

COLLAS DAY | DISPUTE RESOLUTION

Guernsey Funds

When it all goes wrong.

August 2008

The situation

The prospect of an economic downturn gives cause for concern. If there is a collapse in bond prices, or share prices, or a problem in the currency markets offshore funds may face problems such as suddenly declining net asset values, claims of negligence or even allegations of fraud against the fund's management. That is as true of Guernsey as of any other financial centre.

The parties

The typical fund is run on a day-to-day basis by a collection of contracted professionals including an investment manager, an administrator, and a prime broker or custodian. The professional team works under the high level supervision of the directors, who invariably include local offshore-based directors independent of the investment manager. In a crisis, the directors should assume control and protect the interests of the fund and the investors, in conjunction with the investment manager and other service providers where appropriate.

The directors' legal duties are generally to act with reasonable care and diligence in the best interests of the fund, which will equate with the interests of those who have an economic interest in the fund, i.e. investors, and creditors. The directors' role will include communicating with investors, creditors and, very importantly, the regulator, the Guernsey Financial Services Commission.

A crisis for a fund will throw up a whole raft of potential issues which may result in legal action being brought against one or more of the parties, including the directors themselves:

- The directors may have to manage an investigation into potential claims against service providers and third parties.

- The directors must consider how much to retain for the cost of such investigations and potential litigation and how much they can properly distribute to investors (assuming the fund is solvent). This may be complicated if the net asset value has been misstated and there have been subsequent redemptions and subscription.
- The directors may need to consider the termination of service provider contracts. For example, if investment manager fraud, impropriety or negligence is suspected, then terminating the investment management agreement may be a priority.
- Disputed or misstated net asset values may create issues between the fund and its administrator.
- Breaches of investment guidelines, bad investments or undisclosed losses may lead to claims against the investment manager.
- There may also be issues between a fund and former investors whose redemption payments may have been too high due to a misstated NAV.
- There may be tensions between the directors and the investment manager. For example, if the directors opt to suspend the calculation of NAV. The directors must act independently and regardless of whether the fund's business was brought to them by the investment manager. The best interests of the fund and its investors may not be the same as the wide business interests of the investment manager.
- The directors may need to resist attempts by the Channel Islands Stock Exchange to strike off an apparently or potentially insolvent fund.

Insolvency situations

In a potential insolvency situation it may be appropriate for the directors to consider the appointment of independent liquidators or administrators for a number of reasons including the following:

- Investors may have lost confidence in the directors and want a change of control.
- A Royal Court supervised administration creates a moratorium against unsecured creditor claims (although this will not protect the funds from secured creditors or parties with contractual rights of set off).
- The liquidator's or administrator's statutory powers include the power to compel the co-operation of third parties (including directors) who are capable of providing information about the fund's affairs, to unwind preferences and fraudulent dispositions and to avoid post petition dispositions of property.

Investors/Creditors

Some investors may argue that they are creditors and have a priority over other investors. This will usually depend upon whether redemption has occurred in accordance with the fund's constitutional documents and whether the investor is entitled to its redemption payment as a debt. Deals by way of "side letter" that purport to give investors improved redemption rights may affect this analysis.

Many funds give the directors discretion to suspend the calculation of net asset value, which has the effect of suspending redemptions and subscription. Directors may also be able to suspend the actual payment of redemption monies after

redemption has taken place, and to delay calculating net asset value pending the finalising of various contingencies which may have the effect of delaying the investors' change of status to creditor.

A fund in liquidation with significant creditors may have limited liquid assets but valuable claims against service providers or third parties that, if successful, would give investors a return. Obtaining such a return might, however, involve spending money that would otherwise be returned to creditors on litigation that may ultimately not be successful. The creditors may be happy for the claim to be settled at a level that gives them a satisfactory return, whilst the investors want the liquidators to pursue litigation. This can lead to serious conflicts between investors, creditors and, in some cases, liquidators, and can make it difficult for the liquidator to determine what weight to give to investors' views. It is worth noting that third party funding arrangements may now be available to the fund in respect of this potential litigation.

Disgruntled investors will consider taking various courses of action including the following:

- Requesting company documents/records, accounts and minutes of meetings.
- Requisitioning Extraordinary General Meetings and written resolutions.
- Lobbying other shareholders.

- Replacing the directors. Have all agreements been made at arms length and in the interests of the fund? Are there any conflicts of interest? The original prospectus will become the focus. Have the requirements of the prospectus been complied with? Has the management of the fund been in accordance with its stated objectives? Have key risks been identified?
- Derivative actions against the directors for breach of fiduciary duty.
- Legal proceedings against the company and/or co-shareholders, e.g. to obtain relief for any perceived prejudice.
- Complaining to the Guernsey Financial Services Commission or other regulators.
- Application for an administration order and the appointment of an administrator, or joint administrators.

How we can help

Collas Day can advise on a strategy for the resolution of a dispute before it becomes a reality in the form of Royal Court proceedings.

We can offer advice and representation in dealings with the GFSC, including complaints, investigations, enforcement, disqualification and other related proceedings.

If required, we can commence Royal Court proceedings at short notice and obtain any necessary ancillary relief including injunctions and disclosure orders.

For further advice or guidance on how to react to disputes relating to Guernsey funds please contact Christian Hay or Gareth Bell.

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