

Focus on fraud and asset tracing: tips for dealing with allegations of fraud

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Fraud is, thankfully, rare and suspicions or allegations of fraud are typically as unexpected as they are unwelcome. When allegations are made it is important that directors are equipped to respond quickly and effectively.

Below are our top tips for how to manage a situation involving fraud or suspicion of fraud in a fund context.

Fraud/alleged fraud in the fund's underlying portfolio

Seek advice

It is important for directors to seek advice at an early stage so that an effective and proportionate strategy can be formulated to deal with any allegations and the consequences. The priorities will be to investigate, prevent further losses, avoid a "run on the bank", and ensure that all creditors and investors are treated fairly.

Crystallise each investor's exposure

Where the fraud or alleged fraud has occurred in an underlying asset, the fund could look to isolate that asset and crystallise each investor's exposure. This can enable the fund to avoid a wholesale suspension whilst it investigates the allegations. Depending on the terms of the fund documents this can be effected by way of side pocket, a liquidating trust, liquidating account or liquidating special purpose vehicle.

Document each decision

If allegations of fraud are made, each step in the investigation should be documented, including the rationale and decision making process lying behind it, with a conscious appreciation that all actions (and any omissions) taken in response to the fraud may later be put before, and scrutinised by, a court or

any liquidators appointed over the fund.

Fraud/alleged fraud perpetrated by an investment manager

Discovery of fraud is more common when the fund (and by its extension its shareholders) suffers loss. If allegations of fraud are made against an investment manager it will be important for the fund to investigate the allegations quickly and independently (for example through the appointment of an independent forensic investigation firm), particularly where one or more of the directors is an investment manager appointed director which is commonly the case. It is important in this context for directors to seek legal advice regarding their common law and fiduciary duties to a fund, particularly given that director duties are not codified in legislation in the Cayman Islands.

It is also important for the fund to review the exculpation and indemnification clauses in any investment management agreement which usually indemnify the investment manager for any act or omission taken in connection with the conduct of affairs of the fund. Depending on the exact drafting of the indemnity and exculpation provisions, it may be that unless and until a final determination is made by a court that the investment manager was not entitled to indemnification (generally as a result of fraud, gross negligence or wilful misconduct), the fund is liable to pay the costs of the investment manager in defending any allegations of fraud.

A review of the fund's constitutional documents will also allow legal counsel to advise on the powers of the fund including in particular:

1. the ability to suspend redemptions and subscriptions;
2. the ability to suspend calculation of NAV; and
3. the ability to delay payment of redemption proceeds.

Whether any of the above powers can or should be used will depend on the facts of each case. Any exercise of power should be properly documented (for example through a resolution) clearly explaining the reasons an action was taken and providing notice of the same to shareholders, and if applicable the regulator, as soon as practicable. The fund should also consider any suspicious activity reporting obligations that may be required to be made to the Cayman Islands Financial reporting Authority, depending on the facts.

It is important to note that indefinite suspension may leave the fund exposed to shareholder or creditor action, particularly in circumstances where a suspension tends to be the first step on the road to liquidation.

Resignation

Directors may wish to receive advice regarding whether or not to resign from the fund upon the discovery of a fraud. While it is generally tempting for directors to seek to distance themselves from the fund there are four principal reasons why resignation may not actually be the best option: (a) first, resigning will not preclude claims being brought against a director if claims are brought against the rest of the board; (b) second, resigning will make it harder for a director to enforce any indemnification and exculpation rights; (c) third, staying on the board during a time of crisis may enhance the director's reputation in the market; and (d) remaining on the board allows the director to continue their involvement in strategy including, if necessary on the choice of a liquidator.

Consider the continued engagement of the manager

A fund may need to investigate urgently and consider appointing a forensic accountant to review the investment manager's actions and, depending on their initial findings, consider taking steps to appoint someone to take over provisional management of the assets. Consideration will need to be given to the terms of the fund documents as to the power to terminate an investment management agreement and the ancillary consequences of such a step – including a review of side letter terms.

Conclusion

In summary, a fund and its directors should seek advice from counsel as soon as possible with respect to powers available under the fund documents to protect the assets and the fund.

Where allegations have been made against the fund or its service providers, consider suspension and the appointment of a forensic accountant to investigate without delay and most importantly, contemporaneously document each step taken throughout the process.

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