CONNAUGHT ACTION GROUP NEWSLETTER No 2 (24 August 2012)

CONNAUGHT INCOME FUNDS – SUSPECTED MAJOR FRAUD

UPDATE

Rather than repeat the contents of our first newsletter or re-hash Duff and Phelps' presentation to investors on 13 August, we thought it might be helpful to summarise investors' suspicions of wrongdoing, the questions that we hope will be answered in the coming days and weeks and the steps that are being taken, or that we hope to see implemented, to protect our capital.

TIUTA PLC

It is clear that the principal fraud took place within Tiuta plc and its subsidiaries. Steve Nicholas and his cronies treated client monies as a loan to their own firm; it was placed in a single bank account and used for a wide range of purposes not envisaged in the Information Memorandum ('IM') and Limited Partnership Agreement ('LPA'). These included: loans outside of the agreed criteria or made without approval from Connaught/Bluegate; meeting the working capital requirements of Tiuta; loans to the principals and their relations; property purchases by Tiuta and paying one director (we suspect Nicholas) a salary and pension contribution of almost £800k – in a year in which the firm lost £37.5 million…

What's more, Tiuta sought to absolve itself of its liability to the Fund by selling the company in which the loan book was held, Tiuta International Limited, to Connaught for just £1. It claims at the same time to have transferred the guarantee also. Given Tiuta's lack of solvency, this looks to us like a fraudulent preference.

The Action Group is keen to see Tiuta plc wound up as soon as possible. It may be possible to do this more quickly than the 21 days it would take to issue a statutory demand followed by a winding-up petition under the Guarantee (assuming Tiuta was unable to persuade a Court that the Guarantee had been properly reassigned) using the public interest argument, which normally applies when a firm is being grossly mismanaged or wrongful or fraudulent trading is suspected.

A supporter of the Action Group has provided Duff and Phelps with the name of a take-no-prisoners insolvency practitioner (IP) that has a good record of acting in situations such as this, and who would be willing to handle the liquidation.

We very much hope that once the company is in the hands of a sympathetic IP, information will come to light that will be of interest to the police, as well as being of value in tracing and recovering investors' capital.

CONNAUGHT

When does negligence end and acting as an accessory to a crime begin? That is the question that investors, and hopefully in due course the Police, are entitled to ask the directors (and the shadow director, Nigel Walter) of Connaught.

Once the Fund is in administration, we would expect it to issue proceedings against Connaught, which has clearly been negligent in its operation of the Fund

and also misrepresented it when promoting it to investors – both at the outset (because Connaught knew it did not operate as claimed) and especially subsequently, when Connaught concealed from new investors the losses it knew had been incurred. This will make it possible to appoint an IP and to pursue a claim against the firm's professional indemnity (PI) insurer.

We hope that once an IP is in control of the business and its documents, and when the Police are able to investigate the true extent of Mike Davies' and Nigel Walter's roles in Tiuta and any benefit they may directly or indirectly have gained from that firm's operations, that there may be some prospect of recovery from any individuals who may have profited from the Fund being dishonestly promoted or incorrectly managed.

BDO

The Action Group remains extremely concerned that Danny Dartnaill and Malcolm Cohen of BDO LLP ('BDO') have been appointed to the roles of Joint Administrators of Tiuta International Limited ('TIL').

Supporters of the Action Group have received testimony and seen evidence to suggest that BDO was called in to Tiuta plc and its subsidiaries in January 2011 by law firm Watson, Farley and Williams, acting for the firm, following allegations made by the then CEO George Patellis that the firm was having difficulties paying its debts as they fell due and that the Fund's capital had been used improperly. Patellis allegedly presented BDO with documentary evidence of approximately 60 'recycled' and 'not proceeded with' loans.

It is suggested that BDO produced a draft report that accepted that Tiuta plc and its subsidiaries were insolvent and implicitly vindicated the alleged cause of the group's financial difficulties.

