

Campbells

The Weaving Decision

18 November 2011



Factual Summary

- The Fund was set up and the directors were appointed in 2003.
- Directors were related to the individual who controlled the investment manager and received no remuneration.
- The administrator was PNC and the Fund's auditor was Ernst & Young, both based in Dublin, Ireland.
- The Fund traded on the Irish Stock Exchange.
- The Fund's Articles contained a provision indemnifying and exculpating the directors from losses except those cause by the directors' "willful neglect or default".

Factual Summary

- The Investment Management Agreement contained the usual provision that the investment manager would manage the Fund's investments but such management would be "subject to the overall supervision of the directors".
- The Administration Agreement provided that the Administrator would value the Fund's investments and calculate NAV, i.e. it was not an "NAV-lite" agreement but also contained a provision that the Administrator was under no duty to take any action on behalf of the Fund.
- The Fund's governing documents contain a prohibition from investing more than 20% of its gross assets in the securities of any one issuer or be exposed to the credit worthiness or solvency of any one counter-party.

Factual Summary

- Further, it was specifically provided that interest rate swaps were only permitted if a major bank was the counter-party.
- To disguise trading losses the IM created fictitious assets, namely gains on fictitious interest rate swaps.
- The counter-party to the interest rate swap agreements was a shell company incorporated in the BVI of which the directors were also directors.
- Following the collapse of Lehman Brothers and the credit crisis in 2008 the Fund received substantial redemption requests.

Factual Summary

- Despite having evidence in the form of a quarterly report received from the administrator in November 2008, which would have revealed that the IRS counter-party could not possibly pay the sums owed to the Fund, the directors authorised payment of substantial redemption proceeds between November 2008 and February 2009.
- These redemption payments were based upon an incorrectly stated NAV per share.
- The inability of the interest rate swap counter-party to pay the sums due to the Fund was discovered and the Fund was put into liquidation on 19 March 2009.

The Judge's Findings

The law on directors' duties

- No allegation of breach of fiduciary duty, the allegation was that the directors had acted in breach of their duty to exercise independent judgment, reasonable care, skill and diligence.
- It was not disputed that in spite of having properly delegated functions to the investment manager and the administrators that the directors did retain a supervisory duty.
- They were “expected to perform a higher level supervisory role” and act in a professional businesslike manner.

The Judge's Findings

The law on directors' duties (cont'd)

- They were not expected to monitor the IM's investment strategies in a direct hands on manner but were expected to satisfy themselves that the IM strategy was fairly described in the offering document and that the IM was complying with whatever investment criteria and restrictions had been adopted by the Fund.

The Judge's Findings

The law on directors' duties (cont'd)

- Also expected to acquire a proper understanding of the financial results of the investment and trading activity, ensure an appropriate division of function and responsibility between the IM and the administrator and that the various service providers were performing their functions in accordance with the terms of their respective contracts.
- In assessing the extent of the duty it was also necessary to look at the skill and experience which the directors actually possessed.

The Judge's Findings

The law on directors' duties (cont'd)

- The obligation to exercise independent judgment required the directors to make enquiry and not to assume that other service providers had all performed their respective roles.
- The fact that directors were not paid fees did not reduce the scope of their duties.

The Judge's Findings

The law of “willful neglect or default”

- The Judge adopted the test set out in *Re City Equitable Fire Insurance*. He held that the tests had two limbs (a) knowing and intentional breach of duty or (b) acting recklessly, not caring whether or not the act or omission is a breach of duty.
- The Judge held that the neglect of the directors was intentional and that the case came squarely within the first limb of the test. He therefore had no need to consider the second limb of the test.
- The Judge's analysis of the performance of the directors' supervisory role in the three stages of the Fund's life

The Judge's Findings

Phase 1 - Establishment of the Fund

- Duty to satisfy themselves that the overall structure was consistent with Cayman Islands industry standards and that the terms of the service providers' contracts were reasonable and consistent with industry standards.
- They had a duty to ensure the appointment of appropriately qualified professional service providers and gain an understanding of how each service provider intended to perform their respective duties.

