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### Security for Expense Statutes: Easing Shareholder Hopelessness?

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# SECURITY FOR EXPENSE STATUTES: EASING SHAREHOLDER HOPELESSNESS?

*Miriam R. Albert\**

## ABSTRACT

The quintessential derivative suit is a suit by a shareholder to force the corporation to sue a manager for fraud, which is admittedly an awkward and likely unpleasant endeavor and, according to the Supreme Court, a “remedy born of stockholder helplessness.”<sup>1</sup> Where ownership and control of an enterprise are vested in the same population, the need for a corrective mechanism like a derivative suit is greatly lessened because the owner/managers’ self-interests will arguably guide managerial conduct. But where ownership and control are in separate hands, the incentives change, and managerial conduct may not conform to the owners’ views of the best course of action. This may lead to what the owners consider to be director misconduct. The existing corporate laws have not been effective in stopping this kind of director misconduct, so “stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust.”<sup>2</sup> In these situations, shareholders are arguably in need of legal strategies to protect themselves from abuses by management.

Presumably in an effort to limit the abuse of strike suits that would take up managerial time, resources, and corporate dollars, several significant procedural hurdles for derivative plaintiffs have arisen, including the requirement of contemporaneous share ownership—a requirement that derivative plaintiffs make a “demand” on the corporation, in particular, to take requested action—the lack of access to the discovery process, and compliance with any relevant security for expense statutes. Balancing the right of shareholders to hold their directors accountable against the need for directors to have the freedom and autonomy to discharge their statutory and fiduciary duties is no easy feat. That said, these hurdles, when combined, may

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1. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949).
2. *Id.*

erode or even undermine the ultimate utility of the derivative litigation process.

This Article provides an evaluation and analysis of one of the primary procedural roadblocks facing derivative plaintiffs as they seek to hold their corporations accountable: the security for expense statute. The Article compares existing security for expense statutes in nine states, while offering observations on those challenges present in the current statutes, as well as new challenges flowing from the statutes. The Article also evaluates the limited amount of case law flowing from the statutes, as part of an evaluation of the usefulness of this mechanism as a gatekeeper in derivative litigation. Finally, the Article provides recommendations for legislative reform and modifications to existing doctrine to help further the goals of shareholder empowerment through the derivative litigation process, while keeping the potential for strike suits in check.

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## INTRODUCTION

The quintessential derivative suit is one filed by a shareholder to force the corporation to sue a manager for fraud, which is admittedly an awkward and likely unpleasant endeavor and, according to the Supreme Court, a “remedy born of stockholder helplessness.”<sup>3</sup> The Court noted that in the absence of derivative litigation, directors were “not subject to an effective accountability,” thereby arguably creating incentives for directors to misbehave.<sup>4</sup> The derivative suit, thus, was “long the chief regulator of corporate management.”<sup>5</sup>

Stockholders who hold no concurrent management role are indeed limited in their arsenal to combat perceived managerial neglect or malfeasance. Other than exercising their voting rights to bring about a change in management, these shareholders are at the whim of their elected

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3. *Id.* at 548; see also John Matheson, *Restoring the Promise of the Shareholder Derivative Suit*, 50 GA. L. REV. 327, 334 (2016):

The crux of the derivative suit is that a shareholder seeks to have the corporation enforce supposed rights or claims that the corporation has not yet asserted . . . the historical focus of the derivative suit has been an attempt by shareholders to hold the corporate board or officers accountable for perceived harm to the corporation caused by a violation of their fiduciary duties.

4. *Cohen*, 337 U.S. at 547.

5. *Id.* at 548.

and appointment champions, subject to the not insignificant fiduciary duties imposed on these managers.<sup>6</sup>

Where ownership and control of an enterprise are vested in the same population, the need for a corrective mechanism like a derivative suit is greatly lessened because the owner/managers' self-interests will arguably guide managerial conduct. But where ownership and control are in separate hands, the incentives change and managerial conduct may not conform to the owners' views of the best course of action. This may lead to what the owners consider to be director misconduct. The existing corporate laws have not been effective in stopping this kind of director misconduct, so "stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust."<sup>7</sup> In these situations, shareholders are arguably in "need of legal [strategies] to protect them[selves] from abuses by [] management."<sup>8</sup>

While derivative suits have been characterized as "the chief regulator of corporate management"<sup>9</sup> and "the most important procedure the law has yet developed to police the internal affairs of corporations,"<sup>10</sup> this form of litigation has its share of critics and has generated some degree of controversy since its debut in the 1855 Supreme Court case *Dodge v.*

6. See Bryant G. Garth, Ilene H. Nagel & Sheldon J. Plager, *Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate*, 48 L. & CONTEMP. PROBS. 137 (Summer 1985).

When control and investment are separated, as is so often the case in the modern business corporation, the accountability of management to the shareholders becomes a central concern. This concern is triggered by, but not limited to, the shareholders' narrow pecuniary interest: it implicates notions of mutuality of consent, of fair dealing, and of moral responsibility to those over whom or over whose interests one has power. In this context the responsibilities of the corporate manager are often cast in terms of fiduciary duties—duties which historically have arisen out of relationships of trust and confidence.

*Id.* at 138.

7. *Cohen*, 337 U.S. at 548.

8. Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927 (1983).

9. *Cohen*, 337 U.S. at 548.

10. Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77 (1967) (quoting Eugene V. Rostow, *To Whom and for What Ends is Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY* 46, 48 (Edward Mason ed. 1959)).

*Woolsey*.<sup>11</sup> While derivative litigation offers shareholders the right to hold their directors accountable, this remedy itself also provides opportunities for abuse by the very shareholders the process seeks to protect.<sup>12</sup> Presumably in an effort to limit the abuse of strike suits that would take up both managerial time and resources, as well as corporate dollars, several significant procedural hurdles for derivative plaintiffs have arisen,<sup>13</sup> including the requirement of contemporaneous share ownership. Under this requirement, derivative plaintiffs must make a “demand” on the corporation, with particularity,<sup>14</sup> to take requested action without access to the discovery process,<sup>15</sup> and complying with any relevant

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11. *Dodge v. Woolsey*, 59 U.S. 331 (1855). Commentators agree that *Dodge v. Woolsey* was the first shareholder derivative lawsuit. See Larry Hamermesh, *A Most Adequate Response to Excessive Shareholder Litigation*, 45 HOFSTRA L. REV. 147, 152 (2016) (citing RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE SUITS: BESIEGING THE BOARD § 1.03 (2d ed. 2015) (“[T]he Supreme Court’s decision in *Dodge v. Woolsey*, firmly established the equitable jurisdiction of American courts to entertain shareholders’ derivative actions.”)); see also John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 261 n.2 (1981); Garth, et al., *supra* note 6.

12. According to the Supreme Court:

Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as ‘strike suits.’ And it was said that these suits were more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest was more often within the capacity and readiness of management to compromise than a large one.

*Cohen*, 337 U.S. at 548.

13. Garth et al., *supra* note 6, at 139.

14. Franklin S. Wood, the author of a comprehensive study of derivative suits that has come to be known as “The Wood Report” addresses this challenge: “[d]ealing now with the sufficiency of particular allegations, the mere allegation of demand and refusal to sue is insufficient, since it does not adequately establish the exhaustion of the plaintiff’s remedies before resort to equity.” FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS’ DERIVATIVE SUITS 59 (1944) [hereinafter *The Wood Report*].

15. “The difficulty of drawing a complaint on facts of which the plaintiffs have no first hand knowledge or sources of information was originally felt to warrant considerable lenience in judging the sufficiency of a complaint . . . This view is now believed to have been overruled.” *Id.* at 58. The current approach in most statutes requiring derivative plaintiffs to make a formal demand is to require specificity of facts. “The courts have come to recognize this [unfounded claims], to appraise such general and adverbial

security for expense statutes. Balancing the right of shareholders to hold their directors accountable against the need for directors to have the freedom and autonomy to discharge their statutory and fiduciary duties is no easy feat.<sup>16</sup> That said, these hurdles, when combined, may erode or even undermine the ultimate utility of the derivative litigation process.<sup>17</sup>

Some critics find that the idea that the shareholders could weigh in on managerial conduct outside of their franchise rights threatens the unquestioned control of the enterprise by its corporate managers.<sup>18</sup> And most agree that the attorneys bringing these suits are the real parties in interest in most cases.<sup>19</sup> So how can we balance the desire to help and

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allegations at their true value, and to apply increasing strictures upon general allegations with no specific facts in support of them.” *Id.* at 59.

16. See Matheson, *supra* note 3, at 330.

17. According to Professor Scott:

The result of all this seems to be an absurd state of affairs. Ringing statements on the sacredness of the management’s fiduciary responsibilities are accompanied by a series of impediments to their enforcement. Each obstacle has its own peculiar history and rationale, but their unifying theme purports to be fear of the ‘strike suit’—an unwarranted action brought by an attorney in order to be bought off for a sum that is less than the costs of defense.

Scott, *supra* note 8, at 942. According to Professor Matheson, “the current state of derivative litigation is encumbered by a series of primarily procedural impediments that make pursuit of the derivative claim unduly litigious and its successful prosecution practically impossible.” Matheson, *supra* note 3, at 331.

18. According to Garth et al.:

The emergence of the derivative suit as a major threat to unquestioned control of the business enterprise by corporate management has not gone unchallenged. The challenges have not been motivated simply by venal self-interest of managerial power-wielders. Managers understandably may question procedures that, in the risk-laden atmosphere of high finance and corporate business venture, could hold them to an ex post facto measure of the reasonableness of their judgments.

Garth et al., *supra* note 6, at 139.

19. According to Professor Scott:

The obvious difficulty with using derivative suits as a means of ex post settling up is the question of who will bring and pay for the suit. The corporation (which is to say its management) will not, at least not in good faith; people are not strongly motivated to sue themselves, and the loyalty actions we are concerned with necessarily implicate members of the control group as defendants. The individual small shareholder in the public corporation will not; he would bear 100% of the risk and expense in return for an infinitesimal share of the benefit that will redound to all of the shareholders. This free rider problem, which otherwise would defeat enforcement of fiduciary duties, has been surmounted in practice by giving the plaintiff’s attorney the right to obtain attorney’s fees if successful. Thus, in the typical case, the attorney becomes the real party in interest, and the suing stockholder becomes a nominal or figurehead plaintiff.

empower shareholders to hold their corporations accountable with the need for managerial freedom and discretion to discharge their fiduciary duties without spurious and time-wasting litigation?

This Article provides an evaluation and analysis of one of the primary procedural roadblocks facing derivative plaintiffs as they seek to hold their corporation accountable: the security for expense statute. An immutable truth about litigation is that it is costly—for all parties. The cost of potential litigation can be an insurmountable roadblock to seeking one's day in court, particularly if the relevant state law requires the plaintiff to post security.

The theory behind these security for expense statutes is that they will act as a sieve and somehow weed out strike suits that have no merit. A major problem is that these suits have no true metric to determine which suits are in fact meritorious.<sup>20</sup> They all use a percentage of stock or market value of stock owned, arguably as some sort of proxy for thoughtful and meritorious litigation. The theory implicitly assumes that stockholders with less than the required threshold will not bring meritorious claims; the sole metric to determine if a shareholder is acting in good faith and, thus, should be permitted a day in court, is the amount of stock owned.<sup>21</sup> The idea presumes that a major shareholder has a financial interest in not wasting corporate time and resources on a frivolous claim and may be deterred from posting the required bond.<sup>22</sup> It does not follow, however, that minority shareholders necessarily lack the same financial incentives.<sup>23</sup> The amount of stock, or even the market value of one's stock,

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Scott, *supra* note 8, at 940.

