THE EASTERN CARIBBEAN SUPREME COURT

IN THE HIGH COURT OF JUSTICE

ANTIGUA AND BARBUDA

Claim No: ANUHCV 2009/0149

In the Matter of Stanford International Bank (In Liquidation)
And
In the Matter of the International Business Corporations Act, Cap. 222 of the Laws of Antigua and Barbuda

HECTOR VELASQUEZ

Claimant

And

STANFORD INTERNATIONAL BANK (IN LIQUIDATION)
(Acting by and through its Joint Liquidators, Marcus A. Wide and Hugh Dickson)

Defendant

And

TIMOUR GAINOULLINE

Claimant

And

STANFORD INTERNATIONAL BANK (IN LIQUIDATION)
(Acting by and through its Joint Liquidators, Marcus A. Wide and Hugh Dickson)

Defendant

Appearances: Mr Lenworth Johnson and Ms Fiona Murphy, Counsel for the Claimants; Mr Malcolm Arthurs, Ms Nicolette Doherty and Mr Craig Christopher, Counsel for the Defendants

JUDGMENT
[2013: 16, 23 and 28 October]

(Alleged "Ponzi scheme" – ambit of liquidators' discretion to determine asset distribution methodology – whether competing methods reasonable – Antigua & Barbuda International Business Corporations Act, Cap. 222 and United Kingdom Insolvency Rules 1986 (S.I. 1925)

INTRODUCTION

[1] **Wallbank J (Ag):** The Claimants, **HECTOR VELAZQUEZ** and **TIMOUR GAINOULLINE,** are depositor creditors of the Defendant Stanford International Bank (in liquidation) ("SIB"). SIB was incorporated as a Bank in Antigua and Barbuda pursuant to the International Business Corporations Act of Antigua and Barbuda, Cap. 222 ("IBC Act").

[2] SIB collapsed in 2009 and has been placed into liquidation. The current liquidators appointed by this Court in 2011 revisited and adjusted downward the calculation for the Claimants' respective distributions that had been made by the original liquidators. The Claimants challenge this downwards adjustment and ask this Court to reinstate the earlier calculation, which would see them receive more money, or impose one that is, they submit, more equitable.

[3] This case turns upon the question of how much discretion a liquidator has in adjusting claims before this Court should interfere with such discretion. For the reasons stated below, this Court is of the view that it should not in this case intervene.

[4] In reaching its decision the Court has been guided by the "correct test", as propounded by the English Court of Appeal, Civil Division, by Nourse LJ, in "***Re Edennote Ltd; Tottenham Hotspur plc and others vs Ryman and another [1996] 2 BCLC 389***, namely that, fraud and bad faith apart on the part of a liquidator, the court will only interfere with the act of a liquidator "*if he has done something so utterly unreasonable and absurd that no reasonable man would have done it*". Liquidators must, in most of what they do, also stated Nourse LJ, "*act as prudent businessmen*."

[5] The English High Court, Chancery Division adopted this thinking in ***Abbey Forwarding Limited and Hone and others [2010] EWHC 1644 (Ch)***, stating that "[t]*he test is a high one*". This was with reference to the

discretion afforded to a liquidator pursuant to the English Insolvency Act 1986, section 168. By subsection (4) of that section: "[s]*ubject to the provisions of this Act, the liquidator shall use his own discretion in the management of the assets and their distribution among the creditors*." By subsection (5) of that section: "[i]*f any person is aggrieved by an act or decision of the liquidator, that person may apply to the court; and the court may confirm, reverse or modify the act or decision complained of, and make such order in the case as it thinks just.*"

[6] Counsel for the Defendants submitted that liquidations pursuant to the IBC Act follow the same scheme as that which operates in England, namely that a liquidator has discretion as to the distribution of assets in a liquidation, subject to review of this Court, and that the IBC Act does not articulate where the liquidator's discretion ends and when the Court should override an act or decision of a liquidator.

[7] Counsel for the Claimants could point to no contrary authority to this submission, which, in this Court's view, is correct.

[8] When this matter was first presented to the Court, both sides appeared to take the view that it was for this Court to determine which distribution calculation method is the most appropriate. Both sides submitted that this Court could and should look to jurisprudence emanating from the United States in relation to the treatment of "Ponzi schemes", not as foreign law by way of evidence of fact, but as providing useful guidance. It was only at the Reply stage of skeleton arguments that Counsel for the Defendants submitted that this Court should not interfere with what he submitted was the Current Liquidators' wide discretion. As this is not a case where the liquidator himself has applied for directions, but it is rather a challenge to the Current Liquidators' exercise of discretion, the primary issue is not which calculation method is more appropriate in the circumstances of this

case, but whether the Current Liquidators' adoption of the method they did falls within the ambit of their discretion.

[9] The Claimants brought their claims separately. As each of these raises the same issues, and involved the same Counsel, they were directed to be heard together.

Background

[10] Mr Velasquez deposited money with SIB in around 1996. To be more precise, he purchased one or more certificates of deposit ("CDs"), which carried an entitlement for him to receive 7.125% of interest per annum plus repayment of his principal.

[11] Mr Gainoulline is the Personal Representative of his late father, who had been a depositor with the bank since prior to 2002. It is apparently not known precisely when Mr Gainoulline became a depositor. He purchased one or more CDs which carried an entitlement to interest of 5% per annum plus repayment of his principal.