Patellis left shortly after, concerned at the malpractice he had uncovered and frustrated that the directors were not minded to resolve the situation. Subsequently, for reasons that have not yet become clear, BDO would appear to have changed its position, believing that the companies should continue to trade and – it is alleged – even advising the FSA not to close it down. Coincidentally, around that time, the accountancy firm would appear to have picked up two further lucrative engagements – one to advise Tiuta's management on its business model, and another, ongoing brief to monitor the firm's finances for the FSA.

If these allegations are well founded and BDO knew in early 2011 that Tiuta was insolvent and that there had been wrongful or fraudulent trading as a result of an engagement for which it owed a duty of care to the firm and its subsidiaries, there may be a claim against the firm for the benefit of the creditors.

The insolvency profession's Code of Ethics lays down a number of potential threats to the independence and credibility of IPs that they are required to consider before taking on appointments. These include familiarity (knowing the directors of a failed firm as a result of working with them for an extended period), self-review (having to assess whether a firm was soundly advised, having previously advised it) and litigation (the risk of being the respondent in a claim by the insolvent company). Furthermore, they claimed to have disclosed their prior engagements to the Court prior to appointment.

Subsequently, documents have come to light that cast doubts on BDO's version of events. The Tiuta accounts for the year ending September 2011 claim that it undertook 'a full review of the Group's financial position' and Connaught's (reconstructed, after the event) Q11 report to investors states that BDO was appointed 'to review their financial situation and structure'. Even BDO's own report to investors on 13 August states that:

'In January 2011 the directors of the company identified a potential loan security issue. BDO was approached by the group to provide advice".

Last month, an investor submitted a complaint to Dartnaill's and Cohen's professional body, the Institute of Chartered Accountants for England and Wales ('ICAEW') asking it to investigate whether a breach of the Code of Conduct has taken place and, if so, to discipline the individuals. Unfortunately the ICAEW does not have the power to order IPs to relinquish appointments, but it does have the power to revoke their memberships of the body, after which they would no longer be able to act as Administrators.

It is hoped that the investigation will focus on the details of the mandates to which BDO had been working, their findings and the actions they took as a result, together with the nature and extent of their disclosure to the Court about these engagements before being appointed.

Irrespective of the outcome of the ICAEW investigation, the Fund has the right, as the principal creditor of TIL, to remove the Joint Administrators. We recognise that this is unlikely to happen while Connaught continues to manage the Fund – not least because it is currently earning close to half a million pounds a year for continuing to manage the loan book – but we hope that it will occur promptly once Duff and Phelps is appointed as administrator.

Once BDO is removed, and with it Connaught, it is hoped that it can be established whether either party has removed or destroyed any documents that could be helpful in tracing monies or establishing liabilities.

CAPITA, BLUEGATE, RAWLINSON AND HUNTER AND MAZARS

At the heart of the alleged fraud is the innocent, or perhaps not so innocent, error that took place in the way the Fund's capital was handled by the professionals who ought to have been safeguarding it. Specifically, it was passed over to Tiuta, which regarded it as a loan, much like a bank overdraft, and co-mingled it with its own capital and credit lines from other sources.

The Action Group believes that Capita, as the original Operator, has a lot to answer for. Had it ensured that the Fund had operated as outlined in the original IM and LPA, the Fund's capital would have gone directly from a client account to mortgage borrowers, without passing through Tiuta.

Coincidentally, we understand that Capita faces a £150m claim in connection with its alleged mismanagement of another Unregulated Collective Investment Scheme ('UCIS'), CF Arch Cru. It has so far been ordered by the FSA to provide £54m of compensation to investors, who consider this insufficient and are pressing, through the vehicle of a Parliamentary action group, for the full £200m they have lost.

Another name in the frame is Bluegate, which allowed the malpractice to continue, but we understand it has negligible assets and only £2m of PI insurance, and is hence unlikely to move the dial significantly in investors' favour.

Finally, there's Rawlinson and Hunter, a multinational accountancy and tax advisory firm with a particular specialism in tax havens. It has audited Tiuta plc since 2005, if not before.

