Filed 10/20/05

CERTIFIED FOR PUBLICATION

COURT OF APPEAL, FOURTH APPELLATE DISTRICT

DIVISION ONE

STATE OF CALIFORNIA

RICHARD GROSSET, Plaintiff, v. ERIC P. WENAAS et al., Defendants and Respondents; SIK-LIN HUANG, Intervener and Appellant.	D043684 (Super. Ct. No. GIC775153)

APPEAL from a judgment of the Superior Court of San Diego County, E. Mac Amos, Jr., Judge. Dismissed for lack of standing.

Kreindler & Kreindler, Gretchen M. Nelson; Federman & Sherwood, William B. Federman, Stuart W. Emmons; Law Offices of George A. Shohet and George A. Shohet for Intervener and Appellant.

Gray Cary Ware & Freidenrich; DLA Piper Rudnick Gray Cary US, Robert W. Brownlie, Paul A. Reynolds and Kathryn E. Karcher for Defendants and Respondents.

In this shareholder derivative action brought by Sik-Lin Huang against Eric P. Wenaas, Neal Waddington, John Bolger, Terry M. Flannagan, Ph.D., Lawrence E. Fox, John C. Stiska, Gloria Purdy, Scott Ruple and Thomas K. Gregory (collectively respondents), who are all officers and directors of JNI Corporation (JNI), Huang appeals a dismissal of this action following a determination by a special litigation committee of JNI that it was not in the best interests of the company to continue to pursue this derivative action. However, after the court granted the dismissal motion, JNI merged with another corporation, resulting in Huang's stock being repurchased by JNI.

We are therefore presented preliminarily with the issue of whether Huang lacks standing to continue to pursue this action because he is no longer a shareholder of JNI as a result of the merger. We are also presented with the question of whether California law or the law of the State of Delaware, the state of incorporation for JNI, governs the standing issue.

We conclude that Delaware law applies to the question of standing, and because Delaware law requires continuous stock ownership throughout the litigation, Huang lacks standing to pursue this action as he no longer owns stock in JNI. We further conclude that even if California law applies, Huang still lacks standing due to his lack of stock ownership in JNI as a result of the merger. Therefore, the appeal must be dismissed.

FACTUAL AND PROCEDURAL BACKGROUND

A. *The Parties*

Wenaas, Waddington, Bolger, Flanagan, Fox and Stiska are directors of JNI, a San Diego-based, Delaware corporation. Purdy, Ruple and Gregory are officers of JNI. JNI

designs, manufactures and markets hardware and software products that connect computer servers to data storage devices to form "storage area networks."

The original plaintiff in this action, Richard Grosset, lost standing to pursue this matter when he sold his stock in JNI. The court, applying Delaware law, ruled that in order to maintain standing to pursue a derivative action, a plaintiff must continuously hold stock in the company that is the subject of the litigation throughout the life of the action. However, the court allowed Huang, another shareholder of JNI, to intervene in the case in place of Grosset. Grosset is not a party to this appeal.

In October 2003 JNI merged with Applied Micro Circuits Corporation (AMCC). As a result, the stock in JNI was purchased by AMCC from shareholders, including Huang, for $7 a share. Huang therefore is no longer a shareholder of JNI.

B. *The Actions*

In March 2002 a class action lawsuit on behalf of stockholders alleging violations of securities laws by JNI and certain officers and directors of JNI was filed in federal court after JNI's stock price fell in late 2000 and early 2001. (*Osher v. JNI Corporation* (S.D.Cal. 2002) No. 01-CV-0557-J (NLS) (*Osher*).) The plaintiff in *Osher* alleged that JNI overstated the amount of revenues it thought it could achieve during the fourth quarter of 2000 and failed to write off obsolete inventory early enough. The plaintiff also alleged that some of the respondents in that action engaged in insider trading when they sold some of their stock in connection with a public secondary offering in October 2000. It was alleged that certain of the respondents overstated the earnings prospects of JNI for the fourth quarter of 2000 in order to sell their stock at an inflated price.

Soon after *Osher* was filed, Grosset initiated this derivative case. This action is what is commonly known as a "piggy back" derivative suit. It alleges that respondents breached their fiduciary duties to JNI by allowing JNI to be sued in the federal securities class action suit. It also alleges, similar to the federal class action suit, that respondents engaged in insider trading in connection with a secondary offering by JNI.

JNI brought a motion to dismiss the *Osher* action. In reported decisions, the district court granted JNI's motions to dismiss three times, the last time without leave to amend. (See *Osher v. JNI Corp.* (S.D.Cal. 2004) 308 F.Supp.2d 1168; *Osher v. JNI Corp.* (S.D.Cal. 2003) 302 F.Supp. 2d 1145; *Osher v. JNI Corp.* (S.D.Cal. 2003) 256 F.Supp.2d 1144.) In the most recently reported decision, granting the defendants' motion to dismiss without leave to amend, the federal district court held that (1) defendants' failure to disclose certain information did not render their public statements misleading; (2) plaintiffs failed to state a securities fraud claim based on statements in analyst reports; (3) other public statements by defendants did not support the securities fraud claim; and (4) certain defendants' stock sales did not give rise to an inference that defendants made false statements regarding corporation's performance. (*Osher v. JNI Corp., supra,* 308 F.Supp.2d at pp. 1179-1197.) *Osher* is now on appeal before the Ninth Circuit Court of Appeals.

