ASSOCIATION OF BUSINESS TRIAL LAWYERS

abtl REPORT

ORANGE COUNTY

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Q&A with the Hon. Marc L. Goldman
by Leo J. Presiado

Q: Can you tell us a little about the type of practice you had before taking the bench?

A: I started off as a state public defender in Michigan. I spent my first four years in practice doing both trial and appellate work for indigent defendants. I spent the next three years as a clinical law professor at Wayne State University Law School in Detroit. I directed the Criminal Defense Clinic and taught courses in Evidence and Michigan Civil Procedure. I then spent one year as a visiting professor at the University of Michigan Law School. Following that, I worked for three years as an assistant United States Attorney in the Eastern District of Michigan.

Q: Is your case load divided equally between criminal and civil practice?

A: No. I would say 90% is civil and 10% is criminal.

Q: And how are you adjusting to that?

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A Little Primer on the State of Derivative Litigation Law in California
by Michael S. Strimling

To: Judge Smith
From: Research Attorney
Re: *Case No. Civil 555: Frequent L. Shareperson v. Corrupt Directorperson*: Demurrer to Derivative Complaint and Motion for Discovery

The complaint of *Shareperson v. Directorperson* is a good example of some current issues in derivative litigation as of mid-2002. Since Your Honor is new to the complex litigation department, I will make this a more inclusive memorandum to bring you up to date on some common arguments in this area of the law. As you know, the U.S. Congress has recently passed legislation concerning securities and accountants, but it is not yet known how much of that will end up in civil litigation.

The *Shareperson* case concerns TechWidget Technology ("TechWidget"). It apparently makes data gathering systems like that which Safeway uses in customer cards to determine customer buying habits. TechWidget had several quarters of very high growth and then a couple of bad quarters in 2000.

The complaint claims that insiders sold some $25 million of stock on inside information that things were not going to go as well as they had been going, or as had been represented. When revenues went down and were flat in 2000, the stock went down to about 1/5 of where it had been at the time of the initial public offering and about 90% from its peak. The problem is that there is not much of an objective case with this complaint.

There is a hierarchy of securities-type cases, which have been catalogued by students of the field, such as Professor Grundfest of Stanford. Among the more serious cases are those where past earnings need to be *restated* because of some manipulation that insiders may have known about when they sold stock. At the time that earnings are restated, stock prices often fall precipitously.

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President's Message
by Jeffrey W. Shields

Much has transpired during the year of 2002, and there is much to reflect upon as we prepare to launch into 2003. With regards to the Association of Business Trial Lawyers, 2002 has been a very good year, and our Orange County Chapter can be grateful for many things.

Our programs have been consistently successful. Our revenues are in the black, and our Chapter is in good financial shape. We are led by a sterling cast of attorneys and judges who make up our Chapter's Board of Governors, and who regularly donate their time and efforts. Perhaps most significantly, we are fortunate to enjoy tremendous support from the lawyers across the County – both big firm and small – as well as invaluable participation from our Orange County Judiciary.

During 2002, our total ABTL membership in Orange County grew to and exceeded five hundred members for the first time. Of course, this milestone number is a direct result of the diligence and hard work of many of our Chapter's leaders and members over the past six years. Indeed, because of the voluntary and unselfish efforts of a vast number of supporters, our Chapter's membership totals have consistently increased every year since our Chapter was first chartered back in 1997.

During 2002, our Orange County Chapter was also the host organizer of the 29th Annual ABTL Seminar on the Big Island of Hawaii. Although other ABTL chapters across the State have been putting on such Annual Seminars for many years, this was the first opportunity for our Orange County Chapter to take the lead in this role. I am proud to report that the leaders and members of our Chapter really stepped up to the plate and, together with many others across the State, helped deliver an outstanding event. On top of a superb educational program, and a fantastic resort situation, the Seminar also successfully attracted more attendees and participants than any other Annual Seminar in ABTL history. Not bad for Orange County's first crack at playing host.

While it is certainly pleasant to look back on an excellent ABTL year, it is also vital that we look forward to 2003, and recognize the significance of continuing membership and active participation in our Orange County

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Hawaii Memo
by The Honorable Sheila B. Fell

Aloha!

Congratulations to Jeff Shields and his outstanding committee for the highly successful and enjoyable bi-yearly Hawaiian adventure. The record attendance enjoyed by ABTL members, friends and family at the September 18 - 22 conference was a tribute to the stupendous educational program and magnificent site selection. And a significant show of gratitude goes to Becky Cien who labored tirelessly in performing all the administrative tasks in putting this conference together - no small achievement. We offer our appreciation and sincerely thank her.

This year's program successfully brought together a number of the highly talented Business Trial Lawyers and members of our bench including Trial Judges, Appellate Justices and not least, Justice Carlos Moreno from the California Supreme Court. The combination of talent and experiences from all presenters left us professionally rewarded and cross-pollinated with the input from chapters throughout the State. It was a job well done.

In addition to the professional rewards, we were treated to world class accommodations and hospitality at the Mauna Lani Resort and to vacation experiences as are only found on The Big Island. On the lighter side, many of us were able to take advantage of outstanding water sports, golfing, island sight seeing, the wonderful luau performed for us and our families, and the spectacle of Kilauea Volcano in constant eruption. Finally, there were the temptations of local shopping and dining for the truly dedicated.

With all votes counted, Orange County`s lead in hosting this conference has done us all proud. Mahalo, Jeff, to you and your exceptional band of inspired cohorts.

▪ *The Honorable Sheila B. Fell is a Judge of the Orange County Superior Court.*

DO YOU HAVE SOMETHING TO SAY?

If you are interested in submitting material for publication in any upcoming issues of the ABTL Orange County Report, please contact the ABTL's Report Editor or submit your material directly to abtl@attbi.com.

ABTL Hawaii Seminar 2002: A Lawyer's Perspective
by John Sganga

Wednesday A.M., LAX

A large crowd anxiously awaits the flight to the Big Island. There are two easily discernable types of travelers in this group: the relaxed looking tourists, and the lawyers. The lawyers are easy to spot – they are still lugging briefcases, and clutching to cell phones for that last radio contact with the office.

Wednesday P.M., Hawaii

Upon deplaning, the lawyer group wins the quick draw contest on the cell phones, only to learn that life on the mainland, and in their offices, continues to go on without them. A short drive along the scenic coast through lava fields to the Mauna Lani resort makes the mainland seem that much farther away. At the resort, the lawyers don't seem to stand out as much. In fact, those that arrived a day or two earlier look different. Sort of like the tourists. Relaxed tourists.

