

SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

BY EDWARD M. SPIRO

Standing to Bring Derivative Actions

Recently, Judges Denny Chin and Robert W. Sweet of the U.S. District Court for the Southern District of New York each issued decisions addressing threshold issues relating to standing to bring derivative actions.

Judge Chin's decision in *Bischoff v. Boar's Head Provisions Co.*,¹ opens the door to a class of potential plaintiffs, holding that members of a limited liability company (LLC) have the right to bring derivative litigation on behalf of the LLC, despite the lack of express statutory authorization for such suits. Judge Sweet's decision in *Henik v. LaBranche*,² closes the door to derivative plaintiffs where another plaintiff, suing on behalf of the same corporation, has already made an unsuccessful effort to establish demand futility. Judge Sweet held that the doctrines of res judicata and collateral estoppel bar relitigating that question, even where the plaintiff in the subsequent action did not participate in the first lawsuit.

LLC Derivative Actions

Bischoff concerned the allocation of profits between a pair of family-owned businesses that manufacture and distribute Boar's Head brand meats. The plaintiff as well as the defendants were all descendants of Frank Brunckhorst, who founded the business a century ago. All the parties had an ownership interest in both companies, although the plaintiff was entitled to a higher share of the profits in the company that handled distribution (FB Co.), while the defendants had a greater interest in the company that manufactured the processed meats (Provisions). Plaintiff claimed that the defendants, who were directors and controlling shareholders of FB Co., a limited liability company, had improperly used that control to divert revenues from FB Co. to Provisions, thereby increasing their own profits.

Plaintiff initially filed suit in New York State Supreme Court, asserting derivative claims on behalf of FB Co. for breach of fiduciary duty, waste, unjust enrichment and money had and received. Defendants removed the action to



federal court and moved to dismiss, arguing that plaintiff had no right under New York law to sue derivatively on behalf of an LLC. Plaintiff opposed that motion, and cross-moved to remand the case to state court for lack of federal subject matter jurisdiction because the presence of FB Co. as a defendant destroyed diversity.

In denying the motion to dismiss and ordering the case remanded to state court, Judge Chin had to navigate his way around two significant and related obstacles in order to find that a member of an LLC has the right to maintain a derivative action. First, although the statute authorizing the formation of LLCs³ is silent on the right of members to bring derivative suits, the legislative history reveals that a provision authorizing such suits was contained in the original version of the bill, but was dropped from the final version "to avoid jeopardizing passage of the balance of the law," after some legislators raised questions about that provision.⁴ The second obstacle to finding a right to sue derivatively on behalf of an LLC was the fact that based on this legislative history, the only four state court decisions to address this question had all ruled that members of an LLC were prohibited from commencing derivative actions under New York law.⁵

Common-Law Right

Despite these apparent barriers, Judge Chin concluded that under the common law, a member of an LLC had a right to sue derivatively, and that that right was not overridden by either the statute creating LLCs or the decisions of the lower New York courts to the contrary. He stressed that the common law right to sue derivatively, stemming from recognition of a beneficiary's right to bring an action belonging to a trust, extended back to the 1800s. He noted that in reliance on this

common-law right, the New York Court of Appeals had recognized under common law, first the right of corporate shareholders⁶ and then the right of limited partners⁷ to sue derivatively, independent of any statutory authorization, which in both cases followed recognition of the right under common law.

Judge Chin reasoned that because an LLC is essentially a hybrid of the corporate and limited partnership forms ("offering the tax benefits and operating flexibility of a limited partnership with the limited liability protection of a corporation") members of an LLC would "undoubtedly" have the common law right to sue derivatively, just as their shareholder and limited partner counterparts do. He then observed that only "a clear and specific" expression of legislative intent is sufficient to displace a common-law right, and found that the legislature's silence on the question of derivative rights did not constitute such a clear statement. He acknowledged that changes to proposed legislation are a factor in determining legislative intent, but expressed hesitation to read the Legislature's omission of the derivative rights provision as an abrogation of the common-law derivative right. Judge Chin found support for this position elsewhere in the legislative history of the statute, noting testimony before the New York State Assembly during consideration of the bill, that an LLC member would have the common-law right to bring a derivative suit "whether or not the statute contains such an express right."⁸ Observing that legislation is presumed to take place "against a backdrop of common law adjudicatory principles," Judge Chin concluded that the Legislature's failure to include the derivative rights provision was not a bar to enforcing such rights under common law.

