IN THE SUPREME COURT OF BERMUDA

Commercial Court

2008: No. 266

IN THE MATTER OF STEWARDSHIP CREDIT ARBITRAGE FUND, LTD.

AND IN THE MATTER OF THE COMPANIES ACT 1981

BETWEEN:

1. **BNY AIS NOMINEES LIMITED (as Nominee for the 2nd to 6th Petitioners)**
2. **GOTTEX ABI MASTER FUND LIMITED**
3. **GOTTEX ABL (CAYMAN) LIMITED**
4. **GOTTEX/NOMURA MARKET NEUTRAL FUND (USD) LIMITED**
5. **HUDSON ABL FUND LIMITED**
6. **GOTTEX MATRIX ASSET FOCUSED MASTER FUND LIMITED**

Petitioners / Applicants

and

STEWARDSHIP CREDIT ARBITRAGE FUND, LTD.

The Company / Respondent

REASONS FOR RULING

Date of Hearing: 20, 21, 24 and 25 November, 2008

Date of Ruling: 27 November 2008

Mr. Alex Potts and Ms. Lakilah Spencer, Conyers Dill & Pearman, for the Petitioners

Mr. Andrew Martin and Mr. Saul Froomklin Q.C., Mello, Jones and Martin, for the Company

Mr. Jan Woloniecki and Mr. Peter Dunlop, Attride-Stirling & Woloniecki, for the Intervener

Introduction

1. The petition in these proceedings was issued on 4 November 2008 and was first returnable on Friday, 28 November 2008. I will refer to the petitioners collectively as "the Gottex Funds" and to the respondent either as "the Company" or "the Fund". The Company's principal lender, DZ Bank AG Deutsche Zentral-Genossenschaftsbank ("DZ Bank") has sought to intervene in the proceedings to oppose the application.

Background

2. This is the second set of proceedings between the Gottex Funds and the Company, the first being proceedings No. 114 of 2008 ("the Debt Action"), which was commenced on 23 May 2008 by specially indorsed writ of summons. The issue of those proceedings was followed by an application for a worldwide Mareva injunction up to the value of US$110 million, made by a summons dated 27 June 2008, which summons came on for hearing before the Chief Justice that same day. The Chief Justice made an order broadly in terms of the relief sought, and there was a further hearing on Monday, 30 June 2008 which dealt with outstanding aspects of that Mareva injunction.

3. A defence was filed in the Debt Action on 15 July 2008, following which there was little activity on the court file, although no doubt considerable activity as between the parties and their legal advisors. Following the issue of these proceedings, DZ Bank applied to vary the Mareva injunction, as did the Company itself. I took the view that it was preferable to deal with the applications in these proceedings first, so that at the date of this ruling the variation applications in the Debt Action remain outstanding.

These Proceedings

4. The petition in these proceedings identifies the Gottex Funds, which are funds of funds, as current, contingent and/or prospective creditors of the Company for the reasons set out in the petition. It details the nature of the contractual arrangements between the Gottex Funds and the Company, and I will deal with that aspect of matters when I come to deal with the material facts. Suffice it to say at this stage that the Gottex Funds, having entered into various investment contracts to acquire Class A shares in the Company between 1 December 2005 and 1 November 2007 (the latter date apparently being the date of the latest share transfer), served redemption requests between 31 May 2007 and 8 October 2007, requesting a complete redemption of their Class A shares in the Company. By virtue of an agreed variation as to the effective redemption date, the redemption date became 31 March 2008 and the Gottex Funds maintain that the value of their Class A shares held in the Company at that date totalled $103,152,659.15.

5. I will also deal with the relevant redemption provisions in more detail in due course, but for the purpose of this part of the narrative it is sufficient to say that the arrangements in relation to payment of the redemption price, as set out in bye-law 15 of the Company's bye-laws, provided for a payment of 90% of the redemption price within thirty business days, with the balance of 10% being payable within ten days following the final determination of the net asset value per participating share of the redeemed shares as of the redemption date.

6. The primary case for the Gottex Funds is that they were entitled to be paid in cash, firstly as to 100% of the redemption price on or before 12 May 2008 (the date representing thirty business days following the agreed redemption date of 31 March 2008), and alternatively as to 90% in cash on or before 12 May 2008, with the balance of 10% payable in accordance with the formula referred to above.

7. The alternative position taken on behalf of the Gottex Funds is that the Company was obliged to pay to them the sum of US$103,152,659.15 either in cash or in

kind on or before 12 May 2008, with the same alternative position as to the payments of 90% and 10%.

8. It is then the position of the Gottex Funds that the Company has paid out only a "tiny fraction" of the redemption price owed to them on or before 12 May 2008, in the total sum of $64,547.61. However, further payments were made, in the sum of $429,577.82 on or about 4 June 2008, and the sum of $1,976,505.43 on or about 18 June 2008. The Gottex Funds maintain that the Company still owes them the aggregate sum of US$100,814,573.03.

9. The petition then deals with the purported tender by the Company to the Gottex Funds, on or about 13 May 2008, of certain documents described on their face as participation notes, which the Company asserts, but the Gottex Funds deny, were worth an aggregate sum of US$92,772,845.63 as at 13 May 2003. The Gottex Funds then complain that the Company is in breach of its obligation by not making the payment of the redemption price in cash in full, or alternatively not making a valid payment in kind. The petition refers to the Debt Action and then pleads that the Company was unable to pay its debts, and particularly its debts to the Gottex Funds, and was therefore insolvent on a commercial basis insofar as it could not meet its liabilities as they fell due. Alternatively, the Gottex Funds maintain that the Company's liabilities exceed the value of its assets taking into account its current liabilities, contingent liabilities and prospective liabilities. In this latter regard the Gottex Funds relied upon the fact that the Company had indefinitely suspended the calculation and publication of its NAV statements and all subscriptions and redemptions with effect from 10 June 2008, saying:

> "the Fund cannot withstand such a large demand for redemption requests at the same time in the current market conditions".

Further, the Gottex Funds refer to the fact that the Company had almost 70% of its assets owing from various companies connected to one Thomas Petters, and in view of the allegations of fraud which have now been made in relation to Mr. Petters and his companies ("the Petters Fraud"), and the proceedings which have

been taken against various Petters entities in the United States, there was no realistic prospect that the Company would recover any or any substantial value from those assets within a reasonable period of time. Finally, the petition sought in the alternative to wind up the Company on the basis that it was just and equitable to do so, for the reasons set out in an affidavit sworn on 30 October 2008 by Amy Lai, who holds a senior position with the investment manager for the Gottex Funds. That affidavit also supported the application for the appointment of joint provisional liquidators referred to below.

10. The petition sought the winding up of the Company by the Court under the provisions of the Companies Act 1981 ("the Act"), and also prayed for the appointment of Peter Mitchell and Geoffrey Hunter of PricewaterhouseCoopers Advisory Ltd. as joint liquidators.

11. At the same time, an application was made by ex parte summons dated 4 November 2008 for Messrs. Mitchell and Hunter to be appointed as joint provisional liquidators of the Company, with the powers identified in the form of draft order attached.

12. The first return date of the ex parte summons was 5 November 2008. By that time, the Company had been put on notice of the application by the Gottex Funds. The position on that first return date was that Mr. Potts for the Gottex Funds sought to proceed forthwith on the basis of the extreme urgency of the situation, whereas Mr. Martin for the Company sought fourteen days within which to file affidavits in reply in opposition to the application. In the event, I ordered that the Company should have seven days within which to file its reply evidence, and that the matter should be set down for an inter partes hearing during the course of the week of Monday, 17 November 2008. The deadline for the filing of affidavits was therefore by close of business on Wednesday, 12 November 2008 and I will in due course come to the fact that the Company was two days late in filing its affidavits, and the point made by Mr. Potts in that regard as to the solvency of the

Company at the time that the affidavits should have been filed, and the time that they were in fact filed.

