The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation

Schulte Roth & Zabel

www.hflawreport.com Volume 6, Number 3 January 17, 2013

Derivative Suits

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?

By Christopher Russell, David Butler, Michael Swartz and Daniel Cohen

The evolution of the law relating to corporations, and in particular the doctrine of the company as a separate legal person, presented a risk from the earliest times that minority investors might be left without a remedy if those in control of the company breached their trusts or duties and destroyed the value of that investment through mismanagement, self-dealing or other misconduct. The risk of losing one's investment in circumstances where there has been corporate wrongdoing has not abated, and in today's hedge fund universe, the likelihood is that the shareholder will have invested a very substantial amount of capital for a minority position in a fund, the majority of whose directors and whose investment manager and other service providers are based in another country. There are over 10,000 registered Mutual Funds in the Cayman Islands alone, many of which are directed and managed out of New York or Delaware.

In response to the concern that there is no remedy for the shareholder for such wrongs, many jurisdictions have sought to implement the procedural device of the derivative action as a means of affording substantive relief to investors. Wherever they are brought, derivative actions have a common theme and a universal aim: the theme is that shareholders are not being heard and cannot take action themselves; the aim is to restore value to the company in which they have invested. The mechanics for providing this substantive relief vary across the different jurisdictions. This article compares the mechanics of how hedge fund investors may pursue derivative actions in three different jurisdictions: the Cayman Islands, Delaware and New York.

Overview of the Historical Development of Shareholder Derivative Action

The modern limited liability incorporated company is one of the great lungs through which modern commerce and investment breathe. Its origins lie in the English trade expansion in the sixteenth century, although the principle of limited liability is far older, dating back at least as far as Roman law. Such a company is a creation of law and, under Cayman and English law, it is a legal person in its own right, separate and distinct from its shareholders and its directors or other administrators.[1]

As a distinct legal entity, a company has its own assets, liabilities, rights and duties. Shareholders will have such right of control over internal regulation, and such right of participation in the assets of the company in a dissolution as may be prescribed by its charter and by law: shareholders have no title to or interest in the assets of the company and, in the case of a limited liability company, limited by shares or guarantee, their exposure is limited to any unpaid call on their shares, or by the limit of their guarantee (unless the court is willing to disregard the separate legal status of the company, by piercing its veil of incorporation, which it may do, for example to prevent or redress fraud or other wrongdoing, or to untangle hopelessly intertwined group assets, which will be rare).

It follows that the right to sue for redress for a wrong done to the company is itself an asset of the company, and a right

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

exercisable only by the company, through its appointed internal management (in practice, its directors or, in liquidation, its liquidators). This is the well-known so-called first rule set out in the nineteenth century English case of *Foss v. Harbottle*.[2] The rule has been adopted and applied in the Cayman Islands.[3] It is a rule of common law, and although many jurisdictions now provide a statutory derivative process (e.g., the U.K., Canada, Australia, New Zealand, Singapore, Hong Kong and the U.S., as set forth below), Cayman law does not, although its Rules of Court provide a procedure for a common law derivative claim. New York and Delaware, however, have both adopted statutory derivative remedies.[4] It is not always clear in the jurisdictions that do provide a statutory derivative remedy whether the common law remedy still subsists alongside it. It may be thought that a statutory remedy is intended to supersede the common law remedy and that for both to co-exist is needless, and a source of complication and confusion.

The rationale for the first rule in *Foss v. Harbottle* has been expressed in a variety of ways, for example, in *Edwards v. Halliwell*,[5] in which the English Court of Appeal (Jenkins L.J.) said:

> (1) The proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is, prima facie, the corporation. (2) Where the alleged wrong is a transaction which might be made binding on the corporation and all its members by a simple majority of the members, no individual member of the corporation is allowed to maintain an action in respect of that matter because, if the majority confirms the transaction, cadit quaestio;[[6]] . . . or, if the majority challenges the transaction, there is no valid reason why the company should not sue. (3) There is no room for the operation of the rule if the alleged wrong is ultra vires the corporation, because the majority of members cannot confirm the transaction. (4) There is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority. (5) There is an exception to the rule in which what has been done amounts to a fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders' action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue.

In *Prudential Assurance Ltd. v. Newman Industries Ltd* (No. 2),[7] it was said:

> [The rule in *Foss v. Harbottle*] is not merely a tiresome procedural obstacle placed in the path of a shareholder by a legalistic judiciary. The rule is the consequence of the fact that a corporation is a separate legal entity. Other consequences are limited liability and limited rights. The company is liable for its contracts and torts; the shareholder has no such liability. The company acquires causes of action for breaches of contract and for torts which damage the company. No cause of action vests in the shareholder.

