IN THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION

CAUSE NO FSD 27 OF 2013 – AJJ

Before the Honourable Mr Justice Andrew J. Jones QC
In Open Court, 18 and 19 July 2016

IN THE MATTER OF THE COMPANIES LAW (2013 REVISION)
AND
IN THE MATTER OF HERALD FUND SPC (IN OFFICIAL LIQUIDATION)

BETWEEN

MICHAEL PEARSON
(as Additional Liquidator of Herald Fund SPC (in Official Liquidation))

Plaintiff

and

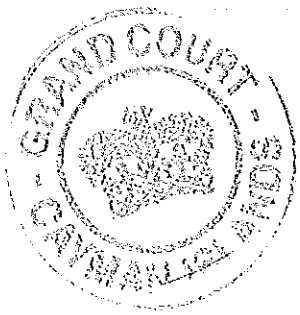
PRIMEO FUND (IN OFFICIAL LIQUIDATION)

Defendant

Appearances:
Rt. Hon. Lord Goldsmith QC and Francis Tregear QC instructed by Matthew Goucke and Chris Keefe of Walkers on behalf of the Additional Liquidator of Herald Fund SPC (In Official Liquidation)

Tom Smith QC instructed by Peter Hayden, Rocco Cecere and Christopher Levers of Mourant Ozannes on behalf of Primeo Fund (In Official Liquidation)

## RULING




### Introduction and Factual Background

1. Herald Fund SPC ("Herald") was established and promoted by Medici Bank AG (now known as 20:20 Medici AG) as an open-ended investment fund which would place its funds for investment with Bernard L. Madoff Investments Securities LLC ("BLMIS"). It was incorporated as a segregated portfolio company (an "SPC") on 24 March 2004 and launched its business immediately thereafter pursuant to offering memoranda issued in respect of two portfolios, namely *Herald USA Segregated Portfolio One* and *Herald Europe Segregated Portfolio Two.*[1] Each portfolio issued both US$ and Euro denominated shares at an initial offer price of US$1,000 and €1,000 respectively. The Initial Offer Period closed on 1 April 2004. Thereafter, shares were issued and redeemed on each Subscription/Redemption Day at the NAV determined in respect of each portfolio as at the applicable Valuation Point. According to the Additional Liquidator's First Report, the *Herald Europe Segregated Portfolio Two* was "effectively closed down on or about 1 September 2005". For present purposes nothing turns on the fact that Herald was incorporated as an SPC and I shall refer to it simply as "Herald", without identifying or distinguishing between the segregated portfolios.

2. The Subscription/Valuation Day was the first business day of each month and the applicable Valuation Point was the last business day of the previous month. In the absence of any direct evidence on the point, it follows that the first Valuation Point must have been the last business day in April and the first Subscription/Redemption Day must have been the first business day in May 2004. There is also a provision which empowered (but did not oblige) the directors to accept subscriptions and make redemptions on the 15th of the month, with the result that they would have to declare

[1] The only offering memorandum put in evidence is dated 3 April 2008 and was issued in respect of Herald USA Segregated Portfolio One, which was the only portfolio in existence at that time. I have assumed that it does not differ from previously issued offering memoranda in any material respect.

an additional NAV for that day (referred to as a Special Valuation Point). It is my understanding that this did happen, at least in some months.

3. From the inception of Herald's business, the whole of its invested assets (which was always substantially the whole of its total assets) supposedly comprised a portfolio of marketable securities managed by BLMIS. In fact, BLMIS had become a massive *Ponzi* scheme long before April 2004 when Herald first transferred funds to it for investment. It is an agreed fact that BLMIS never bought and sold any securities at all. It is also an agreed fact that the statements of account, trade slips and other documents generated by BLMIS in respect of Herald's managed account were all bogus. The securities recorded in these documents as being held for Herald never in fact existed.

4. Herald's administrator was HSBC Securities Services (Luxembourg) SA ("HSSL") which was responsible for determining the NAVs throughout the company's active life. It is agreed that every NAV ever reported by or on behalf of Herald throughout its trading life was mis-stated by reason of fraud on the part of BLMIS. The reported NAVs reflected a profitable fund whose net asset value per share was steadily increasing as a result of a consistently positive investment performance. This picture was wholly fictitious. In reality, substantially the whole of the shareholders' subscription money was being transferred into a *Ponzi* scheme and Herald's ability to make redemptions was wholly dependent upon Madoff's fraud remaining undetected. Inevitably, Herald's business collapsed, literally overnight, when Madoff confessed to his crimes on 11 December 2008. On the following day, its directors resolved to suspend redemptions and subscriptions with immediate effect and until further notice.

5. Primeo was established and promoted by UniCredit Bank Austria AG as an open-ended investment fund which would place is funds for investment with BLMIS. It was incorporated as an exempted company on 18 November 1993 and launched its business on 1 January 1994. Primeo and Herald shared certain professional service providers. In particular, HSSL acted as administrator for both funds. Until the end of 2003, the whole of Primeo's invested funds (which comprised substantially the whole of its total assets) were placed for investment directly with BLMIS. From the end of 2003, Primeo began to subscribe for shares in another investment fund, also

established and promoted by Bank Austria, called Alpha Prime Fund Limited ("Alpha") which then placed the whole of its funds with BLMIS for investment. From August 2004, Primeo also subscribed for shares in Herald but continued to place funds for investment directly with BLMIS until 2 May 2007, when the balance standing to the credit of its managed account as at the 30 April 2007 Valuation Point (US$463,353,186.26) was assigned to Herald in consideration for the issue of 371,604.1272 USD class shares. This transaction is referred to as "the Primeo *In Specie* Subscription" and its details are described in my previous judgment dated 18 February 2016 ("the February Judgment"). Thereafter, Primeo ceased to place funds directly with BLMIS. Instead, it continued to subscribe for and redeem shares in Herald by means of cash transactions.

