

**Shaev v Pandit**

2014 NY Slip Op 30783(U)

January 24, 2014

Supreme Court, New York County

Docket Number: 651011/2012

Judge: Melvin L. Schweitzer

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Judith Rodin, Robert Ryan, William Thompson Jr., Timothy Collins, Robert Joss, Ernesto Zedillo, Nanoo Pamnani, Harish Manwani, Pradeep Bhide, Anil Menon, Joan Spero, and Franz Humer were and are the directors of Citigroup. Vikram Pandit was the Chief Executive Officer (CEO) of Citigroup and Richard D. Parsons the Chairman of the Citigroup Board of Directors at the time of the events giving rise to this action.

James Forese, Wesley Williams Jr., Robert Denham, Shigeru Myojin, Warren Buffett, Gedale Horowitz, David Maxwell, Charles Munger, Louis Simpson, Claire Fagin, John Morris, and Vikram Pandit were and are the directors of Global. James Forese is the Chairman and CEO of Global.

Shaev's allegations concern two separate events involving Citigroup and Global. The first involves Global's sale of collateralized debt obligations (CDOs) consisting of residential mortgaged-backed securities (RMBSs). An RMBS is a type of security whose cash flows come from a pool of residential mortgage loans. Shaev alleges that many of Citigroup's CDOs were backed by subprime RMBSs, created by Citigroup or one of its subsidiaries under the express direction and approval of its directors and as the result of relaxed lending standards approved by such directors in violation of their fiduciary duties. In late 2006 and early 2007, market participants foresaw a downturn in the housing market and came to believe that CDOs whose assets consisted primarily of BBB-rated subprime RMBSs would experience significant losses, leading even the A-rated tranches of these CDOs to become potentially worthless.

In order to profit from the market weaknesses, Global created a series of CDOs with collateral consisting of subprime RMBSs. These programs were valued at \$1 billion, and would magnify the losses suffered by investors if the housing market collapsed. One such program was Class V Funding III. Global's marketing materials represented that the investment portfolio for

Class V III was selected by Credit Suisse Alternative Capital, Inc., a registered investment adviser who was promoted as having experience and expertise in analyzing the credit risk in CDOs. However, the marketing materials failed to disclose to investors that Global exercised significant influence over the selection of \$500 million of the assets in the Class V Funding III investment portfolio. It also failed to disclose that Global retained a short position through credit default swaps (CDSs) on the assets that it helped select for Class V Funding III and would therefore stand to profit from the poor performance of those assets while the investors of the CDO suffered losses.

Shaev alleges that, with knowledge of the weakness in the RMBS market and the defects in its offerings of CDOs and particularly Class V Funding III, and in violation of the director duty of care, defendants authorized and permitted Global and its employees to engage in issuing, promoting, and trading in CDOs without proper disclosure to clients. These actions led the Securities and Exchange Commission (SEC) to file suit against Global in the United States District Court for the Southern District of New York. A settlement was reached in that litigation under which Global was to pay \$285 million without admitting or denying guilt. The settlement was not approved by the District Court, and the rejection has been appealed to the United States Court of Appeals for the Second Circuit. If the Second Circuit reverses the rejection, Global will pay the original settlement amount of \$285 million; if it is affirmed, Global may be required to pay more than that amount to resolve the claim. Private suits against Citigroup and Global may also be expected from this litigation, to the detriment of Citigroup and Global shareholders. Furthermore, Citigroup's investment in Global has been substantially damaged now and in the future.

The second event giving rise to a shareholder derivative action against Citigroup involves the London Interbank Official Rate (LIBOR). LIBOR is an average of the interest rates banks are charged to borrow from other banks. In order to calculate LIBOR, a number of banks, including Citigroup, report their borrowing costs at different maturity rates to the British Bankers Association (BBA) daily. BBA then uses the middle eight quotes to calculate LIBOR. LIBOR is a benchmark interest rate, affecting the price of numerous financial instruments, including notes Citigroup used and uses to raise capital and sell instruments to the public and investors.

Shaev alleges that Citigroup engaged in a scheme with other prominent financial institutions to depress LIBOR by submitting falsified LIBOR rate quotes to the BBA with the approval and authorization of Citigroup directors. This would allow Citigroup, which had sustained significant losses during the financial crisis of 2007-2008, to continue to appear prosperous. Between 2007 and 2010, the difference between Citigroup's LIBOR rate quotes and the Federal Reserve Eurodollar Deposit rate was minus 32 base points; when Lehman Brothers declared bankruptcy, the difference was minus 142 base points. These discrepancies are consistent with other banks similarly artificially depressing their LIBOR rate quotes.

