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HEDGE FUNDS

REVIEW

Madoff feeder funds face recovery challenges

British Virgin Islands Supplement October 2010: Hedge fund ambitions

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Court-appointed liquidators trying to recover assets funnelled to Bernard Madoff through British Virgin Islands feeder funds are pursuing claims. It could be years before investors see results.

The British Virgin Islands (BVI) was home to some of the largest Madoff feeder funds, including those run by Fairfield Greenwich, Kingate and Mount Capital. Between them these entities are believed to have had over \$10 billion invested in Bernard L Madoff Investment Securities (BLMIS) when it was exposed as a Ponzi scheme.

The liquidators hope to recover funds from three main sources. Claims have been made against the Madoff estate and proceedings have also been initiated against investors who redeemed from the feeder funds in the 90 days before the fraud was exposed.

The liquidators are also weighing up claims against service providers to the feeder funds.

The priority is settling the competing claims between the Madoff estate and the offshore feeder funds. Irving Picard, the trustee for the liquidation of BLMIS, is seeking to recover all redemptions payments made by BLMIS within 90 days of it going into bankruptcy.

Picard claims the three Fairfield funds withdrew \$1.2 billion in the 90 days before BLMIS collapsed and \$3.2 billion over an extended six-year clawback period. The Kingate funds face similar claims for \$250 million.

Picard is seeking to recover a combined total of \$14.5 billion in a series of clawback claims against Madoff's biggest investors. He is refusing to consider any claims these investors have against the Madoff estate until his clawback claims are resolved.

Liquidators in the BVI are locked in negotiations with Picard over these claims. One issue they face is a conflict in the law relating to cross-claims in insolvency proceedings.

Claims by entities subject to unresolved recovery are not eligible for distribution payments under section 502(d) of the US bankruptcy code. Under BVI law such claims can be offset, paving the way for appropriate distributions to be made.

Liquidators in the BVI face a strategic choice in their dealings with the Madoff trustee, notes Hadley Chilton of Baker Tilly, joint liquidator of the Mount Capital funds. "We have to decide whether it is in the interests of Mount Capital's creditors to settle with the Madoff trustee. It makes sense to reach a settlement if we believe the Madoff estate will in turn be able to return a meaningful sum to Mount Capital's creditors."

Picard is seeking to recover around \$40 million in redemption payments made to Mount Capital in the 90 days before BLMIS filed for bankruptcy.

The liquidators to the Kingate and Fairfield funds are in a similar position. "We are discussing a potential settlement but we are yet to reach an agreement," says William Tacon of Zolfo Cooper, the joint liquidator of the Kingate funds alongside Richard Fogerty.

Kenneth Kryss of Kryss & Associates, joint liquidator of the Fairfield funds, says his discussions with Picard have been encouraging. "We have had some open and frank discussions with Mr Picard and his team. It is in the interests of both estates to resolve the claims between each other," he says.

Picard has also sought to gain access to the share registries of the BVI feeder funds in order to identify and pursue claims against end-investors. The liquidators are opposed to this action. "We are sensitive to confidentiality issues and have not disclosed information on shareholders," says Tacon. The other court-appointed liquidators echo that sentiment.

Picard is seeking permission from the courts to trace the investors in offshore feeder funds. The BVI courts are "unlikely to allow the Madoff trustee to view the shareholder registers of BVI companies," says Arabella di Iorio, partner and head of the BVI litigation group of the offshore law firm Maples and Calder.

The liquidators are also pursuing claims against shareholders who redeemed from the feeder funds in the 90 days before the discovery

of the Madoff scheme.

Krys & Associates has filed over 100 claims against shareholders that redeemed from Fairfield Sentry before it filed for bankruptcy. The lawsuits target entities affiliated with JP Morgan, Deutsche Bank, UBS and Banque Privée Edmond de Rothschild, among others. Krys described the claims as “the main focus” in terms of recovering assets for creditors.

Those efforts have been bolstered by a successful application to have the Fairfield funds’ insolvency proceedings in the BVI recognised as foreign main proceedings under Chapter 15 of the US bankruptcy code. The recognition was granted by a New York court in July and means the Fairfield funds have the protection of US bankruptcy law when they pursue claims and defend proceedings in the US.

The other main aspect of the recovery effort is focused on claims against service providers. Fairfield Sentry has filed a claim in New York to recover more than \$900 million in fees paid to investment manager Fairfield Greenwich in relation to Madoff-related investments.

The liquidators have not filed any claims against other service providers to the Fairfield funds. “We want to see if we can resolve this without unnecessary litigation,” says Krys.

The liquidators of Kingate and Mount Capital are also exploring claims against service providers. “We are looking very actively at the extent to which the Kingate funds have claims against third parties,” says Tacon.

Chilton and joint liquidator John Greenwood at Baker Tilly are taking legal advice on the potential claims they have against various parties, including the investment manager and other service providers to Mount Capital’s funds.

The liquidator’s claims are likely to be targeted at deep-pocketed service providers, says Maples and Calder’s di Iorio. Fund administrators, custodian banks and auditors are likely to bear the brunt of these claims, she notes.

Claims against service providers are “an unknown quantity,” says di Iorio. “A lot of these actions are ultimately claims against investors. There is a possibility they may stick, but more often than not there is a break-in causation which prevents the claimant from recovering damages from a service provider.”

The liquidators admit the legal challenges are considerable. “There is nothing simple about this liquidation,” says Krys. “The magnitude of the fraud means the normal ‘deep pockets’ don’t have sufficient assets to produce a good return for investors. We have to look at other options.”

“The multi-jurisdictional nature of this case has thrown up some very complex legal problems,” adds Tacon. “The team here is working very hard to maximise the position of creditors, but it is very difficult,” he says.

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