IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY

I TE KOTI MATUA O AOTEAROA
TE WHANGANUI-A-TARA ROE

CIV-2012-485-2591

UNDER	Sections 271 and 284 of the Companies Act 1993 and the High Court Rules
IN THE MATTER OF	Ross Asset Management Limited (In liquidation) and related entities
BETWEEN	**J H R FISK** and **D J BRIDGMAN** as Liquidators of Ross Asset Management Limited (In liquidation) and related entities, each being Chartered Accountants of Wellington and Auckland respectively
	Applicants

FIRST MEMORANDUM OF AMICUS CURIAE AS TO DIRECTIONS AND ORDERS OF THE COURT DATED 13 DECEMBER 2017 DATED 16 MARCH 2018

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MAY IT PLEASE THE COURT

Introduction

1. Counsel was appointed Amicus Curiae by way of this Honourable Court's Minute dated 13 December 2017.

2. Since that time, Counsel has had the opportunity to review the pleadings filed, met with the Liquidators and the Liquidation Committee and met and corresponded with the sub-set of the Liquidation Committee who support the Alternative Distribution Model ("the ADM").

3. Counsel has also corresponded with the New York law firm of BakerHostelter. BakerHostelter acts for the Trustee (Mr Irving H Picard) appointed pursuant to the Security Investor Ponzi Act ("SIPA") to the Ponzi scheme operated by Mr Bernard Madoff and his investment company Bernard I. Madoff Investment Securities LLC ("BLMIS"). While the sheer scale of the BLMIS Ponzi dwarfs the fraud carried in Ross Asset Management Limited ("RAM") Ponzi, there are startling similarities as to the nature of the fraud, the conduct of the perpetrators and the outcomes that have occurred in BLMIS and RAM.

4. BakerHostelter have helpfully provided Counsel with a wealth of information and US case law arising out of the BLMIS Ponzi and in particular the treatment of creditors, net equity treatment of creditors as to arriving at a net equity position of money in, minus money out together with other issues determined as to inflation adjustments, treatment of inter-company trading accounts and tracing issues.

5. Counsel has also reviewed information relating to the method of distribution to creditors of funds recovered by the United States Justice Department in the BLMIS Ponzi. This method of distribution, called the "rising tide" ("the RT") gives rise to a further proposed distribution model that Counsel will be inviting this Court to consider at the substantive hearing of the Liquidators' application.

6. Counsel has also had further meetings with the Counsel and the Solicitors instructed by the Liquidators. Counsel is very grateful for the high level of co-operation extended by the Liquidators' Counsel and Solicitors.

7. Inquiries have been made further in relation to matters that arise on the Liquidators' application.

8. The Minute dated 13 December 2017 directed that Counsel file with this honourable Court a Memorandum addressing matters raised at paragraphs 4(a)(i) and 4(a)(ii) of the Minute, being:

    5.1 Whether Counsel intends to advance and provide submissions on any other distribution model (aside from the Net Contributions Model ("the NCM") and the ADM), and if so a description of the model; and

    5.2 Whether Counsel intends to advance submissions on any of the other orders sought by the Liquidators in the Application.

9. Accordingly, this memorandum will address those matters in turn.

10. Also, in undertaking inquiries, Counsel wishes to bring to the attention of the Court preliminary matters that, respectfully, should be considered at the first Court conference. Two matters have been identified:

    (a) Whether the Liquidators may venture outside, and if so, to what extent, of the Companies Act 1993's mandatory distribution methods.

    (b) The basis for the application of CPI adjustments to pre-liquidation net balances.

Any other Distribution Model

11. As mentioned, the RT should be considered by the Court as it has been identified as a distribution methodology that can accomplish an equitable distribution between defrauded Ponzi scheme investors - being the essential task facing the Court here. The RT may be seen, in certain respects, as a variation of the ADM.

