

1 **IN THE GRAND COURT OF THE CAYMAN ISLANDS**

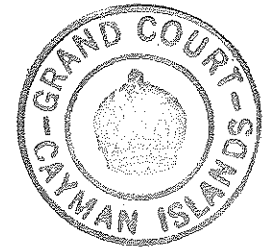
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3 **FINANCIAL SERVICES DIVISION**

4 **Cause NO. FSD 27 OF 2013 – AJJ**

5 **The Hon Mr Justice Andrew J. Jones QC**  
6 **In Chambers, 28 January 2014**

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9 **IN THE MATTER OF THE COMPANIES LAW (2013 REVISION)**

10 **AND IN THE MATTER OF HERALD FUND SPC**



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12 **Appearances: Mr Matthew Goucke of Walkers on behalf of the Principal Liquidators**

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**RULING**

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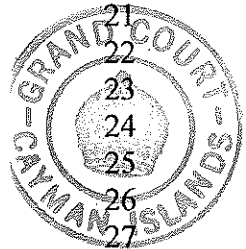
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18  
19 1. Herald Fund SPC (“Herald”) was incorporated as a segregated portfolio company in 2004  
20 and carried on business as an open ended investment fund. It was promoted by Bank  
21 Medici AG, which is a small Austrian bank, 75% owned by Mrs Sonja Kohn and 25%  
22 owned by UniCredit Bank Austria AG, a subsidiary of the Italian banking and financial  
23 services group, UniCredit SpA. Practically all of Herald’s assets were placed under  
24 management with Bernard L. Madoff Investment Securities LLC (“BLMIS”) which  
25 turned out to be an enormous “Ponzi scheme”. BLMIS was put into liquidation in the  
26 United States in December 2008 and continues to be under the control of a court  
27 appointed trustee (“the Trustee”). Herald’s business collapsed overnight as a result of the  
28 discovery of the Madoff fraud, but it continued to be managed under the supervision of  
29 its independent directors until 16 July 2013 when it was put into compulsory liquidation  
30 by order of this Court. The winding up order was made on a contributory’s petition on the  
31 uncontested assumption that Herald is solvent. Following further lengthy argument, the  
32 Court made an order on 23 July 2013 by which two firms of professional insolvency  
33 practitioners were appointed as joint official liquidators. Mr Michael Pearson of Fund  
34 Solutions Services Limited (“the Additional Liquidator”) was appointed to carry out the  
35 limited role of settling the list of contributories and determining various related issues,  
36 including the question whether Herald’s share register should be rectified.<sup>1</sup> Messrs

<sup>1</sup> Section 112(2) of the Companies Law and Order 12, rule 2 of the Companies Winding Up Rules (“the CWR”) provide for the rectification of share registers in circumstances where shares have been issued and redeemed at prices based upon mis-stated NAVs which are not binding upon the company and its shareholders by reason of fraud or default.

1 Russell Smith and Niall Goodsir-Cullen of BDO CRI (Cayman) Ltd (“the Principal  
2 Liquidators”) were appointed to perform all the other duties and responsibilities relating  
3 to the liquidation.

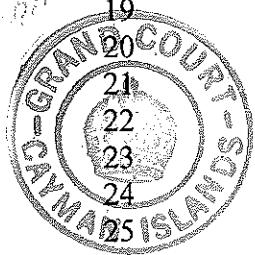
4 2. This is an application by the Principal Liquidators, made by a letter to the Court dated 23  
5 December 2013, for an order sanctioning the establishment of a liquidation committee in  
6 a manner which does not comply with the requirements of CWR Order 9, rule 1(6). They  
7 are also seeking a consequential direction that rule 5(8) be dis-applied. The Principal  
8 Liquidators have made a certification of “doubtful solvency” for the purposes of CWR  
9 Order 9, which means that the liquidation committee (if any) must be composed of not  
10 less than three nor more than six members, of whom a majority shall be creditors elected  
11 at a meeting of creditors and at least one of whom shall be a contributory (shareholder)  
12 elected at a meeting of contributories. The Principal Liquidators now seek a direction  
13 sanctioning the establishment of a non-compliant committee composed of one creditor  
14 and four contributories. I have come to the conclusion that the Court has no jurisdiction  
15 to dis-apply the mandatory requirements of CWR Order 9 and so this application must be  
16 dismissed, with the result that the Court should go on to consider whether or not to make  
17 a direction pursuant to rule 1(1) dispensing with the need to establish any liquidation  
18 committee at all.