20. Justice Hanson, writing for the District Court of Appeal for the Second District of California about the then-current California security for expense statute noted:

The test laid down by the statutes as to one who has participated in some act complained of does not turn on whether the suit is or is not a "strike" suit but whether there is a reasonable probability that its prosecution against the moving party will or will not prove of ultimate benefit to the corporation or its security holders. The statute does not distinguish between so-called strike suits and those that are generally classed as being bona fide. The distinction between such suits is however well known and, indeed, recognized by statutes of like tenor in other states. Accordingly, we must assume the legislature was fully cognizant of those statutes and intended by the statute it enacted not to differentiate between the two types of suits.

Wood v. Gordon, 246 P.2d 84, 86 (Cal. Dist. Ct. App. 1952).

21. Hamermesh, *supra* note 11, at 156–57.

22. *Id.*

23. According to Professor Hamermesh:



is not a perfect proxy for a metric to measure whether a particular shareholder will be wasting corporate time and money. Yet, shareholders whose holdings are below the relevant statutory threshold are required to provide security in order for their claims to move forward.

Part I provides necessary background on derivative suits generally. Part II examines and compares the nine existing security for expense statutes, offering observations on those challenges present in the current statutes and those new challenges flowing from these statutes. This Part also evaluates the limited amount of case law flowing from these statutes, as part of an evaluation of the usefulness of this mechanism as a gatekeeper in derivative litigation. Part III provides recommendations for legislative reform and modifications to existing doctrine that will help further the goals of shareholder empowerment through the derivative litigation process, while keeping the potential for strike suits in check.

## I. DERIVATIVE LAWSUITS GENERALLY

One of the first examinations of the derivative suit came in the form of a comprehensive study by the Chamber of Commerce of the State of New York in the mid-1940s, known as the “Wood Report.”<sup>24</sup> In his letter introducing the report to the Special Committee on Corporate Litigation

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[T]here is nothing in the statute that assures that a holder or a group of holders with sufficient shares to avoid the bond requirement will have resources or motivations adequate to ensure an informed, deliberate, and disinterested assessment of the merits of the litigation. If only because of collective action problems, it seems eminently possible that disaggregated stockholders will underinvest in efforts to evaluate and then support meritorious litigation; and, it seems equally possible that stockholders with enough shares to avoid the bond requirement but, without the inclination to invest in evaluating derivative claims, could choose to support litigation that lacks merit. In sum, what the New York security for expense statute lacks is any assurance that the persons (other than plaintiff’s counsel) whose decisions determine whether a bond is required will expend any resources to evaluate the quality of the derivative claims to be pursued.

Hamermesh, *supra* note 11, at 156.

24. The Wood Report covered all derivative suits filed in the Supreme Court of New York and in the U.S. District Court for the Southern District of New York between 1932 and 1942, and those derivative suits filed in the Supreme Court of Kings County between 1938 and 1942. Wood noted that “about sixty percent of the more substantial cases [were] found to be conducted by a limited group of attorneys and law firms,” and that the representative plaintiffs had very small stakes in the outcome. He then concluded that the lawyers bringing these suits made “the ambulance-chaser by comparison a paragon of propriety.” *The Wood Report*, *supra* note 14, at 47.

of the Chamber of Commerce of the State of New York, author Robert Wood set out the scope of the report and shed light on the issues leading up to his engagement to prepare the report:

I have undertaken and been engaged since shortly prior to September 1, 1942, in an investigation and survey of litigation by minority stockholders of corporations with a view to providing an adequate basis of fact research to determine the advisability of possible changes in law or procedure which would facilitate the correction of wrongdoing in corporate affairs but reduce groundless and costly litigation of this type.<sup>25</sup>

Wood noted the “outstanding fact derived” from his survey to be an observation that most stockholder derivative suits in his study were unsuccessful and unfounded.<sup>26</sup> Wood concluded that the financial results of these suits were not favorable to the plaintiffs, and that the real party in interest were the lawyers bringing the suits.<sup>27</sup> According to Garth et al., “[Wood’s] conclusions thus led to a call for reform, culminating in widespread adoption of the requirement of security for expense in derivative suits.”<sup>28</sup>

One of the primary recommendations from the Wood Report was that New York lawmakers enact a security for expense statute, with the goal of effecting “a proper differentiation between actions involving privately held and publicly held corporations and insure some responsibility in the bringing of such actions in the latter instances where

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25. *The Wood Report*, *supra* note 14, at 1.

26. As per Wood:

Because of the large recoveries had in a few instances involving nationally known corporations, the enormous fees awarded plaintiffs’ attorneys in those cases and the resulting newspaper publicity, there has been a definite tendency on the part of the public and the bar to assume a ratio of success in these actions not in accord with the record. In direct consequence of this general misconception, the common attitude on the part of laymen and lawyers has been, while admitting the abuses in this field of litigation, to condone them as necessary evils or as outweighed by the assumed beneficial effects of such litigation. The record of these cases should demonstrate the fallacy of this last assumption, and without that all excuses for further indulgence of the abuses fails.

*The Wood Report*, *supra* note 14, at 112.

27. Wood did not have kind words for the shareholder derivative bar, referring to the “shoddy burlesque of a professional relationship to clients [that] makes the ambulance-chaser by comparison a paragon of propriety.” *The Wood Report*, *supra* note 14, at 47.

28. Garth et al., *supra* note 6, at 142-43.

the plaintiffs' stockholdings are too small to indicate legitimate personal interest in the outcome and accordingly in the bringing of the action."<sup>29</sup>

Commentators have made note of both the Wood Report's influence, its "clear anti-shareholder bias,"<sup>30</sup> and "its confidence in the security for expense device as the exclusive safeguard against abusive practices in shareholder derivative litigation."<sup>31</sup>

Wood referenced and rejected several proposals that he did not feel would advance his goal.<sup>32</sup> The first such proposal was to create a committee of a lawyer, a director, and an accountant who would be available to advise plaintiff stockholders in a non-binding fashion.<sup>33</sup> Wood correctly concluded that the non-binding nature of such committee's recommendations "render it impotent against the strike suit"<sup>34</sup> and stockholders' attorneys are "not likely to be given pause by the recommendations of the committee."<sup>35</sup>

The second proposal that Wood rejected is the idea of some sort of preliminary court hearing to determine whether the derivative suit should be permitted to proceed.<sup>36</sup> He again concludes, correctly, that such an approach would "either be inadequate from the plaintiff's standpoint, or double burdensome from the defendants'."<sup>37</sup>

Wood also considered a proposal that actions by stockholders with less than five percent of stock outstanding should be put to a shareholder vote at stockholder meetings.<sup>38</sup> His reasons for rejecting this proposal stemmed from his concern that this might allow majority stockholders to ratify their own wrongdoing.<sup>39</sup> Wood concluded that:

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29. *The Wood Report*, *supra* note 14, at 21.

30. PAUL J. GALANTI, SECURITY FOR EXPENSE STATUTES, 19 IND. PRAC., BUS. ORGS. § 38.25 (2017).

31. *Id.*

32. *The Wood Report*, *supra* note 14, at 22-23.

33. *Id.* at 22.

34. *Id.* at 23.

35. *Id.*

36. *Id.*

37. "It would not be *res adjudicata* in another forum; it would inevitably involve a costly reference, and since it would not be final, there would always be a disinclination to deny trial on facts short of defenses which would warrant dismissal on motion." *Id.*

38. *Id.*

39. *Id.* at 24.

[i]deally and theoretically the real determination as to whether suit on a particular corporate claim should or should not be brought should rest with the stockholders. If the transaction were one which it was beyond the power of a majority of stockholders to ratify, and if a substantial percentage of the stockholders agreed that suit should be brought, few would deny that it would be maintained without any security for costs or imposition of costs in the event of failure. On the other hand, no practicable way appears at present to insure such appeal and determination by the stockholders. In the meantime analogy to the safeguards already provided with respect to actions by bondholders for accountings, actions by creditors in a corporation reorganization proceedings and other similar situations where the fiction of the right of one to represent all may give rise to an undue temptation to indulge in litigation for the private profit of the fees involved, seems to indicate an extension of the same principle to stockholders' derivative actions as the logical, fairest, most workable and at the same time broadest solution for the entire problem.<sup>40</sup>

His ultimate conclusion and recommendation for a security for expense statute honored his goal and allowed the shareholders to determine whether to move forward in any given case, "safeguarded by the requirement that the plaintiff have a legitimate interest in the subject-matter and assume reasonable responsibility in the way of costs in the event of failure."<sup>41</sup> Wood's idea was that a "legitimate interest in the subject matter" could be satisfied by some threshold of stock ownership.<sup>42</sup> This idea is the cornerstone of all of the current security for expense statutes which began to be adopted following the Wood Report in an effort to discourage non-meritorious strike suits, starting with New York in 1944.<sup>43</sup>

## II. SECURITY FOR EXPENSE STATUTES

### A. GOALS AND CHALLENGES OF THESE STATUTES

Following the Wood Report, the New York business community succeeded in pressing for a security for expense statute that created

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40. *Id.* at 117.

41. *Id.* at 116–17.

42. *Id.*

43. Garth et al., *supra* note 6; see also Donna I. Dennis, *Contrivance and Collusion: The Corporate Origins of Shareholder Derivative Litigation in the United States*, 67 RUTGERS L. REV. 1479, 1519 (2015).

liability for the corporation's reasonable expenses if the derivative suit failed. The statute requires a posting of security for reasonable expenses by shareholders filing a derivative suit who own less than a set percentage or dollar amount of shares.

Since the enactment of the New York security for expense statute, a number of states have enacted similar statutes for various periods of time.<sup>44</sup> Nine states currently have enacted security for expense statutes.<sup>45</sup> In these states, defendants in derivative suits are authorized to seek a court order to require derivative plaintiffs to post a bond to secure such expenses before the suit goes forward.<sup>46</sup>

Most of the security for expense statutes are structured the same way: the defendant, which always includes the subject corporation but may also include other defendants (presumably directors and officers) may move to compel the plaintiff to post a bond to cover the defendants' reasonable expenses if the plaintiff's shares do not meet any relevant statutory minimum in terms of the percentage of ownership and/or market value.<sup>47</sup> The required minimum share ownership ranges from \$25,000 in Arkansas, Colorado, and North Dakota to \$250,000 in New Jersey.<sup>48</sup> California is the only state with a ceiling, limiting the bond to no more than \$50,000, regardless of the number of defendants.<sup>49</sup>

The goal of these statutes was to deter baseless derivative suits, or nuisance suits.<sup>50</sup> Reasonable minds can differ on whether this has proven true.<sup>51</sup> Evaluating whether this goal has been satisfied is challenging. The case law exploring these statutes is quite limited. Perhaps this makes sense in that these statutes may have become a practical reality for potential plaintiffs who do not want to confront additional economic risk in litigation. These statutes put risks on plaintiffs not typically imposed in

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44. Florida, Hawaii, Maryland, Nebraska, New Hampshire, Tennessee, Texas, Washington, Wisconsin, and Wyoming all had previously enacted security for expense statutes but have since eliminated the provisions. DEBORAH A. DEMOTT, SHAREHOLDER DERIV. ACTIONS L. & PRAC. §§ 3.1, 3.2 (2017-2018).

