under the Cayman Islands Companies Law. The Cayman SPC structure (including SMFF), allowed segregation of assets and liabilities into separate portfolios within a single SPC company. According to SphinX's corporate documents and offering and marketing materials, SPhinX's investors'

assets were required to be protected in customer segregated accounts, "ring-fenced" from possible claims against the other segregated portfolios and immune from possible claims of creditors against the prime broker or custodian of SPhinX's customers' assets.

12. It is alleged that unknown to the SPhinX and Plus Funds directorship and management, DPM, through its senior operatives – in particular a Mr. Robert Aaron – allowed SMFF's assets to be diverted from this regulated, protected, customer segregated account structure under the control of Refco LLC as investment manager, to the non-regulated RCM accounts, where those assets were co-mingled with assets from non-SPhinX sources and exposed to the risks of the imminent insolvency of the Refco Group as a whole. In this regard, it is claimed that DPM are liable for Aaron's breaches of duty, DPM having been responsible for his nomination to the boards of the SPhinX Companies.

13. It is further alleged that the DPM operatives acted fraudulently in their own interests in breach of their fiduciary duties and deliberately adversely to the interests of SPhinX and of Plus Funds, in violation of the explicit requirement that the SPhinX assets must be protected in customer segregated accounts. This is a requirement which, it is asserted, is also imposed as a matter of the operation of the Cayman Islands Companies Law.

14. Thus, while these serious allegations are to be tried in the New York proceedings, at least two distinct issues of Cayman Islands law arise to be resolved – those relating to (i) vicarious liability for the failings of directors in particular Mr. Aaron and (ii) to the segregated nature of portfolios within SPC companies.

All this, notwithstanding that New York law governs the Service Agreements between the SPhinX companies and DPM and thus will govern the outcome of the New York proceedings.

15. It is for this reason that DPM contends for the trial as preliminary issues in these proceedings of those matters of Cayman Islands law which DPM also contends can best be decided by this Court. This contention is at the heart of the present matter.

16. A bit about these proceedings. They are brought by DPM by way of an appeal against the JOLs' rejection of DPM's proof of debt filed in the liquidation of the SPhinX Companies. DPM'S claim in the proof of debt is said to be based on indemnities against liability in its favour, contained in the Service Agreements.

17. The JOLs' case both in the New York and in these proceedings, is that the role of the DPM operatives and entities in the Refco fraud amounted to wilful misconduct or gross negligence so as to disentitle DPM from relying on the indemnities contained in the Service Agreements.

18. Thus, the proof of debt which was rejected relates to DPM's claim for "*indemnification in respect of all and any claims brought by any person or entity against DPM (and against any directors, officers, or representatives of DPM who may be entitled to an indemnity from DPM in connection therewith) in relation to the provision of services by DPM to the "SPhinX Funds", together with fees and expenses incurred in defence of such claims.*"

19. As it is agreed that the primary question of whether there are any claims against DPM for which it may be entitled to indemnification must await the outcome of

the New York proceedings, DPM's concession that its appeal here should be stayed pending the outcome of the New York proceedings is not surprising.

20. To complete the context for the examination of DPM's contention nonetheless for the trial of the preliminary issues, I must set them out. The first raises the question of the extent, if any, of DPM's vicarious liability for the actions or omissions of Mr. Robert Aaron as a member of the Boards of the SPhinX Companies, to which he was appointed on the nomination of DPM:

"(1) Would any of the following propositions (assuming, contrary to DPM's case, that they are all correct) constitute a valid legal basis for DPM being held vicariously liable for any breaches by Mr. Aaron of any duties which he owed to the SPhinX Companies by virtue of his position as a director (assuming, contrary to DPM's case, that such breaches occurred):

(i) that DPM exercised its right to nominate Mr. Aaron as a director of the SPhinX Companies and/or instigated such appointment under Clause 2N of the Service Agreement;

(ii) that Mr. Aaron thereby represented DPM on the SPhinX Companies boards;

(iii) that Mr. Aaron was DPM's chief executive officer and/or main shareholder and/or member; and/or

(iv) that DPM owed the SPhinX Companies a duty pursuant to New York law to supervise and manage Mr. Aaron?"

