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Guide to Expert Witnesses
PAGE 38

EARN MCLE CREDIT

2014 Ethics Roundup
page 23

Lender Liability after *Foley*
page 12

Inverse Condemnation for Water Damage
page 14

Secrecy in Mediation
page 68

PLUS

Prosecuting Elder Financial Abuse
page 30

Doubling Down

Los Angeles lawyer Robert M. Heller argues that double derivative indemnity litigation may come to California
page 16

by Robert M. Heller

Doubling Down

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California has yet to follow Delaware and other jurisdictions and allow double derivative standing

ALTHOUGH DOUBLE DERIVATIVE standing has been adopted in many jurisdictions outside California to address the modern corporate form,[1] California courts have yet to rule on whether it will be allowed in this state. Application of the double derivative principle permits a shareholder of a parent company to sue for harm to its subsidiary and prevents corporate fiduciaries from using the parent-subsidiary form to circumvent shareholder derivative litigation. California's policy of affording a right for every wrong, however, portends California's adoption of double derivative standing.[2]

Shareholders, limited partners, LLC members, and others may bring a derivative action on behalf of an entity when that entity has suffered harm and those controlling it refuse to file suit. The right of an individual to sue derivatively is critical to ensure that insider corporate wrongdoing is addressed. In fact, it is the only recourse available when the corporation is controlled by the wrongdoers who may be expected to refuse to file suit against themselves.[3] On the other hand, when an individual owns an interest in a parent company, and its subsidiary is the target of wrongdoing, the individual does not directly own shares in the subsidiary.[4] Classic single derivative standing does not convey a right to sue on behalf of the subsidiary, because the individual only owns an interest in the parent. Technically, only the parent, as the direct owner of the subsidiary, has single derivative standing to sue on behalf of the subsidiary.

What recourse, then, exists if the subsidiary's board refuses to file suit, and the board of the parent also refuses to bring a single derivative action on the subsidiary's behalf? If no other person has standing to sue, a subsidiary could be left without a remedy. The mere layer of a second corporate structure could insulate wrongdoers under a simple formula of abuse: corporate boards and officers who wished to reduce or eliminate the risk of breach of fiduciary duty and other actions against themselves could simply form and operate through a corporate subsidiary while also controlling the parent.[5] For this reason, numerous jurisdictions have kept stride with "the realities of the changing techniques and structures of the modern corporation."[6] Courts in other states have recognized and steadily expanded the double derivative category of standing, which allows an owner in a parent company to file suit in favor of a subsidiary.[7]

Foreign Law

Double derivative theory evolved over a century ago.[8] It was well established in New York as early as 1948,[9] in Delaware as early as 1963,[10] and has been applied and ex- panded in numerous other jurisdictions as well as in the

