IN THE GRAND COURT OF THE CAYMAN ISLANDS

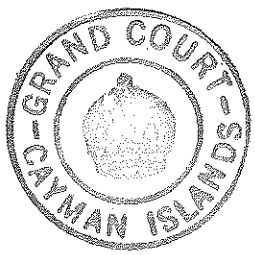
FINANCIAL SERVICES DIVISION

Cause NO. FSD 27 OF 2013 – AJJ

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

IN THE MATTER OF THE COMPANIES LAW (2013 REVISION)

AND IN THE MATTER OF HERALD FUND SPC



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

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RULING

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

[1] 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.

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

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

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

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

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

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

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

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

[3] 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.

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

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

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

[4] $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.

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

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

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

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

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

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

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

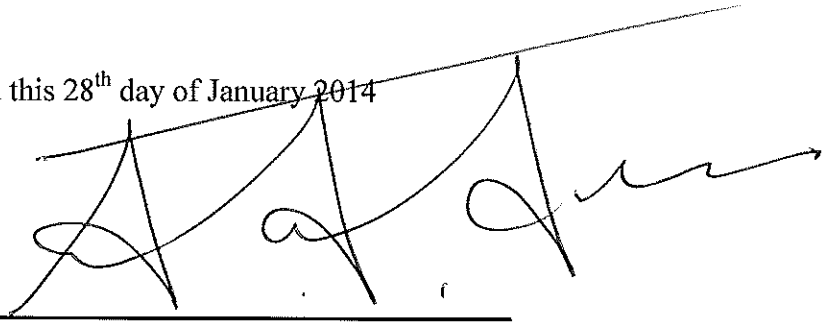
(6) For these reasons the Court will direct the Principal Liquidators to reconsider their determination of "doubtful solvency", as they are entitled to do under CWR Order 8, rule 2.

(7) If, having reconsidered the matter, the Principal Liquidators are of the opinion that Herald should be regard as being "solvent" for the purposes of CWR Order 9, they

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

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

Dated this 28th day of January 2014



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