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What Rejected Renren Settlement Means For Investor Suits

By **Peter Shakro, Jonathan Schenker and Muhammad Faridi**
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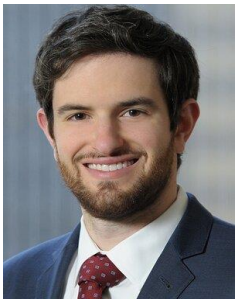
Peter Shakro



Jonathan Schenker

Muhammad Faridi

This past December, in In re: Renren Inc. Derivative Litigation, Justice Andrew Borrok of the New York County Commercial Division rejected a proposed $300 million settlement between Renren Inc. and minority shareholders.

The shareholders allege that Renren's board of directors engaged in a series of self-dealing transactions to divest Renren of its most valuable assets for a fraction of their fair market value.[1] The court rejected the proposed settlement because it directed funds exclusively to current minority shareholders of Renren rather than minority shareholders at the time of the alleged injury.

The court reasoned that the recovery must go to the shareholders at the time of the alleged wrongdoing and not to shareholders who have since purchased shares in an efficient marketplace with knowledge of the alleged wrongdoing. The court also rejected the plaintiffs' counsel's request for legal fees totaling $99 million, or 33% of the settlement amount, as unreasonable.

The court's reasoned opinion is intuitively appealing, but it is susceptible to the criticism that it blurs the distinction between derivative and direct shareholder claims. In addition, critics are likely to argue that the court's decision does not address that, in an efficient marketplace, former shareholders who sold their shares after the alleged wrongdoing became public were fairly compensated for the potential of a recovery.

On the other hand, shareholders who purchased their shares with knowledge of the alleged unfair spinoff transaction arguably lack standing to sue because they were not shareholders at the time of the alleged wrongdoing.

Factual Background

Three minority shareholder plaintiffs brought this derivative action on behalf of all affected minority shareholders alleging that Renren's controlling shareholders spun off its valuable assets into an entity they privately owned at a fraction of the assets' value.

According to the amended complaint, after the Chinese government blocked Facebook, owned by Meta Platforms Inc., Renren emerged as a potential successor and raised over $950 million in an initial public offering.[2] After the IPO, Renren's social media business struggled and Renren's chairman and CEO, Joseph Chen, along with former Renren director, David Chao, used IPO proceeds to make significant investments in startup ventures, including investing $242 million in Social Finance Inc.[3]

Chen then took Renren's valuable investment portfolio private in April 2018.[4] To execute the transaction, according to the amended complaint, Chen formed Oak Pacific Investment as a holding company and wholly owned subsidiary of Renren, and then transferred Renren's investment portfolio to OPI.

With Renren's investments isolated in OPI, Chen and Renren's controlling shareholders then caused Renren to surrender its entire interest in OPI.[5] But rather than distribute OPI's shares to all Renren shareholders, according to the amended complaint, Renren's controlling shareholders presented Renren's minority shareholders with an alleged Hobson's choice between (1) accepting an allegedly inadequate cash dividend or (2) participating in a private placement of OPI shares on allegedly unfair terms to the minority shareholders.[6]

In their amended derivative complaint, the plaintiffs brought claims for breach of fiduciary duty and breach of contract in connection with the defendants' alleged self-dealing, among other claims.

Procedural History

In May 2020, New York Supreme Court Justice Borrok denied the defendants' motions to dismiss the complaint, and the Supreme Court of the State of New York, Appellate Division, First Department later affirmed that decision.[7]

While the defendants' motions to dismiss were pending, the plaintiffs moved for a prejudgment attachment based on allegations that the defendant OPI had transferred over 22 million shares of SoFi for below fair market value after the commencement of this litigation.[8]

Justice Borrok granted the plaintiffs' request for prejudgment attachment against assets of the defendants OPI, Renren SF Holdings Inc., and Renren Lianhe Holdings in an amount up to $560 million. The court also prohibited those defendants from disposing of any assets or making any payment beyond routine business expenses in an amount not to exceed $400,000 per month unless approved by the court.[9]

The Parties' Settlement Proposal and Objections to the Settlement

In October 2021, the parties submitted a settlement for the court's approval that provided for payments from the defendants totaling $300 million to be deposited into a settlement fund.[10] These funds would be disbursed directly to nondefendant Renren shareholders based on the number of shares held by such shareholders as of a record date.

