## Side Letters and offshore Hedge Funds

The Wall Street Journal recently paid particular attention to a growing trend in the area of hedge fund operation, the "side letter"[1]. There is no doubt that side letters are now used with increasing frequency for a growing variety of functions within the management and operation of Hedge Funds. Most commonly and in their purest form, side letters are used to cut side deals outside of the constitutional or contractual arrangements of the Hedge Fund with specific investors. These side deals encompass anything from waivers of fees to variations or modifications of generally applying redemption provisions for the Hedge Fund and can be concluded between an investor and the Hedge Fund directly, or as is becoming more common, by an investment adviser or management company on behalf and with authority of the Hedge fund. The Wall Street Journal article also raised specifically the growing use of side letters in offshore funds and made specific mention of recent legal developments in the area of side letters in the Cayman Islands. With the overwhelming percentage of offshore Hedge Funds being domiciled in the Cayman Islands[2], the legal position with regard to the use of side letters by Hedge Funds domiciled in the Cayman Islands and what, if any, implication this has for directors of Hedge Funds in terms of their corporate governance, are highly topical issues both in Cayman and abroad.

First, it should be stated that the duties and obligations of directors of Hedge Funds established as corporate entities under the laws of the Cayman Islands are governed by two sources of law: (i) the Companies Law of the Cayman Islands; and (ii) the common law (to the extent it has not been amended by legislation). Other than compliance with a number of administrative and filing requirements, the Companies Law is silent on directors' duties. The more prescriptive source of law governing duties and obligations of directors of companies incorporated under the laws of the Cayman Islands is the common law. Second, under the common law, a director's duties to the company can generally be divided into the fiduciary duties which arise because of the nature of the holding of office as a director, and the duties of skill and care in the performance of the director's duties.

A fiduciary duty of a director is essentially a duty to act in what the director *bona fide* considers (and not necessarily what a court may consider) to be the best interests of the company. Conceptually, we can talk in terms of "trusteeship" of the company's assets.

The duty of "skill and care" of a director stems primarily from the leading English case of ***re: City Equitable Fire Insurance Co., (1925) Ch 407***. This decision established the principle that, subject to satisfaction of a subjective test, a director owed certain duties in the performance of their directorship. The subjective test was qualified to the extent that in respect of all duties that, having regard to the requirements of the company's business and the articles of association, may probably be left to some other officer or manager, a director is, in the absence of grounds for suspicion justified in trusting that officer or manager to perform such duties honestly. The more recent case of ***Re Barings plc (5)***

[1] Street Sleuth: Some Big Investors Get to Use the Side Door, Carrick Mollenkamp and David Reilly, Wall St. Journal Online, March 14 2005.

[2] May/June 2004 AFSR/CorrectNet Hedge Fund Administrators Survey

***1999 1 BCLC 433*** went on to state that the director's duty extends to being informed about the Company's affairs and supervising and controlling the company's business; and that whilst Directors can delegate to a reasonable extent, delegation does not abrogate a director's duties (as there is an argument that the director is under a continuing obligation to supervise and monitor the activities of such delegate or agent). A director may, however, be liable if he has failed to supervise the activities of a delegate in circumstances where his duty of care obliges him to do so or where he has knowingly participated in or sanctioned conduct which constitutes a breach of such duty. In such circumstances, the historical position has been that a comparatively slight participation is sufficient to create liability.

Under Cayman Islands law, if a director is not negligent or fraudulent, complies with his fiduciary duties and acts within his authority, the fact that a decision turns out to be wrong or causes loss to the company is unlikely to result in personal liability for the director. A Cayman Islands court is not likely to review a proper exercise of the director's discretion purely because as matters turned out, the decision was wrong or caused loss to the company.

This is an important aspect for consideration in the analysis of side letters, given that Hedge Funds often contain constitutional provisions for allowing directors to delegate certain functions and responsibilities to investment advisers or management companies, particularly with regard to variations of redemption terms and/or waivers of fees.

The evolution of judicial thinking and regulation in the area of directors' duties has expanded the law in this area and it could further be argued that activities of modern companies, moreso in the case of offshore companies operating as Hedge Funds, now hold directors to a higher standard of care and skill, requiring them to be more competent to carry out specialised functions and take greater involvement in and to be more familiar with the company's affairs. In our view this may well be the judicial interpretation applied today if such issues were being considered.

An important further consideration is that under English law and by extraction, Cayman Islands law, directors' duties are owed by the director to the company upon whose board of directors he or she serves. The duties are not owed to the individual shareholders. Although it is outside the scope of this discussion, it should be noted that the rights of individual shareholders to bring actions against a director are limited under Cayman Islands law.

