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UPDATE

Commercial fund litigation: A manager's duties – getting it right!

Update prepared by Robert Shepherd (Senior Partner, Guernsey)

Fund Managers should consider with care the legal duties they owe and how they may be properly discharged. This update addresses some recent judgments.

The net asset value of total funds under management and administration in Guernsey is some £227.6 billion.[1]

Managers and administrators should consider with care the duties they owe, how those duties may be discharged and what can be done now to improve their position if they later become the subject of legal proceedings. This article addresses some recent judgments which are useful examples.

The English SPL Case

Although not binding on the Guernsey courts, the English decision of *SPL Private Finance (PF1) IC Limited & Ors v Arch Financial Products LLP*[2] (SPL) had close connections with Guernsey and will be of interest to investors and industry alike.

Arch managed 'the Arch-Cru funds', for which a Guernsey incorporated cell company (ICC) was used to invest in real estate opportunities. Each cell entered into an investment management agreement (the IMA) with Arch, which procured investments from late October 2007 to August 2009 in a UK-based student housing business known as 'Club Easy'.

The claimant cells asserted that the decisions to invest were driven by Arch's own financial interest rather than proper consideration of the investments' merits and the interests of the cells. Accordingly, Arch had acted in breach of fiduciary duty, in breach of the IMA and negligently.

It was found that Arch owed:

- an express duty to exercise reasonable skill and care in managing the ICC's portfolio (but otherwise such duty was to be implied); and
- an implied fiduciary duty to give preference to the interests of the claimant cells over its own, including a duty to avoid conflicts of interest and not to make a secret profit.

Duty 1 – reasonable skill and care

Was Club Easy a bad investment? It was certainly highly geared, unable to generate sufficient profits to cover the interest payable and needed further capital injections to survive.

Or was it just another victim of the credit crunch which, by 2008, was in full swing? The English High Court held that warning signs were discoverable when the initial investments, totalling some £20m, were made in

[1] Source: GFSC Fourth Quarter 2015 – Investment Statistics

[2] [2014] EWHC 4268 (Comm).

October 2007. The accountants at the time warned of the need for more capital, and Arch placed too great a reliance on property valuations artificially inflated by the 'Club Easy' name. That, and the failure to conduct any satisfactory risk/reward analysis, resulted in a finding of negligence against Arch for having failed to meet the requisite standard of care.

The problems persisted when further investments of some £6m were made, which could not be blamed on a generally worsening financial climate and were only made by reason of the initial investment.

An indemnity for loss under the IMA was of no assistance to Arch in circumstances where the loss resulted from its own negligence. The High Court did not consider whether the result would have been the same if, say, the relevant clause had specified that (only) 'gross negligence' would exclude its application. It is a stark reminder that fund managers ought to consider drafting indemnities in the most favourable terms, and with the benefit of professional legal advice.

Duty 2 – fiduciary duty

Arch was also found to have breached an implied fiduciary duty to avoid actual or potential conflicts of interest and not to make a secret profit, most notably by receipt on 6 November 2007 of a £3m payment funded almost entirely from investors' money, which was not disclosed to the claimant cells. The question was whether the IMA expressly excluded, or otherwise permitted conduct amounting to, a breach of fiduciary duty.

Whilst the High Court accepted there was a specific exclusion relating to conflicts of interest, it did not amount to a general exclusion and Arch could only act where there was a conflict subject to an overriding (and express) obligation to ensure that it was managed 'fairly'. The evidence suggested that it had not been managed fairly; the High Court concluded that Arch's failure to disclose its own interest resulted in a serious breach of its fiduciary duties, for which it could not rely on the IMA as a defence.

Once again, it is not clear if tighter drafting might have assisted Arch, but this further emphasises the need for legal advice in preparing any scheme's principal documentation.

Waiver & Release – a complete defence?

Arch was replaced as manager on 30 November 2009 and by letter had agreed to waive its entitlement to fees in exchange for a full release of liability to the claimant cells.

Upon a true construction of the waiver, the High Court held it was not intended to apply to all claims against Arch. Had it been drafted in wider terms, perhaps it could have afforded the protection that Arch was expecting it to.

The Guernsey Invista Case

The Guernsey courts have recently considered the duties owed by a fund manager in *Tranquility Holdings Limited v Invista Real Estate Investment Management (CI) Limited*[3] in which a circa £3m claim by a plaintiff unitholder in a Class B open-ended unit trust was struck out for lack of causation, the loss having resulted from the 2007 downturn in the UK property market and not the actions of the fund's manager. A subsequent attempt to appeal that decision was unsuccessful.[4]

It is important to note that, whilst this case involved an entirely different investment structure to that used in SPL it is likely, in the absence of other Guernsey authority on point, that the principles identified by the High Court in SPL will be extremely persuasive in Guernsey.

As to the duties owed by a fund manager to an individual unitholder in the context of a unit trust arrangement, Bailiff R. Collas accepted the position expressed in Jersey[5] that:

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[3] Royal Court, Civil No 1782, 13 August 2015.

[4] Guernsey Court of Appeal, Appeal No. 500, 4 March 2016.

[5] *Barclays Wealth Trustees (Jersey) Limited (in its capacity as trustee of the R2 Bulgaria Property Fund) v Equity Trust (Jersey) Limited* [2014] JRC 102 D.

> 'It is … at least arguable that fiduciary duties and/or a duty of care may be owed by the Manager to the Plaintiff [unitholder]. Whether that is so involves a novel point of law as to the tripartite relationship that exists between the trustee, manager and unitholders of a unit trust on which, as yet, there is no conclusive judicial decision. Resolving such an important legal question … would require full consideration of the factual matrix of the relationships, after a full trial on the facts.'[6]

The case considered the existence of similar duties to those explored in SPL although, unlike the terms of the IMA in SPL, there were no express obligations owed by the manager to the unitholder in the fund's principal documentation. The judgment leaves open whether managers of collective investment schemes owe such duties – by implication if not expressly – and can be held to account by individual investors claiming breach of fiduciary duty, breach of contract or negligence.

However, the message from local jurisprudence, to be complemented (if nothing more) by English authority, is that fund managers may not be able to hide behind scheme documentation in the face of investor claims.

In SPL (albeit in the context of an ICC arrangement), the court took the next step and explored not only the types of duties that may arise in a managerial context, but also how they might be discharged or otherwise mitigated, for instance by careful drafting of a scheme's principal documentation.

Those principles are likely to be of relevance not only to fund managers investing through ICCs, but to the Guernsey fund industry as a whole.

It is far safer to assume that obligations of the type covered above are indeed owed. Steps should be taken in advance to address those obligations, rather than fund managers running the risk that they are not owed or, worse, find that they are and have no contractual defence in future legal proceedings.

Robert Shepherd and Daniel Brouard headed Mourant Ozannes' specialist fund litigation team who successfully represented Invista Real Estate Investment Management (CI) Limited, in the claim brought against it by Tranquility Holdings Limited.

[6] At para 112 of the Royal Court Invista judgment – Op Cit.

Contacts

Robert Shepherd
Senior Partner, Mourant Ozannes
Guernsey
+44 1481 731 418
robert.shepherd@mourant.com

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