



CAYMAN ISLANDS LAW REFORM COMMISSION



Directors' Duties – Is Statutory Codification Needed?

Final Report

30th March, 2017

The Cayman Islands Law Reform Commission

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DIRECTORS' DUTIES – IS STATUTORY CODIFICATION NEEDED?

1. The Law Reform Commission submits for consideration its Final Report on the issue of whether there should be codification of the fiduciary duties of company directors in the Cayman Islands.

BACKGROUND

2. The issue of the codification of directors' duties first came to the fore during the Law Reform Commission's review of the law dealing with corporate insolvency.¹ At that time, the Hon. Chief Justice raised the question of whether an amended Companies Law should codify the duties of directors. The Chief Justice further suggested that the Commission should consider whether the law should bring certainty to the issue of directors' duties.

3. It is with these recommendations that the Law Reform Commission (the Commission), in 2013, commenced an examination into the issue of whether the common law fiduciary duties should be codified. The Commission also took into consideration the *Weaving Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom*² which sought to place the issue of fiduciary responsibilities of directors under the microscope.

RECOMMENDATION

4. The Commission extensively examined the views of respondents to its Issues Paper entitled: "Directors' Duties – Is Statutory Codification Needed?" dated 16th January, 2014 ("Issues Paper"). This examination was done in conjunction with the research material on the subject of codification, including the related issues and the legislative approach of other jurisdictions.

5. After deliberations on 8th December, 2016 the Commission recommended that no action be taken to codify the fiduciary duties of directors. The recommendation of no action also applies to the question of whether there is a need to expand the legislative regime for the disqualification of directors and to introduce legislation for the indemnification of directors. These two issues formed part of the general codification question but were later discretely examined by the Commission to determine whether there is a mischief which might be appropriately addressed through codification.

6. With respect to the codification of the fiduciary duties of directors, the Commission was persuaded by the arguments of a majority of the respondents which suggested that the common law position should remain as the means through which a determination is made as to whether a director has breached his fiduciary responsibility and also the means through which appropriate remedies for a breach are determined.

7. The Commission was also persuaded by the arguments of stakeholders that issues surrounding indemnities have been successfully tested in the courts to the point where there are a core set of duties from which a director cannot be absolved through indemnification. As such, codification of the issues that involve indemnities would serve no material purpose.

¹See para. 7 of the Law Reform Commission, Final Report No. 3, Review of Corporate Insolvency Law and Recommendation for the Amendment of Part V of the Companies Law, July 2007, Supplemental Report.

² [2011 (2) CILR 203], Grand Court Financial Services Division, (Jones, J.): August 26th, 2011.

8. In the case of a disqualification regime, the Commission supports the view that there is no compelling need for a disqualification regime beyond that which exists under the Directors Registration and Licensing Law, 2014 for regulated entities.

RESEARCH AND CONSULTATION PROCESS

9. The research of the Commission into the issue of the codification of directors' duties included an examination of who is a director, the different categories of directors and the fiduciary duties of directors generally. Particular focus was placed on the duties of directors in the Cayman Islands and the arguments for and against the codification of those duties.

10. The research findings of the Commission were relied upon in the formulation of the Issues Paper. In the Issues Paper several issues were identified relating to whether the fiduciary duties and the duty of care, skill and diligence of company directors in the Cayman Islands should be codified in order to promote consistency, predictability, transparency and high standards of corporate governance.

11. The Issues Paper was published for general public comment and was specifically forwarded to the -

- Hon. Chief Justice;
- Cayman Islands Chamber of Commerce;
- Alternative Investment Management Association (Cayman Islands);
- Cayman Islands Association of Insurance and Financial Advisors;
- Cayman Islands Bankers Association;
- Cayman Islands Directors Association;
- Cayman Islands Company Managers Association;
- Cayman Islands Financial Services Association;
- Cayman Islands Fund Administrators Association;
- Cayman Islands Insurance Association;
- Cayman Islands Law Society;
- Cayman Islands Society of Professional Accountants;
- Caymanian Bar Association;
- CFA Society of the Cayman Islands;
- Cayman Islands Compliance Association;
- Insurance Managers Associations of Cayman; and
- Society of Trust and Estate Practitioners (Cayman Islands).

12. Stakeholders and members of the general public were invited to respond to the issues identified in the paper and to indicate whether there are other areas that should be reformed in order to improve the corporate governance structures in the Cayman Islands.

13. The consultation period on the Issues Paper commenced on 16th January, 2014 and concluded on 24th March, 2014. By the end of the consultation period, the Commission received responses from the following companies and organisations -

- Appleby (Cayman) Ltd. (Appleby);
- The CFA Society Cayman Islands (CFA);
- The Cayman Islands Directors Association (CDA);
- The Cayman Islands Law Society (CILS);
- Intertrust Cayman (Intertrust); and
- Walkers Cayman (Walkers).

DISCUSSION OF THE CODIFICATION ISSUE

14. In the Issues Paper it was pointed out that when dealing with the regulation of companies, the issue of duties of directors is one of the critical areas to be considered in the formulation of an appropriate legislative framework. The activities of companies are conducted by individuals through the application of the corporate legal personality principle and given that a company's directors are its principal agents, the duties of those directors to the company and third parties are central to the legal control and operations of that company.

