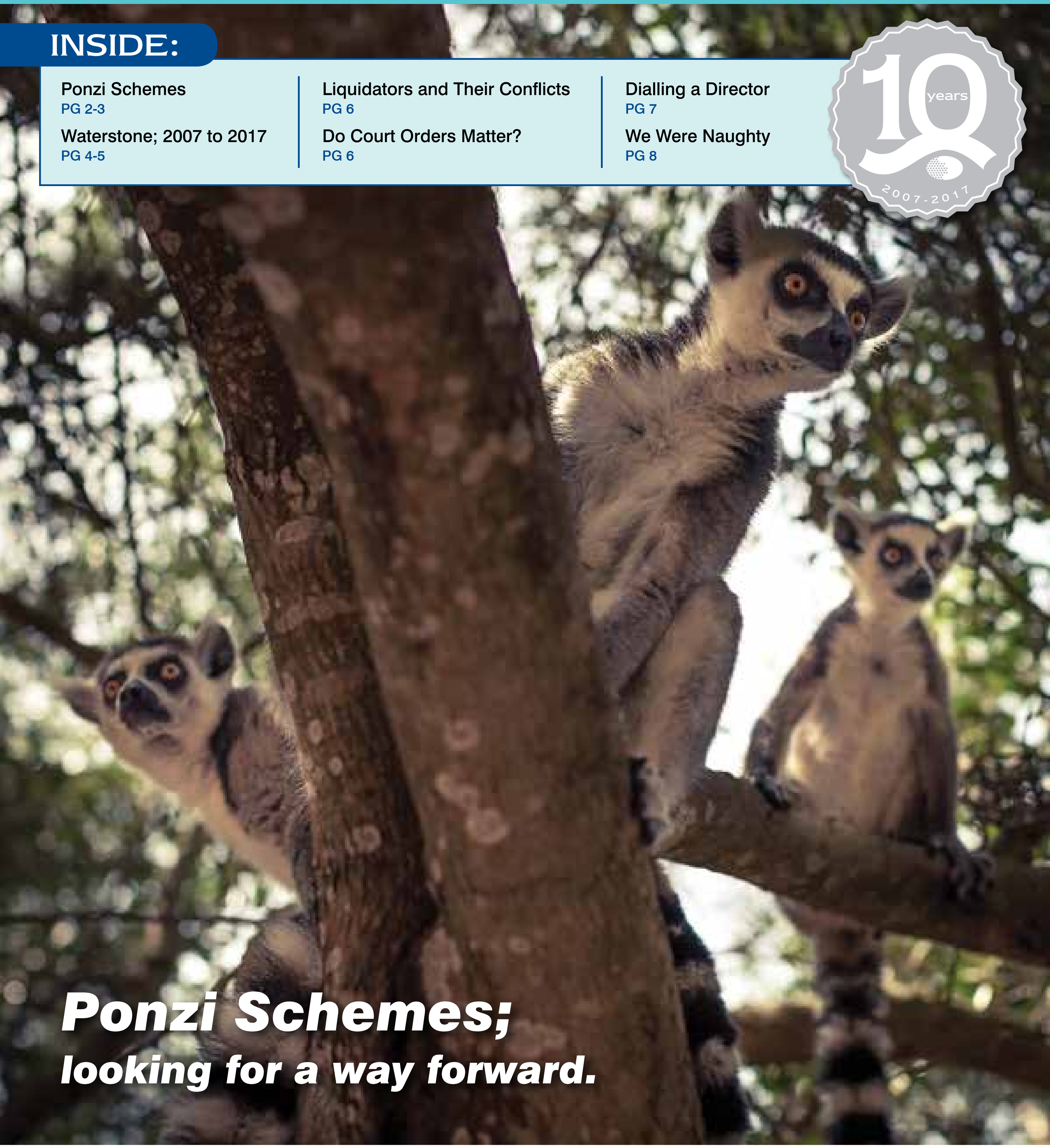
waterline

waterstone INSOLVENCY

2017 EDITION 19

INSIDE:

10 years 2007-2017



Ponzi Schemes;
looking for a way forward.

