ASSOCIATION OF BUSINESS TRIAL LAWYERS

abtl REPORT

Volume XXV No. 2 Spring 2003

The Demand Requirement in Derivative Actions — Part 2

The first half of this article, published in the last issue, discussed the statutory framework for the demand requirement and the policy considerations underlying the rule. This article focuses on specific allegations often found in derivative actions and how courts have dealt with such allegations.

Eric S. Waxman

Courts Reject Non-Specific Allegations of Demand Futility

Prior to *Shields v. Singleton,* 15 Cal. App. 4th 1611 (1993), there were few published opinions scrutinizing demand futility allegations in California. *See, e.g., Fairchild v. Bank Am. Nat'l Trust & Savs. Ass'n*, 192 Cal. App. 2d 252, 259 (1961); *Reed v. Norman*, 152 Cal. App. 2d 892, 898-200 (1957). As a result, in attacking the sufficiency of a derivative plaintiff's demand futility allegations, defendants often cited to cases where plaintiff's allegations were aimed at rebutting the presumption afforded directors under the "business judgment rule" because "'demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability.'" *See Lee v. Interinsurance Exch.*, 50 Cal. App. 4th 694, 715 (1996) ("[t]he business judgment rule sets up a presumption that directors' decisions are made in good faith and are based upon sound and informal business judgment"); *Katz v. Chevron Corp.*, 22 Cal. App. 4th 1352, 1366-67 (1994) (same). *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 103 (1991) (citing *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984). *See Findley v. Garrett*, 109 Cal. App. 2d 166, 174 (1952) (general allegations of fraud and conspiracy insufficient to rebut business judgment rule because "*[e]very presumption is in favor of the good faith of the directors*") (emphasis added).

(Continued on page 2)

INSIDE

California's Sanctions Statute: Potent Weapon Against Frivolous or Bad Faith Actions and Claims
by Kent A. Halkett .... p. 3

Proving a Mark Is Generic Under the Lanham Act: What Are the Consequences?
by Allen B. Grodsky .... p. 5

Drafting and Enforcing Attorneys' Fees Clauses
by William S. Garr .... p. 7

Pending in the California Supreme Court
by Rex S. Heinke and Sandra M. Lee .... p. 9

Measure of Damages for Interference with a Shareholder's Ability to Sell Stock — Part 1

In today's business climate which, for most investors, often feels more like a roller coaster ride than a smooth assent towards financial security, the need to have complete freedom in the decision to buy and sell stock is paramount. What can an investor do, however, on those occasions where his right to freely trade his stock has been undermined, either intentionally or negligently, by the corporation in which he holds the stock, or by a transfer agent vested with the authority to timely provide stock certificates? While the causes of action available for an investor who has been harmed by the wrongful interference with his ability to sell stock vary depending upon the factual scenario involved, one common issue which arises under most any such cause of action is the appropriate measure of damages for the investor's inability to trade his stock during the period of wrongful interference. This issue is especially important in a matter involving a highly volatile stock where interference with the right to trade for even a single day could mean the difference between financial security and financial disaster.

Scott H. Carr

This issue arose in a recent case involving the improper withholding of stock certificates from an investor in a private corporation which was undergoing a merger with a large publicly traded corporation. In that case, the plaintiff had a $50,000 investment in a private corporation. Several years later, in one of the slew of corporate takeovers and mergers occurring in 1999 and 2000, the private company was purchased by a larger corporation publicly traded on the NASDAQ stock exchange.

As a result of the merger, the plaintiff's 56,000 shares in the new corporation would be valued at several million dollars, the exact amount largely depending upon the stock price at the time the plaintiff became able to publicly sell his shares. When he learned of the merger, the plaintiff made known to the acquired company, the acquiring company and his stock broker that he wanted to sell his shares in the publicly traded company immediately upon his receipt of the stock certificates. His broker had advised him that the stock certificates were necessary to effectuate a trade, given some confusion over whether the stock carried any restrictive legends.

The closing date for the merger was February 10, 2000. At that time, the stock was trading at $105 - $113 per share. As of

(Continued on page 10)

Demand Requirement in Derivative Actions

Continued from page 1

See, e.g., Lee, 50 Cal. App. 4th at 715 (Plaintiff cannot rely upon "conclusory allegations of improper motives and conflict of interest" in attempting to rebut presumption that directors were disinterested and independent); *Starbird v. Lane*, 203 Cal. App. 2d 247, 258-59 (1962) (rejecting conclusory allegations that directors were "controlled" absent specific facts "indicat[ing] how such control is being exercised"). While *Shields* and *The Oakland Raiders v. Nat'l Football League,* 93 Cal. App. 4th 572 (2001), filled this gap in the case law by confirming that, in the context of demand futility, "conclusory facts are insufficient" (*id.* at 586-87), Delaware case law remains more illuminative with respect to allegations challenging director independence typically found in derivative complaints.

