Claims against Custodians, Investment Managers and Investment Advisers

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Funds becoming “distressed” (as it is so elegantly described) and the potential knock on effects for service providers to those funds are by no means new phenomena. In fact, typically, the types of claims that might be brought against service providers are more likely to arise when a fund becomes distressed - the facts underlying such claims can be as much the cause as the effect of the “distress”.

Whilst we have not yet seen fund collapses on a dramatic scale being played out in the Jersey Court to compare with, for example, the United States, the Cayman Islands and the British Virgin Islands, that is not to say that such a situation will not arise, either with its centre in Jersey, or elsewhere but which could have a direct impact for Jersey funds and service providers. There is a tendency in the funds business for those running funds to avoid resort to the Courts - the reasons for that might be many: a desire to be pragmatic given the fluctuation in asset values; possibly a closeness to the potential target; the desire to avoid public washing of laundry and potentially make precedents (albeit arbitration could avoid both if of real concern).

These notes will outline some of the practical and legal issues to be considered in relation to claims against custodians, investment advisors and investment managers. Such claims will invariably be based in contract. Clearly, no two contracts and circumstances pertaining to them are identical and, therefore, any guide can only realistically be based on broad principles, although certain examples are cited to demonstrate the nature and focus of actions against service providers (particularly in other jurisdictions). The typical matrix of relationships in a fund structure will also very much depend on the fund model that is under consideration.

Typical roles: Custodian, Investment Adviser, Investment

Manager

The respective roles and typical contractual arrangements between funds and their service providers (depending upon the fund model) will be broadly familiar. However, in order to provide context for the matters addressed in these notes in terms of the manner in which claims might arise and potential areas of liability, below is a list of the typical features of the arrangements between funds and their service providers:

Investment management agreement

Custodian agreement

Investment advisory agreement

Potential claims

Whatever the scenario (e.g. a corporate fund acting through its board of directors, or perhaps more likely a liquidator, is seeking to recover losses suffered by a fund from a service provider) the starting point is to consider the nature of the relationship and extent and meaning of the obligations. The legal principles addressed below (unless otherwise stated) are those arising under Jersey law.

Which law applies and where will any claim be litigated?

The first question after identifying the likely target for a claim is to consider which law will apply to any dispute. Whilst the presence of onshore and offshore funds and providers gives scope for a range of different laws applying to different any given dispute, ordinarily identifying the law that is to be applied will be straightforward as the relevant agreement will invariably contain a governing law provision. That becomes more of an issue when claims are being brought in the law of tort (i.e. essentially negligence) rather than under a contract. Factors such as where the tort was committed (i.e. the acts complained of performed) and where the damage was suffered will likely be determinative.

Where and before which court or tribunal a claim will be brought and determined will again very likely be provided for in the agreement under which the action is brought - there will typically be a jurisdiction clause or an arbitration clause.

Who can bring claims against service providers?

There are two main groups of potential candidates, namely: the party with whom the service provider has contracted - typically the fund, (but possibly in the case of the investment adviser, that could be the investment manager); or, alternatively, the party who has ultimately suffered loss - the investors (although their ability to pursue a claim will be limited to claims in negligence/breach of duty which are by no means straightforward legally).

As far as corporate vehicles are concerned, the question of the ability of shareholders to pursue claims against third parties has been considered recently by the Royal Court of Jersey which confirmed that the principle against “reflective loss” is part of Jersey law. The case is Freeman v Ansbacher Trustees Limited which, although a case concerning allegations of breach of trust, is relevant to any consideration of claims involving losses suffered by a company which losses impact on the value of shares held in that company.

First, what does reflective loss mean? In short, it is the company not the shareholder who is the proper claimant for loss suffered to the company - i.e., even though a shareholding has been diminished in value by the loss suffered to the company, the starting point is that such shareholder loss is merely reflective of the loss suffered by the Company. Essentially it is a reaffirmation of the legal concept that a company has legal personality and its assets are its own.

