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The Importance of Sufficiently Alleging Demand Futility in Derivative Lawsuits

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Attorneys face myriad hurdles and pitfalls in their representation of business owners. In its recent decision in *Retirement Plan for General Employees of the City of North Miami Beach v. McGraw*, the First Department reminded us of one often overlooked in the litigation context—the importance of an owner adequately alleging demand futility in a derivative action. 2018 N.Y. Slip. Op. 01027 (Feb. 13, 2018)

What Is a Derivative Action?

Before one can understand the role demand futility plays in a derivative lawsuit, and why it is so important, one must understand what a derivative claim is in the first place. Generally speaking, if a claim concerns harm directly to the business, but it is asserted by a shareholder on behalf of the business, then it is a derivative claim.

The determination of whether a claim is direct or derivative turns on who was harmed first and who would receive the benefit of any recovery or other remedy, the member or the entity. *Yudell v. Gilbert*, 99 A.D.3d 108 (1st Dept. 2012) ("[a] plaintiff asserting a derivative claim seeks to recover for injury to the business entity" while "[a] plaintiff asserting a direct claim seeks redress for injury to him or herself individually"). As the Court of Appeals explained nearly a century ago, claims asserted by a business owner are derivative when "[t]he remedy sought is for wrong done to the corporation; the primary cause of action belongs to the corporation; [and] recovery must enure to the benefit of the corporation." *Isaac v. Marcus*, 258 N.Y. 257 (1932); see also *Marx v. Akers*, 88 N.Y.2d 189 (1996).

> The decision in 'McGraw' reaffirms that, under any 'Marx' scenario, a plaintiff asserting a derivative claim must allege with particularity why it would be futile for the owner-plaintiff to make a demand upon the board of directors to authorize the corporation to bring the lawsuit.

Examples of typical derivative claims include those alleging waste and mismanagement of corporate funds, the payment of excessive salaries to majority members and their families, and diversion of corporate opportunities. See, e.g., *Abrams v. Donati*, 66 N.Y.2d 951 (1985); *Glenn v. Hoteltron Sys.*, 74 N.Y.2d 386 (1989). Although often mis-asserted, the courts have made clear that claims based solely on a

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purported decrease in the value of one's ownership interest is a quintessential derivative claim. *Abrams*, supra.

Why Is Demand Futility Necessary?

Understanding that a derivative claim is one that primarily seeks to benefit the business, one can next see why demanding that the business bring a lawsuit or asserting demand futility is important.

It is a basic principal of the general corporation law that directors, rather than shareholders, manage the business and affairs of the corporation under their charge. With this responsibility comes the authority to decide whether to bring a lawsuit, or to refrain from litigating a claim, on behalf of the corporation. *Bansbach v. Zinn,* 1 N.Y.3d 1 (2003).

The board, however, does not have exclusive dominion over this decision. Shareholders and members alike are imbued with the authority to assert claims derivatively on behalf of the businesses in which they have an ownership stake. See B.C.L. §626(a); *Tzolis v. Wolff*, 10 N.Y.3d 100 (2008).

Because the shareholders' ability to institute an action on behalf of the corporation inherently impinges upon the directors' power to manage the affairs of the corporation, and can cause the corporation to incur significant legal fees upon reimbursement to the litigating owner (see B.C.L. §626(e)), the law imposes certain prerequisites on an owner's right to sue derivatively.

When Is a Demand Futile? The 'McGraw' Decision

Business Corporation Law §626(c) requires that a shareholder bringing a derivative action seeking to vindicate the rights of the corporation allege, with particularity, either that an attempt was first made to get the board of directors to initiate such an action or that any such effort would be futile. The same requirement is imposed upon members of companies asserting derivative claims. *Najjar Group v. W. 56th Hotel*, 110 A.D.3d 638 (1st Dept. 2013).

Initially, if a demand is made and the board rejects it or refuses to initiate the lawsuit, then the shareholder can assert his or her derivative claim. The corporation can then move to dismiss the complaint based on the board's business judgment that the suit is not in the best interests of the corporation. But, if the board's rejection of the pre-suit demand is a foregone conclusion, then the shareholder is excused from making it.