45. See *infra* Part II.c.

46. DEMOTT, *supra* note 44, § 3.2.

47. See *infra* Part II.c.

48. *Id.*

49. *Id.*

50. DEMOTT, *supra* note 44, § 3.1.

51. "The present trend appears to be away from reposing great confidence in the ability of security requirements to deter strike suits." *Id.*

the United States where the general rule is that each side bears its own litigation fees.<sup>52</sup>

Most security for expense statutes go beyond only requiring the bond and create potential liability for the full amount of a successful corporation's costs and expenses, including, in most cases, attorney's fees.<sup>53</sup>

The timing of these statutes can also create issues for plaintiffs. Requiring plaintiffs to post the bond far in advance of the outcome of the litigation may be difficult for even the most well-intentioned and honorable derivative plaintiff who is light on funds. These statutes may impose a greater economic risk on the plaintiff rather than simply requiring plaintiffs to pay the successful defendants' expenses after the final resolution of the case.<sup>54</sup>

#### B. MODEL BUSINESS CORPORATION ACT

The Model Business Corporation Act of 1971 (MBCA) contained a security for expense provision that applied only to derivative suits and required any plaintiff owning less than five percent of the outstanding shares of any class or stock with a market value in excess of \$25,000 to "give security for the reasonable expenses."<sup>55</sup> This five percent threshold is followed in seven of the current statutes.<sup>56</sup> Over forty years later, the \$25,000 market value metric has continued in three of today's security for expense statutes, putting into question the value of this dollar figure as a

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52. According to Professor DeMott:

The significance of security for expense statutes is that, in the cases to which they apply, the plaintiff confronts a substantial economic risk should the defendants prevail in the action. This risk is one that is not typically imposed on the plaintiff in the United States; the "American" rule generally is that, with a few exceptions, both parties bear their own litigation expenses, including, most importantly, attorney fees, and that the court does not shift the prevailing party's attorney fees to the nonprevailing party at the termination of the litigation.

*Id.*

53. GALANTI, *supra* note 30, § 38.25.

54. DEMOTT, *supra* note 44, § 3.1.

55. *Id.*

56. These states are Alaska, Arkansas, Colorado, New Jersey, New York, North Dakota, and Pennsylvania. *See infra* Part II.c.

true proxy for anything about the relevant shareholders in those three states.<sup>57</sup>

The 1971 provision did not explicitly provide for defendants other than the corporation to move for plaintiffs to provide security; some of the security for expense statutes do provide this, with language referring to the corporation “or other defendant,” thereby empowering directors or officers sued in a derivative suit to either move to demand security themselves, or at least to empower the corporation to include the expenses of these directors or officers in its motion for security.<sup>58</sup>

The 1971 provision provides that the amount of security can be changed over time at the discretion of the court.<sup>59</sup> It gives the corporation recourse to the security upon the termination of the action, whether or not the action was brought without reasonable cause, a concept that also shows up in some of the current security for expense statutes.<sup>60</sup>

Most states have some statutory provisions dealing with shareholder derivative claims against for-profit corporations. Yet, only nine states currently have security for expense statutes.<sup>61</sup> Eleven states have eliminated their security for expense statutes since 1986,<sup>62</sup> and North Carolina added a statute for derivative suits against directors of public corporations.<sup>63</sup> The nine current security for expense statutes have a number of similarities, which makes sense since they are all based in large part on the security for expense provision in the MBCA.<sup>64</sup> The statutes

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57. These states are Arkansas, Colorado, and North Dakota. *See* ARK. CODE ANN. § 4-26-714(c)(1) (2018); COLO. REV. STAT. § 7-107-402(3) (2018); N.D. CENT. CODE § 10-19.1-86(2) (2017).

58. MODEL BUS. CORP. ACT ANN. § 49 (AM. BAR ASS’N, 1971).

59. *Id.*

60. *Id.*

61. *See infra* Part II.c.

62. Arizona, Florida, Hawaii, Maryland, Nebraska, New Hampshire, Tennessee, Texas, Washington, Wisconsin, and Wyoming. DEMOTT, *supra* note 44, § 3.2.

63. *See* N.C. GEN. STAT. § 55-7-48(3)(2018) (stating that if a court so orders, a plaintiff may be required to deposit a written undertaking with sufficient surety against expenses reasonably expected to be incurred by a corporation, including expenses by way of indemnity).

64. The language of the 1971 security for expense statute is as follows:

In any action now pending or hereafter instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of record of less than five [percent] of the outstanding shares of any class of such corporation or of voting trust certificates therefor[e], unless the shares or voting trust certificates so held have a market value in excess of twenty-five thousand dollars, the corporation in whose right

generally allow corporations, and sometimes individual defendants, to request that derivative plaintiffs post a bond to provide security for the defendant corporation's expenses, including attorney's fees, in the event the defendants are successful.<sup>65</sup> Successful defendants "may have recourse to the security if they prevail in the litigation, although some statutes limit recourse to those cases which the court determines were brought without reasonable cause."<sup>66</sup>

The current version of the MBCA contains a chapter dealing with derivative proceedings, which includes requirements for standing,<sup>67</sup>

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such action is brought shall be entitled at any time before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including fees of attorneys, that may be incurred by it in connection with such action or may be incurred by other parties named as defendant for which it may become legally liable. Market value shall be determined as of the date that the plaintiff institutes the action or, in the case of an intervenor, as of the date that he becomes a party to the action. The amount of such security may from time to time be increased or decreased, in the discretion of the court, upon showing that the security provided has or may become inadequate or is excessive. The corporation shall have recourse to such security in such amount as the court having jurisdiction shall determine upon the termination of such action, whether or not the court finds the action was brought without reasonable cause.

MODEL BUS. CORP. ACT ANN. § 49 (AM. BAR ASS'N, 1971).

65. See DEMOTT, *supra* note 44, § 3.2.

66. See *id.* § 3.1. "In several states, if the court after final judgment finds that the action was brought 'without reasonable cause,' a statute authorizes the court to require the plaintiff to pay the defendants' reasonable expenses incurred in the defense of the action, including the defendants' attorneys fees." *Id.* These state statutes include: ARIZ. REV. STAT. ANN. § 10-049(B) (1975); FLA. STAT. § 607.147(4) (repealed 1990); GA. CODE ANN. § 14-2-123(f); N.C. GEN. STAT. § 55-55(e); N.D. CENT. CODE § 10-19.1-86(1)(2017); N.M. STAT. ANN. § 53-11-47(B); TEX. BUS. CORP. ACT. ANN. art 5.14(J)(1)(b) (expired 2010); WASH. REV. CODE § 23A.08.460 (repealed 1990); WIS. STAT. § 180.0746 (2) (2018).

67. The MBCA has standing requirements for derivative plaintiffs, including contemporaneous ownership. See MODEL BUS. CORP. ACT § 7.41 (2016). A number of states have adopted this provision and require contemporaneous ownership. See, e.g., MICH. COMP. LAWS § 450.1492a (2018); ME. STAT. tit. 13-C, § 752 (2018). Some states have adopted a softer version of this, allowing the court to use its discretion to permit suits to go forward in the absence of contemporaneous ownership. See, e.g., ALASKA STAT. § 10.06.435 (2017); CAL. CORP. CODE § 800 (West 1982); 15 PA. CONS. STAT. § 1782 (2016). Section 7.41 also requires that derivative plaintiffs must "fairly and adequately represent[] the interests of the corporation in enforcing the right of the corporation." MODEL BUS. CORP. ACT § 7.41 (2016). A number of state statutes require this as well. See, e.g., MICH. COMP. LAWS § 450.1492a (2018); ME. STAT. tit. 13-C, § 752 (2018).



making a demand,<sup>68</sup> judicial stays of derivative proceedings,<sup>69</sup> dismissal of derivative suits,<sup>70</sup> and discontinuance or settlement of derivative suits.<sup>71</sup> The MBCA drops the security for expense provision and instead authorizes the court to order payment of expenses in three different scenarios.<sup>72</sup> First, the court may order the corporation to pay the successful derivative plaintiff's expenses if it determines that the proceedings resulted in a "substantial benefit to the corporation."<sup>73</sup> The MBCA does not specifically include attorney's fees as a repayable expense, but neither does it specifically exclude attorney's fees.<sup>74</sup> The purpose of this first scenario is to "discourage a plaintiff from proposing inconsequential matters to justify the payment of counsel fees."<sup>75</sup>

The second scenario is a successful defendant, in which case the court may order the plaintiff to pay the defendant's expenses in defending the proceeding, if it determines that the proceeding was either commenced or maintained "without reasonable cause" or for an "improper purpose."<sup>76</sup> This provision is "intended to discourage proceedings brought for the sole purpose of obtaining early settlement payments by defendants to avoid

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The introductory language of section 7.41 refers both to the commencement and maintenance of the proceeding to make it clear that the proceeding should be dismissed if, after commencement, the plaintiff ceases to be a shareholder or a fair and adequate representative. The latter would occur, for example, if the plaintiff were using the proceeding for personal advantage. If a plaintiff no longer has standing, courts have in a number of instances provided an opportunity for one or more other shareholders to intervene.

MODEL BUS. CORP. ACT § 7.41 cmt. (2016).

68. The MBCA requires all shareholders to make a written demand, to "eliminate[] the time and expense of litigating whether demand is required." *See* MODEL BUS. CORP. ACT § 7.42 (2016); *id.* § 7.42 cmt.

69. MODEL BUS. CORP. ACT § 7.43 (2016).

70. *Id.* § 7.44.

71. *Id.* § 7.45.

72. *Id.* § 7.46.

73. *Id.* § 7.46(1).

74. *See id.* § 7.46 (2016).

75. This provision "does not specify the method for calculating attorneys' fees given that there is a substantial body of case law that delineates this issue, which usually includes taking into account the amount or character of the benefit to the corporation." MODEL BUS. CORP. ACT § 7.46 cmt. (2016).

76. *Id.* § 7.46(2).

significant defense costs, while also protecting plaintiffs whose suits have a reasonable foundation.”<sup>77</sup>

The final scenario allows the court to order either party to pay the other’s expenses because of the filing of a pleading, motion, or other paper if the court determines that such pleading, motion, or paper was not “well grounded in fact” or warranted by existing law, or was “interposed for an improper purpose,” such as harassment or delay.<sup>78</sup> This provision “addresses other abuses in the conduct of derivative litigation which may occur on the part of the defendants and their counsel as well as by the plaintiffs and their counsel. This provision may be unnecessary if these abuses are already addressed under applicable rules of civil procedure.”<sup>79</sup>

More than forty states have general security for expense statutes that require unsuccessful plaintiffs to pay the defendants’ costs.<sup>80</sup> Most include some or all of the current MBCA provisions.

### C. ANALYSIS OF CURRENT SECURITY FOR EXPENSE STATUTES

Nine states currently have security for expense statutes that include or are exclusively applicable to derivative suits. A brief description of each statute follows, with a summary of relevant case law involving the statutes. The case law is modest in terms of number, scope, and significance. Early litigation found these statutory schemes constitutional.<sup>81</sup> The absence of robust litigation on whether and how much bond to post may indicate that, in the years since the enactment of the first security for expense statutes, the concept has been woven into the fabric of the shareholder experience.

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77. *Id.* § 7.46 cmt.

78. *Id.* § 7.46(3).

79. *Id.* § 7.46 cmt.

