

## Memorandum 76-19

Subject: Study 77.80 - Nonprofit Corporations (Members' Derivative Actions)

By means of the derivative action, a shareholder or member of a corporation may enforce a corporate right, where the corporation refuses to act, against officers or directors of the corporation or against third persons. The plaintiff sues on behalf of the corporation, and any resulting money judgment is in favor of the corporation rather than the plaintiff. Of course, a prevailing plaintiff is generally allowed costs and attorney's fees. Derivative actions should be distinguished from shareholders' or members' direct actions (which may be class actions) against the corporation. Examples of derivative actions include: actions to recover damages from an ultra vires act; actions to enjoin directors, officers, or controlling shareholders from breaching their fiduciary duty to the corporation or to recover damages for breach of duty; actions to enjoin outsiders from wronging the corporation or to recover for such wrong. Examples of direct actions include: actions based on corporate contract with stockholder or member as individual; tort actions for injury to the shareholder or member; actions to enforce the right to vote in the corporation; actions to compel dissolution; actions to remedy the wrongful expulsion of a member. Direct and derivative causes may be combined in the same action. (The foregoing discussion is derived from 13 W. Fletcher, Private Corporations §§ 5907-6045.5 (perm. ed. rev. vol. 1970), and H. Henn, Corporations §§ 358-380 (2d ed. 1970).)

The existing General Nonprofit Corporation Law does not explicitly provide for derivative actions in the right of a nonprofit corporation. Presumably, the shareholder derivative action provision of the General Corporation Law (Section 834 in the existing law, see Exhibit I--pink) governs derivative actions in the right of nonprofit corporations by force of Section 9002 which incorporates

provisions of the General Corporation Law for the purposes of the General Nonprofit Corporation Law and by force of Section 103 which defines "shareholder" to include "member."

Derivative actions by members of nonprofit corporations have not resulted in many reported cases in California. We have found only one such case. In Ashton v. Dashaway Association, 81 Cal. 61, 22 P. 660 (1890), a member of an incorporated temperance association was permitted to bring an action in equity to prevent the distribution of the assets of the association to the members. A leading treatise states that the "right of a stockholder to sue is not affected by the nature or kind of the corporation, and the law pertaining to derivative suits applies to a nonprofit corporation exactly the same as if it were a business corporation." (13 Fletcher, supra, at § 5950, citing decisions in Washington, Louisiana, Delaware, New York, and New Jersey.) New York and Pennsylvania have made explicit the right of a member to bring a derivative action. (N.Y. Not-for-Profit Corporation Law § 623 (Exhibit II--yellow); Pa. Corporation Not-for-profit Code § 7765 (Exhibit III--green).)

At the June 1974 meeting, the Commission considered a draft of provisions relating to derivative actions and decided that the General Nonprofit Corporation Law should provide explicitly for derivative actions. The staff has given further consideration to the earlier draft, particularly in light of the new General Corporation Law and the Commission discussion and decisions concerning the earlier draft, and has drafted a new set of provisions which are attached to this memorandum. The remainder of this memorandum is a discussion of the attached draft and possible alternative provisions.

#### Who May Bring Derivative Actions

Under the General Corporation Law, any shareholder may bring a derivative action if he meets the other requirements, but an undertaking in the amount of

up to \$50,000 may be required. The earlier staff draft was similar to the New York provision in that it required an action to be brought by the lesser of 50 members or 10 percent of the members and eliminated the undertaking provision. However, at the June 1974 meeting, the Commission expressed some concern that this might be too restrictive. Accordingly, the attached draft proposes to combine the two provisions by permitting a derivative action to be brought by the lesser of 50 members or 10 percent of the members (provided that they all meet the requirements discussed below) without the necessity of giving an undertaking; where the plaintiffs do not meet this numerical qualification, the defendant corporation or the defendant directors or officers may move for an undertaking in the same manner as is provided in Section 834 of the General Corporation Law (new Section 800). This scheme is similar to that provided in Pennsylvania. (See Pa. Corporation Not-for-profit Code § 7765 in Exhibit I.)

This scheme provides flexibility in the nonprofit situation while, at the same time, protecting against "strike suits" by means of the 50-member or 10-percent rule or by means of the undertaking requirement in cases where fewer members sue.

