

## **Analysis: Madoff Funds Fallout**

*By Phillip Kite*

The Madoff scandal appears to be on a scale rarely seen in modern times. While it comes from the very heart of Wall Street, this fraud has huge repercussions outside the US.

Thousands of investors have lost billions of dollars between them including established funds in the Cayman Islands and the British Virgin Islands. Some funds which thought they were worth billions in November 2008, found in December they might be worth a fraction of that sum. Worse still, those funds face the real prospect of claims made by the bankruptcy trustee of Bernard L Madoff Investment Securities (BMIS).

As common in these types of cases, someone has to pay and it is often not the ones who are most to blame.

The BMIS trustee has a positive armoury of powers to claw back payments made by BMIS. Many of these potential claw back claims will be against the funds which are the victims of the fraud. As the case law develops, the trustee may demand back payments made out of BMIS in the 90 days before the date of liquidation as well as previous transactions going back years which the trustee regards as 'fictitious profits'.

If proved such claims will have an immediate impact on investments funds and might make previously solvent funds, insolvent. It may also kick start claims by investors who are still wondering where all the money has gone. Funds should look out for a number of potential claims.

### **Investors as creditors**

Beware of investors who submitted redemption claims but were not paid or who submitted funds that were never invested. They may be creditors who could have direct actions against the assets of the fund or even to liquidate the fund.

### **Shareholders actions**

As redemptions have typically been suspended, these rights might be limited at the moment. However, investors are starting action groups which might give them more of a say in Madoff affected funds. Investors could bring actions to liquidate the fund and attempt derivative actions on behalf of the fund for alleged actions/inactions by the directors.

Misrepresentation may be claimed as inaccurate statements made by the fund or persons connected with them are fertile areas of litigation. Funds should check marketing material and other fund documents.

## **Director liability**

Investing into BMIS may have seemed like a privilege before December 2008. Madoff certainly created an invitation only club like atmosphere. Those directors are likely to feel very exposed.

As well as potential derivative actions and mis-selling claims, directors need to consider carefully whether normally solvent structures are now insolvent. This is highly relevant if those structures subsequently go into liquidation, as directors can be personally liable for the debts of a company if, for example in the BVI, they knew or ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation and failed to take every step reasonably open to minimise the loss to the creditors.

One piece of good news could be that derivative actions against directors of companies in offshore centres such as Cayman and BVI are more restrictive than in the US. Early action can stop or limit US claims.

## **Investment managers**

Managers are clearly in the firing line for claims. Much will depend on what due diligence was done and what the investment manager knew about BMIS. Managers should be particularly concerned with actions in the US (some of which have already started) where discovery rules extensive and damages are generally higher.

It is also doubtful that an offshore manager will receive a welcome reception in the US courts. Managers might be wise to ensure they do not submit to the jurisdiction of the US courts and therefore meet any allegations in their home court.

## **Other actions**

The 'others' may turn out to be the most significant as they include the targets with the deepest pockets, including custodians, administrators and auditors. Some banks commonly promoted funds to their clients.

There was nothing wrong with this per se. In the good years this is the sort of in house banking product which was popular with customers. However, in providing this service the banks may have assumed more responsibility, and therefore duties, to their customers.

Finally, auditors have the ultimate deep pockets in a Madoff made world of very shallow pockets. Seemingly a target, auditors are not an easy one they will probably fight back.

Importantly, most audit engagements may not be under US law although if audit teams visited BMIS extensively in the course of their duties then this might lead to allegations of 'Nelsonian' blindness. Such claims could be damaging to reputation as well.

All in all, Madoff, former chairman of NASDAQ and previously Wall Street icon, has left a huge mess in his wake.

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