80. DEMOTT, *supra* note 44, § 3.3.

81. In *Cohen v. Beneficial Indust. Loan Corp.*, 337 U.S. 541 (1949), the Supreme Court held that security for expense statutes do not violate either the due process or equal protection clauses of the Constitution, although these statutes clearly can result in different treatment for different plaintiffs, depending on their shareholdings. At least one state case raised constitutional grounds to set aside a security for expense statute: in *Moran v. Murtaugh Miller Meyer & Nelson, LLP*, 152 P. 3d 416 (Cal. 2007), the plaintiff argued that the requirement to post such security was unconstitutional and discriminated against the plaintiffs of “modest means.” The court rejected this contention as well, as this would allow any security requirement statute to be held unconstitutional if a party cannot afford to post the security.

1. Alaska<sup>82</sup>

Alaska's security for expense statute allows both the subject corporation and other defendants (presumably directors and/or officers) to move the court to require that certain derivative plaintiffs "give security" for the reasonable expenses that such moving party or parties might incur.<sup>83</sup> These expenses explicitly include attorney's fees.<sup>84</sup> These defendants can make this motion at any time before final judgment.<sup>85</sup>

The Alaska statute requires contemporaneous ownership by derivative plaintiffs, absent court intervention based on the merits.<sup>86</sup> The statute requires a plaintiff to make a formal demand, unless grounds exist for excusing such a demand.<sup>87</sup> Court approval is required before a derivative suit can be "discontinued, abandoned, compromised, or settled."<sup>88</sup>

Derivative plaintiffs subject to the security posting provision are those holding less than five percent of any class of the corporation's stock.<sup>89</sup> Unlike most other security for expense statutes, the Alaska statute does not provide an alternate metric to avoid posting a bond for stockholders owning stock in excess of some stated financial value. There is no fixed dollar cap for the amount of the bond, which can be increased

82. ALASKA STAT. § 10.06.435(h) (2017).

83. *Id.*

84. *Id.*

85. *Id.*

86. ALASKA STAT. § 10.06.435(b) provides:

A shareholder who does not meet the requirements of this section may be allowed in the discretion of the court to maintain the action on a preliminary showing to and determination by the court, by motion and after a hearing at which the court considers evidence, by affidavit or testimony, as it considers material, that:

- (1) there is a strong prima facie case in favor of the claim asserted on behalf of the corporation;
- (2) no other similar action has been or is likely to be instituted;
- (3) the plaintiff acquired the shares before there was disclosure to the public or to the plaintiff of the wrongdoing of which the plaintiff complains;
- (4) unless the action can be maintained the defendant may retain a gain derived from a defendant's wilful [sic] breach of a fiduciary duty; and
- (5) the requested relief will not result in unjust enrichment of the corporation or a shareholder of the corporation.

*Id.* § 10.06.435(b).

87. *Id.* § 10.06.435(c).

88. *Id.* § 10.06.435(i).

89. *Id.* § 10.06.435(h).

or decreased “from time to time in the discretion of the court upon a showing that the security has become inadequate or excessive.”<sup>90</sup>

The Alaska statute specifically provides that the court may award reasonable expenses, including attorney’s fees, to successful plaintiffs if “anything is received as a result of the judgment, compromise, or settlement of that action.”<sup>91</sup>

Alaska case law flowing from the security for expense statute is sparse. Only four Alaska cases reference the statute at all, and these courts never discuss the security for expense requirement, other than to note that it had not been satisfied and, thus, the suit in question should be dismissed.<sup>92</sup>

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90. *Id.*

91. *Id.* § 10.06.435(j).

92. In *Jerue v. Millett*, 66 P.3d 736 (Alaska 2003), shareholders brought a derivative action against directors after the state issued a certificate of involuntary dissolution. The lower court dismissed the case as moot following the reinstatement of the corporation and shareholders meeting, denied shareholder’s request for attorney’s fees and costs, and awarded attorney’s fees to the directors. The shareholders did not make a pre-suit demand and did not establish demand excusal as required by the statute. The Alaska Supreme Court, however, did not use the security for expense statute in its analysis and instead focused on determining who was a “prevailing party” to be awarded attorney’s fees under Civil Rule 82. Because the shareholders failed to satisfy the statutory standard for a derivative action, the defendant directors were deemed to be the prevailing parties but the plaintiffs did not have to make a demand under the security for expense statute since the derivative suit was not going forward. *See also* *Erickson v. Wolf*, No. 3AN-04-13743CI, 2008 WL 8589631 (Alaska Sept. 26, 2008) (holding that filing a derivative lawsuit without posting the bond required based on plaintiffs’ shareholdings of less than five percent triggered dismissal of the derivative claims but allowed the non-derivative claims to continue). In *Holmes v. Wolf*, No. S-13641, 2011 WL 6046407 (Alaska Nov. 30, 2011), the court dismissed the derivative claim when the shareholders failed to file the required bond; the case proceeded with only the shareholders’ claims against the three directors directly. The Alaska Supreme Court did not address the Alaska security for expense statute in its analysis. *See also* *Ivy v. Calais Co., Inc.*, 2008 WL 9337985 (Alaska Super. May 5, 2008) (dismissing plaintiff’s derivative action for failing to meet the procedural requirements of the Federal Rules of Civil Procedure Section 23.1 and the Alaska Statute Section 10.06.435). The order did not specify which procedural requirements were not met, but the court did allow the plaintiff an opportunity to refile. The second amended complaint filed by plaintiff alleged that the aggrieved shareholders owned 6.25 percent of the company’s shares and 18.75 percent of the company’s assets. These ownership levels make it unlikely that the security for expense statute was even part of the reasoning for dismissing the case.

2. *Arkansas*<sup>93</sup>

Arkansas has a security for expense statute that allows both the subject corporation and “any defendant” (presumably directors or officers) to move the court to require that certain derivative plaintiffs “furnish security”<sup>94</sup> for probable reasonable expenses that such moving party might incur.<sup>95</sup> These expenses explicitly include attorney’s fees.<sup>96</sup> The statute is silent on the timing of any such motion, other than to say that the motion must be “upon notice and hearing.”<sup>97</sup>

The Arkansas statute requires absolute contemporaneous ownership by derivative plaintiffs (with no provision for court intervention based on the merits found in the Alaska and California statutes).<sup>98</sup> The statute permits courts, upon a finding that the action was brought “without reasonable cause,” to require a plaintiff to pay reasonable expenses, including attorney’s fees of the defendants;<sup>99</sup> the statute also requires court approval before a derivative suit can be “dismissed or compromised.”<sup>100</sup> The Arkansas Rules of Civil Procedure carry additional requirements for derivative proceedings, parallel to Federal Rule of Civil Procedure 23.1, including a requirement that plaintiffs make a formal demand.<sup>101</sup>

Derivative plaintiffs subject to the security posting provision are those holding less than five percent of any class of the corporation’s stock and \$25,000 or less of the corporation’s stock.<sup>102</sup> There is no fixed dollar cap for the amount of the bond, which can “from time to time be increased or decreased in the discretion of the court upon a showing that the security provided has or may become inadequate or is excessive.”<sup>103</sup>

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93. See ARK. CODE ANN. § 4-26-714(c) (2018). The statute is superseded in part by ARK. R. CIV. P. 23.1 Actions by Shareholders.

94. *Id.* § 4-26-714(c)(1).

95. *Id.* § 4-26-714(c)(3).

96. *Id.*

97. *Id.* § 4-26-714(c)(1).

98. *Id.* § 4-26-714(a).

99. *Id.* § 4-26-714(b).

100. *Id.* § 4-26-714(d).

101. ARK. R. CIV. P. 23.1.

102. ARK. CODE ANN. § 4-26-714(c)(1).

103. *Id.* § 4-26-714(c)(7).

The motion for security must show either (a) that there is no “reasonable possibility” that the suit will benefit the corporation or its security holders, or (b) that the moving party did not participate in the transaction complained of “in any capacity.”<sup>104</sup> Once filed, this motion stays the proceedings until ten days after the motion has been decided.<sup>105</sup>

The statute makes it clear that failure to provide security when ordered is fatal for the plaintiff’s case.<sup>106</sup> The moving parties will have access to the security “in such amount as the court shall determine upon the termination of the action.”<sup>107</sup>

Like Alaska, Arkansas case law flowing from the security for expense statute is sparse. No Arkansas cases even mention the security for expense requirement.

### 3. California<sup>108</sup>

California’s security for expense statute allows both the subject corporation and any other defendant, specified in the statute as an officer or director (or former officer or director) to move the court to require certain derivative plaintiffs to “furnish a bond” for the reasonable expenses that such moving party might incur.<sup>109</sup> These expenses explicitly include attorney’s fees.<sup>110</sup> The defendants must bring this motion within thirty days after service of summons on the moving party.<sup>111</sup>

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104. *Id.* § 4-26-714(c)(2). This second ground is not available to the corporation. *Id.* § 4-26-714(c)(2)(B).

105. *Id.* § 4-26-714(c)(9).

106. Subsection 8 says:

If the court makes a determination that security shall be furnished by the plaintiff for the benefit of any one (1) or more defendants, the action shall be dismissed as to such defendant unless the security required by the court shall have been furnished within such reasonable time as may be fixed by the court.

ARK. CODE ANN. § 4-26-714(c)(8).

107. ARK. CODE ANN. § 4-26-714(c)(6).

108. CAL. CORP. CODE § 800(c), (d) (West 1982). “Few statutes in California are asked to do the kind of heavy lifting that is required of Corporations Code Section 800. Fewer than 1,000 words in length, Section 800 represents the sum total of all legislation on the subject of shareholder derivative litigation in California.” Charles J. Greaves, *The Unique Issues in Shareholder Derivative Litigation*, L.A. LAW. 16, 16 (Dec. 2002).

109. CAL. CORP. CODE § 800(c), (d) (West 1982).

110. *Id.* § 800(d).

111. However, the court may, for good cause, extend this thirty-day period for an additional period of up to sixty days. *Id.* § 800(c). The reality is that if a plaintiff’s bond

The California statute requires contemporaneous ownership by a plaintiff, absent court intervention, based on both the merits of the claim and the plaintiff's allegation with particularity of its efforts to get the corporation to take the plaintiff's desired course of action and written notice to the corporation or board of the cause of action.<sup>112</sup>

The motion for security must show either (a) there is no "reasonable possibility" that the suit will benefit the corporation or its shareholders, or (b) that the moving party did not participate in the complained of transaction "in any capacity."<sup>113</sup> Filing this motion stays the proceedings until ten days after the motion has been decided.<sup>114</sup>

The statute makes it clear that a ruling by the court on the motion for security "shall not be a determination of any issue in the action or of the merits thereof."<sup>115</sup> Despite this language, if the motion for security is granted, it likely ends the lawsuit. Why would any rational derivative plaintiff agree to post \$50,000 after the court decided the suit indicated that either there is no reasonable possibility of success or that the defendant was not involved in the complained-of act in any capacity?<sup>116</sup>

Unlike most other security for expense statutes, the California statute does not require court approval for a derivative suit to be settled. In addition, there is no statutory threshold amount of stock that must be held by plaintiffs to satisfy the California statute. Rather, the court has discretion to require any plaintiff to provide security.<sup>117</sup> If the motion is granted, the court will establish the amount of security for reasonable

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is sought in a shareholder derivative action, it is likely because "the corporation's board of directors has, in response to the plaintiff's demand, already determined that prosecution of the action is not in the best interests of the corporation." Greaves, *supra* note 108, at 17. See *Davis Family Capital Partners, Inc. v. Comte*, No. G046254, 2013 Cal. App. Unpub. LEXIS 2213 (Mar. 26, 2013). In *Davis*, the plaintiffs filed a derivative action. The trial court ordered the plaintiffs to post a bond of \$50,000, and subsequently dismissed their complaint. The plaintiffs argued that the motion to require the bond was filed over seven months after the original complaint, far exceeding the thirty-day limit, and was thus untimely. The court rejected this argument, however, because the second amended complaint was filed one month before the defendants' motion for the security for expense and therefore was considered to be timely.

