

Shareholders Granted More Power to Challenge Corporate Elections

Family and money don't always mix well, so it's not surprising that family-owned businesses are particularly likely to litigate their disputes. A recent California appellate decision makes it easier for shareholders of California corporations to challenge corporate elections.

Morrical v. Rogers, A137011 (decision filed October 10, 2013), involved disputes between two brothers and their sister over the management of a family-owned business. The McGraw Group was a group of three companies that was started in the 1970s by Jack McGraw and specialized in the sale of motorcycle and watercraft insurance. It later expanded to other lines of insurance as the business grew and profits increased. In the 1990s, Jack and his wife Joan, transferred ownership of the McGraw Group to their three children, Ann, John and Mike, who became sole and equal shareholders of the companies. Disputes arose when Mike took over as chief executive officer of the McGraw Group in the 1990s and disputes and litigation arose between the siblings over the management of the companies. Beginning in August 2011, Mike and John entered into a series of transactions with Altamont, an outside management company, and voted to restructure the corporate boards of the McGraw Group so that effective control of the companies was given to Altamont.

On May 2, 2012, Ann sued Altamont pursuant to California Corporations Code Section 709, which allows shareholders to challenge the appointment and election of corporate directors by filing suit in superior court. Ann alleged that Mike and John should not have been allowed to vote to put Altamont in charge of the companies because they had borrowed \$6 million from Altamont and also given Altamont cash-settled stock option rights. Ann argued that her brother had a material financial interest that should have disqualified them from voting under Corporations Code Section 310. After settlement negotiations failed to resolve the dispute, the trial court ruled that the election of the Altamont directors was invalid, and set aside all acts taken by Altamont to facilitate, implement, or effectuate the invalid election. Altamont appealed the trial court's ruling.

The court of appeal affirmed the trial court's ruling that the election of the Altamont directors was invalid. In doing so, the court took an expansive view of the judicial review authorized under Section 709, holding that there was "no express restriction on the grounds on which the validity could be challenged" and "the court's remedial powers are equitable and broad." *Id.* at 16. The court rejected Altamont's argument that the summary procedures set forth in Corporations Code Section 709(b) implies that Section 709 proceedings must be limited to technical and procedural issues related to the validity of a corporate board election.

Impact on Businesses

Businesses should be prepared to vigorously defend their election of corporate directors from lawsuits brought by aggrieved shareholders who are dissatisfied with how an election turned out. A copy of the full court of appeal opinion can be found here - <http://www.courts.ca.gov/opinions/documents/A137011.PDF>.

In the wake of *Morrical* dissatisfied shareholders may seek to find any financial conflicts between directors and shareholders or to show that shareholders acted to promote their own interests rather than acting in the best interests of the corporation in order to invalidate an election.

In addition, businesses defending Section 709 lawsuits should be prepared to aggressively litigate these types of disputes. Although Section 709 proceedings are summary in nature in that the court sets a hearing within five days of the date the complaint is filed, discovery is permitted and the court is empowered to postpone hearing dates upon "good cause shown." Consequently, attorneys defending corporations in Section 709 actions should also take heed to request additional time to conduct the necessary discovery to present an adequate defense if the plaintiffs' claims involve complex issues of breach of fiduciary duty and conflicts of interest.

In essence, when lawsuits demanding relief under Section 709 involve more than mere allegations that proper procedures were not followed, attorneys defending majority shareholders should be prepared to conduct mini-trials on an expedited schedule.

It should also be noted that Morrival's impact is not limited to family-owned businesses or corporations incorporated in California as Section 709 empowers state courts in California to not only determine the validity of any election or appointment of a director of a domestic corporation but also "any foreign corporation if the election was held or the appointment was made" in California. Thus, in light of Morrival, I expect that lawsuits challenging corporate elections will become more widespread.

If you have any questions or comments, I would be delighted to hear from you.

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