
Attorney Fee Awards in Shareholder Derivative Actions

Thomas J. Hall, *New York Law Journal*

George Bundy Smith: *A great man-my co-author, former law partner and friend-passed away on Aug. 5, 2017. A man of incredible conviction and moral character, he served as a role model and mentor to so many. His actions and example left the world a far better place. He will be sorely missed.*

When a plaintiff shareholder is successful in a derivative lawsuit brought on behalf of a corporation, New York Business Corporation Law §626(e) provides courts with the discretion to award reasonable expenses, including attorney fees, as reimbursement for those incurred in bringing the action on the corporation's behalf. Success in such an action is measured by whether plaintiff achieved a "substantial benefit" for the corporation or its shareholders, but a substantial benefit alone will not entitle a plaintiff to reimbursement. Section 626 imposes other requirements that must be met to recover attorney fees, including that the plaintiff be a shareholder both at the time of the issue as well as commencement of the suit, and that such plaintiff make and plead with particularity a pre-suit demand upon the corporation or the circumstances why such a demand would have been futile.

This column addresses recent Commercial Division decisions evaluating claims for awards of expenses and attorney fees, pursuant to §626(e).

Section 626(e)

Business Corporation Law §626 governs when a plaintiff is authorized to bring a derivative action on behalf of a domestic or foreign corporation. To do so, the plaintiff must be a shareholder of the corporation both at the time of the transaction complained of and when the suit was commenced. The plaintiff is required to plead with particularity her pre-suit demand upon the corporation's board of directors or the reasons why such a demand would be futile. A shareholder derivative action cannot be discontinued, compromised or settled without court approval.

Section 626 also authorizes a court to award expenses, including attorney fees, to a successful plaintiff:

If [a derivative] action on behalf of the corporation is

successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise, or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the corporation for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured shareholders only and limited to a recovery of the loss or damage sustained by them.

Section 626(e) does not authorize the imposition of attorney fees on the losing party; rather, because the costs to plaintiff are incurred on behalf of the corporation, attorney fees, when awarded, are to be paid by the corporation or out of the monetary award to the corporation, if any. *Glenn v. Hoteltron Sys.*, 74 N.Y.2d 386,393 (1989); *Motherway v. Cartisano*, No.

25543-09, 2014 WL 1921281, at *5 (Suff. Co. April 2, 2014). Based on the same principle, when a shareholder plaintiff's action asserts both direct and derivative claims, the court can award under §626(e) only those legal fees incurred to pursue the derivative claims. *Zelouf v. Zelouf*, No. 603746/2009, 2013 WL 4734873, at *1 (N.Y. Co. Aug. 30, 2013). Fees can only be sought in the action in which they are incurred, not in a subsequent action. *Sardis v. Sardis*, 53 N.Y.S.3d 904, 913 (Suff. Co. 2017).

Substantial Benefit Rule

Left unsaid in the text of §626(e) is an explanation of what constitutes success. To determine if the derivative action was successful, courts have looked to whether the plaintiff obtained a "substantial benefit" for the corporation or its shareholders as a result of the derivative action.

In *Seinfeld v. Robinson*, 246 A.D.2d 291 (1st Dep't 1998), the First Department relied upon the substantial benefit rule articulated by federal courts in holding that resolutions to improve corporate behavior may constitute a substantial benefit. In *Seinfeld*, shareholders filed a derivative suit alleging misconduct by the officers and directors of their corporation's hiring of a private investigator who planted false news stories about a former executive. The derivative suit settled, resulting in the adoption of resolutions implementing procedures to govern the retention of such investigators in the future. Upon the shareholders' request for attorney fees, the trial court denied the application, holding that there was no substantial benefit to the corporation from the settlement, and that the suit was unsuccessful in finding wrongdoing by members of the board or recovering a monetary settlement. *Seinfeld v. Robinson*, 172 Misc.2d 159, 163-71 (N.Y. Co. 1997). The First Department reversed, holding that establishing procedures to prevent the corporation from using outside investigators for questionable activities qualified as "corporate therapeutics" that would prevent future public humiliation of the company and its shareholders and therefore achieved a substantial benefit.

In *Gusinsky v. Bailey*, No. 603126/06, 2008 WL 4490008 (N.Y. Co. Sept. 17, 2008), shareholders alleged that their corporation's board of directors breached their fiduciary duties to the company by misdating stock options and otherwise failing to account for option grants properly. In response, the board conducted a review and determined that selective backdating had not occurred but that, as a result of ineffective oversight, the company would restate its financial results. The parties entered into a proposed settlement wherein

the company agreed to adopt corporate reforms to improve practices regarding equity compensation and internal controls over financial reporting.

Plaintiff's sought to recover attorney fees under §626(e). New York County Commercial Division Justice Herman Cahn denied the request, acknowledging that while attorney fees may be awarded for non-monetary benefits, the benefits must be "substantial." The court held that here, "[t]he sole benefits obtained by the class appear to be some minor changes in corporate governance. In fact, the Board's Special Committee conducted an investigation [and] reported that there had been no wrongdoing." On appeal, the First Department reversed, holding that the settlement "confer[ed] 'substantial benefits' on the company since it caused extensive improvements to the company's corporate governance and internal control policies, which provide material, lasting benefits to the company and its shareholders." *Gusinsky v. Bailey*, 66 A.D.3d 614, 615 (1st Dep't 2009).

