



Legal Briefings

Derivative Claims in the Cayman Islands

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Introduction

In this Briefing Note, we provide a brief overview of the principles governing derivative actions in the Cayman Islands, both in a company and in a limited partnership setting.

What is a derivative action?

A derivative action is one commenced by one or more minority shareholders on behalf of a company of which they are member in respect of loss or damage which that company has suffered. Such a claim can only be brought in certain circumstances and amounts to an exception to the rule that a company, as a separate legal person, should sue and be sued in its own name (often referred to as the rule in Foss v Harbottle (1843), 2 Hare 461; 67 E.R. 189). The circumstances in which such a claim may be brought were set out by Jenkins, L.J., in Edwards v Halliwell [1950] 2 All E.R. 1064:

“It has been further pointed out that where what has been done amounts to what is generally called in these cases a fraud on the minority and the wrongdoers are themselves in control of the company, the rule [in Foss v Harbottle] is relaxed in favour of the aggrieved minority who are allowed to bring what is known as 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.”

The true nature of a derivative claim is often misunderstood. In the leading case on such actions in the Cayman Islands, Renova Resources Private Equity Limited [2009] CILR 268, at p. 275, Foster, J cited the explanation of such actions offered by Professor Gower in *Modern Company Law*, 3rd ed. (1969), at 587:

“Where such an action is allowed, the member is not really suing on his own behalf nor on behalf of the members generally, but on behalf of the company itself. Although (...) he will have to frame his action as a representative one on behalf of himself and all the members other than the wrongdoers, this gives a misleading impression of what really occurs. The plaintiff shareholder is not acting as a representative of other shareholders, but as a representative of the company (...) In the United States (...) this type of action has been given the distinctive name of a “derivative

action,” recognising that its true nature is that the individual sues on behalf of the company to enforce rights derived from it.”

How to commence a derivative claim

Derivative claims, as with the majority of actions commenced in the Cayman Islands, are normally begun by serving a writ and statement of claim on the relevant defendant or defendants. Grand Court Rules O.15, r.12A provides that where a defendant gives notice of an intention to defend the claim, then the plaintiff must apply to the Court for leave to continue the action. Such an application should be supported by affidavit evidence verifying the facts on which the claim and entitlement to sue on behalf of the company are based. The same must be issued within 21 days of the later of (a) the date of service of the statement of claim; or (b) the date when notice of an intention to defend was given. Further, the application, together with the affidavit evidence in support and any exhibits, must be served on the defendant or defendants not less than 10 clear days before the date for the hearing of the application (known as the return date). Where the plaintiff does not meet this deadline, the defendant may apply for the dismissal of the action.

The hearing of the application

Pursuant to Grand Court Rules O.15 r.12A(8) on the hearing of the application, the Court may grant leave to continue the action for such period and upon such terms as it thinks fit, dismiss the action, or adjourn the application and give such direction as to joinder of parties, the filing of further evidence, discovery, cross-examination of deponents and otherwise as it considers expedient.

In Renova Resources Private Equity Limited, Foster, J., affirmed the application in the Cayman Islands of the test to be applied in determining whether to grant leave to continue the action put forward by the English Court of Appeal in Prudential Assur. Co. Ltd v Newman Indus. Ltd (No. 2) [1981] Ch. 257. Foster, J., held that:

“(...)there are two elements to this: first the plaintiff [is] required to show prima facie that there [is] a viable cause of action vested in the company and, secondly, that the alleged wrongdoers [have] control of the company (or could block any resolution of the company or the board) and thereby prevent the company bringing an action against themselves.”

The Judge further held that (at p. 283):

“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, on behalf of 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.”

Foster, J., ruled that in order to satisfy the Court in the above terms it was necessary for the plaintiff to do more than show the absence of the grounds required for a strike-out in the ordinary course of litigation. However, the Court should not look to hold a mini-trial of the issues. Instead, the Court should form a view based on its first impressions, having regard to its assessment of all of the evidence before it, including any evidence submitted by the defendant.

