

## Directors' duties and obligations under Cayman Islands law

In most cases directors are responsible to the company and not, in the absence of special circumstances, to the shareholders as individuals. For these purposes, the company is generally defined with reference to the interest of both present and future shareholders of the company as a whole and as a general rule the consent of individual disadvantaged shareholders is not required where directors choose a particular course of action.

If a company is in financial difficulty the interests of the company will also include the interests of the creditors. In other words, those with the greatest economic interest in the company at any given time (predominantly shareholders if the company is solvent and continuing business, but predominantly creditors if it is insolvent or winding down) are the parties with reference to whom the directors' duties to the company are assessed.

In special circumstances, the directors may owe duties to individual shareholders. For instance, the articles of association (**Articles**) or a shareholders' agreement may impose specific duties towards shareholders, and representations made by directors to shareholders may impose fiduciary duties to the shareholders (e.g. the courts may recognise a fiduciary duty owed by directors to individual shareholders in the context of advice given by the directors to the shareholders as to whether they should sell their shares to a bidder).

### THE COMMON LAW DUTIES OF DIRECTORS

There is no statutory codification of the general duties and liabilities owed by directors to companies and so the general duties derive from English common law. At common law a director owes two types of duty to the company, fiduciary duties and duties of skill, care and diligence.

#### ***Fiduciary Duties***

An individual director must act in good faith in his dealings with or on behalf of the company and exercise the powers and fulfil the duties of the office honestly. Fiduciary duties covered by the general obligation include:

**A Duty to Act in Good Faith** - A director has a duty to act in good faith in what he considers is the best interests of the company and not for any collateral purpose.

**A Duty to Exercise Powers in the Company's Interests** – A director must exercise his powers in the company's interests and in accordance with the relevant provisions of the company's constitutional documents and not for any personal or improper purpose.

**Unfettered discretion** - A director must not fetter the future exercise of his powers and so should not agree to exercise his powers in accordance with the instructions of some third party irrespective of the best interests of the company. This will be of particular relevance to a nominee director or one who represents a particular shareholder. His duties will always be to the company not to the appointor.

**Secret Profits** - A director's fiduciary position precludes him from taking a personal profit from any opportunities that result from the directorship, even if the director is acting honestly and for the good of the company, unless the Articles provide otherwise. Subject to the Articles, any profit so arising must be paid over to the company. This applies whether the profit arises from a contract with the company or a third party.

**To avoid Conflicts of Interest** - The general rule is that a director must not put himself in a position where there is an actual or potential conflict between a personal interest or duties owed to third parties and his duty to the company. For instance, if a director directs business to a company in which he is interested, perhaps because the person is also a director of that company, then the director is in danger of breaching his fiduciary duty.

**Disclosure** - Notwithstanding the general duty to avoid a conflict of interest, a director may enter into a contract where a conflict of interest might arise if the articles allow it or if the company gives its approval in a general meeting of shareholders. The Articles commonly provide that a director will not be disqualified by his office from contracting with the company, or be liable to account to the company for any profit realised from such contract, provided that disclosure is made.

**Acting in other capacities** - A director is not prohibited from acting as an officer or employee of the company (other than auditor), as a director of another company, or from representing the interests of a shareholder or another third party, provided that the company consents and the director can continue to act in the best interests of the company. However, a director in such position must preserve independent discretion as to how he exercises his powers and, if a conflict arises, he must not subordinate the interests of the company to those of the other company or third party as a means of resolving the conflict.

### ***Duty of Skill and Care***

In recent years English and Commonwealth authorities have moved from the traditional purely subjective test referencing the individual director whose conduct is being judged towards an objective test for the applicable standard of skill and care which a director will be required to have.

Following these cases it is likely that the applicable skill and care test will be that

of:

***“A reasonable 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”. (Re D’Jan of London Limited [1994] 1BCLC 561)***

Therefore, there is a minimum objective standard based upon the functions given to the director in question but the standard can be raised where the director in question has more knowledge, skill and experience than would normally be expected; if, for example, he has been recruited as an expert in a particular business of the company.

**Attention to the Business** - A director is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature and he is not bound to attend all meetings but he should attend all meetings which he is reasonably able to be present at.

