

# Corporate & Commercial

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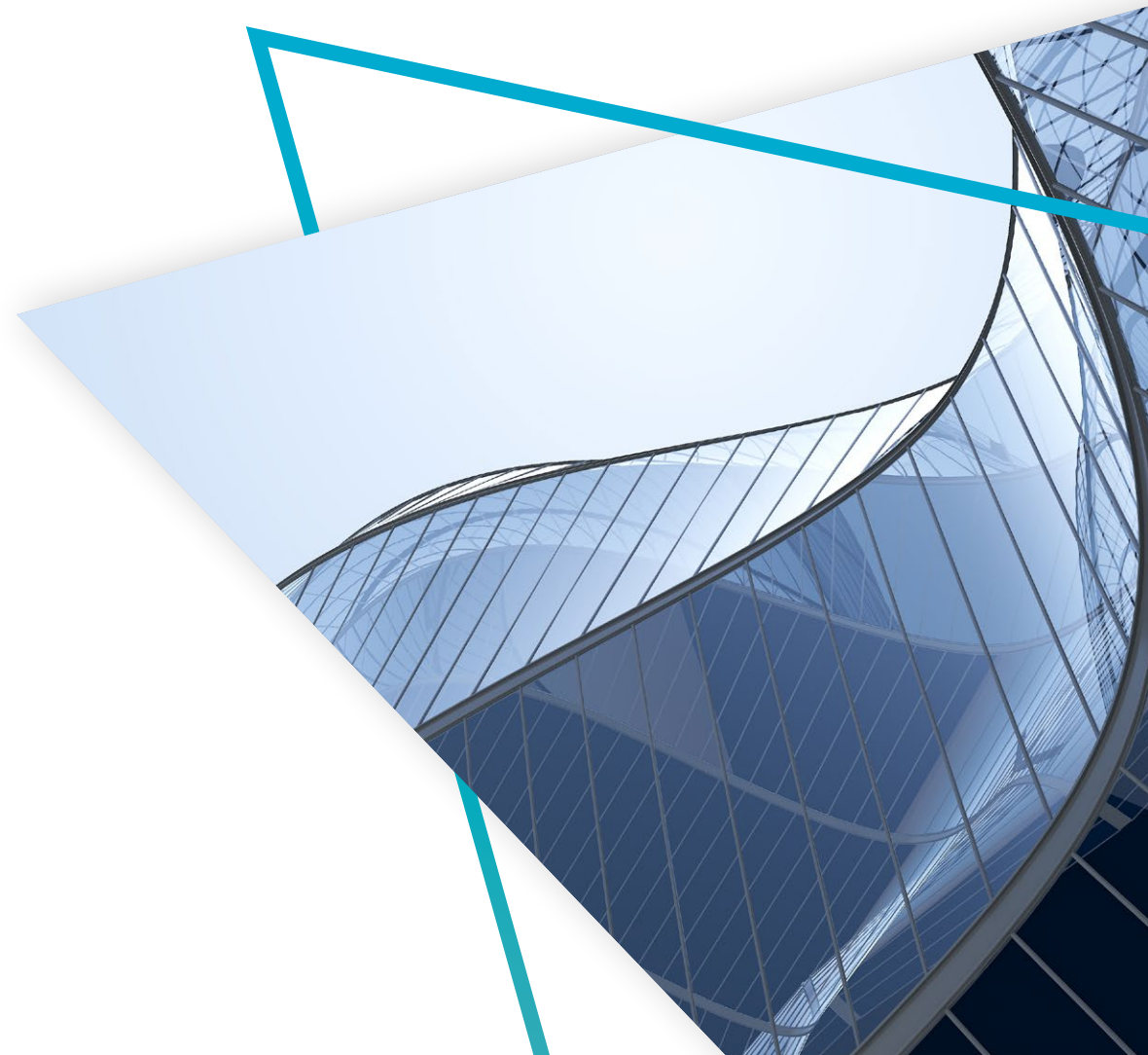
## In this issue

KENYA

Constructive trusts and shareholding in Kenya: Supreme Court provides clarity



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## Constructive trusts and shareholding in Kenya: Supreme Court provides clarity

The recent landmark decision by the Kenyan Supreme Court in *Arvind Shah and 7 Others v Mombasa Bricks and Tiles Limited and 5 Others* has significant implications for share ownership in Kenya. In particular, the Supreme Court sought to determine “*whether a constructive trust can be imported into a shareholding of a company as to disentitle a registered holder of shares in a company obtained for valuable consideration*”.

