

By Charles J. Greaves

The Unique Issues in Shareholder Derivative Litigation

A limited statutory scheme has led courts to play a key role in shaping derivative lawsuits

Few statutes in California are asked to do the kind of heavy lifting that is required of Corporations Code Section 800. Fewer than 1,000 words in length, Section 800 represents the sum total of all legislation on the subject of shareholder derivative litigation in California.¹ Yet in light of recent corporate and accounting scandals and the prevailing atmosphere of hostility toward corporate management, few statutes are more important. With Section 800 as their touchstone, both corporate counsel and those who litigate in the corporate arena need to understand and must be prepared to address a variety of issues unique to shareholder derivative litigation in California.²

What is a derivative action? It is an action that is asserted by a shareholder against one or more defendants—typically including the corporation’s own directors—on behalf of the corporation. The first obstacles confronting a prospective shareholder-plaintiff are the “demand” and “notice” requirements of

Section 800(b)(2). Failure to satisfy these requirements subjects a shareholder’s complaint to demurrer.³ The applicable statutory language⁴ permits a derivative lawsuit only if:

The plaintiff alleges in the complaint with particularity plaintiff’s efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort, and alleges further that plaintiff has either informed the corporation or the board in writing of the ultimate facts of each cause of action against each defendant or delivered to the corporation or the board a true copy of the complaint which plaintiff proposes to file.

Although couched as a pleading requirement, this language imposes upon a would-be derivative plaintiff two separate and distinct affirmative obligations.⁵

Charles J. Greaves is the chair of the litigation department at Hahn & Hahn LLP. He represents both plaintiffs and defendants in complex business, tort, and employment litigation.

In order to comply with the first (or demand) requirement, the shareholder must make some effort to secure from the corporation’s board of directors whatever action the shareholder wishes the board to take. This will typically be a demand that the board vote to sue in the corporation’s name to redress a wrong that the shareholder believes the corporation has suffered. This demand requirement is, however, a qualified one, since

it is excused when there are “reasons for not making such effort.” Courts interpreting this qualification have crafted a “futility exception,” pursuant to which the shareholder’s demand upon the corporation’s board of directors will be excused if, under the particular facts of the case, making such a demand would be useless.⁶ Futility has been found to exist when, for example, a majority of the board is alleged to have directly participated in, or benefited financially from, fraudulent or criminal conduct.⁷

The second (or notice) requirement imposed by Section 800 is that the shareholder either must inform the corporation or its board of directors in writing of the ultimate facts of each proposed cause of action against each prospective defendant, or must deliver to the corporation or its board of directors a copy of the complaint that the shareholder proposes to file. While a shareholder may be excused from complying with the demand requirement by demonstrating futility, the structure of the statute makes clear that there is no corresponding futility exception to the requirement of written notice. Written notice is, in all cases, mandatory.

After making a demand (unless one is futile) and giving written notice, the putative plaintiff must then affirmatively plead “with particularity” the plaintiff’s compliance with the statute’s threshold requirements. While pleading actual demand and notice is simple enough, pleading futility, in order to excuse the demand requirement, is clearly less so. As a rule, mere general-

ities or conclusive allegations of perceived futility will not suffice.⁸ Courts will instead require specific factual allegations as to why each particular director could not have fairly evaluated the shareholder’s demand.⁹

In light of these pleading requirements, the better practice for plaintiff’s counsel in all cases is to actually make the demand and give the required notice. Both requirements can be met by, for example, including the proposed complaint as an enclosure to the shareholder’s prefiling demand letter.

The Plaintiff’s Bond

There is no attorney’s fee provision per se in Section 800. The corporation, however, or any defendant who is an officer or director of the corporation, may move to require that the shareholder plaintiff furnish a bond if a moving defendant demonstrates either 1) that there is no reasonable possibility that prosecution of the action will benefit the corporation or its shareholders, or 2) that the moving defendant, if other than the corporation, did not participate in the challenged transaction in any capacity.¹⁰ If the court determines that a moving party has established “a probability” in support of any ground upon which the motion is based, the court must fix the amount of the bond, not to exceed \$50,000, by considering the reasonable expenses, including attorney’s fees, that may be incurred by the moving party, including the corporation, in connection with defending the action.¹¹