[(This latter assumption would be a further necessary basis for DPM to be found liable in the New York proceedings, even if as a

matter of Cayman Islands law, DPM could be found to be vicariously liable for Mr. Aaron's breaches of fiduciary duty)].

The other four preliminary issues raise the questions of the meaning and applicability of the Cayman Companies Law provisions relating to segregated portfolio companies:

"(2) Did DPM owe a duty to any of the SPhinX Companies pursuant to Section 239 or any other provision of the Companies Law –

(a) to segregate, and keep segregated, portfolio assets separate and separately identifiable from general assets of the company;

(b) to segregate and keep segregated, portfolio assets of each segregated portfolio separate and separately identifiable from segregated portfolio assets of any other segregated portfolio; and/or

(c) to ensure that assets and liabilities were not transferred between segregated portfolios other than at full value?

(3) On the proper construction of the SPhinX Companies Articles of Association, did DPM owe the SPhinX Companies any duty pursuant thereto to ensure that the SPhinX Companies held the assets in each segregated portfolio for the benefit of the holders of the relevant common shares attributed to such segregated portfolio and to apply them solely in respect of the liabilities of such segregated portfolio in accordance with the provisions of the Companies Laws?

(4) Did the directors of the SPhinX Companies or DPM owe any duties pursuant to Section 239 or any other provision of the Companies Law to establish and maintain (or cause to be established and maintained) procedures to segregate, and keep segregated, portfolio assets and/or general assets held with third parties (and, in particular, prime brokers) separate and/or separately identifiable from assets belonging to those third parties?

(5) On the proper construction of the SPhinX Companies Articles of Association, did the directors of the SPhinX Companies or DPM owe any duties pursuant thereto to establish and maintain (or cause to be established and maintained) procedures to segregate, and keep segregated, portfolio assets and/or general assets held with third parties (and, in particular, prime brokers) separate and/or separately identifiable from assets belonging to those third parties?"

21. As to issue (1) – vicarious liability – DPM's argument is that as a matter of Cayman Islands law, the principle is already settled and so this Court can readily now so declare. For this proposition DPM relies upon the decision of the Court of Appeal in ***Paget Brown and Company Ltd. v Omni Securities Ltd. 1999 CILR 184.*** In that case, the respondent Omni had alleged that the plaintiff owed it a duty of care to ensure that a director appointed to the board of Omni on the nomination of the plaintiff, performed his functions diligently and competently. And further, that the plaintiff was vicariously liable for the director's breaches of duty in that regard.

22. The Court of Appeal held (as reflected in the head note) that in the absence of fraud or bad faith on its part, the plaintiff did not – as the person nominating the director for appointment – owe a duty of care to Omni and its creditors to ensure that he performed his functions diligently and competently. The plaintiff could not be vicariously or directly liable to Omni for the director's negligence or breaches of fiduciary duty, since the director had not acted in his capacity as employee of the plaintiff, and received no instructions from it. On the contrary, as an agent of Omni itself, he was answerable to it and to its shareholders who had appointed him, and was obliged to ignore the interests of his employer, the plaintiff.

23. In so deciding, the Court of Appeal followed and applied the decision of the Privy Council in ***Kuwait Asia Bank E.C.V. v National Mutual Life Nominees Ltd. [1991] 1 A.C. 187.***

24. And so, it seems, the answer to the first preliminary issue could indeed be readily determined by this Court. As a matter of Cayman Islands law, in the circumstances presented, it seems that DPM could not be held vicariously liable for Mr. Aaron's breach of fiduciary duties owed to the SPhinX Companies as their director.

25. The JOLs' opposition to the preliminary determination of that issue is nonetheless maintained because, in the context of the New York proceedings, the issue would remain one for resolution not as a matter of Cayman Islands law, but as one of New York law which governs the Service Agreements.

26. A determination of that issue now in these proceedings, the JOLs say, would therefore be conclusive of nothing. Only if DPM is held to be vicariously liable under New York law and then seeks the protection of its indemnity in the Service Agreements on its proof of debt, would this Court be required finally to determine the question of vicarious liability under Cayman Islands law.