6. Both Primeo and Herald were always inextricably linked with BLMIS and, from 2 May 2007 onwards, the two funds became inextricably linked with each other. In effect, Primeo became a feeder fund of Herald, which was in turn a feeder fund for BLMIS. Primeo's only other investment was its relatively small shareholding in Alpha, which was itself a feeder fund for BLMIS. Inevitably, Primeo's business also collapsed overnight as a result of the disclosure of the Madoff fraud. Both Primeo's directors and Herald's directors passed resolutions on 12 December 2008 for the purpose of suspending redemptions and subscriptions. This date is referred to as "the Suspension Date".

7. Primeo's directors decided to put the company into liquidation immediately. On 23 January 2009 its investment manager, as holder of the voting shares, passed a special resolution putting it into voluntary liquidation and an order was made on 8 April 2009 that the liquidation continue under the supervision of the Court.

8. Herald's directors took a different course. They attempted to conduct what is sometimes called a "soft liquidation". This state of affairs continued until 14 February 2013 when Primeo presented a contributory's winding up petition. Following a contested hearing, a winding up order was made on 16 July 2013. By a subsequent order made on 23 July 2013, Messrs. Russell Smith and Niall Goodsir-Cullen of BDO CRI (Cayman) Ltd were appointed as joint official liquidators. They are referred to as Herald's "Principal Liquidators". At the same time, Michael Pearson of Fund

Solution Services Limited was appointed as an additional official liquidator ("the Additional Liquidator") with limited powers, as follows –

*3. The Additional Liquidator's functions shall be limited to settling the list of contributories pursuant to section 112(1) of the Companies Law and determining related issues, including whether [Herald's] register of members should be restated pursuant to section 112(2) of the Companies Law and whether [Primeo's] shareholding in [Herald] should be adjusted on the ground that the consideration for the issue of its shares was the transfer to [Herald] of the portfolio of securities and/or cash held by Primeo in its account with BLMIS, the amount or value of which had been fraudulently overstated.*

On 6 February 2014, Primeo became a member of Herald's liquidation committee.

**The Issues Before The Court and Their Procedural History**

***The general rectification issue***

9. By an order made on 24 November 2014, the Court directed (pursuant to CWR Order 11, rule 3) that certain issues arising in the liquidation of Herald be adjudicated by means of an *inter partes* proceeding between the Additional Liquidator and Primeo acting as representative parties. The list of issues included –

*(a) whether the NAVs determined pursuant to Herald's articles of association during the period from 24 March 2004 (being the date of its incorporation) and 10 December 2008 (being the date immediately prior to the revelation of the Madoff fraud) in respect of each Separate Class of Participating Non-Voting Shares issued by Herald are not binding upon Herald by reason of "fraud or default" within the meaning of Section 112 of the Companies Law and Order 12, rule 2(1) of the Companies Winding Up Rules; and*

*(b) whether Section 112 of the Companies Law and/or Order 12, rule 2(1) of the Companies Winding Up Rules apply so as to require or empower the Additional Liquidator of Herald to rectify Herald's register of members.*

Primeo was appointed as representative of the class of Herald investors arguing that these issues should be determined in the negative and the Additional Liquidator was appointed as representative of the class arguing that they should be determined in the affirmative.

10. The Court dealt with these issues only partially in its judgment delivered on 12 June 2015 ("the June Judgment"). It was held that the mis-stated NAVs determined by HSSL on behalf of Herald are binding as a matter of contract as between Herald and

its shareholders with the result that unpaid redeemed shareholders (described as "the December Redeemers") are entitled to prove in the liquidation as creditors. However, the Court went on to make the following findings which left open the question whether the register of members should be re-stated and rectified amongst those recorded on the register as shareholders of Herald as at the commencement of the liquidation pursuant to section 112(2) of the Companies Law (2013 Revision) –

*47. I now go on to consider whether the Additional Liquidator can properly exercise the power of rectification created by section 112(2) even though Rule 2 is not engaged. Primeo's case is that it is implicit that if the conditions specified in Rule 2 are not satisfied, the Additional Liquidator should not exercise the power. However, it seems to me that the existence of a rule which imposes a duty to exercise a statutory power in a particular circumstance, does not necessarily lead to the conclusion that it is the only circumstance in which the power ought to be exercised or is capable of being exercised. The language used in section 112(2) is unqualified. It does not contain anything to suggest that the power of rectification is limited to the one specific scenario stated in Rule 2. If the scope of the power was intended to be limited in this way, one would have expected the draftsman to have said so in the statute itself.*

*48. Rectification of Herald's register in order to do justice amongst those recorded as members as at the commencement of the liquidation would not be inconsistent with the policy considerations expressed by Lord Sumption in Fairfield Sentry. There are obviously sound reasons why a company and its shareholders should be allowed to agree that throughout its trading life the directors' determination of the NAV shall be binding so long as they are acting in good faith, but it seems to me that different policy considerations come into play after the commencement of a compulsory winding up proceeding. It seems to me that Section 112(2) contemplates the possibility of rectifying the register, if necessary, to eliminate or ameliorate the consequences of both "internal" and "external" fraud. Rule 2 sets out what must happen in the case of internal fraud or default having the result that the issue and/or redemption of shares is not binding on the company and its members. It leaves open what is to happen in the case of "external fraud" which has the result that issues and/or redemptions of shares based upon mis-stated NAVs are nevertheless binding upon the company and its members as a matter of contract. Empowering the official liquidator to rectify the register only amongst those who are shareholders as at the commencement of the liquidation does not give rise to commercially unacceptable results of the kind described by Lord Sumption in Fairfield Sentry. A rectification of the register pursuant to section 112(2) would not have any effect upon the December Redeemers, for example, who are entitled to prove in the liquidation as creditors.*

