Study J-602 December 5, 1995

First Supplement to Memorandum 95-72

Demand and Excuse in Shareholder Derivative Actions: Comments of Interested Persons

Attached as Exhibit pp. 1-6 is a letter from William S. Lerach of San Diego commenting on the study of demand and excuse in shareholder derivative actions. Mr. Lerach points out that his firm is active in the field of shareholder derivative actions. In his experience, courts take the existing demand and excuse requirements seriously. He details a number of cases in which the court initially refused to excuse the requirement of the plaintiff's demand, but after discovery and particularized pleadings the court determined that the plaintiff's demand would be futile and should be excused. Mr. Lerach urges the Commission to proceed cautiously before proposing any changes in this area.

Respectfully submitted,

Nathaniel Sterling
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VIA FEDERAL EXPRESS

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Re: Study B-602 -- Demand And Excused Demand In Shareholder Derivative Actions

Dear Chairperson Wied, Mr. Sterling and Members:

We have read with interest the study prepared by Professor Melvin A. Eisenberg entitled "The Requirement Of Making A Demand On The Board Before Bringing A Derivative Action And The Standard Of Review Of A Board Or Committee Determination That A Derivative Action Is Not In The Corporation's Best Interests," dated October 1995 (Study B-602), as well as Memorandum 95-71, "Business Judgment Rule: Staff Draft", to be discussed at the special order of business on Corporate Governance at the Law Revision Commission meeting scheduled for 1:00 p.m. on December 8, 1995 in San Francisco.

As the Commission may be aware, we have been counsel for plaintiffs in numerous shareholder derivative actions initiated in both California state and federal courts; in fact, we have represented aggrieved shareholders and their affected corporations in more than 40 shareholder derivative actions in California state and federal courts over the last 10 years.

As a result of our experience in this area, we are particularly familiar with how courts handle the "demand required/demand excused" requirement of Cal. Corp. Code §800(b)(2) in connection with the maintenance of shareholder derivative actions, both in the State of California and throughout the United States. While the issue of enhancing the duty of a board of directors to review a demand in a shareholder derivative action is an interesting concept

to review (and based upon our experience, the ALI proposals are more even-handed than the Delaware law in this arena), one of the issues raised in Professor Eisenberg's study -- whether a "universal demand" requirement is appropriate because of a perception that courts sometimes act as a "rubber stamp" in finding demand futility -- is not supported in either the most recent case authorities or in the practice and rulings of both California state and federal court judges.

The most recent published decision on this issue is Shields v. Singleton, 15 Cal. App. 4th 1611 (1993), which discusses the derivative litigation demand requirement in terms of both compliance and the pleading requirements necessary to justify a finding of demand futility and should have been made. In upholding a finding of the trial court that demand would not have been futile, the Court of Appeal found that the allegations of the Complaint were insufficient to find futility because:

> [T]he complaint does not allege a single fact which would indicate that the directors had knowledge of, much less participated in any criminal or fraudulent activities, nor does it allege that they have benefited directly from the wrongdoing or were otherwise disabled from exercising independent business judgment."

The Court of Appeal ultimately held:

> [I]n order to evaluate the demand futility claim, the court must be apprised of facts specific to each director from which it can conclude that the particular director could or could not be expected to fairly evaluate the claims of the shareholder plaintiff."

Id. at 1622 (emphasis added).[1]

Thus, as even Shields shows, courts do not simply "rubber stamp" claims of demand futility and in fact are instructed by the case law of California not to do so. Complaints must be specific in detail before a court will find that a pre-litigation demand is futile, and such allegations are carefully scrutinized. A universal demand requirement is therefore neither necessary nor appropriate.

In almost every situation we have encountered over the past several years, courts have not accepted plaintiffs' initial

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[1] A copy of Shields v. Singleton will be sent per your request.

allegations of demand futility, and in fact have required a great deal of factual specificity in the complaint as a prerequisite for finding that demand would be futile. The following is a representative summary of shareholder derivative actions in which we have acted as plaintiffs' counsel, where the court has addressed the demand futility issue:

1. Deliquanti and Salem v. Coulson, et al. (Case No. BC021028). The trial judge in this case (pending in Los Angeles Superior Court) ruled initially that demand would not have been futile. The Court of Appeal ultimately reversed that decision, determining (in an unpublished decision) that, based upon the allegations of the complaint, there were sufficient facts upon which to base a finding that demand would have been futile.

2. Weinberger v. St. Dennis, et al. (Case No. BC013663). The initial allegations of the derivative complaint (also pending in Los Angeles Superior Court) explained why demand would have been futile. Defendants demurred to that complaint and the court sustained the demurrer, but allowed discovery on the demand futility issue. After limited discovery, the complaint was amended to allege very specific facts regarding the bias of each parties as directors. The court found that, based upon the very particular facts alleged in the Second Amended Complaint, demand would have been futile.

