Investment Funds Alert

After the Music Stops: Delaware and Cayman Courts Opine on Fiduciary Duties of Fund Control Persons

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The collapse of the global economy in 2008 brought unprecedented scrutiny to the corporate governance and governing documents of private investment funds. And as a consequence of the wave of litigation that commenced in the aftermath, we are now beginning to see judicial interpretation of what had previously been seen as standard or "market practice" with mixed results for the industry. In the past month, both the Grand Court of the Cayman Islands, Financial Services Division and the Delaware Chancery Court have issued opinions that interpret, for the first time, fiduciary duties as they relate to control persons of hedge funds.

In the Cayman Islands case of *Weavering Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom*, the Grand Court was asked to consider the nature of a director's standard of care and determine whether these particular directors had breached their fiduciary duty to exercise independent judgment; to exercise reasonable skill, care and diligence; and to act in the interests of the fund. On the facts of the case, the court found that the directors in this case had willfully neglected their duty of care and were liable for at least US$111 million to the fund, which was then in liquidation.

In the case before the Delaware Chancery Court, *Paige Capital Management, LLC v. Lerner Master Fund, LLC et al.*, Chancellor Leo Strine found that the imposition of a gate to prevent the only outside investor in a limited partnership from withdrawing its seed capital was in violation of fiduciary duty when the only reasonable explanation was to preserve management fee revenue for the investment manager.

Weavering v. Peterson

The Grand Court's decision in the Weavering case addresses the duty of hedge fund directors to supervise the fund for which they serve. Weavering Macro Fixed Income Fund Ltd. (the "Weavering Fund") had two "independent" directors, consisting of the brother and the stepfather of the principal of the investment manager (the "Directors"). In January 2005, the principal of the Weavering Fund, Magnus Peterson, began trading interest rate swaps with a related-party shell entity in, among other things, violation of the requirement in the Weavering Fund's offering memorandum that all counterparties be "major banks." Those interest rate swaps were regularly in the money, as indicated by the reports from the administrator, but no payments were actually made from the related-party entity to the Weavering Fund. During the term of the interest rate swaps, the value of the interest rate swaps as compared to other investments generally constituted more than 70 percent of the value of the Weavering Fund, despite the fact that Weavering Fund's offering memorandum stated that no more than 20 percent of Weavering Fund's gross assets would be invested in the securities of any one issuer or exposed to the creditworthiness of any one counterparty.

According to the Grand Court, the Directors' willful neglect of their duties as directors was directly responsible for the continuation of the Weavering Fund's trading losses. This neglect was evidenced by, among other things—

- the minutes being substantially identical from meeting to meeting
- the Directors' failure to meet as often as the minutes indicated (on a number of occasions, minutes of meetings that never took place were signed off)
- the Directors' failure to review the reports that they received from the administrator or to request any further information from the administrator or auditors to confirm whether the Weavering Fund was, in fact, complying with the investment limitations (especially when such reports, in fact, documented evident breaches of the investment restrictions)
- the notation in the minutes that the Weavering Fund was complying with its investment limitations when the Directors took no action to so verify
- the Directors' failure to scrutinize records even after the Weavering Fund began to suffer from a severe liquidity crisis
- the Directors' signature on financial statements and management attestations without reviewing them in an "inquisitorial manner" and an apparent willingness to sign "whatever was put in front of them without exercising any judgment or applying their minds to the matter in any way."

Justice Andrew J. Jones applied the typical standards for corporate directors under the laws of England and Wales and adopted them as constituting Cayman Islands law. Specifically, he stated,

> (i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
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> (ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain [or outside parties in this case], and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions….

Justice Jones went on to say that, while a director's limited role within an organization may be a factor in determining the extent to which a director must supervise a fund, a director's independent status does not absolve the director from his or her duty to supervise or ensure that supervision is occurring. Furthermore, the amount paid as compensation to a director does not limit those duties, but it may be a factor in determining the scope of responsibility. In the context of the Weavering Fund, the fact that the Directors were not paid a fee did not suggest that the scope of their duties was reduced; in fact, the court used it to support the liquidator's case that they never intended to perform their duties in any serious way.

Accordingly, on the facts of the case, the court found that both the Directors were guilty of willful neglect because they consciously chose not to perform their duties to the Weavering Fund in any meaningful way. Further, the court found that the evidence clearly pointed to the conclusion that the Directors subordinated themselves to the wishes of the investment manager's principal and that they were motivated by a desire to keep him happy by going through the motions. Damningly, the court found that "if they had applied their minds for a moment, they would have appreciated that their behavior was wrong."

