

Cayman Directors Blog Series: responding to fraud or alleged fraud in your fund

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Fraud is rare, but it happens; and when it does it is likely to be as unexpected as it is unwelcome. Therefore, it is important for directors to be fully prepared to respond to an allegation of fraud quickly and effectively.

Fraud can arise in a number of scenarios in the fund context – including within the underlying portfolio of investments, or amongst service providers to the fund. Below are our top tips to help manage such situations.

Fraud / alleged fraud in the fund's underlying portfolio

Seek advice – it is crucial to seek advice at an early stage so that we can assist you in formulating an effective and proportionate strategy to deal with any allegations and the consequences. The priorities will be to prevent further losses, avoid a "run on the bank", and ensure that each investor is treated fairly.

Crystallise each investor's exposure - where the fraud or alleged fraud has occurred in an underlying asset, you would look to isolate that asset and crystallise each investor's exposure. This can enable you to avoid wholesale suspension whilst buying time to investigate. Depending on the terms of the fund documents this can be effected by way of side pocket, a liquidating trust, liquidating account or liquidating special purpose vehicle or potentially a capitalisation and bonus share issuance.

Document each decision - once a fraud has been identified or is suspected each step needs to be documented, including the rationale and decision making process lying behind it, with a conscious appreciation that all actions (and any omissions) taken in response to the fraud may later be scrutinised by a liquidator and/the court.

Fraud / alleged fraud perpetrated by the Investment Manager

As above – seek advice, and seek it early.

Suspension - we would look to the Articles for three key powers:

1. the ability to suspend redemptions and subscriptions
2. the ability to suspend calculation of NAV
3. the ability to delay payment of redemption proceeds

If these are present then we look at the circumstances prescribed by the offering memorandum when such powers may be employed to ensure that the facts qualify.

If the decision is taken to suspend, then it is imperative that the resolutions to do so make clear what you are suspending and why. Notice must then be provided to investors as soon as practicable.

Indefinite suspension leaves the fund exposed to shareholder or creditor action. Indeed, whilst some funds have recovered from a suspension, that is the exception - suspension tends to be the first step on the road to liquidation.

Resignation

We usually advise directors against resigning upon discovery of a fraud, for four principal reasons. First, resigning will not preclude claims being brought against you if claims are brought against the rest of the board. Second, resigning will make it harder to enforce any indemnification right you might have. Third, staying on the board during a time of crisis may well enhance your reputation in the market. Fourth, remaining on the board allows you to influence strategy and the choice of liquidator, should one have to be appointed.

Consider the continued engagement of the manager

You will need to investigate urgently and consider appointing a forensic accountant to review the investment manager's actions and, depending on their initial findings, consider taking steps to appoint someone to take over provisional management of the assets. Consideration will need to be given to the terms of the fund documents as to the power to terminate the IMA, the ancillary consequences of such a step – including a review of side letter terms.

Conclusion

In summary, seek advice, stay on board and consider with counsel the powers under the fund documents to take action to protect the assets and the fund.

Where the allegation relates to the fund internally, consider suspension and the appointment of

a forensic accountant to investigate without delay.

Finally, document, document, document.

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