Weavering Litigation - Cayman Hedge Fund Directors' Duties and Indemnity/Exculpation Clauses...

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On 12 February 2015, the Cayman Islands Court of Appeal issued its much anticipated decision in *Weavering Macro Fixed Income Fund Limited (In liquidation)* (the "**Fund**") *vs Stefan Peterson and Hans Ekstrom* (the "**Directors**"). The appellate Court's decision - which held that the Directors had not acted with wilful neglect or default - now stands as the leading Cayman Islands authority on the high-level supervisory duties of Cayman investment fund directors, and on the meaning and effect of 'wilful neglect or default' in the context of exculpation and indemnity provisions.

1. Summary

The Fund collapsed in 2009 following the discovery that the majority of its recorded assets (being US$625m of interest rate swap positions held with a single connected counterparty, Weavering Capital Fund Limited) were in fact fictitious. Following the Fund entering into official liquidation in 2009, liquidators brought proceedings in the Grand Court of the Cayman Islands alleging that the Directors had acted in 'wiful neglect or default' of their high-level duty as independent non-executive directors to supervise the Fund's affairs. The liquidators argued that had the Directors not so acted, the fictitious nature of the Fund's assets would have been identified sooner and the Fund would not have made redemptions on the basis of grossly inflated NAVs; those redemptions caused the Fund to make at least US$111m in over payments.

The Court of Appeal overturned the decision of the Grand Court, by holding that the evidence at trial did not satisfy either of the two limbs of the legal test for "wilful default or neglect". The Directors could therefore rely on an exculpation provision contained in the Fund's Articles of Association and thereby defeated the liquidators' claim.

The decision is now being appealed to the Privy Council.

2. Background

The Fund's Structure

The Fund's structure was not unusual. The Fund was incorporated as a Cayman Islands exempted company to carry on business as an open-ended investment fund, with shares admitted to listing on the Irish Stock Exchange. Mr Stefan Peterson and Mr Ekstrom were the Fund's sole directors. PNC Global Investment Servicing (Europe) Limited was the Fund's appointed Administrator and PNC International Bank Limited was its custodian. The Fund's appointed auditors were Ernst & Young. The Fund also appointed an Investment Manager: Weavering Capital Management Ltd (the "**Investment Manager**"). One notable and unusual feature, however, was that the Investment Manager's director and chief executive officer, Mr Magnus Peterson, had close familial relations with the Fund's Directors: he was the elder brother of one (Mr Stefan Peterson) and the step-son of the other (Mr Ekstrom).

The Fund's Articles of Association provided that:

- subject to the usual provisos, the business of the Fund should be managed by the Directors who might exercise all powers of the Fund;
- the Directors had the power to appoint any person to act as Manager of the Fund's affairs, and
- the Directors had the ability to "entrust to and confer upon the Manager any of the functions, duties, powers and discretions exercisable by them as Directors upon such terms and conditions … and with such powers of delegation and such restrictions as they think fit".

Article 182 contained the provisions on indemnity and exculpation which proved pivotal in the case: "Every Director, agent or officer of the [Fund] shall be indemnified out of the assets of the [Fund] against any liability incurred by him as a result of any act or failure to act in carrying out his functions other than such liability (if any) that he may incur by his own willful neglect or default. *No such Director*, agent or officer *shall be liable* to the [Fund] for any loss or damage in carrying out his functions *unless that liability arises through the willful neglect or default of such Director*, agent or officer." (emphasis added).

The Fund's Investments

The Offering Memorandum reflected the Irish Stock Exchange Listing Rule requirement that no more than 20% of the value of the Gross Assets of the Fund was to be lent to or invested in the securities of any one issuer or is exposed to the creditworthiness or solvency of any one counterparty. Despite this, during the period 2005 to 2008, the Fund purportedly entered into 30 Interest Rate Swap contracts (or "**IRS contracts**") with Weavering Capital Fund Limited, a related party incorporated in BVI with no external administrator, and in which Mr Magnus Peterson held a majority interest. These IRS contracts were not traded on public exchange but were "over the

counter" transactions. The reported combined value of the IRS contracts rose from US$2.6 million in February 2005 to US$637.1 million in February 2009.

The Judge held that it should have been apparent from the Quarterly Reports provided to the Directors by the Administrator that the 20% investment restriction was being ignored, and noted, in reference to evidence from the liquidators, that the IRS contracts constituted 61.44% of reported gross assets as at 31 December 2007. That was three times the 20% limit for single counterparty exposure.