Judge Chin had previously recognized the common-law right to sue an LLC derivatively in his decision in *Cabrini Dev. Council v. LCA-Vision, Inc.*,⁹ as had U.S. District Judge Jacob Mishler for the Eastern of New York in *Weber v. King*.¹⁰ Judge Chin concluded that the four New York State courts which had subsequently reached the opposite conclusion were unpersuasive because they had relied on the Legislature's decision to omit the derivative rights provision without addressing (except for one case) the need to view the legislation against the backdrop of the common law right discussed

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above.¹¹ Although he owed “proper regard” to these state court rulings, Judge Chin concluded that they were not binding in the absence of a decision from the New York Court of Appeals, and did not provide a persuasive basis for barring a member of an LLC from bringing a derivative suit.

An LLC has the citizenship of each of its members for purposes of diversity jurisdiction.¹² Thus, because the derivative suit was proper, the presence of the LLC as a defendant necessarily destroyed diversity because it shared citizenship with the plaintiff, and required that the case be remanded to state court.

Relitigating Demand Futility

The issue in *Henik v. LaBranche* was whether dismissal of previous derivative plaintiffs’ claims for failure to allege adequately that a pre-suit demand on the corporation would have been futile, precludes subsequent plaintiffs from relitigating the question of demand futility with respect to the same underlying claim. Plaintiffs in that action sought to assert derivative claims against members of the board of directors of LaBranche & Co., based on allegations that LaBranche’s specialist subsidiary improperly traded ahead of public orders on the New York Stock Exchange. The derivative complaint sought recovery against the defendant directors for breach of fiduciary duty to monitor the trading operations of the subsidiary and to institute reasonable controls over the business.

Several months before the initial complaints in that consolidated action were filed, New York State Supreme Court Justice Helen E. Freedman had dismissed a similar complaint against LaBranche filed by other plaintiffs, holding that the plaintiffs in that action had not adequately pleaded that a pre-suit demand upon LaBranche would have been futile¹³—a prerequisite to a derivative suit against a Delaware corporation.¹⁴ The defendants in *Henik* argued that under the doctrines of collateral estoppel and res judicata, Justice Freedman’s dismissal of the earlier action, *Brown v. LaBranche & Co.*, precluded the plaintiffs in *Henik* from relitigating the question of demand futility.

The plaintiffs opposed the application of these preclusion doctrines on two grounds. First, they argued that the dismissal in *Brown* was not a “final decision on the merits,” as required for res judicata. Specifically, they posited that the requirement that derivative plaintiffs either make a pre-suit demand on the corporation’s board or demonstrate that such a demand would have been futile, relates to the plaintiffs’ standing to bring the suit and not to the merits of the litigation. Judge Sweet recognized that the determination in *Brown* regarding the disinterestedness of the board was “technically a procedural issue of standing to proceed derivatively,” but concluded that it nevertheless did constitute a decision on the merits for the purposes of preclusion, noting that the Supreme Court has found the demand requirement one of substance rather than procedure.¹⁵

Judge Sweet also reasoned that because Justice

Freedman dismissed the *Brown* action without prejudice to bringing a new action if a pre-suit demand is either rejected or not acted upon, by implication, the case was dismissed with prejudice in the absence of such a showing. Citing *Elfenbein v. Gulf & Western Indus., Inc.*,¹⁶ which held that an order dismissing a derivative action for failure to allege demand futility was a final appealable order, Judge Sweet concluded that the *Brown* “dismissal was a final adjudication and could thus support the application of res judicata.

Other Shareholders Bound

The plaintiffs’ second objection to the application of either collateral estoppel or res judicata was that because these particular plaintiffs did not have an opportunity to litigate the question of demand futility in *Brown*, they should not be barred from doing so, whatever the preclusive effect of the *Brown* decision with respect to the plaintiffs in *Brown*. Judge Sweet acknowledged that as a general rule, preclusion should not be imposed on individuals who have not had an opportunity to litigate in the initial action. He noted, however, that “privity among shareholder plaintiffs in the derivative litigation context presents an atypical situation.”¹⁷

He explained that unlike most lawsuits, where standing questions turn on the characteristics of the individual plaintiff and will thus differ from one potential plaintiff to another, the plaintiff in a derivative suit is actually the corporation, and the facts about the corporation’s board will not differ based on the identity of the shareholder who is suing in the corporation’s name.

Although no court in the U.S. District Court for the Southern District of New York had previously ruled on the preclusive effect of one plaintiff’s unsuccessful attempts to establish demand futility on other shareholders’ attempts to do so, Judge Sweet noted that his analysis was bolstered by a number of longstanding decisions holding that a judgment on the merits in a derivative action is res judicata on shareholders that were not parties to the original litigation.¹⁸ He concluded that “[t]he fact that the *Brown* dismissal was based upon the standing to sue derivatively and not upon the merits of the underlying action bears not on the fact that the suit was commenced and litigated on behalf of the LaBranche corporation and all of its shareholders.”