12. The RT provides a scale approach to distributions where investor losses are calculated by reference to pre-liquidation deposits and withdrawals (ignoring fictitious profits as reported by the Ponzi operator). Where there is a shortfall for distribution, investors will receive a distribution to compensate to a certain proportion of losses on a sliding scale subject to the funds available. By way of example, investors who suffered a 100% loss (those who deposited funds and withdrew nothing throughout the life of the Ponzi) may receive a distribution of funds equivalent to 10% of their loss. If there are funds remaining after that distribution, then investors who suffered a 90% loss (which will include those who have received the first distribution bringing their

loss to 90%) will receive a distribution equivalent to say 5% of their loss, and so on.

13. The RT is described in Davis, *The Rising Tide in the Wake of a Ponzi Scheme*, American Bankruptcy Institute Journal[1] a copy of which is attached to this memorandum and marked '**A**'.

14. While the majority decisions in both the Court of Appeal and Supreme Court in *McIntosh v Fisk* hold that the Court should not have regard to pre-liquidation withdrawals of principal (on the basis that there was value given), the minority decisions of his Honour Justice Miller and her Honour Justice Glazebrook in the Court of Appeal and Supreme Court, respectively, provide some judicial support for distribution models such as the RT or the ADM, which both take pre-liquidation withdrawals into account.

15. With regard to background of the ADM, this distribution model is understood to have been first considered in an investor's application in *Graham & Anor v Arena Capital Ltd (in liq)*[2].

16. To advance matters, it is suggested that the Liquidators also provide to the Court, prior to the substantive hearing of the application, the "maths" as to the RT distribution model on the same basis / comparisons as the tables contained at pages 34 and 36 of the affidavit of John Fisk filed in support of the application.

Intention to advance submissions on any of the other orders sought by the Liquidators

17. As a summary and following the order as set out in the Liquidators' application to the Court dated 12 December 2017 the Liquidators have also sought the following orders (excluding those already granted by her Honour Justice Thomas in the Court's minute of 13 December 2017):

    (a) That the assets of RAM and Dagger be pooled and the liquidations of those companies proceed as one.

    (b) That the recovered assets of RAM and Dagger after costs be treated as one pool of assets available for distribution to unsecured creditors and investors.

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[1] 32-Jul-Am. Bankr. Inst. J. 40

[2] *Graham & Anor v Arena Capital Ltd (in liq)* [2017] NZHC 973 at [31] – [41]

(c) Distribution of assets takes place as follows:

(i) No tracing of particular investor's investments occurs.

(ii) Any investor who received payments from RAM (adjusted for CPI to 17 December 2012) which exceeded their contributions to RAM (adjusted for CPI to 17 December 2012) is not entitled to any distribution.

(iii) In respect of investor portfolio transfers:

(A) Transfers are recognised to the extent of any positive net 'contributions balance' in the transferring portfolio as at the date of transfer.

(B) 'Contribution balances' are calculated by deducting from contributions made by an investor, payments to that investor by RAM (both adjusted for CPI to 17 December 2012).

(iv) If the method for calculating the value of transferred portfolios described in (iii) above is unjust or ineffective in specific instances:

(A) The Liquidators are permitted to apply a reasonable and logical alternative methodology.

(B) If an alternative methodology is applied, the investors affected be granted leave to apply to the Court to challenge the method adopted by the liquidators in respect of the specific portfolio transfer in question.

(g) The Liquidators be entitled to deduct their costs and expenses in the liquidation from the common pool of assets;

(h) That a specified procedure be provided for investor entitled to receive a distribution in the liquidation of RAM and Dagger following the resolution of the Liquidators' preceding application for directions being resolved (as set out at (h)(i) – (iv)).

(i) Investor distributions will be deemed Unclaimed Money if they do not sign or object to a transaction summary within 6 months from its provision, or if investors are not able to be located by the Liquidators.

(j) That:

(i) leave is given to seek pooling orders as part of the present application as opposed to a separate application under Part 18 of the High Court Rules.

