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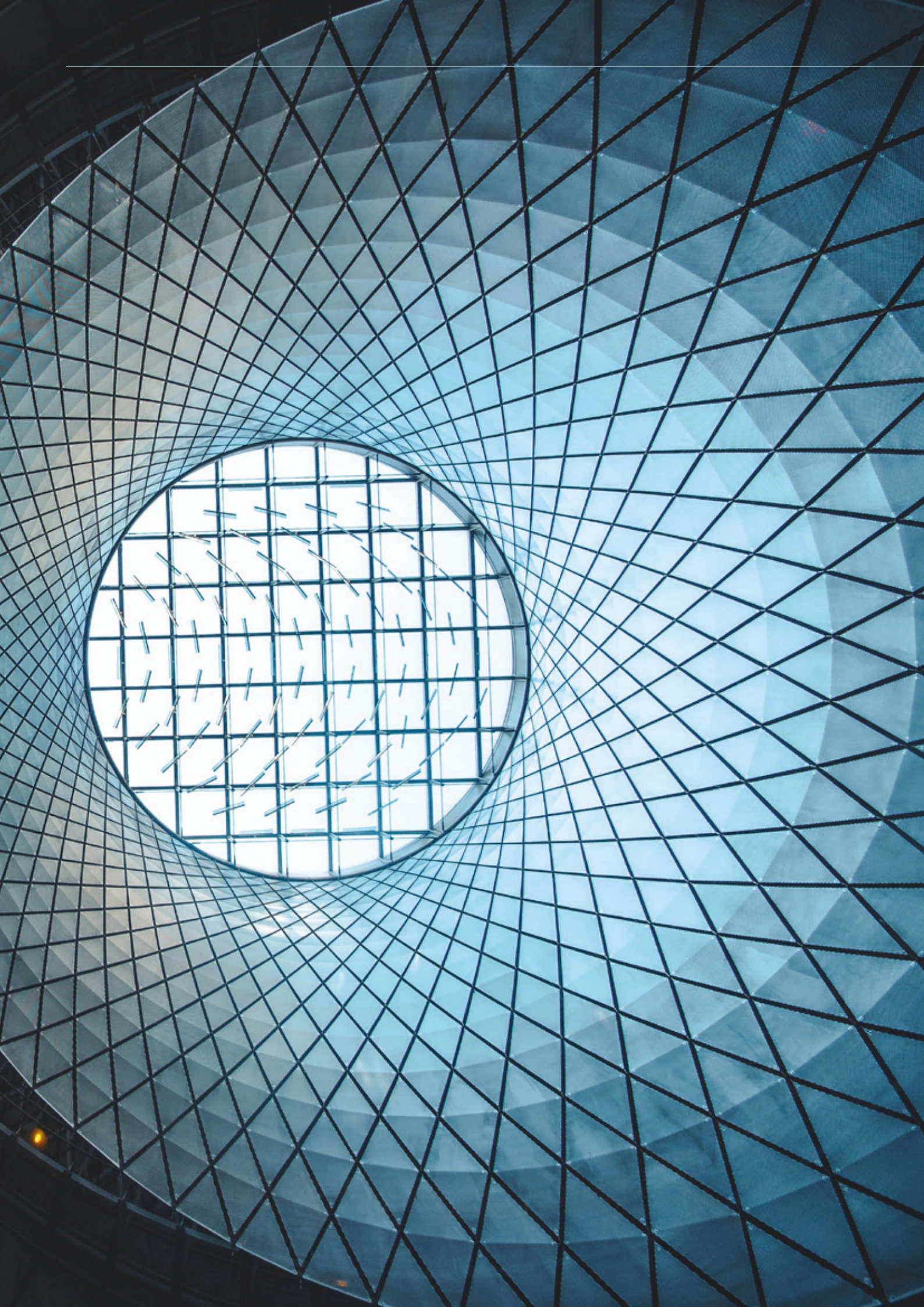

Introduction

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Shareholders increasingly targeting D&Os of foreign companies in New York derivative actions

U.S. shareholder derivative actions have long been a concern for directors and officers ("D&Os") of U.S. companies and their insurers due to their consistent claims frequency. With respect to companies based outside of the U.S., for many years the more significant concern with respect to U.S. shareholder litigation has been the steadily rising number of securities class actions targeting foreign companies.

