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Second Circuit decision (re)opens the door to offshore M&A litigation being filed in the U.S.

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More shareholder challenges of offshore corporate transactions are likely to be filed in U.S. courts following a recent decision holding that a forum clause in a foreign issuer's depositary agreement covers claims that, at their core, concern alleged breaches of fiduciary duty by directors and controlling shareholders, which are governed by Cayman law. The prevalence of mandatory forum selection clauses in depositary agreements means this decision is likely to have a significant impact.

Background

This is the latest in the long-running litigation concerning the 2016 going-private transaction of E-Commerce China Dangdang. Our prior summary of the case can be found here.

Dangdang, a company incorporated in the Cayman Islands with operations based in China, went public in 2010, listing American depositary shares (ADSs) on the New York Stock Exchange. The depositary agreement contained a forum selection clause and an arbitration agreement, which state:

"Any controversy, claim or cause of action brought by any party hereto against the Company arising out of or relating to the Shares or other Deposited Securities, the American Depositary Shares, the Receipts or the Deposit Agreement, or the breach thereof, shall be settled by arbitration in accordance with the International Arbitration Rules of the American Arbitration Association […] provided, further, that any such controversy, claim or cause of action brought by a party hereto against the Company relating to or based upon the provisions of the Federal securities laws of the United States or the rules and regulations promulgated thereunder shall be submitted to arbitration as provided in [the relevant section] of the Deposit Agreement if, but only if, so elected by the claimant.

The place of the arbitration shall be The City of New York, State of New York, United States of America […]"

Any controversy, claim or cause of action arising out of or relating to the Shares or other Deposited Securities, the American Depositary Shares, the Receipts or this Deposit Agreement not subject to arbitration under [the relevant section] of the Deposit Agreement shall be litigated in the Federal and state courts in the Borough of Manhattan, The City of New York and the Company hereby submits to the personal jurisdiction of the court in which such action or proceeding is brought."

In 2016, shareholders representing 97.7% of Dangdang's shares voted to approve a merger that resulted in the company becoming delisted from the New York Stock Exchange and continuing as a private company. The merger was proposed by a group controlling 83.6% of Dangdang's voting power, who made a bid to buy out the minority shareholders at $7.81 per ADS. A third-party private equity firm had subsequently submitted an all-cash offer of $8.80 per ADS, but the special committee appointed by the company to evaluate the controlling group's bid nonetheless approved the group's proposed merger.

History of the case

In 2016, three investors filed a putative class action complaint in the Southern District of New York, challenging the merger as "grossly unfair," and alleging breaches of fiduciary duty, negligent misrepresentation, and violations of federal securities laws.

In 2017, the district court dismissed the action on the ground of forum non conveniens, holding that the Cayman Islands is a more appropriate forum because the "action involves a Cayman Islands company with its principal place of business in China, a merger executed in the Cayman Islands, and a dispute governed principally, if not exclusively, by Cayman Islands law."

The dismissal was vacated in 2019, when the Second Circuit held that the district court abused its discretion by failing to consider the effect of the forum selection clause. (This Second Circuit decision is discussed in our prior summary of the case.) The case was remanded, and the district court was instructed to determine the forum non conveniens issue in light of the forum selection clause. The Second Circuit's 2019 decision did not address the question of whether the claims and parties named in the complaint are within the scope of the forum selection clause.

On remand, the district court found that the forum selection clause covered only federal securities claims and not common law claims such as breach of fiduciary duty, which it concluded were likely Cayman-law governed. Further, based on its finding that the relevant transaction for the forum selection clause is the issuance of the ADSs, the court concluded that the clause did not cover five of the 13 defendants who were not signatories to the depositary agreement or connected with Dangdang's issuance of ADSs in 2010. The district court again dismissed the case on forum non conveniens grounds in a 2020 decision, citing public interest factors, such as "Cayman Islands[‘] … interest in having this localized controversy decided at home," and the court's reluctance "to bifurcate the instant action between those claims and parties that are covered by the Forum Selection Clause and those that are not."

