APPLEBY

eAlert | February 2015

A New Chapter in Directors' Liability: Weavering v Peterson & Ekstrom Overturned on Appeal

Weavering Macro Fixed Income Fund Limited (In Liquidation) (**Fund**) was a Cayman Islands hedge fund which collapsed when it emerged that its biggest trading position was, in fact, fictitious. The red flag missed by the board was that the counterparty to that trade was an entity controlled by the fund's manager. The Fund subsequently initiated proceedings against its former independent directors in the Grand Court of the Cayman Islands for breach of their duties to exercise independent judgment, to exercise reasonable care and skill and to act in its best interests.

At first instance, the Court found the Fund's independent directors guilty of wilful neglect and default in the discharge of their duties, and ordered them to pay damages to the Fund's liquidators in the sum of US$111 million, representing the losses suffered by the fund which were caused by their default.

In a seminal decision, the trial judge made a series of stern statements of principle about the duties of hedge fund directors which generated considerable comment and reaction across the hedge fund industry. The Court took long-standing principles concerning the duties of non-executive directors in a conventional company structure and adapted them for the unique structure of a hedge fund, with its array of professionals independently performing various critical functions in support of the fund's management.

However, in a decision published on 12 February 2015, the Cayman Islands Court of Appeal (**CICA**) has taken a different view of the evidence which was presented to the Grand Court and has allowed the directors' appeal against the findings of the Grand Court.

The CICA upheld the finding of the Grand Court below that the directors were, indeed, in breach of the duties which they owed to the Fund, which included a "high-level" supervisory duty in relation to the performance of the Fund's service providers of their delegated functions. In doing so, the CICA relied on the evidence of the directors that they had "missed", "not picked up" or failed to read in its entirety a quarterly report which would have put the board on enquiry of the facts which led to the Fund's demise.

The Grand Court had ruled that these failings by the directors amounted to "wilful neglect or default" such that the directors were unable to rely on the exemption from liability contained in the Fund's Articles of Association. The CICA considered in some detail the first limb of the test in *Re City Equitable Fire Insurance*[1] and concluded that:

> *in order to establish wilful neglect or default for the purposes of defeating the protection given to directors under an article in the terms of Article 182 of the Company's Articles of Association, it is necessary (at least under the first limb of Mr Justice Romer's test in the City Equitable case) for the Company to prove to the satisfaction of the court that the director made a deliberate and conscious decision to act or to fail to act in knowing breach of his duty: negligence, however gross, is not enough.*

The CICA held that there was, in fact, no specific evidence of either director having made a deliberate and conscious decision not to read the relevant report with sufficient care knowing that failure to do so was in breach of his duty.

Turning then to the second limb of the test in *Re City Equitable Fire Insurance* (i.e. being recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty), the CICA held that:

[1] [1925] Ch 407 – adopted in the Cayman Islands in *Prospect Properties Limited (In Liquidation) v McNeill* [1990-91] CILR 171

> *it is necessary to satisfy the court that the director appreciated (at the least) that his or her conduct might be a breach of duty and made a conscious decision that, nevertheless, he or she would do (or omit to do) the act complained of without regard to the consequences; and if the evidence does not establish that the defendant at least suspected that his conduct might constitute a breach of duty, it is not appropriate to characterise his breach of duty as "wilful neglect or default".*

Since there was no support in the evidence for the contention that the two directors had the requisite conscious appreciation that they might be breaching their duty to read the reports to the board with sufficient care to discover that the counterparty to the trades was a related party, the claim against them failed and their appeal was allowed.

Comment

It is apparent from this decision that it is impermissible to draw an inference of wilful default – positive evidence of a conscious decision to act in breach of duty or at least with a suspicion of breach is required. This will have a material impact on the way in which claims against directors are litigated in the future.

The decision of the Grand Court was perhaps best known for the trial judge's famous exposition of directors' duties throughout the 3 stages of a fund's lifecycle – the CICA did not comment on this part of that decision so it is unclear how much weight will be given to those dicta in future, either by the courts or by the industry as a whole. One apparent reservation was the CICA's view that directors can take comfort and obtain protection from exposure to liability by signing documents on advice from the fund's lawyers.

The CICA's decision provides a stark reminder that the standard provision in hedge funds' constitutional documents, which exempts directors from liability for acts other than acts of wilful neglect or default, is designed to protect directors who do their "incompetent best". However, the decision may cause investors to revisit the scope of indemnity clauses in a fund's documents before investing – and may put pressure on fund promoters to lower the bar (again) to the level of "gross negligence". For many investors, and the former shareholders of this Fund, doing one's "incompetent best" will simply not be good enough.

That said, since the initial decision of the Grand Court, many providers of independent directors in the Cayman Islands have updated their systems and procedures and oversight of the funds that they manage. Additionally, the Cayman Islands Monetary Authority has issued a statement of guidance for fund directors and fiduciaries of regulated funds which covers some of the ground that was originally covered by the trial judge. The nature and scope of operational due diligence that is now undertaken by institutional and sophisticated hedge fund investors is vastly different from what it was prior to the financial crisis or even the initial decision in this case. More is expected from all parties involved in hedge fund management and administration, as well as the directors.

Key Contacts

Jeremy Walton
Partner | Group Head, Cayman Islands
Dispute Resolution
+1 814 2013
jwalton@applebyglobal.com

Paul Kennedy
Associate
Dispute Resolution
+1 345 814 2004
pkennedy@applebyglobal.com

© Appleby Global Group Services Limited 2014 • All Rights Reserved

This eAlert is published by APPLEBY and is not intended to be, nor should it be used as, a substitute for specific legal advice on any particular transaction or set of circumstances. It does not purport to be comprehensive or to render legal advice and is only intended to provide general information for the clients and professional contacts of Appleby as of the date hereof.