# CLAWBACK CLAIMS BY INSOLVENT FUNDS

1. When an open ended investment fund has been trading illegally and subsequently collapses into insolvency, investors will divide into those who remained invested at the point of collapse and those who got out by redeeming before the collapse. Both groups are innocent participants in the fund over the period of illegal trading. At the point of collapse, and without the intervention of the law, the group that redeemed will be left largely unscathed, possibly even holding profits, whereas the group that did not will be facing a paltry dividend – if it receives anything at all. This paper addresses the questions whether the law should decline to intervene in these situations for policy reasons and, if the law were to intervene how, in the Cayman Islands, it might intervene to distribute losses among the two groups. The questions arise acutely in the case of Ponzi schemes.

2. The Chief Justice (**CJ**) in *DD Growth* thought that as a matter of policy the law should resist claw back claims, even in the case of a collapsed Cayman Islands investment fund operated as a Ponzi scheme (*RMF Neutral Strategies (Master) Ltd. v. DD Growth Premium 2x Fund FSD 33 of 2011* (at paragraphs 141, 214 and 215)). It is worth reflecting on what this means. Before the collapse those who redeem will normally receive their initial investment plus the sort of profit that will keep new investors rolling in. But there is no underlying investment: the profits are funded from money coming in; the profits are fictitious – the proceeds of a fraud on the incoming investor. The same will be true of the non-profit element of the redemption payment.

3. In *Fairfield Sentry v. Migani* [2014] UKPC 9, Lord Sumption declared:

> *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.*

On a practical level that is true, but ought the law to stand aside and let this happen? The CJ in *DD Growth* appeared to think that it should because he thought that investors who 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*". The Court of Appeal was not so sure (*DD Growth Premium 2x Fund v. RMF Neutral Strategies (Master) Ltd.* CICA No.24 of 2014 paragraph 40). It is not entirely clear why an investor who knew his redemption payment was the proceeds of a fraud on another investor would expect to be able to keep the payment. The experience of investors in the U.S., moreover, is directly to the contrary. In the U.S. it is has been established for over fifty years that on the collapse of a Ponzi scheme the general rule is that investors who got paid out have to return their pay out to a central pot for distribution among all the victims of the fraud.

4. The view in the U.S. is that *"… 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). 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. It is well known that investors in Cayman Funds are not immune from this phenomenon. Indeed, on Nov. 17, 2014 — the very day of the CJ's 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 claw back 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.

5. It is suggested that whereas there is no sound policy reason to rule out claw back claims, there are strong policy arguments in favour of redistributing assets to ensure equitable sharing of loss among the innocent victims of a Ponzi fund. But could Cayman Law achieve that result? Here too, it is suggested, there are lessons to be learned from the U.S.

6. The way in which U.S. bankruptcy law analyses a Ponzi scheme is instructive.

> *"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.

7. 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?

8. 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).

9. 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.*"
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> "*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.*

10. 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.

11. Could this be achieved in Cayman? Consider section 145(1) of the Companies Law.

> "*Every conveyance or transfer of property … made by any company in favour any creditor at a time when the company is unable to pay its debts within the meaning of section 93 with a view to giving such creditor a preference over the other creditors shall be invalid if made .. within six months immediately preceding the commencement of a liquidation."*

12. The payment to a redeeming Ponzi investor is certainly going to have the effect of preferring that creditor over other investors. Under Cayman law that it is not enough (see *DD Growth*). The question would be whether the fact that the payment was made with a view to keeping the Ponzi scheme going prevents the necessary intention to prefer. There is no authority on the point. The authority would require a determination of the fraudster's intention. Does the fact that the fraudster made the payment to keep the scheme going amount to a choice to pay one creditor over others. On one view that is so fundamental to a Ponzi scheme that a decision to operate in that way involves the necessary fraudulent intention to prefer. That is the way it has been analysed in the U.S.

13. Consider also section 146(2) of the Companies Law.

> *"Every disposition of property made at an undervalue by or on behalf of a company with intent to defraud its creditors shall be voidable at the instance of its official liquidator."*

Payments to redeeming Ponzi investors are payments that extinguish an entitlement to participate in fictitious investments and non-existent profits. There ought to be little difficulty in demonstrating that the payment made by the company to the redeemer is given in exchange for something that is worth significantly less than the cash amount of the redemption payment and is therefore a disposition of that part of the company's assets at an undervalue.

14. The question would become, is the payment made with intent to defraud creditors? Once again, the question becomes whether the fact that the payment is made to keep the Ponzi scheme going makes it a payment with intent to defraud creditors. That question was answered in the affirmative in the U.S. over fifty years ago.

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