

2010

The Plight of the Derivative Plaintiff: Justice Carter's Dissent in Hogan v. Ingold

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Recommended Citation

Benedetto Neitz, Michele, "The Plight of the Derivative Plaintiff: Justice Carter's Dissent in Hogan v. Ingold" (2010). *Publications*. Paper 179.

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THE GREAT DISSENTS OF THE “LONE DISSENTER”

*Justice Jesse W. Carter’s Twenty Tumultuous
Years on the California Supreme Court*

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Library of Congress Cataloging-in-Publication Data

Carter, Jesse W., 1888-1959.

The great dissents of the "lone dissenter" : Justice Jesse W. Carter's twenty tumultuous years on the California Supreme Court / [edited by] David B. Oppenheimer, Allan Brotsky.

p. cm.

ISBN 978-1-59460-810-0 (alk. paper)

1. Carter, Jesse W., 1888-1959. 2. Dissenting opinions--California. I. Oppenheimer, David Benjamin. II. Brotsky, Allan. III. Title.

KF213.C37O67 2010
347.794'035092--dc22

2010004174

CAROLINA ACADEMIC PRESS
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
www.cap-press.com

Printed in the United States of America

THE PLIGHT OF THE DERIVATIVE PLAINTIFF: JUSTICE CARTER'S DISSSENT IN *HOGAN V. INGOLD*

By Michele Benedetto Neitz*

Introduction

The early years of the twenty-first century were plagued by an unprecedented number of scandals involving management of American corporations. Dubious accounting practices, designed to conceal corporate mismanagement and fraud, ultimately led to crises for numerous American companies, including Tyco International Inc., Adelphia Communications Co., and World-Com Inc.¹ Many of the corporate officers involved in illegal and unethical activities were convicted and sentenced to extensive prison terms.² The most famous scandal of this era was undoubtedly the collapse of Enron Corporation in November 2001, which was quickly followed by the related collapse of Enron's accounting firm, Arthur Andersen, LLP.³

Individual shareholders, in these companies and others, were outraged by arrogant and egregious behavior on the part of corporate officers and directors. In addition to widespread business failures leading to the losses of billions of dollars, these corporate scandals facilitated a loss of public confidence

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1. Robert W. Hamilton, et al., *Cases on Material on Corporations, Including Partnerships and Limited Liability Companies* 582–88 (9th ed. 2005).

2. *Id.*; see also Alexei Barrionuevo, "Enron Chiefs Guilty of Fraud and Conspiracy," New York Times, May 25, 2006, available at <http://www.nytimes.com/2006/05/25/business/25cnd-enron.html?ex=1306209600&en=c2b6d39cd980959f&ei=5088&partner=rssnyt&emc=rss> (last visited June 19, 2007).

3. *Id.*

in the American corporate structure. As the media vocalized the public outcry, lawmakers rapidly responded to the corporate governance disasters with the enactment of the Sarbanes-Oxley Act in 2002, a law intended to protect investors by creating more accountability for corporate managers.⁴ In the meantime, shareholders sought to remedy their losses through legal channels. With the current renewed attention to the ability of individual shareholders to monitor corporate governance, Justice Jesse Carter's focus on the substantive rights of shareholders renders his dissent in *Hogan v. Ingold* particularly relevant today.

Like many derivative plaintiffs, Clarence Hogan was a shareholder in a corporation that was allegedly suffering from mismanagement and fraud on the part of the corporation's officers and directors. In 1952, Hogan filed a derivative suit on behalf of Washington Holding Company ("Washington") against Washington's officers and directors, alleging conspiracy "to acquire all the property of Washington to the exclusion of the other shareholders."⁵

Written over fifty years ago, Justice Carter's *Hogan* dissent championed the rights of individuals with corporate investments to sue dishonest corporate officials through derivative lawsuits. His emphasis on justice and fairness for shareholders established Justice Carter as a visionary in the area of corporate ethics. Unfortunately, as the scandals of the modern era have demonstrated, many of Justice Carter's concerns for shareholders remain justified.

Derivative Lawsuits

A shareholder with personal claims against a corporation has the right to sue a corporation or its officers directly to enforce those personal claims. In addition to these "direct suits," the law allows a shareholder to bring or defend an action on behalf of a corporation in "exceptional cases," when the corporation's officers or directors fail to act.⁶ In many cases, as in the Enron scandal, those persons officially designated to act on behalf of the corporation (such as members of the board of directors or other corporate officers) are responsible for the fraud or mismanagement. However, in their capacity as decision-makers for the corporate entity, the corporate officers often elect not to sue in

4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

5. *Hogan v. Ingold*, 38 Cal. 2d 802 (1952). Although Clarence Hogan died while litigation was pending, Gladys Hogan, as executrix of his estate, was substituted as plaintiff. *Id.* Because Clarence Hogan served as the original plaintiff, this comment will use the masculine pronoun to refer to the plaintiff in *Hogan v. Ingold*.

