

Funds Hotline

March 31, 2015

RIISING STANDARDS OF FUND GOVERNANCE: FUND DIRECTORS BEWARE

- The Cayman Islands Court of Appeal has set-aside the order of Cayman Islands Grand Court in the case of *Weaving Macro Fixed Income Fund Ltd. (in Liquidation) vs. The Stefan Peterson & Hanks Ekstrom* whereby the Court of Appeals while concurring with the Grand Court that the Directors indeed acted negligently, held that there was no element of 'willful' negligence or 'default' on part of the Directors.
- Consequently, the Ruling against the Directors for damages of USD 111 million each was set-aside and the Directors were allowed to claim indemnity and exculpation from liability provided in the Fund's articles of association.

The 2011 ruling given by the Grand Court of Cayman Islands in the case of *Weaving Macro Fixed Income Fund Limited ("Fund") v. Stefan Peterson and Hans Ekstrom ("Ruling")*¹ had laid down certain stringent standards for directors' role in funds. The Ruling has now been set-aside by the Cayman Islands Court of Appeal's by its judgment dated February 12, 2015.²

The Court of Appeals has held that while the directors of the Fund ("**Directors**") acted negligently, there was no element of 'willful' negligence or default on their part. Therefore, the Directors are entitled to indemnity from the Fund, as provided under the Fund documents.

BACKGROUND

As a matter of brief background, the Fund was a Cayman Islands based hedge fund. The Fund appointed an investment manager to '*manage the affairs of the Fund subject to the overall supervision of the Directors*'; and a professional administrator to conduct the accounting functions of the Fund (including maintenance of books and accounts of the administrator), as is the case with almost all private equity funds and hedge funds. The Fund went into liquidation when it was discovered that certain assets shown on the Fund's balance sheet were fictitious.

The Grand Court's Ruling

In the Ruling, the Grand Court found evidence that while board meetings were held timely, the meetings largely recorded information that was also present in the communication to fund investors and that the Directors were performing 'administrative functions' in so far as they merely signed the documents that were placed before them.

Based on such factual matrix, the Grand Court held against the Directors for willful neglect in carrying out their duties. It was also observed that based on their inactions, the defendant Directors "did nothing and carried on doing nothing". The measure of loss was determined on the difference between the Fund's actual financial position with that of the hypothetical financial position had the relevant duties been performed by the Directors.

The Grand Court ruled against each of the Directors in the amount of \$111 million. It was also observed, that the comfort from indemnity clauses are for reasonably diligent independent Directors to protect those who make an attempt to perform their duties but fail, not those who made no serious attempt to perform their duties at all. The Grand Court observed that the Directors are bound by a number of common law and fiduciary duties including those to (1) act in good faith in the best interests of the fund; and (2) to exercise independent judgment, reasonable care, skill and diligence when acting in the fund's interests.

THE COURT OF APPEAL'S DECISION

As per the Court of Appeal's ("**Court**") decision,³ the Directors did not perform their supervisory duty to watch over the functions of the investment manager and the administrators and merely participated in administrative activities related to the Fund. However, the Court was not convinced that the Directors purposely or knowingly acted in such breach of their duties. In other words, the Court found 'neglect' but not 'willful neglect' or 'default'.

The Court, while relying on the *City Equitable Case*⁴, observed that in order to establish willful neglect, either of the following elements is required to be satisfied:

- Knowledge of and intention to commit a breach of duty; or
- Reckless carelessness, i.e. the person does not care whether or not his act or omission is a breach of duty.

The Grand Court had relied on (a) above to establish that the Directors were acting negligently with the knowledge and intention to do so. The Court, however, held that the available evidence failed to establish knowledge or intention of the Directors to breach their duties towards the Fund. While the Grand Court did not examine the element under (b) above, the Court observed that the Directors would not fall foul of even (b) above.

The element (b) above requires that the Directors be fully aware of the ambit of their duties to be able to

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act *recklessly* in the breach of such duties without giving due regard to them. In the present case, as the Court observed and held, the Directors were not aware that they are acting in disregard of their duties.

The Court thus held that though the Directors acted negligently, in absence of 'willful' negligence or default, the Directors will be entitled to the indemnity provided to them under the articles of association of the Fund.

CONCLUSION

The principles of corporate governance though an unwritten law, have evolved over a period of time only through corporate laws in some jurisdictions and largely judicial precedents. In times where corporate fraud is quite prevalent, fund managers and directors of funds are commonly expected to make sure that appropriate checks and balances are put in place and the standards of governance are maintained by the funds.

Also, in some cases, where the administrators fill in for the post of directors in a fund, such administrators will have to be mindful of these instances and be vigilant and supervise the actions of the outsourced entities such as accountants, etc. more diligently.

The fund documents generally provide for indemnity of its directors with a carve-out for directors acting in 'willful negligence or default'. Since the element of 'willfulness' is the determining factor, the directors should be extremely cautious about their acts and omissions with respect to the fund.

The principles of fund governance which were laid down in the Ruling by the Grand Court would continue to be applicable to funds generally, as the Court of Appeal has set-aside the Ruling strictly on the basis of facts.

— **Nandini Pathak, Sahil Shah & Nishchal Joshipura**

You can direct your queries or comments to the authors

¹ Cause No. FSD 113 of 2010 (AJJ)

² CICA Judgment, February 12, 2015, On appeal from the Grand Court Financial Services Division (Cause No. 113 of 2010 AJJ), *available at* <http://clients.squareeye.net/uploads/fountain/Weaving%20CICA%20judgment%20-%2012%202%202015.pdf>

³ *Supra*, note 2.

⁴ [1925] Ch 407

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