13. In terms of the affidavit evidence, I have referred to the affidavit sworn by Ms. Lai, but not the fact that it exhibited pleadings in the Debt Action, and more particularly the extensive affidavits of J. P. Bailey and Gabriel Bousbib, sworn respectively on 25 and 26 June 2008, which affidavits were sworn in support of the application for the Mareva injunction in the Debt Action. In reply, the Company filed four affidavits, sworn by Jennifer Kelly, Marlon Quan and Gustav Escher on 14 November 2008 and by Thomas Davis on 18 November 2008. All four deponents are directors of the Fund. Finally, Sandeep Srinath swore an affidavit on behalf of DZ Bank on 14 November 2008 and those various affidavits were sworn both in opposition to the application made on behalf of the Gottex Funds and in support of summonses which both the Company and DZ Bank had filed, seeking to strike out the winding up petition, and in the case of the Company, regularising the late filing of its affidavit evidence and seeking an order restraining the advertisement of the petition.

Factual Background

14. I will now turn to the factual background, taken from a combination of the affidavits sworn on both sides and the extensive material filed, particularly in the form of the exhibits to Ms. Lai's affidavit, which as I have said included the affidavits of Messrs. Bailey and Bousbib and the material which they exhibited. One background matter which is highly relevant is Ms. Lai's statement in paragraph 12 of her affidavit that the redemption price for the investments of the Gottex Funds represented about 40% of the Company's total net asset value as at 31 March 2008.

15. The starting point is to say something about Mr. Quan. Although he described himself in his affidavit merely as a director of the Fund, Mr. Bailey referred to him as the founder of the Fund, as well as its managing director, and said that in

that capacity he supervises and administers all of the general business and affairs of the Fund. Mr. Quan described himself as the managing member of Stewardship Investment Advisors LLC ("SIA") which he said was the managing member of the Stewardship Credit Arbitrage Fund LLC ("the On-Shore Fund"), and which is the investment manager of both the On-Shore Fund and the Fund. He is also the chief executive officer of Acorn Capital LLC ("Acorn"), which Mr. Bailey described as the financing company used by the Company, which he said was also owned and controlled by Mr. Quan. Mr. Bailey's description was not disputed by Mr. Quan.

16. In terms of the investment by the Gottex Funds in the Company, the position is not, as I understand it, in dispute. The disputed factual matters start with the terms of the conversations which took place between Mr. Quan and Mr. Bailey after the Gottex Funds had become dissatisfied with their returns from the Fund, in the summer of 2006. Mr. Bailey said that he had met with Mr. Quan to express this dissatisfaction, and there followed negotiations which Mr. Bailey said did not result in any form of agreement, in consequence of which the Gottex Funds submitted redemption requests to the Company for the full value of their interests, which requests called for redemptions as of 31 August 2007 and 31 October 2007.

17. Mr. Bailey then indicated that he had been contacted in August 2007 by Mr. Quan, who asked if the Gottex Funds would agree to defer those redemptions until a later date. There is a dispute between the parties as to whether it was agreed that the deferred redemption would be paid in cash. It is of course not possible to resolve that dispute in the context of an interlocutory application, but it is of note that Mr. Bailey does not say that Mr. Quan told him in terms that the redemption would be made in cash. He said that Mr. Quan had told him that he wanted time to raise cash by attracting new investors into the Fund so that such cash could be used to pay the Gottex Funds' redemptions, and that statement only made sense on the basis that it was Mr. Quan's intention that the Company should

pay the redemption in cash. Mr. Quan simply says that he made no such agreement.

18. In any event, the conversation of 30 August 2007 was confirmed in an email from Mr. Quan to Mr. Bailey sent on 4 September 2007, which was in the following terms:

> "Thank you for the call and the proposal you made Thursday (8/30/07) concerning the impending redemptions from the Stewardship Credit Arbitrage Fund, Ltd. Class A. I have submitted the proposal to the Board of Directors and received back the following:
>
> > *The Board has paid significant consideration to your proposal and has determined that they would consider the following: In return for waiving the early redemption penalty fees, the valuation/effective date for ALL Gottex related redemptions would be March 31, 2008. These redemptions would remain subject to all other terms and conditions detailed in the Fund's Private Placement Memorandum. It is their view that the waiver would be a fair and just compromise for the remaining investors in the Fund, should the revised redemption date be accepted by you.*
>
> Otherwise, the Board will proceed with the current redemptions as noticed and scheduled, subject to the terms and conditions set forth in the Fund's Private Placement Memorandum.
>
> Please let me know if you would be willing to accept this proposal or wish to keep the 9/30 and 10/31 redemptions as scheduled."

19. Mr. Bailey commented in his affidavit that the reference to a redemption of 30 September 2008 appeared to be in error, given that the correct redemption dates were as indicated in paragraph 16 above, but this is academic given that the proposal was accepted, as it was on 13 September 2008. Mr. Bailey then gave five reasons as the basis for his understanding that the Gottex Funds' redemptions would be paid in cash. These were:

(i) The prospectuses clearly stated that the Company intended to pay redemptions in cash, while reserving the right to pay redemptions in kind, in whole or in part.

(ii) In Mr. Bailey's experience the ordinary business practice in the hedge fund industry was to satisfy redemptions in cash.

(iii) A substantial portion of the Company's assets were highly liquid.

(iv) By the time for payment, the Company would have had more than enough time to generate sufficient cash to satisfy the redemptions, and

(v) The reason given by Mr. Quan in his request to delay redemptions.

20. Mr. Bailey referred then to the events between September 2007 and early April 2008, and the fact that Mr. Quan had told him and his colleagues Mr. Bousbib and Ms. Lai on 1 April 2008 for the first time that the Company would be paying the Gottex Funds' redemptions in full, but in kind rather than in cash. In this regard, Mr. Bailey said in terms that Mr. Quan had made it clear that the reason for this decision was to avoid any lag in performance returns resulting from holding cash pending the redemption payment. Put another way, Mr. Quan was saying that the Fund would have the ability to pay the redemptions in cash, but chose not to do so. Mr. Quan did not dispute Mr. Bailey's comment, but he did say that the Company's liquidity problems began in late 2007. Mr. Bailey also said that Mr. Quan stated in the course of that conversation that he had known for a while that the Company did not plan to pay the Gottex Funds' redemptions in cash, although he was only now informing the Gottex Funds of this decision.

21. Mr. Quan did not contradict this statement in his affidavit and indeed his affidavit is consistent with it, insofar as he indicated that the Fund had run into liquidity problems in late 2007, in consequence of which the Fund's directors had resolved at an earlier stage to seek to satisfy redeeming shareholders by means of a participation note structure. Mr. Quan said that the first redemptions effected by the distribution of participation notes were on 14 April 2008, based on the NAV of 29 February 2008. Presumably it would have taken some time to prepare the

participation note structure, so I read paragraph 6 of Mr. Quan's affidavit as not being inconsistent with the statement made by Mr. Bailey, in relation to Mr. Quan's failure to give a prompt indication of the Fund's intention to redeem in kind rather than in cash.

22. Following that 1 April 2008 telephone conversation, Mr. Bousbib took over the conduct of negotiations with the Fund, and he described the efforts of the Gottex Funds to determine the nature of the proposed "in kind" distribution, and the failure on the part of the Company to give any meaningful information in response to the enquiries of the Gottex Funds.