#### Contemporaneous Membership Rule

At the June 1974 meeting, the Commission decided that a plaintiff member must have been a member at the time the transaction complained of occurred. In the attached draft, we have followed the form of the contemporaneous ownership rule as it appears in Section 800 of the new General Corporation Law. Section 800 contains an exception to the contemporaneous ownership rule that did not appear in Section 834 of the old General Corporation Law. We have included this exception in the draft of Section 5801 for the sake of consistency.

#### Other Conditions Precedent to Suit

The draft, like Sections 800 and 834, requires the member to make some effort to secure from the nonprofit corporation the action he is suing for or to give his reasons for not making such effort. Usually this takes the form of a demand on the board of directors. This need not be done where the alleged wrongdoers are in control of the corporation. A demand on members might also be required where the members have the power to ratify the alleged wrongdoing. The exact nature of the efforts needed to satisfy the exhaustion of remedies requirement cannot, of course, be specified in the statute. However, the draft statute, like Sections 800 and 834, does require the plaintiff to inform the board of directors or the corporation in writing of the grounds for the action or deliver a copy of the complaint that the plaintiff proposes to file.

#### Costs and Attorney's Fees

The draft statute, like Sections 800 and 834, does not attempt to state the law regarding the award of costs and attorney's fees except where an undertaking is given (see discussion below). The normal rules concerning costs apply in derivative actions. Some special rules concerning attorney's fees developed by the courts are applicable to derivative actions. Hence, where the plaintiff's action results in the preservation of a fund or the award of damages to the corporation, the plaintiff is entitled to be compensated for his attorney's fees (as well as costs) from the fund. Even where no actual monetary gain results from the action, the plaintiff may receive his attorney's fees if the corporation has received a "substantial benefit" from the litigation. Fletcher v. A. J. Industries, Inc., 266 Cal. App.2d 313, 72 Cal. Rptr. 146 (1968). We do not propose to codify these rules.

Under the staff draft, if the plaintiffs satisfy the 50 member or 10 percent of the members rule, they do not have to give an undertaking, and the nonprofit corporation would not be entitled to attorney's fees.

#### Undertaking to Secure Defendant's Expenses

Section 5803 of the staff draft parallels the provision of Section 800 of the new General Corporation Law relating to security for expenses, including attorney's fees. In order to obtain an order for an undertaking, the defendant must show either that there is no reasonable possibility that the action will benefit the corporation or that the individual defendant who is an officer or director did not participate in the transaction complained of. If an undertaking is required, and the defendant ultimately prevails, then his costs and attorney's fees may be satisfied out of the security. However, this provision does not provide authority for the award of attorney's fees where no undertaking is given--e.g., where the defendant does not seek an undertaking within the time provided, where the defendant does not show that the grounds for requiring an undertaking exist, or where an undertaking is ordered but the action is dismissed because the plaintiff fails to furnish the undertaking. See Code Civ. Proc. § 1021 ("except as attorney's fees are specifically provided for by statute, the measure and mode of compensation of attorneys . . . is left to the agreement, express or implied, of the parties"); Freeman v. Goldberg, 55 Cal.2d 622, 361 P.2d 244, 12 Cal. Rptr. 668 (1961)(no attorney's fees awarded where derivative action dismissed because of plaintiff's failure to give undertaking).

#### Court Approval of Settlement

We have codified the requirement of case law that the court approve any settlement or compromise of the derivative action. See Ensher v. Ensher,

Alexander & Barsoom, Inc., 187 Cal. App.2d 407, 9 Cal. Rptr. 732 (1960). The theory of this rule is that the plaintiff in a derivative action is a trustee for the corporation's cause of action. Court approval is required to protect against suits brought for the personal enrichment of the plaintiffs or their attorneys.

Respectfully submitted,

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EXHIBIT I

[Cal. Corp. Code § 834.]

**§ 834. Conditions precedent to maintenance of member's or shareholder's action: Motion for plaintiff to furnish security: When pleadings to be filed: Application of section to incorporated and unincorporated associations.**

(a) No action may be instituted or maintained in right of any unincorporated association or of any domestic or foreign corporation by a member of such association or by the holder or holders of shares, or of voting trust certificates representing shares, of such corporation unless both of the following conditions exist:

(1) The plaintiff alleges in the complaint that he was a member, registered shareholder or the holder of voting trust certificates at the time of the transaction or any part thereof of which he complains or that his membership, shares or voting trust certificates thereafter devolved upon him by operation of law from a holder who was a holder at the time of the transaction or any part thereof complained of.