The rule gives rise to no difficulty where a wrong is committed against the company, and those within the

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT The definitive source of actionable intelligence on hedge fund law and regulation

Schulte Roth & Zabel

company are in a position to bring, and do bring, proceedings in its name. But an obvious mischief will arise where those in control of the company, for their own purposes, whether to protect themselves from being sued by the company where they have perpetrated the wrong, or for some other self-serving reason, refuse to bring the proceedings. Where it is the directors who seek to stifle the claim, one remedy might be to seek to remove the directors from office, and appoint others who will act in the interest of the company, rather than their own interests. But this may be illusory – removal proceedings are complex, and gathering requisite shareholder support can be difficult if, as in Cayman, the identity of other shareholders is not readily ascertainable, if at all; also if the voting shares are held by those who support the directors in the stifling of the claim (including the directors themselves who might have majority control of the company).

Absent some procedural mechanism to enable shareholders to circumvent the improper stifling of a claim by those in control of the company, the wrong committed against the company will go unremedied. The potential for mischief was described in terms of typical eloquence by Lord Denning in the English Court of Appeal case of *Wallersteiner v. Moir* (No. 2):[8]

> But suppose [the company] is defrauded by insiders who control its affairs – by directors who hold a majority of the shares – who then can sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorize the proceedings to be taken by the company against themselves. If a general meeting is called, they will vote down any suggestion that the company should sue them themselves. Yet the company is the one person who is damnified. It is the person who should sue. In one way or another some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress.

In *Foss v. Harbottle* itself, the Judge spotted the problem, and suggested a solution. He thought that the company could sue in the name of someone whom the law has appointed to be its representative. A claim could be brought by individual shareholders in their private character, seeking protection of those rights to which, in their corporate character, they were entitled.

This is the origin of what is now known by its U.S. name of the derivative action. The suggestion of the Judge in *Foss v. Harbottle* was picked up and elaborated in the later nineteenth century English case of *Atwool v. Merryweather*,[9] and the practice developed of disgruntled shareholders seeking the leave of the court to bring proceedings in the name of the company, as its court appointed representatives: the proceedings remained, as they are today, the bringing of the company's claim, on its behalf, and the proceeds of which inure to the benefit of the company.

Shareholders may become disgruntled for any number of reasons, some good, some bad: it was for this reason that leave of the court was required in order to prevent the issuing of hopeless claims or those brought in bad faith. But this useful filter did not survive, and derivative claims could be freely issued and continued without court permission. A defendant facing a hopeless or improper derivative claim had only two options: either to apply to strike out (or move to dismiss) the claim (which posed its own difficulties because, in such an application, the court would assume the truth of the alleged

©2013 The Hedge Fund Law Report. All rights reserved.

wrongdoing) or to challenge the shareholder's right to bring a derivative action. Neither was satisfactory. In *Prudential*,[10] a solution was found to lie in requiring the shareholder, in whichever course he adopted, to prove a prima facie case of both. This was later adopted by English Rules of Court, by requiring the shareholder to seek the permission of the court to continue (not to issue) a derivative claim, and the "prima facie" test continued to be the relevant criterion. Cayman Rules of Court[11] lay down a required procedure for derivative actions, including the requirement for leave of the court to continue such an action. The test to be applied by the Cayman Court in considering whether to give leave was put by the Judge in the following terms in *Renova*:[12]

> For the plaintiff to obtain leave to continue with the action, I consider that I must be satisfied, in the exercise of my discretion, that its case is not spurious or unfounded, that it is a serious as opposed to a speculative case, that it is a case brought bona fide on reasonable grounds and in the interests of the company and that it is sufficiently strong to justify granting leave for the action to continue rather than dismissing it at this preliminary stage.

In the sections that follow, we consider the different jurisdictional and substantive tests that shareholders must meet in order to pursue derivative actions in the Cayman Islands, Delaware and New York.

Cayman Islands Derivative Actions: Essential Requirements

The Shareholder Must Show "Fraud on a Minority"

The principle of allowing a derivative action to continue in the context of redressing a wrong done to a company that is being stifled by those in control of it is regarded as falling within the third category of exception to the *Foss v. Harbottle* rule, viz, "fraud on a minority." There are two other exceptions: (1) when the act complained of is ultra vires (beyond the powers) of the company, and (2) where the act complained of can be ratified only by more than a simple majority of shareholders (fraud in the sense of dishonesty cannot be ratified).