112. CAL. CORP. CODE § 800(b) (West 1982).

113. *Id.* § 800(c). This second ground is not available to the corporation. *Id.*

114. *Id.* § 800(f).

115. *Id.* § 800(d).

116. See Greaves, *supra* note 108, at 17.

117. CAL. CORP. CODE § 800(d) (West 1982).

expenses, including attorney's fees, not to exceed \$50,000.<sup>118</sup> This threshold is an aggregate and the court cannot require a greater bond, even if there are multiple defendants or causes of action.<sup>119</sup>

California courts have noted that a goal of this statute is "to give the corporation security against groundless suits on the part of shareholders"<sup>120</sup> and to "prevent unwarranted shareholder derivative lawsuits."<sup>121</sup> California courts have provided guidance with respect to the scope and meaning of this statute.<sup>122</sup> Several of the main issues are discussed below.

a. Can a California Derivative Plaintiff Be Required to Furnish \$50,000 in Security for Each of Multiple Defendants?

The statutory aggregate of \$50,000 is the total amount one derivative plaintiff can be required to post, regardless of the number of individual defendants.<sup>123</sup> The statute uses the word "aggregate" when referencing the required bond: derivative plaintiffs must "furnish a bond in the aggregate amount of fifty thousand dollars (\$50,000) to secure the reasonable expenses of the parties."<sup>124</sup> However, the literal wording of the statute does not clearly indicate that this is the total for any and all defendants, collectively. Defendants have argued that, as a result, an ambiguity exists about whether the \$50,000 is a cap per defendant or if it is a cap on the total amount the derivative plaintiff can be asked to furnish.<sup>125</sup>

In *Hale v. Southern California IPA Medical Group, Inc.*,<sup>126</sup> the derivative plaintiff sued the defendant corporation and its individual directors. Each defendant moved for the plaintiff to post bond pursuant to

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118. *Id.*

119. *Hale v. S. Cal. IPA Med. Grp., Inc.*, 103 Cal. Rptr. 2d 773, 778 (Cal. Ct. App. 2001).

120. *Barber v. Lewis & Kaufman, Inc.*, 269 P.2d 929, 931 (Cal. Dist. Ct. App. 1954).

121. *Donner Mgmt. Co. v. Schaffer*, 48 Cal. Rptr. 3d 534, 538 (Cal. Ct. App. 2006).

122. "Because the statutory scheme governing shareholder derivative actions in California is skeletal, and because these actions are equitable in nature, the courts have played a prominent role in shaping the substantive law and procedure in this area." Greaves, *supra* note 108, at 18.

123. CAL. CORP. CODE § 800(d) (West 1982).

124. *Id.* § 800(e).

125. *See Hale v. S. Cal. IPA Med. Grp., Inc.*, 103 Cal. Rptr. 2d 773, 774 (Cal. Ct. App. 2001).

126. *Id.*



Section 800, and the trial court held that the plaintiff was required to furnish security for each defendant, totaling a bond of \$250,000.<sup>127</sup> According to the defendants, the “underlying public policy manifest by Corporations Code Section 800 is to discourage frivolous shareholder derivative litigation . . . Placing an artificial ceiling of an aggregate totally ignores the underlying purpose of the statute and adds the word ‘aggregate’ where the legislature pointedly deleted it.”<sup>128</sup> When the plaintiff failed to post the \$250,000 bond, the trial court dismissed the case, and the plaintiff appealed.<sup>129</sup> The court found ambiguity in the statute in that subdivision (d) is silent on whether the language “not to exceed fifty thousand dollars” is applicable to *each* individual defendant or if it applies to the maximum amount without regard to the number of defendants.<sup>130</sup> The court looked to the wording of subdivision (e) “in the aggregate amount of fifty thousand dollars,”<sup>131</sup> which the court interpreted to mean that a bond of \$50,000 fully satisfies the plaintiff’s statutory obligation.<sup>132</sup> The court supported its interpretation by noting that “absurdity could result” if plaintiffs were required to post up to \$50,000 in security for *each* defendant in a derivative suit.<sup>133</sup> Moreover, the court found that the legislative history of the most recent amendment to Section 800, which removed an explicit cap in subdivision (d), was not intended to be a substantive change to that provision.<sup>134</sup> A comment to the amendment reading “[t]he other changes in Section 800 are technical” further supported the court’s contention that the maximum amount of bond security to be posted is \$50,000, even though subdivision (d) does not explicitly say so.<sup>135</sup> Thus, the court overturned the dismissal for the plaintiff’s failure to post the \$250,000 bond because it exceeded the statutory maximum of an *aggregate* of \$50,000.

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127. *Id.* at 774.

128. *Ruling Guts State Bond Law, Directors Tell California High Court*, 16 No. 14 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. 5 (April 23, 2001).

129. *Hale*, 103 Cal. Rptr. 2d at 774.

130. *Id.* at 775.

131. CAL. CORP. CODE § 800(e) (West 1982).

132. *Hale*, 103 Cal. Rptr. 2d at 775.

133. *Id.* at 776.

134. *Id.* at 777-78.

135. *Id.* at 778.

b. Is the \$50,000 Aggregate Maximum Security Also a Limit on Total Liability for Defendant Expenses Payable by Derivative Plaintiffs?

The \$50,000 figure in the statute is both the maximum bond a derivative shareholder can be required to post and also the maximum liability such shareholder will accrue, regardless of the actual expenses of a successful defendant or defendants.

In *West Hills Farms, Inc. v. RCO Ag Credit, Inc.*,<sup>136</sup> a derivative plaintiff was required to, and furnished, a \$50,000 bond, but eventually lost the case because it could not prove demand futility. The successful defendant corporation wanted payment from the plaintiff of all of its reasonable expenses and attorney's fees, regardless of the amount of the plaintiff's bond.<sup>137</sup> The appellate court noted the essential purpose of the statute as "a deterrent to unwarranted shareholder derivative lawsuits."<sup>138</sup> Moreover, the court pointed out that Section 800(d) expressly limits, in plain language, the amount of the bond to be posted at \$50,000 to cover litigation expenses incurred by the defendant.<sup>139</sup> The court distinguished Section 800, a "bond or security statute," from an "open-ended attorney fee liability statute," noting that the former defines the particular relief available.<sup>140</sup> It also explains that the statute makes no mention of attorney's fees except in subdivision (d) which is limited in context to what the bond is intended to cover.<sup>141</sup> The appellate court found nothing in the language of the statute to support the notion that it was "intended to create an independent basis for recovery . . . apart from recourse to the bond."<sup>142</sup> The court then analyzed the relevant case law and found it to be in agreement with the premise that Section 800 was a security for expense statute and not a liability statute, which means the only recourse available is the amount of the bond, if one was posted.<sup>143</sup> The court therefore refused to write into the statute something that was not there and

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136. 88 Cal. Rptr. 3d 458 (Cal. Ct. App. 2009) (quoting *Donner Mgmt. Co. v. Schaffer*, 48 Cal. Rptr. 3d 534, 540 (Cal. Ct. App. 2006)).

137. *Id.* at 459.

138. *Id.* at 461.

139. *Id.* at 460.

140. *Id.* at 462.

141. *Id.*

142. *Id.*

143. *Id.* at 463-64.

confirmed the trial court's finding that the defendant was only entitled to the amount of the bond posted by the plaintiffs.<sup>144</sup>

c. What Are the Ramifications of a Derivative Plaintiff Voluntarily Posting Bond Under Section 800(e)?

Once a derivative plaintiff voluntarily posts bond, defendants have no responsibilities under the statute. That said, the California courts explore whether the derivative plaintiff is the "prevailing party."<sup>145</sup> Voluntarily posting bond does not absolve the derivative plaintiff from the other statutory responsibilities like contemporaneous ownership or making the required demand.<sup>146</sup>

Section 800(e) authorizes derivative plaintiffs to voluntarily post bond before the court orders them to do so:

(e) If the plaintiff shall, either before or after a motion is made pursuant to subdivision (c), or any order or determination pursuant to the motion, furnish a bond in the aggregate amount of fifty thousand dollars (\$50,000) to secure the reasonable expenses of the parties entitled to make the motion, the plaintiff has complied with the requirements of this section and with any order for a bond therefore made, and any such motion then pending shall be dismissed and no further or additional bond shall be required.<sup>147</sup>

Plaintiffs who choose to get ahead of a court order to post bond may do so for strategic reasons, such as avoiding a delay in the litigation because of court proceedings on the bond issue since Section 800(f) provides that if a defendant moves to require a bond, the prosecution of the action "shall be stayed until ten days after the motion has been disposed of."<sup>148</sup>

In *Donner Management Company v. Schaffer*, the derivative plaintiff voluntarily posted a \$50,000 bond to avoid a discovery stay.<sup>149</sup> After the

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144. *Id.* at 464.

145. *See, e.g., Donner Mgmt. Co. v. Schaffer*, 48 Cal. Rptr. 3d 534, 535 (Cal. Ct. App. 2006) (holding that the defendant was the "prevailing party for purposes of an attorney fees award based on the security").

146. *Id.* at 541.

147. CAL. CORP. CODE § 800(e) (West 1982).

148. *Id.* § 800(f).

149. 48 Cal. Rptr. 3d at 536.

defendant's special litigation committee found that going to trial would be detrimental to the company, the plaintiff moved for a motion to dismiss without prejudice, which was granted.<sup>150</sup> One of the defendants moved for attorney fees to be paid from the \$50,000 bond posted by the plaintiff.<sup>151</sup> The trial court awarded the fees because it determined that this defendant was a "prevailing party."<sup>152</sup> Since the statute does not use or define the term "prevailing party," California courts have avoided using a "rigid definition" and left the decision up to the trial courts to determine whether a party has prevailed "on a practical level."<sup>153</sup> Because the special litigation committee found that the lawsuit would not be successful, the trial court exercised appropriate discretion to determine the defendants

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150. *Id.*

151. *Id.*

152. *Id.* at 535.