(ii) the notice requirements in s 271A of the Companies Act 1993 are varied such that notice is deemed to have been given via service in accordance with order 1(f) and if there is any objection to the pooling orders, any such objection be filed within 20 working days.

(k) Pages 112 – 135 of the bundle of exhibits to Liquidator John Howard Ross Fisk be sealed on the Court file and not be required to be served on the Creditors and Investors.

18. The other orders sought by the Liquidators will be addressed and commented on following a brief outline of the preliminary issues identified.

Preliminary matters

A. Sections 312, 313 and the Seventh Schedule of the Companies Act 1993, Statutory Powers / Trusts – what distribution options are available for consideration?

19. The first preliminary issue that has been discussed with Counsel for the Liquidators involves the potential effect of the mandatory statutory regime for distribution of company assets as provided for in sections 312, 313 and the Seventh Schedule to the Companies Act 1993.

20. The question that arises for the Court's consideration is whether the Liquidators have the ability to distribute company assets otherwise than as prescribed by the Companies Act regime. The answer to this question may be determinative (in whole or part) as to whether or not any model other than a statutory rateable abatement method can be applied.

21. As part of this question, the appropriate characterisation of funds recovered by the Liquidators through the liquidations of RAM and Dagger also arises. Whether funds recovered are seen assets of the company, or whether they are otherwise impressed with a trust or sit in the Liquidators' hands such that they sit outside the company for the benefit of investor beneficiaries will need to be considered.

22. Having consulted with the Liquidators, there seem to be two main sources of funds recovered in the RAM and Dagger liquidations. It is understood the

Liquidators will also helpfully set out the breakdown of the funds recovered and their sources in an updating affidavit prior to the hearing of the application.

23. The first source of funds are those derived from the director of RAM and Dagger, Mr Ross together with the sale of some limited equity securities held by those companies.

24. The second and more sizeable source of funds recovered has been derived through the Liquidators' claims against overpaid investors (those who received more back from RAM during its operation than they invested). The Liquidators, in clawing-back these funds have utilised their statutory powers under the voidable transaction provisions in the Companies Act 1993 and the Property Law Act 2007 ("the PLA"). The Liquidators have recovered the claw-back funds through Court action or through negotiated settlements.

25. In respect of the first source of funds (those recovered from RAM, Dagger or Mr Ross), it is anticipated the argument may be made that those funds were impressed with a trust for the benefit of the investors as a result of the failure by the trustee entities and their director to adhere to the express trust established in respect of each investor's investment.[3] If that is the case, then the Liquidators may be found to hold the funds as trustees for the investors' benefit and as such, it should be relatively straight forward for the Liquidators to seek orders for distribution as the Court considers just.

26. With regard to claw-back funds recovered by the Liquidators, the question arises whether there are specific rules applying to those funds given they were generated by application of statutory powers. There is a line of authority to the effect that voidable preference funds recovered are held by the liquidator rather than the company for the benefit of unsecured creditors.[4] If that applies then the Companies Act distribution regime may not take precedence. Whether or not that remains good law, in light of the enactment of the Companies Act 1993 and subsequent amendments including to section 295 (which provides the Court may order voidable transactions are paid to the company as opposed to the liquidator), may need to be addressed given the potential effect that a decision on characterising the

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[3] Refer for example, *Re Tilley's Will Trusts; Burgin v Croad and Another* [1967] 1 Ch 1179

[4] For example, *Re Hibiscus Coast Marine Centre Ltd (in liq)* (1986) 3 NZCLC 99,615, 2 BCR 27.

funds held may have on what distribution methods are available to the Liquidators (i.e. rateable / parri passu or other methods).

27. With regard to funds obtained through exercise of statutory powers pursuant to the PLA, section 350(1)(b) provides payments ordered to be repaid are repaid to the debtor if the company is in liquidation. In this instance, any funds ordered to be repaid by any Court pursuant to the PLA, would accordingly be to RAM, the company, and not the liquidators.