Elements of "Fraud on the Minority" Under Cayman Islands Law

For the fraud on a minority exception to apply, the shareholder bringing the derivative claim must show: (1) "fraud," within the meaning of the exception, and (2) control by the wrongdoers. "Fraud" is not limited to dishonesty, but embraces conduct which benefit the wrongdoers. In the Cayman Islands case of *Schultz v. Reynolds*,[13] it was said:

> Thus the authorities show that the exception applies not only where the allegation is that directors who control a company have improperly appropriated to themselves money, property or advantages which belong to the company or, in breach of their duty to the company, diverted business to themselves which ought to have been given to the company, but more generally where it is alleged that directors were acting "in the belief that they were doing nothing wrong" (per Lord Lindley, M.R. in Alexander v Automatic Telephone Co. [1900] 2 Ch. 56 at 65), are guilty of a breach of duty to the company (including their duty to exercise proper care) and as a result of that breach obtain some benefit . . . . On the other hand, the exception does not apply if all that is alleged is that directors who control a company are liable to the company for damages for negligence, it not being shown that they have in fact obtained any benefit from it.

©2013 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth & Zabel

www.hflawreport.com Volume 6, Number 3 January 17, 2013

A further example of "fraud" was given in *Prudential*,[14] where interested voting shareholders used their voting power to stultify proceedings being brought against them.

The Plaintiff Must Be a Shareholder

A derivative action may be brought only by a registered shareholder of the company, and not by an underlying beneficial owner. In the case of a double or multiple derivative action, the plaintiff must be a shareholder in the parent company.[15] English law, however, does permit a beneficial owner of shares to bring such an action in certain circumstances.[16]

The Shareholder Must Establish Self-Interest or Self-Dealing

Some element of self-interest or self-dealing must be shown to establish "fraud" in this context. This was exemplified in graphic terms in the English case of *Pavlides v. Jensen*,[17] in which it was held that although the directors were an "amiable set of lunatics," they derived no benefit from their activities, and accordingly a derivative claim could not be allowed to continue.

The Shareholder Must Establish the Board Is Improperly Preventing the Shareholder from Bringing the Legal Claims

Control will, in essence, be found where the wrongdoers form a majority of the directors or the voting shareholders, and are in a position to stifle the bringing of proceedings. But control is not the only issue when the court comes to consider whether leave should be given to continue a derivative action. The fundamental question is whether the plaintiff shareholder is being improperly prevented from bringing the proceedings.[18] If the plaintiff is being prevented by the expression of the corporate will of the company through its designated organ (e.g., the directors), that is, untainted by self-interest, then the plaintiff is being prevented properly.[19] There is, however, now a divergence between Cayman law and English law – in *Airey v. Cordell*,[20] the English Court held that the appropriate test is whether it would have been reasonable for an independent Board of Directors to bring the proceedings. However, in *Renova*,[21] the Cayman Court held that the test of the hypothetical Board of Directors propounded in *Airey v. Cordell* did not represent Cayman law, and in consequence the court may consider the actual views of independent directors.

The Shareholder Must Establish that the Proceedings Are Brought in Good Faith

There is one further hurdle: the plaintiff shareholder, in bringing the proceedings, must be acting in good faith in doing so, and acting in the best interests of the company; he must not be acting from some collateral and improper purpose, which will be regarded as an abuse of process.[22] This is the mirror image of the requirement to show self-interest on the part of those in control of the company. The plaintiff-shareholder may also be disqualified in equity from appearing as plaintiff on the company's behalf, for example, if he participated in the wrong of which he complains.

New York and Delaware Requirements for Bringing Shareholder Derivative Claims

In New York and Delaware, the procedure for bringing a derivative action for harm to the corporation requires the shareholder to meet the shareholder status requirement, satisfy the contemporaneous ownership rule and adequately represent the class of shareholders. Each of the three threshold requirements is discussed below. If the three requirements are met, the shareholder must then make a pre-

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

suit demand on the company's Board of Directors to bring the suit, unless, like under the *Foss* rule, such a demand is excused.

Although in both states the shareholder may step in the shoes of the company to bring suit against third parties, derivative suits are more typically brought by shareholders against directors when the corporation fails to bring suit. Such suits include those charging waste of corporate assets, mismanagement and the failure to bring suit against others when warranted.[23]

Eligible Shareholder Status Requirement

In order to meet the eligible shareholder status test in New York, the shareholder must hold shares or voting trust certificates of the corporation, or have a beneficial interest in such shares or certificates.[24] In Delaware, unlike with voting, dividend payments and appraisal proceedings, where shareholder status is determined by being a registered shareholder, a shareholder need not be registered to bring a derivative action. Rather, Delaware applies an "equitable interest test" to determine shareholder status, which permits an individual with an equitable interest in the stock to bring a derivative claim.[25]

Contemporaneous Ownership Rule

In both Delaware and New York, in addition to meeting the shareholder status requirement, the plaintiff must meet the contemporaneous ownership rule, which requires the plaintiff to be a shareholder at the time of the alleged wrong and continue to be a shareholder while the suit is pending. Thus, a derivative action cannot be maintained by someone who has transferred or lost title to his or her stock, or by a shareholder who obtained the shares after the alleged injury.[26]
The contemporaneous ownership rule was developed to prevent strike suits brought by shareholders who obtained shares after the alleged misconduct occurred. In any event, this rule should not serve a bar to suit to the typical fund investor that seeks to take action for corporate wrongs engaged in after the investment was made, so long as the shares are still held by the investor through the time of suit.

