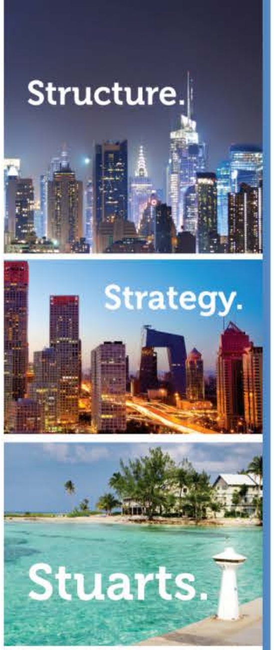
GUIDANCE NOTE

Duties of a Director under the Law of the Cayman Islands



GUIDANCE NOTE

DUTIES OF A DIRECTOR UNDER THE LAW OF THE CAYMAN ISLANDS

I INTRODUCTION

Set out below is a summary of the duties imposed by the law of the Cayman Islands upon a director of a Cayman Islands company and a description of the standard a director is obliged to meet in the proper discharge of those duties.

It should be noted that, in setting out the following summary, reference is only made to the law of the Cayman Islands (which essentially imports the appropriate principles of English common law) which have been substantially confirmed by a number of decisions of the Courts of the Cayman Islands. In the case of the directors of many Cayman Islands companies, the law of other jurisdictions, e.g. the United States, may, in the courts of those other jurisdictions, have a significant impact on the standard expected from them. The question (a) whether a foreign court would apply the law of the Cayman Islands; and (b) if not, what law or laws would it apply, are matters on which the advice of legal counsel qualified in the relevant jurisdictions should be sought. The following discussion assumes therefore that the issues would fall to be dealt with on an application of the law of the Cayman Islands, either before a Cayman Islands court or before a foreign court applying purely Cayman Islands law.

There have been a number of reported decisions in the Cayman Islands which underscore the basic principle that a director must act in good faith and in the interests of the company on whose board he serves. The courts of the Cayman Islands will normally follow English and Commonwealth decisions where general principles of company law are involved, unless there are specific statutory differences. In addition, a director is under a number of statutory duties as prescribed by the Companies Law (as Revised) and these are addressed in Section IV of this Note below.

II DIRECTOR'S DUTIES

It has long been established that a director owes both common law and fiduciary duties to the company for whom he acts.

In essence, this means that directors, operating and making decisions as a board, are required to:

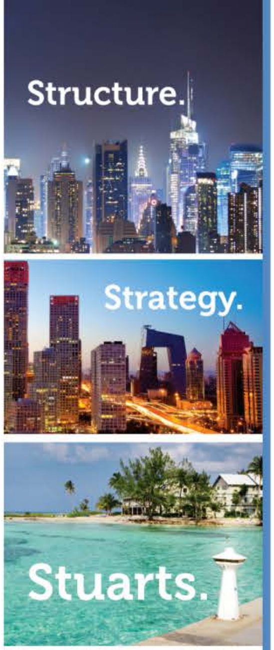
(a) act in good faith in the best interests of the company;

(b) use powers conferred on them for their proper purpose; and

(c) exercise whatever skill they possess and reasonable care when acting in the company's interests.

Where a director breaches any of his common law or fiduciary duties, the company can take action to recover its property or to obtain payment of damages from the director as compensation for any loss incurred. The company is also entitled to recover any personal profit a director may have made by exploiting his position.

In addition, it should be noted that a minority shareholder may bring a derivative action on behalf of a company against the directors if they use their powers either fraudulenty or negligently with the intention of benefitting themselves at the



expense of the company for whom they act (*Schultz v. Reynolds and Newport Limited* [1992-93] CILR 59, Cayman Islands Court of Appeal).

To Whom Duty is Owed

Generally directors' duties are owed to the company as a whole and not to individual members. It follows that the general rule is that the enforcement of a director's duties is for the company alone and this rule is subject to only limited exceptions, for instance, where derivative claims can be bought by a minority shareholder.

In this context, the company is defined usually by reference to the shareholders as a whole, as opposed to any particular shareholder. As a general principle, the directors need to balance the short-term interests of the present members against the long-term interests of future members.

