GUIDE

APPLEBY

GUIDE TO DIRECTORS' DUTIES IN THE CAYMAN ISLANDS

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PREFACE

This Guide is a summary of the law relating to directors and their duties in the Cayman Islands.

We recognise that this Guide will not completely answer detailed questions which clients and their advisers may have; it is not intended to be comprehensive. If any such questions arise in relation to the contents, they may be addressed to any member of the team, using the contact information provided at the end of this Guide.

Appleby
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1. CAYMAN ISLANDS – JURISDICTION OF CHOICE

The Cayman Islands is a jurisdiction recognised worldwide as an international financial centre of the highest calibre. Leading financial institutions, Fortune 500 companies and private and public businesses from across the globe have chosen Cayman as their jurisdiction of choice for many reasons, including the following:

Reputation: due to its well established legal system, stability and strong financial services industry, the Cayman Islands have a reputation as a high quality offshore centre.

Flexibility: the Cayman Islands have the advantage of progressive "leading edge" legislation, developed in consultation and collaboration with industry stakeholders.

Central time location: the Cayman Islands' central time location (GMT-5) is ideal for organisations operating their businesses from Asia, Europe and the Americas.

Tax neutrality: Cayman has no capital gains, income, profits, corporation or withholding taxes (whether on the offshore vehicle or on holders of securities issued by such vehicle). If the offshore vehicle is incorporated as an exempted company it can obtain a renewable undertaking from the Cayman Islands Government that it will remain tax-free for a 20 year period and in the case of exempted trust or an exempted limited partnership the period is up to 50 years. Investors in Cayman vehicles must always obtain advice on the impact of taxation in the jurisdiction in which they are tax resident before investing.

Speed: once all necessary information, including "know your client" documentation, is gathered and verified, a Cayman Islands company can be incorporated within a day.

Availability of world-class professional services: Cayman has a wealth of lawyers, accountants and other service providers with renowned expertise.

Trustworthy and reliable legal system: Cayman Islands law, derived from English common law and supplemented by local legislation, ensures that Cayman Islands entities are internationally understood and accepted. The Cayman court system is well developed with appeals ultimately going to the Privy Council in London.

Compliance culture: the Cayman Islands has long been committed to implementing best international practices and is compliant with the anti-money laundering and anti-terrorist financing requirements of the Organisation of Economic Cooperation and Development (**OECD**) and Financial Action Task Force. Cayman is on the OECD "white list" and has entered into a multitude of tax information exchange agreements.

Stable and business-oriented government: the Cayman Islands are a British Overseas Territory and have a history of stable government, committed to promoting the financial services industry.

Sensible and proportionate regulation by the Cayman Islands Monetary Authority (the **Authority**): the Authority's mission is to regulate and supervise the financial services industry in order to maintain a first class financial system. The Authority's focus is on safeguarding the interests of investors in, and customers of, regulated institutions from undue loss. The Authority has regard to international standards and the need for operational freedom by financial services providers, with the focus on maintaining a dynamic and competitive industry.

Exchange controls: there are no exchange control regulations in the Cayman Islands. As such, money and securities in any currency may be freely transferred to and from the Cayman Islands.

With this extensive portfolio of advantages, it is unsurprising that the Cayman Islands has established itself as a leading offshore financial centre.

2. SOURCES OF DIRECTORS' DUTIES

Each company registered in the Cayman Islands has a set of constitutional documents which describe and delimit the duties and responsibilities of its directors. The company's constitutional documents are supplemented by common law and statute. As such, the duties of directors of Cayman Islands companies originate in statute, case law and each company's constitutional documents.

Directors' duties also arise by virtue of the general law of agency. Directors are agents of the company for which they act and the general principles of the law of principal and agent regulate in many respects the relationship between the company and its directors. This position has long been established and in *Ferguson v Wilson*, Cairns LJ stated:

> "What is the position of directors of a public company? They are merely agents of a company. The company itself cannot act in its own person, for it has no person; it can only act through directors, and the case is, as regards those directors, merely the ordinary case of principal and agent. Wherever an agent is liable those directors would be liable; and where the liability would attach to the principal, and the principal only, the liability is the liability of the company."