JNI demurred to the complaint in this action, asserting that the plaintiff failed to adequately allege that a demand on the board to take action against the respondents was futile, a requirement for standing to bring a derivative suit on JNI's behalf. The court twice sustained JNI's demurrer with leave to amend.

JNI brought a third demurrer, again asserting that plaintiff Grosset had not sufficiently alleged demand futility and also alleging that he no longer had standing because he had sold his stock. The court overruled the demurrer on the issue of demand futility. However, as discussed, *ante*, the court, applying Delaware law, found that because Grosset no longer owned JNI stock, his claims must be dismissed because, under the continuous ownership requirement, he no longer had standing to sue derivatively on JNI's behalf. The court, however, allowed another shareholder, the current plaintiff Huang, to intervene and continue the litigation.

C. *The Special Litigation Committee*

In September 2002 JNI's board of directors (the Board) created a special litigation committee (SLC) to investigate the allegations in the derivative complaint and to determine whether JNI's best interests were advanced by Huang maintaining this action on JNI's behalf.

JNI appointed two new members to its board, the Honorable Howard Weiner (Retired) and Admiral Leon "Bud" Edney (Retired). Justice Weiner was an Associate Justice of the California Court of Appeal, Fourth Appellate District, Division One from 1978 to 1994. Admiral Edney is a retired Navy four-star Admiral and former Commander in Chief of the U.S. Atlantic Command and NATO Supreme Allied Commander, Atlantic. He graduated from the U.S. Naval Academy in 1957 and was in the Navy until 1992.

The Board then appointed Justice Weiner and Admiral Edney to serve as the SLC. Before their appointments as members of JNI's board and the SLC, neither Justice

Weiner nor Admiral Edney had met any of the respondents, JNI executives, or other members of the board, in either a professional or business setting, and they did not have any prior business dealings with or own stock in JNI.

Justice Weiner and Admiral Edney retained Robert S. Brewer, Jr., and McKenna Long & Aldridge LLP (McKenna Long) as separate counsel to assist in the SLC's investigation of the claims made in this action. The SLC made this selection independent of JNI, the respondents and the respondents' counsel. McKenna Long had not previously represented JNI or any of the respondents.

In October 2002 the SLC and Huang stipulated to a stay of deposition discovery until the earlier of January 15, 2003, or the issuance of a final report by the SLC. They also stipulated that document discovery and third party discovery would still go forward.

The SLC and its counsel conducted an investigation into the allegations in this case. The SLC identified and reviewed the allegations and causes of action in the derivative complaint, including the challenged public statements which were the bases of the federal securities class action. The SLC researched the law controlling the claims in the derivative complaint.

The SLC interviewed 24 witnesses, totaling over 60 hours of questioning. During these interviews, they questioned the witnesses about factual allegations in the derivative complaint and relevant JNI documents, including documents provided to the SLC by Huang's counsel. These interviews included JNI employees, auditors and attorneys knowledgeable about the events surrounding derivative action's allegations. The SLC also reviewed complaints for wrongful termination filed by some former employees, the

depositions and declarations filed in those actions, and e-mails written by them when they would not agree to be interviewed by the SLC.

The SLC and its counsel also spent hundreds of hours reviewing thousands of pages of documents pertaining to the derivative complaint's allegations. These documents included, among others, every press release issued by JNI in 2000 and 2001; internal company documents relating to JNI's sales forecasts, sales volumes, production, research and development efforts, marketing, product certifications, financing, and corporate reorganization; documents relating to JNI's secondary public offering of its common stock; and SEC filings, analysts reports, industry reports, competitors' press releases and historical stock information for JNI and its competitors.

The SLC met with the plaintiff's and respondents' counsel in this matter, both of whom made presentations to the SLC concerning the allegations in this action. Huang's attorneys provided documents they believed supported the claims made in this action.

The SLC examined the facts regarding the positioning and performance of JNI's competitors, the state of technology at JNI and in the market, and overall technology market conditions.

The SLC further considered factors affecting the potential value of the derivative action if it was meritorious. It consulted with Thomas Lambert, an expert experienced in assessing damages in federal securities actions and related derivative cases.

Using this information, the SLC analyzed the derivative complaint's allegations. That analysis led to a 64-page report, which the SLC issued in February 2003. The report concluded that the claims made in this action lacked merit and would likely not be

successful. The SLC first concluded that the rise of JNI's stock to $126 per share, followed by a decline to under $10 per share during a two-month period following the secondary offering "was influenced by a confluence of events driven by the exploding and then collapsing market place; not a contrived scheme of false and misleading statements by directors and management to promote JNI's stock motivated solely for personal profit." The SLC further concluded that the prospectus filed with the secondary offering undermined several of Huang's allegations as it "fully disclosed the risk" associated with the market for JNI's products. The SLC stated in its report that the prospectus "fairly depicts the company as being in a critical, high risk period."

