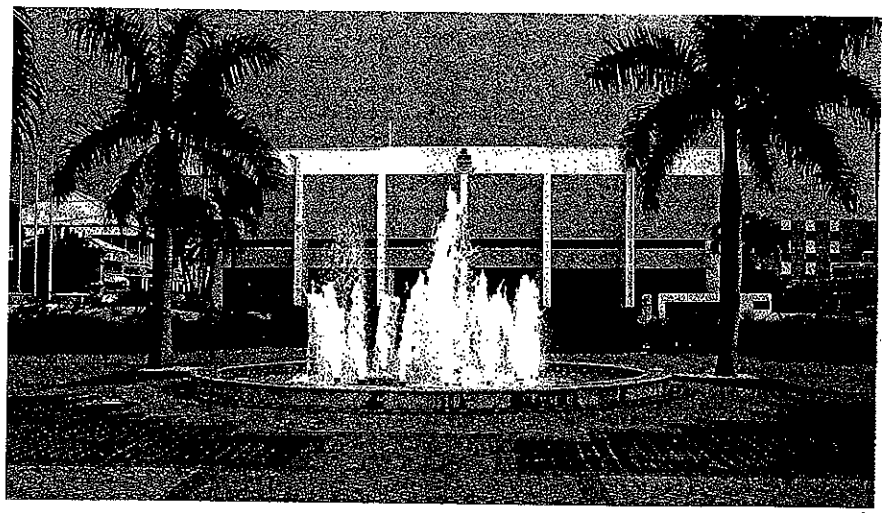
Accountability of Cayman Islands directors

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

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



Omission of section 205 of the Companies Act 1948

This potential encouragement to overly relaxed corporate governance was addressed over fifty years ago in the UK by a statutory provision that is designed to keep directors on their toes. While the Companies Law (2007 Revision) of the Cayman Islands is substantially based upon the English company law statutes of 1862, 1929 and 1948, there are important differences and one of them is the omission of section 205 of the Companies Act 1948[2]. Section 205 was enacted to render void the then well established English legal principle that a company, under its articles of association, could exempt directors from liability for their negligent management of the company[3]. In the Cayman Islands, there is no such statutory provision and, accordingly, no statutory bar to articles of association providing for director exemptions. Consequently the articles of association of a Cayman Islands company typically contain indemnities and exculpations to relieve directors from liability for negligence, gross negligence and wilful default[4].

The move to greater accountability

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

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

'Gross negligence' and 'wilful default'

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

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

"The prevalence of director indemnities and exculpations raise a potential concern for the many investors in mutual funds incorporated in the Cayman Islands."

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

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

Director Services Agreement

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

The wind of change?

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

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

[2] Section 205, Companies Law 1948 is the predecessor section to section 310, Companies Law 1985, now section 232, Companies Law 2006.

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

[4] This list is not exhaustive.

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

[6] Section 59 Companies Law (2007 Revision).

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

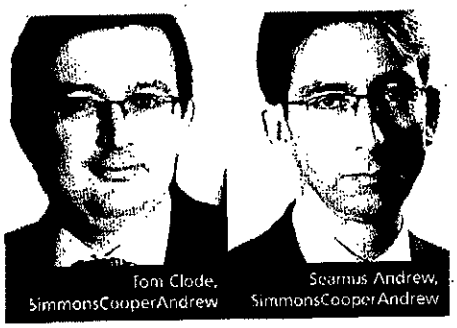
[8] *Prospect Properties Limited (in liquidation)* v. *McNeill and J.M. Bodden II* [1990-91] CILR 171.

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

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

Seamus Andrew (right) is the managing partner at SimmonsCooperAndrew and Niall Goodsir-Cullen (far right) is a consultant at Chris Johnson Associates Ltd, Cayman Islands.

Where big firms fear to tread



Tom Clode, SimmonsCooperAndrew

Seamus Andrew, SimmonsCooperAndrew

SimmonsCooperAndrew is a niche law firm founded in London just over two years ago which specialises in the kind of contentious cross-border insolvency litigation its larger and stuffier English rivals steer clear of.

One of the three founding partners, Tom Clode, joined from US bankruptcy giant Weil Gotshal.

Clode says: "As individuals we are fairly well known in the cross-border turnaround market and have an interesting story to tell about operating as a niche firm, and our ability and willingness to do significant cases on a conditional fee basis."