In Freeman there was a Jersey Trust, of which Ansbacher was trustee, holding shares in an underlying company (known as "SDR"). Claims were brought by the beneficiaries for breach of trust to seek to recover loss suffered at the SDR level on land and software deals and for tax. The trustee applied to strike out the claim on various grounds, including on the ground that the beneficiaries were in the same position as shareholders (effectively), and therefore had no locus to bring a claim for losses suffered as a result of the value of the holding in SDR being diminished, because those losses would be reflective of the loss of SDR as a company.

It is easy to see the analogy with an investor/shareholder in a fund seeking to bring a claim directly against an investment manager - arguments deployed by way of defence by the manager would inevitably include (in addition to those suggesting that no duty of care was owed to the investors - the obligations on the manager being contractual and owed to the fund as an entity) one based on the reflective loss principle: i.e. the losses resulting in a diminution in the NAV of the fund and hence a diminished value of each share held by the investor, would be reflective of the loss suffered by the fund (i.e. the actual reduction in the value of assets held by the fund) and therefore it is the fund, not the investor, that has locus to sue.

The starting point is to analyse who has the cause of action. If a duty is owed to a company alone the company will have standing to sue; if a duty were owed to a shareholder alone, the shareholder would have standing. The third permutation is the more difficult one, namely where the duty is owed to both the company and the shareholder and both could sue - in that case the reflective loss principle will preclude the shareholder from suing for diminution in shareholding if that loss is reflective of the loss suffered to the assets of the company.

The rationale for the rule is twofold: – first, it avoids double recovery (by the shareholder and the company) for the same ultimate losses; and, second, it protects creditors because if a single shareholder were to sue successfully, it would get paid but the company's assets as a whole would not be replenished to meet the claims of creditors.

Potential claims: contract

The basic maxim that is the starting point for the Jersey Court's consideration of a contractual dispute is la convention fait la loi des parties - i.e. literally, "the agreement makes the law of the parties", or in other words, the Court will begin with the premise that the parties are bound by what they agreed (on a proper construction of the contract). There is far less legislative intervention in Jersey contract law than there is, for example under English law (e.g. there is no Unfair Contract Terms Act).

The scope of the service provider's obligations, the nature of its duties and the defences it might have will thus depend upon the terms of the contract that it has with the fund. There might well be some implied terms or standards/requirements linked to the extent to which the service provider is regulated (beyond the scope of these notes). However, battle grounds will likely be drawn in respect of the following: how is the contract to be construed - what was the service provider actually obliged to do? What breach of that obligation has occurred? What losses have flowed as a result of that breach? Were those losses reasonably foreseeable and are they not too remote? What is the extent of any exculpation provided in the agreement and what is the hurdle that has to be overcome in that regard?

As noted above, the implication of terms into contracts governed by Jersey law is limited. Jersey law will imply terms in 3 broad circumstances: (a) necessity (where the contract would be absurd, futile or inefficacious - in other words, will not work without the implied term; (b) usage - i.e. the implication of terms that are typical through common usage; and (c) intention - i.e., what the parties were actually agreeing to if not stated on the face of the contract. Obviously, if the agreement in question is governed by a law other than Jersey, there may well be terms implied (possibly based on provisions of law or regulations in that jurisdiction) that could impact on the scope and nature of duties that the service provider might owe to the fund, or the extent to which it can avoid liability for certain acts or omissions.

Contractual claims that might arise against fund service providers include the following:

The relief that might typically be sought include:

Potential claims: Tort

As noted above, claims in tort are less likely to be brought by a fund or liquidator against a service provider on the basis that there will almost invariably be a direct contractual relationship. Jersey law follows English law as regards concurrent liabilities in contract and tort, such that in a case where a general tortious duty will arise as a matter of law even though there is a contract between the parties, the Court is likely to permit the plaintiff to seek the most advantageous remedy available to it, on the basis that the duty of care in tort will apply unless the contract excludes or limits it.

Likely defences: exculpation clauses (fraud, wilful

default or gross negligence)

The primary defence that a service provider will likely raise is that it has the benefit of an exculpation clause limiting its liability to situations where it can be established that it has been guilty of gross negligence, wilful default/misconduct or fraud. A claiming fund has to be alive to the hurdle it has to overcome in order to establish liability and just what is the nature and/or the constituent elements of those concepts.

Evidence of fraud or wilful default might well exist in the context of distressed fund - it is not unheard of at the investment manager level. However, the bar to overcome in evidential terms for a fund to sue a service provider in fraud is a high one.

It was held by the Jersey Court of Appeal in Foster-v-The Attorney General, that to establish criminal fraud it was necessary to show that a defendant deliberately made a false representation with the intention and consequence of causing thereby actual prejudice to someone and actual benefit to himself or another. A representation by a defendant, whether by speech, writing or conduct was necessary to avoid giving unreasonable width and imprecision to the offence. The Court also stated that although potentially prejudicial conduct was reprehensible, it was not fraudulent.

In the case of West-v-Lazard Bros & Co (Jersey) Ltd the Royal Court had to consider what was meant by fraud in the context of an allegation for breach of trust by certain beneficiaries against Lazard Brothers. A particular point in issue was that, for the plaintiffs to succeed, they had to show "fraud", but there was insufficient evidence on the facts for them to prove the matters required under the principles laid down in Foster. The Court was however, prepared to consider whether “fraud” as a concept went beyond the definition in Foster (being of criminal fraud) and whether the claim could be considered by reference to the concept of dol. The Royal Court has given a broad definition of dol by reference to an 18th Century French commentator, Pothier, whose writings (particularly on contract law) are highly authoritative in Jersey and are often cited by the Jersey Courts. The Royal Court has defined dol as every type of "artifice" that one person used to deceive or cheat another. "Artifice" is defined as a contrivance, dodge, trick, strategy, craft or ruse. Dol has also been defined with approval by the Court as cheating, trickery, or machinations intended to outwit trick or deceive another.

The Court in West v Lazard also considered English authorities on “equitable fraud” which is considered to include "conduct which, having regard to some special relationship between the parties concerned, is an unconscionable thing for one to do towards the other". In other words, it goes beyond “unlawful misconduct” and there has to be shown to be “conscious wrongdoing”.

Perhaps the most important decision of the Jersey Courts in the area of exculpation clauses and what amounts to the requisite degree of misconduct for such purposes was in the case of Midland Bank & Trust Company (Jersey) Limited v Federated Pension Services. The case concerned alleged breaches of trust in connection with a pension scheme operated for the benefit of certain employees of the States of Jersey. The central complaint concerned the failure by the trustee of the fund (then, FPS), to place the assets in the fund with a new investment manager in a timely fashion and whether the exculpation clause contained in the trust deed was sufficient to afford a defence to the breach of trust allegations. The Court necessarily had to consider the nature of the trustees' acts and omissions and determine whether the exculpation clause in the deed could be upheld as a matter of law and, if so, how was it to be interpreted. The clause in that case excluded liability "for anything whatever other than breach of trust knowingly and wilfully committed".

The Court of Appeal confirmed that the approach of the Jersey Courts to the construction of exculpation clauses is to construe them narrowly but in the context of the contract as a whole - "clear, unequivocal and unambiguous terms" are required, especially in a trust context where a trustee seeking to rely on such a clause is a paid professional. The party seeking to rely on the clause will bear the burden of showing that a case alleged against it falls within the exclusions, with any ambiguity in the meaning of the words resolved against the person relying on them. Clearly, the position of a trustee will be considered in a more strict light in view of the fiduciary duties owed by a trustee, than would the position of two contracting commercial parties; however, the broad principles are nevertheless instructive and would be the starting point for any fund service provider seeking to rely on an exculpation clause in the face of a claim.

In relation to what amounts to "wilful misconduct", the Court concluded that there had to be an appreciation by the defendant that what it was doing was contrary to its duties. Alternatively, it required recklessness consisting of the defendant shutting its eyes to the probability that its misconduct was in breach of duty. Duties, of course, in the context of the case were those of a trustee (a fiduciary) and not a contracting party.

The Court of Appeal also considered what amounts to "gross negligence", (overruling the findings of the Royal Court). In a much cited passage, Le Quesne J.A. stated (at page 393) after considering a number of cases relied on at first instance:

"In each of [these cases] the approach was to treat 'gross negligence' as meaning 'very great negligence', or flagrant or extreme negligence, or negligence consisting of 'a very marked departure from the standards' of responsible and competent people. In none of them was it suggested that 'gross negligence' involved either 'a certain mens rea' or 'an intentional disregard of danger' or 'recklessness'.

In our judgment, the direction to the Jurats in the present case as to the meaning of 'gross negligence' was erroneous. All that this phrase means is a serious or flagrant degree of negligence. It does not import any question of intentional or reckless fault. ."

Although each case will turn on its facts, the particular circumstances of Midland Bank provide some useful guidance on what could amount to gross negligence. The Court suggested seven elements that together amounted to gross negligence in the context of the facts of the case:

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Given that the concept of gross negligence has not received much further judicial comment since Midland Bank and is, based on that case, measured on the basis of the degree of negligence rather than crossing a threshold into recklessness, it is not possible to set down strict definitions or guidance as matters will be very much dependent on the circumstances of each particular case. Having said that, the above elements could readily be applied to consider whether or not an investment manager or adviser (and possibly custodian) had failed to act to a requisite contractual standard so as to take it outside the scope of a typical exculpation clause.

Proving the case against service providers

Notwithstanding that the service provider will bear the burden of establishing that liability for any particular acts or omissions is caught by an exculpation clause, the primary burden of proving breach and loss will of course be borne by the plaintiff - ie, the fund.

The ability to prove negligence and gross negligence will invariably require expert evidence. Naturally, the discipline of any expert whose evidence is needed will depend upon the nature of the claim. Typically, a claim against a fund manager or adviser for failing to meet the contractual standards of performance provided for in the respective agreement with the fund will require evidence from suitably qualified and experienced professionals from that field.

Typically, for an investment management claim, depending upon the facts and allegations that are made, the expert would need to be competent and suitably qualified to address issues such as: performance levels; benchmarks against which performance would be measured; market movements; market practice; reviews of decisions taken or not taken; due diligence procedures in respect of investments made (especially if into other funds); and fee levels.

Expert evidence can take on a wholly more complicated nature when claims are based upon alleged mis-valuations of fund assets, especially if of an illiquid/derivative nature. Suffice to say that in cases where a fund's portfolio of assets is made up of openly traded investments, assessing the extent to which an investment manager has mis-stated the underlying values to provide an administrator with the necessary data to calculate the NAV of the fund, will be more straightforward than cases where there are securities, asset/mortgage backed investments, particularly over recent times. A stark contradiction to that basic position is provided by claims filed in the fall out from Madoff, in which it allegations have been made (see below) that trading prices in quoted stock were mis-stated in reports to funds investing with Madoff and that it was simply impossible for Madoff to have bought and sold the volume of options necessary to run his split-strike conversion programme.

Deep pockets: auditors, the alternative target

A regular alternative target to service providers should assets of a fund disappear in distressed circumstances, are the auditors of the fund. A detailed analysis of comparative law of audit negligence or even the law of Jersey on the subject is beyond the scope of these notes, but the potential availability of action against an insured auditor might be of crucial importance to a fund, especially if assets have simply disappeared or were never there in the first place and there is no immediately obvious or adequate asset base against which any judgment could be enforced against, for example, an allegedly grossly negligent adviser or manager.

Basic principles of English law as to the scope of the parties to whom an auditor might owe duties in the performance of an audit and production of financial statements have been the subject of a number of significant English judgments over time. The watershed case of Caparo v Dickman which made it significantly more difficult for third parties (i.e. other than the entity being audited) to successfully sue for losses allegedly caused by reliance on audited financial statements, essentially remains good law.

There is, however, an audit negligence case pending before the House of Lords in which judgment is due to be delivered in June 2009. That case is Moore Stephens v Stone & Rolls Ltd in which the so called “very thing” doctrine is being considered. That doctrine holds that the detection of fraud is the very thing that an auditor is engaged to discover through the audit process. The issues in that case centre upon the situation where there has been fraudulent activity by the controlling mind of the company being audited.

The company’s position is that, as one of the “victims” (the other being the Czech bank which paid out on letters of credit that were fraudulently obtained by the company) it should be entitled to recover damages in negligence from the auditors as identifying the fraud that was perpetrated was the “very thing” the auditors were engaged to do; the auditors argue that the company was wholly controlled by the individual fraudster and should be attributed with his knowledge such that the company should not be able to found a negligence claim against the auditors which necessarily involved the company having to rely on what would effectively be its own wrongdoing/illegal conduct.

The Czech bank obtained judgment against the company and the individual and as the company was unable to satisfy the judgment it went into liquidation. The liquidators sued the auditors alleging that they were negligent in failing to detect the frauds. Moore Stephens applied to strike out the claim on the grounds that company's claim arose out of the company's own fraudulent conduct and so was barred by public policy by reason of the so-called “illegality” doctrine. Moore Stephens were unsuccessful at first instance but won in the Court of Appeal.

Whilst it might be said (ignoring Mr Madoff) to be difficult to envisage the circumstances of Stone & Rolls pertaining to an investment fund (i.e. one individual alone having such control over the assets of the fund that his fraud could be attributed to the fund as a company) and from a jurisprudential point of view the decision is sound, the House of Lords' ruling on the appeal will be of great interest. If the Court of Appeal's decision is overturned, many might see that as a policy driven decision by the House of Lords to shift the burden in respect of who should bear ultimate liability for such frauds, back onto the auditors. Whether offshore jurisdictions, where House of Lords' decisions are persuasive but not binding, would develop their own common law along similar lines would remain to be seen. As noted below, there appears to be no holding back in the US with regard to naming auditors in actions brought to recover losses suffered by funds.

Risk and how to reduce it

Clearly risks are present on both sides of the relationship between a fund and its service providers. How to minimise that risk will depend on which side of the negotiating table you are and also the fund model that is adopted in any particular instance. General areas of concern include the following:

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It might well be that tighter regulation in the wake of Madoff and other collapses will address some of the risks by requiring certain higher standards to be met.

Where might it all end - stories from not so far off lands?

By way of contrast to the legal position in Jersey that is described above, with there being little by way of recent or current reported examples of service provider claims in a funds context, it is of note that there are a number of cases that are currently underway in other jurisdictions. Clearly, different legal systems will produce different conditions for claims to be made; accordingly, there is not always a comparative link between the types of claims being litigated in one jurisdiction and those in another. It might be a but for the grace of God matter and even ultimately nothing more than voyeuristic interest, but looking at examples from overseas is certainly informative.

For example:

Conclusion

Noises emanating from Europe, particularly France and Luxembourg in the wake of Madoff and the claims against UBS and HSBC, might sound a worrying note, particularly for custodians. It will remain to be seen whether feared increases in exposure as a result of regulatory changes will come to pass and if so, whether they will have an impact on what if any litigation emerges in Jersey. As things stand, the broad principles on which actions might be brought are well established in Jersey and protagonists will undoubtedly be well placed to act and react. If there are specific claims made it will be very interesting to see how such principles are applied in a funds context and with what result.

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