BRIEFING

WARNING TO INVESTMENT FUND DIRECTORS – CAYMAN DIRECTORS FOUND PERSONALLY LIABLE FOR $111M EACH

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INTRODUCTION

In *Weavering Limited v Peterson and Ekstrom*, the Grand Court of the Cayman Islands found that two directors of a failed hedge fund had '*consciously chose*[n] *not to perform their duties*' as directors, ordering them to pay $111m each in damages to the fund's liquidators as a result of the losses flowing from the '*wilful neglect*' which they had displayed.

The case is the first in which directors of a Cayman investment fund have been made personally liable for corporate losses; when combined with the eye-watering damages awarded it represents a game-changing shift in the enforcement of directors' responsibilities and deserves the close attention of the whole of the CI financial services sector.

FACTS

In April 2003 the Weavering Macro Fixed Income Fund Limited ("the Fund") was incorporated in the Cayman Islands as an open ended investment company with a share listing on the Irish Stock Exchange ('ISE'). The Fund was subject to Cayman law and the ISE's *Code of Listing Requirements and Procedures for Investment Funds*. The investment manager was Weavering Capital (UK) Limited, which was indirectly owned and controlled by Magnus Peterson, a former head of global trading at Swedish bank SEB.

In March 2009 the Fund went into liquidation after it emerged that $637m out of the $639m being actively traded was held in a single position with another Weavering vehicle (based in the BVI), also controlled by Magnus Peterson. This was in breach of the Fund's investment criteria; further, the assets available to the second fund were very much less than the redemption value of the trade.

The management structure employed by the Fund was entirely conventional, except for the composition of its board of directors. The ISE Code required the appointment of two independents to the board: Mr Peterson selected his younger brother, Stefan Peterson, and their 79 year old stepfather, Hans Ekstrom. Both had significant relevant experience and satisfied (on paper) the ISE's independence requirements.

The Fund was established as a limited company; under the articles of association directors were fully indemnified so far as corporate losses were concerned, except where losses arose as a result of a director's '*wilful neglect or default*.'

The Court heard that Peterson and Ekstrom '*went through the motions of appearing to hold regular quarterly board meetings but, in reality, did nothing in that these meetings served no purpose other than recording of information that was in large part apparent from the monthly statements sent to investors,'* and that they '*provided an "administrative service" in that they signed documents or took responsibility for documents when asked to do so by Magnus Peterson without making any enquiry or attempt to understand their content.*'

FINDINGS

Breach of duty by directors

The case was heard by Mr Justice Jones QC. He found that Peterson and Ekstrom had wilfully neglected their duties as directors or defaulted in their discharge of them. The test for '*wilful neglect or default*' has two limbs:

Knowing or intentional breach of duty; or

Acting recklessly, not caring whether or not the act or omission is a breach of duty.

Both men were found to be in breach of the first limb in that, being conscious of the existence of a duty to supervise the Fund's affairs, they '*did nothing, and carried on doing nothing for almost six years'.* They had failed to discharge their duties by '*signing whatever documents were put in front of them without reading them, or, if they did read them, without applying their minds to their content.*'

Consequences

The court found that, had the directors discharged their duties correctly, the Fund's perilous financial position and breach of its own investment criteria would have been identified by the board, and the Fund put into liquidation at a much earlier stage. The net losses flowing from this failure were assessed by the court to be not less than $111m, and damages were awarded against each defendant in that sum.

COMMENT

This case should act as a wake-up call to companies and directors across the financial services sector: where wilful negligence is shown, directors will not be protected from the consequences by indemnities or other legal instruments. The judgement gives clear examples of the sort of negligence which may lead to such a finding being made. In particular, the court held that:

Directors in post when a fund is being established must satisfy themselves that the fund's investment manager and administrator properly understand their respective roles, that responsibility is appropriately divided between the two, and that the scope of their own supervisory

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role as directors is clearly understood by all others concerned;

When satisfying themselves as to the above matters, directors cannot absolve themselves of personal responsibility simply because the articles of association, investment manager administrator and auditor contracts, and share offer documentation have been prepared by professional advisers – '*the lawyers' duty to their client is quite different from that of the directors' duty to the company... it is* [the directors'] *duty to stand back, review the various contracts and satisfy themselves that each one is appropriate and consistent with industry standards.*';

It is the duty of directors to perform a '*high level supervisory role*' in a '*professional, businesslike manner.*' In discharging this function, directors must '*acquire and maintain a sufficient knowledge and understanding of the company's business,*' and make active enquiries concerning the financial affairs and administration of a company. Where there is no evidence that directors have ever requested reports from company officers, agents or service providers, or sight of periodic management accounts, a court will be slow to infer that directors were providing the active supervision which their duties require;

Directors have an on-going duty to satisfy themselves that a fund's investment manager is operating within the investment criteria and restrictions set out by its offering memorandum and/or the requirements of the exchange on which it is listed;

It is a cardinal responsibility of the directors to ensure that the minutes of board meetings accurately summarise the discussion that takes place so that the basis on which decisions have been taken can be understood.

The judgement sends a strong signal that the judiciary of the Cayman Islands will not tolerate directors who have been found to be sleeping on the job. Those in such a position should read the judgement, and make careful note of its contents.

For information on the Governance and Fund Advisory Services at Stephen Platt & Associates LLP contact Stephen Platt or Richard Smerdon.