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California Supreme Court Affirms “Continuous Stock Ownership Requirement” for Plaintiffs in Derivative Shareholder Litigation

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The California Supreme Court ruled today in *Grosset v. Wenaas*, No. S139285 (February 14, 2008), that California law includes a “continuous stock ownership requirement” for plaintiffs in derivative shareholder actions. The Court held that a plaintiff’s loss of shareholder status at any point in the litigation deprives that plaintiff of standing to further pursue the derivative action. *Grosset* also holds that this requirement applies even where the plaintiff’s shareholder status is terminated involuntarily, including where the plaintiff lost his shares as a result of the corporation’s merger with another corporation.

The plaintiff in *Grosset* filed a derivative shareholder action on behalf of JNI Corporation (JNI), a company incorporated in Delaware and headquartered in California, against certain JNI directors and officers. On the defendants’ motion, the trial court dismissed the plaintiff’s complaint with prejudice.

After the dismissal, JNI merged with a wholly owned subsidiary of Applied Micro Circuits Corporation (AMCC). As part of the merger, AMCC bought all outstanding shares of JNI stock, including the plaintiff’s shares. The plaintiff then appealed the dismissal of his complaint, but the defendants moved to dismiss the appeal, contending that the plaintiff lacked standing to pursue the litigation after selling his JNI stock as part of the merger.

The California Court of Appeal agreed and dismissed the plaintiff’s appeal for lack of standing. That court concluded that the requirements for standing implicate a corporation’s “internal affairs” and, therefore, the law of the state of incorporation, here Delaware, applies. Because Delaware law has a continuous stock ownership requirement, the court concluded that the plaintiff was deprived of standing when he sold his JNI stock. The court held in the alternative that California law also imposes a continuous stock ownership requirement.

The California Supreme Court granted discretionary review and affirmed, but based on a somewhat different legal analysis.

The California Supreme Court first examined Section 800(b)(1) of the California Corporations Code, which provides generally that a derivative shareholder action may not be “instituted *or maintained*” unless the plaintiff was a shareholder at the time of the transaction complained of. The Court reasoned that, although this statutory language “seems to point to a continuous ownership requirement,” it “does not clearly impose it.”

The Court then examined the “basic legal principles pertaining to corporations and shareholder litigation” and observed that the purpose of a derivative action is to enforce the rights of the corporation, and that such a claim belongs to the corporation, not the shareholder asserting it. Consequently, standing to maintain a derivative action “is justified only by the stockholder relationship and the indirect benefits made possible thereby, which furnish the stockholder with an interest and incentive to seek redress for injury to the corporation.” The Court concluded that, “[o]nce this relationship ceases to exist, the derivative plaintiff lacks standing because he or she ‘no

longer has a financial interest in any recovery pursued for the benefit of the corporation.”

The California Supreme Court rejected the plaintiff’s argument that a continuous stock ownership rule is inappropriate where the plaintiff loses his shareholder status involuntarily as a result of a merger. Regardless of whether the loss of stock was voluntary or involuntary, “a derivative plaintiff loses standing because he or she no longer has even an indirect interest in any recovery pursued for the corporation’s benefit.”

The Court also rejected the plaintiff’s suggestion that Section 800 should be interpreted consistently with Section 16(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78p(b). Although the United States Supreme Court has held that Section 16(b) does not impose a continuous stock ownership requirement, such a requirement is imposed in Section 16(b) actions by other federal rules and by the standing requirement of Article III of the United States Constitution.

The Court found unpersuasive the plaintiff’s assertion that the California Legislature’s lack of response to an earlier California Court of Appeal decision rejecting a continuous ownership rule signified that the Legislature had also rejected such a rule.

The plaintiff also did not prevail on his argument that a continuous ownership rule would be unfair to plaintiffs who litigate a derivative action for several years and then are involuntarily stripped of standing. The Court reiterated that a derivative claim belongs to the corporation, not the shareholder, and it observed that shareholders may recover the costs of pursuing a derivative action if the action confers a substantial benefit on the corporation. The Court also rejected the argument that former stockholders are entitled to a pro rata share of recovery in a derivative action.

Because California and Delaware law both impose a continuous stock ownership rule, the plaintiff lacked standing regardless of which State’s law applied. Therefore, the Court did not reach the question whether the “internal affairs” doctrine required application of Delaware law in this case.

The *Grosset* decision is important to the many public companies that are incorporated in Delaware and do business in California. Plaintiffs frequently have brought derivative actions against these companies in California courts and have argued that California law should apply to their claims, in the hopes of gaining a result more favorable than under Delaware law. The Court’s decision today deprives plaintiffs of one of the bases for this type of forum-shopping. Moreover, the tenor of the Court’s decision may signal further difficulties for plaintiffs who seek to gain an advantage in California courts.

Morrison & Foerster filed a brief on behalf of the Chamber of Commerce of the United States of America as *amicus curiae* in support of the defendants/respondents.