28. For the purpose of highlighting the issues for the first Court conference, it is noted that the Supreme Court in *McIntosh v Fisk* ordered Mr McIntosh to repay funds pursuant to both the Companies Act 1993 and the PLA. Thus the funds received by the Liquidators from Mr McIntosh do not have a clear demarcation as to which of the two Acts the payment was derived from. There may be a different outcome as to how funds must be distributed if paid under the Companies Act 1993 or paid under the PLA (although ultimately it may not matter). As mentioned above, a distinction may also apply to funds held by the liquidators as trustees.

29. In that regard, and as a separate consideration, further arguments in equity may need to be considered by the Court as to the characterisation of all the funds including backwards tracing[5]and remedial constructive trusts.[6] These matters will be further developed for the Court's consideration at the substantive hearing.

30. It is understood that most of the funds held by the Liquidators, except those funds ordered by the Court to be paid by Mr McIntosh, are from out of Court settlement payments that have arisen after the Liquidators have threatened claw back proceedings pursuant to the Companies Act 1993 and the PLA. Like the payments received by the Liquidators from the *McIntosh* decision, there was no distinction as to which Act or power the payments were made under.

31. Accordingly, and as an overriding consideration for the substantive hearing, it is suggested that the Court may have to first consider the nature of funds held by the Liquidators and whether classes of funds arise which then may be subjected to a possible mandatory distribution model or not. In particular, does section 313 of the Companies Act 1993 apply or is the Court free to

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[5] For example, *Brazil v Durant International Corp* [2015] UKPC 35 and *Agricultural Credit Corpn of Saskatchewan v Pettyjohn* (1991) 79 DLR (4 th 0 22 (Sask CA).
[6] For example, refer *Fortex Group Ltd v MacIntosh* (1998) 3 NZLR 171.

consider the different models of distribution to a particular class of fund as it thinks fit (consideration of all distribution models on the "table").

32. To assist the Court, it is further suggested that the Liquidators provide some further information as to classes of funds, whether held by the liquidators by exercise of statutory powers and/or in equity. It is respectfully submitted that this may be very helpful information as the "maths" may give rise to pragmatics as to the justice of any particular model, then having regard to the actual quantum in the class and how the funds would be distributed in particular amounts the investors.

B. CPI adjustments on investor balances

33. The second preliminary issue identified involves whether it is appropriate to order the adjustment of investor claims by applying CPI. The Liquidators, with the agreement of the Investor Committee, seek to adjust investor balances at liquidation (to 17 December 2012) using CPI. It is considered this part of the application should be considered by the Court substantively for two reasons.

34. First, section 311 of the Companies Act 1993 provides for pre-liquidation interest on creditor claims in two defined circumstances; where interest is provided under contract, or, pursuant to a judgment debt. Here, neither of those factors are present. The investment agreements with RAM did not provide for interest. The investments made were into (fictitious) share portfolios held on trust for each investor.

35. Second, the application of pre-administration interest or CPI adjustments to investor claims was expressly rejected in a recent US Court of Appeal, Second Circuit decision in the BLMIS litigation.[7] The US Court of Appeal rejected an application that interest or CPI be added to investor balances, not only on the basis of a proper construction of their applicable statute (the Securities Investor Protection Act 15 U.S.C 78), but also on broader grounds including that to allow interest or inflation to investor balances, every recovered dollar allocated to earlier investors in recognition of inflation reduces the amount of principal recovered by later investors.

36. On the basis of the Companies Act interest provisions and in light of the application of broader principles, it is considered that the CPI adjustment

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[7] *In re Bernard L. Madoff Investment Securities LLC*, No. 14-97-bk(L), 2015 WL 727965 (2d Cir. Feb. 20, 2015)

sought by the Liquidators is appropriately an issue for consideration of the Court.

Other orders sought by the Liquidators

37. Each order by reference to the numbering used in the Liquidators' application is now addressed:

    (a) That the assets of RAM and Dagger be pooled is seen as orthodox and sensible in the circumstances. Accordingly, this is supported.

