MINI-ROUNDTABLE

INVESTMENT FUND AND TRUST DISPUTES

PANEL EXPERTS

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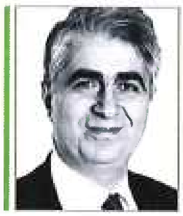
Jon Barclay is of counsel at Bedell Cristin Guernsey Partnership. Besides his work at court, where he is highly rated for his presence, he advises institutions, law firms and in-house teams worldwide across the range of international financial services and international private client matters. Mr Barclay has a close interest in cross-border enforcement and asset recovery and has received particular recognition for his work in the fraud arena, with freezing injunctions and related orders.



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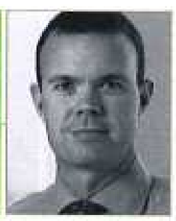
Hossein Hamedani is the senior partner in forensic investigation services. He has acted as expert and adviser in hedge fund disputes and as inspector and skilled person on regulatory investigations in Jersey, Guernsey, Cayman, BVI, New York, Hong Kong and London. The cases have involved currency derivatives, property investments, energy and tech funds. He has been a partner since 1991 and investigated 12 major bank failures with a view to recovery of funds and assessment of causes of failure.



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Guy Manning is a partner in Campbells' Litigation and Dispute Resolution Department where he specialises in investment fund and insolvency litigation. He joined the firm in 2005 having spent the previous eight years working for a major London law firm. Mr Manning advises and appears in the Cayman Islands Courts on behalf of liquidators, creditors, shareholders, directors, managers and other professional service providers in relation to a broad range of pre and post liquidation disputes, principally concerning distressed and failed investment funds.

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Nick Matthews leads Kinetic Partners' Global Forensic and Disputes Services practice. He has over 17 years of forensic accounting, litigation support and liquidation experience, with an emphasis on financial services clients. He has led significant international projects in the UK, Europe, Caribbean and the US. A particular focus of his work has been financial crime and anti-money laundering (AML) advisory services. Mr Matthews is a Fellow of the Institute of Chartered Accountants in England and Wales (ICAEW).

CD: Could you provide a brief overview of common fund-related disputes? What, in your opinion, are the underlying causes of the recent uptick in such disputes?

Barclay: The common factor in most fund-related disputes is a mismatch between investor expectations and actual investment performance. This may, or may not, be a result of initial misselling, subsequent negligent asset management or fund administration, or even negligence on the part of external service providers such as auditors. Claims of fraudulent behaviour have a higher public profile, but occur less frequently in practice, and where an insolvency intervenes there is likely to be a battle among investors as to priorities. The recent uptick in fund litigation is unsurprising, because fund disputes tend to have a relatively protracted gestation period before court proceedings are formally launched. Many jurisdictions, including Guernsey, apply something like a six-year limitation period to most of the claims which commonly arise in fund disputes. Therefore, a lot of potential litigation which has been bubbling under since the early stages of the financial crisis is now being formalised before it becomes potentially time-barred. This gestation period has been coupled with an upturn in the market, not to mention the development of litigation funding giving rise to the financial means to pursue claims.

Manning: Most disputes concerning Cayman funds fall into one of three broad categories. First, investors' attempts to realise their investment through seeking declaratory relief as to their redemption rights or bringing winding up proceedings. Second, disputes within a liquidation as to the value and priority of claims against the failed fund. Finally, claims by liquidators to recover losses from the failed fund's former service providers. Disputes in the first two categories are generally determined in the Cayman Islands courts. Disputes in the third category might be resolved in Cayman, but Cayman liquidators will often try to litigate in the United States (typically New York) due to the wider availability of contingency fee arrangements, the rarity of adverse costs orders, and the option of a jury trial. It is difficult to pinpoint any one cause for the recent uptick in fund disputes. I suspect that it is principally due to a combination of the state of the global economy, increased investor activism and frustration since the financial crisis, and the emergence of litigation and liquidation funders operating in the distressed funds space.

Matthews: Common issues include mismanagement of assets – such as breaches of investment restrictions – overvaluation of assets, failure by other parties to perform contractual duties and fraud. We have been instructed by investors and liquidators as claimants, and the various parties to a fund who might find themselves as defendants, such as directors, investment managers, brokers, auditors, custodians and administrators. Although directors are ultimately responsible for a fund's activities, it is the service providers who are contracted to perform the various operational duties on a day to day basis. Service providers who might seem peripheral to the misconduct are often dragged into proceedings on the basis that they could or should have known something was wrong. There has been a surge of disputes over the last five years. Not only did the financial crisis precipitate the collapse of many funds, but it also led to the exposure of portfolios carrying excessive risk, as well as a number of frauds and Ponzi schemes.

