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Escaping Cayman

New York's highest court permits shareholder of a Cayman-incorporated company to bypass Cayman law and bring derivative action in New York

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A recent decision by New York's highest court may have opened the door for shareholders in Cayman-incorporated companies to bring derivative lawsuits in the United States. This is a significant development, as investors are more likely to have success in New York courts than in the fund-friendly confines of the Cayman Islands.

What happened

In *Davis v. Scottish Re Grp. Ltd.*, No. 111, 2017 N.Y. LEXIS 3277 (N.Y. Nov. 20, 2017) the New York Court of Appeals found that the plaintiff, a minority shareholder in defendant Scottish Re Group, Limited (Scottish Re), a Cayman Islands company, could bring a derivative cause of action on behalf of Scottish Re based on allegations that the company's board of directors engaged in a series of transactions to enrich themselves at the expense of the company. The Court reached its conclusion by determining that Rule 12A of the Grand Court of the Cayman Islands (Rule 12A), which provides that a shareholder must first seek leave from a Cayman court before bringing a derivative action on behalf of a company, is a procedural rule that courts in New York are not bound to follow.

A derivative lawsuit is one brought by a shareholder of a corporation against the directors or management of the corporation and seeks recovery *on the corporation's behalf*. These lawsuits are typically viewed as internal disputes that should be governed in accordance with the law where the corporation is incorporated. Corporations defending these lawsuits often argue that they chose to incorporate in a given jurisdiction precisely so they would enjoy the benefits of the corporate law in that jurisdiction, including those rules governing how shareholders must initiate derivative lawsuits.

In *Davis*, the question was whether Rule 12A was a procedural rule, rather than substantive law. If the Court of Appeals found that Rule 12A was procedural, meaning that it simply provided the process for a case to appear before a Cayman court, New York was generally free to disregard it. If, on the other hand, the Court found that Rule 12A was substantive, meaning that it governed the legal relationship between the company and its board of directors and shareholders, the Court had to apply it, including the portion of it requiring shareholders to first seek approval from a Cayman Islands Grand Court (which the plaintiff did not do here).

The plaintiff shareholder argued that Scottish Re did not enjoy the benefits of Rule 12A because it was merely a procedural rule governing the way in which parties appear before the Cayman courts, what manner of evidence shall be presented and, should a court make a determination to grant plaintiff leave to continue, the next steps to be taken toward ultimate resolution of a derivative action. *Davis*, 2017 N.Y. LEXIS 3277, at *6. Therefore, according to the plaintiff, Rule 12A does not apply to derivative actions on behalf of Cayman companies litigated in New York courts. *Id*.

In response, Scottish Re effectively argued that New York had no business adjudicating the dispute between a shareholder and a Cayman Islands company. Scottish Re asserted that Rule 12A governed the relationship between the company and the shareholder, and provided the requirements that a shareholder must meet before bringing a derivative action, including the requirement that the shareholder apply to the Cayman Islands Grand Court for leave to continue the action. Accord to Scottish Re, Rule 12A functions as a substantive "gatekeeper" in derivative actions involving Cayman-incorporated companies—the shareholder could not make an end-run around this requirement by bringing a derivative lawsuit in New York, or anywhere else in the world. *Id.* at *7.

The Court concluded that the plain language of Rule 12A demonstrated that it is a procedural rule rather than a substantive rule. The rule outlines procedures that are specific to Cayman Islands litigation, and has no extra-jurisdictional applicability. *Id.* at *7-*9.

The Court also considered general policy considerations that courts weigh when determining whether a rule is substantive or procedural—namely, whether the Court's finding that Rule 12A was procedural would burden the Cayman Grand Court or impair judicial efficiency. The Court found that finding Rule 12A to be substantive and requiring a shareholder to first seek leave from a Cayman Islands court before attempting to bring suit in New York would increase judicial inefficiency and confusion. Rule 12A provided no guidance on the proper procedure where a shareholder wished to proceed with a derivative action outside of the Cayman Islands. The Court contrasted Cayman law with British Virgin Islands (BVI) law. The BVI Business Companies Act, according to the Court, expressly requires that a shareholder who seeks to commence a derivative action in *any* court on behalf of a BVI-incorporated company first obtain leave from a BVI court.

In sum, the Court found that Rule 12A is procedural and does not impose a burden on New York Courts or the courts of the Cayman Islands. New York courts, according to the Court of Appeals, are capable of applying Cayman substantive law to decide whether a plaintiff may bring shareholder derivative claims on behalf of a Cayman corporation.

Looking ahead

This decision by the New York Court of Appeals allows the possibility for shareholders in Cayman Island companies to bring derivative lawsuits in New York, so long as the plaintiff shareholder has a jurisdictional "hook" in New York. New York's status as an international financial and banking center often provides plaintiffs with such a hook. This decision is likely to open the floodgates to new litigation in U.S. courts by investors in offshore Cayman funds.

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