

LIABILITIES OF DIRECTORS OF AN INVESTMENT FUND



By Noble & Scheidecker Law Firm

The current turmoil in the investment fund industry has particularly drawn the attention of professionals, including “Directors”, to the liabilities they may incur in the framework of their duties as director of an investment vehicle.

Currently, a predictable forecast is that an increase in the number of lawsuits against Directors brought by investors will be experienced by the fund industry in Luxembourg. Directors are being named or will be named as parties to lawsuits, potentially exposing all of their personal assets to satisfy a claim.

By “Directors” we mean the board of directors and its members in the case of an investment company (SICAV, SICAF, SICAR) incorporated under the form of a S.A. assuming that this form is the most frequent one in practice (the rules applicable to the general partner of a S.C.A. and the managers of an S.à.r.l. being quite similar) and the management company and its directors in the case of a common fund (FCP).

To adequately protect themselves, Directors should be aware of their duties and familiar with the obligations imposed upon them. Directors are subject to various duties, not defined as such by the commercial law, but resulting from the execution of their mandate as directors of a company.

■ What duties must Directors execute?

Directors are entitled to act in the interest of the fund and of the investors. They have to respect the provisions of the constitutive documents (prospectus, information memorandum, simplified prospectus, issuing documents, management regulations, articles of association). Directors also are under a general obligation to act competently, diligently, in good faith and in an informed manner.

In terms of internal organization, Directors are allowed to delegate some of their duties by allocating some specific tasks to a third party (committee, investment manager, central administrative agent, etc.). Nevertheless towards third parties, this delegation remains inefficient to limit their liabilities.

■ What types of liability can be engaged?

➤ Civil liability

- for damages resulting from the execution of the mandate given to Directors and for any misconduct in the management of the fund;
- for all damages resulting from the non-compliance with the company’s articles of association or the provisions of the Commercial Law ;
- extra-contractual liability in respect of the acts or omissions of a director which do not constitute a purely contractual fault ;
- liabilities relating to specific duties (such as in case of conflict of interest, capital increase, loss of more than half or three quarters of the share capital).

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In the case of an investment company, the liability can concern collectively all the members of the board of directors or one or several Directors individually.

For a FCP, the liability is upon the head of the management company. Directors of the management company do not automatically engage their responsibility for the misconduct of the management company. Their fault should be separate from the one of the management company.

However, it should be reminded that Directors do not have any obligation to achieve a result in the performance of a fund. As regard the selection of the investments, they are only responsible to make their best endeavors (“*obligations de moyens*”). However, they have the duty to comply with the investment policy as such policy has been disclosed to the investors in the prospectus or the offering document issued by the fund (“*obligation de résultats*”). Therefore, an investor who seeks to establish the liability of Directors for underperformance of the fund can not based its claim only on the absence of the result, but must demonstrate that such a bad performance is due to a fault committed by Directors.

- **Criminal liability: as defined in the commercial law, the law of 2002 relating to the UCI and the law of 2007 relating to the SIF**

Directors engage their criminal liabilities for example for (i) not having determined issue and redemption prices at the specified intervals, (ii) distributing shares/units without having obtained/applied for the relevant CSSF approval, (iii) not having called the extraordinary general meeting of shareholders (“EGM”) when the assets have fall below the minimum legal, (iv) not complying with the investment policy for a Part I UCITS, (v) having violated the provisions of the constitutive documents on valuation principles and time limits for payments of issued / redeemed shares or units. Directors also engage their criminal liability for any breach of the anti-money laundering provisions.

- **Liability in the event of bankruptcy: as defined in the commercial law**

A Director can be declared personally bankrupt for example for having (i) disposed of the company’s assets as its own assets; (ii) under the guise of the company, doing commercial acts in its personal interest.

■ Who can bring an action against Directors?

- In any case, the company is entitled to engage the contractual liability of Directors through a decision of its shareholders’ meeting.
- The investors and the creditors are also entitled to bring an action against Directors, provided that they have suffered a personal damage which is separate from the one suffered by the fund in case of (i) mismanagement, (ii) violation of the commercial law and of the articles of association, (iii) fault committed outside of the scope of their management duties.

■ What penalties?

- **Civil penalties:** full indemnification of the loss suffered through the granting of damages.

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However, it is always difficult for a Court to evaluate adequately the damages which shall only correspond to the prejudice suffered as a result of the fault.

- **Criminal penalties:** penalty of imprisonment and fine in accordance with the provisions of commercial law, the law of 2002 relating to UCI or the law of 2007 relating to the SIF.

■ How Directors can protect themselves?

What steps can Directors take to reduce exposure to liability in any of these circumstances?