The SLC concluded that other allegations of wrongdoing had "no factual basis." The report stated that even if some claims could survive a motion for summary judgment/summary adjudication of issues, "the economic value to the corporation to pursue the derivative [action] is far less than the direct and indirect costs in doing so." The report considered other factors, including insurance coverage ramifications on the class action, as well as distraction and disruption, and concluded it was not in the best interest of JNI to pursue the derivative action.

D. *The SLC's Motion To Dismiss*

Based upon its report, the SLC filed a motion to dismiss the derivative complaint. In response to the motion, Huang asserted that he needed to conduct discovery to properly oppose the motion. The court allowed Huang to demand documents relevant to the issues raised by the motion to dismiss and also allowed Huang to depose the SLC members, and a former JNI employee

In July 2003 Huang filed his opposition to the SLC's motion to dismiss. Huang's opposition was supported by four declarations in which Huang's expert witnesses opined that the claims made in this action were meritorious. Huang also challenged the SLC's independence, the adequacy of its investigation and the reasonableness of its conclusions.

E. *The Court's Order*

On August 2003 the court ruled on the motion to dismiss. The trial court found that the SLC members were disinterested and independent. The trial court also found the bases for the SLC's conclusions appeared to be reasonable, but allowed further discovery and requested further briefing as to two conclusions. Specifically, the court was considering whether the respondents failed to disclose problems with moving from a product line that was outdated to its new line, and whether respondents knew, but failed to disclose, that JNI would not meet its forecasted revenue and earnings for the fourth quarter of 2000. The court allowed Huang to continue the depositions of Justice Weiner and Admiral Edney. The depositions were limited to the two specific conclusions at issue. The trial court also allowed Huang to file a supplemental opposition brief to the motion to dismiss.

Huang filed a supplemental opposition brief, again accompanied by expert declarations. Respondents filed a supplemental reply brief and supporting declarations.

In October 2003 the trial court, in a telephonic ruling, granted the SLC's motion to dismiss. After oral argument, the trial court issued an order affirming its telephonic ruling and dismissing the derivative complaint with prejudice. In its order, the court stated that a two-step analysis was required for reviewing a special litigation committee's

motion to dismiss. The court found that, first, a court may grant a special litigation committee's motion to dismiss if the SLC establishes that it was independent, conducted its investigation in good faith and had reasonable bases for its conclusions. The trial court also stated that the second step of the analysis was the application of the court's own business judgment to the SLC's conclusions. The court found that its decision whether to go to the second step was discretionary.

The trial court then articulated and applied the legal standard to determine whether the SLC met its burden of proof as "whether there are material facts in dispute concerning the conduct and activity of the SLC in making its evaluation of the factual allegations." The court also noted that in ruling on the SLC's motion to dismiss, the court does not pass on the merits of the plaintiff's allegations in the derivative action and does not apply the traditional summary judgment standard.

The court found that the SLC was independent and acted in good faith.[1] The trial court also found that the SLC conducted an adequate investigation because it read thousands of pages of documents, including every press release issued by JNI in 2000-2001, and interviewed 24 witnesses over the course of five months. The court found Huang's arguments about additional steps he thought the SLC should have taken were insufficient to lead to a conclusion the investigation was not reasonable.

Based in part on the additional deposition discovery it allowed Huang and the other information reviewed by the SLC, the trial court found that the SLC had reasonable

---

1 Huang does not challenge these findings on appeal.

bases for its conclusions. The court concluded that the evidence uncovered by the SLC provided a reasonable basis for the SLC's conclusions as to the additional issues on which it requested further briefing and allowed further discovery.

Because the SLC had established its burden under the first step of the required analysis, the trial court exercised its discretion and did not engage in the second step of the analysis.

F. *Appeal and Motion To Dismiss Appeal*

Huang timely appealed from the court's grant of the SLC's motion to dismiss. On appeal, Huang asserts that the court erred in granting the motion to dismiss because (1) triable issues of fact exist as to the adequacy of the SLC's investigation and the reasonableness of its conclusions; and (2) the court abused its discretion in refusing to proceed to the second discretionary step of the analysis of the SLC's motion to dismiss.