15. This point was especially important within the Cayman Islands given that the economy of the Islands benefits from the efficiency and profitability of the companies registered in the Islands and the affiliates of those companies. As such, the effectiveness of a board of directors in discharging their duties and responsibilities will play an integral role in determining the global competitive position of the Islands.

16. It was clear from our research that while company directors should be allowed a certain degree of flexibility in the advancement of their companies that flexibility needed to be exercised within a framework of effective accountability. A proper and efficient system of corporate governance is therefore necessary in a company in order to regulate the directors and prevent them from abusing their powers.

17. In pursuing the regulation of directors' duties, we were cognisant of the challenge to ensure that any proposed legal framework preserves established common law principles that govern the relevant duties, while at the same time allowing the nature of those duties to develop. Balancing clarity and certainty that codification may offer against the need for flexibility in judicial interpretation based on the circumstances of a particular case was a focal aim of our investigation.

DIRECTORS' DUTIES IN THE CAYMAN ISLANDS AND THE WEAVERING MACRO JUDGMENT

(a) Directors' Duties in the Cayman Islands

18. Our research commenced with an examination of the position in the Cayman Islands on directors' duties. It was found that, in the Cayman Islands, the primary source from which directors' duties emanate is the common law. The duties of directors and, by extension, other company officers, are not codified under the law of the Cayman Islands.

19. The Companies Law (2016 Revision) does however impose specific statutory duties in relation to the internal administration of a company. These duties extend to registration, filing, the payment of

dividends, making correct statements, taking company minutes, making annual returns and dealing with insolvency and fraud issues.

20. Personal liability may be imposed on a director for misapplication of company money, misfeasance, breach of trust, or for knowingly carrying on the company's business for fraudulent trading.

21. Statutory duties are also imposed on directors under the Local Companies (Control) Law (2015 Revision)³ and the Penal Code (2013 Revision)⁴. These laws contain provisions which provide for the imposition of penalties for breaches of statutory duties by directors.

22. The Cayman Islands Directors Association formulated the Cayman Islands Directors Professional Code of Conduct which sets out rules that govern its membership⁵. The Code provides for several duties of directors relating to the exercise of leadership, standards of good practice, serving legitimate interest of the company's shareholders, complying with relevant laws, acting honestly in business dealings, avoiding conflict of interest and acting for a proper purpose.

23. Also of note is that the Cayman Islands Monetary Authority has formulated its own Regulatory Handbook⁶ which sets out the code of conduct applicable to its Board of Directors.

(b) The Weaving Macro Judgment

24. It was critical that our examination also focused on the decision of *Weaving Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom*⁷. This decision, we argued, reinforced the necessity to examine the need for codification of directors' duties in the Cayman Islands.

25. This case sought⁸ to establish how directors should approach the discharge of their fiduciary and other duties to the funds of which they are directors. It also established standards of behaviour which are expected of directors.

26. The court provided guidance as to the main duties and responsibilities of all directors. It was held that -

- (i) directors owe fiduciary duties to their companies to act bona fide in the best interests of the company in that they must exercise their powers for the purposes for which they are conferred and not to place themselves in a position where there is a conflict between their personal interest and their duty to the company;

³ For example see section 14(1). The Board may, at any time by notice in writing, require the directors of a local company to forward to it such information as to the directors of and shareholdings (including the classes of shares and the voting and other rights attached to each class) in the local company as the Board may specify.

⁴ The Penal Code (2013 Revision) is perhaps the only law which imposes a direct duty on directors in the sense that it provides that a person who, 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.

⁵ 2008 Articles 1 to 12.

⁶ March 2010.

⁷ [2011 (2) CILR 203], Grand Court Financial Services Division, (Jones, J.): August 26th, 2011.

⁸ Cayman Hedge Fund Judgment Brings Directors' Duties Starkly Into Focus- Mourant Ozannes – September, 2011 Robert Duggan, Partner, Cayman Islands, Based in the London office.

- (ii) a director must exercise his powers independently, without subordinating those powers to the will of others, except to the extent that they have properly delegated their powers;
- (iii) the director has a duty to exercise reasonable care, skill and diligence; and
- (iv) the director's duty is to exercise an independent judgment.

THE CONCEPTS OF A COMPANY AND CORPORATE GOVERNANCE

27. In order to properly address the issue of whether codification of directors' duties was necessary, we felt it critical to examine the core concepts of company and corporate governance.

(a) The company concept

28. Our research reflected the well-established principle that a company is a distinct legal entity from its directors, shareholders and beneficial owners. A company has its own corporate personality and is legally a different person from its subscribers even though after incorporation the business is the same as it was before. However, it was noted that the company is not at law the agent of the subscribers or a trustee for them, nor are the subscribers as members liable, in any form, except to the extent and manner provided by law.⁹

(b) The corporate governance concept

29. The term corporate governance in a narrow sense refers to control of corporations and to systems of accountability by those in control. In a wide sense it includes the entire network of formal and informal relations involving the corporate sector and their consequences for society in general.¹⁰

30. Historically, directors in many jurisdictions dictated the extent to which they governed their companies and the extent to which the members or shareholders of the corporation, as well as the other stakeholders of the company, actively participated in corporate governance processes. One commentator noted that "the trouble with British companies is that the directors mark their own examination papers."¹¹

WHO IS A DIRECTOR OF A COMPANY?