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> *Nick Matthews, Kinetic Partners LLP*

Hamedani: As Warren Buffet put it "It's only when the tide goes out that you learn who's been swimming naked." The onset of the credit crunch in 2007 resulted in a rapid fall in valuations and shortage of liquidity. This accelerated following the collapse of Lehman in the fourth quarter of 2008. The financial crisis and the market turbulence were unprecedented. Funds exposed to gearing and exotic products experienced suspension of funds and/or sometimes complete loss of value. Loss of confidence resulted in the withdrawal of funds by investors exacerbating liquidity issues. This led to an increase in the number of administrations of master funds and fund management businesses. Such administrations led to litigation with a view to the recovery of funds. The funds impacted had invested in derivatives such as CDOs that caused issues for a number of financial institutions and were popularly described as toxic investments. Frauds such as Madoff and Stanford amplified the investor and regulatory concerns. Since then, there has been a marked increase in fund litigation, particularly in the US and offshore jurisdictions. There has been a significant increase in regulatory investigations of collapsed funds and their service providers such as fund managers, directors, administrators and custodians in offshore jurisdictions. Litigation is expensive and pursuing claims though multiple jurisdictions in complex fund structures is even more expensive. However, taking action becomes inevitable in cases where institutions such as funds of funds are involved and the performance of the feeder funds impacts the return of the fund of funds. The aim is to obtain redress, or to protect the reputation of the institutions concerned and the directors involved.

CD: Have you seen an increase in the number of distressed funds since the financial crisis? To what extent has this distress led to particularly complex disputes?

Manning: We have seen a significant increase in the number of distressed funds since 2008. This is unsurprising. What is perhaps surprising is the significant number of those funds which have managed to survive, at least in the sense of avoiding liquidation, through the use of suspension, gating and other mechanisms which were never really designed or intended for such long term use. The proliferation of distressed funds has not necessarily resulted in an increase in the complexity of fund disputes. It has however led, and in my view will continue to lead, to the determination of novel and interesting questions of law which have not previously been decided, at least in the context of the operation of a modern investment fund. Cayman examples include the Privy Council's decision in *Culross Global SPC Ltd v Strategic Turnaround Master Partnership Ltd* [2010 (2) CILR 364] clarifying the status of a redeemed investor, and the Grand Court's decision – currently subject to appeal – in *Weavering Macro Fixed Income Fund Limited v Peterson and Ekstrom* [2011 (2) CILR 203] on the scope of the duties of a fund director.

Hamedani: The financial crisis caused a significant increase in the number of distressed funds that have lost some or all of their value. The complexity of disputes arises from the prevalence of factors such as the use of structures that span many jurisdictions, issues around the integrity of the custody chain, the challenges of valuing relatively recent exotic investment products that service providers may be unfamiliar with or thinly traded assets – such as development properties in Eastern Europe – that were hyped up in the over exuberant market conditions before the financial crisis. Fund transactions are not particularly complex. The complexity arises from the availability of information in multiple jurisdictions and the extent to which such information can be used, even where it can be obtained, while abiding by disclosure rules.

Matthews: There has been an increase in the number of distressed funds since the financial crisis. In 2008, hedge fund values were down 18 percent on average. At the time, redemptions led to liquidity problems and the collapse of many funds. There are still many funds out there with locked-up and potentially overvalued assets waiting to be released for the benefit of investors. Disputes in the financial services sector can often appear complex due to the products, terminology, contractual arrangements, corporate structures, and can be further complicated by the cross-border nature of the funds industry. Specialist advisers and experts may be needed to help demystify the position for the parties and the courts. Our experience, however, is that whilst the global financial crisis has led to an increase in the volume of fund disputes, it has not generally led to an increase in the complexity of fund disputes. By way of example, whilst the size of the Madoff Ponzi scheme was unprecedented, and the subsequent legal actions will continue for several years, the disputes themselves are no more complex than other fund-related disputes.