Ponzi Schemes

Ponzi schemes have been in the news recently, they appear to the insolvency world's topic of the year. It all began with our own Bernie Madoff, David Ross, quickly followed up by Arena Capital and Paul Hibbs and Hansa.

This flowering of Ponzi scams has compelled the courts to examine some of the issues that arise and there are several.

- How to account for the losses
- How to distribute the assets
- What about actual assets held by the Ponzi in the investor's name
- What can be clawed back
- How far back can liquidators go in searching for claw-backs
- Classes of creditors
- Tracing
- Can liquidators use investors' money for their fees

Accounting for the Losses

In addition to the shock for many investors being caught in a Ponzi Scheme is the difference between their valid claim in the liquidation and their perceived losses. An investor may have paid in $100,000 and on paper have $200,000 in the fraud. However, the liquidator of a Ponzi will only consider they have a claim for their initial investment.

In a Ponzi a victim can only claim for their actual losses. This is a practical as much as a legal issue because the fraud is not going to have enough money to pay every victim even their actual cash losses so what happens is a pro-rata allocation between the victims.

This particular issue has not been litigated in New Zealand but has been extensively in other jurisdictions and is accepted by insolvency practitioners in New Zealand.

How to Distribute the Assets

By taking the actual cash losses only into account gives the liquidator a simple basis by which to distribute any recoveries. If an investor who had paid in capital but succeeded in taking out their initial investment they could still have a paper profits. If an investor could claim their losses as per the fraudulent statement issued by the Ponzi scheme then they could claim a share of any recovered assets.

By ignoring the paper profits this issue is avoided.

Assets held in by the Ponzi

A Ponzi can take two forms. One; where the fraud takes investors' money and invests it in a 'black-box' and gives the victims monthly statements of their holdings and the second where the fraud purports to hold investments on behalf of the victim but in truth these holdings do not exist.

Most are combinations of both and the Ross Asset Management was one such example. However, in one case Duncan and Nora Priest had given money to Ross with instructions on what investments to make. The Priests could prove that these specific assets were not the property of Ross but were only held by his company in trust for the Priests and they were able to retain possession of the assets.

"You claw my back and I'll run to court."

What can be clawed back

The recent Supreme Court decision in the Ross Asset Management case; Fisk and McIntosh, settled this issue. McIntosh had invested $500k in the Ross fraud, but had been successful in recovering his initial investment plus an additional $450k; a total of $950k.

The liquidators sought to recover the full $950k. McIntosh sought to keep all of his money. The Supreme Court agreed with the lower courts and declared that the investor could keep his initial investment, being $500k, but had to refund the additional $450k in fictitious profits.

This can be seen as unfair, as the entire $950k was funds David Ross had swindled off other investors, but as the saying goes; the only place to go after the Supreme Court is the pub.

How far back can liquidators go in searching for claw-backs

Claw-backs, or voidable transactions, are where a liquidator can recover preliquidation payments. There are two conditions for this;

- The Company must have been insolvent at the time the money was paid

- The person who received the money gets a benefit relative to other creditors

If these two conditions are satisfied then the person who received the money can raise a defence;

They must show that they;

- Acted in good faith (usually a given)
- Had no knowledge the company was insolvent
- Gave value for the transaction

In terms of a Ponzi scheme the liquidators can look at creditors who got money out and seek to claw the money back. They will need to show that the company was insolvent when the money was repaid and that the creditor who got the money received more than others.

Two laws apply here; the Property Law Act and the Companies Act. Under the Companies Act the liquidator can go back two years; however under the Property Law Act payments as old as six years can be aside; six years being the limit under the Limitation Act.

However, a liquidator could potentially invoke the law of equity to go back further than six years but this does not appear to have been attempted.

