

Briefing Note 3rd October 2017

Directors' duties post-Carlyle

This note is for information purposes only and is not intended to be legal advice.

This is the first Briefing Note in our series arising out of the case of *Carlyle Capital Corporation Limited v Conway & Others* ("**Carlyle**"). Babbé LLP acted as lead counsel for the Defendants. All of the Plaintiffs' 187 claims were dismissed in a judgment given by the Guernsey Royal Court in September 2017.

This note outlines certain key legal principles set out in the *Carlyle* judgment relating to the duties of directors which provide important guidance to those involved with Guernsey companies

INTRODUCTION

Carlyle Capital Corporation Limited ("**CCC**") was a publicly-listed, closed-ended investment fund set up as a Guernsey company. A key part of its business model was to borrow money on a 30-day short-term basis in the repurchase ("**repo**") market and use such funds to purchase US residential mortgage backed securities. In March 2008, a liquidity crisis struck financial markets causing a massive contraction in repo financing. CCC was subject to margin calls which it could not meet and went into insolvent liquidation.

The liquidators of CCC brought claims against all of the individual directors and the investment manager, alleging various breaches of fiduciary duty, breaches

of the duty of skill and care and wrongful trading. They argued that CCC should have sold a substantial part of its portfolio ahead of this crisis and that failure to do so caused a significant loss.

The Court examined in detail the legal principles of the claims against the directors of CCC and dismissed all of the liquidators' claims - finding that the directors had fulfilled their duties and that, even if they had sought to sell a substantial proportion of CCC's assets, it could not be shown that CCC would have fared any better.

Among other things, the *Carlyle* judgment distinguished between a director's fiduciary duties (i.e. duties of loyalty that a director owes to the company by virtue of his or her position as director) and a director's duty of care (i.e. the general duty to exercise reasonable skill and diligence). Guernsey law now expressly endorses the distinction between a duty of loyalty and a duty of competence, rejecting the Plaintiffs' attempt to blur that distinction.

FIDUCIARY DUTIES

The Court confirmed that the core fiduciary duty of a director is one of *loyalty* and held that:

- this is the duty of the director to act in what he or she honestly considers to be the best interests of the company. This is a “subjective” duty. If the director honestly believes that he or she is acting in the company’s best interests, then the duty is discharged. That is so even if the relevant act was not in the company’s best interests viewed from an objective standpoint.
- this duty means that the best interests of the company must always be the central reason for the action taken by the director. A director’s action is not wrong just because it happens to benefit someone else as well as the company, but the company’s interests cannot simply be incidental or “conveniently arguable” reasons for the action.
- directors have a fiduciary duty to exercise their own independent judgment. Directors will fail in this duty if they merely do, or acquiesce unquestioningly in, what they are told by others. Directors must, at a minimum, oversee the company and keep themselves sufficiently informed to make their own decisions.
- the duty of directors to avoid actual or possible conflicts of interests is a fiduciary duty. This means avoiding conflicts between the company’s interests and the director’s personal interests, as well as avoiding conflicts between the duties owed to different principals of the company.
- directors have a fiduciary duty to act for “proper purposes” of the company. This fiduciary duty has an “objective” element, in that directors can breach the duty by violating the purposes of a company as set out in statute or the company’s memorandum and articles, even if they honestly believed that they were not doing so.

DUTY OF CARE

Unlike the fiduciary duties, the duty of care is an “objective” duty. A director can fail to exercise the standard of care required by law, even if the director honestly believes that he or she has acted with proper skill and diligence.

Establishing the director’s standard of care requires examining both subjective and objective elements. In *Carlyle*, the Court held that:

- the standard of care to which a director will be held is that of a reasonable person having both:
 - (i) the director’s knowledge, skill and experience; and
 - (ii) the knowledge, skill and experience that may be reasonably expected of someone with the director’s function.
- the following factors can be used to evaluate the level of diligence and skill reasonably expected of a director:
 - the role of the director in the governance and management structure of the company;

- the skill which the director has held himself or herself out as having;
 - the level of remuneration of the director; and
 - the size of the company and nature of the business.
- not every commercial misjudgement by directors constitutes a breach of the duty of skill and care. The Court must be satisfied that no reasonably diligent director with the applicable level of knowledge, skill and expertise would have acted as the director did.

In the *Carlyle* judgment, the Court held that the law does not lay down particular steps that a director must take to discharge the duty of care. Rather, the law sets a general standard against which the Court will examine the facts and circumstances of each case for evidence of whether appropriate diligence and skill was exercised. For example, in some circumstances a lack of minuted board meetings might be evidence of insufficient regard to the company's affairs, while in other circumstances the directors might diligently decide that other ways of sharing information and making decisions would be more efficient than a formal board meeting. Similarly, while there is no absolute rule on when a board should seek expert advice, the Court noted that in some circumstances directors taking and following expert advice could "go a long way" towards demonstrating that they were not in breach of a duty of care.

KEY POINTS TO NOTE

The *Carlyle* judgment:

- is the first Guernsey judgment that clearly distinguishes a director's fiduciary duties from a director's duty of care.
- sets out the fiduciary duty of loyalty as subjective, requiring that directors act in good faith with the best interests of the company being central to every decision they make.
- sets out the director's standard of care as that of a reasonable person having both:
 - (i) the director's knowledge, skill and experience; and
 - (ii) the knowledge, skill and experience reasonably expected of someone with the director's function.
- clarifies that the duty of care implies no universal rules or procedures for directors, but rather a standard to which directors must adhere in their particular circumstances.

For more information on this and any legal principles applicable to directors in Guernsey, please contact our Corporate or Dispute Resolution teams.