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In Shareholder Derivative Suits, Determining What Law Governs Isn't Easy

By Keith Paul Bishop

When suing the directors of a Nevada corporation, it may seem to be a safe bet to assume that Nevada's corporation law applies even when the complaint is filed in California. After all, California Corporations Code Section 2116 provides that the directors of a foreign corporation transacting intrastate business are liable according to any applicable laws of the state of incorporation whether the directors committed acts in California or elsewhere. A safe bet, however, is still a bet. Sometimes it can even turn out to be the wrong bet.

This was illustrated by the Court of Appeal's recent opinion in *Kruss v. Booth*, 2010 DJDAR 8824 (June 11, 2010). This case involved a shareholder's derivative suit alleging breach of fiduciary duty on the part of the directors of VitroTech, a Nevada corporation. According to the opinion, VitroTech is a publicly traded corporation that is the product of a reverse merger of a private company and a public shell. The plaintiff's original complaint did not specify whether Nevada or California's corporate law applied to the suit. One of the defendants successfully demurred. In sustaining the demurrer, the trial court observed that the plaintiff had not pled the requirements of California Corporations Code Section 2115.

Section 2115 represents the California Legislature's most significant attempt to impose California corporate law standards so-called "pseudo-foreign" corporations. These are corporations organized in another state but that have their most significant business and shareholder connections to California. The statute operates by imposing specified provisions of the California General Corporation Law on these corporations to the exclusion of the law of the state of incorporation.

Following the successful demurrer by one of the defendants, the other defendants moved for judgment on the pleadings based on the theory that Nevada law (NRS 78.138) immunizes directors from liability unless it has been proven that there was intentional misconduct, fraud or a knowing violation of the law. The trial court granted the defendants' motion. The plaintiff responded with his first amended complaint. This time, the plaintiff specifically alleged that the corporation was subject to California law. The defendants demurred successfully with the judge ruling that Nevada law applied. The plaintiff therefore amended his complaint again, this time basing it on violations of Nevada law, including NRS 78.138. His final attempt was again unsuccessful.

The Court of Appeal disagreed, finding that the defendants had improperly attempted to try the question of the applicability of Section 2115 by demurrer. The court noted that when deciding a demurrer, both the trial and the appellate court were to accept all facts alleged in the complaint as true, and draw all reasonable inferences from those facts in favor of the plaintiff. The court then embarked on a lengthy and thoughtful discussion of the intricacies of Section 2115. This discussion is a "must read" for any litigation or transactional lawyer confronting the question of whether and when Section 2115 applies. Applying this analysis, the court concluded that the plaintiff must be given leave to amend his complaint to reallege the applicability of California law.

Notably, the Court of Appeal did not conclude that California law would ultimately apply to the case. In fact, the court said that it is entirely possible that at some later stage of the suit, it may be shown that Nevada law is the operative law. The reason for the contingent application of California law is due to the procedural context of the case (coming to the appellate court after the final demurrer without leave to amend).

There are some fundamental omissions in the Court of Appeal's analysis. Section 2115 does not impose the entirety of the California General Corporation Law on foreign corporations. Rather, Section 2115 requires a foreign corporation "to conform to certain kinds of [internal] corporate behavior as delineated in specified

sections of toe Corporations Code..." The defendants had invoked NRS 78.138, a statute that immunizes directors and officers of Nevada corporations from liability. The California analog to NRS 78.138 is Corporations Code Section 204(a)(10), a section not listed in Section 2115 as being applicable to a pseudo-foreign corporation. Thus, even if Section 2115 applies to a Nevada corporation, it does not expressly override NRS 78.138. So, the question should be whether NRS 78.138 must be pled as an element of cause of action against a director or officer or whether NRS 78.138 constitutes an affirmative defense. If it is former, then a trial court considering a demurrer should review the complaint to determine whether the plaintiff has sufficiently alleged that the defendants' actions constituted a breach of fiduciary duty and involved intentional misconduct, fraud or a knowing violation of the law as required for individual liability under NRS 78.138.

The Court of Appeal also refers repeatedly to self-dealing on the part of VitroTech's directors. The term "self-dealing" appears over a dozen times. Yet the court never acknowledges that California's self-dealing statute (Corporations Code Section 310) is not listed in Section 2115 as applying to foreign corporations. Thus, there should be no question that Nevada's statute (NRS 78.140) applies to the plaintiff's allegations of self-dealing regardless of whether VitroTech is subject to Section 2115.

Additionally, the opinion fails to mention whether the plaintiff attempted to elicit information from the corporation regarding its status as a pseudo-foreign corporation. Section 2115(f) requires that any corporation subject to Section 2115 to advise upon request from, among others, any shareholder of record whether it is subject to Section 2115. If a corporation fails to provide this information or provides incorrect information, the requesting party may obtain an award of attorneys' fees and costs. Thus, a shareholder could seek this information before filing suit and thereby take some of the guesswork out of the complaint. Although a corporation may be tempted either to not respond (which it is only required to do if it is subject to Section 2115) or to misstate the applicability of Section 2115, this temptation should be tempered by the possibility of liability for fees and costs.

Another problem is that the court states, without citation to any authority, that Section 2115 is an exception to Section 2116. Section 2116 was enacted at the same time as Section 2115 and immediately follows Section 2115. Therefore, it seems plausible to assume that the Legislature would have provided an exception in Section 2116 for corporations subject to Section 2115 had it intended that result. Because the legislature did not, it is logical to conclude that the legislature intended Section 2116 to apply to all foreign corporations without exception.

The opinion also does not consider whether Section 2115 should be enforced at all. In 2005, the Delaware Supreme Court invoked the "internal affairs doctrine" and refused to enforce Section 2115. *VantagePoint Venture Partners 1996 v. Examen Inc*. 871 A.2d 1108 (Del. 2005). See Keith Paul Bishop, "*The War Between the States - Delaware's Supreme Court Ignores California's Corporate 'Outreach' Statute*," 19 Insights 19 (2005). The internal affairs doctrine requires that matters involving the internal affairs of a corporation must be based on the law of the state of incorporation and not the law of the forum. While the Delaware high court stopped short of declaring Section 2115 unconstitutional, the court stated that the internal affairs doctrine is mandated by constitutional principles. The California courts, however, may be less ready to rule Section 2115 unconstitutional. See, e.g., *Valtz v. Penta Investment Corp*., 139 Cal.App. 3d 803(1983).

The opinion in *Kruss* is thoughtful and should provide counsel with a useful guide to Section 2115, particularly the complicated provisions of the statute governing when it applies. The opinion, however, is suffused with a tone that is highly critical of the defendants. Although hearing an appeal of an order sustaining a demurrer, the Court of Appeal seems to have already reached its conclusions about the defendants. The court seems to have adopted the plaintiff's allegations as facts rather than simply accepting those allegations as true for purposes of review on appeal. The plaintiff may ultimately prove his allegations, but he hasn't yet. It is also possible that the defendants will win or settle the case without admitting liability. If so, the only public record may be the Court of Appeal's opinion and defendants will have no place to go to get their good names back.

The effect of the *Kruss* opinion allows plaintiffs leeway to allege California's corporate law applies to foreign corporations. Defendants will have difficulty in challenging those allegations by demurrer, but may succeed in a motion for summary adjudication or in a bifurcated trial. This may lead to the seemingly odd situation in which sufficiency of a plaintiff's pleadings are tested under California law, but the law of another state is ultimately applied to the case.

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