If a derivative plaintiff pleads

multiple causes of action, security is proper if any one of the causes of action falls within the purview of the statute.¹² The \$50,000 bond amount is an aggregate, however, and a court may not require a greater bond regardless of the number of defendants or causes of action.¹³ In practice, a plaintiff's bond is sought in most shareholder derivative actions because the corporation's board of directors has, in response to the plaintiff's demand, already determined that prosecution of the action is not in the best interests of the corporation. The motion for security must be filed within 30 days after service of summons upon the corporation or other moving defendant,¹⁴ and the filing of the motion stays all further proceedings in the case until 10 days after the disposition of the motion.¹⁵

As a practical matter, success on the bond motion often terminates the lawsuit, since few disgruntled shareholders will post a \$50,000 bond in the face of a judicial determination that there is no reasonable possibility that further prosecution of the action will benefit the corporation or its shareholders. The additional significance of the motion for security is that the prevailing defendant in a derivative action has no right to recover attorney's fees, in the absence of a contractual fee provision, unless the defendant is first successful on a motion for security. In that case, the plaintiff's potential liability for fees is both established and limited by the face amount of the bond.¹⁶

Peremptory Dismissal

There are procedures that are unique to shareholder derivative litigation that, if successful, will result in the peremptory dismissal of the plaintiff's claims without the need for a trial on their merits. These include a demurrer or summary judgment motion following the vote of a disinterested board majority against prosecution of the action, and a motion for summary judgment following a like vote by a board-appointed special litigation committee.

Courts have long recognized that a disinterested board majority, exercising its good faith business judgment, can obtain dismissal of a shareholder derivative lawsuit on the ground that the burdens of its further prosecution—including time, money, and the disruption of business—outweigh the likely benefits.¹⁷ The rationale behind this rule is that the management of a corporation's affairs is properly vested in the duly elected board of directors and may not be usurped by one or more litigious shareholders.¹⁸

A vote by a disinterested board majority against the prosecution of the action creates a legal presumption that the board's decision was made in good faith, on an informed basis,

and with an honest belief that the decision is in the best interests of the corporation.¹⁹ This presumption—the so-called business judgment rule—is, however, a rebuttable one, and dismissal will not lie if there has been fraud, bad faith, overreaching, or an unreasonable failure by the board to investigate material facts.²⁰ Faced with a motion for summary judgment by an allegedly disinterested board majority, the court must determine:

- Whether the board majority is truly independent, and not financially or otherwise interested in the challenged transaction.
- Whether the board conducted a reasonable investigation into the operative facts before voting.
- Whether the vote represents a good faith exercise of the business judgment of the board majority.²¹

Plaintiffs seeking to avoid dismissal by this procedure will often implicate the board majority in the challenged transaction or will preemptively allege failure of inquiry or other affirmative misconduct to rebut the presumption arising from the business judgment rule. The court's role on summary judgment is limited to a determination of whether triable issues of material fact exist regarding these matters. If so, the "directors' discretion" defense becomes an issue of fact, and while it may be bifurcated from the remaining issues in the case at trial, it may not be the subject of a special pretrial evidentiary proceeding.²²

Even when there is no disinterested board majority, courts will still entertain a motion for summary judgment when a disinterested special litigation committee appointed by an interested board majority so requests.²³ The special litigation committee must be composed of two or more directors who have not benefited financially from the challenged transaction.²⁴ The statutory authority for this delegation of responsibility is Corporations Code Section 311, which permits a board of directors to designate committees having the full authority of the board, except for certain enumerated matters.

Just as a disinterested board majority may move for summary judgment, so too may a special litigation committee if the committee determines that further prosecution of the action will not, on balance, benefit the corporation or its shareholders. Courts faced with this type of motion follow the same procedures and apply the same analyses as they would in the case of a motion filed by a disinterested board majority.²⁵

Corporate Counsel

Once a shareholder derivative action is filed, the defendants must quickly address the roles to be played by both corporate and spe-

cial litigation counsel. While a derivative action is ostensibly prosecuted for the benefit of the corporation, the corporation itself, as an indispensable party, must be named as a defendant.²⁶ As a nominal defendant, the corporation is entitled to have counsel at all stages of the proceeding.²⁷ The corporation's dual role as de facto plaintiff and nominal defendant creates conflict-of-interest issues for counsel that are unique to shareholder derivative lawsuits.