6. 9 Witkin, Summary 10th (2005) Corp., §170, p. 942.

the corporation's own name to recover losses.⁷ In such instances, the burden to sue and recover such losses for the corporation falls on the shareholders themselves.

Such lawsuits are called "derivative actions," because the rights of the plaintiff shareholders to sue on behalf of the corporation "derive from the primary corporate right to redress the wrongs against it."⁸ Derivative plaintiffs are often individual shareholders suing corporate officials as derivative defendants. As such, plaintiffs in derivative suits frequently litigate on uneven playing fields, operating with fewer economic resources than wealthy corporate defendants. Because the derivative plaintiff's claim belongs to the corporation, any damages are usually paid to the corporation rather than the shareholders individually.⁹ However, plaintiffs could benefit if share prices increase as a result of successful derivative litigation.

While derivative lawsuits have gained prominence in today's post-Enron era, the modern form of American derivative litigation developed during the mid-nineteenth century.¹⁰ In spite of the obvious need for a shareholder remedy in cases of corporate mismanagement, early courts were concerned about the possibility of abuse by minority shareholders "trying to usurp the directors' decision making role."¹¹ In response to these concerns, the United States Supreme Court in 1881 set forth circumstances necessary for shareholder plaintiffs to proceed in a derivative suit in federal court.¹² These rules were codified in 1938 in

7. See *Hogan*, 38 Cal. 2d at 817–18 (Carter, J., dissenting); see also Hamilton, et al., *supra* note 2 at 583–84.

8. *Deigoudar v. Meyercord*, 108 Cal. App. 4th 173, 183 (6th Dist 2003), following *Gagnon Co. v. Nevada Desert Inn*, 45 Cal. 2d 448, 452–53 (1955).

9. Larry E. Ribstein et al., *Business Associations*, § 10.01[B] (4th Ed. 2003).

10. Sarah Wells, *Maintaining Standing in a Shareholder Derivative Action*, 38 U.C. DAVIS L. REV. 343, 347 (2004).

11. *Id.*

12. *Hawes v. City of Oakland*, 104 U.S. 450, 460 (1881); see also Wells, *supra* note 11, at 347–48. Among those circumstances required by the Supreme Court to exist as the foundation of a derivative suit were [1] "Some action or threatened action of the managing board of directors or trustees of the corporation which is beyond the authority conferred on them by their charter or other source of organization; [2] Or such a fraudulent transaction completed or contemplated by the acting managers, in connection with some other party, or among themselves, or with other shareholders as will result in serious injury to the corporation, or to the interests of the other shareholders; [3] Or where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the corporation itself, or of the rights of the other shareholders; [4] Or where the majority of shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation, which is in violation of the rights of other shareholders, and which can only be restrained by the aid of a court of equity." See *Hawes*, 104 U.S. at 460.

Rule 23 of the Federal Rules of Civil Procedure. In 1966, Rule 23.1 was created to treat derivative suits separately from other class action suits.¹³

As the federal rules developed regarding derivative suits, states also created their own statutory provisions addressing such cases. Thirty-three states have developed unique statutory provisions addressing derivative lawsuits.¹⁴

One particularly important element of derivative actions is the issue of standing to bring and maintain such an action. Nearly sixty years ago, the California state legislature established requirements for the bringing of a derivative suit with the creation of Cal. Corp. Code §834.¹⁵ These requirements included a “contemporaneous ownership requirement,” mandating that a derivative plaintiff allege he or she was a shareholder at the time of the wrongdoing, or acquired shares from someone who was a registered shareholder at that time.¹⁶ In addition, the statute codified a “demand requirement,” providing that a derivative plaintiff must allege efforts to obtain action from the board of directors, and must provide notice to the corporation or the board of directors of the facts of the case.¹⁷

The third condition mandated by §834 was a “security-for-expenses” requirement. On the motion of a defendant, the court could require a derivative plaintiff to provide security for the probable reasonable expenses of the corporation and individual defendants, including attorneys’ fees.¹⁸ A plaintiff’s failure to furnish security within a reasonable time would result in dismissal of the action.¹⁹ Security-for-expenses provisions are designed to deter derivative actions, since “plaintiffs may be unable or unwilling to post security.”²⁰

13. *Wells*, *supra* note 11, at 348; *see also* Fed. R. Civ. P. 23.1 (2007).

14. *Id.*

15. The statute became effective on December 9, 1949, and established requirements for the bringing of a derivative suit. *See Hogan*, 38 Cal. 2d at 805. Today in California, Corporations Code §800 outlines the requirements for shareholder derivative actions. *See CAL. CORP. CODE* §800 (2007).

16. *Id.* at 805 n.1 (citing CAL. CORP. CODE §834(a)(1) (Stats. 1949, ch. 499, §1)).

17. *Id.* (citing CAL. CORP. CODE §834(a)(2)). Alternatively, a shareholder may allege the reason for failure to give notice. *Id.*

18. *Id.* (citing CAL. CORP. CODE §834(b)(1)–(2)).

19. *Id.* (citing CAL. CORP. CODE §834(b)(2)).