The Judge's Findings

Phase 1 - Establishment of the Fund (cont'd)

- They had a duty to satisfy themselves that the offering documents complied with the requirements of the Mutual Funds Law.
- They were not entitled to rely on the fact that the offering documents had been drafted by lawyers.
- The Judge held that there was no evidence to suggest that either of the directors played any role or attempted to perform their duties in respect of the establishment and launch of the Fund in any way whatsoever.

The Judge's Findings

Phase 2 – Ordinary Course of Business

- The Judge held that it was the duty of the directors to inform themselves about the Fund's investment activities and to have a proper understanding of its financial condition.
- The directors were provided with quarterly statements from the administrator.
- The Judge held that the directors never paid any attention to the content of these quarterly reports which would have revealed that the Fund was operating outside its investment restrictions.

The Judge's Findings

Phase 2 – Ordinary Course of Business (cont'd)

- The directors failed to comply with their own adopted policies.
- The adopted a resolution that the Board would meet weekly with the investment manager to discuss the Fund's performance but they never did so.
- The directors simply rubber stamped boiler plate minutes containing effectively the same information from meeting to meeting.

The Judge's Findings

Phase 2 – Ordinary Course of Business (cont'd)

- Minutes were signed in the same form irrespective of the discussion that might have actually taken place and the Judge held that the directors were “willing to sign whatever board minutes the investment manager put in front of them and did so without caring whether or not the content was true”.
- The directors signed off on the Fund's financial statements without undertaking any analysis of them or exercising independent judgment in satisfying themselves that they were correct.

The Judge's Findings

Phase 2 – Ordinary Course of Business (cont'd)

- The directors signed sham contracts that gave the impression that the Fund had a new investment manager when in fact the investment management function remained with WCUK.
- The directors approved and signed side letters with investors that had been approved by the investment manager but never made any enquiry or sought to understand whether or not the execution of the side letters of this sort could have an adverse impact on the Fund.

The Judge's Findings

Phase 3 – Financial Crisis and Liquidation

- By the time of the collapse of Lehman Brothers the interest rate swaps with WCF represented about 76% of the reported NAV.
- The Judge held that the directors did not read the Q3 report or apply their mind to its content.
- The directors did not ask the investment manager to provide a counter-party risk analysis.

The Judge's Findings

Phase 3 – Financial Crisis and Liquidation (cont'd)

- On receipt of the Q4 report the defendants failed to note that seven of the IRS contracts listed in the Q3 report had simply disappeared from the list.
- Despite this, the directors signed waiver forms on 31 December 2008 and 1 January 2009 authorising payment of 25% of the November redemptions.

The Judge's Findings

Conclusion

- The Judge had little hesitation in finding that the directors were guilty of willful neglect or default because they consciously chose not to perform their duties to the Fund or at least not in any meaningful way.

The Judge's Findings

Causation and Quantum of Damage

- The Judge held, at the invitation of the liquidators' Counsel, that the directors were responsible for the loss that had been suffered by the Fund during the period from the date in which the Fund's business should have been terminated (sometime shortly after 6 November 2008) until the date that it was actually terminated (19 March 2009).

The Judge's Findings

Causation and Quantum of Damage (cont'd)

- The Liquidators' Counsel contended that the loss suffered by the Fund in this period was the amount of the irrecoverable redemption payments made in this period on the basis of falsely inflated NAV calculations which amounted to US\$111 million.
- The Judge awarded damages of US\$111 million.

The Judge's Findings

Post Script

- The directors have appealed and the Fund's liquidators have cross-appealed.
- Proceedings against the IM and other employees of the IM are currently ongoing in the High Court in London.
- Proceedings against the administrator and auditor are currently ongoing in Ireland.