"Adequate Representation" Requirement

Shareholders who brings suit in a derivative action must fairly and adequately represent shareholder interests.[27] Courts are sensitive to any conflict of interest between the named derivative plaintiff and similarly situated shareholders because the plaintiff is bringing suit in a representative capacity. This test may prevent a shareholder from bringing a derivative action solely to gain advantages that are not shared by the shareholders as a class, such as advancing the shareholder's interest as a hostile bidder in a tender offer.

In Delaware, the plaintiff must have a true interest in the case and show that he or she is likely to pursue it with vigor on behalf of the corporation and the other shareholders. The burden is on the defendant to establish that the proposed plaintiff is an inadequate representative, by showing "that a serious conflict of interests exists . . . and that the plaintiff cannot be expected to act in the interests of other [shareholders] because doing so would harm" his or her interest.[28] Such interests include plaintiff's economic ones.[29]

"A plaintiff in a stockholder derivative suit will not be disqualified simply because he may have interests which go beyond the interests of the class and, as long as the plaintiff's interests are coextensive with the class, his representation of the class will not be proscribed."[30] Thus, a shareholder may be an adequate representative to bring a derivative suit,

©2013 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

even if the shareholder previously demonstrated "severe economic antagonisms" to other shareholders by allegedly engaging in greenmail and demonstrating interest only in short term profits or where the plaintiff has shown "extreme vindictiveness" toward the defendants in prosecuting the action, so long as the court is satisfied that the shareholder can and will carry out its fiduciary duties as a representative shareholder.[31] In those instances, among others, the requirement that the court approve any settlement provides protections to the other shareholders.[32]

Pre-Suit Demand Requirement

Once the shareholder has demonstrated that he or she meets the qualified shareholder status, satisfies the contemporaneous ownership rule and adequately represents the class, the shareholder must meet the "demand requirement," which requires the shareholder to make a pre-suit demand on the company's Board of Directors to bring the suit itself, or allege demand futility because the Board of Directors was unable to consider the matter in an impartial fashion.[33] The demand requirement applies only to derivative actions brought to remedy harm applicable to all shareholders; it does not apply to direct actions brought by shareholders to remedy a special injury or one not applicable to all shareholders.[34] The distinction between direct and derivative claims can be critical to the shareholder's ability to bring suit because the Board's rejection of a pre-suit demand is, as discussed below, generally subject to the business judgment rule. Thus, a properly considered and rejected shareholder demand can stop a derivative suit dead in its tracks. By contrast, a shareholder may bring a direct suit whenever it wishes, regardless of the business judgment of the company.

The demand requirement was designed for derivative actions for three reasons: It "relieve[s] the courts from deciding matters of internal corporate governance by providing the directors with an opportunity to correct alleged abuses"; it provides Boards of Directors "with reasonable protection from harassment" on matters that are within their discretion; and it discourages shareholder abuse by limiting the possibility of derivative actions being "commenced by shareholders for personal gain rather than for the benefits of the corporation."[35]

The demand requirement can be traced back to the opinion of the U.S. Supreme Court in 1882 in *Hawes v. Oakland*,[36] which required the plaintiff shareholder to demonstrate to the court that he has made an earnest effort and "exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes."[37] The purpose of the demand requirement is "to give a corporation the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise."[38]

If the Board of Directors, after considering the shareholder's demand, votes to initiate the legal action requested by the shareholder in the demand, the subsequent legal action is no longer "derivative" because the litigation is then conducted by the corporation and in its name. However, if the Board of Directors rejects the pre-suit demand, either expressly through statements and declarations or impliedly through inaction in pursuing the lawsuit, the plaintiff may file a derivative action on behalf of the company if the plaintiff can show that the Board of Directors' decision was wrong.