Allegations Regarding Independence and Disinterestedness

In an effort to demonstrate a lack of independence, derivative plaintiffs generally rely on allegations of: (a) "domination and control" generally based on a director's appointment or election to the board by interested directors, particularly a majority shareholder; (b) personal and business relationships amongst board members; (c) a desire to maintain "lucrative" director or consulting fees and (d) participation in the alleged wrongdoing coupled with director inaction or a desire by directors not to sue themselves. As demonstrated below, courts rarely find such allegations sufficient to demonstrate a lack of independence.

Allegations of Domination and Control With or Without a Majority Shareholder

Generalized allegations of "domination and control" are never sufficient to demonstrate demand futility. *Aronson,* 473 A.2d at 816 ("*[t]he shorthand shibboleth of 'dominated and controlled directors' is insufficient" to excuse demand*) (emphasis added); *Ash v. McCall*, No. CIV. A. 17132, 2000 WL 1370341, at *7 (Del. Ch. Sept. 15, 2000) ("conclusory allegations of domination and control insufficient to excuse pre-suit demand" where complaint stated without particularized factual support that ten outside directors acted "due to their loyalty to, and domination by" the two interested directors, demand was not excused); *Starbird v. Lane,* 203 Cal. App. 2d 247, 258-59 (1962) (disregarding "alleged by way of conclusion that the present board of directors is under the control of" the two defendants).

Such general allegations are not enhanced by references to directors being appointed to the board by interested parties. In California, appointment of new directors by preexisting board members is specifically authorized by statute. *See* Cal. Corp. Code § 305(a) ("[V]acancies on the board may be filled by approval of the board…"). *See, e.g., Aronson,* 473 A.2d at 816 ("The personal-selection-of-directors allegation…is a conclusion devoid of factual support"). As pointed out by the Delaware Supreme Court:

> [I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence.

Id. Cf. Telxon Corp. v. Meyerson, 802 A.2d 257, 264-65 (Del. 2002) (factual issue raised by, among other things, interested party's long stint as CEO and the respect other directors had for his "business acumen"). Nor does the existence of a majority shareholder defendant necessarily establish "domination and control." *See Aronson*, 473 A.2d at 815 ("[I]n the demand context even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation."). *See also Benerofe v. Cha*, C.A. No. 14614, 1996 WL 535405, at *7 (Del. Ch. Sept. 12, 1996) ("the fact that the corporation has one controlling shareholder does not, as a matter of law, establish that its directors are dominated or controlled by that shareholder"); *Stroud v. Miliken Enters., Inc.*, 585 A.2d 1306, 1309 (Del. Ch. 1988) (demand not excused where defendants held greater than 50% of corporation's shares); *Kaster v. Modification Sys., Inc.*, 731 F.2d 1014, 1017-18 (2d Cir. 1984) (demand not excused where defendants owned 71% of corporation's shares); *Vernars v. Young,* 539 F.2d 966, 967-68 (3d Cir. 1976) (demand not excused where defendant owned 50% of corporation's shares). *See generally Raiders*, 93 Cal. App. 4th at 587 ("facts relating to the structural bias common to corporate boards throughout America are…insufficient" to excuse demand).

Rather, to be successful, a derivative plaintiff must plead specific facts showing that a board member is so "'beholden'" to an interested party that the director's decisions would be "sterilized." *Rales v. Blasband*, 634 A.2d 927, 936 (1993) (citations omitted) (allegations that a director owed his position to the controlling shareholder defendant were held to create "a reasonable doubt that [he] can be expected to act independently considering his substantial financial stake in maintaining his current offices" as President and CEO (for which he received an annual salary of $1 million)). *Id.* at 937. Also inadequate are related allegations regarding directors' desires to "entrench" themselves. *See Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) (generalized allegations of entrenchment "wholly insufficient to establish a case of demand excusal"); *cf. In re Fuqua Indus., Inc. Litig.*, No. CIV. A. 11974, 1997 WL 257460, at *10 (Del. Ch. May 13, 1997) (plaintiffs alleged futility with sufficient particularity — based on the allegations that the transaction in question, entering into an agreement that required a major shareholder to vote its shares in favor of the new directors nominated by the existing board — was "motivated solely by the defendants' desire to secure their positions in office."). *Id.*, at *4, 5. The test is not "an objective 'reasonable director standard'; instead, the Court must apply a 'subjective,' 'actual person' test to determine whether a *particular* director [ ] lacks independence because he is controlled by another." *In re The Ltd., Inc. S'holder Litig.*, No. CIV. A. 17148-NC, 2002 WL 537692 at *4 (Del. Ch. Mar. 27, 2002) (citation omitted). *See also Orman v. Cullman*, 794 A.2d 5, 24 (Del. Ch. 2002) ("the Delaware Supreme Court has rejected an objective 'reasonable director' test and instead requires the application of a subjective 'actual person' standard to determine whether a *particular* director's interest is material and debilitating or that he lacks independence because he is controlled by another") (citation omitted). Not surprisingly, the difficulty in establishing such "sterilization" based on allegations of "'domination and control'" with respect to "outside" directors is substantially lessened with regard to "inside" directors, whose primary livelihood comes from the company. *See, e.g., In re The Ltd, Inc. S'holders Litig.*, No. CIV. A. 17148-NC, 2002 WL 537692, at *5-6 (Del. Ch. Mar. 27, 2002) (allegations of $1.8 million in salary and bonuses being "compensation from one's principal employment," for director who was also company's vice chairman and chief administrative officer, sufficient to establish lack of independence); *In re The Student Loan Corp.*, 2002 WL 75479, at *3 (directors who held "full-time managerial" positions with corporate grandparent could not "impartially consider a demand"); *In re Cooper Cos. S'holders Derivative Litig.*, No. 12584, 2000 WL 1664167, at *6-7 (Del. Ch. Oct.†31, 2000) (holding that allegations that directors who were also members of senior management "owed their positions and their livelihood" to the wrongdoers creates the requisite reasonable doubt sufficient to excuse demand); *Mizel v. Connelly*, Civil Action No. 16638, 1999 Del. Ch. LEXIS 157, at *8, 15 (Del. Ch. July 22, 1999) (finding that the board's dependence on the controlling wrongdoer was sufficiently pleaded, as plaintiff alleged that the directors' offices are their "'principal employment

