Submission on Report No. 2 of the Insolvency Working Group

In relation to report no. 2 of the Insolvency Working Group, on voidable transactions, Ponzi schemes and other corporate insolvency matters

23 JUNE 2017

BELL GULLY

Introduction and overview

This submission on Report No. 2 of the Insolvency Working Group is made by Bell Gully.

About Bell Gully

Bell Gully has a wealth of expertise and experience in insolvency, corporate restructuring, receiverships and liquidations. The practice is built around the multi-disciplinary expertise of experienced and highly regarded finance, litigation and corporate specialists. Our specialist team is regularly engaged to assist receivers, liquidators, other insolvency practitioners, and creditors, across the broad range of insolvency and restructuring matters.

Approach to this submission

We consider the Working Group's report is very well considered and, on the whole, we support its recommendations. Rather than address all of the questions posed, or comment on areas of general agreement, we have focussed our response on issues in which we have particular interest or expertise which we hope may be of assistance to the Working Group.

The views in this report are our own, and do not necessarily represent the views of any of Bell Gully's clients.

Contact information

We would be very pleased to provide further input as the legislation implementing the proposed reforms is developed. At first instance, you may contact Tim Fitzgerald, litigation partner, Bell Gully, Auckland (details below).

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Chapter 2: Other issues relating to voidable transactions and other recoveries

Recommendation 5: Use the definitions of 'related creditor' and 'related entity' that appear in section 245A (and section 239AM) of the Companies Act for determining whether a party is a related party in relation to all recoverable transactions, charges and securities

1. We support this proposal.

2. In our view, the wider definition is preferable to make it more difficult for those in control of the company to circumvent the related party provisions. However, we consider that there are two additional points to consider:

   (a) First, the definition of "relative" in the Companies Act 1993 is more restricted than in the Financial Markets Conduct Act 2013. In that Act, a "relative" includes "a grandparent, parent, child, grandchild, brother, sister, nephew, niece, uncle, aunt, or first cousin of A or B, whether or not by a step relationship". This is comparable overseas jurisdictions, for example:

      (i) Australian legislation defines a relative as including (amongst others) remote lineal ancestor and a remoter issue (i.e. grandparents and grandchildren) (Corporations Act 2001, s9).

      (ii) English legislation defines a relative as including (amongst others) an uncle, aunt, niece, nephew, lineal ancestor and descendant. (Insolvency Act 1986, s435).

      (iii) Canadian legislation has sought to define relative by description, rather than a discrete list. It provides that anyone is related if they are connected by blood relationship, marriage, common law partnership or adoption. (Bankruptcy and Insolvency Act 1985, s4(2)(a)).

   Therefore, we consider that the definition of "relative" should be reviewed and expanded to include, at least, the relative groups identified above.

   (b) Second, we suggest that section 126 ought to be amended to ensure deemed and shadow directors fall within the definition of "director" for the purpose of these provisions.

Recommendation 7: Reduce deadline for liquidators to file in the High Court claims under section 292 to 299 from six to three years.

3. We support this proposal.

4. As the limitation period on such claims does not commence running until the appointment of a liquidator over the company, there can be a period of eight years or more between the impugned transactions and a claim being filed by the liquidator.[1] This

[1] The period of vulnerability for a claim falling under section 298 is three years, leading to the potential for almost nine years between the transaction taking place and a claim being filed. Even in the voidable transaction context, the period between the transaction and claim can exceed eight years due to the specified period including the time between the liquidation application being filed and the commencement of the liquidation: section 292(5)(b) of the Act.

leads to a lengthy period of uncertainty for creditors as to whether they could be faced with a claim by a liquidator for claw back. The current length of this period of uncertainty is of particular concern given that, in most claims, the transaction in question will be a perfectly ordinary commercial transaction that, but for the subsequent liquidation of the company, would attract no legal sanction.

5. We note that a reduced limitation period may be of assistance to liquidators as well. Due to the length of the current limitation period, there have been a number of cases where creditors have argued that, despite the claims being brought within the limitation period, the Court should exercise its discretion to not allow recovery because of the delay in bringing the claim. In at least one case in the High Court, the Associate Judge refused to rule out denying relief due to delay.[2] This introduces uncertainty for liquidators and the potential for evidence needing to be adduced by liquidators as to the reasons for the length of time taken to bring proceedings. With a shorter limitation period, these types of arguments may fall away, or at least, will likely be given less weight by the Court.

6. We agree that three years is an appropriate length of time for the reduced limitation period. This still provides sufficient time for liquidators to undertake their investigations, particularly having regard to the fact that liquidations should be completed with reasonable speed. We are in agreement that setting a shorter limitation period is only likely to lead to more applications for extensions of time and, likely, the Court taking a more forgiving approach to such applications.

Recommendation 8: Provide the High Court with the discretion to extend the filing period under sections 292 to 299 if it would be just and equitable to do so.

7. We support this proposal.

8. Given the proposal for a limitation period that is half as long as the ordinary limitation period, there is obvious merit in providing an ability for liquidators to obtain an extension from the Court. In our view, such extensions should be granted relatively rarely to incentivise liquidators to bring claims without undue delay and to avoid extensive satellite litigation developing in this area.

Recommendation 9: Add a defence for a creditor with a valid security interest who can demonstrate that there was no preference at the time they received payment.

9. We support this proposal.

10. In our view, it is unfair for a creditor who was adequately secured at the time of payment to be required to repay amounts they received simply because they either subsequently discharged their security or the value of that security reduced due to the Company's worsening position.

