

WHAT HAPPENS TO THE MOST RECENT SUBSCRIBERS
WHEN A HEDGE FUND BECOMES INSOLVENT?

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Introduction

1. The way most hedge funds work is that subscribers subscribe for shares normally every month and are issued shares at the net asset value (“NAV”) calculated as at, but subsequent to, the subscription date.
2. Similarly those existing shareholders who wish to redeem their shares do so at the same NAV.
3. The directors of a hedge fund normally have the power to postpone the calculation of the NAV. In the event of an insolvency the situation may occur where a subscriber has subscribed for shares and paid a sum of money over but not been issued with shares because the NAV was never calculated. In such circumstances an issue may arise as to whether that unsuccessful subscriber is (i) a member of the company, (ii) an unsecured creditor of the company for the amount it has paid for the shares or (iii) entitled to a proprietary interest in the monies it has paid over for the shares.
4. In the absence of the issue of any shares the unsuccessful subscriber does not become a member of the company. However whether or not the unsuccessful subscriber is merely entitled to rank as an unsecured creditor or has a proprietary interest in the shares will depend on the terms on which the company received and thereafter held the purchase monies.

The Older Cases

5. There are authorities which deal with the situation where money has been paid to a company for the purpose of obtaining an allotment of shares. For example: _

- a. In Moseley v Cressey's Co (1865) LR 1 Eq 405, a company invited applications for shares by means of a prospectus which stated that deposits would be returned if no allotment of shares was made. It was held that that was insufficient to create a lien or trust. In that case Sir William Page Wood said:-

“... if the object had been to create a lien of this kind, the obvious way of doing so would have been to have said in the prospectus that there would be a lien on the deposits until the company was established, or that it was to be set apart as a trust fund in the names of the trustees, to be returned in the event of the company not being established. Nothing of that kind was done, nor was that the contract. The contract was – “You are to pay so much per share when you apply for shares, and your deposits will be returned if no allotment is made” – not that the actual thing so deposited was to be paid back; for payment to the company's bankers to the account of the company made the money ipso facto part of the company's assets.”

- b. By contrast, in Nanwa Gold Mines Ltd [1955] 1 WLR 1080, the application form sent out by a company when inviting subscriptions for a further issue of capital contained a statement that if certain conditions were not fulfilled *“application moneys will be refunded and meanwhile will be retained in a separate account”*. Harman J held that the promise to keep the money in a separate account distinguished this case from Moseley and held that the subscription monies did not form

part of the general assets of the company and were returnable to the subscribers.

The Quistclose Trust

6. In Barclays Bank v Quistclose [1970] AC 567, monies that were advanced to the company were advanced on the express basis (which the bank knew about) that they were only to be used for one purpose namely to pay a dividend, and would be kept in a separate bank account opened specifically to hold the monies advanced pending the payment of the dividend. As Lord Wilberforce said at 579H:-

“It is not difficult to establish precisely upon what terms the money was advanced by the respondents to Rolls Razor Ltd. There is no doubt that the loan was made specifically in order to enable Rolls Razor Ltd to pay the dividend. There is equally, in my opinion, no doubt that the loan was made only so as to enable Rolls Razor to pay the dividend and for no other purpose. This follows quite clearly from the terms of the letter of Rolls Razor to the bank of July 1, 1964, which letter, before transmission to the bank, was sent to the respondents under open cover in order that the cheque might be (as it was) enclosed in it. The mutual intention of the respondents and of Rolls Razor Ltd, and the essence of the bargain, was that the sum advanced should not become part of the assets of Rolls Razor Ltd, but should be used exclusively for payment of a particular class of its creditors, namely, those entitled to the dividend. A necessary consequence from this, by process simply of interpretation, must be that if, for any reason, the dividend could not be paid, the money was to be returned to the respondents: the word “only” or “exclusively” can have no other meaning or effect.”

7. In Quistclose Lord Wilberforce referred to the 2 cases mentioned in paragraph 5 above and said at 581C:-

“They are merely examples which show that, in the absence of some special arrangement creating a trust (as was shown to exist in In re Nanwa Gold Mines Ltd), payments of this kind are made upon the basis that they are to be included in the company’s assets.”

