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TRANSACTIONS

Don't ignore 'demanding' pre-litigation procedures

By Lynda Chung

Recent cases from California and Delaware tell us that a shareholder's filing a derivative action without first complying with the pre-litigation demand procedures may result in a dismissal.

In a derivative action, the plaintiff acts as the corporation's representative prosecuting the corporation's claim against third parties (often officers or directors of the company) who allegedly harmed the corporation. To attain "representative" status, the plaintiff must comply with the pre-suit demand procedure in California Corporations Code Section 800. Federal Rules of Civil Procedure Rule 23.1 and Delaware Rules of Chancery Court Rule 23.1 impose a similar demand requirement. Per Section 800(b)(2), a shareholder's derivative complaint must allege (1) that the plaintiff is a shareholder or the holder of voting trust certificates of the corporation, and (2) *with particularity* the plaintiff's efforts to secure from the board of the corporation such action as the plaintiff desires or the reasons for not making such effort, i.e., "demand futility."

However, in California there is one additional step involved. The complaint in a derivative action must further allege that the plaintiff has delivered a copy of the proposed complaint or provided comparable written notice to the corporate board. Corp. Code Sections 800(b)(2), 17709.02(a)(2). This is a major distinction between the California statutes and the Delaware/federal rules because Rule 23.1 does not have the same written notice requirement. What is puzzling, though, is there is no case law regarding whether a California plaintiff who successfully alleged demand futility must still comply with this written notice requirement.

The demand requirement is nothing new. It was recognized over 120

years ago by the U.S. Supreme Court. Despite this well-established requirement, many complaining shareholders often cannot resist the temptation to rush to court without first making the demand, claiming the demand would have been futile. This has resulted in substantial litigation over the demand futility issue. When demand futility is at issue, under the internal affairs doctrine, courts will apply the law of the place of incorporation regarding the directors' duties and liabilities. Thus, Delaware law governs the analysis of whether to excuse a demand in a shareholder's derivative action on behalf of a company in California but incorporated in Delaware. However, this doctrine makes little practical difference in California, where demand futility is concerned, because California courts frequently adopt Delaware precedents on demand futility, commonly known as the Aronson test. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

Aronson laid out the standard for demand futility: To allege "demand futility," the complaint must allege particularized facts creating a reasonable doubt that either (1) the directors were disinterested and independent or (2) the challenged transaction was the product of a valid exercise of business judgment. If either prong is satisfied, then the plaintiff has met the demand futility burden. If a plaintiff fails to satisfy the first prong, there is a presumption that the board's actions were the product of a valid exercise of business judgment. See *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004). To meet the second prong, the plaintiff must plead particularized facts sufficient to question the board members' good faith or the adequacy of the information they had when making the challenged decision. *Raul v. Rynd*, 929 F.Supp.2d 333 (D. Del. 2013).

Two 2013 cases on demand futility, one from California (Charter Township of Clinton Police & Fire Retirement *System v. Martin*, 219

Cal. App. 4th 924) and the other from Delaware (*Raul*, above) illustrate how risky it can be to file a derivative suit without first making a demand. In *Martin*, the California Court of Appeal followed the Delaware federal court's reasoning in *Raul* and dismissed the complaint against the directors who had approved high level executives' pay raises while company revenues were down. Both courts held that the plaintiff's argument that a pre-suit demand would have been "useless and futile" did not meet the demand futility test because the board's decision could have been based on a legitimate business goal such as retaining the high-level executives.

Unlike the two 2013 cases where in the California and Delaware courts made consistent decisions, the shareholders of Allergan Inc., an Irvine company incorporated in Delaware, experienced a demand futility rollercoaster ride. The 9th U.S. Circuit Court of Appeals' recent decision in *Rosenbloom v. Pyott*, 765 F.3d 1137 (9th Cir. 2014), ended the bi-coastal tug of war between Allergan and its shareholders in favor of the shareholders in California, which resulted in the revival of another shareholders' action in Delaware, which the Delaware Supreme Court had previously dismissed.

Botox is an Allergan product, a neurotoxin approved by the FDA from 1989 to 2010 for only certain therapeutic and cosmetic uses. In the mid- to late-2000s, whistleblower actions and criminal charges were brought against Allergan which marketed Botox for unapproved uses. These actions resulted in a civil settlement and criminal penalties totaling \$600 million. In 2010, two sets of plaintiffs sued Allergan's board of directors — one group filed in federal court in California and another group filed in Delaware state court. Neither sets of plaintiffs presented their demand to the board prior to suing. Both alleged that the Allergan

board breached its fiduciary duty by, among other things, turning a blind eye to Allergan's continuous, illegal marketing of Botox for unapproved uses. In both courts, defendants moved to dismiss for failure to adequately allege demand futility.

In January 2012, the federal court in California granted the defendants' motion to dismiss. In June 2012, however, the Delaware state court denied the defendants' motion to dismiss, and the defendants' appeal ensued. In 2013, rather than applying Delaware demand futility law, the Delaware Supreme Court reversed the lower court's decision solely on the ground that the dismissal of the California complaint had a preclusive effect on the Delaware case under the full faith and credit clause of the U.S. Constitution, even though the Delaware case was brought by different plaintiffs, a rather surprising result given that the Delaware Supreme Court, the highest court in the mecca of corporate law, applied California collateral estoppel doctrine to a Delaware corporation. However, because the Delaware Supreme Court's decision was based on honoring a sister state's judgment, the 9th Circuit's decision resulted in the reinstatement of the Delaware case.

What these cases tell us is that (1) relying on demand futility is risky, and (2) Delaware may very well honor sister states' decisions, even though it has a well-developed body of law on demand futility.

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