    (b) In general terms the application that the recovered assets of RAM and Dagger after costs be treated as one pool of assets (which may be subjected to different classes of funds) available for distribution for unsecured creditors and investors appears appropriate. However, the preliminary issues raised above (as to the effect that characterisation of recovered assets may have on what distribution methods are available to the Liquidators) should be addressed substantively and orders made following such consideration.

    (c) With regard to the distribution of assets:

        (i) That no tracing of individual investment accounts takes place is supported in light of how RAM and Dagger were operated by Mr Ross, as described by Mr Fisk in his affidavit in support.

        (ii) That any investor who received payments which exceeded their contributions (in the application, both after CPI adjustment, discussed above) is not entitled to a distribution is an appropriate order, given the approach of the Courts in the *Mcintosh v Fisk* proceeding where the majority judgments held fictitious profits had to be repaid.

        (iii) The orders sought as to portfolio transfers are seen as appropriate.

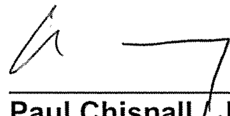
        (iv) The Liquidators seek the ability to adopt an alternative methodology to calculating inter-portfolio balances if the method at (iii) proves unjust or ineffective, and that leave be sought for affected investors to apply to challenge such method. In my view this is also appropriate but an order should address service on the affected investors with a clearly set out timetable to file any challenge.

(g) That the Liquidators be entitled to deduct their costs from the common pool of assets is sensible but the form of the Court order be subject to the Court's resolution of the characterisation of funds as a preliminary issue.

(h) The procedure sought by the Liquidators for investors to confirm or challenge the sum calculated as owing to them after the Court determines the distribution method is considered unobjectionable. For completeness and avoidance of doubt the order should confirm that investor claims are to exclude all fictitious profits reported by RAM during the life of the Ponzi.

(i) – (k) None of the balance of orders sought are commented on.

Dated at Wellington this 16th day of March 2018



Paul Chisnall / Jonathan Haig
Amicus Curiae / Counsel assisting

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American Bankruptcy Institute Journal
July, 2013

Claims Chat
Melissa Davis[a1]

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*40 THE RISING TIDE IN THE WAKE OF A PONZI SCHEME

The infamous 1920s fraud coined in the name of Charles **Ponzi** led thousands of New England residents to invest in a postage stamp speculation scheme that promised 50 percent returns in just 90 days.[1] Investors were duped, and many received no return at all. Modern-day fraudsters continue to follow in **Ponzi's** footsteps, enticing investors with promises of high returns.

For those unfamiliar with the concept, a **Ponzi** scheme is a fraud that involves the payment of returns to existing investors from funds contributed by new investors.[2] New investors are solicited into the fraud with a promise of high returns with little or no risk. New money is used to pay earlier investors' returns and to fund the fraudsters' personal expenses, which is usually an extravagant lifestyle.[3] The purported business underlying the investment scheme depends on external investors and commonly lacks sufficient profit to provide the promised returns and subsequently requires a continually increasing inflow of new funds. When the flow of new investor money slows or stops, **Ponzi** schemes "implode" since no new funds are available to pay the required earlier investor returns. In the wake of the implosion, there is a scramble by defrauded investors to recover the maximum amount of their investment. Courts, receivers and trustees strive to find an equitable manner to distribute assets to investors. The **rising tide** distribution methodology is one way to accomplish this goal.

Administration of a Ponzi Estate

The end of a **Ponzi** scheme often results in a liquidation process designed to protect the interests of the defrauded investors, most commonly through a receivership or bankruptcy proceeding and the appointment of a receiver or bankruptcy trustee. As fiduciaries of the court, receivers and trustees administer assets and distribute them in an equitable fashion to creditors. Administration of a receivership or bankruptcy estate involving **Ponzi** schemes is plagued with challenges, since there is usually little remaining in the way of liquid assets and there are often many angry and dumbfounded investors, some of whom may have lost their life's savings in the scheme.