31. The question of who is a director was essential to place the discussion into context. Directors are persons to whom the duty of managing the general affairs of a company is delegated and as such are considered the fiduciaries of a company. A fiduciary relationship stems from the concept of trust and putting the interest of the company before one's own interest. In broad terms a fiduciary is a person who has the responsibility, or is required by law to act in the best interests of a company. Therefore, by dealing with the company's affairs the director owes a fiduciary duty to that company.¹²

32. In large public companies directors are likely to have limited involvement in the day-to-day management of the company. A director's role in such companies will be more one of providing general direction, oversight and review. In many such companies, the directors will be non-executive directors

⁹ *Salomon v Salomon & Company* [1897] A.C. 22.

¹⁰ J Farrar (2005), *Corporate Governance Theories, Principles, and Practice*, 2nd edn, Oxford University Press, 3-6.

¹¹ RI Tricker (1984), *Corporate Governance: Practices, procedures and powers in British companies and their boards of directors*, The Corporate Policy Group, Oxford, 236.

¹² Dixon J. in *Mills v Mills* (1938) 60 C.L.R. 150 at p. 186.

whose main occupation lies outside the company and whose function is to bring an independent view to, and a broader outlook on, the company's decision-making and to assist company management with specialised expertise or ability.

33. By contrast, in small and medium sized companies, the directors may be members of the company with the main occupation of conducting all of the operations of the company. These directors will be involved in the day-to-day management of the company.

34. Within these two extremes, across companies, there will be a mix of executive and non-executive directors and there will be differences in the extent of directors' involvement in day-to-day management or the more general direction of management.

CATEGORIES OF DIRECTORS

35. Following upon the recognition that the types of directors that exist in a company can vary, focus was placed on the following categories of directors -

- (a) executive and non-executive directors;
- (b) de facto directors;
- (c) shadow directors;
- (d) alternate directors; and
- (e) nominee directors.

Issue #1

The issue emerging from the discussion of the categories of directors that exist was whether respondents supported a proposal which expressly identified the various categories of directors in legislation and prescribed the manner in which each should execute their duties and the extent of the liability to be attached for a breach of those duties.

36. The shared view expressed by the CDA, CILS, Walkers and Intertrust on this issue is that categorisation and sub-categorisation would lead to an absence of flexibility in relation to the way particular duties are applied to particular factual circumstances. It was felt that by attempting to categorise directors in legislation we would stifle the development of the law in relation to commercial transactions and it would limit freedom of contract.

37. It was argued that all directors, regardless of category, should be treated equally so as to achieve certainty and consistency in the application of the law to all persons acting as director. In the view of the respondents, the *Weaving* judgment gave guidance as to the main duties and responsibilities of all directors and as such is flexible but certain enough for directors to appreciate the duties they owe to the company.

38. Appleby, however expressed the view that some form of categorisation may be necessary, especially as it relates to shadow directors. It was indicated that the common law rules and equitable principles do not apply as automatically to subject shadow directors to the same general duties as are owed by *de jure* and *de facto* directors. This is notwithstanding the fact that the activities of a particular shadow director may go beyond the mere exertion of influence and may give rise to one or more general

duties. It was also suggested that another category that might give rise to such an occurrence is that relating to former directors.

39. The overall majority view on this issue however is that any attempt to categorise directors will likely result in uncertainty and would provoke additional case law in order to provide clarity.

TO WHOM DO DIRECTORS OWE THEIR DUTIES?

40. We examined the different persons to whom directors owe a duty. In this regard, the following was determined -

- (a) In the case of the for-profit company the duties of a director are owed to the company.
- (b) In the case of the non-profit company the directors owe a duty to the donors and to the members.
- (c) In the case of the hedge fund or mutual fund, the directors owe a duty to the general body of shareholders, rather than to individual shareholders or to particular classes of shareholders and they extend to the creditors of the fund in cases of insolvency.¹³

Issue #2

In relation to this issue, respondents were asked to assess whether we should identify, in legislation, the persons to whom directors owe a duty and make a distinction as to which duties and the elements of such duties should apply to particular stakeholders.

41. All respondents are against any proposal to identify the persons to whom duties are owed. It is argued that the various stakeholders to whom a duty is owed will change over time and in some instances may be conflicted rather than aligned. The director's role, it is contended, is to make an objective decision in instances of such misalignment or conflict.

42. Directors should therefore have the responsibility to understand to whom a duty is owed. Respondents do not believe that any identification or distinction would simplify matters but instead may add further complication as it may not be possible to capture all the duties and to whom the duties are owed. Doing so, it is argued, would reduce the flexibility which is enjoyed by the current system which continues to evolve.