The corporation itself, and not its shareholders, is the holder of the attorney-client privilege.²⁸ Therefore, the shareholders of a corporation cannot waive the privilege on the corporation's behalf.²⁹ Building upon this premise, recent case authority holds that a shareholder plaintiff cannot sue a corporation's outside general counsel for legal malpractice in a derivative action, because doing so would compel corporate counsel to waive the attorney-client privilege in order to mount a meaningful defense to the plaintiff's claims.³⁰ In other words, while a derivative plaintiff otherwise stands in the shoes of the corporation, the plaintiff does not do so with respect to the attorney-client privilege, and a shareholder cannot compel a waiver of the privilege by the expedient of naming both the corporation and its counsel as defendants in a derivative action.

Even if corporate counsel is immune from liability in a derivative action for advice given to the corporation regarding the challenged transaction, corporate counsel may not, in defense of a derivative lawsuit, simultaneously represent both the corporation and the directors whose wrongdoing is alleged to have damaged the corporation.³¹ Nor in most cases may corporate counsel continue to represent either the corporation or the defendant directors, because the applicable Rules of Professional Conduct preclude counsel from accepting employment adverse to a current or former client when counsel has obtained confidential information material to the employment—and meaningful consent to representation in these circumstances, while technically allowed by the Rules of Professional Conduct, is often difficult to obtain in shareholder derivative litigation.³²

Although each case is unique, the better practice in most cases is to retain new, independent litigation counsel for both the corporation and the director defendants. Doing so removes conflict-of-interest issues from the case and leaves corporate counsel in the appropriate role of disinterested percipient witness.

Advancement and Indemnity

When a director, officer, employee, or other agent of a corporation is sued in his or

her corporate capacity and wins a judgment on the merits in defense of a derivative action, indemnification from the corporation for all related defense costs and attorney's fees actually and reasonably incurred is mandatory.³³ In all other cases, a director, officer, employee, or other agent's right to indemnification from the corporation for litigation-related expenses will depend upon the facts of the case and the language of the corporation's articles and bylaws.³⁴ The policy behind the statutes and cases authorizing corporate indemnification is to encourage competent individuals to serve as officers and directors of corporations and to discourage strike suits and other frivolous shareholder litigation by assuring a vigorous defense to these actions.³⁵

In the absence of a judgment on the merits in defense of a derivative action, the right to indemnification is governed by Corporations Code Section 317(c). That statute expressly prohibits indemnification for:

- 1) Amounts paid in settling a derivative action without court approval.
- 2) Expenses incurred in defending a derivative action that is settled without court approval.
- 3) Any claim for which the defendant is adjudged to be liable, unless the court determines that, in view of all of the circumstances of the case, the defendant is "fairly and reasonably entitled to indemnity for expenses and then only to the extent that the court shall determine."

Corporations Code Section 317(c) allows indemnification in the absence of a defense judgment on the merits only if the defendant "acted in good faith, in a manner the person believed to be in the best interests of the corporation and its shareholders." Such "permissive indemnification" may be authorized by:

- 1) Majority vote of a quorum of directors who were not parties to the action,
- 2) Independent legal counsel in a written opinion, if a quorum of nonparty directors cannot be obtained,
- 3) Approval of the shareholders, excluding the shares owned by the person or persons to be indemnified, or
- 4) The court in which the proceeding is or was pending, "whether or not the application by the agent, attorney or other person is opposed by the corporation."³⁶

If a corporate agent is forced to seek and obtains court approval for permissive indemnification, the agent is also entitled to recover his or her reasonable expenses, including attorney's fees, incurred in obtaining the court order.³⁷

A corporation's board of directors may vote to advance litigation expenses as they are incurred by any director, officer, employee, or

other agent of the corporation who is named in a derivative lawsuit.³⁸ The structure of Corporations Code Section 317 suggests—and at least one influential commentator concurs—that even interested directors may participate in the vote to advance litigation expenses, including to themselves.³⁹ The provisions of Corporations Code Section 315(a), which require a shareholder vote with respect to any loans made to directors or corporate officers, does not apply to litigation advances made under Corporations Code Section 317.⁴⁰

As a prerequisite to obtaining advancement of litigation expenses, a defendant—whether he or she is a director, officer, employee, or other agent of the corporation—must provide the corporation with "an undertaking" to repay the sums advanced in the event it is determined, at the conclusion of the case, that the defendant is not entitled to indemnification.⁴¹ While the statute does not specify the form of the undertaking, the Bond and Undertaking Law⁴² presumably applies by reference.