The wrongful refusal rule, as it is known, presumes that the Board's decisions were made pursuant to the standard set forth in the business judgment rule unless the shareholders can establish reasonable doubt that the majority of the Board was not disinterested and independent when rejecting the pre-suit demand, that the Board lacked good faith, that the

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

Board acted without due care in rejecting the demand or the rejection was not in the best interest of the company.[39]

Exceptions to the Pre-Suit Demand Rule

Delaware and New York both provide exceptions to the pre-suit demand rule where the shareholder can demonstrate that making a pre-suit demand would have been futile.[40] In New York, a demand is considered futile if the complaint alleges with particularity that (1) the majority of directors were "interested in the challenged transaction" (either through self-interest in the transaction or a loss of independence because the director was "controlled" by a self-interested director), (2) the directors failed to inform themselves about the transaction to a degree reasonably appropriate or (3) "the challenged transaction was so egregious on its face that it could not have been the product of the sound business judgment of the directors."[41] Simply naming a majority of directors as defendants in a lawsuit, without particularized allegations of self-interest in the transaction, does not excuse demand.[42]

In Delaware, two different tests, known as the *Aronson* test and the *Rales* test, are applied to determine excuse demand due to futility. The *Aronson* test is applied in cases challenging a Board's action. The *Rales* test is applied in cases of action challenging the Board's failure to act.

The *Aronson* test for demonstrating demand futility consists of two prongs, and if either prong is satisfied, the shareholder is not required to meet the demand requirement. The first prong asks whether the shareholder raised reasonable doubt that a majority of the directors who approved the transaction in question were disinterested and independent. The second prong requires the shareholder to raise a reasonable doubt that the transaction was the product of the Board's informed business judgment.[43]

Under the *Rales* test, applicable where the subject of the suit is not a business decision of the Board, the pre-suit demand requirement is excused only if the shareholder can, through particularized allegations, "create a reasonable doubt that, as of the time the complaint [was] filed, the Board of Directors could have properly exercised its independent and disinterested judgment in responding to a demand."[44] Under this test, demand is excused only if the plaintiff can show a "substantial likelihood" that a majority of the Board will be personally liable.[45] A heavy burden is placed on the shareholder here because the shareholder must show that the conduct of the directors was so egregious that Board approval cannot meet the business judgment test and a substantial likelihood exists that the director will be liable for any losses caused to the company by their actions.[46] As in New York, the mere threat of personal liability is not enough to render a director disinterested.[47]

Making a demand on the Board of Directors can waive the shareholder's right to claim that a demand would have been futile.[48] In Delaware, such a demand is deemed an acknowledgment by the shareholder that the Board was capable of acting independently.[49] A demand, however, does not concede the Board's independence absolutely and for all purposes related to the demand. As set forth above, the shareholder may still claim that the demand was wrongfully refused.[50]

Awarding the Cost of Litigation in the Cayman Islands, New York and Delaware

In the Cayman Islands, as regard the costs incurred by the plaintiff shareholder in bringing a derivative action, in addition to any costs which the defendant may be ordered to pay, the court may award the shareholder's costs to be paid out of the company's assets to the plaintiff shareholder on the indemnity basis, as the benefit of the action enures to the company.

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

In New York, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees.[51] However, the right to counsel's fees and expenses lie with the discretion of the court.[52]

Delaware Courts have held that that plaintiff's counsel is entitled to a fee for obtaining monetary and significant non-monetary benefits for a company, including corporate governance reform. Moreover, Delaware law recognizes a shareholder's right to recover attorneys' fees based on corrective action taken in response to a demand, but without the necessity of filing any complaint.[53] The reasoning is that the benefit to the corporation is the same, regardless of whether suit is brought.

Double Derivative Actions

"Double" or "multiple" derivative actions under which a parent or ultimate holding company may sue for a wrong committed against a subsidiary or sub-subsidiary company, are recognized in Cayman,[54] essentially following the law of many states in the U.S.[55] The mischief addressed by derivative actions arises just as much where the wrongdoers, through control of the parent company, control the subsidiary damaged by their wrongdoing, as it does where they damage the parent company itself.

New York and Delaware also both recognize double derivative actions, permitting shareholders of a parent corporation in New York and Delaware to bring a shareholders' derivative action for wrongs inflicted upon that corporation's subsidiaries.[56] In Delaware, in order to maintain a double derivative claim, a demand must be made on the Board of Directors of the parent company. A separate claim on the subsidiary is not required because the parent company supposedly has total control of the legal rights of the subsidiary.[57]

Choice of Law in Derivative Actions Involving a Foreign Corporation

If a derivative action is brought by a shareholder of a Cayman fund in another jurisdiction (e.g., the U.S.), the question will arise: Which law – Cayman or the foreign law – should apply? In *Waddington Ltd. v. Chan Chun Hoo Thomas*,[58] a case decided by the Hong Kong Final Court of Appeal, the view was expressed that the question whether a derivative action was available at all to a shareholder was to be determined by reference to the law of the jurisdiction in which the company was incorporated, and the question whether leave was required to continue such an action was a procedural matter, to be determined in accordance with the law of the jurisdiction in which the action was taking place.