It should be noted that where there are different groups of shareholders with different interests, the directors must act fairly as between these different groups. There is an element of objectivity in this test (*Mutual Life & Insurance Co. of New York v. Rank Organisation Ltd [1985] BCLC 11 followed by Re BSB Holdings Ltd (No 2) [1996]* 1 BCLC 155, both English 1st Instance decisions*).*

Importantly, whilst the interests of the shareholders as a whole are paramount in circumstances where a company is a going concern, it is now well settled that where a company becomes insolvent or is nearly so, then the interests of the company include the interests of the creditors and in such cases, the interests of the creditors may be paramount. This is addressed in more detail at Section III of this Note.

It should also be noted that where the directors have specifically undertaken to act as the agent of an individual shareholder (or group of shareholders) then a duty will be owed to that individual shareholder or group of shareholders.

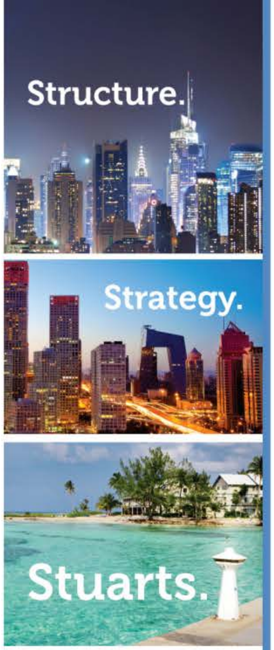
In addition, fiduciary obligations may, in principle, arise from a special relationship between the directors and shareholders (*Coleman v. Myers* [1977] 2 NZLR 225 (New Zealand Court of Appeal) and as illustrated by the English decision in *Re Chez Nico (Restaurants) Ltd* [1992] BCLC 192. For such a fiduciary relationship to arise, there will need to be a special factual relationship between the parties and this was emphasised in the Cayman Islands Court of Appeal decision in *Brandner v. Peintner* [2000] CILR Note 6a.

Duty to act in good faith

An individual director must act in good faith in his dealings with or on behalf of the company and exercise the powers conferred on him and fulfil the duties of his office honestly.

For instance, in the Cayman Islands case of *Argentine Holdings (Cayman) Limited v Buenos Aires Hotel Corporation S.A. and Seven Others* [1997] CILR 90 at page 104, it was held that:-

> "by virtue of their fiduciary positions, Directors owe strict duties to act *bona fide* in the best interest of their company and to act only for a proper purpose",



and likewise, again in the Cayman Islands case of *Prospect Properties Limited (in liquidation) v. McNeill and J.M. Bodden II* [1990-91] CILR 171 at page 199, it was held that:-

> 'It is well established that one of the fiduciary duties owed by a Director to his company is the duty to act in the best interest of that company".

The duty to act bona fide in the interests of the company is a subjective one. Accordingly, directors acting as a Board have a duty to act in good faith in what *they* consider to be the best interests of the company (*Re Smith and Fawcett Ltd* [1942] Ch 304, at 306, English Court of Appeal). They must not use their powers for the benefit of third parties or themselves. It is likely that, provided the director's motives were honest and he genuinely believed the action taken was in the best interests of the company, such director would not normally be subject to claims that he should have acted differently.

The duty is subjective and, taking the judge's comment in *Re Smith & Fawcett Ltd* [1942] 1 All ER 542, (English Court of Appeal) that:-

> "directors must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interest of the company, and not for any collateral purposes'",

the court will usually allow directors a very wide discretion, interfering only where they believe no reasonable director would consider the action taken to be in the best interests of the company.

Where a director is found to have acted honestly but not in the best interests of the company, he is in breach of duty.

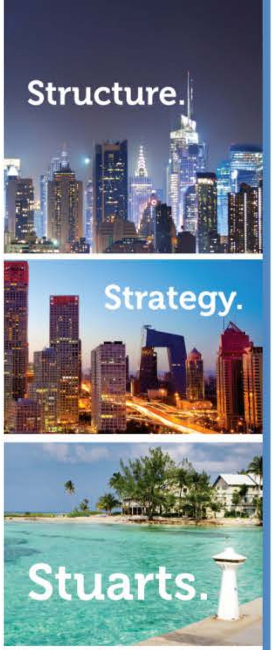
Duty to exercise powers for a proper purpose

A company's memorandum of association and articles of association, relevant shareholders' resolutions and Board minutes will determine the powers conferred upon directors and the context in which they can be reasonably exercised. Any director who exercises these powers over the company's assets other than for the purposes intended or for the benefit of the company as a whole will be liable for a breach of duty. The duty to act for a proper purpose was confirmed in the Cayman Islands decision in *Argentine Holdings (Cayman) Limited v. Buenos Aires Hotel Corporation S.A.* [1997] CILR 90, as set out above.

