Breach of Duty by Director of a Cayman fund – The path to investor relief in the Cayman Islands vs New York

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Liquidation – the most complete path to relief

One distinctive feature of Weavering Macro Fixed Income Fund Ltd v Peterson 2011 (2) CILR 203 is that the claims against the directors were brought by the liquidators of a fund in liquidation. Where the circumstances exist for a shareholders’ winding up, liquidation provides the most complete path to recovery of compensation for the fund, and if solvent, its investors, for the breaches of duties owed to it by its directors and service providers.

Liquidators can pursue all claims which the fund could itself have pursued as a going concern. These include claims for breaches of fiduciary duties, as well as the breaches of the duty to exercise reasonable skill, care and diligence. Liquidators also have the power to pursue statutory claims which individual investors cannot pursue, such as voidable preference claims and claims to set aside fraudulent transfers at an undervalue.

In addition, liquidators have special statutory powers to require directors and fund service providers, such as investment managers and administrators, to produce information and documents which could reveal previously unidentified claims.

When liquidation is not the best option

Winding up a fund is, however, not always seen as a viable option. A shareholders’ winding up petition is usually presented on the just and equitable ground that the fund has ‘lost its sub-stratum’, said to be established where, for example, it has become impractical or impossible for the fund to achieve its investment objectives (In re Belmont Asset Based Lending Limited 2010 (1) CILR 83); the fund has permanently suspended redemptions and subscriptions (In re Wyser-Oratt Eurovalue Fund Limited 2010 (2) CILR 194); or, there has been a justifiable loss of confidence in the directors (In re Freerider Ltd 2010 (1) CILR 486).

Even where a winding up order is made, consideration has to be given to whether there are sufficient assets to fund the fees and expenses of the liquidators, over and above the costs of pursuing claims.

There may also be legitimate reasons why investors prefer to pursue claims in places like New York against the fund’s directors and management, without sounding the death knell of liquidation: the fund may still be a viable going concern and the majority of investors may not be prepared to support a liquidation. The targets of the litigation are very often located and carry on business in New York and may have significant assets there. The investor may have viable personal claims with which derivative claims on behalf of the fund may be conveniently joined. The underlying transactions, the location of the witnesses and documentary evidence may make New York a more natural and appropriate forum for the resolution of the dispute.

Personal claim or derivative claim?

The typical investor complaint sets out a range of allegations against the fund’s directors and manager. Examples of such claims include misrepresentation in the promotional documents; breaches of the
subscription agreement; breaches of shareholder or class rights, including rights of redemption; a fundamental departure from the fund’s investment objectives; breaches of fiduciary duties; and/or negligence. It is not always clear in the complaint whether the claims are being pursued as personal claims by the investor, or as derivative claims on behalf of the fund. Claims based on breaches of fiduciary duties and negligence are almost invariably claims properly belonging to the fund, and not the individual shareholder investor, and may only be pursued by the individual shareholder investor as a derivative claim on behalf of the fund.

**The derivative claim**

Most US jurisdictions apply the ‘internal affairs doctrine’ under which the internal affairs of a corporation, including the question as to who has standing to bring an action on its behalf, are governed by the law of the place of incorporation. Usually without much controversy, US courts will apply Cayman Islands law to determine which investor claims are properly personal claims, and which are, in effect, derivative claims, and if derivative, whether the claim is sustainable. If a derivative claim is not sustainable as a matter of Cayman Islands law, by prevailing and widely accepted principles, it will not be sustainable as a matter of New York law.

**The rule in Foss v Harbottle**

The general rule, derived from the rule in *Foss v Harbottle* [1843] 2 Hare 461, is that the proper plaintiff in an action to recover loss arising from a breach of duty owed to a company is the company itself. This principle has been accepted by several US courts as representing the law of the Cayman Islands on this issue: eg see *Shenwick v HM Ruby Fund, LP et al*[ref], citing *City of Harper Woods Empls’ Retirement Sys. V Oliver, 577 F Supp 2d 124, 131 [Dist DC 2008]*, affd 589 F3d 1292 [DC Cir 2009]; *CMIA Partners Equity Ltd v O’Neill, 29 Misc 3d 1228 (A), 2010 NY Slip Op 52068 [U].