The law is slightly different in New York and Delaware. Both recognize the "internal affairs" doctrine pursuant to which the law of the state of incorporation applies to the governing of the internal affairs of the company. That doctrine recognizes that corporations are creatures of state law and that shareholders associate themselves with corporations with the expectations that their rights and obligations will be governed by the law of the state of incorporation. Both states regard pre-suit demand as an issue of substantive law. Thus, both states apply the law of the state of incorporation to determine if a stockholder asserting derivative claims has satisfied the demand requirement.[59]

The Cayman Islands, New York and Delaware All Recognize the Representative Capacity in which a Shareholder Litigates a Derivative Action

It is always essential to bear in mind that, in a derivative action, the plaintiff shareholder is bringing the action in the name of the company for losses that the company itself has

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

sustained or restoration of the company's assets, and not for loss suffered by the shareholder through diminution in the value of his shareholding, or otherwise. Such a claim by the shareholder for his own loss sustained through a wrong committed against the company may in any event be barred by the reflective loss principle, under which a shareholder has no cause of action for loss in the value of his shares which merely mirrors the loss sustained by the company, and in respect of which the company itself has a cause of action (whether or not it pursues that cause of action); if both the company and the shareholder could sue, the shareholder would recover twice – once through damages recovered in his own action, and secondly through the increase in the value of his shareholding through recovery of damages by the company.[60] But the principle is not engaged if the company has no cause of action, or if the shareholder has suffered some loss separate and distinct from that suffered by the company, for example, other than diminution in the value of the shareholding or other benefit from the company. In those circumstances, there is no risk of double recovery. The principle is not limited to the avoidance of double recovery, and includes respecting corporate autonomy, and avoiding recovery by one shareholder at the expense of creditors and other shareholders.

New York and Delaware also recognize that the company remains the real plaintiff in shareholder derivative claims, and the shareholder serves as an agent of the company.[61] Thus, if a company decides to sue in its own right, shareholders cannot also bring a derivative action alleging the same claims. As discussed above, a shareholder is not precluded from bringing a direct claim for a breach of duty if the company has an independent duty to the shareholder.[62]

Limited Partners' Right to Bring Derivative Actions

Until recently, it was not clear whether limited partners of an English limited partnership could bring derivative claims on behalf of a general partner who, in his own self-interest, refuses to bring proceedings, but it would have been surprising had this not been the case. A partnership is fundamentally different from a company, and limited partners should be able to sue the general partner directly for breach of duty owed to them,[63] and should also be able to sue in the name of the general partner where the general partner itself refuses to commence the proceedings, whereas ordinarily shareholders cannot sue the directors of their company because directors owe duties to the company, not to its shareholders.[64] The point has been considered recently by the English High Court,[65] which held that the limited partners of a limited partnership were entitled to commence proceedings derivatively in the name of the general partner against the manager of the general partnership, although the price for such action was that the limited partners lost their limited liability for the duration of the litigation as by litigating they were taking part in the management of the firm.[66]

The position in Cayman is much clearer than in England, and far more generous to limited partners. Under the current version of the Exempted Limited Partnership Law, limited partners are afforded an express right by section 13 to commence actions on behalf of the exempted limited partnership in the name of the general partner where the general partner refuses to do so without good cause. This is a lesser test to overcome than the one which the English Court identified in *Henderson*. Moreover, section 7(3) of the Exempted Limited Partnership Law makes clear that bringing a derivative action does not of itself compromise the

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

continuing limited liability of the limited partner bringing the derivative action on behalf of the partnership.

In New York and Delaware, both of which jurisdictions have adopted the Revised Uniform Limited Partnership Act, derivative actions by limited partners on behalf of the partnership operate in much the same way as corporate derivative suits do. Limited partnership derivative suits are authorized by statute, and incorporate many of the same requirements involved in shareholder derivative suits.[67] For instance, limited partners seeking to bring a derivative claim must do so to vindicate the partnership's rights, rather than their own,[68] and they must meet the statutory standing requirements to do so.[69] Further, the limited partners must demonstrate that they made a demand for action on the general partner and that the demand was rebuffed,[70] or else they must show demand futility.[71]

Chris Russell is a Partner in the Litigation and Insolvency Department of Appleby Cayman, and David Butler is a senior Associate in the Department. Michael Swartz is a Partner and Daniel Cohen is an Associate at Schulte Roth & Zabel LLP, New York.

[1] *Salomon v. Salomon* (A) & Co. Ltd. [1897] A.C. 22, recognized and applied in the Cayman Islands. See, e.g., *Cayman Hotel and Gulf Incorporated v. Resort Gems Ltd.* [1992-3] C.I.L.R. 372.