After the appeal was filed, respondents filed a motion to dismiss the appeal, asserting that (1) Delaware law requires that to have standing to pursue a derivative action, a plaintiff must maintain stock ownership throughout the litigation; and (2) because Huang is no longer a stockholder of JNI as a result of its merger with AMCC, he lacks standing to pursue this action. Huang opposed the motion, arguing that (1) California law applied to the issue of his standing to pursue this action; and (2) under California law, he need only have owned the stock at the time of the respondents' alleged

wrongdoing and at the time the complaint was filed. We ordered that the motion to dismiss would be heard in conjunction with the appeal.[2]

DISCUSSION

A. *Standing To Pursue Appeal*

An appeal may be taken only by parties with standing to appeal. This is a jurisdictional requirement that cannot be waived. (*Marsh v. Mountain Zephyr, Inc.* (1996) 43 Cal.App.4th 289, 295.) Moreover, a motion to dismiss the appeal is the appropriate mechanism to resolve a claim of lack of standing. (*Eggert v. Pacific States Savings & Loan Co.* (1942) 20 Cal.2d 199, 200-201; *In re Pacific Std. Life Ins. Co.* (1992) 9 Cal.App.4th 1197, 1201-1203, 1204.)

B. *Delaware Law on Continuous Ownership of Stock*

Under Delaware law, in order for an individual to pursue a derivative claim, he or she not only must have been a shareholder of the nominal defendant corporation at the time of the challenged transaction, he or she must also remain a shareholder at the time of the filing of the suit and throughout the litigation. (8 Del. C., § 327; *Lewis v. Anderson* (Del. 1984) 477 A.2d 1040, 1046 (*Lewis*).)

---

2 Respondents and Huang also filed motions for judicial notice of certain documents in support of and in opposition to the motion to dismiss which we ordered to be considered with the appeal. Because neither side opposed the other's motion, and the documents submitted are properly the subject of judicial notice, the motions are granted to the extent that we relied on any of those documents in this opinion. Respondents' request under rule 977(c) to file opinions only available from computer sources, which we also ordered considered with the appeal, is granted.

In *Lewis,* the plaintiff had originally brought a derivative suit against the various officers and directors of a company the court designated "Old Conoco." (*Lewis, supra,* 477 A.2d at 1042.) However, during the pendency of the litigation, Old Conoco was merged with a wholly owned subsidiary of Du Pont. (*Ibid.*) Under the terms of the merger, the merged entity became "New Conoco"; shareholders of Old Conoco, including plaintiff Lewis, became shareholders of Du Pont; and Du Pont became the sole shareholder of New Conoco. (*Ibid.*) Under such circumstances, the court ruled that Lewis no longer had standing to pursue his derivative suit: "A plaintiff who ceases to be a shareholder, *whether by reason of merger or for any other reason*, loses standing to continue a derivative suit." (*Id.* at p. 1049, italics added.) This is so because, "upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action." (*Schreiber v. Carney* (Del.Ch.Ct. 1982) 447 A.2d 17, 21.) The Delaware Supreme Court also set forth two exceptions, not applicable here, to the rule that a merger causing loss of stock destroys standing in a derivative action: "(i) if the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive shareholders of the standing to bring a derivative action; or (ii) if the merger is in reality merely a reorganization which does not affect plaintiff's ownership in the business enterprise." (*Lewis v. Ward* (Del. 2004) 852 A.2d 896, 902, fn. omitted.)

Since Huang no longer owns any JNI stock as a result of the merger with AMCC, respondents contend in their motion to dismiss that *Lewis* controls and Huang's claims must be dismissed for lack of standing. Huang does not deny that if Delaware law applies, he no longer has standing to pursue this action. However, Huang makes two

arguments in opposition to respondents' motion to dismiss. Huang first asserts that California law must be applied to the issue of standing. He then contends that under California law, there is no "continuous ownership" of stock requirement for standing. Rather, Huang asserts that under California law a plaintiff in a derivative action must only be a shareholder at the time of the transaction that is the subject of the action and at the time of the filing of the complaint.

We conclude that Delaware law applies to the question of standing and therefore, under the *Lewis* decision, the appeal must be dismissed as Huang no longer owns stock in JNI. We further conclude that if California law does apply, Huang still lacks standing due to his lack of stock ownership in JNI.[3]

C. *Choice of Law*

Respondents contend that under the "internal affairs" doctrine the law of JNI's place of incorporation, Delaware, applies to the question of Huang's standing to pursue this action. The Court of Appeal in *State Farm Mut. Auto. Ins. Co. v. Superior Court* (2003) 114 Cal.App.4th 434, 442 (*State Farm*), describes the internal affairs doctrine as: "'[A] conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.'

---

[3] We therefore need not address the merits of Huang's contention that the court erred in granting the SLC's motion to dismiss.

[Citation.] States normally look to the State of a business' incorporation for the law that provides the relevant corporate governance general standard of care.'" "In general, courts in California follow this rule and apply the law of the state of incorporation in considering claims relating to internal corporate affairs." (*In re Sagent Technology, Inc.* (N.D.Cal. 2003) 278 F.Supp.2d 1079, 1087.)

This is so because the state of incorporation has an "overriding interest in the internal affairs of corporations domiciled there." (*Nedlloyd Lines B.V. v. Superior Court* (1992) 3 Cal.4th 459, 471.) Only one state should have the authority to regulate a corporation's internal affairs. (*State Farm, supra,* 114 Cal.App.4th at p. 442.)

