1/9/05

IN THE GRAND COURT OF THE CAYMAN ISLANDS
HOLDEN AT GEORGE TOWN, GRAND CAYMAN – Civil

CAUSE NO. 414 OF 2004

IN THE MATTER OF THE COMPANIES LAW (2004 REVISION)

AND IN THE MATTER OF PARADIGM HOLDINGS LIMITED

Appearances: **Mr. Peter Broadhurst of Broadhurst Barristers for the Petitioner and Joint Provisional Liquidators**
Mr. Alan Turner with Andrea Dunsby of Turner & Roulstone for the Company

Before: **Hon. Justice Henderson**

Heard: **February 16 & 17, May 2 & 3 and August 4, 2005**

JUDGMENT

Strathvale House Ltd. ("Strathvale") says it is an unpaid creditor of Paradigm Holdings Limited ("Paradigm") and asks for its winding up on the grounds of insolvency and that it is just and equitable to do so.

Strathvale has alleged, in support of the just and equitable ground, that the principle of Paradigm, Robert Middlemiss, has been engaged since 2003 in a conspiracy to defraud the public of money by a scheme to sell wine futures.

Strathvale also alleges that Paradigm and Middlemiss operated a fraudulent Ponzi scheme. These allegations of fraud, conspiracy and a Ponzi scheme have not been proven.

During the extended hearing of the petition, another question of substance arose – was Paradigm selling wine futures in violation of the *Securities Investment Business Law (2004 Revision)* ("the *S.I.B. Law* ")?

Mr. Christopher Johnson was appointed Provisional Liquidator of Paradigm by order of this court on October 12, 2004. Strathvale now seeks his appointment as Joint Official Liquidator together with Mr. Russell Smith.

Paradigm has responded with its own summons, asking for dismissal or a stay of the petition, the discharge of the earlier court order, and the revocation of the appointment of the Provisional Liquidator.

Facts

Strathvale was Paradigm's landlord. The petition asserts that Paradigm is indebted to Strathvale for unpaid rent, certain fit out costs provided for in the lease agreement, and some professional fees also arising from the rental of the premises. During the hearing, it became apparent that Strathvale had failed to comply with the notice provisions applicable to landlords where the rent is in arrears and might, therefore, have difficulty in pressing its claim. (I express no opinion on that.) It also became clear over the course of the hearing that Strathvale was not in a position to adduce a *prima facie* case supporting the allegations of conspiracy, fraud, and a Ponzi scheme made in the petition.

However, Strathvale advanced, after adequate notice to Paradigm, an argument not pleaded in the petition. It says the business of Paradigm and its subsidiaries amount to an unlawful selling of securities from the Cayman Islands without the appropriate registration under the *S.I.B. Law*. Extensive argument was advanced by Strathvale and Paradigm on this point.

Paradigm was incorporated in 2002 in the Cayman Islands as a holding Company. Its wholly owned subsidiaries include Architects of Wine Ltd. ("AoW"), AVE. International Ltd. ("AVE") and AVE North America Ltd. (also referred to herein as ("AVE"). AoW owns a subsidiary which in turn owns the majority of shares in Architects of Wine (U.K.) Ltd. (also referred to herein as "AoW").

AoW has been in the business of selling "wine forward" contracts to investors and wine fanciers, primarily American doctors. AVE purchases wines from AoW's customers and others and resells them to distributors, retailers, hotels and restaurants.

The wine forward contracts are in a standard form. AoW agrees to sell certain wines (described in a schedule) to the purchaser but reserves the right to provide "substitute wines of substantially similar quality" if the seller is "unable to sell or deliver" the subject of the contract. The customer agrees to pay the purchase price by instalments. Aow says it will deliver the wine to a warehouse facility in Europe after the payment of all instalments due or the date upon which the wine is "commercially released" by the

European distributor whichever is later. The wines are not matured at the time the contract is entered into and, in any event, cannot be delivered to the United States customers because of American import restrictions. Therefore, upon "delivery" after the instalment payments have been made, the wines are held in a European warehouse for the order of the customer, who bears the storage cost.