In certain circumstances where there is no question of insolvency of the company, these breaches of duty can be ratified after the event by the members in general meeting. This was permitted in *Bamford v Bamford* [1970] Ch 212, where the English Court of Appeal held that the improper issue of 500,000 shares by the directors to defend a take-over bid could be ratified by a majority of the votes of the shareholders at a general meeting of the company and therefore no challenge could be made to the directors' actions. Shareholders cannot ratify a breach of duty by the directors where the company is insolvent.

Conflict of interest

A director must not put himself in a position where there is an actual or potential conflict between his personal interest and his duty to the company.



A director owes fiduciary obligations towards the company he acts for requiring the observance of general standards of loyalty, good faith and the avoidance of a conflict of duty and self-interest (*Cayman Islands News Bureau Limited v. Cohen and Cohen Associates Limited* [1988-89] CILR 195, Grand Court). A fiduciary will not be allowed to benefit from a gain or advantage obtained by virtue of having acted in a manner in conflict with or not in accordance with his fiduciary duties (*Corporacion Nacional Del Cobre de Chile v. Interglobal Incorporated and Avendano Sabugao* [2002] CILR, 298, Cayman Islands Grand Court).

A conflict of interest will arise where the director seeks to exploit the assets or opportunities of the company for his own benefit. The effect of this at common law is that a director may not enter into a valid contract (other than a service contract) with the company, directly or indirectly, unless the company gives its approval in general meeting, or the Articles permit such transaction.

Strict application of this principle in all circumstances would often work to the detriment of companies and it is established that disclosure by the director of his interest may validate the contract. In practice, most companies provisions in the Articles render contracts in which a director is interested enforceable subject to disclosure by the director of his interest to the Board.

It is unclear the extent to which a director of a company can carry on a competing business or serve on the Boards of competing companies. There is old case law which provides that it is not a breach of duty for a director to serve on the boards of competing companies where that director is not breaching any restrictive agreement or disclosing any confidential information (*London and Mashonaland Exploration Co. v New Mashonaland Exploration Co.* [1891] WN 165, English 1st instance decision) which was applied by the House of Lords in *Bell v. Lever Brothers* [1932] AC 161. However, the fiduciary duties which bind all directors may in certain circumstances make such an appointment virtually untenable in practice.

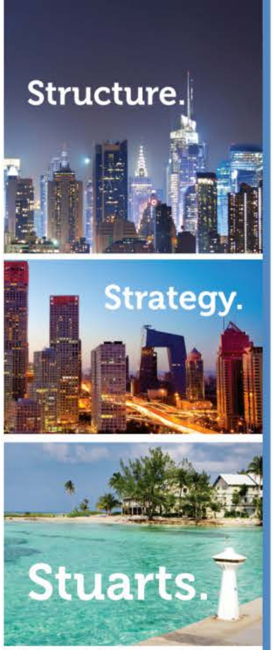
In certain circumstances a contract which is voidable by reason of a director's interest can be ratified by the company in general meeting (*North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589).

Duty not to fetter his own discretion

By extension, a director must not in general ‘fetter his discretion' to act in the best interests of the company. This means that a director must not enter into an agreement with a third party as to how he will exercise his discretion. To do so would prevent the director from exercising an independent judgment at the appropriate time.

Accordingly, a director who is appointed by a shareholder cannot agree with that shareholder, for example, to vote at board meetings in any particular way (even if voting in that way would not otherwise be a breach of his duties to the company). This situation is distinguishable from one where the directors enter into an agreement on behalf of the company under which they bind themselves to vote in such a way as to ensure that the company performs its obligations under that agreement *(Fulham Football Club Limited and Others v Cabra Estates plc* [1994] 1 BCLC 363 (English Court of Appeal)).

Whilst the director is not under an obligation to refrain from competing with his company or even from becoming a director in a rival company, care must be



exercised to ensure that he does not subordinate the interests of the one company to those of the other (*Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324, House of Lords).

