



# **The Cayman Islands Law Reform Commission**

## **Directors' Duties – Is Statutory Codification Needed?**

### **Issues Paper**

16<sup>th</sup> January, 2014

## **The Cayman Islands Law Reform Commission**

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# **Directors' Duties – Is Statutory Codification Needed?**

## **TERMS OF REFERENCE**

1. 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.<sup>1</sup> At that time, the Hon. Chief Justice raised the question of whether an amended Companies Law should codify the duties of directors. He further suggested that the Commission consider whether Cayman law should bring certainty to the issue of directors' duties. The Law Reform Commission, in keeping with its reform agenda and the recommendation of the Hon. Chief Justice has now commenced an examination into the issue of whether the common law 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.

## **INTRODUCTION**

2. 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 under the guise of corporate legal personality 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.

3. The Cayman Islands economy continues to benefit from the efficiency and profitability of the companies registered in the Islands and their affiliates. Arguably therefore, the effectiveness of the board of directors in discharging their duties and responsibilities will play an integral role in determining the global competitive position of the Islands.

4. While company directors should be allowed a certain degree of flexibility in the advancement of their companies, that flexibility needs 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.

5. The legal responsibilities and powers of directors are therefore the subject of this examination and in particular the general fiduciary duties and the duty of care, skill and diligence which a director owes to his company in exercising these powers.

6. In pursuing the regulation of directors' duties, the challenge is 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. One therefore has to balance the clarity and certainty that codification may offer against the need for flexibility in judicial interpretation based on the circumstances of a particular case.

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<sup>1</sup>See 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.

## SUMMARY OF ISSUES FOR CONSULTATION

7. The following reflects the issues on which respondents are requested to comment-

- Issue #1-** To the extent that different categories of directors feature in the companies registered in the Cayman Islands, do respondents support a proposal which expressly identifies the various categories of directors in legislation and prescribes the manner in which each should execute their duties and the extent of the liability to be attached for a breach of those duties? (Paras. 32 - 51)
- Issue #2-** In assessing whether the codification of directors duties is necessary, should we identify, in legislation, the persons to whom directors owe a duty and make a distinction as to which duties and the elements of such duty should apply to particular stakeholders? (Paras. 52 - 66)
- Issue #3-** Do respondents view these fiduciary duties as the principal duties of directors? If not, what duties should be included or excluded? (Paras. 67 - 101)
- Issue #4-** Is there a general awareness amongst directors of the legal duties arising from their fiduciary position? (Paras. 67 - 101)
- Issue #5-** Should a director's duties be stricter and more clearly defined, and if so, in what respects? (Paras. 67 - 101)
- Issue #6-** Do respondents support the codification of these fiduciary duties? (Paras. 67 - 101)
- Issue #7-** Should these fiduciary duties be represented as guidance rules for directors? (Paras. 67 - 101)
- Issue #8-** Do respondents support the introduction of a statutory statement on the director's duty of care to the company in order to clarify the law and make it more accessible to directors? (Paras. 102 - 116)
- Issue #9-** Should the standard of care expected of a director 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? (Paras. 102 - 116)

- Issue #10-** 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? (Paras. 102 - 116)
- Issue #11-** Should the disqualification of directors extend to other instances such as fraud, unfitness or summary conviction? (Paras. 102 - 116)
- Issue #12-** Do respondents find merit in any of the arguments against or in support of codification? (Paras. 117 - 118)
- Issue #13-** Taking into account the arguments against codification as stated in paragraph 118 do respondents support the comprehensive codification of directors duties? (Para. 177)
- Issue #14-** Do respondents support limited codification or view limited codification 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? (Para. 178)
- Issue #15-** Do respondents support the concurrent treatment of directors duties in light of the possibility that if two regimes exist-
- (i) their duties as directors could potentially increase if the statutory regime is wider; and
  - (ii) this could mislead a director into thinking that he could not be liable for doing something not mentioned in the statute and if liable should be treated more leniently as a result? (Para. 179)
- Issue #16-** Do respondents support the option of a codified statement on how directors should govern given that-
- (i) the principles that are codified may not at all time represent the law as developed by the courts thereby requiring new legislation; and
  - (ii) it can be regarded as uncommon for a statute to contain provisions which merely offer guidance rather than articulate the law? (Paras. 180 - 182)
- Issue #17-** If codification of directors' duties is supported should the provisions apply equally-
- (i) to directors in public, private, holding and subsidiary companies; and
  - (ii) to directors sitting on statutory boards? (Paras. 180 - 182)

- Issue #18-** Do respondents 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? (Paras. 183 - 191)

- Issue #19-** Is there a need for specific legislative authority-
- (i) to 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? (Paras. 192 - 201)

- Issue #20-** Should 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? (Paras. 202 - 209)

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

### **(a) Directors' Duties in the Cayman Islands**

8. 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.

9. The Companies Law (2013 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, annual returns, insolvency and fraud issues.

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

11. Statutory duties are also imposed on directors under the Local Companies (Control) Law (2007 Revision)<sup>2</sup> and the Penal Code (2013 Revision)<sup>3</sup>. These laws contain provisions which provide for the imposition of penalties for breaches of statutory duties by directors.

12. The Cayman Islands Directors Association formulated the Cayman Islands Directors Professional Code of Conduct which sets out rules that governs its membership<sup>4</sup>. 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.

13. Also of note is that the Cayman Islands Monetary has formulated its own Regulatory Handbook<sup>5</sup> which sets out the code of conduct applicable to its Board of Directors.

### **(b) The Weaving Macro Judgment**

14. The relatively recent decision, and perhaps a decision which has reinforced the need to examine the need for codification of directors duties in the Cayman Islands, is

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<sup>2</sup> 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.

<sup>3</sup> The Penal Code (2010 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.

<sup>4</sup> 2008 Articles 1 to 12.

<sup>5</sup> March 2010.

that of *Weaving Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom*<sup>6</sup>.

15. This case sought<sup>7</sup> to establish how directors should approach the discharge of their fiduciary and other duties to the funds of which they are directors. It also establishes standards of behaviour which are expected of directors.

16. The Weaving Macro Fund Limited was incorporated in the Cayman Islands and the Fund failed due to allegations of fraud.

17. The liquidators of the Macro Fund sued the directors claiming damages for losses caused by the directors' alleged breaches of fiduciary duty in the exercise of their powers and the discharge of their duties as directors. Further, it was contended that the directors were in breach of their duty to exercise independent judgement, reasonable care, skill and diligence and to act in the interests of the Fund.

18. In defence, the Directors relied upon provisions in the Fund's articles of association which provided that they would only be liable for loss or damage arising out of their wilful neglect or default.

19. The Court<sup>8</sup> concluded that, because the directors knew that they had a duty of supervision, but consciously chose not to perform that duty in any meaningful way, they were in fact guilty of wilful neglect or default. The court found that the directors had signed documents that were put before them by the investment manager "without applying their minds to their content".<sup>9</sup>

20. The Court observed that the directors would have been protected by the provisions in the Fund's articles of association had they attempted to perform their duty but failed as a result of their carelessness, no matter how gross.

21. In consequence of the directors' egregious failure to perform their duty, the Court made an award of damages against the directors.<sup>10</sup>

22. The court provided guidance as to the main duties and responsibilities of all directors. It was stated 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

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<sup>6</sup> [2011 (2) CILR 203], Grand Court Financial Services Division, (Jones, J.): August 26th, 2011.

<sup>7</sup> Cayman Hedge Fund Judgment Brings Directors' Duties Starkly Into Focus- Mourant Ozannes – September, 2011 Robert Duggan, Partner, Cayman Islands, Based in the London office.

<sup>8</sup> Per Justice Andrew Jones.

