

CHAPPELL & CO'S POSITION PAPER

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. Chappell & Co (CC) are exposed to potential 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 Lara).
2. Potential claimants:
 - a. The obvious primary claimant is Lara Corp (Lara) which has, subject to the merits, a direct claim against CC. But Lloyd as director of Lara is a chum of CC's owner and can block legal action by Lara. To circumvent this, Worrall (if so minded) would have to obtain Kanhai's agreement to procure that Sobers remove Lloyd as a director of Lara in general meeting.
 - b. Sobers as trustee, which involves the additional hurdle that Kanhai and Worrall would have to agree to take action. Sobers is a step removed from Lara in terms of mounting a claim as there is likely no direct contractual or advisory relationship. In order to bring a tortious claim, Sobers will have to bring itself within *Caparo v Dickman* [1990] 2 AC 605 HL i.e. CC knew its advice would be communicated to and acted/relied upon by Sobers without independent enquiry and Sobers in fact so acted to its detriment, or

show CC voluntarily assumed responsibility to it under *Henderson v Merrett Syndicates Ltd* [1995] 1 AC 145 HL.

- c. If Lloyd as a director of Lara wants to sue but is thwarted by Worrall/Sobers, can he/is he obliged to sue CC or Sobers in his capacity as enforcer? In this regard, the meaning of a “*right or duty to bring an action for the enforcement of a special trust*” (see s.95 of Part VIII of Trusts Law (2001 Revision)) (TLR) is unclear. It is strongly arguable that the right to sue vests in the trustee and that Lloyd is confined, as is any beneficiary of an ordinary trust, to bringing an administrative or derivative action (see s.102 TLR).

B. Defences on the merits

3. CC will argue that:

- a. 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.
- b. 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.
- c. Madoff had a clean regulatory record with the US authorities.
- d. 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 CC.

- e. 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.
- f. Lara agreed to the lack of diversification and retained and made the ultimate investment decisions. This was reflected in the relatively low fees (2%) charged by CC 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.
- g. Check the small print: were warnings given by CC 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 e.g. Lara, CC/its directors will seek:
 - a. An indemnity from its liability/D&O insurers; and
 - b. A contribution from Lara'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.

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