27. I must also consider the practical implications of the proposed trial of the other four preliminary issues relating to the Cayman SPCS.

28. It must indeed be acknowledged that these issues give rise to questions peculiarly of Cayman Islands law even though they arise for consideration in the New York proceedings. A fundamental plank of the JOLs' case in the New York (as in these) proceedings, is that the segregation provisions of the Companies Law required the SPhinX Companies to keep their assets separate from those of other persons, even if given over into the hands of third parties for investment and management. See paragraph 81 of the Complaint in the New York proceedings where the JOLs claim that:

> *"The customer segregation requirement was central to the structure and purpose of the SPhinX Funds. This structure was mandated under Cayman Islands law and relied upon by SPhinX investors. Safeguarding the segregated nature of the assets provided the crucial level of protection to SPhinX's assets against the bankruptcy or insolvency of other investors, brokers, custodians and service providers."*

29. In the context of these proceedings, a similar assertion appears at paragraph 31 of their Defence to DPM's claim, where the JOLs plead that preserving the segregation of assets *"...provided the crucial level of protection to the assets of the SPhinX companies against the bankruptcy or insolvency of other investors, brokers, custodians and service providers"*. And further, at paragraph 87 of their Defence, that:

> *"By signing the [Letter with RCM] Mr. Aaron ensured that the protections specifically designed to preserve SMFF's assets for its investors were never implemented, thereby acting in breach of his fiduciary duties as set out above and, in breach of Section 239(6) of the Companies Law..., failed to maintain procedures to segregate and keep segregated portfolio assets and authorised a contravention of Section 240."*

30. As my task does not now require me to determine the meaning of Sections 239 and 240, there is no need to set them out here.

31. DPM's defence to these claims, put shortly, is that there is nothing in the Articles of the SPhinX Companies or in the Service Agreements to suggest that they imposed such direct obligations on DPM. On the contrary, it is pleaded that DPM's relationship with the SPhinX Companies was entirely governed by the Service Agreements, as is expressly provided in Clause 21 of each Agreement:

> *"This Agreement contains the sole and entire agreement between the parties and supersedes any and all other agreements between the parties relating to the subject matter hereof."*

32. Moreover, that by Clause 7 of the Service Agreements, DPM is expressly excluded from "*...any duty to ensure that the SPhinX Companies...* [acted] *in compliance with any applicable domestic or international laws or regulations*".

33. DPM will further argue that on the proper construction of the relevant provisions of the Companies Law, there is imposed no obligation as to the treatment of an SPC's assets upon anyone besides its directors. The same, it is said by DPM, applies moreover to the purported imposition by the Articles of obligations to segregate assets.

34. There is in any event, contends DPM, no provision of the Companies Law equating the "segregation" requirement imposed on SPCs, in any way to a requirement that an SPC's assets in the hands of a third party should remain segregated from the third party's assets.

35. Such a fundamental mischaracterization of the Companies Law, says DPM, would mean that an SPC would be effectively prevented from making any kind of deposit (including ordinary bank deposits), because that would entail the sum deposited being mixed with the assets of the bank of other depositors. It would also preclude an SPC from making any kind of investment in which its assets became co-mingled with, and exposed to the insolvency risk of, third parties; thus restricting in an untenable way, the ability of SPCs to manage and invest their shareholders' assets.

36. Instead of the imposition of what may be described in its articulation as a strict statutory trust for segregation of portfolio assets, DPM would argue that the

obligation which the Caymanian Law imposes instead is that the assets must be strictly and separately accounted for as belonging to the respective portfolios.

37. These, on the face of them, are cogent arguments on behalf of DPM as to the true meaning and effect of the SPC provisions of the Companies Law. As in the case of the vicarious liability issue, DPM's arguments and the arguments to the contrary on behalf of the JOLs (and for the Liquidation Committee per Mr. Phillips QC) are doubtlessly amenable as issues of Cayman Islands law, to authoritative resolution by this Court.