CODIFICATION OF DIRECTORS' FIDUCIARY DUTIES AND DUTY OF CARE, SKILL AND DILIGENCE

43. Specific examination was undertaken into the duties we proposed to be the subject of codification. These duties fall into three broad categories:

- (i) contractual duties;**
- (ii) fiduciary duties; and**
- (iii) tortious – duty of care, diligence and skill.**

¹³ Anna-Lise Bailey, Duties and Responsibilities of Corporate Hedge Fund Directors, February, 2009.

(i) Contractual duties

44. A director may have contractual duties to a company under a contract of service. Such a contract may include a range of duties, both expressed and implied, owed by the directors of the company, including a duty of care in the performance of the contract.¹⁴ Contractual duties are governed by contract law and the remedies for breach are certain. As such it is impractical to codify such duties.

(ii) Fiduciary duties

45. A director's relationship with the company is regarded as fiduciary. The duties owed to the company are enforceable by the company and a breach of those fiduciary obligations gives rise to liability to account for improper profits and to pay equitable compensation for improper loss of company assets.

46. There are a range of fiduciary duties owed by directors. In identifying those duties it was pointed out that they are by no means an exhaustive list and that elements of some duties may overlap. The duties identified represented those that feature prominently in the common law and the legislation of other jurisdictions. These are -

- (a) duty to act in good faith or bona fide in the interest of the company;
- (b) duty of loyalty;
- (c) duty to exercise powers for a proper purpose;
- (d) duty to act confidentially;
- (e) duty not to act in conflict of interest;
- (f) duty to declare interest in a proposed transaction;
- (g) duty not to make secret profits;
- (h) duty not to fetter discretion;
- (i) duty to promote the success of the company;
- (j) duty to exercise independent judgment;
- (k) duty not to accept benefits from third parties;
- (l) duty not to misapply the company's property;
- (m) duty not to exceed authority;
- (n) duty to deal fairly between shareholders; and
- (o) duty to act in accordance with the company's Articles of Association or Constitution.

47. Arising from these duties respondents were requested to consider several issues.

Issue #3

We queried whether respondents viewed these fiduciary duties as the principal duties of directors and if not, what duties should be included or excluded.

48. All respondents viewed the fiduciary duties identified in the Issues Paper as the principal duties. It was however added that these fiduciary duties (many of which are amenable to variation by the company's constitution or by agreement of its shareholders) are only a part of a director's principal duties. The equitable duties complement a director's common law duties, primarily the duty of skill and

¹⁴ Lister v Romford Ice and Cold Storage Co [1957] AC 555.

care. It was noted that the duty to act confidentially, while owed, is peripheral to the core directors' duties.

Issue #4

We queried whether there is a general awareness amongst directors of the legal duties arising from their fiduciary position.

49. All respondents are of the view that there is general awareness amongst directors of what their duties are. It was stated that many directors are "professional" directors or employees of regulated service providers, and such awareness is a necessary part of their business. For them, and for others, written briefings are available from the main law firms in the Cayman Islands and articles in journals and case law.

Issue #5

Should director duties be stricter and more clearly defined, and if so, in what respects?

50. All respondents argued that fiduciary duties are, in principle, absolute but, like the duties of other fiduciaries such as trustees, partners or agents, they are capable of relaxation by contract. The view is that there is no reason to limit that capability in the case of directors, whether by the company's constitution or a shareholders' agreement.

51. It was pointed out that the common law duty of skill and care has a minimum standard of the reasonable person in the position of the director that is capable of being increased by reference to the actual skill and experience of the particular director. Respondents do not see any policy reason to disturb this position. The *Weaving* decision is cited as an example of directors acting in breach of their fiduciary duties.

52. The thinking expressed is that a code of duties would not have prevented the directors in *Weaving* acting in the manner they did. The current use of the common law allows for the evolution of directors' duties which codification would not provide due to the inherent rigidity.

Issue #6

Do respondents support the codification of the identified fiduciary duties?

53. The CDA, CILS, WALKERS and CFA share the common view that codification should not be explored at this time. They do not believe that there is either a lack of understanding of the duties of directors or concerns around the consistent application of the law as it relates to the duties of directors by stakeholders.

54. The law in this area, it is contended, has certainty and the courts have applied that law clearly and unambiguously. Professional directors, it is argued, are well advised and do understand their duties as directors under the laws of the Cayman Islands. It is also the position that the duties of directors of Cayman Islands companies are well known in onshore jurisdictions and any uncertainty introduced by statutory reform would be detrimental.

55. The point was made that the *Weavering* decision, which was critical of the conduct of certain persons acting as directors, was given in the absence of codified statutory duties. In that context, it was argued that the *Weavering* case did not create new law, but robustly applied the existing law. As such, the associations see no reason for statutory codification.

56. Intertrust and Appleby however do support a limited codification of the main duties owed by a director following the scheme set out in the 2006 UK Act. Their views will be later discussed.

Issue #7

Should the fiduciary duties be represented as guidance rules for directors?