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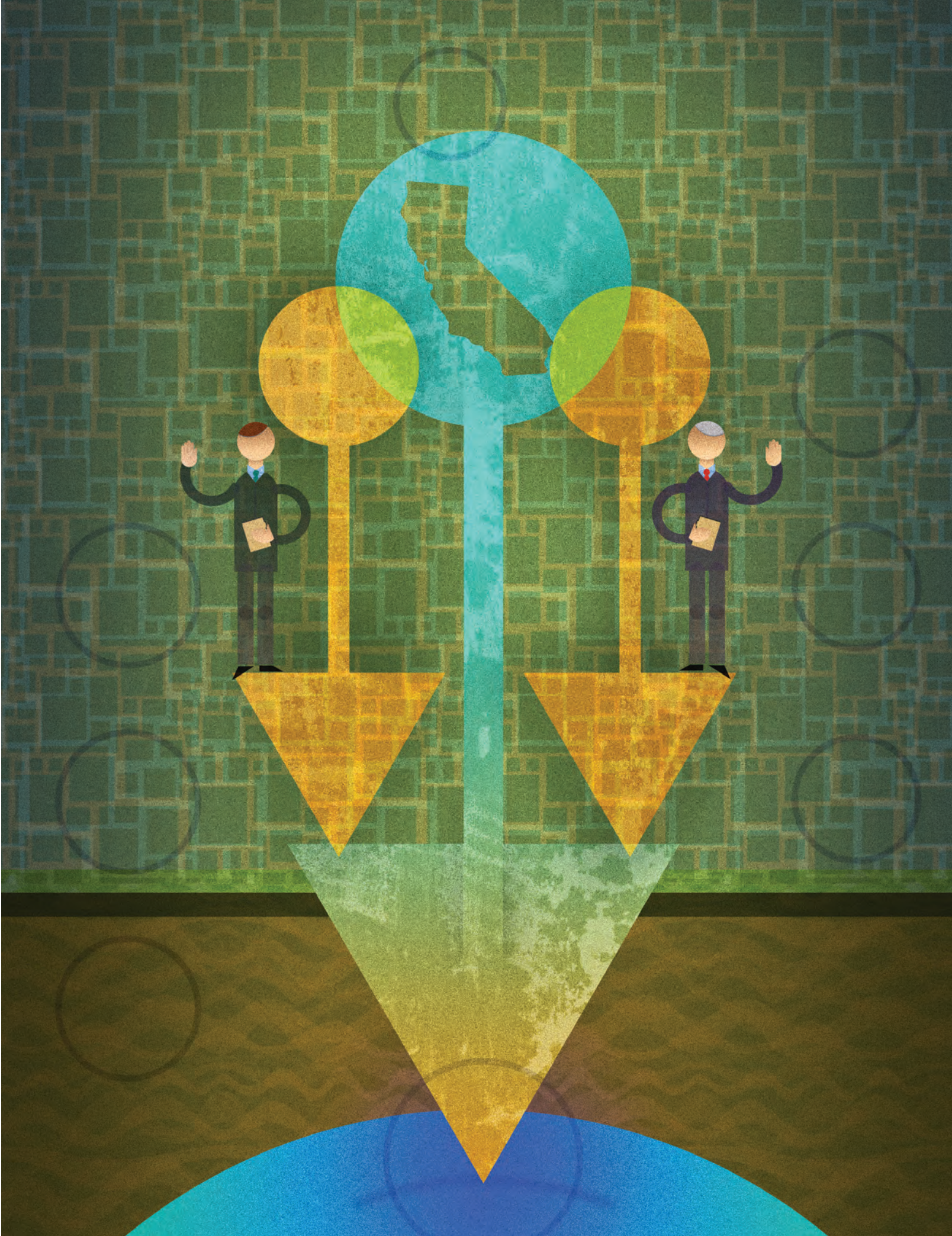


Model Business Corporations Act.[11] The question of whether California will adopt double derivative standing can, in part, be evaluated by examining the reasons double derivative standing has been adopted in other states.

A particularly illustrative opinion was issued in 1988 by the Illinois Supreme Court in *Brown v. Tenney*.[12] There, three shareholders formed a corporation, appointed themselves to its board of directors, and operated the business. They then formed a separate corporation to act as a holding company, exchanged their shares for an equal percentage of the holding company's shares, and elected themselves as directors of the holding company.

The plaintiff, a minority shareholder in the parent, alleged that the defendants breached their fiduciary duties by converting corporate funds of the subsidiary and that both the parent and the subsidiary were controlled by the wrongdoers, who refused to sue. The plaintiff shareholder brought a derivative lawsuit on behalf of the parent and its subsidiary. The trial court refused to recognize double derivative theory for the subsidiary's suit, the appellate court reversed, and the Illinois Supreme Court accepted the appeal.

The Illinois Supreme Court noted that a "double derivative action is a long-standing doctrine of equity jurisprudence" and the "overwhelming weight of authority does accept the double derivative action."[13] The Illinois high court agreed with the plaintiff, finding that "this court should not be derailed by convenient corporate formations which do not reflect business realities."[14] Illinois had a well-settled principle to look beneath the corporate veil and disregard legal fictions "when used as a shield for wrongful acts."[15] The court was more concerned with protecting the natural persons for whom the corporations were created rather than the "artificial creatures in whom legal title is vested."[16]

The Illinois Supreme Court was further persuaded that corporate officers and directors are fiduciaries and that single-derivative standing evolved to ensure someone could represent the interests of corporations and shareholders should the fiduciaries fail to act properly. The court reasoned that double derivative standing merely extended single derivative theory, so that the "beneficiary is in turn also a fiduciary" that deserves representation should interlocking directorates or collusion result in lack of representation.[17] Otherwise, "the subsidiary is accountable to no one since its shareholder, the holding company, is controlled by the wrongdoers."[18]

The Illinois court rejected the defendants' contention that recognizing double derivative actions was tantamount to judicial legislation. The court swiftly disposed of that argument by noting that single derivative actions also had equitable, rather than purely statutory, origins.