*51. The statutory power created by section 112(2) is a power to rectify the register. It does not enable the Additional Liquidator to impose upon Herald's shareholders a scheme of distribution which is inconsistent with the requirements of section 140(1) of the Companies Law. In other words, the distribution methodology is fixed by the statute, but it is left to the official liquidator to determine what rectification methodology (and associated valuation methodology) is most appropriate to achieve the object of rectifying the register in the circumstances of the particular case. The object of a rectification of Herald's register of*

*members would be to produce what can properly be regarded as a true register, which eliminates the effect of BLMIS' fraud amongst those recorded as shareholders as at the commencement of the liquidation. The process of rectification therefore involves re-stating the number of shares which ought to have been issued or redeemed if the transactions had been done at a true NAV. This is done with the benefit of hindsight in accordance with whatever valuation methodology is appropriate having regard to the particular circumstances of the case.*

*52. Section 112(2) applies to empower the Additional Liquidator to rectify Herald's register of members amongst those on the register as at the commencement of the liquidation. Whether or not the Additional Liquidator should exercise the power and, if so, what rectification methodology (and any associated valuation methodology) should be adopted will be determined at the next hearing.*

11. The outstanding issue now before the Court is (a) whether Herald's register should be re-stated and rectified, as amongst its shareholders, because each and every NAV reported throughout the period of its trading life, from inception until the Suspension Date, was mis-stated by reason of BLMIS' fraud and (b) if so, on what basis or by what methodology should the rectification be performed.

***The Primeo in specie rectification issue***

12 By paragraph 1(c) of a summons issued on 7 November 2014, the Additional Liquidator sought an order authorising him to adjust the number of shares issued by Herald as a result of the Primeo *In Specie* Subscription. By an order made on 13 May 2015 (as amended on 22 June 2015) the Court directed that the following issues be tried as an *inter partes* proceeding between the Additional Liquidator as plaintiff and Primeo as defendant –

*Whether for the purpose of settling a list of Herald's contributories (and adjusting the rights of the contributories amongst themselves) the Additional Liquidator shall be authorised to adjust the number of USD class shares in Herald issued to Primeo on 2 May 2007 ("the Shares") in respect of its in specie subscription in Herald pursuant to*

*(i) section 112(1) of the Companies Law and Order 12 rule 1 of CWR by reason of fraud or default as contemplated by Order 12 rule 2 and/or if Primeo provided insufficient consideration for the issue of the shares; and/or*

*(ii) section 112(2) of the Companies Law and Order 12 rule 2 of the CWR by reason of fraud or default as contemplated by Order 12 rule 2 of the CWR.*

In the event, this turned into two quite different issues which have been argued at separate hearings.

13. The value of the securities supposedly held to the credit of Primeo's managed account with BLMIS as at 30 April 2007 was reported to be US$463,353,186. This holding was assigned to Herald in consideration for the issue of 371,604.1272 shares at US$1,246.90 per share, being the NAV per share reported for the 30 April 2007 Valuation Point.[2] In fact, certain adjustments were subsequently made and the final recorded value of the Primeo *In Specie* Subscription was US$465,418,349.08 in consideration for which 373,260.3648 shares were issued to Primeo with a 2 May 2007 dealing date. Both sides of this transaction were affected by the same fraud. The securities supposedly held by BLMIS for the accounts of both Primeo and Herald never in fact existed. It follows that both the recorded value of Primeo's *In Specie* Subscription and the amount of Herald's reported NAV per share (as at 30 April 2007) were overstated by reason of the same fraud.

14. In June 2009 Herald filed a customer claim in the BLMIS bankruptcy proceeding based upon the amount recorded in its last statement of account. This claim necessarily included the final recorded value of the Primeo *In Specie* Subscription, which was the same as the closing balance reported by BLMIS on Primeo's last statement of account.[3] However, the United States Bankruptcy Court has determined that customer claims will be dealt with by the 'Net Equity Method' (also known as the 'Net Investment Method'). This means that the quantum of a customer's admissible claim is that amount which equates to the total cash invested less the total cash withdrawn. The purpose and effect of this methodology is that customers cannot make claims in respect of the fictitious profits recorded in their last statements of account. It follows that, for the purpose of calculating the amount of Herald's customer claim, the Trustee of BLMIS had to determine the net amount of cash which Primeo had invested with BLMIS as at the date of the Primeo *In Specie* Subscription. This amount was determined to be US$149,780,967. By a tripartite settlement agreement made on 12 November 2014 by and amongst the Trustee of BLMIS, the official liquidators of Primeo and the Principal Liquidators of Herald ("the Settlement Agreement"), various issues relating to Herald's customer claim and the Trustee's

2 The Court's analysis of this transaction is set out in the February Judgment at paragraph 34.

3 On or about 22 June 2009 Herald filed a customer claim in the sum of US$1,894,066,134 being the market value of the securities reflected in the last statement of accounts issued by BLMIS. Herald also filed an alternative claim calculated in accordance with the net equity methodology, originally in the sums of US$1,205,203,590 and €308,242,771 although it was subsequently agreed that these figures had been wrongly calculated.

clawback claims against both Herald and Primeo were settled.[4] For present purposes, it is relevant that the parties agreed that the net cash value attributable to the Primeo *In Specie* Subscription for the purposes of Herald's customer claim is US$149,780,967. It was agreed that this amount would be included in Herald's Net Equity Claim in the BLMIS bankruptcy. The difference between the recorded value of the Primeo *In Specie* Subscription (US$465,824,061 after adjustments) and its agreed cash value (US$149,780,967) is US$316,043,094 which represents fictitious profit reported by BLMIS in respect of Primeo's managed account.