Therefore, the general rule is that directors are considered to be acting as agents for the company and, as long as they make this fact clear to third parties, they should not incur any personal liability for breach of contract or any tortious act committed by the company. It follows that if a director fails to make it clear to a third party that he acts as a director of a company or if, for instance, the director gives personal guarantees, then personal liability will result.

3. TO WHOM ARE THE DUTIES OWED?

In general, the duties described in this Guide are owed by the directors to the underlying company as a whole rather than to individual shareholders or to particular classes of shareholders.

Where the company is on the brink of insolvency (i.e. where its solvency is in doubt), directors' duties also extend to the company's creditors, whose interests will become paramount if the company actually becomes insolvent.

The director is not usually a trustee for individual shareholders. Thus a director may accept a shareholder's offer to sell shares in the company although he may have information which is not available to that shareholder and the contract cannot be upset even if the director knew of some fact which made the offer an attractive proposition.

In certain circumstances, however, the directors may by their actions have placed themselves in a relationship with the shareholders by virtue of which they owe fiduciary duties to the shareholders as well as to the company. The English courts have held directors to be under a duty to act in good faith when giving shareholders advice whether to accept a takeover offer for their shares or whether to sanction a scheme for the purchase of a large block of assets from another company. The directors have no obligation to give such advice but if they give it, the advice should not be given for their own improper reasons.

4. WHAT ARE THE DUTIES OF A DIRECTOR?

A director of a Cayman Islands company has a duty to attend to the requirements of his offices with care, diligence and skill. In addition, a director owes broader fiduciary duties, including the duty to act in good faith and in the best interests of the company, for a proper purpose, and to avoid any conflict of interest. Specific statutory obligations also apply to directors. Each category of duty is examined in greater detail below.

4.1 Duties of Care, Diligence and Skill

A director's duties of care, diligence and skill can be summarised as follows:

(a) **Directors are not expected to be experts unless appointed as such**

A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. The test is partly objective (the standard of the reasonable man) and partly subjective (the reasonable man is deemed to have the knowledge and experience of the particular director). A director is therefore not expected to exercise skill which he does not possess.

Directors of a specific company are not required to be experts of the type of business which the company promotes unless they are appointed because of their specialist qualifications. Many boards consist only partly of such experts and, for the rest, of persons who are specialists in business administration or in certain general aspects of business management such as legal, financial, accounting, banking or expert trade practice.

A number of English cases have accepted the distinction between the duty to be skilful on the one hand and to take care on the other; the first being defined by reference to the particular director's skill and experience, and the latter by reference to the standard to be expected of the ordinary man.

(b) **A director must exercise reasonable care and diligence but is not liable for errors of judgment**

Where a director takes part in the company's business, he must display reasonable care and diligence. Such reasonable care must be measured by the care that an ordinary man might be expected to take in the same circumstances on his own behalf. He is not responsible for damages occasioned by any errors of judgment. From this it falls that in appropriate circumstances the director may rely upon an opinion of an outsider. Of course the obtaining of outside advice does not absolve directors from the duty of exercising their business judgment upon such advice.

(c) **A director may reasonably rely on co-directors and officers of the company**

A director may reasonably rely on co-directors and other officers or managers of the company. Consideration must be given to the nature and demands of the company's business. Of course the reliance of the director upon his co-directors and the officers should not be unquestioning and the director must have no ground for suspicion that the other director, officer or manager on whom he is relying is performing his duties other than honestly. Even non-executive directors, when delegating responsibility to management, are under a duty to ensure that sufficient controls are in place to ensure that abuses can be quickly identified and the board is always in a position to guide and monitor the management.

This point is extremely important as in large companies the board cannot in fact manage the company. Extensive delegation to particular executive directors, to senior managers who are not directors and to senior employees of the company is inevitable in a large business organisation.

A director must give a reasonable amount of attention to the company's affairs but is not bound to give continuous attention. The amount of time to be given will depend largely upon the extent to which devolution of duties has been organised, and upon the number of directors.

