LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

NY Shareholder Litigation Dismissal Raises Bar For Plaintiffs

By **Ian Kerr and Muhammad Faridi** (June 3, 2020, 6:28 PM EDT)

Ian Kerr

Muhammad Faridi

In derivative shareholder actions, New York law requires a plaintiff shareholder seeking to vindicate the rights of a corporation to plead, with particularity, either that before filing suit a request was made on the corporation's board of directors to initiate the action or that any such demand, if made, would have been futile.[1]

This presuit demand requirement may seem straightforward in theory, but a March 19 New York Supreme Court Commercial Division decision by Justice Andrea Masley serves as a cautionary reminder of tricky nuances in its application.

Consider the following scenario: Shareholders commenced a derivative lawsuit on behalf of a corporation and, in their initial pleading, satisfied the presuit demand requirement. Years into the litigation, the corporation entered liquidation and a receiver or trustee was appointed to oversee that process. Sometime later, the court dismissed the derivative complaint but allowed leave to amend.

Under those circumstances, how does the presuit demand requirement apply? In Culligan Soft Water Co. v. Clayton Dubilier & Rice LLC,[2]the Commercial Division held that shareholders must replead demand or demand futility.

The court also held that, for purposes of the presuit allegations, the relevant party is the receiver or trustee — not the corporation's board of directors. Under the court's reasoning, the plaintiff shareholder cannot simply repackage its original presuit demand allegations, and failure to abide by this rule will result in dismissal.

Background

In 2012, minority shareholders of Culligan Ltd. brought a derivative lawsuit asserting claims on behalf of the corporation against the board of directors, including breach of fiduciary duty, illegal distributions and corporate waste, and unjust enrichment.[3] At the time, the plaintiffs alleged that they made multiple demands on Culligan's board and, further, that those demands were "futile because of the Director Defendants' self-interest."[4]

In 2013, roughly one year after the complaint was filed, Culligan entered into a voluntary liquidation under Bermuda law and, by shareholder resolution, appointed certain managing directors from KPMG

International to serve as liquidators.[5]

In 2015, the trial court dismissed the shareholders' third amended complaint without prejudice, on the ground that they failed to adequately allege standing to maintain a derivative action.[6]

The First Department affirmed, but ordered that the shareholders be granted the opportunity to amend and conform to the proper pleading standing.[7] The plaintiffs thereafter filed the fourth amended complaint and, with respect to presuit demand, continued to allege they made multiple, and futile, demands on Culligan's board of directors before commencing the action in 2012.[8]

The liquidators filed a motion seeking (1) to be substituted as plaintiffs pursuant to Civil Practice Law and Rules Sections 1017 and 1021, or (2) in the alternative, to dismiss the action for failure to plead facts satisfying New York's presuit demand requirement.

Analysis

The court denied the liquidators' motion for substitution,[9] but granted their motion to dismiss the fourth amended complaint. In so holding, the court started from the premise that presuit demand and demand futility are "assessed with respect to the board of directors extant 'as of the time the complaint was filed.'"[10]

The issue, the court observed, was whether the Culligan shareholders should "continue looking at the board" of directors in place at the time they first commenced the lawsuit in 2012 or, instead, "to the Liquidators for assessing demand and demand futility with respect to the [fourth amended complaint]."[11]

The court held that the law required the latter. In determining whether plaintiffs may repeat their original allegations of presuit demand or demand futility in an amended pleading, the relevant inquiry is whether the earlier complaint was "validly in litigation."[12]

According to the court, that question must be answered in the negative, and new demand allegations will be required, when the earlier complaint was dismissed for any reason. As the court observed, even "[a] complaint that is dismissed without prejudice but with express leave to amend is nevertheless a dismissed complaint" no longer in litigation.[13]

Thus, the court identified the following decisional rule: "When ... a complaint is amended following dismissal without prejudice, demand and demand futility must be assessed by reference to the board in place at the time the amended pleading is filed."[14]

As applied to the facts, this rule required dismissal of the fourth amended complaint. The court had dismissed the third amended complaint without prejudice, and the First Department affirmed that dismissal.

The plaintiffs therefore could not relate back to 2012 for demand or demand futility purposes and, instead, were "required to show that they made a demand on the Liquidators [in 2019] or that [such demand] would have been futile."[15]

Because the fourth amended complaint lacked those new allegations, the court granted the liquidators' motion to dismiss — but, notably, allowed the plaintiffs leave to file a fifth amended complaint that corrected that deficiency.[16]

Conclusion

Presuit demand and demand futility are hallmarks of shareholder derivative litigation, and these issues have been thoroughly litigated in New York and other courts. Justice Masley's decision in Culligan highlights the nuances associated with these issues and imposes an additional hurdle for shareholders to meet when there is a change in the company's control before an amended complaint is filed upon dismissal of an earlier pleading.

Ian C. Kerr is an associate and Muhammad U. Faridi is a partner at Patterson Belknap Webb & Tyler LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] N.Y. Bus. Corp. Law § 626(c);accord Wandel v. Eisenberg, 60 A.D.3d 77, 79 (1st Dep't 2009).

[2] 2020 N.Y. Slip Op. 30828(U) (Sup. Ct. N.Y. Cnty. Mar. 19, 2020) (Masley, J.).

[3] Id.at *3.

[4] Id.at *8.

[5] Id.at *3.

[6] Id.at *8.

[7] Culligan Soft Water Co. v. Clayton Dubilier & Rice LLC, 139 A.D.3d 621, 621 (1st Dep't 2016).

[8] Culligan,2020 N.Y. Slip Op. 30828(U), at *8.

[9] The court determined that substitution was not appropriate in light of plaintiffs' breach-of-fiduciary claims against the liquidators.Id.at *6-7.

[10] Id.at *7 (quoting In re Citigroup Inc. Shareholder Derivative Litig., 788 F. Supp. 2d 211, 213 (S.D.N.Y. 2011) (quoting Braddock v. Zimmerman, 906 A.2d 776, 785 (Del. 2006))).

[11] Id.at *7-9.

[12] Id.at *9.

[13] Id.(quoting Korsinsky v. Winkelreld, 143 A.D.3d 427, 427 (1st Dep't 2016)).

[14] Id.

[15] Id.

[16] Id.at *9, *12.