These are long term contracts. In a typical example, a contract entered into in 2002 provides for a final instalment payment in 2011.

After Hurricane Ivan in September, 2004, Paradigm moved its operations to the United Kingdom. It says it did so temporarily, with an intention of returning to the Cayman Islands but the appointment of the Provisional Liquidator intervened. The records of Paradigm in the possession of the Provisional Liquidator are fragmentary. The efforts of the Liquidator have not been well funded and he has been unable to recover anything approaching a complete set of financial records.

The records which do exist establish that many, although by no means all, of the customers purchasing wine from AoW were doing so for investment purposes. Mr. Middlemiss himself says (paragraph 18, first affidavit): "it is extremely common for the AoW customers to treat the wine as an investment rather than as a purchase for personal consumption." The wine could neither be imported into the United States nor consumed there. Many of the purchases involved quantities far in excess of what one wine fancier could reasonably be expected to consume. The dollar value of the purchases varies

considerably, but a substantial majority of the amounts seem to fall in the $1,000 to $10,000 range. A large number of letters of complaint from unhappy purchasers have been entered in evidence. In general, these letters demonstrate that the purchases were made for investment purposes. A number of the purchasers were elderly; quite a few complain of not being able to afford the investment. (Not all of the purchasers who wrote letters of complaint made their initial purchase from AoW. A number made their purchases from Seed International, which was conducting a similar business, and accepted AoW's offer to fulfil Seed's obligations after the demise of the latter.)

Not only were the wine forward contracts being entered into by purchasers for the dominant purpose of investment, but the wine was being promoted by AoW as an investment. Mr. Russell Talbot, who worked for AoW as a salesman, said:

> "I was employed to sell wine purchased by Architects of Wine Limited ("AoW") … My responsibility was to contact persons on a list supplied by my employer and offer to sell them contracts to purchase wine being produced by a number of wine producers in Europe. The contact list consisted of persons largely in the medical profession in the United States of America. … This wine would be stored in a warehouse in Switzerland for the purchaser and the purchaser was given the option of either keeping the wine for himself, selling the wine to third parties or offering to sell the wine to a company known as AVE International ("AVE"). I was told by Middlemiss that AVE was an International Wine Distribution Company which might be interested in purchasing wine from AoW customers. We were also told by Middlemiss to explain to potential customers that AVE was part of the Paradigm alliance and that, while we could not promise that AVE would purchase a customer's wine, it would be in the best interests of AVE and the customer for a purchase to take place."

Customers purchasing wine from AoW were sent "bid sheets" and instructions on how to make a bid to AVE (i.e., offer to sell the wine to it). This material included a document describing the "terms and conditions of offer and sale" which specified that AVE was not obliged to accept any offer of sale to it. With the consent of the customer, AoW was providing to AVE the name and contact details of the purchaser.

Richard Cranswick, the Paradigm accountant, says that in 2004 "AVE was increasingly contracting to buy wines from AoW customers and there were no funds available to my knowledge to pay for these contracts." Mr. Middlemiss notes (paragraph 25, first affidavit) that of 735 customers who entered into contracts to purchase from AoW, 690 requested that AoW provide their contact details to AVE It "received offers" from 575 of these and accepted bids from 462. The average aggregate value of the sale price to AVE in this group was 3,173 euros. Mr. Talbot, in his second affidavit (paragraph 4) asserts that … "in conversations with sales staff Middlemiss clearly and repeatedly stated that, not only would it be in the best interests of all parties concerned for such purchases to take place, but that in fact the availability of a pool of bottle-aged wine owned by AoW customers, to which AVE had access, was indeed central to AVE's strategy to become a significant supplier of wine to the retail trade in the U.S.A. and elsewhere in the world."

The first affidavit of Robert Middlemiss was filed December 30, 2004. On May 2nd and 3rd, 2005 Mr. Middlemiss gave oral evidence before me. By this time, the question of whether Aow and AVE were trading in securities had become an issue. Some of his answers in oral evidence contradict aspects of his first affidavit. For example, when

asked about the "selling point" to customers, Mr. Middlemiss said: "they weren't investing, they were buying wine" (May 2nd, 2005 page 16).