(Continued next page)

and means of earning a living'"). *In re The Ltd.*, 2002 WL 537692, at *4 & n.24.

Close Personal or Business Relationships

Allegations of "longstanding personal, professional and financial relationships" are also rarely sufficient by themselves to demonstrate a lack of independence. *See, e.g., Orman*, 794 A.2d at 27 ("The naked assertion of a previous business relationship is not enough to overcome the presumption of a director's independence."); *In re Paxson Communication Corp. S'holders Litig.*, No. CIV. A. 17568, 2001 WL 812028, at *9-10 (Del. Ch. July 12, 2001) (finding inadequate to establish demand futility, "hopelessly vague" allegations of "close personal…ties" with the allegedly interested directors). As recognized by numerous courts, directors often have business and personal relationships with fellow board members. *See Katz*, 22 Cal. App. 4th at 1368 (1994) ("A director's association with a company that does business with the corporation does not in and of itself establish a lack of independence."); *see also In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355 (Del. Ch. 1998), *aff'd in part, rev'd in part on other grounds sub. nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ("The fact that Eisner has long-standing personal and business ties to Ovitz cannot overcome the presumptions of independence that all directors, including Eisner, are afforded."); *Stein v. Orloff*, Civil Action No. 7276, 1985 Del. Ch. LEXIS 418, at *10 (Del. Ch. May 30, 1985) ("The Complaint also contains allegations of extensive business relationships between the various directors…. The existence of these relationships…is also insufficient to excuse the failure to make a pre-suit demand."). "[V]ery close family relationships," however, can be sufficient in certain circumstances. *See In re Cooper Cos.*, 2000 WL 1664167, at *6 (father-in-law not disinterested); *Mizel*, 1999 Del. Ch. LEXIS 157, at *10-12 (holding that a director who was the grandson of the CEO benefitting from the questioned transaction could not independently consider a demand).

The Receipt of Director and Consulting Fees

The mere receipt of director fees and, by extension, the desire to retain those fees, is not sufficient to demonstrate a lack of independence. *See, e.g., Kahn v. MSB Bancorp, Inc.*, No. CIV. A. 14712-NC, 1998 WL 409355, at *3 (Del. Ch. July 16, 1998), *aff'd*, 734 A.2d 158 (Del. Supr. 1999) ("[T]he mere fact that the directors receive fees for their service is *not enough* to establish an entrenchment motive.") (emphasis added); *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) (allegations that directors receive fees "do not establish any financial interest"). *See also Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1074-75 (Del. Ch.) ("Where a majority of the directors are independent or outside directors receiving no income other than usual directors' fees the presumption of good faith is heightened."), *aff'd,* 500 A.2d 1346 (Del. 1985); *British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519, 1530 (S.D.N.Y. 1987) ("Because the receipt of directors' fees is not sufficient to show self-interest by a board member,…the Court does not believe that the directors were truly self-interested in the recapitalization."). To hold otherwise would mean that directors would never be independent because "every director who receives a director's fee would be biased." *In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986).

Significantly, at least one court has held that fees, even when coupled with options, the value of which are material to a director, do not compromise independence. *Disney*, 731 A.2d at 359-60. Indeed, when the plaintiff argued that the fees of one director, a school principal, so far outstripped her salary that "only the most rigidly formalistic or myopic analysis would view [the director] as not beholden to [Disney's CEO]" (*id.* at 359), the court refused to find that the director lacked independence, declaring that to adopt plaintiffs' position:

(Continued on page 5)

California's Sanctions Statute: Potent Weapon Against Frivolous or Bad Faith Actions and Claims

Frivolous or bad faith actions have been a vexing problem in California and elsewhere for a long time. The California legislature has attempted to "strike a balance between competing interests: the need to control improper litigation 'tactics' and the desire to avoid chilling vigorous advocacy" by enacting statutes providing for an award of sanctions against the wrongdoers under certain circumstances.

