Directors' liability negligence and gross negligence

May 2015

Weavering (2). At one point, in the not so distant past, it seemed impossible to have a conversation with anyone in the financial services industry without the word being mentioned. Legal commentators spouted out articles on the subject as if it was the Holy Grail of decisions regarding directors in the Cayman Islands. And, perhaps it was, until such time as the Court of Appeal weighed in on the debate in February of this year. Now it seems that it has bowed out into the shadows of relative anonymity. Or has it?

Left in the unsettled waters of the wake of **Weavering** is a ripple of shifting focus. That focus is now being trained upon director's indemnity provisions. Gross Negligence and Wilful Neglect/Default are now widely considered to be very different animals following the Court of Appeal's decision in **Weavering** and, we suspect, that a director's "incompetent best" is unlikely to be tolerated by the Industry for much longer.

The Court of Appeal (subject to an appeal to the Privy Council) has confirmed that positive evidence, as formulated by the Court in **Re City Equitable Fire Insurance**, is required for a finding of wilful neglect or willful default by evidencing, on the balance of probabilities, that an individual knows that:

(i) he or she is committing or intends to commit a breach of his/her duty; or

(ii) is so recklessly careless that he or she does not care whether or not a particular act or omission is a breach of duty.

What this means is that when a person does not intend to commit a breach of duty or does not suspect that his or her conduct might constitute a breach of duty, that act or omission cannot be characterized as wilful neglect or default in the eyes of the law (ignorant bliss, perhaps). Whilst this might be celebrated by directors, it will almost certainly not be applauded by investor shareholders and, ultimately, it will be the latter who will dictate the rules of the game of the Industry when appointing directors to boards of Cayman Islands Companies.

Mr Justice Romer in **Re City** explained that the exculpatory provisions within the company's articles of association were designed to protect directors who do their "incompetent best" (2). In our view, there is now a distinct possibility that shareholders and investors will be seeking more robust and narrower exculpatory provisions, given the difficulties that they are now faced with when seeking to evidence willful neglect or default. The next logical step is to start carving out exculpatory protection and indemnification for acts of gross negligence and, potentially, even negligence.

But all is not lost. This practical briefing note has been authored specifically with a view to drawing directors' focus towards the fundamentals of negligence and gross negligence for which they have long enjoyed relief from liability.

The Common Law Duties

Fiduciary Duties

- Act honestly
- Act in good faith
- Act with loyalty
- Act with fidelity

Additional Duties

- Act in the best interests of the Company
- Act with care and skill
- Avoid conflicts of interest
- Exercise independent judgment
- Use powers for a proper purpose
- Disclose personal interests
- Do not make secret profits

The Expected Standard

A director of a Cayman Islands Company is required to:

1. exercise the care, skill and diligence that would be exercised by a reasonably diligent director having the general knowledge, skill and experience reasonably to be expected of a director carrying out the same function;

2. as seen in the light of the general knowledge, skill and experience that that particular director has (3).

The test for meeting the expected standard comprises both an objective element (the reasonably diligent person) and a subjective element (the general knowledge, skill and experience that the director actually has). It is a deliberately fl exible test (to apply to an infi nite amount of circumstances) and is designed to provide a minimum standard (the reasonably diligent director), which can be increased in the event that the individual has more general knowledge, skill and/or experience. If you do not meet this standard in the performance of your duties as a director, you could potentially be found to have been negligent or, worse still, grossly negligent.

Also Note

1. Directors have a duty to acquire and maintain a suffi cient amount of knowledge and understanding of the company's business to enable them to properly discharge their duties.

Read the company material available to you. If you do not think you have enough material to understand what is going on at all times, you should ask for more.

Be wary of seeking to hive off responsibility via delegation and committees. A director must still always have a general knowledge and understanding about what is going on across the company.

2. Whilst directors are entitled (subject to the articles of association) to delegate particular functions to those below them, and to trust their competence, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of delegated functions.

For example, if you appoint an investment manager, you are responsible for understanding the investment manager's plan and approach at all times, albeit at a somewhat higher level.

