

Duties and Responsibilities of Corporate Hedge Fund Directors

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Anna-Lise Bailey, February 2009

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The Cayman Islands is the leading offshore jurisdiction for the establishment of hedge funds. As of December 2008, approximately 9,870 funds were registered or licensed with the Cayman Islands Monetary Authority, the vast majority of these being hedge funds. Although some are structured as partnerships or trusts, the majority use a corporate structure involving shareholders of various classes and a board of directors. In recent years, onshore tax and regulatory considerations have driven the demand for the provision of directors who are not affiliated with the managers of these funds, and a number of offshore-based directors and firms focused on providing independent director services have arisen to meet this demand. Particularly in these times marked by the collapse of a number of hedge funds, it is important that all directors, including independent directors, know and understand their duties and responsibilities, to whom these duties are owed and the circumstances in which they may be exposed to personal liability.

To whom are Duties Owed?

Each fund registered in the Cayman Islands has a set of constitutional documents which describe and delimit the duties and responsibilities of its directors. The fund's constitutional documents are supplemented by common law and statute. In general, the duties described in this update are owed by the directors to the underlying company as a whole – that is, to the general body of shareholders, rather than to individual shareholders or to particular classes of shareholders. Where the fund is on the brink of insolvency (ie, where its solvency is in doubt), directors' duties also extend to the fund's creditors, whose interests will become paramount if the fund actually becomes insolvent.

In situations where the voting shares of the fund are held by the investment manager so that the manager effectively controls the vote, directors would be well advised to seek the views of the general body of investors on significant decisions

(eg, a decision to wind up the fund). Independent directors can do much in these potentially volatile situations to increase transparency and enhance investor communications.

Sources of Directors' Duties

The articles of association of the company underlying the fund will usually permit the directors to exercise all the powers of the company that are not required to be exercised by the company in a general meeting. Barring any specific restrictions on their powers set forth in the Articles of Association, the directors are responsible for managing the fund's affairs. It is important for fund directors to remember that although they may delegate investment management and administrative functions to the fund's service providers, the responsibility for the management of the fund ultimately lies with them.

Although Cayman law does not stipulate that board meetings must take place every year, good corporate governance dictates that periodic board meetings be held so that directors may maintain oversight of the fund's service providers. Where some of the fund's directors are provided by its investment manager, the independent directors can act as a check and balance on the investment manager's influence on the fund. An annual meeting will not be enough to achieve this.

Statutory Duties and Obligations

Most of the duties and obligations imposed by statute relate to those who are responsible for the day-to-day operation of the company, rather than to the company itself. For example, the directors are under a duty to ensure that the company makes its required annual filings with the Companies Registry and that it keeps a register of members in writing.

The potential for a director to incur personal liability in the management of a company increases where the company enters into liquidation, particularly insolvent liquidation. Cayman law provides that a director who wilfully authorizes or permits a distribution or dividend to members out of a company's share premium account is liable to a fine or imprisonment unless, on the date that the distribution is made or dividend paid, the

company can pay its debts as they fall due in the ordinary course of business.

Similarly, a director who knowingly or wilfully authorizes or permits a payment out of capital by a company for the redemption or purchase of its own shares is subject to a fine or imprisonment unless, following the date on which the payment is proposed to be made, the company is able to pay its debts as they fall due in the ordinary course of business.

Furthermore, if during the course of a liquidation (whether solvent or insolvent), a director has been guilty of any misfeasance or breach of trust, the liquidator may bring a claim against such director for misfeasance.

Common Law Duties and Obligations

At common law, two categories of duties are generally held to arise: fiduciary duties and a duty of care and skill. Fiduciary duties require a director to:

- use his or her powers for the purposes for which they were intended;
- act in good faith with a view to the best interests of the company;
- avoid conflicts between his or her personal interests and his or her duty to the company; and
- not fetter his or her discretion.

In fulfilling the duty of care and skill owed to a company, a director need not exhibit in the performance of his or her duties a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience..

Independent directors with several years' relevant industry experience and exposure to market trends, can undoubtedly bring valuable skill sets to the boardroom. However, care must be taken when selecting an independent director to ensure that he or she can carry out his or her role and responsibilities effectively.

Factors to be considered include:

- the level of relevant experience of the individuals who will be acting as directors;
- whether the director may have conflicts of interest with other service providers to the fund (eg, conflicts with the fund's lawyers or auditors); and
- whether the director has the resources and the capacity to deal with his or her obligations, given the number of other funds of which he or she is a director.

With the unprecedented growth in the Cayman Islands' hedge fund sector, it is arguable that the pool of qualified independent directors who are willing and able to act in that capacity for new funds is too limited. Indeed, given that the demand for independent directors appears to far outweigh the local supply of those services, the Cayman Islands Monetary Authority has declined to impose a requirement for independent directors to reside in the Cayman Islands.

Cayman Islands Directors Association

Where the same pool of directors supplies directorship services to a number of funds, there is a real danger that they will be unable to fulfil effectively the obligations owed to the entities they serve, and that they will regularly face conflicts of interest. After ongoing discussions in the industry concerning the need to ensure oversight

of the provision of director services and to increase local directorship options for Cayman Islands hedge funds, the Cayman Islands Directors Association was formed in March 2008. There are over 120 members at present. Membership is open to all fit and proper individuals acting as directors of funds, public companies, private companies and special purpose vehicles.

In October 2008 the association issued a Code of Practice for Cayman directors. According to the association's website, this code has been based on the Code of Professional Conduct adopted by the UK Institute of Directors in August 2008.

It is hoped that, through discussion of the issues affecting the industry, education and training programmes, the Cayman Islands Directors Association will increase awareness of the duties and responsibilities associated with acting as a director and assist in increasing the pool of locally based qualified directors. In an era of increased litigation involving hedge funds and their directors, and the increased focus on this jurisdiction, the formation of a self-regulatory body committed to establishing best practices, increasing awareness and harnessing talent will be most timely.

Anna-Lise Bailey is an Associate in the Cayman office at Appleby and can be contacted by telephone on +1 345 814 2718 or email abailey@applebyglobal.com

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The Right People. The Right Places.

Bermuda

Canon's Court
22 Victoria Street
PO Box HM 1179
Hamilton HM EX
Bermuda

Tel +1 441 295 2244
Fax +1 441 292 8666

Jersey

PO Box 207
13-14 Esplanade
St Helier
Jersey JE1 1BD
Channel Islands

Tel +44 (0)1534 888 777
Fax +44 (0)1534 888 778

British Virgin Islands

No 56 Admin Drive
Wickhams Cay 1
PO Box 3190
Road Town
Tortola VG 1110
British Virgin Islands

Tel +1 284 494 4742
Fax +1 284 494 7279

London

2nd Floor
2 Royal Exchange Bldgs
London EC3V 3LF
United Kingdom

Tel +44 (0)20 7283 6061
Fax +44 (0)20 7469 0540

Cayman Islands

Clifton House
75 Fort Street
PO Box 190
Grand Cayman KY1-1104
Cayman Islands

Tel +1 345 949 4900
Fax +1 345 949 4901

Mauritius

8th Floor
Medine Mews
La Chaussée
Port Louis
Mauritius

Tel +230 203 4300
Fax +230 210 8792

Hong Kong

8th Floor
Bank of America Tower
12 Harcourt Road
Central
Hong Kong

Tel +852 2523 8123
Fax +852 2524 5548

Zurich

Bahnhofstrasse 52
CH-8001
Zurich
Switzerland

Tel: +41 44 214 6525
Fax: +41 44 214 6524