The initial statute (Cal. Code of Civil Procedure § 128.5) required proof of subjective bad faith as well as an objectively meritless or frivolous action or tactic. In 1994, given its concern that the subjective element rendered the sanctions statute "ineffective," the California legislature decided to try an alternative approach by enacting an "experimental statute" (Cal. Code of Civil Procedure § 128.7), patterned after the federal sanctions rule (Fed. R. Civ. Proc. Rule 11), that eliminated the subjective bad faith requirement for actions and proceedings filed after January 1, 1995. Despite early procedural setbacks, California's appellate courts have started to publish precedent-setting decisions upholding the trial courts' awards of monetary sanctions under Section 128.7 against parties and their counsel for filing and pursuing frivolous or bad faith actions.

Kent A. Halkett

Section 128.7 sets forth certain requirements and standards that must be followed by parties and their counsel in actions and proceedings in California's state courts, and provides for sanctions if those requirements and standards are violated. Specifically, Section 128.7(b) provides:

> By presenting to the court, whether by signing, filing, submitting, or later advocating, a pleading, petition, written notice of motion, or other similar paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, all of the following conditions are met:
>
> (1) It is not being presented primarily for an improper purpose, such as to harass or to cause unnecessary or needless increase in the cost of litigation.
>
> (2) The claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law.
>
> (3) The allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery.
>
> (4) The denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

Section 128.7(c) provides a "safe harbor" whereby offending parties and/or their counsel are given an opportunity to correct the wrongdoing and avoid any sanctions by "withdrawing or appropriately correcting" the "challenged paper, claim, defense, contention, allegation, or denial" within the statute's twenty-one (21) day window of opportunity. Absent such voluntary corrective action, Section 128.7(d) sets forth the range of sanctions available to the trial court, including "directives of a nonmonetary

(Continued on page 4)

Continued from page 3

nature," monetary penalties payable to the court and/or "an order directing payment to the movant of some or all of the reasonable attorney's fees and other expenses incurred as a direct result of the violation." Section 128.7 sanctions are not available for discovery misconduct nor for appellate matters. A party may file a motion requesting Section 128.7 sanctions after following the two-step statutory guidelines or the court may impose such sanctions upon its own motion after following similar statutory guidelines.

There are very few reported appellate decisions addressing sanctions under Section 128.7. Moreover, until recently, all of the reported decisions from California's appellate courts uniformly reversed the trial courts' sanction awards under Section 128.7 on procedural grounds such as untimeliness, insufficient notice, and failure to comply with the "safe harbor" provisions and/or intent. That trend was changed dramatically by the decisions in *Liberty Mutual Fire Ins. Co. v. McKenzie*, 88 Cal. App. 4th 681 (2001), *Laborde v. Aronson*, 92 Cal. App. 4th 459 (2001), and *Eichenbaum v. Alon*, 2003 Cal. App. LEXIS, 2003 WL 723252, wherein monetary sanctions that had been imposed on the offending parties and their counsel under Section 128.7 were upheld on appeal.

In Liberty Mutual, an insurer filed a declaratory relief action against its insured seeking to determine coverage and, potentially, to recover the insurance proceeds that it had already paid out to the insured. The insured filed a cross-complaint against the insurer and its claims adjuster alleging breach of contract and breach of the implied covenant of good faith and fair dealing. The trial court granted the insurer's motion for summary judgment on both the complaint and cross-complaint. The trial court also imposed sanctions of $2,574 against the insured and his counsel under Section 128.7 for naming the insurer's claims adjuster as an additional defendant to the cross-complaint. Significantly, the appellate court upheld the sanctions award even though the cross-complaint had never been served on the claims adjuster and he had been dismissed without prejudice prior to the hearing on the sanctions motion. The *Liberty Mutual* court explained that sanctions were warranted since the insured had not notified the insurer or the trial court that the claims adjuster had been dismissed until the day before the sanctions hearing thereby requiring "the unnecessary expenditure of attorney and court time which could have simply been avoided had notice been given" which violated the stated purpose of Section 128.7.

In *Laborde*, while his divorce proceeding was pending, the plaintiff filed a separate action against his wife's divorce attorney and a psychologist retained to prepare a report and to testify in the divorce proceeding. The plaintiff asserted several claims, including defamation and intentional infliction of emotional distress. The trial court overruled the defendants' demurrers, but cautioned the plaintiff and his counsel about Section 128.7 sanctions. Both defendants filed motions for summary judgment and/or summary adjudication of issues, and both requested monetary sanctions under Section 128.7.

