IN THE COURT OF APPEAL OF THE CAYMAN ISLANDS

CICA 10 of 2011

BEFORE

The Rt Hon Sir John Chadwick, President
The Hon Dr Abdulai Conteh, Justice of Appeal
The Rt Hon Sir Anthony Campbell, Justice of Appeal

ON APPEAL FROM THE GRAND COURT
FINANCIAL SERVICES DIVISION
(Cause No 113 of 2010 AJJ)

BETWEEN

WEAVERING MACRO FIXED INCOME FUND LIMITED
(IN LIQUIDATION)

Claimant/Respondent to Appeal

-and-

(1) STEFAN PETERSON
(2) HANS EKSTROM

Defendants/Appellants

Mr. Ben Valentin with **Ms. Kirsten Houghton** of Campbells for the Appellants, Stefan Peterson and Hans Ekstrom
Mr. David Lord QC with **Mr Shaun Folpp** of Ogier for the Respondent to the Appeal, Weavering Macro Fixed Income Fund Limited (in liquidation)

Hearing: 3, 4 and 5 April 2012
Judgment: 12 February 2015

CAYMAN ISLANDS COURT OF APPEAL

JUDGMENT

Sir John Chadwick, President:

1. This is an appeal from an order made on 26 August 2011 by Justice Andrew Jones QC in proceedings brought by Weavering Macro Fixed Income Fund Limited (formerly known as Weavering Fixed Income Fund Limited), a company in insolvent liquidation acting by its Joint Official Liquidators, ("the Company" or "the Macro Fund") against its former directors, Stefan Peterson and Hans Ekstrom (together "the Directors"). It is alleged on behalf of the Company that, during the whole of the period that they held office, the Directors acted in breach of their duties to exercise independent judgment, to exercise reasonable care and skill and to act in its best interests. The judge upheld that allegation.

2. In particular, it is alleged that the Directors acted in breach of their duties in failing to inform themselves of the identity of the counter-party to substantial Interest Rate Swap ("IRS") contracts into which the Company had entered in 2005 and thereafter. The judge upheld that allegation. He held that the Directors ought to have discovered, not later than early November 2008, that the counter-party to the IRS contracts then outstanding was Weavering Capital Fund Ltd ("WCF").

3. Further, the judge held that, had the Directors discovered in early November 2008 that WCF was the counter-party to the IRS contracts then shown as assets of value in the unaudited interim balance sheet of the Company, they would have appreciated that the values attributed to those contracts could not be justified; that the Company was seriously insolvent; and that it should be put into immediate liquidation. He found that, in the period between early November 2008 and March 2009 (when voluntary liquidators were appointed), the Company had paid out to investors, by way of irrecoverable redemption payments, sums in excess of US$141 million; and that this had led to a loss to the Company (being the difference between what was actually paid out in respect of redemptions and what would have been payable based on a realistic Net Asset Value after taking account of the true value of the IRS contacts) of not less than US$111 million.

4. In those circumstances, the judge expressed himself satisfied that the loss suffered by the Company by reason of what he had held to be the Directors' wilful neglect or default was at least US$111 million; and he gave judgment against each of them in that sum. The Directors appeal from the order which gave effect to that judgment.

The underlying facts

5. The following facts were agreed between the parties for the purposes of the trial:

   (1) The Company was incorporated in April 2003 under the laws of the Cayman Islands as an exempted company. It was established in order to carry on business as an open-ended investment fund. The share capital of the Company was US$50,000 divided into 100 management shares of US$1.00 each and 4,990,000 participating shares of US$0.01 each. The participating shares were admitted to listing on the Irish Stock Exchange; and the Company was subject to the Irish Stock Exchange Listing Requirements. At all material times from its

incorporation Mr Stefan Peterson and Mr Ekstrom were the sole directors of the Company.

(2) By a written agreement dated 30 July 2003 ("the Administration and Accounting Services Agreement") the Company appointed PNC Global Investment Servicing (Europe) Limited ("PNC"), a company incorporated in the Republic of Ireland, as its administrator and PNC International Bank Limited as its custodian.

(3) By a written agreement dated 31 July 2003 ("the Advisory Agreement") the Company appointed Weavering Capital (UK) Limited ("WCUK"), a company incorporated in England and Wales, as its advisor and investment manager. Mr Magnus Peterson, the elder brother of Mr Stefan Peterson and the stepson of Mr Ekstrom, was a director and the chief executive officer of WCUK and was its "Principal Investment Advisor".