153. *Id.* at 542. In *Anderson v. Ingargiola*, a derivative plaintiff voluntarily posted a \$50,000 security bond. No. A112267, 2006 Cal. App. Unpub. LEXIS 6764, at \*2-3 (Cal Ct. App. Aug. 3, 2006). A year later, the parties settled the matter, with the court entering a judgment against the defendants, in favor of the plaintiff. *Id.* The settlement order included a \$50,000 award to the plaintiff, but the plaintiff was not permitted to recover fees and costs. *Id.* at \*3-4. After the settlement was entered, defendants moved to enforce liability on the security bond because the plaintiff recovered personally and no benefit was given to the corporation or shareholders. The plaintiff filed a "Satisfaction of Debt and Release" stating that the \$50,000 award was considered satisfied and there were no further obligations of the defendants. *Id.* at \*4. The trial court granted the defendants' motion to enforce liability on the bond because the plaintiff could not have obtained judgment on the derivative cause of action, thus finding defendants were entitled to recovery of the bond pursuant to Section 800 even when they were not the prevailing party. *Id.* at \*4. The appellate court affirmed, analyzing what it means to be a "prevailing party" when the plaintiff technically prevails but the suit brings no benefit to the corporation or its shareholders. *Id.* at \*5-6. The court also stated that prevailing defendants are entitled to enforce a bond, but that prevailing plaintiffs may not always be able to avoid enforcement of the bond. *Id.* The parties' decision to settle, according to the court, was one of temporal resolution and not an "adjudication of either liability or damages." *Id.* at \*7. Moreover, the fact that a judgment was entered did not establish that the plaintiff's allegations had validity to qualify one party as prevailing over the other. *Id.* The court went on to point out that even if the settlement exposed any kind of liability, which it did not, it would only be liable to the plaintiff individually and not to the corporation or shareholders. *Id.* at \*6-8. Therefore, since no liability from the cause of action was imposed by the settlement, the defendants' motion to enforce the bond was allowed. *Id.* at \*6-8, \*11.

were the prevailing party and, thus, were entitled to the attorney fees out of the bond posted by the plaintiff.<sup>154</sup>

The plaintiff argued that fees should not be awarded until after it has been determined there was no reasonable possibility the lawsuit would benefit the corporation, as required by Section 800(c)(1).<sup>155</sup> The court found that when a plaintiff voluntarily posts security, as the plaintiff did here, a defendant need not make any further showing to collect beyond being a prevailing party.<sup>156</sup> Here specifically, the defendant did not need to make the showing that there is no reasonable possibility of benefit to the corporation.<sup>157</sup>

The court also acknowledged that it would be awkward to address the reasonableness issue at the *close* of litigation, because the decision about whether the litigation benefits the corporation is effectively made when the case is over or dismissed, as it was in this case.<sup>158</sup>

In *Shields v. Singleton*, the derivative plaintiff voluntarily posted the \$50,000 security bond but the trial court ruled that the plaintiff failed to make the required demand.<sup>159</sup> The plaintiff appealed, arguing that voluntarily posting the bond somehow obviated the demand requirement.<sup>160</sup> The plaintiff argued that the statute's use of "section" as opposed to "subdivision" or "subsection" meant the legislature intended a voluntary bond to essentially remove the standing requirements in Section 800(b).<sup>161</sup> The court looked to the California legislature's revisions of Section 800, along with its predecessor, and determined the use of "section" instead of "subsection" was not intended to change the purpose of the statute, which was to "facilitate the prosecution of legitimate derivative claims."<sup>162</sup>

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154. *Donner Mgmt. Co.*, 48 Cal. Rptr. 3d at 543.

155. *Id.* at 537.

156. *Id.* at 539.

157. *Id.* at 541.

158. *Id.* at 540-41 (emphasis added).

159. 19 Cal. Rptr. 2d 459, 462-63 (Cal. Ct. App. 1993).

160. *Id.* at 463.

161. *Id.* at 463-64.

162. *Id.* at 464-65.

## d. Does a California Derivative Plaintiff Have to Pay the Defendants' Costs if No Bond is Ever Posted?

In *Alcott v. M. E. V. Corporation*, the derivative plaintiff unsuccessfully sued the defendant corporation and individual defendants.<sup>163</sup> The defendants never sought security to be posted pursuant to Section 800, but attorney's fees were awarded to them.<sup>164</sup> The trial court awarded the requested fees and the plaintiffs appealed, arguing that attorney's fees cannot be awarded under Section 800 when no security bond was posted by the plaintiff.<sup>165</sup>

The appellate court agreed with the plaintiff and rejected the defendant's argument that an amendment to Section 800 in 1982 "transmuted" a security statute into a liability statute; because no security was posted, the plaintiffs are not responsible for the fees, at least pursuant to Section 800.<sup>166</sup>

4. Colorado<sup>167</sup>

Colorado's security for expense statute allows the subject corporation to move the court to require certain derivative plaintiffs to "give security for the costs and reasonable expenses" that such moving party might incur.<sup>168</sup> These moving parties may include "other parties named as defendant."<sup>169</sup> These expenses explicitly exclude attorney's fees.<sup>170</sup> This motion may be brought at any time before final judgment.<sup>171</sup>

The Colorado statute requires contemporaneous ownership by a plaintiff (with no provision for court intervention based on the merits found in the Alaska and California statutes).<sup>172</sup> The Colorado Rules of Civil Procedure add additional requirements for derivative proceedings,

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163. 238 Cal. Rptr. 520, 521 (Cal. Ct. App. 1987).

164. *Id.* at 521-22.

165. *Id.*

166. *Id.*

167. COLO. REV. STAT. § 7-107-402(3) (1994).

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* § 7-107-402(1).

paralleling Federal Rule of Civil Procedure 23.1, including the requirement that a plaintiff make a formal demand.<sup>173</sup>

Derivative plaintiffs subject to the security posting provision are those holding less than five percent of any class of the corporation's stock and \$25,000 or less of the corporation's stock.<sup>174</sup> There is no fixed dollar cap for the amount of the bond, which can be "from time to time . . . increased or decreased, in the discretion of the court, upon showing that the security provided has or may become inadequate or is excessive."<sup>175</sup> Unlike other security for expense statutes, the Colorado statute does not require court approval for a derivative suit to be settled.<sup>176</sup>

Unlike the California statute, the Colorado statute provides that if the court determines that the derivative "action was commenced without reasonable cause," the corporation shall have recourse to the security upon termination of the action.<sup>177</sup> If the "costs and expenses exceed the amount of the bond or if no bond is posted," the derivative plaintiff must "pay the costs and reasonable expenses directly attributable to the defense" of the derivative suit, excluding attorney's fees.<sup>178</sup>

No Colorado case law discusses the security for expense statutes.

### 5. Nevada<sup>179</sup>

Nevada's security for expense statute allows both the subject corporation and any other defendant, specified in the statute as an officer, director, or former officer or director, to move the court to require certain derivative plaintiffs to "furnish security" for the reasonable expenses that such moving party might incur.<sup>180</sup> These expenses explicitly include attorney's fees.<sup>181</sup> Like the California statute, the Nevada statute requires

173. See FED. R. CIV. P. 23.1(b)(3); COLO. R. CIV. P. 23.1.

174. COLO. REV. STAT. § 7-107-402(3).

175. *Id.*

176. See generally COLO. REV. STAT. § 7-107-402.

177. *Id.* § 7-107-402(3).

178. Jolyn J. Moses, *Shareholders' Derivative Action*, in 1 COLO. PRACTICE, METHODS OF PRACTICE § 2:66 (7th ed. 2018).

179. NEV. REV. STAT. § 41.520 (1997).

180. *Id.* § 41.520(3)-(4).

181. *Id.* § 41.520(4)(b).

that this motion be brought within thirty days after service of a summons on the moving party.<sup>182</sup>

The Nevada statute requires absolute contemporaneous ownership by a plaintiff (with no provision for court intervention based on the merits found in the Alaska and California statutes).<sup>183</sup> The Nevada statute and the Nevada Rules of Civil Procedure add additional requirements for derivative proceedings, paralleling Federal Rule of Civil Procedure 23.1, including a requirement that the plaintiff make a formal demand.<sup>184</sup>

Similar to the California statute, the Nevada statute does not provide a threshold amount of stock that must be held by plaintiffs to satisfy the statute and avoid posting security.<sup>185</sup> Rather, the court has discretion to require any plaintiff to provide security.<sup>186</sup> If the motion is granted, the court will establish the amount of security for reasonable expenses, but without a cap as provided in the California statute.<sup>187</sup>

As in the California statute, under the Nevada statute, the motion for security must show either (a) “[t]hat there is no reasonable possibility that the . . . [suit] will benefit the corporation or its security holders,”<sup>188</sup> or (b) “[t]hat the moving party . . . did not participate in the transaction complained of in any capacity.”<sup>189</sup> Filing this motion stays the proceedings until ten days after the motion has been decided.<sup>190</sup>

If a court determines after a hearing that the moving party established a probability in support of either of the statutory grounds, the court decides “the nature and amount of security to be furnished by the plaintiff for reasonable expenses, including attorney’s fees . . . .”<sup>191</sup> The amount of security can be increased or decreased by the court’s discretion upon a showing that the security provided “has or may become inadequate or is

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182. *Id.* § 41.520(3). However, as in the California statute, the court may, for good cause, extend this thirty-day period for an additional period of up to sixty days. *Id.*

183. *Id.* § 41.520(2).

184. *Id.*; NEV. R. CIV. P. 23.1; *see* FED. R. CIV. P. 23.1(b)(3). Like the Federal Rule of Civil Procedure 23.1(b)(3), the Nevada statute also requires derivative plaintiffs to make a demand. NEV. REV. STAT. § 41.520(2).

185. NEV. REV. STAT. § 41.520.

186. *Id.* § 41.520(3).

187. *Compare id.* § 41.520(4)(b), with CAL. CORP. CODE § 800(d) (West 1982).

188. *Id.* § 41.520(3)(a).

189. *Id.* § 41.520(3). This second ground is not available to the corporation. *Id.*

190. *Id.* § 41.520(5).

191. *Id.* § 41.520(4)(b).



excessive.”<sup>192</sup> The statute makes it clear that failure to provide security when ordered is fatal to a plaintiff’s case.<sup>193</sup>

The corporation and the moving party may have recourse to the security upon termination of the action.<sup>194</sup> The statute makes it clear that a ruling by the court on the motion for security “shall not be deemed a determination of any one or more issues in the action or of the merits thereof.”<sup>195</sup> Unlike most other security for expense statutes, the Nevada statute does not require court approval for a derivative suit to be settled.

Only one case has addressed the Nevada statute.<sup>196</sup> In *In re Cook*, the derivative plaintiffs filed a motion to dismiss the derivative claims.<sup>197</sup> The defendant objected, not necessarily to the claims being dismissed, but instead contended that the plaintiffs should be required to post bond pursuant to the Nevada statute to cover the defendant’s attorney’s fees.<sup>198</sup> The court declined to require a bond and acknowledged that, under the terms of the statute, the bond is not an automatic right and requires a court to make certain determinations before ordering such security to be posted.<sup>199</sup> Here, the plaintiffs moved for dismissal before any such demand for security was made, thus, before the hearing required by the statute to determine if the bond should be ordered, and if so, how much.<sup>200</sup> The court then determined that Section 41.520(2) is applicable to derivative suits only, and once such a suit is dismissed, the statute no longer applies.<sup>201</sup>

### 6. New Jersey<sup>202</sup>

New Jersey has a security for expense statute that allows the subject corporation to move the court to require certain derivative plaintiffs to “give security for the reasonable expenses” that such moving party might

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192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.*

196. *In re Cook*, 444 B.R. 207 (Bankr. D.N.M. 2011).

197. *Id.* at 208.

198. *Id.* at 208-10.

199. *Id.* at 209.

200. *Id.*

201. *Id.* at 209-10.