That evening, I am sitting on my balcony watching the sunset. I can see something out in the ocean, about 50 yards offshore, maybe a buoy. It's moving. Actually, it looks like a fisherman in knee-deep water casting a net. How many mai-tais did I have at lunch?

The first ABTL event is a cocktail party. The party is a great mixer – running into lawyers and judges from across the state, some old friends, meeting new ones. I am expecting only appetizers, but instead the food is a fabulous spread, with everything from sashimi to sweets. No cell phones in sight.

Thursday AM

The first educational program begins, chronicling a preliminary injunction from cradle to grave. A fact pattern with enough twists and turns to seem like those cases everyone is calling the office about. Outstanding mock oral arguments at a TRO hearing are presented, followed by some candid insights from a panel of judges.

Thursday PM

Many leisure activities to choose from – golf, snorkeling, hiking, etc. Top on the hit parade is lying in a hammock on the beach. I think I see a rock moving in the surf. Too many mai-tais at lunch again? No -- it's a green turtle.

That evening, the Orange County lawyers and judges in attendance join together for a private cocktail reception.

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Post Enron/Worldcom World
by Benjamin P. Pugh

In today's post-Enron/ WorldCom world, the public is clamoring for, and Congress is enacting, new laws requiring more disclosure from public corporations. More disclosure to the public, however, also means more disclosure of once-private corporate information to anyone with access to Edgar-online - which means everyone. The new challenge for legislators and the courts in the wake of Enron/WorldCom is to reassess the appropriate balance between privacy and openness of corporate affairs.

In weighing these competing values, the California Court of Appeal, Fourth Appellate District, Division Three, recently came down squarely on the side of corporate openness in Saline v. Superior Court (Commonwealth Energy Corporation), 100 Cal.App.4th 909; 122 Cal. Rptr.2d 813 (2002). In Saline, a dissident director sought to inspect corporate documents under Corporations Code section 1602, which reads in relevant part, "Every director shall have the absolute right at any reasonable time to inspect and copy all books, records and documents of every kind . . ." Saline's stated intention was to share these documents with the shareholders. The corporation's management resisted, claiming the documents were "confidential."

In a pre-Enron/WorldCom ruling, the trial court allowed Saline to inspect some documents, but refused to acknowledge or enforce Saline's statutory right to inspect all Commonwealth's documents, and further prohibited Saline from disclosing the documents to shareholders. Saline sought a writ of mandate challenging the trial court's ruling. In a post-Enron/WorldCom opinion, the Court of Appeal issued a peremptory writ reversing the trial court on both the issue of Saline's access to documents and his ability to show the documents to shareholders.

Attorneys handling inter-corporate disputes should take note of Saline v. Superior Court because one can expect to see an increase in directors seeking access to corporate documents in the near future. Not only does Saline v. Superior Court provide a clear legal right to do so, but in today's climate it is easy to anticipate an increase in Enron-type lawsuits against directors allegedly "asleep at the

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High Stakes Arbitration in the Sports World: Lessons for Business Litigators
by Richard Grabowski

On Wednesday, June 5th, 2002, the members of the Orange County chapter of the Association of Business Trial Lawyers met for an evening of wine tasting and a panel discussion of "High Stakes Arbitration in the Sports World: Lessons for Business Litigators." Numerous contributors sponsored the wine tasting, which benefited the Public Law Center. After the wine testing, everyone retired to the dining room for the panel discussion lead by Doug DeCinces, Jeffrey Moorad and Russell Sauer, Jr. Despite the fact that the Los Angeles Lakers were embroiled in a semi-final playoff game against the Sacramento Kings, the event drew a strong turn out.

The panel provided differing perspectives of baseball's salary arbitration process. Speaking for the players was Doug DeCinces, a former Anaheim Angel who served for six years as the American League Player Representative. Mr. DeCinces began by reiterating what every baseball fan already knows: that those few individuals who make into the major leagues constitute the elite of the baseball world. In this vein, while Mr. DeCinces recognized that the players' salaries had increased dramatically in the years since his retirement, he felt that those salaries were well deserved, given the amount of revenue those players generate for their respective clubs. As a former professional himself, Mr. DeCinces spoke from personal experience regarding the often-complicated process of baseball arbitration, which he regarded as an often unpleasant, but nevertheless essential aspect of baseball today.

Representing the players' agents' viewpoint was Jeffrey Moorad of Steinberg & Moorad. Mr. Moorad began by telling the audience of his long love affair with the game of baseball. A diehard sports fan, Mr. Moorad sought to mix his then-hobby with his new legal career, a feat he accomplished by opening his own sports law office. Drawing on personal acquaintances with professional athletes, Mr. Moorad developed his office into one of the top sports law firms in the state. His experience naturally led him into the role of a player agent, where he has now developed his firm into one of the top in the country. As an agent, Mr. Moorad has been involved in numerous high-profile salary arbitrations and, from his background, provided the audience with an explanation of the procedures involved in such an arbitration. As Mr. Moorad explained, both the player and the team owner present the arbitrator with competing salary offers. The mediator must then choose one of those offers, without modification or compromise. As Mr. Moorad put it, there is no

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A: It is really the same as it was in Michigan. People forget that Magistrate Judges have very limited criminal jurisdiction. So the workload -- the division of cases between civil and criminal -- is pretty much the same as I was doing before.

Q: How did it come about that you transferred here to California from Michigan?

A: I had lived in Ann Arbor Michigan for 35 years. It was a wonderful place to live but I was looking for a change in life. My children had grown and had left Michigan. I thought it'd be interesting, challenging and exciting to move to a different part of the country. I enjoy my job a great deal. I was fortunate to be able to continue to perform the type of work I was doing, just in a sunnier and warmer climate.

Q: What is a typical day like for you as a magistrate judge?

A: It's consists of a variety of tasks. Probably three or four hours are spent writing and editing opinions. The usual day will involve about an hour's worth of time with criminal matters such as initial appearances, bail hearings and the presentation of requests for warrants. Several times each week, I will conduct a settlement conference, which may take anywhere from two to six hours. And a couple of times a week I conduct law and motion hearings, which will take three or four hours. So depending on the day, I can spend three to four hours in court and then another four to six hours reviewing files and working on opinions.

Q: Do you use technology in your daily routine?