57. Respondents generally do not see guidance rules as a practical alternative to codification. It is viewed as inappropriate to legislate guidance for fiduciary or common law duties which, by their nature, are not of uniform application and are the subject of continuous refinement by the courts. It is felt that flexibility is lost with no corresponding benefit.

58. Reference was made to the statement on Corporate Governance issued by CIMA. The statement is viewed as a viable alternative. It is contended that if these duties are going to be codified, they should be actual legal duties owed and not simply guidance, otherwise they would either become confusing, given the existence of parallel rules, or disregarded.

(iii) Tortious - Duty of care, skill and diligence

59. With respect to tortious liability it was determined that directors owe a duty of care, skill and diligence to the company. The duty of care, skill and diligence involves positive obligations to act. This is similar to the common law duty to avoid negligence resulting in reasonably foreseeable harm.¹⁵

60. A director is required to show the degree of care, skill and diligence as may be reasonably expected from a person with his knowledge and experience. Also, a director is required to take such care as an ordinary man might be expected to take on his own behalf.¹⁶

61. In other words, the common law duty of care of a director is the conduct 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."¹⁷

62. If a director does not have the knowledge and experience that a reasonably competent director would have, account is taken of that fact and his conduct is judged by reference to the knowledge that he in fact possesses.¹⁸

63. It was pointed out that the standard applicable to making a determination as to whether a director has properly discharged his duty of care can be objective, subjective or dual (i.e. subjective and objective).

¹⁵ Donoghue v Stevenson [1932] AC 562

¹⁶ Dorchester Finance Co v Stebbing [1989] BCLC 498.

¹⁷ Norman v Theodore Goddard [1992] BCC 14.

¹⁸ Gower's Principles of Modern Company Law (6th ed, 1997), pp 641-4.

64. We noted that Justice Jones, in the *Weaving* case, pointed out that the duty to exercise reasonable care, skill and diligence comprises both an objective and a subjective element.

65. From an objective element he noted -

“Directors must exercise the care, skill and diligence that would be exercised by a reasonably diligent person having the general knowledge, skill and experience reasonably to be expected of a person acting as an independent non-executive director of an open ended investment fund incorporated in this jurisdiction. They are expected to perform a high level supervisory role. They are expected to act in a professional, businesslike manner....Whilst independent non-executive directors rarely have the technical expertise and experience to be able to monitor sophisticated investment strategies and trading techniques in a direct hands-on manner, they are expected to satisfy themselves (on a continuing basis) that the investment manager's strategy is fairly described in the offering document and that the investment manager is complying with whatever investment criteria and restrictions have been adopted by the fund.”

66. The subjective element of their duty of skill and care requires the exercise of knowledge, skill and experience which they actually possess. The professional qualifications and business experience of the directors is material information which needs to be disclosed. Any conflicts of interest or other relevant information that would ensure that such disclosed information is accurate and not misleading, is necessary to be included.

Issue #8

The issue arising was whether the standard of care expected of a director should be judged -

- (i) subjectively, so as to be that expected of a reasonable person having the same knowledge and experience that the director has;**
- (ii) objectively, so as to be that expected of a reasonable person having the knowledge and experience which may reasonably be expected of a person in the same position as the director without taking account of any special expertise that the particular director possesses; or**
- (iii) both subjectively and objectively?**

67. All respondents support the dual objective and subjective tests. It was indicated that the current law states that the standard of care is a duty to act with the care skill and diligence that would be exercised by a reasonably diligent person with -

- the general knowledge, skill and diligence that would be expected of a person carrying out the functions carried out by a director in relation to the company (the objective element); and
- the general knowledge, skill and experience that the director in question actually has (the subjective element).

68. It was noted that the dual test, as reflected in *Weaving*, has been consistently applied in the UK. It is also the standard adopted in the 2006 Act. Retaining the same standard in our law, it is argued, will ensure the continued relevance of English Law.

Issue #9

In circumstances where the duties of a director are breached do respondents support -

- (i) the imposition of civil remedies such as liability for profit made and damages suffered;**
- (ii) the imposition of criminal sanctions such as fine and imprisonment of directors; and**
- (iii) the imposition of a regime which permits the disqualification of directors?**

69. The view posited is that civil remedies are already available (subject to any relevant exculpation or indemnity provisions) in the form of both damages and an account of profits in appropriate circumstances.

70. Appleby however would not object to the inclusion of a remedies section in legislation which includes the power of the Court to excuse a director who has acted honestly and reasonably, but has nevertheless breached his duties.

ARGUMENTS IN SUPPORT OF AND AGAINST CODIFICATION OF DIRECTORS' DUTIES

71. Our research focused on some of the arguments in support of and against codification. These were identified as follows -

72. (a) Arguments in support of codification

- Given that the principles relating to directors' duties exist in case law rather than in companies legislation, the view held is that this makes the law on directors' duties difficult to find or understand. The law should be such that it can be easily found and explained in reasonably comprehensible terms. Legal advice should be unnecessary in order to acquire an understanding of the principles.
- Codification places a director or any other person in a position to know what the law is before acting.
- Codification of directors' duties has the effect of achieving consistency in the application of the law, certainty in knowing what is required, accessibility and comprehensibility.
- Predictability would be achieved by codification and the court would be minimised in its power to develop the law in a way which may result in a person coming under a liability which had not been imposed before and could not reasonably have been predicted.
- Codified duties could be expressed in broad and general language which would be capable of being applied in a very wide range of situations. It would thus be capable of being developed as more examples arose which fell within the general terms.