Had R&H made reasonable enquiries into the source, nature and ownership of the capital that found itself in Tiuta's bank account as a result of its relationship with the Fund when it audited the first accounts that reflected the firm's relationship with the Fund (those for the period ending March 2009), the Action Group believes it ought to have spotted that these were client monies, to be kept ring-fenced, and not a short-term loan to Tiuta plc.

If the auditor had spotted this obvious error in the treatment of the Fund's capital, we believe that the fraudulent and wrongful activites that subsequently occurred would not have been possible and Tiuta would not now be facing a ruinous claim under the Guarantee. While we acknowledge that auditors generally owe a duty of care only to the firms that they audit, and not to creditors, were R&H pursued for the cost of rectifying the loss that Tiuta plc and its subsidiaries face, which they would not have faced had the audit spotted the error we've described, the firm would be in a position to honour its obligations to its creditors (including the Fund).

Likewise, had the Fund's auditor, Mazars, followed the money trail early on and found that investors' money was being co-mingled with Tiuta's and that of other providers of lines of credit, and subsequently noticed that many of the loans were unapproved and unsecured, the problems would have been a fraction of their eventual size and the prospects of full recovery much higher. The firm's website claims that it 'employs 13,000 professionals in 69 countries' so it ought to be good for the money we've lost.

We therefore hope that substantial claims will be pursued against Capita, Rawlinson and Hunter and Mazars, and that Bluegate and its insurer will be taken for whatever they can contribute.

THE FSA

Among the most disturbing allegations that has come to light in recent weeks is the suggestion that the FSA was made aware of the recycled and NPW loan issue, and the potential insolvency of the Fund, as early as March 2011 and that, for whatever reason, it failed in its statutory duty to act to protect investors' capital.

A supporter of the Action Group first spoke with Lorraine Wadhams, the FSA representative cited by Mike Davies as his point of contact, in early July 2012; his contemporaneous notes show that he found her 'very cagey', 'unco-operative' and 'reluctant to listen to my evidence of malpractice'. It has subsequently come to light that she and Davies were old colleagues who worked together at the now-dissolved sub-prime lender Infinity Mortgages prior to his stint at Connaught and Tiuta and hers at the regulator. Moreover, it has also been alleged that the FSA was given the same evidence as BDO about the unapproved and unsecured loans in March 2011 and that it failed to act on this well-founded allegation of malpractice.

Subsequently, the FSA has tried to absolve itself of responsibility, refusing to engage in further correspondence with one investor despite having been notified of the conflict of interest and the allegations of inaction.

We hope that the FSA will revise its position and engage constructively with investors to investigate what has happened and seek recovery of their capital, even if doing so entails exposing any wrong-doing or negligence on the part of anyone at the FSA.

NEXT STEPS

1. We urge investors to vote for the appointment of Duff and Phelps of Administrator to the Fund and for the removal of BDO as Administrator to TIL;

2. We also urge investors to write to Lord Turner at the FSA using the template provided on our website (http://connaughtactiongroup.com/2012/08/22/an-open-letter-to-the-fsa/)

3. The Action Group will continue to investigate the events leading up to the announcement of the Fund's insolvency and will keep the pressure up on the relevant professionals to ensure that no stone is left unturned in pursuing civil remedies to recover money and criminal prosecutions to deal with wrong-doers. If you have any specific evidence that could be of use in civil or criminal proceedings please email connaughtactiongroup@gmail.com.
4. The Action Group needs your financial support. Please donate £100 here http://connaughtactiongroup.com/contribute-2/ if you have not already done so.

CONCLUSION

The Fund was raised and loans issued overwhelmingly since the global financial crisis that took place in the second half of 2008, so those involved cannot point to a catastrophic decline in property prices as grounds for having lost, approximately, half of investors' money.

We contend that such a spectacular loss cannot be explained by a market downturn, nor by the occasional optimistic or fraudulent property valuation; on the contrary, the only credible explanation is large-scale, systematic fraud.

We will work tirelessly to identify the causes of that fraud, the beneficiaries of it and also the regulatory and professional services bodies that – whether through negligence or collusion – allowed it to happen.

The Connaught Action Group
24 August 2012