

KEY POINTS

- It is conventional in the financial industry to delegate extensively to investment managers and administrators. Fund directors, however, retain a non-delegable duty of supervision.
- In light of the decision of the Cayman Court in *Weaving*, the fund director's duty of supervision is onerous, considerably more so than the practice of some individuals taking on numerous directorships would suggest.
- In the light of that decision it is doubtful whether corporate service firms can continue to offer numerous appointments for the same individuals at cheap rates. These firms may render themselves liable when doing so.

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How many times can I do this? Independent fund directorships

INTRODUCTION

In *Weaving Macro Fixed Income Fund Ltd v Peterson* the Grand Court of the Cayman Islands awarded damages of US\$111m against two independent fund directors of an "open-ended investment company", colloquially, a hedge fund. From a legal perspective the judgment is entirely unremarkable, the court applying well-settled English principles. The case has now sparked a lively debate as to the role of director services firms and, in particular, as to the level of supervision required of them in the financial industry.

DELEGATION OF CORPORATE FUNCTIONS IN THE FINANCIAL INDUSTRY

The offshore hedge fund industry

Hedge funds are formed in offshore jurisdictions primarily because these provide a tax neutral platform and light-touch regulation. Tax neutrality ensures that the fund can be promoted to diverse international institutions and that none of the investors are troubled by tax complications peculiar to either other investors or the investment managers. Light regulation reduces cost.

Although not wholly reliable, statistics suggest that the Cayman Islands is host to 70% of offshore hedge funds, between three and four times as many as are incorporated in the BVI and six times the number of such funds in jurisdictions such as Bermuda, Jersey or Dublin. 8,929 such funds were registered as at 30 June 2010 (see Cayman Island Monetary Authority Report 2010 and BVI Financial Services Commission Report Q3 for 2011).

The assets held on the books of hedge funds are colossal. Cayman based hedge fund vehicles are estimated to hold net assets of US\$2trn as at the end of 2011. This industry has grown up surrounded by a substantial service business. For example, over 300 banks, mostly

This article explains the paramount duty of part time directors of hedge funds to supervise investment managers and administrators and the challenge presented by a recent case for corporate service firms that put forward individuals for dozens of director appointments.

subsidiaries or branches of well-established financial institutions, are represented in the Cayman Islands.

Delegation of functions to offshore directors

Of necessity, the industry operates on the basis that investment management, administration and accounting functions will be delegated to professional service providers. Since hedge funds are investment vehicles, the most important activities they undertake consist, on the investment side, of taking and liquidating positions and, on the investor side, of receiving subscriptions and meeting redemptions. The investment side is left to investment managers or "advisers", predominantly based in London or New York, whereas the day-to-day handling of investors is entrusted to administrators.

In the good times most of this activity could take place without any input or interference from fund directors. No investor would notice if everything was unquestioningly rubber-stamped. Until the recent financial crisis exposed the many corners that were cut, few investors expected offshore directors to be more than supernumeraries, signing the occasional formal document. After all, if fund managers are trusted, why bother spending much on unknown independent directors?

Of the numerous funds incorporated in the Cayman Islands in 2010 only 427 or around 5% were administered and only 130 were managed within the jurisdiction. The picture in the BVI is similar. The best chance of avoiding unwanted fiscal consequences from this is for the onshore investment managers to

appoint offshore fund directors. Accordingly, there is a demand for local directors to be supplied offshore from the moment of incorporation. Moreover these have to be real, functioning directors since the tax status of the offshore fund entities otherwise become vulnerable to challenge.

The growth of director services firms

Small wonder that these conditions have spawned a low-price "director services" industry in offshore jurisdictions. Fund promoters can use law firms offering themselves as one-stop shops for anything from incorporation, drafting offering memoranda to obviously commercial services such as the provision of directors. These compete with a small contingent of specialist "corporate service" companies.

At one end of the spectrum, directors, such as those appointed by established funds, charge in the region of \$40,000 pa per appointment. More common are corporate service firms' directors' fees of typically US\$5–\$10,000 or less to cover both master and feeder funds. Low fees indicate a volume game. The more numerous the directorships, the more lucrative it is to rent out the services of an employee.

It is a matter for debate how many directorships an individual can properly handle. In the UK in 2010 the average multiple directorship for the nearest comparable part-time/non-executives on FTSE listed companies was no higher than 15. Individuals nominated by offshore corporate service firms have a much higher level of appointments. It is self-evident that this can lead to trouble.