19 3. For obvious reasons, the composition of liquidation committees is driven by the financial  
20 status of the liquidation at the time when the committee is established. CWR Order 9,  
21 rule 1 provides that when a company is certified as solvent its committee must be  
22 comprised of contributories (shareholders) and when it is certified as insolvent its  
23 committee must be comprised of creditors. CWR Order 8, rule 1 provides that the official  
24 liquidator shall summarily determine whether or not a company should be treated as  
25 solvent, insolvent or of doubtful solvency for the limited purpose of determining the  
26 composition of the liquidation committee and the composition of the meeting(s) by which  
27 the committee is elected. Inevitably, liquidators are called upon to make such  
28 determinations at a very early stage when it may well be apparent that the final outcome  
29 of the liquidation will turn upon the resolution of a myriad of different contingencies. The  
30 Rules make allowance for this situation in the following way. First, the liquidator may  
31 make a determination of “doubtful solvency” which is, in effect, a provisional  
32 determination which will hold good so long as the circumstances prevent a liquidator  
33 from expressing a firm opinion about the most likely final outcome. Second, the  
34 liquidator must keep his initial determination under review. Rule 1(2) provides that “If  
35 and when the official liquidator considers that his initial determination about the  
36 company’s solvency may no longer be justified, he shall re-consider the matter and may  
37 change his determination if he considers that it is appropriate to do so.” When an official  
38 liquidator does change his determination, the consequence is that the composition of the  
39 company’s liquidation committee must be changed accordingly. So long as a liquidator’s  
40 certification of “doubtful solvency” remains in effect, CWR Order 9, rule 1(6) requires  
41 that its liquidation committee shall comprise not less than three nor more than six  
42 members, of whom a majority shall be creditors elected at a meeting of creditors and at  
43 least one shall be a contributory (shareholder) elected at a meeting of contributories.



1 4. The policy underlying these rules is clear. If, and so long as, a company in liquidation is  
2 properly considered to be insolvent in the sense that the amount of its liabilities is thought  
3 to be greater than the realizable value of its assets, its shareholders have no financial  
4 interest and therefore should not be allowed to influence the conduct of the company's  
5 liquidation as members of its liquidation committee. Conversely, ordinary creditors  
6 should be excluded from participation when a company is properly considered to be  
7 solvent in the sense that they will be paid in full in any event (though not necessarily on  
8 the date when their debts fall due) because the realizable value of the company's assets is  
9 properly considered to be greater than the amount of its liabilities. A company in  
10 liquidation will be considered to be of "doubtful solvency" for the purposes of CWR  
11 Order 9 if, at any given time, its official liquidator is of the opinion that the final outcome  
12 is no more or less likely to be solvent or insolvent, having regard to the likely resolution  
13 of some particular contingency or the likely outcome of a combination of different  
14 unrelated contingencies. In these circumstances the rules require that both creditors and  
15 contributories (shareholders) should be represented on the liquidation committee, with  
16 the creditors having a majority, unless and until changes in circumstances enable the  
17 official liquidator to reach a positive opinion about the most likely outcome, whereupon  
18 the committee must be reconstituted. The Court no longer has any discretionary power to  
19 depart from this policy. As originally enacted, CWR Order 9, rule 1(7) empowered the  
20 Court to make directions "permitting the establishment of a liquidation committee with a  
21 fewer number of members or a different combination of creditors and contributories."  
22 However, this rule was revoked by the Companies Winding Up (Amendment) Rules  
23 2013. Counsel for the Liquidators argues that the Court retains an inherent jurisdiction to  
24 make a direction in these terms as if the rule had not been revoked. In my view this  
25 argument is untenable. The Court's inherent power can be exercised to supplement the  
26 Companies Winding Up Rules in a way which is not inconsistent with their overall  
27 scheme. It cannot be said that the Court has an inherent power, if the exercise of that  
28 power would amount to re-instating a statutory power which the legislature or rule  
29 making authority, in this case the Insolvency Rules Committee, has seen fit to revoke.  
30 See *Re HSH Cayman I GP Limited-v- ABN Amro Bank NV* [2010(1)] CILR 114 at  
31 paragraphs 21-26. For these reasons, I have come to the conclusion that I have no  
32 jurisdiction to make an order dispensing with Order 9, rule 1(6) and/or sanctioning the  
33 establishment of a liquidation committee, the composition of which would contravene the  
34 express mandatory requirements of the rule. In these circumstances, it seems to me that I  
35 should go on and treat this as an application under rule 1(1) by which the Court may  
36 make a direction dispensing with the need to establish any liquidation committee at all.