11. In our experience, since the decision in *Levin v Market Square Trust*, this issue has often arisen between liquidators and formerly secured creditors. As this issue was apparently not raised before the Court of Appeal in *Market Square Trust*, both liquidators and creditors have tended to recognise a degree of litigation risk and compromised their position. Given this, a statutory clarification is likely to lead to some reduction in the total amount of funds that liquidators would be able to recover for the benefit of creditors.

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[2] *Levin v Titan Cranes* [2013] NZHC 2628.

12. One aspect of this recommendation that may benefit from further consideration is whether this should be a defence needing to be established on the balance of probabilities by the creditor, or whether the burden should be left with the liquidator.

13. Ordinarily, it is for the liquidator to show that a creditor has received a preference through the impugned transaction. In practical terms, the liquidator (rather than the creditor) will often have the information needed to establish the value of the security at the relevant time (e.g, in the case of a retention of title arrangement, the liquidator is likely to be better placed to establish the value of the secured goods at the time of the transaction). A creditor may lack the information needed to establish this part of a defence. For this reason, we suggest that further consideration be given to which party bears the burden of proof, and that the allocation of the burden be made clear in any revised draft of the section.

Recommendation 10: Simplify the continuing business relationship rule in section 292(4B) of the Companies Act by removing the subjective element relating to the parties' intentions

14. We do not support this proposal.

15. It is not entirely clear to us what change the recommendation would involve to the text of s 292(4B). We agree with the Working Group that some form of continuing business relationship rule is appropriate, and in our view the difficulties that can arise with the existing rule are usually manageable, so our view is that the risks associated with a change to the legislation outweigh the benefits that might be gained from the change.

16. In addition, we note that s 292(4B) is closely modelled on section 588FA(3A) of the Corporations Act 2001 (Cth). In our view, given the clear intent to adopt the Australian provisions into New Zealand law, a cautious approach should be taken to amending s 292(4B) in such a way that it becomes substantively different to s 588FA(3A) as is currently proposed. The result of such change would be to deprive the New Zealand courts of the voluminous Australian case law on the continuing business relationship rule.

Recommendation 11: The starting point under the continuing business relationship rule

17. We support this proposal.

18. Where the company is able to pay its due debts at the start of the specified period, the starting point for the continuing business relationship must be the point of the company's insolvency. Otherwise, the single transaction would take into account payments that, if the continuing business relationship rule did not apply, would not be voidable under the ordinary requirements of section 292(2) of the Act.

19. As the *Timberworld* case did not address this point, it would be useful for the Act to set this out.

Chapter 3 – Procedural issues relating to voidable transactions

Recommendations 12 and 13: Requirements as to Notices to set aside a transaction

20. We support these proposals.

21. We consider that there are three key benefits of including the information detailed in recommendation 13 (the **Notice**).

22. First, the consequences of a creditor failing to serve a notice of objection to the Notice on the liquidators within the requisite timeframe are strict. Accordingly, the Notice should provide creditors with sufficient information to enable them to make an informed decision as to whether to serve a notice of objection. In particular:

    (a) If a notice of objection is not served in time the transaction in issue is automatically set aside. The courts have no ability to extend the timeframe for serving a notice of objection, nor can they undo the automatic setting aside of the transaction.[3]

    (b) The consequences of the transaction being set aside include that:

        (i) The question of voidability of the transaction cannot be reopened.

        (ii) The creditor cannot contend that the company was in fact solvent at the time of the transaction or that they have not received more from the transaction that they would receive under the liquidation.

        (iii) Upon an application by the liquidator, and in the absence of the creditor establishing a defence, the court must make one or more of the orders specified in section 295 of the CA (although the court retains a discretion as to the nature and extent of the appropriate remedy). There is no general discretion based on just and equitable considerations for the Court to decline to make one or more orders specified in section 295.[4]

23. Second, notices will be served on a range of people who are not insolvency practitioners or lawyers and may not appreciate the legal basis for the notice and whether they could have a valid reason to object to the Notice. Given the strict consequences of failing to serve an objection in time, the notice itself should provide some information to a recipient which will enable them to consider whether they should serve a notice of objection and if so, the matters which could be included in that notice.

24. Third, this is consistent with the clawback regime pursuant to the prejudicial disposition provisions of the Property Law Act 2007 (the **PLA**). In particular, section 347(3) requires the plaintiff in such a clawback action to serve on the defendant a notice communicating the effects of section 348 (the court's powers to set aside certain dispositions of property) and section 349 (the value and change in position defences available to the defendant). There is no reason why a similar type of notice should not be provided to those facing clawback under the voidable transaction provisions.

25. Providing this information in the Notice will allow a recipient to identify whether there are any material inaccuracies in the liquidators' assessment of the transaction, including, for

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[3] *Khov v Lotus Gardens Limited* [2013] NZHC 1135 at [82]

[4] See *Khov v Lotus Gardens Limited* [2013] NZHC 1135 at [82] and *Petterson v Browne* [2016] NZCA 189 at [138]

example, the dollar value attributed to the transaction and the dollar value of all transactions the liquidator considers forms part of a continuing business relationship.

26. Ultimately, a more detailed Notice may assist to identify the key areas of dispute promptly and either:

    (a) promote settlement discussions between the parties; or

    (b) at least make it less likely that liquidators need to incur the cost of applying to the court for orders pursuant to section 295 of the CA, only to then have substantive issues raised in the context of the proceeding for the first time.