202. N.J. REV. STAT. § 14A:3-6.8 (2013).

incur.<sup>203</sup> These other parties may include “other parties named as defendant.”<sup>204</sup> Under the statute, expenses explicitly include attorney’s fees.<sup>205</sup> This motion may be brought at any time before final judgment.<sup>206</sup>

The New Jersey statute requires absolute contemporaneous ownership by a plaintiff (with no provision for court intervention based on the merits, as found in the Alaska and California statutes).<sup>207</sup> And derivative plaintiffs must “fairly and adequately represent [] the interests of the corporation” in the action<sup>208</sup> and must make a formal demand.<sup>209</sup> Before a derivative suit can be “discontinued or settled,” court approval is required.<sup>210</sup>

Derivative plaintiffs subject to the security posting provision are those holding less than five percent of any class of the corporation’s stock and \$250,000 or less of the corporation’s stock.<sup>211</sup> There is no fixed dollar cap for the amount of the bond.<sup>212</sup>

Upon termination of the suit, the court can order the corporation to pay the plaintiffs’ expenses if it finds that the derivative proceeding resulted in a “substantial benefit” to the corporation.<sup>213</sup> If the court finds that the suit was commenced or maintained without the exercise of “reasonable diligence by the plaintiff, or without reasonable cause or for

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203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

207. *See* ALASKA STAT. § 10.06.435(B) (1989); CAL. CORP. CODE § 800(b)(1) (West 1982); N.J. REV. STAT. § 14A:3-6.2 (2013). According to the Senate Commerce Committee Statement:

Current law provides that a shareholder cannot commence a derivative proceeding unless the shareholder was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time. The bill retains this requirement and adds to it the requirement that the shareholder remain a shareholder throughout the derivative proceeding. The bill also provides that a shareholder may not maintain a derivative proceeding unless the suit fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

S. Commerce Comm. Statement, Senate Bill, No. 2326-L.2013, Jan. 14, 2013.

208. N.J. REV. STAT. § 14A:3-6.2 (2013).

209. *Id.* § 14A:3-6.3.

210. *Id.* § 14A:3-6.6.

211. *Id.* § 14A:3-6.8.

212. *See generally id.* § 14A:3.

213. *Id.* § 14A:3-6.7(1).

an improper purpose,” the court can order the plaintiff to pay the defendant’s expenses in defending the proceeding.<sup>214</sup> Unlike the California statute, which has a ceiling dollar amount, the New Jersey statute allows for the full amount of such expenses to be paid.<sup>215</sup> And finally, the court can order either party to pay the other’s expenses for filing pleadings, motions, or other papers frivolously.<sup>216</sup>

No New Jersey cases explore the security for expense process.

### 7. New York<sup>217</sup>

New York’s security for expense statute allows the subject corporation to move the court to require certain derivative plaintiffs to “give security for the reasonable expenses” that the corporation might incur.<sup>218</sup> The statute permits the corporation to request a bond on behalf of “the other parties [sic] defendant,” presumably officers and directors, to cover any fees “for which the corporation may become liable under this chapter, under any contract or otherwise under law . . .”<sup>219</sup> These expenses explicitly include attorney’s fees.<sup>220</sup> This motion may be brought at any time before final judgment.<sup>221</sup>

The New York statute requires contemporaneous ownership by a plaintiff (with no provision for court intervention based on the merits, as found in the Alaska and California statutes).<sup>222</sup> Derivative plaintiffs must

214. *Id.* § 14A:3-6.7(2)-(3).

215. *Compare* CAL. CORP. CODE § 800(d) (West 1982), *with* N.J. REV. STAT. § 14A:3-6.7 (2013).

216. The statute provides that the court may:

(3) order a party to pay an opposing party’s expenses incurred because of the filing of a pleading, motion or other paper, if it finds that the pleading, motion or other paper was not well grounded in fact, after reasonable inquiry, or warranted by existing law or a good faith argument for the extension, modification or reversal of existing law and was interposed for an improper purpose, such as to harass or cause unnecessary delay or needlessly increase the cost of litigation.

N.J. REV. STAT. § 14A:3-6.7(3) (2013).

217. N.Y. BUS. CORP. LAW § 627 (McKinney 2018).

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. N.Y. BUS. CORP. LAW § 626(b) (McKinney 2018); *see also* ALASKA STAT. § 10.06.435(b) (1989); CAL. CORP. CODE §§ 800(b)(1), (b)(2) (West 1982).

make a formal demand.<sup>223</sup> Court approval is required before a derivative suit can be “discontinued, compromised or settled.”<sup>224</sup>

Derivative plaintiffs subject to the security posting provision are those holding less than five percent of any class of the corporation’s stock and \$50,000 or less of the corporation’s stock.<sup>225</sup> There is no fixed dollar cap for the amount of the bond, which can be increased or decreased from time to time, “in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.”<sup>226</sup>

Upon termination of the suit, the corporation shall have recourse to the security posted “in such amount as the court having jurisdiction of such action shall determine . . .”<sup>227</sup>

New York courts have noted that a goal of the five percent ownership threshold is to protect corporations from the “abuse of derivative actions instituted by stockholders having small or minuscule interests in a large corporation” since “stockholder[s] motivated by personal gain instead of the welfare of the corporation” would be deterred by the threshold from bringing a frivolous action.<sup>228</sup> New York courts have provided guidance with respect to the scope and meaning of this statute.<sup>229</sup>

#### a. When is it Too Late for Defendants to Move for Security?

The language of the statute permits this motion to be brought “at any stage of the proceedings before final judgment.”<sup>230</sup> In interpreting this language, courts have held that “the corporation’s entitlement to security for the reasonable expenses incurred in the action terminates with the entry of a final judgment.”<sup>231</sup> In *Shapiro v. Rockville Country Club, Inc.*, the defendants moved for plaintiff to post bond, but the action was dismissed before any judicial determination, since the defendant board’s

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223. N.Y. BUS. CORP. LAW § 626(c).

224. *Id.* § 626(d).

225. *Id.* § 627.

226. *Id.*

227. *Id.*

228. *Roach v. Franchises Int’l, Inc.*, 300 N.Y.S.2d 630, 633 (N.Y. App. Div. 1969).

229. *See id.* at 633-34.

230. N.Y. BUS. CORP. LAW § 627.

231. *Shapiro v. Rockville Country Club, Inc.*, 802 N.Y.S.2d 717, 720 (N.Y. App. Div. 2005).

decisions were found to be reasonable.<sup>232</sup> The defendants, however, made a motion for leave to renew the prior motion regarding the posting of bond by the plaintiff after the dismissals, which the plaintiff appealed.<sup>233</sup> The court interpreted the language of Section 627 to clearly mean “the corporation’s entitlement to security for the reasonable expenses incurred in the action terminates with the entry of a final judgment.”<sup>234</sup> The court then entered final judgment in the defendant’s favor before the defendant’s motion to renew the bond.<sup>235</sup>

b. When Does the Court Calculate the Five Percent Ownership Stake: At “Any Stage of the Proceeding?”

New York courts have made clear that the calculation of ownership for purposes of the security for expense requirement cannot be done after the suit is filed, and thus must be made at the time the derivative suit is filed.<sup>236</sup> This makes implicit sense, and also should foreclose opportunistic behavior by defendant corporations issuing stock simply to trigger a security for expense for derivative plaintiffs. The timing requirement should also foreclose efforts by plaintiffs to buy more stock after filing the derivative suit to avoid posting a bond.

There is no New York case law in which a court considers decrease in stock ownership after the filing of the derivative suit for the purpose of Section 627. The reverse is true as well; if plaintiff is below five percent when filing the complaint, subsequent stock acquisition during the pendency of the suit will not discharge the obligation to post security.<sup>237</sup>

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232. *Id.* at 719-20.

233. *Id.*

234. *Id.* at 720.

235. *Id.* at 719-20.

236. *See, e.g.,* Tyler v. Gas Consumers Association, 229 N.Y.S.2d 169, 170-71 (N.Y. Sup. Ct. 1962) (granting the corporate defendant’s cross motion to dismiss for plaintiff’s failure to fulfill the terms of the order for security on the basis that he personally acquired additional shares after commencement of the action and after the order for security was entered).

237. *See* Haberman v. Tobin, 626 F.2d 1101, 1104 (2d Cir. 1980) (holding that the acquisition of stock over the statutory threshold after the commencement of a shareholder derivative action is insufficient to avoid security for expense under Section 627); *see also* Tyler, 229 N.Y.S.2d at 170-71 (holding that plaintiff failed to fulfill the terms of the court’s order for security on the basis that he acquired additional stock after the action was commenced).

In *Roach v. Franchises International, Inc.*,<sup>238</sup> the derivative plaintiff owned more than five percent of the defendant corporation's stock when the suit was filed. Thereafter, the corporation issued more stock, purportedly to raise money for operating expenses to retire a bank loan.<sup>239</sup> The plaintiff did not buy any of the new stock, claiming that the additional stock issuance was undertaken instead to win the bond motion by diluting the plaintiff below the five percent threshold to post bond.<sup>240</sup> The defendants argued that the statutory language permitting the motion for security to be brought "at any stage of the proceedings before final judgment" somehow also applies to the minimum ownership threshold necessary to avoid security for expense.<sup>241</sup> The court rejected this contention and interpreted that the language does nothing more than "permit the making of the application for security by the corporation at any time before judgment and is not an inflexible direction . . ."<sup>242</sup> Therefore, the plaintiffs, at the time the action commenced, satisfied the statutory threshold and the motion for security for expense was correctly denied.<sup>243</sup>

*Dingle v. Xtenit, Inc.*<sup>244</sup> provides a similar scenario and result. The minority shareholder plaintiff brought a shareholder derivative action while owning five percent or more of the defendant's stock. The defendant responded by increasing its outstanding common stock from 10,000,000 shares to 500,000,000 shares, offering the new shares to officers and future employees of the corporation, excluding, of course, the plaintiff.<sup>245</sup> The defendant then filed a motion to dismiss, on grounds that included plaintiff's failure to post the required bond.<sup>246</sup> The court rejected the defendant's argument that the plaintiff needed to post a bond, because the actions outlined in the complaint were the very actions that caused the plaintiff's ownership percentage to drop below the five percent threshold.<sup>247</sup> The court felt that this alone was enough to demonstrate that

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238. *Roach v. Franchises Int'l, Inc.*, 300 N.Y.S.2d 630, 631 (N.Y. App. Div. 1969).

239. *Id.*

240. *Id.* at 631-32.

241. *Id.* at 632-33 (internal citation omitted).

242. *Id.* at 634.

243. *Id.* at 635-36.

244. 2008 N.Y. Slip Op. 51587(U) (N.Y. Sup. Ct. 2008).

245. *Id.* at \*1.

246. *Id.* at \*2-3.

247. *Id.* at \*5.

the suit was not a “baseless strike suit[.]” to serve the interests of a minority shareholder, as opposed to the interest of the company.<sup>248</sup> The court cited case law that did not require the plaintiffs to post bond when their ownership interest was originally over the statutory threshold and was only diluted, during the pendency of the proceeding, as a result of an act by the corporation.<sup>249</sup> Since the plaintiff owned fifteen percent at the time of the complaint, no bond was required to be posted.<sup>250</sup>

c. Can Derivative Plaintiffs Aggregate Ownership to Get Over the Five Percent Threshold?

The statute is silent on this issue, but courts have opined that the language in the statute “unless the plaintiff or plaintiffs hold five percent or more” allows for plaintiffs to aggregate their shares with intervenors.<sup>251</sup> But the aggregation must be done before the lawsuit is filed so that the plaintiffs “hold” the necessary stock ownership when filing the derivative complaint.<sup>252</sup>

In *Miller v. Victor*,<sup>253</sup> after the defendant moved for security for expense, the plaintiff joined another shareholder as an additional party so their combined interests would be above the five percent statutory minimum. The court found this action to be too late to prevent the security for expense requirement.<sup>254</sup>

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248. *Id.*

249. *Id.*

250. *Id.*

251. *See, e.g.*, *Miller v. Victor*, No. 14-cv-1819 (PKC), 2015 WL 892276, at \*1-2 (S.D.N.Y. Mar. 2, 2015).

