

CONDOMINIUMS AND COOPERATIVES

Defending a Co-op Against Derivative Claims: A Look Back to 'Auerbach'

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Shareholder litigation commenced against boards of cooperative corporations is often brought both individually and derivatively on behalf of the corporation for good reason. The Business Corporation Law (BCL) broadly provides that a shareholder who is successful, in whole or in part, or who receives anything as a result of a judgment or settlement, in a derivative action, may be awarded reasonable expenses, including reasonable attorneys' fees. BCL Section 626(e). In contrast, the attorneys' fees provisions commonly found in proprietary leases (if any) are much narrower and limit recovery. Dismissing the derivative claims from the lawsuit can significantly change the posture of the litigation and substantially narrow the issues in the case, which can strengthen the board's position and mitigate expenses. This article discusses a basis for seeking dismissal of derivative claims, which may be overlooked by practitioners.

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Derivative claims, alleging that the board of directors breached a fiduciary duty to the corporation (i.e., caused harm to the corporation), belong to the corporation, not to the shareholder. It is not for one shareholder to decide

whether it is in the best interest of the corporation to assert such a claim against the board. Derivative claims are permitted because a corrupt board, comprised of self-interested directors, would presumably not sue itself. However, independent, disinterested directors can decide whether the corporation should pursue a claim against the board, and they are better suited to do so, under the protections of the business judgment rule. The Court of Appeals established this precedent in the landmark case *Auerbach v Bennett*, 47 NY2d 619 (1979), and this precedent has been successfully applied to cooperative



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corporations. *Ungerleider v One Fifth Ave Apt Corp*, 164 Misc 2d 118, 120 (NY Sup Ct 1995).

Auerbach provides that a defendant board of directors may appoint a “special litigation committee” (SLC) consisting of disinterested independent directors to conduct a thorough investigation of a shareholder’s derivative claim. If the SLC finds the claim to be meritless, or not in the corporation’s interests to assert, the court will defer to the SLC’s decision and grant a summary judgment motion to dismiss the claim on those grounds. Under the business judgment

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rule, the court cannot question the SLC’s decision to seek dismissal of the derivative claim. Rather, the court’s inquiry is limited to just an examination of whether the members of the SLC were “disinterested and independent,” and whether the SLC conducted an “appropriate and sufficient” investigation of the derivative claim. *Auerbach*, 47 NY2d at 620.

The underlying facts of *Auerbach* are important to understanding this principle. A publicly traded corporation, General Telephone & Electronics, conducted an internal preliminary investigation to ascertain whether the corporation made questionable payments to public officials and political parties. The audit revealed that the corporation had, in fact, made payments constituting bribes and kickbacks amounting to \$11 million, which the corporation, in turn, reported to the Securities and Exchange Commission (SEC). Immediately after the SEC filing, *Auerbach*, a shareholder of

the corporation, commenced a derivative action against the directors on the board asserting that the directors are liable for breach of their duties to the corporation and should be made to account for payments made in those transactions.

Immediately after the derivative claim was filed, the board formed the SLC, consisting of just three of the 15 directors comprising the board. These three directors, who joined the board after the challenged transactions occurred, were vested with the “authority of the Board of Directors to determine, on behalf of the Board, the position that the corporation shall take with respect to the derivative claims alleged on its behalf.” *Id* at 625. After a seven-month investigation, the SLC concluded that “no proper interest of the corporation or its shareholders would be served by the continued assertion of a claim against it.” *Id* at 625. The SLC found that there was no breach of duty, that none of the directors profited personally, and that the derivative claim had no merit. Notwithstanding that kickbacks and bribes did occur, the SLC determined that, “if the action were allowed to proceed, the time and talents of the corporation’s senior management would be wasted on lengthy pretrial and trial proceedings, that litigation costs would be inordinately high in view of the unlikelihood of success, and that the continuing publicity could be damaging to the corporation’s business.” *Id* at 626.

Finding that there was no evidence of bad faith or fraud in *Auerbach*, the Court of Appeals granted summary judgment dismissing the derivative claims, holding that the SLC’s determinations must be respected because “courts are ill equipped to evaluate what are and must be essentially business judgments.” *Id* at 630. Since the SLC determined that it is in the corporation’s

best interests to terminate a plaintiff's derivative claims, the business judgment rule "bars judicial inquiry into the actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate processes." *Id* at 629.

This procedure to evaluate and seek dismissal of derivative claims was followed by a cooperative board with similar success in *Ungerleider v One Fifth Ave Apt Corp*, 164 Misc 2d 118 (NY Sup Ct 1995). Deferring to the SLC's judgment, the *Ungerleider* court found that "[a]s to what has

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been uncovered and the relative weight accorded in evaluating and balancing the several factors and considerations are beyond the scope of judicial concern." *Id* at 121. However, "[w]hile the substantive aspects of a decision to terminate a shareholder's derivative action against defendant corporate directors appointed by the corporation's board of directors are beyond judicial inquiry under the business judgment doctrine, the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedure chosen and pursued by the committee." *Id* at 120.

