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DIRECTORS

Directors of Cayman Islands Hedge Funds Assume a More Substantive Governance Role in Response to Institutional Investor Demands

By Christopher Faille

As hedge fund investment performance has stumbled, institutional investors have ramped up the rigor of their pre-investment and ongoing due diligence, subjecting heretofore ignored aspects of hedge fund operations to new levels of scrutiny. One such area of newfound concern among investors is the role of directors of hedge funds organized in the Cayman Islands. Accurate or not, the general perception in the hedge fund industry has been that Cayman directors have played a less substantive role in the governance of the hedge funds they are supposed to oversee. Moreover, as a result of a dearth of qualified directors, certain individuals serve on the boards of dozens of hedge funds, which renders it virtually impossible for those directors to actively participate in the governance of any one fund.

To address the concern that various Cayman directors are detached from their obligations or are spread too thin, institutional investors are demanding more evidence of substance in directors' roles in overseeing hedge funds, and more accountability from directors who fail to fulfill their oversight obligations.

Scott Lennon, Senior Vice President with Walkers Fund Services, Ltd., told The Hedge Fund Law Report that today, as distinct from years past, "asset managers want a board that they can introduce to their institutional investors – to pension fund managers. The redefinition of the directors' role is not coming about through statute or court decisions. It is coming about through investor demand and due diligence."

Convergence of Four Factors

The convergence of a number of factors is leading to enhanced scrutiny of Cayman directors. First, the number of hedge funds organized in the Caymans is growing at a steady clip. A year ago, the number of investment funds registered with the Cayman Islands Monetary Authority (CIMA) passed 10,000. See generally "[Cayman Islands Monetary Authority Issues Report on Hedge Fund Statistics](#)," The Hedge Fund Law

Report, Vol. 1, No. 14 (Jun. 19, 2008).

Second, the U.S. Congress has been focusing ever-greater attention on perceived tax avoidance by U.S. persons via offshore hedge funds. See "[Senate Proposals and GAO Report Focus on Taxation of Cayman Islands Accounts](#)," The Hedge Fund Law Report, Vol. 1, No. 18 (Aug. 11, 2008). Most recently, that focus has manifested itself in a proposal to tax offshore hedge funds as U.S. corporations. See "[Congress Introduces Legislation That Would Tax Offshore Hedge Funds as U.S. Corporations](#)," The Hedge Fund Law Report, Vol. 2, No. 14 (Apr. 9, 2009).

Third, international groups have expressed an intention to crack down on what they perceive as opaque offshore arrangements. For example, at the recent G-20 meeting in London, leaders of the industrial nations pledged to take action against jurisdictions that do not comply with "international standards for exchange of information." At roughly the same time, the Organization for Economic Cooperation and Development (OECD) published "blacklist" of four non-cooperative nations (Costa Rica, Malaysia, the Philippines and Uruguay) as well as a "grey list" of countries that agreed to improve their transparency but that have yet to sign the necessary international accords. The grey list included the Cayman Islands.

Fourth, the collapse last month of Weavering Macro Fixed Income Fund Ltd., a Cayman Islands hedge fund, and its London-based manager, Weavering Capital (UK) Ltd., has prompted calls for change in the system of corporate governance in the Caymans. See "[The Weavering Blow-Up and What It May Mean for Boards of Directors of Cayman Islands Hedge Funds](#)," The Hedge Fund Law Report, Vol. 2, No. 13 (Apr. 2, 2009).

Peter Cockhill, an Ogier partner and a leading hedge fund lawyer in the Caymans, told The Hedge Fund Law Report that the Weavering debacle shows "the need to have service providers and fiduciaries who are independent of the principals of the investment manager and so who are thereby not compromised and are well placed to provide oversight for the benefit of a fund and its investors."

Director Disqualification Laws

The laws of some jurisdictions include directors' disqualification laws, i.e., procedures by which a particular individual can be found to be ineligible to serve on a board, or can become disqualified from continued service even after the commencement of service on the board. The Caymans do not have such a director disqualification law on the books or in applicable common law.

Chris Johnson, principal of Chris Johnson Associates Ltd., an accounting and insolvency firm headquartered in George Town, Grand Cayman, told The Hedge Fund Law Report that he believes directorships are the next big regulatory issue in the Caymans. As one

example of the inadequacy of the present regulatory system, he said that the absence of any disqualification laws “permits undesirable directors to not only commit fraud but to act in negligent and reckless ways without fear.”

Cockhill, however, sees the issue of disqualification differently. He said that standards in the Caymans are high and have risen in recent years by virtue of the voluntary adoption by a number of Cayman-based companies that provide director services of the Alternative Investment Management Association’s Code of Conduct. He also noted, with respect to laws that disqualify a director following a bad act, that such laws “would not be much help as [disqualification under such laws] is an after the event action.”

