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Date: Tue, Jun 7, 2016 at 10:09 AM
Subject: Alert: Cayman Director Liability in the U.S.
To: [redacted]

SECURITIES LITIGATION ALERT JUNE 7, 2016

Cayman Director Liability in the U.S.

For further information about this *Alert*, please contact:

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Cayman directors' legal responsibilities have been the focus of much discussion since the Cayman Islands Court of Appeals, in*Weavering*[1], vacated a $111 million dollar judgement against two directors of a failed hedge fund. Assuming *Weavering* is not reversed on further

appeal, the decision provides Cayman directors with useful guidance as to when they will be held personally liable for a violation of a duty of care because their conduct was "willful".[2] Combined with the Statement of Guidance issued by CIMA in 2014[3], the scope of potential liability for Cayman directors in Cayman is theoretically much clearer than ever before.

Unfortunately for Cayman directors, their liability is not circumscribed by the geographic boundaries of their offshore location. As demonstrated by the vast amount of litigation arising from the financial crisis of 2008, Cayman directors often find themselves being sued in the U.S., especially in New York courts. In such suits, Cayman directors and their counsel must grapple with the following key legal issues that can significantly impact their potential liability.

Which Law Governs - Cayman or New York?

It is often the case that certain claims in a lawsuit are not governed by a choice of law provision. There could be a number of reasons for this, ranging from the fact that the claims are brought by a non-party to the contract, to the fact that the choice of law provision is not drafted to include tort claims[4].

In the absence of an applicable choice of law provision [5], the question of whether Cayman or New York law applies is primarily governed by the types of claims that are brought. For example, under New York's "internal affairs" doctrine, claims concerning the relationship between a corporation, its directors, and its shareholders are governed by the substantive law of the state or country of incorporation. *Davis v. Scottish Re Group Ltd*., 2016 NY Slip Op 01756 (1st Dept. 2016).

In *Davis*, the plaintiff shareholder brought direct and derivative breach of fiduciary duty claims against the Cayman Corporation's directors. The appellate court had little trouble in determining that breach of fiduciary duty claims against directors - whether direct or derivative - involve the "internal affairs" of the corporation, and held that these claims are controlled by Cayman law. The application of Cayman law was quite significant because the Court found that the plaintiff's derivative claims for breach of fiduciary duty failed to comply with Order 15, Rule 12A of the Grand Court Rules of the Cayman Islands ("Rule 12A"), which requires that a plaintiff seek leave of court before proceeding with a derivative action[6]. The Court reasoned that Rule 12A is a substantive rule as applied in New York courts-not a procedural one[7]- because "the underlying remedy is extinguished if a plaintiff fails to file an application for leave to continue a derivative action."[8] Since the Court had already found that the internal affairs doctrine required the application of Cayman law to the breach of fiduciary duty claims against the directors, the Court dismissed the derivative breach of fiduciary duty claims against them based on plaintiff's failure to seek leave of Court in Cayman to bring such claims. The Court's decision in *Davis* demonstrates the importance of the choice of law analysis.

Where claims do not involve the "internal affairs" of the corporation and a conflict of law exists, New York courts apply an "interest analysis" to determine which jurisdiction "because of its relationship or contact with the occurrence or the parties, has the greatest concern with the specific issue raised in the litigation." *UBS Securities LLC v. Highland Capital Management, L.P.*, 924 N.Y.S.2d 312, 2011 WL 781481 (Sup. Ct. 2011) (applying the interest analysis because claims to pierce the corporate veil do not involve the internal affairs of the corporation); *K.T. v. Dash*, 37 A.D.3d 107, 111 (1st Dept. 2006)(quoting *Babcock v. Jackson*, 12 N.Y.2d 473, 481 (1963)); *see also Padula v. Lilarn Properties Corp*., 84 N.Y.2d 519, 521 (1994).

The Court's decision in *Davis* provides directors to a Cayman corporation with fertile ground to argue for the application of Cayman law to the typical breach of fiduciary duty claim. Plaintiffs must analyze their case under Cayman law and comply with the Rule before bringing

derivative claims. Directors may also be able to successfully apply the stringent standards for personal liability set forth in *Weavering* in a New York court.

