



The Phoenix Judgment

Introduction

A recent judgment of the Supreme Court of Bermuda has considered the potential liabilities of hedge fund administrators and custodians in Bermuda, in the event of hedge fund trading losses.

In *Phoenix Global Fund Limited and Phoenix Capital Reserve Fund Limited v Citigroup Fund Services (Bermuda) Limited and The Bank of Bermuda Limited*, Mr. Justice Bell dismissed various claims pursued by two Bermuda-based hedge funds¹ against their former administrators and custodian, in a lengthy judgment handed down on 4 December 2009.

Summary of the dispute

The claims arose out of trading losses allegedly suffered by the funds between 2001 and 2003, in circumstances where the funds' directors and investment manager had traded the funds' assets in alleged breach of various investment restrictions contained in the funds' offering documents.

One fund (Phoenix Capital) had invested in securities that were allegedly in breach of an illiquidity restriction. The other fund (Phoenix Global) had continued to trade speculatively after its NAV had been temporarily suspended, allegedly in breach of a 'stop loss' investment restriction.

As a result of their dissatisfaction with the management of the funds by the directors and investment manager, each of the administrators and custodian resigned from the funds, as did the funds' auditors. The funds' directors and investment manager also resigned, in turn.

¹ The funds had been classified as Bermuda Standard Schemes under the Bermuda Monetary Authority (Collective Investment Classification Scheme) Regulations 1998. These Regulations were repealed in Bermuda by the Investment Funds Act 2006.

The funds appointed new directors, who decided to restructure the funds by migrating to the Cayman Islands and by continuing to trade the funds' remaining assets. The funds subsequently decided not to pursue any claims against the funds' former directors, investment manager, or auditors.

The funds did decide, however, to issue proceedings against the funds' administrators and custodian in an attempt to recover the funds' alleged trading losses. The principal allegations made by the funds were that:

- a. The funds' administrators and custodian were allegedly under an obligation to monitor the directors' and investment manager's trading activities on behalf of the funds, and to enforce compliance with the funds' investment restrictions in the event of a breach;
- b. Such obligations had been allegedly breached by the administrators and custodian; and
- c. The alleged breaches of such obligations had caused the funds to suffer the trading losses that they had allegedly sustained.

So far as the issue of causation was concerned, the funds speculated that, had the directors, the investment manager, or some other third party, been informed by the funds' service providers of the alleged breaches of the funds' investment restrictions, the funds would not have been allowed to continue to suffer the losses that they did. In the alternative, they argued that the funds had suffered a 'loss of a chance' not to sustain the trading losses that they did.

The administrators and custodian denied all of the funds' allegations.

Summary of the Judgment

Mr. Justice Bell dismissed all of the Plaintiffs' claims after trial, both on the facts and on the law. In summary, the Judge's primary conclusions were that:

1. It was the responsibility of the funds' directors and investment manager to manage the trading of the funds' assets, and to ensure compliance with the funds' investment restrictions;
2. The funds' administrators and custodian did not owe the funds an obligation to monitor the trading activities of the directors and investment manager, nor to seek to enforce compliance with the funds' investment restrictions;
3. Although Phoenix Capital had been in breach of its 'illiquidity' investment restriction, any trading losses suffered as a result of that breach were relatively modest;

4. Phoenix Global was not in breach of its 'stop loss' investment restriction, on a true analysis of its offering documents and the facts of the case; and
5. In any event, Phoenix Capital's and Phoenix Global's trading losses had been caused by the funds themselves, acting by their directors and investment manager, and not by the funds' administrators or custodian.

The Judge also accepted a number of alternative defences that had been advanced by the defendants:

1. The funds were not entitled to seek to rely upon, or to take advantage of, their own wrongdoing, by relying upon their own alleged breaches of their investment restrictions and associated conduct;
2. The funds' directors and voting shareholders had ratified the funds' alleged breaches of their investment restrictions, with the effect that the funds were not entitled to complain of their own acts or omissions;
3. The funds had unreasonably failed to mitigate their losses by their continued trading in alleged breach of their investment restrictions;
4. The administrators and custodian were entitled to the benefit of exculpation and indemnity clauses contained in the relevant Administration Agreements, Custodian Agreements, and the funds' Bye-laws, which excluded liability for, and indemnified the administrators and custodian against, the claims asserted by the funds;
5. The administrators and custodian were properly characterised as 'officers' of the funds, and they were entitled to be relieved from all liability, as a matter of the Court's discretion, pursuant to section 281 of the Companies Act 1981;
6. Even assuming some causative breach of duty on their part, the administrators and custodian were entitled to rely on principles of contributory negligence and statutory apportionment of liability under section 98B of the Companies Act 1981. The funds' contributory negligence, by their directors and investment manager, warranted a deduction of at least 75% of the damages claimed by the funds.

The Plaintiffs have chosen not to pursue an appeal against the judgment of Mr. Justice Bell.

Narinder Hargun and Alex Potts of Conyers Dill & Pearman Bermuda appeared on behalf of the successful 2nd Defendant, The Bank of Bermuda Limited.



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