Underpinning the rule is the principle that the court will not interfere with the internal management of a company. The proper organ of the company to institute legal action is the board of directors, and the directors’ failure or refusal to bring an action is usually a matter which can be ratified or overruled by a simple majority of the company in general meeting.

**Exceptions to the rule in Foss v Harbottle**

The rule in *Foss v Harbottle* does however contain a few limited exceptions:

- **Ultra Vires**
  
  At common law, the majority shareholders of a company have no capacity to ratify acts which are *ultra vires* the company. Further, by section 28 of the Cayman Islands’ Companies Law (2013 Revision), an individual shareholder may bring an action to prohibit the company from disposing of property where the company is acting *ultra vires*.
  
  In effect, in light of the standard terms of the memorandum of association of a fund, an act is only likely to be *ultra vires* if it is illegal under Cayman Islands law. The scope for an investor coming within this exception is extremely narrow.

- **Special Majority Required**
  
  A derivative claim may be allowed if the wrongful act complained of may only be ratified by a special majority of the company in general meeting. The usual rule which prevents the court from intervening would not apply in such circumstances unless the company has in fact convened a general meeting and obtained the required special majority to ratify the act.

- **Fraud on the Minority**
  
  Finally, a derivative action is sustainable if there has been a ‘fraud on the minority’ and the wrongdoers are in control of a majority of the voting power.

This last exception is the one most commonly invoked in investor complaints. It comprises two separate elements, both required to exist together – ‘fraud’; and wrongdoer control.

**Fraud**

‘Fraud’ does not require an allegation or evidence of actual fraud, (in other words, dishonesty), on the part of the directors. It is however accepted that there must be some element of self-dealing or the deriving of some wrongful benefit by the alleged wrongdoers.
This might be established by evidence showing, for example, that: the wrongdoers made a concealed profit from the sale of company property; or diverted business from the company to another in which they are interested; or fraudulently misappropriated corporate property.

An allegation of mere negligence, even gross negligence, without the added element of self-dealing will be insufficient. The receipt of management fees under the investment management agreement is usually not by itself sufficient.

This requirement was accepted as necessary by Justice Melvin L. Schweitzer in the New York State Supreme Court in Shenwick v HM Ruby Fund, LP (supra).

Wrongdoer control

The plaintiff must also show that the wrongdoers are in control of the company. Control in this sense means that they possess the majority of the voting rights.

There is usually no difficulty where the directors themselves control the voting power. Very often the directors do not. In many Cayman Islands funds the shares are divided into management shares and participating shares. The management shares, which control all the voting power in the fund, are usually held by the manager or an affiliate. The investors are usually issued participating shares, which carry the right to participate in the assets in a liquidation, but no voting power.

In such circumstances the complaint must show that the directors are among the wrongdoers and are therefore unlikely to institute action against themselves or, if a general meeting were called, the investment manager or its affiliate, also being among the wrongdoers, will use their voting power to prevent the fund from instituting action.

Under Cayman Islands law, unlike the ‘demand futility’ requirement in a number of US states, there is no requirement that the investor actually requested the board to institute a claim or to convene a meeting. Evidence of voting control by the alleged wrongdoers is sufficient: Renova Resources Private Equity Ltd v Gilbertson [2009] CILR 268.

In some instances voting control is said to be constituted by virtue of a proxy given by each investor to the investment manager in their subscription agreement. This issue has not been specifically considered as a matter of Cayman Islands law, but Justice Schweitzer in Shenwick v HM Ruby Fund has expressed the view that revocable proxies granted to the investment manager at the time of subscription would be sufficient to establish the manager’s voting control.

Is there a requirement that investors first obtain leave of Cayman court?

In the Cayman Islands, Order 15 rule 12A of the Grand Court Rules provides that in every derivative action, after the defendants have served notice of intention to defend, the plaintiff must file an application for leave to continue the action. This rule was introduced in 1995 to codify a requirement at common law that the court in all cases must determine as a preliminary issue the question whether a derivative action should proceed to trial.