Over the past year, however, shareholders have filed a number of derivative actions in New York courts on behalf of non-U.S. companies. In these cases, which are in their early stages, the plaintiffs seek to pursue their foreign corporate law claims with the benefits of U.S. litigation.[1]

If the New York actions are allowed to proceed, shareholders may pursue more derivative claims against D&Os of non-U.S. companies in U.S. courts. Such actions could create additional liability and unexpected exposure for D&Os of foreign companies. Risk managers and D&O insurers should closely monitor these cases and consider the potential risks from this type of litigation.

[1] A derivative action is a lawsuit brought by one or more shareholders on behalf of the corporation in which they hold shares, to enforce a right or claim that the corporation has failed to exercise. The shareholders typically name as defendants the company's D&Os and possibly other shareholders and third parties such as outside advisers, for alleged breaches of fiduciary duties or aiding and abetting such breaches.

The recent wave of New York derivative actions against D&Os of foreign companies

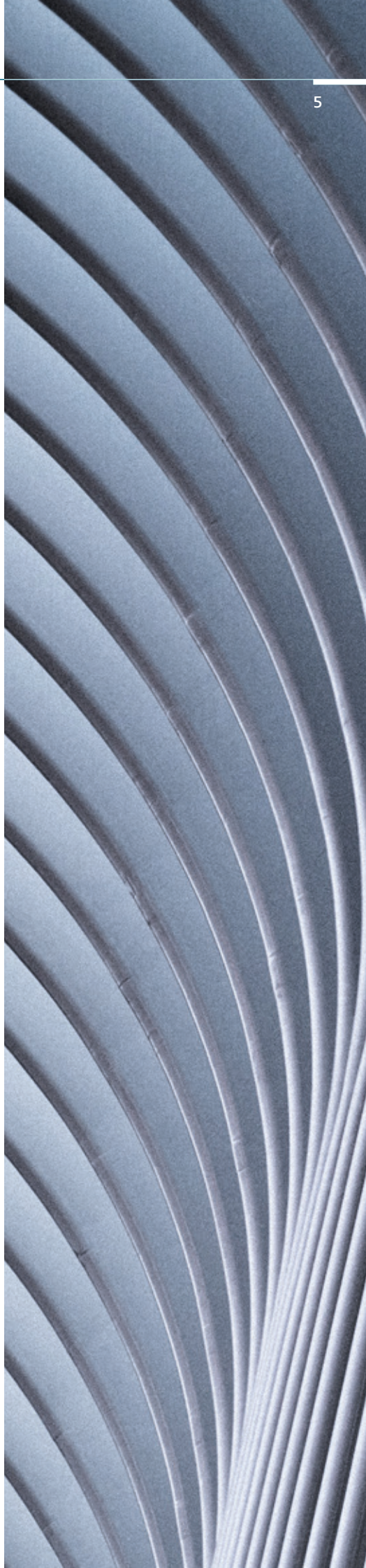
In 2020, a group of law firms filed a number of shareholder derivative actions in New York State courts on behalf of non-U.S. companies, including five European banks and two pharmaceutical companies.[2]

The plaintiffs generally allege that the D&O defendants, in some cases with the assistance of their outside advisers, breached their fiduciary duties and caused substantial harm to the company by allowing it to engage in ill-advised or illegal transactions and other improper conduct, including money-laundering, tax evasion and sanctions violations. As an alleged result, the companies suffered billions of dollars of harm from penalties, fines, costs, settlements, convictions, trading losses and/or damage to reputation.