[12] SIB was part of a wider group of entities, which can loosely be referred to as the "Stanford Group" ("Group"). The sole beneficial owner of the Group is one Robert Allen Stanford ("Stanford").

[13] The Defendants have placed affidavit evidence before the Court which attests that SIB sold customers, like the Claimants, CDs, and that they were led to believe that sums deposited with SIB would be invested using a low-risk investment strategy concentrating on maximum liquidity in a well-balanced, widely diversified global portfolio that would provide generous returns. As a result, approximately US$10 billion in CDs were sold to more than 21,000 creditors/investors in approximately 113 different countries.

[14] The Defendants' affidavit evidence further attests that SIB collapsed in February 2009, precipitated by the global financial crisis in 2008. CD sales decreased that year. Conversely CD redemptions increased and grew exponentially with the collapse of Lehman Brothers in September 2008 and rumors of an investigation by the United States Securities and Exchange Commission ("SEC").

[15] Ultimately SIB collapsed, say the Defendants, because SIB's liquid assets became insufficient to meet redemptions sought by depositors.

[16] On 17 February 2009 the SEC applied to the United States District Court of Dallas, Texas, and obtained an order appointing a Receiver, Mr Ralph Janvey ("U.S. Receiver"), over the assets of SIB and some of its affiliates, directors or insiders.

[17] SIB was placed into liquidation by order of this Court in April 2009. The Joint Liquidators originally appointed by this Court ("Original Liquidators") were removed for cause and replaced by the incumbent Joint Liquidators ("Current Liquidators") pursuant to an Order of this Court dated 12 May 2011.

[18] There were apparently initial tensions between the U.S. Receiver and the liquidators appointed by this Court, but these appear to have been resolved and they have commendably agreed upon a cooperation plan.

[19] The investigations which ensued upon the collapse, both by the U.S. Receiver and the liquidators appointed by this Court, revealed that SIB was heavily insolvent. There was also evidence that the Group, including SIB, had not been operating as a bona fide financial institution, but as a "Ponzi scheme", with SIB at its centre.

[20] The Defendants' evidence is that the Current Liquidators have subjected hundreds of thousands of pages of SIB documents to forensic accounting analysis, revealing that:

i. Instead of investing the monies deposited in the manner represented by SIB to its customers, the moving spirits behind SIB, being Sanford and a small number of other insiders, placed monies received by SIB into speculative, largely illiquid investments, and/or diverted them to other companies owned by Stanford, that they made approximately US$2 billion in concealed and unsecured "shareholder loans" to Stanford and used the proceeds of sale from the CDs to fund Stanford's and other insiders' lavish lifestyles;

ii. The Current Liquidators have been unable to identify any genuine underlying profitable activity carried on by SIB;

iii. Most of SIB's investment and performance data was fictitious and concocted by Stanford and other insiders to deceive the regulatory authorities and customers;

iv. CD redemption and interest payments to earlier depositors were made from sums paid in by subsequent depositors. This, say the Current Liquidators, is the quintessential component of a "Ponzi scheme".

[21] The Current Liquidators raise the possibility that because they have found no evidence of any profitable activity by SIB in its entire history, despite their analysis of SIB's financial information, SIB appears to have been a "Ponzi scheme" from the outset. SIB appears, on the basis of a statement by Stanford, to have been established in or about 1985, although this statement itself must be taken with the caution that it may not be true. SIB was originally established elsewhere in the Eastern Caribbean, before

migrating to Antigua. The Current Liquidators do not know if SIB was indeed a “Ponzi scheme” from the outset, or whether it commenced legitimately and subsequently degenerated into one.

[22] The Defendants’ evidence is that by the time the Original Liquidators were appointed in February 2009, an estimated US$5.6 billion had been paid or repaid to depositors in ostensible interest or CD redemption payments, leaving an estimated core capital loss of approximately US$4.4billion. As between the U.S. Receiver and the Current Liquidators, the total amount of SIB assets recovered or identified is approximately US$826million. Great though this amount is, it represents a very large short-fall. A figure of in excess of US$3 billion of principal remains unaccounted for. If interest were to be included, say the Defendants, the amount unaccounted for would be closer to US$5.5billion.

[23] The Current Liquidators appear to concur with the findings of the U.S. Receiver in his Third Interim Report to the Texas Court, dated 11 November 2011, which has been placed into evidence in these proceedings, that SIB was operated as a “Ponzi scheme” since at least 1999.

[24] Earlier, in a Declaration made on 24 May 2010 by Mr Karyl Van Tassel, a Certified Public Accountant assisting the U.S. Receiver, which has also been put into evidence before this Court, Mr Van Tassel explained their findings that SIB had been insolvent from at least 2004 and probably much longer, and that they had found within SIB’s accounting records worksheets used to derive fictitious SIB revenues going back to 2004. Mr Van Tassel declared that the most significant numbers in SIB’s financial statements-revenues and asset values were fictitious. Assets were inflated to off-set CD obligations and revenues were reverse-engineered to arrive at desired levels.

