Fund Judgment Brings Gibraltar Directors Duties Into Focus

Introduction

Corporate governance is an important live issue worldwide particularly in the alternative fund management space, fuelled both by scandals (for example Madoff and Weavering) and tightening regulation. The role of the Gibraltar fund director came under the microscope last week when the Supreme Court of Gibraltar ("Court") found that directors of a failed investment fund had breached their duties as directors. The judgment contains important commentary, although the implications for well-advised investment funds with competent and diligent directors are limited. Nevertheless, all directors should revisit their practices to ensure that they remain consistent with key corporate governance principles.

Background to the Advalorem Case

Advalorem Value Asset Fund Limited ("Advalorem") was a collective investment scheme registered under the Financial Services (Collective Investment Schemes) Act 2011 as an Experienced Investor Fund. Advalorem's investment objective was to invest in distressed assets on the terms set out in the offer document issued by Advalorem.

The Gibraltar Financial Services Commission ("FSC") conducted an investigation into Advalorem, between February and October 2013, following which it petitioned the Court for a protection order to protect the interest of participants and potential participants. The protection order was granted in January 2014 and the Court appointed an administrator to safeguard Advalorem's assets[1].

Subsequent regulatory action by the FSC in respect of Mrs. Minette Compson (a director of a company that was itself a director of Advalorem) and Mr. Brian Weal[2] (a director of Advalorem), was taken in the public interest and to protect investors and in particular to address what the FSC considered were serious and significant corporate governance failings on the part of Mrs. Compson and Mr. Weal. In a nutshell, these related to investments made by Advalorem following inappropriate property valuations (the valuations made special assumptions that were inapplicable and unrealistic).

The FSC's decisions were appealed by Mrs. Compson and Mr. Weal, but in a judgment of 29 April 2015, the Court dismissed both appeals against the FSC's decisions[3] and not only did the Court confirm the expected duties and responsibilities of investment fund directors but also made it clear that it will not normally interfere with any sanctions imposed by the FSC (however severe) where directors choose to ignore their responsibilities as directors.

The Court's findings - Directors' duties

The Court found that this was a serious case of two directors ignoring their obligations as directors and that their conduct fell well below that which was required of them.

The judgment does not create any new directors' duties - it serves as a reminder that investment fund directors and others are required to exercise care, skill and diligence in the performance of their duties. Specifically, the judgment deals with the extent to which ignorance can constitute a defence in a director's breach of duties. The Court confirmed that the often cited principles of Jonathan Parker J in Re Barings Plc[4] as regards directors' duties form part of Gibraltar law, including that:

- Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors; and
- While directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve directors of their duty to supervise the discharge of the delegated functions.

In Advalorem, the Court rejected the argument put forward by Mrs. Compson and Mr. Weal, that since they were not the directors of Advalorem with particular expertise in property matters (they were not the only directors of Advalorem), they lacked the relevant knowledge, either actual or constructive, of the inappropriateness of the valuations obtained by Advalorem. The Court rejected this argument on the basis that the valuation processes were set out in the offer document which was a document that all directors should have been familiar with. Any director should have been able to identify that the offer document was being breached, irrespective of property-related expertise. The regulatory design of the Experienced Investor Fund regime means that great importance is placed on the declarations/warranties made by the directors in the offer document, including truth and accuracy of the contents of the offer document and it is apparent that the Court followed a similar approach.

The Court did accept that there were some matters, such as the commercial attractiveness of the land that could perhaps be the subject of reliance on the property expert directors. This however would not absolve Mrs. Compson and Mr. Weal of responsibility, that is, the duty to supervise cannot be delegated.This shows that although investment fund directors are not expected to be experts in every field, they are required to apply their minds to the appropriate issues and not rely solely on the explanations of others.

Ultimately, whether a director discharged his/her duty to display appropriate levels of knowledge, skill and experience will depend on the facts of each particular case, which assessment will necessarily include a detailed examination of that director's particular role in the management of the company and his/her own individual skills or experience. Likewise, the extent to which an individual director can rely on the expertise of other directors is fact-sensitive. In some cases it will be appropriate; in other cases it will not be.

The Court did not rule on whether unfitness of directors was to be determined by an objective or subjective standard, given that the Court was ruling on the validity of the directions imposed by the chief executive officer of the FSC and there had been clear evidence to support a finding of breach. It is unclear what standard would be applied under Gibraltar law should such a case go before the Court. Under English law, the common law test was heavily subjective. Accordingly, this allowed unskilled, inexperienced and incompetent directors to use their deficiencies as a shield against liability. Accordingly, a dual subjective/objective test relating to the duty to exercise reasonable care, skill and diligence was codified in England through the enactment of section 174(2) of the English Companies Act 2006. Gibraltar law does not have an equivalent. However, the Corporate Governance Code for Gibraltar Collective Investment Schemes issued by the Gibraltar Funds & Investments Association[5], although of voluntary application, imposes a dual test and this underpins not only the view of the industry on this matter but also that of the FSC, concerning the proper operation and governance of an investment company.