15. The Additional Liquidator's case is that Herald's shareholders should be treated equally in the sense that the adverse impact upon Herald of the Madoff fraud should be passed on in the same way to *all* those who are recorded as shareholders as at the commencement of the liquidation. In order to achieve this result as between Primeo and all the other shareholders who subscribed cash for their shares, the Additional Liquidator argues that the Primeo *In Specie* Subscription cannot be allowed to stand to the extent that it is based upon fictitious profits which are not recoverable by Herald (and would not have been recoverable by Primeo) in the bankruptcy of BLMIS. The Additional Liquidator has sought to achieve this result in two ways.

16. At the previous hearing in February 2016, the Additional Liquidator argued that the Primeo *In Specie* Subscription is void for mistake in that the parties were under the common misapprehension that Primeo was the legal and/or beneficial owner of a portfolio of securities whereas, in fact, those securities did not exist. His argument was that if the parties were to be put back in the position they would have been in, but for their common mistake, the value of the holding assigned by Primeo would be treated as US$149,780,967 in consideration for which only 120,122.68 shares would have been issued by Herald (at the mis-stated NAV of US$1,246.90 per share). It follows, according to the Additional Liquidator's argument, that Herald's share register should be rectified by reducing Primeo's recorded shareholding from 373,585.74 to 120,122.68 shares. For the reasons given in the February Judgment, the Court ruled against the Additional Liquidator and upheld the validity of the subscription agreement.

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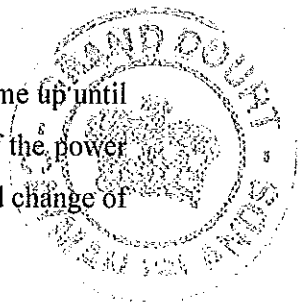
[4] By Clause 11 of the Settlement Agreement, Primeo and Herald agreed that the matters agreed and positions taken by them in reaching the agreement shall be without prejudice to their respective ability to make any arguments before this Court in relation to the Primeo *In Specie* Subscription.

17 The economic result of this decision is that Primeo will be a major beneficiary, if not *the* major beneficiary, of Madoff's fraud. As it presently stands, Primeo will succeed in making a recovery in respect of around US$316 million worth of fictitious profits, indirectly through its shareholding in Herald. It will do so at the expense of Herald's other shareholders who subscribed cash for their shares because, under the terms of the Settlement Agreement, this amount has to be taken out of Herald's customer claim in the BLMIS bankruptcy. The outstanding issue for determination at this hearing is whether this amount can also be taken out of Primeo's claim in the Herald liquidation by reducing Primeo's shareholding to 120,122.68 shares (plus or minus those resulting from cash transactions). The Additional Liquidator's argument is that, notwithstanding the Court held that the Primeo *In Specie* Subscription is not void for mistake, he still has power to rectify Herald's share register under section 112(2) and that the power should be exercised so as to achieve substantive justice amongst the shareholders by putting them on an equal footing.

***Further argument about the construction of section 112(2)***

18. Counsel for Primeo sought to pursue the argument that, as a matter of construction, section 112(2) does not create any freestanding power of rectification. He sought to persuade me that this part of my June Judgment was wrongly decided and should be changed. The possibility of entertaining further argument on the point only arises because no order giving effect to this part of the June Judgment has been drawn up and perfected. This was deliberate. The parties agreed, with the approval of the Court, to postpone perfection of the order until after the determination of other related issues. The intended result is that the time for appealing all the decisions relating to the rectification issues will start to run from the same date.

19. It is not in dispute that a judge has power to change his decision unless and until a written order has been drawn up, signed, sealed and filed, although it was held by the English Court of Appeal in *Re Barrell Enterprises Ltd* [1973] 1 W.L.R. 19 that the power should only be exercised "in most exceptional circumstances". The scope of this power was reconsidered by the United Kingdom Supreme Court in *Re L and B (Children)* [2013] UKSC 8. The Supreme Court declined to follow *Barrell* and previous cases in which it had been held that there was any such limitation upon the



acknowledged jurisdiction of the judge to revisit his own decision at any time up until his resulting order is perfected. The overriding objective in the exercise of the power is simply to deal with the matters in issue justly and a "carefully considered change of mind can be sufficient" justification for changing a decision.

20. I concluded that I should not re-open this construction issue because it was fully argued at the first hearing, I delivered a reasoned judgment and that judgment has now been reported in the Cayman Islands Law Reports 2015 (1) 482.

