Ponzi schemes: when proprietary claims exist against fraudulent fiduciaries

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The English Court of Appeal recently considered the relief that could be granted to investors following a fraudulent Ponzi scheme. In particular, the Court analysed when a proprietary interest exists in funds fraudulently acquired by a fiduciary and what is required for that interest to undermine a later settlement with third party banks.

Sinclair Investments (UK) Ltd ("Sinclair") had provided funds to Trading Partners Limited. These funds were supposed to be used for the purposes of carrying out certain trades. However, the director of Trading Partners Limited, Mr Cushnie, actually transferred the funds to another company that he controlled called Versailles Trade Finance Ltd ("VTFL"). VTFL then used the funds for fraudulent activities, which inflated its turnover and raised its share value. A number of banks ("Banks") took charges over VTFL's assets.

Before the fraud was discovered, Mr Cushnie sold his shares in VTFL for almost £29 million. Once the deception came to light, receivers were called in and VTFL was wound up. The receivers negotiated with Mr Cushnie and received money from him to settle the debts that he and VTFL owed the banks. The receivers reached settlement agreements with the Banks, however Sinclair was left out of pocket. Consequently, Sinclair brought a claim asserting that it was entitled to assert a proprietary interest in the proceeds of Mr Cushnie's share sale and sought to undermine the settlement agreements that the receivers had reached with the Banks using these funds.

The key obstacle faced by Sinclair in establishing a proprietary claim was that Mr Cushnie had acquired his shares in VTFL independently of Sinclair. He had not used funds, or money derived from funds, that were beneficially owned by Sinclair, to purchase the shares. Nor had he acquired the shares as an indirect consequence of his misuse of Sinclair's funds. The only connection with

Sinclair was that its funds had been fraudulently used by Mr Cushnie to increase the value of the shares in VTFL.

The Court of Appeal drew an analogy with fiduciaries that receive a monetary bribe by virtue of his or her fiduciary position and in breach of his or her fiduciary duties, but the money itself is not part of the assets that are subject to the fiduciary's duties, nor is it money derived from those assets. The Privy Council had earlier decided Attorney General for Hong Kong v Reid & Anor [1994] 1 AC 324 that a principal has a proprietary interest in any bribe received by his or her agent in breach of the agent's fiduciary duties. However, there was a consistent line of English authority to the contrary. The English courts had held that a proprietary interest could not exist in a bribe which could not have been obtained without enjoying a fiduciary status, but was not beneficially owned, or derived from opportunities beneficially owned, by the principal.

The Court held that it should follow the previous domestic decisions rather than the decision of the Privy Council on a foreign appeal, unless there were powerful reasons to the contrary. No such reasons were found to exist. Consequently, the Court found that Sinclair did not have a proprietary interest in the share proceeds. Sinclair's claim therefore only gave rise to a personal remedy and the share proceeds could not be traced into the settlements that had been reached with the Banks.

While not necessary to do so, the Court then considered whether any proprietary claim that Sinclair may have had would have been defeated by the Banks being bona fide purchasers for value without notice. On this issue, the Court was of the view that Sinclair would have needed to show that the Banks actually knew of its potential proprietary right, or that it would have been obvious to a reasonable person (with the knowledge and experience of the Banks after making proper enquiries) that the settlement transactions were probably improper.

The Court distinguished the effect of knowing material facts that give rise to a competing claim from appreciating the legal consequences of those facts. Thus, notice of a potential proprietary claim by Sinclair could only be attributed to the Banks if the Banks actually appreciated, or ought to have appreciated the legal consequences of the facts that gave rise to Sinclair's claim. Even though the Banks were aware that there had been a massive misappropriation of funds and that Sinclair was the victim of a substantial fraud, at the time of settlement it was not known that Mr Cushnie was responsible for the fraud and no mention had been made of a proprietary claim against him. Consequently, the Court held that, even if Sinclair had a proprietary claim to the proceeds of the share sale, the Banks would have taken free of that claim.

Comment

This case illustrates the English Court's reluctance to give any priority to investors over other creditors when a fiduciary acts fraudulently. Unless funds can be identified as being either subject to the fiduciary's duties, or derived from such funds, investors' claims will rank equally with other creditors upon insolvency. Furthermore, even if a proprietary interest is established, it will not

take precedence over subsequent third party transactions such as bank settlements unless the third party appreciated, or ought to have appreciated, the legal consequences of the prior claim. This will provide a degree of comfort to English creditors who settle their claims early in the insolvency process. It remains to be seen how the Jersey Courts will view the English Court of Appeal's rejection of the Privy Council's decision in Reid.

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