A: Yes, very much so. I have elected to employ two law clerks instead of a law clerk and a secretary so I am always on the computer. The courtroom here at the federal building is fully outfitted with the state-of-the-art technological systems, although I can't say that I'm as familiar as I would like to be with it. As a matter of fact, tomorrow, I'm conducting my first evidentiary hearing by video-conference. I have a habeas corpus petition with a prisoners who is incarcerated on the East Coast. He and his attorney have agreed that he could participate from the prison by video-conference. That way, he will be able to see and hear everything that goes on and we will be able to see and hear him. We are also arranging for a secure private telephone line so he can talk privately with his lawyer during the course of the hearing. That type of technology can save the government the tremendous costs of transporting him to California with minimal intrusion on the quality of the hearing and the attorney client relationship. In terms of audio-visual, the courtroom is also fully automated.

Q: Do you see the use of technology in the courtroom becoming more prevalent?

A: Oh yes, I think it has to and will become more prevalent . Judges and lawyers simply need to become more familiar with technology and figure out how to use it in the most effective way. It both cuts costs and enhances the ability to present cases to a jury or judge. In terms of use in the courtroom, I think it's more effective in the context of jury trials than it is in the context of motions and hearings. However, the use of new automation techniques by the courts will make life simpler for attorneys.

Q: What are your pet peeves when it comes to lawyers that appear before you?

A: Lack of preparation is troublesome. I prepare for the hearings and trials that are scheduled before me. I expect the lawyers to prepared for the hearings as well. I must say, however, that I have been impressed with the quality of lawyering in this district. It is also problematic when a lawyer is unwilling to retreat from an unsupported or untenable position. In other words, I lose patience with lawyers who persist in legal or factual arguments for which they don't have a good faith basis for arguing. Lawyers should be aware that this results in a loss of trust and credibility on the part of the court which is a lawyers most important asset. Lawyers need to realize how important it is to establish and maintain a credible reputation in court. Finally, civility is important to me. A lack of civility in depositions or courtroom proceedings is not tolerated. All lawyers should familiarize themselves and try to abide by the Rules of Civility adopted by the court.

Q: Do you sanction attorneys for courtroom misconduct?

A: I have never had to do that in my 19 years as a judicial officer. I can think of only one occasion where I had a problem with an attorney's courtroom conduct to the extent that I had to take some action. I've gotten angry at lawyers for their courtroom behavior, but I think it's the judge's responsibility to control the tenor of proceedings in the courtroom and make sure that things don't get out of hand. Of course, I have sanctioned lawyers for discovery abuses and for filing vexatious proceedings, but never for improper conduct.

Q: Are there any noticeable differences between the way attorneys practice in Michigan and the practice of attorneys here?

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A: There are significant differences which I believe are a function of the local culture and the local rules. First, the pleadings that are filed, even in simple discovery disputes, are far more extensive than those I saw in Michigan. This is magnified by the extensive use of exhibits and declarations. Declarations were never attached to discovery motions in Michigan. Here, these huge pleadings are filed with all these declarations attached. That's really new to me. It was shocking to me how much paper could be filed over a simple discovery matter when I first arrived here.

The mix of cases is also different, even in the criminal context. There are far more commercial disputes and intellectual property cases here than I saw in Michigan. In the criminal context, there's far more white collar criminal cases. You see drug offenses and bank robberies here, but white collar offenses are more prevalent.

Finally, there was a greater use of the consent option for Magistrate Judges in Michigan. Under 28 U.S.C. § 636, Magistrate Judges can preside over a civil case and enter judgment upon the consent of the parties. This includes both trial and dispositive motions. Under the rules of this district, the parties can consent to any magistrate judge on the consent list. There was a greater use of this alternative in Michigan than here. It is something that attorneys should think about given the criminal caseload for district judges and the quality of the magistrate judges in this district.

Q: Do you have, or did you have a mentor?

A: I had several different mentors throughout my career. As a young lawyer, I was employed by the Michigan State Appellate Defender Office. It was a time of great change in the criminal law. The office was filled with incredibly bright young aggressive lawyers, most only a few years older than me, who mentored me in my formative years as a lawyer.

When I was appointed a magistrate judge, I was assigned to a divisional courthouse in Flint, Michigan in which there was one district judge and me. The district judge was named Stewart Newblatt. I had practiced before him as an AUSA and I greatly admired him. I thought he was intelligent, fair, and kind. Just an all around fine person and judge. The two of us worked together for 12 years until he retired. I have tried to model myself after him but am not sure how successful I have been.

Q: What do you do in your spare time?

A: I've moved out to a beautiful climate with wonderful opportunities but I've got about twice the work load that I had in Michigan. But, in my spare time, I'm exploring Southern California. Probably twice a month I'll take a road trip on the weekends and explore the area. I try to improve my golf game, enjoy the year round gardening and I do a lot of cooking and reading.

Q: Any favorite spots in Southern California you've discovered?

A: I enjoy the Cleveland National Forest. I spend a lot of time up there when the weather is cooler. I also enjoy the beaches. I try to get up to LA for the museums, theater, restaurants and music about once a month. I have also spent time driving south along the coast toward San Diego. I'm enjoying it all. I still need to get up to the mountains and the National Parks in Central and Northern California.

Q: Okay, one last question. What advice do you have for young lawyers?

A: I think I'd repeat what I said before about credibility. It's a lawyers most important asset. Once you have created a reputation, it can follow you forever. Judges talk to one another about lawyers. I have asked colleagues here about the trustworthiness of attorneys if I have my doubts. I've even had some of my former colleagues in Detroit call asking me about lawyers from this area, inquiring about their skill and honesty. Maintaining you credibility, establishing reasonableness and honesty will get you as far as any lawyering skill you may have acquired.

▪ *Hon. Marc L. Goldman is a Magistrate Judge of the United States District Court, Central District of California, Southern Division*

▪ *Leo J. Presiado is member with the firm of Rus, Miliband & Smith, A Professional Corporation.*

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Another more objective case than this one, sometimes combined with restatement of past earnings and sometimes just depressing current earnings, is alleged "channel stuffing." In channel stuffing, managers are so intent on keeping revenue figures high that they accelerate shipping and book sales on products in the current quarter that they know are in excess of what the market can bear. This has the effect of shifting or "cannibalizing" sales from the next quarter, as distributors seek to return the excess inventory. There is nothing like that in this

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complaint. There are allegations in another consolidated complaint of *Smith v. Directorpersons* that insiders knew that customers were finding TechWidget software defective and were refusing to pay for it, and that key personnel were resigning, but even these facts are lacking from the *Shareperson* complaint at issue.

