STUARTS HUMPHRIES

CASE LAW REVIEW

Is ignorance bliss?

Weavering Macro Fixed Income Fund Limited v Stefan Peterson and Hans Ekstrom

We review the decision of the Court of Appeal of the Cayman Islands ("CoA") in Weavering Macro Fixed Income Fund Limited (In Liquidation) (the "Respondent") v Stefan Peterson and Hans Ekstrom (the "Appellants") on 12 February 2015.

Summary

In a judgment dated 26 August 2011, the Appellants had been found to have been in breach of their duties as directors of the Respondent, a failed fund. The Grand Court of the Cayman Islands ("**Grand Court**") also found that the Appellants were guilty of willful neglect or default and that, accordingly, the indemnity and exculpation clause contained in the articles of association of the Respondent (which would render the directors not liable for losses arising out of their actions save in the event of their willful neglect or default) would not apply. Judgment was therefore entered against each of the directors in the sum of US$111 million. This decision was widely reported and analysed due to the extensive guidance it provided as to directors' best practices and procedures and due to the severe financial penalties handed down to each of the Appellants.

The Appellants appealed this decision and the CoA has now found in their favour. The CoA's decision was that, whilst the directors had clearly breached their duties and been negligent, the indemnity and exculpation clause was there to protect "**directors who do their incompetent best**" and that "**negligence, however gross, is not enough**". It remains to be seen what the impact of the judgment will be but, due to the emphasis being placed on the inexperience of the Appellants and the delegation and trust placed in professional advisors, there is likely to be little practical significance for the majority of companies or funds with professional, experienced directors. However, shareholders and investors should perhaps be aware that, if they expect a director to be personally liable for his gross negligence, they will need to ensure that the articles of association do not provide for exculpation in such circumstances as, following the CoA's decision, it is now clear that gross negligence and willful neglect are by no means the same in the eyes of the Court.

What is the background to the case?

The Appellants are the brother and the step-father of the principal of the Respondent's fund manager ("**Mr E**") and had agreed to act as the sole directors of the Respondent as a favour and to effectively "make up the numbers". All administrative and investment management functions were delegated to professional providers.

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The net asset value of the Respondent was reported to have increased from US$37.9 million in April 2005 to US$742.7 million in October 2008. However, these figures were grossly incorrect and the Respondent was actually making huge losses. These losses were hidden by fictitious gains on a basket of interest rate swaps with Weavering Capital Fund ("**WCF**"), a shell company controlled by Mr E. The Appellants had, in their capacity as directors of the Respondent, signed documents relating to at least 43 transactions with WCF and had admitted that they quite often did not read the documentation they were signing.

Following the collapse of Lehman Brothers in 2008, the Respondent received an impossible level of redemption requests which could not be satisfied. The Respondent collapsed and so its liquidators sought to bring proceedings against the Appellants in an attempt to recover some of the lost monies. Approximately US$141 million had been paid out in irrecoverable redemption payments and the loss to the Respondent was valued at US$111 million.

The Appellants argued that the articles of the association of the Respondent contained an indemnity and exculpation clause in their favour (which would only be lost in the case of "willful neglect or default") and also maintained that they did not know the counterparty to the interest rate swap transactions was WCF.

The Grand Court delivered a damning critique of the Appellants' failures to fulfil their duties as directors and held that the Appellants had in fact acted with willful neglect and that, therefore, the benefit of the indemnity and exculpation clause in the articles of association was lost. Accordingly, each of the Appellants were held liable and ordered to pay US$111 million.

On what basis was the case successfully appealed?

In delivering its judgment, the CoA stated that it needed to consider three key issues:-

1. Were the Appellants in breach of their duty to exercise reasonable care and skill or perform a high-level supervisory function in failing to discover that WCF was the counterparty to the interest rate swap transactions?

The CoA decided that, whilst the Grand Court had erred in taking too little consideration of the context (i.e. the Appellants were non-executive directors, received no remuneration, had delegated management to a third party provider (which all parties were aware of) and the reliance and trust placed on the service providers by the Appellants), the Appellants had indeed failed to perform their supervisory duties with reasonable care and skill (notwithstanding the lower standard which the CoA believed it was appropriate to apply in the circumstances). The CoA stated that the Grand Court had **"imposed duties on them retrospectively which it was impossible for them to have discharged, no-one ever expected them to discharge or believed they were discharging".**

2. Was the failure to discover the issue with the interest rate swap transactions the result of willful neglect or default?

The CoA held that there needed to be a "**will to be negligent**" i.e. a deliberate and conscious decision by a director to act or fail to act in knowing breach of his duty. The Appellants were essentially unaware of their duties and had believed that they were all duly delegated to their service providers. They had been negligent but had not made a conscious decision to be negligent. The CoA said that "**negligence, however gross, is not enough**". The Appellants' failure to read the documents they were signing was considered less damning by the CoA in this regard as the Appellants had been advised to sign them by their professional providers.

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3. Whether the Grand Court ought to have held that the failure to discover the counterparty arose as a result of 'reckless carelessness' which, itself, could constitute 'willful neglect or default' on the basis of existing case law?

The CoA held that the Grand Court should not. The Appellants would have needed to have appreciated that their conduct may be a breach of duty and make a conscious decision to proceed regardless of the consequences. This was not the case given the prevailing facts.

Accordingly, the CoA overturned the Grand Court's decision and found in favour of the Appellants.

What are the likely consequences of the case?

In practice, the implications of this case are unlikely to be considered in as zealous a manner as the Grand Court's decision. The practical advice given in the Grand Court's decision as to directors' best practices and procedures is still relevant and should, as a matter of good governance, be adhered to.

However, the real significance of the case is to reaffirm that the Court must have regard to all the facts of the case in determining whether a breach of duty has occurred and that, to some extent, ignorance can be a defence. It should also be noted that the facts of the case are very particular and that it is unlikely that many funds would have directors who are anything other than seasoned professionals with a wealth of experience in the fund industry. Using this case, such directors would accordingly have a higher burden to satisfy in the exercise of their duties and so the case does not, by any stretch, provide a 'get out of jail free card' for directors of a fund. In fact, the emphasis on considering the particular circumstances of each case may well seek to increase the threshold for the majority of experienced directors of funds.

The case also clarifies that there is indeed a distinction between gross and willful negligence in the Cayman Islands which has perhaps become less clear given the prevalence of US definitions of 'gross negligence' finding their way into the governing documents for most funds. Accordingly, as indemnity and exculpation provisions similar to that used in this case are common, any shareholders or investors who believe that the fund should be able to pursue a director personally for liabilities arising from their gross negligence should ensure that indemnity provisions in the constitutional documents are appropriately drafted.

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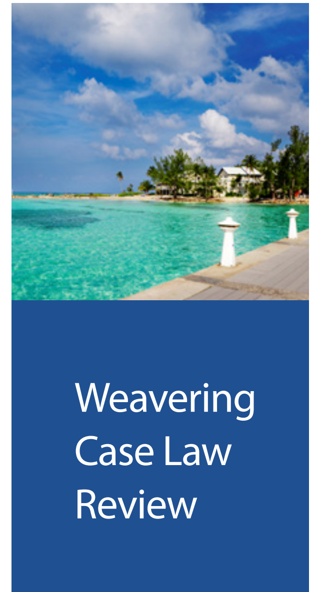

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