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DERIVATIVE SUITS

Recent New York Court of Appeals Decision Eases Path for Investor Lawsuits Against Cayman Funds, but Certain Hurdles Remain

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When an offshore fund investor sues in a U.S. court, the defendant may argue that certain claims must be brought derivatively on behalf of the fund, rather than directly by the investor. Cayman law, which frequently governs claims involving offshore hedge funds, presents a number of potential obstacles to derivative claims, however. Rule 12A of the Rules of the Grand Court of the Cayman Islands, for example, requires a plaintiff asserting a derivative claim to follow certain procedures to obtain that court's permission to proceed.

A number of defendants have recently argued, and some New York courts have held, that a plaintiff's failure to allege compliance with Rule 12A bars a derivative claim even in a U.S. court because without Cayman court permission, the plaintiff lacks standing to sue.[1] Prior to these New York decisions, a Massachusetts state trial court declined to apply Rule 12A, finding it was procedural and did not govern a proceeding in that court.[2]

In an opinion issued last month in Davis v. Scottish Re Group Ltd., the New York Court of Appeals decided this issue. While the decision does make it easier for a Cayman fund investor to sue in the U.S., it eliminates only one obstacle to derivative claims. Investors will continue to face significant hurdles when bringing claims against hedge fund managers and others.

This article outlines the trial court, Appellate Division and Court of Appeals decisions in Davis, as well as the implications for investors, funds and managers of the Court of Appeals' ultimate decision.

For more on derivative suits, see "Registered Fund Advisers Delegating to Subadvisers Gain Greater Flexibility From U.S. District Court Ruling to Charge Management Fees" (Mar. 16, 2017); and "Derivative Actions and Books and Records Demands Involving Hedge Funds" (Oct. 17, 2014).

The Trial Court and Appellate Division Decisions

The Davis case involves claims by Paul Davis, an individual owner of two types of securities issued by defendant Scottish Re Group (Scottish Re). Davis sued Scottish Re and a number of its corporate affiliates and directors, as well as certain majority holders of securities issued by Scottish Re and its affiliates. He sought recovery of damages resulting from several transactions, including a merger, multiple tender offers and a redemption of certain securities, as well as certain dividend payments.

Davis brought a variety of claims, including, most notably here, derivative claims against Scottish Re's directors for breach of fiduciary duty. On a motion to dismiss, the trial court concluded, over Davis' objection, that his claims were governed by Cayman law because they implicated the "internal affairs" of Scottish Re, of which Davis was a shareholder and which was a Cayman corporation.

The directors then argued that Davis lacked standing to sue under Cayman law because he had not complied with Rule 12A, which states in relevant part as follows:[3]

(2) Where a defendant in a derivative action has given notice of intention to defend, the plaintiff must apply to the Court for leave to continue the action.
(3) The application must be supported by an affidavit verifying the facts on which the claim and the entitlement to sue on behalf of the company are based.
(4) Unless the Court otherwise orders, the application must be issued within 21 days after the [date on which defendant gave its notice of intention to defend]. . . .

Davis argued that Rule 12A is procedural and therefore inapplicable to a case brought in a New York court.[4] In particular, he noted that the rule "is 'intended to govern claims pending in the Grand Court [of the Cayman Islands], and [is] therefore principally concerned with remedies rather than the existence of underlying rights.'"[5]

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Even if Rule 12A were applicable to a New York action, Davis argued that it was inapplicable to his lawsuit for two reasons. First, he argued that the rule expressly applies only to an action begun by filing a "writ," and none had been filed in his lawsuit. Second, along a similar vein, he argued that Rule 12A's requirement of an application to the Grand Court was triggered by the filing of a "notice of intention to defend," which is a unique document used only in that court – not in a New York court.[6]

The trial court rejected all of Davis' arguments and dismissed his derivative claims, noting that his "failure to comply with Rule 12A deprives him of standing" to pursue them.[7] The court held that Rule 12A is substantive, because noncompliance extinguishes the remedy of bringing a derivative claim on behalf of a Cayman corporation.[8] It also rejected Davis' arguments about the absence of a "writ" or a "notice of intention to defend" necessary to trigger the rule, finding that Davis could not fault the defendants for his own failure to commence the action by writ in Cayman or for their failure to complete paperwork not available in the New York forum.[9]

In a further discussion, which is arguably mere dictum in light of the initial determination that Davis lacked standing to bring derivative claims, the court went on to hold that his claims were also barred by Foss v. Harbottle.[10] Foss is an English case from the nineteenth century, which is followed by Cayman courts because they follow English common law where there is no Cayman authority on point.