3. Flagstar Companies, Inc., by Adam Lazar v. Richardson, et al. (Case No. 736748-7). The Complaint in this case (pending in Alameda County Superior Court) explained why demand on the Board of Directors would have been futile. The court found that the facts had not been pleaded with particularity and requested that plaintiff add additional facts. Even with these additional facts, the court found that demand would not have been futile. This matter is currently pending before the California Court of Appeal.

4. Goldman, et al. v. Belzberg, et al. (Case No. C-754698). In this action the Los Angeles Superior Court initially upheld various attacks on the complaint. Again after discovery, the court found demand futility once the complaint had alleged such facts with specificity.

5. Krangel, Kanter v. Crown, et al. (Case No. 632915). The San Diego Superior Court initially found that demand would not be futile based on the allegations of the complaint and ordered demand be made, but ordered demand related to discovery go forward. After repleading, the court found that demand would in fact be futile.

6. Goldberg v. Kurtzig, et al. (Case No. CV739786). This action was pending in the Santa Clara County Superior Court. The court found that demand was not adequately plead in terms of justifying demand futility, but granted plaintiffs' motion to compel further discovery. The court ultimately found that demand was futile.

7. Polikoff, et al. v. Eamer, et al. (Case Nos. BC039354, BC039504, BC041561). The court in this action (pending in Los Angeles Superior Court) found demand was not futile, but then reversed this finding after a motion to compel discovery and repleading.

Other shareholder derivative actions where demand was found not to be futile and a demand made are numerous, including shareholder derivative actions against Cal-Mat, Pacific Enterprises, Coast Savings Financial, Inc., Lockheed Corp., Maxxam Group Inc., Northrop Corp., Pacific Gas & Electric and Rohr Industries, just to name a few.[2]

As the Commission can see, in several of these cases demand was found to be futile; in others, demand was found not to be futile. However, in almost every case demand was found to be not futile in the first instance, and it was only after plaintiffs were permitted discovery and pleaded specific facts which alleged specific reasons why demand would be futile in terms of director bias were such allegations upheld. Thus, even in cases where demand futility is ultimately found, we have not seen a circumstance where the court merely "rubber stamped" such allegations.

What the above analysis also shows is why it is so important for the Commission to carefully consider the ramifications of any proposed amendments. What we see in our practice, particularly in light of Shields v. Singleton, is that courts applying Cal. Corp. Code §800(b)(2) regularly do not find that demand is futile, and only find demand futility after discovery and after specific facts are plead detailing why each particular director would not be able to independently and critically assess the validity of the claims at issue. In fact, after discovery is allowed and after such specific allegations are made courts do find demand futility; however, this generally occurs months, if not years, after the

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[2] If the Commission is interested in such information, we can provide a detailed list of the over 40 derivative actions in which we have been involved outlining the court's findings regarding demand futility under Cal. Corp. Code §800(b)(2).

initial derivative action has been filed. What this means is that plaintiffs are generally correct that pre-litigation demand would be futile, but because of the strict scrutiny which courts undertake in analyzing the demand futility issue, such a finding is generally not made until after the case has been advanced. To rely upon the Board of Directors in every circumstance to determine whether the litigation should proceed would ultimately undermine the very reason for shareholder derivative actions, as it would be very difficult to determine those situations where the Board was in fact biased and not in a position to authorize litigation and act in the best interests of the corporation.

As the foregoing shows, a broad requirement excusing demand futility in every situation would in fact be contrary to what courts actually find after the specific facts are detailed to the court after appropriate discovery.

This analysis also establishes that discovery sometimes is necessary to establish the correctness of plaintiffs' allegations and that such litigation is heavily scrutinized. Thus, there is no evidence of a groundswell of "unmeritorious" shareholder derivative actions (as suggested by some business interests with an entirely separate agenda) to justify clearly imposing the burden of proof on plaintiffs, increasing the bond requirement, imposing discovery stays or special motions to strike unless probability of success is established, or other suggested possibilities in Memorandum 95-71.

In addition, codifying the business judgment rule -- an inherently flexible standard which addresses a myriad of situations -- is an extremely volatile and complicated subject requiring a great deal of study and policy decisions. However, there is no justification for engaging in a "race to the bottom" by attempting to codify the business judgment rule in California to conform it to the pro-business and anti-shareholder version in place in Delaware.

As the staff correctly notes, the issue of the scope of the business judgment rule and the demand requirement in shareholder derivative actions is an issue of extreme sensitivity involving numerous public policy issues. If the Commission should find any interest in pursuing this matter, it should do so only after there has been a more exhaustive analysis of the real world experiences of shareholder derivative litigation throughout California. We urge the Commission to proceed cautiously in this sensitive area.

We appreciate the Commission's consideration of our views.

Respectfully submitted,

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WSL/jms