In Pari Delicto Is Strengthened

In New York, the doctrine of *in pari delicto*is a significant obstacle that investors/liquidators must overcome to successfully sue third parties. The doctrine of *in pari delicto* mandates that the courts will not intercede to resolve a dispute between two wrongdoers.*Kirschner v. KPMG LLP*, 15 N.Y.3d 446, 464, 912 N.Y.S.2d 508, 938 N.E.2d 941 (N.Y.2010). Consequently, when a trustee, receiver or liquidator stands in the shoes of an entity that has engaged in wrongdoing, the doctrine of *in pari delicto* has been used successfully to bar claims brought by liquidators against third parties.

For example, Irving Picard, the trustee for Bernard L. Madoff Inv. Securities ("BLMIS"), brought claims on behalf of BLMIS against various third parties-allegedly aiding and abetting the BLMIS Ponzi scheme. However, under the doctrine of *in pari delicto*, the debtor's misconduct is imputed to the trustee because, "innocent as he may be, he acts as the debtor's representative." *In re Bernard L. Madoff Securities*, LLC, 721 F.3d 54 (2d Cir. 2013).

Picard unsuccessfully argued that the "adverse interest" exception prevented BLMIS's wrongdoing from being imputed to him. The adverse interest exception instructs that the wrongdoing of a corporation's agent shall not be imputed to the corporation - if the agent has totally abandoned his principal's interests and is acting entirely for his own or another's purposes. However, this limited exception to imputation does not apply where there is a benefit to both the agent and the corporation. *Kirschner v. KPMG LLP*, 15 N.Y.3d 446 (2010). In the case of BLMIS, the Court rejected the application of the adverse interest exception based on its finding that the fraud was not committed against BLMIS, but on its behalf. Consequently, the wrongdoing of BLMIS was imputed to Picard, which in turn barred him from bringing claims for intentional wrongdoing on behalf of BLMIS against third parties.

Over the last few years, the *in pari delicto* doctrine has been diluted by a series of New York bankruptcy court decisions which created a new exception to the doctrine - the bankruptcy "insider's exception".[9] The "insider's exception" provides that corporate insiders' intentional wrongdoing should not be imputed to the corporation, so that the insiders may be held accountable for their actions. However, the viability of the bankruptcy "insider's exception" recently suffered a significant setback.

Acting as an appellate court to the bankruptcy court, the federal district court in *In re Lehr Construction Corp*., 2016 WL 164616 (S.D.N.Y. 2016) rejected the notion that the bankruptcy court could create a new exception to the well-settled concept that the acts of a corporation's agents are imputed to the corporation - regardless of whether the agents are insiders. The *Lehr* court observed that the New York Court of Appeals made clear in *Kirschner* that the doctrine of *in pari delicto* had only one "narrow" exception to imputation - the adverse interest exception. The *Lehr* court explained that New York's highest court had specifically ruled that there could only be one very narrow exception to imputation, so as to avoid "ambiguity where there is a benefit to both the insider and the corporation".[10] Given that *Kirschner* explicitly sought to avoid ambiguity by limiting the exception to imputation to the adverse interest exception, the *Lehr* court concluded that *Kirschner* had specifically "rejected the proposition that the acts of an insider would be exempted from imputation in situations where the adverse interest exception did not apply".[11]

Lehr is a significant ruling and may signal the end to the "insider's exception" created by the bankruptcy courts. Without the availability of the "insider's exception", liquidators whose claims are governed by New York law must carefully evaluate whether an insider's intentional

wrongdoing benefitted the corporation, the insider, or both. This analysis will most likely be determinative as to whether the *in pari delicto* doctrine will apply.[12]

The Death of Martin Act Preemption

The Martin Act is New York's securities fraud or "blue sky" statute. It grants the New York Attorney General broad regulatory and remedial powers to prevent securities fraud. There is no private right of action under the Martin Act. Prior to 2011, the Martin Act preempted common law claims in the context of securities fraud to the extent said claims did not require proof of deceitful intent. *See e.g., Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171 (2d Cir. 2001). Consequently, courts in New York regularly held that breach of fiduciary duty claims and negligent misrepresentation claims that would effectively allow private rights of action under the Martin Act were pre-empted. *Horn v. 440 E.57th Co.*, 151 A.D.2d 112 (1st Dept. 1989); *Stephenson v. Citco Group Limited*; *Citco Fund Services (Europe) BV*, 700 F.Supp.2d 599 (S.D.N.Y. 2010); *Barron v. Igolnick*, 2010 WL 882890 (S.D.N.Y.)

