

The Carlyle case – the final chapter

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The Carlyle case arose from the collapse in March 2008 of a Guernsey fund called Carlyle Capital Corporation Ltd (CCC), which led to the loss of all of its \$1bn of capital. CCC was set up as a Guernsey company in 2006 and invested mainly in residential mortgage-backed securities (RMBS) issued by US Government-sponsored entities known as Fannie Mae and Freddie Mac.

Lessons to be learned

The Carlyle case is of particular relevance now, during the current climate of the Covid-19 pandemic, which is having severe economic repercussions across the globe, and will likely lead to more fund collapses.

Lessons which can be learned from the Carlyle saga include:

- Guernsey has proven itself to be a jurisdiction with a skilled and versatile judiciary and bar, capable of handling the most complex and demanding fund litigation cases.
- Investors, fund managers and directors involved in Guernsey funds can be confident that any disputes will be dealt with fairly and with expertise by the Guernsey courts.
- Strong corporate governance is essential to provide directors and fund managers 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.
- Fund directors and managers should ensure company documentation is kept up to date and that cohesive and contemporaneous records are kept of all meetings and decisions made.
- Fund directors should ensure that D&O insurance is adequate – that it covers a director for the largest financial loss that can reasonably be contemplated, and in particular that it covers defence costs during any proceedings.

The Carlyle case

In July 2010 claims were issued by CCC and its liquidators against the former executive and independent directors of CCC, the investment manager, the promoter of CCC (the Carlyle Group) and a holding company within the Carlyle structure, for damages of not less than \$1 billion, which rose close to \$2 billion (including interest) at the close of trial.

The plaintiffs alleged numerous breaches of duty which were focussed on the alleged fundamental failure of the defendants to take steps to reduce CCC's leverage and increase liquidity. This would have been achieved by selling a substantial number of its RMBS assets, raising more capital, or conducting an orderly winding down of CCC from July 2007. The alleged breaches included that the defendants had acted in breach of their duties to:

1. act in good faith. In relation to this duty, the judge stated that "the duty to act in what the director bona fide believes is in the best interests of the company is the essential fiduciary duty of a company director";
2. exercise their own independent judgment. These claims were aimed at the independent directors against whom it was alleged that they were not truly independent, but merely acted as a rubber stamp for decisions made by the Carlyle Group;
3. not act in relation to the affairs of CCC in circumstances where there was an actual or possible conflict between their duties to CCC and their other duties or interests, and to avoid such situations of conflict;
4. exercise powers for a proper purpose. The defendants allegedly acted with the improper purpose of prioritising the Carlyle Group's reputational interests over the interests of CCC; and
5. exercise due skill and care in carrying out their roles.

The trial took 25 weeks (almost six months), the longest in recent history for Guernsey, and judgment was handed down by the Royal Court in September 2017. All of the 187 claims against the defendants were dismissed in their entirety.

The Judge agreed with the defendants' argument that "viewed objectively and without the influence of hindsight, [the directors'] reactions to the events as they happened were appropriate, responsible and not in any breach of duty to CCC".

The appeal

The defendants won everything at trial on both the law and the facts. But, despite such a comprehensive loss, the liquidators decided to appeal. The appeal was heard over two weeks in October 2018 and judgment was handed down by the Guernsey Court of Appeal on 12 April 2019.

The appeal included a claim that there had been a "critical misunderstanding which infects the

whole body of evidence". In short, the appellants alleged that the Royal Court had been led into material error and there should be a retrial.

The Court of Appeal held that, on the evidence, the prices at which CCC's directors would have been prepared to sell in August 2007 were lower than the trial judge had found.

However, the Court of Appeal went on to consider that even if the trial judge had made correct findings regarding the prices at which CCC was willing to sell RMBS assets in August 2007, it did not follow that there had been any breach of duty by the directors.

The Court of Appeal held that "the existence of such an error [that the findings of the [judge] as to perception of risk were based on a misunderstanding] does not, in our judgment, have the result that the issues are at large for determination by this court or that the case must be sent back for even a partial retrial."

It went on to hold that, taken with other issues, no breach of duty could exist.

The Court of Appeal further found that other findings of the judge, including the risks of selling at the lower prices, were not infected by the mistake the judge made as to the prices at which CCC was willing to sell in August 2007.

In addition, there was no basis for concluding that the independent directors had lacked independence or failed properly to inform themselves of relevant matters.

The Court of Appeal said:

"...it was common ground that there was nothing that CCC could have done which would have saved it from the consequences of the March 2008 liquidity crisis, which was unforeseen and unforeseeable. However startling the history of CCC's short life appears at first sight, its failure was the result of circumstances beyond the control of any board of directors. The Lieutenant Bailiff's view was that the appellant's claim depended entirely on hindsight, and we agree with her."

The final chapter

Despite losing again at the Court of Appeal stage, the plaintiffs further appealed to the Privy Council. This appeal was listed to be heard during the first week of October 2020 in Guernsey.

However in April 2020, a non-confidential settlement was reached between the parties. The withdrawal of the appeal was consequently ordered by the Privy Council on 7 May 2020, whereafter all proceedings in all jurisdictions were brought to an end.

None of the defendants paid a penny to the plaintiffs. In fact, the plaintiffs paid millions of dollars to the defendants towards their costs of the Guernsey proceedings.

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