The First and Fifth Defendants in *Renova Resources Private Equity Limited* had sought to argue based on the English authority *Airey v Cordell* [2007] Bus. L.R. that the Court needed to go further and consider whether a hypothetical independent board acting reasonably would have brought the claim and proceeded with the case. After considering the authorities in the area, Foster, J., concluded that such a question was only relevant where the shareholder in question sought an indemnity for his costs from the company on whose behalf the action was being taken.

Multiple derivative actions

In *Renova Resources Private Equity Limited* the Grand Court held that in appropriate circumstances multiple derivative actions would be permitted. In that case the plaintiff had brought an action in respect of loss incurred by a wholly-owned subsidiary of the company in which it was a shareholder and therefore loss to the subsidiary caused indirect loss to its parent company and shareholders. However, the rule against recovery of reflective loss applied such that a shareholder or parent company would not be permitted to claim for indirect losses which mirrored those losses suffered directly by the relevant subsidiary or indeed sub-sub-subsidiary on whose behalf the action was being brought.

Derivative actions against third parties in a foreign jurisdiction

In *Top Jet Enterprises Limited v Sino Jet Holding Ltd and Jet Midwest Incorporated* [2018] CILR 18 the Grand Court held that a shareholder of a Cayman Islands company does not require leave from the Cayman courts (pursuant to Grand Court Rules O.15 r.12A(2)) to pursue a derivative action in a foreign jurisdiction and identified circumstances where an aggrieved shareholder may bring an action against a third party. It was held in that case that, if it can be shown that (i) the matter at hand falls within an exception to the rule in *Foss v Harbottle* allowing a minority shareholder to sue in the name of the company, and (ii) the third party is either “a party or accessory to or closely associated with the conduct which gives rise to the fraud on the minority”, then a derivative claim against a third party may be permissible.

Derivative actions in limited partnerships

In a recent decision by the Cayman Islands Court of Appeal in *Kuwait Ports Authority & Ors v. Port Link GP Ltd & Ors* (CICA (Civil) Appeal Nos. 002 & 003 of 2022, 20 January 2023), the Court of Appeal was asked for the first time to deal with the issue of derivative claims brought by a limited partner on behalf of an exempted limited partnership pursuant to section 33(3) of the Exempted Limited Partnership Act (2021 Revision) (the “ELP Act”) which provides that limited partners may bring an action on behalf of an exempted limited partnership if any one or more of the general partners with authority to do so have, without cause, failed or refused to institute proceedings.

The Court of Appeal’s judgment involved decisions on two separate matters: (i) direct claims brought by limited partners against the general partner, and (ii) derivative claims brought by limited partners both against the general partner and third parties. For the purposes of this note, we will focus on the latter.

As regards the derivative claims brought against the general partner, these were not successful for two main reasons. Firstly, the limited partnership in the case at hand had not suffered any loss or damage and therefore the limited partnership did not have a claim of its own to bring, which in turn meant that the limited partners could not bring a claim derivatively. Secondly, the claims were struck out due to the fact that the limited partners had an adequate alternative remedy in the form of a direct claim against the general partner such that a derivative action was not necessary.

With respect to the derivative claims brought against third parties, the Court of Appeal decided in the limited partners' favour as it was found that the general partner was under a relevant inhibition due to a conflict of interest which meant that the general partner had, without cause, failed to institute proceedings within the meaning of section 33(3) of the ELP Act and it therefore justified the limited partners' ability to bring a derivative claim in the circumstances.

This judgment will no doubt be of interest to all of those private equity investors and/or venture capitalists who have, or are looking to, set up their investment vehicle in the Cayman Islands by way of the established GP-LP structure.

For more information relating to derivative claims and/or shareholder/partner disputes more in general, please contact a member of the team at Loeb Smith.

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About Loeb Smith Attorneys

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