California courts are also likely to look to Delaware decisions.[19] For decades, Delaware courts have recognized double derivative standing, and in 2010, the Delaware Supreme Court greatly expanded the theory in *Lambrecht v. O'Neal*.[20] The *Lambrecht* court first reviewed prior Delaware decisions, such as *Sternberg v. O'Neil,*[21] in which the parent company acquired the subsidiary before the alleged wrongdoing had occurred. The *Lambrecht* court confirmed: "In these circumstances, our law recognizes a right to proceed double derivatively. Otherwise, there would be no procedural vehicle to remedy the claimed wrongdoing in cases where the parent company board's decision not to enforce the subsidiary's claim is unprotected by the business judgment rule."[22] The *Lambrecht* court further reasoned that double derivative standing arises "where the parent corporation's board is shown to be incapable of making an impartial business judgment regarding whether to assert the subsidiary's claim."[23]

The *Lambrecht* case, however, presented an even more complex issue. The *Lambrecht* plaintiff had initially owned shares in the corporation at issue individually and directly, and had properly filed a single derivative case on behalf of that nominal defendant corporation. During the litigation, the nominal defendant entity merged with another corporation, thereby causing plaintiff to lose direct shareholder status. The court noted that a "post-merger double derivative action" was "a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the [current] board, post-merger, to enforce the premerger claim of its wholly-owned subsidiary."[24] Despite the more complicated ownership issues presented, the Delaware Supreme Court nevertheless confirmed that "Delaware case law clearly endorses the double-derivative action as a post-merger remedy" and extended double-derivative standing to those circumstances as well.[25]

California Law

Despite the acceptance of double derivative standing elsewhere, the theory has remained an elusive issue of first impression in California and has avoided full evaluation in a published decision in the state's courts. California's lack of precedent complicates matters for California practitioners since, given the popularity of the parent-subsidiary form, the double derivative standing issue will likely arise in shareholder disputes. Moreover, since a successful lack of standing defense can terminate all liability, fiduciary defendants will likely contest the issue. California practitioners representing the would-be double derivative plaintiff may cite the foreign cases discussed above and may further consider advancing additional arguments to secure standing.

First, Corporations Code Section 800(b), which authorizes shareholder derivative suits, expressly permits derivative actions by "a shareholder, of record or beneficially." The legislature added the term "beneficially" to Section 800(b) in 1975, but did not define the term. *Pearce v. Superior Court*,[26] a 1983 appellate court decision, was the first case to examine the new term, observing that beneficial shareholder standing was added as part of "the 1975 liberalization of the standing requirements" to bring California in line with the majority rule.[27] Framing the term within the context of both the legal definition and that of usage in ordinary social discourse, *Pearce* stresses that a "liberal and expansive reading of section 800 and the phrase 'shareholder…beneficially'" is proper.[28]

Pearce holds that a beneficiary of corpus of a trust was a "beneficial stock owner" under Section 800(b), even though the beneficiary did not personally own the corporate stock. In a subsequent case, *Patrick v. Alacer Corporation*, the wife of a shareholder with a community property interest in her husband's shares was deemed a beneficial owner with derivative standing, despite the fact the stock was not in her name.[29] Thus, Section 800(b) expressly creates an exception to direct stock ownership, opening the door to the argument that a parent company shareholder is a "beneficial" owner of the subsidiary's stock and, as such, expressly granted standing by legislative enactment.

Second, California's creation of single derivative law was initially based in equity,[30] and California strongly supports the "fundamental principle of our system of jurisprudence that for every legal wrong there is a remedy."[31] California compensates injured parties for all damage proximately caused by the wrongdoer unless a departure from the basic principle is "mandated by a legislative exception or by strong public policy."[32] When individuals are subjected to conduct by others that is deemed unfair and contrary to public policy, the courts have full power to afford necessary protection.[33] Thus, even if a California court were to find in Section 800(b) that "beneficial" shareholder language did not legislatively sanction double derivative standing, California is rife with authority to support the theory based on equity alone.

Third, California opinions that have had indirect brushes with double derivative theory are favorable. In *Gaillard v. Natomas Company*,[34] the court considered double derivative theory in the context of a merger. Before the merger was effective, the plaintiff

