Ogier

The tale of three funds

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This article explores the collapse of three funds across three different jurisdictions and then sets out some of the lessons to be learnt by directors and fund managers.

1MDB

1Malaysia Development Berhad (**1MBD**) was founded in 2009 as a Malaysian state investment fund established to develop the nation's tourism and green energy by then Prime Minister Najib Razak. 1MDB raised billions of dollars from the Middle East and leading banks like Goldman Sachs, ostensibly for infrastructure projects. However, the U.S. Department of Justice has alleged that from 2009 to 2014, $4.5bn was diverted to shell companies and offshore accounts to enrich corrupt government officials. The money was spent on an array of eye-watering purchases including but not limited to: $275m on luxury goods such as watches and jewellery, $100m into funding Hollywood production *The Wolf of Wall Street* and $85m in gambling debts run up in Las Vegas.

The fraud is alleged to have been masterminded by Low Taek Jho (better known as Jho Low), who, apparently acting with Mr Razak's approval, employed a number of techniques to defraud the creditors. In particular:

- funds were transferred back and forth through different legal entities with the same beneficial owner as a means of obscuring the nature, source, location and control of the original funds.
- they created bank accounts whose names mimicked those of legitimate companies such as Blackrock; and
- money was transferred into the client accounts of US law firms like DLA Piper and Shearman and Sterling in order to avoid strict customer due diligence/anti-money laundering checks

The scandal was uncovered in 2015 when 227,000 documents were leaked to the Sawarak Report and the Wall Street Journal.

1MDB's Articles of Association were written so that the management team could control transactions in priority to the board of directors. Article 117 stated that the board must have written approval from Mr Razak (who was chairman of the fund's board of advisers) to make any investment decision. Furthermore, the board was kept in the dark regarding the key details of deals. For example, with the joint energy venture with PetroSaudi, the board was not informed of a clause in the joint venture agreement stipulating that the newly formed joint venture vehicle had to settle substantial debts ($700 million) incurred by PetroSaudi's holding company. On other occasions, management ignored instructions and queries from the board.

It appears that management hid their fraudulent actions from the board. The structure of the company allowed management to do this by using teams that worked covertly in silos without knowing the end goal of their task. However, ignorance cannot exonerate directors from breaching their duties.

There are criminal investigations in over 10 jurisdictions, including the United States, Singapore and the United Kingdom. The scandal has led to Mr Razak's defeat in the 2018 Malaysian general election, as his rival ran on a platform denouncing his corruption. The alleged mastermind of the operation, Jho Low, became an international fugitive in 2015 and it is unclear where he is residing at the moment. This is despite an Interpol red alert submitted by the Malaysian police, an act which Jho Low describes as politically motivated.

Carlyle Capital Corporation

Carlyle Capital Corporation (**CCC**) was an investment fund set up as a Guernsey company by the US private equity group Carlyle, and went into insolvency in 2008, losing all of its USD 1 billion of capital. CCC had invested mainly in US residential mortgage backed securities (**RMBS**) issued by US government sponsored entities known as Fannie Mae and Freddie Mac. The RMBS purchased by CCC had express guarantees that principal and interest would be paid by the government agencies in the event of any default by the homeowners and also carried the implied guarantee of the US government itself.

The directors (both executive and non-executive) were accused of breaching their duties to CCC because they failed to:

- insist or recommend that CCC take urgent steps to sell down CCC's RMBS assets; and
- raise additional equity capital or conduct an orderly winding down of CCC from the end of July 2007.

In particular, they were accused of breaching their duty to act in good faith, to exercise independent judgment, and to take reasonable skill and care. They also faced applications for disqualification orders and allegations of wrongful trading. However, the Royal Court of Guernsey concluded (and the conclusion was upheld by the Guernsey Court of Appeal) that there was no breach of the duty of care of the directors or the investment managers. Without the benefit of hindsight, they had taken rational and reasonable actions. The failure was beyond the control of any board of directors and was the result of unforeseen and unforeseeable circumstances. They were therefore cleared of all 187 charges brought by the liquidators. The liquidators also lost the appeal they subsequently made to the Guernsey Court of Appeal. Our detailed analysis of this case can be found here.

Ogier acted for three of the Defendants (the Carlyle Group, Carlyle Investment Management, and TCGH) in the Royal Court case and Carlyle Investment Management (the investment manager) during the appeal.

