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'Can do' approach heralds quick settlement for Madoff investors

TOPIC: Funds
By: **Declan Magennis**
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Bernard Madoff

Against a long history of hostile relations between management and certain of its investors on one side and the U.S. trustee on the other side, combined with high pessimism and even strong adversity on the part of certain stakeholders to even communicate with the trustee, the recently court appointed principal liquidators of a Cayman Islands registered Madoff feeder fund, Herald Fund SPC (In Official Liquidation), immediately began a 'hearts and minds' campaign aimed at establishing trust with the trustee.

From this point the two parties were able to work closely to set aside adversarial rhetoric and posturing on the many and varied complex legal arguments in favor of identifying specific core issues fundamental to each party. This progressive and collaborative approach led to a successful and rapid mediation and settlement under which both parties can be classed as winners.

To the general praise and, indeed, surprise of the Herald stakeholders, within 17 months of their July 23, 2013, appointment as joint principal official liquidators of Herald, Russell Smith and Niall Goodsir-Cullen of BDO CRI (Cayman) Ltd. had negotiated the benchmark settlement agreement, agreed the terms and had it approved in both the Cayman and U.S. courts.

It includes a Securities Investor Protection Act, 15 U.S.C. (SIPA) claim approved by Irving H. Picard, the trustee of Bernard L. Madoff Investment Securities LLC (BLMIS), and the consolidated estate of Bernard L. Madoff, in favor of Herald for approximately \$1.64 billion (gross).

In contrast to this success, a number of directors and liquidators of other Madoff feeder funds have become mired in protracted and expensive litigation or else have entered into settlements with the trustee under terms which are significantly less favorable than those obtained by Herald.

At the time of Madoff's arrest on Dec. 11, 2008, and the subsequent Dec. 12, 2008, suspension by the Herald directors of the issue and redemption of Herald shares, only \$20 million in cash was held for Herald by Herald's Luxembourg Custodian and Administrator, HSBC Securities Services (Luxembourg) S.A. (HSSL) with the balance of the net cash subscriptions having been transferred to BLMIS by HSSL.

From the date of the arrest of Madoff to July 23, 2013, the date the principal liquidators were appointed by the Grand Court, Herald was in 'soft' wind-down under the control of

its two remaining European-based directors, Franco Mugnai and Friedrich Pfeffer. On June 23, 2009, Herald filed a timely BLMIS customer claim with the trustee, which asserted the entitlement of Herald to the securities reflected on the BLMIS account with HSSL with a Nov. 30, 2008, value of \$2 billion or, in the alternative, the Herald BLMIS net equity of \$1.17 billion.

In March 2009, Herald issued proceedings in Luxembourg against HSSL, seeking release (or restitution) to Herald of the securities that HSSL had advised Herald were held by HSSL as its custodian. In the alternative, Herald has claims for breach of contractual and tortious duties which claims are stayed pending outcome of the restitution claim.

In July 2009, the trustee issued a complaint against Herald, HSBC Bank Plc and HSSL in the Bankruptcy Court listing nine causes of action. This complaint included claw back transfers of \$578 million made by BLMIS to HSSL that took place within six years of December 2008. In August 2009, the trustee filed an amended complaint adding that the trustee should be entitled to an order disallowing the BLMIS customer claim of Herald and, in December 2010, the trustee filed a further amended complaint against Herald, HSBC Bank Plc, HSSL and several other funds asserting claims to also equitably subordinate the Herald customer claim.

As at July 23, 2013, the date of the appointment of the principal liquidators, in addition to the above issues, the risk existed that the trustee would impose other onerous claims in the SIPA proceedings against Herald.

Indication had been given by the trustee, as he had required of the Herald (Lux) SICAV liquidators, that there should be a voluntary due diligence of the Herald share register including a review of the beneficial ownership and their agents to determine whether any direct or indirect shareholder should be classified as a Madoff 'bad actor' and therefore should not be entitled to any benefit from the SIPA proceedings.

The requirement for a shareholder due diligence process would have required a considerable amount of additional work by the principal liquidators risked protracted litigation delayed or, possibly, prevented any BLMIS customer claim distribution by the trustee to the principal liquidators and delayed or, possibly, prevented any distribution of the Herald BLMIS customer claim to the Herald shareholders.

There was a possibility that the trustee might have sought to share a percentage of the proceeds from any judgment that Herald might obtain from other legal claims, including in Luxembourg against HSSL. This had been the case with the Cayman Islands fund, Senator Fund SPC, where the settlement agreement included a provision to allow the trustee 50 percent of proceeds of any future claims.

Another potential obstacle emerged in the Thema International Fund PLC case that involved HSSL and HSBC Institutional Trust Services (Ireland) Limited who provided custodial, administration and other services to Thema and the issue of the payments to Thema's 'bad actors' who might be considered to have knowledge of or have been willfully blind of the Madoff Ponzi scheme. Thema had agreed a settlement with HSBC in Ireland and a settlement payment was made from HSBC to Thema. However, no sooner had the bank transfer happened than the Trustee sought, and won, an injunction preventing Thema from distributing the HSBC settlement proceeds to its shareholders on the basis that the trustee considered some of Thema's shareholders to be Madoff 'bad actors.'