"We are also happy to find funders to purchase actions from liquidators, and our conflict free status enables us to act where large firms won't, for instance against financial institutions," says Clode.

Big words for a small firm. But with conflicts of interest handicapping large law firms as much as their accountancy counterparts, the new firm could be on to a good thing, particularly in London, arguably the busiest offshore centre in the world.

The firm also scores big with its link to a US plaintiff class action firm, Simmons Cooper. This is where the UK firm's entrepreneurial drive to work on a conditional fee basis and sue big financial institutions comes from.

SimmonsCooperAndrew's partnership will grow to four this month when insolvency and restructuring specialist Charles Shiramba arrives after six years with Freshfields Bruckhaus Deringer, one of the leading law firms in the European restructuring market.

The new firm was founded in 2004 by solicitor-advocate Seamus Andrew, following a six-year stint with Walkers in the Cayman Islands and some time with Clifford Chance in London. Andrew is also a barrister.

Charles Fussell joined as a partner last spring from Herbert Smith where he was a commercial and insolvency litigation solicitor-advocate, and Clode came on board in July.

Andrew says: "We have had an extremely busy start and expect that to continue. We will continue to build our practice in our chosen area of complex cross-border litigation and insolvency. Our conflict-free boutique offering is in big demand to a wide range of clients and we expect that to continue".

In 2006 the firm has worked on a number of hedge fund liquidations and litigation, a successful action against Barclays in the English Commercial Court brought on behalf of the Cayman liquidators of Architects of Wine, and the innovative purchase of a significant negligence claim from the Cayman liquidators of Trade and Commerce Bank.

How to buy an audit negligence claim

Clode says one of the most innovative cases SimmonsCooperAndrew has worked on this year is the liquidation of a Cayman-based institution called Trade and Commerce Bank.

The Bank was part of a larger South American group and went into liquidation in 2002 with a 'black hole' totalling US$800 million.

The liquidation estate had insufficient funds to pursue an audit negligence claim against the Bank's auditors, Arthur Andersen.

So the liquidators sold the claim to a funding vehicle called TCB Creditor Recoveries Limited, which is now prosecuting this claim. Quantifying the claim is a complex process which has not been started yet, but could total the full US$800 million plus interest.

SimmonsCooperAndrew have advised the funding vehicle on the purchase and pursuit of the case, together with a local Cayman law firm, Samson & McGrath. The Cayman Court confirmed the purchase in October.

Clode comments: "Selling a claim like this is an innovative transaction. Liquidators don't often do so."

"The claim has been dormant since 2002. The sale to a funding vehicle has revived it," he says.

Selling such claims is banned outside liquidation, under the legal rule of 'champerty and maintenance.' This says that you can't fund or interfere with litigation if you have no interest in it.

Uniquely, liquidators are allowed to sell such claims.

The purchase of the Trade and Commerce Bank claim was funded by the US law firm Simmons Cooper, which as a plaintiff class action law firm has experience in working on a contingency fee basis.

Interestingly, despite the fact that Andersen collapsed due to its audit of another company, Enron, there was still a legal entity in the US with the Andersen name that was able to defend the claim.

Indeed, what remains of the audit firm is still recognised 'with good standing' in Chicago, and has been subject to no formal insolvency process.

Trade and Commerce Bank Firms & Faces

The liquidators

The joint liquidators were **Richard Fogerty** and **Jim Cleaver** of Kroll Cayman, formerly of Ernst & Young Cayman, together with **Chris Johnson** of Chris Johnson & Associates Limited, formerly of PricewaterhouseCoopers.

The liquidators got legal advice from Quin & Hampson, a Cayman law firm.

The funding vehicle

The funding vehicle for the audit negligence claim against Arthur Andersen is called TCB Creditor Recoveries Limited. SimmonsCooperAndrew advised the funding vehicle on the purchase and pursuit of the case, together with a local Cayman law firm, Samson & McGrath.

The auditors

The legacy entity representing the Arthur Andersen audit firm is represented on Cayman by Ogier, a local law firm.

Global Turnaround is publishing its annual survey of restructuring and insolvency in offshore jurisdictions in February 2007. The deadline for copy is 15 January. If you would like to appear in it, or have ideas for articles, please contact the Editor John Willcock on: **johnwillcock@globalturnaround.com**