20. Robert W. Hamilton, et al., *Corporations*, (5th Ed. 2006) at 615. Some older security-for-expenses statutes turned on the size of the derivative plaintiffs’ holdings in the corporation. *Id.* at 616. For example, a statute might require a plaintiff to post security-for-expenses unless her holding represented more than 5% of the corporation’s stock, or exceeded a market value of \$25,000. *Id.* Such statutes were clearly designed to discourage derivative lawsuits by limiting the identities of derivative plaintiffs. *Id.* In California, however, the value or percentage of a plaintiff’s holdings of stock in the corporation “has no bearing on the issue” regarding whether there is a reasonable probability that the

The United States Supreme Court upheld the constitutionality of security-for-expenses provisions in *Cohen v. Beneficial Indus. Loan Corp.*²¹

Despite the California legislature's attempt to specifically delineate requirements for derivative suits, several gaps relating to the application of §834 were left to be determined by the courts. In 1952, the California Supreme Court addressed §834's contemporaneous ownership requirement and security-for-expenses requirement in *Hogan v. Ingold*.

The majority opinion outlined the underlying facts of the case.²² Plaintiff Hogan had purchased shares in the Washington Holding Company in 1949, and subsequently became concerned that members of the board of directors had engaged in fraud.

Hogan's allegations of fraudulent activity committed by Washington's officers and directors may appear strikingly familiar to individuals living in today's post-Enron era. Among other things, Hogan accused the defendants of issuing false financial statements on behalf of the company, leasing company property to organizations under defendants' control for less than its market rental value (and subsequently failing to collect rental payments), and providing a lease with an option to purchase at below-market value to an organization controlled by defendants.²³ With the exception of the third of these allegations, all alleged acts of fraud occurred before Hogan became a shareholder.²⁴ Significantly, all alleged acts of fraud also occurred before Cal. Corp. Code §834 went into effect in December 1949.²⁵

After Hogan's complaint was filed, several of the defendants moved for an order requiring Hogan to furnish security-for-expenses in accordance with §834. The trial court agreed with defendants that plaintiff Hogan had not fulfilled the contemporaneous ownership requirement of §834, and therefore Hogan could not establish a "reasonable probability" that prosecution of his action would benefit Washington or its shareholders.²⁶ With this reasoning, the court in effect determined that Hogan was not a proper plaintiff under §834, and ordered Hogan to furnish security-for-expenses as provided by the statute.²⁷

action will benefit the corporation or its shareholders. *Suburban Water Systems v. Superior Court for County of L.A.*, 264 Cal. App. 2d. 956, 961 (1968).

21. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949).

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

Despite the court's directive, Hogan did not furnish security-for-expenses. As a result, the court dismissed Hogan's action in accordance with the requirements of § 834.²⁸ When the appellate court upheld the trial court's order requiring security-for-expenses, Hogan appealed to the California Supreme Court. In the Supreme Court, Hogan argued that his status as a plaintiff suing derivatively was a substantial property right. Hogan further argued that imposing § 834's conditions in this case gave the statute "retroactive effect" depriving Hogan of a "valuable property right."²⁹

Hence, there were two issues facing the California Supreme Court in *Hogan v. Ingold*. First, the court was asked to consider the timing of applying § 834 to derivative suits.³⁰ Depending on that determination, the court needed to decide whether applying § 834 in such a case would deprive a derivative shareholder plaintiff of a vested property right.

The majority opinion of the Supreme Court held that § 834 was a procedural statute applied prospectively, not retroactively, and its application did not divest the plaintiff of any substantive vested right.³¹ The majority began its analysis with the observation that application of § 834 did not prevent Hogan from continuing his derivative lawsuit; it merely required that he furnish security in order to proceed further with this litigation.³² The majority analogized the role of a shareholder plaintiff in a derivative lawsuit to a guardian ad litem, standing as "the representative of some person incompetent to sue or be sued directly."³³ Because a shareholder suing derivatively is not suing for herself, but rather is suing for the corporation, she "cannot even be considered a party to the cause."³⁴ Accordingly, a shareholder plaintiff suing derivatively does not possess any "property right" of her own, but rather is simply representing the rights of the corporation.³⁵

28. *Id.*

29. *Id.*

30. *Id.* at 805. Specifically, the court needed to determine whether § 834 could be applied to a derivative suit "commenced *after* the effective date of the statute, but concerning wrongs allegedly committed *before*" the effective date of § 834, when such suit was brought by a shareholder who acquired stock "otherwise than by operation of law" and at a time *after* the wrongs were committed but *before* enactment of the statute. *Id.* (emphasis added).

31. *Id.*

32. *Id.* at 808.

33. *Id.* at 810.

