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Legal Developments: Debating Derivatives

The Companies Act comes into force later this year, but a test case is already pending – in an Alaskan state court, by **Werner R. Kranenburg**[^]

ABN Amro may currently be at the centre of some serious legal wrangling, but it has recently emerged victorious out of at least one legal proceeding: a derivative action brought against it in a New York district court was dismissed in March, just before the takeover battle erupted. A pre-unification Royal Dutch Shell settled one such action in the New Jersey disctrict court two years ago; the facts on which the action was brought were the same as those which led to the record-breaking settlement with European and other non-US investors last month over the company's allegedly improper reporting of its proven oil and gas reserves.

The action against BP – brought in Alaska State Court in October last year – is still pending (*Unite v Lord Browne* [2006]). The result of that case could go several ways, one of which would see the latest UK Companies Act come into play in legal proceedings overseas.

In the US, a derivative action is an action brought by one or more shareholders of a corporation or members of an unincorporated association, against the corporation's directors and the corporation itself as nominal defendant on behalf of the corporation. Rule 23.1 of the Federal Rules of Civil Procedure applies to derivative actions in federal court and in each state the courts apply that state's laws. The aim of the action is to enforce a corporation's right or to hold directors accountable to the corporation (see *Meyer v Fleming* [1946] and *Lewis v Knutson* [1983]). It is different from a direct action or a securities class action. A direct action is brough not on behalf of the corporation but the plaintiff, and recovered damages do not flow back to the corporation but to the plaintiff. A

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class action is also not brought on behalf of the corporation but a class of shareholders collectively, and any damages recovered go to them, not the corporation.

A plaintiff derivatively suing a non-US corporation in a US court is likely to claim personal jurisdiction and proper venue based on the dealings of the directors with or in the US and the existence of US operations of the business. (Even without contact, jurisdiction may exist in such case: a federal court has subject matter jurisdiction under the Securities Exchange Act of 1934 if foreign conduct has a negative effect on US investors (*Schoenbaum v Firstbrook* [1969]).

Plaintiffs, however, do have to prove standing to pursue their claims and courts, in cases against out-of-state or non-US corporations, decide what law to apply. That may be based on either the internal affairs doctrine or, assuming a US listing via an American Depository Receipt (ADR) programme, the presumption of validity of choice of law in the programme agreement.

In the case against ABN Amro and its board members (*Seybold v Groenink* [2006]), the court applied the internal affairs doctrine. Under the doctrine, the law of the state of incorporation adjudicates a corporation's internal affairs since only one state has the authority to regulate a corporation's internal affairs (*Edgar v MITE Corp* [1982]) and so Dutch law would apply here. Under Dutch law, however, members of the management and supervisory boards do not owe fiduciary duties directly to shareholders, but the law provides different avenues for shareholders to address malfeasance than affording shareholders a right to bring a claim on behalf of a corporation. Plaintiff lacks standing, public policy exception denied: case dismissed.

Batchelder v Kawamoteo [1998] was also dismissed on a lack of standing. A clause in the ADR agreement stated that Japanese law must apply. But Japan allows such actions to be brought by registered shareholders only, which an ADR holder is not. The ABN Amro defence - that the case was also brought by an American ADR holder - claimed the plaintiff didn't own actual ABN Amro shares, but the court didn't decide on that issue.

Shell, with roots in both English and Dutch law, took a different route to derivative litigation: it quickly settled (see *Unite v Watts* [2004], one of four brought in state and federal court). The allegations against members of the boards of the Shell Transport and Trading and Royal Dutch Petroleum companies included claims of breach of fiduciary duties – which do currently exist to shareholders under English common law – and abuse of their control over the nominal defendants. The case was settled within a year, resulting in the establishment of its documented corporate governance principles. The unification

into an English plc later that year fulfilled one of the corporate governance terms.

So, which way will BP go? Both plaintiffs are ADR holders, so it may turn on the beneficial ownership of shares or whether the programme agreement validly states a certain law must apply, other than Alaskan state or US federal law. For BP to succesfully rely on the internal affairs doctrine, it will have to show that its shareholders have sufficient avenues to address malfeasance under the UK law. Plaintiffs will argue – and already have in the complaint, alongside an exception to the internal affairs doctrine under the laws of Alaska – that the UK Companies Act 2006 provides for a new statutory derivative action. However, the Act itself, which comes into force later this year and, according to some, increases the fiduciary burden on directors and the likelihood of derivative actions in the UK, limits its application to the English courts (section 260). Or BP may settle, but how interesting would that be?