<sup>9</sup> Although the directors acknowledged that they had a high level supervisory duty, Justice Andrew Jones wrote in his judgment, "They never once, in six years, asked any of those they were supposedly supervising to give them a written report or attend a board meeting to provide them with an oral report".

<sup>10</sup> An amount of US\$111 million, representing the minimum amount of the Fund's loss occasioned by the irrecoverable redemption payments made by the Fund during the extended period of its trading on the basis of falsely inflated net asset value calculations.

- position where there is a conflict between their personal interest and their duty to the company;
- (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; and
  - (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**

23. In order to properly address the issue of whether codification of directors duties is necessary, it might first be useful to briefly examine the core concepts of company and corporate governance.

### **(a) The company concept**

24. It is well established 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, 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.<sup>11</sup>

### **(b) The corporate governance concept**

25. 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.<sup>12</sup>

26. Consequently, although corporate governance can be defined in a variety of ways, it generally refers to the mechanisms by which a company is directed and controlled. These mechanisms include a determination of the accountability for corporate conduct and performance by managers and directors.

27. Often times ambiguity exists as to the scope of corporate governance and to whether it encompasses solely the relationship between shareholders and managers, or whether it is more expansive, involving the relationship between a broader range of stakeholders and the board of directors.<sup>13</sup>

28. It has been noted, however, that the term corporate governance is used globally<sup>14</sup> and encompasses all the issues facing a board in directing and controlling a company's

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<sup>11</sup> Salomon v Salomon & Company [1897] A.C. 22.

<sup>12</sup> J Farrar (2005), Corporate Governance Theories, Principles, and Practice, 2nd edn, Oxford University Press, 3-6.

<sup>13</sup> J Hill, "Deconstructing Sunbeam – Contemporary issues in corporate governance", (1999) Company and Securities Law Journal, 17, 288.

<sup>14</sup>The OECD exercises an important role in setting global standards for corporate governance. In May 1999, the OECD Council approved Principles of Corporate Governance. Among these were guidelines for directors which emphasised the role of the board in monitoring and managing potential conflicts of interest

operations. These issues include its interaction with management and with other stakeholders including the shareholders, employees, creditors, suppliers, purchasers, auditors, corporate regulators, the community at large and the Government.<sup>15</sup> Therefore, how directors execute their fiduciary duties, and what functions are prescribed by the law affects all stakeholders.

29. Thus the main objective of corporate governance ultimately is to improve corporate efficiency. To achieve this, issues regarding the nature of the corporation, the reasons for incorporation, for whose benefits the corporation is governed and how the corporation should be governed are critical.<sup>16</sup>

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.”<sup>17</sup>

31. Our examination of this issue is seeking to devise approaches that would ensure that directors in the Cayman Islands are aware of and understand their duties and are properly held accountable when those duties are breached.<sup>18</sup>

### **WHO IS A DIRECTOR OF A COMPANY?**

32. 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 interest of a company. Therefore, by dealing with the company's affairs the director owes a fiduciary duty to that company.<sup>19</sup>

33. The distinguishing obligation of a fiduciary is the obligation of loyalty and as such the company is entitled to the loyalty of its fiduciary. A director is not subject to fiduciary obligations because he is a fiduciary, it is because he is subject to them that he is a fiduciary.

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of management, misuse of corporate assets and abuse in related party transactions. These cover the rights of shareholders, the equitable treatment of shareholders, the role of shareholders in corporate governance, disclosure and transparency and the responsibilities of the board.

<sup>15</sup>T. Shaw (1999), *Corporate Governance a Director's Handbook*, CCH New Zealand Limited, Auckland, New Zealand Weil, Gotshal & Manges LLP (2002), *Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States*.

<sup>16</sup>RAG Monks & N Minow (2005), *Corporate Governance*, 3<sup>rd</sup> edn, Blackwell Publishing, US, 295.

<sup>17</sup>RI Tricker (1984), *Corporate Governance: Practices, procedures and powers in British companies and their boards of directors*, The Corporate Policy Group, Oxford, 236.

<sup>18</sup>It should be pointed out that whilst Cayman companies were utilized in the structure of the Weaving Macro Fund, the directors were not based in the Cayman Islands. This obviously may lead one to argue that the issue is not with the regulation of Cayman Island directors and as such there is no need to codify the regime that currently comprises the common law and the Cayman Islands Directors Association Code of Professional Conduct.

<sup>19</sup>Dixon J. in *Mills v Mills* (1938) 60 C.L.R. 150 at p. 186.

34. 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 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.

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

36. 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**

37. In practice, therefore companies will have different types of directors. These may include full-time directors, executive directors and part-time non-executive directors. The more complex the company or group of companies, the more likely it is that different directors will have very different responsibilities within the organisation.

38. A director is defined in law according to what they do, rather than their actual job title. Even a person not formally appointed to the board might be deemed a director if their role could be considered equivalent to that of a director, or if they have acted as a director.

39. For purposes of this Issues Paper the following categories of directors will be considered-

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

#### **(a) Executive and non-executive directors**

40. Larger companies tend to have executive and non-executive directors forming part of their board. Executive directors have extensive powers delegated to them by the articles of association of the Company and these powers are usually formalised by contracts. In contrast, non-executive directors do not have contracts with the company, may be less concerned with the day to day running of the company and tend to be more involved with general policy and overall supervision.

41. Both executive and non-executive directors however have overall and equal responsibility for the leadership of the company and they are both subject to the same legal framework. In other words, the duty of care owed by non-executive directors is the

same as that expected of executive directors. However, the non-executive is likely to have to do less than an executive director to discharge his duty.<sup>20</sup>

**(b) De facto directors**

42. De facto directors are directors who have not been legally appointed but act as or assume the position of de facto directors. A de facto director openly acts as though he has been validly appointed despite a lack of authority. Equally, a person who is not appointed but is held out as a director is also, de facto, a director.

43. To establish that a person is a de facto director of a company, it is necessary to prove that he undertakes functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of a company's affairs.<sup>21</sup>

**(c) Shadow directors**

44. Shadow directors are those who exercise control over the management decisions of the directors of the company. The term essentially means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.

45. Many of the modern statutory controls over directors have been applied expressly to shadow directors. The difference between liability as a de facto director and as a shadow director is that the former has openly acted as if he had been validly appointed, whereas the definition of a shadow director presupposes that there is a board of directors who act in accordance with instructions from the shadow director.

46. The terms are alternatives and mutually exclusive. Provisions formulated to deal with shadow directors are done to prevent the people who really exercise control from sheltering behind a "puppet board". The view has been expressed that because the concept of shadow director is a statutory creation it only applies where statutory provisions specify it. Pennington<sup>22</sup> states that the UK Companies Act merely uses the category of shadow director to impose certain liabilities or prohibitions on persons who would not otherwise be classed as directors, and such persons do not thereby acquire any rights nor powers in connection with the management of the company, nor are they subject to the common law or equitable duties of directors.

47. However, the more accepted view is that the shadow director is to be regarded as akin to a de facto director and that he can incur the liability of a de jure director under the general law where he effectively acts as a director through the people over whom he has influence.<sup>23</sup>

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<sup>20</sup> In *Dorchester Finance Co Ltd v Stebbing* Foster J held that it was unacceptable for even non-executive directors not to attend board meetings or take active interest in the company's affairs.

<sup>21</sup> *Re Hydrodan (Corby) Ltd*, Millett J. [1994] 2 B.C.L.C. 180, 183.

<sup>22</sup> *Pennington's Company Law* (7th ed, 1995), p 712.

<sup>23</sup> In *Yukong Line Ltd v Rendsburg Investments Corporation (No 2)* [1998] 1 WLR 294, at p 311, Toulson J proceeded on the basis that a shadow director could be in breach of the fiduciary duties as a director.