The evidence given by Mr. Middlemiss was highly argumentative, at times unresponsive, and entirely lacking in objectivity. Where his oral evidence contradicts something in his first affidavit, I find the latter to be more reliable.

During the period when he established the AoW and AVE business plans, Mr. Middlemiss was alive to the question of possible violations of securities legislation. He says he received two legal opinions on the matter, at considerable cost: one from Coudert Brothers LLP dealing with the various securities laws at the state level in the United States, and an opinion from Walkers concerning possible contravention of the *S.I.B. Law*. Mr. Middlemiss says that Coudert Brothers advised him in writing that the proposed business plan would not contravene any securities laws in 48 of the 50 states. He was advised to refrain from selling in two states with particularly broad definitions of a securities transaction, which he did.

The difficulty with this piece of evidence is that the Coudert Brothers opinion has never been produced. Despite being aware of its crucial significance to this proceeding for a period of several months, Mr. Middlemiss has not produced a copy of it. He has testified that he cannot locate his copy, and that Coudert Brothers will not produce another unless and until their account for legal fees is paid. It seems unlikely that a document of this importance (which cost almost US $200,000 to produce) could be misplaced.

The Walkers opinion is in evidence. It concludes that the wine forward contracts are not securities within the meaning of the *S.I.B. Law*. I will return to that subject later.

A number of securities commissions in the United States take the opposite view.

On March 4th, 2004 the State of Arkansas Securities Commissioner issued a cease and desist order directed to Architects of Wine (and others) which concludes that the wine forward contracts are investment contracts and therefore securities under Arkansas law.

On July 29th, 2004 the Commissioner of Securities for the State of West Virginia concluded that AoW was selling unregistered securities in that state; it issued a cease and desist order.

On August 13th, 2004 the office of the Comptroller of Currency in the United States Department of the Treasury said it had received information regarding enforcement actions taken by "multiple state regulatory authorities" against AoW for the sale of unregistered securities using unlicensed persons. It issued a "nationwide bank alert" regarding AoW.

On March 18th, 2005, the Secretary of State for the State of Mississippi concluded that AoW was offering and selling unregistered securities in that state; it issued a cease and desist order.

The Arkansas ruling cites prior rulings by regulatory officials in Wisconsin, Iowa, North Dakota, Arizona, Kansas, and Mississippi to the same effect. AoW was not a respondent in these other jurisdictions; however, the regulatory bodies were considering similar wine sale schemes.

The regulatory orders I have mentioned were made *ex parte*. Mr. Middlemiss said that AoW has asked for a review of each of the orders but the first hearing (in West Virginia) occurred only after the Provisional Liquidator was installed and he made no effort to present AoW's case. Given that a period of some nineteen months elapsed between the time of the Arkansas ruling and the installation of the Provisional Liquidator, and considering that the regulatory ruling struck at the heart of AoW's business plan, I find it surprising that the ruling (and the other similar rulings) were not challenged more aggressively.

The S.I.B. Law

Paradigm, Architects of Wine Limited, AVE International Limited, and AVE North America Limited are companies incorporated in the Cayman Islands. Much of the business of AoW and AVE was conducted from Grand Cayman Island at all material times. None of these entities was registered to carry on securities investment business under the *S.I.B. Law*.

No person may carry on or purport to carry on a securities investment business unless that person is licensed under the *S.I.B. Law* or is exempt: section 5 (1), *S.I.B. Law*. The exemptions, which are set out in the fourth schedule to the *S.I.B. Law*, are not material. In this regard, I accept the affidavit evidence of Mr. Russell Talbot to the effect that the AoW sales people were never asked to scrutinize the financial sophistication or net worth of their potential customers. There is no reliable evidence that AoW attempted to confine its sales of wine to persons who are financially "sophisticated" or possess a high net worth: see fourth schedule, section 4, *S.I.B. Law*.

A person carries on a securities investment business in the Cayman Islands if it has established a place of business in the islands which engages in any one or more of the activities described in the second schedule to the *S.I.B. Law*; the third schedule describes excluded activities.