(4) In 2007 the structure established by the Advisory Agreement was altered; at least in form. By a written agreement dated 30 January 2007 ('the IM Agreement') the Company appointed Weavering Capital Management Ltd ("WCM") as its investment manager. WCM had been incorporated in the Cayman Islands on or about 7 July 2006. The directors of WCM were, at all material times, Mr Stefan Peterson and Mr Ekstrom. Also on 30 January 2007 the Company, WCM and WCUK entered into an Investment Advisory Agreement ("the IA Agreement") pursuant to which WCUK was appointed as the Investment Advisor. In practice, the introduction of WCM as the Company's investment manager – and the formal insertion of WCM between the Company and WCUK - made no difference to the manner in which the affairs of the Company were conducted.

(5) The Directors appointed Ernst & Young ("EY") to be the Company's auditor. EY's Cayman office was the Company's statutory auditor for the purposes of the Mutual Funds Law. The appointment was upon terms recorded in letters of engagement exchanged between EY and the Directors. In connection with the audit of the 2005, 2006 and 2007 financial statements, the Directors signed representation letters addressed to EY (in June of the year following the financial year under audit). With each of the financial statements there was a Directors' Report signed by the Directors in which they reviewed the development of the

Company's business and explained the investment objective and strategy and the results, activities and future developments.

(6) The Company issued Offering Memoranda inviting investors to subscribe for participating shares in the Company.

(7) Until early 2005, the Company's trading assets comprised, in the main, interest rate derivatives referenced to the London Interbank Overnight Rate ("LIBOR"): in particular, its trading assets included futures and options contracts traded through the London International Financial Futures and Options Exchange ("LIFFE") (together "Exchange Traded Instruments") and LIBOR referenced Future Rate Agreements ("FRAs").

(8) From 2005 onwards, the Company continued to trade in Exchange Traded Instruments; but it began, also, to enter into LIBOR referenced IRS contracts with WCF. At all material times Mr Ekstrom was a director of WCF. Mr Stefan Peterson was a director of WCF until early 2006.

(9) Shortly before they entered into the first of the IRS contracts, the Company and WCF purportedly entered into an ISDA 2002 Master Agreement dated 20 January 2005 in anticipation of entering into swap transactions. Over the following three years, the Company purportedly entered into thirty IRS contracts with WCF. The reported combined value of the IRS contracts rose from US$2.6 million in February 2005 to US$637.1 million in the draft statement of Net Asset Value as at 28 February 2009. The IRS contracts were not Exchange Traded Instruments: they were "over the counter" contracts. They were not traded on public exchanges; but were direct contractual transactions between party and counter-party with no financial intermediary.

(10) Between February 2005 and February 2009 the Company purportedly entered into forty three termination or "step down" transactions. Under each such transaction one of the IRS contracts was either terminated outright (as was the case in twenty six of the transactions) or the notional value was reduced. In the twenty six transactions under which an IRS contract was terminated outright, no payments were made from the Company to WCF or from WCF to the Company. The only payments that were made pursuant to the IRS contracts were alleged interest payments (amounting to £8 million or thereabouts) made by the Company

to WCF between July 2006 and September 2007. In 2007 and 2008 the Company made substantial losses in respect of options trading on LIFFE. But, nevertheless, the value attributed to the IRS contracts was such as to cause the Net Asset Value ("NAV") of the Company to increase over that period.

(11) From October 2008 – following the failure of Lehman Brothers - the Company received a large volume of redemption requests from investors. Redemption payments were to be made within 30 calendar days after the "Redemption Day"; which was defined as the first business day of each calendar month. Redemption requests totalling US$138.4 million were processed on the 3 November 2008 Redemption Day; redemption requests totalling US$54.7 million were processed on the 1 December 2008 Redemption Day; and redemption requests totalling US$30 million were processed on the 1 January 2009 Redemption Day. The Company was unable to make the redemption payments in respect of those redemption requests in full; but it was able to make (and did make) redemption payments of US$7.6 million in December 2008, US$72.3 million in January 2009 and US$10.2 million in February 2009.

(12) On 13 December 2008 the Directors, pursuant to article 38 of the Company's Articles of Association, determined that redemption payments would be "deferred to such time as liquidity returned to the fixed income market and assets could be realised at fair value on the basis of an orderly liquidation". Further redemption requests received by the Company in January and February 2009 had the effect that the Company's liquidity problem increased.