The settlement defined record date as a future date: "[t]he earliest practicable date" after the date on which court approval of the settlement became final.[11] The plaintiffs' counsel also requested $99 million from the fund in attorney fees.[12]

Altimeo Asset Management, a former Renren shareholder from the time of the defendants' alleged misconduct, filed an objection arguing that the settlement was unfair and inadequate because it was structured to provide recoveries exclusively to current shareholders.[13]

Altimeo highlighted that the three plaintiffs would receive approximately 55% of the settlement proceeds because they increased their holdings after they commenced this litigation, while former shareholders who were injured by the defendants' alleged misconduct would not receive any compensation.[14] Other minority shareholders objected to the unprecedented size of the $99 million attorney fees request.[15]

The plaintiffs responded to the objectors' arguments: First, the plaintiffs argued that former shareholders lacked standing to object to the settlement because this is a derivative action, meaning the claims and potential recovery belonged to Renren, and former shareholders had no claim in any recovery by Renren.[16]

Second, the plaintiffs defended their request for attorney fees. The plaintiffs argued that their requested fee "compares favorably to that awarded for the largest derivative judgment," and that a 33% fee is warranted here given the large settlement amount that they negotiated, as well as the novelty and complexity of the issues that they navigated.[17]

Justice Borrok's Decision and Supplemental Orders

On Dec. 9, 2021, the court held a hearing in which it made clear that it would not approve the parties' settlement proposal for two primary reasons.

First, the court disagreed with the plaintiffs' contention that the record date used to determine the injured minority shareholders must be a date in the future. Instead, the court noted that it was not prepared to approve a settlement that does not set April 29, 2018 — the day before the allegedly improper spinoff transaction was announced — as the record date.[18]

In its written decision, the court held that the settlement was "so unfair on its face to preclude judicial approval" because the plaintiffs attempted to exclude former minority shareholders who were harmed by the defendants' alleged self-dealing.[19]

The court distinguished between the former shareholders' lack of standing to sue derivatively and their ability to participate in the recovery for injuries suffered when they were shareholders.[20] The court reasoned that the substantive claims require the court "to set a record date to determine the identity of the minority shareholders who were allegedly defrauded," and that the appropriate date is therefore April 29, 2018.[21]

Second, the court rejected the plaintiffs' counsel's $99 million fee request as unfair and excessive.[22] The court determined that the fee request amounted to an award of nearly $6,000 per hour spent working on the case, which the court found to be inappropriate.[23] The court reasoned that approval of the "extraordinary fee request" could incentivize otherwise meritless lawsuits meant solely to induce quick settlements.[24]

Justice Borrok's rejection of the settlement has led to a flurry of activity. Justice Borrok entered two supplemental orders to clarify the decision. In the first supplemental order, Justice Borrok noted that certain plaintiffs are shareholders who purchased their shares after the announcement of the allegedly fraudulent spinoff transaction and therefore "knew exactly what they were buying."[25]

In light of that knowledge, Justice Borrok reasoned that those investors "could not possibly have been defrauded" and granted the defendants leave to file an order to show cause seeking dismissal of the complaint with respect to investors who bought their shares after the announcement of the spinoff.[26] The

defendants subsequently moved to dismiss two of the three plaintiffs, which had each first purchased shares in May 2018.[27]

In an additional supplemental order, Justice Borrok further clarified the court's reasoning in rejecting the proposed settlement and in granting the defendants leave to file a motion to dismiss with respect to certain plaintiffs. Justice Borrok explained that this is a derivative action in which eligible shareholders bring a claim on behalf of Renren against the alleged wrongdoers.[28]