It is not necessary for a director to attend every board meeting unless the articles specify this; but he ought to attend whenever he is reasonably able to do so and continuous non-attendance at meetings may render the director liable for any breaches of trust committed by others. It is not part of the duty of a director to take part in every transaction which is considered at a board meeting. It should be pointed out that even where a director has been shown to be negligent as a result of non-attendance at board meetings it may nevertheless be very difficult to demonstrate that any particular loss has occurred to the company as a result of the non-attendance.

4.2 Directors' Fiduciary Duties

A director's fiduciary duties can be summarised as follows:

(a) A director must act in good faith in the best interests of the company

This duty is a subjective one and it is generally left to the business judgment of the directors to decide how the interests of the company may best be promoted. The company is defined in equity usually by reference to the shareholders as a whole and not by reference to the company as an entity as distinct from its members. The company does not mean the sectional interest of some (it may be a majority) of the present members, but of present and future members of the company and that on the basis that the company is to continue as a going concern. The directors should balance a long term view against the short term interest of present members.

There is now a growing body of dicta in the English Courts to the effect that, when the company becomes insolvent or is nearly so, then the interest to which directors must have regard when acting in the interests of the company include the interest of the creditors as well, perhaps in some cases instead of, those of the shareholders. An important consequence of this change in the definition of the company for the purposes of directors' duties is that actions of the directors which have adversely affected the value of the company's assets of which, whilst the company was solvent, could have been ratified by the shareholders may no longer be so ratified.

The courts will interfere only if no reasonable director could have concluded that a particular course of action was in the interests of the company.

It should be noted that the interests of employees are not recognised in their own right as an object of the directors' concerns.

It is a logical extension of the principle that a director must act in the company's best interests that a director is not permitted to contract with other directors or with third parties in such a way as to fetter his future discretion, although there is little judicial authority on the point. This is so even though there is no improper motive or purpose and no personal advantage to the directors under the voting agreement. This does not prevent the directors, having determined to enter into a transaction, from voting to take all further action necessary to complete the transaction.

The concept of nominee directors will often involve a breach of fiduciary duties, conceivably on the basis of a fettering of their discretion and also on the basis that they have an inherent conflict of

interest. However, so long as the director is left free to exercise his best business judgement in the interests of the company, there is nothing to prevent the appointment of nominee directors.

(b) **A director must exercise his powers for a proper purpose**

Where directors have a discretion and are, bona fide, acting in the exercise of it, the courts will not interfere with their acts unless the particular purpose for which the discretion is being exercised is not one of the purposes for which it is conferred. A common example is the exercise by directors of their power to issue shares for purposes of maintaining their control over the affairs of the company. Where the power is exercised for more than one purpose, the court will look at the director's primary purpose. In one of the leading cases on this point the exercise of the power to issue shares by directors whose purposes were both to raise capital and to dilute an existing majority stake was held to be improper because the primary purpose was to dilute the majority stake. This led to the issue of shares being set aside. Regard must be had to the circumstances of the company at the relevant time on a case by case basis. The court will generally leave the exercise of the power to issue shares to the business judgment of the directors who decide how the interests of the company may best be promoted. It is only if, objectively considered, the power has been used for an improper purpose that the court will interfere.

(c) **A director must avoid any conflict of duty and interest**

Like other fiduciaries, directors are required not to put themselves in a position where there is a conflict (actual or potential) between their personal interests and their duties to the company or between their duty to the company and the duty owed to another person.

At common law, however, the company is at liberty to waive completely the rules protecting it as principal in dealings in which the directors have an interest. Most Cayman companies have articles of association which allow directors to attend, be counted in the quorum and usually also to vote on transactions in which they are interested as long as their interest is disclosed. Generally, however, directors should not use for their own profit the company's assets, opportunities or information.

A director is not prohibited from acting as an officer or an employee of the company (except as an auditor), as a director of another company, or from representing the interests of a member or other third parties, as long as the company consents and the director is able to continue to act in the best interests of the company. If a conflict situation arises, the director must not subordinate the interests of the company to those of another company or third party in order to resolve such conflict.

The English case of *Charterbridge Corporation v Lloyds Bank Ltd* determined that a director must not be guided by the interests of the group of companies as a whole if this might be detrimental to the interests of his own company, particularly if his company has separate creditors. If, however, the intended measure does not conflict with the interests of his company, it is not a breach of duty to his own company that he has taken into account the benefit of the group as a whole. Further a director cannot be compelled to take into account the interests of the group of companies.