37 5. The reason why it has not been possible to establish a compliant liquidation committee  
38 stems from the Principal Liquidators' certification of "doubtful solvency". If they had  
39 made a certification of "solvency", a liquidation committee composed of four  
40 contributories could have been established. In deciding whether or not to make a  
41 direction that no liquidation committee be established at all, it seems to me that the Court  
42 should consider, *inter alia*, whether to direct the Principal Liquidators to re-consider their  
43 analysis of Herald's financial position in accordance with CWR Order 8, rule 1(2). The  
44 Principal Liquidators have to ask themselves whether Herald is, or is likely to become  
45 solvent or insolvent, applying a balance sheet test, and making reasonable assumptions



1 about assets and liabilities which are contingent or contingent in amount.<sup>2</sup> Apart from a  
2 small amount of cash, Herald's assets comprise (a) the customer claim filed in the  
3 liquidation of BLMIS, which is subject to the Trustee's "clawback" (preference) claims  
4 and (b) claims asserted against its custodian, HSBC Securities Services (Luxembourg)  
5 SA ("HSSL"). There are no ordinary creditors (apart from the Petitioner's claim for the  
6 costs of the petition). However, subordinated creditor claims for about \$193 million have  
7 been made by unpaid redeemed shareholders. In order to determine whether Herald's  
8 liquidation committee should comprise creditors or contributories (shareholders) or a  
9 combination of both, the Principal Liquidators have to make reasonable assumptions  
10 about the most likely outcomes of the various contingencies, based upon the relevant  
11 circumstances as they presently exist. They have to undertake this exercise, albeit only in  
12 a summary manner, no matter how difficult it may appear to them. A certification of  
13 "doubtful solvency" is not a fall-back position which can be adopted in any case of  
14 difficulty without actually conducting any proper analysis of the likely outcome of the  
15 liquidation.

- 16
- 17 6. The US Bankruptcy Court has decided that investors' claims against the BLMIS estate  
18 must be made on a "net equity" basis and this decision has been upheld on appeal. What  
19 this means is that the dishonestly inflated balances in the statements of account issued by  
20 BLMIS are ignored and investors are limited to claiming the difference between the total  
21 cash invested and the total cash repaid. Applying this methodology, Herald has a claim  
22 for about \$1.15 billion.<sup>3</sup> However, no dividend will be paid in respect of this claim unless  
23 the Trustee's "clawback" (preference) claims are first properly accounted for in  
24 accordance with the applicable law. The Trustee has asserted three clawback claims, the  
25 most significant of which is the claim for repayment of \$537 million representing the  
26 total of the sums paid out by BLMIS to Herald during the 90 days immediately preceding  
27 the commencement of its liquidation. Herald has a possible defence to this claim under  
28 the applicable US law (referred to as "the safe harbour defence") but for present purposes  
29 it seems to me that it would be reasonable for the Principal Liquidators to assume that the  
30 Trustee makes good his claim. The other two preference claims are less significant in  
31 amount (about \$25.8 million and \$14.7 million) and would, I think, depend upon  
32 establishing (as a matter of US law) that the (alleged) fraud of Mrs Sonja Kohn (who was  
33 allegedly involved in the management of Herald) can be imputed to the company. For  
34 present purposes, it seems to me that it would be reasonable for the Principal Liquidators  
35 to assume that the Trustee will not make good these two claims. If and when the "90 day  
36 clawback obligation" (\$537 million) is satisfied, it increases the fund available for  
37 distribution to BLMIS' creditors as a whole (including Herald) and also increases the  
38 value of Herald's own claim, dollar for dollar. In broad terms, it may be reasonable to

<sup>2</sup> The proposition that contingent liabilities should be ignored for these purposes was firmly rejected in *Re AWAL Finance Company Limited* [2011(1)] CILR 487.