Barclay: We have definitely seen an increase in the number of distressed funds since the financial crisis. As the financial crisis was preceded by such a long boom, distressed structures had become something of a rarity outside of particular high-risk sectors. Generally depressed conditions in property markets in particular are creating solvency problems for a variety of private and retail structures which were overly leveraged. As the sheer volume of distressed structures increases, so does the scope for novel or complicated legal points to arise wherever there is a dispute. Fund and investor documentation never previously tested in sunnier financial times is now coming before the courts in a harsher wintry climate for detailed analysis. Interesting and sometimes divergent lines of legal authority are being developed in different jurisdictions, for example with regard to investors' rights where there is a suspension of redemptions. The potential overlap between the respective duties of trustees, fund managers, administrators and other professionals involved in any particular investment can also create headaches for those concerned with trying to resolve disputes where negligence is an issue.

CD: What impact have enhanced regulations, supervision and requirements for funds had on disputes in this area? What advice can you offer to fund managers and trustees on handling disputes with the authorities?

Hamedani: Regulations tend to be behind the curve in terms of addressing fully new innovative investment products and how they are structured and marketed. However, the issues that surface are not new and frequently involve matters such as compliance with constitutive documents that may be poorly drafted, pressure to approve transactions at the last minute and lack of sufficient regard to the duties of directors and other providers, unrealistic valuations with significant caveats overlooked, loss of custody of assets in the chain of ownership through untested jurisdictions, and related party transactions that lack adequate disclosure. My advice to any party that is subject to regulatory investigation is to seek the best legal advice, investigate the facts and candidly discuss them with the regulator before the regulator concludes its report and offer solutions that provide assurance that lessons have been learnt and risks are managed to avoid the issues recurring.

Matthews: The regulation of funds themselves has, in our experience, had only a limited impact on disputes, most noticeably as a consequence of the wider marketability of regulated products, causing less sophisticated investors to be exposed to the risks as well as rewards of investing, sometimes with inadequate protection on the part of the provider. Regardless of where a fund may be domiciled, fund managers are usually regulated in the jurisdiction where they are registered – for example, the CFTC and the SEC in the US and the FCA in the UK. Plaintiffs and litigators are becoming far more aware of regulatory requirements as applicable variously to fund managers or service providers. It is common for fund disputes to contain a regulatory aspect, such as reference to the appropriateness of advice or the segregation of assets, alongside contractual, negligence or fiduciary duty claims. By extension, the better that managers or trustees can demonstrate compliance with regulations, both during business-as-usual and in the event of problems, the better will be their defence.

Barclay: Although regulatory angles are often a factor in how fund disputes are managed, the role of the regulator in resolving the dispute itself is often fairly limited. More often, and certainly in Guernsey, the regulator will become involved at the request of investors but its focus will be on broader issues, usually related to general corporate governance and compliance, than the specific points raised by the investors themselves. A formal regulatory investigation may follow, but the investors will not necessarily be privy to the details or the result, nor does it necessarily provide a means of financial redress or compensation. They will usually be left to resolve their particular dispute through agreement or ultimately through the courts. The best advice on handling disputes with the authorities is always to be prepared. Internal processes and procedures will be under scrutiny, large volumes of documentation will have to be located and produced, and often within extremely short timescales. Businesses which have not kept their document management systems and procedures up to scratch can expect to experience

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> *Jon Barclay, Bedell Cristin Guernsey Partnership*

considerable disruption if a regulatory inquiry materialises.

Manning: We have not noticed a significant correlation between enhanced regulation and the volume or nature of recent fund disputes. The best means of handling regulatory issues is undoubtedly through full, frank, regular and timely dialogue with the regulator.

CD: What types of claims do you regularly see brought against fund managers and trustees? What insights do such cases provide into the potential risks and liabilities facing these individuals in the current market?

Matthews: Other than fraud, cases we have seen against fund managers include claims where losses have been attributed to a failure to value assets appropriately, breaches of investment restrictions, unsuitable advice, and a failure to ensure proper segregation of customer and broker assets. Where losses have been incurred, claimants might look for causation attributable to the manager, claiming that they would not have invested had they been aware of the true situation. Managers therefore need to ensure accurate and complete disclosure in fund documentation, and ensure compliance with the fund documentation, whilst being mindful of industry standards, thereafter.

Barclay: The traditional causes of action – breach of contract, breach of fiduciary duty, negligence and so on – still form the backbone of most types of investment dispute. In Guernsey there are additional claims that may be available under specific

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'protection for investors' legislation. If criminal-type activity is suspected then there will often be allegations of fraud and conspiracy, which will in turn tend to raise issues about insurance cover. On the subject of insurance cover, one grey area in many D&O policies is how they will respond to regulatory investigations and sanction. The nature of regulatory proceedings can fall between the worlds of civil and criminal law, and policy documents which were not originally written with regulatory investigations in mind may result in an expensive and possibly unexpected – and unwelcome – gap in coverage. The best thing to do of course is always to review this issue with brokers at renewal.