**The Rectification Issues**

***The purpose and effect of section 112(2)***

21. Whilst I am not prepared to revisit my decision that the Additional Liquidator has a freestanding power under section 112(2) to rectify the register, it is still necessary to consider the purpose and effect of the legislation in order to decide whether or not the power should be exercised in the circumstances of this case. As Mr. Smith correctly pointed out, it is well established that the power to rectify a company's register of members under legislation derived from the English Companies Act, 1862 is only exercisable where the applicant has an existing legal right to be registered as a shareholder or, conversely, the company has an existing legal right to have a shareholder's name removed from the register. The rectification jurisdiction under section 46 of the Companies Law (2013 Revision), which is substantially the same as section 35 of the 1862 Act, does not confer a freestanding power to rectify a share register. Rather, it is in the nature of a remedy to give effect to an existing right or recognition of the absence of any such right. This point has been recently confirmed by the Privy Council in *Nilon Ltd v. Royal Westminster Investments SA* [2015] 2 BCLC 1.[5] Similarly, the provisions of section 38 of the 1862 Act (dealing with the liability of members to contribute to a company's assets) are reproduced into section 49 of Companies Law (2013 Revision). The elaborate provisions relating to settling the list of contributories and making calls against them contained in sections 98 to 106 of the 1862 Act were also reproduced in the original Companies Law, Cap.22, but these provisions were removed and replaced with the very much simplified

5 The Court was not referred to this decision at the hearing in June 2015.

sections 112(1) and 113 as part of the reform of the corporate liquidation regime introduced by the Companies (Amendment) Law 2007 and the Companies Winding Up Rules 2008 which were brought into effect simultaneously on 1 March 2009.

22. It may be said that sections 112(1) and 113 have their genesis in the 1862 Act because they continue to deal with settling a list of contributories and making calls against contributories. However, section 112(2) and CWR Order 12, rule 2 are entirely new provisions specifically aimed at dealing with issues which can arise in connection with open ended mutual funds which collapse (and are consequently put into compulsory liquidation) because shares have been issued and redeemed at NAVs which are materially mis-stated, often as a result of fraud or default on the part of a third party which is not imputed to the company or exempted limited partnership in question.[6] Unlike the Court's power of rectification under section 46, this power applies only to a limited class of companies and only when such a company is the subject of an official liquidation which is certified to be solvent (applying a balance sheet test). The power is expressed in very general terms but, because its exercise is dependent upon the company having issued redeemable shares at prices based upon its NAV, it seems to me that the legislature must have intended that this power of rectification will be exercisable only in circumstances where the NAV has been materially mis-stated. This is the way in which it has been interpreted by the Insolvency Rules Committee.

***Should the section 112(2) power be exercised ?***

23. The concept of "rectification" under section 112(2) implies restoring the register to the position which accurately reflects the *relative* position of the shareholders as it would be if all the relevant subscriptions and redemptions had been transacted at a true NAV. The language of section 112(2), especially when read with CWR Order 12, rule 2 which was brought into force simultaneously with the statute, does not permit any wider interpretation. It merely empowers the Additional Liquidator to rectify Herald's register of members amongst its unredeemed shareholders to give effect to the substitution of a true NAV per share for those which were mis-stated as a result of

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6 The provisions of Part V of the Companies Law (2013 Revision) and the Companies Winding Up Rules 2008 (as amended) apply to exempted limited partnerships by virtue of section 36(3) of the Exempted Limited Partnerships Law 2014 (which re-enacts the relevant provision from the previous law).

BLMIS' fraud. I agree with Mr. Smith that it is inherently improbable that the legislature intended to confer upon official liquidators a power to interfere with an individual shareholder's proprietary rights in the company. Section 112(2) does not empower an official liquidator to rectify the register as against a former shareholder who has validly redeemed his shares and is therefore entitled, as a matter of contract, to prove in the liquidation as a creditor. Nor does it empower the liquidator to rectify the register in order to give effect to a scheme of distribution which is different from that mandated by section 140(1) of the Companies Law (2013 Revision). Nor does it empower the Additional Liquidator to rectify the register as against Primeo because the parties were mistaken about the value of the consideration given for the Primeo *In Specie* Subscription.

24. The power conferred by section 112(2) is in the nature of a class remedy, the purpose of which is to restore the register of members to a position which reflects the result of substituting true NAVs for those which have been mis-stated. The question before the Court is whether, in the circumstances of this case, the Additional Liquidator should properly exercise this power, notwithstanding that the NAVs are binding as between the company and its shareholders as a matter of contract for the reasons given in the June Judgment.

25. The subscriptions transacted by Herald during the initial offering period (which ended on 1 April 2004) were done at fixed prices of US$1,000 and €1,000. Thereafter, every subscription and redemption of shares was transacted on the basis of reported NAVs which were mis-stated by reason of fraud or default on the part of BLMIS within the meaning of CWR Order 12, rule 2. In my view, there could be no clearer case in which the power ought to be exercised. It is not a case in which the valuation of a particular asset was affected by fraud. This case is at the other extreme of the spectrum. Herald's reported NAV was driven by fraud from the inception of its business. Although it was not known at the time, Herald was in fact nothing more than a feeder fund for a *Ponzi* scheme. A failure to exercise the Addition Liquidator's power under section 112(2) would result in giving effect to Madoff's fraud and enabling some shareholders to benefit from realising fictitious profits at the expense of other shareholders.

*How should the section 112(2) power be exercised ?*

26. The next question is 'how should the register be rectified?' This question should be answered by reference to CWR Order 12, rule 2. The starting point is rule 2(3) which provides that the Additional Liquidator has to determine a true NAV as at each relevant Valuation Point and Special Valuation Point in accordance with the applicable accounting principles specified in Article 18 of Herald's articles of association, which is of course drafted on the assumption that the company will have multiple segregated portfolios and that each one will own a portfolio of marketable securities.