**(d) Alternate directors**

48. An alternate director may be appointed to act for and on behalf of another director if the other director is unable to act at any time. Such an alternate may be another director, or a third person.

49. The extent of the alternate director's powers and the conditions attached to his role depend on the terms of the relevant articles of association. Whilst the alternate is acting as a director, he stands in a fiduciary position in relation to the company, and accordingly owes the company all the same duties as are owed by a director. However, he has no legal status when he is not acting as a director.

**(e) Nominee directors**

50. Nominee directors have been defined as persons who, independently of the method of their appointment, but in relation to their office, are expected to act in accordance with some understanding or arrangement which creates an obligation or mutual expectation of loyalty to some person or persons other than the company as a whole.<sup>24</sup>

51. By definition, nominee directors represent groups whose interests may differ from the interests of the company as a whole. However, they are precluded from placing themselves in a position where their duty to exercise their powers for the company's benefit may be fettered.<sup>25</sup>

**Issue #1- To the extent that different categories of directors feature in the companies registered in the Cayman Islands, do respondents support a proposal which expressly identifies the various categories of directors in legislation and prescribes the manner in which each should execute their duties and the extent of the liability to be attached for a breach of those duties?**

**TO WHOM DO DIRECTORS OWE THEIR DUTIES?**

**(a) The Director and the for profit company**

52. The duties of a director are owed to the company. The question however is in whose interests are we purporting to act when it is stated that a director owes a duty to the company.

53. The company is an artificial entity. In reality it has no interests of its own. In *Greenhalgh v. Arderne Cinema*<sup>26</sup> it was stated that the phrase, "the company as a whole," does not mean the company as a commercial entity as distinct from the corporators - it means the corporators as a general body.

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<sup>24</sup> Companies and Securities Law Review Committee (NSW, Australia) Nominee Directors and Alternate Directors: Report No 8, 2 March 1989, at p 7.

<sup>25</sup> The English courts have taken a strict view of the duties of nominee directors. In *Scottish Co-operative Wholesale Society Ltd v Meyer* confirms the view that a nominated director must not put his principal's interests above those of the company.

<sup>26</sup> [1951] Ch 286.

54. The principle that directors and other officers owe duties to the company as a whole ordinarily means that whilst duties are owed to the collective body of shareholders, duties are not owed to particular shareholders individually.<sup>27</sup> This has prevented individual shareholders from taking action against the board of directors for breach of their duties, because the duties were owed not to particular shareholders, but to the company as a whole. This meant that only the company could take action against the directors and this is referred to as the rule in *Foss v. Harbottle*<sup>28</sup> or ‘the proper plaintiff rule.’

55. On the other hand, regard should not be had only to present members but also to the interests of future members. In an appropriate case, the interests of the company may mean the interests of its creditors. The directors must have regard to the interests of the company’s creditors where there is a danger of the company becoming insolvent because they are then the persons interested in the company’s assets.

56. In *Winkworth v. Edward Baron Development Co Ltd*<sup>29</sup> it was held that a duty is owed by the directors of the company to the company and the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.<sup>30</sup>

57. The traditional view was that company law assumes that the directors’ role is to run the company for the benefit of its shareholders alone and to maximise profits for them. In many instances, the distinction is not significant, since what is good for the company will also benefit its shareholders .

58. Maximising the return to shareholders in many cases, does not conflict with the interests of the company. However, there may be situations where the interests of the company and shareholders conflict. The interests of shareholders may lie in realizing a short-term gain on their investment, something which the directors could decide is not in the interest of the company in the long term.

59. It can be argued, however, that this view is too narrow. Rather, company directors should have regard to the rights and interests of a broader range of corporate stakeholders.

60. Hence, the question is whether we should change our perception of the company or corporation from one run by directors dedicated exclusively to serving the interests of shareholders to that of a corporation whose main purpose is to bring benefit not only to its owners and creditors, but also to its employees, the community and the environment.

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<sup>27</sup> *Percival v Wright* [1902] 2 Ch 421.

<sup>28</sup> (1843) 67 ER 189.

<sup>29</sup> [1987] 1 All ER 114.

<sup>30</sup> [1986] 1 WLR 1512.

**(b) The Director and the non-profit company**

61. In a for-profit corporation, the directors have responsibilities to the corporation and its shareholders. If the non-profit organisation is organised as a corporation, the non-profit's board of directors has the same fiduciary responsibilities as any other corporate board.<sup>31</sup>

62. However, because a non-profit company has no shareholders, it is less clear to whom the fiduciary responsibilities are owed in addition to the organisation. It is however viewed that logically the duties will be owed to the donors to non-profits. Where the donor specifies funds for a specific activity, the board must ensure that the funds are used in that particular way. Where the donor does not specify the particular uses for the funds, the non-profit company might not be obligated to apply the money to a specific activity. In this case, the object of the fiduciary duties is the organisation's purpose.

63. A duty may also be owed to the members. The board is not a direct fiduciary of the members of the non-profit. Members of a non-profit are not the same as shareholders of corporation, as members do not own or have residual rights to the non-profit corporation. However, to the extent that the members donate and volunteer toward the charitable objectives, the directors have the responsibility to affirm the objectives in a clear and consistent manner.

**(c) The director and the hedge fund or mutual fund**

64. Funds such as hedge funds and mutual funds are usually organised as companies and a board of directors assumes oversight responsibility for their operations and ensure that there is compliance with its corporate policies.<sup>32</sup>

65. The operations of funds are conducted by companies or firms hired by the fund due to the fact that they have no employees. For example, the fund's portfolio is managed by an investment adviser, who also usually perform various administrative activities on behalf of the fund. The fund, through its board of directors, negotiates contracts to provide services for shareholders.<sup>33</sup>

66. The duties and responsibilities of the directors in each fund registered in the Cayman Islands are set out in its constitutional documents. The directors in these arrangements owe a duty to the general body of shareholders, rather than to individual shareholders or to particular classes of shareholders. The duties of directors extend to the creditors of the fund in cases of insolvency.<sup>34</sup>

**Issue #2- In assessing whether the codification of directors duties is necessary, should we identify in legislation the persons to whom directors owe a duty and make a distinction as to which duties and the elements of such duty should apply to particular stakeholders?**

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<sup>31</sup> Douglas Y. Park, April 16, 2012, To Whom Does The Non-profit Board of Directors Owe Fiduciary Duties?

<sup>32</sup> Mark Beames, The Role of Independent Directors in Offshore Hedge Funds, July, 2004.

<sup>33</sup> Investment Company Institute, Understanding the Role of Mutual Fund Directors, 1999.

<sup>34</sup> Anna-Lise Bailey, Duties and Responsibilities of Corporate Hedge Fund Directors, February, 2009.

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

67. Whether we refer to the expression codification of directors duties, formulating a statutory statement of directors duties or statutory codification of directors duties we are referring to the representation of all the common law duties of directors in legislative form and in a manner which makes the identification of those duties easier and certain.

68. Given the critical role directors play in the functioning of a company and their role generally in ensuring good corporate governance, one may argue that the question of why is there a need to codify directors duties is rhetorical in nature. However, there are arguments for and against the statutory codification of all the common law duties of directors.

69. First, there is a need to identify and examine more specifically the duties we propose to be the subject of codification.

### **Types of directors' duties to be the subject of codification**

70. The duties of directors fall into three broad categories:

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

#### **(i) Contractual duties**

71. 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.<sup>35</sup> 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**

72. As earlier discussed, 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.

73. There are a range of fiduciary duties owed by the directors. The following duties are by no means an exhaustive list and indeed the elements of some duties may overlap. However, the duties identified for discussion represent 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;

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<sup>35</sup> Lister v Romford Ice and Cold Storage Co [1957] AC 555.

- (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.

