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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Don't Just Sit There, Fund Directors — Do Something!

Law360, New York (October 05, 2011, 2:13 PM ET) -- If you don't want to pay up, do your best — even if it is your incompetent best. That is one message from Justice Andrew Jones QC in the recent Cayman Islands Grand Court decision in Weavering Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom[1] ("Weavering"), where the two defendants, both "independent" directors of the Weavering Macro Fixed Income Fund (the "fund"), were each ordered to pay damages in the amount of $111 million for wilful neglect or default in carrying out their duties.

The case arose out of the liquidation of the fund following the discovery that Magnus Peterson, the promoter and principal investment manager, had been fabricating interest rate swaps as investments to inflate the net asset value of the fund and hide the fact that the fund was making losses. The messages from this case, however, are generally applicable to all private fund directors and, indeed, have relevance to all directors.

In Weavering, it appeared as though the defendants were chosen for their familial ties to Magnus Peterson rather than their professional judgment. While the defendants looked good on paper, Stefan Peterson was in fact the younger brother of Magnus Peterson and held a busy full-time job with a large insurance company in Oslo, Norway. Hans Ekstrom was the Peterson brothers' 79-year-old stepfather who had retired from his position as head of a large financial group's trustee department 13 years earlier. Although appointing relatives is not necessarily a bad sign, it certainly should raise the question of whether a board is truly independent and a proper check and balance.

Weavering, just one in a line of cautionary tales to both investors and industry alike, highlights how easy it may be for a director to become a puppet and for investors to suffer as a consequence. In his judgment, Justice Jones focused upon the apathy and neglect of the defendants in carrying out their duties as directors. It was the fact that the defendants "did nothing and carried on doing nothing for almost six years" which led to the judgment against them and, as Justice Jones noted, the purpose of indemnity clauses such as that contained in the Articles of Association of the Fund is to protect directors who make an attempt to perform their duties but fail, not those who make no serious attempt to perform their duties at all.

Accordingly, in giving his judgment, Justice Jones was compelled to revisit the basic standards that are expected of any directors: to exercise their supervisory powers in a "professional, businesslike manner […] without subordinating those powers to the will of others."

The following are some of the key "dos and don'ts" for directors to be learned from Weavering:

DO consider carefully which service providers are selected for appointment.

It is important that directors consider carefully the contracts for the appointment of each service provider and independently assess the suitability of the appointments for the fund in light of industry standards. Justice Jones noted that not only did the defendants fail to consider the terms of engagement for certain service providers, they did not ensure the service providers appointed were in fact the correct parties.

DO NOT forget to check whether the party appointed is actually the party engaged.

Minutes of the organizational board meeting of the fund reflected resolutions to appoint PricewaterhouseCoopers as auditors to the fund and Fortis Fund Services as administrator. Yet the parties actually appointed were Ernst & Young and PNC, respectively.

DO ensure you understand the nature of the services to be provided by service providers to a fund.

Delegated functions require supervision and, particularly in investment funds, this supervision often represents the most significant way in which directors exercise their oversight. In Weavering, the board of directors delegated functions such as the accounting of the fund's net asset value, management of the investment portfolio and custody of the assets They failed, however, to realize that the terms of PNC's engagement did not include monitoring the investment manager's compliance with investment restrictions.

DO NOT ignore gaps in the services to be provided by service providers.

As neither PNC, nor any other party, was engaged to monitor investment restriction compliance, it was the defendants' duty as directors to monitor breaches of investment restrictions. However, aside from "noting" investment restriction compliance in board minutes, the defendants were found not to have adequately monitored investment restrictions. Had they done so, it is likely that they would have realized that the fund was purported to be engaged in interest rate swaps well above the permissible leverage limits.

DO get all relevant reports from service providers.

While many may assume that providing reports would be a basic part of a service provider's role, Weavering shows it is a director's responsibility to ensure they are provided and, once provided, they are read. In Weavering, PNC was only documented as having provided a quarterly administration report nearly two years after the launch of the fund. Moreover, the first documented report offered the directors a chance to request information they would like to receive from the administrator, but it does not appear the defendants responded.

DO NOT assume that the reports provided contain all the necessary information.

The quarterly reports produced did not contain monthly or quarterly management accounts. There was no evidence these accounts were ever requested despite monthly calculation of the fund's net asset value and processing of its subscriptions and redemptions. This meant that the only documents the directors ever received to supervise the financial position of the fund were the half-yearly and year-end financial statements.

DO read the reports received.

Although the fund's directors began receiving the administrator's report, albeit almost two years after the fund's launch, they rarely reviewed the reports as a means of supervising the fund. Ekstrom testified to the fact that he had only looked at the first few pages of quarterly reports produced by PNC and even noted that he had never finished one because he had "no experience of these papers."

DO NOT underestimate the importance of reviewing reports from an independent director's perspective.

Peterson reported that, after he had become a full-time executive of a company in the Weavering group, he felt he did not need to read the reports because they would only be independent verification of what he already knew. Yet, he further testified that had he actually read the reports he would have seen that the profitable interest rate swaps recorded on the accounts (although they were actually fictitious) were being closed out for no consideration. Justice Jones highlighted that it appeared Peterson did not separate his roles and attempt to review the reports from a director's standpoint to satisfy himself — as an independent director — about the financial condition of the fund.

DO ensure regularity of board meetings and accuracy of records.

The Weavering case shows that missing the bare essentials, such as staging board meetings, can spell disaster for directors. There were several instances where meetings were purportedly held, but did not in fact take place. Also, on several occasions, board minutes recorded parties as having attended when, in fact, they did not.

DO NOT conduct board meetings without the structure and formality that they require.