[25] Mr Van Tassel also explained that SIB investments were divided into three tiers:

i. Tier 1, the smallest tier in dollar value, consisted of cash and cash equivalents. As of 18 February 2009 tier 1 totaled approximately US$31.8 million;

ii. Tier 2 principally consisted of investments placed with a variety of investment firms or funds located in the United States and Europe, together with a small amount of cash or cash equivalents. Tier 2 totaled approximately US$345million. Tier 2, it would appear, gave the semblance of legitimate banking and investment business by SIB, but it represented only a small fraction of its dealings.

iii. Tier 3 was by far the most significant financially, and the most secret. SIB tier 3 records indicate however that Tier 3 included approximately US$1.844 billion in unsecured notes receivable from Stanford, corresponding to monies diverted by Stanford and his associates to some 51 other entities in the Group. Paradoxically, so regular and so significant in value had such diversions become that Stanford had an internal report maintained to keep track of them, and this shows diversions made by SIB on behalf of Stanford to some 35 Group entities. This report was, according to examination evidence taken in the United States proceedings, and exhibited as evidence in these proceedings, kept on an external hard drive, known as “the football”. The data in “the football” was maintained by an internal Group accountant by name of Mr Henry Amadio. Tier 3 also had approximately US$1.2 billion in value in merchant banking assets, as represented by Stanford and one of his associates by name of Davis (one Mr James Davis who went by the title of “Chief Financial Officer” for SIB), although the U.S. Receiver and his team considered that its real value was only a small

> fraction of this. Consisting mainly in equity and debt instruments in private and public companies, these assets did not match the description of the assets the customers had been led to believe their deposits would be invested in. Tier 3 also comprised real estate that Stanford and his associates had assigned a value of US$3.175billion. However, this category only contained two pieces of real estate, which had been purchased for US$63.5million in total, making the enormous appreciation to US$3.175 billion most improbable.

[26] In support of the view of both the Current Liquidators and the U.S. Receiver that SIB was a "Ponzi scheme", Mr Van Tassel in his Declaration recounts that Davis admitted that SIB was "*a massive Ponzi scheme" "whereby CD redemptions ultimately could only be accomplished with new infusions of investor funds*." This Court considers it necessary to treat this statement of Davis, as quoted by Mr Van Tassel, with caution, because this admission appears to have been part of a Plea Agreement unaccompanied by a certificate of truth and this Court cannot rule out that Davis may have considered it expedient to admit this in return for more favourable sentencing or other benefit. Mr Van Tassel nonetheless asserts that his own findings support Davis' admission.

[27] In support of their theory that SIB operated as a "Ponzi scheme", the Current Liquidators also rely upon direct examination oral evidence taken in the United States legal proceedings from Mr Henry Amadio, who had turned Government's Witness. Mr Amadio stated that he had come to a realization that funds being sent to affiliates of SIB in the Group must have come from depositors' money: "*Q: And you knew that it was depositor money because? A: Because that – it started to grow, the money is getting larger and larger, it had – the conclusion was it had to be deposits money*."

[28] For the purposes of this claim, Counsel for Mr Velasquez and Mr Gainoulline submits that if SIB was a “Ponzi scheme” from 1999, that places Mr Velasquez on a slightly different footing from Mr Gainouline, in that Mr Velasquez started investing with SIB before it became a “Ponzi scheme”, and thus that on any view he would be entitled to have or retain the benefit of “genuine” interest up to that point, whereas Mr Gainoulline began investing with SIB after it became a “Ponzi scheme” and thus that he would be unable to point to any “genuine” interest, to the extent that such a distinction is relevant, which he says it is not (see further below). This slight distinction need not trouble the Court further on this occasion, because of the establishment of a net equity baseline for all depositor creditors in 2002 due to insufficient records preceding that year.

[29] The problem in the present case arose because the Original Liquidators used one accounting method to calculate what each of the depositor creditors would be entitled to receive on a distribution, but the Current Liquidators decided to adopt a different method. This resulted in a number of creditors, including the Claimants, being told by the Current Liquidators that they would receive a lower amount than the Original Liquidators had been prepared to allow. The Claimants query the equity of this downwards adjustment. The Claimants are disgruntled to receive a lower amount than what they had been given to expect, and understandably so.

[30] In respect of Mr. Velazquez, the Currently Liquidators disallowed the sum of US$303,207.71 and substituted instead the sum of US$157,748.12.

[31] With regard to Mr. Gainoulline the Current Liquidators disallowed the sum of US$102,283.24 and substituted instead the sum of US$66,919.53. The larger amounts had been allowed by the Original Liquidators.

[32] The Original Liquidators had adopted what has become known as the "Last Statement Balance" method, whereas the Current Liquidators decided not to use this but to use the "Net Investment", or "Cash-in - Cash-out" method.

[33] Mr Velasquez and Mr Gainouilline now come to this Court seeking a ruling that the Current Liquidators should maintain the distribution calculation method adopted by the Original Liquidators, as being more equitable, alternatively for the Court to impose a different methodology upon the current Joint Liquidators which allows the Claimants a reasonable amount of interest return upon their investment in SIB to accord with their legitimate contractual expectations, or which gives effect to the "time value" of money.

Distribution calculation methodologies

[34] In the "Net Investment" method, a customer's net equity in the available funds for distribution is calculated by starting with the principal amounts that the customer deposited in an investment account or similar investment vehicle and then subtracting amounts the customer withdrew. Hence, "Cash-in - Cash-out."