(13) In early March 2009, the Company's legal advisors, at the instigation of WCUK, approached PricewaterhouseCoopers UK hedge fund restructuring team to seek advice on possible restructuring options. A draft balance sheet as at 27 February 2009 indicated (i) that the Company had cash balances of US$22,248,842; (ii) that the value of Company's non-cash assets, other than the IRS contracts to which WCF was stated to be the counterparty, was approximately $7.2 million; (iii) that the IRS contracts to which WCF was stated to be the counterparty had an aggregate value (on a mark-to-market basis) of $637,121,094; (iv) that redemptions payable to third party shareholders totalled $132,622,413; and (v) that the Company's Total Net Assets totalled $506,307,035. Following advice that a high proportion of the assets in the draft balance sheet were fictitious – or, at the

least, substantially over-valued - the Directors concluded that steps should be taken to place the Company in voluntary liquidation.

(14) On 19 March 2009 the Company's sole voting shareholder, Codan Trustees (BVI) Limited, as a trustee of the M.P. Number One Trust, resolved that the Company be wound up. Ian Stokoe and David Walker of PricewaterhouseCoopers Finance & Recovery (Cayman) Ltd were appointed as joint voluntary liquidators. They applied under section 124 of the Companies Law to have the liquidation brought under the supervision of the Grand Court: that application was made on the basis that the Directors had confirmed that they would be unable to provide a declaration of solvency. On 3 April 2009 the Grand Court granted a Supervision Order; and Mr Stokoe and Mr Walker were appointed as Joint Official Liquidators of the Company.

(15) On 24 April 2009 an order for the provisional liquidation of WCF was made in the British Virgin Islands. On 2 June 2009, an order was made for the winding up of WCF.

(16) On 19 March 2009 WCUK went into administration. Subsequently it was ordered to be wound up by the High Court of England and Wales. On 8 October 2009 liquidators of WCUK were appointed. They commenced proceedings in the High Court against Mr. Magnus Peterson, and others, seeking various forms of relief.

The IRS Contracts

6. As I have said, from early 2005 the Company entered into thirty over-the-counter IRS contracts with WCF. Under these contracts WCF agreed to pay interest based upon a predetermined fixed rate on a specified notional amount, in consideration for the Company's agreement to pay interest on the same notional amount based upon a floating rate referenced to one year sterling LIBOR. The value of an IRS contract to the floating-rate payer increases when (during the term of the contract) interest rates decline; and - given that, in the events which happened, there was a general decline in interest rates over the term of these contracts (and a sharp decline in 2008) - these IRS contracts were (on paper) very profitable for the Company (as the floating rate payer). Quarterly Reports prepared by PNC showed that the aggregate market value of outstanding IRS contracts rose from US$15.9 million at the end of 2005 to US$86.8

million by the end of 2006, to US$195.6 million by the end of 2007 and to US$626.6 million by the end of 2008. The percentage of the Company's reported NAV represented by the aggregate value of the IRS contracts fluctuated from time to time; but, from and after mid-2006, it was generally in excess of 70%.

7. The judge recorded (at paragraph 46 of his judgment) that it was not disputed that the IRS contracts with WCF were fictitious. The contracts were (he said) the mechanism by which Mr Magnus Peterson "dressed up" the balance sheet of the Company to inflate its NAV; and so give the impression that it was making a steady return, when in fact it was suffering substantial losses. Although it was not, I think, necessary for the judge to decide (if he did so) that the IRS contracts were "sham" (in the strict sense), there are a number of factors which support the view that the judge was correct to reach the conclusion that they were made for the purpose which he identified:
   (1) WCF, a company incorporated in the British Virgin Islands in 1999 was the vehicle through which Mr Magnus Peterson originally promoted his investment fund business. The investment manager of WCF was WCUK. The directors of WCF, from its incorporation, were Mr Ekstrom and Mr Stefan Peterson. Their evidence was that they had thought that WCF had been dormant from 2003.
   (2) The IRS contracts with WCF purported to be made under the ISDA 2002 Master Agreement. That agreement, dated 20 January 2005 appeared to bear the signatures of Mr Ekstrom (on behalf of the Company) and Mr Stefan Peterson (on behalf of WCF); but, in their evidence at trial, both Mr Ekstrom and Mr Stefan Peterson stated that they had no recollection of signing that document and had not become aware of it until March 2009 (when the Company went into liquidation). The judge was told by counsel that it was Mr Magnus Peterson's case, in the proceedings brought against him in the High Court of England and Wales by WCUK (acting by its liquidators), that he signed the document by copying the signatures of Mr Ekstrom and Mr Stefan Peterson and that he was authorised by them to do so.
   (3) Mr Stefan Peterson was said to have resigned as a director of WCF in 2006. Mr Ekstrom continued to be a director until WCF was put into liquidation by order of the BVI Court in April 2009. Mr Ekstrom had stated in his witness statement

that:

> "My recollection now of WCF, my role as a director and what I did in that capacity is very limited indeed. I remember that WCF was a relatively small fund and believe that it was relatively volatile, initially making but then losing money".

The unchallenged evidence of Mr Nicholas Carter, the joint official liquidator of WCF, was that WCF had no assets (or at least no assets having a realizable value) other than a receivable of about £250,000 in respect of a loan due from a former employee of WCUK and secured on a residential property in England.

(4) IRS contracts were listed in the PNC Quarterly Reports, in the section headed "Portfolio Analysis". From 30 September 2006 each IRS contract was identified by a distinctive "Security ID". By comparing successive reports, it can be seen that, from time to time, IRS contracts shown to have had a substantial market value ceased to appear on the list; indicating that those contracts had been closed out. On 26 occasions between February 2005 and February 2009 documentation was generated to show that IRS contracts, recorded in the balance sheet of the Company as having a positive value, were closed out for nil consideration; and, on 17 other occasions in the same period, the specified notional amount was reduced (which had the effect of reducing the value of the IRS contract to the Company). But, as the judge pointed out in his judgment, if a profitable IRS contract were closed out before maturity – or if the specified notional amount were reduced - the Company should have received a payment in respect of the reported value. The judge found that, in the events which happened, the Company received no payments from WCF.

The judge concluded that the reason for the continued existence of WCF after 2003 was that it was the vehicle through which (by means of the IRS contracts) Mr Magnus Peterson manipulated the Company's balance sheet; that IRS contracts were closed out "because the greater the amount of fictitious assets reflected on the balance sheet [of the Company], the greater the risk for Mr Magnus Peterson that his fraud would be discovered"; and that apparently valuable contracts were closed out without payment because WCF had no assets (or no assets of substance) from which such payments could be made.

8. Although there is obvious force in the judge's view that the IRS contracts were "fictitious" – in the sense that they were the means by which Mr Magnus Peterson

"dressed up" the balance sheet of the Company to inflate its NAV and so give the impression that it was making a steady return, when in fact it was suffering substantial losses – the case against the Directors in these proceedings does not turn upon a finding (or a concession) to that effect. The case against the Directors turns on the judge's finding of fact that the Directors ought to have discovered, not later than early November 2008, that the counter-party to the IRS contracts then outstanding was WCF; and on his further finding of fact that, had the Directors discovered in early November 2008 that WCF was the counter-party to the IRS contracts then shown as assets of value in the unaudited interim balance sheet of the Company, they would have appreciated that the values attributed to those contracts could not be justified, that the Company was seriously insolvent and that it should be put into immediate liquidation.

The management structure

9. The Amended and Restated Articles of Association of the Company, adopted on 5 August 2003, required (by article 121) that there should be a board of directors consisting of not less than two persons; and provided (by article 122) that, subject to the provisions of the Companies Law (2003 Revision), the Memorandum of Association and the Articles and to any directions given by Special Resolution, the business of the Company should be managed by the directors who might exercise all the powers of the Company. Article 5 gave the directors power to appoint any person to act as the Manager of the Company's business affairs. Article 6 provided that the directors might "entrust to and confer upon the Manager any of the functions, duties, powers and discretions exercisable by them as Directors upon such terms and conditions . . . and with such powers of delegation and such restrictions as they think fit".

10. Article 182 of the Amended and Restated Articles of Association was in these terms:

> "182. Every Director, agent or officer of the Company shall be indemnified out of the assets of the Company against any liability incurred by him as a result of any act or failure to act in carrying out his functions other than such liability (if any) that he may incur by his own wilful neglect or default. No such Director, agent or officer shall be liable to the Company for any loss or damage in carrying out his functions unless that liability arises through the wilful neglect or default of such Director, agent or officer."