23. On 17 April 2008, one of Mr. Quan's colleagues at SIA, John Ruggiero, sent an email to Ms. Lai indicating that the Company anticipated being able to distribute "draft participation notes with preliminary schedule of notes to you later today". By this time, the Gottex Funds were clearly becoming concerned as to the nature of the asset which might be presented to them in purported satisfaction of the redemption obligation. The Gottex Funds' general counsel, William Woolverton, sent a detailed letter to Mr. Quan on 24 April 2008 expressing a variety of different concerns. The reply came in the form of a letter from Doug Molyneux, an attorney with the Company's Bermuda lawyers, Appleby, sent on 25 April 2008 to the Gottex Funds' general counsel, which letter attached a copy of "the current working draft of the contemplated participation note", without any assurance being given that this would represent the final form of note to be provided. Mr. Molyneux's letter did not seek to respond to the various concerns raised by Mr. Woolverton.

24. This draft prompted Matthew Dowgert, another in-house lawyer at the Gottex Funds, to send an email on 29 April 2008, which asked no less than twenty five detailed questions. Mr. Potts asserted that there had never been a response to these questions, something which Mr. Bousbib himself had indicated in his affidavit, and which statement was not controverted by the Company.

25. There were continuing questions raised on the part of the Gottex Funds, which prompted an email response from Mr. Quan on 2 May 2008 which was relatively uncompromising, and indicated that the Company was "not prepared to revisit the form and composition of the redemption in kind".

26. There was then a further comprehensive letter from Mr. Woolverton on 6 May 2008, again asking detailed questions, which again, according to Mr. Bousbib, received no substantive response. One of the points which Mr. Woolverton made was that the Gottex Funds needed responses to the questions which had been asked so that they could make an independent determination of the value of the interests that were being transferred to the trust created by the proposed participation notes as of the redemption date, and thus the value of the Gottex Funds' interests in the participation notes. Mr. Woolverton pointed out that this was a critical exercise which needed to be performed so that the Gottex Funds could satisfy their own fiduciary obligations to their investors.

27. Mr. Bousbib then referred to a meeting which he had had with Mr. Quan on 8 May 2008, at which Mr. Quan had referred to the yield of the underlying assets, and this in turn led to more extensive communication in the form of emails from Mr. Bousbib on 9 and 12 May, 2008 neither of which received a response. Instead, at 9:08 p.m. on 12 May 2008, the due date for payment, Mr. Ruggiero purported to tender five different forms of participation note ("the Participation Notes"), one for each of the investing Gottex Funds, with the following message:

> "Please find attached Participation Notes for the following accounts as payments in kind in satisfaction of the March 31, 2008 redemptions submitted by those accounts to Stewardship Credit Arbitrage Fund, Ltd. concerning Class A shares".

28. The following day, Mr. Dowgert informed Mr. Quan that the Gottex Funds did not accept that the email or the attached Participation Notes constituted a valid

tender of payment by the Company of any or all of the amounts owed to the Gottex Funds, and reserved their rights. There was continuing communication, both by email and telephone, including a letter from Mr. Molyneux dated 14 May 2008, indicating that he was "astounded" by the assertion that the Gottex Funds did not accept that the payments by means of the Participation Notes was a valid form of payment of the redemption price. Mr. Molyneux maintained that this was the first time that the Gottex Funds had taken such a position, and that it had been nearly a month since they had been advised that redemption in kind would be made by means of participation notes. Mr. Molyneux must either have been unaware that there had been no response to the detailed queries made on more than one occasion by the Gottex Funds, or chose to overlook this fact; given that he must have seen Mr. Woolverton's letter of 24 April 2008, it seems to have been the latter.

29. One of the features of the Participation Notes is that they were said to evidence the beneficial ownership interests in a trust created by the Fund, pursuant to a declaration of trust dated as of 12 May 2008, for the purpose of pooling loans subject to the participation. While the original draft sent by Mr. Molyneux in April had attached a form of declaration of trust, there was no such form attached to the Participation Notes sent out on 12 May 2008. There were other provisions in the Participation Notes to which I should refer. Firstly, the Participation Notes purported to be certificates, each referred to as a registered instrument, rather than a bearer instrument. Secondly, they provided for payment to the holder upon receipt by the Fund of any payment of principal or interest on the underlying loans. Next, there were disclaimers of responsibility on the part of the Fund. Next was a restriction on any transfer of the Participation Notes without the written consent of the Fund. The governing law of the participation notes was said to be that of the state of New York, and the underlying notes themselves were set out in an annex. This set out the origination dates of the loans, and in respect of a substantial tranche of these (designated POL 1 through 14), the origination dates were in each case 12 May 2008, the date of issue of the notes. These

particular loans were the successors in title to those described by Mr. Quan as the PAC Facility, which had previously gone into default, a default which was said by Mr. Quan to have been cured by the provision of a forbearance agreement in February 2008, under which the Fund had exchanged aged receivables with new receivables from differing counterparties. The point made by Mr. Potts in regards to these loans is that since the Fund had by this time suspended its NAV calculations, (the suspension came later, but the necessary calculation had not been completed following the April month end), there was no basis upon which these underlying loans could have been properly valued.

30. There will no doubt be other factual matters to which I will need to return but for the present the above is sufficient to take matters beyond the issue of the Participation Notes, following which the Debt Action proceedings were issued less than two weeks later.

The Petters Fraud

31. The next factual matter which I need to refer to is the discovery of the Petters Fraud. In his affidavit, Mr. Quan said (paragraph 11) that "It was with absolute dismay and disbelief that I learned in late September and early October 2008 of the frauds allegedly committed by Mr. Petters and certain of his associates". This level of astonishment seems more than a little overstated. Acorn (presumably directed by Mr. Quan) took proceedings in the U.S. District Court for the Southern District of New York against Mr. Petters, and the complaint dated 14 August 2008 was exhibited to Ms. Lai's affidavit. This complaint refers to the fact that the credit agreement known as the PAC Credit Agreement, of which Mr. Petters was the guarantor, was in default when PAC failed to make a payment of US$10 million on 1 August 2008. The complaint then refers to a conversation which took place between Mr. Quan and Mr. Petters on 4 August 2008, during the course of which Mr. Petters admitted that the collateral which PAC had purported to provide of "at least $289 million in accounts receivable" in fact had a value of substantially less than that figure. Moreover, Mr. Petters was said to have

admitted to Mr. Quan that some of the collateral referred to was not, as had been represented and warranted, accounts receivable, but was inventory. So if Mr. Quan did not know of the full extent of the Petters Fraud on 4 August 2008, he certainly knew that there had been false representations and warranties made in relation to the collateral for the PAC Credit Agreement. It is perhaps interesting that Mr. Srinath in his affidavit in the Debt Action characterised this as being a discovery by the Company of "fraud or material misrepresentation on the part of PAC Funding and Petters", although Mr. Woloniecki was at pains to clarify that this was intended to do no more than refer to the terms of the complaint. Given the subsequent revelations in relation to the Petters Fraud, it is perhaps not surprising that Mr. Srinath shou ld have so characterised the contents of the complaint. It is also to be noted that Mr. Quan does not suggest that he passed this highly material information on to the Gottex Funds; I use the words "highly material" because a significant proportion of the loans which constituted the underlying assets for the Participation Notes (almost $40 million worth) represented the successor loans to the PAC Facility which had gone into default.