Attorney's Fees and Costs

Since a derivative action is prosecuted on behalf of the corporation, any damages recovered in the action will ordinarily inure to the benefit of the corporation and not to the personal benefit of the plaintiff (other than in his or her capacity as a fractional owner of the corporation). Since derivative actions are equitable in nature, however, courts may tailor their judgments to fit the unique circumstances of each case—for example, to avoid a windfall that might result in the absence of a special allocation of damages.⁴³ The shareholder plaintiff cannot, in any event, settle a derivative lawsuit without first obtaining court approval.⁴⁴

A shareholder who is a prevailing plaintiff is entitled to recover his or her reasonable attorney's fees and litigation costs as a charge against the settlement or judgment proceeds. This right to fees is not statutory but is based upon the plaintiff's creation of a common fund for the benefit of the corporation and the plaintiff's fellow shareholders.⁴⁵ In a two-person corporation, attorney's fees may not be awarded to one shareholder who prevails in a derivative action against the other shareholder, since no common fund results from the action.⁴⁶

When one or more defendants prevail in the action, and the plaintiff has posted security pursuant to Corporations Code Section 800, the prevailing defendants have recourse to the security for their reasonable expenses, including attorney's fees. This recourse includes a claim by the corporation for advances or indemnity payments made to

corporate agents under Corporations Code Section 317.⁴⁷

A motion to include attorney's fees in the defendant's memorandum of costs must be filed within the time for filing a notice of appeal from the underlying judgment—typically 60 days from notice of its entry.⁴⁸ Conversely, a motion to enforce the plaintiff's bond in satisfaction of the fee award may only be filed after the entry of final judgment in the action and after the time for appeal has expired or, if an appeal is taken, after the appeal is finally determined.⁴⁹ This often requires the prevailing defendant to follow a two-step process, in which a motion to include attorney's fees in the memorandum of costs is filed first, followed by, if necessary, the filing of a second motion to enforce the bond after the unsuccessful shareholder plaintiff exhausts his or her appeals.

If the derivative action arises out of the breach of a contract that includes an attorney's fee provision, the prevailing defendant is not limited to recourse against the plaintiff's bond (if one is posted) under Corporations Code Section 800 and to indemnity under Corporations Code Section 317. Prevailing defendants may also avail themselves of the reciprocal right to attorney's fees found in Civil Code Section 1717, either in addition to or in lieu of these other sources of potential recovery.⁵⁰

Because the statutory scheme governing shareholder derivative actions in California is skeletal, and because these actions are equitable in nature, the courts have played a prominent role in shaping the substantive law and procedure in this area. The dot-com implosion and recent flood of corporate and accounting scandals should act as catalysts in the years ahead for a greatly accelerated evolution of shareholder derivative law in California. ■

¹ Corporations Code §15702, which governs derivative actions in the context of limited partnerships, simply mirrors Corporations Code §800. Corporations Code §316(c) (directors' joint liability to creditors) and §506(b) (shareholders' direct liability to creditors) authorize actions in the name of the corporation without regard to the provisions of §800.

² For an overview of basic principles of shareholder derivative litigation, see 9 WITKIN, SUMMARY OF CALIFORNIA LAW, *Corporations* §§179 *et seq.* (9th ed. 1989), and 2 FRIEDMAN, CALIFORNIA PRACTICE GUIDE: CORPORATIONS §§6:598 *et seq.* (2002).

³ Shields v. Singleton, 15 Cal. App. 4th 1611, 1619 (1993).

⁴ CORP. CODE §800(b)(2).

⁵ Nelson v. Anderson, 72 Cal. App. 4th 111, 127 (1999).

⁶ Beyerbach v. Juno Oil Co., 42 Cal. 2d 11, 28 (1954).

⁷ Reed v. Norman, 152 Cal. App. 2d 892, 898 (1957).

⁸ Oakland Raiders v. National Football League, 93 Cal. App. 4th 572, 587-89 (2001).

⁹ Shields v. Singleton, 15 Cal. App. 4th 1611, 1622 (1993).

¹⁰ CORP. CODE §800(a).

¹¹ Burt v. Irvine Co., 237 Cal. App. 2d 828, 868 n.5 (1965).

¹² Bailey v. Fosca Oil Co., 180 Cal. App. 2d 289, 296-97 (1960).

¹³ Hale v. Southern Cal. IPA Med. Group, Inc., 86 Cal. App. 4th 919, 927-28 (2001).

¹⁴ CORP. CODE §800(c).

¹⁵ CORP. CODE §800(f).

¹⁶ Alcott v. M.E.V. Corp., 193 Cal. App. 3d 797, 799-800 (1987).

¹⁷ Findley v. Garrett, 109 Cal. App. 2d 166, 177-78 (1952).