Justice Borrok added that in the context of a lawsuit alleging fraud perpetrated against minority shareholders, "the shareholders of record at the time of the alleged wrongdoing are the eligible shareholders."[29] The corollary, Justice Borrok reasoned, is that investors who purchased their shares after the announcement of the spinoff transaction lack standing to file an action for breach of fiduciary duty and fraud because they were not shareholders at the time of the alleged fraud and did not suffer any injury in connection with the allegations set forth in the complaint.[30]

On Dec. 15, 2021, the plaintiffs filed a notice of appeal of Justice Borrok's decision. Although the court made clear in its decision rejecting the settlement that shareholders at the time of the alleged breach of the fiduciary duty are the only shareholders eligible to recover from a settlement, the plaintiffs have argued that the derivative claims belong solely to the corporation, and therefore, current minority shareholders.[31]

According to the plaintiffs, while the corporation under the control of the defendants cannot be trusted to distribute settlement proceeds, there are still no direct claims asserted on behalf of individual shareholders.[32]

Moreover, though the court highlighted that investors who purchased their shares after the announcement of the spinoff transaction had full knowledge of the spinoff and therefore cannot claim to have been defrauded by it, the plaintiffs argue that former shareholders similarly sold their stakes in Renren and voluntarily chose to forego any benefit from Renren's potential legal claims.[33]

In addition, shareholder CRCM Institutional Master Fund (BVI) Limited recently moved to intervene in the action to defend the court's ruling disallowing the distribution of settlement funds to new Renren shareholders.[34] CRCM argues that, despite the fact that the complaint is styled as a derivative action, the action only seeks redress for direct harm to minority Renren shareholders.[35]

According to CRCM, because the complaint seeks to recover for direct harm to a subset of shareholders rather than the company as a whole, only shareholders actually harmed by the alleged unfair spinoff transaction should recover. CRCM disagrees, however, with the April 29, 2018, record date and contends that the record date should be set as of June 21, 2018, the date when the spinoff closed and nonparticipating shareholders were paid an inadequate dividend.[36]

If accepted by the court, this new date would presumably also resolve the motions to dismiss against the two plaintiffs that first bought shares in May 2018.

Analysis

Much of the complexity in this case stems from the plaintiffs styling this suit as a derivative suit on behalf of Renren, despite the alleged injury befalling only certain minority shareholders. This led to the unusual settlement structure for a derivative suit of a direct payment to minority shareholders, rather than a recovery by the corporation.

Justice Borrok's carefully reasoned opinion that such a direct recovery should go to the shareholders from 2018 who were actually injured has practical and moral appeal. And courts have discretion to ensure that settlements are fair, including that derivative settlements help right the substantive wrong at issue.

However, some critics may argue that direct payments to former shareholders would also turn the traditional derivative or direct claim distinction on its head. They may claim that the justification here for a direct payment to minority shareholders is not that they were specifically injured — as in a direct claim — but that the corporation is controlled by the defendants who cannot be trusted to act as proper fiduciaries of the settlement proceeds if the settlement were paid to the corporation.

For this reason, it will be interesting to follow the court's decision on the proposed intervenor CRCM, which argued that the court should treat — or already has treated — this suit as a direct claim. Courts commonly treat securities lawsuits brought as direct claims as derivative claims, but it is unusual for derivative claims to be treated as direct shareholder claims.

In addition, some may argue that the court's economic reasoning has an equally persuasive opposite side of the coin. The court reasoned that shareholders who purchased a share after the alleged breach of fiduciary duty became public are not entitled to recovery because they knew of the breach and at that point the shares they bought were priced efficiently.

However, the shareholders from the time period before the breach became public who sold their shares after it became public could also be said to have sold into an efficient market where the potential for recovery was priced into the sale. And the investors who purchased at that price could arguably have purchased the chance of recovery, allowing the market to efficiently allocate risks to participants more willing to take them.