32. Thereafter, matters in relation to Mr. Petters and his various corporate entities quickly went from bad to worse. In late September the FBI raided the operating facilities of the Petters companies, and on 3 October 2008 Mr. Petters was arrested, and according to press reports quoted by Mr. Quan, has remained in custody ever since. On 6 October 2008, the US District Court for the District of Minnesota issued a receiving order in respect of the assets of various Petters companies, and on 22 October 2008, the Minnesota court extended the receiving order, adding Mr. Petters and thus, according to Mr. Quan, thwarting Acorn's plan to move for summary judgment in the proceedings taken against Mr. Petters on his guarantee.

33. The extension of the receivership order to Mr. Petters personally was also significant because when the PAC Facility went into default, and SIA became uncomfortable with the PAC Facility's existing collateral of receivables, it began

to negotiate a new security in April 2008, which involved the grant of a security interest in additional assets, referred to by Mr. Quan as the Polaroid assets. The value of these assets has been the subject of much argument, and I will refer to this aspect of matters in more detail in due course.

34. It may well also be necessary for me to refer to other further factual matters or to go into further detail in relation to the factual matters referred to above. In any event, I would propose at this stage to move on to consider the relevant legal issues.

Principles Governing the Appointment of Provisional Liquidators

35. Essentially, the legal position in Bermuda is not in dispute, and is perhaps best set out in the judgment of Kawaley J. in *Discover Reinsurance Company v PEG Reinsurance Co. Ltd.* [2006] Bda L.R. 88, from which I quote as follows: (paragraph 17):

> "The English position is most germane, in terms of persuasive authority, because our winding-up regime is effectively identical to that contained in the English Companies Act 1948, which evolved out of the nineteenth century statutory antecedents which gave rise to the cases referred to above. Thus in the leading Bermudian case on the principles governing the appointment of provisional liquidators, *In the matter of CTRAK Ltd. et al* [1994] Bda LR 37, Ground J. (as he then was) cited with approval the following dictum of Sir Robert Megarry (V-C) in *Re Highfield Commodities Ltd.* [1984] 3 All ER 884 at 892-893:
>
> "At the outset let me say that I accept that the court will be slow to appoint a provisional liquidator unless there is at least a good prima facie case for saying that a winding-up order will be made: see Re Mercantile Bank of Australia [1892] 2 Ch 204 at 210, Re North Wales Gunpowder Co [1982] 2 QB 220 at 224. Founding himself on cases such as Re Cilfoden Benefit Building Society (1968) LR 3 Ch App 462 (where the words 'in general' should be noted) and Re London and Manchester Industrial Association (1875) 1 Ch D 466, counsel for HCL contended that if the company opposed the application for the appointment of a provisional liquidator, no appointment would be made (and any ex parte appointment would be terminated) unless either the company was obviously insolvent or it was otherwise clear that it was bound to be wound up, or else the company's assets were in jeopardy, as seems to have been the case in Re Marseilles

Extension Rly and Land Co [1867] WN 68. Counsel for the Secretary of State, on the other hand, relied strongly on Re Union Accident Insurance Co Ltd [1972] 1 All ER 1105 (the report of the case at [1972] 1 WLR 640 omits the relevant part of the decision). That case has some similarities to the present case. The Department of Trade and Industry presented a petition for the winding up of a motor insurance company under s 35 of the 1967 Act and the Insurance Companies Act 1958, s 13, after having required the company to produce books and documents and on the same day the department obtained an ex parte order appointing a provisional liquidator. No point seems to have been taken on the power of the department to apply for such an appointment. The company, acting promptly (in contrast with the present case), moved for the determination of the provisional liquidatorship and other relief. Plowman J refused to accept that the power to appoint a provisional liquidator was restricted in the manner for which counsel for HCL contended before me, and pointed out that s 238 of the 1948 Act conferred a quite general power of appointing a provisional liquidator. He held that the department had made out a good prima facie case for the winding up of the company on the hearing of the petition, and then asked whether in the circumstances of the case it was right that a provisional liquidator should have been appointed. He referred to the fact that a direction had been given which prevented the company from writing new policies of insurance, and that the presentation of the petition had prevented it from paying claims. Then he said (at 1110) that 'there is the public interest to be considered', and that this required either that the solvency of the company should be maintained or else that the company should be wound up before its liabilities exceeded its assets. That solvency depended largely on the company recovering in full from its brokers and agents the balances that they held for the company. After considering the evidence, the judge came to the conclusion that the registrar had been perfectly right to appoint a provisional liquidator, and he dismissed the motion.

I would respectfully express my complete agreement with the view taken by the judge. I do not think that the old authorities, properly read, had the effect of laying down any rule that the power to appoint a provisional liquidator is to be restricted in the way for which counsel for HCL contends. No doubt a provisional liquidator can properly be appointed if the company is obviously insolvent or the assets are in jeopardy but I do not think that the cases show that in no other case can a provisional liquidator be appointed over the company's objection. As the judge said, s 238 is in quite general terms. I can see no hint in it that it is to be restricted to certain categories of cases. The section confers on the court a discretionary power, and that power must obviously be exercised in a proper judicial manner. The exercise of that power may have serious consequences for the company, and so a need for the exercise of the power must overtop those consequences."

36. So the position is that the applicant for the appointment of provisional liquidators must at least make out a good prima facie case that a winding-up order will be made. Once that hurdle has been cleared, the Court must consider whether in the circumstances of the case it is right that joint provisional liquidators should be appointed. In this regard, it is to be noted that the section providing for the appointment of a provisional liquidator (which in Bermuda is section 170 of the Act) is in general terms and does not restrict the power of appointment to certain categories of cases. I particularly bear in mind the last two sentences of the extract quoted above. The exercise of the power of appointment of joint provisional liquidators in this case will certainly have very serious consequences for the Company.

The Position of the Gottex Funds

37. Although Mr. Martin and Mr. Woloniecki put different emphasis on the status of the Gottex Funds, it does seem to me that this needs to be determined with reference to the prospectuses and the Company's bye-laws. Mr. Martin said that following redemption, the Gottex Funds were neither creditors nor shareholders, but were the beneficiaries of the Participation Notes. He carried on to say that if the Company was wrong in that regard, the status of the Gottex Funds was that of unredeemed shareholders. Mr. Woloniecki agreed with Mr. Martin's analysis of the position.

38. In the first instance, therefore, I need to consider the nature of the obligation imposed upon the Company by the redemption provisions, and then consider whether there has been a breach of those provisions, and if so, the position of the Gottex Funds in consequence of such breach.

39. The first matter to deal with is Mr. Potts' contention that the obligation on the Company is to settle the redemptions of the Gottex Funds' investments in cash. I have referred in paragraph 19 above to the reasons given by Mr. Bailey for his

assertion that there was such an obligation, but I have also referred, at paragraph 17, to the fact that Mr. Bailey never said in terms that Mr. Quan had agreed that the redemptions would be made in cash, and I referred there to the fact that such a dispute could not be resolved in the context of an interlocutory application. It does therefore follow that I am not prepared to proceed on the basis that there was an obligation on the Company to settle the Gottex Funds' redemptions in cash, and I would therefore propose to look at matters on the basis of the Company's obligation in the event that it chose to redeem partially in kind.

40. The prospectuses simply refer to the Company's right to redeem in cash or in kind, in relatively general terms. The prospectuses were exhibited to Mr. Bailey's affidavit, and dated 1 July 2005 and 26 February 2007. The relevant provision appears in the prospectuses under the heading "Limitations On Redemptions" and simply says:

> "Although the Fund intends to pay redemptions in cash, the Fund reserves the right to pay redemptions in-kind, in whole or in part."

There is a similar provision under the heading "Redemption Payments", which deals with the split between 90% of the proceeds and the balance of 10%.

