



Guide to Duties and Liabilities in Relation to Offering Shares in Cayman Companies

TABLE OF CONTENTS

Introduction	2
Potential Liability for Subscriber Shares	3
Position of Directors at Common Law	5
Conflicts of Interest	6
Statutory Criminal Liability of Directors	6
The Mutual Funds Law (2009 Revision)	7
Mutual Funds Offering Document	7

1. INTRODUCTION

This memorandum considers the duties and liabilities under Cayman Islands law in respect of an offering of shares in a Cayman Islands company. It deals first with general principles applicable to all companies and then covers mutual funds specifically.

Cayman Islands companies are governed primarily by the Companies Law (2010 Revision) (“Companies Law”). There are, for present purposes, three types of Cayman Islands companies: exempted companies, ordinary non-resident companies and ordinary resident companies. The first two types of companies are considered “offshore” companies but in practice due to confidentiality advantages, the ability to apply for an exemption in respect of future taxes and other reasons the great majority of Cayman “offshore” companies are exempted. An exempted company may carry on business in any part of the world but its activities in the Cayman Islands are restricted to the furtherance of its business abroad. Section 175 of the Companies Law prohibits an exempted company from making an invitation to the public in the Cayman Islands to subscribe for its securities unless the exempted company is listed on the Cayman Islands Stock Exchange. An offer to other exempted or ordinary non-resident companies or other Cayman “offshore” entities such as exempted limited partnerships does not constitute an offer to the public in the Cayman Islands for these purposes.

Appleby
January 2011

2. POTENTIAL LIABILITY TO SUBSCRIBERS FOR SHARES

2.1 Negligent Misstatement

Misstatements in a share offering document may give rise to a claim in tort. On this basis, any shareholder who suffers a financial loss as a result of buying shares in reliance on a misstatement in an offering document could potentially bring an action for negligence. Establishing reliance on the offering document will be a key element.

2.2 Fraudulent Misstatement

There may also be a tortious liability where there has been a fraudulent misstatement of fact (as distinct from opinions, forecasts etc). Fraudulent for these purposes covers statements made either knowing them to be false or without regard as to whether or not they were false (fraud in the specific sense is not required).

2.3 Deceit

A further possible course of action in tort would be an action for deceit where a material misstatement made knowingly or without regard for whether or not it was accurate induced the subscriber to purchase the shares. For these purposes the misstatement could include not only a positive misstatement of fact but also statements which omit information with the result that what is stated is misleading.

2.4 Contracts Law (1996 Revision) (the “Contracts Law”)

Part III of the Contracts Law gives statutory rights in respect of misstatements made prior to entering into a contract without reasonable grounds to believe they are true. Section 14 provides:

“14. (1) Where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently unless he proves that he had reasonable grounds to believe and did believe up to the time the contract was made that the facts represented were true.

- (2) Where a person has entered into a contract after misrepresentation has been made to him otherwise than fraudulently, and he would be entitled, by reason of the misrepresentation, to rescind the contract, then, if it is claimed, in any proceedings arising out of the contract, that the contract ought to be or has been rescinded, the court may declare the contract subsisting and award damages in lieu of rescission, if of opinion that it would be equitable so to do, having regard to the nature of the misrepresentation and the loss that would be caused by it if the contract were upheld, as well as to the loss that rescission would cause to the other party”.

2.5 Remedies

2.5.1 Damages in tort

A shareholder who claims based on liability in tort for negligent misstatement, fraudulent misstatement or deceit may recover damages for any loss sustained from the persons responsible for the misstatement. A company may be vicariously liable for the acts of its agents or servants. Damages will be measured on the basis that the shareholder should be put back in the position they would have been in had the misstatement not occurred.

The judgment in the English case of *Houldsworth v City of Glasgow Bank* provides that where the subscription is on the basis of fraud, a subscriber’s claim against the company for damages may fail if they remain a member. This will apply in the situation where the subscription cannot be rescinded (see below). The *Houldsworth* case has been overruled by statute in England. It is uncertain whether it would still be followed in a Cayman court. The rationale for the judgment would be less persuasive in circumstances where the Cayman company had itself rights of action against third parties (eg: directors, promoters, advisers).

2.5.2 Damages for breach of contract

The terms of an offering document will typically be incorporated as a term of a contract to subscribe for or acquire shares. A breach of the terms could therefore result in an action for damages for breach of contract if the shareholder chooses not to rescind the contract (see below). Damages in an action for breach of contract would be based upon putting the shareholder in the position it would have been in had the breach of terms not taken place; in other words with reference to the value the shares would have had if the statement had been correct.

2.5.3 Rescission

An investor who subscribes on the basis of a misrepresentation is entitled at common law to rescind the contract and receive the subscription monies back. The subscription must be on the basis of reliance on a material misstatement of fact. In the case of contractual misrepresentations section 14(2) of the Contracts Law provides that where it is equitable to do so the court may reject a claim for rescission and award damages instead.

2.5.4 Who does the Subscriber have rights against?

So far as concerns tortious claims for negligent misstatement, fraudulent misstatement and deceit, the subscriber's claim will lie against the relevant party making the misstatement. In practice this is likely to be the company but it may also include the directors, promoters, or advisors or agents to the extent that they were responsible for the misstatement. It is also possible that the company may be vicariously liable for the acts of its agents or servants.