(2) The plaintiff alleges in the complaint with particularity his efforts to secure from the board of directors such action as he desires and alleges further that he has either informed the corporation or such board of directors in writing of the ultimate facts of each cause of action against each defendant director or delivered to the corporation or such board of directors a true copy of the complaint which he proposes to file, and the reasons for his failure to obtain such action or the reasons for not making such effort.

(b) In any such action, at any time within 30 days after service of summons upon the corporation or any defendant who is an officer or director of the corporation, or held such office at the time of the acts complained of, the corporation or such defendant may move the court for an order, upon notice and hearing, requiring the plaintiff to furnish security as hereinafter provided. Such motion shall be based upon one or more of the following grounds:

(1) That there is no reasonable possibility that the prosecution of the cause of action alleged in the complaint against the moving party will benefit the corporation or its security holders;

(2) That the moving party, if other than the corporation, did not participate in the transaction complained of in any capacity.

The court on application of the corporation or any defendant may, for good cause shown, extend such 30-day period for an additional period or periods not exceeding 60 days.

At the hearing upon such motion, the court shall consider such evidence, written or oral, by witnesses or affidavit, as may be material: (a) to the ground or grounds upon which the motion is based, or (b) to a determination of the probable reasonable expenses, including attorney's fees, of the corporation and the moving party which will be incurred in the defense of the action. If the court determines, after hearing the evidence adduced by the parties at the hearing, that the moving party has established a probability in support of any of the grounds upon which the motion is based, the court shall fix the nature and amount of security, not to exceed twenty-five thousand dollars (\$25,000), to be furnished by the plaintiff for reasonable expenses, including attorney's fees, which may be incurred by the moving party and the corporation in connection with such action, including expenses for which said corporation may become liable pursuant to Section 830. A determination by the court that security either shall or shall not be furnished or shall be furnished as to one or more defendants and not as to others, shall not be deemed a

determination of any one or more issues in the action or of the merits thereof. The corporation and the moving party shall have recourse to such security in such amount as the court shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court upon showing that the security provided has or may become inadequate or is excessive, but such order shall not increase the total amount of such security beyond twenty-five thousand dollars (\$25,000). If the court, upon any such motion, makes a determination that security shall be furnished by the plaintiff as to any one or more defendants, the action shall be dismissed as to such defendant or defendants, unless the security required by the court shall have been furnished within such reasonable time as may be fixed by the court.

If the plaintiff in any such action shall, either before or after a motion is made pursuant to this subdivision, or any order or determination pursuant to such motion, post good and sufficient bond or bonds in the aggregate amount of twenty-five thousand dollars (\$25,000) to secure the reasonable expenses of the parties entitled to make such motion, such plaintiff or plaintiffs shall be deemed to have fully complied with the requirements of this subdivision and with any order for security theretofore made pursuant hereto, any such motion then pending shall be deemed disposed of, and no further or additional bond or other security shall be required.

(c) If any such motion is filed, no pleadings need be filed by the corporation or any other defendant, and the prosecution of such action shall be stayed, until 10 days after such motion shall have been disposed of.

(d) The provisions of this section are applicable to all associations, both incorporated and unincorporated. As used in this section "corporation" includes an unincorporated association, and "board of directors" includes the managing body of an unincorporated association.

EXHIBIT II

[New York Not-for-Profit Corporation Law § 623.]

NOT-FOR-PROFIT CORP.

6-184

**N.P.C.L.**

§ 623. Members' derivative action brought in the right of the corporation to procure a judgment in its favor.

(a) An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor by five percent or more of any class of members or by such percentage of the holders of capital certificates or of the owners of a beneficial interest in the capital certificates of such corporation.

(b) In any such action, it shall be made to appear that each plaintiff is such a member, holder or owner at the time of bringing the action.

(c) In any such action, the complaint shall set forth with particularity the efforts of the plaintiff or plaintiffs to secure the initiation of such action by the board of the reason for not making such effort.

(d) Such action shall not be discontinued, compromised or settled without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the members or of any class or classes thereof will be substantially affected by such discontinuance, compromise or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the members or class or classes thereof whose interests it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable in the same manner as statutory taxable costs.

(e) If the action on behalf of the corporation was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the corporation for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured members or non-record owners only and limited to a recovery of the loss or damage sustained by them.

EXHIBIT III

[Pennsylvania Corporation Not-for-Profit Code § 7765.]