41. Greater details appear in the Company's bye-laws, where the position is covered in bye-law 14.2 in the following terms:

> "The Board may, in its discretion, settle redemptions, in whole or in part, in kind by distributing assets of the Company having a value equal to the relevant Redemption Price (or part thereof being settled in kind) to the redeeming Member, provided that any such payment of all or part of any Redemption Price payable by an in-kind distribution of the Company's assets shall not in the opinion of the Board materially prejudice the interests of the Company's non-redeeming Members."

The key words of the bye-law in my view are "by distributing assets of the Company having a value equal to the relevant Redemption Price", and this appears to break down into three parts. First, the assets in question have to be "distributed"; secondly, the assets to be distributed in kind must be "assets of the Company"; and thirdly, they must be assets "having a value equal to the relevant

Redemption Price". Mr. Potts argued in relation to the trust arrangements which were an integral part of the Participation Notes that the Company continued to hold the assets in question in trust for the Gottex Funds. It seems to me in these circumstances highly doubtful that the arrangement envisaged under the Participation Notes could properly be described as a distribution.

42. Mr. Potts next argued that the Participation Notes were not assets of the Company, and contended that the relevant date for the determination of the notes as assets of the Company was the redemption date of 31 March 2008. Hence he said that the Participation Notes could not be assets of the Company, having been created by the Company on 12 May 2008.

43. I do not see that it is necessary for the assets which are to be distributed to the Company in kind, thirty business days after redemption, should have been assets which the Company was holding at the redemption date. However, I am highly doubtful that the Participation Notes can properly be described as assets of the Company, although in truth the stronger point is no doubt the value of those assets. Mr. Martin argued that the provisions of bye-law 19.4 (f), which gave a very wide definition of the net assets of the Company, effectively answered the point which Mr. Potts made. I respectfully disagree; I do not think that that provision advances the case for the Company in any way.

44. What is clear is that at the transfer date, there was no value in the Participation Notes. Quite apart from the fact that they were not transferable or negotiable in any way, there was only an expectation that in due course, payments would be made under the underlying note to the Company, which the Company (as trustee) would then have an obligation to pass on to the respective noteholders. The notes were no more than derivative instruments created by the Company. Even if it could be said that the Participation Notes did indeed constitute assets of the Company, it cannot possibly be maintained that the notes have a value equal to the relevant Redemption Price. So I have no hesitation in finding, and I do find,

that the tender or production, call it what you will, of the Participation Notes did not constitute a payment in kind, and did not constitute satisfaction of the Company's obligation pursuant to the redemptions by the Gottex Funds.

45. This is no doubt also the appropriate time to deal with the "health warning" argument. This argument by Mr. Martin was based upon the warnings in the prospectuses to the effect that an investment in the Company's Class A shares was very speculative and involved substantial risks. I have no doubt that the Gottex Funds, as sophisticated investors, appreciated those risks when they made their investments in the Fund. What they did not expect was that the Company would seek to drive a coach and horses through the provisions in relation to redemptions in kind. I do not think there is anything to this point.

The Restatement of the NAV Argument

46. In considering the standing of the Gottex Funds, it is no doubt necessary to consider the argument that the NAV of the Fund at the time of the Gottex Funds' redemptions needed to be re-calculated. The argument was first advanced in Mr. Quan's affidavit, and was repeated in Mr. Davis' affidavit, when he suggested that Ms. Lai's affidavit contained a major flaw. He then said:

> "On the one hand she states that the amount owing to Gottex, as calculated using the 31st March 2008 Net Asset Value of the Fund, is approximately $103 million. She then argues that the Fund's assets are probably overstated in value because of the Petters fraud. If the Fund's assets are overstated in value, then so too is the amount owing to Gottex as the amount so owing has been calculated based on, in part, the alleged overstated values of the Petters assets."

47. This argument ignores at least two factual matters. First, it ignores the provisions of bye-law 19.2 which provides:

> "Any certificate as to Net Asset Value, a Class NAV, a Series NAV or the Net Asset Value per Participating Share of any Class or Series or as to the Subscription Price or Redemption Price therefor given in good faith by or on behalf of the Board shall be binding on all parties".

For the Company, it was suggested that there was no evidence that a certificate had been provided by the NAV calculation agent, who was identified in the prospectuses. Any such certificate would of course have been available to the Company, but not to the Gottex Funds. One would have expected that if the Company wished to run this argument, it would have furnished evidence as to the position in relation to the production of a certificate.

48. But that point apart, it is perfectly apparent that there are enormous difficulties in determining the true position, even if such an argument were to be accepted. There is no logic in simply recalculating the NAV at the redemption date for the Gottex Funds of 31 March 2008, when the Petters Fraud was not discovered until some months later; there would also be a need to effect a recalculation of the position when the Gottex Funds first invested, and no doubt also in relation to all other redemptions and subscriptions. As Mr. Potts put it, it would be necessary to unravel the entire operation of the fund and the magnitude of such a task cannot be over emphasized. It also seems to me that to do the exercise properly, the Company would need to know the true position in relation to the value of the underlying loan collateral for each revision date, or, put another way, the extent of the Petters Fraud in relation to each such collateral, a truly impossible task. No doubt that is precisely why the relevant bye-law contained the provision which it did, making for certainty once the NAV had been determined.

49. Quite apart from these factual difficulties, it seems to me that there are difficulties with the legal basis for suggesting that there should be a restatement of the NAV. Mr. Martin referred to the relevant text contained in the 29th edition of Chitty on Contracts. He relied upon the statement appearing at paragraph 29-032 that it was not necessary for the mistake on the part of the payer to be shared by the payee, and that indeed the payee did not need to know of it.

50. Paragraph 29-034 of Chitty deals with the burden of proof, which is said not to be heavy, but this paragraph also contains the statement that the mistake must be the effective cause of the payment. That was clearly not the position in relation to the facts of this case, where the payment was made in the ordinary course of business by reason of the redemptions by the Gottex Funds of their investments. The underlying mistake, said to be a lack of knowledge on the part of the Company as to the Petters Fraud, would go to the amount of the payment to be made, but could not be said to be the effective cause of payment.

51. In the circumstances, the burden being on the Company in relation to this matter, I do not consider that it has made out a case for recalculation of the NAV as at 31 March 2008.

Conclusion as to the Status of the Gottex Funds

52. Given the failure of the Company to meet its obligations to the Gottex Funds pursuant to their redemptions, what then is the status of the Gottex Funds? During the course of his argument, Mr. Martin contended firstly that if the obligation to redeem was not in cash, then the redemption did not create a debt. He conceded that there was an obligation on the part of the Company to settle the redemptions, but once his position as to the efficacy of the payment in kind is rejected, as I have found, I find it impossible to accept Mr. Martin's argument that, there having been neither payment in cash, nor payment in kind for the very large balance of the outstanding redemption monies, there is not a debt obligation imposed upon the Company. Mr. Martin's solution was to suggest that the Gottex Funds were left with a cause of action in specific performance only, but were not creditors. I reject that submission. It seems to me to create an entirely artificial distinction between satisfaction of the debt obligation in cash and satisfaction in kind. Whether the debt representing the redemption monies would be satisfied in cash or satisfied by the distribution of assets in kind, it remained a debt obligation.

