When a derivative action is brought on behalf of an onshore or offshore fund, U.S. courts typically apply the “internal affairs” doctrine, which requires that the law of the state or country in which the fund is organized be applied to the derivative action. U.S. courts have consistently used the “internal affairs” doctrine to limit the rights of investors to bring derivative actions against BVI and Cayman funds in the U.S. As a result, the ability of an investor in an offshore fund to bring a claim in a U.S. court against a fund manager for breach of fiduciary duty or other conduct that impacts fund investors generally is severely limited.

What Is a Derivative Action?

In a derivative action, an investor in a fund brings a lawsuit on behalf of the fund for alleged wrongdoing to investors in the fund as a whole and seeks relief for the fund’s benefit. The basis for a derivative action is to enforce a right of the fund that the fund’s managing member, general partner or board of directors have refused to assert.

Derivative actions seek relief on behalf of the fund as a whole. Derivative actions are different from a direct action, which is brought by an investor in the investor’s individual capacity, and addresses the harm only to that particular investor. Any recovery in a derivative action belongs to the fund, and the investor asserting the derivative claims does not seek recovery for himself as an individual, but that investor will obtain his proportionate share of any recovery by the fund. And, as stated, if the investor prevails in the derivative action, the investor’s legal fees are paid out of the fund.

Investors can bring derivative actions asserting a variety of claims. Generally, any misconduct by a third party that affects the fund or the fund’s investors as a whole, and not simply a single investor or a handful of investors,
must be brought as a derivative action. Courts will not permit investors to bring derivative claims as direct claims to avoid the requirements that must be satisfied to bring a derivative action. For example, a claim by an investor against a fund manager alleging that the manager made misrepresentations concerning the fund before the investor invested would be a direct claim by the investor, because the investor suffered a direct injury resulting from the manager’s alleged misconduct. On the other hand, a claim that the manager breached his fiduciary duty to the fund, or committed fraud in managing the fund, would be required to be brought as a derivative claim because the manager’s alleged conduct injured the fund as a whole and equally impacted all investors in the fund.

Derivative Actions by Onshore Fund Investors

Generally, to pursue a derivative claim under Delaware law, and the law of most other states, an investor must (1) satisfy an eligible investor status requirement, (2) satisfy the contemporaneous ownership rule, and (3) be able to adequately represent other investors. Generally, to pursue litigation, an investor must be an investor in the fund at the time of the alleged wrongdoing, and, according to some authority, must continue to be an investor while the lawsuit is pending. Former investors or redeemed investors who have not yet received their redemption payment generally cannot bring derivative claims. The investor must also have a true interest in the case and show that he is likely to vigorously pursue the litigation on behalf of the fund and other investors.

If an investor qualifies to pursue derivative litigation, the next step is the issuance of a demand, unless a demand is excused as a matter of law. Under Delaware law, and the laws of most other states, an investor’s right to bring a derivative action is limited by this “demand requirement.” In the case of an onshore hedge fund organized as an LLC or LP, this requirement requires that, before asserting a derivative claim, an investor must make a demand on the managing member or general partner, which is typically the fund manager. See Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990).

Often, an investor sends a letter to the manager, requesting that an action be brought against the alleged wrongdoers. To be considered a demand, the investor’s communication must (1) identify the alleged wrongdoers, (2) state the wrongdoing allegedly perpetrated and the resultant injury to the fund, and (3) state the legal action the investor wants the manager to take on the fund’s behalf. The manager is entitled to a sufficient period of time in which to investigate and respond to the demand. There is no specific procedure that must be followed when a manager investigates a demand made by an investor in the fund. If the manager properly considers and rejects the demand, there should be no basis for litigation to commence. If the manager concludes that an action should be initiated against the alleged wrongdoers, then the ensuing lawsuit by the fund would not be derivative litigation – it would be a direct action brought by the fund.

If the fund manager rejects a demand, it is presumed to have rejected the demand “on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests” of the fund. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). If the investor believes his demand was improperly rejected by the fund manager, he can file a derivative action if there is evidence to overcome the presumption of the business judgment rule. The presumption can be rebutted only if the investor creates a reasonable doubt that the decision to reject the demand was a valid exercise of business judgment. See Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996).