Instead, this complaint merely states that the quarterly reports trumpeted large revenue growth, seeming to predict that it would continue, and then revenue growth went in reverse or flat in the first and third quarters of 2000. There were losses, but TechWidget had losses even when its stock price was high. The complaint is reduced to pretentious phraseology to try to make a case. One waits in vain for a clear statement of what specifically the defendant directors knew that was undisclosed. The complaint finally accuses the defendant managers and directors of being "aware of critical facts about TechWidget's business which reasonably put them on notice that effective controls over the Company's release of statements relating to its financial prospects were vital: (a) TechWidget operated in an extremely competitive environment and....was under tremendous pressure to increase revenues; and (b) TechWidget faced heavy pressure to increase revenue to maintain the market price of its stock." Besides the fact that the colon in that sentence makes no sense, these truisms could probably be gleaned by anyone who reads a business page in a newspaper once or twice. That stock prices are related to steady increases in revenue, and that the tech sector is extremely competitive, are not the type of "facts" which TechWidget needed to disclose or omitted to disclose. They certainly are not hard facts that were misrepresented or undisclosed to the market.

The accusation, at worst, appears to be that TechWidget did not do as well as it had done, or as well as it implied that it would do, and insiders had some vaguely identified information that its results would be negative. TechWidget had been growing at the rate of over 100% per year, and the complaint implies that TechWidget promised this would continue. Even if there had not been a general technology downturn, it is difficult to say that a shareholder would or should expect that 100% sales growth can continue year after year indefinitely, although in 2000 some stocks were valued as if that were possible.

TechWidget had a couple ofbad quarterly reports and its stock dropped precipitously, which makes this derivative case something like what used to be called a simple "stock drop" case. In the 1980's, a number of forces combined to make securities litigation active. Among these influences was the theory of "fraud on the market" pioneered by the Ninth Circuit in Blackie v. Barrack and eventually endorsed by the Supreme Court. In that theory, markets digest all information to price a stock. Therefore, if information is announced which causes a big stock drop, it was inherently material information that was unknown and undisclosed, because the market would have factored in that information if it had been known. This created a tautology, and led to an increase in suits and settlements.

In an attempt to curb this, Congress did not address the fraud-on-the-market tautology but rather passed the Private Securities Litigation Reform Act (PSLRA), Pub.L. 104-67, 109 Stat. 737 (1995) (codified in part at 15 U.S.C. §§ 77z-1, 78u). It purported to provide uniform and rigorous pleading standards for class actions and other suits alleging fraud in the securities market, requiring the fraudulent statements and the reasons for their falsity to be specifically identified. PSLRA and further acts were intended to prevent "strike suits" – meritless class actions that allege fraud in the sale of securities. Arguably, the most strict and high standard for allegations of securities fraud under PSLRA, was set in the Ninth Circuit in Silicon Graphics Inc. Securities Litigation, 183 F.3d 970, 974 (9th Cir. 1999). (The standards of Silicon Graphics are being reviewed by the Ninth Circuit currently.) Congress was apparently concerned that it was common for litigation to continue for years based on the mere general allegations, with expensive discovery leading to unwarranted settlements. (Actually, in my experience, there often were many bad facts in suits that led to large settlements.) Thus, many good securities actions -- not just stock drop cases -- now get thrown out for lack of particularity in the allegations.

The PSLRA and further implementing legislation specifically exempted *derivative* litigation from its reach. Securities Law Uniform Standards Act, 15 U.S.C. § 77p(f)(2)(B).[/] In *derivative* litigation, plaintiff sues on behalf of the corporation, as opposed to defrauded shareholders suing the corporation itself. Under Delaware law, a *derivative* plaintiff also has long been able to recover on behalf of the corporation the insider profits made by individual defendants who breach their fiduciary duties to the corporation by using insider information. See, e.g., Brophy v. Cities Service Co. 70 A.2d 5. (Del. Ch. 1949) (Some states do not believe that insider trading actually damages the corporation – as opposed to other stockholders – but Delaware posits that it hurts the management of the corporation and standing of the corporation in the market.) California actually imposes treble damages for some insider trading, and Shareperson purports to sue under the California statutes.

Even under securities laws as they existed before the

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PSLRA, however, the current complaint probably would not stand up to a motion to dismiss as a 10b-5 action. This complaint alleges that there are several securities actions pending on the TechWidget stock drop, but the Shareperson suit is the derivative suit. Derivative suits have their own strict requirements under Delaware law, and most of these requirements are also in California law, as shown below.

Delaware Law, Demand-Futility and Discovery

There are pleading requirements for a derivative claim under Delaware law that are comparable to the new pleading requirements under the PSLRA. Perhaps, because these hurdles were still considered to be high, derivative suits were exempted by Congress from the PSLRA. Commonly, in these cases, there is an argument as to whether Delaware law or California law applies to pleading a case against these Silicon Valley corporations that are commonly incorporated under Delaware law.

Defendants say that Delaware law governs this action and choice of law is governed by the "internal affairs doctrine." The internal affairs doctrine has been set out in several U.S. Supreme Court opinions and is codified in California Corporations Code Section 2116. Section 2116 states: "[t]he directors of a foreign corporation transacting intrastate business are liable to the corporation [and] its shareholders for the violation of official duty *according to any applicable laws of the state or place of incorporation* whether committed or done in this state or elsewhere."

Plaintiffs usually argue, and argue here, that this does not extend to the complaint here. As stated in Wilson v. Louisiana-Pacific Resources, Inc. 138 Cal.App.3d 216, 224 (1982) :

> The "internal affairs doctrine," according to which courts traditionally looked to the law of the state of incorporation in resolving questions regarding a corporation's internal affairs (citation); has no application here. That doctrine has never been followed blindly in California (see Wait v. Kern River Mining etc. Co. (1909) 157 Cal. 16, 21 [106 P. 98]; see also Western Air Lines, Inc. v. Sobieski, supra, 191 Cal.App.2d 399); it is inconsistent with the "comparative impairment" approach used by this state in resolving conflict of law problems (Citation).

See also Havlicek v. Coast-to-Coast Analytical Services, Inc. 39 Cal.App.4th 1844, 1855 (1995) Plaintiffs point particularly to Western Air Lines, Inc. v. Sobieski 191 Cal.App.2d 399, 409-410, (1961) which held that the California corporation commissioner could rule on whether Western, a Delaware corporation, could institute cumulative voting of shares. In Western, the court repeatedly held the internal affairs doctrine at bay, with language such as the following:

> 'It is true that the courts in California cannot control the internal affairs of any foreign corporation. Such matters are to be conducted in pursuance of and in compliance with the provisions of the charter of the foreign corporation, and the laws of the country where it was created; *but in the management and method of its business affairs in California with the citizens and residents thereof, in the sale or disposition or transfer of the shares of stock, it must conform to the laws of California in relation to such matters, and is bound thereby*. In the recent case of Williams v. Gaylord, supra, 186 U.S. 157 [22 S.Ct. 798, 46 L.Ed. 1102], the Supreme Court of the United States said: "*When a corporation* sells or encumbers its property, incurs debts, or *gives securities, it does business; and a statute regulating such transactions does not regulate the internal affairs of the corporation*."'

