

Funds Hotline

May 30, 2013

FUND DIRECTORS BEWARE: FIDUCIARY DUTIES OF FUND DIRECTORS IN QUESTION!!!

In this hotline, our Funds Formation team summarizes the emerging offshore jurisprudence which suggests that the threshold of fiduciary duties to be met with by directors is shifting from "exercising supervision" to "making reasonable and proportionate efforts commensurate with the situations". A failure to perform their supervisory role could impose severe liabilities on themselves as well as the independent directors for resultant business losses as would be seen in the case of Weaving Macro Fixed Income Fund (summarised later in this memo) where the directors were penalised with a sum of \$111 million.

The objective of this hotline is to highlight the roles and responsibilities of fund directors, managers and may very well also be considered by members of the investment committee in the context of the India based funds that are primarily set up in the form of a trust.

In this context, we have examined some of the recent cases that directors would do well to take note of.

1. In Puda Coal, Inc. Stockholders Litigation¹, Chancellor Strine of the Delaware Chancery Court issued a bench ruling addressing the duty of independent directors. The court reasoned that outside directors are selected, not "for their industry experience," but "because of their independence and their ability to monitor the people who are managing the company."

As a matter of brief background, Puda was a publicly-held Delaware corporation with its operations in China. The audit committee determined that the company's chairman had inappropriately transferred the company's primary operating subsidiary to himself.

The Court held that the complaint sufficiently alleged that the former outside directors breached their fiduciary duty of loyalty by failing to discharge their overview function. Interestingly, the court observed that independent directors have a duty not to be dummy directors.

2. In Paige Capital Management, LLC v. Lerner Master Fund, LLC², the Delaware Chancery Court inter alia investigated who owes 'fiduciary' obligations to the fund and its investors. The seed investor had a specifically negotiated 'Seeder Agreement' which allowed withdrawal from the fund within 3 years only upon a liquidated penalty being levied. The investor also had a more typical fund limited partnership (LP) agreement that had a usual 'gates' clause that enabled the hedge fund manager to restrict a withdrawal of capital if it results in more than a defined threshold of the total assets of the fund being withdrawn in a period. It so also happened that the fund manager could not secure any other outside investor in the fund, and the fund's contributed capital significantly comprised of the seed investment.

Controversy arose when the 'gates' were raised after the 3rd year (under the LP Agreement) to prevent the exit of the investor (as was understood under the Seeder Agreement) for preserving the management fee for the manager.

If wide powers are granted to a person pursuant to the terms of their appointment, the same may make such party a fiduciary. In the concerned matter, the court observed that acting in self-interest does not absolve a governing fiduciary. Accordingly, preventing the exit of an investor for preserving its management fee is in violation of fiduciary obligation of the investment manager. The case also provides the limits of discretion that fund managers can validly exercise.

3. It is also interesting to note the learnings from a ruling by the Grand Court of Cayman Islands in the case of Weaving Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom³ ("Ruling"). The objective is to lay down the 'standard' for directors' role in a funds context.

As a matter of brief background, Weaving Macro Fixed Income Fund ("Fund") was a Cayman Islands based hedge fund. The Fund appointed an investment manager to 'manage the affairs of the Fund subject to the overall supervision of the Directors'. The Fund went into liquidation at which point in time, action for damages was initiated by the official liquidators against the former "independent" directors.

In the instant case, the court found evidence that while board meetings were held timely, the meetings largely recorded information that was also present in the communication to fund investors and that the directors were performing 'administrative functions' in so far as that they merely signed the documents that were placed before them.

Based on such factual matrix, the court held against the directors for wilful neglect in carrying out their duties. It was also observed that based on their inactions, the defendant directors "did nothing and carried on doing nothing". The measure of loss was determined on the difference between the Fund's actual financial position with

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that of the hypothetical financial position had the relevant duties been performed by the directors.

The court ruled against each of the directors penalizing them with an amount of \$111 million.

It was also observed, that the comfort from indemnity clauses are for reasonably diligent independent directors to protect those who make an attempt to perform their duties but fail, not those who made no serious attempt to perform their duties at all.

The court observed that the directors are bound by a number of common law and fiduciary duties including those to (1) act in good faith in the best interests of the fund and (2) to exercise independent judgment, reasonable care, skill and diligence when acting in the fund's interests.

These duties should guide everything that a director / member of an investment committee does during the following phases in the life of a fund:

AT THE FUND FORMATION STAGE

1. Directors must satisfy themselves that the offering documents comply with applicable laws, that the terms of the service providers' contracts are reasonable and consistent with industry standards, and that the overall structure of the fund will ensure a proper division of responsibility among service providers. Directors must act in the best interests of the fund which, in this context, means its future investors.

In this respect, we believe 'verification notes' can be generated. The notes would record the steps which have been taken to verify the facts, the statements of opinion and expectation, contained in the fund's offering document(s). The notes also serve the further purpose of protecting the directors who may incur civil and criminal liability for any untrue and misleading statements therein or material or misleading omissions therefrom. Alternatively, a 'closing opinion' may also be relied upon.

DURING THE FUND'S TENURE

1. **Appointment of service providers:** Directors should consider carefully which service providers are selected for appointment and should understand the nature of the services to be provided by such service providers to the fund.
2. **Agenda:** The formalities of conducting proper board meetings should be observed. An agenda for such meetings should list the matters up for discussion, materials to be inspected, and inputs from the manager / members of investment committee, the service providers and directors themselves. It should be circulated in advance.
3. **Actions outside board meetings:** The directors should review reports and information that they received from the administrator and auditors from time to time to independently assess the functioning of the fund and whether it is in keeping with the fund's investment strategy.
4. **Decision making process:** Directors / members of investment committee should exhibit that there was an application of mind when considering different proposals before it. For example, in case of investor 'side letters' that may restrict the fund's investments into a restricted asset class, etc., could raise management issues. While execution of such 'side letters' may not be harmful to the fund, but an approval at 'short notice' may be taken up to reflect on the manner in which the directors / members of investment committee perform their duties.
5. **Minutes:** Board meetings should be followed by accurately recorded minutes. They should be able to demonstrate to a reader that how the decision was arrived at and resolution thereon passed. The minutes should reflect that the directors were alive to the issues that were being discussed. Clearly, a 'boilerplate' approach would not work.
6. **Remuneration:** The remuneration for independent directors should be commensurate to the role and functions expected to be discharged by them. While a more-than-adequate remuneration does not establish anything, an inadequate recompense can be taken as a ground to question whether the concerned director intends to perform his/her duties to the fund.
7. **Reports to the investors:** The investors should be regularly updated about the events in the fund such as investments / divestments, any important occurrence in any portfolio company, etc.
8. **Conflict of interest:** If related party transactions or transactions that may raise conflict of interest cannot be avoided, a policy should be outlined and disclosed to the investors where events and mechanisms to identify and resolve events which could lead to potential conflicts, should be recorded. Suitable measures that demonstrate governance and that the interest of the investors would be unimpaired, have to be adopted.

The discussed rulings confirm that a fund's board has duties cast on it and the 'business judgment rule' may not shield from liability in all cases.

There are certain non-delegable functions for the directors to discharge on an on-going basis and none more paramount than reviewing of the fund's performance, portfolio composition and ensuring that an effective compliance program is in place. These functions require action 'between' board meetings and not 'during' board meetings only.

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- Sahil Shah, Richie Sancheti, Nishchal Joshipura, Pratibha Jain and Nishith Desai

You can direct your queries or comments to the authors

¹C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013)

²5502-CS, Delaware Chancery Court

³Cause No. FSD 113 of 2010 (AJJ)

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