Recent Second Circuit Decision May Lead to an Increase in Offshore M&A Litigation Being Filed in the United States

April 25, 2019

On April 12, 2019, the United States Court of Appeals for the Second Circuit held that the district court abused its discretion by failing to consider a forum selection clause in a foreign issuer's Depositary Agreement, notwithstanding the fact that the issuer is a Cayman Islands company and the gravamen of the lawsuit concerned an alleged breach of fiduciary duty by the issuer's board of directors, which is an issue of Cayman law. This decision may encourage more shareholders to challenge offshore corporate transactions in U.S. courts.

Background

E-Commerce China Dangdang ("Dangdang" or the "company") is a company incorporated in the Cayman Islands with its principal place of business in China. In 2010, the company went public, listing American Depositary Shares ("ADSs") on the New York Stock Exchange. The Depositary Agreement, entered into between Dangdang, the Bank of New York Mellon (as the Depositary for the shares backing the ADSs), and Owners and Holders of ADSs included a forum selection clause providing that "[a]ny controversy, claim or cause of action arising out of or relating to the [ADSs] . . . 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."

On July 9, 2015, a group controlling 83.6% of Dangdang's voting power made a bid to buy out the minority shareholders at $7.81 per ADS. In response, Dangdang appointed a special committee composed of three independent members of its board of directors to evaluate the offer. On March 9, 2016, a third-party private equity firm, iMeigu Capital Management, submitted an all-cash offer of $8.80 per ADS. However, on May 28, 2016, the special committee voted to approve the controlling group's proposed merger at $7.81 per ADS. On September 12, 2016, Dangdang held a shareholder meeting at which 97.7% of its shares voted to approve the merger, with nine shareholders objecting. The merger closed on September 20, 2016.

On November 10, 2016, three investors (who did not object to the merger) filed a putative class action complaint in the Southern District of New York alleging that the taking private merger was "grossly unfair," the special committee failed to protect public shareholders' interests, and public shareholders were misled when they were told in proxy statements filed with the Securities and Exchange Commission that the special committee had obtained independent legal counsel, when in fact the special committee's counsel had also served as the company's counsel. The plaintiffs sought damages for breach of fiduciary duties, violations of U.S. securities law and New York common law, and a quasi-appraisal due to misrepresentations and omissions in the proxy statements.

The defendants moved to dismiss on *forum non conveniens* grounds, arguing that the Cayman Islands was more suitable for the litigation. The district court granted the motion, 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. This Court and a New York jury would have more difficulty and less interest in adjudicating this matter as compared to their counterparts in the Cayman Islands."[1]

The Second Circuit's Decision

The plaintiffs appealed to the Second Circuit and argued that the district court erred by (1) failing to address the forum selection clause in Dangdang's ADSs; (2) giving "little deference" to a New York resident-plaintiff's choice of a New York forum; (3) applying the wrong standard for weighing the public and private interests in a *forum non conveniens* analysis by "balancing" the interests instead of requiring Dangdang to show that plaintiffs' choice of forum was "oppressive and vexatious"; and (4) failing to consider the United States' and New York's interests in enforcing their respective securities laws.

Defendant Dangdang countered that the Cayman Islands is the least burdensome forum to hear the case. Specifically, the company argued that the district court properly weighed the public and private interests in dismissing the claims based on *forum non conveniens* because a foreign plaintiff's choice of forum is due little deference, ties to the New York Stock Exchange are alone insufficient to tip the balance of equities, and talismanic invocation of federal securities law alone is insufficient to access the U.S. courts.

With respect to the ADS forum selection clause, Dangdang argued that the individual defendants—the controlling shareholders and directors who allegedly breached their fiduciary duties—were not parties to the Depositary Agreement and, therefore, were not bound by the choice of forum. Dangdang also asserted that, if applicable, the forum selection clause covered only federal securities claims and not common-law claims like breach of fiduciary duty. In response, the plaintiffs argued that the language "arising out of or relating to the Shares" was broad enough to cover all of their claims.