**(a) Duty to act in good faith or bona fide in the interest of the company**

74. The duty to act in good faith for the benefit of the company is subjective and requires directors to exercise their powers and discharge their duties in what they believe to be in the company's interests.

75. However, this duty also has an objective element in that a court may intervene if an act is one which no reasonable director could regard as being in the interests of the company.

76. A director must act in what he sincerely believes to be in the best interest of the company. It is usual for the court to intervene if it is felt that no director could have reasonably believed that the action taken was in the best interests of the company.

**(b) Duty of loyalty**

77. Directors must act bona fide in what they consider is in the best interests of the company<sup>36</sup> and not to seek a benefit for themselves or third parties. This duty is a subjective one and is not breached if the court would not have reached the same conclusion as the directors as to what was in the company's interests.

78. Once the director acts in a manner which reflects good faith and he acts in what he believes to be in the company's best interests, it is irrelevant that his decision also promotes their own interests.<sup>37</sup>

**(c) Duty to exercise powers for a proper purpose**

79. A director must exercise his powers only for the purpose for which they were conferred and not for any collateral purpose. This will continue to be the case even if he may have honestly believed that he was acting in the company's best interests.<sup>38</sup>

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<sup>36</sup> Lord Greene MR in *Re Smith and Fawcett Ltd* [1942] Ch 304, at 306.

<sup>37</sup> *Hirsche v Sims* [1894] AC 654.

<sup>38</sup> *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187 at 218, per Ipp J.

80. Before it can be concluded that a fiduciary power had been properly exercised, the purpose for which it might be exercised has first to be investigated. Having ascertained the nature of this power, it is then necessary for the court, if a particular exercise of the power is challenged, to examine the substantial purpose for which it was exercised and to reach a conclusion as to whether that purpose was improper.

**(d) Duty to act confidentially**

81. A director owes a common law duty of confidentiality to the company and may only use or disclose information obtained in confidence for the benefit of the company.

82. The duty of confidentiality is continuing in nature in that if a director wishes to act against a former client or for a rival of a former client, he should only do so if he can avoid disclosing confidential information given to him by the former client.<sup>39</sup>

**(e) Duty not to act in conflict of interest**

83. Directors must avoid placing themselves in a position in which their own interests or the interests of another may conflict with the interests of the company. However, in circumstances where a director obtains the fully informed consent of the company he may act notwithstanding a conflict of interest.

84. The duty to avoid conflicts of interest may be broken down into the following rules:

- (i) *the conflict rule* – directors must not have a personal interest in a matter falling within the scope of their service, or enter into an inconsistent obligation with a third party, except with the company’s fully informed consent;
- (ii) *the profit rule* - directors must not misuse their position for their own or a third party’s possible advantage, except with the company’s fully informed consent; and
- (iii) *the misappropriation rule* - directors must not misappropriate the company’s property for their own or a third party’s benefit.<sup>40</sup>

85. The duty to avoid conflicts of interest will continue to apply after a person ceases to be a director. In that regard, a director is prohibited from exploiting any company property or any information or opportunity of which he became aware when he was a director.

**(f) Duty to declare interest in a proposed transaction or arrangement**

86. A director must disclose an interest in any transaction whether it be proposed or existing. If a director is directly or indirectly interested in a proposed transaction or arrangement with the company he must declare the nature and extent of that interest to the board before the company enters into that transaction or arrangement.<sup>41</sup>

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<sup>39</sup> Parry-Jones v Law Society (1969) 1 Ch.

<sup>40</sup> Regal (Hastings) Ltd v Gulliver [1967] 2 AC 134.

<sup>41</sup> UK Companies Act, 2006, sections 177-185.

**(g) Duty not to make secret profits**

87. A director's fiduciary position precludes him from making a personal profit from any opportunities of which he becomes aware or which are available to him as a result of his directorship.<sup>42</sup> This prohibition applies even if he is acting honestly and for the good of the company, unless he has the approval of the company.

88. Equally, this prohibition also applies to contracts with the company and third parties. Any profit arising in such circumstances must be disclosed. If the opportunity to profit arose through his directorship, the director will be liable to account for the profit irrespective of the company not being interested in, or not being able to take advantage of, the opportunity.

**(h) Duty not to fetter discretion**

89. Directors are bound to exercise their functions for the benefit of the company and as such may not generally fetter discretions conferred on them by the company's articles or constitution. This means that directors must give adequate consideration in exercising discretions and must not delegate or fetter future exercise of discretions without authority.

90. Directors may however contract to exercise their discretions in the future in a particular way provided that, in deciding to make the contract, they give proper consideration to whether the contract is in the best interests of the company.<sup>43</sup>

**(i) Duty to promote the success of the company**

91. This duty is related to good faith and requires that a director act in a manner likely to promote the success of the company and for the benefit of its members as a whole.<sup>44</sup> In doing so, the director must have regard to-

- the likely consequences of a decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly between the members of the company.

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<sup>42</sup> *Furs Ltd. v Tomkies*, (1936) 54 CLR.

<sup>43</sup> In *Fulham Football Club Ltd v Cabra Estates plc*,<sup>43</sup> the Court of Appeal stated: "It is trite law that directors are under a duty to act bona fide in the interests of their company. However, it does not follow from that proposition that directors can never make a contract by which they bind themselves to the future exercise of their powers in a particular manner, even though the contract taken as a whole is manifestly for the benefit of the company. Such a rule could well prevent companies from entering into contracts which were commercially beneficial to them.

<sup>44</sup> UK Companies Act, 2006, section 172.

92. Directors must exercise reasonable care, skill and diligence in having regard to this non-exhaustive list of factors. While some of these factors may sometimes conflict with each other, the overriding consideration is the success of the company.

**(j) Duty to exercise independent judgment**

93. A director must exercise independent judgment. This duty does not however prevent a director from acting in accordance with an agreement entered into by the company or in a way authorised by the company's articles of association.

94. While directors may delegate certain matters to other directors or employees with specialist expertise, they must exercise independent judgment in deciding to delegate and in deciding whether or not to follow the advice provided.<sup>45</sup>

**(k) Duty not to accept benefits from third parties**

95. A director is prohibited from exploiting his position for personal benefit. In other words, directors must not accept any benefit from a third party which is conferred due to his position as a director or his doing or not doing anything as a director.<sup>46</sup>

96. The duty will not be breached if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Excluded from this prohibition are benefits conferred by the company, its holding company or subsidiaries, and benefits received from a person who provide the director services to the company. However, the members of a company or the company's articles may, in principle, authorise the acceptance of benefits that would otherwise be a breach of this duty.

97. The duty not to benefit will continue to apply after a person ceases to be a director in relation to things done or omitted by him before he ceased to be a director.

**(l) Duty not to misapply the company's property**

98. A director must not take for his own benefit or pass to a third party property which arises out of the company's business. A director who has misapplied or taken anything belonging to the company, must return it or compensate the company for the resulting loss. In circumstances where a director has used the company's money for purposes which the company has not sanctioned, he must replace it, however honestly he may have acted.<sup>47</sup>

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<sup>45</sup> In *Weaving Justice Jones* referred to *Re Westmid Packing Services Ltd [1998]*<sup>5</sup> which was examined in the judgment, noting, 'delegation of responsibility is permissible, and often necessary, but total abrogation of responsibility is not. A board of directors must not permit one individual to dominate them and use them...'. Whilst the delegation of functions of investment management, administration and accounting functions are commonly delegated to contracted service providers, directors remain obligated to high level supervision of these functions and to exercise independent judgment in this regard.

<sup>46</sup> UK Companies Act, 2006, section 176.

<sup>47</sup> Taylor Wessing LLP, *Directors' duties*, September 2011.