Further, "[t]he internal affairs doctrine is not . . . only a conflicts of law principle. Pursuant to the Fourteenth Amendment Due Process Clause, directors and officers of corporations 'have a significant right . . . to know what law will be applied to their actions' and '[s]tockholders . . . have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs.'" (*VantagePoint Venture Partners 1996 v. Examen, Inc.* (Del. 2005) 871 A.2d 1108, 1113, fn. omitted (*VantagePoint*).) In *Edgar v. MITE Corp.* (1982) 457 U.S. 624, 645-646, the Supreme Court held that under the commerce clause a state "'has no interest in regulating the internal affairs of foreign corporations.'" (*VantagePoint, supra,* at p. 1113, fn. omitted.) Therefore, "'application of the internal affairs doctrine is mandated by constitutional principles, except in the "rarest situations,"' e.g., when 'the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce.'" (*VantagePoint, supra,* 871 A.2d at p. 1113, fns.omitted.)

The question then becomes: Is the issue of a plaintiff's standing based upon share ownership a question that involves the "internal affairs" of a corporation, thus making it subject to the law of the state of incorporation? No case that we could locate has resolved this question. As we shall discuss, we conclude that it is.

The issue of whether a stockholder has standing to pursue a derivative action based upon stock ownership is an issue that concerns the relationship between a corporation and its shareholders because it is asking whether a stockholder will be allowed to maintain an action on behalf of the corporation. One definition of an internal affair of a corporation is the extent of a shareholder's right """to participate in the administration of the affairs of the corporation . . . .""" (*State Farm, supra,* 114 Cal.App.4th at p. 443.)

Further, Delaware has concluded that the shareholder demand requirement, which, like continuous stock ownership is a requirement of standing, is a question concerning the internal affairs of a corporation, and thus controlled by the state of incorporation. (*Rales v. Blasband* (Del. 1993) 634 A.2d 927, 932, fn. 7.)[4]

One treatise discussing the issue of *contemporaneous* ownership requirement, a similar doctrine that requires a shareholder to own stock at the time of the wrongdoing,

---

4 The "shareholder demand" requirement for standing in a derivative suit has been described as follows: "[T]he right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation." (*Rales v. Blasband, supra,* 634 A.2d at p. 932.)

also supports the conclusion that the issue of standing based upon share ownership is governed by the law of the state of incorporation: "[T]he contemporaneous ownership requirement should validly be considered a substantive rule of law and not merely a procedural rule. If this is the case, the choice of law questions surrounding the contemporaneous ownership requirement should be resolved in the same way that they are for demand on directors. When an action is commenced in state court or in federal court under diversity jurisdiction, the governing substantive law will be that of the state of incorporation of the entity on whose behalf the suit is commenced." (Ferrara et al., *Shareholder Derivative Litigation: Besieging the Board* (2005) § 4.02[2].) We conclude that the continuous ownership requirement for standing to pursue a derivative action is a substantive matter within the internal affairs doctrine, and thus subject to Delaware law, the state of JNI's incorporation.

Huang asserts that California law applies because the Legislature, in Corporations Code section 800,[5] has adopted a statute that specifically addresses this issue, thereby taking precedence over Delaware law. Section 800, subdivision (b)(1) (section 800(b)(1)) provides in part:

> "No action may be instituted or maintained in right of any domestic *or foreign corporation* by *any holder of shares* or of voting trust certificates of the corporation unless . . . . [¶] (1) *The plaintiff alleges in the complaint that plaintiff was a shareholder . . . at the time of the transaction or any part thereof of which plaintiff complains* . . . ." (Italics added.)

---

5 All further statutory references are to the Corporations Code unless otherwise specified.

However, section 800(b)(1) is merely a procedural pleading requirement, stating that a plaintiff must at a minimum allege that he or she was a shareholder at the time of the transaction, not a statement of California law on the standing requirement of continuous ownership of stock. The reason for this "contemporaneous ownership" pleading requirement in section 800(b)(1) is to prevent lawsuits brought by persons who were not injured by the wrongdoing but seek to capitalize upon a later purchase of stock. (*Bateson v. Magna Oil Corp.* (5th Cir. 1969) 414 F.2d 128, 131; see also Wells, *Maintaining Standing in a Shareholder Derivative Action* (2004) 38 U.C. Davis L. Rev. 343, 349-350, fns. omitted.)

The *continuous* ownership requirement, the rule that a shareholder must maintain his or her shareholder status throughout the litigation, reflects different concerns:

" 'Standing [to bring a derivative action on behalf of a corporation] is justified only by the proprietary interest created by the stockholder relationship and the possible indirect benefits the nominal plaintiff may acquire *qua* stockholder of the corporation which is the real party in interest.' [Citations.] Thus, standing . . . concerns the plaintiff's relationship with the real party in interest, the corporation, and not the injury of the corporation. Whether this particular plaintiff or another shareholder prosecutes the corporation's claim as a representative shareholder has no effect on the corporation's cause of action." (*Lewis v. Knutson* (5th Cir.1983) 699 F.2d 230, 238 (*Knutson*).) As we expressed above, this is why under Delaware law "upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action." (*Schreiber v. Carney, supra,* 447 A.2d at p. 21.)