- In March 2020 a shareholder filed a derivative action in Manhattan against numerous D&Os of a multinational pharmaceutical company, as well as two banks and two law firms that advised the company on its acquisition of a biotechnology company. The D&Os allegedly ignored warning signs and failed to conduct due diligence on the acquired company, which had significant exposure to U.S. product liability lawsuits that ultimately resulted in billions of dollars in damages to the acquiring company.
- Also in March, the same law firm filed a derivative action in the same Manhattan court against numerous D&Os of a European bank, as well as its outside counsel. Following the Financial Crisis, the bank allegedly expanded without adequate internal controls, which it repeatedly failed to fix, update and modernize. According to the plaintiffs, this allowed the bank to engage in sizeable transactions with entities subject to U.S. sanctions and an allegedly large scale money laundering scheme involving payments from Russia. The bank also allegedly retaliated against whistleblowers, failed to cooperate with government investigations, and was a major lender to the Trump enterprises/ family when other banks would not do business with them. As an alleged result, the bank incurred substantial criminal and civil penalties.
- In June 2020, after courts lifted COVID-19 restrictions, plaintiffs filed three additional derivative actions in New York State courts on behalf of foreign companies. A shareholder filed an action in Manhattan against a European bank's D&Os for allegedly allowing systemic misconduct, illegality and inadequate accounting and compliance controls at the bank during the relevant period. Due to this conduct, the bank allegedly became embroiled in endless scandals, lawsuits, prosecutions, and regulatory proceedings, and suffered sizeable damages from fines, settlements, convictions, trading losses, and damage to its reputation.
- Separately in June, a shareholder of another European bank filed a derivative action in Nassau County alleging that its D&Os systemically and knowingly caused and allowed U.S. banks to engage in illegal transactions with foreign entities that had been sanctioned by the Office of Foreign Assets Control.

[2] Six of the actions were filed by the Robert & Robert, Brafman & Associates and Bottini & Bottini firms in New York County (Manhattan), while the seventh action was filed by Ridrodsky & Long and Grabar Law Office in Nassau County (Long Island).

- Finally, in the same month, a shareholder of an additional European bank filed a derivative action in Manhattan alleging that its D&Os allowed systematic supervisory and control failures, resulting in wide-scale criminal and reckless activities in the bank's private and investment banking groups. This allegedly resulted in severe penalties that drastically hurt the bank and its reputation.
- In November 2020, a shareholder of a European bank filed a derivative action in Manhattan alleging that over the past ten years its D&Os engaged in a pattern of negligent, reckless, improper and criminal conduct, and committed numerous breaches of fiduciary duty, including undertaking unlawful financing transactions with Middle Eastern sheikhs. The D&Os allegedly failed to adopt and implement adequate and effective compliance controls and allowed a toxic and "out of control" culture to persist. As an alleged result, the bank incurred penalties and fines, increased costs, loss of market cap, and harm to its corporate reputation.
- In January 2021, a shareholder of a European pharmaceutical company filed a derivative action in Manhattan alleging that, due to the misconduct of its D&Os over a decade, the company was forced to plead guilty to criminal antitrust conspiracies, price fixing, bid rigging, allocating markets and falsifying its books and records, admitted to lying to the FDA, altered and manipulated test data, and concealed material information from regulators and shareholders. The company allegedly paid $3.5 billion in fines, penalties and settlements and incurred hundreds of millions of dollars in defense costs.



The potential benefits of U.S. litigation for plaintiffs

There are a number of reasons why shareholders and plaintiff law firms would pursue claims subject to foreign laws in a U.S. court. First, the plaintiffs may seek to avoid what are perceived as onerous procedural requirements of the foreign jurisdiction. For example, one of the complaints describes requirements to file a corporate derivative suit in the country of incorporation, including a "special action admission procedure conducted by the Regional Court of the Company's Seat." This requires that shareholders meet substantial minimum ownership thresholds, and produce evidence demonstrating "gross" wrongdoing to survive a pre-filing adversarial hearing on the merits without any discovery. Further, even if permission to file is granted, this can be appealed and the action delayed for years.