The plaintiff opposed the psychologist's motion, but the trial court granted summary judgment (holding that all of his claims were barred by the litigation privilege) and awarded sanctions against him and his counsel "jointly and severally" in the amount of $24,000 (subject to further proof and approval of the psychologist's bills) payable to the psychologist. The appellate court held that summary judgment was proper, and it affirmed the sanctions award.

The plaintiff did not oppose the attorney's motion, but rather filed a request for dismissal without prejudice as to the attorney. The trial court ordered that the plaintiff's dismissal request be withdrawn, dismissed the action against the attorney (and his firm) with prejudice, granted the sanctions motion based upon its finding that the action was "frivolous and without merit…and with bad faith (harassment)," and awarded $33,000 in sanctions against the plaintiff and his counsel. The appellate court affirmed the sanctions award, concluding that a sanctions award which compensates the wronged party "for expenses incurred in the defense of meritless claims furthers the intent" of Section 128.7. Surprisingly, given the attorney's stated willingness to withdraw his sanctions request if the complaint was withdrawn and the plaintiff's attempt to comply by dismissing the attorney prior to the hearing, the *Laborde* court did not discuss the applicability or ramifications, if any, of the "safe harbor" provisions of Section 128.7.

In 2002, following the *Liberty Mutual* and *Laborde* decisions, the Conference of Delegates of the State Bar sponsored a bill (SB 2009) to amend Section 128.7 to shorten the "safe harbor" period and to extend Section 128.7 sanctions indefinitely by eliminating the January 1, 2003 sunset date. According to its sponsor, Section 128.7 "was working well in keeping attorneys and parties from filing frivolous motions and lawsuits." The California Judges Association supported the bill, noting that the proposed amendment was consistent with the procedures and goal of the Fast Track rules and would make sanctions "meaningful" by shortening the "safe harbor" period. Ultimately, by amendment, the "safe harbor" period was reduced from 30 days to 21 days and the sunset date was extended to January 1, 2006. The California Legislature unanimously passed the bill, as amended, and Governor Davis signed it into law.

In *Eichenbaum*, the plaintiff repeatedly filed amended complaints asserting claims which the trial court had stricken "without leave to amend." The defendant served a motion for sanctions under Section 128.7, but the plaintiff dismissed his fourth amended complaint after the 21-day "safe harbor" period. Thereafter, the trial court granted the sanction motion, imposing monetary sanctions against the plaintiff and his counsel. The appellate court affirmed the sanctions award, concluding that "an untimely dismissal, with or without prejudice, is not" sufficient to preclude Section 128.7 sanctions pursuant to a motion timely filed before entry of any dismissal because the function of such sanctions is "to deter frivolous filings" as well as "to deter repetition of this conduct or comparable conduct by others similarly situated."

The *Liberty Mutual, Laborde* and *Eichenbaum* decisions demonstrate that trial courts can and will impose binding Section 128.7 sanctions against parties and their counsel who bring and pursue frivolous or bad faith actions and/or who improperly name additional parties to actions without a good faith basis for doing so. The monetary sanctions being awarded against such wrongdoers can be much more than a "slap on the wrist," thereby providing them with a real economic incentive to avoid or withdraw such actions or claims. Accordingly, Section 128.7 provides parties and future litigants with a potentially potent weapon against frivolous or bad faith actions or claims.

— Kent A. Halkett

Contributors to this Issue

Scott H. Carr is with Greene, Broillet, Panish & Wheeler LLP.

William S. Garr is a senior partner with the law firm of Hahn & Hahn LLP, Pasadena.

Allen Grodsky, a member of the *ABTL* Board of Governors, practices in Santa Monica.

Kent A. Halkett is a partner in the law firm of Miller & Holguin in Century City.

Rex S. Heinke is a partner and *Sandra M. Lee* is an associate with Akin Gump Strauss Hauer & Feld LLP in Los Angeles.

Cliff Meyer is a shareholder with Buchalter, Nemer, Fields & Younger.

Eric S. Waxman is a partner with the Los Angeles office of Skadden, Arps, Slate, Meagher & Flom LLP.

> [W]ould be to discourage the membership on corporate boards of people of less-than extraordinary means. *Such "regular folks" would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries.* I am especially unwilling to facilitate such a result.

Id. at 360 (emphasis added). *See also In re The Ltd.*, 2002 WL 537692, at *5 (a director's "compensation from his role as a director of [the company], alone, does not create a reasonable doubt as to that director's independence").