34. *Id.*

35. *Id.*; see also *id.* at 812. The Court explained: "The stockholder does not bring such a suit because his rights had been directly violated, or because the cause of action is his or because he is entitled to the relief sought. He is permitted to sue in this manner simply in

Since the majority found that §834 did not affect any substantive rights of shareholders, it held §834 was a procedural statute.³⁶ Citing the U.S. Supreme Court's declaration in *Cohen* that "it is within the power of a state to close its doors" to derivative litigation, the majority held that derivative litigation could be subject to the type of procedural regulation intended by California's §834.³⁷

This determination supported the majority's conclusion that Hogan did not have a vested property right as a derivative plaintiff, and the majority thus affirmed the order of the lower courts that Hogan post security-for-expenses.³⁸ With this decision, the majority failed to consider the broader view of justice for victims of corporate misconduct. The court instead threw procedural road-blocks into the path of an individual shareholder attempting to remedy corporate fraud.

Justice Carter wrote the opinion for the three dissenting judges. Justice Carter's opinion was grounded in a fundamental difference from the majority view: Justice Carter believed a shareholder plaintiff in a derivative suit possessed a "substantial property right."³⁹ Justice Carter also recognized the burden of imposing security-for-expenses requirements on individual plaintiffs. Accordingly, Justice Carter disapproved of the majority's guardian ad litem analogy, and raised constitutional concerns which were unresolved by the majority opinion.

DISSENT

CARTER, J. I dissent.

The main question presented is whether section 834 of the Corporations Code is to be applied to past transactions, that is, retroactively, as in the case at bar. That section requires two things prerequisite to the maintenance of a derivative action by a corporation shareholder: (1) That he be a registered stockholder at the time the fraudulent transaction occurred and at the time of the commencement of the action, and (2) that he post security guaranteeing the payment of the expenses of the defense of the suit if he is unsuccessful.

Before discussing the main issue certain pertinent principles should be clarified inasmuch as the majority opinion either casts serious doubt upon them

order to set in motion the judicial machinery of the court." *Id.* at 809 (citing *Whitten v. Dabney*, 171 Cal. 621, 630-31 (1915)).

36. *Id.* at 812.

37. See *Hogan*, 38 Cal. 2d at 812.

38. *Id.* at 816.

39. *Id.* at 818 (Carter, J., dissenting).

or repudiates them. The right to bring such an action is the established law of this state and elsewhere, except under the rules of procedure of the federal court, whether the shareholder was or was not a registered owner when the fraud was committed. It is a substantial right whether it be called procedural, property or otherwise. It is the only method whereby the fraud of the corporation management may be exposed and restitution obtained, contrary to the intimation of the majority opinion. In an attempt to ameliorate the serious consequence of its holding, the majority make the following highly misleading statements: "Stockholders, if they have a personal cause of action, are still free to sue the corporation, the majority stockholders, or the directors of the corporation, and to recover for any cause they can establish... Plaintiff's stock is still his; any personal rights of action he may possess as attributes or incidents of the stock are still his and, as already noted, are completely unaffected by section 834." There can be no doubt that the majority is fully cognizant of the fact that there is no other remedy or cause of action known to the law available to obtain the relief sought, other than the one here involved. Historically speaking the remedy here sought is equitable, as will appear from the discussion to follow.

The majority cite and quote at some length from *Whitten v. Dabney*, 171 Cal. 621, 154 P. 312, relative to the capacity of a plaintiff in a so-called derivative action on behalf of a corporation and emphasis is placed upon the analogy made in that case between such a plaintiff and a guardian ad litem in the ordinary civil action. While this analogy strikes me as being inappropriate for obvious reasons, I can see no basis for resorting to terminology in order to impair plaintiff's right to prosecute a derivative action. It should be apparent that the analogy between a plaintiff in a derivative action and a guardian ad litem is wholly unrealistic as there is no requirement whatever that a guardian ad litem have any interest directly or indirectly in the subject matter or outcome directly in the subject matter or outcome place of the plaintiff who lacks capacity to prosecute the action in his own name. Such is not the case when a corporation is in control of officers who have committed frauds which have resulted in pecuniary loss to its stockholders. There is no incapacity on the part of such corporation to seek redress for the loss sustained as the result of the fraudulent conduct of its officers, but the officers guilty of the fraud will not permit the corporation to sue in its own name to recover for the loss sustained. Hence, a stockholder who has indirectly suffered such loss in common with the other stockholders has the right to prosecute such an action on behalf of himself and those similarly affected, including the corporation. Such right is a substantial property right as it may have the effect of substantially increasing the value of the shares of stock owned by the plaintiff by virtue of requiring the defraud-

ing officers to return to the corporation the portion of its assets which they have misappropriated or misused to the detriment of not only the corporation but the shareholders thereof. While it is true as stated by the Supreme Court of the United States in *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 69 S.Ct. 1221, 93 L.Ed. 1528, that the plaintiff in such an action assumes a position of a fiduciary character, this does not mean that so far as his own interests are concerned, he is not acting for himself. The fiduciary capacity in which he serves is with relation to the corporation and the other stockholders whose interests he is seeking to advance in common with his own.