The Foss case holds that a shareholder cannot bring a derivative action except where one of four exceptions applies – i.e., where the alleged wrong:

1. is ultra vires;
2. requires a special majority to ratify;
3. infringes the shareholder's personal rights; or
4. qualifies as a "fraud on the minority."[11]

The trial court held that none of these exceptions applied to Davis' derivative claims and cited Foss as an independent basis to dismiss them.[12] For more on Foss, see "In What Circumstances May Hedge Fund Investors Bring Proceedings in the Name of the Fund for a Wrong Committed Against the Fund, When Those in Control of It Refuse to Do So?" (Jan. 17, 2013).

Davis appealed the trial court's decision on the motion to dismiss to the Appellate Division, First Department. That court affirmed the dismissal of the derivative claims on the same basis as the trial court, noting that "plaintiff does not even allege that he attempted to comply with the Grand Court Rule."[13] The court also decided certain other issues not relevant to Davis' derivative claims.

The Court of Appeals Decision

Davis obtained leave to appeal the Appellate Division's decision on the derivative claims only, which was granted. At the argument[14] before the Court of Appeals in October 2017, much of the questioning of the defendants' counsel focused on the practical aspects of how a New York proceeding would work if a plaintiff did obtain leave of the Cayman court under Rule 12A, as well as how the interests of the Cayman Islands would be furthered by the Court's decision.

The Court of Appeals reversed, holding that Rule 12A is procedural and does not apply to a derivative claim brought in a New York court. It remitted the case to the Appellate Division for a determination as to whether Davis has standing under Foss to bring a derivative claim.

Davis Only Partially Clears the Way for Plaintiffs

The Davis decision removes one significant hurdle to investor claims involving Cayman funds that had gained traction in recent years. The decision does not, however, remove the potentially more serious obstacle presented by Foss, which generally bars derivative claims by shareholders in entities formed in many English-law-based jurisdictions, including Cayman. The rationale of the rule is one of standing, namely, that the "proper plaintiff" for such claims is the entity, not its shareholders.

There are a number of ways for a plaintiff to try to avoid the Foss rule. One is to allege facts that will bring the case within one of the four exceptions.[15] As of the publication date of this article, there are several reported decisions by U.S. courts applying "the rule in Foss v. Harbottle" in the context of a Cayman entity.[16] In only one reported case has the court held that the plaintiff successfully alleged that one of the four exceptions to that rule applied and denied a motion to dismiss a derivative claim under Cayman law.[17] Plaintiffs fare equally poorly where the applicable law comes from a jurisdiction other than Cayman where the law is based on English law.[18] In none of these cases did the plaintiff successfully state a derivative claim.

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Another option is to seek recovery through a direct – i.e., non-derivative – claim. Such a claim can be challenging to plead, however, because the investor must be able to allege that it was harmed not merely because it was a shareholder in a fund that was harmed, but rather that the investor was harmed in a way that can be distinguished from any harm to the fund and all of its investors, which can be a rare circumstance. For example, in the case of a claim for breach of fiduciary duty, any duties may be owed to the fund as a whole, not to individual fund investors. Therefore, they cannot be the basis for a direct claim, although there are exceptions in which a direct claim can be pleaded.[19] That said, even a direct claim may have to navigate the so-called "reflective loss" rule, which can preclude a direct claim seeking damages that result from a diminution in the value of shares in an entity governed by Cayman, Bermuda or British Virgin Islands (BVI) law.[20]

A plaintiff may also avoid the Foss rule by bringing a claim that is governed by the law of a jurisdiction, such as New York, that does not apply English law. In particular, New York law allows shareholder derivative claims (subject to certain requirements) and generally can be more receptive to finding that a shareholder's claim is direct.

While investors can take some heart from the Court of Appeals' rejection of an application to the Cayman court as a prerequisite to a derivative claim in a New York court, the Davis decision does not remove the Foss rule as a significant obstacle to derivative claims governed by Cayman law (as well as other English-law-based legal regimes). Conversely, managers of Cayman funds should not be overly troubled by Davis, because it does not affect existing legal protections that can preclude many investor claims.

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[1] See, e.g., *Davis v. Scottish Re Group Ltd.*, Index No. 654027/2013, 2014 N.Y. Slip Op. 51898(U), at *14 (Sup. Ct. N.Y. Cnty. Oct. 14, 2014); and *Arc Capital LLC v. Kalra,* Index No. 652931/2012, 2013 WL 3072008, at *4-5 (Sup. Ct. N.Y. Cnty. Jun. 18, 2013).

