

"A Primer on Shareholder Derivative Lawsuits under New York Law," American Bar Association's (ABA) *Securities Litigation Journal*

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Jenner & Block Partners Gabriel K. Gillett, Howard S. Suskin, and Associate Zoë Higgins Reinstein co-authored an article published in the American Bar Association's (ABA) *Securities Litigation Journal*, titled "A Primer on Shareholder Derivative Lawsuits Under New York Law." The article provides an overview of how shareholder derivative lawsuits are prosecuted and defended in New York.

A shareholder derivative lawsuit is a lawsuit brought by one or more shareholders of a corporation, purportedly on behalf of the corporation, to address an alleged wrong committed against the corporation. Typically the case is styled with the shareholder as the plaintiff, the corporation's officers or directors as defendants, and the corporation itself as the nominal defendant. In New York, derivative claims are governed by section 626 of New York's Business Corporation Law.

Generally speaking, New York law and Delaware law are similar when it comes to derivative claims. On some issues, New York law and Delaware law diverge. For example, New York "has declined to adopt the Delaware approach to demand futility," *Wandel v. Eisenberg*, 60 A.D.3d 77, 80 (N.Y. App. Div. 1st Dep't 2009), which, as discussed below, is a key issue in derivative cases. However, where New York law is undeveloped, New York courts "look to the views of Delaware's learned jurists when analyzing issues of corporate law." *RSL Commc'ns PLC v. Bildirici*, 649 F. Supp. 2d 184, 205–6 (S.D.N.Y. 2009).

Standing

Under New York law, the plaintiff in a derivative lawsuit must demonstrate that the plaintiff was a shareholder of the company at the time of the alleged misconduct and at the time of bringing the lawsuit and that the plaintiff will fairly represent the interests of the corporation. N.Y. Bus. Corp. Law § 626(b); *Steinberg v. Steinberg*, 434 N.Y.S.2d 877, 879 (Sup. Ct. 1980). If the shareholder's interests are hostile to the corporation or other shareholders, or if there is a conflict of interest with

the corporation or other shareholders, the shareholder will not be able to bring the lawsuit. *Steinberg*, 434 N.Y.S.2d at 879. Further, courts distinguish between direct and derivative shareholder lawsuits. When the alleged harm suffered and the benefit of the remedy sought by the lawsuit would go to the corporation as opposed to the shareholder individually, the suit is derivative and may proceed as such. *Yudell v. Gilbert*, 949 N.Y.S.2d 380 (App. Div. 1st Dep't 2012) (adopting standard set by *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004)).

Demand Futility

Before filing the lawsuit, the shareholder must make a pre-lawsuit demand on the company's board of directors, requesting that the board bring litigation advocating for the corporation's interests. If the shareholder fails to make a demand, the shareholder must demonstrate why the demand on the corporation's board would have been futile. N.Y. Bus. Corp. Law § 626(c); *Marx v. Akers*, 666 N.E.2d 1034, 1040 (N.Y. 1996). Demand futility is a common ground on which defendants and the nominal defendant (meaning the corporation on behalf of which the derivative action is brought) may move to dismiss a shareholder derivative action. Under New York law, demand is futile in the following circumstances:

1. A majority of the corporation's board of directors were interested in the challenged transaction due to a personal financial interest in the transaction or due to a loss of independence because a director is "controlled" by a self-interested director;
2. The board of directors failed to fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances; or
3. The board of directors failed to exercise their business judgment in approving the transaction because the transaction was "egregious on its face."

See *Marx*, 666 N.E.2d at 1039–42; *Barr v. Wackman*, 329 N.E.2d 180 (N.Y. 1975); *Wandel*, 60 A.D.3d at 80.

The shareholder must demonstrate demand futility "with particularity," and conclusory claims will not suffice. *Ret. Plan for Gen. Emps. of N. Miami Beach v. McGraw*, 2016 WL7475835, at *3 (N.Y. Sup. Ct. Dec. 21, 2016). For example, for demand to be excused based on the board's lack of oversight, a shareholder must plead with particularity that "that the directors had specific information or reason to inform themselves about the details" of a particular issue and "failed to do so." *Wandel*, 60 A.D.3d at 81. Significantly, this differs from Delaware's standard for pleading demand futility because no portion of the required analysis considers whether the directors themselves face a "substantial likelihood of liability" with respect to the derivative claims asserted, which is crucial to two of the three grounds under Delaware law on which a court may find demand futile. See *United Food & Com. Workers Union v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021) (outlining Delaware's three-part demand futility test).