In the event, Weavering Capital Fund Limited had no meaningful assets to satisfy its liabilities to the Fund under the IRS contracts, resulting in catastrophic losses [1] for the Fund. The Fund's losses were compounded by redemption payments made to shareholders after November 2008, which, the Judge found, would not otherwise have been paid had the true state of the Fund's affairs been known.

3. Decision of the Grand Court of the Cayman Islands [2]

In holding the Directors liable to pay damages of US$111m, the Grand Court found that the Directors had negligently failed to detect that the counterparty to substantial interest rate swap agreements was a related party, and therefore that the swap agreements were effectively worthless; significantly, it was found that the Directors' neglect was 'wilful':

The Judge's (largely obiter) comments regarding directors' duties and the steps to be taken to discharge those duties in a Cayman investment fund context were of particular note. Of principal significance was the Judge's statement of the high-level supervisory duty that directors of Cayman investment funds owed, and the practical and somewhat prescriptive steps required to discharge that duty.

The Judge based his decision on his finding of fact that i) the Directors ought to have discovered, in early November 2008, that the counterparty to the IRS contracts was Weavering Capital Fund Limited ("**WCF**"); and ii) that had the Directors discovered in early November 2008 that WCF was the counterparty to those IRS contracts, they would have appreciated that the Company was seriously insolvent and should be put into immediate liquidation (the "Factual Findings").

The Judge described the case against the Directors as having been put "fairly and squarely under the first limb" of the City Equitable test, namely that a director will not be liable for breach of duty unless *he knows that he is committing, and intends to commit, a breach of his duty*.

The Judge concluded that "If the evidence establishes that directors have completely and utterly ignored their duty and made no serious attempt to perform their duty, in spite of being conscious of a duty to supervise, as I think it does in this case, then their default must be regarded as wilful. The purpose and intended effect of Article 182 is to protect directors who do their incompetent

best. Those who *attempt* to perform their duty, but fail as a result of their carelessness, no matter how gross, are relieved from liability. Those who have an appreciation of their duty, but make no attempt, or at least no serious attempt to perform the duty are not relieved from liability."

The Judge considered that "the evidence in this case leads, unequivocally, to the conclusion that both of these Directors are guilty of wilful neglect or default because they consciously chose not to perform their duties to the Fund, or least not in any meaningful way. The evidence clearly points to the conclusion that they both subordinated themselves to Magnus Peterson's wishes. They were motivated by a desire to keep him happy by going through the motions of appearing to act as independent directors of his investment fund. If they had applied their minds for a moment, they would have appreciated that their behaviour was wrong." Not so according to the Court of Appeal.

4. Decision of Cayman Islands Court of Appeal

In a detailed, 78 page ruling (in which Sir John Chadwick, the President of the Court of Appeal gave the leading judgment, and with whom Sir Anthony Campbell and Dr Abdulai Conteh JJAs concurred), the Cayman Islands Court of Appeal carefully considered and clarified the necessary ingredients for a finding of wilful default. They did so in the context of three issues:

1. Were the Directors in breach of duty in failing to discover, in early November 2008, that WCF was the counter-party to the IRS Contracts?
2. Was the failure of each of the Directors to discover, no later than early November 2008, that the counterparty to the IRS Contracts was WCF the result of his own wilful neglect or default within the first limb of Mr Justice Romer's test in the *City Equitable* case [3] (as the Judge found)?
3. Whether the Judge ought to have held that the failure of each of the Directors to discover (as and when they should have done) that the counterparty to the IRS contracts was WCF arose as a result of his own wilful neglect or default within that second limb of Mr Justice Romer's test in the *City Equitable* case?

Issue One – Breach of Duty

Agreeing with the first instance decision, the Court of Appeal concluded that the Directors were plainly in breach of duty in failing to discover, in early November 2008, that WCF was the counter-party to the IRS contracts for the following reasons:

- The duties of the Directors to the Fund included a "high-level" supervisory duty in relation to the performance by the service providers – including, in particular, the Investment Manager – of the functions which had been delegated to them.
- That high-level supervisory duty required (at the least) that the Directors took the necessary

steps to meet the objectives which they had set themselves when the Fund was established. The Directors acknowledged that it was "essential that the investment manager acts within the guidelines and investment restrictions set by the Board.