27. The legal analysis of the contractual relationship between Primeo and BLMIS and the nature of the asset held by Primeo (prior to 2 May 2007) is set out in the February Judgment at paragraphs 16-20. I have not reviewed the contracts made between Herald and BLMIS for the purposes of this application, but it is reasonable to assume that they must be substantially (if not exactly) the same as those pertaining to Primeo. The analysis of the nature of Primeo's asset must apply equally to Herald. It had a right as against BLMIS to receive equivalent securities (or their market value) and an equivalent amount of cash to that recorded in each monthly statement of account which reflected a net balance. The final net balance was US$1,894,066,134, being the amount reflected in the last statement of account issued to Herald by BLMIS as at 30 November 2008. Since BLMIS was a *ponzi* scheme, the nature of that asset is now translated (as a matter of US law) into a customer claim in the bankruptcy of BLMIS calculated in accordance with the Net Equity Methodology, the amount of which has been agreed with the Trustee in the sum of US$1,639,896,943. The value of this claim is currently estimated to be around US$750,000,000.

28. It follows that Herald's true NAV, as at any given Valuation Point, is the value of Herald's customer claim in a hypothetical bankruptcy of BLMIS commenced as at that date. Clearly, the Additional Liquidator is not in a position to perform this valuation exercise. It could only be done, if at all, by or with the help of BLMIS's Trustee. A NAV per share determined in accordance with Article 18 would be marginally different as at each Valuation Point. Understandably, he is not willing to assist. For this reason, it is now "impractical or not cost effective" to determine Herald's NAV per share as the relevant dates in the manner contemplated by Article

18, with the result that the Additional Liquidator must adopt an alternative methodology which is "both cost effective and fair and equitable as between the shareholders" in accordance with CWR Order 12, rule 2(5). [7]

29. The Additional Liquidator's approach is that the net loss of subscription money should be borne rateably and that shareholders should share equally in the pool of funds available for distribution. He considers the Net Investment Method and a variant of it called the Rising Tide Method and concludes that the latter should be employed. He describes and compares these methodologies in the following way (17th Affidavit of Michael Pearson, paragraphs 83 and 84) –

*83. As described above, the Net Investment Method calculates each contributory's economic interest in Herald on the basis of their individual net equity (total subscriptions less redemptions) as a percentage of the total pool of surplus funds available for distribution. On this basis, each contributory whose total subscriptions exceed their redemptions will receive a pro rata share of any surplus assets available for distribution, regardless of the quantum of redemption proceeds received during the life of Herald/BLMIS. This means that those contributories who redeemed a significant percentage of their total capital contribution pre-liquidation will ultimately recover a larger percentage of their total capital contribution when compared with those contributories who redeemed less of their overall total capital contribution, or those that did not redeem at all. .....*

*84. The main difference as compared to the Rising Tide Method is that the latter factors in the quantum of redemptions previously received by contributories to ensure that no contributory will recover a greater percentage of their total capital contribution than any other contributory (unless a contributory has already received a greater percentage pre-liquidation than contributories will otherwise receive from the liquidation itself). This is achieved by rectifying the register in a manner which restricts the amount of, or participation in, any distributions so that contributories remain on an equal footing. For example, if the quantum of surplus funds available for distribution is only sufficient to ensure that each contributory can recover 50% of their total capital contribution, those contributories who have previously received redemption proceeds equivalent to 50% or more of their total capital contribution will not receive any further payments by way of a distribution, while a contributory who did not redeem at all (that is, a contributory who has received 0% of their total capital contribution) will receive a larger distribution than a contributory who had*

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[7] The Additional Liquidator states that "I have reached the conclusion that recalculating Herald's true NAV is an exercise which would, in practical terms, be impossible to carry out in any meaningful or useful way". 17th Affidavit of Michael Pearson, paragraph 71.

*previously received redemption proceeds equivalent to 40% of their total capital contribution. .....*

30. I agree with the Additional Liquidator's objective. Herald's shareholders are victims of Madoff's fraud. They have suffered a common misfortune. To share in the common misfortune equally, or at least on an equal footing, by recovering an equal proportion of their net cash invested would be a just result. I agree with the notion that it would be unjust for some shareholders to benefit from the common misfortune at the expense of others. Section 112(2) and CWR Order 12, rule 2 provide a limited mechanism for achieving a more just result by allowing the members' shareholdings to be adjusted on the basis of NAVs which are deemed to be 'true' or at least not distorted by the inclusion of fictitious profits. However, I have come to the conclusion that the use of the Net Investment or Rising Tide methodologies in the manner proposed by the Additional Liquidator is legally inadmissible because it amounts to substituting a scheme of distribution which is different from that mandated by section 140(1) of the Companies Law (2013 Revision). It seems to me that it amounts to lifting the corporate veil and treating the shareholders as if they were trust creditors having a proprietary claim against a co-mingled pool of assets. That might well be the proper approach if Herald was itself a *Ponzi* scheme, but the Court has no jurisdiction to proceed in this way on the agreed facts of this case.