Indemnification

Johnson and Cockhill likewise expressed different views on the issue of the indemnification of the officers or directors of a company for negligence and gross negligence. According to Johnson, “certainly indemnities are a thing of the past and must go. Guernsey banned them last year on account of public interest and Cayman must do the same.”

Cockhill, on the other hand, said that banning indemnification of directors would only increase the cost of providing director services while not providing any discernable offsetting benefit in terms of risk control. “A director will not want to be held liable as a result of its appointment of, say, a big four audit firm, if it turns out that the audit firm made a mistake but is not liable or only liable to a defined capped amount and the director can be held liable in accordance with a higher standard of care when he or she has acted appropriately in supporting a capable audit firm. If a director has no indemnity or exculpation provisions in the constitutive documents of the fund, then he or she will ensure that they have the protection in a service agreement that they sign with the fund.”

Indemnification for Negligence and Gross Negligence Permissible

U.K. case law, which is persuasive in the Caymans, generally provides that indemnification of directors is permissible except in the cases where the director has engaged in fraud or willful misconduct, or has recklessly disregarded his fiduciary obligations. (In this sense, U.K. law largely tracks Delaware law.)

The Companies Law of the Cayman Islands does not set out any specific restrictions on the ability of a company to indemnify its officers or directors. Although the law is substantially based on the United Kingdom’s company law statutes, there is an important distinction. Section 205 of the U.K. Companies Act voids any clause in a corporate charter that attempts to exempt directors from liability for their negligent management of the company. The Caymans have never adopted Section 205, leaving intact earlier

common law principles allowing such provisions.

Under those common law principles, indemnification for fraud is impermissible, but indemnification for acts of negligence is permitted. Furthermore "negligence" in this context includes acts that U.S. law would construe as "gross negligence," because the common law did not recognize "gross negligence" as a concept distinct from negligence.

Increasingly Active Role of Cayman Directors

Scott Lennon, of Walkers Fund Services, currently holds directorships on the boards of various types of funds covering a wide range of strategies. He told The Hedge Fund Law Report that there has been a change in the role of directors over the last ten years. At the start of that period, "many asset managers just wanted to sign up a retired banker or lawyer as a director, and they did not expect the directors to play an active role. But that has changed because the nature of the investors has changed."

Jonathan Tonge, Managing Partner of Walkers' Hedge Funds Group, agreed with the proposition that there has been a trend over roughly the last decade of directors becoming increasingly active and involved. "In late 2008," he said, "directors were well-placed to give the managers some very good advice on behalf of the funds, about redemptions, net asset value computation, gates, and the whole range of structural issues."

The Cayman Islands Directors' Association

A related development in recent years has been the increase in the number of management firms set up in the Cayman Islands to offer director services to Cayman-registered hedge funds. Such firms sprung up largely in response to the explosive growth in the number of Cayman funds – a classic case of supply meeting demand – but the trend nonetheless raise concern. An April 2008 article in Cayman Net News stated that "[a]ttorneys are leaving law firms and accountants are leaving banks and accounting firms to set up company management firms." The article added: "one can surmise that this trend" has given the CIMA "some concern."

The focus of that article was the creation of a new industry self-regulatory body, the Cayman Islands Directors' Association (CIDA). In the words of its Memorandum of Association, dated March 17, 2008, the CIDA exists to "represent and promote the interests of all those persons who act as directors of Cayman Islands registered companies, to protect the commercial and other interests of all such persons, and to define a code of conduct and best practice for such persons."

In June 2008, Thomas Ridley, chairman of the CIMA, spoke to a lunch gathering of the CIDA and expressed his view of the role their new association could play. "We need to

expand the qualified director pool in Cayman. There are simply too few today This lack may lead to individuals arguably holding too many directorships and thus not being able to meet their responsibilities to those entities, facing (or ignoring or not dealing with) inevitable conflicts or simply not being qualified (and I use the term in its broadest sense) or experienced enough to carry out their functions as required.” He went on to express the hope that the CIDA would work to expand the pool of talent through education and training.

In October 2008, the CIDA promulgated its Code of Professional Conduct. Much of the Code is directed at independence and the avoidance of conflict. Article Six (of 12), for example, provides: “At all times have a duty to respect the truth and act honestly in his business dealings and in the exercise of his responsibilities as a director.” Paragraph three thereunder explains: “A CIDA member should accept that resignation or dismissal may sometimes be the ultimate consequence of sustained protest on a matter of conscience or judgment.”

Role of Institutional Investors

Looking over the trend toward increased participation and accountability among directors, Ogier’s Cockhill concluded that the trend has been fueled by demands of institutional investors, and such investors will continue to shape the role of Cayman directors. Prior to an investment in a Cayman fund, Cockhill suggested that an institutional investor satisfy itself that the fiduciaries of the fund – including its directors – have adequate experience and ability to capably govern its investments and operations. “If they are not so satisfied, they can decide not to invest, or can insist that other directors are appointed.”