Manning: When a fund or investment trust collapses, the most obvious claims often lie against its investment manager. Probably the most common such claim is for repayment of management fees which were calculated and paid based on overstated NAVs. However, liquidators considering such claims generally face two significant obstacles. First, the legal difficulty that the manager probably has the benefit of a contractual indemnity in respect of any losses caused other than by its intentional wrongdoing. Second, the practical difficulty that the manager will probably have distributed its assets to its principals or owners, making recovery significantly harder even in cases of fraud or other wilful misconduct. The principals of an investment manager are often most at personal risk from regulatory enforcement action in their home jurisdiction, which is rarely Cayman.

Hamedani: The claims typically concern alleged breaches of duties and involve valuation of assets, breach of constitutive requirements, related party transactions that have been inadequately explained and disclosed and loss of assets due to long custody chains and loss of control. None of these features are new, and are recurrent features of litigation and regulatory investigations in recent decades. Funds often rely on a small team and reliance on trust and lapses in oversight and challenge can lead to involvement in disputes that may tarnish reputations.

CD: What key challenges and issues regularly surface in complex fund-related disputes? In what ways are disputes further complicated by multi-jurisdictional and multi-party considerations?

Barclay: Keeping costs in check is usually the prime challenge followed in second place by keeping up momentum towards a resolution – whichever side of the dispute you are on. Limiting both legal and factual issues to those which are really essential for determining the dispute are key, requiring open dialogue and cooperation between the rival camps, their representatives and the court. Where this breaks down, 'mission creep' sets in, costs begin to spiral and the underlying claim gets bogged down in satellite legal and procedural issues that cannot benefit anyone except, maybe, the lawyers.

Hamedani: The key challenges are the limited number of lawyers – in particular, where conflicts arise – and the sufficiency of resources of legal service providers in certain jurisdictions, access to information, late disclosure of relevant evidence, and the coordination of legal advice from multiple jurisdictions. The complexity arises from the need for recognition to ask questions in different jurisdictions and lack of clarity on ownership of documents that may be in the control of multiple organisations or organisations wearing different hats in the chain of transactions and service providers. Lack of clarity on ownership of transactions can lead to challenges in different jurisdictions, long delays in obtaining information and increased costs. Another challenge is the relatively small number of people involved in fund organisations and the significant demands on their time during the disclosure process, in the drafting of witness statements and in the lead-up to court hearings.

Manning: In investor litigation, issues of standing are surprisingly common. The issue generally arises in two ways. First, an investor's ability to bring proceedings is often dependent on the cooperation of a willing and indemnified custodian, because a beneficial owner of shares will typically not have standing under Cayman law to bring proceedings against the fund. Second, there have been a spate of recent cases in which problems have been encountered attempting to enforce redemption and other rights contained in side letters entered into between parties other than the fund (such as the investment manager) and the shareholder of record (such as the beneficial owner of the shares). In actions by liquidators, indemnities are a perennial problem. Not only can indemnities provide service providers with a defence or counterclaim to recovery actions; they may also result in the estate's assets being tied up for years because of the need for liquidators to quantify and make full reserves for service providers' indemnity claims prior to distributing any assets to investors. Most complex fund disputes involve a cross-border element, but Cayman practitioners and courts are very familiar with dealing with the issues which this can raise. Multi-party litigation, in the sense of a class action, does not really exist in Cayman.

Matthews: In fraud or negligence cases, the multiple parties and roles in a fund arrangement can make liability difficult to tie down. In other cases, the stark truth may be that complex or vague contractual arrangements may not have been properly understood by the parties in the first place. A complexity we have experienced is the potential cross-liability and/or additional liability where a service provider provides more than one service to the fund. Common examples are brokers or administrators providing custody services and any party providing a director to sit on the board of the fund in addition to providing other services. The subjective nature of investment decisions, and the obvious need to avoid reliance on perfect hindsight, mean that in fund mismanagement cases it can be difficult to support an argument for alternative assets to those actually acquired, however badly they performed, both to prove liability and determine damages.

CD: Tracing cash to the source can be a particularly challenging part of investment fund and trust disputes. What steps does the process of identifying ownership of funds and trusts involve?

