The Carlyle case and Directors' Duties

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A judgment handed down in September 2017 by the Royal Court of Guernsey cleared the Carlyle Group, Carlyle Investment Management, and TCGH (represented by Simon Davies of Ogier) together with its seven executive and non-executive directors of liability over the collapse of Carlyle Capital Corporation (**CCC**), a Guernsey investment fund that went into insolvency in the wake of the financial crash in 2008. Ogier were instructed by Williams & Connolly LLP of Washington DC.

The Plaintiffs pleaded more than 187 claims against the Defendants, including, *inter alia*, breaches of fiduciary duties and duties of skill and care.

This article will focus on how the Judge dealt with the allegations relating to directors' duties, record-keeping and board minutes.

Background

CCC was an investment fund set up as a Guernsey company which went into insolvency in 2008, losing all of its $1 billion of capital. CCC invested mainly in residential mortgage backed securities (**RMBS**) issued by US government sponsored entities known as Fannie Mae and Freddie Mac. The RMBS purchased by CCC had express guarantees that principal and interest would be paid by the government agencies in the event of any default by the homeowners and also carried the implied guarantee of the US government itself.

The RMBS assets were purchased using one-month repurchase (repo) borrowing. The assets were subject to daily margin calls if prices changed and CCC's investment guidelines stated that CCC should keep a 20% liquidity cushion in cash (or equivalent) to meet foreseeable margin calls should they occur.

The claims were brought by the fund in liquidation and its liquidators against the executive and independent directors of the fund, the investment manager, the promoter of the fund and a Carlyle holding company of the structure.

The central allegation pursued by the Plaintiffs was that the Defendants breached their duties to CCC by failing to insist or recommend that CCC take urgent steps to sell down CCC's RMBS assets, raise additional equity capital or conduct an orderly winding down of CCC from the end of July 2007.

Directors' Duties

The Judge went through the main alleged breaches of duty and the following is a summary of the Judge's findings.

1. *Duty to act in good faith*

The Plaintiffs alleged that the Defendants had acted in breach of the duty to act in good faith.

In terms of the scope of this duty, the Judge noted that "*the central point is ... that a management or governance decision of a director, honestly and responsibly made, amounts to due performance of that director's duty of good faith* [and] *the test for this is subjective.*"

The Judge went on to state that the only objective element of this test can be *"if the relevant decision appears clearly and objectively not to have been in the best interests of the company, this could certainly cast doubt on a director's assertion that he genuinely believed that it was.*"

The Plaintiffs argued that this duty was breached and said the amendment or suspension of CCC's risk management measures in its Investment Guidelines was "plainly" not in CCC's best interests. However, the Judge rejected this contention and held in any event that as a breach of its own, it caused no loss and added nothing to the key complaint of the Plaintiffs.

1. *Duty to exercise own independent judgment*

The Plaintiffs raised this breach of duty particularly in respect of the independent directors. The Plaintiffs alleged that the independent directors were not truly independent, but merely acted as a rubber stamp for decisions made by Carlyle.

The judge accepted that the "*broad principle behind this duty is that the company is entitled to the benefit of an actual and freely arrived at decision or judgement from those who are its directors. A director will therefore breach this duty if he merely does what he is told by others for whatever reasons, or acquiesces without question or consideration in what he is asked to do or told by others."*

The Judge then went on to qualify that *"a duty to exercise an independent judgement does not mean a duty to act entirely alone, nor to act without taking into account any views expressed or even decisions which are made by his fellow director. A director must exercise his own judgement according to his own assessment of the facts but where, for example, a director does not possess a particular expertise but is aware that one of his fellow directors does, there is*

nothing in this duty which obliges the first director either to make a decision without ascertaining the views of the expert director or without having regard to them, or to make himself a sufficient expert in the area that he can assess the opinions of the expert director from a position of expertise."

The Judge held that the directors did exercise independent judgement throughout all decisions made in respect of CCC.

1. *Duty not to act in relation to the affairs of CCC in circumstances where there was an actual or possible conflict between their duties to CCC and their other duties or interests*

The Plaintiffs alleged that there was a conflict between the corporate and reputational interest of Carlyle and the personal financial interests of the Carlyle directors on the one hand, and the interests of CCC on the other.

Here, the parties agreed that this is an objective test. The Judge agreed with the Defendants in holding that "*there is no rule in English law ... that a person may not be a director of more than one company, even if both companies are in competition*."

The Judge held that there was no evidence to support the Plaintiffs' allegations in this regard and that the directors felt no tension between CCC's own interests, which they saw as being survival and recovery, and Carlyle's best interests, which they also saw as being CCC's survival and recovery.

In terms of the personal interests of the directors, the Judge held that she had some difficulty in seeing any real substance, as opposed to theory, in the alleged conflict of interest itself.

1. *Duty of Skill and Care*

The Judge stated that the test for the standard of care is "*that of a reasonably diligent person having both (a) the general knowledge skill and experience that may reasonably be expected of a person carrying out the same functions as those of the relevant director with regard to the company and (b) the actual knowledge skill and experience of that director. ... It is further common ground that this is therefore a combined objective and subjective test, and that the subjective element is capable of raising, but not lowering, the standards to be expected of an individual director.*"

In terms of the subjective element to this test, the Judge said that this "*refers to the particular attributes which a director is expected to bring to the Board for the benefit of the company*".

On the question of breach, the Defendants argued, and the Judge agreed, that "*the test for whether there has been a breach of duty is a high one. It is that a director will be in breach of his duty of skill and care only if the court is satisfied that no reasonably diligent director with the material degree of knowledge, skill and expertise could have acted in the way in which the*

particular defendant director did act. The point is that the court must be satisfied that the decision complained of went beyond a mere error of commercial judgment." (emphasis added).

The Plaintiffs' alleged that CCC's board was "dysfunctional" because they said it did not hold enough board meetings. In response, the Judge held that, "*apart from any legal requirement of an actual meeting either under statute or to comply with the company's articles of association, there is no legal requirement to hold meetings, even though it will be common practice and probably most efficient to do so. Any suggested "rule" that the holding of meetings is part of a director's duty of care (or fiduciary duty) is simply expressing a facet of the directors' duty actively to join and participate in the conduct of the company's affairs as entrusted to its board. Holding meetings is not an end in itself. It is a means to an end, namely the arrival at considered and appropriate decisions on relevant aspects of the conduct of the company's business by those to whose charge it is confided.*"

Board Minutes

Moving on to the issue of board minutes, during cross examination, the Plaintiffs asked a lot of questions about changes made to draft board minutes during the process of getting them finalised and approved. The Judge made some specific comments about the content of board minutes and commenting on draft board minutes:

"*The point of meeting minutes is, obviously, to provide an accurate and sufficient record of the business of the meeting for whatever purpose such record is required, but what that requires as to the minutes themselves can vary hugely, depending on the purpose and function of the body concerned. In addition, styles of minute taking can, in my view quite legitimately, vary enormously, from a detailed record of the entire course of discussion, to the style which records only that discussion took place and what was ultimately resolved. Whilst recording elements of the discussion can provide a helpful record of the ideas and views which were aired, the recording of too much such detail and the attribution of views to individuals can inhibit discussion and become invidious, even in a body which continues in existence with no pressures. When the possibility of later recriminations, or investigation by hostile outsiders, is added into the equation, the laconic style of minute taking, leaving no hostages to fortune, may reasonably appear to be preferable.*"

The Judge went on to say that the only legal requirement as to what is to be recorded in the minutes of Directors' meetings of a Guernsey company at the time was that it should be minutes of "the proceedings" at the meeting which she said would seem to encourage a more succinct style of minuting.

So the requirement in Guernsey is that all formal elements of the business of the meeting (items of business, presentations, proposals, motions, appointments, resolutions etc.) would need to be recorded, but the Judge doubted whether the content of a discussion, as contrasted the fact

that there was discussion, would be within the concept of the “proceedings”.

The Plaintiffs were very critical of the number and types of amendments that were made to draft minutes of the boards – both by the directors present and also their legal advisers. In relation to that the Judge found it quite unsurprising that draft minutes should bear the stamp of having been combed through and amended by lawyers. She also found it unsurprising and not unreasonable that lay persons (whose lawyers, acting on their behalf and examining proposed minutes of meetings) should accept legal advice or guidance as to what is either correct, necessary or appropriate to include in minutes, and that they would therefore tend to accept lawyers’ amendments without demur. The Judge saw no reason why lay persons should not do so, so long as these still appear fairly and reasonably to represent what did occur at the meeting.

Conclusion

The Judge agreed with the Defendants that, "*taking matters as they appeared at the time and without the benefit of hindsight,* [the directors'] *decisions and actions remained perfectly rational, prudent, proper and reasonable, in context. They were an appropriate response to market events as they unfolded and affected CCC, and were properly taken in what each of them believed, on adequate and careful consideration, to be CCC's best interests. Further, not only were the steps taken reasonably perceived to be in CCC's best interests, but on the evidence, they actually were the safest and best course for CCC to adopt in the circumstances.*"

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