73. (b) **Arguments against codification**

- The law dealing with directors' duties is not settled. For example, a director is in breach of duty if he misappropriates information which he receives and should have reported to his board, but the circumstances in which he ought to report information he receives to his board have not been defined by the courts. As such there are likely to be differences in the interpretation as to what those circumstances entail.
- It is arguable as to whether codification is likely to result in a comprehensive statement of the law given that there is always the possibility that there will be some element that is not clear on its face. Accessibility is then only superficially improved since a lay person can never be sure what the law is unless he looks elsewhere or seeks professional advice.
- Given that judges have to interpret the law, codification may not always lead to predictability. The legislature is unlikely to foresee every situation that might arise or to pass legislation to cover every case. Even when the law is statutory, there is scope for the courts to fill in gaps in the law. It is the judicial function to provide an answer when asked to interpret a statute in a particular situation.
- Flexibility could be lost when principles are codified. Due to the dynamism of the law of fiduciaries it is essential to cater for the need to adapt to new circumstances. When duties are codified, there is a tendency to ask whether, as a matter of statutory construction, they apply to a given situation rather than whether the situation is one caught by the policy or principle behind the decided cases. While loss of flexibility is mitigated if the codification is in broad and general language, the danger is that if the language is broad uncertainty may result. The lay person will still need a professional to inform him of the decisions of the courts as to what fell within the language.
- It might be challenging to exhaustively define all the fiduciary duties of directors and as such there may be a lacuna in the law which would make a determination of what the duties were more uncertain.
- Codification may restrict evolution of the law. As a result, the law cannot be brought in line quickly and in accordance with changing circumstances unless new legislation is enacted. The principle of separation of powers prevents the court from rewriting existing law or substituting a provision which they think Parliament should have enacted.

74. Also, in order to demonstrate that we are not seeking to reinvent the wheel as far as codification was concerned, our research examined the approach of other jurisdictions to the issue of codification. We noted that many jurisdictions examined the arguments relating to codification and have chosen to codify the duties of directors to varying degrees.

75. The provisions examined were those in the –

- (a) United Kingdom Companies Act, 2006;
- (b) Australia Corporations Act 2001;
- (c) New Zealand Companies Act, 1993;
- (d) Hong Kong Companies Ordinance, 2012;

- (e) Jersey Companies Law, 1991;
- (f) Bermuda Companies Act, 1981;
- (g) Singapore Companies Act, 2003; and
- (h) Malaysia Companies, Act 1965.¹⁹

76. The various approaches of these jurisdictions may be examined in more detail in our Issues Paper.

77. The responses to follow arise from the issue raised with respect to the arguments for and against codification.

Issue #10

We posed the question whether respondents found merit in any of the arguments against or in support of codification.

78. The CDA, CILS, CFA and Walkers are all against codification. The sentiments shared are that flexibility could be lost due to the dynamism of the law of fiduciaries and the variety of **Caymanian** products. There is, they argue, a need to be able to adapt to new circumstances. In this regard codification may restrict the evolution of the law and the resulting law would not be able to be brought in line fast enough to adapt to the changing circumstances unless new legislation were enacted.

79. Intertrust found some merit in arguments both against and in support of codification. They indicated that it is arguable as to whether codification is likely to result in a comprehensive statement of the law and that common law better provides for a flexible body of law to evolve and develop over time.

Issue #11

We raised the issue of whether limited codification could be viewed as defeating the objective of making the duties of directors easily accessible and identifiable by the lay person and creating uncertainty where it is discovered that there are duties which are not set out in the statute. Further, given that the common law duties with respect to directors responsibilities are not completely settled the issue was raised as to whether partial codification may assist by placing those duties which are not in doubt in statutory form.

80. Intertrust did agree that limited codification may achieve consistency and certainty in the application of certain laws.

81. Appleby advised that the major benefit of some codification is clarity to the public (including foreign promoters, managers and investors considering using companies in the Cayman Islands for their business). Even if not exhaustive, they felt that some codification would be an improvement on the present position. Drawing the duties widely and therefore protecting the ability of the Grand Court to be flexible and develop the law is important. Appleby supported adopting the approach in the UK 2006 Act.

82. It was however argued that such statutory provisions should not replace their respective equivalents under common law and that any intended statutory provision should continue to be

¹⁹ Amended up to 2006.

interpreted and developed in the same way as the common law. It was pointed out that this position is the same as the position under the UK Companies Act, 2006 as it has a limited codification of directors' duties but will not replace the common law provisions.

Issue #12

We raised the issue of the codification of directors' duties concurrent with the common law.