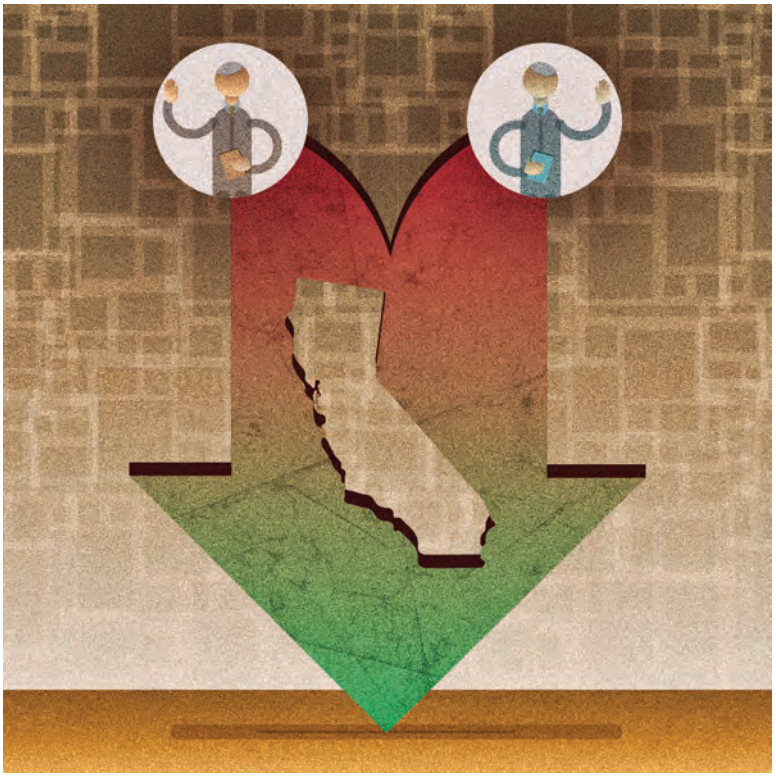
stockholder filed a single derivative shareholder suit against Natomas's officers and directors challenging their substantial benefits approved as part of the merger. Within hours after the complaint was filed, the merger concluded, forcing the plaintiff to exchange her shares in Natomas for common stock in the second company, which became the sole shareholder of Natomas's common stock.

The trial court held that the plaintiff lost standing to proceed derivatively when she was no longer a Natomas shareholder. Upon reversing the decision, the appellate court framed the issue before it narrowly within single derivative theory, and concluded that Section 800(b)(1) did not require the plaintiff to maintain continuing shareholder status throughout the litigation, as it would "leave Gaillard and all those similarly situated without a remedy."[35]

The *Gaillard* court's concern over its plaintiff's potential lack of remedy was prompted by its further comments about double derivative standing, whereby the court concluded that double derivative standing could not aid its plaintiff "in the context of this case."[36] First, *Gaillard* reasoned that a double derivative action would be dismissed as moot under its unique facts because it resulted in the "anomalous" situation of a corporation, postmerger, "suing itself for its own benefit, because of acts it performed."[37] Second, the court reasoned that its plaintiff did not own the parent company at the time of the alleged wrongdoing or filing of the complaint, and thus could not meet the contemporaneous shareholder requirement for the parent company. The *Gaillard* court carefully limited its holding, thereby implicitly recognizing that double derivative standing could be viable based on other facts and circumstances.[38] A number of authorities continue to describe *Gaillard* as looking favorably on the double derivative suit concept.[39]

In *Grosset v. Wenaas*,[40] the California Supreme Court overruled *Gaillard*'s holding on postmerger standing. Without addressing double derivative theory, and under what was essentially a single derivative analysis, the *Grosset* court concluded that under both Delaware's and California's contemporaneous ownership rules a postmerger plaintiff does not have standing and dismissed the appeal.[41]

However, two years later, the Delaware Supreme Court in *Lambrecht* seemingly pulled the rug out from under the *Grosset* decision, expressly recognizing that double derivative standing does, in fact, exist under Delaware law to afford standing in the postmerger context.[42] Because *Grosset* did not consider double derivative standing, *Grosset* is not controlling on that issue and remains one of first impression in California. The question thus remains whether California courts will follow Delaware's numerous opinions, including *Lambrecht,* which hold that double derivative standing is, and has been, a viable theory for decades, whether under the postmerger cases or otherwise.



It seems likely that California will do so, given that California courts have historically been persuaded by and often follow Delaware corporate case law.[43] *Grosset* itself illustrates a circumstance in which the action of the California Supreme Court could be interpreted as desiring to parallel Delaware law.[44] Moreover, given that the *Grosset* court has already concluded that Delaware's statutory "contemporaneous ownership" requirement is the same as, if not narrower, than California's requirement for the purpose of single derivative standing,[45] California courts will be hard pressed to now attempt to distinguish California law from Delaware law or otherwise conclude that double derivative standing cannot exist in California in light of *Lambrecht*.

Since *Lambrecht,* two California appellate courts have seemingly concurred and telegraphed that double derivative standing may soon be expressly adopted in this state. In *Kruss v. Booth*,[46] the plaintiff's second amended complaint alleged double derivative theory. The appellate court reversed the trial court and permitted the pleading to stand on demurrer, thus implicitly recognizing that double derivative standing exists in California.