- The only independent source from which the Directors sought to satisfy themselves that the investment manager was acting within the guidelines and investment restrictions which they had set were the quarterly reports received from the Administrator.
- It was impossible to read the Q3 2008 Final Report (however cursorily) without noticing the statement " *The Interest Rate Swap positions are priced from the counterparty which is Weavering Capital Fund Limited*".
- A director who did notice that text would know that he could rely (at least not without enquiry of the Administrator) on the statement that "There have been no pricing errors on this fund" as confirmation from the Administrator that here had been no breach of the investment restrictions. This was because: i) the aggregate value of the IRS contracts indicated a breach of the restriction against investment which exposed in excess of 20% of the Gross Assets of the Fund to the creditworthiness or solvency of any one counterparty, ii) that there was no basis for the view that WCF was a major bank, and ii) the name " *Weavering Capital Fund*" itself suggested that there was some association between the Fund and the counterparty.
- In failing to read the relevant text in the circumstances, the Directors failed to exercise the degree of care and skill which the law requires of them.

Issue Two – Wilful Neglect or Default (limb one of the *City Equitable* test)

It was accepted by all as a consequence of the exculpation and indemnity provisions contained in Article 182 of the Articles, that for the Directors to be liable for any loss or damage suffered by the Fund as result of the manner in which they carried out their functions, it was necessary for the liquidators to establish that such loss or damage arose through the Directors' "wilful default or neglect".

The Court of Appeal did not part with the first instance Judge in relation to the formulation and meaning of limb one of the *City Equitable* test, namely that a director will **not** be liable for breach of duty unless he knows that *he is committing, and intends to commit, a breach of his duty*. The Court of Appeal also refused to accept the Directors' contention that the Judge fell into error in failing to appreciate the stringent requirements of the applicable test.

The Court of Appeal regarded it as clear, on the authorities that in order to establish "wilful neglect or default" it is necessary (at least under the first limb of the *City Equitable* test) for the Fund to prove to the satisfaction of the court that the director made a *deliberate and conscious decision* to act or to fail to act in knowing breach of his duty: negligence, however gross, is not

enough. Adopting Sir Robin Auld in Spread Trustee Company Limited v Hutcheson [2011] UKPC 13, the Court of Appeal regarded wilful neglect and default as "*the antithesis of negligence or an inadvertent falling short of a duty to take reasonable care*". The Court of Appeal considered that the Judge did appreciate that limb one of the *City Equitable* test required that, before holding the either of the Directors liable, he must be satisfied that, in failing to read the Q3 2008 Quarterly Report with sufficient care to satisfy himself that there had been no breach of the investment restrictions, the Director made a deliberate and conscious decision to act or fail to act in knowing breach of his duty.

Where the Court of Appeal took issue with the Judge, however, was in his failure to properly evaluate the evidence against those requirements. The Court agreed with the Directors' contention that it was not open to the Judge to draw the inference that the Directors had each consciously chosen, generally, not to perform their duties to the Fund. According to the Court, the evidential foundation for the Judge's ruling was lacking: it was not established on the findings of fact which the Judge made, namely, that the Directors' failure to read the Q3 2008 Quarterly Report with sufficient care to satisfy himself that the counterparty to the IRS contract was WCF was the result of wilful neglect or default (within the first limb of the *City Equitable* test).

Issue Three – Wilful Neglect or Default (limb two of the *City Equitable* test)

As mentioned, the Judge did not find it necessary to rule on whether a company which sought to establish the liability of a director under the second limb of the *City Equitable* test (i.e. being "recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty") needed to satisfy the court that the director appreciated that his or her conduct might be a breach of duty and made a conscious decision that, nevertheless, he or she would do (or omit to do) the act complained of without regard to the consequences. Given the Court of Appeal's ruling on Issue Two, the meaning of limb two of Romer J's test in *City Equitable* became key.

In this regard, the President of the Court of Appeal concluded that "…it is I think, clear that, when [Romer J] referred in his formulation of the test of a director who "*is recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty*", he did not intend to suggest that if, a director who did not (at the least) suspect that his conduct might constitute a breach of duty would be in "wilful neglect or default". Absence such an appreciation, it is not appropriate to characterise a breach of duty as "wilful neglect or default".