[35] In the "Last Statement Balance" method, all investors are permitted to pursue claims for their net equity in the principal amount invested by them, together with a pro-rata distribution of expected profits, based upon the investment positions listed in the last account statement received by the customer before liquidation.

[36] The "Net Investment" method favours later investors and net losers, whereas the "Last Statement Balance" method favours earlier investors and net winners, as it allows investors to receive profits that never in fact existed.

[37] To say that the Current Liquidators have adopted the "Net Investment" method is a slight over-simplification, because they used what appears to be a version of what has become known as the "Modified Net Investment" method, to arrive at a base line figure for calculating distributions as at a date in 2002. By this "Modified Net Investment" method, supposed interest payable was rolled over so that as at that date in 2002 all depositor creditors would be deemed to start with a principal amount invested. Interest supposedly previously earned would be treated as at that date as part of the principal that the depositor creditor had invested with SIB. The reason for applying this "Modified Net Investment" method, explain the Current Liquidators, is that the information and data for the antecedent period was insufficient for them to be able to ascertain with reasonable accuracy how much should be ascribed to each depositor creditor for principal and how much for interest. This method would thus draw a base-line date from which subsequent payments in and out of principal could be ascertained.

[38] The Current Liquidators contend that the "Net Investment Method" is conceptually superior to the "Last Statement Method", in that the "Net Investment Method" disregards entitlement to fictitious interest (which would have to be taken from another depositor's principal if SIB was a "Ponzi scheme"), whereas the "Last Statement Method" includes entitlement to fictitious interest. The difficulty with the "Last Statement Method", say the Current Liquidators, is that if SIB was a "Ponzi scheme" it gives credence to the falsehood that the investment generated profits out of which interest would be paid, and ratifies the misappropriation of other depositors money.

[39] Counsel for the Claimants has submitted that an entirely different method, known as the "Rising Tide Method", would achieve the most equitable result, although he acknowledges whether or not it, or a competing

method, is the most appropriate, depends upon the facts of each case. Here, Counsel for the Claimants concedes that the relative complexity of the "Rising Tide Method", coupled with the relatively large number of SIB investors concerned, excludes this from practical consideration, as being too expensive and lengthy to administer.

[40] The "Rising Tide Method", for completeness, has been described in the United States case of *CFTC vs Equity Financial Group, LLC 2005 WL 2143975* as represented by the following formula: *"(actual dollars invested x pro rata multiplier) – withdrawals previously received = distribution amount*". We need not dwell on this method here, save to say that in order to ascertain the distribution amount for each customer approximately four arithmetical stages require to be completed. In *United States Commodity Futures Trading Commission vs Lake Shore Asset Management Limited* et al. *07 C 3598*, the United States District Court for the Northern District of Illinois, Eastern Division, approved the use of the "Rising Tide Method" in a receiver's proposed distribution plan, and explained the calculation methodology further. That case concerned a proposed distribution of approximately US$110 million of receivership assets, out of a total of approximately US$273.5million of total funds under the management of the defendants at the time of the receiver's appointment, to a pool of only about 1000 investors. By contrast, in SIB's case, the pool of potential investors is exponentially larger. The Current Liquidators put the figure at approximately 21,000 investors. It is not difficult to see why Counsel for the Claimants did not press for use of the "Rising Tide Method" here.

[41] Although the sums involved in this particular claim are small in relation to the overall SIB liquidation, they are significant for the Claimants concerned and the principles involved have far-reaching ramifications for the administration of the estate as a whole. This is particularly so, as the U.S. Receiver has also adopted the Net Investment Method to calculate

creditor distributions. Counsel for the Claimants suggests that the U.S. Receiver had somehow been persuaded, unfairly, he implies, by the Current Liquidators to adopt what the Claimants consider a less equitable method than that which the Claimants themselves advocate, but this, even if it were the case, takes the Claimants' case no further.

[42] The Claimants submit that if it remains unproven that SIB is a "Ponzi scheme" then it would be wrong for the Current Liquidators to adopt a method which ignores interest, and that this Court should overrule the Current Liquidators' choice of this method. The Claimants therefore urge that it is a preliminary issue of fact whether or not SIB is proven to be a "Ponzi scheme".

Discussion

[43] In the Court's view the Current Liquidators do not need to have had a prior finding of fact from this Court that SIB was a "Ponzi scheme" in order to have exercised their discretion in a manner that is not utterly unreasonable or absurd. It suffices for them to have reasonable grounds for concluding that SIB operated as a "Ponzi scheme".

[44] On the other hand, if the Current Liquidators would be unable to satisfy the Court, on a balance of probabilities, that SIB operated as a "Ponzi scheme", then this would call into serious question whether indeed the Current Liquidators had acted utterly unreasonably or absurdly.

[45] In this matter the evidential treatment whether or not SIB operated as a "Ponzi scheme" suffers from a number of handicaps:

a. The Claimants, being customers of SIB, do not have access to the books and records of SIB to be able to give evidence either way on whether SIB operated as a "Ponzi scheme" or not;

b. The Claimants' claims were commenced and proceeded by way of Fixed Date Claim Form, on affidavit evidence only, with no oral evidence being heard.