Federal courts and other states applying pleading statutes similar to section 800(b)(1) have also held that such statutes do not trump the substantive continuous ownership rule. Rule 23.1 of the Federal Rules of Civil Procedure (28 U.S.C.) (hereafter rule 23.1) provides that a derivative complaint must allege that "the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains . . . ." Delaware Chancery Court Rule 23.1 provides that "the complaint shall allege that the plaintiff was a stockholder or member at the time of the transaction of which the plaintiff complains." Neither statute, like section 800(b)(1), expressly requires share ownership throughout the litigation. However, federal and Delaware courts are uniform in the conclusion that a continuous ownership of shares is nevertheless required. (*Knutson, supra,* 699 F.2d at p. 238; *Lewis v. Chiles* (9th Cir. 1983) 719 F.2d 1044, 1047; *Lewis v. Ward, supra,* 852 A.2d at pp. 901-902.)

Further, even if section 800 were a substantive statute that controlled the issue whether a plaintiff must own stock throughout the derivative litigation to have standing, to the extent that statute conflicts with Delaware law, Delaware law prevails, based upon both choice of law and constitutional principles. (*VantagePoint, supra,* 871 A.2d at pp. 1113-1116.) In *VantagePoint,* the Delaware Supreme Court held that the internal affairs doctrine required that Delaware law prevail over a contrary California statute, section

2115, which dealt with the internal affairs of corporations.[6] (*VantagePoint, supra,* 871 A.2d at pp. 1113-1116.)

Huang asserts that even if section 800 does not require application of California law to the standing issue, a choice of law analysis would still require application of California law because it would "advance California's interests without impairing Delaware's." In support of this assertion, Huang points out that JNI is headquartered in California, the respondents reside here, and the wrongs alleged in the complaint occurred in this state. Thus, Huang argues, California has a stronger interest than Delaware in regulating JNI's affairs.

However, while these facts might be relevant in an ordinary choice of law analysis, they are irrelevant to application of the internal affairs doctrine because, as explained in *State Farm, supra,* 114 Cal.App.4th at pp. 445-446, "'[t]he corporate internal affairs rule is deeply ingrained in the choice-of-law culture. It has survived the conflicts resolution largely unscathed. In all but a handful of cases, the law of the state of incorporation is applied to disputes involving internal corporate affairs in spite of the various choice-of-law theories adopted from year-to-year by the individual courts.'" (See also *Nedlloyd Lines B.V. v. Superior Court, supra,* 3 Cal.4th at p. 471 [state of incorporation has "overriding interest in the internal affairs of corporations domiciled

---

6 Section 2115 requires that California law apply to foreign corporations that have certain ties to California, as to numerous aspects of a corporation's internal affairs, including election and removal of directors, directors' standard of care, liability of directors and shareholders, voting shares, sale of assets and mergers. (See § 2115, subd. (b).)

there"].) Further, as discussed, *ante*, the internal affairs doctrine has constitutional underpinnings, requiring application of the law of the state of incorporation "'except in the "rarest situations,"' e.g., when the 'law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce.'" (*VantagePoint, supra,* 871 A.2d at p. 1113, fns. omitted.) We do not have that situation here.

In sum, we conclude that Delaware law controls the issue of whether a plaintiff in a derivative action must own stock in the relevant corporation throughout the litigation. Because it is not subject to dispute that Delaware requires such ownership, Huang lacks standing to pursue this matter and his appeal must be dismissed.

D. *California Law Also Requires Continuous Ownership*

Even assuming California law applies to the issue of continuous ownership of stock, we conclude that Huang has no standing to pursue this action because he no longer owns stock in JNI as a result of the merger with AMCC.

In *Heckmann v. Ahmanson* (1985) 168 Cal.App.3d 119, 123 (*Heckmann*), stockholders in a corporation which purchased a large block of its own shares from defendants brought an action alleging that a purchase of the shares at above market price, in exchange for the foregoing of a takeover attempt and dismissal of lawsuits, constituted "greenmail" activities violating duties of the selling corporation and the directors of purchasing corporation. The superior court entered a preliminary injunction effectively imposing a trust on the profit from the transaction and requiring selling corporation to make adequate accountings of the disposition of the proceeds, and the seller appealed. (*Ibid.*)

On appeal, one issue presented was what was the effect on the standing of a plaintiff in a derivative action where the plaintiff has sold its stock during the pendency of the action. The Second District Court of Appeal concluded, relying on federal law, that "[o]nce a derivative plaintiff sells its stock, it no longer has standing to prosecute the derivative claims on behalf of the remaining shareholders." (*Heckmann, supra,* 168 Cal.App.3d at p. 130, citing *Knutson, supra,* 699 F.2d 230, 238 & 7A Wright & Miller, Federal Practice and Procedure (1972) § 1839, p. 437.)

