

The Kingate Judgment

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Conyers Dill & Pearman



A question of trust: are share subscription monies held on trust by a mutual fund company in the event that it is unable to issue shares?

Introduction

The Court of Appeal for Bermuda has recently considered the issue of whether share subscription monies are held on trust by a mutual fund company, in the event that the fund is unable to issue shares to the subscribing investor, whether as a result of a suspension of dealing or winding up.

*In **Kingate Global Fund Ltd v Knightsbridge (USD) Fund Limited et al** [2009] CA (Bda) 17 Civ (19 November 2009), the Court of Appeal concluded that, on the particular facts of the case, share subscription monies were held on trust for subscribing investors until shares have actually been issued.*

As a result, share subscription monies were not available for the fund's own use prior to the issue of the relevant shares, and they were not available for distribution to the fund's unsecured creditors, in the event of the fund's insolvency or liquidation.

The Court of Appeal upheld the first-instance judgment of Mr. Justice Kawaley in *Knightsbridge (USD) Fund Limited et al v Kingate Global Fund Ltd* [2009] SC (Bda) 39 Civ (28 August 2009), and, in doing so, applied 'special purpose' trust principles articulated by the House of Lords in *Barclays Bank Ltd. v Quistclose Investments* [1970] AC 567 and *Twinstetra Ltd. v Yardley and others* [2002] 2 AC 164.

The Court of Appeal considered that the relevant legal principles set out in those authorities were clear, although the parties differed as to their application to the unusual facts of this case.

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Summary of of background facts

Kingate Global Fund Ltd ('the Fund') was a British Virgin Islands "Feeder Fund" that invested mainly in Bernard L. Madoff Investment Securities LLC in New York ('Madoff'). The Fund issued shares to investors wishing to invest, indirectly, in Madoff.

On 28 November 2008, various subscribing investors submitted share subscription agreements, and subscription monies, which they sent to a subscription account held with the Fund's custodian, in Bermuda, for the account of the Fund.

The subsequent arrest of Mr. Madoff on 11 December 2008 made it impossible for the Fund to issue the shares for which the Respondents had subscribed, and led later to the insolvency and liquidation of the Fund.

The subscribing investors and the liquidators of the Fund were at odds as to whether the share subscription monies should be held on trust for the relevant investors, or whether they should form part of the assets of the Fund available for distribution to all unsecured creditors.

Summary of the Court of Appeal's Judgment

It was common ground between the parties that the resolution of the dispute turned on the proper construction of the terms of the Fund's share subscription agreement and offering documents, which included a Confidential Information Memorandum, Articles of Association, and associated documents¹.

There was no justification for inferring that the subscription monies were intended to become the Fund's own money before that status was achieved by the actual issue of shares.

Having considered the relevant documents, the Court of Appeal concluded, on their interpretation, that there was no justification for inferring that the subscription monies were intended to become the Fund's own money before that status was achieved by the actual issue of shares. The monies were paid into the subscription account for the purpose of acquiring shares and for that purpose alone.

One interesting aspect of the Court of Appeal's judgment is its conclusion, on the facts of this case, that all monies held in the subscription and redemption account, whether on their way into or out of the Fund, were held on trust for the relevant subscribing or redeeming investor. The Court of Appeal said that "those moneys by definition would not form part of the Fund itself, nor was there any reason why they should be used by the company for any other purpose of its own... subscription funds and redemption moneys are the shareholders' money, not the Funds'."

Subscription funds and redemption monies are the shareholders' money, not the Funds'

Another interesting aspect of the decision is the Court of Appeal's decision not to follow a line of English and Australian authorities (including *Moseley v. Cressley's Co.* (1865) L.R. 1 Eq. 405, *In re Fada (Australia) Ltd.* [1927] S.A. State Reports 590, and *Re Associated Securities Ltd.* (1981) 6 ACLR 248 (Supreme Court of NSW) that suggest that, in an ordinary case (in the absence of special circumstances), money paid to a company for a projected share issue becomes the property of the company, even if the shares are not issued, and that it is not normally held on trust for the subscribing investor, although the investor would have a claim to repayment as an unsecured creditor.

¹ The parties, and the Court, appear to have proceeded on the basis that Bermuda law was the applicable governing law, although it seems likely that the applicable governing law would otherwise have been BVI law (since that was the place of the Fund's incorporation).

The Court of Appeal did not consider those authorities to be applicable to the particular facts of this case². The Court of Appeal acknowledged, however, that those principles might apply on the facts of other cases, subject to the terms of the relevant documents: “We do not consider that it is conceptually impossible that money paid to a company in respect of a projected issue of shares should be received by the company as its own”.

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It is possible that there might be an appeal to the Privy Council in due course.

What does this mean in practice?

Primarily, the Court of Appeal’s judgment is of relevance to the creditors, investors, directors and liquidators of mutual funds that go into liquidation, in similar circumstances.

However, other mutual funds might sensibly review their own documents and practices regarding the holding and use of subscription and redemption monies, to clarify whether such monies are held on trust for the relevant investor, or held for the fund’s own account and use.

Furthermore, mutual funds, and their directors, managers, and service providers, should be alert to the fiduciary obligations associated with the management and holding of subscription and redemption monies on trust, and the potential risks associated with any potential breach of trust or fiduciary duty.

² It is unclear whether the Court’s attention was drawn to *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd* [2008] NSWSC 766, in which Mr. Justice Austin of the Supreme Court of New South Wales accepted, at paragraph 109, that those authorities could be applied in the context of a mutual fund scheme structured as a unit trust.

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