27. Bell Gully does not consider the costs of providing this information would be significant. Unless a liquidator is issuing notices without regard to the substance of the transaction, these will likely be matters the liquidator has established in the context of deciding whether to issue a notice. In any event, the cost to liquidators needs to be balanced against the interests of the recipients: the information specified in recommendation 13 is not onerous and much of it is required to simply identify the transaction in issue. Therefore, it is required to give the recipient fair notice of the claim to set aside the transaction, in order to enable them to decide whether to serve a notice of objection.

28. Additionally, the matters contained at recommendation 13 (c)(i) to (iii) are general information about the voidable transaction regime and defences available and will not be transaction specific. Therefore, it would be possible for the Order in Council to provide a precedent for that aspect of the notice (in the same way as the High Court Rules provides for the wording of various forms) thus ensuring a consistently high standard of information on those matters is provided to recipients of a notice, without the drafting cost to the liquidators.

Chapter 4 Ponzi Schemes

29. This part of our submissions has the following parts:

    (a) Preliminary issues:

        (i) Defining a Ponzi scheme

        (ii) Sole right of recourse pursuant to the PLA?

    (b) Specific Recommendations:

        (i) Fictitious profits are not value

        (ii) Ponzi presumption

        (iii) Objective standard of knowledge

    (c) Additional issues:

        (i) The application of CA section 296(3) to a PLA clawback action

        (ii) Procedural issues

30. We note that Bell Gully is currently acting for the liquidators of two Ponzi schemes:

    (a) Ross Asset Management Limited (in liquidation) (**RAM**) and related entities; and

    (b) Arena Capital Limited (in liquidation).

31. However, these submissions are those of Bell Gully only and are not provided on behalf of the liquidators of either RAM or Arena.

Preliminary issues

32. Before considering the specific recommendations contained within the Report, we discuss two key issues:

    (a) First, how any amendment to the legislation would define a "Ponzi scheme". This will be a complex issue, which necessarily needs to be considered before:

        (i) adopting any Ponzi presumption; or

        (ii) introducing an amendment clarifying how "valuable consideration" or "value" is to be assessed for the purpose of a defence to a clawback claim pursuant to the prejudicial disposition provisions of the Property Law Act 2007 (the **PLA**) or the voidable transaction provisions of the Companies Act.

    (b) Second, assuming that the Report's core recommendations in respect of voidable transactions are implemented (i.e. Recommendations 1 and 2), whether the law should be further amended to provide that clawback claims against investors who received funds in furtherance of a Ponzi scheme fall only under the prejudicial

disposition provisions of the PLA, and not also under the voidable transaction provisions of the CA.

33. Finally, investors in a Ponzi scheme are generally categorised as either:

    (a) "Net Winners" being those investors who were paid out more than their capital contributions; or

    (b) "Net Losers" being those investors who were paid out less than their capital contributions.

34. We have adopted those terms in this submission.

Defining a Ponzi Scheme

35. As the Report identifies, defining a Ponzi scheme is inherently difficult. While the Ponzi that has run its course and collapsed will be easy to recognise, where a Ponzi scheme is caught early, it may share many of the characteristics of a legitimate business that has overextended itself and is temporarily using money deposited by new investors to pay amounts to exiting investors, pending an improvement in cashflow.

36. There will be four key issues to balance in any definition:

    (a) the various forms a Ponzi can take;

    (b) whether the practice of using new money to pay withdrawing investors is sufficiently pervasive;

    (c) the requisite element of fraud; and

    (d) whether insolvency should be a defining factor.

Types of Ponzi scheme

37. A Ponzi scheme can take various forms and any definition of a Ponzi will need to ensure that it is sufficiently broad to encompass different types of schemes.

38. By way of example:

    (a) Ponzis can provide for different forms of "returns" for investors. Generally, Ponzis will fall into two categories:

        (i) those schemes where the returns are not fixed and are purportedly based on the performance of other investments (a **Performance based Ponzi**). An example of this was RAM, whereby investor "returns" purportedly represented the performance of shares purchased.

        (ii) those schemes where there is a contractual obligation to provide a specified return (a **Fixed Returns Ponzi**). An example of a Fixed Returns Ponzi was that run by Charles Ponzi in 1920, whereby he promised a 50% return on investments over a period of 90 days. (It was following the collapse of this scheme that the term Ponzi scheme was coined.) However, as with all Ponzis, the capital investments were being used to repay other investors their capital plus fixed returns.

(b) Ponzis will also comprise various different arrangements between the operator and the investor. Again, Ponzis will generally fall into two categories:

(i) those schemes where investors' capital contributions, and any investments purchased with those contributions, are intended to be held on trust for the investor. By way of example, RAM was operating this type of scheme.

(ii) those schemes where the investors' capital contributions were not intended by the parties to be held on trust for the investor, but instead simply gave rise to a simple contract debtor/creditor relationship. Arena is an example of this type of scheme.[5]

Pervasiveness of the practice

39. Many Ponzis schemes are not Ponzis at the outset. They begin as operators conducting legitimate business, but either the actual investment returns drop significantly in circumstances where the operators feel pressure to maintain returns at a certain level or their cashflow deteriorates. This leads to the operators starting to use new investor funds to pay "returns" to withdrawing investors, in a manner which is inconsistent with various representations made by the operator as to the application of the new investor's funds and/or the source of the purported "returns". In a Ponzi, this practice will be systemic.