However, a later California case, without citing to *Heckmann*, concluded that, at least under the facts presented there, there was no continuous ownership requirement in California. In that case, a shareholder filed a derivative suit challenging "golden parachute" agreements and other benefits provided for certain officers and directors of corporation as part of merger agreement. (*Gaillard v. Natomas Co.* (1985) 173 Cal.App.3d 410, 413 (*Gaillard*).) The superior court sustained defendants' demurrer to the complaint on the basis that the plaintiff no longer owned any shares in the corporation because of the merger, and therefore the plaintiff had no standing to sue. (*Id.* at p. 421.) The shareholder appealed, and the First District Court of Appeal reversed. It held that to have standing, a plaintiff in a derivative action need only be a shareholder (1) at the time of the transaction and (2) when the action is filed. (*Id.* at p. 413.)

The *Gaillard* court concluded that because section 800 only required a plaintiff to allege ownership at the time of the underlying transaction and at the time of filing suit, there was no continuous ownership rule in California: "The statute herein clearly states that the plaintiff must be a shareholder 'at the time' of the alleged wrongdoing. It does

not have an express provision requiring a plaintiff to maintain shareholder status throughout the course of the litigation. Under the maxim that the expression of certain things in a statute necessarily precludes the inclusion of things not expressed, we cannot presume continuing shareholder status is a requirement of [section 800(b)(1)]." (*Gaillard, supra,* 173 Cal.App.3d at p. 414.)

The *Gaillard* court also declined to follow federal cases holding that continuous ownership was required, even in the event of a merger, as opposed to a voluntary sale of stock. The court first noted that federal cases holding that there was a continuous ownership requirement relied upon federal rule 23.1. The *Gaillard* court opined that federal rule 23.1 "has an implied continuous ownership requirement. [Citation.] We are certainly not concerned here with the federal rules or their interpretations." (*Gaillard, supra,* 173 Cal.App.3d at p. 417.) The court distinguished a federal merger case because in the cited case the merged corporation ceased to exist, while in the *Gaillard* action the corporation in which the plaintiff owned shares was still a viable entity after the merger. (*Id.* at pp. 417-418.) The *Gaillard* court also distinguished that case because in *Gaillard* the plaintiff was attacking the merger itself. (*Id.*at p. 418.) As noted above, the derivative suit in *Gaillard* attacked the golden parachute agreements and other benefits certain officers and directors received for their agreement to the merger. (*Id.* at p. 413.)

The First District also rejected the Delaware Supreme Court's holding in *Lewis, supra,* 453 A.2d 474, stating: "Although we note with interest the holding in that case, we are not bound thereby." (*Gaillard, supra,* 173 Cal.App.3d at p. 420.)

We find the reasoning in *Gaillard* unpersuasive and the case itself distinguishable. First, it ignores the overwhelming majority of courts in other jurisdictions, most with statutes substantively the same as section 800(b)(1), which have concluded that stock ownership throughout the litigation is required for a derivative plaintiff to have standing. (See *Schilling v. Belcher* (5th Cir. 1978) 582 F.2d 995, 999 [interpreting federal rule 23.1; sale of stock during pendency of appeal from judgment in derivative suit defeats standing to continue]; *Timko v. Triarsi* (Fl.App. 2005) 898 So.2d 89, 91-92 (*Timko*) [under Florida statute, similar to section 800, loss of stock during pendency of action results in lack of standing; following "overwhelming majority of courts in other jurisdictions"]; *Lewis, supra,* 477 A.2d at p. 1049 [under Delaware statute, similar to California's, loss of ownership of stock through merger during pendency of suit divests plaintiff of standing]; *Lewis v. Turner Broad. Sys., Inc.* (Ga.App. 1998) 232 Ga.App. 831, 833 [503 S.E.2d 81, 84] [after loss of share ownership through merger, plaintiffs lost standing to maintain derivative action]; *A-Plus Janitorial & Carpet Cleaning v. Employers' Workers' Compensation Association* (Ok. 1997) 936 P.2d 916, 924, and cases cited therein [under Oklahoma statute, similar to California's, continuous ownership required to maintain derivative claim]; *Christopher v. Liberty Oil & Gas Corp.,* (La.App. 1995) 665 So.2d 410, 411 [former shareholders of corporation lacked standing under statute similar to California's]; *U.S. Fidelity & Guar. Co. v. Griffin* (Ind.App. 1989) 541 N.E.2d 553, 554-555 [continuous ownership required to have standing]; *Weil v. Northwest Industries, Inc.* (Ill.App. 1988) 168 Ill.App.3d 1, 5, fn. 1 [522 N.E.2d 172, 174, fn. 1] [share ownership by plaintiff must be maintained during pendency of suit];

Yanow v. Teal Industries, Inc. (Conn. 1979) 178 Conn. 262, 285 [422 A.2d 311, 323] [continuous ownership from time acts occur until judgment required to have standing to maintain derivative suit].)

