

Lerner v. Prince: New York Appellate Division Holds No Right to Discovery in Demand-Refused Litigation, Applies Delaware Substantive Law

On May 22, 2014, in *Lerner v. Prince*, the New York Appellate Division held that the plaintiff's right to discovery in a demand-refused derivative action is a substantive question, rather than a procedural one, and thus is governed by the law of the state where the corporation is chartered rather than the law of the forum state.¹

I. Background and Procedural History

In the wake of the subprime mortgage meltdown and the resulting financial crisis, Citigroup Inc. ("Citigroup"), a Delaware corporation with its principal place of business in New York, reported write-downs on its holdings in mortgage-related securities. In late 2007, Stanley Lerner made a formal pre-suit demand ("the demand") on Citigroup's Board of Directors (the "Board") to sue senior management for alleged mismanagement of the company's subprime assets.

The Board formed a committee (the "demand committee") to investigate and analyze the allegations in Lerner's demand. Lerner filed suit in New York in July 2009. In May 2010, the demand committee recommended to the Board that the Board refuse Lerner's demand. The Board unanimously accepted the committee's recommendation.

Plaintiff's complaint alleged that the demand committee was a "sham" and that the Board's two-year delay in responding to the demand constituted constructive and wrongful refusal. Plaintiff alleged breaches of fiduciary duty, aiding and abetting breaches of fiduciary duty, and waste of corporate assets. In October 2010, defendants moved to dismiss the suit, asserting that the Board's demand refusal, undertaken after a thorough investigation, was protected under the business judgment rule and that plaintiff had failed to adequately plead facts creating a reasonable doubt as to the reasonableness and good faith of the Board's investigation and its refusal of the demand.

Before the trial court ruled on the motions to dismiss, plaintiff served discovery requests on defendants. Defendants refused to comply, asserting that plaintiff was not entitled to discovery under Delaware or New York law on a pre-answer motion to dismiss. Plaintiff moved to compel discovery and convert defendants' motions to dismiss to summary judgment motions. The court denied plaintiff's motion to compel and convert, on the grounds that there was no basis to permit discovery and no reason for the court to exercise its discretion and convert defendants' motions to motions for summary judgment.

On May 17, 2012, the trial court granted defendants' motions to dismiss. The court held that under New York State's choice-of-law rules, the substantive law of the state of incorporation governs compliance with the demand requirement. The court found that plaintiff failed to allege particular facts creating reasonable doubt as to the reasonableness and good faith of the Board's investigation of the demand. As a result, the court determined that the business judgment rule shielded the Board from further inquiry. Therefore, plaintiff lacked standing to pursue the derivative claims arising out of the demand.

Plaintiff appealed from the trial court's denial of the motion to compel and convert and the granting of defendants' motions to dismiss to the New York Appellate Division.

¹ *Lerner v. Prince*, No. 650417/09-10616, slip op. at 5 (N.Y. App. Div. May 22, 2014) ("Slip Op."), available at http://www.nycourts.gov/reporter/3dseries/2014/2014_03763.htm.

II. The Court’s Decision

Justice Karla Moskowitz, writing for the New York Appellate Division, affirmed the trial court’s rulings.

The court noted that “[a]lthough New York courts have applied the law of the forum when deciding matters, such as discovery, affecting the conduct of the litigation, that this case is a purported derivative action places it in a different context.”² As a result, the court held that in the context of a demand refusal case, the plaintiff’s right to discovery is a substantive question, rather than a procedural one, as the right to discovery in this context goes directly to the basis of such actions. Therefore, pursuant to New York choice-of-law rules, the law of the state where the corporation is chartered controls this discovery issue. In this case, Delaware law is controlling and Delaware law prohibits discovery.

Allowing any other result, the court reasoned, would subvert “the directors’ authority to decide, under the business judgment rule, whether litigation was in the corporation’s best interests – the very reason underlying the demand requirement.”³ Additionally, the court emphasized the risk of future forum shopping, if plaintiff was allowed discovery under New York law and thereby able to circumvent Delaware’s prohibition on discovery.

The court further stated, that for the sake of argument, even if “New York law applies, plaintiff would still not be entitled to discovery in this demand-refused case” because “demand refused cases get the presumption of valid business judgment.”⁴ The court pointed out that when a complaint does not overcome the presumption of valid business judgment, as the court found was the case here, courts may properly deny discovery because discovery is a tool “to find out additional facts about a well-pleaded claim, not whether such a claim exists.”⁵

Justice Moskowitz then affirmed the trial court’s granting of the defendants’ motions to dismiss, finding the allegations in the complaint to be insufficient to support plaintiff’s contention that defendants’ investigation was unreasonable, uninformed, or conducted in bad faith. Lastly, the court affirmed the trial court’s decision not to convert the dismissal motions into summary judgment motions because the parties did not specifically undertake summary judgment proceedings.

III. Significance

Lerner recognizes the validity of properly constituted demand committees and that the context of a purported derivative action requires that discovery, although typically a procedural issue determined by the law of the forum in New York courts, be treated as a substantive issue determined by the law of the state where the corporation is chartered because the availability of discovery in a demand-refused derivative action goes directly to the basis of such actions.

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² *Id.* at 5-6 (citations omitted).

³ *Id.* at 6.

⁴ *Id.* (citing *Stoner v. Walsh*, 772 F. Supp. 790, 800, 806-807 (S.D.N.Y. 1991) (applying New York law)).

⁵ *Id.* (quoting *Stoner*, 772 F. Supp. at 800) (internal quotations omitted).

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