**To Side Letter or Not Side Letter?**

Given the foregoing considerations with respect to directors of companies operating as Hedge Funds, where does this leave directors and the Hedge Funds themselves in the use and operation of side letters. A typical Cayman Islands offshore Hedge Fund would fall within a lightly regulated category of the applicable legislation. This means that the regulatory authority generally does not perform any form of statutory or ongoing oversight or compliance review of such category of regulated funds. The operation and

compliance of the Hedge Fund therefore falls within the corporate governance employed by the directors. It becomes apparent then that the directors may at times be in an invidious position of having to balance commercial considerations for Hedge Funds, such as enthusing large-scale investment from institutional investors (by offering favourable terms), with a duty to act in the best interests of the fund. The lines can often be blurred. Apart from current judicial and commercial discussions regarding the validity and enforceability of side letters, there is the overarching and perhaps interwoven issue of liability for directors.

Generally speaking, the constitutional documents of a Hedge Fund established as a Cayman Islands company will consist of its memorandum of association and articles of association. The articles of association will deal with matters related to the internal workings of the company. The company's articles of association may authorise the directors to transact the business of the company and to exercise all of its powers so long as the powers are not, whether by law or by the articles of association themselves, reserved to the shareholders or illegal or prohibited activities which are beyond the scope of the company's legal capacity. The ability to use side letters is not challenged; they are generally accepted as being within the purview of the directors and within the authority and powers vested by the articles and their use has become well established custom and practice in the management and operation of Cayman Islands funds. In some cases, side letters are left to be negotiated by an investment adviser or management company under delegation from the directors. If permitted by the articles of association, the directors may delegate functions and these commonly include the ability to negotiate side letters, monitor gating, accept or reject subscriptions and often even the opening or closing of the fund. The Companies Law of the Cayman Islands contains provisions which are designed to protect third parties entering into transactions with the company from such transactions being deemed invalid or *ultra vires* (beyond the scope of the company's powers) by reason of the company's lack of capacity or lack of corporate benefit.

It is important to note that the use of side letters to manage the investment process of Hedge Funds by directors of the funds or their delegates (such as investment advisers or management companies) are essentially the entering into of contractual arrangements by the Hedge Fund with its shareholders. Such arrangements may in fact constitute a variation to the primary source of contract between a company and its shareholders, the articles of association. This raises some relevant points in terms of the document management of offshore Hedge Funds in the Cayman Islands.

## Variation of Shareholder Rights?

It is common for articles of association for Hedge Funds established under the laws of the Cayman Islands to contain provisions deeming certain matters as a variation or modification to the rights of existing shareholders. Where a side letter enhances the position of a particular shareholder with regard to the priority of that shareholder's claim and/or enhances the participation of a particular shareholder beyond that which is *pari passu* with other shareholders, such enhancement may give rise to a variation or

modification of the rights of existing shareholders. In such case, articles containing provisions for variation or modification would require shareholder approval either on a class basis if it were the case that the side letter arrangements created inequities amongst shareholders of a particular class, or the shareholders of the company in general meeting in the event that participating shares are deemed issued as a single class. Where such provisions apply, it is not likely to be within the remit of directors to negotiate side letter terms without the shareholders having mandated such arrangements. The side letter of itself may not be invalidated given the provisions in the Companies Law of the Cayman Islands which will protect the party entering into transactions with a company from a potential lack of capacity or a lack of corporate benefit by the company. The law does permit such undertakings to be ratified by the shareholders in general meeting and therefore a side letter undertaken by a company may be validated *post factum* by a later shareholders' meeting in which the side letter was validly and duly approved by the company's shareholders.

**Disclosure**

This leads us to explore the issue of disclosure of side letter agreements and what, if any, obligations may fall upon the directors. Under the Mutual Funds Law of the Cayman Islands ("MFL"), directors of Hedge Funds regulated by the Cayman Islands Monetary Authority pursuant to the registration requirements in the MFL must prepare offering documents in respect of equity interests which (a) describe the equity interests in all material respects; and (b) contain such other information as is necessary to enable a prospective investor in the fund to make an informed decision as to whether or not to subscribe for or purchase the equity interests. This requirement is expressed to be without prejudice to any duty of disclosure under the common law or any other law. This raises the issue of whether the fiduciary obligations of a director require the disclosure of side letters as "necessary to enable a prospective investor in the fund to make an informed decision as to whether or not to subscribe for or purchase the equity interests" and whether this may be in the best interests of the fund.

There is no doubt the potential for conflict between commercial considerations and legal responsibility exists. Large institutional investors may carry greater risk than smaller investors by virtue of their larger investment exposure to a particular Hedge Fund. The commercial argument will be that the assumption of a larger degree of risk necessitates or should be accommodated by a corresponding increase in return which can be facilitated through side letters offering non-standard enhancements not available to other, smaller shareholders. Likewise, in the case of large institutions who are either deliberately or inadvertently seeding Hedge Funds or who believe their larger critical mass merits special treatment, a side letter may appear as a perfectly legitimate tool for accommodating such investment and, in turn, it may be difficult to argue that such investments are not in the fund's best interests. This is not to say that there are no potential legal obligations that arise merely because the director appears to be acting in what may be the best interests of the fund and within the scope of the powers bestowed upon him by the articles of association. Regulatory requirements as aforementioned clearly require a certain degree of disclosure. They stop short, however, of offering an

exact or precise definition of what is material or what may be "necessary" to enable that informed decision. It could be argued that such matters are properly left to the judgment and discretion of the directors of the fund and that this therefore creates an enhanced or extended duty upon those directors. Whilst the law of the Cayman Islands would not likely extend so far as to enforce or require disclosure of specific terms of such side letters with specific shareholders, it may be a matter for some serious consideration as to whether general enabling language should be included in offering documents and/or articles of association for funds which may wish to entertain the use of side letters.