Consulting fees or fees provided to a firm with which a director is affiliated are treated much the same, except that courts will examine the amounts paid to determine if the amount was material to the individual director. Director fees or consulting fees must be distinguished, however, from situations where a director has a material financial interest in the challenged transaction itself. *See, e.g., Telxon Corp.*, 802 A.2d at 265 ("Like any other interested transaction, directoral self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation") (citations omitted); *Rales*, 634 A.2d at 936 ("A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."); *Beneville*, 769 A.2d at 84 (inside director had a "classic" self-dealing interest for purposes of demand futility where an entity in which he had a financial interest entered a marketing agreement with the corporation); *Noerr v. Greenwood*, Civil Action No. 14320, 1997 Del. Ch. LEXIS 121, at *33-36 (Del. Ch. July 16, 1997) (finding that demand was excused because a majority of the board "stood to benefit" from the challenged adoption of incentive plans). *See Orman*, 794 A.2d at 30 (while recognizing "there is no bright-line dollar amount at which consulting fees received by a director become material," court infers $75,000 to be material); *Disney*, 731 A.2d at 360 (where plaintiffs failed to allege that legal fees paid to firm affiliated with a director and consulting fees paid to him by the company were material to him, the complaint did not raise a reasonable doubt as to his independence); *In re The Ltd.*, 2002 WL 537692, at *6 (consulting fees of $150,000 to director who was a college administrator found to be material). *Accord In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999) ("[t]o show…[a] director's independence was compromised…plaintiffs must plead that the amount…was of a *sufficiently material importance, in the context of the director's economic circumstances*, as to have made it improbable that the director could perform her fiduciary duties…") (emphasis added). Similarly, charitable contributions to a public institution with which a director is affiliated may be sufficient if a plaintiff can plead facts indicating other significant ties coupled with large contributions. *Cf. Disney*, 731 A.2d at 359 ($1 million dollar donation to Georgetown insufficient when no other ties) with *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985) ("generous donations to Duke University coupled with membership on board of trustees and lengthy history of political, social and business relationships found sufficient to create reasonable doubt as to independence); *In re The Ltd.*, 2002 WL 537692, at *7 ($25 million dollar donation so "significant" as to create reasonable doubt as to independence even without facts indicating additional ties).

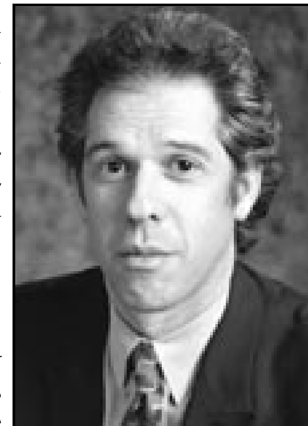
Participation in Decision or Inability to Ratify Alleged Wrongdoing

A director's independence in the demand context cannot be compromised by allegations that the director approved of or

(Continued on page 6)

Proving a Mark Is Generic Under the Lanham Act: What Are the Consequences?

Trademarks are "classified along a conceptual spectrum of increasing inherent distinctiveness." *Go-To.com, Inc. v. The Walt Disney Co.*, 202 F.3d 1199, 1207 (9th Cir. 2000). From weakest to strongest, courts categorize marks as generic, descriptive, suggestive, and arbitrary or fanciful. *Id.* This article focuses on the weakest — the generic mark. Virtually all lawyers are familiar with the term generic as applied to trademarks, but few understand precisely how courts determine what is and is not generic and what it means if a mark is found to be generic.



Allen B. Grodsky

This article will discuss the Ninth Circuit's test for genericness and show how it is applied to specific marks. The article will then examine the consequences of a finding that a mark is generic, and show how a holder of a generic mark may still assert a claim under the Lanham Act.

The Test for Genericness

The test for genericness is fairly straightforward: "A 'generic' term is one that refers, or has come to be understood as referring, to the genus of which the particular product or service is a species." *Filipino Yellow Pages, Inc. v. Asian Journal Publications, Inc.*, 198 F.3d 1143, 1147 (9th Cir. 1999). Whether a trademark is generic "depends on the primary significance of the mark *to the relevant public*." *Films of Distinction, Inc. v. Allegro Film Productions, Inc.*, 12 F. Supp. 2d 1068, 1075 (C.D. Cal. 1998)(emphasis added). The issue of genericness is a question of fact. *Committee for Idaho's High Desert, Inc. v. Yost*, 92 F.3d 814 (9th Cir. 1996).

Another way of phrasing the test is whether it is "difficult to imagine another term of reasonable conciseness and clarity by which the public [could] refer[]" to these goods and services and their producer." *See Committee For Idaho's High Desert*, 92 F.3d at 822, quoting, *Blinded Veterans Ass'n v. Blinded American Veterans Foundation*, 872 F.2d 1035, 1041 (D.C. Cir. 1989). If the Court can imagine another way to describe the goods and services in a reasonably concise way, then the marks are not generic.

In making the determination of whether a mark is generic, many courts follow the test set forth by Judge Learned Hand:

> "What do the buyers understand by the word for whose use the parties are contending?" If buyers take the word to refer only to a particular producer's goods or services, it is not generic. But if the word is identified with all such goods and services, regardless of their suppliers, it is generic and so not a valid mark.