Following their appointment the principal liquidators were advised by U.S. counsel Kirkland & Ellis LLP (New York office) that while it might be possible to both defeat the Herald clawback claims of the trustee and to have the Herald BLMIS Customer Claim accepted, it would be prudent to assume that these legal outcomes could take up to six years to achieve and would carry all of the costs of litigation and uncertainties as to the eventual outcome.

Following their review of the SIPA proceedings and discussions with Kirkland & Ellis and Cayman counsel Walkers, the principal liquidators took the decision that the most favored strategy was to attempt to minimize the prospect of becoming further entangled in litigation and explore the possibility of finding an alternative solution which might be more attractive to Herald's stakeholders. Other than selling Herald's customer claim, which value would reflect the continuing litigation anyhow, or the highly unlikely collapse or withdrawal of the trustee's various actions relating to Herald, such a solution would be by means of negotiation with the trustee.

However, the acrimonious relationship and poor level of trust demonstrated between Herald and the trustee in the years prior to the appointment of the principal liquidators was not conducive to the prospect of entering constructive negotiation or even establishing cordial correspondence.

Despite this the principal liquidators reached out to the trustee, through his New York lawyers, Baker & Hostetler LLP in order to set up an introductory meeting. In September 2013, just two months following their appointment, a meeting with Baker Hostetler was held in New York. From the principal liquidators' perspective, the primary purpose of the initial meeting was to inform the trustee and his legal representatives as to the recent appointment of the principal liquidators, the fact that they were officers of the court in the Cayman Islands and to advise on their duties and responsibilities as office holders.

As this stage it was crucial that the principal liquidators be recognized by the trustee as clearly and distinctly separate from the former management of Herald, so focus was given on communicating their independence and bona fide intentions. It was vital that no attempt be made by the principal liquidators to discuss the various party and counter-party claims or to try to discuss historical positions as this could raise temperatures and risk an instant hardening of attitudes toward the principal liquidators, attitudes that might never be reversed.

A fundamental position of the trustee was that the clawback claim of \$578 million was required to be paid to the BLMIS estate by Herald prior to the trustee's consideration of Herald's own customer claim. In this respect the trustee was reflecting the status of a creditor of Herald in first instance and a debtor of Herald subsequently but only subject to prior discharge of the clawback claim by payment in cash, not set-off, or final legal determination. Without the required funds to even consider payment of the demand, and without the certainty of having the larger customer claim accepted by the trustee in order to raise the finance, the position presented a formidable obstacle to the avoidance of protracted litigation.

While not agreeing with the trustee's views, the principal liquidators were clear that the road to any possibility of a successful recovery of Herald's customer claim would be either through the courts or by reaching a settlement agreement with the trustee at some earlier date. The trustee's battle line with Herald was entrenched and was fully consistent with the hard-line battle plans the trustee had when engaging with other Madoff feeder fund's directors and liquidators. In turn, and understandably, many of the other Madoff feeder fund directors and liquidators had adopted reciprocal hard-line positions with the trustee resulting in inevitable legal battles on all fronts.

In contrast, the Principal Liquidators decided to examine where certain points of confrontation with the Trustee might be lessened or removed altogether. As the Trustee was claiming to have creditor status in the Herald liquidation in respect of the clawback claim, but without having yet determined this claim as agreed, the principal liquidators allowed the trustee to attend the first liquidation meeting of Herald's creditors and contributories. While the principal liquidators expected that, at some future time, the likely final determination of the trustee's creditor claim would be that it is rejected, due to Herald's larger customer claim against BLMIS, the opportunity and flexibility presently existed to allow the trustee inclusion in the meeting. The principal liquidators perceived this simple concession to be unexpected on the part of the trustee and a welcome gesture of goodwill and transparency of administration.

With an element of trust having now been established, the next step in the process was to find appetite in the trustee to consider settlement discussions. In order to get to this position, it was necessary for both the principal liquidators and the trustee to recognize the possibility of weaknesses or uncertainties in their own respective legal positions and the possibility of strengths in each others. Without conceding any points on either side, this step further elevated growing trust between the parties.

With the acceptance by both sides that, despite their most forceful arguments being presented, the only concrete certainty about the outcome of the litigation would be that it would be long and costly, the stage was now set. By their nature, settlement agreements rarely result in one party achieving all it desires. Some level of compromise is usually inherent. In evaluating what points might be conceded or compromised by the principal liquidators it was necessary for them to consider not only the commercial consequences but the legal parameters imposed by the Cayman Islands Companies Law and winding up rules. Practically speaking, the principal liquidators were unable to negotiate any repayment or set-off of the clawback claim without receiving 100 percent credit uplift on the Herald customer claim, else risk having the difference being deemed by the Cayman court to be a preferential payment to the trustee and having any related settlement agreement rejected accordingly.