Section two of the second schedule provides:

> "the following activities are activities carried on in the course of securities investment business for the purposes of this law - …
>
> 2. Arranging deals in securities
>
> Making arrangements with a view to –
>
> (a) another person (whether as a principal or an agent) buying, selling, subscribing for or underwriting securities; or
>
> (b) a person who participates in the arrangements buying, selling, subscribing for or underwriting securities."

Clearly, this definition catches the activities of AoW and AVE if the wine forward contracts are "securities."

"Securities" means assets, rights or interests specified in the first schedule: *S.I.B. Law*, section 2.

Sections 6 to 12 inclusive of the first schedule of the *S.I.B. Law* define the type of security known as a futures contract. *Prima facie*, the wine forward contracts are caught by section 6, which reads:

> "rights under a contract for the disposal of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed upon when the contract is made other than a contract made for commercial and not investment purposes." (underlining added)

Wine is a commodity. The wine forward contracts give rights to the customer to dispose of the commodity. Delivery is to be made at a future date, but the price is agreed upon when the contract is made. Thus, unless the contract is one made for "commercial" and not "investment" purposes, the wine forward contract is deemed by section 6 to be a security.

Sections 7 and 8 of the first schedule contain specific provisions which are not material here. Sections 9 to 12 contain guidance for classifying a futures contract as one for commercial or investment purposes and read:

> 9. "The following are indications that a contract not falling within paragraph 7 or 8 is made for commercial purposes and the absence of them is an indication that it is made for investment purposes –

(a) one or more of the parties is a producer of the commodity or other property or uses it in his business; or

(b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it.

10. It is an indication that a contract is made for commercial purposes that the prices, the lot, the delivery date or other terms are determined by the parties for the purposes of the particular contract and not by reference (or not solely by reference) to regularly published prices, to standard lots or delivery dates or to standard terms.

11. The following are indications that a contract is made for investment purposes –

(a) it is expressed to be as traded on a securities exchange;

(b) performance of the contract is ensured by a securities exchange or a clearing house; or

(c) there are arrangements for the payment or provision of margin.

12. For the purposes of paragraph 6, a price is to be taken to be agreed on when a contract is made –

(a) notwithstanding that it is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract; or

(b) in a case where the contract is expressed to be by reference to a standard lot and quality, notwithstanding that provision is made for a variation in the price to take account of any variation in quantity or quality on delivery."

AoW is not a producer of the wine and does not "use" the wine in its business in the sense intended by section 9 (a).

No delivery of the wine is made at the time the contract is entered into. Does AoW intend to "deliver" the wine and do the purchasers intend to take delivery of it?

No purchaser may take delivery of the wine in the United States. The quantities purchased and the cost of the purchases suggest that most customers are buying the wine for investment. Mr. Middlemiss says that treating the wine as an investment "is extremely common." The letters of complaint from unhappy purchasers confirm this. Potential customers were encouraged to think that AVE would purchaser the wine from them later on; of one group of 735 customers, over half sold their wine forward contract to AVE. On balance, I am satisfied that a large majority of the purchasers did not intend to take delivery of the wine and AoW did not intend them to do so.

Thus, each of the two "indications" that the contract is made for investment purposes set out in section 9 of the first schedule have been established.

Section 10 of the first schedule describes a number of factors which will point to a conclusion that a contract is made for commercial purposes. These turn on how the essential terms of the contract are determined by the parties. There is not enough evidence before me to permit a conclusion on whether these factors are present or absent.

Section 11 of the first schedule describes some further indications that a contract is made for investment purposes; these have no application to the wine forward contracts.

There are a number of specific exemptions provided in the third schedule to persons who would otherwise be caught by the terms of the *SIB Law*. None of these have application to the activities of AoW and AVE.

The *SIB Law* is essentially consumer protection legislation, designed to protect the investing public. It requires persons engaged in the business of selling securities to register under the law and to abide by the regulatory regime established under it. The intent of the legislation is remedial. For these reasons, the legislation should be construed broadly. When determining whether a certain business activity is caught by the law, the emphasis must be on substance not form.

