Business Law POV

Shareholder Claims

By David Gurnick

EVERY BUSINESS LAWYER hears it from time to time. A shareholder client complains of mistreatment, self-dealing, mismanagement or incompetence by a corporation's board of directors or management. The shareholder, whose investment lost a lot of its value, wants to demand corrective action, or sue. It seems intuitive that someone who invested in a company should have a claim for misconduct, whether negligent, or worse, by members of the board of directors. After all, directors are fiduciaries: "a corporation, through its officers and directors, owes fiduciary duties to its investors, shareholders or subscribers, and must act in the highest good faith towards its investors, shareholders or subscribers."[1]

But shareholders cannot always bring a claim against a company's directors or board. Rather, there are two possibilities. Sometimes, a shareholder can bring a direct action, either individually or on behalf of a class of shareholders, for injury to his or her interest as a shareholder. Or, a shareholder may bring a "derivative action." That is a suit against a director or the board, on behalf of the corporation, for injury suffered by the corporation, for which it failed or refused to sue. "The two actions are mutually exclusive: . . . the right of action and recovery belongs either to the shareholders (direct action) or to the corporation (derivative action)."[2]

Thus, under California law, despite suffering loss to the value of one's shares, due to misconduct by a director, board, or management, a shareholder cannot bring a direct action for damages on the theory that the misconduct decreased the value of his or her stock. The corporation itself must bring the action. Or, the shareholder may bring the action, but it is on the corporation's behalf.[3] This principle makes it useful for business lawyers to know the different circumstances when a direct action may be brought, and when a shareholder's claim requires a derivative action.

An action is derivative if the claim is for injury to the corporation, or to the whole body of its stock or property, "without any severance of distribution among individual holders," or if the action seeks to recover assets for the corporation or prevent dissipation of the entity's assets.[4] A shareholder may bring only a derivative suit to enjoin or recover damages for a director's or management's breach of fiduciary duty owed to the corporation.[5] In a derivative claim, the shareholder is the nominal plaintiff, and the corporation is the nominal defendant. The corporation is the real party in interest, entitled to any recovery.[6]

In contrast, an individual cause of action exists if damages to the shareholders were not incidental to damages to the corporation. Examples of direct shareholder actions include suits to compel the board to declare a dividend, or for payment of lawfully declared or mandatory dividends, or to enjoin a threatened action in excess of the board's authority, or enforce shareholder voting rights.[7]

In *Bader v. Anderson*, plaintiff brought an action against Apple and its directors. She claimed the board used a

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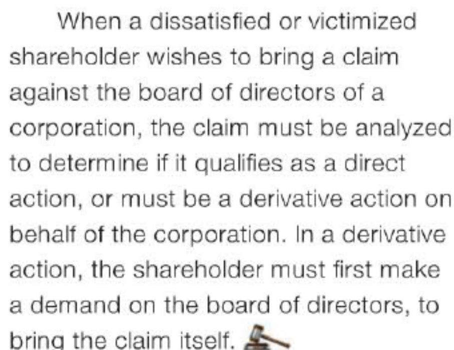
misleading proxy statement to persuade shareholders to approve a bonus plan. She sought a judicial declaration cancelling the plan, and voiding the shareholders vote that approved it. The appellate court stated that whether a claim is direct or derivative turns on two inquiries: Who suffered the harm—the corporation or the suing stockholder individually—and who would receive the benefit of any recovery or other remedy? Under this analysis, the injury, bonus payments made to executives and stock options granted to Chairman Steve Jobs, was to the corporation, not to shareholders. Therefore, the claim was derivative.[8]

In deference to a corporate board's managerial role, and to curb abuse, a shareholder bringing a derivative claim must first make a demand on the board to take the desired action. This demand requirement was recognized over 120 years ago by the Supreme Court[9] and is codified in the Corporations Code.[10] Alternatively, "when it is clear that making a demand upon the company's board of directors would be futile, the demand requirement may be excused." Futility may be shown by proving the directors were not disinterested and independent in their decision-making or that the challenged action was not a valid exercise of business judgment by the directors.[11]

When a dissatisfied or victimized shareholder wishes to bring a claim against the board of directors of a corporation, the claim must be analyzed to determine if it qualifies as a direct action, or must be a derivative action on behalf of the corporation. In a derivative action, the shareholder must first make a demand on the board of directors, to bring the claim itself.



[1] *Cleveland v. Johnson* 209 Cal.App.4th 1315, 1338 (2012).
[2] *Schuster v. Gardner* 127 Cal.App.4th 305, 311-312 (2005).
[3] Id. at 312.
[4] *Jones v. H.F. Ahmanson & Co.* 1 Cal.3d 93, 106–107 (1969).
[5] *Schuster v. Gardner* 127 Cal.App.4th 305, 313 (2005).
[6] Id. at 312.
[7] Id. at 313.
[8] *Bader v. Anderson* 179 Cal.App.4th 775 (2009).
[9] *Hawes v. City of Oakland* 104 U.S. 450 (1881).
[10] Cal. Corps. Code Sec. 800(b)(2).
[11] *Charter Township of Clinton Police and Fire Retirement System v. Martin* 219 Cal.App.4th 924, 935-6 (2013).