Plaintiffs reason that insider trading is a particular concern to the California legislature which added Corporations Code §25502.5 in 1988, imposing treble damages for insider trading. They cite a direct holding to that effect by the Northern District here in Bilunka v. Sanders, 1994 WL 447156, at *3, [1994-5 Transfer Binder] Fed. Sec. L. Rep.(CCH) ¶98,314 (N.D.Cal. Mar. 1, 1994), where Judge Ware held:

> Plaintiff seeks statutory treble damages and attorney's fees, a remedy for a violation of Section 25402, available under Section 25502.5. Defendant contends that Plaintiff cannot rely on Section 25502.5 because California law does not apply to a foreign corporation pursuant to California Corporations Code Section 2116. Section 2116: "[t]he directors of a foreign corporation transacting intrastate business are liable to the corporation [and] its shareholders ... for the ... violation of official duty according to any applicable laws of the state or place of incorporation ... whether committed or done in this state or elsewhere...."

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> A shareholder's derivative suit against directors of a corporation for allegedly trading on inside information was examined in Johnson v. Hui, 752 F.Supp. 909 (N.D.Cal.1990)**. *The Court found insider trading to be unrelated to corporate purpose because of the personal benefit derived on the trading directors at the expense of the shareholders and the corporation***. This Court agrees that insider trading is not a violation of official duty as discussed in Section 2116. Therefore, the Court finds that section 2116 does not apply to this case. Accordingly, Defendant's motion to dismiss for failure to state a claim under California Corporations Code Section 25502.5 is DENIED."

Therefore, there is good authority that the action for insider trading can take place under California law, not Delaware law. Some of these cases are probably errant. A *derivative* action against a Delaware Corporation to recover for insider trading generally seems to be treated under Delaware law. Although it might be a different story if this were a securities action *against* the corporation, it appears generally that federal courts and courts of other states apply Delaware law to a derivative action against a Delaware corporation. This is a matter that is still somewhat uncertain on the appellate level in California, but Superior Court rulings commonly are attached to these kinds of motions. These indicate that Superior Courts are imposing Delaware requirements on derivative actions.

Demand Futility Allegations

One thing that causes companies to incorporate in Delaware is the hurdles created by Delaware law in derivative litigation. Under Delaware Rule 23.1, a party wanting to bring a derivative suit must first demand that the directors of the corporation bring the suit - **or make particular allegations as to why such a demand would be futile.** This issue goes under the common name of "demand futility." California also requires allegations of demand futility but there appear to be a very important difference in the effect of these requirements: Delaware purports to stay all discovery until such particular allegations of demand futility are made and demurrer on that ground is overruled, reasoning that the discovery causes disruption of the company. It appears that California allows discovery to proceed while demurrers are pending (Mattco Forge, Inc. v. Arthur Young & Co. 223 Cal.App.3d 1429, 1436 n.3 (1990)), without the specific exception for derivative suits.

Delaware's pleading rules for demand futility are also generally treated by federal and other state courts as "substantive law," not procedural.

Defendants make the usual argument regarding inadequate allegations of demand futility, based on Rales v. Blasband, 634 A.2d 927, 936 (Del.Supr. 1993), and on Aronson v. Lewis**,** 473 A.2d 805 (Del.Supr.1984). The theory is that a board governs a corporation, not stockholders, and derivative litigation is disruptive. Therefore, the board should be able to decide in the first instance whether to sue for return of money to the corporation. Therefore, plaintiff is supposed to make a demand first on directors to bring suit, or allege particular facts why such a demand would be futile. A plaintiff basically must rebut the presumption that board members would act independently and reasonably to consider a suit if a demand were made. Even under Aronson, the more liberal standard applicable to questioning a board's action, an allegation of demand futility is not sufficient just because the directors would be personally liable for the wrongs and would have to sue themselves. Something additional is needed, although self-interest by a majority of directors in challenged transactions will generally lead to a situation where demand is excused as futile.

Defendants on insider-trading cases argue that the more difficult one-factor standard in Rales applies, since that is the standard when it is individual actions rather than board actions that are being challenged. That standard is:

> whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. Thus, a court must determine *whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand*. If the derivative plaintiff satisfies this burden, then demand will be excused as futile. Rales, 634 A.2d at 934.

Thus this court must determine "whether or not the particularized factual allegations ... create a reasonable doubt that, as of the time the complaint is filed, [a majority of] the board could have properly exercised its independent and disinterested business judgement in responding to a demand." Rales, 634 A.2d at 934. "A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders." Id.; Heineman v. Datapoint, 611 A.2d 950, 952 Del Supr. (1992) ("[D]emand is futile where a reasonable doubt exists that the board has the ability to

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exercise its managerial power, in relation to the decision to prosecute, within the strictures of its fiduciary obligations."). How that fits with the Aronson statements that directors are not necessarily disqualified if they would have to sue themselves is a complicated question. It comes down to whether they would sue themselves as a *board*, apparently, as opposed to Directorperson voting for the board to sue Directorperson himself – which would make him interested. Don't look for this distinction to be clearly explained in any briefs or cases, however, since they all seem to quote whatever dictum suits their purpose.

The Aronson two-prong test looks at (1) allegations that the defendants were interested in the corporate transaction, *or* (2) that the transaction is far outside the bounds of what would be a reasonable exercise of business judgment. Thus, conduct far outside of reasonable business judgment is another prong to allege demand futility where it is board conduct that is challenged. Although this complaint attempts to characterize its allegations as board decisions to misrepresent the state of the company, it is insiders dumping shares at a profit ahead of the stock price falling that is the heart of the complaint. The Rales test would therefore apply rather than Aronson to at least the main body of the complaint and the first cause of action for insider trading. (Plaintiff, of course, maintains that his insider trading causes of action are under *California* Corporations Code §25402 and §25502.5, and therefore should not be subject to *Delaware* tests of demand futility.)

