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Client Alert

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Derivative Action May Be Brought Notwithstanding Lack of Share Ownership and Failure to Pay Share Assessment

Christopher A. Lilly

In *Haro v. Ibarra*, the California Court of Appeal recently determined that a plaintiff need not have continuous ownership of shares in a company, or to have paid an assessment against shares, to have standing to bring a shareholders' derivative lawsuit.

Haro involved a not uncommon struggle between shareholders. The majority shareholders, who were also directors and officers of the company, decided to levy an assessment of nearly $60,000 per share against the minority shareholders – ostensibly to fund the purchase of a new company. They did not assess such levy on themselves. The minority shareholders refused to pay the assessment. The company declared the shares of the minority shareholders to be forfeit.

The former minority shareholders, among other claims, sued the company in a derivative action for conversion of shares and an accounting.

The former minority shareholders ran up against two substantial procedural obstacles. First, under California Corporations Code section 423, no action shall be maintained to recover shares sold for a delinquent assessment, unless such assessment has first been paid. Second, the California Supreme Court, in the 2008 *Grosset* decision, made clear that California law, like Delaware law, requires continuous ownership of shares in order to maintain a derivative lawsuit.

In view of those obstacles, the trial court sustained the defendants' demurrer to the former minority shareholders' complaint, without leave to amend.

The Court of Appeal found an equitable way around each of the two procedural obstacles:

- First, although Section 423 appears absolute, the court found prior cases (*Kraft* and *Cheney*) that provide that the assessment need not be first paid if the assessment itself can be alleged to be void, because either: (a) the board of directors meeting at which the assessment was approved was not called in accordance with the corporate by-laws; or (b) the assessment was not assessed equally on all shareholders. The Court of Appeal held that the plaintiffs had alleged both grounds as exceptions to their having had to first pay the assessment in order to bring the action.
- Second, although the rule is that a shareholder must have continuous ownership of stock, the Court of Appeal held that it is only a "general rule," citing to language in the *Grosset* case that appears to have left the door open for exceptions to that general rule. One such exception, according to the Court of Appeal, is when the plaintiffs are able to allege that their shares were taken away from them by fraud. The court pointed to a 2004 Delaware case that seemed to support that conclusion – involving allegations that a shareholder lost shares though a merger that itself was a fraudulent scheme to deprive him of standing to bring the derivative action.

Having found a way around these two formidable procedural obstacles, the Court of Appeal determined that the plaintiffs had standing to bring a derivative action, reversed the trial court's order sustaining the demurrer, and sent the case back to the trial court to be tried on its merits.

Conclusion. A lesson from *Haro*, from the company's perspective, is that dealing with troublesome shareholders requires a carefully crafted plan, before any action is taken.

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