Moreover, the *Gaillard* court, in distinguishing federal case law, cited to federal rule 23.1, but failed to recognize that the language of that statute also only requires that a plaintiff allege stock ownership at the time "of the transaction of which the plaintiff complains." Thus, the *Galliard* court's comment that federal rule 23.1 has "an implied continuous ownership requirement" actually supports the conclusion that California does as well, as section 800(b)(1) is substantively the same as federal rule 23.1.

Even more important, *Gaillard* did not recognize the rationale for the federal court and other state courts' imposition of a continuous ownership requirement where there is a statute that states that a plaintiff must only plead stock ownership as of a certain date. In *Shilling v. Belcher, supra,* 582 F.2d at page 999, the court explained the reason for the continuous ownership rule: "Only a shareholder, by virtue of his 'proprietary interest in the corporate enterprise, [citation], may 'step into the corporation's shoes and . . . seek in its right the restitution he could not demand in his own.' [Citation.] Thus, it is generally held that the ownership requirement continues throughout the life of the suit and that the action will abate if the plaintiff ceases to be a shareholder before the litigation ends."

This rationale applies equally to derivative actions brought in California. A derivative action is brought on behalf of the corporation, not the individual plaintiff. Standing to bring such an action is appropriate only where the nominal plaintiff has a proprietary relationship with the corporation by virtue of stock ownership, and the

possible indirect benefit the plaintiff will obtain if the corporation prevails and reaps a financial benefit from the litigation. When a merger occurs, standing is lost because "upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action." (*Schreiber v. Carney, supra,* 447 A.2d at p. 21.) As Huang is not a stockholder in the new corporation, he has no proprietary interest therein that can provide the basis for standing to pursue a derivative action. There is nothing in California law or policy that is contrary to this most basic principle of derivative actions.

Cases from other states also support the conclusion that California has a continuous ownership requirement. In *Timko, supra,* 898 So.2d 89, the Florida statute at issue provided that "[a] person may not commence a proceeding in the right of . . . a corporation unless the person was a shareholder of the corporation when the transaction complained of occurred." (*Id.* at p. 91.) In that case the stockholder that no longer owned stock in the corporation that was the subject of the derivative suit argued, as the court in *Gaillard* found, that because the statute did not expressly require present share ownership, the statute abrogated the continuous ownership rule. (*Ibid.*) The Florida Court of Appeal rejected this argument. First, the court found that because the statute did not create a new right of action, it could not abrogate a preexisting common law rule such as continuous ownership of stock. Rather, the court found that the statute merely placed "additional limits upon this preexisting right to ensure that a plaintiff's stake in the lawsuit is 'legitimate,' meaning an *ownership* interest that is not acquired for predatory purposes." (*Ibid.*) In conclusion, the Court of Appeal noted, "we align ourselves with the

overwhelming majority of courts in other jurisdictions that have confronted this issue." (*Id.* at pp. 91-92, citing the cases from various jurisdictions we reference, *ante*.)

We also follow the majority rule that continuous stock ownership is necessary for standing to pursue a derivative action. Section 800(b)(1), which merely requires a plaintiff to also plead that he or she owned stock at the time of the transaction, does not abrogate this preexisting substantive law.[7]

Indeed, *Gaillard* can in some respects be distinguished from the facts of this case. In that case the court based its decision in part upon the fact that the plaintiff was attacking transactions that were a part of the merger itself. (*Gaillard, supra*, 173 Cal.App.3d at p. 418.) The Court of Appeal held there that it would be unjust to bar "a lawsuit which challenges the wrongful acts of management in bringing about the merger, because [of the operation] of the merger itself." (*Id.* at p. 420.) As we noted above, courts applying the continuous ownership rule have carved out an exception in merger cases where the suit is challenging the merger itself. (See *Lewis v. Ward, supra*, 852 A.2d at p. 902.) Moreover, because that type of action alleges an injury to the stockholders and not the corporation, it is a direct, not derivative action, and the plaintiff maintains standing to pursue the action even after a merger. (*Parnes v. Bally Entertainment Corp.* (Del. 1999) 722 A.2d 1243, 1245 ["A stockholder who directly

---

7 Huang has identified three cases from other jurisdictions that have not required shareholders to own stock throughout the litigation. (See *In re General Instrument Corp. Securities Litigation* (N.D. Ill. 1998) 23 F.Supp.2d 867, 872; *Alford v. Shaw* (N.C. 1990) 398 S.E.2d 445, 449-450; *Shelton v. Thompson* (Ala. 1989) 544 So.2d 845, 848-849.) However, we decline to follow these cases embracing the minority view.

attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated"].)

In this case, however, there is no challenge to the merger itself. Therefore, *Gaillard* is inapplicable and the majority rule that a plaintiff in a derivative action must maintain stock ownership throughout the litigation applies. Because Huang no longer owns stock in JNI, he lacks standing to pursue this appeal, and it must be dismissed.

DISPOSITION

The appeal is dismissed for a lack of standing. Respondents to recover their costs on appeal.

CERTIFIED FOR PUBLICATION

NARES, Acting P. J.

WE CONCUR:

McDONALD, J.

O'ROURKE, J.