Instead, the plaintiffs hope to pursue their substantive claims under foreign laws in the more plaintiff-friendly U.S. litigation system. Not surprisingly, the recent complaints include demands for a jury trial, which likely would not be available outside of the U.S. Also, if the plaintiffs defeat a motion to dismiss, they may conduct broad fact discovery, which would likely be much more limited in the company's home jurisdiction. Further, in the U.S., the plaintiff lawyers may work on a contingency fee basis, which is not allowed in most jurisdictions. Finally, in jurisdictions that follow the American rule, each side bears its own costs, as opposed to the loser pay rule in effect in many other jurisdictions. As many of the complaints acknowledge, pursuing the derivative claims in the company's jurisdiction would be "gravely difficult" and financially risky to the plaintiffs.

Interestingly, the six complaints filed in Manhattan openly suggest that the true goal of the derivative actions is to access the limits of each company's D&O insurance program. The plaintiffs allege that the companies purchased sizeable D&O insurance policies to protect against damages due to breaches of fiduciary duties by their D&Os. The complaints describe the D&O policies as corporate assets that should be accessed to compensate the company for the D&Os' alleged wrongdoing. Despite the existence of significant D&O coverage, the Boards have allegedly failed to prosecute direct claims against the D&Os. Further, the plaintiffs note that insured v. insured exclusions in the D&O policies typically do not apply to derivative claims, and therefore such actions are the "best available legal vehicle" to attain these corporate assets for the companies.

U.S. litigation may provide a number of advantages for plaintiff shareholders, including:

- Avoiding onerous procedural requirements of the company's home jurisdiction
- Broad fact discovery
- Contingency fee arrangements with plaintiff's counsel
- The American Rule: each party bears their own costs, rather than loser pays as in most other jurisdictions
- Jury trials

Grounds for motions to dismiss

In each of the actions discussed above, the defendants have filed, or are expected to soon file, motions to dismiss the complaints.[3] For example, in a motion to dismiss one of the actions against a European bank, the defendants argue that under applicable local country law, the plaintiff lacks standing to bring derivative claims on behalf of the company as she failed to request leave from the local regional court where the bank has its corporate seat. Even if the local statutory law did not apply, the motion asserts that the plaintiff cannot assert derivative claims on behalf of a foreign bank under New York law. In addition, the defendants contend that the court should exercise its broad discretion under the doctrine of forum non conveniens to dismiss the case in favour of the more appropriate local country forum. Further, the plaintiff failed to satisfy the heightened pleading standard under New York procedural rules. Finally, the applicable six-year statute of limitations under New York law would bar many of the plaintiff's claims.

With respect to whether plaintiff has complied with relevant foreign law, defendants may also argue that under the "internal affairs doctrine," "claims concerning the relationship between the corporation, its directors, and a shareholder are governed by the substantive law of the state or country of incorporation."[4] This conflict of laws principle "recognizes that only one State should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders – because otherwise a corporation could be faced with conflicting demands."[5] Thus, U.S. courts should apply substantive foreign law to shareholder derivative lawsuits involving foreign corporations.

Courts have rejected prior attempts to pursue a non-U.S. company's derivative claims in New York. For example, in City of Aventura Police Officers' Retirement Fund v. Arison[6], the plaintiff alleged that Carnival plc's Board failed to properly oversee the operations of Princess Cruise Lines, resulting in substantial fines and penalties for environmental and maritime crimes.[7] In dismissing the claim, the New York trial court held that the plaintiff shareholder did not have standing under English law to bring a "derivative claim" under the United Kingdom Companies Act of 2006 because they were not a "member of a company." The court found that the "membership requirement" of the Act was substantive, rather than procedural, because it shaped the "substantive rights of stakeholders to sue derivatively on behalf of English corporations", and therefore could negate the "plaintiff's right to ever bring an action in court."

