

UPDATE

Is it the end of the road for NY derivative claims against Cayman companies? Whether GCR Order 15, rule 12A is a substantive or procedural requirement

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A recent decision of the Appellate Division of the New York Supreme Court, First Department, has now confirmed whether the Order 15, rule 12A requirement is substantive or procedural. In *Davis v Scottish Re Group Ltd*, the court held that a minority shareholder's claims against directors and majority shareholders of a Cayman reinsurance company were barred under Cayman Islands law. The New York appellate court has, for the first time, recognised the rule requiring plaintiffs asserting derivative claims under Cayman law to first obtain leave of the Cayman courts.

The rule in *Foss v Harbottle*: a recap

In our previous guide, '[Breach of Duty by Director of a Cayman fund – The path to investor relief in the Cayman Islands vs New York](#)', we set out the circumstances in which investors can seek relief against the directors of a Cayman fund. Claims based upon breaches of fiduciary duties by and the negligence of directors are almost invariably claims properly belonging to the fund, and not the individual shareholder investor. Such claims may only be pursued by the individual shareholder investor as a derivative claim on behalf of the fund.

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 according to accepted Cayman Islands principles, it will not be sustainable as a matter of New York law.

The general rule, derived from the rule in *Foss v Harbottle*¹ 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. The rule in *Foss v Harbottle* does, however, contain a few limited exceptions in relation to acts which are *ultra vires* the company, where a special majority is required to ratify an act, or where there has been a fraud on the minority.

The requirement under GCR Order 15, rule 12A for leave to continue the action

In the Cayman Islands, Order 15, rule 12A of the Grand Court Rules provides that in every derivative action, after the defendants have served a 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 of whether a derivative action should proceed to trial.

¹ [1843] 2 Hare 46.

On an Order 15, rule 12A application, the plaintiff must adduce affidavit evidence which establishes *prima facie* 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 Private Equity Ltd v Gilbertson*.²

Is the requirement substantive or procedural?

The Order 15, rule 12A requirement has precipitated a debate as to whether it 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. Pursuant to section 184C of the Business Companies Act 2004 (as amended), a derivative action on behalf of a BVI company may not be brought by a shareholder except with leave of the BVI court. BVI courts have accepted that this is a substantive requirement of BVI law which determines whether the plaintiff has standing to commence a derivative claim, whether within or outside the BVI.³

There is no similar approach with respect to the Cayman Islands requirement in Order 15, rule 12A. In *Abdumohsen Hayat v Wael Al-Mazeed*⁴ 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*⁵ 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*).⁶

Recent decision of the Appellate Division of the New York Supreme Court in *Davis v Scottish Re Group Ltd*

A recent decision of the Appellate Division of the New York Supreme Court, First Department, has now confirmed whether the Order 15, rule 12A requirement is substantive or procedural. In *Davis v Scottish Re Group Ltd (Scottish Re)*, the court held that a minority shareholder's claims against directors and majority shareholders of a Cayman reinsurance company were barred under Cayman Islands law. The New York appellate court has, for the first time, recognised the rule requiring plaintiffs asserting derivative claims under Cayman law to first obtain leave of the Cayman courts.

Scottish Re is a reinsurance company incorporated in the Cayman Islands. In January 2011, the majority shareholders of the company acquired all of its outstanding ordinary shares in a merger transaction that was approved by both the board and shareholders. Shareholders received a 76 per cent premium on the pink sheet trading value of their shares. Plaintiff Paul Davis was a significant holder of Scottish Re ordinary and preferred shares. In November 2013, Davis filed a complaint containing 10 causes of action, including two claims for breach of fiduciary duty against the Scottish Re directors and majority shareholders.

The directors and majority shareholders moved to dismiss Davis' fiduciary duty claims on the grounds that they were actually derivative claims, which, under Cayman law, Davis lacked standing to assert. In support, the defendants cited Order 15, rule 12A of the Grand Court Rules and argued that rule 12A is a substantive rule with which Davis was required to comply before bringing his claims in New York.

There was no dispute over whether Davis had sought leave of the Cayman court to assert his derivative claims – he had not. Rather, Davis argued that he was not required to seek leave because the fiduciary duty

² [2009] CILR 268.

³ *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).

⁴ 28 Mass L Rep 23 (MA 2011).

⁵ No 652931/2012, 2013 NY Misc. LEXIS 2600.

⁶ 93 NY 2d 48, 54 (1999).

claims were direct, not derivative, and because Order 15, rule 12A of the Grand Court Rules is procedural, not substantive. The Supreme Court, New York County disagreed, holding that the claims were, in fact, derivative, and that Davis lacked standing to assert his derivative claims because he had not sought leave of the Cayman courts, pursuant to rule 12A. Davis appealed.

Considering the issue for the first time, the Appellate Division, First Department, agreed with the lower court and rejected Davis' argument on the basis that because a Cayman derivative action is extinguished if a plaintiff fails to comply with rule 12A, it is a substantive rule with which the plaintiff had failed to comply.

Conclusion

Given the position has now been confirmed by the Appellate Division of the New York Supreme Court, as a matter of New York law, failure to seek leave in Cayman will be fatal to an investor derivative action brought in New York.

According to the GCR, the applicant must seek 'leave to continue' substantive proceedings already commenced in the Cayman Islands. 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).

However, there is some doubt whether the Cayman court would entertain such applications only as a pre-requisite 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.

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