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California Court of Appeal Affirms: Early Discovery Will Not Be Permitted to Aid Derivative Plaintiff in Stating a Claim

BY [THE SECURITIES LITIGATION PRACTICE GROUP](#)

Under Delaware law, before a private plaintiff can file a derivative lawsuit against a corporation's officers or directors, he or she must either make a demand on the board or plead with particularity that it would be futile to do so.¹ On October 2, 2014, the California Court of Appeal issued its decision in *Jones v. Martinez*, a shareholder derivative action filed against the officers and directors of Deckers Outdoor Corporation, a Delaware corporation.² The decision is the first from a California appellate court to consider whether shareholders bringing demand futility derivative actions against Delaware corporations in California are entitled to discovery prior to establishing that demand would be futile. The Court of Appeal held that the Delaware demand futility rules are substantive, and plaintiffs cannot rely on California's general policy of allowing broad discovery to circumvent Delaware substantive law to help "fashion a sufficient complaint."³

The Shareholder Demand Requirement

The right to manage the affairs of a corporation is vested in the company's board of directors. To prevent stockholders from usurping that right, a stockholder that believes the company should pursue legal action must ordinarily make a demand on the company's board to take such action.⁴ If the stockholder believes that making a demand on the board would be futile, the stockholder may alternatively seek to bring a derivative action on behalf of the corporation.⁵ Under the internal affairs doctrine, the internal affairs of the corporation (e.g., conflicts between management and shareholders) are governed by the law where the company is incorporated, including state law in connection with demand requirements.⁶ So, for example, Delaware law requires a shareholder filing a derivative action—without first making a demand on the corporation—to allege with particularity the reasons demand would be futile.

In *Jones*, the California court considered the scope of the internal affairs doctrine in connection with Delaware's demand futility requirements. Delaware law precludes shareholder plaintiffs from obtaining discovery to aid the plaintiff in alleging demand futility to survive an early dispositive motion (e.g., motion to dismiss) under Court of Chancery Rule 23.1. The plaintiff attempted to argue that California's procedural rules governing the right to discovery trumped Rule 23.1's prohibitions. *Jones* directly addressed the issue of whether California's policies on discovery could override Delaware's rules precluding discovery in a matter of first impression in California.

***Jones* and Discovery in Shareholder Derivative Actions**

Danny Jones owned 1,900 shares of Deckers common stock.⁷ In July 2012, he filed a derivative action against the company's directors and officers, alleging claims for insider trading, breach of fiduciary duty, and unjust enrichment, among others.⁸ He then served a request for production of documents. Deckers objected, arguing that Jones lacked standing because he had not made a demand on the board or demonstrated that such a demand would be futile.⁹ The trial court denied Jones's request to seek discovery in aid of his complaint and granted Deckers' demurrer (i.e., motion to dismiss).¹⁰ Jones then appealed, challenging only the trial court's determination that he was not entitled to discovery.¹¹

On appeal, Jones argued that the trial erred in applying Delaware law, rather than California law, to a "purely procedural matter concerning the timing of discovery."¹² The California Court of Appeal disagreed. The court held that Jones' litigation tactic would divert the attention of the directors "from the internal affairs of the corporation" while helping Jones gather information he needed to meet the "stringent requirements of factual particularity" for alleging demand futility.¹³

The Court of Appeal determined that no such right to discovery existed. Highlighting the "fundamental principle of Delaware law" that "directors, not shareholders, manage the affairs of the corporation,"¹⁴ the court recognized that Delaware's rule prohibiting discovery in aid of particularity exists to protect this fundamental principle, in that it prohibits a stockholder from forcing "the cooperation to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinions, or speculations."¹⁵ Accordingly, the court determined that derivative plaintiffs must comply with Delaware's particularized pleading requirements without the benefit of discovery because "[t]he proper purpose of discovery in a shareholder derivative action is to find out additional facts about a well-pleaded claim, not to find out whether such a claim exists."¹⁶

***Jones* May Result in More Books and Records Demands**

The Court of Appeals decision in *Jones* demonstrates California's deference to the substantive law of the company's state of incorporation in connection with derivative lawsuits. It is now clear in California that a shareholder plaintiff may not leverage lenient procedural rules favoring discovery to aid in challenging the business and affairs of a Delaware corporation. The decision confirms the long-standing position that defendant corporations have taken in defending derivative actions in Delaware to foreclose premature discovery in demand futility derivative actions that would otherwise potentially distract the company's board of directors from the daily operations of the company. Therefore, the decision is not a game-changer, but instead precludes another avenue for plaintiffs' lawyers to escape Delaware law. While prospective shareholder plaintiffs may heed the advice of the Court of Appeal and seek discovery through alternative means, namely inspection demands to review a corporations books and records, these avenues will lead back to the Delaware Court of Chancery, which is well equipped to handle these demands and their narrow purpose. Corporations should be mindful of these shareholder rights to inspection and consult counsel on the appropriate response in the event a shareholder requests access to certain records.



Partner Joshua G. Hamilton and associates D. Scott Carlton, Timothy D. Reynolds, and Scott M. Klausner contributed to this alert.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Chicago

Mark D. Pollack
1.312.499.6050
markpollack@paulhastings.com

Houston

Samuel W. Cooper
1.713.860.7305
samuelcooper@paulhastings.com

Los Angeles

John S. Durrant
1.213.683.6144
johndurrant@paulhastings.com

Joshua G. Hamilton
1.213.683.6186
joshuahamilton@paulhastings.com

Howard M. Privette
1.213.683.6229
howardprivette@paulhastings.com

William F. Sullivan
1.213.683.6252
williamsullivan@paulhastings.com

New York

Douglas H. Flaum
1.212.318.6259
douglasflaum@paulhastings.com

Shahzeb Lari
1.212.318.6098
shahzeblari@paulhastings.com

Kevin C. Logue
1.212.318.6039
kevinlogue@paulhastings.com

Barry G. Sher
1.212.318.6085
barrysher@paulhastings.com

Palo Alto

Edward Han
1.650.320.1813
edwardhan@paulhastings.com

Peter M. Stone
1.650.320.1843
peterstone@paulhastings.com

San Diego

Christopher H. McGrath
1.858.458.3027
chrismcgrath@paulhastings.com

San Francisco

Grace A. Carter
1.415.856.7015
gracecarter@paulhastings.com

¹ Del. Chancery Ct. R. 23.1.

² 2d Civil No. B249146, --- Cal. Rptr. 3d ---, 2014 WL 5425628 (Cal. Ct. App. Oct. 2, 2014).

³ *Id.* at *3.

⁴ *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95–96 (1991).

⁵ *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

⁶ *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

⁷ 2014 WL 5425628, at *1.

⁸ *Id.*

⁹ *Id.* at *1–*2.

¹⁰ *Id.* at *2.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at *2–*3.

¹⁴ *Id.* at *3.

¹⁵ *Id.* (quoting *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000)).

¹⁶ *Id.*

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