Classes of creditors

In an investment firm, even one run as a Ponzi, assets taken from investors are held in trust by the company. The funds are not, strictly speaking, the company's assets. As a result any funds recovered from investors' money should only be used to repay investors and not used to settle general creditors; such as a landlord for unpaid rent.

This issue was canvassed in the Arena Ponzi where liquidators, Korda Mentha, sought permission to treat the 23k of non-investor creditors in the same manner as investor creditors. The court agreed, primarily because of the economic cost of separating out the different classes would have been far in excess of any economic benefit.

Tracing

One means of recovery is for one investor who put money into a Ponzi late in the game to trace where their money went and demand restitution from those who had received their money.

Say, a year before a fraud collapses, an investor had put in $100,000. The Ponzi manager had then paid this money out to five other parties. The investor could argue that the five who had received his money should repay it.

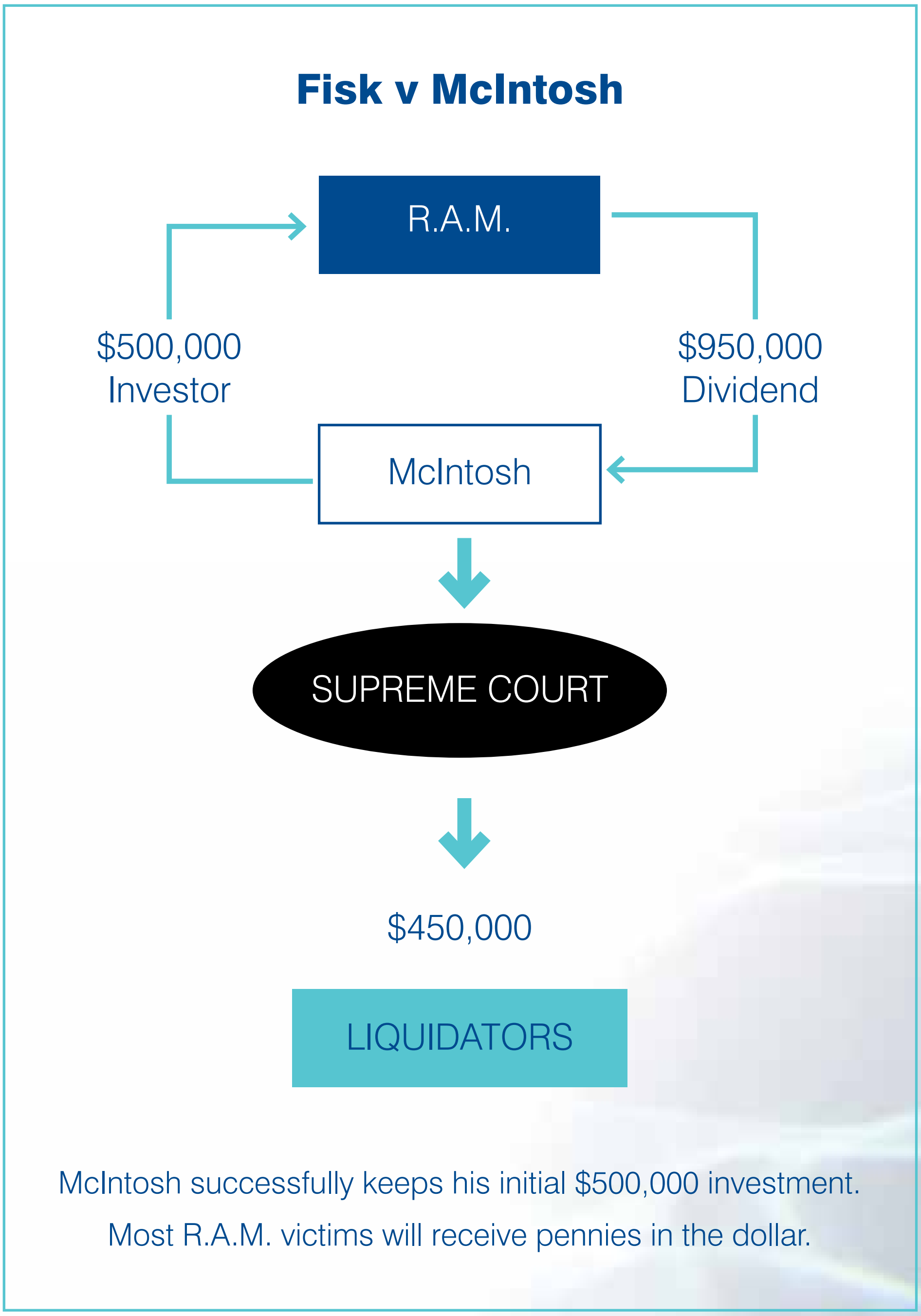
This is rarely attempted, primarily because those managing Ponzi estates do not share the information with the parties and because it is uncertain if the courts would entertain such a claim.