53. Mr. Potts referred to authority from the seventh edition of Principles of Modern Company Law by Gower and Davies, and particularly the passages at pages 256 and 257, where the authors consider the remedies of a shareholder if a company did not perform the contract to redeem or purchase his shares. The question was answered with reference to the relevant provision of the U.K. Companies Act, to the effect that the redeeming shareholder will cease to be a member or contributory, and will become a creditor in respect of the redemption price. Mr. Martin argued that that statement in Gower turned on a provision of the English Companies Act which Bermuda does not have. In an effort to shore up his position, Mr. Potts referred me to an Australian authority, *Basis Capital Funds Management Ltd. v BT Portfolio Services Ltd.* [2008] NSWSC 766, a first instance decision of the New South Wales Supreme Court. Mr. Potts relied particularly upon a passage at paragraph 142 of the judgment, where the learned judge, Austin J., said:

> "Once redemption has taken place, the position of the former unitholder is "transmuted" from unitholder to creditor, if the redemption price is unpaid".

54. Authority for that proposition was provided by the judge in terms of the case of *MSP Nominees Pty Ltd. v Commissioner of Stamps* [1999] 198 CLR 494. Mr. Martin and Mr. Woloniecki disputed that the authority of *MSP Nominees* justified the conclusion reached by Austin J. in the *Basis Capital* case. At best, I accept that it can be said that the statement is obiter. Mr. Woloniecki also produced the authority of *Heesh v Baker* [2008] NSWSC 711. That case can be distinguished on the facts, because redemption had not occurred, and in any event the comments made in the judgment support the view as to the effect of the judgment in *MSP Nominees* which was accepted by Austin J. in *Basis Capital*. Mr. Woloniecki placed great emphasis on the fact that the obligation in the case of *Heesh v Baker* consisted of the payment of money, but with respect I think it is

difficult to draw general points of principle from cases where the underlying facts are so clearly different.

55. Quite apart from the authorities upon which Mr. Potts relied, it seems to me both sensible and obvious to find that a failure on the part of the Company to discharge its redemption obligations puts the Gottex Funds in the position of creditor, and I so find.

The Disputed Debt Argument

56. It is effectively common ground that winding up proceedings are not suitable proceedings in which to determine a genuine dispute whether a company owes a particular debt. A winding up petition based on a debt which is disputed on some substantial ground is an abuse of the process of the court and will be struck out or restrained as improper – see *Mann v Goldstein* [1968] 1WLR 1091 and *Stonegate Securities Ltd v Gregory* [1980] 1AllER 242.

57. Those cases do make it clear that the words "bona fide disputed", sometimes used to describe the requisite test, do not simply refer to the bona fides of the party maintaining that the debt is disputed; there must also be some substantial ground for the dispute. In this case, the Company has repeatedly and forcefully asserted that there is such substantial ground. I have indicated in my findings above that I do not accept that the Participation Notes represented the discharge of the Company's obligations to the Gottex Funds on redemption. For the avoidance of doubt, I should stress that I do not regard the Company's position as being arguable; there is, in my view, no question of the Participation Notes representing an effective redemption in kind. I do, therefore, hold that the debt in respect of the redemptions of the investments of the Gottex Funds is not one which can properly be said to be disputed on substantial grounds, and I so find.

Insolvency on a Cash Flow Basis

58. This is no doubt the appropriate point to deal with the position as it was both at 5 and 12 November 2008, the former being the first return date of the summons to appoint joint provisional liquidators, and the second being the date by which the Company should have filed its affidavit evidence.

59. The relevant information comes from Mr. Quan's affidavit, and concerns the Company's relationship with DZ Bank. DZ Bank was said to hold a security interest and senior lien over the assets of the Company's subsidiary, Putnam Green Ltd. Mr. Quan referred to DZ Bank having been kept informed of the litigation, and the fact that they had not declared a default as a result of the Fund's failure to pay some relatively small sums due under the Fund's loan facility and the expectation that the problem would be resolved. Mr. Quan did not say why it was that the Fund had been unable to make payment of a relatively small sum, but carried on to say that the discovery of the Petters Fraud had given DZ Bank the right to assert a recourse claim against the Fund, based upon the Fund's representations and warranties that the underlying loans were made without fraud by the underlying borrower, lender or the Fund. As well as asserting a recourse claim, DZ Bank delivered an acceleration notice to the Fund on 30 October 2008 requiring repayment of the full amount of the Fund's borrowing from DZ Bank in the sum of US$16,612,622.61. That is an amount which it seems the Fund was unable to pay, since Mr. Quan carried on to say that DZ Bank had agreed to require payment only of the amounts that the Fund could reasonably repay out of its cash assets and recoveries, so as to leave it with sufficient liquid assets to meet its current obligations. The agreement reached between the Fund and DZ Bank calls for payment of the sum of US$ 8.3 million by 13 December 2008, with the balance payable by 13 June 2009, although DZ Bank has indicated that it will consider extending those dates.

60. Mr. Quan exhibited an execution copy of the agreement with DZ Bank, which was dated 13 November 2008 (the day after the Company's evidence should have

been filed). The agreement refers to the Mareva injunction and the petition, but indicates that even if the Mareva order were to be varied so as to permit the Company to pay the amount of approximately $16.6 million (defined as the "Repurchase Amount"), and even if the winding up petition were to be defeated, the Company had insufficient cash to pay the Repurchase Amount in full.

61. So Mr. Martin necessarily had to concede, as he did, that the Company had been cash flow insolvent as at 12 November 2008. Further, he was bound to concede, as he did, that if Mr. Potts is right, and the Gottex Funds are entitled to approximately $93 million, representing 90% of the redemption proceeds, the Fund is now insolvent on a cash basis. I have of course, found that the Gottex Funds are so entitled, and the consequence of that must necessarily be that the Company is substantially insolvent on a cash flow basis, and I so find.

Balance Sheet Insolvency

62. The position in relation to the Company's insolvency on a balance sheet basis is necessarily more difficult to determine, particularly given the circumstances surrounding the value of the Company's investments in the different entities, which value has no doubt been severely compromised by the discovery of the Petters Fraud. Similarly, the value of the security given by Mr. Petters in the form of his investment in the Polaroid company ("the Polaroid Asset") is no doubt affected by the receivership order made in the Minnesota proceedings. Staying with the value of the Polaroid Asset for a moment, I was taken to a valuation prepared by the firm of Duff & Phelps, which is not only more than one year old, but subject to some highly significant caveats, contained in a letter of 12 March 2008 sent to Acorn by Duff & Phelps. These caveats include statements to the effect that the range of values provided was not intended to be a definite valuation, that the analysis and range of values were based on information supplied by the management of the company, as well as a number of other caveats. One stipulation which seems to have been ignored is that Duff & Phelps required that Acorn should not use their report for any purpose other than the then

proposed investment. The reliance placed on it by Mr. Quan would appear to breach this.

63. Before getting to the details of the value of the Polaroid Asset, it is important to note what Mr. Quan had to say in relation to the Petters loans. Having referred to the case made on behalf of the Gottex Funds, that the loans were worth substantially less than their $273 million face value, Mr. Quan said "although there is reason to expect some recovery on the loans, it is too soon to estimate reliably what this may achieve". He carried on to say that the Fund would have to rely mainly on recovery of the security of the Polaroid Asset, and continued that he and his colleagues at Acorn and SIA had now estimated that this would be realised at between 28% and 50% of its gross assessed value of US$456 million. It is difficult to know where that figure comes from, given that Duffs & Phelps' year old valuation has a range of $310 million to $380 million. That range appears to come from three different valuation methods, but Mr. Quan gives no explanation for the disparity, or how he reaches his figures of 28% and 50%. Mr. Quan indicates that he is expecting to receive further information, but it has to be said that the position is far from clear.

64. Neither is the position any clearer in relation to what Mr. Quan had to say in his affidavit as to the Company's solvency on a balance sheet basis. He did also speak to the Company's solvency on a cash flow basis, but as I have indicated, this turns in practical terms on the finding I have made as to the nature of the Company's obligation on redemption.