<sup>3</sup> The application of the net equity methodology in Herald's case is slightly complicated by its transactions with Primeo Fund (In Liquidation) ("Primeo"). Primeo was an investor with BLMIS. In June 2007 its investment was transferred on the books of BLMIS to Herald, in consideration for the issue by Herald of shares to Primeo. This transaction was done at the inflated book value, with the result that it is only the net cash value of Primeo's investment, as at that date, which is taken into account as cash invested by Herald. One of the functions of the Additional Liquidator is to determine how this transaction should now be treated on the books of Herald in the light of the Madoff fraud.

1 assume that the most likely overall economic result is that Herald will have a claim for  
2 about \$1.7 billion, subject to satisfying a clawback claim of \$537 million plus interest.  
3 On the basis of the information published in the Trustee's reports, the Principal  
4 Liquidators may reasonably expect the ultimate dividend to be in excess of 50 cents in  
5 the dollar. This suggests that Herald's claim is worth as much as \$300 million.<sup>4</sup> Whilst  
6 the Trustee is considered to be a contingent creditor of Herald today, because the  
7 clawback claims have not yet been adjudicated, I do not think that he can be treated as a  
8 creditor or contingent creditor for the purposes of the CWR Order 8 determination, if the  
9 present assessment of the most likely overall outcome is that Herald will be recognised as  
10 a net creditor of BLMIS in the sum of \$300 million or thereabouts. The Principal  
11 Liquidators' Second Report and Mr Russell Smith's second affidavit do not contain any  
12 indication of the way this matter was analysed.  
13

14 7. The action against HSSL was commenced in Luxembourg in 2009 upon the authority of  
15 Herald's board of directors, long before the commencement of the liquidation. It  
16 comprised a restitution claim in respect of securities which HSSL valued at about \$2  
17 billion as at 30 November 2008 and also claims for damages for breach of contract and/or  
18 negligence. The damages claims were stayed and the action proceeded to trial on the  
19 restitution claim alone. The Luxembourg court handed down judgment in favour of  
20 HSSL in March 2013. In brief summary, it held that HSSL had an obligation of  
21 restitution in respect of assets deposited with HSSL, but HSSL has no corresponding  
22 restitution obligation for assets sub-deposited with BLMIS. Since the whole of the assets  
23 had been sub-deposited by HSSL with BLMIS, Herald's restitution claim was dismissed.  
24 This decision is now subject to appeal. However, even if the appeal is decided against  
25 Herald, the claims for damages remain open because it was held that, as a result of sub-  
26 depositing the assets with BLMIS, HSSL owed a heightened duty of care to Herald to  
27 monitor and supervise BLMIS. Assuming that the Principal Liquidators consider that  
28 Herald does still have a good arguable case for damages which ought to be pursued, it  
29 may be that some value should be put on it for the purposes of their CWR Order 8  
30 determination. Their evidence before the Court suggests that no such evaluation has been  
31 conducted.  
32

33 8. Apart from the expenses of the liquidation and the Petitioner's costs of the petition, the  
34 only other creditor claims asserted against Herald are in respect of the so-called  
35 "December Redeemers." These are shareholders whose shares were redeemed at the 30  
36 November 2008 NAV which was published immediately before the discovery of  
37 Madoff's fraud. Herald's NAV was materially overstated because practically the whole  
38 of its assets had been placed under management with BLMIS since its inception in 2004.  
39 Resolution of the issues relating to the claims of the December Redeemers falls within  
40 the scope of the Additional Liquidator's responsibility, with the result that the Principal  
41 Liquidators should rely upon his opinion to the extent that it is relevant to their  
42 determination of solvency/insolvency for the purposes of CWR Order 8. Based upon the  
43 opinion of leading counsel, the Additional Liquidator's view (expressed in paragraph  
44 54.4 of his First Report dated 16 January 2014) is that the December Redeemers should

<sup>4</sup> \$1.7 billion x 50% = \$850 million, less \$537 million = \$313 million, subject to a downward adjustment in respect of interest on the clawback claim.