Liquidator's costs

Money invested into a Ponzi scheme is money held in trust. Funds that are recovered from these investors are also trust money.

In a normal liquidation a liquidator can seek to cover their costs from the assets of the company. However, in a Ponzi the recovered money isn't the companies. Typically, the liquidators should apply to court to get permission to take their fees from any recovered money.

However, the liquidators could argue that they have a right of salvage, a common law right, to take their fees from any recovered assets.



Waterstone; 2007 to 2017

Craig Fisher, Damien Grant and Nick Malarao

Steven Khov and Paul Deveraux

Waterstone
has been around for
TEN YEARS!
We are pretty pleased
with this achievement,
so we threw a small
party and invited
some friends.

Wei Ting

Assembled delegates from the Hawkes Bay

Assorted attendees

Carien Louw, Eugene St John and Pam Goodall

Waterstone 2017

Pam Goodall, Rebecca Grant and Jo Pidgeon

The Cast of 'Something Illicit'; a TVNZ Legal Drama

Dr Brash; Guest Speaker

Liquidators and Their Conflicts

A curious case over the appointment of liquidators erupted across the Tasman last year involving the unfortunately named Butmall Pty Limited and its director, Mr Renshaw.

The liquidator was Mr James White, a partner from BDO. The court papers for his appointment had been served on Butmall well in advance and in December 2015 the court placed Butmall into the care of Mr White.

It was at this point that Mr Renshaw sprang into life. He was unhappy with BDO being the liquidators because BDO were the auditors of the Queensland Mining Corporation Limited who owed several hundred thousand dollars to Butmall.

There was a possible conflict of interest if BDO were unlikely to pursue a claim on behalf of the liquidation against one of their clients.

Referring to previous cases the court held that the benchmark was;

> *"…there must be a real and not merely theoretical possibility of conflict of duty or interest."*

Renshaw's application failed for two reasons. The first was that he'd been aware that BDO was going to be appointed as liquidators for months and had not raised an objection. A simple estoppel argument was raised against him.

The second was more interesting. There was considerable evidence brought to court that the claim against Queensland Mining Corporation was hopeless. However, if the claim had been stronger the court may have taken a different view;

> *"As I have said, this might have some substance if I could be persuaded that the claims were in any way reasonably arguable. The problem for this application is that, as matters presently stand, there is no basis upon which I could be satisfied that the claims are reasonably arguable."*

In New Zealand there is a provision that prevents liquidators who have ongoing commercial relationships with a firm's secured creditors from taking appointments. There is a provision where a creditor of the company in liquidation cannot take an appointment. However, appointments are always personal, so a liquidator could argue that if their employer was a creditor, but they weren't, they could still take the appointment. We wouldn't recommend it.

Do Court Orders Matter?

The whole basis of our legal system is that court orders are obeyed. If we are able to ignore a court ruling, then what use are they? If a ruling from a local court is as effective as a cavalry charge from the Salvation Army how do we maintain any semblance of order?