Surgicenters of America, Inc. v. Medical Dental Surgeries Co., 601 F.2d 1011, 1016 (9th Cir. 1979), citing, *Bayer Co. v. United Drug Co.*, 272 F. 505, 509 (S.D.N.Y. 1921).

In determining whether a mark is generic, the Court must look at the mark "as a whole, rather than looking at its constituent parts individually." *Committee for Idaho's High Desert*, 92 F.3d at 821. Thus, in *Committee for Idaho's High Desert*, the Ninth Circuit held that it made no difference whether "Committee" or "Idaho's High Desert" are generic. What matters is whether the complete term "Committee for Idaho's High Desert" is generic.

(Continued on page 6)

The Lanham Act

Continued from page 5

Furthermore, the Ninth Circuit has held that dictionary definitions are "not determinative." *Filipino Yellow Pages*, 198 F.3d at 1148, *citing, Surgicenters of America*, 601 F.2d at 1015 n.11. Nevertheless, dictionary definitions are "relevant and often persuasive in determining how a term is understood by the consuming public." *Id.*

The Genericness Test as Applied

Perhaps the best way to understand the genericness test is to see how courts apply it. In the following cases, courts found that the marks at issue were generic:

• *Surgicenters of America*, 601 F.2d at 1017: "Surgicenter" is held generic because evidence (including use of term by third-parties such as Department of Health, Education & Welfare, Library of Congress, medical schools, medical publications, and many others) established that "the consuming public connected the term 'Surgicenter' with the service rather than the server."

• *Self-Realization Fellowship Church v. Ananda Church of Self-Realization*, 59 F.3d 902 (9th Cir. 1995): "Self-realization" is held generic in the context of the name of a spiritual organization. However, the Court reversed the grant of summary judgment on the issue of whether "Self-Realization Fellowship" and "Self-Realization Church" — combinations of individually generic terms — were generic, noting that the validity of those combinations was not based on the validity of the individual parts.

• *Filipino Yellow Pages*, 198 F.3d at 1151: The Ninth Circuit affirmed a finding that "Filipino Yellow Pages" is generic because "[i]f faced with the question 'What are you?', [distributors of yellow pages for the Filipino community] could all respond in the same way: 'A Filipino yellow pages.'"

In the following cases, courts found that marks were not generic:

• *Committee for Idaho's High Desert*, 92 F.3d at 821-22: "Committee for Idaho's High Desert" is not generic, because the name for the genus to which these particular services belong would probably be "environmental education and advocacy" and the name for a supplier of these goods and services might be "environmental advocacy organization."

• *Chronicle Publishing Co. v. Chronicle Publications, Inc.*, 733 F. Supp. 1371, 1375 (N.D. Cal. 1989): "Chronicle" is not "a synonym for a book and the general consuming public does not perceive 'Chronicle,' 'Chronicle Books,' or 'Chronicle Publishing,' to exclusively describe a book or a type of book or a type of book published by plaintiff."

• *Deborah Heart & Lung Center v. Children of the World Foundation, Ltd.*, 99 F. Supp.2d 481 (D. N.J. 2000): "Children of the World" is not generic to describe a charity that provides hospital services to foreign children because there are other terms that can be used to describe the targeted group, such as "Humanity's Children" or "The World's Children."

What Is the Effect of a Mark Being Generic?

A generic mark cannot become, and cannot be protected as, a trademark. *Surgicenters*, 601 F.2d at 1014; *Chronicle Publishing Co.*, 733 F. Supp. at 1375.

While a generic mark cannot be protected "as a trademark," that does not necessarily mean that a misleading use of a generic mark cannot form the basis of a false designation of origin claim under Section 43(a) of the Lanham Act.

Various courts have found that the *misleading* use of a generic mark can still support a claim for relief under the Lanham Act. The Second Circuit has held that a finding that a mark is generic does not foreclose relief under Section 43 (a) if:

(1) goods or services are involved,

(2) interstate commerce is affected,

(3) "an association of origin by the consumer" between the generic term and the first user exists (*i.e.*, secondary meaning), and

(4) there is a likelihood of consumer confusion as to the goods' or services' source when the generic term is applied to the second user's goods or services.

Manning Int'l. Inc. v. Home Shopping Network, Inc., 152 F. Supp.2d 432, 436 (S.D.N.Y. 2001). *See also Blinded Veterans Ass'n*, 872 F.2d 1035 (while a subsequent competitor cannot be prevented from using a generic term to denote itself or its product, "it may be enjoined from passing itself or its product off as the first organization or its product"). The Ninth Circuit has not yet opined on the validity of this test.

Conclusion

Defendants in a trademark action (especially where the trademark is not registered) should always consider raising genericness as an issue: the consequences of a finding of genericness are devastating to the plaintiff's claim. On the other hand, a trademark plaintiff should draft its complaint with the risk of genericness in mind and define the genus of the product or service in such a way that it is *not the same* as the name of the product itself.