83. It was noted that this option contemplated codification of the main principles governing fiduciary duties as established by the common law which are not intended to replace the common law. The advantage of this course would be that it would make part of the law more accessible while not causing the law to lose any of its flexibility since it would always be open to the court to rely on the common law.

84. All respondents were however against concurrent regimes and noted that any option that could create confusion should be discouraged.

Issue #13

As another option, we queried whether a codified statement on corporate governance by directors would be useful.

85. This option contemplates provisions which indicate that the statute is to serve for information or guidance purposes and does not replace the common law or impose any liability on a director.

86. In other words, it will be a directors' governance code which does not impose legally binding obligations on directors but rather sets out principles of good governance in relation to directors and the composition of the board, and includes recommendations that the board should regularly undergo a period of continuing professional skills development.

87. This would avoid the situation in which directors are exposed to two sets of rules and in which the statutory rules turn out to be wider than the rules under the common law. It allows for recognition in the Act of the important areas of company law that directors owe significant duties under the common law.

88. Respondents did not support the introduction of a codified statement on corporate governance. It was noted that as statements of guidance already exist for most industry sectors (in particular for regulated entities and further for regulated mutual funds in particular), it would be uncommon for a statute to contain guidance rather than articulate law.

OTHER ISSUES CONSIDERED

(a) The business judgement rule

89. The business judgment rule is an American case law concept in corporate law.²⁰ In many states of the United States there exists a judge-made rule which prevents directors from being liable for claims

²⁰ *Gimbel v. Signal Cos.*, 1974; *Aronson v. Lewis*, 1984; *Kaplan v. Centex Corp.*, 1971.

for breach of duty/negligence where certain factors are established.²¹ The rule has developed, and received recognition, as a judicial doctrine. It operates as a legal presumption and as a rule of the law.

90. The business judgement rule specifies that a court will not review the business decisions of directors if the business judgement rule applies and it creates a strong presumption in favour of the director.²² The business judgement rule stipulates that a director will not be considered liable for a breach of duty if he -

- acted in good faith;
- acted in the honest belief that his or her actions were in the company's best interest;
- acted on an informed basis;
- was not wasteful; or
- was not involved in self-interest or self-dealing.

91. The rule does not apply when a director fails to act, abdicates his responsibilities, or if his conduct was an abuse of discretion.²³

92. The underlying policy behind the rule is to prevent the judicial review of business decisions made in good faith and with due care.

Issue #14

Respondents were asked to consider that there should be a business judgment rule which -

- (i) stipulates that the courts should only intervene in the exercise of a director's duty in a case of obvious breach of that duty;**
- (ii) presumes that directors have made informed business decisions in good faith and with care; and**
- (iii) absolves the director from paying compensation if the presumption is not rebutted.**

93. CDA, Appleby and the CILS do not support a business judgement rule. They state that aside from the courts' reluctance to enter into the merits of commercial decisions, the existing statutory, equitable and common law rules applicable to directors provide sufficient guidance on the permissible scope for directors to exercise their judgment in managing the company's affairs.

94. At the same time it is contended that adequate protection of stakeholders is afforded where a director's actions fall outside the latitude which the law gives to directors to decide how best to advance the interests of the company. The current law is seen as striking the appropriate balance between these two objectives. Provided that directors adhere to those standards a directors' business judgment ought not to be open to question. In considering a director's exercise of business judgment, the court's role is not to evaluate the commercial merits of the decision with the benefit of hindsight.

²¹ M E Eisenberg, "The Duty of Care and the Business Judgment Rule in American Corporate Law" [1997] 2 CFILR 185.

²² Sieg, O. Directors' Liability and Indemnification, p. 121.

²³ Bailey Dan A., Kandawalla Darius N., Directors' Liability and Indemnification: A Global Guide. Globe Business Publishing Ltd, 2007, p. 339.

95. Intertrust and CFA, however believe there is merit in the codification of a business judgment rule. They view such a rule as an extension of any limited codification of directors' fiduciary duties to ensure an appropriate balance between compliance with fiduciary duties and the risk of liability for non-compliance with such duties that should, in practice, allow directors the freedom to exercise fiduciary duties without undue fear of liability.

(b) Delegation of duties and reliance on other professionals

96. We questioned the extent to which it is permissible for directors to delegate their functions to, and rely on the judgements of, others. The traditional view²⁴ is that a director having regard to the exigencies of a business, and the articles of association, and in the absence of grounds for suspicion, may properly trust officials such as co-directors and other company officers, auditors and other professional advisers to assist in the performance of his duties.

97. It was noted that Justice Jones in the *Weaving* case stated that it is conventional that the investment management, administration and accounting functions will be delegated to external entities or service providers and a company's independent non-executive directors will exercise a high level supervisory role.

98. Whilst directors are entitled to delegate particular functions to those below them in the management chain and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.

99. No rule of universal application can be formulated as to the duty of a director who delegates. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case including the directors' role in the management of the company.

100. We found that the powers of delegation and reliance are uncertain. This uncertainty about the circumstances in which it is appropriate for a director to delegate to, or place reliance on the advice of, others could lead to an overly conservative approach to management and could impede the decision-making processes within a company.