40. Accordingly, any definition should convey the appropriate level of pervasiveness of the practice.

The requisite element of fraud

41. Definitions adopted overseas have preferred to focus on the fraudulent arrangement itself, thus avoiding an occasional use of new money to repay a withdrawing investor falling within the definition. For example, the United States Securities and Exchange Commission defines a Ponzi as:

> an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. [6]

42. Similarly, the United States Courts have previously defined it as:

> A fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than from any "profits" of the underlying business venture[7]

and indicated that a plaintiff would need to prove the following factors for the purpose of establishing the Ponzi presumption:

(a) deposits were made by an investor;

(b) the debtor conducted little or no legitimate business operations as represented to investors;

(c) the purported business operations produced little or no profits or earnings; and

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[5] See *Graham & Jackson v Arena Capital Limited (in liquidation)* [2016] NZHC 194 at [31] –[33] and [39].

[6] www.sec.gov/fast-answers/answersponzihtm.html

[7] Phelps & Rhodes *The Ponzi Book: An legal resource for unravelling Ponzi schemes* (2012), LexisNexis at 1.02

(d) the source of payments to investors was from funds infused by new investors.[8]

43. As can be seen from these definitions above, the fraudulent nature of the scheme itself is a necessary element of a Ponzi. Simply using new investors' money to pay returns to withdrawing investors is not sufficient – even if the practice is pervasive. Many legitimate investment schemes operate on such a practice – for example a bank. When an investor deposits $1,000 in a term deposit account with their bank, there is no suggestion that those particular funds will be held on trust or applied in a particular manner – the customer would likely be unsurprised to learn that the funds deposited by them were subsequently applied by the Bank to fund a withdrawal by one of its other customers. Rather, it is the additional element of fraud which defines Ponzi.

Insolvency

44. An issue in any definition will be whether a scheme can only be a Ponzi when there is the additional ingredient of insolvency.

45. Bell Gully considers that insolvency should not be an element of any definition of a Ponzi scheme for two key reasons:

    (a) First, establishing solvency of a Ponzi scheme at any given time could be complex.

        (i) This is, in part, because incomplete, inaccurate and/or fraudulent records is a frequent feature of a Ponzi scheme.

        (ii) Additionally, there may be instances where a debtor is engaging in legitimate business activities alongside a Ponzi scheme. The fact that there is some legitimate business revenue which is, at least temporarily, keeping the business afloat, should not render a scheme which otherwise has all the hallmarks of a Ponzi scheme, as something else.

    (b) Second, focusing on balance sheet solvency avoids the realities of a Ponzi scheme itself. An obvious feature of a Ponzi scheme is that it cannot last forever. They are reliant on attracting new investors at an exponential rate, in order to sustain the returns paid out to exiting investors. At some point, the rate of new investments will inevitably be unable to sustain the returns to be paid out to exiting investors and the scheme will collapse.

46. Introducing insolvency into the definition of a Ponzi could, in effect, mean that a scheme which otherwise has all the hallmarks of a Ponzi will only become a Ponzi when it has reached the point that the rate of new investments can no longer sustain the payments to existing investors.

Sole right of recourse under the PLA?

47. As the law currently stands following the release of the Supreme Court's decision in *McIntosh v Fisk* [2017] NZSC 78, where a payment has been made to an investor in a Ponzi scheme in furtherance of the Ponzi scheme, the liquidators of the Ponzi operator can claw back such payments (subject to the value and change in position defences) through two routes:

    (a) the prejudicial disposition provisions of the PLA; and

[8] Phelps & Rhodes at 2-8

(b) in respect of payments made two years prior to the liquidation of the Ponzi operator, the voidable transaction provisions of the CA.

48. The Supreme Court's decision in *McIntosh* in respect of the "value" defence means (assuming an investor can establish no knowledge of the Ponzi or the insolvency and the requisite good faith) the investor can retain the amount of their capital contributions. In practical terms, this means that clawback claims can be taken against Net Winners but not Net Losers. Generally, the result will be the same under either the PLA or the CA.[9]

49. The recommendation to remove the value defence from the CA, if implemented, will mean the result of a clawback action under the PLA will be significantly different from a clawback action under the CA. In particular if the CA offers no value defence all payments made in the six months prior to the liquidation of the Ponzi operator could be clawed back, unless there was a valid change in position defence. This would include any payments made to Net Losers.

50. On the one hand, this creates an arbitrary distinction between like investors.

51. Consider for example the following:

> Two Net Losers each contributed $500,000 to the same Ponzi scheme. They each withdrew $100,000 before the liquidation of the Ponzi operator – Investor A received the funds five months prior to the liquidation and Investor B received the funds seven months prior to the liquidation. Upon liquidation of the Ponzi operator, they both still had $400,000 'invested' and are unlikely to substantially recover that capital contribution.
>
> Investor A will likely have to repay the $100,000 payment under the CA clawback regime (subject to establishing a change of position defence) as the payment was received within six months of the liquidation.
>
> Investor B will not have to repay his $100,000 payment. As it fell outside the six months prior to the liquidation, any clawback action would fall under the PLA, meaning Investor B would have a valid value defence (assuming the requisite good faith and lack of knowledge is established).

52. There are good policy reasons to avoid such an arbitrary distinction based on an accident of timing as to when the relevant funds were withdrawn and to treat all victims of a Ponzi scheme equally.

53. This issue could be addressed by the CA providing that sections 292 to 297 of the CA did not apply to any claim by a liquidator of a Ponzi scheme operator to clawback payments made to investors, in furtherance of the Ponzi scheme.