1 be treated as shareholders, not subordinated creditors. If the Principal Liquidators had had  
2 the benefit of this Report at the time when they made their initial determination, they  
3 would not have assumed that the Decemblers Redeemers' creditor claims totalling about  
4 \$193 million would most likely be admitted to proof.  
5

6 9. For these reasons, I have come to the following conclusions.  
7

8 (1) The Principal Liquidators' original application must be dismissed because this Court  
9 has no jurisdiction to dis-apply CWR Order 9, rules 1(6) and 5(8) and sanction the  
10 establishment of a liquidation committee, the composition of which does not comply  
11 with the express requirements of the Rules.  
12

13 (2) It follows that no liquidation committee has been validly established, with the result  
14 that the Court must go on to consider, under CWR Order 9, rule 1(1), whether or not  
15 to dispense with the requirement to establish a liquidation committee at all.

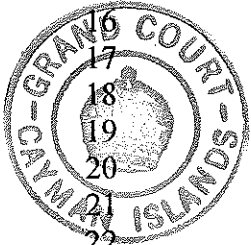
16 (3) The Court will not make an order dispensing with the need to establish a liquidation  
17 committee in this case because the inability to establish a compliant committee arises  
18 solely from the Principal Liquidators' certification of "doubtful solvency" and the  
19 evidence suggests that they did not conduct their determination properly. Instead of  
20 asking themselves whether Herald is, or is likely to become solvent or insolvent on a  
21 balance sheet test, making reasonable assumptions about the various contingencies  
22 based upon the circumstances known to them at the time, they appear to have  
23 regarded "doubtful solvency" as the default position which can be adopted in any  
24 case of difficulty or uncertainty. This was the wrong approach.  
25

26 (4) The Principal Liquidators appear to have thought that it was unnecessary for them to  
27 take any view about the most likely outcome of Herald's claim in the BLMIS  
28 liquidation and the Trustee's related clawback claims. If they had done so, it seems to  
29 me that they may well have concluded that it would be reasonable to assume that  
30 BLMIS is a net debtor.  
31

32 (5) The Principal Liquidators should rely upon the judgment and determinations of the  
33 Additional Liquidator in respect of matters falling within his exclusive responsibility  
34 and outside their own responsibility. Having apparently assumed that the  
35 subordinated creditor claims would most likely be admitted in full, they must now  
36 reconsider the appropriateness of this assumption in the light of the Additional  
37 Liquidator's Report which suggests that the subordinated creditor claims are most  
38 likely to be rejected.  
39

40 (6) For these reasons the Court will direct the Principal Liquidators to reconsider their  
41 determination of "doubtful solvency", as they are entitled to do under CWR Order 8,  
42 rule 2.  
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44 (7) If, having reconsidered the matter, the Principal Liquidators are of the opinion that  
45 Herald should be regard as being "solvent" for the purposes of CWR Order 9, they  
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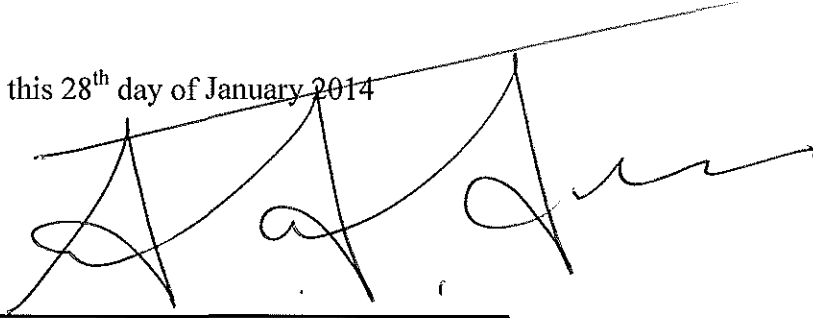


1 should certify the establishment of a liquidation committee comprising the four  
2 contributories (shareholders) elected at the first meeting of contributories held on 17  
3 September 2013.

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5  
6 (8) The Principal Liquidators' costs of the application should be paid out of the assets as  
7 an expense of the liquidation.  
8

9  
10 Dated this 28<sup>th</sup> day of January 2014

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15 **The Hon. Mr Justice Andrew J. Jones, QC**  
16 **JUDGE OF THE GRAND COURT**