Issue #15

The issue raised was whether there is a need for specific legislative authority to -

- (i) allow for a director to delegate his duties;**
- (ii) to stipulate the liability of directors when they delegate their powers to others; and**
- (iii) to provide for the circumstances in which directors may rely on information provided by third parties.**

101. All respondents share the view that it is well understood, without controversy, that directors may delegate powers if authorized to do so by their company's Articles of Association.

²⁴ Re City Equitable Fire Insurance (1925) Ch 407.

102. The current law is certain and effective with respect to delegation by directors that specific legislative authority is not required. The view expressed is that issues of delegation should be left to be dealt with in a company's Articles of Association or a contract pursuant to which delegation is made.

103. It was also stated that it is seen as impractical and will result in a lack of flexibility if we seek to codify the circumstances of delegation through statute. The common law, it is argued, provides certainty as to the power of a director to delegate his duties, the liability of a director upon delegation and the ability of a director to rely on information provided by others.

104. It is contended that the law as set out in *Weaving* is clear on this point. What may be appropriate in one case will not necessarily be appropriate in another. In this regard, the view is that it will be difficult to formulate statutory provisions on the potential liability of directors when they delegate the performance of their duties.

(c) Directors' duties and human rights

105. A director's duties and, by extension, the company's, can impact the human rights of a broad set of persons, including employees, customers, suppliers and their employees, business partners, and communities in which a company operates.

106. We noted that the Companies Law of the Cayman Islands does not impose any specific duty upon directors to ensure that a corporation respects human rights, nor any duty that directors take into account human rights considerations. The question posed was whether there is a need for this.

Issue #16

The question asked was whether a statutory obligation be imposed on directors to consider -

- (i) human rights issues in the execution of their duties; and**
- (ii) employee, social, and environmental considerations in fulfilling their duty to act in good faith and promote the success of the company.**

107. Respondents share the view that the majority of Cayman Islands companies, being exempted companies, conduct activities which are external to the Cayman Islands and are different in scope and operation to companies carrying on activities in jurisdictions, such as the United Kingdom, which have adopted company law provisions, intended to require the consideration of socio-economic issues. It is the view also of respondents that Cayman Islands companies law should not be used to legislate for environmental or social policy or objectives.

(d) Disqualification of Directors

Issue #17

The questions posed were -

- (i) whether respondents support the imposition of a regime which permits the disqualification of directors?; and**
- (ii) should the disqualification of directors extend to other instances such as fraud, unfitness or summary conviction?**

108. The CDA and the CILS share the view that there is no need for a disqualification regime beyond that which exists under the *Directors Registration and Licensing Law, 2014* for regulated entities.

109. It is argued that the system of advanced approval or subsequent compulsory replacement of directors is sufficient to meet the mischief at which disqualification measures are aimed. In the case of unlicensed and unregulated entities, they view disqualification other than in criminal proceedings of questionable value. The investigation and prosecution elements of any civil disqualification regime, it is argued, would need to be properly resourced and would be costly.

110. Further, given that CIMA has responsibility for regulation in relation to regulated entities, there is concern in relation to the consistency in approach and who would have power to disqualify. The CILS, in particular, considers that such costs would outweigh any recognisable benefit.

111. The CFA, Intertrust and Appleby however support the imposition of a general regime which permits disqualification supported by civil remedies.

(e) Indemnification of Directors

Issue #18

In circumstances where the duties of a director are breached do respondents support the imposition of civil remedies such as liability for profit lost and damages suffered?

112. The respondents to this issue argue that indemnities have been successfully tested by the court to the point where there is a core of set of duties from which a director cannot be absolved through indemnification. The courts, it is argued, have determined that actions ranging from unconscionable conduct to willful default, fraud and dishonesty fall within that core. However, breaches of the duties of care, skill and diligence are not part of those core duties and accordingly it is possible for a company to agree to indemnify a director for the consequences of his negligence.

113. This point also relates to the question in the discussion paper of whether a business judgment rule should be introduced. One of the reasons given for the introduction of a statutory business judgment rule is that it would enable directors to make decisions which involve risks without fear of breaching their duties. However, the argument of respondents is that the law currently permits companies to agree to indemnify directors for the consequences of their negligence. As such there is no need for a business judgment rule.

114. The Commission noted that under the Companies Law the Insolvency Rules Committee is empowered to make rules for the purpose of specifying the nature and scope of professional indemnity insurance to be held by persons appointed to the office of official liquidators.

CONCLUSION

115. The overall issue of whether the fiduciary duties of directors should be codified elicited extensive comments from stakeholders. The Commission is persuaded that codification in this area of the law is not appropriate at this time in light of the principles established under the common law. Notwithstanding our recommendation against codification, it remains crucial that we ensure that company directors act in the best interests of their companies as well as ensure the observance and

compliance with all laws, regulations, codes of conduct and best practices. To the extent that the common law is unable to clarify or reformulate directors' duties so as to promote accountability within the corporate structures in the Islands, we may have to revisit the issue to determine whether codification is necessary.

Mr. Kenneth Farrow, QC
Chairman