[2] [1843] 2 Hare 461.

[3] See, e.g., *Svanstrom v. Jonasson* [1997] C.I.L.R. 192; and *Renova Resources Private Equity Ltd. v. Gilbertson* [2009] C.I.L.R. 268.

[4] N.Y. Bus. Corp. Law § 626; Del. Code tit. 12, § 3816.

[5] [1950] 2 All E.R. 1066.

[6] That is, "That is the end of the matter."

[7] [1982] Ch. 724.

[8] [1975] Q.B. 373.

[9] (1867-8) L R 5 Eq. 464.

[10] See note 7 above.

[11] Grand Court Rules, Order 15, rule 12 (A).

[12] See note 3 above.

[13] [1992-3] C.I.L.R. 59.

[14] See note 7 above.

[15] *Svanstrom v. Jonasson*.

[16] *Mohammad Jafari – Fini v. Skillglass Ltd.*, [2004] EWHC 3353; and see note 20, below.

[17] [1956] Ch. 565.

[18] *Smith v. Croft*, (No. 2) [1988] Ch. 114.

[19] Id.

[20] [2007] B.C.C. 785.

[21] See note 3 above.

[22] *Goldsmith v. Sperrings Ltd.*, [1977] I WLR 478; and *Iesini v. Westrip Holdings Ltd* [2010] B.C.C. 420.

[23] Although available to hedge fund investors, this process is driven largely by plaintiff lawyers who seek qualified shareholder representatives through advertisements posted on the Internet. Although some such suits have been shown to have merit, they have become so prevalent in the U.S. – regardless of whether there appears to be any real issue of concern to shareholders – that many companies have come to accept them, with great regret, as an expected cost of doing business

[24] N.Y. Bus. Corp. Law § 626(a).

[25] *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1176 (Del. 1988); *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106, 113 (Del. Ch. 1948).

[26] See N.Y. Bus. Corp. Law § 626(b); Del. Code tit. 12, § 3816(b). There are exceptions to the contemporaneous

©2013 The Hedge Fund Law Report. All rights reserved.

ownership rule. For example, under the continuing wrong doctrine, the contemporaneous ownership requirement does not apply if the alleged wrong was continuing at the time the shareholder purchased his shares, despite the fact that the alleged wrong commenced at a prior date. *Schreiber v. Bryan*, 396 A.2d 512, 156 (Del. Ch. 1978); *Ripley v. Int'l Rys. of Cent. Am.*, 8 A.D.2d 310, 324 (N.Y. App. Div. 1st Dept. 1959).

[27] *Youngman v. Tahmoush*, 457 A.2d 376, 379 (Del. Ch. 1983); *Steinberg v. Steinberg*, 434 N.Y.S.2d 877, 878 (N.Y. Sup. Ct. 1980).

[28] *Emerald Partners. v. Berlin*, 564 A.2d 670, 674 (Del. Ch.1989); see also *Schneider v. Austin*, 94 F.R.D. 44, 46 n.1 (S.D.N.Y. 1982).

[29] *Youngman v. Tahmoush*, 457 A. 2d 376, 381 (Del. Ch. 1983).

[30] *Emerald Partners*, 564 A.2d at 674.

[31] See id. at 673-75.

[32] Id. at 675; N.Y. Bus. Corp. Law § 626(d).

[33] Fed. R. Civ. P. 23.1; N.Y. Bus. Corp. Law § 626(c); Del. Code tit. 12, § 3816(c).

[34] See, e.g., *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996) (overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000)) ("To pursue a direct action, the stockholder-plaintiff must allege more than an injury resulting from a wrong to the corporation. The plaintiff must state a claim for an injury which is separate and distinct from that suffered by other shareholders . . . or a wrong involving a contractual right of a shareholder . . . which exists independently of any right of the corporation.") (alteration in original; citations and internal quotation marks omitted). See also *Inre Stillwater Capital Partners Inc. Litig.*, 851 F. Supp. 2d 556, 567-68 (S.D.N.Y. 2012). Direct actions include inadequate disclosures in connection with a shareholder votes, dilution and violation of minority shareholder rights. Actions are more likely to be considered direct where the relief sought is injunctive or prospective, as opposed to monetary damages.

[35] *Marx v. Akers*, 666 N.E.2d 1034, 88 N.Y.2d 189, 194 (N.Y. 1996).

[36] 104 U.S. 450 (1881).

[37] Id. at 460-61.

[38] *Aronson v. Lewis*, 473 A.3d 805, 809 (Del. 1984) (overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000)).