The rule here involved is stated in Fletcher Cyclopedia Corporations with supporting authorities: "In several of the states the rule is well settled that a stockholder may sue although he purchased his shares after the transaction complained of. And it is generally held immaterial that he purchased for the purpose of acquiring the right to sue. A subsequent stockholder cannot recover, however, even under this majority rule, (1) when he is not a bona fide stockholder, or (2) when himself guilty of acquiescence in the wrong, or (3) when himself guilty of laches, or (4) where the transferor of the stock would have been barred from bringing suit by laches or acquiescence or the like." (Fletcher Cyclopedia Corporations, (Perm. Ed.) § 5980.) The opposing view is chiefly represented by federal cases which are controlled by a rule of procedure (Fed. Rules of Civ. Proc., Rule 23(b)) similar to section 834. (Fletcher Cyclopedia Corporations, (Perm. Ed.) § 5981.) The majority rule has been established in this state. (citations omitted). In [*Harvey v. Meigs*, 17 Cal.App. 353, 364 (1911)] the court said... "However this may be, both plaintiffs in any view have, on the showing made in the complaint, a right to prevent the payment of the fraudulent credits shown to stand on the company's books in favor of defendants. And if the defendants have without consideration and fraudulently appropriated \$94,000 of the corporate funds which should be restored to its treasury, I fail to see why they have not a cause of action to compel such return even though they acquired their shares after such misappropriation. See the question fully considered in *Just v. Idaho Canal Irr. Co.*, 16 Idaho 639, 102 P. 381, 133 Am.St.Rep. 140 (1909)." The majority opinion fails to point out any sound reason why a transferee of stock should not receive any rights of action incidental to ownership of the stock which the transferor had. There is no reason for doubting the soundness of the rule, for otherwise there is a grave question of discrimination. If a transferee cannot sue because he did not own stock when the fraud occurred, it would logically follow that if some qualified stockholder sued and recovered, the stock of the transferee could not benefit by the recovery. The benefit would have to go to his transferor. No one would advocate such a proposition. Hence it must follow that when the stock is trans-

ferred, the transfer carries with it the right to recover on behalf of the corporation for past frauds perpetrated by its officers. An expert in corporation law agrees that it is "... a sound rule on principle as each share represents an interest in the entire concern and the several shareholders are entitled to equal rights irrespective of when they acquired their shares. The corporate cause of action is enforced for the benefit of all the shareholders." (Ballantine, *Abuses of Shareholders Derivative Suits: How Far is California's New 'Security for Expenses' Act Sound Regulation?* 37 Cal.L.Rev. 399, 414 (1949).)

Further, in this connection, and also pointing out the substantial character of the right, the United States Supreme Court has this to say in speaking of similar but less drastic New Jersey legislation than our section 834: "As business enterprise increasingly sought the advantages of incorporation, management became vested with almost *uncontrolled discretion in handling other people's money*. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. *The director was not subject to an effective accountability*. That created strong temptation for managers to profit personally at expense of their trust. *The business code became all too tolerant of such practices*. Corporate laws were lax and were not self-enforcing, and *stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust*."

"Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without *reason, that without it there would be little practical check on such abuses*." (Italics added.) *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 547 (1949). And, speaking of the statutory requirement for security for expenses, 337 U.S. at page 555: "However, it creates a *new liability where none existed before*, for it makes a stockholder who institutes a derivative action liable for the expense to which he puts the corporation and other defendants, if he does not make good his claims. Such liability *is not usual and it goes beyond payment of what we know as 'costs'*. If all the Act did was to create this liability, *it would clearly be substantive*. But this new liability would be without meaning and value in many cases if it resulted in noth-

ing but a judgment for expenses at or after the end of the case. Therefore, a procedure is prescribed by which the liability is insured by entitling the corporate defendant to a bond of indemnity before the outlay is incurred. *We do not think a statute which so conditions the stockholder's action can be disregarded by the federal court as a mere procedural device.*" (Italics added.)

In the face of those salutary and established principles the majority opinion arrives at the conclusion that section 834 was intended to apply to past transactions because, as to the expense security requirement, it is mere procedure, a proposition squarely contrary to the Cohen case, which holds that the requirement is more than for costs. That the statute would be given retroactive application in the instant case is clear. The last word by this court on the subject is that: "A retrospective law is one which affects rights, obligations, acts, transactions and conditions which are performed or exist prior to the adoption of the statute." *Aetna Casualty & Surety Co. v. Industrial Accident Commission*, 30 Cal.2d 388, 391 (1947). There is by section 834 a requirement that security be posted by the plaintiff in derivative actions, and the plaintiff must have owned the stock when the fraud occurred. The right to maintain the action by one who acquired stock after the perpetration of the fraud without posting security for expenses both existed before section 834 was passed. If that section is applied in this case those rights are being affected. The new law is one, which in the language of the Aetna case, affects rights, obligations and conditions which existed prior to its adoption. That is true of both the expense and ownership requirements.