However, in 2011, the New York Court of Appeals reversed years of lower court precedent and held that the Martin Act does not preempt a common law claim where the claim "is not entirely dependent on the Martin Act for its viability." *Assured Guar. (UK) Ltd. v. J.P.Morgan Inv. Management Inc.*, 18 N.Y.3d 341 (2011). The Court distinguished two of its prior decisions that discussed Martin Act preemption and stated:

> Read together, *CPC Intl. and Kerusas* stand for the proposition that a private litigant may not pursue a common-law cause of action where the claim is predicated solely on a violation of the Martin Act or its implementing regulations and would not exist but for the statute. But, an injured investor may bring a common-law claim (for fraud or otherwise) that is not entirely dependent on the Martin Act for its viability. Mere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies.

Assured Guar. (UK) Ltd. v. J.P.Morgan Inv. Management Inc., 18 N.Y.3d 341 (2011).

Therefore, claims for breach of fiduciary duty or negligence that do not rely upon a violation of a provision of the Martin Act-but merely overlap with the statute - are no longer preempted. This development, although not recent, has resulted in a significant expansion of private securities claims in New York.

Conclusion

The *Davis* decision should provide directors and their counsel with much-needed clarity on a significant choice of law question from the outset of the case. It remains to be seen if the *Lehr* decision will put an end to the "bankruptcy insiders" exception and restore the doctrine of *in pari delicto* to its position as a formidable defense in New York.

There are a number of other issues impacting an offshore director's liability in the U.S., such as personal jurisdiction and venue. Offshore directors are advised to regularly consult with independent U.S. counsel in connection with any issues that have the potential to result in U.S. - based litigation. Should you have any questions, please contact Douglas R. Hirsch at [redacted].

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[1] *Weavering Macro Fixed Income Fund Limited (in Liquidation) v. Stefan Peterson and Hans Ekstrom*, Cayman Islands Court of Appeal, February 12, 2015.
[2] Exculpation clauses in fund documents generally shield Directors from liability for non-willful acts.
[3] CIMA, Statement of Guidance, Corporate Governance, January 28, 2014.

[4] New York courts enforce choice of law provisions between contracting parties unless the foreign law creates a contract that is so fundamentally contrary to New York public policy that the court deems it necessary to override the choice of law provision. *Welsbach Electric Corp. v. Mastec North America, Inc.*, 7 N.Y.3d 624 (2006).
[5] *See Stokoe v. Marcum & Kliegman LLP*, 135 A.D.3d 645 (1st Dept. 2016)(rejecting plaintiff's attempt to apply Cayman law and applying New York law pursuant to the choice of law provision in the contract between the parties).
[6] Order 15, Rule 12A of the Grand Court Rules of the Cayman Islands.
[7] In a New York court, procedural rules are controlled by New York law.
[8] *Davis*, 138 A.D.3d at 238.
[9] See e.g., *In re Bernard L. Madoff Inv. Secs. LLC*., 458 BR 87 (Bkrtcy S.D.N.Y. 2011).
[10] *Kirschner*, 15 N.Y.3d at 467.
[11] *Lehr*, 2016 WL 164616 at *4.
[12]*See Stokoe v. Marcum & Kliegman LLP*, 135 A.D.3d 645 (1st Dept. 2016) (denying defendant's motion to dismiss based upon In Pari Delicto because the Complaint alleged that the manager acted completely adverse to the funds thereby falling within the adverse interest exception to imputation).

Sadis & Goldberg LLP

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