**(m) Duty not to exceed authority**

99. A director has a duty not to act beyond his powers. Any director who acts beyond his powers will be guilty of misfeasance and will be personally liable to the company for any resulting loss.<sup>48</sup>

**(n) Duty to deal fairly between different shareholders**

100. This duty requires directors to exercise their functions fairly between different shareholders.<sup>49</sup>

**(o) Duty to act in accordance with the company's Articles of Association or Constitution**

101. This duty requires directors to act in accordance with the company's constitution or its articles of association and shareholder resolutions.

**Issue #3- Do respondents view these fiduciary duties as the principal duties of directors? If not, what duties should be included or excluded?**

**Issue #4- Is there a general awareness amongst directors of the legal duties arising from their fiduciary position?**

**Issue #5- Should a director's duties be stricter and more clearly defined, and if so, in what respects?**

**Issue #6- Do respondents support the codification of these fiduciary duties?**

**Issue #7- Should these fiduciary duties be represented as guidance rules for directors?**

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

102. Under the law of negligence 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.<sup>50</sup>

103. The view initially held was that a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person with his knowledge and experience.<sup>51</sup> Also, a director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings and he is not, bound to attend all meetings, though he ought to attend whenever the circumstances reasonably permit.

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<sup>48</sup> Supra.

<sup>49</sup> Mutual Life Insurance v Rank Organisation Ltd.

<sup>50</sup> Donoghue v Stevenson [1932] AC 562

<sup>51</sup> Re City Equitable Fire Insurance Co [1925] Ch 407.

104. However, a director is now required to show the degree of care, skill and diligence as may be reasonably expected from a person with his knowledge and experience, and requiring a director to take such care as an ordinary man might be expected to take on his own behalf.<sup>52</sup>

105. 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."<sup>53</sup>

106. 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.<sup>54</sup>

107. 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).

**(a) A subjective test**

108. In the application of a subjective test it would be stated that a director owes a duty to his company to exercise the care, diligence and skill that would be exercised by a reasonable person having his knowledge and experience. In this instance, account would be taken of the responsibilities of the director and the circumstances of the particular company.

109. Various justifications are advanced for a low standard. It is argued that management is not a profession and that directors do not require particular skills to discharge their duties. It is also argued that to raise the standard of care may encourage litigation whereas management should be supervised by shareholders, not the courts.<sup>55</sup>

110. A further factor is that the power of institutional shareholders to assess, and act upon, managerial incompetence is often not as strong as may at first appear.

**(b) An objective test**

111. During the life of the company a director's conduct would be judged by a purely objective standard. In applying this test, the special qualifications that a director has are not taken into consideration. It is immaterial as to whether or not he holds himself out as having any additional knowledge, skill and experience.

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<sup>52</sup> *Dorchester Finance Co v Stebbing* [1989] BCLC 498.

<sup>53</sup> *Norman v Theodore Goddard* [1992] BCC 14.

<sup>54</sup> *Gower's Principles of Modern Company Law* (6th ed, 1997), pp 641-4.

<sup>55</sup> *Palmer's Company Law*, vol 2, para 8.032.

**(c) A dual objective/subjective test**

112. The application of a dual objective and subjective test would enable the court to ask what would be reasonable to expect the director to have done both by reference to the responsibilities that he undertook, and by reference to his own special knowledge and skills.

113. The director can avoid liability if he takes those steps which would be taken by a reasonably diligent person with the knowledge skill and experience reasonably to be expected of a director carrying out the same functions; and also which would be taken by a reasonably diligent person with his knowledge skill and experience.

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

115. 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.”

116. 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- Do respondents support the introduction of a statutory statement on the director’s duty of care to the company in order to clarify the law and make it more accessible to directors?**

**Issue #9- Should the standard of care expected of a director 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?**

**Issue #10- 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?**

**Issue #11- Should the disqualification of directors extend to other instances such as fraud, unfitness or summary conviction?**

### **ARGUMENTS IN SUPPORT OF AND AGAINST CODIFICATION OF DIRECTORS' DUTIES**

**117. (a) Arguments in support of codification**

- Given that the principles relating to directors duties exist in case law rather than in a provision of 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.

**118. (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 we need 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 prevent the court from rewriting existing law or substituting a provision which they think Parliament should have enacted.

**Issue #12- Do respondents find merit in any of the arguments against or in support of codification?**

### **DIRECTORS' STATUTORY DUTIES IN COMPARABLE JURISDICTIONS**

119. The issues concerning the codification of directors' duties are not unique. Many jurisdictions have examined the arguments relating to codification and have chosen to codify the duties of directors to varying degrees. The legislation examined for this paper are 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.<sup>56</sup>

**(a) United Kingdom Companies Act, 2006**

120. In the United Kingdom (UK), a statutory statement on directors duties was introduced by the Companies Act 2006. The provisions<sup>57</sup> of the Act codify the common law duties and cover the following general duties-

- (i) duty to act within powers;
- (ii) duty to promote the success of the company;
- (iii) duty to exercise independent judgment;
- (iv) duty to exercise reasonable care, skill and diligence;
- (v) duty to avoid conflicts of interest;
- (vi) duty not to accept benefits from third parties; and
- (vii) duty to declare interest in a proposed transaction or arrangement.

121. While the statutory duties replace the corresponding common law rules and equitable principles from which they derive, these duties are required to be interpreted in the same way as the common law rules and equitable principles.

122. In other words, the courts have been required to interpret and develop the general duties in a way that reflects the nature of the rules and principles they replace. This approach can be regarded as one which seeks to achieve both the precision of the statutory statement and the continued flexibility and development of the law.

123. The statutory duties do not however cover all the duties that a director may owe to the company. Many duties are imposed elsewhere in the legislation, such as the duty to file accounts and returns to the Registrar of Companies. Other duties remain uncodified, such as the duty to consider the interests of creditors.

124. The remedies for breach of the statutory duties have not been codified. The Act states that the same consequences and remedies as are currently available should apply to a breach of the statutory general duties. In circumstances where the statutory duties depart from their equitable equivalent, the court must identify the equivalent rule and apply the same consequences and remedies.

125. The principle of “enlightened shareholder value” has been introduced in the Act and is part and parcel of the duty to promote the success of the company. The duty requires a director to act in the way in which he or she considers, in good faith, would be most likely to promote the success of the company and for the benefit of its members as a whole. In doing so, regard must be had to a list of wider factors, such as the interests of

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<sup>56</sup> Amended up to 2006.

<sup>57</sup> Sections 170–177.

employees, suppliers and customers and the impact of the company's operation on the environment.

126. The Act<sup>58</sup> also includes a statement of directors' duties in respect of the environmental and social impacts of their company's business. The law explicitly requires directors to take into regard these issues, highlighting the important link between responsible business behaviour and business success.

**(b) Australia Corporations Act, 2001**

127. In Australia, the regulatory framework for directors' duties and corporate governance generally is governed by the Corporations Act, 2001.

128. The primary provisions in the Corporations Act regarding directors' statutory duties are under Chapter 2D and include duties of care and diligence, good faith, improper use of position and information, and criminal offences.

129. Other provisions related to directors' duties are those regarding insolvent trading, disclosure of material personal interests, financial benefits to related parties, financial reporting, reliance on delegates and others and the company constitution.

130. The duty of care and diligence is reinforced under section 180(1) of the Act. That section provides that a director or other officer of a corporation must exercise his powers and discharge his duties with the degree of care and diligence that a reasonable person would exercise if he were a director or officer of a corporation in the corporation's circumstances and occupied the office held by, and had the same responsibilities within the corporation as a director or officer.

131. The reference to a reasonable person indicates an objective standard of care, consistent with the development of the equivalent fiduciary duty. The foreseeable risk of harm is balanced against the potential benefits that could reasonably have been expected to affect the company from the conduct in question. The court also takes into account the subjective elements of the position of an officer and the particular circumstances of the relevant corporation in assessing whether the duty has been breached.