- To oppose their non involvement in the fault: if at any board meeting, a director has opposed a decision to be taken by the board, then such director cannot be held liable for the consequences of such decision. To avoid the presumption of liability a director must prove that:
 - he did not take part in the infringement;
 - no misconduct is attributable to him; and
 - he reported such infringement to the first shareholders' meeting or to the regulator (as the case may be) after having acquired knowledge thereof.
- To oppose the disclaimers and risk profile description contained in the constitutive documents: such disclaimers might be protective in certain circumstances (e.g. the risks of loss of capital in any financial investment) but in any case Directors must demonstrate that they have not committed any infringement.
- To oppose the compliance with their "best endeavors" obligation ("obligation de moyens") since Directors are not liable as long as they can demonstrate that they have acted in accordance with the constitutive documents and in the best interest of the fund and the investors, for example, by having :
 - invested in accordance with the investment policy and restrictions,
 - conducted all the required due diligence in the selection of the investment managers, advisers or all other third party intervening in the fund,
 - implemented all the internal process for control, risk management, etc.
- To oppose the authorization and/or discharge given by the shareholders in a general meeting. Such discharge can only be efficient if the investors could have knowledge of the fault at the time they have granted the discharge.

■ What are the best practices to avoid a conflicting situation?

Here are some non-exhaustive recommendations. The rule is that Directors should fulfill carefully the provisions of the law and of the constitutive documents and act in the best interest of the fund and the investors.

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➤ Issuing, redemption of shares, marketing of the fund

Directors must ensure that:

- the issue and redemption price of the shares/units is determined at the specified intervals and such prices are made public according to the law
- the shares/units are issued and redeemed on the related net asset value
- the payment period for any issuance and redemption of shares is respected
- the guarantees offered by the fund in accordance with the prospectus are fully met.
- the fund is not marketed before its listing in the CSSF list (except for a SIF)
- no beneficiary shares or similar assets are issued where this is prohibited
- the principle of equality between the investors, with fair and consistent treatment is fully observed
- shares/units are not offered to prohibited persons as defined in the constitutive documents
- an EGM is called when the assets fall below the legal minimum.

➤ Delegation of some duties to third parties

The delegation of duties to third parties must be done in accordance with the provisions of the law and of the constitutive document. Only specific tasks or the daily management may be delegated. Directors must fulfill some due-diligences to ensure that a specific duty (for example the management of the assets) is delegated to a professional having the required skills and experience to achieve such a duty.

➤ Investment and disinvestment of assets

As a general practice, the management of the assets (e.g. investment and disinvestment in accordance with the investment objective and policy of the fund) is delegated by Directors to investment managers. However, Directors remain liable of the compliance with the placement policy and restrictions of the fund. They must check that the purchase and sale of assets are made at a price in accordance with the valuation rules.

➤ Management of the risk profile in accordance with the current turmoil

The current financial crisis features the credit risk, the liquidity risk and the counterparty risk. Directors must take measures to mitigate such risks for example by ensuring of: the liquidity of the underlying assets, the appropriate collateralization of all the exposures, the management of the exposure to structured products.

➤ Conflict of interest

Directors should not accept a mandate if there can be a potential conflict of interest. If a situation of conflict of interest arises, it is recommended to Directors to automatically fully disclose this to the other Directors. Directors may engage in various business activities other than the fund's business, but they must devote the time and effort necessary and appropriate to the business of the fund. It is recommended to Directors to attempt to resolve all arising conflicts in a manner that is deemed equitable to all parties under the given circumstances (for example, by avoiding to take part on the decision of the board related to a conflict situation).

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➤ **Implementation of a risk management process and of other proceedings required by the law and the CSSF**

A risk management process is compulsory for any UCITS funds. Directors may also ensure that all the proceedings to prevent the practices of late trading, market timing and anti-money laundering are implemented and carefully fulfilled.

➤ **Relationships towards the investors**

Directors must update regularly the prospectus of the fund in accordance with any amendment occurred from time to time for instance for an important change in the constitutive documents or for example in the case of delegation of the management to a third party if for such a delegation, the law requires the updating of the prospectus.

As a matter of principle, they must inform the investors in the form provided for by the law in any event required so.

➤ **Attitude to adopt on Board meetings**

It is recommended to Directors to regularly attend to the board of Directors meetings. They must make their decision carefully. Directors should be able to clearly demonstrate that they fully explored all alternatives to the chosen approach, acted in good faith and in the best interests of the fund and investors, and opted for the best alternative reasonably possible under the circumstances.

➤ **Other obvious recommendations**

Directors must ensure that the appropriate resources for the “fund administration” are dedicated to the fund. They must also ensure that all the expenses of the fund with their justification are correctly recorded in the accounting and financial books and must publish financial and management reports by the statutory deadlines. As provided by the commercial law, any payment of fictitious dividends not taken from actual profits is a criminal offence as well as the presentation of falsified balance sheets or profit and loss accounts.

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