As I have already found, a large majority of the customers purchased wine forward contracts with the intention of reselling. They had an expectation of profit. That profit would come, if it came at all, from the efforts of Mr. Middlemiss and AoW. The customer played only a passive role; after committing to put up the money, he had no further ability to influence the outcome. If he was able to sell a wine forward contract at a higher price and realize a profit, that would be owing to the efforts of Middlemiss, AoW and the European wine producers.

Middlemiss and AoW, for their part, relied upon customers to supply the capital which they then invested in the production facilities. The future value of the wine forward contracts depends upon the wisdom of the investment decisions by AoW and Middlemiss, the abilities and business practices of the European wine producers in question, and luck.

These are the important elements of substance in the relationship between AoW, AVE and their customers. Collectively, they establish the true nature of the relationship: the customers are investors of capital and AoW reinvests that capital with a view to making a profit for all. The only thing of substance delivered to the investor is the wine forward contract itself, which he intends to resell. The fact that it evidences title to wine produced and stored in a European warehouse is unimportant. The wine forward contract itself is the real object of the transaction. These are the hallmarks of securities trading; the wine forward contract is a security within the meaning of the *SIB Law*. In reaching this conclusion, I have derived considerable assistance from the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange of Canada Ltd. et al v. Ontario Securities Commission [1978]* 2 SCR 112.

The Walkers opinion is relatively abbreviated. It proceeds on the assumption that AoW and its customers intend that the customer will take delivery of the wine. It also assumes that the wine forward contracts are an incidental part of a broader business carried on by AoW. Undoubtedly, the opinion is based (as it must be) upon assumptions of fact provided by Walkers' client. For the reasons I have already given, these factual assumptions are incorrect.

Is it just and equitable to wind up Paradigm? Two of its subsidiaries have been pursuing a business plan which amounts to trading in securities, in violation of the law of the Cayman Islands. In September, 2004, after Hurricane Ivan, the operations of AoW and AVE were transferred to the United Kingdom. The assets of these entities and all but one

of their employees have left the country. AoW is prohibited from selling wine in a number of American states by regulatory action taken there. The Provisional Liquidator has formed the view that some 9.2 million euros owing to customers who have sold their wine to AVE will not be paid due to insufficient funds. He says that proper books of account have not been maintained and it is impossible at present to determine the financial position of the group. Based on the current records in his possession (which are far from complete), the Provisional Liquidator is of the view that Paradigm, AoW and AVE are insolvent.

These are matters which require a full investigation. That is one of the traditional reasons for making a winding up order under the just and equitable ground: see *Palmer's Company Law*, Volume I, London, 1976, page 887; and *Re Peruvian Amazon Co. (1913)* 29 TLR 384. Moreover, it seems likely that the main objects for which AoW and AVE were formed have become impracticable, so that the substratum of these entities and the parent holding company are gone. That is another of the traditional justifications for invoking the just and equitable ground.

This is a creditor's petition but the evidence does not establish with clarity that Strathvale has a provable claim. Another creditor, Mrs. Ida Brown, appeared at the hearing of the petition and gave evidence in support of it. She testified that she was one of Paradigm's landlords. She said that rent was past due before Hurricane Ivan and is still due and owing now. She has demanded payment, and was told that Paradigm would be prepared

to pay her in "small instalments." However, they have made no payments at all. I accept this evidence.

Where there is doubt about the standing of the petitioning creditor, the court has jurisdiction to substitute a different creditor whose claim to standing is clear: see Halsbury's Fourth Edition, volume 3 (2), paragraph 182 and 183. Strathvale and Mrs. Ida Brown should apply for an order for substitution of petitioner forthwith.

I order that Paradigm be wound up and appoint Mr. Christopher Johnson and Mr. Russell Smith as Official Liquidators. I direct that the Official Liquidators proceed to sell the wine inventory. The cross-summons by Paradigm is dismissed.

Dated this 1st day of September, 2005

Henderson, J.

Henderson, J.
Judge of the Grand Court

GRAND COURT - CAYMAN ISLANDS