132. A business judgment rule is incorporated under section 180(2) of the Act, whereby the director must make his judgment in good faith for a proper purpose, not have a material personal interest in the subject matter of the judgment, inform himself about the subject matter of the judgment to the extent he reasonably believes to be appropriate and rationally believe that the judgment is in the best interests of the corporation.

133. The director must satisfy these requirements in order to have been taken to have satisfied the statutory duty of care and diligence in respect of the particular business judgment. A "business judgment" means any decision to take or not take action in respect of a matter relevant to the business operations of a corporation.

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<sup>58</sup> Section 417.

134. Under the Act<sup>59</sup> a director or other officer of a corporation must exercise his powers and discharge his duties in good faith and in the best interests of the corporation and for a proper purpose. This provision is more consistent with the fiduciary duty to act bona fide for the benefit of the company, providing for an obligation to act honestly at all times, despite any other conflicting duties. Directors can be in breach of this duty where their power is exercised for an improper purpose, even if they believe they are acting honestly.

135. A director of a corporation must not improperly use his position to gain an advantage for himself or someone else, or cause detriment to the corporation. A director contravenes this section when engaging in conduct with the intention and purpose of obtaining an advantage or causing a detriment, regardless of whether the benefit or detriment actually occurs in fact.<sup>60</sup>

136. A duty not to make improper use of information is provided under the Act.<sup>61</sup> A person who obtains information because he is, or has been, a director of a corporation must not improperly use the information to gain an advantage for himself or someone else, or cause detriment to the corporation.

137. A director will be in breach of engaging in conduct with the purpose and intention of obtaining a benefit for anyone or causing a detriment to the company, despite what actually occurs in fact.<sup>62</sup> A contravention of this section may occur where a director's conduct involves knowledge of the poor financial position of the company and the possibility of insolvency.

138. The criminal offences<sup>63</sup> for a breach of a directors' duties include- (i) reckless or intentional dishonesty; (ii) failure to exercise powers and discharge duties in good faith in the best interests of the corporation or for a proper purpose; (iii) using information with intentional dishonesty or recklessly in order to directly or indirectly gain an advantage for themselves, or someone else; (iv) causing detriment to the corporation; (v) failure to prevent the company trading while insolvent in a dishonest manner; and (vi) failure to prevent the company incurring debt in a dishonest manner.

### **(c) New Zealand Companies Act, 1993**

139. Under the New Zealand Companies Act a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.<sup>64</sup>

140. The Act does lend itself to subjectivity by use of the words "believes to be in the best interest of the company". Note the reference to "the best interests of the company" - not, the shareholders or the creditors. This is a restatement of the common law rule that if directors act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company. The section also affirms

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<sup>59</sup> Section 181.

<sup>60</sup> Section 182.

<sup>61</sup> Supra.

<sup>62</sup> Section 183.

<sup>63</sup> Section 184

<sup>64</sup> Section 131.

the reluctance of the courts to review an exercise of business judgment taken in a boardroom.

141. The Act requires the director to exercise a power for a proper purpose<sup>65</sup> and not to act in a manner likely to create a substantial risk of serious loss to the company's creditors; or cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.<sup>66</sup>

142. A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances.<sup>67</sup>

143. Notwithstanding that the directors must act in the best interest of the company, the Act does recognise that directors do owe duties to shareholders in circumstances in which they deal in shares on the basis of confidential, price insensitive information.<sup>68</sup>

144. Directors of a company are prohibited from entering into a major transaction unless the transaction is approved or contingent on approval by special resolution. "Major transaction" means the acquisition of assets equivalent in value to the value of or the greater part of the assets of the company for acquisition or the disposition of the whole or greater part of the assets of the company. This provision results in a major restriction on the powers of directors. It is based on the view that some dealings have such far-reaching effects that they should be referred to shareholders. Shareholders should not find that, without warning, massive transactions have transformed the company in which they invested.<sup>69</sup>

145. The Act adopts a policy of requiring directors to sign a certificate in a large number of instances where they are likely to be making decisions of significance. The purpose of such certificates is essentially to concentrate the minds of the directors on the decision or action in question and to provide evidence if breaches of directors' obligations are alleged and pursued by shareholders or a liquidator.

146. Certificates are required, for example, in relation to the consideration for issue of shares, satisfaction of the solvency test on authorising distributions, financial assistance for share purchases, directors' remuneration and amalgamations.

#### **(d) Hong Kong Companies Ordinance, 2012**

147. The Hong Kong Companies Ordinance was passed in July 2012. A comprehensive exercise to rewrite the Companies Ordinance started in 2006 with the aim of modernising Hong Kong's company law. One element of the reforms relates to directors' duties.

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<sup>65</sup> Section 133.

<sup>66</sup> Sections 135 and 136.

<sup>67</sup> Section 137.

<sup>68</sup> Section 149.

<sup>69</sup> Section 129.

148. The Ordinance<sup>70</sup> codifies a director's duty to exercise reasonable care, skill and diligence. With a view to providing clear guidance to directors it provides for a mixed test. In performing duties, a director must bring to bear his or her own skills and experience (a subjective test), as well as those that any director in that position would be presumed to have (an objective test). This duty applies equally to shadow directors and directors.

149. The Ordinance also codifies the circumstances in which a company is able to ratify the actions of a director which are negligent, in breach of duty or represent a breach of trust. It also puts an obligation on directors to disclose any "transaction or arrangement" which the director has entered or proposes to enter into, if it is of significance to the company's business.

150. However, it is to be noted that the Ordinance does not codify the common law fiduciary duties and as such these remain subject to the common law.

**(e) Jersey Companies Law, 1991**

151. Under Article 74(1) of the Companies Law, a director of a Jersey company is obliged to (a) act honestly and in good faith with a view to the best interests of the company; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

152. These statutory duties are a codification of the common law fiduciary duties of directors which, in practice, continue to be relevant when interpreting a director's duties. In other words, the general statutory duties set out in Article 74 reflect but do not replace the fiduciary and common law duties that had evolved prior to the Companies Law. Such common law duties include a duty to act in good faith, a duty to act with diligence, a duty to exercise powers for their proper purpose and a duty to account for profits.

153. If a director breaches these statutory duties the Law provides that the breach can be absolved if all of the shareholders authorise or ratify the relevant act or omission, provided that the company is solvent and will be able to discharge its liabilities as they fall due immediately following the relevant breach.<sup>71</sup>

154. It is to be noted that the duties of directors in Jersey cannot be found exhaustively in any one piece of legislation.<sup>72</sup> While Articles 75 to 84 of the Companies Law state some general provisions about appointment, removal, qualifications, duties and responsibilities of directors, other more specific requirements are imposed on directors elsewhere in the Companies Law. However, many of the most important features of directors' duties are based on case law.

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<sup>70</sup> Sections 465 and 466.

<sup>71</sup> Article 74(2).

<sup>72</sup> The duties of directors under Jersey law Bedell Cristin Jersey briefing January 2009.

**(f) Bermuda Companies Act, 1981**

155. In Bermuda, directors' duties are regulated by the Companies Act 1981 and the common law.<sup>73</sup>

156. The Act does not impose an all-embracing code of conduct on directors. It contains several provisions relating to the duties of directors and in some instances prescribes penalties for breach of such duties.

157. Under the Act no distinction is made between executive and non-executive directors. It seems that the function of the substantive law is to supplement the internal constitutional checks on a director's powers and to deal with areas where the company's constitution may be silent.

158. Many of the duties and obligations of a director are statutory while others are found in the common law. The principal statutory<sup>74</sup> duties include-

- a duty of care of officers in exercising his powers and discharging his duties honestly and in good faith with a view to the best interests of the company;
- a duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances;<sup>75</sup> and
- a duty to disclose to the company any material interest he has in a contract to which the company or any of its subsidiaries is, or is to be, a party, and any interest he has in shares of the company.