The plaintiffs appealed, and on August 26, 2022, the Second Circuit – for the second time in this litigation – issued a decision vacating the lower courts' dismissal of the case.

The Second Circuit's decision

The Second Circuit took issue with the lower court's finding that the relevant transaction for the forum selection clause is the issuance of Dangdang's ADSs, which had led to the conclusion that the forum selection clause "bears no direct connection to the merger." In holding that the plaintiffs' federal securities claims fall within the scope of the forum selection clause, the Second Circuit pointed to the broad language adopted in the clause ("arising out of or relating to" the "American Depositary Shares") and its reference to the ADSs themselves rather than the "issuance of" Dangdang's ADSs. The court held that the plaintiffs' federal securities claims alleging "the unlawful, fraudulent, or unfair deprivation of plaintiffs' ADSs" present controversies that "plainly relate to the ADSs."

Second, the court rejected the district court's finding that five defendants, who were not signatories to the depositary agreement, could not be covered by the clause. The district court had concluded that because there was no indication that those five defendants "had any connection with the 2010 issuance or listing of the ADSs," they therefore "could not have foreseen being bound by the forum selection clause . . . merely because they participated in a merger six years after the formation of the Depositary Agreement." The Second Circuit disagreed, holding that these five defendants could not plausibly claim to have been blind-sided by the forum selection clause after participating in the going-private merger, as they were among those identified in the merger's proxy materials as members of the "Buyer Group" and the proxy materials stated multiple times that the merger's effect on the ADSs were "*SUBJECT TO THE TERMS AND CONDITIONS OF* APPLICABLE LAW AND *THE ADS DEPOSIT AGREEMENT*."

With respect to the plaintiffs' non-securities claims, the Second Circuit appears to agree with the lower court that the common law claims are likely governed by Cayman law, given Dangdang's incorporation in the Cayman Islands. However, it disagreed that public interest concerns weigh in favor of those claims being dismissed. The Second Circuit reasoned that dismissal "cannot serve the Cayman Islands' interest in having the common law claims 'decided at home'" because those claims are required to be submitted to arbitration in New York under the depositary agreement. The court noted that the only claims that can be determined in a Cayman court would be the plaintiffs' federal securities claims, including the claim under Section 13(e) of the Exchange Act, and the United States "has a vital interest in having its own courts decide whether to imply a private right of action" under Section 13(e).

Implications of the decision

It is exceedingly common for depositary agreements to include forum selection clauses, which generally come in two forms: (i) mandatory clauses, which require claims to be brought in a specific forum, and (ii) permissive clauses, which allow claims to be brought in a forum without precluding other forums. As illustrated by the Dangdang litigation, some depositary agreements also include clauses requiring certain claims to be arbitrated.

For offshore companies that are renewing their depositary agreements or in the process of listing in the U.S. markets, the Second Circuit's most recent decision in the Dangdang litigation suggests careful consideration of the scope of mandatory forum selection clauses in those agreements.

For offshore companies that have mandatory forum selection clauses requiring claims arising out of or relating to the company's ADSs in a U.S. jurisdiction, we expect the Second Circuit's most recent decision in the Dangdang litigation to give rise to more challenges of offshore mergers in the U.S.

The decision is likely to affect Chinese companies listed in the U.S. in particular. Many such companies are considering going-private transactions in light of the difficult U.S.-China relations and uncertainties surrounding the ability of Chinese companies to remain listed in the U.S. long term. Historically, the method for shareholders to challenge an undervalued going-private transaction is to commence proceedings in the company's home jurisdiction (in the case of a Cayman company, an appraisal action under section 238 of the Cayman Islands Companies Act). But the Second Circuit's most recent decision opens the door to U.S. proceedings instead. The decision could also provide a basis for companies to seek dismissal of proceedings in their home jurisdiction.

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