In holding that the decision in *Brown* precluded the *Henik* plaintiffs from relitigating the question of demand futility, Judge Sweet noted that the result might differ if the plaintiffs in the second action could make a showing that the plaintiffs in the first did not adequately represent the interests of all of the shareholders by, for example, failing to put forward all of the available evidence in support of demand futility. Because the *Henik* plaintiffs made no such claim, Judge Sweet concluded that there was no reason to question the diligence of the *Brown* plaintiffs in representing the interests of all the LaBranche shareholders. He further noted that the *Henik* plaintiffs knew of the *Brown* litigation and could have intervened in that action to put forward any

arguments they deemed appropriate. Having failed to do so, Judge Sweet held that they were precluded from relitigating the question of demand futility and granted the defendants’ motion to dismiss.

Conclusion

Judge Chin’s decision in *Bischoff* paves the way for members of an LLC to avail themselves of a very useful and powerful tool in policing the management and operations of this relatively new class of business entity. Judge Sweet’s decision in *Henik* makes clear, however, that those who enjoy the right to sue derivatively are effectively all in the same boat when it comes to exercising those rights, and should monitor closely any derivative litigation brought in the company’s name because the first case filed may be the only opportunity for adjudication of those rights.

1. 2006 WL 1793653 (SDNY, June 29, 2006).
2. 2006 WL 1548037 (SDNY, June 6, 2006).
3. New York Limited Liability Company Law (NYLLCL) §101 et seq.
4. 2006 WL 1793653, at *3 (quoting Bruce A. Rich, Practice Commentaries to NYLLCL §(1)(G) (McKinney 2005)).
5. *Hoffman v. Unterberg*, 780 N.Y.S.2d 617 (2d Dept. 2004); *Tzolis v. Wolff*, 2006 WL 1310621 (N.Y. Sup. Ct. March 20, 2006); *Lio v. Zhong*, 2006 WL 37044 (N.Y. Sup. Ct. Jan. 6, 2006); *Schindler v. Niche Media Holdings, LLC*, 772 N.Y.S.2d 781 (N.Y. Sup. Ct. 2003).
6. *Brinckerhoff v. Bostwick*, 88 N.Y. 52 (1882).
7. *Riviera Cong. Assocs. v. Yassky*, 18 N.Y.S.2d 540 (1966). See also *Klebanow v. N.Y. Prod. Exch.*, 344 F.2d 294 (2d Cir. 1965) (recognizing the common law right of limited partners to sue derivatively, the year prior to the New York Court of Appeals decision in *Yassky*).
8. 2006 WL 1793653, at *6 (quoting Public Hearing on Limited Liability Company Legislation, N.Y. Ass. 133 (1992)).
9. 197 FRD 90 (SDNY, 2000), vacated in part on other grounds sub nom. *Excimer Assocs. v. LCA Vision, Inc.*, 292 F.3d 134 (2d Cir. 2002).
10. 110 F. Supp. 2d 124 (E.D.N.Y. 2000).
11. In that case, *Lio v. Zhong*, the court acknowledged case law recognizing the right to bring a derivative suit under common law, but concurred with the analysis of other New York State courts finding that “the deliberate omission of such a remedy in the statute means that there is no such right at all.” 2006 WL 37044, at *3. Judge Chin noted that this observation was contained in dicta, because the derivative claims had been withdrawn.
12. *Handelsman v. Bedford Vill. Assocs. Ltd. P’ship*, 213 F.3d 48, 51-52 (2d Cir. 2000).
13. *Brown v. LaBranche & Co.*, No. 0603512/03 (N.Y. Sup. Ct. Nov. 8, 2004).
14. Under Delaware law, a plaintiff in a derivative action must either allege with particularity the steps taken to obtain action from the board of directors, or that a demand for such action would be futile. Del. Ch. Ct. R. 23.1. To establish demand futility, the plaintiff must allege facts showing a reasonable doubt both as to the independence of the members of the board, and that the challenged transaction was otherwise the product of a valid exercise of business judgment. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).
15. 2006 WL 1548037, at *6 (citing *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96-7 (1991)).
16. 590 F.2d 445 (2d Cir. 1978).
17. 2006 WL 1548037, at *7 (citing *In re Sonus Networks, Inc. Shareholder Derivative Litig.*, 422 F. Supp. 2d 281, 291-92 (D. Mass. 2006)).
18. 2006 WL 1548037, at *8 (citing *Dana v. Morgan*, 232 F. 85, 89 (2d Cir. 1916); *Ratner v. Paramount Pictures, Inc.*, 6 F.R.D. 618, 619 (SDNY. 1942)).