[39] See *Grimes*, 673 A.2d at 1219; *Aronson*,473 A.2dat 814. For its part, New York rejects the "reasonable doubt" aspect of the inquiry. See *Akers*, 88 N.Y.2d at 198. Boards of Directors sometimes form independent or special committees of disinterred directors when considering shareholder demands so that, in the event the demand is rejected, the rejection is subject to the business judgment rule.

[40] See generally *Akers*, 666 N.E.2d 1034 (describing both Delaware and New York's approach to demand futility).

[41] Id. at 200-01.

[42] Id. at 199-200.

[43] *Aronson*, 473 A.2d at 814.

[44] *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

[45] Id. at 936; *Inre Baxter Int'l Inc. Shareholders Litig.*, 654 A.2d 1268, 1269 (Del. Ch. 1995).

[46] See *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995).

[47] Id.

[48] *Scattered Corp. v. Chicago Stock Exchange, Inc.*, 701 A.2d 70, 74 (Del. 1997) (overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000)).

[49] Id.

[50] *Grimes*, 673 A.3d at 1219 ("If there is reason to doubt

©2013 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 6, Number 3 January 17, 2013

that the board acted independently or with due care in responding to the demand, the stockholder may have the basis ex post to claim wrongful refusal. The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, *ex ante*, if the demand had been excused as futile.") (citation omitted); *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 273 N.Y.S. 2d 16, 25 (N.Y. Sup. Ct. 1966).

[51] N.Y. Bus. Corp. Law § 626(e).

[52] Id.; c.f. *Cent. Laborers' Pension Fund ex rel. Goldman Sachs Grp., Inc. v. Blankfein*, 931 N.Y.S.2d 835, 843 (N.Y. Sup. Ct. 2011).

[53]*Bird v. Lida*, 681 A.2d 399, 405 (Del. Ch. 1996).

[54] The claim in *Renova* was allowed to proceed on the basis that it was a multiple derivative action, although this was not strictly speaking the correct analysis.

[55] See, e.g., *Brown v. Tenney*, 532 N.E.2d 230, 235 (Ill. 1988); *Holmes v. Camp*, 180 A.D. 409, 411 (N.Y. 1917). English law currently allows double, but not, it appears, multiple, derivative actions.

[56] *Overmyer v. Todd*, 431 N.E.2d 971, 971 (N.Y. 1981); *Lambrecht v. O'Neal*, 3 A.3d 277, 281 (Del. 2010).

[57] See *Inre Merrill Lynch & Co. Inc., Sec., Derivative & ERISA Litig.*, 773 F. Supp. 2d 330, 338-39 (S.D.N.Y. 2011).

[58] [2009] 2 BCLC 82 (Hong Kong Final Court of Appeal).

[59] See *Hart v. Gen. Motors Corp.*, 129 A.D.2d 179, 182 (N.Y. App. Div. 1st Dept. 1987); *Levine v. Milton*, 219 A.2d 145, 147 (Del. Ch. 1966).

[60] *Johnson v. Gore Wood & Co.*, [2002] 2 A.C. 1.

[61] See *Lehrman v. Godchaux Sugars*, 138 N.Y.S. 164, 166 (N.Y. Sup. Ct. 1955); *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1264 (Del. 2012).

[62] See *Theriault*, 51 A.3d at 1264; *Yudell v. Gilberg*, 99 A.D.3d 108, 114 (N.Y. App. Div. 1st Dept. 2012).

[63] This is the law in Canada. See *Skye Properties v. Wu* [2008] OJ 4349 (Superior Court of Ontario).

[64] Although there are cases where it has been held that the directors have assumed a responsibility to the shareholders. See *Peskin v Anderson* [2001] 1 BCLC 372 for a useful summary of the relevant principles.

[65/*Certain limited partners in Henderson PFI Secondary Fund II LP (a firm) v Henderson PFI Secondary Fund LP (a firm) and others* [2012] EWHC 3259 (Comm).

[66] It is understood that the determination of this question is likely to the subject of an appeal.

[67] SeeDel. Code tit. 6, §§ 17-1001 et seq.; N.Y. P'ship Law §§ 121-1002 et seq.

[68] See *Cialeo v. Mehlman*, 210 A.D.2d 67, 67-68 (N.Y. App. Div. 1st Dept. 1994).

[69] Del. Code tit. 6 § 1002.

[70] See *Seaford Funding Ltd. P'ship v. M & M Associates II, L.P.*, 672 A.2d 66, 70 (Del. Ch. 1995) ("This Court has already ruled corporate standards apply to limited partnerships in the 'demand excused' analysis.").

[71] *Litman v. Prudential-Bache Props.*, Inc., 1993 WL 5922 (Del. Ch. 1993) (unpublished).

©2013 The Hedge Fund Law Report. All rights reserved.