Chapman Law Review

Volume 12 | Issue 1 Article 14

2008

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Recommended Citation
Charles Alikin, *Digest: Grosset v. Wenaas*, 12 CHAP. L. REV. 195sa (2008).
Available at: https://digitalcommons.chapman.edu/chapman-law-review/vol12/iss1/14

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Digest: Grosset v. Wenaas

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Opinion by Baxter, J., expressing the unanimous view of the Court.

Issue

Is continuous stock ownership throughout the litigation process required to maintain standing in a shareholder's derivative action?

Facts

JNI Corporation (JNI), a designer, manufacturer and seller of hardware and software products, was incorporated in Delaware and based in San Diego.[1] After JNI's stock price fell and securities fraud class actions were filed against the corporation, Richard Grosset filed a shareholder's derivative action on behalf of JNI against some of its directors and officers for breach of fiduciary duty and other causes of action.[2] When Grosset sold his stock, the trial court permitted shareholder Sik-Lin Huang to intervene to continue litigating the action.[3]

In September 2002, JNI's board of directors created a special litigation committee (SLC) to investigate the allegations in the derivative complaint and to determine whether to bring the action.[4] After an extensive investigation, the SLC issued a report concluding that "the derivative claims lacked merit and would likely not be successful."[5] The court dismissed the complaint on the SLC's motion with prejudice.[6] Before Huang appealed, the stockholders voted to approve a merger whereby another company would purchase all outstanding shares of JNI stock.[7]

The Court of Appeal dismissed Huang's appeal on the grounds that he no longer had standing to pursue the litigation after selling his JNI stock in the merger.[8] The court determined that Delaware law applied because the standing requirements implicate the internal affairs of a corporation.[9]

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1 Grosset v. Wenaas, 175 P.3d 1184, 1187 (Cal. 2008).

2 *Id.*

3 *Id.*

4 *Id.* at 1187–88.

5 *Id.*at 1188.

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

Under the law of Delaware, a plaintiff who brings a derivative action must maintain continuous stock ownership in the corporation throughout the action's pendency.[10] The court alternatively held that Huang lacked standing in any event because California law imposes a continuous ownership requirement that parallels Delaware law.[11] The Supreme Court of California granted review.[12]

Analysis

After reviewing basic principles of corporation law and shareholder derivative litigation, the Court compared Delaware and California law.[13] The Court noted that the relevant Delaware statute provides that, "[i]n any derivative suit instituted by a stockholder" the plaintiff must allege that he held stock at the time of the transaction from which the suit arose.[14] Delaware courts interpreted this statute to require that a derivative plaintiff also maintain stock ownership throughout the litigation.[15] The Court found that California's statute states that "'[n]o action may be instituted or *maintained* in right of any . . . corporation by any holder of shares . . . of the corporation' unless conditions such as the contemporaneous stock ownership requirements are met."[16]

The Court then noted that two appellate decisions reached opposite conclusions regarding whether a plaintiff is required to maintain continuous stock ownership to have standing to bring a derivative suit on behalf of the remaining shareholders.[17]

The Court concluded that, while the "instituted or maintained" language does not clearly impose a continuous ownership requirement, other considerations ultimately support and compel this interpretation of the statute.[18] The Court said that contemporaneous ownership furthers the statutory purpose to minimize abuse of the derivative suit.[19] The Court explained that "[b]ecause a derivative claim does not belong to the stockholder asserting it, standing to maintain such a claim is justified only by the stockholder relationship and the indirect benefits made possible thereby, which furnish the stockholder with an interest and incentive to seek redress for the injury to the corporation."[20] "Once this relationship ceases to exist," the court continued, "the derivative plaintiff lacks standing

10 *Id.*

11 *Id.* at 1188–89.

12 *Id.* at 1188.

13 *Id.* at 1189–90 (internal quotations omitted).

14 *Id.* at 1190.

15 *Id.*

16 *Id.* at 1191 (quoting CAL. CORP. CODE § 800(b)(1) (West 2008)).

17 *Id.* at 1192 (citing Heckmann v. Ahmanson, 214 Cal. Rptr. 177 (Ct. App. 1985); Gaillard v. Natomas Co., 219 Cal. Rptr. 74 (Ct. App. 1985)).

18 *Id.* at 1193.

19 *Id.*

20 *Id.*

because he or she no longer has a financial interest in any recovery pursued for the benefit of the corporation."[21] The Court also noted that a "vast majority" of other states have a contemporaneous ownership requirement.[22]

Holding

The Court held that a shareholder lacks standing to continue litigating a derivative action once he no longer owns stock in the corporation.[23]

Legal Significance

California law now requires a plaintiff in a shareholder's derivative suit to maintain continuous stock ownership throughout the pendency of the litigation, including appeals. A plaintiff in a derivative action who ceases to be a stockholder by reason of a merger ordinarily loses standing to continue the litigation. Exceptions may include situations where the merger itself is used to wrongfully deprive the plaintiff of standing, or if the merger is merely a reorganization that does not affect the plaintiff's ownership interest.

21 *Id.* at 1194 (internal quotations omitted).

22 *Id.*

23 *Id.* at 1197.