8. A trust does not arise purely because money is paid for a particular purpose. As stated by Lord Millett in Twinsectra Ltd v Yardley [2002] 2 AC 164 at paragraphs 73 and 74:-

“A Quistclose trust does not necessarily arise merely because money is paid for a particular purpose. A lender will often inquire into the purpose for which a loan is sought in order to decide whether he would be justified in making it. He may be said to lend the money for the purpose in question, but this is not enough to create a trust; once lent the money is at the free disposal of the borrower. Similarly payments in advance for goods or services are paid for a particular purpose, but such payments do not ordinarily create a trust. The money is intended to be at the free disposal of the supplier and may be used as part of his cashflow. Commercial life would be impossible if this were not the case.

The question in every case is whether the parties intended the money to be at the free disposal of the recipient: In re Goldcorp Exchange Ltd [1995] 1 AC 74, 100 per Lord Mustill.”

9. As Evans-Lombe J stated in Cooper v PRG Powerhouse Ltd [2008] EWHC 498 at paragraph 15, whether or not money has been paid subject to a purpose trust is a question of fact. The key factual question is that identified by Lord Millett in Twinsectra, namely was the money intended to be at the free disposal of the Company pending the issue of the shares or was it to be held on behalf of the subscriber until the shares were actually issued?
10. That is the question that has to be addressed in relation to hedge funds.

Kingate v Knightsbridge and Ors

11. In Kingate Global Fund Ltd v Knightsbridge (USD) Fund Ltd which was heard by the Court of Appeal for Bermuda (Civil Appeal No. 17 of 2009) subscribers raised the very point addressed in this paper.
12. The Court held that “*on the circumstances of the individual case, and specifically upon the true construction of the terms on which payment was made*” a “purpose” trust did arise and the subscribers were entitled to claim back the monies they had paid to subscribe for shares in full. Those monies were readily identifiable in a bank account into which they had been paid for the purpose of subscribing for shares. The funds in that bank account were not treated as being readily available for the company to deal with as it saw fit.

Neste Oy

13. Even in the absence of a Quistclose Trust a subscriber may be able to claim a proprietary interest in the subscription monies if at the time of receipt the company had already decided to cease trading.
14. In Neste Oy v Lloyds Bank Plc [1983] 2 Lloyd’s Rep 658 a company decided that it should cease trading on 22nd February 1980. On the same date a payment was made to it of moneys to enable it to discharge its function as shipowner’s agent by discharging certain liabilities (five other such payments had been made earlier). The final payment was made by inter-bank transfer on that day. It was found that this money was paid and received at a time when the recipient company had resolved to cease trading immediately, when it had not itself paid for the services which it was entitled to discharge out with the remitted monies and when there was no chance that it would pay for those services. Bingham J held that there was a constructive trusteeship of the monies forming the final payment

(but not of the monies forming 5 earlier payments that pre-dated the decision to cease trading):-

“Given the situation of [the recipient company] when the last payment was received, any reasonable and honest directors of that company ... would, I feel sure, have arranged for the repayment of that sum to the plaintiffs without hesitation or delay. It would have seemed little short of sharp practice for [the company] to take any benefit from the payment, and it would have seemed contrary to any notion of fairness that the general body of creditors should profit from the accident of a payment made at a time when there was bound to be a total failure of consideration... It ... seems to me that at the time of its receipt [the company] could not in good conscience retain this payment and that accordingly a constructive trust is to be inferred.”

15. As explained by Mann J in Re Farepak Food and Gifts Ltd (in administration) [2006] EWHC 3272 (Ch) at paragraph 38 of his judgment, the reasoning of Bingham J has been criticised in a number of cases whilst also receiving support (sometimes only tacitly) in others. The main criticism seems to be that it smacks of a remedial constructive trust which is not recognised by English law. However, given the other cases which Mann J refers to and the fact that Lord Scott’s recent judgment in Thorne v Majors [2009] UKHL 18 is based on a remedial constructive trust, it appears that Neste Oy is likely to remain good law.

Conclusion

16. Whether or not a proprietary interest can be established by an unsuccessful subscriber will depend upon the facts, and in particular, whether the parties intended the subscription monies to be at the free disposal of the company pending the shares being issue or whether at the date of receipt the company had already decided to cease trading.