The complaint then purports to state causes of action for "Breach of Fiduciary Duty," and "Abuse of Control." These would be actions more of the Board and as Board members, and subject therefore to the Aronson two-prong test, theoretically. The plaintiff makes allegations to fulfill the second prong of the Aronson test – that defendants actions were far outside of the realm of business judgment – but these allegations are very weak. The most that can be said is that the board members helped issue statements – or "reviewed and approved" statements – of the corporation that tended to show that TechWidget was doing very well. These statements were impliedly contradicted when TechWidget did not have good results "subjecting the corporation to securities suits." Defendants cite good case law that sustained demurrers because damages are speculative for a claim that securities suits were caused by mismanagement – since the outcome of those suits is still unknown. The allegations here, however, are still so thin, that such case law is not necessary. Demurrer should be sustained merely because there are no real facts supplied as to what the insiders knew or should have known that made their actions unreasonable or outside of business judgment.

Particularity:

In determining the particularity of the allegations of demand-futility, one often goes back in a rather circular fashion to the general allegations on the merits. If there were to be an accounting change causing a restatement of earnings and a director knew of it, then the director's sale of stock is suspect. If a director has inside information that sales are going down, which is not reported to the market, similarly, the director's sale of stock makes him too interested to entertain a demand. Directors presumably sell stock at many times, however, including on general knowledge available to anyone in the market that, for instance, stocks are overvalued, the market has peaked, the tech sector is weak, or similar hunches. The same Delaware case that held that insider trading created liability, also said that directors have a perfect right to buy and sell stock if the sales are not infected with inside information. Brophy v. Cities Service Co. 70 A.2d 5 (Del. Ch. 1949)

Therefore, the mere sale of stock at a particular time is not enough. At least some "*particularized factual allegation*" (Rales, supra) is necessary as to a discrete bit of inside information known by the insider. Otherwise, all directors who sell stock prior to a stock drop would be disqualified from entertaining a demand to sue. As defendants argue, a plaintiff would merely have to choose a long enough period before any stock drop to rope in a majority of directors and file suit. Instead, Delaware requires that the allegations of demand-futility must create not just a possibility but a "substantial likelihood" that enough directors traded on inside information as to cause demand on the Board to sue to be futile.

As one factor, the courts look to the closeness in time of the insider trades to the time at which directors have knowledge of the negative information, or closeness to the falsely positive information. Here, as defendants point out, the insider trading period in the complaint is stretched to a full 10 months, covering the negative reports in both the first and third quarters of 2000, and still only ropes in 3 of 7 directors who made trades at that time. (A fourth director, Gardner, is also the CEO, and thus, plaintiffs argue, he is such an insider that he cannot consider a demand, and argue that his actions are additionally not shielded by the business judgment rule which applies only to directors.)

The complaint does not attempt to tie particular sales of stock to knowledge of particular negative facts. Actually, the Shareperson complaint does not seem to state any particular negative accounting or sales facts that any defendant is supposed to have known, other than just

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generally lacking grounds for the corporation's positive statements. Plaintiff puts much biographical information about the defendant directors in the complaint at paragraphs 55-76, and allegations that the subject conduct was outside the business judgment rule at paragraphs 77-83. There is little there. The allegations are very general and seem to imply that the directors were just as much dependent on the company doing well as anyone. Gardner who was CEO and held a million shares did not sell any during the period. At this point, the allegations of the complaint are so thin that it is difficult to find a "reasonable doubt that" that the Board "could have properly exercised its independent and disinterested business judgement in responding to a demand." Rales v. Blasband, 634 A.2d at 934. There is also not a coherent statement of why their decisions to issue or approve financial reports was a breach of loyalty or fiduciary duty.

The defendants also suggest that the board could have formed a special committee of the directors who did not sell stock or otherwise participate in the wrongs, such that demand to the board would not have been futile. There are cases of board special committees of disinterested directors being appointed to review demands to sue. (The litigation often then turns on whether the members of the special committee were truly independent and sufficiently deliberated.) Such cases, however, seem to be in a situation where the board has taken the initiative and appointed the committee already. To sustain demurrer based on the possibility that the board will one day appoint a committee, that will one day act to sue or not sue, would seem to give an open-ended extension for the Board to cover up wrongdoing. This ground for demurrer is surplusage and not necessary at this point, since demand-futility is inadequately alleged.

Other Grounds for Demurrer

The corporation, TechWidget, demurs on the basis of demand-futility, as above. The individual officer and director defendants file a separate demurrer, incorporating the TechWidget demurrer, but also demurring to each cause of action on other grounds. This memo is already lengthy, and demurrer should already be sustained because of inadequate allegations of demand futility. There is no need to go further. Therefore, these other grounds will only be briefed quickly. They include defendants' arguments that:

1. There is no allegation of actionable harm to TechWidget; it is premature and speculative to sue directors for causing TechWidget to be subject to securities suits, as those suits have not yet been successful. (However, under Delaware law, harm to the company's reputation and good will in the market from insider trading are considered actionable in a derivative complaint).

2. That the first, second and third causes of action do not allege a "causal link" between the alleged trading and any supposed inside information, and fail to allege facts showing that defendants knowingly engaged in conduct contrary to TechWidget's best interests - such that they are shielded by the business judgment rule. (However, plaintiff cites authority that only directors and not officers or officer-directors are protected by the business judgment rule in this context.)

3. That TechWidget's Articles of Incorporation take advantage of a provision of Delaware law which protects directors from conduct that is not intentional. Again, plaintiff argues that California law applies. Plaintiff also argues such provisions do not shield those directors who were also officers, nor do they shield from breaches of loyalty.

Recommendation:
Demurrer is sustained with leave to amend to state particular factual allegations that create a reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.

Discovery – Motion to Compel.

Plaintiff moves to compel discovery. This is common, as is an opposing motion from defendants to stay discovery while the complaint is subject to demurrer on grounds of demand-futility

Under Delaware law, "plaintiffs ... are not entitled to discovery to assist their compliance with the particularized pleading requirement of [demand futility]...." Scattered Corp. v. Chicago Stock Exch., Inc. 701 A.2d 70, 77 ; see also Levine v. Smith 591 A.2d 194, 208-210 (Del. Supr.1991) (same) .[7] As mentioned above, plaintiff maintains that California law of free and open discovery applies instead.

There appear to be several reasons, however, why the Delaware "rule" cutting off discovery is not actually a rule, and limited discovery is permitted.