31. It seems to me that the proper approach, based upon CWR Order 12, rule 2, is to treat the subscription price of US$1,000 (or €1,000) as the 'true' NAV per share for the purposes of each and every subscription and redemption. This puts the shareholders on an equal footing. Equating the NAV to the net amount transferred to BLMIS for investment is realistic because it equates to the basis upon which Herald's claim in the BLMIS bankruptcy has been determined. It is fair and equitable amongst the shareholders to apply the same NAV to each and every subscription and redemption because it results in a share register which puts an equal value on the funds invested by all subscribers and does not give credit to those who succeeded in realising fictitious profits or penalize those who subscribed at a fraudulently inflated price. Substituting 'true' NAVs for mis-stated ones does not circumvent the scheme of distribution mandated by section 140(1) because the liquidators will still distribute the surplus assets in accordance with the shareholders' rights and interests in the company as reflected in the rectified register. Both the Net Investment and the Rising

Tide methodologies are legally inadmissible because their application would circumvent the requirements of section 140(1). Either of these distribution methodologies can be used without the need for any share register at all. Their application would merely require the quantification of each investors' net cash investment in the pool of assets held by Herald. In the case of the Rising Tide Method, it cannot be applied until the liquidation has reached its conclusion and the total amount available for distribution is known. Admittedly, the application of the Net Investment Method in the manner proposed by the Additional Liquidator and the re-statement of the register using 'true' NAVs of $1,000/€1,000 per share in the manner proposed by the Court, are capable of producing similar economic results, but the legal foundation for their application is wholly different. The Additional Liquidator's proposed methodologies are inadmissible because they involve disregarding the Herald's corporate personality and calculating the investors' economic interest in the underlying pool of assets by reference to the net cash invested. The Court's approach assumes that the assets are beneficially owned by Herald and that the shareholders are entitled to participate in the distribution of the surplus assets pro rata to their shareholdings. Section 112(2) permits the register to be rectified in order to give effect to the substitution of 'true' NAVs for those which were mis-stated by reason of BLMIS's fraud, notwithstanding that the mis-stated NAVs would otherwise be binding as a matter of contract. It does not permit the Additional Liquidator to disregard the corporate personality and treat the shareholders as if they are trust creditors.

***Can the section 112 powers be used to adjust the number of shares issued in respect of the Primeo In Specie Subscription ?***

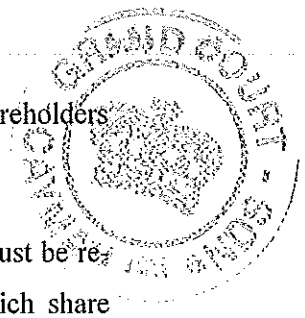
32. I now turn back to the Primeo *In Specie* Subscription. If it were possible to employ either of the Net Investment or Rising Tide distribution methodologies, the validity of the Primeo *In Specie* Subscription would be irrelevant. Primeo's right to a share in the available assets would depend upon the net amount of the cash invested into the pool which was US$149,780,967 plus and/or minus various other relatively small cash subscriptions and redemptions which took place both before and after 2 May 2007. Having rejected this approach, I have come to the conclusion that there is no other legal basis upon which the Additional Liquidator can reduce the value of the consideration and thereby reduce the number of shares issued.

33. For the reasons given in my February Judgment, I found that the Primeo *In Specie* Subscription was not void for mistake and is therefore binding and enforceable in accordance with its terms. The Additional Liquidator has no power under section 112 to set aside or vary a valid contract. Nor is there any other basis upon which the Additional Liquidator or this Court can enquire into the adequacy of the consideration for this transaction. (See *Pilmer v. Duke Group Ltd* [2001] 2 BCLC 773, at paragraphs [26] to [40]). The Additional Liquidator's power is limited to re-stating the number of shares which ought to have been issued in consideration for US$465,824,061 at a 'true' NAV. This power is exercisable for the benefit of the shareholders as a class and the 'true' NAV must be applied to all subscription and redemption transactions throughout the period of Herald's active trading life, including the Primeo *In Specie* Subscription.

**Ancillary Issues**

***Share transfers prior to the Suspension Date***

34. In addition to subscriptions and redemptions, Herald's share register reflects internal transfers of shares which took place prior to the Suspension Date. These transactions are referred to as 'transfers in' and 'transfers out' of the shareholder accounts. The Additional Liquidator investigated the reasons for these transfers and has concluded that they fall into two categories. First, there are transfers which reflect no change in the underlying beneficial ownership. Presumably, most of these are transfers between custodians and their clients. Second, there are transfers which do reflect a change in beneficial ownership. Presumably, most of these are related party purchase and sale transactions done at the reported NAV. If the Court had accepted the Additional Liquidator's proposal to distribute the surplus assets in accordance with the Net Investment Method, it would be necessary to investigate those transactions in which there is a change of beneficial ownership in order to ascertain whether the transferor had a sufficient net equity in his shareholder account to meet the value of the transfer. The fact that an exercise of this sort would be necessary supports my conclusion that the adoption of the Net Investment Method of distribution is inadmissible as a matter of law. The Additional Liquidator has no power under section 112(2) to interfere in



contracts for the transfer of shares, whether made between two existing shareholders or between a shareholder and a non-shareholder.

35. The Court's direction is that each and every subscription and redemption must be re-stated using an NAV of US$1,000 or €1,000 per share. The way in which share transfers are dealt with is best illustrated by reference to an example. If A was the registered holder of 833.33 US$ denominated shares (having subscribed US$1m at a NAV of US$1200 per share) and he transferred those shares to B, B will have become the registered holder of those 833.33 shares. In order to rectify the register in accordance with the Court's direction, the Additional Liquidator will merely have to trace the origin of B's shares and, in this example, B's shareholding will be re-stated to reflect a holding of 1,000 shares. The reason why the shares were transferred and whether or not the transfer was done for valuable consideration is irrelevant. It does not matter for the purposes of rectifying the register whether the transfer resulted from a purchase and sale agreement between A and B or whether A was a custodian who was directed by his client, B, to transfer the shares into his own name.