[46] Nonetheless, the affidavit evidence presented by the Defendants was very detailed, and reflected information from numerous sources, including from independent professionals, such that this Court considers that it is capable of making a determination, on a balance of probabilities, whether or not SIB operated as a "Ponzi scheme". In stating this, this Court acknowledges that there are other legal proceedings on foot before this Court, albeit currently at an early stage, in which new and possibly better evidence may be led on this question, and this Court expressly leaves it open for the litigants in those proceedings to dispute the point further.

[47] It was also submitted to this Court by both sides that this case is the first time that the Eastern Caribbean Supreme Court has had to consider questions relating to the winding up of an alleged "Ponzi scheme".

[48] A word on "Ponzi schemes". "Ponzi schemes" have gained a degree of global notoriety, with recent well-known examples including a scheme established by a putative financier named Madoff, which, so the Court understands, is alleged to have defrauded investors of approximately US$18 billion.

[49] The workings of such schemes are in essence simple. Investors are induced to commit cash or near-cash assets to the perpetrator of the scheme, in exchange for a promised profit or interest return. The investments of new and existing customers are then used to fund withdrawal of principal and supposed profit for earlier customers. The earlier and the later funds are commingled. It is not hard to see that such a scheme can only sustain itself as long as new funds keep coming in to settle amounts ostensibly payable to the earlier customers. Such a

scheme (like all evil) is inherently irrational, the primary fatal flaw being that the supposed profits are a falsehood.

[50] "Ponzi schemes" took their name from a certain confidence trickster known as "Charles Ponzi": see *Cunningham vs Brown, 265 U.S. 1, 7 (1924)*, although variations on the scheme date back earlier.

[51] This Court understands that the term "Ponzi scheme", although not using the term "fraud" in its title or on its face, carries seriously negative connotations in United States legal linguistic usage, precisely because of the fraud, or dishonesty or deceit that underlies such a scheme. This should be borne in mind, as the description "massive Ponzi scheme" has become something of a cliché, and thus tends to devalue its actual gravity.

[52] For instance, in *Securities and Exchange Commission vs Byers et al. no. 08 CIV. 7104 (DC), the United States District Court, S.D., New York*, the Court was presented with what was alleged to be a "*massive Ponzi scheme that defrauded more than 1,000 investors of approximately $255million*".

[53] There is more than enough evidence for the present Court, for the purposes of this claim, to be satisfied on the civil standard of proof of a balance of probabilities, that SIB operated as a "Ponzi scheme", and I so find.

[54] It was also reasonable for the Current Liquidators to proceed on the basis that SIB was a "Ponzi scheme".

[55] If the scheme in *Securities and Exchange Commission vs Byers et al.* was "massive" – and clearly it was – the SIB scheme manifested in evidence before this Court is a monstrous behemoth, demonically mendacious, with some serpentine subtlety calculated towards evading scrutiny, festering in its own corruption beneath a beautiful skin – until it inevitably imploded.

There is also a sting in its tail that is particularly cruel to the thousands of depositors who lost out. Although the layers, obfuscations and deceptions that appear to have been erected by Stanford and his associates were rather crude, there were many of them, and there were very many apparently wrongful transfers of money. This has made it complicated to unwind, and hence obviously costly, depleting the remaining assets that would otherwise be available for distribution to creditors.

[56] The United States Courts have, over the years, been trammeled with the difficult task of assisting in the unraveling of a considerable number of such schemes.

[57] This Court is grateful to both sides' very able learned Counsel Mr Lenworth Johnson and Mr Malcolm Arthurs, respectively, for their lucid explanations of the United States' legal approach to these matters. It is clear that the United States' legal system, covering a vast economy, has developed very sophisticated remedial measures to deal with this unfortunately persistent form of fraud. Such measures include numerous instruments of primary legislation as well as case law jurisprudence. There are even practitioners' text books, such as "*The Ponzi Book, A Legal Resource For Unravelling Ponzi Schemes*", by Phelps and Rhodes, published by LexisNexis. It is equally clear that that great legal system continues to develop rational solutions to do equity for the innocent victims of Ponzi schemes, but with painful difficulty, precisely because "Ponzi schemes" have no inherent integrity.

[58] The starting principle which emerges from the United States cases is one shared with our own English principles of equity and indeed it derives from it. The United States Supreme Court, in *Cunningham vs Brown* (supra), stated: "*It is a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt law*." *Cunningham vs Brown* was a case where Ponzi's trustee in bankruptcy,

Mr Cunningham, brought an action to attempt to recover for the benefit of the bankrupt estate payments made to certain customers by Ponzi in a certain period immediately prior to its collapse, when there was a "run" on the scheme after allegations of its insolvency had surfaced. The United States Supreme Court was required to consider whether a distinction should be made between those customers who had sought to rescind their contracts with Ponzi on grounds of fraud and those who had sought to rely upon their contracts with him to claim payment. The Supreme Court decided that both types of customers should be treated equally as having obtained an unlawful preference. *Cunningham vs Brown* was an example of what can be called "claw-back litigation", in which the United States Supreme Court applied a relatively aggressive approach towards recovering sums previously paid out to Ponzi's customers. More modern authorities appear to have adopted a less invasive stance towards the issue whether customers, or victims, of a Ponzi scheme should be required to repay monies received.

