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TWO APPROACHES TO PONZI FRAUD TREATMENT – WHICH IS RIGHT?

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What is the correct way to treat investors in a fund operated as a Ponzi scheme? If nothing is done to redress the fraud, those left in the fund when the music stops will usually lose everything — in stark contrast to those who took their money out before the collapse. Both types of investor are equally innocent.

The position is clear in the United States. Investors who lose money in mutual funds operated as Ponzi schemes when they collapse have a well-grounded expectation that those who took out money before the collapse will be required to pay back what they took out. The money goes to the fund's trustee in bankruptcy and gets shared between all victims, without distinction between those who got out before the collapse and those who were still in. Two decisions last year in the English common law world suggest the beginnings of a significant divergence between the treatment of Ponzi frauds in the U.S. and in the English common law world. That would be surprising and unwelcome.

The seed of schism was sown in April 2014 when the Privy Council (one of the highest judicial tribunals in England and Wales) remarked in *Fairfield Sentry v. Migani* [2014] UKPC 9:

> *It is inherent in a Ponzi scheme that those who withdraw their funds before the scheme collapses escape without loss, and quite possibly with substantial fictitious profits. The loss falls entirely on those investors whose funds are still invested when the money runs out and the scheme fails.*

At the time this seemed a mere statement about everyday experience, not a principle of law.

However, in November 2014, the remark gained traction when the chief justice of the Cayman Islands apparently treated it as a presumption of law and seemed to conclude that as a matter of principle, losses inflicted by the collapse of a Cayman Islands investment fund operated as a Ponzi scheme should rest where they fell and that the law should stay its hand rather than intervene to achieve a balance between winners and losers: see *RMF Neutral Strategies (Master) Ltd. v. DD Growth Premium 2x Fund FSD 33 of 2011* (at paragraphs 141, 214 and 215).

Rather surprisingly, he went further and concluded that investors in a Cayman fund that had been operated as a Ponzi scheme who had got out before the collapse "*would not expect that there could be recourse against them by those who were still members of the fund when it collapsed*".

This attitude to Ponzi schemes results in losses being arbitrarily distributed among innocent victims. Good luck for those who happened to get out before the edifice tumbles; tough luck for those who are left. The law in the U.S. takes the opposite approach, there the loss does not fall on those who were last out and those who were first out do not earn fictitious profits. The view in the U.S. is *"… if a Ponzi scheme robs Peter to pay Paul, Paul is not entitled to his misbegotten profits*" (see Samuel P. Rothschild *Bad Guys in Bankruptcy* Columbia Law Review Vol 112: 1376). Ponzi schemes end in insolvency, and in the U.S., upon the liquidation of a Ponzi scheme the courts apply "the Ponzi scheme presumption" to achieve a sharing of losses.

If the Cayman Islands is developing a reverse presumption, that is to be deprecated. The position in the U.S. is the result of carefully thought-out legal analysis developed over almost 50 years. The idea that losses must simply lie where they fall is fatalistic, a priori reasoning from a supposed inherent characteristic of a Ponzi scheme. It is suggested that this is unsatisfactory and diminishes the rule of law. If losses simply lie where they fall, with the law being indifferent to the consequences, it means that the fraudster and not the law determines the incidence of losses in a Ponzi scheme.

The reasoning is fatalistic because it simply accepts the consequences of the fraudster's action. Because it is a priori reasoning, there is no consideration of what exactly a Ponzi scheme is and the question whether the law should react is not even addressed. In the U.S. where there is a considerable body of jurisprudence on Ponzi schemes going back almost 50 years, the default presumption is the reverse. Once it is shown that a Ponzi scheme has been operating, there is a "Ponzi scheme presumption," which leads to the reversal of gains by "winners" with a return of assets to a pool that is then shared between all victims of the scheme.

The U.S. jurisprudence is pellucid in its analysis of what a Ponzi scheme actually is.

> "*A 'Ponzi' or 'Pyramid' scheme is a fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion of profitability, thus attracting new investors.*"
>
> "*A Ponzi scheme is a scheme whereby a corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors.*"
>
> *"… a hedge fund Ponzi scheme, a species of fraud whereby an investment fund that is unprofitable uses money from new investors to pay 'false profits' to old investors in order to encourage further investment and sustain the scheme."*
>
> "*We have defined a Ponzi scheme as an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments*."

See the authorities cited by Justice John Lifland in *Manhattan Investment Fund Ltd v. Helen Gredd* 397 B.R. 1, 10.

A Ponzi scheme does not produce any revenue or other returns from its business because there is no underlying business. The only "business" of a Ponzi scheme is to steal money coming in from new investors or to dress it up as fictitious returns that it pays to other innocent investors who are exiting.