***Transfers of shares on the secondary market formed after the Suspension Date***

36. The Additional Liquidator also draws attention to the fact that a secondary market for Herald's shares formed after the Suspension Date and has continued after the commencement of the liquidation.[8] Commercially, the reasons for transferring shares prior to the Suspension Date will be wholly different from the reasons for buying and selling shares thereafter on the secondary market, but the legal analysis is the same. If the Additional Liquidator had been directed to apply a Net Investment Method of distribution, I think it would follow that a transfer of shares on the secondary market would have to be treated as a transfer of the net equity belonging to the transferor as at the Suspension Date. However, the consequence of the Court's direction is that there is no distinction between transfers done before and after the Suspension Date.

***Translating Euro denominated shares into US$ denominated shares***

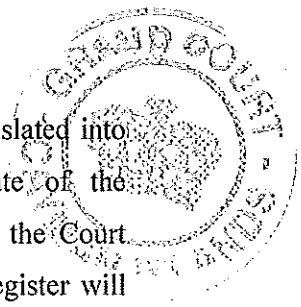
37. Where the assets of an insolvent company in liquidation are distributed amongst its creditors pro rata to the amount of their debts or the surplus assets of a solvent company in liquidation are distributed amongst its shareholders pro rata to their

8 Shares are transferred in accordance with a 'Liquidation Share Transfer Protocol' dated 13 November 2013.

shareholdings, there has to be a common benchmark. In the case of an insolvent liquidation, this issue is dealt with by CWR Order 16, rule 13 which requires that the creditors' claims have to be translated into the functional currency of the company (which becomes the currency of the liquidation) at the mid-market exchange rates ruling on the date of the commencement of the voluntary liquidation or the date on which the winding up order is made, as the case may be. The CWR do not expressly deal with the way in which a pro rata distribution of surplus assets shall be made to shareholders in the case of a company which has issued shares denominated in multiple currencies. Unless the issue is specifically dealt with in a company's articles of association, then it seems to me that the scheme of CWR Order 16, rule 13 must be applied and the shareholdings have to be translated into the currency of the liquidation in order to determine the shareholders' relative interests in the surplus assets available for distribution.

38. Herald was incorporated as an SPC. If it had continued to operate two segregated portfolios and issued US$ denominated shares in respect of one portfolio and Euro denominated shares in respect of the other one, there would now be two separate liquidations and the currencies of the liquidations would likely be different. In fact, *Herald Europe Segregated Portfolio Two* was closed down, but two classes of shares denominated in US$ and Euros have been issued by the one remaining segregated portfolio. Article 155 of Herald's articles of association deals with the way in which the assets available for distribution to the shareholders are to be applied in the event of a winding up. It contemplates that multiple share classes will be issued in different currencies in respect of the same segregated portfolio, which is what has in fact happened, but it does not specifically say that they have to be (notionally) translated into the currency of the liquidation for the purpose of ascertaining the shareholders' relative interests in the assets available for distribution. It merely says that *payment* has to be made in the currency of the shares in question.

39. The functional currency of a company is a question of fact. It has been determined that Herald's functional currency was the US$ (because practically all of its assets are and always were denominated in US$) with the result that the US$ has been certified to be the currency of the liquidation. Subject to any further submission which counsel may wish to make, I propose to direct that Herald's Additional Liquidators proceed in



the following way. The Euro denominated shares will be (notionally) translated into US$ shares as at the mid-market exchange rate ruling on the date of the commencement of the liquidation. By an order made on 8 April 2015, the Court determined that the applicable Euro/US$ exchange rate is 1.3334. The register will then be rectified accordingly. The result can be illustrated by the following example. If there were only two shareholders and A holds 1,000 US$ shares and B holds 1,000 Euro shares, following translation into the currency of the liquidation, B will hold 1333.40 US$ shares. It follows that A would receive 42.86% and B would receive 57.14% of the surplus assets available for distribution. Pursuant to Article 155, B is still entitled to receive payment in Euros and so the liquidators will use the dollar amount of his distribution to buy Euros at the market rate ruling on a date selected by the liquidators within 14 days of the date of payment.

**Conclusions**

40. The Additional Liquidator will be directed to re-state each subscription and redemption throughout Herald's active life at an NAV of US$1,000 or €1,000 per share (as the case may be) and rectify the register of members accordingly as at the commencement of the liquidation.

41. The fact that transfers of shares have taken place, both before and after the Suspension Date, is irrelevant.

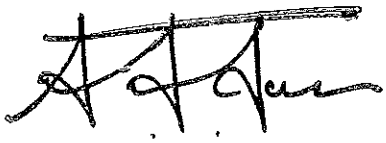
42. The Additional Liquidator has no power under section 112 or otherwise to vary the terms of the Primeo *In Specie* Subscription by adjusting the value of the consideration or reducing the number of shares issued for the agreed consideration.

43. For the purposes of making interim distributions and the final distribution to shareholders, the Additional Liquidators will be directed to translate the Euro denominated shares into US$ denominated shares at a Euro/US$ exchange rate of 1.3334. The holders of Euro denominated shares should be given the option of receiving payment of their distributions in US$ or Euros. For the purpose of meeting the Euro payment obligations, the official liquidators shall buy Euros at the market rate ruling on a date selected by them within 14 days of the date of payment.

44. The Additional Liquidators shall have liberty to apply for any consequential directions.

45. The Court has previously ordered that the costs of this proceeding, at least to the extent that Primeo is acting in a representative capacity, shall be paid out of the assets of Herald, such costs to be taxed if not agreed with the Principal Liquidators. As regards Primeo's costs of and incidental to the Primeo *In Specie* Subscription Issues, I will hear further argument either orally or by means of written submissions.

DATED this 2nd day of September 2016



**The Honourable Mr Justice Andrew J. Jones QC**
**Judge of the Grand Court**