In other cases, however, U.S. courts have determined that certain requirements of foreign law are procedural, and not substantive, and therefore non-compliance with such requirements was not fatal to a derivative action in a U.S. court. For example, in Davis v. Scottish Re Grp. Ltd., the New York Court of Appeals held that a Cayman Islands rule requiring a plaintiff in a contested derivative action to first apply to the Cayman Islands Grand Court for leave

[3] We anticipate that the courts will rule on most of the pending motions to dismiss in late-2021 and early-2022.
[4] New Greenwich Litig. Tr., LLC v. Citco Fund Services (Europe) B.V., 145 A.D. 3d 16, 22, 41 N.Y.S. 3d 1 (1st Dep't 2016).
[5] Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).
[6] 2020 WL 6108148, 2020 N.Y. Slip Op 20267 (Sup. Ct. N.Y., N.Y. Cty., Oct. 15, 2020).
[7] Carnival plc, together with Carnival Corporation, is part of a dual-listed company. Carnival plc is its own separate legal entity incorporated in England and Wales, and its stock trades on the London Stock Exchange and with American Depository Shares listed on the New York Stock Exchange.

to continue the action, was procedural and not substantive.[8] The court contrasted the rule with the laws of other nations requiring shareholders intending to commence derivative actions to first obtain leave from the courts of the jurisdiction in which they are incorporated.[9]

As noted above, defendants may also argue that derivative actions brought on behalf of foreign companies in U.S. courts should be dismissed on forum non conveniens grounds. U.S. courts generally consider three factors in assessing motions to dismiss for forum non conveniens: (1) the degree of deference owed to plaintiff's choice of forum; (2) whether an adequate alternative forum exists; and (3) a balancing of public and private interest factors, weighing the relative merits of adjudicating in plaintiff's chosen forum or an alternative forum proposed by defendant.[10]

In many foreign company derivative actions, defendants will have good arguments for dismissal based on the doctrine of forum non conveniens, particularly as most relevant witnesses and documents will be located outside of the U.S. Defendants can also argue that while a New York court is capable of applying foreign laws, it could not do so as knowledgeably or efficiently as a court in the jurisdiction whose law governs the claims.[11]

Further, defendant D&Os may have strong arguments that a U.S. court does not have personal jurisdiction. Derivative actions involving foreign companies are likely to be based on acts or failures of D&Os that took place where the company is headquartered, rather than where the U.S. action is filed. To exercise jurisdiction under New York's long-arm statute, for example, the court must first determine whether defendants transacted any business in New York and whether plaintiff's claims arise out of such transactions.[12]

Finally, U.S. courts may be required to enforce forum selection clauses in the company's charter or by-laws requiring that shareholder actions be brought in another jurisdiction.

[8] 88 N.E.3d 892 (N.Y. Ct. App. 2017).
[9] See e.g., Mason-Mahon v. Flint, 166 A.D. 3d 754 (2018).
[10] See Holzman v. Xin, 2015 WL 5544357 (S.D.N.Y. Sept. 18, 2015) (dismissing derivative action on forum non conveniens grounds as adequate forum existed in the Cayman Islands and litigating in New York would create additional expert witness costs for proving aspects of foreign law).
[11] See e.g., Little v. XL Ins. Co. SE, 2019 WL 6119118 (S.D.N.Y. Nov. 18, 2019).
[12] See Best Van Lines, Inc. v. Walker, 490 F.3d 239, 246 (2d Cir. 2007).

Potential exposure to D&Os and insurers of foreign companies

If shareholders are able to clear the initial hurdles and defeat a motion to dismiss, plaintiffs will be entitled to broad discovery and the D&Os and their insurers may face significant litigation risk and substantial exposure to both defense costs and a settlement or judgment.[13] For example, in November 2015, a New York court granted a bank's motion to dismiss a derivative action based on the internal affairs doctrine. The New York Appellate Division reversed the trial court and denied the motion to dismiss. After months of further litigation and substantial defense costs, the parties reached a substantial eight figure settlement, which was apparently funded by the bank's D&O insurers.

To date, U.S. derivative actions have not been considered a significant exposure for non-U.S. companies and their D&O insurers, and they are rarely taken into consideration in the pricing of non-U.S. companies.