We thus come to the question of whether it was intended that section 834 should be applied retroactively. "It is an established canon of interpretation that statutes *are not to be given a retrospective operation unless it is clearly made to appear that such was the legislative intent*.... It is contended upon behalf of respondents that this rule of statutory construction has no application to procedural statutes, and that section 4661 relates solely to matters of procedure or remedy. *Feckenscher v. Gamble*, 12 Cal.2d 482 (1938); *City of Los Angeles v. Oliver*, 102 Cal.App. 299, 283 P. 298 (1929); *San Bernardino County v. Industrial Accident Commission*, 217 Cal. 618 (1933), and *Davis & McMillan v. Industrial Accident Commission*, 198 Cal. 631, 246 P. 1046 (1926), are relied upon in support of the contention. In those cases, with one exception, it was held that the language of the statutes showed that the Legislature intended them to be applied retroactively, and the court was concerned mainly with the question of whether the Legislature has power to give those laws such retroactive effect. Since the question of the constitutionality of retroactive legislation and the question of the applicability of a rule of statutory construction are distinct (*Ware v. Heller*, 63 Cal.App.2d 817, 821 (1944)) these cases are not in point..

.. If *substantial* changes are made, *even in a statute which might ordinarily be classified as procedural*, the operation on existing rights would be retroactive because the legal effects of past events would be changed, and the *statute will be construed to operate only in futuro unless the legislative intent to the contrary clearly appears.*" (Italics added.) *Aetna Casualty & Surety Co. v. Industrial Accident Commission*, 30 Cal.2d 388, 393 (1947). That the change in the law wrought by the adoption of section 834 is substantial and does affect existing rights is too obvious to require further discussion. True, section 834 states that no action may be "instituted or maintained," but that is not sufficient to abrogate the rule that to be construed as retroactive in operation on substantial rights a statute must clearly so state. In *Shielcrawt v. Moffett*, 294 N.Y. 180, 61 N.E.2d 435 (1945), the court had before it a New York statute similarly phrased, which required posting of security for costs if plaintiff in a derivative action owned less than a specified percentage of stock. The court interpreted the statute as not applicable to an action which was commenced before its adoption, and while it mentioned a possible distinction between that situation and where the action was commenced later, it emphasized the nature of the right affected as substantial and invoked the rule of construction against retrospective operation, stating, 61 N.E.2d at page 440: 'It is said that, when the Legislature provided that the defendant is entitled to require the plaintiff or plaintiffs to give security "in any action instituted or maintained in the right of any foreign or domestic corporation," it disclosed an intention that the statute should apply not only in actions thereafter instituted but also in actions previously 'instituted' and thereafter maintained.' The word 'maintained' may be used in a context where it clearly denotes that it includes pending actions. (Citation omitted). In other context it has frequently been given other construction. (Citation omitted). In the statute we are now construing it is at most equivocal and does not, we think, disclose an intent of the Legislature that it should be applied in actions previously instituted." A reasonable interpretation is that the use of the phraseology in section 834 that no action may be "instituted or maintained" unless the stock ownership at the time of the transaction is alleged, and security is posted if required, is merely another way of stating that a shareholder has no right of action on behalf of the corporation unless those conditions exist or are complied with. Such construction carries no retroactive implication. It does not necessarily point to an intent to have the statute operate on accrued rights....

Furthermore, it should be remembered that section 834 embraces the requirement of shareholding at the time named as well as the requirement of security in one cohesive coverage regulating derivative actions. It is not to be supposed that part of it is to be retroactive but not the remainder, the security

mandate and stockholder prerequisite, for the first sentence purports to require all of the conditions to be on the same footing. There can be no doubt that the stock ownership requirement would operate upon a prior accrued right of vital importance.

In connection with the ownership requirement it should be observed that the majority opinion does not discuss that phase of section 834, with reference to retroactivity. It holds the expense security requirement either is not being applied retrospectively, or even if it is, that is a proper construction of it. If such is true of that part of the section it must also be true of the ownership requisite, unless it is said that the parts of the section are severable, a problem heretofore mentioned by me but not even discussed in the majority opinion. If the majority thinks there is severability, it need not discuss the ownership feature. Otherwise it must.

The majority opinion endeavors to sidestep the ownership question by the statement: "As previously mentioned, ... it was for failure to furnish the security as ordered that the action was dismissed. Thus as applied here the statute did not operate to absolutely preclude plaintiff from maintaining the suit; it merely required him to furnish the security if he were to proceed further in his fiduciary capacity." That is not true in any realistic sense. The majority concedes that the trial court based its dismissal of the action solely upon the fact that plaintiff was not an owner of stock when the fraud was committed. It was on *that basis, and that alone*, that the expense security was ordered by the court. The dismissal followed when the security was not furnished. But, nevertheless, it was in effect based upon the lack of stock ownership. It is idle to reason, as does the majority, that plaintiff was not injured because he could have posted the security and thus avoided dismissal. If he had supplied it, he would have suffered the burden imposed by section 834, and his complaint would be subject to dismissal on general demurrer for it shows that he was not an owner of stock when the fraud occurred.

