CHAPMAN TRIPP

23 June 2017

FROM:

The Ministry of Business, Innovation and Employment

EMAIL:
REF:

by email – corporate.law@mbie.govt.nz

SUBMISSION ON THE REVIEW OF CORPORATE INSOLVENCY LAW (REPORT NUMBER 2)

1 This submission comments only on the working group's discussion of Ponzi schemes (chapter 4). It is a personal submission, as time has not permitted wider discussion of the issues within the firm.

2 While it might be unusual to make a submission on a paper I was involved in writing, the reason for the submission is to draw your attention to aspects of two judicial decisions on Ponzi schemes since the report.

Summary

3 This submission argues that neither the Companies Act 1993 nor the Property Law Act 2007 should provide a defence to a clawback action in a Ponzi scheme merely because an innocent investor provided value by way of his or her initial contribution to the scheme.

4 Because of the differences between ordinary trade creditors of a non-fraudulent and operating business and investors in a fraudulent Ponzi scheme, investors lucky enough to obtain funds from a Ponzi scheme should not gain an advantage over those who were not so fortunate.

The recent judgments

5 In the well-publicised decision of *McIntosh v Fisk* [2017] NZSC 78, the Supreme Court held, by a majority, that a Ponzi investor could retain the funds he had withdrawn from the scheme, to the extent those funds equated to the investor's original investment.

6 All of the Judges agreed that Mr McIntosh could not retain the fictitious profits that he had obtained. They were voidable under the Companies Act, and could be set aside under the Property Law Act. The more controversial aspect of the decision related to whether Mr McIntosh could keep the amount he had received as repayment for his initial capital "investment".

7 The majority held that he could. Their reasoning was essentially the same as that adopted by the majority in the Court of Appeal. That is, in applying the "gave value" defence as articulated in the *Allied Concrete* decision. The Court held that

Mr McIntosh had given value by depositing into the Ponzi scheme his initial investment amount.

8 One member of the Court, Glazebrook J, disagreed with the majority. Her Honour considered that the provision of funds by an investor into a Ponzi scheme does not benefit the company. No value is therefore given such that the defence as adopted by the majority is not available.

9 I respectfully agree with Her Honour on that point. It is long established (in the context of duties owed by directors) that the interests of the company effectively means the interests of creditors at a time when the company is insolvent. The rationale is simple; in times of insolvency, the shareholders have lost their equity. The funds at risk are now those of the creditors. A Ponzi scheme is by definition insolvent. It is based on fraud. Introduction of further funds in fact harms the company and the interests of creditors as it allows for the perpetuation of the fraud and enables greater harm to be done to current and future investors.

10 The *Allied Concrete* decision seeks to provide ordinary creditors with certainty in the context of an ordinary or "unremarkable" transaction. But, as Glazebrook J points out, Ponzi schemes are not ordinary commercial transactions. Their purpose is to defraud. Introduction of further funds perpetuates that fraud. That is quite different to the situation of supplies being made to and paid for by a company on the brink of insolvency. In that situation, new supplies bring value for the creditors as a whole so there is merit in providing certainty to creditors.

11 In short, the alleged value given by Ponzi investors is not a ground to favour those investors who were fortunate enough to seek withdrawals prior to the collapse of the scheme. As Glazebrook J put it:[1]

> *"I accept that Mr McIntosh was an innocent investor who had no knowledge of the fraud. However, this was the same for all of the investors. In policy terms an accident of timing as to when funds are withdrawn should not favour one defrauded investor over another. This is particularly the case as the very essence of a Ponzi scheme is that investment by new investors is used to pay out those investors who wish to withdraw their funds. As the liquidators submit, the very purpose of the payments made to Mr McIntosh was to defraud other investors."*

12 That policy point is drawn out in the High Court decision of *Graham v Arena Capital Limited (In Liquidation)* [2017] NZHC 973.[2] In that case the High Court gave directions to the liquidators as to how to distribute to defrauded investors the funds held in a Ponzi scheme. The key part of the judgment begins at paragraph 30. The High Court applies the Court of Appeal's decision in *Allied Concrete* to determine that repayments made to investors during the course of the Ponzi scheme, while reducing the quantum provable by those recipients, cannot be taken into account in calculating the distribution amounts. In other words, investors lucky enough to

---

1 *McIntosh v Fisk* at [275].

2 The judgment was dated 12 May 2017 but was not available to the working group prior to the release of its report on 15 May 2017.

obtain repayments during the course of the Ponzi scheme, based on the *Allied Concrete* decision, get to keep 100 cents in the dollar of any repayments during the course of the scheme. And they get to participate in the pro rata distribution by the liquidators, to the extent they did not get their original capital repaid.

13 The unfairness of that result is demonstrated in the calculations set out at paragraph 32 of the *Arena Capital* judgment. The Judge said that he was bound to come to that decision as a result of the reasoning in *Allied Concrete*.

14 Now that the Supreme Court has ruled on the issue, the rules on the clawback of Ponzi scheme repayments are very clear. As long as an investor was unaware of the fraud, if the investor was fortunate enough to make a timely withdrawal from the scheme, that investor will always be entitled to keep the amount of the withdrawal, up to an amount equal to the amount of the investor's original capital investment. That is because "value" will always have been given in that amount.

15 In my submission, this conclusion is unfair, for the reasons set out by Glazebrook J in the Supreme Court decision, and as set out by Miller J in the Court of Appeal decision in the *McIntosh v Fisk* litigation.[3] In the Court of Appeal, Miller J said:

> *"Ponzi schemes do not generate profits sufficient to yield their promised profits but rather use new investor money to pay "profits" and to repay existing investors, with each such payment exacerbating the scheme's financial position. That is their distinctive characteristic. It follows that the introduction of new money creates no value but merely delays and worsens the inevitable ruin. As the Supreme Court of the United States put it in 1924 when speaking of the man who lent Ponzi schemes his name "[h]e was always insolvent, and daily became more so, the more his business succeeded"."*

16 For the reasons explained by the minority judgments in the *Ross Asset Management* litigation, and as exemplified in the *Arena Capital* decision, I submit that the "value" comprised in the initial investment into a Ponzi scheme should not be sufficient to prevent clawback of repayment of such an amount.

17 The relevant statutes should provide that contribution to a fraudulent scheme does not constitute value in this context. Or, put another way, such value should not amount to a defence in this type of claim.

18 Such an amendment could assist liquidators in two ways:

18.1 first, liquidators could bring recovery actions against those who had obtained repayments during the course of the Ponzi scheme; and

18.2 as urged on the Court in the *Arena Capital* case, Courts could direct liquidators to take prior distributions into account when distributing the assets of a Ponzi scheme.

---

[3] *McIntosh v Fisk* [2016] NZCA 74.

19 Clawback should still, however, be unavailable where the recipient has, in a very specific way, relied on the validity of the payment.

Companies Act and Property Law Act

20 In the Supreme Court, at paragraph [136] of the judgment, the majority confirmed that the value given by the investor is sufficient to provide a defence under both the Companies Act and the Property Law Act. If the defence that succeeded in the *Ross Asset Management* litigation is to be rendered unavailable, both statutes would need to provide that contribution to a fraudulent scheme does not constitute value.

Yours faithfully

PARTNER

EMAIL: