

## Carlyle Capital Corporation Limited (in liquidation) and others v William Elias Conway Jr and others

Insights - 24/04/2019

*"However startling the history of [Carlyle Capital Corporation's] short life appears at first sight, its failure was the result of circumstances beyond the control of any board of directors. The Lieutenant Bailiff's view was that the Appellants' claim depended entirely on hindsight, and we agree with her."*

A judgment handed down in April 2019 by the Court of Appeal of Guernsey has upheld the decision at first instance that the directors of Carlyle Capital Corporation Limited (CCC) were not in breach of their duty of skill and care or their fiduciary duty. The judgment further upholds the decision as first instance that CCC's investment manager, Carlyle Investment Management LLC (CIM) was not in breach of its contractual obligations pursuant to an investment management agreement with CCC or its obligations in tort.

The first instance judgment was handed down in September 2017 by the Royal Court of Guernsey. Copies of the Ogier articles produced on the initial judgment are available at [How the £1 billion, seven-year Carlyle case puts Guernsey on the map for funds litigation](#) and [The Carlyle case and Directors' Duties](#). Simon Davies of Ogier (Guernsey) LLP acts for CIM and was instructed by Williams & Connolly LLP of Washington DC.

### 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 provided that CCC should have a 20% liquidity cushion in cash (or equivalent) that could be used to meet foreseeable margin calls should they occur.

The claims at first instance were brought by the fund in liquidation and its liquidators against the executive and independent directors of the fund, CIM as 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.

Although this allegation was rejected by the Royal Court at first instance, the Plaintiffs alleged on appeal that the Lieutenant Bailiff had misunderstood and overemphasized the risks of selling RMBS such that, when properly understood, the only reasonable response to the crisis was to sell RMBS starting in October 2007 (the Plaintiffs having abandoned any allegation of breach prior to that time).

As a result, it was alleged by the Appellants on appeal that "*the Lieutenant Bailiff made a fundamental error when she held that any reasonably competent director would have perceived that there were very significant risks in selling RMBS at [the relevant time] ... That there was no evidence upon which the Lieutenant Bailiff could properly make such a finding and that, when that finding is removed, selling RMBS was the obvious thing to do ...*".

## **Breach of Duty by the Directors**

The Court of Appeal heard significant discussion during oral submissions about the attitude of the directors of CCC to the sale of the RMBS in connection with an emergency joint meeting of the board of CCC and its Asset and Liability Committee on 23 August 2007.

Although the Court of Appeal found that findings at trial as to perception of risk were based on a misunderstanding, it went on to hold that "*the existence of such an error [had] not, in [their] judgment, [had] the result that the issues [were] at large for determination*". The Court stated that, even if findings had been made:

- (i) that CCC was prepared to sell a material tranche of RMBS in August 2007 at or about repo prices (which were on average lower than the prices the trial judge purportedly held CCC would have sold at);
- (ii) that CCC was not at that point concerned that such sales would send a damaging message to the market; and therefore

(iii) that such sales could have been undertaken without risk,

they would not, in themselves, lead ineluctably to a conclusion that the defendants were in breach of their duties as directors. There was no criticism of the capital preservation strategy adopted in August 2007, nor did the Court agree that there was any overriding imperative on CCC to restore its liquidity cushion (which had been diminished due to the turbulent market conditions which CCC found itself in).

The Court ruled that the Lieutenant Bailiff's conclusions were "*wholly unaffected by the ... mistaken view that CCC was only prepared to contemplate sales at [higher] IDP prices*". [Indeed, the Court noted that some repo dealers were still using IDP prices such that a willingness to sell at repo prices did not preclude sales at IDP prices.] It went on to state its agreement with the Lieutenant Bailiff's statements at first instance, that the Plaintiff's claim depended entirely on being "*wise with hindsight*".

## Breach of Duty by the Independent Directors

The Appellants raised similar allegations against the independent directors of CCC, that they "*should have required CCC to raise liquidity by selling RMBS*". In light of the judgment of the Court of Appeal in respect of the breach of duty by the directors of CCC in not selling the RMBS, and the Court's decisions in relation to the capital preservation strategy, the Court of Appeal agreed with the Lieutenant Bailiff's conclusion that the independent directors were not in breach of fiduciary duty as contended by the Plaintiffs.

## Consideration of the Defences

Although the defences raised by the Respondents did not arise for decision, as they were argued, the Court felt that resolution of some of them may be of assistance in the future. In particular, the Court ruled:

(i) the directors of CCC would have been able to rely upon a provision in CCC's articles exempting them from liability in certain circumstances, despite not being included in their contracts of employment. Reinforcing the decision in *Perpetual Media Capital Limited v Enevoldsen [2014] GLR 57*, the Court ruled that "*where a person accepts appointment as director, the starting point will be that he does so upon the terms set out in the articles*";

(ii) that, for the purposes of section 106 of the Companies (Guernsey) Law, 1994 (which is couched in very similar terms to section 422 of the Companies (Guernsey) Law, 2008), 'misfeasance' does not include a simple breach of the duty of skill and care. Further and as a result, any alleged wrongful retention of RMBS was a simple allegation of negligent

breach of duty, and did not constitute misfeasance for the purposes of section 106;

(iii) As a consequence, the provisions of section 67F of the Companies (Guernsey) Law, 1994, which render void exoneration and indemnification provisions which exempt or indemnify a person from claims under section 106, above, did not preclude the directors from relying on the indemnifications and exculpations in CCC's articles; and

(iv) had the Court found that the directors of CCC had been in breach of duty, they would not have been guilty of wilful default or wilful neglect. This would have meant that they were able to rely on the provisions of CCC's articles in (i) above, which carved out instances of wilful default or wilful neglect. The Court ruled that "*in order for a person to be guilty of wilful default (or misconduct or wrongdoing) ... it is necessary for the person concerned to have suspected ... that his conduct might constitute a breach of duty but to have decided to continue with the conduct nevertheless*";

## Conclusion

Dismissing the appeal, the Court of Appeal upheld the Lieutenant Bailiff's decision at first instance with regards to directors' duties, and CIM's contractual and tortious obligations.

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