Feature

In the ongoing case about the collapsed funds in *Bear Stearns High Grade Funds v JP Morgan* in the Southern District of New York one of the directors provided by the corporate service arm of a law firm is said to have held more than 200 such offices. As the *Financial Times* recently revealed, the principal of one specialist corporate services provider held 567 directorships in 2006. In *Bulmore v Ernst & Young* this director was criticised by the New York Court of Appeal for the fact that he had spent only “a little time” or a “few hours” on the collapsed *Beacon Hill* fund.

THE DECISION IN WEAVERING The issue

There was nothing unconventional about the structure of the Weaving Macro Fixed Income Fund. The investment manager, Weaving Capital UK Ltd, operating onshore in Europe was owned and controlled by one Magnus Peterson. Administrators maintained and prepared financial statements and prepared the NAV calculations. The delegation of day-to-day decision-making implicit in this arrangement was not criticised.

The claim arose because Magnus Peterson had manipulated the Macro Fund's balance sheet. A dormant BVI company, which he controlled, was the principal counterparty to fictitious and worthless interest rate swaps, which falsely appeared to be highly profitable. As a result NAV calculations were wildly overstated. The loss claimed was the irrecoverable overpayment of redemptions from the date when the fraud should have been discovered.

The charge against the directors was not so much that they had delegated their duties improperly to the investment manager but that they had failed to exercise proper supervision over the tasks they had delegated. The problem was not that they had too many appointments. These directors were not from local corporate service companies but, as the judge concluded, individuals who had been chosen to look the other way. The First Defendant was Mr Magnus Peterson's brother and the Second Defendant, his elderly stepfather. The case is nevertheless important to other independent directors because it explains their duty of supervision.

General duty of care of independent directors

That the duty of a director to exercise reasonable care, skill and diligence contains an objective element goes without saying. The director must exercise such a degree of care as would be exercised by a reasonably diligent person having the knowledge, skill and experience reasonably expected of a person acting, in this case, as an independent director of a hedge fund.

The duty of care also has a subjective element: directors are expected to exercise the skills and use the experience, which they actually possess with the same degree of care as a reasonable person in their position (see *Re D'Jan of London Ltd* [1994] 1 BCLC 561, 563 per Hoffmann LJ). This is the first of the propositions in Romer J's classical exposition of the duty in *Re City Equitable Fire Insurance Co Ltd*, above at p 427. The subjective element gives effect to the natural expectations and reliance placed by investors on the experience and skill of a particular director (see *Daniels v Anderson* (1995) 16 ACSR 607 at 668). Both defendants in *Weaving* were highly qualified.

The duty of supervision

The old fashioned view, derived from the classic statements of Romer J in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch. 407, 427, was that directors have no special responsibility once they have delegated their functions in the absence of grounds for suspicion. This view is no longer consistent with modern English case law such as the decision of Jonathan Parker J in *Re Barings Plc No 5* (approved by the Court of Appeal [2000] 1 BCLC 523, 535–6) which was followed by Mr Justice Jones in *Weaving*. There are two important principles.

- “While directors are entitled to delegate functions to those below them” in accordance with the Articles of Association, “the exercise of a power of delegation does not absolve the director from the duty to supervise the discharge of the delegated functions”.
- Directors are subject to a continuing requirement collectively and individually to acquire and maintain a sufficient knowledge and understanding of the

company's business to enable them to discharge their duties.

Delegation by directors to other directors was discussed in *Re Equitable Life Assurance Society v Bowley* [2004] 1 BCLC 180. The all-important point is that a director must supervise the discharge of the properly delegated functions in an informed manner.

The duty of supervision applied in the context of hedge funds

It is not therefore surprising given this subjective element that, as Romer J explained in *Re City Equitable Fire Insurance Co Ltd* and Jonathan Parker J reiterated in *Re Barings*, the nature and scope of the duty of supervision and the question whether it is discharged is a question of fact which can only be determined by reference to the actual circumstances of the case. That the issue is fact sensitive is so, observed Jones J, notwithstanding the fact that the management structure may appear to be no different from countless other hedge funds.

It is nevertheless difficult to imagine that the parameters of the duty of supervision would vary very much for independent directors of hedge funds and what was said by Jones J is unmistakably general. One can well see how the content of the duty will have to be revisited when the Alternative Investment Fund Managers Directive 2011/61 takes effect at least for those European managed hedge funds still incorporated offshore and outside the EU: Depositories will assume extensive “supervisory” functions over these funds. For now *Weaving* is likely to provide a reasonably accurate guide.

(i) Given the permissible delegation to investment managers and administrators, the independent directors are, so Jones J said (see para 8 of his judgment), expected to perform “a high level” supervisory role. They must exercise an independent judgment in respect of all the matters falling within the scope of their supervisory responsibilities.

(ii) Independent directors are expected to satisfy themselves continuously that the investment manager is carrying out the investment strategy and observing investment restrictions as described in the offering memoranda.