Secret profits

A director's fiduciary position precludes him from taking a personal profit from any opportunities that result from his position as a director even if he is acting honestly and for the good of the company. Any profit arising in such circumstances must be repaid to the company unless it has been previously disclosed and authorised. This applies whether the profit arises from a contract with the company or a third party.

Even if the director's profit would not have accrued to the company, he must still account for it if the opportunity to make it arose through his directorship.

It should also be noted that a director cannot escape his duty to account for a personal profit by resigning before he takes it and that, even where the company could not have benefited from the contract, the director is liable to give up the profit (*Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162 (English 1st Instance decision)).

Duty of Skill and Care

The directors' fiduciary duties impose on them a largely negative obligation to do nothing which conflicts with the company's interests. At the same time, when they are acting in the company's interests they are expected to exercise whatever skill they possess and reasonable care.

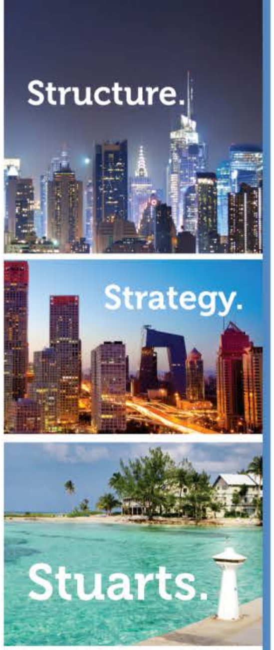
Case law has long established that a director must attend diligently to the affairs of the company and that in performing his duties he must display the 'reasonable care … an ordinary man might be expected to take in the same circumstances on his own behalf' (*Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 (English 1st Instance decision)).

The leading case on the nature and extent of the duty of skill and care is the English Court of Appeal decision in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, ("**City Equitable**"), as approved in the Cayman Islands Court of Appeal decision in *Paget Brown and Company Limited v. Omni Securities Limited* [1999] CILR 184, and more recently *In the Matter of Bristol Fund Limited* [2008] CILR 317 (Cayman Islands Grand Court). This case established three basic principles as follows:

- A director is not an expert, and need only display skills he actually possesses. He is not expected to exercise a level of skill he does not have.

- A director need not devote his continuous attention to the business.

- A director is entitled, in the absence of suspicious circumstances, to rely on the experience and expertise of his co-directors and other officers of the company.



Degree of skill

The level of skill required by a director based on the *City Equitable* case is subjective and implies that he would not be expected, merely by virtue of his office, to possess any particular skills. His performance is judged by the way he applies any skills which he actually has.

The most concerning limitation of this subjective test is that it exonerates the incompetent but honest director from his actions on the basis that he can do no better. In reality, such person is unlikely to remain a director of the company for long.

The English Courts have increasingly applied an "objective' test in respect of the standard of skill and care expected of a director and the Cayman Islands Courts are likely to follow this approach. In that respect, the standard of skill and care expected of directors has been held to be that of:-

> "A reasonably diligent person having both – (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has".

Further, where there is a service contract between the director and the company, where the director is under a contractual obligation to fulfil specific tasks within the company based upon his expertise, knowledge and experience, the director would be required to display an objective level of skill implied in such contract.

Attention to the business

It was held in *City Equitable* that:-

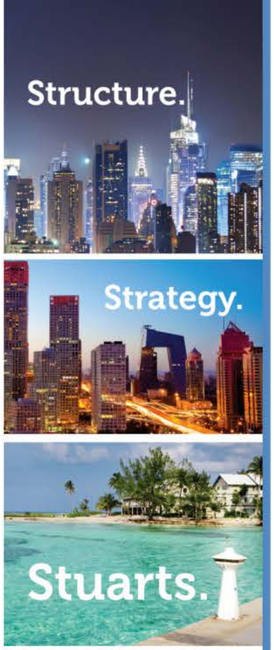
> "a director is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature".

This dictum is clearly more appropriate to the circumstances of a director who does not have a service contract with the company and refers specifically to attendance at board meetings. A director's service contract normally requires that he devotes his full attention to the business of the company.

Clearly the size and nature of a company's operations will determine the matters which are attended to by the directors personally. In a small family owned and run company they will be very different to those which concern the directors of a large multinational organisation. In the latter case the scale of operations makes it impossible for the directors to attend to many matters personally, and the need for effective delegation and supervision becomes essential.

