Cayman Islands Court of Appeal untangles directors in the case of Weavering

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On 12 February 2015 the Cayman Islands Court of Appeal ('the Court of Appeal') overturned the Grand Court's decision that two directors must pay damages of US$111 million.

BACKGROUND

Weavering Macro Fixed Income Fund (In Liquidation) ('the Fund'), a Cayman Island hedge fund, collapsed into insolvency in 2009. The performance of the Fund appeared to be staggeringly impressive, with its net asset value ('NAV') (on paper at least) multiplying over 19 times between 2005 and 2008. It really was too good to be true.

As the Grand Court found in 2011, the Fund was actually making heavy losses, potentially from inception. The losses were cloaked by artificial gains from fictitious interest rate swaps with another entity, Weavering Capital Fund ('WCF').

Details of the interest rate swaps and the market value attributed to them were set out in the Fund's Quarterly Reports, which reflected that their total market value rose significantly from US$15.9 million at the end of 2005; to US$86.8 million by the end of 2006; US$195.6 million by the end of 2007; and US$626.6 million by the end of 2008. As a percentage of the Fund's reported NAV, the total value of the interest rate swaps fluctuated but it was generally more that 70% from mid 2006 onwards.

No monies were ever paid by WCF to the Fund under the swaps, which meant that when an investor wished to leave the Fund, the redemption money was invariably paid by new and/or additional subscription payments. The Fund continued to operate in this way until late 2008, when it became unable to pay the level of redemption requests, due to the economic crash.

The liquidators of the Fund brought proceedings against the two directors of the Fund and the Grand Court found that they had been guilty of wilful neglect or default. In doing so it found that their conduct fell well below that required of them. The directors were ordered to pay damages to the Fund for what it had lost by paying the irrecoverable amounts to redeemed investors. The Grand Court was satisfied that such losses amounted to at least US$111 million and gave judgment against each of the directors in that amount.

The Court of Appeal has now reversed the decision of the Grand Court meaning that the directors are no longer liable to pay back the money.

WHAT HAPPENED?

Given the scale of the Fund's losses and the disparity between the purported NAV and the true NAV, the question of what the two directors were doing must be asked. The curiosity heightens further when considering the relationships between the relevant individuals.

Mr Peterson and Mr Ekstrom were the two directors of the Fund. Mr Peterson's older brother, Mr Magnus Peterson ('Magnus') controlled WCF and the Fund's investment manager, Weavering Capital (UK) Limited ('WCUK'). Further, Mr Ekstrom was Mr Peterson's and Magnus' step-father.

Neither Mr Peterson nor Mr Ekstrom claimed to have any specific experience in the type of investments the Fund was concerned with. The management of the Fund was left to WCUK and, in particular, Magnus. Aside from attending board meetings and perhaps attending to the occasional administrative task, what the directors actually did is difficult to ascertain. This lead to the Grand Court deciding that they had deliberately ignored their duties.

By way of example, in relation to the interest rate swaps, the directors asserted in the proceedings that they did not know that the counterparty was WCF, instead believing (without making further enquiries) the Fund to be trading with international financial institutions.

The directors also failed to ask the even more fundamental question of the Fund's performance. The Grand Court held that had the directors been paying proper attention, they would have identified in a report produced in the third quarter of 2008 that the fund was insolvent and should been wound up (without paying out vast redemption requests at the time).

Further, the annual accounts, provided by WCUK (Magnus) were simply signed off by the directors without being scrutinised.

Both Mr Peterson and Mr Ekstrom accepted that they had a duty to supervise and a duty to exercise independent judgement, skill and diligence. Whilst they had the power to delegate functions to service providers, such as WCUK, this did not absolve them of their duty of supervision, which cannot be delegated.

Despite the directors claiming that they each genuinely believed that they were complying with their duties, because they were found to have ignored them, the Grand Court decided that their actions must have been a deliberate. Consequently, they were found to be guilty of wilful neglect or default by applying the established tests in **Re City Equitable Fire Insurance** namely:

i. knowing and intentional breach of duty; or

ii. acting recklessly, not caring whether or not the act or omission is a breach of duty.

INDEMNITY FAILURE

In England and other offshore jurisdictions such as Jersey and Guernsey, legislation renders contractual provisions to relieve directors of liability unenforceable. However, they remain permissible in the Cayman Islands.

Mr Peterson and Mr Ekstrom had a safety net of an indemnity within the Fund's Articles of Association, but this did not apply because of the 'wilful' nature of the finding by the Grand Court.

It was noted that the directors would have been protected by the exculpatory provisions had they failed to perform their duties as a result of carelessness, no matter how gross. The Grand Court went on to describe the indemnity provision being designed to protect an individual who does his or her "*incompetent best*".

As the two directors had been found guilty of wilful neglect or default, their shortcomings could not be characterised as carelessness or incompetence, rather they were deliberate, and the indemnity could not protect them.

REVERSAL BY THE COURT OF APPEAL

The Court of Appeal endorsed the use of the two limb test in **Re City Equitable Fire Insurance** by the Grand Court, but held that neither test had been satisfied in this case.

In finding that the directors had been guilty of wilful neglect or default, the Grand Court relied on inferences, as there was no direct evidence available that the directors knew that they were acting negligently. Whilst the Court of Appeal agreed that the directors had breached their duties, the evidence available to the Grand Court was deemed insufficient by the Court of Appeal to support the finding that the directors' conduct amounted to wilful neglect or default.

This meant that the directors were entitled to rely on the exculpatory indemnity provisions within the Fund's Articles, resulting in the Grand Court's original order for damages against them being set aside.

SUMMARY

The exceptional circumstances of this case should mean that it has limited comparative use, but legally it is, and remains, of widespread application. The Grand Court's judgment highlighted the vulnerability of directors in the funds industry and a number of points have been given regulatory force by the Cayman Islands' Monetary Authority.

The Court of Appeal's approach to trying issues of alleged wilful neglect or default means that the bar for liability is a very high one. An inference of wilful default is not good enough; direct, positive evidence appears to be required for a proper finding to be made.

Therefore, subject to the terms of the articles of association, a director may be absolved of liability for the most serious of breaches, as long as they are not wilful. It might again be time for directors and investors concerned with Cayman corporate entities to pause for thought.

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