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California Court Of Appeal Addresses Important Issues Affecting Shareholder Derivative Claims Under Delaware Law

In [*Bader v. Anderson*](#), No. CV041521, 2009 Cal. App. LEXIS 1880 (Cal. App. Nov. 23, 2009), the [California Court of Appeal for the Sixth Appellate District](#) addressed two important issues affecting shareholder derivative actions under California law. First, the Court offered guidance regarding the distinctions between *direct* claims and *derivative* claims by shareholders against corporate management, holding that “incidental harm” to shareholders, in the form of reduced share value, does not transform a derivative claim into a direct cause of action. Second, the Court confirmed that no exception to the presuit demand requirement exists for claims alleging misleading statements or omissions in proxy statements.

Plaintiff, a shareholder in Apple, Inc. (“Apple”), filed suit in May 2005 against Apple and its directors and officers, alleging that the Apple shareholders’ approval of a cash performance bonus plan (the “Plan”) for nondirector executives was based upon misleading representations and omissions in the corporation’s proxy statement. Over the next several years, plaintiff amended her complaint to add what she characterized as direct claims, putatively on behalf of a class of investors, alleging, *inter alia*, that the members of the corporation’s board of directors breached their fiduciary duties by delegating authority to enact the Plan to the board’s compensation committee and by causing the corporation to distribute the allegedly misleading proxy statement. The [Santa Clara County Superior Court](#) (Komar, J.), applying Delaware law, sustained defendants’ demurrer to plaintiff’s sixth amended complaint, without leave to amend, holding that plaintiff had failed to adequately plead (1) demand futility, (2) that the proxy statement was false or misleading and (3) facts sufficient to constitute a direct cause of action.

The Court of Appeal affirmed. First, it rejected plaintiff’s argument that the claims were properly brought as direct, not derivative, causes of action. Although the Court noted that California law, not Delaware law, properly applied to the claims (Apple was incorporated in California, not Delaware), the Court nonetheless held that California and Delaware law are in accord on this question and, as a result, borrowed heavily from Delaware decisions when explaining the direct/derivative distinction. The Court explained that the distinction turns on two questions: (1) who suffered the alleged harm – the corporation or the suing stockholder individually – and (2) who would receive the benefit of the recover or other remedy? The Court held that in the case at bar, it was the corporation, and not its shareholders, that suffered harm because it was the corporation that suffered a loss of value through the Plan’s adoption. The Court further noted that

to the extent any individual shareholder suffered a loss of stock value as a result of the Plan, that loss was merely incidental to the harm suffered by the corporation as a whole and, therefore, not sufficient to convert the claims into direct causes of action. Likewise, the Court further held that it was the corporation, not the shareholders, that would receive the benefit of recovery in the form of a cessation of further bonuses, accounting of losses and invalidation of the Plan.

The Court also rejected plaintiff's argument that her proxy statement claims were exempt from the demand requirement under a 2003 New York federal court decision, *Vides v. Amelio*, 265 F. Supp. 2d 273 (S.D.N.Y. 2003). In *Vides*, the [United States District Court for the Southern District of New York](#), applying Delaware law, held that false assertions and material nondisclosures in a proxy statement are presumed not to be the product of a valid exercise of business judgment and are therefore not subject to the demand requirement. The California Court of Appeal categorically rejected the *Vides* exception, noting that it had been questioned and/or rejected by numerous federal courts.

Because the claims were derivative, the Court held, they belonged to the corporation and the decision to bring suit rested with the corporation's board of directors unless plaintiff was able to meet her burden, under [California Corporations Code § 800](#), of pleading particularized facts establishing that she either had made a demand for litigation on the corporation or that no demand was made because it would have been futile. Plaintiff did not allege that she had made a demand for litigation on the board. Therefore, the Court – again looking to Delaware law for guidance – considered whether plaintiff had met her burden of pleading particularized facts establishing demand futility.

The Court applied the test enunciated in [Rales v. Blasband](#), 634 A.2d 927 (Del. 1993), to plaintiff's challenge to enactment of the Plan because, the Court found, the Plan was enacted only by Apple's compensation committee and not by its full board of directors. *Rales* governs demand futility analysis when a board is accused of breaching its fiduciary duty by failing to act. Under *Rales*, a shareholder plaintiff must plead facts creating a "reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." The Court held that plaintiff failed to meet that standard because she alleged only that the board lacked disinterest and independence based on each director's potential liability for Plan's enactment. The Court rejected this argument, holding "a plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves."

With respect to plaintiff's claim that the board breached its fiduciary duty by distributing the proxy statement, the Court applied the test from [Aronson v. Lewis](#), 473 A.2d 805 (Del. 1984) because plaintiff's claims were the product of a "conscious decisions by directors to act." *Aronson* asks whether (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of

a valid exercise of business judgment. Applying *Aronson*, the Court noted that plaintiff's counsel had acknowledged "this is not a case involving an interested board" and that the complaint itself included no allegations that the board lacked independence. Further, the Court held, plaintiff had failed to plead particularized facts in the complaint establishing that distribution of the proxy statement was not the product of valid business judgment.

Bader serves as a reminder of the difficult hurdles shareholder plaintiffs face when seeking to bring suit derivatively under either California or Delaware law. As the Court stated, California courts will not permit a shareholder plaintiff to evade the stringent requirements for pleading demand futility "simply because" a shareholder alleges that the challenged action has had an "indirect impact in some fashion on the shareholders as well." Instead, where the fundamental nature of the harm alleged is one suffered by a corporation, as a whole (as with allegedly inappropriate compensation schemes) California courts will require shareholder plaintiffs to first either make a demand for litigation on the corporation's board of directors or plead particularized facts establishing that demand should be excused.

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