First, Delaware courts have noted a significant exception to the limitation on discovery. The Supreme Court of Delaware in Grimes v. Donald 673 A.2d 1207, 1216 (Del.Supr.1996) , noted that in spite of the limitation in Levine, a shareholder can use "the summary procedure embodied in 8 Del.C. § 220 to investigate the possibility of corporate wrongdoing." Id.; See also, Scattered, supra

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(same); Rales v. Blasband 634 A.2d 927, 934-5, n.10 (Del. Supr.1993) (same). The cited Section 220 gives shareholders the right upon a showing of a proper purpose to examine corporate books and records, including minutes and other corporate documents. It appears broadly similar to California Corporations Code §1601, under which the right of the shareholder to examine corporate records has never been precisely defined, except that the right of inspection relates broadly to the relevant matters at issue in a legal case. Schnabel v. Superior Court, (1993) 5 Cal.4th 704, 716. Since the comments in Rales, Grimes and other cases, there appears to be jurisprudence in Delaware of plaintiffs bringing summary proceedings under Section 220 to obtain discovery. Subsequent decisions in the Grimes case itself have permitted extensive discovery related to the issues in the case, under Section 220. Grimes v. DSC Communications Corp. 724 A.2d 561 (Del.Ch. 1998) (Grimes II).[/] The latter decision appears to be broadly in accord with the California standards in Schnabel. They are also broadly in accord with allowing limited discovery relevant to the questions involved in pleading demand futility.

The upshot is that this court could cut off discovery and force a plaintiff shareholder to go to Delaware to bring a proceeding under 8 Del.C. § 220 to obtain documents from a corporation, when the corporation admittedly is headquartered in Santa Clara County and does most of its business here. If the parties then went to Delaware and obtained Delaware counsel, at great cost to the corporation and to plaintiff and the other defendants, the Delaware court would be left to review anew the issues with which this court is already familiar. It would likely come to a determination such as that in the Grimes II decision. More appropriately, this court can allow discovery and put appropriate limitations on it, to relate it to the issues, following the guidelines of that decision.

Secondly, it has been argued that, even if the particularity required in demand futility pleading is not "procedural" but rather substantive, the issues surrounding discovery of that issue are procedural. See Note, Discovery in Federal Demand-Refused Litigation, 105 Harv.L.Rev. 1025 (1992). The basic notion that a company should not through mere secrecy defeat a meritorious claim seems now to have found its way into the use of 8 Del.C. § 220 and other arguments to Delaware chancellors, to allow limited discovery before dismissing a derivative lawsuit. This seems especially applicable in cases in which there appears to have been something so significant as a restatement of past earnings, although it may not serve as a rule in other cases.[/]

California, as mentioned, appears to allow discovery before an operative complaint passes muster at demurrer. Moreover, California has fast-track rules to move discovery along, rather than let it wallow for the many months of repeated demurrers.

This raises the question of whether Delaware's right to apply Section 220 surpasses or exceeds this court's ability to apply proper discovery guidelines in this case. The opinion in Havlicek v. Coast-to-Coast Analytical Services, Inc. 39 Cal.App.4th 1844, 1849 (1995) [46 Cal.Rptr.2d 696], a leading case on whether California law or Delaware law should govern, ironically considered just such an issue. It considered whether the right of a director to examine corporate records under California's Corporations Code Sections 1601-1603, or rather the asserted right of Delaware courts to decide what records were to be examined under the correlative Delaware statute, applied, when the corporation was located in California but was incorporated in Delaware. Much of the facts and reasoning in Havlicek, which permitted California law to apply also apply here. If this court basically is applying Delaware's Section 220 to discovery here, the Havlicek test of which state's "interests would be more impaired if its policy were subordinated to the policy of the other state," would not favor Delaware. Delaware's interests should not be affected if discovery is permitted as would be permitted under Section 220.

Therefore, a practice has grown up in some complex litigation departments of allowing limited discovery, as would exist under Section 220, commensurate to the seriousness of the issues to be examined. Some defendants have taken writs, and now at least one petition has been addressed to the Supreme Court of California on the issue of the practice of allowing some demand-futility discovery, but no appellate court has yet taken the issue for review. Superior Court decisions going both ways are frequently attached to moving and responding papers.

Both plaintiffs and defendants in this case show that they are aware of this court's past practice and its finding justification for allowing discovery as analogous to Delaware Section 220. Therefore, defendants here offered to provide very limited discovery of Board and Audit Committee minutes. Plaintiff rejected that, arguing that much broader discovery is permitted under California law and even under the practices of this court.

Therefore it seems appropriate to order basic examination of corporate books and records and limits on discovery as were set out in Grimes II, as appropriate to this case.

Since the allegations are so thin here, there would seem

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to be very limited relevant discovery – and little reason to upset business at the corporation by allowing broader discovery. The one area of discovery that would seem appropriate under such limits would be minutes and agendas of corporate Board meetings and the packets of information and presentations that were provided to Board members for those meetings. If those documents indicated a slowdown in revenues before the market was informed of that slowdown, and if the directors made stock sales shortly after receipt of that information. They would go directly to whether the directors could fairly entertain a demand against them trying to recover damages for such trading. Such inspection of corporate minutes and Board meeting materials would seem to be permitted under a Delaware action pursuant to Section 220. The only real difference is ordering it to proceed here, against a corporation that is, after all, located here.

Recommendation: As to the motion to compel discovery, limited discovery is permitted of only the following materials: minutes and agendas of Board of Directors and Audit Committee meetings, and of the packets of information, reports and presentations that were provided to Board members, either for those meetings or relative to their position as a Board member, for the years 1999 and 2000. The motion granted to that extent only, and otherwise it is denied. All other discovery is stayed until further order of this court, or until demurrer is overruled to the complaint, whichever occurs first. Defendants shall have 20 days from the date of this order to provide the described documents.

I hope this has been useful to orient you to the many derivative complaints we see in this department. As you see, some of the issues are undetermined and the concepts are somewhat "sloppy" in their application. Similar cases seem, even in Delaware, to receive vastly different treatment. Although we can expect to see some efforts to assert private rights of action under the new securities legislation from Congress, the derivative area of litigation is likely to remain lively for some time.

Foot Notes_____

1. The Securities Law Uniform Standards Act (SLUSA) attempted to deal with state securities law claims which accelerated after the passage of the PSLRA, by preempting them. Therefore, the *derivative* complaint is where these actions are centered in the last couple years, and this complex litigation department sees many such actions.

2. Plaintiff argues that California's law applies, allowing free discovery prior to an operative complaint. See, Mattco Forge, Inc. v. Arthur Young & Co. (1990) 223 Cal. App.3d 1429, 1436 n.3

3. There Grimes made demand on the corporation for inspection of certain books and records of the corporation in order to determine whether his demand was wrongfully refused. The Chancery Court held that: (1) shareholder sought inspection for proper purpose; (2) shareholder was entitled to inspect special committee's report; (3) shareholder showed sufficient good cause to preclude application of attorney-client privilege; (4) shareholder demonstrated substantial need for information protected by work product doctrine; and (5) the self-critical analysis doctrine, even if adopted, could not be asserted against shareholder. Id.