**§ 7765. Action by members to enforce a secondary right**

(a) **General rule.**—Except as provided in subsection (b) of this section, in any action brought to enforce a secondary right on the part of one or more members against any officer or director, or former officer or director, of a nonprofit corporation because such corporation refuses to enforce rights which may properly be asserted by it, the plaintiff or plaintiffs must aver and it must be made to appear, that the plaintiff or each plaintiff was a member of such corporation at the time of the transaction of which he complains.

(b) **Exception.**—Any member who, except for the provisions of subsection (a) of this section, would be entitled to maintain such an action and who does not meet such requirements, may, nevertheless in the discretion of the court, be allowed to maintain such action on preliminary showing to the court, by petition, and upon affidavits and depositions as may be required by the court, that there is a strong prima facie case in favor of the claim asserted on behalf of the corporation and that without such action serious injustice will result.

(c) **Security for costs.**—In any such action instituted or maintained by less than the smaller of 50 members of any class or 5% of the members of any class of such nonprofit corporation the corporation in whose right such action is brought shall be entitled at any stage of the proceedings to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorneys' fees, which may be incurred by it in connection therewith, for which it may become liable pursuant to section 7743 of this title (relating to mandatory indemnification) (but only insofar as relates to actions by or in the right of the corporation) to which security the corporation shall have recourse in such amount as the court having jurisdiction shall determine upon the termination of such action. The amount of such security may, from time to time, be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive. Such security may be denied or limited in the discretion of the court upon preliminary showing to the court, by petition, and affidavits and depositions as may be required by the court, establishing prima facie that the requirement of security or full security would impose undue hardship on plaintiffs and serious injustice would result.

(d) **Nonqualified foreign corporations.**—The provisions of this section shall extend to nonqualified foreign corporations.

## CHAPTER 3. MEMBERS' DERIVATIVE ACTIONS

§ 5800. Right of member to bring derivative action

5800. A member of a domestic or foreign nonprofit corporation may institute and maintain an action in the right of the nonprofit corporation only as provided in this chapter.

Comment. Section 5800 makes explicit the right of a member of a nonprofit corporation to bring a derivative suit. Formerly, Section 834 of the former General Corporation Law (predecessor of Section 800 of the new General Corporation Law) governed such actions in the right of nonprofit corporations. See former Sections 103 ("shareholder" includes "member") and 9002 (incorporating provisions of General Corporation Law). See also Ashton v. Dashaway Ass'n, 31 Cal. 61, 22 P. 660 (1890).

Note. The staff will give further consideration to the inclusion of foreign nonprofit corporations in this section when we consider the general subject of foreign nonprofit corporations. Whether the holder of a voting trust certificate should be permitted to maintain an action will depend upon whether voting trusts are authorized by the nonprofit corporation law.

§ 5801. Allegations of complaint

5801. (a) In an action brought pursuant to this chapter, the complaint shall contain all of the following allegations:

(1) Each plaintiff is a member of the nonprofit corporation at the time the action is commenced.

(2) Each plaintiff was a member of the nonprofit corporation at the time of the transaction (or any part thereof) complained of or holds a membership which devolved upon the plaintiff by operation of law from a person who was a member at such time.

(3) The plaintiff's efforts to secure from the board the action the plaintiff desires or the reasons for not making such efforts. Such allegations shall be made with particularity.

(4) The plaintiff has either informed the nonprofit corporation or the board in writing of the ultimate facts of each cause of action against each defendant or delivered to the nonprofit corporation or the board a true copy of the complaint which the plaintiff proposes to file.

(b) The court, in its discretion, may allow a plaintiff who does not meet the requirements of paragraph (2) of subdivision (a) to maintain an action under this chapter after a preliminary showing and determination by the court by motion and after a hearing at which the court shall consider such evidence, by affidavit or testimony, as it deems material of all of the following:

(1) There is a strong prima facie case in favor of the claim asserted on behalf of the nonprofit corporation.

(2) No other similar action has been or is likely to be instituted.

(3) The plaintiff acquired the membership before there was disclosure to the public or to the plaintiff of the wrongdoing of which the plaintiff complains.

(4) Unless the action can be maintained, the defendant may retain a gain derived from defendant's willful breach of a fiduciary duty.

(5) The requested relief will not result in unjust enrichment of the nonprofit corporation or any member of the nonprofit corporation.

Comment. Section 5802 provides for the allegation in the plaintiff's complaint of several conditions to bringing a derivative action.