Regulatory action by FSC

The Court also considered the enforcement powers of the FSC specifically in respect of the imposition of sanctions and it is not the intention to set these out in full, suffice to say that the Court confirmed that the chief executive officer of the FSC is afforded significant discretion when enforcement action is concerned. The Court referred to

[1] http://fsc.gi/fsclists/pressrelease.aspx?PressReleaseID=132
[2] http://fsc.gi/fsclists/pressrelease.aspx?PressReleaseID=132
[3] http://fsc.gi/fsclists/pressrelease.aspx?PressReleaseID=132
[4] Re Barings plc (No 5) [2000] 1 BCLC 523

the FSC and its chief executive officer as being likely to be better placed than the Court to determine what measures are necessary in order to protect the good reputation of Gibraltar, to protect consumers and to reduce financial crime, as well as pursuing the other regulatory objectives of the FSC. The Court endorsed the suggestion that deterrence of other directors from failing to monitor the activities of companies on whose boards they sit, is a justifiable regulatory consideration when imposing sanctions.

The Court went further and confirmed that it would have upheld the imposition of even stiffer sanctions on Mr. Weal, had the chief executive officer of the FSC so determined. This was the case notwithstanding that the Court in its judgment, found that Mr. Weal's involvement in the matters complained of was less than that of Mrs. Compson, that he was not a property expert and that he was not present at a specific board meeting where the approval was given to acquire certain special purpose vehicles which held land and notably, that no investor had lost money even presumptively from his action. The Court, having indicated that the imposition of stiffer sanctions for Mr. Weal would have been supported, makes it clear that whilst the Court is willing to consider the actions of individual directing minds of an investment company, it will not be sympathetic towards a director who has seriously breached his/her duties, irrespective of specific involvement nor will it be a defence that a director has held office for a short period of time. New directors should therefore ensure that they acquire key information when they are first appointed and that they are well versed with the investment fund's history and any major events affecting the investment fund. A comprehensive and formal induction should be provided so that a new director is provided with the information he/she will need to become as effective as possible in their role within the shortest practicable time.

Other points to note

Other matters of note arose from the proceedings although, as these did not form part of the case found by the chief executive officer of the FSC, such matters should be considered for information purposes only.

Firstly, directors must satisfy themselves that the terms of contracts with the investment fund are in the best interests of the investment fund and the directors cannot simply rely on a person who is not on the record as providing a function in respect of the investment fund to negotiate its terms, not least because such person may have a vested interest in the terms of contact with the investment fund.

Secondly, investment funds should be acutely aware of the use of Gibraltar funds as part of a pension liberation exercise. Investment funds are advised to refer to the letter sent by the FSC during December 2013, to every Experienced Investor Fund registered with the FSC, by way of a reminder.

Thirdly, there was no finding of dishonesty either by the Court or the FSC, even though a letter from the FSC to Mrs. Compson said that she furnished false, misleading or inaccurate information to the FSC. In the Court's judgment, there was evidence it said, on which the chief executive officer of the FSC could properly have come to the view that Mrs. Compson had furnished false, misleading or inaccurate information to the FSC. However, the chief executive officer of the FSC had made no findings that Mrs. Compson had deliberately lied to the FSC. Given the seriousness of such an allegation, it was incumbent on the chief executive officer of the FSC to make that allegation clear to Mrs. Compson and to make clear findings on it. Since the allegations of the chief executive officer of the FSC relied solely on failures to exercise due care, skill and diligence and these allegations were inconsistent with an allegation of dishonesty, the Court did not consider it right to make a finding of dishonesty.

Lastly, Mrs. Compson was dealt with by Court separately, had she been a directly appointed director of Advalorem, rather than having been a director of a body corporate which itself was a corporate director of Advalorem. Arguments were raised as to whether she did or did not owe duties to Advalorem. The Court took the view that because the case related to her fitness to be involved in the financial services industry, this was independent of that consideration and the Court was therefore not required to rule on whether it would look at the ultimate directing mind of an investment company, irrespective whether management and control is being exercised directly or through a body corporate.

Conclusion

This decision gives some guidance as to what, in practice, is required of directors of Gibraltar investment funds, as well as the steps directors ought to take to ensure they are properly discharging their duties. Since there is no statutory codification of the duties of directors of a Gibraltar company and the duties are derived primarily from English case law, the consideration by a Gibraltar court of directors' duties in the particular context of investment funds is welcome. However, this judgment has shown that good corporate governance is no less important for an investment fund than for any other entity regulated under any of the FSC's Supervisory Acts. Directors must strive to ensure that their role does not become a "tick-box" function and that they are fulfilling their high-level supervisory role.

The guidance that can be drawn from this case is not exhaustive but it shows the ongoing active role that directors must take in the affairs and business of the investment fund during its life, despite the usual delegation of their functions to the other members of the board. Directors must continually take active steps and apply their own judgement to satisfy themselves that the investment fund's business is undertaken properly. It does not matter that the directors may have used their powers of delegation to delegate certain functions to other directors. The fundamental duties owed by a director remain undiminished and directors must satisfy themselves that the director who is performing a delegated function is complying with all terms of the investment fund's offer document. This includes ensuring that any professional service providers appointed by such director (for example, property valuers) are performing their functions in accordance with their contractual obligations.

The Court also expressed its reluctance to interfere with a sanction imposed by the chief executive officer of the FSC, unless it is clearly wrong or if the chief executive officer of the FSC has taken irrelevant considerations into account. Therefore, it is clear that the term "fit and proper" as determined by the FSC and which is not defined in law, will continue to be defined based on the considerations which the chief executive officer of the FSC considers relevant. Lastly, whether or not the chief executive officer of the FSC intended to make a finding of dishonesty is not clear. However, if this was the intention, it was incumbent on the chief executive officer of the FSC, rather than the Court, to make clear findings on it.

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[1] *http://www.gfia.gi/material/Code_of_Conduct_Gibraltar_Collective_Investment_Schemes_300513.pdf*