[59] The "equality is equity" principle has also been invoked in cases where the United States Courts have had to consider the competing merits of different distribution plans, and the Claimants in this case seek to do the same. In the latter context however there is the fundamental difficulty that equality of treatment between defrauded creditors is elusive. As the Court in *Securities and Exchange Commission vs Byers et al.* observed: "*For a District Court sitting in equity, however, it is important to remember that each investor's recovery comes at the expense of others. … "[w]hen funds are limited, hard choices must be made*"."

[60] The Court there also observed that "*pro rata distributions are the most fair and most favored in receivership cases.*"

[61] In that case the receiver sought, and was granted, Court approval to use what the court there called the "net investor method" for calculating

distributions as being the "*most equitable*" in the circumstances of that case. The Court considered that this method would provide the greatest number of investors with the greatest recovery possible without inequitably rewarding some investors at the expense of others. The "net investor method" used in that case appears to have been a version of the "Modified Net Investment Method" described above, in that the receiver there also proposed to account for rolled-over distributions in addition to looking at the cash-in – cash-out position.

[62] In *United States Commodity Futures Trading Commission vs Lake Shore Asset Management Limited et al., No. 07 C 3598*, the United States District Court for the Northern District of Illinois, Eastern Division was asked to consider the respective merits of the "Net Investment Method" as against the "Rising Tide Method". The Court embarked upon a comparison exercise, which analyzed the number and percentage of investors who would recover more depending upon which method was adopted. The Court agreed with the receiver that " "*the Rising Tide" method is the most equitable because it prevents an investor who previously received funds as withdrawal from "benefitting at the expense of other investors by retaining the benefit of the full amount of his withdrawal plus a distribution calculated on the basis of net funds invested, rather than the recommended distribution amount adjusted to take into account all amounts already received".*" The relatively small number of investors concerned made that approach feasible in that case. The Court there again invoked the principle that "equality is equity". The Court however recognized that each of these methods would produce its own "net winners" and "net losers". Achieving equality in fact appears impossible.

[63] In the United States Court of Appeals, Second Circuit, case of *In re: Bernard L. Madoff Investment Securities LLC, no. 10-2378-bk (L)*, the

Court considered that on the facts of that case the investors' "net equity", should be calculated on the "Net Investment Method".

[64] "Net equity" is a statutorily defined term under the United States Securities Investor Protection Act ("SIPA"). It is defined as follows: "*The term "net equity" means the dollar amount of the account or accounts of a customer, to be determined by (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer …; minus (B) any indebtedness of such customer to the debtor on the filing date…*". The Court in *Madoff* (supra) observed that SIPA "*does not prescribe any single means of calculating "net equity" that applies in the myriad circumstances that may arise in a SIPA liquidation*."

[65] In that case the two "Methods" which were vying for the Court's approval were the "Net Investment Method" and the "Last Statement Method".

[66] The Court stated that: "*Differing fact patterns will inevitably call for differing approaches to ascertaining the fairest method for approximating "net equity" as defined by SIPA. … "[a]ny dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested. If the Last Statement Method were adopted," those claimants who have withdrawn funds from their BLMIS accounts that exceed their initial investments "would receive more favorable treatment by profiting from the principal investments of [those claimants who have withdrawn less money than they deposited], yielding an inequitable result." …Use of the Last Statement Method in this case would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations. … "[t]he Net Investment Method is appropriate because it relies solely on unmanipulated withdrawals and deposits and refuses to permit Madoff to arbitrarily decide who wins and who loses."… In holding that it was proper for* [the Trustee]

to reject the Last Statement Method, we expressly do not hold that such a method of calculating "net equity" is inherently impermissible. To the contrary, a customer's last account statement will likely be the most appropriate means of calculating "net equity" in more conventional cases. We would expect that resort to the Net Investment Method would be rare because this method wipes out all events of a customer's investment history except for cash deposits and withdrawals. The extraordinary facts of this case make the Net Investment Method appropriate, whereas in many instances, it would not be. The Last Statement Method, for example, may be appropriate when securities were actually purchased by the debtor, but then converted by the debtor. Indeed, the Last Statement Method may be especially appropriate where – unlike with the BLMIS accounts at issue in this appeal – customers authorize or direct purchases of specific stocks."

[67] The Court in that case explained its thinking further in an enlightening foot-note: "*Because we find that, in this case, the Net Investment Method …is superior to the Last Statement Method as a matter of law, we have no need to consider whether a SIPA trustee may exercise discretion in selecting a method to calculate "net equity". Fraud is endlessly resourceful and the unraveling of weaved-up sins may sometimes require the grant of a measure of latitude to a SIPA trustee. It therefore appears to us that that in many circumstances a SIPA trustee may, and should, exercise some discretion in determining what method, or combination of methods, will best measure "net equity". We have no doubt that a reviewing court could and should accord a degree of deference to such an exercise of discretion so long as the method chosen by the trustee allocates "net equity" among the competing claimants in a manner that is not clearly inferior to other methods under consideration*."

[68] The reference to a "*not clearly inferior*" method seems deliberately to avoid calling one method superior over another, since no method is capable of making all creditors whole, nor indeed able to eliminate net losers.