54. On the other hand, the reality is that an arbitrary distinction based on an accident of timing already exists within a Ponzi scheme scenario. Despite any possible clawback action, those who were paid out before the scheme collapsed have a distinct advantage over those who did not withdraw their funds in advance of the collapse. This is because they have a chance of retaining that payment or some of it by raising a change in position defence or through settlement. Additionally, for long running Ponzis, limitation periods may create a further arbitrary distinction.

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[9] For differences between the PLA and the CA defences, see paragraph 79 below.

55. There are also good policy reasons in favour of clawing back all payments made in the six months prior to liquidation of a Ponzi operator.

(a) First, it is common in the context of Ponzi schemes for there to be a "conspiracy theory" amongst the Net Losers that those who were fortunate enough to get their money out of the Ponzi in the period immediately before its collapse were somehow "in the know". Clawing back all payments made in the six months prior to liquidation, subject to a change in position defence, would assist to dispel these theories and the sense of injustice that they cultivate.

(b) Second, in the lead up to the demise of a Ponzi, some signs of strain may become apparent – for example, it may be difficult to contact the operator, requests for withdrawals may not be processed or are otherwise delayed. However, the current regime arguably deters investors from raising these issues with the appropriate regulatory bodies.

Once these issues become apparent, an investor who puts more pressure on the operator for the withdrawal of their funds, in the hope that the payment is met before the apparent issues worsen, and is so paid, is likely in a better position than the person who raises these matters with the regulatory bodies. This is because a complaint to the regulatory bodies may mean the investor is seen to have actual or constructive knowledge of the insolvency/prejudicial nature of the disposition, jeopardising a value or change in position defence in respect of any subsequent payment received.

56. Accordingly, the Government may decide that that the policy factors above outweigh any arbitrary distinction between investors, created by the proposed changes to the voidable transaction regime.

Recommendations from the Report

Fictitious profits are not value

57. While Bell Gully supports in principle the recommendation that the PLA be amended to clarify that the "gave value" element of the defence is not satisfied by receiving "fictitious profits", any such amendment should apply to all types of "returns" purportedly provided by a Ponzi scheme. The term "fictitious profits" may not clearly convey that it encompasses all such purported returns.

58. The term fictitious profits more readily applies in the context of the Performance Based Ponzi – as the "returns" were said to be profits from share trading or similar investments, where the underlying investment was fictitious. However, it could be argued that the term "fictitious profits" does not apply to a Fixed Returns Ponzi, allowing an investor to argue that the value provided was foregoing a contractual claim against the operator in respect of a contractual right to a significant and specified return.[10]

59. The better approach would be to clarify that regardless of the form the Ponzi took, an investor cannot purport to retain a profit or return from a Ponzi scheme, at the expense of other investors in that scheme (subject to a valid change of position defence).

[10] In contrast, an investor in a Performance Based Ponzi would likely be unable to make a similar argument as there was no contractual right to a specific return – their only entitlement was to receive the returns on the (fictitious) investment, of which there were none. See *McIntosh* at [245] for Glazebrook J's response to this argument in the context of a Performance Based Ponzi.

The Ponzi presumption

60. Bell Gully supports the recommendation to introduce a "Ponzi presumption" to the prejudicial disposition provisions of the PLA. Additionally, if it is intended that a liquidator of a Ponzi could use both the PLA and CA provisions to clawback payments made to investors in a Ponzi, the presumption (in respect of insolvency) should apply to the CA also.

61. A Ponzi presumption has been consistently applied by the United States courts when considering claims to clawback payments made to investors in a Ponzi scheme, pursuant to section 548(a)(1) of the Bankruptcy Code (which is on near identical terms to the prejudicial disposition provisions of the PLA).[11] The practical effect of a Ponzi scheme presumption is that once it was established that:

    (a) the debtor company was running a Ponzi scheme; and

    (b) the payment was made in furtherance of that Ponzi scheme;

    then the Courts would presume that:

    (c) the payment was a disposition of property which prejudiced the Ponzi scheme operators' creditors by hindering, delaying or defeating those creditors in the exercise of any right of recourse of the creditor in respect of the property (satisfying PLA, s345(1)(a) and s346(1)b));

    (d) the payment was not made with intent only of preferring one creditor over another (satisfying PLA, s345(1)(b)); and

    (e) the Ponzi scheme operator will be treated as insolvent at the time the payment was made (satisfying PLA s346(1)(a) and (2)(a)).

62. That is, in practical terms, once the plaintiff has established that the debtor was running a Ponzi scheme and that the payment was made in furtherance of the Ponzi scheme, the elements of the clawback claim will be presumed, shifting the focus of any proceedings to the investor to establish a defence to the claim – either a value defence or a change in position defence.

Presumption of insolvency

63. The fact that a Ponzi scheme will inevitably collapse has led to the United States courts adopting a legal presumption of insolvency from the moment the nature of the business became a Ponzi scheme. This presumption is based on the premise that where a business is running a Ponzi scheme and conducting little or no legitimate business, at no point can the business pay the debts owed to all investors.[12]

64. This approach makes sense. In contrast, a requirement that the plaintiff in a clawback action prove insolvency at the time the challenged disposition was made ultimately ignores the realities of a Ponzi scheme. See our discussion on this at paragraph 45(a) and (b) above.

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[11] Some of the individual states within the United States have implemented state laws which are on substantially the same terms as Section 548(a)(1) of the Bankruptcy Code – see for example, Florida's Uniform Fraudulent Transfer Act Fla. Stat, ss726.105(1)(a).

