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California Appellate Court Issues Significant Ruling in Shareholder Derivative Litigation

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On May 26, 2009, the California Court of Appeal for the Second District issued a ruling in *Vaughn v. LJ International, Inc.*, a case that will be significant in the development of California law governing shareholder derivative litigation.

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In 2007, a shareholder of fine jewelry designer-distributor LJI filed a derivative action in California asserting breaches of fiduciary duty by the company's officers and directors. LJI is incorporated in the British Virgin Islands with its headquarters in Hong Kong. Aside from a single director who resides in Colorado, all of LJI's officers and directors reside in Hong Kong, and the company's manufacturing facility is located in China, where it employs about 3,000 people. Outside China, LJI rents office space in Los Angeles for three full-time employees. The derivative complaint filed against LJI alleged that this rented office space was LJI's headquarters, that LJI had substantial sales in California, and that purportedly false company press releases were issued in Los Angeles.

LJI demurred on the ground that the shareholder was not entitled to sue derivatively without leave from the High Court of the British Virgin Islands, as required by section 184C of the British Virgin Islands Business Companies Act of 2004. The trial court sustained the demurrer and dismissed the action, and the decision was upheld in the Court of Appeal.

The decision's application of the internal affairs doctrine provided clarification of the law, which will benefit companies and their directors and officers. The case holds that the law of the place of incorporation determines both whether a shareholder can bring a derivative suit asserting claims for breach of fiduciary duty, and the preconditions that govern instituting such actions. While the holding confirmed well-recognized principles of corporate governance, no previous California appellate decision has so clearly articulated the principle.

Furthermore, the court ruled that whether a shareholder has standing to sue is a substantive issue, not procedural, even though state laws may establish both procedures for perfecting the right to sue, and

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procedures for determining whether demand is excused in a derivative case. This confirms that the law of the place of incorporation must be applied, and that when a court adjudicates derivative claims for breach of fiduciary duty, it must apply the laws of the place where the company is incorporated.

Morrison & Foerster partner Dan Marmalefsky was the lead attorney in this case, with assistance from partners Jack Auspitz and Joel Haims, and associates Lily Fan and Saro Balian.

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