38. That, however, is by no means the only factor to be considered in deciding now whether to direct that the Preliminary Issues should be tried as proposed by DPM. There are several considerations – practical and legal – recognised in the case law, which must be considered before deciding.

Legal principles

39. As a fundamental matter, it must be recognised that DPM brings its appeal as of right in this jurisdiction against the liquidation estate of the SPhinX Companies which are incorporated here. Thus, insofar as DPM's appeal is concerned, it must also be acknowledged that this Court is the only appropriate forum for its ultimate resolution.

40. This fact is however, in the circumstances of this case, immediately relegated to the common acceptance of the parties that New York is clearly the more appropriate forum for the trial of the main questions of liability raised against DPM (and others) in the New York proceedings.

41. The resolution of those questions must precede the resolution of DPM's claim before this Court. This is common ground.

42. Viewed in that way, the present matter gives rise, in my view, to no real question of whether Cayman or New York is the more appropriate forum for determination of the issues. There is no question for determination whether ***"...the interest of all the parties and the ends of justice...."*** (per Lord Goff as elaborated in ***The Spilada [1987] AC 460 at 478)*** dictate that the trial of the main questions of liability should take place in New York or here. The appropriate forum for the determination of the main issues of liability is New York with the appeal against rejection of DPM's proof of debt to follow in Cayman depending on the outcome in New York.

43. In so viewing the realities of the two sets of proceedings, no question arises – as it did in ***Reichhold Norway ASA v Goldman Sachs 2 Lloyds Rep. 567 at 574*** – of this Court ***"...lightly disturb(ing) jurisdiction established here [(in the Cayman Islands)] as of right...."*** by a party entitled to sue here.

44. I strike the foregoing distinctions to explain that I do not see the present matter over directing the trial of preliminary issues as one involving a determination of what is the more appropriate forum for the trial of those issues. Rather, I see the matter as one of proper case management.

45. The way I approach the issue is therefore to seek the answer to this question: is it in the best interest of the proper management of these proceedings and so in the best interests of the parties, that this Court should proceed to try the preliminary

issues even though it will direct the stay thereafter of these proceedings, generally in deference to the trial of the New York proceedings?

46. It seems, from recent cases, that the courts have come to recognise such an issues-based approach to the resolution of problems of *forum conveniens.*

47. In ***Curtis v Lockheed Martin UK Holding Ltd.*** *[2008] EWHC 260 (Comm)* Teare J. recognised that his court had the power to stay its own proceedings on case management grounds pending the determination of a discrete issue between related parties in other proceedings then pending before an Italian Court. In the end, Teare J. decided that the small risk of inconsistent judgments – the argument posited in support of the stay – did not outweigh the harm to the parties in having to await the determination of the issue in Italy.

48. And so, in the end, while recognizing that the jurisdiction existed to give directions for the trial of those issues overseas and to stay proceedings in England in the meantime, that jurisdiction was not exercised.

49. In ***Al Bassam v Al Bassam*** *[200] EWCA Cir. 857,* case management directions were given to ensure that a Saudi Court could reach a decision on Sharia law which would assist in the resolution of the proceedings before the English Court, in the event that such assistance became necessary.

50. So, from those two last mentioned cases it is to be noted that while the English Courts recognised the existence of the jurisdiction in appropriate circumstances to stay their own proceedings pending the resolution of discrete issues between the same or related parties before a foreign court, the English Courts remained seized

of the main proceedings in which the contest between the parties would ultimately be resolved.

51. That was the obverse to what is proposed here. Here the Court is being invited to try discrete issues which may be relevant to the outcome of the proceedings in New York and then to stay its own proceedings pending the outcome of those foreign proceedings. It is moreover being asked to do so without having been asked by the New York Court and so without the acknowledgement of the New York Court that the outcome here would be of assistance to its proceedings.

52. A primary argument of Mr. Sheldon for the Court acting in such an officious manner, proceeded on the notion that because this is the Court of the jurisdiction of incorporation of the SPhinX Companies it must, by definition, be the most appropriate forum for the resolution of issues relating to their governance.