A Cayman Islands Case Study: The *Weavering* Decision and Subsequent Appeal

Weavering Macro Fixed Income Fund Limited (**Fund**) was a Cayman Islands hedge fund which collapsed when it emerged that its biggest trading position was, in fact, fictitious. One of the red flag missed by the board was that the counterparty to that trade was an entity controlled by the fund's manager. The Fund subsequently initiated proceedings against its former independent directors in the Grand Court of the Cayman Islands for breach of their duties to exercise independent judgment, to exercise reasonable care and skill and to act in its best interests. At first

instance, the court found that the Fund's independent directors has been wilfully negligent and in default of the discharge of their duties, and ordered them to pay damages to the Fund's liquidators in the sum of USD111 million, representing the losses suffered by the Fund which were caused by their default. In a seminal decision, the trial judge made a series of stern statements of principle about the duties of hedge fund directors which generated considerable comment and reaction across the hedge fund industry. The Court took long-standing principles concerning the duties of non-executive directors in a conventional company structure and adapted them for the unique structure of a hedge fund, with its array of professionals independently performing various critical functions in support of the fund's management.

However, in a decision published on 12 February 2015, the Cayman Islands Court of Appeal (**CICA**) has taken a different view of the evidence which was presented to the Grand Court and has allowed the directors' appeal against the findings of the Grand Court. The CICA upheld the finding of the Grand Court below that the directors were, indeed, in breach of the duties which they owed to the Fund, which included a "high-level" supervisory duty in relation to the performance of the Fund's service providers of their delegated functions. In doing so, the CICA relied on the evidence of the directors that they had "missed", "not picked up" or failed to read in its entirety a quarterly report which would have put the board on enquiry of the facts which led to the Fund's demise. The Grand Court had ruled that these failings by the directors amounted to "wilful neglect or default" such that the directors were unable to rely on the exemption from liability contained in the Fund's Articles of Association. The CICA considered in some detail the first limb of the test in Re City Equitable Fire Insurance and concluded that: in order to establish wilful neglect or default for the purposes of defeating the protection given to the directors under the Fund's Articles of Association, it is necessary for the company to prove to the satisfaction of the Court that the director made a deliberate and conscious decision to act or to fail to act in knowing breach of his duty: negligence, however gross, is not enough. The CICA held that there was, in fact, no specific evidence of either director having made a deliberate and conscious decision not to read the relevant report with sufficient care knowing that failure to do so was in breach of his duty. Turning then to the second limb of the test in *Re City Equitable Fire Insurance* (i.e. being recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty), the CICA held that:

> "it is necessary to satisfy the court that the director appreciated (at the least) that his or her conduct might be a breach of duty and made a conscious decision that, nevertheless, he or she would do (or omit to do) the act complained of without regard to the consequences; and if the evidence does not establish that the defendant at least suspected that his conduct might constitute a breach of duty, it is not appropriate to characterise his breach of duty as 'wilful neglect or default'".

Since there was no support in the evidence for the contention that the two directors had the requisite conscious appreciation that they might be breaching their duty to read the reports to the board with sufficient care to discover that the counterparty to the trades was a related party, the claim against them failed and their appeal was allowed.

4.3 Statutory Duties

The Companies Law (Revised) (the **Law**) sets out certain specific duties that must be met by the company (which, as mentioned above, acts through the agency of its directors). Other duties are imposed on directors themselves. Foremost amongst these statutory duties are the following:

- the Registers of Members, of Directors and Officers and of Mortgages and Charges must be maintained and kept at the company's registered office;

- the directors must ensure that the company complies with reporting requirements under the Law such as filing of the annual return, notifying of changes to directors and officers or changes to the registered office address;
- the directors are responsible for ensuring that the company complies with accounting requirements;
- directors have a duty to ensure that no distribution or dividend is paid to members out of the share premium account and no redemption or purchase of its own shares is made, unless the statutory solvency test is met;
- directors of an insolvent company have a duty to cooperate with the liquidator; and
- directors are in breach of their statutory duties where they divest the company of assets or tamper with the books of the company with the intent to defraud creditors or contributories in advance of or during a winding up.