As a result of Citigroup's falsification of its LIBOR rate quotes, Citigroup sold LIBOR-based financial instruments which paid artificially low and false returns to investors. These investors have brought suit against Citigroup, and will result in Citigroup having to pay substantial damages.

Shaev filed a shareholder derivative suit against defendants seeking an accounting for all damages with respect to Global's sale of the Class V Funding III CDOs and Citigroup's

involvement in artificially depressing LIBOR and requesting that the individual director defendants be jointly and severally liable for such damages.

### Discussion

On a motion to dismiss for failure to state a claim, the court accepts all factual allegations pleaded in plaintiff's complaint as true and gives plaintiff the benefit of every favorable inference. CPLR 3211 (a) (7); *Sheila C. v Povich*, 11 AD3d 120 (1st Dept 2004). The court must determine whether "from the [complaint's] four corners[,] 'factual allegations are discerned which taken together manifest any cause of action cognizable at law.'" *Gorelik v Mount Sinai Hosp. Ctr.*, 19 AD3d 319, 319 (1st Dept 2005) (quoting *Guggenheimer v Ginzburg*, 43 NY2d 268, 275 (1977)). Vague and conclusory allegations, however, are not sufficient to sustain a cause of action. *Fowler v American Lawyer Media, Inc.*, 306 AD2d 113 (1st Dept 2003).

The primary issue in this motion to dismiss is whether Shaev has standing to file a shareholders derivative suit. Shaev contends that this determination should be made under the New York Banking Law, as "[t]here is and can be no dispute that Citigroup, though incorporated in Delaware, is authorized to do and does banking business in New York. . . . It is effectively a New York entity." Defendants claim that Delaware corporation law should govern this suit.

"The first step in any case presenting a potential choice of law issue is to determine whether there is an actual conflict between the laws of the jurisdiction involved." *Matter of Allstate Ins. Co. (Stolarz)*, 81 NY2d 219, 223 (1993). New York Banking Law § 7017 authorizes an action under § 6025 "against one or more directors or officers of a corporation . . . by a stockholder or the owner of a beneficial interest in shares thereof." Shaev argues that, under New York Banking Law § 7019, "there is no authorization or authority under the Banking Law permitting a director or committee to make a determination that a suit should not be brought,

thus absolving the wrongdoer.” This section of the statute speaks to a corporation’s ability to indemnify parties to an action or proceeding rather than the requirements of a shareholder derivative suit. New York Banking Law § 7017, which governs such actions, does not expressly require that a shareholder make a demand upon the board of directors to institute an action against the corporation before being able to bring suit himself. New York case law has held that demand is required: as noted in *Harris v State Bank of Williamson*, which involved the misconduct of bank directors, a shareholder can maintain such an action against directors “only after demand upon the corporation to institute the action, where such a demand is reasonably necessary.” 177 NYS 545, 547 (1919).

Delaware law similarly has a demand requirement for shareholder derivative suits. Under Delaware law, “the right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation.” *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A2d 362, 366--367 (Del. 2006); see *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

There is no actual conflict of laws on this issue: both New York and Delaware require that, for a shareholder to make a derivative claim, either a demand must be brought to a corporation’s directors and wrongfully refused, or that such demand must be excused due to the futility of the action.

Even if an actual conflict existed between Delaware and New York law on this issue, New York courts have repeatedly held that shareholder derivative suits are governed by the law of the state of incorporation: “The nature of the challenged transaction itself, as well as the

equitable relief sought, militates against separate determinations by courts in different jurisdictions. One of the abiding principles of the law of corporations is that the issue of corporate governance, including the threshold demand issue, is governed by the law of the state in which the corporation is chartered.” *Hart v General Motors Corp.*, 129 AD2d 179, 182 (1987); *see also Diamond v Oreamuno*, 24 NY2d 494, 503--504 (“The primary source of law in this area remains that of the State which created the corporation.”). As Citigroup is incorporated in Delaware, Delaware law governs.

As Shaev did not make a demand on either Citigroup’s or Global’s boards of directors, she must adequately allege that the demand requirement should be excused in order to have standing to bring a shareholder derivative suit. The standard for alleging demand futility is strict: allegations of demand futility must “comply with ‘stringent requirements of factual particularity’ and set forth ‘particularized factual statements that are essential to the claim.’” *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A3d 106, 120--121 (Del. Ch. 2009) (quoting *Brehm v Eisner*, 746 A2d 244, 254 (Del. 2000)). *Aronson v Lewis* set forth the traditional test for whether demand is futile and, therefore, excused: “the Court . . . must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.” 473 A2d at 814 (Del. 1984).

