UK: Clarification of duties of fund managers

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The UK High Court’s decision in SPL Private Finance (PF1) IC Limited and others v Arch Financial Products LLP; SPL Private Finance (PF2) IC Limited and other v Robin Farrell [2014] EWHC 4268 (Comm) demonstrates a fund manager’s potential liability when they fail to act in a fund’s best interests.

Arch Financial Products LLP (Arch FP) was the investment manager of: (i) two UK incorporated open-ended investment companies (the UK Funds); and (ii) 22 cells within a Guernsey cell company (the Cells) into which the UK Funds invested.

Arch FP committed the Cells to investing in excess of £20m in “Club Easy” student housing investments (the Investment). The Investment indirectly exposed the UK Funds to illiquid assets, an asset class to which the UK Funds should arguably not have been exposed. When the financial crisis hit the Investment was not sufficiently liquid to meet redemption requests in the UK Funds. The value of the Investment was subsequently written down to zero, leading to a significant loss for the Cells and investors in the UK Funds. It was alleged that Arch FP’s decision to invest was driven by its own interest in receiving an illegitimate payment of £3m rather than proper consideration of the Investment’s merits.

The court held that no reasonable investment manager could possibly have considered that the Investment was in the best interests of the Cells. In reaching this decision, the court considered the following principles that apply to a fund manager when exercising discretionary management powers:

1. duty not to exceed investment mandate – if an investment manager exceeds the authority of its investment mandate when making an investment it will be liable to the fund for losses caused;
2. management powers and duties – unless the parties agree a different level of protection an investment manager has a duty to exercise discretionary powers with due skill and care; and
3. duties of loyalty – an investment manager owes fiduciary duties to the funds it manages, which means that it must give preference to the fund’s interests above its own interests. This obligation is reinforced by the duties of an investment manager to avoid conflicts of interest with its funds and not to use its position to make a secret profit.

The court was not persuaded by Arch FP’s defence that the £3m payment was disclosed and consented to by the Cells. The “disclosure” defence will succeed only where a fund manager can demonstrate that before entering into a transaction it made full disclosure of material facts and the extent of its own interests.

Robin Farrell, CEO of Arch FP, was also liable for dishonestly assisting Arch FP to breach its fiduciary duties and inducing Arch FP’s breaches of contract.
Separately, Arch FP and Robin Farrell have been subject to regulatory sanctions from the Financial Conduct Authority.