Additionally, in *Villari v. Mozilo*,[47] the plaintiff alleged multiple double derivative actions after a postcomplaint merger, but then dropped the double derivative theory of standing on appeal. Despite this, the court took the opportunity to cite and even quote extensively from *Lambrecht*, concluding "The continuous ownership rule, however, does not preclude a double derivative action by a former shareholder."[48] Apparently, the only thing standing in the way of double derivative standing in *Villari* was the fact that the plaintiff had abandoned it.

California courts may also be influenced by the Ninth Circuit's holding in *In re Imperial Corporation of America*,[49] in which the Ninth Circuit considered whether double derivative standing existed in the context of the doctrine of claim preclusion (res judicata).[50] The court observed that claim preclusion bars not only claims that were actually litigated but also any claims that could have been litigated. In a prior lawsuit, the shareholders brought and settled a single derivative action against the officers and directors relating to the failure of Imperial Savings Association, which was a wholly owned subsidiary of Imperial Corporation of America.[51] However, the shareholders only sued the parent company Imperial Corporation of America and did not bring a double derivative lawsuit on behalf of the subsidiary.

The Federal Deposit Insurance Corporation (FDIC), as receiver for the failed subsidiary, brought a separate action on behalf of the subsidiary against the same officers and directors for the same conduct. After concluding that the FDIC was in privity with the prior shareholder plaintiffs (a requirement for claim preclusion), the court further examined which claims the prior shareholder plaintiffs had or could have brought. Although the subsidiary was not a named defendant or a party to the settlement in the prior litigation, the Court cited *Gaillard* for the definition of double derivative and held that the prior

shareholder plaintiffs "could have brought a proper double derivative suit" on behalf of the parent in the prior action.[52] After recognizing that double derivative standing would have allowed the prior shareholder plaintiffs to sue on behalf of the subsidiary, the court concluded that the FDIC's claim on behalf of the subsidiary was barred by claim preclusion in the present action.[53]

The primary function of double derivative theory is to provide a remedy to individuals when both the parent company and the subsidiary refuse to act; it favors substance over form and promotes equity for the individual rather than the fiction of the corporate structure. Although California courts have yet to issue a clear, published decision on whether a double derivative plaintiff, in fact, has standing in this state, the nationwide move in that direction and the compelling reasons in favor of the theory should be persuasive argument leading to the formal, explicit approval of double derivative standing in California ■

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[1] Webre v. Sneed, 358 S.W. 3d 322, 334 (Tex. App. 2011) ("Many other jurisdictions" recognize double derivative standing.); West v. West, 825 F. Supp. 1033, 1054 (N.D. Ga. 1992) (citing 3B Moore's Federal Practice §23.1.16[1] (1991) ("The general rule under existing federal case law is that double or multiple derivative actions are permissible.").

[2] "It is a fundamental principle of our system of jurisprudence that for every legal wrong there is a remedy (Civ. Code §3523), and that an injured party should be compensated for all damage proximately caused by the wrongdoer unless a departure from the basic principle is mandated by a legislative exception or by strong public policy." Barbara A. v. John G., 145 Cal. App. 3d 369, 376 (1983).

[3] Friedman, California Practice Guide: Corporations §§6:602-03 (2006).

[4] The use of subsidiaries has become "increasingly popular with the growth and sophistication of the modern corporate enterprise. The reasons for this are complex and varied. Subsidiaries may be useful for tax reasons, for achieving the advantages of limited liability, for centralizing control in a relatively small percentage of stock ownership, for qualifying to do business under the laws of the various states, for reasons related to financing, and doubtless for a number of other purposes." William H. Painter, *Double Derivative Suits and Other Remedies with Regard to Damaged Subsidiaries,* 36 Ind. L. J. 143 (1961).

[5] "The holding company has given rise to numerous new problems of the protection of stockholders from the misconduct of their directors." Note, *Remedies of Stockholder of Parent Corporation for Injuries to Subsidiaries*, 50 Harv. L. Rev. 963 (1937).

[6] Brown v. Tenney, 532 N.E. 2d 230, 233–234 (Ill. 1988).

[7] *See, e.g.* Bivens Gardens Office Bldg., Inc. v. Barnett Banks of Florida, Inc., 140 F. 3d 898, 910 n.5 (11th Cir. 1998); Pessin v. Chris-Craft Indus., Inc., 181 A.D. 2d 66, 72 (N.Y. App. Div. 1992); Webre v. Sneed, 358 S.W. 3d 322, 334 (Tex. App. 2011); West v. West, 825 F. Supp. 1033, 1054 (N.D. Ga. 1992); *and* cases discussed below.

[8] Ryan v. Leavenworth, Atchison & Northwestern R.R. Co., 21 Kan. 365, 402-04 (1879) ("If any other rule were adopted, the plaintiffs would be denied all