In assessing the quantum of damages, the court found that the losses caused by the Directors' willful neglect or default was at least US$111 million, being the amount of irrecoverable redemption payments made on the basis of falsely inflated NAV calculations, less the Weavering Fund's realizable assets today (i.e. nothing).

Paige v. Lerner

In *Paige v. Lerner*, the Delaware Chancery Court limited the discretion of a general partner to enforce the gate terms of a limited partnership agreement for purely self-interested reasons. Lerner Master Fund, LLC invested as a seed investor in Paige Opportunity Partners, L.P. (the “Paige Fund”) in October 2007. The revenue-sharing agreement that formalized the seed arrangement (the “Seed Agreement”) included a commitment to maintain Lerner’s investment in the Paige Fund for at least three years or be subject to an early withdrawal reduction that decreased on an annual basis for each of the three years in which Lerner remained in the Paige Fund. Contemporaneously with the execution of the Seed Agreement, the Paige Fund finalized its limited partnership agreement (the “Partnership Agreement”), which included a lower early withdrawal reduction than the Seed Agreement and allowed the general partner to limit, or “gate,” withdrawals of the net assets of the Paige Fund to 20 percent in its sole discretion.

Lerner gradually became disillusioned with the principals of the Paige Fund, Michelle and Christopher Paige (the “Paige Principals”), both due to Paige Principals’ inability to attract any other outside investors and their failure to deploy Lerner’s invested capital in distressed debt assets, as contemplated by the Paige Fund’s offering materials. In early 2010, Lerner explored the option of withdrawing its capital prior to the three-year term in exchange for the prepayment of management fees. The Paige Principals counterproposed to permit early withdrawal if Lerner agreed to be subject to the early withdrawal reduction in both the Partnership Agreement, which would have been 2 percent until October 2010, and the Seed Agreement, which would have been 3 percent until October 2010. In October 2010, Lerner then tendered its notice to withdraw effective in March 2011. The Paige Principals responded by threatening lengthy litigation that would be subject, in the opinion of the Paige Principals, to repayment under the indemnification provisions of the Partnership Agreement and threatened to raise the gates provided for in the Partnership Agreement. The Paige Principals also brought a declaratory judgment proceeding to request the Delaware Chancery Court, among other things, confirm their ability to restrict withdrawals and to receive indemnification.

Chancellor Strine, writing for the Delaware Chancery Court, determined that the gating provision and withdrawal reduction of the Partnership Agreement did not apply because the Seed Agreement overrode the Partnership Agreement, but, even if the gating provision were to apply, the fiduciary duties of the Paige Fund’s general partner to the Paige Fund would have required the Paige Principals to waive the gating provisions. While the negotiating history of the Seed Agreement presented some ambiguities, Chancellor Strine interpreted the Seed Agreement, which was more specifically tailored to the Lerner’s withdrawal limitations, to override the Partnership Agreement as it relates to withdrawal and, therefore, any gate or early withdrawal reduction. Even if the gating provisions in the Partnership Agreement were to apply, the general partner would have been required to waive the gate. The only apparent reason for imposing the gate was to preserve the management fees for the benefit of the Paige Principals, and the general partner’s fiduciary duty precluded it from exercising its discretion for the purpose of advancing its own interests. In addition, Chancellor Strine ruled that the indemnification provisions of the Partnership Agreement did not protect the Paige Principals because the interpretation of the Partnership Agreement that the Paige Principals advanced was not in good faith.

Conclusion

Directors and general partners of hedge funds and other private investment funds should take note of the above cases’ interpretation of the duty of care and the duty of loyalty. The Weavering case confirms that the long-standing common-law duty of care that applies to directors of companies in general applies equally to the directors of private investment funds, despite the ongoing practice of delegation of day-to-day authority to various service providers. It should be noted that the Weavering decision arises from egregious facts. The Directors fell so far short of the required standard of conduct that the court commented that, due to the exculpation clause in articles of association, the Directors would not have been personally liable if they had merely tried their “incompetent best.” The decision leaves open some questions about the amount of supervision and oversight required of Cayman directors, and we can advise further on the procedures of corporate governance that should be applied to investment funds of this type.

The *Paige v. Lerner* case reinforces the limits on a general partner's discretion when exercise of that discretion comes into conflict with its duty of loyalty. If a general partner has other activities that could conflict with the interests of limited partners or wishes to retain flexibility to look to its self-interest in exercising its contractual rights or its authority pursuant to a partnership agreement, it should disclose those activities to its investors and consider including appropriate language in the fund's limited partnership agreement to limit its fiduciary duty and confirm its ability to act, in some respects, in its own self-interest.

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