

Cayman Hedge Fund Judgment Brings Directors' Duties Starkly Into Focus

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Contacts:

Robert Duggan
Partner, Cayman Islands
Based in the London office

Nicholas Fox
Managing Associate,
Cayman Islands

Shaun Folpp
Partner, BVI

Paul Christopher
Managing Partner, Hong
Kong

For contact details,
please see the end of this
briefing.

In August, the Grand Court of the Cayman Islands handed down its judgment in the case of *Weavering Macro Fixed Income Fund Limited (in liquidation) v Stefan Peterson and Hans Ekstrom* (the "Judgment"), and it has triggered a frisson of excitement in the industry for the extent to which the Court has sought to establish how directors of Cayman Islands open-ended funds should approach the discharge of their fiduciary and other duties to the funds of which they are directors.

Many practitioners have suggested that the judgment represents a panacea for the due discharge by directors of their duties, though a significant weakness of this analysis is that the Court's considerations were cast in the light of, and informed by, the reported failings of the defendant directors of *Weavering Macro Fixed Income Fund Limited* (the "Fund").

Thus the Judgment should be treated as a baseline for performance by hedge fund directors of their duties in specific circumstances, and not to the exclusion of other relevant tenets of good governance and practice.

Background

It is easy to dismiss the Judgment as being uninteresting, for it restates established common law principles regarding directors' duties, but to stop reading there would be to miss the point. Perhaps the most interesting part of the Judgment is not the restatement of existing law or the detail of the disengagement by the directors with their role and duties but the obiter comments which establish minimum standards of behaviour which the Court should expect of hedge fund directors henceforth.

Suffice to say, the Fund was not unusual nor was it inconsistent with market norms in its structuring; the Court noted that its management structure was "entirely

conventional" apart from the fact that the directors were related to the principal of the Fund's investment manager.

The Fund collapsed following its directors and professional advisers discovering that high proportions of the assets reflected on the Fund's balance sheet were fictitious. Indeed it was held that, had the directors acted in accordance with their duty of high level supervision, the circumstances which led to the collapse of the Fund could have been averted.

The Directors sought to rely upon exculpatory provisions in the Fund's articles of association which provided that they would only be liable to the Fund for loss or damage arising out of their wilful neglect or default. The Court concluded that, because the directors knew that they had a duty of supervision, but consciously chose not to perform that duty in any meaningful way, they were therefore guilty of wilful neglect or default. The Court observed that the directors would have been protected by the exculpatory provisions in the Fund's articles of association had they attempted to perform their duty but failed as a result of their carelessness, no matter how gross; in other words that even if they had merely done their incompetent best they would have benefitted from protection.

In consequence of the directors' egregious failure to perform their duty, the Court made an award of damages against them in an amount of US\$111 million, representing the minimum amount of the Fund's loss occasioned by the irrecoverable redemption payments made by the Fund during the extended period of its trading on the basis of falsely inflated net asset value calculations.

Directors' duties

The case against the directors was that they acted in breach of their duty to exercise

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independent judgement, reasonable care, skill and diligence and to act in the interests of the Fund.

The Judgment encapsulates a neat narrative on the duties owed by directors to their companies, including their fiduciary duties (even though a breach of these was not contended) to:

- act bona fide in what they consider to be the best interests of the company;
- exercise their powers for the purposes for which they are conferred; and
- not place themselves in a position of conflict between their personal interests and their duty to the company.

The further duties of directors highlighted by the Court, including those which it adopted from English common law and expressed as constituting Cayman Islands law, were:

- to exercise their powers independently, without subordinating these to the will of others, except to the extent that they have properly delegated their powers;
- a continuing duty to acquire and maintain sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties;
- to supervise the discharge of functions which they delegate to others (though, absent any contrary provision in the company's articles of association, directors are entitled to trust to a reasonable extent in the competence and integrity of those to whom they delegate those functions);
- to exercise the reasonable care, skill and diligence that would be exercised by a reasonably diligent person having the general knowledge, skill and experience reasonably to be expected of a person acting in their capacity, and to bring to bear the knowledge, skill and experience which they actually possess;
- to perform a high level supervisory role;
- to act in a professional, businesslike manner.

Directors' duties – a hedge fund overlay

What makes the Judgment as noteworthy as it is, and what has rendered it the talking point that it has become, is the overlay of

the Court's narrative on directors' duties onto a hedge fund context. Commentators have concluded variously as to the impact of the Judgment, and the extent to which it lends credibility to one model of director services provision or other. The only common conclusion is that it represents a serious assault on disengagement with duty and disregard to responsibility, and that the consequences of failing to meet the Court's expectations are, potentially, eye-watering.