65. In relation to solvency generally, Mr. Quan starts by making the point that although some, but not all, of the Fund's loans are subject to default, this does not automatically reduce the value of those notes, and the security held over the assets of the borrowers may exceed the value of the debt owed. He carries on to say that it is therefore necessary to make an individual assessment of the asset and to decide what effect, if any, the default has on the value of the loan. Mr. Quan

indicates that he has prepared a summary of the Fund's current financial position based on the best information available to the Fund to date, which is exhibited.

66. With all respect to Mr. Quan, this document is extremely difficult to follow, and makes various assumptions for which no explanation, let alone justification, is given. Certainly, the documents do not indicate that an individual assessment has been made of the value of the different loans, and it is difficult to see how that could be done at this relatively early stage. Neither is the position clear in regard to redemptions from other investors. Although Mr. Potts referred to these redemptions as having been in the amount of $50 million, Mr. Martin cautioned that the relevant document, the minutes of a meeting of the Company's board of directors dated 9 June 2008, referred to "requests for redemptions". It is no doubt instructive to consider the terms of the relevant minute. It is not suggested that the redemption requests are in any way faulty; merely that the Fund could not withstand such a large demand for redemption requests at the same time in current market conditions. The relevant part of the minutes reads as follows:

> "MQ stated that approximately US$50m had been received in redemption requests and the Fund size is US$125m. MQ further stated that the Fund cannot withstand such a large demand for redemption requests at the same time in the current market conditions. The Fund would not be able to redeem all shareholders without impairing the company's ability to operate. The redemption requests would have a serious adverse affect on the value of the Fund for the remaining shareholders. Such a large demand represents an emergency and the board should act to protect the interests of the shareholders of the Fund. MQ recommended to the board that the Fund suspend determination of NAV pursuant to bye laws 19.3 b) and e) with effect from June 10, 2008 for an indefinite period so as to enable the board to protect the value of the Fund for shareholders and develop a strategic response to the situation. As a result, MQ recommended that the fund suspend redemptions and the NAV calculation for a period of time.
>
> After due consideration it was RESOLVED, on the recommendation of the Investment Manager, to suspend determination of NAVs for the whole Fund with effect from June 10, 2008 for an indefinite period, to be kept under review by the board. Accordingly it was resolved that no redemptions would be accepted or paid out during the period of suspension".

67. Let me turn next to what Ms. Lai has to say in regard to the Company's insolvency on a balance sheet basis. She starts by conceding that neither she nor her colleagues have up-to-date financial information, but points out that the Company and its investment manager have declined to provide such, save for the inventory summary and fund portfolio analysis dated 30 June 2008, which did of course precede the discovery of the Petters Fraud. Ms. Lai carries on to say in her affidavit that as a result of her own review, and that undertaken by her colleagues, documents and information voluntarily provided by the Company, as well as information publicly available and available from other sources, she firmly believes that the Company is likely to be balance sheet insolvent rather than simply illiquid. In particular, Ms. Lai says that she is of the view that the Company's valuation of the Participation Notes that it purported to tender in payment in kind of the redemption price owed to the Gottex Funds, and the Company's valuation of the promissory notes allegedly tied to the Participation Notes are likely to have been wrong, imprudent and unreasonable, both at 12 May 2008, the date of the Mareva injunction, and the date she swore her affidavit.

68. Ms. Lai then sets out some fifteen reasons for her belief, in paragraph 44 of her affidavit. I would not propose to set those out verbatim, but would say that a number of those, taken alone, would suggest that the Company is balance sheet insolvent. Taken together, they are extremely cogent. It is important to bear in mind at this point that the test in relation to this ground for winding up in the context of the present application is whether a good prima facie case has been made out for saying that a winding up order will be made on the relevant ground. In my judgment it has, and I so find.

69. I am conscious that I have not dealt with the argument which there was as to when the balance of 10% of the redemption funds was due to be paid. Mr. Martin's argument was based on the words which appear in bye-law 15.1(b), which provide for the 10% balance being payable within ten days "following the final determination of the Net Asset Value per Participating Share of the redeemed

shares as of the Redemption Date". Mr. Martin sought to equate the final determination of the net asset value per participating share with the confirmation which would be produced by the auditors on the financial statements at the end of the financial year. I do not believe that such a construction can be justified, but neither do I believe that the point is critical to a determination as to the balance sheet insolvency of the Company.

The Just and Equitable Ground for Winding Up

70. In relation to a winding up on the just and equitable ground, Mr. Martin contended that although technically open to the Gottex Funds, the ground could only be invoked in limited and exceptional circumstances. No doubt the circumstances will be the more exceptional in the case of a solvent company. But that is not the position here. As I have found, the Company is clearly insolvent on a cash flow basis and very likely insolvent on a balance sheet basis – certainly beyond the likelihood measured by the good prima facie test.

71. The case of *Re a company* [1988] BCLC 282 confirmed that a contingent creditor has locus standi to present a petition on the just and equitable ground, and whether the petition would succeed or constituted an abuse of the process of the court would depend on the underlying facts. In that case, there was an application to have the petition struck out, and the critical factor was an action which the petitioner had taken in the Queen's Bench Division. Scott J. said at page 295 of his judgment:

> "The implications of the Queen's Bench action are, in my view, all important. In the Queen's Bench action Mr. A alleges repudiatory breach by the company, by Mr. E and by Mrs. E of the various agreements, including the shareholders agreement and the service agreement. Mr A has elected to accept those breaches as determining the agreements. If the contentions made by Mr A in his pleading in the Queen's Bench action are well founded and the action succeeds, he will obtain damages for breach of contract and an order for the repayment of the £200,000. The £200,000 will then either be repaid by the company, or will not be repaid by the company. If the money is repaid by the company, the basis on which Mr petitions to wind up will be gone. If the winding up were still pending, it would, in that event, have to be dismissed. Mr. A would have no further

> interest. If there is an order for repayment of £200,000 obtained by Mr A in the Queen's Bench action and the money is not repaid, he will then be in a position to present a petition to wind up. He will be an unpaid judgment creditor. He would be entitled ex debito justitiae to a winding-up order if the debt were not paid. Again, the current petition would serve no useful purpose at all".

72. Scott J. accordingly concluded that the petition served no useful purpose, and that the petitioner had in a real sense made an election in favour of the relief sought in the Queen's Bench action. He carried on to conclude that the implications of that election rendered improper the presentation and prosecution of the petition and accordingly dismissed the petition.

73. Mr. Martin urged that the Gottex Funds were in entirely the same position having commenced the Debt Action, and now pursuing these proceedings. In my view, the one highly significant difference is the discovery of the Petters Fraud well after the institution of the Debt Action, and the consequences of that fraud in terms of its impact on the Company's solvency, both on a cash flow and balance sheet basis. I do not think that it can be said in this case that the Company has made an election to pursue the Debt Action such that a petition for winding up a company is necessarily for an improper purpose. The discovery of the Petters Fraud and its consequences completely changed matters.

74. Having determined that the Gottex Funds do have standing to pursue a winding up petition on the just and equitable ground, I now turn to the matters put forward by Mr. Potts in support of his submission that there are good prima facie grounds to wind up the Company on the just and equitable ground. The matters which the Gottex Funds pray in aid of such relief are set out in the affidavit of Ms. Lai. She makes a complaint in regard to the relationship between Mr. Quan, Acorn, SIA, and Mr. Petters and his companies, and indicates that Mr. Quan has a fundamental conflict of interest between his duties to the Company and its creditors, his duties to the investment manager, and his duties to Acorn, and points out that it is highly unlikely that the Company will pursue a claim for damages against Mr. Quan, SIA

or Acorn while Mr. Quan remains a director of the Company. There are then complaints that the Company has delayed in seeking recoveries against Mr. Petters and his Companies, and there are complaints in regards to the different firms of attorneys instructed by the Company and the conflicts which have prevented any meaningful action being taken. All of this leads to a complaint that the board of directors of the Company has acted inefficiently.