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(iii) They must acquire a proper understanding of the financial results of the investment trading activity and review financial statements in an inquisitorial manner, making appropriate inquiries of auditors and administrators;

(iv) In terms of organisation and structure they should ensure that the delegation is effective and that all concerned understand the scope of the directors' supervisory role. A desktop review of contract documents is not enough and they cannot rely on the lawyers retained by differing parties. Accordingly:

- They should satisfy themselves that there is "an appropriate division of function and responsibility between the investment manager and administrator", ensuring that each properly understands their role;
- They should ensure that no managerial or administrative function, which ought to be performed, is left undone by the various service providers. They should also continuously monitor that this remains the case.

(v) The directors also need to satisfy themselves on a continuing basis that the service providers are performing their services in accordance with their respective contracts. They are not entitled to assume that service providers have all performed their respective roles.

These requirements are general in nature. Their application to particular facts may be controversial in any given case. Nevertheless, the work required of an independent director should not be under-estimated.

When these requirements are met, directors will be perceived as *proactive*. In answer to the criticisms made of the serial director in the *Beacon Hill* case, the FT was told that investors had praised the director services firm for the work done once the fraud had been discovered. This is not reassuring. As Jones J said "they must do more than react to whatever problems may be brought to their attention".

CONCLUSIONS: THE IMPLICATIONS FOR DIRECTOR SERVICES COMPANIES Is it still legitimate to assume numerous directorships?

There is obviously no way that a director with several dozens of directorships could himself

perform the duty of supervision outlined in *Weaving*. Indeed, any one individual would find each appointment time-consuming at different points in the life cycle of the fund. Whether the function is performed by one person devoting a lot of time or by a team from the director services company splitting that time makes no real difference; many more man-hours will be required by the guidelines in *Weaving*. This ought to be reflected in the fees that funds should be willing to pay for independent directors.

A different and equally fundamental issue is whether it is legitimate for a single individual to assume numerous directorships when, in reality, he has to sub-contract or delegate much of the work required to others. On a practical level one might see why it should be possible for a competent team of professionals to give high-level briefings to the appointed director about the various matters that concern him.

However, the legal objection is that the duty of supervision is the personal non-delegable element of the duty of care of the director. Is someone else to interrogate the auditors? The natural expectations of investors are not met if the individual whom they appoint is, in reality, fronting a corporate service firm. They were not asked to appoint a corporate director (permissible in the Cayman Islands). As the editors of Mortimore, *Company Directors Duties, Liabilities and Remedies* 2008 OUP point out, "the duty to supervise... cannot be avoided". This is the minimum core duty of care.

Liability of the service firms

The issue is also one of responsibility. The service company director may well be liable if the work done by the team of staff at his disposal fails to match the appropriate objective or possibly subjective standard. Whether the director is liable is not always clear. The issue is whether he alone should be liable in such circumstances.

The director will usually have the benefit of exculpation and/or an indemnity for negligence whereas the service provider would not. However, it would be wholly exceptional for a director from a corporate services firm to be liable for fraud but less so for deliberate misconduct. "D&O" (ie directors and officers)

insurance may be illusory if the director can only be liable for deliberate misconduct or fraud and not negligence. Such misconduct is normally outside any cover, a conundrum with which the successful liquidators in *Weaving* may well have been confronted after the ruling.

In *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*, [1991] 1 AC 187 the Privy Council held that a bank was not vicariously liable for the acts of its employees who had been appointed as directors of a company in which it was interested. Their acts were those undertaken by them in their individual capacity. This was taken one step further in *Paget Brown v Omni Securities* [1999] CILR 184 in which the Court of Appeal of the Cayman Islands held that the director services company did not owe a duty of care in respect of its appointees.

Whether this logic could hold good in circumstances where it is appreciated that the appointed director is unable to perform his supervisory role must be open to question:

- A duty of care or collateral contract may yet be established on appropriate facts. If the director with 200 directorships is not carrying out his role, the corporate service firm may be shown not to have given the back-up service that is implicit in the arrangement made with the fund.
- The question whether a tort of procuring a breach of fiduciary duty exists has not been decided outside England at Court of Appeal level (see *Metal & Rohstoff v Donaldson Lufkin & Jenrette* [1990] 1QB 391 at 481).
- If the corporate service firm was simply doing the bidding of its client (more likely for those linked to a law firm), it may well be shown to have acted in bad faith and there will be no shortage of options for liability.
- The director services firm is also almost certainly responsible as a "shadow director" (eg for the purposes of Cayman Companies Law (2011 Revision) s 89) for the purposes of reversing fraudulent transactions or preferences.

In the US where many of the law suits would be brought there may be other theories of liability. ■