[2] See *Hayat v. Al-Mazeedi,* No. 08-1004, 2011 WL 1532109, at *10 (Mass. Super. Jan. 10, 2011) (declining "to engraft an 'application to continue' procedure, à la Cayman O.15, R. 12A, onto its proceedings in this case," because "the courts of the forum will follow our own procedural rules, absent any indication that the parties shaped their conduct with reference to the rules of another jurisdiction, or that the difference in procedure is likely to be outcome-determinative").

[3] Order 15, Rule 12A, of the Grand Court Rules of the Cayman Islands, quoted in *Davis v. Scottish Re Group Ltd.*, Index No. 654027/2013, 2014 N.Y. Slip Op. 51898(U), at *14 (Sup. Ct. N.Y. Cnty. 2014).

[4] See id.

[5] See id.

[6] See id.

[7] See id.

[8] See id.

[9] See id.

[10] 2 Hare 461, 67 Eng. Rep. 461 (Ch. 1843). See id. at *15.

[11] See id.

[12] See id.

[13] See *Davis v. Scottish Re Group Ltd.,* 138 A.D.3d 230, 238 (1st Dep't 2016).

[14] Video footage of the oral arguments can be found at https://www.youtube.com/watch?v=wzojxO0gBoY

[15] There is some suggestion that there is a fifth "interests of justice" exception, although there do not appear to be any reported cases finding it applicable in a context relevant to hedge fund or other investors.

[16] See, e.g., *In re Harbinger Capital Partners Funds Investor Litig.,* No. 12 Civ. 1244 (AJN), 2013 WL 5441754, at *21-22 (S.D.N.Y. Sep. 30, 2013) (investor in Cayman fund lacked standing); *Shenwick v. Ruby Fund, L.P.,* Index No. 652082/2011, 2012 WL 8700419 (N.Y. Sup. Ct. (N.Y. Cnty.) Jun. 5, 2012) (similar), aff'd, 106 A.D.3d 638 (1st Dep't 2013); *CMIA Partners Equity Ltd. v. O'Neill,* Index No. 603622/2009, 2010 N.Y. Slip Op. 52068(U), at *5-8 (Sup. Ct. (N.Y. Cnty.) Nov. 22, 2010) (similar); *Feiner Family Trust v. VBI Corp.,* No. 07 Civ. 1914 (RPP), 2007 WL 2615448, at *4-6 (S.D.N.Y. Sep. 11, 2007) (similar); and *Winn v. Schafer,* 499 F. Supp. 2d 390, 396-98 (S.D.N.Y. 2007) (similar). See also *Varga v. McGraw Hill Fin., Inc.,* 147 A.D.3d 480, 481 (1st Dep't 2017) (liquidator of Cayman fund lacked standing to assert derivative claims).

[17] See *Cannonball Fund, Ltd.* v. *Dutchess Capital Mgmt., LLC,* 84 Mass. App. Ct. 75, 93-95 (2013) (investor successfully alleged that "fraud on the minority" exception applied).

[18] See, e.g., *Saratoga Advantage Trust Tech. & Commc'ns Portfolio v. Marvell Tech. Group, Ltd.,* Case No. 15-cv-04881-RMW, 2016 WL 4364593, at *3-5 (N.D. Cal. Aug. 16, 2016) (applying Bermuda law and finding plaintiff failed to satisfy any of three Foss exceptions it claimed were applicable); *Erie Cnty. Employees Retirement Sys. v. Isenberg,* Civil Action No. H-11-4052, 2012 WL 3100463, at *3-7 (S.D. Tex. Jul. 30, 2012) (similar); *Seghers v. Thompson,* No. 06-CIV-308 (RMB) (KNF), 2006 WL 2807203, at *4-5 (S.D.N.Y. Sep. 27, 2006) (applying BVI law and finding *Foss* exceptions not applicable); and *Tomran, Inc. v. Passano,* 159 Md. App. 706, 724-35 (2004) (applying Irish law and finding allegations did not support application of "fraud on the minority" exception).

[19] See, e.g., *Public Sector Pension Inv. Bd. v. Saba Capital Mgmt., L.P.,* Index No. 653216/2015, 2016 WL 469642, at *5 (N.Y. Sup. Ct. (N.Y. Cnty.) Feb. 8, 2016) (breach of fiduciary duty claim stated where all shareholders were subject to alleged improper valuation of their shares, but only redeeming shareholders such as plaintiff suffered "tangible harm").

[20] See, e.g., *In re Kingate Mgmt. Ltd. Litig.,* No. 09-CV-5386 (DAB), 2016 WL 5339538, at *39 (S.D.N.Y. Sep. 21, 2016) (applying Bermuda and BVI law).