### Background

In this case, the respondents were experiencing financial difficulties and approached the first appellant for assistance. The first appellant suggested a restructuring plan that included:

- Creation of holding companies: Two holding companies were formed – Holding Company A (owned by the respondents) and Holding Company B (owned by the first appellant).
- Formation of subsidiaries: Four subsidiaries were established to hold the respondents’ assets. Each subsidiary shared an identical ownership structure: first appellant (20 shares), Holding Company B (490 shares) and Holding Company A (490 shares).

This structure granted the first appellant effective control of the subsidiaries. The respondents alleged that the first appellant misrepresented his intentions behind this plan and exploited their financial vulnerability. The first

appellant, on the other hand, maintained that his actions were part of a mutually agreed upon business venture and denied any wrongdoing.

At the Court of Appeal, the court found that the restructuring scheme resulted in the first appellant unjustly enriching himself and that there was a presumption of undue influence on the part of the first appellant, as the net effect of the documents giving rise to the arrangement the parties found themselves in did not reflect the true and independent consent of the respondents. The transactions met the criteria of being regarded as unconscionable bargains.

### Constructive trusts

A constructive trust is a legal remedy imposed by a court to prevent a party from unjustly benefiting from their wrongdoing. In the context of shareholding, this could occur when a shareholder acquires shares through a breach of fiduciary duty, undue influence or other unconscionable conduct.

In considering the question before it, the Supreme Court held that a constructive trust can indeed be applied within a company’s shareholding structure, potentially disentitling a registered shareholder. The court’s rationale was that:

- The imposition of a constructive trust would be the most appropriate remedy where it is established that there was unconscionable or inequitable behaviour. The Supreme Court upheld that the first appellant’s actions were unconscionable, and the imposition of a constructive trust was an appropriate remedy.

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# Constructive trusts and shareholding in Kenya: Supreme Court provides clarity

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- Shares within a company constitute property under Article 260 of the Constitution. When a party obtains shares through wrongdoing, a constructive trust can be imposed to recognise the rightful ownership of a beneficiary, even if the wrongdoer is the registered shareholder.

The court further clarified that while section 104(1) of the Companies Act restricts the company from registering any form of trust (express, implied, or constructive) on its register of members, this limitation does not negate the existence or enforceability of a constructive trust established by a court. The court emphasised that this restriction is designed to safeguard the company's register from becoming cluttered with informal trust arrangements, but it does not prevent courts from imposing constructive trusts to achieve a just outcome.

## Key implications

- **Enhanced due diligence:** M&A transactions will likely require intensified scrutiny of any potential trustee relationships regarding share ownership. Companies and investors must carefully examine existing shareholder structures to identify potential risks related to beneficial ownership.

- **The value of indemnities:** Contractual indemnity provisions will become increasingly important for risk mitigation in share transactions. Indemnities may help protect parties against potential liabilities arising from disputes over beneficial ownership or the imposition of constructive trusts.
- **Beneficial ownership:** While imperfect, Kenya's legal requirement for companies to disclose details of beneficial shareholders offers a degree of protection. However, there is a 10% beneficial ownership threshold for disclosure, which leaves open the potential for unreported beneficial ownership interests.

## Conclusion

The Supreme Court's decision underscores the significance of equitable principles in commercial transactions. Businesses, investors, and their advisors must re-evaluate their approaches to share ownership and transaction structures in light of the potential for constructive trusts.

Careful due diligence, robust contractual provisions, and awareness of evolving jurisprudence will be essential for risk mitigation in Kenya's evolving corporate law landscape.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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