

Position of the investment managers, Donovan and Co

I. EXPOSURE

A. What claims and by whom?

1. With the Madoff funds being hopelessly insolvent, claimants are casting around for alternative targets with deep pockets: investment funds, hedge funds, funds of funds and auditors. Donovan & Co are exposed to potential (although unfounded) claims (i) for breach of contract (ii) in tort for providing negligent advice/failing to conduct adequate due diligence (iii) for breach of fiduciary duty (to the extent that there was e.g. a breach of good faith, conflict of interest or relevant non-disclosure) and (iv) for misrepresentation (depending on the nature of and claims made in any marketing material supplied to Jollybadfellow Corp), including fraudulent misrepresentation i.e. deceit.

2. Potential claimants:
 - a. The obvious primary claimant is Jollybadfellow Corp (Bad) which has, subject to the merits, a direct claim against Donovan. But Whitely, as director of Bad, is a chum of Donovan's owner and is therefore not inclined to pursue Donovan. In any event, Bad's other director, Mr Belrose, has done a runner. To circumvent this, Mr Bassenger (as trustee of Priscilla) will have to procure the appointment of an additional trustee and remove the obstructive directors of Bad. Even if Mr Bassenger takes this course of action, he will have to get around the problem that Bad is now devoid of funds and will no doubt wish to make a *Beddoes* application (costing yet more money) prior to proceeding against Donovan or funding the litigation.

 - b. Can Whitely sue Donovan in his capacity as enforcer and is he obliged to do so? Whitely is only obliged to enforce the non-charitable purpose trust and there is £10 million in cash in Priscilla - ample to celebrate Mr Belrose's life. Accordingly, he has no standing to pursue Donovan. Furthermore, there is no contractual relationship between the trust and Donovan and the former would have to bring a claim in tort.

- c. As for Bob, he is realistically powerless.

B. Defences

3. Donovan will argue that:

- a. The proper forum for the dispute is Cayman and Jersey has no jurisdiction. It will absorb more of Bad or Priscilla's scant funds in preliminary challenges.
- b. Madoff's auditors, Frierling & Horowitz, gave his investment vehicle (MIS) a clean bill of health on the basis of GAAS and GAAP for 17 years. They were indicted on 18 March 2009 by the SEC for fraud. They were primarily responsible for the prolonged perpetuation of the fraud.
- c. The 'big 4' auditors of the feeder funds, such as KPMG, PWC and E&Y, also gave MIS a clean bill of health confirming it had \$billions in assets and despite it posting consistent positive returns over some 17 years, despite a sometimes declining market.
- d. Madoff had a clean regulatory record with the US authorities.
- e. Losses suffered by investors are the fault of a lack of regulation of funds and LLCs, not the fault of investment managers who were not in a position to audit the underlying investments and test their existence. The losses have not been caused by a lack of due diligence on the part of Donovan.
- f. The returns were too good to pass up and the charges levied by Madoff low. There were instances of investors investing huge amounts despite not being allowed by Madoff to independently verify his operations. Accordingly, the losses would have been suffered in any event.
- g. Bad agreed to the lack of diversification and made the ultimate decision to invest. This was reflected in the relatively low fees (2%) charged by Donovan in contrast to the elevated fees (over and above 2 and 20 in the case of hedge funds or 1 and 5-20 for FOFs) charged by many feeder funds.

- h. Check the small print: were warnings given by Donovan of risks associated with one broker-dealer having custody of the assets and executing the investment strategy? The contractual terms could shift the financial risk to the investor and/or entitle the investment manager to rely, if in good faith, on the information provided by Madoff.

II. CONTRIBUTIONS FROM THIRD PARTIES

4. If sued and in addition to its defences against Bad, Donovan will seek:
 - a. An indemnity from its liability/D&O insurers; and
 - b. A contribution from Bad's auditors given that they did not question reliance on a single money manager and blindly accepted the underlying value of the investments – failing to investigate primary brokerage, trading and option purchase documents which would have uncovered the Ponzi scheme.