If sufficient assets are recovered to result in a distribution to investors, the receiver or trustee must adopt a methodology to determine the investors' allowed claim amounts and to distribute the assets to the investors. The challenges in administering the investors' claims are not only in calculating the amount of the investor loss, but also in determining the way in which the assets of the estate will be distributed.

Investors seek to recover not only their principal investment lost in a **Ponzi** scheme, but also the expected returns that were not paid before the implosion. Because of the nature of **Ponzi** schemes, earlier investors may have received profits or even principal distributions before the implosion, while later investors may have received nothing and are left with the largest percentages of loss.

Returns paid to investors may be recovered as fraudulent transfers commonly referred to as "claw-backs" wherein a receiver or trustee may seek to recover funds from investors who received more from the scheme than they put in, commonly referred to as "net winners." In some instances, receivers or trustees may also opt to recover from investors who are "net losers," or those who put more into the scheme than they received back. Net losers may raise the good-faith defense and present a more challenging case for trustees or receivers to contradict.

Distribution Methods

There are commonly accepted methods of distributing assets to investors in a collapsed **Ponzi** scheme. If the liquidation proceeding is a receivership, the district court has discretion over the choice of distribution method. The commonly accepted methods for distribution are (1) last statement, (2) net investment, (3) modified net investment and (4) **rising tide.**[4]

The last statement method determines claims based on the amounts identified on the last statement generated on the customer's accounts. In *Madoff,* Trustee **Irving H. Picard** (BakerHostetler; New York) rejected the last statement method and instead adopted the net investment method, which is calculated as the difference between the amount of funds invested into the scheme reduced by the amount paid back to the investor (commonly referred to the "cash in/cash out" method).[5] With the **41* net investment method, only investors who invested more into the scheme than they withdrew from the scheme participate in the distributions.

The modified net investment method allows investors to retain the returns that they received and participate in a *pro rata* distribution based on their initial investment combined with the illusory profits they never received, reduced by the amount they had already received.[6] Under the **rising tide** method, the investor's percentage of loss is calculated, and distributions are made first to those investors with the greatest percentage of loss. When all creditors reach a plateau with the same loss percentage, funds are then distributed to all creditors ratably.

Rising Tide and Net Investment Illustrated

The most commonly applied methods are the net investment method and the **rising tide** method. To understand the difference between the two methods, the following facts will be applied in a hypothetical illustration of the two distribution methods:

Investors are promised a 50 percent return on a $20,000 investment in a six-month period.

Investor A: Invested $20,000 into the scheme and received $20,000 back;[7]

Investor B: Invested $20,000 into the scheme and received $15,000 back;

Investor C: Invested $20,000 into the scheme and received $10,000 back; and

Investor D: Invested $20,000 into the scheme and received $5,000 back.

When applying the net investment method, the allowed claim is calculated as the difference between the amount of funds invested into the scheme reduced by the amount of funds received back from the scheme. The distribution made to each investor is then allocated ratably based on each investor's allowed claim amount. This method applies in a bankruptcy case where investor claims are classified as general unsecured creditors and assets are distributed *pro rata* based on the creditor's allowed claim amount in the order of priority as established in the Bankruptcy Code.

To illustrate both the net investment method and the **rising tide** method of distribution, assume that there is $30,000 available for distribution to creditors and that it will be distributed in three segments: an initial distribution of $15,000, a second distribution of $10,000 and a final distribution of $5,000. Table 1 demonstrates the distributions when applying the net investment method.