Given the integral importance of judicial rulings to the healthy functioning of our legal system it may surprise readers that there isn't any real consequence for ignoring them. In theory you can go to prison for ingoing a court order. A High Court judge can send you the lock-up for ninety days entirely at their own discretion but a few recent cases indicate that this isn't likely.

Igor Kisselev / Shutterstock.com

Once more; into the breach…

A recent flagrant example was Ms Ying; who sold a property for $399,000 to Ms Zhang. On reflection she regretted this decision, litigation ensured and in a settlement at trial a Consent Order was issued, whereby Ms Ying's company, King David Investments Limited, would transfer the property to the frustrated purchaser and would make a payment of $220,000.

Again, Ms Ying had second thoughts and she sold the property to a third party for $655,000 and proceeded to liquidate the company with Wellington's go-to liquidator for these sorts of problems, Imran Kamal.

Ms Ying's husband was a lawyer and there doesn't seem much doubt she knew what she was doing. In fact the judgement said:

> *"At one point in her evidence she acknowledged what she did probably wasn't right but at another she said she knows she did the right thing and if she needs to be punished she will face the punishment."*
>
> *CIV-2014-404-000680 2016 Zie Zhang & King David Investments Limited (In Liq)*

At the end of the process this strategy didn't pay off financially for Ms Ying but the incensed Zhang demanded imprisonment as a consequence for floating the court orders. Instead a ten thousand dollar fine was imposed, which some readers may consider was an inadequate deterrent given the stakes involved and the apparent willingness of Ms Ying to suffer the consequences.

In several recent cases, including the troublesome Bhanas on the back page of this edition, we have seen company directors refuse to comply with court orders to hand over the books and records of their companies. When we have sought to have some consequences imposed we have been disappointed with fines in the five to fifteen thousand dollar range and a real reluctance of the judiciary to impose a custodial sentence.

Given the financial stakes involved, defying a court order can make financial sense. In at least one case, involving the Masala restaurant chain, we abandoned viable litigation because the defendants made it clear through their actions that they were never going to comply with any court orders. We were never going to get the books and records and what we believe was a deemed director with substantial assets was allowed to keep the gains proceeds of their activities.

We were disappointed.

Dialling a Director

We have a surfeit of Singhs, an oversupply of Owens and an excess of Edwards. Searching for company directors can be a tricky thing. When signing up to be a director, applicants need to supply their date of birth to the Registrar but this information isn't made available for those searching.

There also isn't any restriction on people calling themselves whatever they want. If you fancy yourself as being Lord Buckethead, for example, you can put that down as your name and the Registrar will accept you as being a director.

There isn't any real evidence of a surge in oddly named nobility on our Company Registrar, as opposed to the British Electoral Authorities, but the Ministry of Business, Innovation and Employment has a Discussion Paper out discussing the merits of requiring a unique identifying number for directors.

Some overseas jurisdictions achieve this by requiring directors to supply a national identification number, such as Singapore and Sweden. The Australians, who do not have such an Orwellian identification regime, are also looking at introducing a unique identifying number for directors.

The Ministries plan is to have directors provide sufficient identification before being given a Unique Identification Number. It will not be possible to be a New Zealand director without this.

The idea has clear advantages for those seeking to do business with a firm; the ability to easily search directors and their past failures and, helpfully, changes of names will also be captured. This, of course, will trip up those who like to change their names to hide past sins; and by this we mean wives, of course.

Currently MBIE already has an identification regime in place, the RealMe verification process. Alternatively an applicant director could supply the Ministry sufficient documentation that allows for verification.

A rose by any other name would not be easy to search on the Companies Office Register.

Our mascot Prudence manning a battleship.

The Rotten Borough of Dunwich

Election time is a chance to reflect on simpler times; when MPs were elected by property owning men and, in the case of some electorates, not many of those. Older readers may recall the Black Adder series and the episode where Baldrick was elected to Parliament from a rotten borough.