**Delegation** - A director is not liable for the acts of co-directors or other company officers solely by virtue of the position. A director is entitled to rely on his co-directors or company officers as well as subordinates who are expressly put in charge of attending to specific tasks, provided such reliance is honest and reasonable (although a director cannot absolve himself entirely of responsibility by delegation to others). As a general rule, before delegating responsibility to others, the directors in question should satisfy themselves that the delegates have the requisite skills to discharge the functions delegated to them. In addition, the directors must ensure that they monitor delegate performance on a periodic basis, ensuring that their delegates have fulfilled their obligations. It is not possible to wholly delegate all supervisory functions.

**Experts** - Directors may rely on the advice of an independent outsider, and in respect of fields where they do not have expertise may be considered negligent if they reach a decision without first obtaining appropriate expert (eg legal) advice. Directors must take reasonable care to select an adviser who is qualified to give the advice, and, having received it, the directors must then exercise their own judgment in the light of that advice.

***Financial Responsibilities of Directors***

Directors must exercise skill and care in financial matters. It is the responsibility of the directors to ensure that the company fulfils its obligations to keep proper books of accounts. In addition, liability may attach to a director in the following contexts:

**Control over the company’s borrowings** - The Articles may place a limit on the amount the company can borrow without shareholder approval. If the directors exceed their borrowing powers the loan is generally valid unless the lender is aware of some irregularity, but the directors risk personal liability.

**Dividends** - The company may only declare and pay dividends if it can be sourced

from any one or more of (i) profits, or (ii) the proceeds of a fresh issue of shares and/or share premium account and following the date on which the dividend is proposed to be paid, the company is able to pay its debts as they fall due in the ordinary course of business. The directors risk personal liability for a breach of this requirement.

**Return of Capital** - The company may only redeem or repurchase shares to the extent payments can be sourced from any one or more of (i) profits, or (ii) the proceeds of a fresh issue of shares, share premium account and/or capital and following the date on which the payment is proposed to be paid, the company is able to pay its debts as they fall due in the ordinary course of business. The directors risk personal liability for a breach of this requirement.

**Insolvency and Fraudulent Trading Laws** - Please see below for the scope of potential liability.

## STATUTORY DUTIES

The Companies Law (Revised) (the **Companies Law**) contains numerous provisions relating to the duties of directors and prescribes penalties for breach. The most serious of these involving dishonesty or the authorising of illegal payments carry both criminal and civil penalties.

Examples of the more material provisions include:

- (a) where the director wilfully authorises or permits any distribution or dividend in contravention of the Companies Law;
- (b) where the 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;
- (c) where there has been a failure to maintain the books of account, minutes of meetings, or the statutory registers of members, mortgages and charges or directors;
- (d) where there has been a failure to provide information or access to documents to specified persons as required by the Companies Law;
- (e) Where the director makes or authorises a false annual return to the Registrar; and
- (f) Where an exempted company is found to have been carrying on domestic business in the Cayman Islands.

## INSOLVENCY AND FRAUDULENT TRADING LAWS

Section 3 of the Companies (Amendment) Law, 2007 was brought fully into effect on 1 March 2009, and introduces a new insolvency regime including some new offences for directors.

### ***Section 147 - Fraudulent trading***

Where any person (i.e. a director or officer) was knowingly a party to the carrying on of business by the company with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the liquidator may apply to court for an order requiring those persons to contribute to the company's assets.

### ***Section 134 - Fraud in anticipation of a winding up***

The new provisions consolidate and express as a criminal offence punishable by a fine or conviction for five years, the offence of fraud in anticipation of a winding up by a director, officer (including a **shadow director** (see below for the definition)), professional service advisor or voluntary liquidator, who within 12 months preceding the commencement of the winding up has, with intent to defraud the company's creditors or contributories:

- (a) concealed US\$12,250 or more of the company's property or debt;
- (b) removed US\$12,250 or more of the company's property;
- (c) concealed, destroyed or falsified any documents relating to the company's property;
- (d) made a false entry, altered or made an omission in any documents relating to the company's property or affairs; and
- (e) pawned, pledged or disposed of property obtained on credit and not paid for.

### ***Section 135 - Transactions in fraud of creditors***

The new provisions express as a criminal offence similarly punishable by a fine or conviction for five years, **transactions in fraud of creditors** - where in the case of any company advised to be wound up by the court or voluntarily any officer of the company (including a director) or professional service advisor to a company (a) is found to have made a gift of, or has charged the company's property, (b) connived in levying execution against it or (c) concealed or removed the company's property, in each case with intent to defraud the company's creditors or contributories.