The Court ruled that the case against the Directors found no support in the evidence that they had the requisite conscious appreciation that they might be breaching their duty to read the Q3 2008 Quarterly Report with sufficient care to discover that the counterparty to the IRS contracts was WCF. The Court noted that whilst the conduct of the Directors in not reading the Q3 2008 Report was consistent with the Judge's conclusion that neither of the Directors ever intended to perform

his duties, it was equally consistent with an understanding on the part of the Directors as to what the high-level supervisory duty required which differed from that of the Judge; and equally consistent with negligence or gross negligence in the performance of whatever the Directors believed the high level supervisory duty required of them. Accordingly, the Court found the Judge erred: he was not entitled to draw the inference that he did as the basis for holding the Directors liable for "wilful neglect or default".

5. Significance of Decision

The Court's decision will be of interest to a number of stakeholders in the Cayman fund industry.

Directors

Duties

The Court of Appeal's decision did not take issue with the *type* of duties which the Judge found the Directors owed at first instance (a judgment which spurred various regulatory developments, including the Cayman Islands Monetary Authority's Statement of Guidance on Corporate Governance for Regulated Mutual Funds issued in December 2013). However, the Court will regard the scope of the duties of a director as inherently situation specific, particularly where the Court is concerned with the so called "high-level duty to supervise". In this regard, it must always be remembered that professional directors are required to perform their duties to a level of skill and care commensurate with their particular knowledge and skill set. Therefore, were a *professional* independent director to approach their duties in the same way as these Directors, a Court may be significantly more circumspect in making a finding that they had not been aware that they were breaching their duties.

Exculpation and Indemnity Clauses

Unlike the statutory regulation of exculpation and indemnity clauses for directors found in the Companies Act 2006 in England for example, Cayman Islands law has no statutory proscriptions as to the type of conduct which can be carved out from suit. The effectiveness of such clauses has been left to develop at common law. In short, all types of liability of a director except wilful default or neglect, or fraud (i.e. 'actual fraud' or 'equitable fraud')[4] may be excluded either expressly or by implication by what has been described as a fiduciary's "irreducible core obligations".

The Court of Appeal's decision will be welcomed by directors (and their insurers) as providing further comfort as to the scope and effect of such clauses. Exculpation and indemnities for conduct other than 'wilful neglect of default' or fraud, as considered by the Court of Appeal, means that in all but the narrowest of circumstances will directors find themselves exposed to liability in the discharge of their directors' duties.

Investment Managers/Administrators/Auditors

Other investment fund professional service providers, such as investment managers, investment advisers, administrators, custodians and auditors (and their insurers) will also take comfort from the construction of language which is often found in the indemnity and exculpations clauses of their service agreements.

One note of caution as to the breadth of the decision. In recent years, many funds are being set up with Articles of Association and service agreements which carve out *gross negligence* from any indemnification and exculpation terms. Whilst the Court of Appeal seemed to accept that the conduct of the Directors amounted to 'gross negligence', such were the Articles of the Fund that this was not actually in issue. Accordingly, directors and service providers involved in litigation where a finding of 'gross negligence' is the touchstone of liability should be wary about the amount of reliance placed on this decision.

Liquidators/Investors suing derivatively

Clearly, investors or liquidators looking to challenge the conduct of fund directors and fund professional service providers now face the unattractive prospect of a greater legal and evidential burden than they might have understood before the Court of Appeal's decision. The need to adduce clear evidence that a director (at the very least) appreciated that his conduct might be a breach of duty will be critical; simply relying on an adverse inference from action or inaction (when other inferences, equally credible may be drawn), no matter how grossly negligent that action or inaction, will be insufficient to succeed against a defendant protected by an effective "wilful default or neglect' indemnity and/or exculpation clause.

Cayman Island Policymakers

The question which this decision now poses for Cayman's policymakers is whether the Cayman investment fund industry is well served by allowing such conduct to be carried out by fiduciaries without legal recourse to recompense those stakeholders adversely affected. Short of deliberate misconduct and clear evidence showing that the director appreciated his conduct might be a breach of duty, and that he made a conscious decision to proceed with that conduct without caring if it was a breach, plaintiffs, including liquidators, look set to struggle. Whatever the outcome of the appeal to the Privy Council, the case brings into stark focus the significance of these exculpation and indemnity provisions which are to be found across an investment fund's constitutional and service provider documentation. Institutional hedge fund investors will be well advised to subject them to greater scrutiny and negotiation in the future if they are to shift the allocation of legal risk.

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