The *Ungerleider* court found that the cooperative board demonstrated both the "disinterested independence" of the SLC's members and that the SLC's investigation was "appropriate and sufficient." The board submitted proof that each of the three members of the SLC were not related

to any of the individual defendants in the action, they were not employed by or engaged in any business relationship with the individual defendants, and they were not members of the board during the time periods at issue in the litigation. The SLC reviewed the complaint and litigation papers, it hired independent counsel who investigated, and had counsel prepare a report of counsel's findings. The SLC reviewed the report, met with counsel, and then determined that prosecution of the derivative claims was not in the interest of the cooperative. *Id* at 120-121. The shareholder plaintiff did not submit any proof to raise an issue of fact as to the disinterested independence of the members of the committee; and the proof submitted by plaintiff was insufficient to raise an issue of fact to demonstrate that "the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or half hearted as to constitute a pretext or sham. *Id* at 121; citing *Auerbach*, 47 NY2d at 620.

This standard was also followed in *Lichtenberg v. Zinn*, 260 A.D.2d 741 (3rd Dept 1999); however, it is noteworthy that the trial court held the motion to dismiss in abeyance until after discovery was completed. Although the timeliness of the board's motion to dismiss was not raised on appeal in *Lichtenberg*, requiring a board to complete discovery before the motion is considered would seemingly defeat the purpose of forming an SLC under the principles of *Auerbach*.

Regarding discovery, the Court of Appeals in *Auerbach* did not find there was any affidavit in the record asserting that essential facts may exist which could be obtained by disclosure, and the shareholder did not otherwise identify any particulars to be sought in discovery concerning the disinterestedness of the SLC members or the

procedures it followed. The court held “[t]o speculate that something might be caught on a fishing expedition provides no basis to postpone decision on the summary judgment motions under the authority of CPLR 3212(f).” *Auerbach v Bennett*, 47 NY2d 619, 637. This ruling reversed the Appellate Division, Second Department, which found that a nonfrivolous derivative action should not be foreclosed at the threshold before the plaintiff has been afforded the opportunity of pretrial discovery and examination before trial. *Auerbach v Bennett*, 64 A.D.2d 98, 107-108. Accordingly, the completion of full discovery on the merits, as contemplated by the Second Department, is not warranted, but the Court of Appeals did not preclude discovery altogether. Rather, discovery may be necessary only if the plaintiff raises substantive issues concerning the alleged disinterested independence of the SLC or the appropriateness and sufficiency of its investigation, which demonstrates a need for further factual investigation, short of a fishing expedition.

Interestingly, just days before the Court of Appeals decided *Auerbach*, the Appellate Division, First Department, decided *Byers v. Baxter*, 69 A.D.2d 343 (1st Dept 1979), which reversed the dismissal of a derivative claim, without prejudice to renew, upon the completion of very limited discovery. The *Byers* court opined that “[s]urface formalities may be only a device for concealing the impropriety of the corporation’s decision not to sue,” while recognizing that “disclosure proceedings can become extremely extensive in stockholder suits, so as to nullify a large part of the advantage that a disinterested board of directors, acting in good faith, may legitimately seek to

accomplish by resolution to terminate the action.” *Id* at 348. Accordingly, the *Byers* court granted the plaintiff limited discovery solely as to “the validity and propriety of the board of directors’ resolution in determining to terminate this action and not the underlying merits,” which was to be completed expeditiously. *Id* at 349-350.

The *Ungerleider* court determined that the cooperative board’s motion to dismiss the derivative claim was ripe for adjudication because the plaintiff did not demonstrate that further discovery was necessary. The action was pending for nearly two years and a substantial amount of discovery has been completed, including defendants’ production of over 8,000 pages of materials, an architect’s production of about 3,000 pages of material, and several examinations before trial. Plaintiff failed to identify any particulars of his desired discovery relating to the disinterestedness of the members of the special litigation committee or the procedures followed by that committee. *Ungerleider v One Fifth Ave Apt Corp*, 164 Misc 2d 118, 121.

In conclusion, a cooperative board may consider utilizing a SLC to seek the dismissal of derivative claims asserted by a shareholder. The SLC must be comprised of disinterested independent directors who have full authority to conduct an appropriate and thorough investigation of the claims. Provided that the formation of the SLC, and the methods it uses, are known or otherwise disclosed to the plaintiff, the board should be successful dismissing the derivative claims from the litigation by moving for summary judgment on the basis that the SLC wants to terminate the claims.