53. Whether or not this proposition holds true must surely depend upon the circumstances of the case.

54. It did hold true, for instance, in ***KTH Capital Management Ltd. v China One Financial Management Ltd.*** **2004095 CIL4 213;** where the remedy of specific performance sought against the defendant Cayman Islands company could have been best obtained here, in the forum of its incorporation. But any treatment of the proposition that the place of incorporation must be the appropriate forum as a doctrine of general applicability is now firmly disapproved; see: ***Brasil Telecom S.A. and Opportunity Fund*** *C.I.C.A No. 7 of 2007; 9th April 2008 (unreported) para. 41-42.*

55. The true rule is that while the Courts of the place of incorporation of a company would likely be the most appropriate forum for the resolution of issues governed by the laws of the place of incorporation, there may be circumstances where such issues can be more conveniently and justly determined elsewhere. However, the Courts of the place of incorporation will not readily be by-passed and considerable weight must be attached to their role in determining the appropriate forum. See ***Konamaneni and Others v Rolls Royce Industrial Power (India) Ltd. and Others [2007] 1 WLR 1209 and Brasil Telecom, S.A. and Opportunity Fund*** (above).

56. The issues having devolved, in my view and as explained, as issues of case management, I proceed with the case law on the subject of the giving of directions for the trial of preliminary issues firmly in mind.

57. The trial of preliminary issues should not be taken unless to do so would be clearly conducive to the just and timely outcome of the case. Otherwise, the practice will often tend only to increase the costs, time and anxiety of legal proceedings and add to the difficulties faced by the Court of Appeal in resolving matters coming before them: ***Tilling v Whitemann [1980] A.C. 1 pp 17f-18a.*** In the cautionary words of Lord Scarman from that case: *"Preliminary points of law are too often treacherous short cuts." At p.25 b-c.*

58. The factors which often arise for consideration in deciding whether to direct the trial of preliminary issues have been exhaustively canvassed in the case law; see for instance recently in this Court ***TMSF v Wisteria Bay Ltd. 2007 CILR 310*** and

In the Matter of the Ojjeh Trust 2008 CILR Note 3 (applying the earlier decision in *In Re T Trust 2002 CILR Note 1).*

59. There are several indications here that delay, uncertainty and additional expense would be the consequence of trying the preliminary issues now in these proceedings purportedly in aid of the New York proceedings, instead of deferring to their resolution in the relevant context of those proceedings:

(i) As already indicated, such "assistance" would be wholly uninvited and, as has been explained (see affidavit of Leo Beus), it would be unusual for the New York Court to seek such assistance.

As in our and the case of other common law courts, that Court will determine for itself questions of foreign law (in this instance Cayman Islands corporate law) by reference to competent expert opinion evidence.

(ii) A determination of the preliminary issues as defined between DPM and the JOLs' in these proceedings, would not be unarguably binding on them and certainly not binding on other parties, in the context of the New York proceedings. The case against DPM entities is but part of a larger overall dispute about Refco losses involving a substantial number of other parties in New York (not only in the JOLs' proceedings but also those brought by the Refco Trustee).

(iii) These preliminary issues could take many months or even years to conclude (if appealed to the highest court) and could result in undue delay in the New York proceedings as well, if the final outcome here were to be awaited and so to be of any ultimate value in those proceedings.

(iv) If the outcome of the trial of these preliminary issues by this Court is not readily adopted as binding on all the parties before the New York Court and so leading to a separate determination of the issues by that Court, there would be an obvious risk of inconsistent decisions in relation to the issues.

(v) For this among others, there is reason to doubt – especially so far as the vicarious liability issue is concerned – that there would be value to the New York Court in having this Court's determination. Apart from anything else, New York law, which may well be different on that issue, governs the Service Agreements.

(vi) Finally, if the JOLs are successful in the New York proceedings as against DPM on the liability issues, DPM can have no claim to advance on appeal here. There would then be no need for this Court's determination of the issues and so trying them now might yet prove to be an expensive exercise in futility.

60. For all the foregoing reasons, I refuse DPM's application for the direction of the trial of the preliminary issues.

Hon. Anthony Smellie
Chief Justice

February 23, 2009