If the shareholder does not adequately allege that demand is futile, or if demand is deemed to not be futile, the derivative action will be dismissed, and the shareholder must instead make a demand on the corporation's board to initiate the desired action. In response, the board can decide to commence a lawsuit on behalf of the corporation or to inform the shareholder that the demand is being refused. The board has no duty to go forward with the litigation, but it does have a fiduciary duty to consider carefully, and often investigate, the claims raised by the shareholder. If the board refuses the demand, the shareholder may then file a derivative lawsuit arguing that the board's refusal was wrongful and not justified by the exercise of reasonable discretion. *Rafiy v. Javaheri*, 927 N.Y.S.2d 554 (Sup. Ct. 2011); *Syracuse Tel. Inc. v. Channel 9, Syracuse, Inc.*, 274 N.Y.S.2d 16 (Sup. Ct. 1966).

Substantive Claims

Often the underlying claim in shareholder derivative lawsuits involves claims for breach of the common-law fiduciary duty owed to the corporation by its officers and directors, corporate waste, and insider trading.

Most commonly, shareholder derivative suits often allege a breach of fiduciary duty by the corporation's officers and directors. Officers and directors owe the corporation duties of care, loyalty, and good faith.

- *Duty of care*: Directors and officers must act with the care that an ordinarily prudent person in a similar position would use under similar circumstances. However, the "business judgment rule" presumes that directors and officers act on an informed basis, in good faith, and in the honest belief that their actions are in the best interests of the company. Colvin, "Business Unusual: Recent Applications of New York's Business Judgment Rule," *N.Y. L.J.*, Oct. 31, 2024; *In re Bear Stearns Litig.*, 870 N.Y.S.2d 709 (Sup. Ct. 2008).
- *Duty of loyalty*: Directors and officers must prioritize the best interests of the corporation and its shareholders over any personal interests. A breach of this duty often involves self-dealing or acting in a way that benefits the director or officer at the expense of the corporation. *Higgins v. N.Y. Stock Exch., Inc.*, 806 N.Y.S.2d 339 (Sup. Ct. 2005).
- *Duty of good faith*: Directors and officers must act on an informed basis, in good faith, and in the honest belief that their actions are in the best interests of the company. *In re Goldman Sachs Mortg. Serv. S'holder Derivative Litig.*, 42 F. Supp. 3d 473 (S.D.N.Y. 2012)

Shareholders can raise a wide variety of theories for how officers and directors breached these duties. For example, shareholders may allege directors breached their applicable duties by, among other things, awarding themselves excessive compensation, engaging in an imprudent transaction, knowingly breaking the law, failing to adequately oversee the corporation, adopting unnecessarily risky practices, failing to implement sufficient internal controls, or making false or misleading statements to shareholders.

Derivative lawsuits may assert claims of waste and mismanagement by officers and directors, including due to director compensation or irrational squandering of corporate assets. *Marx*, 666 N.E.2d at 1039–42; *Delta Fin. Corp. v. Morrison*, 831 N.Y.S.2d 352 (Sup. Ct. 2006); *Sec. Police & Fire Prof'l of Am. Ret. Fund v. Mack*, 917 N.Y.S.2d 527 (Sup. Ct. 2010). Actions for waste and mismanagement hinge on breaches of the duty of care and loyalty.

Some derivative lawsuits allege insider trading, which occurs when officers and directors trade the corporation's securities based on material nonpublic information in violation of the duty of trust and confidence owed to shareholders. *SEC v. Watson*, 659 F. Supp. 3d 409 (S.D.N.Y. 2023); *Tsutsui v. Barasch*, 76 A.D.3d 986 (N.Y. App. Div. 2d Dep't 2009). Shareholders may bring derivative suits based on insider transactions as violations of the duty of loyalty.

Books and Records Demands

Books and records demands in New York are governed by section 624 of New York Business Corporation Law.

In recent years, shareholders seeking to bring derivative claims in New York and other jurisdictions have been increasingly seeking corporate books and records as a way to obtain pre-litigation discovery to support their allegations. See, e.g., *Ret. Plan for Gen. Emps. of N. Miami Beach v. McGraw-Hill Cos., Inc.*, 120 A.D.3d 1052, 1056 (N.Y. App. Div. 1st Dep't 2014); *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1145 (Del. 2011) (“Delaware courts have strongly encouraged stockholder-plaintiffs to utilize Section 220 before filing a derivative action, in order to satisfy the heightened demand futility pleading requirements of Court of Chancery Rule 23.1.”). As a result, shareholder derivative suits are often preceded by such demands, which spawn separate disputes and litigation. This trend led the Delaware legislature to amend its books and records law to limit inspection rights, but New York has not yet followed suit.

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