Reliance on others

Generally, a director is entitled to rely on his fellow directors and officers of the company. Thus in *Dovey v Cory* [1901] AC 477 (House of Lords), it was held that a director was entitled to rely on a subordinate 'put in a position of trust for



the express purpose of attending to the detail of management' and was not liable for any loss resulting from wrongful acts committed by that person.

Similarly, in *City Equitable* it was held that:-

> "In respect of duties…that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly".

Thus, in this case, the directors were entitled to sign cheques which appeared to be properly authorised although subsequently put to an unauthorised use.

The absence of suspicious circumstances was also relied on in *Huckerby v Elliott* [1970] 1 All ER 189 (English 1st Instance decision), in which a director failed to enquire whether a gaming licence had been obtained but had no grounds for suspicion. In that case, it was again held that a director of a company cannot be said to be neglectful if he fails to enquire about certain matters which are dealt with by a fellow director.

Directors may also rely on the opinions of outside experts, and in fact may be negligent if they do not obtain an outside opinion in appropriate circumstances (*Re Duomatic* [1969] 2 Ch 365 (English 1st Instance decision)). In *Coulthard v Neville Russell*, [1998] 1 BCLC 143, (English Court of Appeal) it was held that auditors had failed to exercise their duty of care, not only to the company but also to its directors, to advise them that payments and other financial arrangements amounted to unlawful financial assistance for the purchase of own shares.

It is important to note that directors cannot absolve themselves entirely of responsibility by delegation to others. For example, in *Selangor United Rubber Estates Ltd v Cradock* [1967] 2 All ER 1255 (English 1st Instance decision) the directors were held liable where they should have been aware of a wrong even though they were in fact ignorant of it. Ignorance is therefore not necessarily a defence, and directors were expected to exercise their judgment and to delegate and supervise activities in such a manner as to uncover any unauthorised or unapproved actions. Furthermore, in *Re Barings plc; Secretary of State for Trade and Industry v Baker* (1998) BCC 583 at 586, when making a disqualification order the judge held that whilst directors may be entitled to delegate functions, the high level of responsibility associated with their office requires them to supervise the delegated functions, even where they trust the competence and integrity of those below them. Consistent with this, in *Re Barings Plc (No 5)* [2000] BCLC 523, the English Court of Appeal held that:-

> " … the exercise of the power of delegation does not dissolve a director from the duty to supervise the discharge of the delegated functions".

III DIRECTORS DUTIES IN AN INSOLVENCY CONTEXT

When a company encounters financial difficulties and is insolvent or is of uncertain solvency, under Cayman Islands Law, the directors must, in addition, consider the creditors' interests as well as part of their duty to act in the interests of the company itself. This is demonstrated by the Cayman Islands decision in *Hutchinson Limited, Crain Creek Limited Mountain Dew Limited and Forum*

Limited –v- Cititrust (Cayman) Limited and Ten Others [1998] CILR 43 at page 61, where it was found that:-

> "It is settled law in the Cayman Islands and England that when a company is insolvent or doubtfully solvent it is incumbent upon its Directors to keep its assets inviolate for its creditors. If directors fail to perform this duty they will be in breach of their fiduciary duties … ".

The Court's approach is demonstrated by the Cayman Islands case of *Prospect Properties Limited (In Liquidation) v. McNeill and J.M. Bodden II* [1990-91] CILR 171, which approved the New South Wales Court of Appeal decision in *Kinsela v. Russell Kinsela Pty Ltd* (1986) 4 ACLC 215 at 223, where it was held:-

> "In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise … But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholder's assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration".

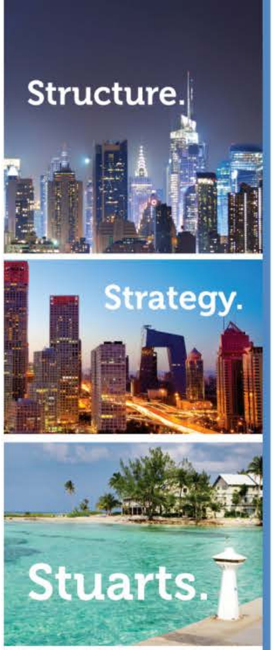
Accordingly, depending upon the circumstances, the creditors interests may be paramount over the shareholders interests. In this respect, the directors must have regard for all the general creditors and not one creditor or a section of creditors (*In Re Pantone 485 Ltd* [2002] 1 BCLC 266 (English 1st Instance decision). Upon insolvency or uncertain solvency the Directors must therefore have regard to what is in the best interests of the general body of creditors. In this context, there are no prescribed statutory duties; duties are determined by reference to the common law.