Finally, it should be pointed out that there are grave questions of constitutionality involving equal protection of the law which were not decided in *Cohen v. Beneficial Loan Corp.*, supra, 337 U.S. 541, in connection with the requirement that security be posted to cover expenses including attorneys' fees and that such expenses shall be allowed against the security if the action is unsuccessful. A situation is presented where the plaintiff must pay the defendant's attorneys' fees if unsuccessful, but the defendant is not required to pay plaintiff's counsel fees if the latter wins. Such a statute is invalid unless there is some reason why plaintiffs are in a different position than defendants. [Citations omitted]. It may be argued that because of the danger of spite suits, bad faith suits, by stockholders in derivative actions it is proper to place those actions in a separate class, but that cannot apply here. Under section 834 plaintiff is

to post security for attorneys' fees when it appears on the motion therefore that the corporation would not benefit by the action. Suppose the court finds the corporation would probably benefit by the action, then the corporation should be required to post security for plaintiff's counsel fees, a wholly reasonable demand because the corporation is the one that benefits by the recovery; the action is on its behalf and ultimately for the good of all stockholders. Section 834 makes no such provision, however, and for that reason is strongly suspect of denying equal protection of the law.

I would therefore reverse the order of the dismissal.

Comment

Justice Carter's dissenting opinion demonstrates his concern for the plight of the derivative plaintiff. While the majority viewed a derivative plaintiff as merely a representative of the corporation, Justice Carter espoused the view that a shareholder plaintiff has a great deal at stake in derivative litigation. After all, simply because a shareholder chooses to sue in a fiduciary position "does not mean that so far as his own interests are concerned, he is not acting for himself."⁴⁰ A derivative plaintiff may have chosen to represent the claims of the corporation, but the "other stockholders whose interests he is seeking to advance" are "in common with his own [interests]."⁴¹

Thus, Justice Carter forcefully argued that the majority's analogy between a derivative plaintiff and a guardian ad litem was "inappropriate for obvious reasons."⁴² Unlike a guardian ad litem, who generally has no personal stake in the case, a derivative plaintiff does indeed have an interest in the outcome of the litigation. Because successful derivative litigation would require defrauding officers to return misappropriated or misused funds to the corporation, the litigation would also substantially increase the value of shares owned by the plaintiff and other shareholders.⁴³ This increased value, declared Justice Carter, represents a "substantial property right" possessed by a derivative plaintiff.⁴⁴

With this proposition, Justice Carter sharply diverged from the majority opinion. If the stake held by a derivative plaintiff was indeed a substantial property right, applying § 834's security-for-expenses requirement to this case

40. *Id.*

41. *Id.*

42. *Id.* at 817.

43. *Id.* at 818.

44. *Id.*

improperly interfered with that right: "... it creates a new liability where none existed before, for it makes a stockholder who institutes a derivative action liable for the expense to which he puts the corporation and other defendants, if he does not make good his claims."⁴⁵ Before § 834 was established, Carter argued, the "right to maintain [a derivative] action by one who *acquired stock after the perpetration of the fraud without posting security expenses*" existed.⁴⁶ Applying § 834's provisions substantively affects this right, and therefore Justice Carter concluded the statute cannot be deemed simply "procedural."⁴⁷

Following this line of reasoning, Justice Carter recognized that application of a statute creating "substantial changes" to existing rights would be retroactive "because the legal effects of past events would be changed."⁴⁸ Here, the fact that adoption of § 834 substantially changed the law and affected existing rights was seen by Carter as "too obvious to require discussion."⁴⁹ Indeed, in Hogan's case, application of § 834 effectively terminated his lawsuit. Unlike the majority, Justice Carter appreciated the impact of § 834's provisions on the substantive rights of derivative plaintiffs. His rights-based analysis foreshadowed the need for courts and legislatures to protect individual shareholders in the face of corporate executive greed.

Justice Carter also raised constitutional concerns inherent in the statute. Since § 834 required a derivative plaintiff to post expenses, including attorneys' fees, and to pay such expenses if the action is unsuccessful, Justice Carter recognized that "a situation is presented" whereby the plaintiff must pay the defendant's attorneys' fees if unsuccessful, but "the defendant is not required to pay plaintiff's counsel fees if the latter wins."⁵⁰ Without a valid justification for placing plaintiffs in a different position than defendants, Justice Carter suspected § 834 of denying equal protection of the law.⁵¹ Here again, we witness Justice Carter's concern for the individual shareholder plaintiff David facing the corporate officer Goliath. As Justice Carter reminds us, and as the Enron-era scandals proved to us, failing to ensure the ability of derivative shareholders to litigate on an equal footing with corporate officers and directors could violate the very essence of our democratic structure. Derivative litigation provides an effective checks-and-balances structure to deter corporate officers from abus-

45. *Id.* at 820, citing *Cohen*, 337 U.S. at 555.

46. *Id.* at 821 (emphasis added).

47. *Id.*

48. *Id.* (citing *Aetna Casualty & Surety Co. v. Indus. Accident Comm'n*, 30 Cal. 2d 388 (1947)).

49. *Id.* at 822.

50. *Id.* at 823.

51. *Id.*

ing their power; without such litigation, individual shareholders would be severely limited in their efforts to combat corporate misconduct.