Qualified directors

The Court was clear in its acceptance that independent non-executive directors of a Cayman Islands hedge fund would rarely - and are not expected to - have the technical expertise and experience to be able directly to monitor sophisticated investment strategies and trading techniques. But it did not let them off the hook of technical expertise totally: they are expected to bring to bear reasonable care, skill and diligence in the discharge of their function and this will require them to have a proper understanding of the financial results of the fund's investment and trading activity as part of their overall supervisory role.

Thus qualifications would not be enough to validate the appointment of a director to the board of a hedge fund in the Cayman Islands, but the person would also need to demonstrate capacity to understand the trading context of the fund and be able to apply their expertise and understanding to the delegation and active supervision of functions which they outsource or delegate.

Delegation of responsibility

Whilst established case law tolerates and concedes the necessity of the delegation to and division among third parties of function and responsibility by directors, this must be proper in degree and must not constitute a dereliction of function or an abrogation of responsibility. Furthermore, directors are expected to remain robust and not to be dominated or used by another person, as the Court considered the defendants were in the Weaving case.

Fund structuring and industry standards

The Court indicates that directors of a Cayman Islands hedge fund should satisfy themselves that the fund's overall structure is

BRIEFING

consistent with industry standards, as well as that the terms of contracts between the fund and its service providers, in particular those relating to the valuation of the fund's assets, remuneration and limitation on the liability of service providers, are reasonable and consistent with industry standards.

The last part of this conclusion sits uncomfortably for its implication that there is an industry standard to which all hedge funds adhere in their structures and terms of engagement with counterparties, and accordingly should be interpreted with care as to perpetuate a standard does not necessarily correlate with acting in the best interests of the fund.

Offering documents

The Court notes its expectation that directors should ensure not only that a proper description of the fund's strategy, investment criteria and restrictions appears in its offering documentation, but also that they should safeguard adherence by the fund and its service providers to them. In addition to these common law duties, statute brings obligations for directors of funds which are regulated by the Cayman Islands Monetary Authority: the Mutual Funds Law requires that funds' offering documents describe the rights attaching to participating interests which will be issued to investors and that they contain all such other information as is necessary to enable a prospective investor to make an informed investment decision.

As the directors are responsible for the fund's offering documents and will be liable in default of this responsibility, the Court encourages a verification exercise to be conducted by appropriate people with the purpose of establishing that offering documents are accurate and complete. Although the Court concedes that the independent directors would not need to conduct the verification exercise themselves, they will need to make enquiry of lawyers or other service providers who have co-ordinated the work so as to gain a proper understanding of what has been done and with what result.

An ancillary benefit of a close engagement by directors with the preparation and verification of the fund's offering documents is that it will

aid their understanding of the trading strategy of the fund as well as its operational structure and the interplay between service providers.

Ongoing monitoring and supervision

Once a fund has commenced trading, directors are to satisfy themselves that the offering documents – which have ongoing disclosure value and could carry corresponding liability – remain accurate statements of the fund's business operations.

The supervisory duties discussed above will continue to be required of directors, and if it is proposed that this be conducted principally by way of board meetings, then the Court will expect:

- an agenda to be prepared and circulated in advance of each meeting, reflecting input from the investment manager, the administrator and the directors themselves, specifying the matters for discussion, the reports to be presented and the individual officers of the investment manager and administrator who will participate at the meeting;
- the directors to have reviewed the fund's most recent management accounts at each board meeting;
- a representative of the administrator to attend, at least occasionally, for the purpose of reviewing the Fund's management accounts with the directors;
- the directors to ensure that someone who understands the fund's investment criteria is performing a proper analysis to ensure that the fund's investment activities are compliant with it; and
- minutes to be taken at each meeting which fairly and accurately record the matters which were considered during the meeting and the decisions which were made (including as to the reasons for the decisions being so made), and for these to be approved and signed by the chairman of the meeting.

Conclusion

The Judgment has introduced some helpful clarity as to certain minimum standards that are to be required of independent, non-executive directors of Cayman Islands open-ended funds, though the guidelines

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should not be viewed as anything other than a starting point: they are neither exhaustive nor as inflexible as the drafting of the Judgment would imply.

All funds are different and the application of the Weaving guidelines should thus differ from fund to fund and over time. Directors should be warned that even the most slavish compliance with the letter of the guidelines would not bestow upon them a bullet-proof protection from judicial criticism for failures of **duty on** other fronts.

Mourant Ozannes Partner, Shaun Folpp, acts for the liquidators of the Fund, and acted for the Fund in the proceedings against the Directors.

Contacts:

Robert Duggan, Partner, Cayman Islands
Based in the London office
+44 20 7796 7622
robert.duggan@mourantozannes.com

Nicholas Fox, Managing Associate, Cayman Islands
+1 345 814 9268
nicholas.fox@mourantozannes.com

Shaun Folpp, Partner, BVI
+1 284 852 1777
shaun.folpp@mourantozannes.com

Paul Christopher, Managing Partner, Hong Kong
+852 3995 5701
paul.christopher@mourantozannes.com