[69] Counsel for the Claimants in the present case seeks to distinguish SIB from ***Madoff***. He points out that SIB was not a broker/dealer, whereas Madoff was. Rather, he submits, unlike in ***Madoff***, where the investors were at the whim of Madoff in ascribing entirely fictional profits to them arbitrarily, with SIB the customers received CDs which stipulated their contractual entitlement to interest. As such, he argued, SIB's customers are straight-forward contractual creditors with a clearly established contractual legitimate expectation. He contends that the Last Statement Method would therefore produce a more equitable result.

[70] I do not agree. There are distinct similarities between ***Madoff*** and SIB, which would, in my view, make the Last Statement Method equally absurd for SIB as it was for ***Madoff***:

a. In both ***Madoff*** and SIB the investors relinquished all investment authority to the scheme perpetrator;
b. Both claimed to invest the funds in a particular way which was claimed to produce consistently high rates of return on investment;
c. In both the customer funds were never invested (in SIB some small portion was invested, but this merely served as a cover, it would appear from the evidence currently before the Court), instead the perpetrators generated fictitious paper account statements in order to conceal the fact that they engaged in no (or in SIB's case, no significant) trading;

d. In both *Madoff* and SIB, the perpetrators used investments of new customers to fund withdrawals of principal and supposed profit or interest made by other customers;
e. In both, the only accurate entries reflected the customers' cash deposits and withdrawals (in SIB's case, at least from 1999 forward);
f. In neither *Madoff* nor SIB is there any contention that any victim knew or should have known that the investments and customer statements were fictitious;
g. In both *Madoff* and SIB some customers argued that they were entitled to recover the market value of their respective instruments reflected on their last customer statements (in SIB's case, the last represented value of their deposits with interest accrued and as represented in their CD's as adopted by the Original Liquidators), ignoring the fact that interest would have to be taken from other depositors' invested principal funds.

[71] I do not think it makes any difference that in *Madoff* the prospective profits for investors were not fixed at the time when they entrusted their money to Madoff, whereas in SIB the investors were promised a contractual rate of interest. In both cases the investors were duped by a falsely represented investment strategy. In both cases the profits or interest respectively which was credited or paid to investors derived directly from deposits from subsequent investors, and not from legitimate investment returns.

[72] In both SIB and *Madoff*, therefore, using the Last Statement Method would adopt in its entirety the false and arbitrary profit or interest representations made by the respective perpetrators, to all intents and purposes continuing not just the fraud, but also the misappropriation of the last investors' monies.

[73] Conversely, the use of the Net Investment Method in SIB, including the use of a Modified Net Investment Method to reach a base-line figure in 2002, not only appears to this Court to be "not clearly inferior" to the Last Statement (or Rising Tide Method, for that matter), but to be reasonable, if of course not perfect, and certainly well within the broad discretion that the English line of authorities exemplified by ***Edennote*** (supra) allow liquidators. This Court also respectfully shares the view of the United States Court of Appeals for the Second Circuit that in a case such as *Madoff* (and by extension SIB) the "Net Investment Method" is superior to the "Last Statement Method" as a matter of law, because it does not adopt nor perpetuate the underlying fraud.

[74] However, Counsel for the Claimants had further submissions based upon United States case law.

[75] Counsel for the Claimants contended that the Claimants should be allowed a reasonable amount of interest, whether at the rate they contracted for with SIB in their CDs, or as the Court may determine. He pointed out that the 7.125% and 5% per annum respectively that the Claimants had been promised by SIB was reasonable, and that it was certainly not "too good to be true".

[76] He referred the Court to dicta in the United States District Court, Western District of New York, case *In Re: Unified Commercial Capital & Douglas Lustig vs Weisz & Associates, Inc., no. 01-MBK-6004L* and *Douglas J. Lustig vs Susan E. Anderson, no. 01-MBK-6005L*, which also concerned an alleged Ponzi scheme: "*It is simply incorrect to say that the perpetrator of a Ponzi scheme does not receive "value" when an innocent victim "invests" money with him. The simple fact is that the use of funds for a period of time has value*."

[77] He also referred the Court to a decision of the United States District Court, D. Connecticut, *In re Carrozzella & Richardson, 286 B.R. 480 (2002)*, in which the Court there stated: "… *allowing an investor to retain reasonable contractual interest does not further a Ponzi scheme any more than allowing that investor to retain repaid principal. … the interest rates were reasonable and there is no suggestion in the record that Defendants were anything but innocent investors. There is nothing to suggest that they were aware that the Debtor was operating a Ponzi scheme. This was not a typical "too-good-to-be-true" investment scheme. In exchange for the interest paid to the Defendant, the Debtor received a dollar-for-dollar forgiveness of a contractual debt. This satisfaction of an antecedent debt is "value" and in this case "reasonably equivalent value". To the extent that these Defendants had not been paid the interest owed, they would have been creditors of the Debtor's bankruptcy estate, asserting claims for unpaid interest"*.

[78] Counsel for the Claimants urged that these dicta applied precisely to SIB's case. He urged that the Claimants were in no different a position in relation to SIB as, for example, a utility company owed money by SIB. The Claimants should therefore be credited with interest in calculating what each depositor would be entitled to receive in a distribution, he argued. In other words, the "Last Statement Method" is more equitable that the "Net Investment Method", he argued.