Under well-settled case law, a demand is deemed futile under any one of three possible scenarios: (1) when a majority of the directors are interested in the challenged transaction, (2) when the directors failed to inform themselves to a degree reasonably necessary about the transaction, or (3) if the directors failed to exercise their business judgment in approving the transaction. *Marx v. Akers*, 88 N.Y.2d 189 (1996).

Under the first scenario, it is not just a matter of simple math. In order to meet the heightened pleading standard, the plaintiff must explain why he or she believes that a majority of the directors are interested in the challenged transaction. If the majority of the board members are interested in the challenged transaction, then they cannot be expected to cause the corporation to sue themselves for breaching their obligations.

Of course, in cases where a business only has two owners, demand futility is relatively easy to allege because the coequal owner-defendant has an obvious conflict of interest. *Jones v. Voskresenskaya*, 125 A.D.3d 532 (1st Dept. 2015). But still, futility must be alleged.

In the more complex circumstance presented by larger corporations with full and active boards and committees, a bare allegation that directors are interested simply because they are "substantially likely to be held liable" for their actions is not enough. New York law in this regard differs from that of the standard-bearer, Delaware. See, e.g., *Stone v. Ritter*, 911 A.2d 362 (Del 2006). As the decision in *McGraw* teaches, the plaintiff in New York must allege specifically why and how the

board member's independence in deciding to bring a lawsuit is compromised.

A lack of independence can be stated if, for example, one can allege that the majority of the board members took an active role in the disputed transaction, they personally reaped the benefits of the transaction, or they are under the control of the primary bad actor, either by familial relationship or otherwise. In *Marx*, self-interest was shown by allegations that the outside directors comprised a majority of the board and therefore received a personal benefit in fixing their own excessive compensation.

With these types of allegations, the court will infer that the interested directors or members are so conflicted that they, as the majority on control, would not authorize the company to bring the lawsuit that would cause themselves financial harm.

Under the second scenario to establish demand futility, the plaintiff needs to allege the board of directors, even if independent, turned a blind eye to "red flags" or that they abdicated their oversight of the business's practices such that they could not exercise validly their business judgment.

In *McGraw*, the plaintiff's claim was defeated by the defendant establishing that the board members held regular meetings where they discussed the challenged transactions and their specific responsive action to allegations of malfeasance. *McGraw*, 2018 N.Y. Slip. Op. 01027 at *2. But such meetings and attempts to remedy a problem are not always the case.

If the plaintiff is relying on this basis to establish demand futility, he or she must specifically identify the alleged instances of the board's intentional ignorance or blatant disregard of concerning facts. For example, the First Department reinstated a shareholder derivative complaint where the plaintiff alleged that compensation committee members approved stock options without question more than a month after the options were granted, orally approved the options in direct violation of the company's bylaws, and approved options without making any inquiry whether the grantees were employees of the company. *Matter of Comverse Tech., Inc. Derivative Litig.*, 56 A.D.3d 49 (1st Dept. 2008).

Under the third scenario, the plaintiff must "allege with particularity that the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors." *Marx*, 88 N.Y.2d at 200-01. This is not a catchall standard. As one court put it, only in "rare cases" will a board's action be deemed "egregious" enough to satisfy the third *Marx* test. *Wandel v. Eisenberg*, 60 A.D.3d 77 (1st Dept. 2009). A plaintiff relying on this basis to avoid demand futility must allege why the board's approval of the transaction cannot meet the business judgment test. For example, a plaintiff could allege that the board improperly delegated approval of the transaction to an unauthorized person.

Conclusion

The decision in *McGraw* reaffirms that, under any *Marx* scenario, a plaintiff asserting a derivative claim must allege with particularity why it would be futile for the owner-plaintiff to make a demand upon the board of directors to authorize the corporation to bring the lawsuit.

Practitioners must pay careful consideration to the basis for demand futility during the early stages of the engagement because it will be vital to the initial success of a derivative complaint. If it is treated as a mere afterthought, all of the hard work put into investigating the claims and then drafting the complaint could be for naught when the lawsuit is dismissed on this basis.

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