That said, a future record date could also allow the defendant majority shareholders to capture some value from the settlement by selling shares to new or minority shareholders at inflated prices before the record date.

In light of the court's rejection of the settlement, the prejudgment attachment imposing onerous restrictions on the defendants' transfer or sale of assets in an amount up to $560 million remains in place. Thus, the defendants will continue to feel pressure to settle the case. However, until the appeal and motions to dismiss and intervene are decided, the defendants may struggle to identify the proper plaintiffs with which to renegotiate a settlement.

When and if the plaintiffs' appeal is perfected, New York's Appellate Division for the First Judicial Department will have to grapple with these derivative standing issues and arguments concerning which shareholders are entitled to recoveries from any potential direct-pay settlement.

The ultimate ruling on the propriety of the settlement could influence the way that speculative investors invest in and litigate against companies with outstanding derivative claims. The outcome could affect the future decision making of majority and minority shareholders and the lawyers that represent them, and shape the types of settlements available to resolve disputes.

Peter Y. Shakro and Jonathan Schenker are associates, and Muhammad U. Faridi is a partner, at Patterson Belknap Webb & Tyler LLP.

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[1] In re Renren Inc. Derivative Litig., No. 653594/2018, 2021 BL 473940 (N.Y. Sup. Ct. Dec. 10, 2021).

[2] Am. Complaint, In re Renren, Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. May 14, 2021), at ¶¶ 1, 2.

[3] Id. at ¶ 92.

[4] Id. at ¶¶ 95, 109.

[5] Id. at ¶ 9.

[6] Id. at ¶ 10.

[7] Matter of Renren, 192 A.D.3d 539 (1st Dep't 2021).

[8] See In re Renren, Inc. Derivative Litig., No. 653594/2018, 2021 BL 193420, at *1 (N.Y. Sup. Ct. May 14, 2021).

[9] NYSCEF Doc. No. 549, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. May 24, 2021).

[10] Id. at NYSCEF Doc. No. 753.

[11] Id. at ¶ A.1.t.

[12] NYSCEF Doc. No. 759 at 16, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Nov. 1, 2021).

[13] NYSCEF Doc. No. 798 at 2, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Nov. 24, 2021).

[14] Id. at 5.

[15] See, e.g., NYSCEF Doc. No. 836, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 2, 2021).

[16] NYSCEF Doc. No. 810 at 2-3, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 2, 2021).

[17] Id. at 6.

[18] NYSCEF Doc. No. 849 at 6:5-10, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 9, 2021).

[19] In re Renren Inc. Derivative Litig., 2021 BL 473940, at *1.

[20] Id. at *2.

[21] Id.

[22] Id. at *3.

[23] Id.

[24] Id.

[25] NYSCEF Doc. No. 851, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 29, 2021).

[26] Id. at 1.

[27] NYSCEF Doc. Nos. 865, 869, 870 In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Jan. 14, 2022).

[28] NYSCEF Doc. No. 852, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 31, 2021).

[29] Id. at 2.

[30] Id. at 3.

[31] NYSCEF Doc. No. 810, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 2, 2021) (citing Abrams v. Donati, 66 N.Y.3d 951, 953 (N.Y. 1985) (diversion of corporate asset claims "plead a wrong to the corporation only").

[32] NYSCEF Doc. No. 810 at 5, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Dec. 2, 2021) (Plaintiffs arguing that objector cannot "cite any legal authority where former investors shared in the recovery achieved through a derivative case involving no direct claims").

[33] See In re Triarc Companies, Inc., 791 A.2d 872, 875 (Del. Ch. Ct. 2001) (former shareholders "chose to dissociate their economic interests from the corporation and, by doing so, to forego…the potential benefit to the corporation of the derivative claims").

[34] NYSCEF Doc. No. 880, In re Renren Inc. Derivative Litig., No. 653594/2018 (N.Y. Sup. Ct. Jan. 26, 2022).

[35] Id. at 13-14.

[36] Id. at 17.