[79] This Court initially had difficulty in reconciling the analysis in *Madoff* with *In Re: Unified Commercial Capital* and *In re Carrozzella & Richardson*, and the Court has not had the benefit of further authority or expert evidence of United States law on this area. However this Court notes that both *In Re: Unified Commercial Capital* and *In re Carrozzella & Richardson* are instances of "claw-back" litigation, whereas *Madoff* had to consider what would be an equitable distribution from an insufficient Ponzi

scheme fund. The two situations appear to be distinct. There would appear to be a fundamental difference between a liquidator positively taking money away from the principal deposits of later investors to credit an earlier investor with interest to reflect a notion that money has time value, and allowing an investor to keep purported interest that he received for valuable consideration in good faith without notice of the Ponzi scheme's fraud, and may already have spent. The Court therefore does not see that *In Re: Unified Commercial Capital* and *In re Carrozzella & Richardson* necessarily assists it in determining the reasonableness or otherwise of possible distribution calculation methods.

[80] Counsel for the Claimant referred the Court to commentary in "*The Ponzi Book*" (supra). However, that most helpful work on balance supports the Defendants' case, not the Claimants'. One comment therein, at 20.04 [2] is that "…*a minority of courts have found that investors should be compensated for the time value of the use of their funds*." Another comment to contrary effect, in the same section, citing the case of "*Scholes v Lehmann*", is that a Ponzi investor "…*should not be permitted to benefit from a fraud at [another creditor's] expense merely because he was not himself to blame for the fraud*." A further comment in the same section is that "…*the majority of courts have found that claims for fictitious profits should be disallowed*."

[81] At 20.04 [3] "*The Ponzi Book*" evaluates differing distribution calculation methods. Concerning the "Last Statement Method", it states that: "…*although not widely adopted,* [it] *is a favorite of investors who have accumulated profits on their statements and who wish to be paid those expected profits*." Concerning the "Net Investment Method", it comments that "[m]*any courts have adopted the "cash in/cash out" methodology or the "net investment" methodology in fixing the amount of investor claims*."

[82] In relation to the "Modified Net Investment Method", "*The Ponzi Book*" comments that "[a] *few courts have modified the Net Investment Method*."

[83] In relation to the "Rising Tide Method", "*The Ponzi Book*" comments generally, with some terseness: "*The "Rising Tide Method" is a complex methodology. The methodology has been described and reviewed in several cases, and one court has adopted a variation on this method. Some courts have concluded that the Rising Tide Method is the most equitable. A step-by-step guide and an illustration demonstrating how to use the Rising Tide Method to calculate the distributions to investors may be found in the Appendix.*"

[84] Counsel for the Claimants submitted that all the competing methods were equitable, but some (i.e. those that he was advocating) were more equitable than others. This does not, in the Court's view, trigger a requirement that the Court should step in and override the Current Liquidators' decision.

[85] Counsel for the Claimants would not go so far as to say that the "Net Investment Method" and "Modified Investment Method" adopted by the Current Liquidators were so utterly unreasonable or absurd that no reasonable man would have done it.

[86] Counsel for the Claimants urged instead that the Court should permit the Current Liquidators only "some little" discretion, due to the exceptional circumstances of the SIB liquidation, and that this Court should review the Current Liquidator's exercise of such discretion "with a keen eye". I take that to mean that the Court should accord the Current Liquidators a narrow discretion only, and that it should be more ready to intervene than suggested by ***Re: Edennote*** (supra). Counsel for the Claimants was however unable to refer to the Court to authority in support of this

submission, and so this Court prefers to treat the principles expressed in ***Re: Edennote*** as the appropriate guidance.

[87] This Court is therefore satisfied that the Current Liquidators have acted well within the scope of their discretion in adopting the distribution calculation methods that they did. They appear to have used a main-stream methodology which gives no credence, ratification or perpetuation to dishonesty underlying the scheme, to the exclusion of one that is not widely adopted and which would do so. The Court is also satisfied that the Current Liquidators acted as prudent businessmen, and that they were reasonable in proceeding on the basis that SIB was a "Ponzi scheme".

[88] The Claims therefore fail.

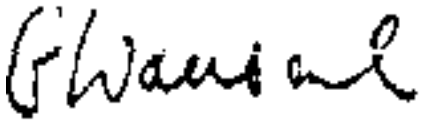
Costs

[89] As costs generally follow the event the Court considers that it is appropriate that the Claimants should bear some of the costs of the Defendant. Although the questions raised in this matter are of wider interest, and have previously not been settled, at least in Antigua and Barbuda, and although the Court has the greatest of sympathy with both Claimants' predicament, it should have been apparent to the Claimants upon consideration of English law authorities that the Court would have been reluctant to interfere with the Current Liquidators' decision, and thus that the Claimants were at risk as to costs.

[90] As both claims were heard together, over two days, with quite voluminous material placed before the Court by the Defendants, the Court is of the view that an appropriate sum of costs ought to be awarded to the Defendants, to be paid by the Claimants jointly. The parties' learned Counsel, after discussions, concurred with each other that such costs

should be in a global amount of EC$6,000.00, with each of the Claimants paying the equal amount of EC$3,000.00. I therefore adopt these figures.

[91] Finally the Court expresses its gratitude to both sides' legal teams, as well as the Court Staff, for their assistance in bringing this matter most efficiently to a conclusion.



Gerhard Wallbank
High Court Judge (Acting)

28 October 2013