However, creditors will not, as a consequence, have a direct right of action against the directors (*Yukong Lines Ltd of Korea v. Rendsburg Investment Corp* [1988] BCC 870 (English 1st Instance decision) or the company for not considering their interests, but the company itself (usually through a liquidator appointed following the company's insolvency) can bring an action against a director for breach of duty.

IV STATUTORY DUTIES

The Companies Law (as Revised) contains a number of provisions relating to directors duties. For example, liabilty may arise where:-

- the books of account, minutes of meetings, or the statutory registers of members, mortgages and charges or directors have not been properly maintained;



- a director authorises or permits any distribution or dividend in breach of the Companies Law;
- a director knowingly or wilfully authorises or permits any payment out of capital by a company for a redemption or purchase of its own shares when the company is insolvent;
- there has been a failure to provide certain information to specified persons as required by the Companies Law;
- a director makes or authorises a false annual return to the Registrar; and
- an exempted company has carried on business within the Cayman Islands.

Directors of any Exempted Segregated Portfolio Company ("**SPC**") have additional duties and liabilities, including:-

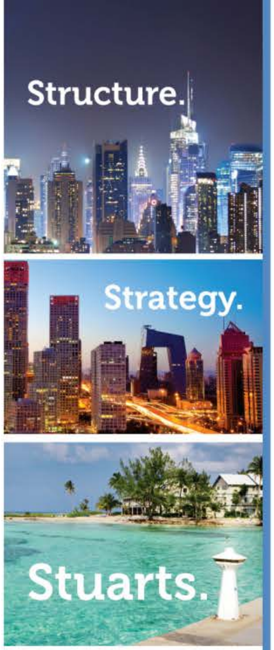
- the duty to establish and maintain the segregation of a portfolio's assets from other segregated portfolios and the general assets of the SPC; and
- the duty to ensure that the SPC states the capacity in which it is contracting in relevant transactional documentation.

V BREACH OF DUTY BY DIRECTORS

A director who fails in his duties to the company may have unlimited liability for a loss suffered by the company, even if he himself has not made any personal gain. Similarly, directors may be directly accountable to third parties for any loss or damage suffered by them as a result of their actions, omissions or in respect of information supplied by them.

Where a director breaches his fiduciary duty or his duty of skill and care to the company, he will be liable to civil action instigated by the party, most often the company, to whom the duty is owed for any loss suffered or undisclosed profit made or advantage taken. The company may consider it appropriate that the director's breach of duty be ratified after the event, permissible in certain circumstances, or may take legal action to obtain:

- an injunction to restrain the director and prevent him from carrying out or continuing with the action constituting the breach of duty in the future;
- damages by way of compensation where the director's action is considered negligent;
- restoration of the company's property, provided it does not prejudice an innocent third party, where the director's fiduciary duty has been broken and assets have been misappropriated;
- an account of profits made by the director;
- rescission of a contract in which the director has an undisclosed interest; or



- dismissal of the director.

It should also be noted that, pursuant to the Companies Law (as Revised), liquidators have a wide range of powers to take action against directors who have acted in breach of their duties.

In this context, directors are under a statutory duty to co-operate with the liquidators (Secton 103 (2) of the Companies Law) and the liquidators can apply to Court for an Order for the examination of a director and that the director transfer or deliver up to the liquidators any property or documents belonging to the company. Failure to, *inter alia*, provide such property or documents may amount to a criminal offence under Section 136 (1) of the Companies Law.

Dismissal of a director

Where the members of the company become aware and are concerned that a director is not carrying out his duties in relation to the company and its affairs, they may consider it necessary to seek to remove the director from office to protect the company, either financially or otherwise. The members may consider that decisions made by the director generally were not in the best interests of the company or that he failed to fulfil specific duties required of him. Whatever the circumstances, the members normally have power to remove a director in accordance with the articles of association of the Company.

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GUIDANCE NOTE

This publication is for general guidance and is not intended to be a substitute for specific legal advice. Specialist advice should be sought about specific circumstances. If you would like further information please contact:

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