[12] See for example, *In Re Universal Clearing House Co* 60 B.R. 985 at 999 (D. Utah 1986), *Warfield v Byron* 436 F 3d 551, 558 (5th Cir. 2006) the US Court of Appeal (5th Circuit) and *Wiand v Lee* 753 F.3d 1194 at 1201 (11th Cir.2014).

Presumption of intent to hinder, delay or defeat creditors

65. The rationale for the legal presumption that a payment made in furtherance of a Ponzi scheme was a payment made with intent to defeat future creditors for the purpose of the Bankruptcy Code was explained by the Court in *Merrill v Abbott (In Re Independent Clearing House Co*) 77 BR 843 as follows:[13]

> One can infer intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money

66. The Supreme Court in *McIntosh* recognised this rationale, holding:[14]

> The reality in the present case was that every time a payment was made to an investor of an amount that was greater than the investors' pro rata share of the co-mingled trust fund, the position of the remaining investors/creditors was worsened. That is the inevitable consequence of the operation of a Ponzi scheme and must have been apparent to Mr Ross, and through him RAM, as the operator of the scheme.

67. While it could be argued that the Supreme Court's comments in *McIntosh* create a strong indication that that these two elements would likely be established where a payment was made in furtherance of a Ponzi scheme, it falls short of a legal presumption. Creating a legal presumption of these issues would provide greater certainty for investors against whom a clawback claim is to be taken.

Objective standard of knowledge

68. Bell Gully supports the recommendation to clarify the knowledge requirement in section 349 of the PLA by expressly providing for an objective standard of knowledge to the defences provided in section 349 of the PLA.

69. However, we note that the Report is not strictly correct when it states that the defence pursuant to section 349 provides only a subjective test as to the investor's actual knowledge. The courts have previously held that the "good faith" element of the defence is to be purposively and objectively assessed.[15] The High Court has commented that this may mean that a creditor does not act in good faith if he acts with knowledge of facts, or the transaction itself gives the creditor notice of facts and circumstances, which either:

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[13] *Merrill v Abbott (In Re Independent Clearing House Co*) 77 BR 843 at 860.

[14] *McIntosh* at [36].

[15] See *Regal Castings Limited v Lightbody* [2009] 2 NZLR 433 at [15] (a decision of the Supreme Court in respect of the equivalent defence under section 60(3) of the Property Law Act 1952. For the purpose of this issue, there is no material difference between the 1952 Act section 60(3) and the PLA section 349.) See also *Stanley v McDonald* [2012] NZHC 597 at [32] and [33].

(a) shows or ought to show that the transaction itself was intended to prejudice creditors; or

(b) renders it incumbent on the creditor to make further inquiry.[16]

70. This is consistent with the equivalent value defence pursuant to section 548(c) of the US Bankruptcy Code, which provides a defence to a claim for return of moneys paid pursuant to the actual fraud limb where the creditor has accepted the payment "for value and in good faith". The Bankruptcy Code itself does not refer to any requisite knowledge requirements – rather the courts assess the good faith element by considering, amongst other elements, whether the transferee objectively knew or should have known of the debtor's fraudulent purpose in making the transfer.[17]

71. As is apparent from this analysis, the objective knowledge element of section 349 is only apparent from a review of the case law. Accordingly, Parliament should clarify section 349 to make the objective element of the enquiry clear.

72. This is, of course, consistent with the policy behind these defences. The purpose of the value and change in position defences in the PLA is to provide a balance between two competing concerns:

(a) that investors in a Ponzi scheme should rank equally – in that an accident in timing of when funds are withdrawn should not, in effect, favour one defrauded investor over another.

(b) that the outcome of a clawback proceeding should not place an innocent and unwitting defendant investor in a worse position than if they had not received the challenged payment.

73. If the defences did not incorporate an objective knowledge element, this could arguably promote wilful blindness amongst investors, by removing any incentive to enquire into returns which appear to be too good to be true or raise any concerns about the scheme operator with regulatory bodies.

74. Additionally, the objective assessment of the good faith / knowledge requirements better balances the policy concerns at paragraph 71 above. That is, where an investor had reasonable grounds for suspecting that the payment was in furtherance of a Ponzi scheme, they should not be entitled to retain that payment at the expense of the other defrauded investors.

75. The wording of the section 349 defences under the PLA should be consistent with the approach taken by Parliament with other similar defences to clawback proceedings including the substantially similar defences under section 296(3) of the CA and section 208 of the Insolvency Act 2007 where the knowledge element is expressed as:

> …a reasonable person in A's position would not have suspected, and A did not have reasonable grounds for suspecting, that the [company/bankrupt] was, or would become, [insolvent/unable to pay his or her debts/unable to pay his or her debts without the aid of the property that the gift is composed of].

76. We note that the Report suggests this change should be made where a Ponzi scheme is established. For the avoidance of doubt, we consider that this recommendation should

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[16] See *Stanley v McDonald* [2012] NZHC 597 at [32] and [33].

[17] Phelps & Rhodes at 4-4 and 4-5

be implemented for any defence pursuant to section 349 of the PLA – i.e. any circumstance where a recipient of a prejudicial disposition had reasonable grounds to suspect that the payment or property received was a prejudicial disposition.

Additional issues

The application of CA section 296(3) to a PLA clawback action

77. It has previously been argued in a clawback claim against a former investor in a Ponzi scheme that the defences contained in section 296(3) of the CA could apply as a defence to a clawback claim brought by a liquidator pursuant to the PLA. While the Supreme Court has stated that this is very unlikely, to avoid any doubt, any legislative changes should make clear that CA section 296(3) defences do not apply to a PLA clawback claim.