A complete inventory of all of the statutory and procedural duties set out in the Law is beyond the scope of this Guide.

The Penal Code (Revised) also provides for offences of theft, fraud, publishing false or misleading statements with an intent to deceive members or creditors and false accounting.

5. DIRECTOR REGISTRATION AND LICENSING

The Directors Registration and Licensing Law, 2014 imposes registration obligations on directors of registered mutual funds and certain securities investment businesses (**Covered Entities**). Licences are required for "Professional Directors", being natural persons appointed to the boards of 20 or more Covered Entities) and corporate directors of Covered Entities.

6. DIRECTORS' LIABILITY

Generally speaking, directors do not incur personal liability for the debts, obligations or liabilities of a company except for those specified by statute and which arise out of negligence, fraud or breach of fiduciary duty on the part of an individual director, or due to an action not within his authority and not ratified by the company.

6.1 Statutory Liability

In a number of cases already discussed above, legislation provides that directors who are in default shall be personally liable to persons outside the company. Such liability may arise for example: by order of the court on the winding up of the company or under the fraudulent trading provisions.

Furthermore, where directors act outside the scope of their authority they may be liable to compensate a contractual counterparty for breach of their implied authority.

6.2 Tortious Liability

There are two potential situations to be distinguished with regard to liability for torts. The first is where a tort is committed by the company through one of its servants or officers and the question is whether a director, although not the officer in question, is liable for the tort committed by the company. The second is where the director is the person whose acts have caused the company to be liable in tort and the question is whether the plaintiff can sue the director personally.

Where the tort is committed by the company, a director does not make himself liable merely because of the fact of his directorship. Nevertheless, a director who, whilst not committing a tort himself, has authorised,

directed and procured the commission of a tort by his company may be personally liable to the victim of the tort even though he was not aware that the acts he authorised were tortious or did not care whether the acts where tortious or not. Whether a director has authorised a tort will depend on the facts of each case.

Equally a director is not held responsible for the fraud of his co-directors, unless he has expressly or impliedly authorised it.

Where it is the acts of the director in question which give rise to the liability of the company, there are two competing approaches to the issue of the personal liability of the director. One approach is to say that the principles applicable are exactly the same as in the cases where the principal is not a company and the agent is not a director. The normal rules of agency would apply and a director acting as agent who commits a tort in the course of his functions as a director is always personally liable and the company will be liable as well on the basis of the doctrine of vicarious liability. The alternative approach, which the English and Commonwealth Courts appear to lean towards, proceeds from the premise that the separate legal personality of the company requires directors to be to some degree shielded from liability which would otherwise apply to them in the same way that the doctrine of limited liability protects the shareholders. On this approach, the director is not made personally liable unless he has made it clear to the third party that he has assumed personal responsibility as opposed to assuming responsibility on behalf of the company.

7. INDEMNIFICATION

Cayman law does not prohibit or restrict a company from indemnifying its directors and officers against personal liability for any loss they may incur arising out of the company's business. A company's articles may provide for the indemnification of a director or an officer for breach of duty, save in circumstances where there has been wilful neglect, wilful default, fraud or dishonesty in the carrying out of fiduciary duties. Such indemnities have been considered by the courts many times and it is clear that the "irreducible core" of a fiduciary's obligations (that is the duty to act in honesty and good faith) remains despite the terms of any indemnity.

If there is an indemnity clause it will have the effect of an exculpatory clause, because there is no cause of action against a person whom you are liable to indemnify in respect of the same matter

The company will commonly obtain directors' and officers' insurance.

8. CONCLUSION

Directors of companies must be fully aware of their powers and duties so that they can avoid personal liability to the company and third parties. In addition to their duties under common law and the statutory regime in the Cayman Islands, directors must always have regard to the company's memorandum and articles, shareholder resolutions and board minutes.

For more specific advice on directors' duties in the Cayman Islands, we invite you to contact:

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For the convenience of clients in other time zones, a list of contacts available in each of our jurisdictions may be found here.