4. It appears that the derivative litigation cases in which demand futility and limitations on discovery are raised often have to do with matters more purely of judgment, such as executive compensation packages or board decisions to merge or change stock structure. A restatement of earnings and the timing and use of knowledge of a change in distributor return practices raises issues more clearly of fact: i.e., who knew what and when. These are open to factual investigation.

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Chapter. ABTL remains the only statewide organization in California that is dedicated exclusively to the interests and needs of business litigators. In addition to providing outstanding educational dinner programs, which consistently attract hundreds of the finest practitioners and judicial officers in the County, ABTL also provides a networking focal point which allows those within the Bench and Bar who share the common interest of business litigation to meet regularly, exchange views, and share each other's company. Of course, because ABTL is a statewide organization, there is also regular interaction between our Chapter and our sister chapters, notably including our Annual Seminars to which all are invited, and our Joint Board of Governors meetings with the leaders of each of the other Chapters.

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-Hawaii Seminar 2002: Continued from page 3-

A common topic of discussion is the fact pattern of the program, which side has the better arguments, and how well the lawyers performed at the mock arguments.

Friday

More free time in the morning. I play in a great round robin tennis tournament. I now have earned some more hammock time.

The afternoon program moves on to depositions. These end up being far more entertaining than the depositions that I attend. What am I doing wrong? Maybe it's just practicing on the mainland.

Another huge spread for dinner as all the ABTL attendees join together after a stirring speech by Justice Carlos Moreno of the California Supreme Court.

Saturday

The grand finale for the program – mock arguments at the preliminary injunction hearing, followed by a panel of judges sharing their views on how they would rule and why. These insights are the highlight of a very well-organized program which provided a chance to observe a variety of lawyering styles, and obtain judicial perspectives on what makes the difference when the extraordinary remedy of preliminary injunction is sought.

Sunday

This is the travel day back for most (the smart ones are staying behind for several days). Overall, the trip was a unique combination of relaxation, socialization, and great legal education. Topping it off, Orange County's finest judges and lawyers did us proud with excellent presentations. And we all learned that we can be lawyers in a relaxed setting by taking a temporary break from the cell phones!

▪ *John Sganga is a partner with the firm Knobbe, Martens, Olson & Bear in Orange County*

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My sincere thanks goes out to all of you who have so willingly and ably contributed to the success of our Orange County Chapter over the years, and particularly during 2002. I look forward to enjoying my membership in ABTL together with you for many years to come.

▪ *Jeffrey W. Shields operates his own firm, Shields Law Offices*

-Baseball Arbitration: Continued from page 4-

"splitting the baby." From Mr. Moorad's perspective, the advantage of such a system is that it discourages either side from proposed salary figure too extreme for fear of being contractually obligated to that figure.

The counterweight to the player-oriented viewpoints submitted by Messrs. DeCinces and Moorad was provided by Russell Sauer, Jr. of Latham & Watkins. Mr. Sauer has built a practice representing team ownership, and has been involved in several in baseball arbitration hearings. Mr. Sauer, pointed out that while players have won slightly more than half of all arbitrations, he had never personally lost an arbitration. Mr. Sauer discussed the application of arbitration to business litigation and settlement. According to Mr. Sauer, the ability for arbitration to unilaterally end litigation in a non-appealable manner was shown to be advantageous in certain situations. As well, it was shown that arbitration may be able to produce results that would have been unexpected or even unlikely in litigation, resulting in damages or awards that would be much more favorable than had a jury been involved.

In sum, the panel provided the audience with unparalleled insights to the world of baseball arbitration. Everyone, from the summer associates to the most senior judge, had an enjoyable evening. And, last but not least, the Lakers won.

▪ *Richard Grabowski is a partner with the firm of Jones, Day, Reavis & Pogue*

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wheel." While the "business judgment rule" codified in California Corporations Code section 309 provides directors with some liability protection, the protection is not absolute. Directors who blindly rely on the representations of management without any independent investigation expose themselves to personal liability. "A director shall perform the duties of a director . . . with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." Cal. Corp. Code § 309(a) (emphasis added).

After the Enron and WorldCom debacles, and the fact that most average Americans have seen their 401k's steadily dwindle over the past year, directors can expect that the "reasonable inquiry" expected of an "ordinarily prudent person in a like position" will sharply increase in the minds of judges and jurors. For this reason, directors will be wise to

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increase their inspection demands - and carefully make a record of such demands and inspections - in order to defend against potential future lawsuits.

An increase in directors' inspection demands will naturally create more disputes between individual directors and management. Moreover, with California's cumulative voting rules, California corporations are more likely to have dissident directors elected by unhappy shareholders blocks - leading to even more disputes over directors' inspection rights. Fortunately, Saline v. Superior Court provides the first clear appellate court guidance on the extent of a director's inspection rights under Corporations Code section 1602.

After finding the defendant corporation's evidentiary showing was "woefully inadequate," the Saline court announced the following rule: a director's "absolute" right to inspect corporate documents can only be limited "where a preponderance of the evidence establishes the director's clear intent to use the documents to commit an egregious tort--one that cannot be easily remedied by subsequent monetary damages--against the corporation." Saline, 122 Cal.Rptr. at 817. On the free speech side of the coin, the court further held that in the context of a director inspecting corporate documents under Corporations Code section 1602, there is "no legal basis for a prior restraint" on free speech. Id.

In other words, under nearly all circumstances, a corporation's management may not shut out a director from accessing corporate documents. Nor may a court place a prior restraint on a director's ability to disclose those document to whomever the director pleases - i.e., the "protective order" mechanism used to limit disclosure of documents produced in the discovery context does not apply to documents obtained via a corporate director's inspection rights.

The lesson for attorneys representing corporations is that they should advise their clients to comply with an inspection demand from one of the corporation's directors absent truly compelling facts that the director is out to harm the corporation. Attorneys representing individual directors should advise their clients that, even though the director has the absolute right to inspect all corporate documents, and may not be restrained beforehand from disclosing the documents, this does not give a director free reign to do whatever he or she pleases. Directors may still be liable for beach of fiduciary duty or similar torts should they improperly disclose truly confidential documents to the harm of the corporation.

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ABTL-Orange County Members Gather for a Reception while Attending the ABTL 29th Annual Seminar in Hawaii - Oct. 2002

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