Contractual rights to damages, including the statutory right embodied in Section 14 of the Contracts Law, lie against the other party to the contract. Typically this will be the company. The company may in turn have a right of action against third parties such as directors, promoters or advisors either for breach of fiduciary duty, in tort for negligence or on the basis of the contractual arrangements between them.

2.5.5 International Factors – Conflicts of Laws

This Memorandum considers the position from the point of view of an action under Cayman law in the Cayman courts. So far as concerns contractual claims Cayman Law will typically apply as the subscription agreement will usually be expressed to be governed by Cayman Law. In the case of claims in tort for negligent or fraudulent misstatement or deceit it is more likely that the governing law would be that of the place where the relevant statement was deemed to be made. This would depend on a number of factors but would likely be the place from which the subscription was made.

3. POSITION OF DIRECTORS AT COMMON LAW

The duties and liabilities of directors of a Cayman company are derived from English common law. For further detail please see the Appleby Guide to Corporate Entities and Partnerships in the Cayman Islands.

4. CONFLICTS OF INTEREST

A director, officer or agent of a company may not profit from any transaction between the company and a third party unless the director, officer or agent has disclosed his interest in the transaction and the transaction has been specifically authorised by the company. A director, officer or agent is accountable to the company for any profit made where the interest in the transaction has not been authorised by the company.

The terms of the articles of association of the company may limit the operation of these common law rules. Nevertheless to avoid a suggestion of misrepresentation and a possible claim against the company it is important that all interests and profits made from those interests are also disclosed in offering documents.

5. STATUTORY CRIMINAL LIABILITY OF DIRECTORS

Section 257 of the Penal Code (2007 Revision) relates to false statements by a company director.

It states at 257 (1) “Whoever, being an officer of a body corporate or unincorporated association (or person purporting to act as such), with intent to deceive members or creditors of the body corporate or association about its affairs, publishes or concurs in publishing a written statement or account which to his knowledge is or may be misleading, false or deceptive in a material particular, is guilty of an offence and liable to imprisonment for seven years.”

Sections 247 and 248 of the Penal Code (2007 Revision) provide, respectively as follows:

“Whoever by any deception dishonestly obtains property belonging to another, with intention of permanently depriving the other of it is guilty of an offence and liable to imprisonment for ten years.”; and

“Whoever by any deception dishonestly obtains for himself or another any pecuniary advantage is guilty of an offence and liable to imprisonment for five years.”.

For the purposes of section 247 and 248, (i) “deception” means any deception (whether reckless or deliberate) by words or conduct as to fact or as to law, including a deception as to the present intentions of the person using the deception or any other person; and (ii) a person is to be treated as obtaining property if he obtains ownership, possession or control of it, and “obtain” includes obtaining for another or enabling another to obtain or retain.

6. THE MUTUAL FUNDS LAW (2009 REVISION) (THE “MUTUAL FUNDS LAW”)

The Mutual Funds Law defines a mutual fund to include “a company that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments”.

A Cayman company which is a mutual fund may apply for a licence under the Mutual Funds Law. In practice this is very rare. Typically a Cayman corporate mutual fund will instead be regulated –

(a) under Section 4(3) on the basis that the minimum purchasable equity investment is US\$100,000, or that the fund’s shares or interests are listed on an exchange approved by the Cayman Islands Monetary Authority (the “**Authority**”); or

(b) under Section 4(1) of the Law by virtue of the fact that a licensed mutual fund administrator provides its principal office.

The above two categories of mutual fund are referred to as “regulated funds”. The primary impact of the regulation for the purposes of this memorandum is that regulated funds are required to file an offering document with the Authority. (For further information on mutual fund regulation generally, please see the Appleby Guide to Investment Funds in the Cayman Islands).

7. MUTUAL FUNDS OFFERING DOCUMENT

Regulated mutual funds are required by the Mutual Funds Law to file with the Authority an offering document which must–

(a) describe the equity interests in all material respects; and

(b) contain such other information as is necessary to enable a prospective investor in the mutual fund to make an informed decision as to whether or not to subscribe for or purchase the equity interests.

The foregoing statutory obligations are without prejudice to any duty of disclosure under the common law or any other law. Although the Mutual Funds Law does not contain any specific prescriptions with respect to the content of the Offering Document, industry practice, as developed over time, is a guide to

the type of matters which should be included. Policy statements from the Authority and the nature of the prescribed filing forms provide further context and guidance.

There are certain exemptions to the requirement to file an offering document with the Authority. The most notable is in respect of a fund where the equity interests are held by not more than fifteen investors, a majority of whom (by number) are capable of appointing or removing the directors of the fund.

The directors or promoters of a fund which fails to comply with the obligations to file an offering document are liable on conviction to a fine of \$120,000. Where a change materially affects information in an offering document for a continuing offering the offering document must be updated and refiled within 21 days of a director or promoter becoming aware of the change.

For more specific advice on duties and liabilities in Cayman companies, we invite you to contact the following:

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