Do not delegate and forget about it.

What is negligence?

"Negligence is the omission to do something which a reasonable [director], guided upon those considerations which ordinarily regulate of human affairs, would do; or doing something which a prudent and reasonable [director] would not do." (4)

The 'reasonable director' objective standard is the minimum level of competence required to be exercised by all directors. In other words, bearing in mind the expected standard above, if you have additional general knowledge, skill and/or experience, the test to show that you were not negligent becomes harder to satisfy. Individuals who are appointed as a consequence of their skills and experience are therefore subject to a higher standard than other less skilled and experienced individuals. In summary, the more you know beyond what a reasonable director would need to know, the higher the standard you are accountable to. This does not mean that a director should strive for mediocrity. The Court will judge the director on the basis of a "snapshot" in time. In other words, it will ask itself what the director's experience, skill, general knowledge and expertise were at the time of the conduct complained of. And, where do you think it will begin its inquiry? In the off ering document of the mutual fund for which you acted as a director. Why? Because the qualifi cations and business experience of the directors of an open-ended investment fund amounts to material information that needs to be disclosed to prospective investors. As a result, directors should (have a duty to) ensure that that disclosure is accurate and in no way misleading. This should also not encourage directors to turn a blind eye to available company information, as this in and of itself, could amount to a breach of a director's fi duciary duty, in particular, the requirement to act with care and skill.

By way of example, in **Weavering** the Grand Court accepted that 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. However, they are expected to satisfy themselves (on a continuing basis) that the investment manager's strategy is fairly described in the off ering document and that the investment manager is complying with all of the investment criteria and restrictions that have been adopted by the fund.

1. If a director fails to satisfy themselves of the above to a reasonable standard, they are negligent; this is the **objective standard**.

2. If a director fails to satisfy themselves of the above to a reasonable standard, but notably had extensive investment management experience at the time, they might be grossly negligent (discussed below); this is the **subjective standard**.

The Cayman Islands courts are alive to the potential for a director's common law duties to be reduced to such a level so as to render them meaningless, which would certainly be the case if directors were not required to supervise and understand the investment manager's performance to a reasonable level. The term "irreducible core of responsibilities" is often mentioned when discussing director's duties; the duty to supervise and understand an investment manager's performance to a reasonable level appears to fall well within this "*irreducible core*" and we would advise directors to take heed of that duty.

What is gross negligence?

It is NOT something qualitatively different to 'mere' negligence. The difference is one of degree rather than of kind (5).

- The English Court considers it "*to represent something more fundamental than failure to exercise proper skill and/or care constituting negligence*"
- The Jersey Court considers it to be "*a serious or flagrant degree of negligence*" (6) or "*a serious, unusual and marked departure from that standard*" (7)

Gross negligence is not easily defined, and has been accused in the past of having a "somewhat sterile and semantic" meaning by the English Court of Appeal. Nevertheless, it is clearly an act which goes beyond mere incompetence, for example.

However, importantly, even the grossest negligence (whatever that might be) cannot amount to wilful neglect or default as decided by Cayman Islands Court of Appeal in **Weavering**:

"*to prove to the satisfaction of the court that a director made a deliberate and conscious decision to act or to fail to act in knowing breach of his duty: negligence, however gross, is not enough.*" (9)

Consequently, the directors in **Weavering** were therefore not found to be liable for wilful neglect or default, despite their extraordinarily negligent conduct, as they were adjudged to have not made a deliberate or conscious decision to act or to fail to act in breach of their duties. In any event, there was not enough positive evidence on the record to find them guilty of wilful neglect or default.

But if that is the case and remains the case, we are of the view that the Industry will not be capable of bearing the weight of director negligence for very much longer. To be forewarned is to be forearmed and it is in that spirit that we offer you, our valued clients, a checklist of practical steps that a director should take in order to avoid the pitfalls of gross negligence (10).

It might well be the case that the Industry chooses not to carve out exculpatory protection for gross negligence in the future. But, then again, in theory: anything's possible, or is it?

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