If an investor does not make a demand, he can still bring a lawsuit if he can demonstrate with particularity that demand should be excused. See Beam v. Stewart, 845 A.2d 1040, 1057 (Del. 2004); Brehm v. Eisner, 746 A.2d 244, 254-55 (Del. 2000). In the case of an onshore hedge fund, because the alleged misconduct is typically directed against the fund manager, demand will typically be excused because the manager is also the managing member or general partner. That is because the courts will most likely view the fund manager as not disinterested.
Most states incorporate some version of the Delaware law requirements discussed above. The law of the state in which a corporation is incorporated applies in determining compliance with the demand requirement. See Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 97 (1991). If the onshore fund is incorporated in a state other than Delaware, the laws of that state should be examined for any deviations from Delaware law.

Derivative Actions by Offshore Fund Investors

Investors who invest in an offshore fund will likely have a more difficult time bringing a derivative action than investors in an onshore fund. In connection with a derivative action involving an offshore fund, courts will apply the “internal affairs” doctrine to determine what law to apply to derivative claims. The “internal affairs” doctrine provides that “the right of a shareholder to object to conduct occurring in the operation of the corporate enterprise is determined by the law of the state of incorporation.” Hauman v. Buckley, 299 F.2d 696, 702 (2d Cir. 1962). Thus, in the case of an offshore fund organized under the law of the British Virgin Islands or the Cayman Islands, BVI or Cayman law would govern an investor’s right to bring a derivative action.

A number of U.S. courts have applied BVI or Cayman law to dismiss investors’ derivative actions. In Microsoft Corp. v. Vadem, Ltd., 2012 Del. Ch. Lexis 90, at *19-20 (Del. Ch. Apr. 27, 2012), for example, the court dismissed a derivative claim because the defendant corporation was organized under the BVI Business Companies Act of 2004, which the court found requires a shareholder to first obtain leave of the High Court of the BVI before proceeding with a derivative claim on behalf of the company. Other U.S. courts have held that the rule in Foss v. Harbottle, which is English precedent from 1843, governs derivative actions under English law, on which the Cayman and BVI law is based. According to those courts, under that rule, a shareholder can bring a derivative action only in certain limited circumstances where (1) the alleged misconduct impacts the shareholder’s personal rights, (2) a simple majority of the shareholders could not ratify the conduct on which the suit is based, (3) there was fraud on a minority shareholder, or (4) the alleged wrongdoer committed ultra vires acts. See Winn v. Schaefer, 499 F. Supp. 2d 390, 396-398 (S.D.N.Y. 2007). U.S. courts have also held that the third basis—fraud on a minority shareholder—is even narrower under English law than one would initially suspect. To show fraud, the wrongdoer must be in control of the company and have used its control to benefit the wrongdoer at the company’s expense. In re Tyco, Int’l., Ltd., 340 F. Supp. 2d 94, 102 (D.N.H. 2004). As the court stated in Tyco, “English law, unlike its American counterpart, does not permit a derivative action to be maintained to remedy a breach of fiduciary duty that does not involve self-dealing by those in control.” Id. at 99.

Thus, the ability of an investor in an offshore fund to obtain relief from a U.S. court on claims that a manager breached its fiduciary duty or fraudulently misused fund assets is strictly limited. Such claims are necessarily derivative claims because the alleged injury is injury to the fund, and not to an individual investor. And, because U.S. courts will apply English law to derivative claims involving Cayman and BVI funds, absent allegations of self dealings or other facts supporting one of the other limited exception to the Foss v. Harbottle rule, the investor’s derivative claim is unlikely to survive a motion to dismiss.

What Is a Books and Records Demand?

A tool often employed prior to the filing of a derivative action against an onshore fund is a books and records demand, which seeks access to the fund’s books and records. These demands are brought because lawsuits cannot be brought based on conclusory allegations. Another goal of these demands is to obtain a list of investors in the fund so that the investor contemplating legal action against the fund can solicit the support of other investors for such legal action.