Hamedani: Obtaining bank statements and tracing cash is not particularly difficult. The complexity can arise where there is a high volume of transactions over an extended period of time. Significant software tools have been developed in recent years to take data from a variety of sources into one common database platform and to facilitate the matching of transactions. Challenges also arise if the transactions are poorly documented and proper accounting records of transactions have not been maintained or have been destroyed. In such cases, using a team with the knowledge of how the particular transactions are carried out and with expertise acquired from working on other incomplete record investigations is critical to the successful tracing of transactions and assets including cash. The process requires teamwork between the professionals involved, early identification of information gaps and how such gaps can be remedied and where necessary, the use of freezing, disclosure and confiscation orders in relation to assets and documents.

Matthews: It is true that the cross-border nature of fund disputes can complicate the process of tracing or accessing assets, with confidentiality considerations, a reluctance to recognise foreign practitioners and restrictions on the enforceability of judgments being common stumbling blocks. In contentious liquidations, determining the ownership of assets can be problematic. For example, whilst it is generally not too difficult to identify transactions and fund movements, cash recently paid out might be deemed a preference payment and subject to claw-back. In other situations, where a fund's broker has become insolvent – for example, Refco, Lehman and MF Global – any lack of segregation of client and broker assets can cause difficulties.

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Barclay: Claimants regularly overlook the fact that 'tracing' is not a claim in itself, but rather a process. The rules of that process are subject to regular development and, in some jurisdictions, they are in a significant state of flux and really capable of argument either way. Wherever in the world you happen to be, however, input from forensic accountants is absolutely essential if you have to try to trace assets. The lawyers have an important role in supporting that exercise – by obtaining disclosure of documents, for example, and of course in developing the best legal arguments to run as a result of how and where monies have actually been moved around – but the analytical aspects of the exercise should definitely be left to the accountants.

Manning: If funds invested in an investment fund or investment trust have been misapplied or misappropriated, the general proprietary remedies available in relation to funds paid away in breach of trust will apply, including following and tracing at common law and in equity. A detailed analysis of the application of those remedies is beyond the scope of this discussion.

CD: Looking ahead, what is the outlook for fund-related disputes over the coming months? What overarching trends do you expect to see?

Manning: In terms of specific trends, we are aware of a series of cases which are currently pending or contemplated in which the Cayman courts will have to grapple for the first time with important issues arising under section 37 of the Companies Law. These relate to the enforceability of claims in liquidations by unpaid redeemed investors, and the ability of liquidators to claw back redemption proceeds from paid redeemed investors, in each case on the grounds that the redemption payments would have been or were unlawful due to the fund's inability to pay its debts. More generally, we anticipate that investment fund litigators will continue to have a busy caseload for the foreseeable future.

Hamedani: The current increase in litigation relates to post credit crunch/financial crisis cases that have been in gestation for reasons already explained. The expiry of limitation periods should mean the peak of the disputes relating to the credit crunch has been passed and as a result the volume of new litigation should decrease. The key issue is whether the industry has learnt the lessons from this turbulent period and risks are professionally managed and controlled to avoid potential breaches when the next cycle of rise and fall of asset prices arrives. Past experience indicates that those charged with controlling and taking preventative action against knowable risks do not maintain the healthy professional scepticism that is required when the good times arrive and performance is taken for granted.

Barclay: It will be some time before the surge in investment disputes directly related to the financial crisis subsides. We expect litigation funders to maintain their interest in this area and regulatory engagement to increase, especially in the offshore world where effective regulation is a high political priority. In turn, this may result in greater visible regulatory activity directed against financial services institutions, their directors and key managers, which will need to be managed in parallel with any underlying disputes – there is already evidence of this in Guernsey.

Matthews: Over five years have passed since the turmoil of the global financial crisis. As limitation periods – generally, six years – for bringing claims relating to issues identified during the financial crisis begin to expire, I expect there to be a short term increase in the number of related complaints being filed. Some of those cases as well as some existing cases will, no doubt, roll on towards the end of the decade. I also expect to see an increased focus on 'zombie' funds, where underperforming or illiquid assets are locked-up; an unrewarding position for investors but also for managers. I expect investors to be increasingly active in taking steps to exit, including using the courts, while others will see opportunities in such funds as an asset class. Beyond that, it remains to be seen how successful funds and trustees will be in recovering losses attributed to the manipulation of LIBOR or foreign currency related transactions. CD