**(g) Singapore Companies Act, 2003**

159. In Singapore<sup>76</sup> the Companies Act was reformed in 2003. Directors statutory duties are found under section 157.

160. Directors in discharging their duties have a statutory duty at all times to (a) act honestly and (b) use reasonable diligence. What is important about this section is that it involves a test of whether a director had acted with due skill and the standard would not be lowered to accommodate inadequacies in an individual's knowledge and experience is inadequate. Rather, the standard would be raised if the individual held himself out as having special knowledge or experience.

161. Officers and agents of the company cannot make improper use of any information acquired by virtue of their position to gain, directly or indirectly, an advantage for himself or for any person, or to cause detriment to the company.

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<sup>73</sup> Bermuda- Guide for Directors and Officers of Bermuda Companies Appleby Hamilton, Bermuda July 2012.

<sup>74</sup> Section 97.

<sup>75</sup> Section 97(1) of the Companies Act is derived from Canadian legislation and it is considered that the provision does impose a higher standard of care upon directors than the common law, namely an objective standard.

<sup>76</sup> Kala Anandarajah and Foo E Lin Rajah & Tan, Highlights of Developments in Singapore that Directors Must be Aware of (Part I)

162. The extensive application of this statutory fiduciary duty to anyone who is deemed to be an officer or agent of the company has significant implications for the corporate governance responsibilities of those persons.

163. The statutory duties of a director under section 157 do not purport to be an exhaustive statement of the law relating to the duties that directors owe to their companies. In this regard, the section provides that the statutory duties are in addition to and not in derogation of any other rule of law relating to the duty or liability of directors or officers of a company.

164. Section 157 renders those duties mandatory while the duties at common law are capable of exclusion by agreement between the company and its directors, assuming that the company has made such a decision independently of the interested directors. A director's breach of this statutory duty can be a civil breach rendering the director liable to the company for any profit made by him or for any damage suffered by the company. The breach can also be a criminal offence.<sup>77</sup>

165. The Act<sup>78</sup> requires directors to disclose certain information to the board on which they serve, namely the holding of office or the possession of property which might create a conflict of interest for the director or contracts with the company in which the director has an interest. The scope of disclosure has also been extended by the replacement of the word 'contracts' with 'transactions'. The latter is wider and captures non-contractual events as well.

166. The nature of the information to be disclosed is wide ranging and includes the continuing disclosure obligations, simple information such as changes in addresses and appointment of officers, and more complex information relating to take-overs and interested person transactions. The penalty for non-compliance is a fine or imprisonment. The obligation to disclose conflicts also arises where the interest is that of a family member.

#### **(h) Malaysia Companies Act, 1965**

167. The Malaysia Companies Act essentially codifies the common law duties of directors and provides for details in respect of the discharge of such duties. The statutory duties of a director under the MCA<sup>79</sup> are set out in paragraphs 168 to 173 below.

168. Duty to act in good faith and for proper purpose- Directors owe a duty to the company to act in its best interests in good faith, and to do so with reasonable skill and care. The degree of skill and care imposed is that which a reasonable person would exercise had he been in a similar position as the director, taking into account any special skill, knowledge or expertise that the director may possess.

169. Duty to exercise reasonable care and skill - This duty is discharged when a director is informed about the subject matter of a business judgment and considers it appropriate,

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<sup>77</sup> Section 157(3).

<sup>78</sup> Section 156.

<sup>79</sup> Section 132.

he makes a business judgment in good faith, believing that such judgment is in the company's best interest and has no material personal interest in the subject matter of the business judgment.

170. Reliance on information and advice- Directors may rely on information, professional or expert advice, opinions, presented by individuals retained by the company to provide such advice. A director's reliance is made on reasonable grounds where it is made in good faith and was made after an independent assessment by him, having regard to his knowledge of the company and the complexity of the corporate structure or operation.

171. Duty to seek shareholders' approval- Directors are to seek shareholders' approval at the general meeting of the company prior to carrying into effect any arrangement or transaction of substantial value relating to the company.

172. Conflicts of Interests- Directors must not place themselves in a position where their personal interests and duties to the company are likely to directly or indirectly conflict. Given that it is not uncommon for individuals to hold directorships in more than one company at any time, directors should be cautious when contracting with another company in which they hold directorships or are substantial shareholders. Such individuals are generally duty-bound to either declare their interests in a particular transaction to the other directors or show that there could be no possibility of conflict.

173. Duty to declare interests- A director, or persons related to him such as a spouse or child, having direct or indirect interests in a contract involving the company must declare such interests as soon as is reasonable to the board of directors.

174. Breaches of statutory duties under the Act attract criminal liability where provided, which includes substantial fines or terms of imprisonment. The Act also provides, in certain cases, for the director to be personally liable for the loss or damage suffered by the company.

175. Companies and third parties affected by the directors' breach of duties may also commence civil proceedings against them. The usual remedy sought is for the directors to account for any profit made unlawfully and/or for them to make good any loss or damage suffered as a result of the directors' actions.

## **REFORM OPTIONS**

176. Against the background of the case law and legislation that exists, several options for reform of the duties of directors could be explored. These are-

- (a) comprehensive codification of all directors' duties;
- (b) limited codification of directors' duties;
- (c) codification of directors duties' concurrent with the common law; or
- (d) codified statement on corporate governance by directors.

**(a) Comprehensive codification of all directors' duties**

177. This option requires the identification of all common law duties and placing them into statute.

**Issue #13- Taking into account the arguments against codification as stated in paragraph 118, do respondents support the comprehensive codification of directors duties?**

**(b) Limited codification of directors' duties**

178. Given that the common law duties with respect to directors responsibilities are not completely settled, one may argue against converting them into statutory form. In this regard, partial codification may assist by placing those duties which are not in doubt in statutory form.

**Issue #14- Do respondents support limited codification or view limited codification 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?**

**(c) Codification of directors duties concurrent with the common law**

179. This option contemplates 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.

**Issue #15- Do respondents support the concurrent treatment of directors duties in light of the possibility that if two regimes exist-**

- (i) their duties as directors could potentially increase if the statutory regime is wider; and**
- (ii) this could mislead a director into thinking that he could not be liable for doing something not mentioned in the statute and if liable should be treated more leniently as a result?**

**(d) Codified statement on corporate governance by directors**

180. 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.

181. 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.

182. 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.

**Issue #16- Do respondents support the option of a codified statement on how directors should govern given that-**

- (i) **the principles that are codified may not at all time represent the law as developed by the courts thereby requiring new legislation; and**
- (ii) **it can be regarded as uncommon for a statute to contain provisions which merely offer guidance rather than articulate the law?**

**Issue #17- If codification of directors' duties is supported should the provisions apply equally-**

- (i) **to directors in public, private, holding and subsidiary companies; and**
- (ii) **to directors sitting on statutory boards?**

### **OTHER AREAS OF REFORM**

**(a) The business judgment rule**

183. A company is managed by its board of directors which exercises all powers directly conferred on, or implicitly granted to, the company. The board makes the broad decisions and designates the officers to execute those decisions.

184. While the courts have been reluctant to review judgements of directors exercised in good faith, they have also, on occasion, refused to exercise their discretion to excuse directors from liability where they have acted fairly and honestly. Arguably, this has led to uncertainty in the minds of directors as to the extent of due diligence required of them.