Meetings that did take place were often held at Ekstrom's home, and Justice Jones noted that he did not believe any real business was carried out at the meetings. Additionally, following Ekstrom's testimony, Justice Jones noted he was "left with the impression of an elderly gentleman sitting at home chatting to his two stepsons in a congratulatory way about Magnus Peterson's apparently successful investment fund business."

DO invite representatives of external service providers to board meetings.

In Weavering, it is highlighted that Magnus Peterson and the two defendants were the only parties ever noted as having attended a board meeting. In his judgment, Justice Jones observed that service providers should be requested to attend board meetings, provide reports and answer questions on a regular basis.

DO NOT rely solely on the reports presented as an assurance that the company is being run properly.

Justice Jones noted that having an oral report from the administrator to explain its written report or a discussion with a representative of the auditor to discuss the financial statements would have been normal and prudent business practice on the part of the directors.

DO produce real minutes of board meetings.

No two meetings are exactly alike. For this reason, the minutes of one meeting should not be exactly the same as the last. Weavering reemphasizes that minutes should be accurate records of the matters actually considered, the discussions held and the decisions made at board meetings. Robust and detailed minutes help establish that directors have properly discharged their duty of care.

DO NOT allow minutes to become boilerplate.

Justice Jones highlighted that the exact same template of board minutes was used for virtually every board meeting that took place, and some that never took place at all. These templates included no dialogue to show how decisions were made or resolutions passed. For example, as mentioned above, the minutes consistently stated that the defendants "noted" the investment restrictions were being complied with. Additionally, even some of the most fundamental elements of the minutes, such as the date of the meeting and attendees present, were often incorrect.

DO expect appropriate remuneration.

As a general rule, independent nonexecutive directors should receive remuneration that corresponds to the responsibilities commensurate with the role and the time it will take to fulfill them.

DO NOT assume that a director's expected level of responsibility is tied to the level of his remuneration.

A lower fee or gratuitous engagement does not mean the director in question is held to a lower standard or expected to do less in fulfilling the director's supervisory role. The defendants' counsel attempted to put forward a defense that Peterson and Ekstrom agreed to act as directors without a fee and, based on an observation made in one of the Barings PLC cases,[2] argued that the level of a director's remuneration may be considered in determining the scope of the director's responsibility. Justice Jones, however, distinguished this position. In his opinion, the fact that the defendants were not paid supported the plaintiff's argument that the defendants had never intended to carry out their duties in the first place.

DO ensure you clearly understand the financial position of the company you direct.

Justice Jones noted the defendants were "expected to acquire a proper understanding of the financial results of the investments and trading activity, without which they would not be able to perform a supervisory role."

DO NOT fail to recognize and investigate unusual events.

In late 2008, Lehman Brothers collapsed, one of the most significant financial crises in recent history ensued, and the fund paid out $138.4 million in redemptions. Justice Jones indicated that the defendants were seemingly not concerned by these events and never made any serious attempt to understand the fund's overall financial position. Additionally, they never considered the detail in the third quarter and fourth quarter administration reports with regard to the counterparties to which the fund was exposed. It took a fax from the administrator to the directors noting that a substantial proportion of the net asset value was exposed to Weavering Capital Finance, a company they had believed dormant since 2003, before red flags were raised.

DO read carefully the documents you are asked to sign.

Almost as a mantra throughout the judgment, Justice Jones repeatedly stated that the defendants failed to "apply their minds" to their respective roles as directors. Instead, the defendants were consistently performing what Justice Jones called an "administrative service," by signing the documents they were asked to sign by Magnus Peterson without independently reviewing them to ensure they were appropriate.

DO NOT become a rubber stamp.

These “rubber-stamped” documents included anything and everything: from inaccurate board meeting minutes to a new investment advisory agreement and new management agreement that could have fundamentally changed the management structure of the fund, but both of which Justice Jones deemed to be “a sham.”

Weavering stands as a reminder that sometimes it is a failure to meet the basic fundamentals that can cause the greatest harm. Those investment groups and directors who rely exclusively or largely on written resolutions or who have no or minimal minutes reflecting discussion and deliberation should consider especially carefully the effect of this judgment.

Board supervision relies on directors to seek out and then read, analyze and utilize the information they are given. As the global financial industry moves toward greater regulation, new laws such as the Alternative Investment Fund Managers Directive in Europe (the “AIFMD”) are focusing minds on the need for a clear distinction between the roles of the governing bodies of funds and delegate service providers.

As negotiations over the text of the AIFMD have unfolded, the liability applicable to different parties has become clearer. Also, the importance of each party to a fund knowing what it is, and is not, responsible for has become apparent. However, while more detail is being set out around the duties of a fund’s governing body versus the duties of a delegate service provider, one thing has remained clear: Directors have the responsibility to oversee the business of the company they direct and ensure that its business is carried out appropriately and in the best interests of the company’s shareholders as a whole. If it is not, it is the directors who must explain why.

The list set out above serves as a reminder to directors to ensure that the foundations of oversight are strong. As corporate governance standards and legal requirements for directorships continue to evolve, it is prudent to remember that the law may protect those who try but fail. However, those who do not try will pay dearly.

--By Peter D. Astleford, George J. Mazin, and Peter McKeown-Walley, Dechert LLP

Peter Astleford is a partner in the London office of Dechert. George Mazin is a partner in the firm's New York office. Peter McKeown-Walley is an associate in the firm's London office. *The authors would like to thank Lindsay Trapp for her assistance in drafting the article.*

[1] Cause No. FSD 113 of 2010 (AJJ).

[2] Re Barings PLC, Secretary of State v. Baker [1998] BCC583, at p. 586.