**Conflicts**

Perhaps a more substantive issue that is likely to arise is in the area of conflicts of interest, specifically where directors of a fund may also be interested in either an affiliated or third party entity making the investment or in an advisory or management company likely to derive fees from the fund. In the latter case, it would seem that any attempts to facilitate or broker side letters to induce investment into the fund compromise the best interest of the fund argument, especially where increased investment also yields a financial benefit for the director personally. Whilst it is common for articles of association in the Cayman Islands to permit interested directors to continue to count in a quorum and vote on issues put before the board upon their disclosure of such interests, the good faith or fiduciary duty of a director should require nothing short of a material and substantive disclosure of an interest in the offering document.

**Where To From Here**

In the United Kingdom, the current programme of company law reform has paid specific attention to the codification of directors' duties[3]. As is the case in the Cayman Islands, in the United Kingdom the law governing directors' duties is comprised mainly of common law principles established by the courts since the middle of the 19th century. Again similar to the Cayman Islands, these principles cover, amongst other things, directors' fiduciary duty, duties of skill and care and delegation of responsibility. These principles underly to some degree the duties enumerated in the United Kingdom Companies Act 1985, which has in some way, shape or form, influenced the evolution of company law in the Cayman Islands. This programme of company law reform is embodied in a White Paper presented to the U.K. Parliament in March 2005. The White Paper formulates a concept of "Enlightened Shareholder Value" which forms the basis for clarification and improved regulation in the area of directors' duties, which may continue to have implications for the development, evolution and interpretation of company law matters in the Cayman Islands. The proposed codification of directors' duties is expected to replace existing common law and equitable rules governing the duties owed by directors to a company.

In the United States, following the Sarbanes-Oxley Act of 2002, corporate governance reform programmes have led to focused attention on fundamental duties owed by directors. Whereas in the United Kingdom (and the Cayman Islands) the directors' duties

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[3] Company Law Reform Bill Part B – Directors, Chapter 1- General Duties

are owed to the company and not the shareholders as a separate body of persons as distinct from the company (although the March 2005 White Paper has discussed the possibility of codifying so-called “derivative actions” currently available to shareholders under common law), in the United States, fiduciary duties of directors are generally seen as being owed to the company and all its shareholders, the concept of company and shareholders often being used interchangeably. Fiduciary duties of directors in the United States generally consist of a duty of loyalty and a duty of care, although there is some discussion as to whether an additional duty of “good faith” also applies. Regardless of how described, these duties are in essence fundamentally the same as the general principles applying under Cayman Islands law. The duties have as their focus the requirement that directors act in the best interests of a company and its shareholders; avoid placing their own interests above those of that company and its shareholders, and act reasonably and prudently in the exercise of their functions.

It is fair to say that the Cayman Islands embraces the same general concepts as are found in the United Kingdom and the United States in its perception of the duties owed by directors. Having said this, there is nothing immediately or obviously inappropriate or imprudent about the use of side letters by directors of Hedge Funds established in the Cayman Islands. A director of a Hedge Fund considering the use of side letters should ensure that in addition to the side letters being properly recorded, specific and individual attention should be given to the merits of their use in each case. Directors of Hedge Funds intending to use side letters may benefit from a clear and concise understanding and appreciation of how such arrangements impact upon their duties and obligations; clear and unambiguous disclosure of the fund’s intention to use such arrangements in the offering documents; and/or specific enumerated powers enabling the directors to enter side letters on behalf of the company enshrined in the constitutional documents of the Hedge Fund. Needless to say, proper and adequate governance should dictate that any conflicts of interest are clearly disclosed. In doing so, directors and the Hedge Funds on whose boards they serve may be better placed to discharge their fiduciary and other duties arising under the laws of the Cayman Islands. It should not be overlooked that whilst many larger investors, who are often themselves fiduciaries, seek to use side letters as risk reduction tools for their own investments, the irony is that the risk reduction on their part may have a corresponding risk enhancement on the part of smaller investors in the Hedge Fund in which they are investing. This may be particularly relevant in offshore Hedge Funds accepting “mixed subscriptions” from both institutional and individual investors. Whilst the use of a side letter can and often may be in the best interests of the Hedge Fund, there is an enduring perception that side letters are an inappropriate method of operation, often criticised as inequitable and treated with some cynicism. It may never be possible to entirely displace this perception and therefore the onus falls upon the directors of the Hedge Fund to ensure they discharge their “trusteeship” of the fund in a manner consistent with the highest standards of prudence and caution available to them at that time. Perhaps as the regulation of Hedge Funds continues to evolve and mature, and as the global financial village continues to get smaller, we may see a convergence of thinking on issues such as side letters and the emergence of a universal standard that directors may look to for guidance. Here’s hoping.

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