In its decision, the Second Circuit held that the district court abused its discretion by failing to consider the forum selection clause in the ADSs when evaluating the *forum non conveniens* issue. As part of the analysis, a district court must consider whether (1) the forum selection clause was "reasonably communicated to the party resisting its enforcement"; (2) the clause is mandatory or permissive; and (3) the claims and parties are within the clause's scope.[2] If, after applying these factors, a court finds the forum selection clause presumptively enforceable, then it must consider whether enforcement would be "'unreasonable or unjust'" or invalid due to "'fraud or overreaching.'"[3]

The Second Circuit declined to address the scope of the forum selection clause in the ADSs; that is, the court did not address whether the clause covers the individual defendants and non-securities claims. The court remanded the case and instructed the district court to apply the correct test in determining the *forum non conveniens* issue in light of the forum selection clause, and then, if necessary, consider whether the scope of the clause covers the key defendants and key claims.

Implications of the Decision

The forum selection clause in Dangdang's Depositary Agreement is a common feature of such agreements, which are necessary for foreign private issuers to list ADSs on U.S. stock exchanges. While shareholders have been successful previously in enforcing forum selection clauses in Depositary

[1] *Fasano v. Juoqing Li*, No. 16-CV-8759 (KPF), 2017 U.S. Dist. LEXIS 213555, at *37 (S.D.N.Y. Dec. 29, 2017).

[2] *Fasano v. Yu Yu*, No. 18-100-CV, 2019 U.S. App. LEXIS 10916, at *3 (2d Cir. Apr. 12, 2019) (citing *Magi XXI, Inc. v. Stato della Città del Vaticano*, 714 F.3d 714, 721 (2d Cir. 2013)).

[3] *Id.* (quoting *Phillips v. Audio Active Ltd.*, 494 F.3d 378, 384 (2d Cir. 2007)).

Agreements in the context of disputes closely relating to their holding of ADSs,[4] the Second Circuit's decision in the *Dangdang* litigation is the first time we are aware of a court suggesting that the same clause could be used to litigate claims that, at bottom, concern an alleged breach of fiduciary duty by directors and controlling shareholders of an offshore company.

As a result, we expect to see an increase in lawsuits in the United States challenging the corporate decision-making of offshore companies who have issued ADSs. Plaintiffs typically file these lawsuits in the offshore company's home jurisdiction as they allege breach of fiduciary duty based on the law of the jurisdiction of incorporation. However, contingency fees, the ability to proceed on a class basis, and the absence of a loser pays costs system makes litigation in the United States a much more attractive proposition to shareholders than litigating in, for example, the Cayman Islands or the British Virgin Islands.

We expect shareholders to rely on the Second Circuit's decision as a gateway to filing their claims in the United States. The district court's decision on remand will be one to watch. A decision that this common forum selection clause can override traditional *forum non conveniens* considerations may effectively open the floodgates for offshore M&A litigation in the United States.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Jon Gray	+81 3 5574 2667	jon.gray@davispolk.com
Li He	+852 2533 3306	li.he@davispolk.com
James C. Lin	+852 2533 3368	james.lin@davispolk.com
Martin Rogers	+852 2533 3307	martin.rogers@davispolk.com
Patrick S. Sinclair	+852 2533 3305	patrick.sinclair@davispolk.com
Miranda So	+852 2533 3373	miranda.so@davispolk.com
Brian S. Weinstein	+1 212 450 4972	brian.weinstein@davispolk.com
Howard Zhang	+86 10 8567 5002	howard.zhang@davispolk.com
Jonathan K. Chang	+852 2533 1028	jonathan.chang@davispolk.com

[4] *See, e.g.*, *JSC Surgutneftegaz v. President & Fellows of Harvard Coll.*, 2005 U.S. Dist. LEXIS 15991 (S.D.N.Y. Aug. 3, 2005) (enforcing arbitration agreement and forum selection clause in dispute concerning distribution of dividends).