Subsequent developments in California law relating to derivative lawsuits acknowledge some, but not all, of Justice Carter's concerns. Section 834 was repealed by the California legislature in 1975, but its provisions are now codified in §800 of the California Corporations Code. As part of the 1975 amendments, the legislature relaxed the contemporaneous ownership requirement to "avoid the harsh results sometimes encountered in the application" of this requirement.⁵² Under current law, a shareholder who does not meet the contemporaneous ownership requirements may "nevertheless be allowed in the discretion of the court" to maintain a derivative action in particular circumstances.⁵³ To do so, a plaintiff must demonstrate one of several factors, such as showing that a strong *prima facie* case exists in favor of the claim asserted on behalf of the corporation, or establishing that no similar action has been or is likely to be asserted.⁵⁴ By providing specific exceptions to the contemporaneous ownership rule, California attempted to "both expand the number of plaintiffs eligible for standing and prevent the misuse that courts fear when a derivative lawsuit is filed."⁵⁵ California's more liberal modern exceptions to this requirement may have allowed Hogan, whose suit was dismissed when he did not post security after failing to pass §834's contemporaneous ownership requirement, to move forward as a derivative plaintiff today against the Washington Holding Company.⁵⁶

52. CAL. CORP. CODE §800, Legislative Committee Comment 1975—Assembly (Corrected) (2007).

53. CAL. CORP. CODE §800 (b)(1).

54. *Id.* Specifically, §800(b)(1) provides that a plaintiff seeking to bring a derivative suit in California who cannot meet the statute's contemporaneous ownership requirements may show on motion and after a hearing, at which the court shall consider such evidence, by affidavit or testimony, as it deems material, that (i) there is a strong *prima facie* case in favor of the claim asserted on behalf of the corporation, (ii) no other similar action has been or is likely to be instituted, (iii) the plaintiff acquired the shares before there was disclosure to the public or to the plaintiff of the wrongdoing of which plaintiff complains, (iv) unless the action can be maintained the defendant may retain a gain derived from defendant's willful breach of a fiduciary duty, and (v) the requested relief will not result in unjust enrichment of the corporation or any shareholder of the corporation.

The plaintiff must also allege plaintiff's efforts to secure action from the board (or reason for not making an effort), and show notice of the lawsuit was given to each defendant and the corporation. CAL. CORP. CODE §800(b)(2).

55. See Wells, 38 U.C. DAVIS L. REV. at 351.

56. The California Supreme Court recently narrowed the stockholder ownership requirements for derivative suits in the context of a lack of "continuous ownership." *Grosset*

Although Justice Carter would undoubtedly be pleased by California's more expansive approach to the ownership requirement for derivative plaintiffs, his concerns relating to the security-for-expenses provision of the state statute have fallen on deaf ears. The *Hogan* majority's analogy between derivative plaintiffs and guardians ad litem is often cited by modern courts struggling to define the roles of shareholder plaintiffs.⁵⁷ Moreover, the current version of § 800 preserves the right of a derivative defendant to require a plaintiff to furnish a bond, up to \$50,000, for reasonable expenses (including attorneys' fees) which may be incurred by the corporation or defendants.⁵⁸ Defendants are not required to post this security. Thus, although some of the issues highlighted in Justice Carter's dissent have been subsequently addressed, derivative plaintiffs remain subject to the deterring effects of security-for-expenses statutes.

Conclusion

Justice Carter's concern for individual shareholder plaintiffs is especially significant in the post-Enron era. Considering the tendency of some modern corporate managers to operate from a "what can I get away with?" perspective,⁵⁹ the rights of shareholders to sue for recovery of losses has become increasingly important. If Justice Carter's vision of a rights-based approach for derivative plaintiffs could be realized, individual rights would be strengthened and access to justice for derivative plaintiffs would be assured. In this way, more individuals would feel comfortable investing in corporate structures, and public confidence in corporate America would likely be considerably improved. Although Justice Carter could not have imagined the shocking events of modern corporate scandals, his dissent in *Hogan v. Ingold* inspires us to protect the substantive rights of shareholders as we strive to eliminate corporate fraud.

v. *Wenaas*, 42 Cal. 4th 1100 (2008). If a shareholder ceases to be a shareholder in the middle of a derivative suit, whether voluntarily through a sale or involuntarily through a merger (as in the *Grosset* case), that shareholder loses standing to proceed as a derivative plaintiff. *Id.* at 1119. The *Grosset* court noted that a shareholder in such circumstances no longer has a "dog in the hunt." *Id.* at 1114.

57. See, e.g., *First Sec. Bank of California, N.A. v. Paquet*, 98 Cal. App. 4th 468, 474–75 (2002) (citing *Hogan*, court found that derivative plaintiffs were not "actual parties to the [derivative] complaint," and therefore the pendency of a derivative suit did not prevent a judgment from being final as to the shareholder's direct claims).

58. CAL. CORP. CODE § 800(c)–(d).

59. Jeffrey D. Van Niel, "Enron—The Primer," *Enron: Corporate Fiascos and Their Implications* 3, Nancy B. Rapoport & Bala G. Dharan, eds., (2003).