Abraaj

The Abraaj Group, founded by Arif Naqvi, was for years the largest private equity investment house in the Middle East and at one point purported that it managed over USD14 billion in assets across emerging markets. However, in 2018, Abraaj Holdings, the holding company of the Group, and Abraaj Investment Management Limited, the central investment manager entity of the group, were placed into provisional liquidation, after a group of investors, including the Bill and Melinda Gates Foundation, commissioned an independent audit into the alleged mismanagement of its $1 billion healthcare fund. PwC, the Liquidator of Abraaj Holdings, has stated that the Group's expenditure had exceeded its revenue for years and debt was used to fund their operating expenses. According to the pleadings filed by the US Department of Justice and the Dubai and US regulatory authorities, in criminal fraud and regulatory enforcement actions against a number of the key Abraaj Group individuals and entities, the Abraaj Group allegedly had:

- misused money from certain funds to try to alleviate cashflow problems across the Group instead of acquiring assets in accordance with the investment mandates of those funds or satisfying legitimate fund expenses;
- overvalued assets and misappropriated investors' funds and manipulated accounting period reporting dates to hide the dismal financial condition of the Group accounts;
- actively misled investors over an extended period of time, and allowed Mr Naqvi to mislead investors and partners and deflect inquiries; and
- suffered from weak governance, especially a lack of adequate oversight controls.

Ultimately, the Dubai Financial Services Authority fined two Abraaj Group companies a combined $315 million for deceiving investors and misappropriating funds. Naqvi denies intentional wrongdoing and is forced to remain in his London home while fighting extradition to the US. He is charged by the US authorities with the theft of hundreds of millions of dollars and misrepresenting the value of the Abraaj Group's holdings.

Ogier acts in respect of a substantial Abraaj fund namely Neoma Private Equity Fund IV L.P. (fna Abraaj Private Equity Fund IV L.P.) and particularly, for the independent director appointed during the immediate fall out of the Abraaj collapse in the summer of 2018.

Flaws of the management of the funds

The above funds collapsed due to a number of different reasons. However, certain "red flags" are apparent from the allegations (or judicial findings) which may indicate problems in the management of any given fund:

- there is one dominant individual in a key decision-making role;
- there is no clear management structure and no chain of accountability (or any such processes are not adequately adhered to);
- there is poor communication between those running the fund, its investors and other relevant parties;
- there are delays in responding to requests for clarification and responses are inadequate or lacking in any substantive independent verification;
- those high up in management are defensive or secretive; and
- there is too much emphasis and focus on the outcome for the fund, rather than on the process of running it.

Takeaways

The three tales of fund collapses demonstrate the vital importance in maintaining strong corporate governance.

The board of directors must be involved in the checks and balances of decision making so as to prevent and deter management misconduct and the misappropriation of assets. Importantly, the board of directors should always be the ultimate decision maker and not management in light of the directors' fiduciary obligations to the fund.

Good corporate governance will provide directors with a strong defence in difficult economic times when funds collapse due to unforeseen and unforeseeable financial crises and they are sued for having allowed the fund to collapse. Read more about directors' duties and corporate governance in Guernsey here.

If fund directors are concerned that their funds are approaching the zone of insolvency, they should seek independent legal and accountancy advice to mitigate the risks of facing allegations for having breached their duties including their duty to have proper regard for the interests of creditors and claims for wrongful trading if their fund does ultimately go insolvent.

Early transparency in the relationship with regulatory authorities of funds and managers facing difficulties is also of paramount importance.

The COVID-19 pandemic is the most recent example of an unexpected "black swan" event which is having severe economic effects across the globe and is likely to lead to more fund collapses.

The take away points for fund managers and directors are that they should:

- ensure that decision making is subject to systematic (and, where appropriate, independent) checks and balances, such as external fund administrators and implemented controls and governance – if there are processes established in the relevant fund's offering materials, ensure that those processes are followed;
- insist on visibility on cash flows and the deployment of drawdowns;
- ensure that there is fund manager due diligence and that it is kept up to date;
- where appropriate and possible, obtain external third party reviews of valuations;
- maintain good and timeous communications with all relevant parties and in particular investors;
- consider undertaking periodic governance reviews conducted by an independent third party; and
- ensure that cohesive and contemporaneous records are kept of all meetings and decisions made.

Overall, the intention is not to stifle the ability of fund managers to do what they do best, but such managers should seek to conduct their affairs defensively – the courts, regulators and investors will always have benefit of hindsight when reviewing a fund and its manager's actions, and so managers are well-advised not to overlook the importance of maintaining strong governance procedures.

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