View Table

TABLE 1: NET INVESTMENT METHOD

	ALLOWED CLAIM AMOUNT	% OF TOTAL ALLOWED CLAIMS	INITIAL DISTRIBUTION AMOUNT	INTERIM DISTRIBUTION AMOUNT	FINAL DISTRII AMOUN
Investor A	$0	0%	$0	$0	$0
Investor B	$5,000	16.67%	$2,500	$1,667	$833
Investor C	$10,000	33.33%	$5,000	$3,333	$1,667
Investor D	$15,000	50%	$7,500	$5,000	$2,500
Total	$30,000	100%	$15,000	$10,000	$5,000

Pro rata distributions are made to each allowed claimholder based on their percentage of the total claims body. In contrast, when applying the **rising tide** method, creditors with the largest percentages of losses are paid first. It may be necessary to calculate multiple layers of distribution in order to determine which creditors participate in the distribution. To calculate distributions using the **rising tide** method, returns paid to creditors are subtracted from the creditor's claim to calculate the percentage of loss, as illustrated in Table 2.

View Table

TABLE 2: RISING TIDE METHOD

	ALLOWED CLAIM AMOUNT	RETURN	LOSS AMOUNT	% LOSS	INITIAL DISTRIBUTION AMOUNT: STEP ONE	% LOS INITL DISTF STEP
Investor A	$20,000	$20,000	$0	0%	$0	0%
Investor B	$20,000	$15,000	$5,000	25%	$0	25%
Investor C	$20,000	$10,000	$10,000	50%	$0	50%

Investor D	$20,000	$5,000	$15,000	75%	$5,000	50%
Total	$80,000	$50,000	$30,000	100%	$15,000	

In this example, Investor A paid $20,000 into the scheme and received $20,000 back and therefore has a loss of $0. Investor B has an allowed claim of $20,000 and received returns of $ 15,000, resulting in a loss percentage of 25 percent. Investor B will not share in distributions until Investors C and Investor D's loss percentage drops to 25 percent. When calculating the initial distribution of $15,000, the first step is to determine the amount of funds necessary to bring the creditor with the largest percent of loss to the same level of loss as a creditor in the next loss tier. In this example, *89 Investor C's loss is 75 percent, so he or she will participate in all distributions until his or her loss level reaches the next tier of loss, or 50 percent. This calculation must be repeated as many times as necessary until all investors reach the same loss tier. At that point, distributions can be made ratably based on the allowed claim amount.

In *United States Commodity Futures Trading Commission v. Barki LLC,* the U.S. District Court of the Western District of North Carolina ultimately rejected the receiver's request to use the **rising tide** approach and instead directed the receiver to distribute the funds using the net investment method [8] Barki LLC operated a **Ponzi** scheme by soliciting $40 million from 79 investors to trade on their behalf in off-exchange foreign currency. [9] The fraud spanned a period of five years, during which only 11 investors received more than 100 percent return on their investment. [10] The receiver requested that the court approve the **rising tide** method to distribute funds to the investors. The court's decision examined five distribution methods available, including the **rising tide** and net investment methods. In applying the net investment method, the court found that 100 percent of the net-loss investors would receive a distribution, and in using the **rising tide** method, only 55 percent would receive a distribution. Siding with the net investment method, the court found that it was "more equitable to compensate all the Investors rather than a fraction of them." [11]

Although the **rising tide** method was not applied in *Barki,* it is considered an equitable method. The goal of the **rising tide** method is to attempt to treat each investor as equally as possible and not penalize those investors that did not withdraw money from the scheme prior to exposure. Factors considered when choosing a distribution method include the lifespan of the **Ponzi** scheme, whether or not the venture was initially a legitimate business and then transitioned into a **Ponzi** scheme, and whether there are other sources of funds available to pay investor returns.

In *SEC v. Huber,* certain investors who had been defrauded in a **Ponzi** scheme appealed the order from U.S. District Court for the Northern District of Illinois that approved the receiver's distribution of assets by using the **rising tide** method of distribution. [12] In that case, William Huber operated a **Ponzi** scheme in which he enticed trusted friends to invest in three investment funds that he administered, [13] and 118 investors lost $22.6 million in the **Ponzi** scheme. [14] Eleven investors that had received funds from Huber before the scheme imploded appealed the receiver's methodology of distribution. [15] The Seventh Circuit Appellate Court ruling stated:

> Under the **rising tide** method, withdrawals are considered part of the distribution received by an investor and so are subtracted from the amount of receivership assets to which he would be entitled had there been no withdrawals. When there are no withdrawals, **rising tide** yields the same distribution of receivership assets as net loss. [16]

The appellants argued that they should not be "penalized" for having withdrawn some of "their" money. The court found that the withdrawals were not the investors' funds; rather, they were stolen money, commingled and not traceable.[17]

Rising Tide in Bankruptcy

Although the Bankruptcy Code governs the classes of creditors and distribution order in bankruptcy cases, the **rising tide** method may be adopted in chapter 11 cases where the chapter 11 plan includes such treatment for a class or classes of investors.

Bayside Ventures LLC

In *In re Bayside Ventures LLC,* a chapter 11 liquidating plan was confirmed by the U.S. Bankruptcy Court of the Southern District of Florida whereby the investors were classified as equity interests and shared in the distribution of assets using the **rising tide** method.[18] Investors had advanced funds to the perpetrator, Reuben Reinstein, in consideration of the purchase of membership units in one or more of Rueben's Bayside entities.[19] Reinstein consistently reported substantial profits (in excess of 40 percent per annum) to investors, but in reality, the Bayside companies never realized the profits and Reinstein instead pilfered investors' funds.[20] Equity-interest claims were limited to the amount of the creditor's total investment and excluded profits. The language in the plan described the basis for **rising tide**:

> Further, to assure [that] the equality of treatment is afforded to all holders and holders are not unfairly advantaged through a pre-petition return of investment and/or distribution of "profits" (the "Pre-Petition Distributions"). Distributions on account of Allowed Equity Interests to holders who have received Pre-Petition Distributions shall not exceed the Pro Rata distribution ... available to holders who have received no Pre-petition Distributions.

Conclusion

Trustees and receivers are faced with the challenge of developing a fair methodology by which to distribute funds to **Ponzi** scheme investors. Although the **rising tide** method favors creditors with the largest loss percentage, it is viewed as an equitable method of distribution that can be adopted not only in receivership proceedings, but also in chapter 11 proceedings through the plan-confirmation process.

Footnotes

a1 *Melissa Davis, CPA, CFE, CIRA is a partner at Kapila & Company in Fort Lauderdale, Fla.*

1 *See* www.sec.gov/answers/ponzi.fitm.

2 **Ponzi** schemes defined by the Securities and Exchange Commission at www.sec.gov/answers/ponzi.htm.

3 *Id.*

4 Kathy Bazoian Phelps and Hon. Steven Rhodes, *The **Ponzi** Book: A Legal Resource for Unraveling **Ponzi** Schemes,* § [20.04] (Lexis Nexis, 2012),

5 *In re Bernard L Madoff Inv. Sees. LLC,* 654 F.3d 229 (2d Cir. 2011).

6 Kathy Bazoian Phelps and Hon, Steven Rhodes, *The **Ponzi** Book: A Legal Resource for Unraveling **Ponzi** Schemes,* § [20-04] (Lexis Nexis, 2012).

7

Although Investor A did not receive any profits from the **Ponzi** scheme, all funds invested into the **Ponzi** scheme were paid back, resulting in an allowed claim amount of zero under the net investment method.

8 *United States Commodity Futures Trading Comm'n v. Barki LLC*, No. 3:09CV106-MU, 2009 WL 3839389 (W.D.N.C. Nov. 12, 2009).

9 *Id.*

10 *Id.*

11 *Id.* at *2.

12 *Secs. & Exchange Comm'n v. Huber*, 702 F.3d 903 (7th Cir. 2012).

13 *Id.*

14 *Id.*

15 *Id.*

16 *Id.* at 905.

17 *Id.*

18 *In re Bayside Ventures LLC*, Case No. 07-15612-BKC-RBR (Bankr. S.D. Fla. Oct. 30. 2008), Order Confirming Chapter 11 Plan, Docket Entry #342.

19 *Id.*

20 *Id.*

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