185. Conduct of business requires decisions. Decisions are based on predictions and assessments. Directors are therefore placed in a difficult situation in which they must make decisions at the risk of being exposed to liability for those decisions.<sup>80</sup>

186. Usually, directors are granted autonomy and flexibility in decision making but are legally liable and thus obligated to exercise care and loyalty when acting in the interests of the business entity. The question is how much freedom should directors be given. If shareholders have appointed the board members, they should trust their business abilities and experience and the law should not give the owners the opportunity to challenge any decision or transaction that the owners do not like. If a decision is based on appropriate information and is fair minded, it is always reasonable and should not be disputable.

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<sup>80</sup> Daniels v. Anderson (1995) 37 NSWLR 438.

187. However, fear of liability may create a situation where board members cannot act freely and take the appropriate risks that are essential for business. This could lead to an opposite effect, with directors trying to act too prudently and risk free, inhibiting the development of the company.

188. The business judgment rule seems to have been formulated to address these situations. The rule is an American case law concept in corporate law.<sup>81</sup> In many states of the United States there exists a judge-made rule which prevents directors from being liable for claims for breach of duty/negligence where certain factors are established.<sup>82</sup> The rule has developed, and received recognition, as a judicial doctrine. It operates as a legal presumption and as a rule of the law.

189. 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.<sup>83</sup> 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/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.

190. The rule does not apply when a director fails to act, abdicates his responsibilities or his conduct was an abuse of discretion.<sup>84</sup>

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

**Issue #18- Do respondents 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?**

**(b) Delegation of duties and reliance on other professionals**

192. We question the extent to which it is permissible for directors to delegate their functions to, and rely on the judgements of, others. One view<sup>85</sup> is that directors cannot

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<sup>81</sup> Gimbel v. Signal Cos., 1974; Aronson v. Lewis, 1984; Kaplan v. Centex Corp., 1971.

<sup>82</sup> M E Eisenberg, "The Duty of Care and the Business Judgment Rule in American Corporate Law" [1997] 2 CFILR 185.

<sup>83</sup> Sieg, O. Directors' Liability and Indemnification, p. 121.

<sup>84</sup> Bailey Dan A., Kandawalla Darius N., Directors' Liability and Indemnification: A Global Guide. Globe Business Publishing Ltd, 2007, p. 339.

<sup>85</sup> (1995) 37 NSWLR 438 at 502-504.

blindly rely on the judgements of others. It is argued that ignorance, a failure to inquire or blind reliance on the judgement of others will not protect directors from liability for breach of their duties. All directors must take positive steps to ensure that they are in a position to satisfy themselves that the company is being run properly and must be reasonably familiar with the business of the company.

193. The traditional view<sup>86</sup> 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.

194. In other words, a director is justified in trusting officers of the corporation to perform all the duties that, having regard to the exigencies of the business, the intelligent devolution of labour and the articles of association, may properly be left to such officers' and may 'rely without verification on the judgements of the officers so entrusted unless the director is aware of circumstances of such a character that no person, acting prudently on his own behalf, would have relied on.'<sup>87</sup>

195. A director may, as a statement of general principle, rely on his co-directors to the extent that the matter in question is, in terms of the board's internal 'division of labour', within their remit.<sup>88</sup> A director may thus rely on a co-director appointed to the board by reason of his expertise in a particular area, and is 'entitled to rely upon the advice of his fellow directors in matters in which they are, or should be, experts'.<sup>89</sup>

196. However, directors will in certain circumstances be in breach of their duties if they fail to take appropriate, especially legal advice.<sup>90</sup> The approach in respect of co-directors and officers, that "business cannot be carried on upon principles of distrust", has been applied in relation to outside advisers. Nonetheless, reckless or slavish reliance on outside advice does not absolve a director from his duty of exercising judgment on such advice.<sup>91</sup>

197. 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.

198. Directors have both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.

199. 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.

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<sup>86</sup> Re City Equitable Fire Insurance (1925) Ch 407.

<sup>87</sup> Re Property Force Consultant Pty Ltd (1995) 13 ACLC 1051.

<sup>88</sup> Re City Equitable Fire Insurance, *supra*.

<sup>89</sup> Palmer's Company Law, para 8.408.

<sup>90</sup> Re Duomatic [1969] 2 Ch 365, 377.

<sup>91</sup> Re Faure Electric Accumulator Co (1880) 40 Ch D 141.

200. 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.

201. The powers of delegation and reliance are indeed 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 #19- Is there a need for specific legislative authority-**

- (i) to 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?**

**(c) Directors' duties and human rights**

202. A directors 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.

203. A company may impact on different rights such as fair working conditions, equality and dignity, health, life and security, standards of living and land and culture.

204. In Australia, for example, companies are subject to a range of domestic human rights law obligations that necessarily entail a corporate duty to respect human rights in certain circumstances. While these laws are not always framed in human rights language, the standards they stipulate are in fact based on Australia's international human rights obligations. Examples include laws prohibiting discrimination and harassment in the workplace, laws requiring employers to provide equal employment opportunities and laws regulating conditions of work.

205. At an international level there have been significant advances in examining and clarifying how businesses can respect international human rights standards. In June 2011, the United Nations Human Rights Council endorsed the Guiding Principles on Business and Human Rights, to operationalise the framework. These principles provide a global standard for preventing and addressing the risk of adverse human impacts linked to business activity.

206. The Guiding Principles outline ways in which businesses can manage risks associated with meeting human rights obligations whether at home or abroad. These strategies focus on companies knowing and showing that they respect human rights, including by preparing a human rights policy, carrying out human rights due diligence and implementing measures, including operational-level grievance mechanisms, to address human rights breaches.

207. 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 is whether there is a need for this. We are cognisant of the fact that the Bill of Rights of the Cayman Islands Constitution requires vertical application and as such will not apply on an individual to individual basis or, as in this case, directors of a company and an individual. However, given the central role courts are placing on directors, it may be meaningful to ensure that protecting human rights are a key part of a directors functions.

208. Of the various duties imposed by the common law, those that provide the greatest scope for the consideration of human rights are the duty to act in good faith in the interests of the company and for a proper purpose, the duty of care and diligence and a duty to report and do a risk assessment.

209. As a result of the above identified duties, directors have scope to assess, oversee and consider relevant human rights issues and risks of their decisions and of their corporation's operations in the course of considering their obligations.<sup>92</sup>

**Issue #20      Should 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?**

## **CONCLUSION**

210. The Cayman Islands has distinguished itself by seeking to raise the standard and efficiency of the country's corporate laws and corporate governance. The various amendments to the relevant laws and the establishment of financial committees indicate Cayman's enthusiasm to achieve these desirable purposes. These issues are being raised in an attempt to strengthen the corporate laws and to help invigorate the existing legislation and enhance responsible management and good governance.

211. It is necessary to ensure that company directors act in the best interests of their companies as well as ensuring the observance and compliance with all laws, regulations and codes of conduct and best practices. The task of clarifying and reformulating directors' duties so as to promote accountability may well be necessary in order to ensure that our corporate law framework remains effective and can facilitate business. The confidence of stakeholders should not be derogated by poor performance of the directors.

**Stakeholders and members of the general public are invited to respond to the issues identified in this Issues 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. The Paper may be viewed on the following website: [www.lrc.gov.ky](http://www.lrc.gov.ky).**

**Unless marked to the contrary, the LRC will assume that comments received are not confidential and that respondents consent to our quoting from, or referring to, their**

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<sup>92</sup> UK Companies Act 2006.

**comments and attributing their comments to them, and to the release or publication of their submissions.**

**Requests for confidentiality or anonymity will be respected to the extent permitted by the Freedom of Information Law, 2007.**

**Submissions should be made no later than 14th March, 2014 and should be posted to the Director, Law Reform Commission, P.O. Box 1999 KY1-1104, delivered by hand to the offices of the Commission at 1st floor dms House, Genesis Close or sent by e-mail to [Cheryl.Neblett@gov.ky](mailto:Cheryl.Neblett@gov.ky) .**