78. Section 296(3) provides that the defences therein apply to any proceeding brought by a liquidator for the recovery of the property of a company (or equivalent value) "*whether under this Act, any other enactment, or in law or in equity..*""

79. There is no material difference between the value defence under section 349 of the PLA and the value defence pursuant to section 296(3) of the CA. However, there is a significant difference between the respective change in position defences:

    (a) The CA change in position defence provides that if the core elements of the defence are established, the Court cannot make an order for the recovery of that property. That is, the defence is a complete answer to the clawback claim.

    (b) In contrast, the PLA defence:

        (i) requires the defendant establish that the change in the defendant's circumstances is such that it would be unjust to order that the property be restored, or reasonable compensation paid, in either case in part or in full; and

        (ii) provides the Court with the discretion to make any order with limited effect or subject to any conditions the Court thinks fit, where the elements of the defence are established.

    Accordingly, the PLA defence is not a complete answer to the claim.

80. This issue was raised in the *McIntosh* proceedings whereby Mr McIntosh sought to argue that he could rely on the section 296(3) change in position defence to the PLA claim against him, instead of the PLA change in position defence. The Supreme Court commented that Mr McIntosh's argument, if correct, would create a "strange doubling up" which seemed "unlikely". However, the Court ultimately concluded there was no valid change in position under either defence so it was not necessary to determine the issue.[18]

81. Accordingly, Bell Gully recommends that to avoid any doubt on this issue, the Government clarify that CA section 296(3) defences do not apply to a claim by a liquidator pursuant to the prejudicial disposition provisions of the PLA.

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[18] *McIntosh v Fisk* at [73]

Procedural issues

82. When a large Ponzi scheme is unravelled, the funds available for investors are usually only a fraction of the claims for the recovery of capital contributions. Therefore, in order for clawback claims to be a viable form of recovery, they must be both cost-effective – for both the liquidator and for the defendant investor – but also cannot unnecessarily delay the conclusion of the liquidation.

83. Therefore, Bell Gully recommends two key procedural changes:

    (a) to amend the High Court Rules to expressly provide that clawback claims brought by liquidators pursuant to the prejudicial dispositions provisions of the PLA can be commenced pursuant to Part 18 of the High Court Rules 2009; and

    (b) to amend the CA to provide that the liquidators can seek a determination as to when the Ponzi commenced, by way of a directions application pursuant to section 284 of the CA.

84. These amendments are discussed below.

Permitting a PLA Clawback Claim to be commenced as a Part 18 proceeding

85. There is no express provision permitting a clawback claim under the PLA is to be commenced by way of one of the simplified trial procedures available under the High Court Rules. This is in contrast to other similar clawback proceedings.

86. The High Court Rules provide for two simplified trial procedures, which are routinely used for claims in liquidation: Part 18 procedure and the Part 19 originating application procedure.[19]

87. Each of these procedures offers a speedy and inexpensive determination of the claims. This is primarily because interlocutory steps such as discovery are not available as of right (although the Court has a wide power to order such steps be taken if it considers they are required) and evidence is by way of affidavit. The main difference between the two proceedings is that Part 18 is commenced by way of statement of claim. Therefore, each of these procedures offer significant time and cost benefits over that of the ordinary proceeding.

88. The issue of how a clawback claim under the PLA should be commenced was considered in the case of *Fisk & Bridgman v E* [2014] NZHC 2797 (another clawback claim brought against an investor by the liquidators of RAM), where the proceeding raised three claims – a clawback claim pursuant to the PLA, a claim pursuant to section 294 of the CA and a claim pursuant to section 297 of the CA. The Court held that the most appropriate procedure was Part 18 on the basis that the clawback claims naturally fell within the category of claims brought under Part 18 or Part 19 and that given the complexity of the claim, a statement of claim would be of assistance to clarify the issues.

89. Accordingly, Bell Gully recommends that the High Court Rules be amended to expressly provide that clawback claims brought by liquidators pursuant to the prejudicial disposition provisions of the PLA be commenced pursuant to Part 18 of the High Court Rules.

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[19] By way of illustration, a claim for relief solely under the Companies Act 1993 which is not a proceeding falling within Part 19 or an application to liquidate a company must be commenced under Part 18 – see HCR 18.1(b)(iii). Claims to set aside voidable transactions and voidable securities under the CA must be brought under Part 19 – see HCR19.2.

Amending the CA to allow for the Court to determine the date the Ponzi commenced by way of directions application

90. Bell Gully recommends that section 284 of the CA be amended to confirm that the liquidator may apply to the Court for a determination of the date on which an investment scheme became a Ponzi.

91. If the Government adopts the recommendation of a Ponzi presumption, the date on which a scheme became a Ponzi (thus triggering the Ponzi presumption) will be a key issue for all investors. It makes sense for such a matter to be determined by way of a directions application. If it could not be determined by way of a directions application, the reality is that the unlucky first investor to be a defendant to a clawback action by the liquidators will likely bear the burden (and associated cost) of testing this date, for the benefit of the liquidation as a whole.

92. The fairest approach is to have the matter raised by the liquidators by way of an application for directions which is served on all affected investors, giving them a process to be heard on the matter. This would also allow for a key issue in the liquidation to be determined at an early point, giving greater certainty to both liquidators and investors subject to a possible clawback claim. To avoid any doubt on this process, the CA should be specifically amended to provide for this.

Chapter 5: Other corporate insolvency issues

Recommendation 17: Amend, for the purposes of Part 16 (Liquidation), the definition of 'secured creditor' to include all creditors holding a security interest as defined in the Personal Property Securities Act 1999.