### ***Section 136 - Misconduct in the winding up***

The new provisions similarly codify and criminalize various aspects of misconduct in the course of the winding up. Section 136 provides that where a company is being wound up by the court or voluntarily, any person who is or was a director, officer (including a shadow director) or professional service advisor to the company who does not make full disclosure to the liquidator of all of the company's property or documents in his custody or control and the details of any property disposed of, other than in the ordinary course of business or who permits any false debt to be

proved in the winding up or who destroys or falsifies any documents or makes any fraudulent entry in any accounts or documents with intent to defraud the company's creditors or contributories, is punishable by a fine or imprisonment for five years.

### ***Sections 101-103 – Obligations to cooperate with liquidator***

These sections provide obligations for directors of a Cayman company being wound up to cooperate with the liquidator and in particular to prepare a statement in the required form as to the affairs of the company and if required by a Cayman court to transfer any documents or other property belonging to the company to the liquidator, to swear an affidavit in respect of written questions of the liquidator or to meet with the liquidator and answer oral queries in respect of the company and its affairs.

### ***Section 137 - Material omission in statement of affairs***

These new provisions authorise a liquidator to require directors, officers, professional service advisors and employees of the company to submit a statement of affairs to the liquidator setting out their knowledge of the assets and liabilities of the company. The ability of the liquidator to require these parties to submit a statement of affairs is enhanced by a corresponding provision which criminalizes and makes punishable by a fine or imprisonment for five years, any material omission by any director, officer (including shadow director), manager or professional service advisor, in any such statement of affairs, made with intent to defraud the company's creditors or contributories.

### ***Shadow directors***

A shadow director is defined to mean any person in accordance with whose directions or instructions the directors of a company are accustomed to act provided that a person is not deemed to be a shadow director by reason only that the directors act on advice given by him in a professional capacity and so an investment manager of a company making recommendations as to the purchase or sale of investments should not, for example, usually constitute a shadow director.

## **THEFT AND FRAUD, SECURITIES LAWS AND MONEY LAUNDERING**

### ***Theft and fraud***

A director can be criminally liable under the Penal Code (Revised) for offences of theft and fraud including:

- (a) Making false statements with an intent to deceive members or creditors; and
- (b) False accounting.

### ***Securities laws***

A director of a company listed on the Cayman Islands stock exchange can be criminally liable:

- (a) if he is involved in misleading statements or practices, which may induce someone to buy or sell shares or other securities; and
- (b) for insider trading under the Securities Investment Business Law (Revised).

Civil liability in respect of securities may flow from other breaches of securities laws, and from common law matters, such as claims for fraudulent or negligent misrepresentation.

### ***Money Laundering Offences***

Directors could incur criminal liability for assisting in money laundering, “tipping off” money launderers and failure to inform the appropriate Cayman authorities of suspected money laundering. Cayman Islands anti-money laundering legislation is beyond the scope of this note.

## **DUTIES OWED TO THIRD PARTIES**

### ***Personal liability for contracts***

Where directors act outside the scope of their authority they may be liable to compensate a contract counterparty for breach of the implied warranty of their authority.

### ***Personal liability for Torts***

There are two potential situations: the first is where the company commits a tort (for example, a negligent act or negligent misrepresentation relied upon by the recipient) through an employee or agent, and the question is whether a director, not being the servant or agent responsible, is liable to the victim. The second is whether a director, who acts so as to cause the company to be liable in tort, can be sued personally by the victim.

In the first instance, a director is not liable for the torts committed by a company simply by virtue of his being a director, but he may be personally liable if he has authorised, directed or procured the commission of the tort, even if he did not know, or did not care, whether the acts so authorised were tortious. In the second instance, the test for personal liability is whether the relevant director has assumed responsibility, either on an actual or imputed basis.

## **INDEMNIFICATION**

The Articles may provide for the indemnification of a director or an officer for breach of duty, save in limited circumstances such as where the director has been fraudulent or dishonest or where there has been wilful neglect or wilful default in the fulfilment of fiduciary duties. Operating companies will commonly obtain

directors and officers' insurance.

## **CONCLUSION**

The Companies Law and the common law impose various duties and responsibilities on directors. Directors should always consider these duties and responsibilities when considering a course of conduct with respect to the company and its interests and specific legal advice should be taken where conflicts arise or duties are unclear.

## **FURTHER INFORMATION**

Please contact any of the following Harneys lawyers if you require additional information on the duties of directors under Cayman Islands law.

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