252. *Id.* at \*2. According to Professor DeMott:

The problems raised by aggregation stem from the interplay between the contemporaneous ownership requirement and the exemption provisions in security for expense statutes. The plaintiff, in order to satisfy the contemporaneous ownership rule, must have owned some shares in the company as of the time of the occurrence of the wrong alleged in the suit; to be exempt from the security for expense requirements, the original plaintiff and any intervenors must own shares in excess of the threshold amount or percentage set by the statute. The problem is whether the purpose of the contemporaneous ownership rule is frustrated if the plaintiff can be exempted from the security requirements by acquiring shares after the time of the wrong alleged in the suit.

DEMOTT, *supra* note 44, § 3:9.

253. *Miller*, 2015 WL 892276, at \*1.

254. *Id.* at \*3.

8. North Dakota<sup>255</sup>

North Dakota's security for expense statute allows the subject corporation to move the court to require that certain derivative plaintiffs "give security for the reasonable expenses" that such moving party might incur.<sup>256</sup> These expenses explicitly include attorney's fees.<sup>257</sup> This motion may be brought at any time before final judgment.<sup>258</sup>

The North Dakota statute requires contemporaneous ownership by a plaintiff (with no provision for court intervention based on the merits, as found in the Alaska and California statutes).<sup>259</sup>

Derivative plaintiffs subject to the security posting provision are those holding less than five percent of any class of the corporation's stock and \$25,000 or less of the corporation's stock.<sup>260</sup> There is no fixed dollar cap for the amount of the bond.<sup>261</sup>

Upon termination of the suit, the court can order the plaintiff to pay the corporation's expenses if it finds that the derivative proceeding was brought "without reasonable cause."<sup>262</sup> Unlike the California statute that has a ceiling dollar amount, the North Dakota statute allows for the full amount of such expenses to be paid.<sup>263</sup> The corporation may have recourse to the security upon termination of the action.<sup>264</sup>

No North Dakota cases explore the security for expense process.

9. Pennsylvania<sup>265</sup>

Pennsylvania's security for expense statute allows the subject corporation to move the court to require that certain derivative plaintiffs "give security for the reasonable expenses" that the corporation might

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255. N.D. CENT. CODE § 10-19.1-86(2) (1997).

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.* § 10-19.1-86.

260. *Id.* § 10-19.1-86(2).

261. *Id.* § 10-19.1-86(2)(b).

262. *Id.* § 10-19.1-86(1).

263. *Id.*; see also CAL. CORP. CODE § 800(d) (West 1982).

264. N.D. CENT. CODE § 10-19.1-86(2)(c).

265. 15 PA. CONS. STAT. § 1782 (2016).



incur.<sup>266</sup> These expenses explicitly include attorney's fees.<sup>267</sup> This motion may be brought at any stage of the proceeding.<sup>268</sup>

The Pennsylvania statute requires contemporaneous ownership by a plaintiff or the showing of "a strong prima facie case in favor of the claim asserted on behalf of the corporation and that without the action serious injustice will result."<sup>269</sup> Derivative plaintiffs must make a formal demand, unless such a demand is excused.<sup>270</sup> Court approval is required before a derivative suit can be "dismissed or compromised."<sup>271</sup>

Derivative plaintiffs subjected to the security posting provision must hold less than five percent of any class of the corporation's stock and \$200,000 or less of the corporation's stock.<sup>272</sup> There is no fixed dollar cap for the amount of the bond, which can be increased or decreased from time to time, "in the discretion of the court upon showing that the security provided has or is likely to become inadequate or excessive."<sup>273</sup>

Pennsylvania is unique among the nine statutes, in that it provides a financial hardship exception where security may be denied or limited under the court's discretion if the security requirement imposes undue hardship on plaintiffs and serious injustice would result.<sup>274</sup> Further, a successful plaintiff may be awarded its reasonable expenses, including attorney's fees and costs, capped at "a reasonable proportion of the value of the relief obtained by plaintiff."<sup>275</sup>

### III. RECOMMENDATIONS

Broader questions exist as to the value and efficacy of derivative litigation as a vehicle for corporate good that are well beyond the scope of this Article.<sup>276</sup> For shareholders bound by one of the nine security for

266. *Id.* § 1782(c).

267. *Id.*

268. *Id.*

269. *Id.* § 1782(b).

270. *Id.* § 1781(a)(1)-(2).

271. 231 PA. CODE § 1506(d) (1991).

272. 15 PA. CONS. STAT. § 1782(c) (2016).

273. *Id.*

274. *Id.* § 1782(b).

275. *Id.* § 1784(b).

276. As described in the introductory comment to the MBCA:

A great deal of controversy has surrounded the derivative suit, and widely different perceptions as to the value and efficacy of this litigation continue to exist. On the one

expense statutes, posting a bond may not be the only option. As discussed above, like-minded shareholders can join together and aggregate their stock ownership to five percent or more of at least one class of the subject corporation's stock before filing the derivative suit.<sup>277</sup> One challenge posed by this idea may arise if the shareholder is not able to access the shareholder list to reach potential co-plaintiffs because of a lack of sufficient stockholding to satisfy any threshold requirement for inspection rights.

Another circumvention method could include a federal cause of action along with the state-law based derivative claim. In federal courts, there is no general federal security for expense statute for derivative actions, although one federal securities law touches on the concept of direct litigation.<sup>278</sup> Security for expense statutes may have the unintended effect of encouraging plaintiffs to couch their claims under these securities laws, which may not be the truest legal claim based on the facts.

But for derivative plaintiffs in the nine states previously discussed who cannot avoid the security for expense statute and must choose between posting a bond that the court thinks is appropriate or failing to pursue the claim, the question remains whether such shareholders are actually better off generally. Do these nine security for expense statutes offer shareholders real options other than voting current management out

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hand, the derivative suit has historically been the principal method of challenging allegedly illegal action by management. On the other hand, it has long been recognized that the derivative suit may be instituted more with a view to obtaining a settlement resulting in fees to the plaintiff's attorney than to righting a wrong to the corporation (the so-called "strike suit").

MODEL BUS. CORP. ACT, Introductory Comment, Subchapter D.

277. See *supra* Part II.c.7.c, for a discussion of aggregation.

278. Section 11(e) of the Securities Act of 1933 provides:

In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

15 U.S.C. § 77k(e) (West 1998). 18(a) of the Securities Exchange Act also permit a court to require security from either party. See 15 U.S.C. §§ 78i(f), 78r(a). For additional discussion on this, see DEMOTT, *supra* note 44, § 3.4.

of office or voting with their feet and selling their ownership interests? In other words, are these statutes actually protecting shareholders from some threat that would not be handled by state law claims of violation of fiduciary duty? The challenge for academics and practitioners is how to measure the existence and degree of any such protection. It seems naïve and simplistic to assume that shareholders who are not required to post security as a result somehow become altruistic, or at least exercise common sense and good judgment. They may nonetheless think they have an axe to grind.

The Wood Report concluded that security for expense statutes were the sole and exclusive way to protect the balance between allowing shareholders to hold their corporations accountable and allowing those corporations to conduct the business of shareholder maximization free from myriad nuisance or strike suits. But using share ownership levels or market value as the sole metric to measure shareholders' intentions is a risky proposition.<sup>279</sup> As with any bright line test, the metric may not get it right. Some valid claims by thoughtful shareholders acting in good faith may never be raised if they cannot satisfy the security for expense statute. Likewise, some meritless claims can and have been brought by shareholders who are not required to post security.

The prudent course is to broaden the application of the MBCA provisions for ordering expenses *after* the matter has been adjudicated and encourage all states to adopt any of the three provisions that have not yet been enacted there. First, if the lawsuit resulted in a "substantial" benefit to the corporation, the plaintiff is entitled to expenses from the defendant.<sup>280</sup> This should be modified to add the idea that such expenses must be reasonable, to avoid opportunistic behavior by the parties.

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279. According to Professor DeMott:

The reasoning of the Wood Report appears naive, or at least anachronistic, in two respects. First, nothing in the report anticipates the widespread use of intervention to exempt the original plaintiff from the security requirements. Second, the report is striking in the confidence it reposes in the security requirements as the *exclusive* safeguard needed to guard against abusive practices in derivative litigation; for example, it argues that a security provision would obviate any need to require court approval of discontinuances and settlements of actions. Finally, the Report's methodology and motivations have received trenchant criticism over the years, but this appears not to have undermined completely the appeal of the Report's conclusions.

DEMOTT, *supra* note 44, § 3.2.

280. MODEL BUS. CORP. ACT § 7.46(1).

According to the MBCA comments, the substantial benefit requirement is necessary “to prevent the plaintiff from proposing inconsequential changes in order to justify the payment of counsel fees.”<sup>281</sup> This is helpful but begs the question of what constitutes a “substantial” benefit. Clarity and uniformity in the parameters of this definition would allow similarly situated parties to be treated similarly.

Next, if instead of finding a substantial benefit, the court finds that the derivative proceeding was “commenced or maintained without reasonable cause or for an improper purpose[.]” the court may order the plaintiff to pay the defendant’s expenses.<sup>282</sup> Unlike the proposed modification to Section 7.46(1), the official comments give us some guidance as to what constitutes an “improper purpose” which can aid in the effort to promote uniform treatment for similarly situated parties:

The test in this section is similar to but not identical with the test utilized in section 13.31, relating to dissenters’ rights, where the standard for award of expenses is that dissenters “acted arbitrarily, vexatiously or not in good faith” in demanding a judicial appraisal of their shares. The derivative action situation is sufficiently different from the dissenters’ rights situation to justify a different and less onerous test for imposing costs on the plaintiff. The test of section 7.46 that the action was brought without reasonable cause or for an improper purpose is appropriate to deter strike suits, on the one hand, and on the other hand to protect plaintiffs whose suits have a reasonable foundation.<sup>283</sup>

Finally, states that have not done so should add in the ideas in MBCA Sections 7.46(2) and (3), which address other abuses and opportunistic conduct by the parties in derivative suits that were not “commenced or maintained without reasonable cause or for an improper purpose.”<sup>284</sup> This broad language also picks up misbehavior on the part of the parties’ counsel.<sup>285</sup>

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281. *Id.* § 7.46 cmt. (2007).

282. *Id.* § 7.46(2).

283. *Id.* § 7.46 cmt.

284. *Id.* § 7.46(2).

285. *Id.* § 7.46(3).

## CONCLUSION

Whether security for expense statutes are effective at all is difficult to say. Since there are so few cases involving them, case law interpreting these statutes and describing the rights and options of derivative plaintiffs would be illustrative. But more salient than the broad question of whether these statutes are working is the embedded issue of how we can measure whether five percent or \$200,000 is the “right” number to weed out strike suits but magically capture meritorious suits. There seems to be no way to be sure. In the absence of evidence that these statutes are helping, and in the further absence of any meaningful way to quantify this, perhaps the prudent course is to stick with a statutory scheme that allows courts to award costs to unsuccessful derivative plaintiffs *ex post*, instead of requiring security to be posted *ex ante*.