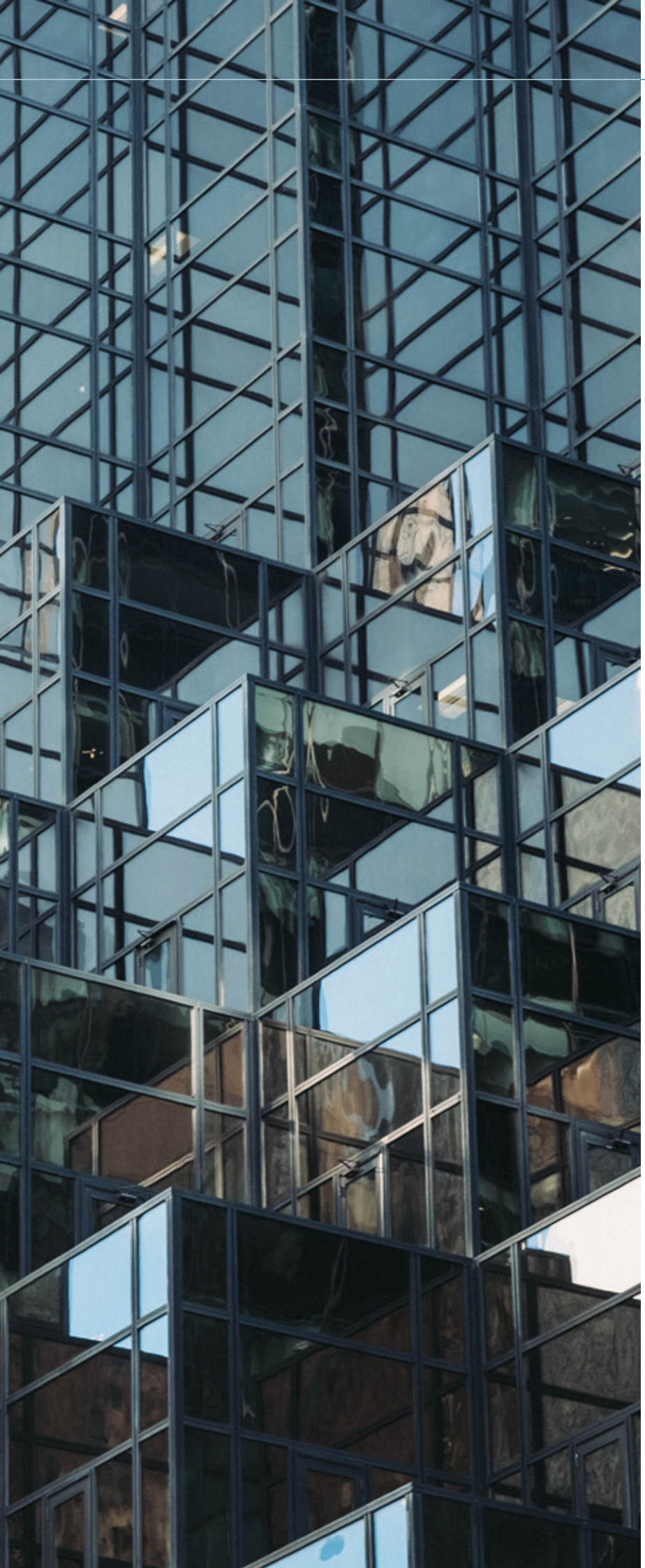
The recent filings in New York State courts demonstrate that plaintiff firms are interested in pursuing derivative claims against D&Os of foreign companies under plaintiff-friendly U.S. litigation rules and in order to cash in on the companies' D&O insurance programs.

Also, D&O insurers should consider that many derivative actions arise out of alleged wrongful acts taking place years before the complaint is filed, and the insurers may have already received a notification relating to that conduct in earlier policy periods. The potential size of these claims, originating from the same wrongdoing, can escalate quickly and for underwriters outside the U.S., this type of potential aggregation is something that merits closer attention going forward.

Conclusion

Shareholder derivative actions brought on behalf of foreign companies in U.S. courts could present substantial and unexpected risks and challenges if plaintiffs are able to clear the initial hurdles. Risk managers of non-U.S. companies and their insurers should closely monitor developments in the foreign company derivative actions recently filed in New York courts and generally consider potential exposures to U.S. derivative actions.

[13] A company may not be allowed to indemnify its D&Os for derivative actions. Coverage for non-indemnifiable loss under most D&O policies is not subject to a retention or deductible.



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