Another critical factor for the principal liquidators was structuring negotiations so that each party could maximize its own 'value indicator' or benchmark for success. In the case of the principal liquidators, the highest value indicator was the maximum net recoveries Herald could obtain from the customer claim. The highest value indicator for

the trustee appeared to be the maximization of the gross clawback claim. In essence, the two parties had different highest value indicators and therefore different main objectives,

which meant that a measure of game theory was in play. The highest win for one party did not necessarily mean the highest loss for the other party.

In conceding to the trustee's demand for full payment of the clawback claim, it would be a requirement under Cayman law that full uplift credit be received on the Herald customer claim. The commercial risk in agreeing this position would be the loss suffered on the percentage of recoveries obtained by way of future distributions. If the trustee ultimately distributes 75 cents in the dollar for claims, the \$1.17 billion customer claim would produce approximately \$880 million of recoveries. In reduction of this, the Herald liquidation estate would lose 25 cents for every dollar of clawback claim paid. On \$578 million this would be approximately \$145 million, or around 12 percent of the \$1.17 billion net customer claim.

However, in light of the possibility that the final outcome of litigation would affirm the trustee's right to demand the clawback, or even reject Herald's right to any customer claim entirely, the principal liquidators were willing to consider this compromise.

In considering this position, the principal liquidators were also aware of a settlement agreement between the trustee and JPMorgan in which the trustee was able to recover \$425 million of direct and indirect Madoff transfers and other payments to JPMorgan prior to the collapse of BLMIS. Of the \$425 million of transfers \$154 million related to transfers having been made from Herald and for which the trustee was also demanding payment from Herald as part of the \$578 million. As part of negotiations with the trustee, the principal liquidators were able to agree a \$100 million credit from the trustee against the Herald clawback claim, this being in line with the pro-rata settlement amount the trustee had received from JPMorgan for the \$154 million portion of that claim.

Although not having the benefit of the \$54 million trustee's settlement difference, the net clawback claim against Herald had been reduced from \$578 million to \$468 million, including a \$10 million tax credit. In this situation, full payment of the \$468 million to the trustee, by way of set-off with 100 percent credit uplift, would result in a Herald customer claim of \$1.64 billion, which based upon 75 percent distributions of \$1.23 billion and full clawback of \$468 million would result in net recoveries to Herald of \$762 million.

This is \$28 million greater recovery than under the previous scenario whereby the \$578 million clawback would result in a customer claim of \$1.75 billion (x 75 percent - \$578 million = \$734 million recoveries). This reduces the settlement risk from \$145 million to \$117 million (or 10 percent) based upon the distribution estimate.

With negotiation with the trustee having been progressed to this point, agreement was made with the trustee to enter mediation. In this process the parties were fortunate to retain the services of an experienced U.S. mediator, Peter Borowitz, a former partner of Debevoise & Plimpton LLP. Through the mediator, the principal liquidators were able to capitalize upon their willingness to provide full clawback payment and the level of trust built up between the principal liquidators and the trustee over the course of their dealings, to convince the trustee to forego many of the conditions that he had sought during litigation or settlement discussions with other Madoff feeder funds. This included pre-distribution payment stakeholder due diligence requirements; 'bad-actor' distribution; subordination and trustee participation in other litigation action recoveries.

The settlement agreement was executed by the parties on Nov.12, 2014, approved by the Cayman Court on Nov. 19, 2014, and approved by the U.S. Bankruptcy Court for the Southern District of New York on Dec. 17, 2014. In January 2015, the trustee paid \$259 million to Herald as an initial net catch-up distribution, after clawback deduction, representing 46 percent of distributions made by the trustee as at Nov. 12, 2014. In addition, the trustee has recently advised that an additional distribution of \$41 million will be paid to Herald in the near future.

In summary, the settlement agreement eliminates substantial litigation outcome risk, related time and costs of litigation and achieves an allowed BLMIS customer claim of \$1.64 billion and a full resolution of the trustee's clawback claim against Herald. This marks the first time in several years that the trustee has agreed to a 100 percent clawback credit in a settlement. In stark contrast to many other settlement agreements, Herald is not required to evidence ultimate beneficiary details of stakeholders to the trustee, nor will its stakeholders be subject to any subordination or holdback in order to be eligible for distributions.

The principal liquidators consider the settlement agreement to be an excellent result for the Herald stakeholders, the wider BLMIS stakeholders and the trustee. Despite the huge and complex obstacles in place as at the date of their appointment, the principal

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liquidators sought to discover and pursue options other than merely accepting the inevitability of long-term and costly litigation, with all of the uncertainties of outcome.

To this achievement the principal liquidators are most grateful to attorneys Matthew Goucke, Fiona MacAdam and Chris Keefe of Cayman counsel, Walkers; Joseph Serino and David Flugman of U.S. Counsel, Kirkland & Ellis LLP (New York); U.S. mediator Peter Borowitz and the Trustee Mr. Irving Picard, through his legal counsel Baker & HostetlerLLP (New York).

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