

Bespoke regime for unwinding Ponzi schemes

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The Government is moving to create a special regime to unwind Ponzi schemes in a way which is fair to all investors.

A discussion paper outlining the options was released this month.

Submissions close on 6 July 2018.

Background

In the absence of a bespoke system to deal with Ponzi schemes, the courts and liquidators have to resort to the Companies Act 1993 and the Property Law Act 2007, but they are not a good fit as they were not designed for recoveries where the fundamental purpose of the business was dishonest.

And case law has not been helpful as the findings are always highly fact-dependent and the courts are tussling with what is in effect a gap in the law.

The need for legislative reform was acknowledged in the second report of the Insolvency Working Group but it made no recommendation as the Supreme Court judgment in *McIntosh v Fisk* – relating to the David Ross Ponzi scheme – was still pending.

The Supreme Court majority decision, which allowed the claimant to recover his investment, although he had to return his fictitious profits, was controversial as the effect was to reduce the capital available for distribution among the other Ross investors.

The Ministry of Business, Innovation and Employment (*MBIE*) aligns itself in the discussion paper with the minority view of Glazebrook J, who said:

"I accept that Mr McIntosh was an innocent investor who had no knowledge of the fraud. However, this was the same for all investors. In policy terms an accident of timing as to when funds are withdrawn should not favour one defrauded investor over another".

The policy aim is to create a framework which will provide consistent outcomes for investors at minimal cost and share losses as fairly as possible.

The proposal

MBIE is proposing that a new liquidation mechanism be incorporated within the Financial Markets Conduct Act 2013.

It also considered establishing a compensation scheme for Ponzi victims funded through a financial sector levy but discarded this as an option because it might encourage investors to disregard risk, could impose significant transactional costs on financial markets which risks distorting market forces, and would require a government contribution or underwriting.

Proposed design features are that the new regime should:

- recognise that Ponzi investors are the victims of fraud
- be blind to the legal structure of the particular Ponzi scheme
- ensure that any distinctions made between investors are based as far as possible on relevant criteria
- be clear with investors that they may have to repay funds they have received
- be simple to administer, and
- provide hardship grounds.

Issues for submission

MBIE's proposed regime contains a number of features that are likely to attract a high degree of interest.

- **A four year proposed clawback period** for a liquidator to recover withdrawals from investors, from the date of the application to declare the scheme a Ponzi scheme. MBIE noted that the shorter two-year clawback period in the voidable transactions regime was motivated by considerations that don't apply in the Ponzi scheme context, and that Ponzi schemes can operate for several years without being detected.
- **No change of position defence**, on the basis that all investors can be expected to argue it, and because the defence has nothing to do with fairness with regards to other investors – the primary motivation of the proposed regime.
- **A significant financial hardship defence** - a concept borrowed from the KiwiSaver Act 2006 in the context of allowing early withdrawals. This defence will have a high bar, given the fact that it would effectively operate to transfer losses from one investor to another.
- **The reputational risk associated with an application to declare a Ponzi scheme.** Regulators, appointed insolvency practitioners of the operator of a Ponzi scheme and certain persons within a scheme (such as the supervisor of a managed investment scheme) may seek as of right a declaration that an investment scheme is a Ponzi scheme. An application by any other person (such as an investor) will require the leave of the court.

The discussion paper recognises the reputational damage associated with such an application, and the potential for an application to tip an innocent scheme over by encouraging mass investor withdrawals. MBIE considers that sealed proceedings are not a solution, as this would prejudice the procedural fairness of other investors. The current regime therefore only protects reputational concerns through limiting who can apply without leave.

There are a number of other issues that will benefit from submissions, including that of determining when a Ponzi scheme began (if a scheme was legitimate to start), methods of distribution of assets to investors, and recoveries against trade creditors of Ponzi schemes (which are proposed to be excluded, and subject to the standard insolvency regime).

From here

The proposed regime is motivated by the goal of investor equality, but comes with the cost of creating a lengthy period of uncertainty for investors, the majority of which will be unable to access the high threshold of the significant financial hardship defence.

For further information or assistance in preparing a submission please get in touch with our contacts.

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