All Ponzi schemes eventually collapse. Without the intervention of the law, those who withdraw, taking profits before the collapse, are winners and those left invested at the point of collapse are losers. But the winners never got a single cent of honestly earned money. They just got handed money stolen from fresh victims as

part of the cycle of fraud. Peter is robbed and Paul is paid from the proceeds of robbery. A system of law that simply accepts this consequence is failing to grapple with the question, why should Paul get to keep what was stolen from Peter?

So how is this dealt with in the U.S.? The Bankruptcy Code empowers a trustee to avoid certain transfers of property made by the debtor before a bankruptcy petition is filed and secure the return of transferred property to the estate for the benefit of all persons who have presented valid claims. Section 548 of the code allows the trustee to avoid any transfer of an interest in property made by the debtor in the year prior to the filing of its petition if the transfer was made with an actual intent to hinder, defraud or delay creditors (s 548(a)(1)A).

Actual intent to defraud requires a high standard of proof, but authorities dating back to 1966 establish that actual intent to defraud for the purposes of the code is proved simply by establishing the existence of a Ponzi scheme. It is by being clear about exactly what is happening in a Ponzi scheme that courts in the U.S. have confidently reached the position that the mere fact that the scheme is a Ponzi scheme establishes actual intention to defraud.

> "*A Ponzi scheme is by definition fraudulent … Every payment made by the debtor to keep the scheme on-going was made with the actual intent to hinder, delay or defraud creditors, primarily the new investors.*"
>
> "*Actual intent to hinder, delay or defraud may be established as a matter of law in cases in which the debtor runs a Ponzi scheme or a similar illegitimate enterprise, because transfers made in the course of a Ponzi operation could have been made for no purpose other than to hinder, delay or defraud creditors.*"
>
> "*In sum, transfers made to investors in furtherance of a Ponzi scheme are deemed to have been made with actual intent to hinder, delay or defraud creditors.*"
>
> "*Thus, bankruptcy [and other] courts nationwide have recognised that establishing the existence of a Ponzi scheme is sufficient to prove a Debtor's actual intent to defraud.*"

See the authorities cited in *Reiser v Hayslip* 343 B.R. 615.

This has become known in the U.S. as "the Ponzi scheme presumption." The transfers to those who got out before the collapse are set aside. Their payments are returned to the estate in bankruptcy. Money returned is then shared between the victims. Victims are not treated as winners and losers, they are treated, as far as possible, the same. This is a just outcome based on sound analysis. It is good law.

In RMF Neutral Strategies the man behind the 2X Fund had "*in effect … put into train, a fraudulent Ponzi scheme*" (see the judgment at paragraph 138). The chief justice observed that the results had been grossly unfair to those who received nothing from the fund (at paragraph 138). In refusing a remedy to those who suffered such grossly unfair results, he explained: "*As I will come to examine below, such are the unfortunate consequences when an investment fund becomes a Ponzi scheme*" (paragraph 141).

He went on to explain this passage by stating that this was what he understood to be the meaning of the statement of the Privy Council in Fairfield Sentry cited at the beginning of this article. He appears to have elevated that statement into a legal presumption about Ponzi schemes, viz that the law should not redress the losses that flow from Ponzi schemes. It is suggested that to take this approach is to fail to grapple fully with what is involved in a Ponzi scheme, to fail to recognize that Peter has been robbed to pay Paul, and to accept too readily that Paul can keep his misbegotten gains. This approach fails to achieve a just outcome and as legal reasoning it lacks analytical rigor.

The chief justice also considered that in denying recourse to the remaining investors he was achieving an outcome that would match the expectations of investors in a collapsed Cayman Ponzi fund. In holding that investors who had redeemed before the collapse were entitled to keep their redemptions in full, he stated: "*Having had their redemptions paid on the basis of NAVs which are also published in keeping with the*

constitutional documents of the fund, those who have redeemed, would not expect that there could be recourse against them by those who were still members of the fund when it collapsed."

Given that this very recourse has been the rule in the U.S. since 1966, and given that a very substantial portion of investors in Cayman mutual funds are U.S.-based, it is difficult to accept the view that investors in Cayman mutual funds as a class would not expect recourse against them when a Ponzi scheme collapses, especially given the widely publicized clawback claims brought by the Madoff trustee. Indeed, on Nov. 17, 2014 — the very day of the RMF judgment — the Madoff trustee publicly announced a massive settlement against two Cayman Islands funds (Herald and Primeo), which had agreed to return $497 million to settle Ponzi clawback claims. The risk of these claims is accepted in the investment community and the level of hedge fund investment in the last couple of years suggests that it has done nothing to blunt the appetite of investors for the use of these vehicles.

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