

Hedge Fund Investors and Minority Shareholders' Litigation Remedies Under Cayman Law

This article first appeared in the December 2010/January 2011 edition of The Hedge Fund Journal



BY GRAEME HALKERSTON AND KATIE BROWN

Recent market turbulence has focused attention on shareholder remedies under Cayman law. In the hedge fund context, this is particularly important as the key relationship of an investor to a fund is as a direct or indirect shareholder.

The remedies available to shareholders will be of concern to hedge fund managers for two reasons. First, managers will be concerned to minimize their own exposure to claims by investors. Second, they may themselves stand in the position of investor if the funds under their management have invested in further funds, and may need to consider pursuing these remedies on behalf of the investor funds if they are experiencing difficulties with the underlying investments.

Direct shareholder claims

The good news for managers concerned about their own exposure is that, despite recent developments in this area, Cayman law has taken a conservative approach to extension of remedies for a disgruntled investor to get a claim up and running against hedge fund management. This is because, under Cayman law, directors generally owe fiduciary duties to the

company and shareholders as a general class, but not to individual shareholders.

There are exceptions to this rule, where duties can be owed to individual shareholders, but these are usually limited to closely-held companies and are not typically relevant in the hedge fund context. The scope for direct claims is further limited by the fact that such claims must be brought to recover the shareholder's personal loss. A decrease in the value of shares caused by a wrong done to the company is not actionable by a shareholder, as his loss is considered "reflective" of loss suffered by the company, which is the proper plaintiff in such a case.

Derivative claims

Given the limits on direct claims, in many cases if a fund investor wishes to bring a claim he will have to do so by way of a derivative action. A derivative action enables a shareholder to bring a claim on behalf of the company for a wrong done to the company.

The Grand Court Rules provide that, if the defendant gives notification that it intends to defend the claim, the shareholder must apply to court for permission to

continue the claim. This is intended as a procedural filter, to stop frivolous claims proceeding. At that stage the shareholder must show that he has a prima facie case, both regarding the merits of the action, and that he falls within one of the established categories of claim which are allowed to be brought in a derivative capacity. The most commonly-used category is that there has been a fraud on the minority shareholders and the wrongdoers are in control of the company.

Recent case law has confirmed that Cayman law will recognise “double derivative” claims, meaning a shareholder in company A, which holds shares in company B, can bring a derivative action on behalf of company B. This is important in Cayman investment structures which often involve chains of companies between investors and the ultimate asset management vehicle.

If a breach of fiduciary duty is threatened (i.e. the managers of the fund are about to do something which the investors believe will be detrimental to the fund, such as disposing of an asset at an undervalue) then investors may be able to apply for an injunction to prevent the fund from proceeding with this course of action. The investor would have to show that there was a claim which was not frivolous or vexatious, and that the balance of convenience favoured granting the injunction (for example, because the damage which investors would suffer if the injunction was not granted would be greater than the damage which would be suffered if it was granted). Practically speaking, the court will be reluctant to grant such an injunction unless there are very good grounds for doing so, as doing so will be contrary to the general principle that it is for management, not investors, to conduct the fund’s business.

Winding-up

An unhappy investor may also consider petitioning the Court to wind up the fund on the ground that it is just and equitable to do so. The Court has recently confirmed that this remedy should be sought as a last resort. However, the recent cases have confirmed that in appropriate cases the Court is willing to take a commercial approach to assist investors in failing funds.

Once a winding-up petition has been presented, any disposal of the company’s property is void unless the court grants an order validating it. The presentation of a petition may be effective to prevent fund management from proceeding with an unusual disposal of assets, as the directors will have to convince the Court that the disposal is in the interests of the company before proceeding.

One important recent development is the Court’s willingness to grant just and equitable winding-up where a fund is in terminal decline and no longer viable, even if its non-viability has arisen without any fault on the part of management. The Court has confirmed that it can wind-up a fund, contrary to the wishes of management, if it has become impractical for the company to carry on investment business in accordance with the reasonable expectations of investors, especially when those expectations are derived from offering documentation. A need for investigation of a company’s affairs is also a ground for just and equitable winding-up. This may be of use to investors who suspect fraud or mismanagement by fund management.

Once appointed, liquidators are able to pursue any claims which the fund (i.e. the underlying company) may have against its managers and therefore the limits on shareholder claims do not apply. Liquidators also have access to the company’s books and records, and may require the company’s directors and service providers to provide them with written information regarding the company, or apply for a court order requiring them to attend court for examination. Given these powers, liquidators will be in a better position than shareholders to collate the information necessary to prepare a claim. For this reason, winding-up petitions are often brought with the ultimate aim of having liquidators pursue claims against fund management or fund service providers.

Regulatory involvement

The possibility of regulatory involvement also should not be forgotten. Cayman-registered mutual funds are regulated by the Cayman Islands Monetary Authority (CIMA). If a fund breaches regulatory requirements

(for example, the requirement to have its accounts audited annually), an investor may report this to CIMA which may investigate the breach and take action including, in appropriate although rare cases, applying to have the fund wound up.

Conclusion

The law on shareholders' remedies is technical, but these issues are all part of the day-to-day practice of a

Cayman corporate litigator. While at first blush the scope for redress may appear restricted, recent case law has confirmed that in appropriate cases, especially where there is evidence of misconduct by fund management, Cayman law will use existing principles in a modern fund context to provide suitable remedies.

Author: GRAEME HALKERSTON
Partner – Cayman
ghalkerston@applebyglobal.com

Author: KATIE BROWN
Associate – Cayman
kbrown@applebyglobal.com

This publication is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to provide legal advice. No person should act in reliance on any statement contained in this publication without first obtaining specific professional advice.

December 2010
© Appleby

Bahrain
Bermuda
British Virgin Islands

Cayman Islands
Guernsey
Hong Kong

Isle of Man
Jersey
London

Mauritius
Seychelles
Zurich