Accountability of Cayman Islands directors

The Cayman Islands is the number one domicile in the world for hedge funds and structured finance transactions and one of the ten largest banking centres – but how accountable are the directors of the companies based there?

There are 8,972 investment funds, over 80,000 active companies and hundreds of specialist bankers, lawyers and accountants in the Cayman Islands, and over US$1.4 trillion on deposit[1]. The Cayman Islands continuing success is due in part to laws that reflect the increasingly complex requirements for a successful offshore financial centre. It might seem surprising, therefore, that the vast majority of directors of Cayman Islands companies appear to operate free from legal responsibility to the company for negligence as a result of directors' indemnity and exculpation clauses in the articles of association of Cayman Islands companies.

Omission of section 205 of the Companies Act 1948

This potential encouragement to overly relaxed corporate governance was addressed over fifty years ago in the UK by a statutory provision that is designed to keep directors on their toes. While the Companies Law (2004 Revision) of the Cayman Islands is substantially based upon the English company law statutes of 1862, 1929 and 1948, there are important differences and one of them is the omission of section 205 of the Companies Act 1948[2]. Section 205 was enacted to render void the then well established English legal principle that a company, under its articles of association, could exempt directors from liability for their negligent management of the company[3]. In the Cayman Islands, there is no such statutory provision and, accordingly, no statutory bar to articles of association providing for director exemptions. Consequently the articles of association of a Cayman Islands' company typically contain indemnities and exculpations to relieve directors from liability for negligence, gross negligence and wilful default[4].

The move to greater accountability

However, whether the courts might consider it acceptable for a Cayman Islands company to hold its directors harmless for their negligent mismanagement might now be open to doubt. Not only has the law relating to the duties of directors moved on since 1925[5] and the case of *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, but there is also an issue of public policy, namely that good corporate governance requires directors to be held accountable for their management of a company. It seems perverse that a Cayman Islands company should be statutorily required to keep proper books of account[6], but at the same time it should be allowed to hold legally harmless the very people whose job it is to ensure that the company fully complies with its statutory obligations, even if they are guilty of wilful default.

Recent case law is not easy to come by. Twice, in 1911 and 1925, the English High Court determined that such clauses were valid (although no court higher than first instance was asked to examine their validity). Thereafter there is a dearth of English authority because of the English statutory ban. The Privy Council considered such a clause in 1986, on appeal from the Royal Court of Jersey, and found that such a clause could be construed so as to confer protection in respect of an act *ultra vires* the company[7]. In 1990 the Cayman Islands Grand Court applied Romer J's definition of 'wilful default', from the decision of *Re City Equitable Fire Insurance Co. Ltd*, and found the directors of a Cayman Islands company liable for reckless carelessness amounting to wilful default. In neither case did the company challenge the essential validity of the clause[8]. Such a challenge would almost certainly be made in a similar case now.

'Gross negligence' and 'wilful default'

Quite apart from the question of whether such clauses are enforceable, there is scope for disagreement as to their breadth, and in particular as to the meaning of 'gross negligence', and 'wilful default'[9].

Although 'gross negligence' appears in certain articles of association, it is unlikely to assist a director substantially, because the English common law does not recognise 'gross negligence' as a separate concept from ordinary negligence[10]. Therefore a director relieved from liability, save where he has committed gross negligence, is probably liable for ordinary negligence.

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However, 'wilful default', it is submitted, is more difficult to interpret. In *Re City Equitable Fire Insurance Co Ltd* Romer J interpreted this expression to mean that the director must know *'that he is committing, and intends to commit, a breach of his duty, or is recklessly careless in a sense of not caring whether his act or mission is or is not a breach of duty'*. By contrast, in the Australian case of *Dalrymple* v *Melvill* (1932) 32 SR (NWS) 596 Long Innes J held that the defendant '*must have known that, in omitting to take the precautions which he ought to have taken, he was committing a breach of his duty,*

and whether he was recklessly careless or not is immaterial'. In practice the culpability necessary to surmount the 'wilful default' hurdle may not be as great as one might assume from the label.

Director Services Agreement

The analysis of directors' indemnities in the Cayman Islands is further complicated by the fact that the directors of a Cayman Islands company will often be provided under a 'Director Services Agreement'. Intuitively, one would assume that a degree of responsibility for the actions of the 'provided directors' should attach to the service provider. However, the Cayman Islands Court of Appeal held in *Paget-Brown and Company Limited* v. *Omni Securities Limited* [1999] CILR 185 that in the absence of an express or implied contractual obligation on behalf of such a service provider to monitor the performance of the 'provided directors', and in the absence of fraud or bad faith on behalf of the service provider, the service provider does not owe a duty of care to the company or its creditors to ensure that the 'provided directors' performed their functions diligently or competently.

The wind of change?

Needless to say, the Cayman Islands remain a recognised world financial centre. Great strides have been made to develop the legal and regulatory infrastructure to ensure that it meets and often exceeds the standards of the global financial community. Nevertheless the prevalence of director indemnities and exculpations raise a potential concern for the many investors in mutual funds incorporated in the Cayman Islands and other offshore financial centres, particularly as indemnities are often not disclosed in the offering documents. These lacunae need to be addressed if the Cayman Islands is to remain the jurisdiction of choice for funds. □

[1] Cayman Islands Monetary Authority, official statistics for second quarter 2007.

[2] Section 205, Companies Law 1948 is the predecessor section to Section 310, Companies Law 1965, now Section 232, Companies Law 2006.

[3] *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch. 425.

[4] This list is not exhaustive

[5] See, for instance, *Dorchester Finance Co Ltd* v. *Stebbing* (1977) [1989] BCLC 498; *Re D'Jan of London Ltd* [1994] 1 BCLC 561; *Norman* v. *Theodore Goddard (a firm)* [1991] BCLC 1028; and Re Barings plc [1999] 1 BCLC 433.

[6] Section 59 Companies Law (2004 Revision).

[7] *Viscount of the Royal Court of Jersey* v. *Shelton* [1986] 1 WLR 985.

[8] *Prospect Properties Limited (in liquidation)* v. *McNeill and J.M. Bodden II* [1990-91] CILR 171.

[9] It is settled law that a clause purporting to exclude fraud is beyond the pale and will not be enforced. Nevertheless such clauses are occasionally seen. They are usually unenforceable in their entirety.

[10] Lord Cranworth in *Wilson* v. *Brett* (1843) M&W 113 said that 'gross negligence is ordinary negligence with a vituperative epithet'. This was recently affirmed by the English Court of Appeal in the case of *Tradigrain S.A.* v. *Intertek Testing Services (ITS) Canada Limited* [2007] EWCA CIV 154: 'The term gross negligence, although often found in commercial documents, has never been accepted by English law as a concept distinct from simple negligence'.

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