Under the first prong of the *Aronson* test, the demand futility analysis must proceed “director-by-director and transaction-by-transaction” in order to be pled with particularity. *Khanna v McMinn*, 2006 WL 1388744, \*14 (Del. Ch., May 9, 2006, No. Civ. A. 20545-NC). Shaev fails to allege that the directors of Citigroup were not disinterested and independent. Instead, Shaev merely makes the cursory allegation that the directors of Global authorized the

improper and damaging acts and that these directors had the “express authorization and approval of the Citigroup Board who had selected and chosen said directors, and they are subservient to the wishes and directions of the Citigroup directors.” These allegations certainly do not satisfy the first prong of the *Aronson* test, as there is no discussion in the complaint regarding individual directors or their independence. Shaev also claims that defendants “aware of their obligations and duties of oversight and their non compliance [sic] cannot be expected to sue themselves.” It is settled doctrine that demand “is not excused solely because the directors would be deciding to sue themselves.” *In re Citigroup Inc.*, 964 A2d at 121.

Shaev also fails to create reasonable doubt that the challenged transaction was otherwise the product of a valid exercise of business judgment. The business judgment rule is “an acknowledgment of the managerial prerogatives of Delaware directors” and is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Aronson*, 473 A2d at 812. In order to overcome this presumption, the plaintiff must plead particularized allegations that the board’s decision “is one so egregious as to be beyond any reasonable business judgment.” *In re infoUSA, Inc. Shareholders Litigation*, 953 A2d 963, 1001 (Del. Ch. 2007). “A plaintiff who seeks to excuse demand through the second prong of *Aronson* thus faces a task closely akin to proving that the underlying transaction *could not have been* a good faith exercise of business judgment.” *Id.* at 972.

In the complaint, Shaev contends that each of the directors of Citigroup and Global were “aware of the foregoing and authorized Global to do the CDOs and [Class V Funding III] nonetheless in violation of their duties as directors of a banking institution.” However, the complaint contains no facts which demonstrate with particularity that the directors knew

about—much less explicitly authorized—CDOs containing risky RMBSs being created and promoted to investors in order to profit from the downturn in the housing market. Conclusory statements as to the directors' involvement and misconduct do satisfy the second prong of the *Aronson* test.

Similarly, the complaint only contains conclusory allegations regarding the Citigroup board's involvement with LIBOR, noting only that the discrepancy between Citigroup's LIBOR rate quotes and the Federal Reserve Eurodollar Deposit Rate was similar to that of other banks supposedly involved in depressing the LIBOR rate. This claim also fails the second prong of the *Aronson* test. The three claims of breach of fiduciary duty with respect to Citigroup are thus dismissed.

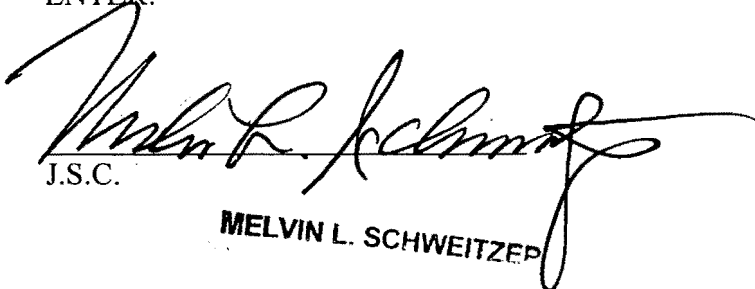
Shaev also fails to state a double derivative claim on behalf of Global. A double derivative suit is “based upon the injury suffered indirectly by the parent corporation, in which the shareholder does have an interest, as a result of injury to the subsidiary. . . . It is a fundamental requirement of a double derivative suit that the injury to the subsidiary must also cause injury to the parent.” *In re Bear Stearns Companies, Inc. Securities, Derivative, and ERISA Litigation*, 763 F Supp 2d 423, 538 (SDNY 2011). Shaev fails to allege facts demonstrating that Global's actions have caused injury to Citigroup, merely stating cursorily that “Citigroup's investment in Global has been substantially damaged.” Furthermore, even if Shaev had alleged enough facts to demonstrate injury to the parent, it would still fail the *Aronson* demand futility test, as discussed above.

The claims of breach of fiduciary duty with respect to Global are dismissed.

ORDERED that defendants' motion to dismiss plaintiff's first, second, and third causes of action is granted.

Dated: January 24, 2014

ENTER:

  
J.S.C.  
MELVIN L. SCHWEITZER