In contrast, in *Sardis v. Sardis*, 53 N.Y.S.3d 904 (Suff. Co. 2017), Commercial Division Justice Elizabeth H. Emerson denied the shareholder plaintiff's application for attorney fees under §626(e) because there had been no substantial benefit to the company. *Sardis* involved a corporation with just two shareholders, the plaintiff and defendant, former husband and wife who had divorced in 2009. As part of their divorce settlement, plaintiff was to be paid distributions of the corporation each year in lieu of maintenance, while the defendant was to be paid a periodically reducing salary while taking commercially reasonable efforts to cause the sale of the corporation's assets. Shortly before the salary reduced to zero, the defendant petitioned a Delaware court to appoint a receiver to dissolve the corporation and potentially allow for sale of its assets to a purchaser owned by or affiliated with him. The plaintiff intervened in that proceeding, arguing that defendant's actions were in violation of their agreement, which required such transactions to be at arms-length and required each stockholder to consent to and vote for the sale. The plaintiff also commenced the derivative action in New York alleging the same violation, along with allegations that the plan was designed to evade the agreement. The defendant then withdrew the Delaware dissolution proceeding and his petition for appointment of a receiver and, after certain stipulations were made, plaintiff agreed to discontinue her New York derivative action conditioned upon approval by the court and payment of legal fees as determined by the court.

The court denied the plaintiff's request for attorney fees, finding no benefit to the corporation from the plaintiff's New

York derivative action. The court held that plaintiff failed to establish that defendant had breached their agreements and that plaintiff's intervention in the Delaware proceeding gave her an opportunity to oppose any sale, ensuring the process would be fair, without the need for the New York derivative suit. Thus, the action did not result in a substantial benefit to the corporation but merely delayed an anticipated sale and benefitted the plaintiff personally by allowing her to continue to receive corporate distributions in the interim.

Other Requirements

Obtaining a substantial benefit for the corporation alone does not entitle a plaintiff to reimbursement of fees and expenses if he fails to comply with the standing and pleading requirements of §626. In *Central Laborers' Pension Fund v. Blankfein*, 111 A.D.3d 40, 971 N.Y.S.2d 282 (1st Dep't 2013), the First Department held that an award of attorney fees under §626(e) is unavailable when the plaintiff does not satisfy or was not excused from §626(c)'s requirement to demand board action. There, the plaintiff shareholders brought suit against board members of Goldman Sachs for a reduction in employee compensation, but failed to make a pre-suit demand. Defendants expressed their intent to move to dismiss the actions, but before doing so issued a press release announcing a decrease in employee compensation compared to the prior year. Plaintiffs then moved to dismiss the actions voluntarily, asserting that they were now moot because the announcement essentially conceded the merits of their claims.

New York County Commercial Division Justice Bernard J. Fried denied plaintiffs a fee award, *Central Laborers' Pension Fund v. Blankfein*, 34 Misc.3d 456,475 (N.Y. Co. 2011), and the First

Department affirmed. 111 A.D.3d at 49, 971 N.Y.S.2d 282, 289. The court held that to award fees when no pre-suit demand was made and no excuse given in the complaint "would reward that plaintiff for unjustifiably wresting the management of the corporation from those to whom it is entrusted by law and by the rest of the shareholders." In those circumstances, the court held that a "derivative plaintiff has no justification for acting on behalf of the corporation."

Conclusion

New York Business Corporation Law §626(e) creates a structure that allows, in the court's discretion, shareholder plaintiffs to be reimbursed for their expenses and legal fees incurred in pursuing a successful shareholder derivative action resulting in a substantial benefit to the corporation or its shareholders. To qualify for such reimbursement, the benefits need not be monetary, but mere action by the corporation in response to a complaint does not necessarily mean a substantial benefit was conferred, and failure to adhere to §626's standing and pleading requirements likely will preclude any recovery.

Thomas J. Hall is a partner with Norton Rose Fulbright. David B. Schwartz, a senior associate, and Niki Ikahihifo-Bender, a law clerk, assisted in the preparation of this article.

Norton Rose Fulbright

Norton Rose Fulbright is a global law firm. We provide the world's preeminent corporations and financial institutions with a full business law service. We have more than 3500 lawyers and other legal staff based in more than 50 cities across Europe, the United States, Canada, Latin America, Asia, Australia, Africa, the Middle East and Central Asia.

Recognized for our industry focus, we are strong across all the key industry sectors: financial institutions; energy; infrastructure, mining and commodities; transport; technology and innovation; and life sciences and healthcare.

Wherever we are, we operate in accordance with our global business principles of quality, unity and integrity. We aim to provide the highest possible standard of legal service in each of our offices and to maintain that level of quality at every point of contact.

Norton Rose Fulbright Verein, a Swiss verein, helps coordinate the activities of Norton Rose Fulbright members but does not itself provide legal services to clients. Norton Rose Fulbright has offices in more than 50 cities worldwide, including London, Houston, Toronto, Sydney and Johannesburg. For more information, see nortonrosefulbright.com/legal-notices.

The purpose of this communication is to provide information as to developments in the law. It does not contain a full analysis of the law nor does it constitute an opinion of any Norton Rose Fulbright entity on the points of law discussed. You must take specific legal advice on any particular matter which concerns you. If you require any advice or further information, please speak to your usual contact at Norton Rose Fulbright.