MINI-ROUNDTABLE

INVESTMENT FUND AND TRUST DISPUTES

PANEL EXPERTS

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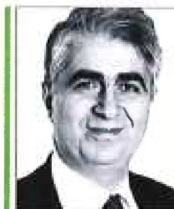
Jon Barclay is of counsel at Bedell Cristin Guernsey Partnership. Besides his work at court, where he is highly rated for his presence, he advises institutions, law firms and in-house teams worldwide across the range of international financial services and international private client matters. Mr Barclay 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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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