

Anna-Lise Bailey of **Appleby Global** gives *HFMWeek* a breakdown of the responsibilities and liabilities of directors of offshore funds in the Cayman Islands

Understanding your duties



Anna-Lise Bailey is an associate in the funds and investment services team at **Appleby Global**, the Cayman Islands. She specialises in the formation and structuring of investment funds, including corporate hedge funds, limited partnerships and private equity funds. She also advises on general corporate law matters.

The Cayman Islands is the leading offshore jurisdiction for the establishment of hedge funds. As of December 2008, just under 9,900 funds were registered or licensed with the Cayman Islands Monetary Authority (CIMA), the vast majority of these being hedge funds. Although some are structured as partnerships or trusts, most hedge funds 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. With recent events having turned the spotlight on corporate governance issues associated with hedge funds, investors are now, increasingly, demanding independent boards. It is therefore 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 article 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 solvency of the fund 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 (for example, 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. An annual meeting will not usually be enough to achieve this. Where some of the fund's directors are provided by its investment manager, independent directors can act as an important check and balance on the investment manager's influence on the fund.

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 willfully authorises 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 willfully authorises 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.

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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.

Regulation

Licensed service providers in the Cayman Islands are subject to a ‘fit and proper’ requirement under the various laws regulating the financial service industry.

The Mutual Funds Law (2007 Revision), as amended, allows the regulator to take action and to impose sanctions where it is satisfied that the management of a fund has not been conducted in a fit and proper manner or that a director is not a fit and proper person to hold such a position.

This is yet another reason for independent professional directors to take an interest in the structure of the fund and the ongoing oversight of its activities.

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.

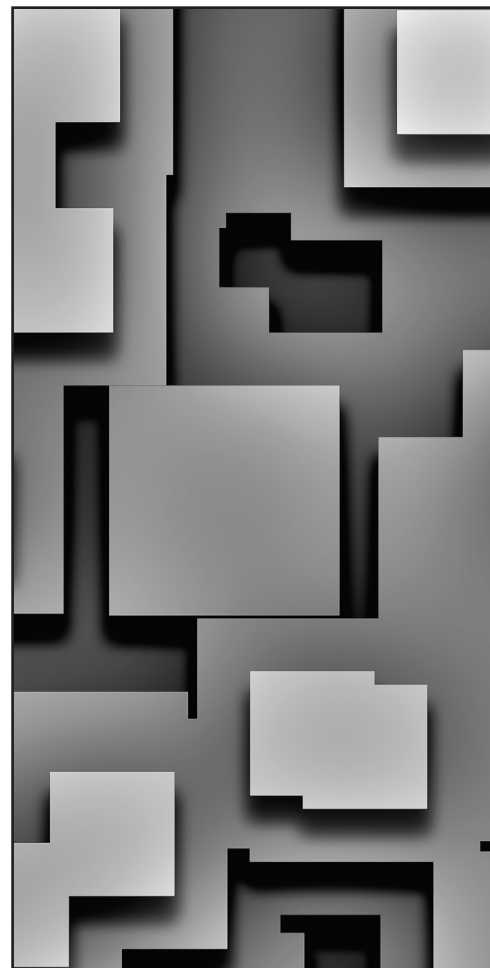
Independent directors with several years’ relevant industry experience and exposure to market trends can undoubtedly bring valuable skill sets to the boardroom. However, care must be taken when selecting an independent director to ensure that he or she can carry out his or her role and responsibilities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

Cayman Islands Directors Association

The unprecedented growth in the Cayman Islands’ hedge fund sector has posed a challenge for the local directorship pool. Indeed, given that the demand for independent directors appears to outweigh the local supply of those services, the Cayman Islands Monetary Authority has, thus far, declined to impose a requirement for independent directors to reside in the Cayman Islands.



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 the role of director and assist in increasing the pool of locally based qualified directors. In an era of increased litigation involving hedge funds and their directors, investment managers are recognising that independent professional directors add value and credibility to their product. With the focus now squarely on corporate governance issues, the formation of a self-regulatory body in the Cayman Islands committed to establishing best practices, increasing awareness and harnessing talent in the local professional director pool is most timely. ■