Subdivision (a) is the same in substance as subdivision (b) of Section 300 of the General Corporation Law and subdivision (a) of former Section 834 except that references to "shareholders" have been changed to "members." The requirement stated in paragraph (1) is implicit in Section 800 and former Section 834.

Subdivision (b) provides an exception to the contemporaneous membership rule of subdivision (a)(2). It is the same in substance as a portion of paragraph (1) of subdivision (b) of Section 800.

§ 5802. Discontinuation of action; court approval

5802. An action brought pursuant to this chapter shall not be discontinued, compromised, or settled without the approval of the court.

Comment. Section 5802 codifies the rule stated in Ensher v. Ensher, Alexander & Barsoom, Inc., 187 Cal. App.2d 407, 9 Cal. Rptr. 732 (1960).

§ 5803. Security for defendant's expenses

5803. (a) Except as otherwise provided in Section 5804, in an action pursuant to this chapter, at any time within 30 days after service of summons upon the nonprofit corporation or upon any defendant who is an officer or director of the nonprofit corporation or held such office at the time of the acts complained of, the nonprofit corporation or such defendant may move the court for an order, upon notice and hearing, requiring the plaintiff to furnish security as provided in this section.

(b) The motion shall be based upon one or both of the following grounds:

(1) That there is no reasonable possibility that the prosecution of the cause of action alleged in the complaint against the moving party will benefit the nonprofit corporation or its members.

(2) That the moving party, if other than the nonprofit corporation, did not participate in the transaction complained of in any capacity.

(c) The court on application of the nonprofit corporation or any defendant may, for good cause shown, extend the 30-day period provided by subdivision (a) for an additional period or periods not exceeding 60 days.

(d) At the hearing on the motion, the court shall consider such evidence, written or oral, by witnesses or affidavit, as may be material (1) to the ground or grounds upon which the motion is based or (2) to a determination of the probable reasonable expenses, including attorneys' fees, of the nonprofit corporation and the moving party which will be

incurred in the defense of the action. If the court determines, after hearing the evidence adduced by the parties, that the moving party has established a probability in support of any of the grounds upon which the motion is based, the court shall fix the nature and amount of security, not to exceed fifty thousand dollars (\$50,000), to be furnished by the plaintiff for reasonable expenses including attorneys' fees which may be incurred by the moving party and the nonprofit corporation in connection with the action.

(e) A ruling by the court on the motion shall not be a determination of any issue in the action or of the merits thereof.

(f) The amount of the security may be increased or decreased in the discretion of the court upon a showing that the security provided has or may become inadequate or is excessive, but the court may not in any event increase the total amount of the security beyond fifty thousand dollars (\$50,000).

(g) If the court makes a determination that security shall be furnished by the plaintiff as to any one or more defendants, the action shall be dismissed as to such defendant or defendants unless the security required by the court has been furnished within a reasonable time fixed by the court.

(h) Upon the termination of the action, the nonprofit corporation and the moving party shall have recourse to the security in an amount determined by the court.

(i) If the plaintiff, either before or after a motion is made pursuant to subdivision (a) or any order or determination pursuant to

such motion, posts good and sufficient bond or bonds in the aggregate amount of fifty thousand dollars (\$50,000) to secure the reasonable expenses of the parties entitled to make the motion, the plaintiff has complied with the requirements of this section. Any motion for security then pending shall be dismissed, and no further or additional bond or other security shall be required.

(j) If a motion is filed pursuant to subdivision (a), no pleadings need be filed by the nonprofit corporation or any other defendant, and the prosecution of the action shall be stayed until 10 days after the disposition of the motion.

Comment. Section 5803 continues the substance of subdivisions (b) and (c) of former Section 834. The maximum amount of the undertaking has been raised to \$50,000 to be consistent with Section 800 of the new General Corporation Law.

Note. If the Commission's Recommendation Relating to Undertakings for Costs is passed, we will amend this section accordingly.

If the Commission decides to provide that the nonprofit corporation may indemnify its directors and officers for their litigation expenses when that subject is considered, we will add a provision for the undertaking under Section 5803 to cover such amounts as is provided in Section 300 of the General Corporation Law.

§ 5804. Exception to security for defendant's expenses

5804. Notwithstanding Section 5803, if an action is brought pursuant to this chapter by at least 50 members or at least 10 percent of the members, whichever number is smaller, the plaintiffs shall not be required to furnish security for the defendant's expenses.