93. We support this recommendation, for the reason set out in Annex 2 of the Working Group's report. In particular, we support the proposition that an amendment to the Companies Act 1993 is desirable to implement any intended change to the meaning of that Act following the enactment of the Personal Property Securities Act 1999.

Recommendation 18: Provide that recoveries from reckless trading claims are not available to secured creditors but instead are distributed only to unsecured creditors (including preferential creditors).

94. We do not support this recommendation.

95. We understand that the proposal is motivated by a concern that reckless trading claims by their nature arise in insolvency situations, and are quantified by reference to the losses suffered by the company. This means that the quantum of the claim will frequently be calculated by reference to losses suffered by unsecured creditors, even though the claim will principally be for the benefit of the secured creditors, even in the (not uncommon) situation where the secured creditors are related to, or the same as, the directors responsible for the reckless trading.

96. As the Working Group points out, this differs from the position in the United Kingdom and Australia, where the proceeds of reckless trading claims are made available to unsecured creditors.

97. Although we understand the Working Group's concern, we do not support the proposal for three reasons:

    (a) Frist, because we consider the practical concern to be less clear and less acute that the summary above suggests. There are many situations in which the principal economic effect of insolvent trading is to reduce the recovery by innocent secured creditors (e.g. when there are relatively few unsecured creditors, or significant secured creditors). There have been several recent examples of this in the context of the finance company cases. In those cases, no injustice in the proceeds of reckless trading claims being available to secured creditors. To the contrary, it would be unjust if they were not.

    (b) Second, because many of the considerations that apply to reckless trading also apply to claims under s 136. Both sections arise from s 320 of the Companies Act 1955, and both arise principally in insolvency. It would be incongruous to have different priority rules apply to claims under the two sections.

    (c) Third, and most importantly, because we consider that the proposed change is not the most appropriate way to address the concern. Unlike the UK and Australia, New Zealand's reckless trading jurisprudence has developed in the context of s 135 operating in the same way as the other statutory directors' duties. There is a substantial degree of overlap between conduct which breaches s 135 and conduct which breaches s 137, and sometimes s 131. If the proceeds of s 135 claims were subject to different priority rules to s 137 claims, then there would be a degree of arbitrariness in which creditors benefit from a claim against directors. It could

depend on which claim was made first, and the form of the pleading (which would in turn lead to a conflict between the interests of receivers and liquidators).

97.2 A change to the priority rules is a blunt tool to address the Working Group's concerns. If the issue must be addressed, we consider that it could be better addressed by a reconsideration of the duty and/or the scope of s 301 of the Companies Act 1993, which has the potential to avoid the problems that concern the Working Group while also minimising the issues set out above.

Recommendation 25: Establish a new preferential claim for gift cards and vouchers, with the same ranking as layby purchases.

98. While we acknowledge the very unfortunate position of gift card holders in insolvency situations, we do not support this recommendation.

99. We understand that the proposal is intended as a consumer protection measure. Gift card holders are particularly vulnerable to retail insolvencies, as has been seen in several high-profile insolvencies in New Zealand such as Whitcoulls and, recently, Dick Smith. As the Working Group notes, gift card holders are arguably less able than other creditors to gauge the solvency of retailers, and typically represent only a small proportion of the value of the total debt.

100. The proposal is to rank gift card holders at the same tier of priority as lay-by purchasers in Schedule 7. The priority for lay-by purchasers was discussed in the New Zealand Law Commission Advisory Report to the Ministry of Commerce *Priority Debts in the Distribution of Insolvent Estates* (1999) at [173]-[176]. That report offers four main reasons for the preference:

(a) First, because the law should encourage prudent budgeting. Anecdotal evidence suggested that layby purchasing was still a popular form of budgeting;

(b) Second, it was thought that those who use lay-by systems are often consumers of "modest means" who can "least afford" to lose money;

(c) Third, the amount of money involved are generally modest and unlikely to impact on dividends received by other creditors; and

(d) Fourth, the appropriation of goods by the vendor is typically beyond the control of the customer.

101. Although there is a degree of similarity between gift card purchasers and layby purchasers (to the extent that both have paid money in advance of receiving goods), these criteria illustrate that different policy considerations apply to the two groups. The first consideration does not apply at all to gift card purchasers. The second consideration applies to a much lesser extent to gift card holders (i.e. we do not consider it would be reasonable to assume that the personal economic position of gift card holders is so different from the economic position of other creditors that there is a public policy justification for treating them differently). The third consideration may apply, though to a lesser extent. The fourth consideration does not apply. Gift card holders have the ability to redeem their gift cards at any time (before insolvency).

101.1 The effect of the preference would be to shift the burden of the insolvency from one group of innocent unsecured creditors to another, in circumstances where, in our view, there is no reason to think that the ordinary unsecured creditors (such as unpaid

suppliers) will be better able to withstand the effects of the insolvency than gift card recipients.

101.2 In addition, we understand anecdotally that the preference would create practical difficulties in insolvency. For example:

(a) It may often be difficult to identify the extent of the company's gift card liability, especially in circumstances where records are poor and gift cards can be sold by third parties.

(b) It may be administratively difficult to manage a large number of relatively small individual preference claims.

(c) It will be particularly burdensome on receivers, who must identify the preferential creditors before making returns to secured creditors.

102. We note also that people that purchase gift cards with certain debit or credit cards may be able to raise a query with their banks, and recover their loss that way.

103. Accordingly, we do not support this proposal.