For onshore funds structured as limited partnerships under the Delaware Uniform Limited Partnership Act (DULPA), for example, the statute is flexible and permits the limited partnership agreement to be drafted in a manager-friendly way. The limited partnership
agreement may provide investors access to the fund’s records upon reasonable notice to the general partner of the fund, or can restrict investors from having such rights. When the limited partnership agreement is silent on an issue covered by the DULPA, the DULPA will control. Section 17-305 of the DULPA provides:

Each limited partner . . . has the right, subject to such reasonable standards . . . to obtain from the general partners from time to time upon reasonable demand for any purpose reasonably related to the limited partner’s interest as a limited partner . . . [a] current list of the name and last known business, residence or mailing address of each partner.

A similar provision for onshore funds organized as limited liability companies under the Delaware LLC Act is codified in Section 18-305 of that Act.

The purpose of the investor’s request for books and records of the fund must be reasonably related to the investor’s interest in the fund. Under Delaware law, the fund, and not the requesting investor, bears the burden of showing that the demand was made for an improper purpose. Delaware courts encourage investors to use this tool to obtain information concerning the fund before filing suit, and will often dismiss complaints containing vague allegations if the investor did not exercise inspection rights prior to filing suit.

Generally, receipt of such a books and records demand requires quick action by the fund manager, which is also the general partner or managing member. In Delaware, an investor can seek to compel production if the fund manager does not reply to the demand within five business days. Assuming the fund is incorporated in Delaware, the fund manager should also be prepared to head into Delaware court for any disputes concerning the investor’s demand for the fund’s books and records, as the Delaware Court of Chancery has exclusive jurisdiction to determine whether the investor is entitled to the inspection sought. However, if the fund’s documents require all investor disputes to be arbitrated, any dispute regarding an investor’s request for the fund’s books and records would be handled in arbitration. See

Aris Multi-Strategy Fund, L.P. v. Southridge Partners, LP, 2010 WL 2173839 (Del. Ch. May 21, 2010) (court rejected argument that books and records inspection rights under Section 17-305 cannot be determined by an arbitrator because the statute grants exclusive jurisdiction to the Court of Chancery and dismissed complaint in favor of arbitration).

Other states also have statutes addressing investors’ demands for books and record, and those statutes often differ from Delaware’s law. For instance, Illinois recently declined to follow Delaware courts by limited inspection rights to documents necessary and relevant to the investor’s purpose, finding that once a proper purpose has been established, an investor can access “any and all” documents necessary for his inquiry. See Sunlitz Holding Co., W.L.L. v. Trading Block Holdings, Inc., 2014 WL 4056022, at *7-8 (Ill. App. Ct. Aug. 14, 2014).

The manager can also keep certain information confidential, and thus prevent the investor from disclosing information concerning the fund to third parties. See DULPA Section 17-305(b). In the event that inspection of documents pursuant to a books and records request is permitted, a confidentiality order should be considered. Courts have allowed the entry of an appropriate confidentiality order prior to an inspection. See, e.g., Amalgamated Bank v. UICI, 2005 WL 1377432 (Del. Ch. June 2, 2005).

Finally, fund managers should be aware that they may be required to turn over certain privileged communications and attorney work product to investors in cases involving substantial allegations of serious fiduciary misconduct. See Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Trust Fund IBEW, 95 A.3d 1264 (Del. 2014).

Document Hold Notice

Upon receipt of a demand (for books and records or to initiate litigation), the directors or manager of a fund should issue a “litigation hold” notice informing employees of the fund manager not to discard or destroy potentially relevant documents. At a minimum,
the notice should go to all senior management of the fund manager, as well as to those employees who were directly involved in the underlying circumstances that gave rise to the demand.

Conclusion

Derivative actions present a variety of issues that will differ from fund to fund depending upon where the fund is organized. By better understanding these issues, fund managers and directors can properly prepare to deal with, and defend against, such actions.

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