75. But the critical complaint to my mind is the one which was emphasised by Mr. Potts in argument, namely that the substratum of the Company has gone. From the time of the 9 June 2008 directors' meeting, the Company has effectively ceased to carry on business, and in practical terms, I have no doubt that the prospect of its carrying on its business in any real way in the future has long since disappeared. It is not just that the Company has suspended its NAV calculation, and suspended redemptions; given that the minutes of the 9 June 2008 directors' meeting of the Company show that there were then approximately $50 million in redemption requests, which of course would not include the Gottex Funds redemptions, and more particularly, given the magnitude of the Petters Fraud, there are no grounds for thinking that the Company will ever be able to do anything other than pursue recoveries where possible, and wind up its affairs as best it can.

76. I do, therefore, take the view that the Gottex Funds have established that there is at least a good prima facie case for saying that a winding up order would be made on the just and equitable ground, and I so find.

The Appointment of Joint Provisional Liquidators

77. The obligation of the Court in exercising the discretionary power conferred on it by section 170 of the Act is to consider whether in all of the circumstances of the case, joint provisional liquidators should be appointed. Those circumstances clearly include all of the facts and matters which I have dealt with in considering the three alternative grounds for winding up of insolvency on a cash flow basis,

insolvency on a balance sheet basis, and winding up on the just and equitable ground.

78. However, it is in my view appropriate to say something more in relation to the management of the Company, not least because the three directors classified as independent directors have sworn affidavits in which they have sought to justify the Company's continued existence. Obviously, there are matters in those affidavits which reflect the legal advice given to the Company, which do not accord with the view that I have taken, particularly in regard to the effect of the Participation Notes in relation to redemption, and the consequent effect on the Company's solvency.

79. Mr. Potts sought to characterise the board as a rubber stamp, and I should make it clear that I decline to accept that characterisation. Nevertheless, it is clear from all the material filed that Mr. Quan is very much the key player, and companies controlled by him such as SIA and Acorn also perform key roles in relation to the business of the Company. It is, therefore, necessary to look at some of the Company's acts, for the most part effected through Mr. Quan, and to consider whether the Gottex Funds are justified in saying, as Ms. Lai does in her affidavit, that they have a complete lack of confidence in the conduct and management of the Company's affairs.

80. In my view there are a number of instances where it cannot be said that the Company has acted as one might expect a Company in its position to act. I start with the position when the PAC Facility went into default in or before February 2008. Mr. Quan speaks in paragraph 6 of his affidavit as to how the default was cured, and how even thereafter, SIA was uncomfortable with the PAC Facility's existing collateral of receivables, and began the negotiation of a new security and refinancing agreement, pursuant to which the Polaroid Asset was acquired as security. There was no suggestion that the Gottex Funds, which did after all represent 40% of the investors in the Company, were informed of this highly

critical development.

81. Next I refer to what Mr. Bailey said in relation to the Company's decision to redeem in kind rather than in cash. Mr. Bailey said in paragraph 52 of his affidavit that in the conversation which he and his colleagues had with Mr. Quan on 1 April 2008, Mr. Quan had stated that he had known for a while that "he did not intend to pay the Gottex Funds' redemptions in cash", although he was only now informing them of this decision. While I have not made a finding that there was an obligation on the Company to satisfy redemptions in cash, Mr. Quan must have been aware that there was such an expectation on the part of the Gottex Funds, and nowhere does he dispute the statement made by Mr. Bailey that redemption in cash is the ordinary business practice in the hedge fund industry. Mr. Quan simply says in his affidavit that he never represented to Mr. Bailey that the Fund had sufficient liquidity to pay the Gottex Funds in cash at that time.

82. I would also refer to the communications from the Company, or lack thereof, while the Gottex Funds were endeavouring to find out just what were the Company's intentions in relation to the redemption in kind, and in this regard I refer to the matters set out in paragraphs 23 to 27 above. I find this cavalier attitude on the part of the Company more than a little surprising given the fact that, as Ms. Lai stated, the investments of the Gottex Funds represented about 40% of the Company's total net asset value as at 31 March 2008. To put matters at their kindest, the Company's attitude during this period does it no credit at all.

83. Next is the question of the Company's audit status. Exhibited to Mr. Quan's affidavit was a copy of an email from a representative of the Company's auditors, sent on 10 October 2008. The email said in terms that the financial statements for Acorn, the On-Shore Fund, and the Company for the year ended 31 December 2007, with the audit opinions dated 31 March 2008, could no longer be relied upon. This was of course in consequence of the discovery of the Petters Fraud. The email carried on to ask that all persons that the Company was aware may

have had access to the financial statements, as well as the SEC, be notified that the auditors' opinion and the financial statements mentioned could no longer be relied upon due to the facts and circumstances which had come to the auditors' attention over the past three days regarding Mr. Petters, of which they had not previously been aware. Mr. Potts made the point that the Gottex Funds fitted within the category of those who had had access to the financial statements of the Company, and there had been no effort to notify them of the auditors' request. Instead, they had discovered the position for the first time in the material exhibited to Mr. Quan's affidavit.

84. Next is the argument put forward by Mr. Potts that it does appear from the schedule of investments, which the Company produced as at 31 December 2007, that the promissory notes scheduled to mature between 1 October 2007 and 9 May 2008, appear to be more than sufficient to pay off the Gottex Funds in their entirety. It seems that the Company could have accumulated cash with a view to discharging its redemption obligations to the Gottex Funds had it wished to, but chose not to do so. I do bear in mind what Mr. Quan had to say about the time that the Company's liquidity problems started, at the end of 2007. But if the Company was experiencing liquidity problems when these notes were becoming due, it seems to have made a decision to favour its own continued existence rather than the discharge of its obligations to the Gottex Funds.

85. Finally, there is the statement made by Mr. Quan in paragraph 3(viii) of his affidavit that the value of the notes underlying each Participation Note had been calculated and allocated based on the value of the overall NAV. As Mr. Potts submitted, this simply cannot be true. Those loan notes with the designation POL 1 to 14 had an origination date of 12 May 2008. By this time there was no NAV calculation in respect of the underlying loans, but instead a host of problems on the horizon, which should have caused the Company to pause and take stock. As Mr. Potts submitted, Mr. Quan has never said in terms what the value of the

underlying notes was.

86. In taking all of the identified circumstances into account as best I could, I came firmly to the view that this company needs to be under the control of joint provisional liquidators who are officers of the Court, rather than under the control of the present board of directors.

Delivery of Ruling

87. When this matter was adjourned on 25 November 2008 for my ruling to be delivered, I set the time for delivery at 4 p.m. on 27 November 2008, because the first return date of the petition was scheduled for Friday, 28 November 2008 at 9:30 a.m.. Although I had hoped to deliver a written ruling by then, in the event this was not possible, and I therefore gave a very brief oral summary of the principal findings set out in the body of this ruling and made an order in terms of the summons issued on behalf of the Gottex Funds, in substantially the same form as the draft attached to the summons. This ruling therefore deals with the reasons for the ruling which I have previously delivered.

Costs

88. These were dealt with when my ruling was delivered in summary form on 27 November 2008.

Dated this day of December 2008.

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Hon. Geoffrey R. Bell
Puisne Judge