¹⁸ *Id.* at 174.

¹⁹ Katz v. Chevron Corp., 22 Cal. App. 4th 1352, 1366 (1994).

²⁰ Lee v. Interinsurance Exch., 50 Cal. App. 4th 694, 715 (1996).

²¹ Findley, 109 Cal. App. 2d at 177.

²² See Will v. Engbertson & Co., 213 Cal. App. 3d 1033, 1041-43 (1989) (special litigation committee); Finley v. Superior Court, 80 Cal. App. 4th 1152, 1162-63 (2000) (same).

²³ Finley, 80 Cal. App. 4th at 1158-63.

²⁴ *Id.* at 1158; CORP. CODE §311.

²⁵ Lewis v. Anderson, 615 F. 2d 778, 781-83 (9th Cir. 1979).

²⁶ Stockton v. Ortiz, 47 Cal. App. 3d 183, 191-92 (1975).

²⁷ Olson v. Basin Oil Co. of Cal., 136 Cal. App. 2d 543, 560-61 (1955).

²⁸ McDermott, Will & Emery v. Superior Court, 83 Cal. App. 4th 378, 383 (2000).

²⁹ Smith v. Laguna Sur Villas Cmty. Ass'n, 79 Cal. App. 4th 639, 644 (2000).

³⁰ McDermott, Will & Emery, 83 Cal. App. 4th at 384. This holding raises the question whether counsel can be sued when director defendants assert an advice-of-counsel defense or otherwise waive the attorney-client privilege.

³¹ Forrest v. Baeza, 58 Cal. App. 4th 65, 74-75 (1997).

³² Compare CAL. RULES OF PROF'L CONDUCT R. 3-600(E) with R. 3-310(E). *But see* Forrest, 58 Cal. App. 4th at 76-82 (disqualification of corporate counsel from continued representation of individual directors/shareholders not required if the "functioning of the corporation has been so intertwined with the individual defendants that any distinction between them is entirely fictional").

³³ CORP. CODE §317(d); Groth Bros. Oldsmobile, Inc. v. Gallagher, 97 Cal. App. 4th 60, 73 (2002).

³⁴ Indemnification beyond that allowed by Corporations Code §317 is authorized, within limits, by Corporations Code §204(a) (11) if a corporation's articles and bylaws so provide.

³⁵ Brusso v. Running Springs Country Club, Inc., 228 Cal. App. 3d 92, 103-04 (1991).

³⁶ CORP. CODE §317(e).

³⁷ CORP. CODE §317(a); Fed-Mart Corp. v. Price, 111 Cal. App. 3d 215, 222 (1980).

³⁸ CORP. CODE §317(f).

³⁹ Compare CORP. CODE §317(e) with CORP. CODE §317(f). See also 1 MARSH'S CALIFORNIA CORPORATION LAW §11.22[I], at 11-217 (4th ed. 1999).

⁴⁰ CORP. CODE §317(f) (last sentence).

⁴¹ CORP. CODE §317(f).

⁴² The Bond and Undertaking Law, CODE CIV. PROC. §§995.010 *et seq.*

⁴³ Rankin v. Freebank Co., 47 Cal. App. 3d 75, 96 (1975).

⁴⁴ Ensher v. Ensher, Alexander & Barsoom, Inc., 187 Cal. App. 2d 407, 410 (1960).

⁴⁵ Baker v. Pratt, 176 Cal. App. 3d 370, 378 (1986).

⁴⁶ *Id.*

⁴⁷ CORP. CODE §800(d).

⁴⁸ CAL. R. OF CT. R. 870.2.

⁴⁹ CODE CIV. PROC. §996.440.

⁵⁰ Brusso v. Running Springs Country Club, Inc., 228 Cal. App. 3d 92, 102-05 (1991).



Judgments Enforced

Law Office of Donald P. Brigham

23232 Peralta Dr., Suite 204, Laguna Hills, CA 92653
P: 949.206.1661
F: 949.206.9718
dbrigham@earthlink.net

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1361 Avenida De Aprisa
Camarillo, CA 93010
(805) 383-8004

Jack Trimarco - President
Former Polygraph Unit Chief
Los Angeles F.B.I. (1990-1998)
CA. P.I. #20970

Former Polygraph Inspection Team Leader
Office of Counter Intelligence
U.S. Department of Energy

Member Society of Former Special Agents
Federal Bureau of Investigation

email: jtrimarco@aol.com