On an Order 15 rule 12A application the plaintiff must adduce affidavit evidence which establishes on a prima facie basis that, as a matter of substance, the case falls within one of the exceptions to the rule in Foss v Harbottle. See per Foster, J. in Renova Resources (supra).

This requirement has given rise to a debate as to whether this is a substantive, or merely procedural, requirement. If substantive, then it appears that a New York court would have to be satisfied that the investor plaintiff, before instituting his claim in New York, had first sought and obtained leave of the Cayman Islands court.

This is the accepted position with respect to a derivative claim on behalf of a BVI company, where by section 184C of the Business Companies Act, a derivative action on behalf of a BVI company may not be brought by a shareholder except with leave of the BVI court.

Courts in the BVI (Microsoft Corporation v Vadem BVICVP 2013/007(Eastern Caribbean Court of Appeal)), California (Vaughan v LJ Int'l Inc. 4 Cal Rptr 3d 166 (Cal Ct App)) and Delaware (Microsoft Corp v Vadem CIVA 6940-VCP (Del Ch 27 April 2012)) have accepted that this is a substantive requirement of BVI
law which goes to the question whether the plaintiff has standing to commence a derivative claim, whether within or outside the BVI.

There is no similar consistency of approach with respect to the Cayman Islands requirement in Order 15 rule 12A. In *Abdulmohsen Hayat v Wael Al-Mazeedi* 28 Mass L Rep 23 (MA 2011), the Superior Court of Massachusetts regarded the Cayman requirement for an application to continue the proceedings as part of the procedural rules of the Cayman court, and refused to conduct its own application to continue procedure, as the defendant argued was a requirement in Massachusetts.

In *ARC Capital, LLC v Karla* No 652931/2012, 2013 NY Misc. LEXIS 2600, the New York State Supreme Court held that Order 15 rule 12A is a substantive, rather than a procedural rule, ‘because the underlying remedy is extinguished if Plaintiff fails to file an application to continue – that is, it “envelopes both the right and the remedy”’ (citing *Tanges v Heidelberg N. Am.*, 93 NY 2d 48, 54 (1999)).

If that position is correct as a matter of New York law, then, as held in *ARC Capital*, failure to seek leave in Cayman would be fatal to an investor derivative action brought in New York. The Court in *ARC Capital* did not appear to have given any consideration to the fact that such a position could effectively bar all derivative claims on behalf of Cayman funds in New York.

The requirement in the Cayman Islands is for an application for ‘leave to continue’ substantive proceedings already commenced in the Cayman Islands. Under the rule, the application must be made not only after the claim has been filed, but after the defendant has filed a notice of intention to defend. Compare this to the BVI requirement under the statute for an application for leave ‘to bring’ proceedings.

There is some doubt whether the Cayman court would entertain such applications only as a prerequisite for an investor pursuing a claim in New York, with the result that actions brought merely to seek leave to continue could, under Cayman Islands’ procedural rules, be deemed an abuse of process. It would therefore be difficult to envisage the circumstances in which, if that position is correct, an investor would be able to pursue a New York derivative claim.

**Conclusion**

From this vantage point the window for an investor claim in New York to seek remedies for breaches of duties owed to the fund is quite narrow, and is getting even narrower. Not only is the threshold for such claims quite high (including the requirement to prove self-dealing or wrongful benefit), but the likely remedies available may be limited, for example there is no ability to recover damages for mere negligence, or to claw back preferential or fraudulently undervalued transfers.

Despite the perceived benefits of a New York based action, the likelihood of such a claim being struck out for not satisfying the requirements of Cayman Islands law is very high. Pursuing such claims through liquidators appointed in Cayman Islands winding up proceedings is not only a far more efficient and complete means by which to seek such relief, it may well be the only realistic and viable path to ensuring that investors are compensated to the full extent possible for the defalcations of the fund’s directors and service providers.

*Please click here to see our update on this matter.*
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