The borough in question was Dunwich and it's a real place. It first sent gentleman to parliament in 1298 when it was a busy port town rivalling London. However, over the centuries it was, literally, washed away. By 1831 most of its former land was underwater and the electorate less than 250 people, only 32 of whom were eligible to vote for the two MPs sent to Westminster.

Sadly, this marvellous institution, and others like it, were abolished in the Reform Act of 1832.

Greyfriars Friary; moved inland as Dunwich slowly sank; destroyed by Henry VIII in 1538.

We Were Naughty

For several years Waterstone has been struggling with a small file from Rotorua; the Ranolf Company Limited.

In addition to the tautology of having 'Company' in a company name this file has proved to be absurdly difficult. Ranolf Company Limited was established as a corporate trustee to oversee the Ranolf Trust.

The Trust was established back in 2003 and had a block of twelve units as a trust asset, with the settlor being Stephen Bhana and his siblings, Ashok and Jasu as trustees. In 2004 Ranolf Company was appointed as the sole trustee.

However, the registered owners of the property remained Ashok and Jasu. During the ten years that Ranolf Company remained trustee 130k of debts were incurred. When Waterstone were appointed as liquidators in 2014 all we had were the debts, the bank records, and a phone number for Stephen Bhana.

Stephen and Jasu Bhana are well known and colourful Rotorua identities. We were in for a treat. For a start, the Bhanas were not inclined to give us any of the books and records of the company and remained unmoved when we obtained a court order insisting that they comply. In response we convinced the High Court to issue an arrest order and in a magnificent display of defiance they completed an affidavit claiming that they never received the court order.

As it happens, this was blatant perjury and we can say this because we have an in-house team of lawyers to handle any possible defamation claim and, helpfully, a High Court judge found the following;

"*The Bhanas each gave evidence and each denied that they were served with the application. The onus is on Messrs Grant and Khov to prove otherwise…*

I find to the criminal standard of beyond reasonable doubt that the Bhanas were served with the documents and they either overlooked the hearing date or chose not to attend."

(Brewer; 4th October 2016)

Still, the Bhanas remained defiant and this has proved an effective strategy because the consequences for their defiance were, in legal terms, de minimis. More on that on page six.

However, due to some creative sleuthing by our underpaid interns (rifling through garbage sacks at the back of an abandoned property where company records had been discarded) we discovered a block of apartments that were trust property.

Thus began a long legal process against the registered owners of the property, Ashok and Jasu, in order to bring the property back under trust control so it could be sold in order to satisfy the creditors.

In the end, once the evidence that the asset was owned by the trust, the process was relatively straight forward. However, we were not successful in having the asset moved back into the company but were forced to stand aside while the sheriff sold the property in order to satisfy the creditors.

However, of considerable interest to ourselves was the right of indemnity for our fees. The trust deed didn't make a specific provision for trustee fees and it was necessary to fall back on the right of a trustee under the soon to be re-vamped Trustee's Act to be compensated.

A liquidator of a corporate trustee has two roles. One as a liquidator and another as a trustee. The ability of a liquidator to rely on the assets of a company to get paid isn't proscribed anywhere. On reviewing this issue the court found;

"*The right of indemnity is an asset of the company; indeed it is the only asset of the company. The costs reasonably incurred by the liquidators in carrying out their obligations are to be paid in priority to the claims of other creditors.*"

Unfortunately for Waterstone Justice Gilbert wasn't impressed at the amount of work we'd put into the file. For completeness, this is what he said:

"*The liquidators' approach to the liquidation has also contributed significantly to the costs. Ranolf has a straightforward claim under the indemnity and it appears that the Trust assets are more than sufficient to meet the claims of creditors in full as well as the reasonable costs of enforcing the indemnity. As noted, the creditors' claims totalled approximately $100,000 at the time of the liquidation. Rather than simply pursuing recovery under the indemnity, the liquidators have chosen to pursue other claims at considerable cost.*"

At the time of writing the property in question has yet to be sold and we are uncertain what, if any, equity remains in this asset.

Waterstone staff monkeying about.