— Allen B. Grodsky

Demand Requirement in Derivative Actions

Continued from page 5

voted for the action complained of by the derivative plaintiff. Allegations that demand is excused because the acts complained of are incapable of ratification likewise "'misses the point of the demand requirement.'" *See Johnson v. Hui*, 752 F. Supp. 909, 912-13 (N.D. Cal. 1990) (*citing Lewis v. Sporck*, 612 F. Supp. 1316, 1322-23 (N.D. Cal. 1985), *declined to follow on other grounds*, by *Chang v. Chen*, 80 F.3d 1293 (9th Cir. 1996)). As noted by the court in *Johnson*, "[r]atification is not the only option; the board must be given a fair opportunity to decide whether the corporation itself should bring the suit." *Id.* at 913. As numerous courts have held:

> Such allegations are conclusory at best…. [M]ere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterestedness of a majority of the directors, is insufficient to excuse demand.

Aronson, 473 A.2d at 817; *see also Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 65 (D.C. Cir. 1988) ("mere 'acquiescence' in the challenged act by the board of directors is not enough to show that the board will not consider the shareholder's petition fairly"); *Findley*, 109 Cal. App. 2d at 176 (allegations that the board "'participated' in," "'knowingly shielded'" and "'actively concealed'" the alleged wrongs are insufficient to demonstrate futility).

Naming of all of the directors as defendants does not strengthen a plaintiff's claim that a board lacks independence to consider a demand. As the Delaware Supreme Court pointed out, to rule otherwise:

> [W]ould effectively abrogate [the demand requirement] and weaken the managerial power of directors. Unless facts are alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, in which case the directors could not be expected to sue themselves, a bare claim of this sort raises no legally cognizable issue under Delaware corporate law.

Aronson, 473 A.2d at 818; *Shields*, 15 Cal. App. 4th at 1621-22. Similarly unavailing are allegations that directors would be unwilling to sue themselves. *See, e.g., Pogostin v. Rice*, 480 A.2d 619, 625 (Del. 1984) (such "bootstrap allegations of futility, based on claims of directorial participation in and liability for the wrongs alleged, coupled with a reluctance by directors to sue

(Continued next page)

themselves, were laid to rest in *Aronson*"); *Lewis v. Sporck*, 612 F. Supp. 1316, 1322-23 (N.D. Cal. 1985) (Plaintiff's allegations that the "'[d]irectors would have to sue themselves'…has been rejected by every circuit court that has considered the issue"). Similarly, a board's failure to act in the face of alleged wrongdoing does not necessarily excuse demand. *Blasband v. Rales*, 971 F.2d 1034, 1052 (3d Cir. 1992) ("[A] board's failure to take action, even if it is aware of wrongdoing, does not demonstrate futility").

On the other hand, demand may be excused where the complaint alleges "'specific facts establishing that the potential for liability is not "a mere threat" but instead may rise to a substantial likelihood.'" *See Kohls v. Duthie*, 791 A.2d 772, 779, 782-83 (Del. Ch. 2000), *aff'd*, 794 A.2d 1160 (2002) (holding that plaintiffs alleged sufficient interest for demand futility purposes where the director faced a "substantial threat of personal liability" because actions "'implicates his duty of loyalty to [the company] and…amounts to bad faith'") (citations omitted); *see also Rales*, 634 A.2d at 936 (where "'a mere threat'" of potential liability rises to "'a substantial likelihood'" of such, the directors are disabled from impartially considering a response to a demand) (citation omitted). It is not sufficient, however, simply to allege that demand is futile because defendants would be exposed to personal liability in an amount likely to be in excess of any insurance coverage available. *See, e.g., Caruana v. Saligman*, Civil Action No. 11135, 1990 Del. Ch. LEXIS 210, at *11 (Del. Ch. Dec. 21, 1990) (the directors' decision whether to cause the corporation to sue themselves does not become "interested" merely because the corporation's directors and officers liability insurance policy excludes coverage for suits brought by the corporation against the directors).

Allegations That the Challenged Transaction Was Not a "Valid Exercise of Business Judgment"

To successfully invoke *Aronson's* second prong, a derivative plaintiff must "plead particularized facts creating a reasonable doubt as to the 'soundness' of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction." *Levine*, 591 A.2d at 206. *See also Brehm v. Eisner*, 746 A.2d 244, 258 (Del. 2000). *Accord Lee*, 50 Cal. App. 4th at 715 (the presumption of good faith and informed business judgment accorded to the board's decisions "can be rebutted only by the affirmative allegations of fact which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts"). This second prong is less frequently invoked by plaintiffs in trying to establish demand futility. This is not surprising because, as described by one noted commentator "the second prong of Aronson is directed to '*extreme cases*' in which, despite the appearance of independence and disinterest, a decision is so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review." II Rodman Ward, Jr., *et al., Folk on the Delaware General Corporate Law*, § 327.4.6.7, at 87 (4th ed. 2000-1 Supp.) (emphasis added).

Satisfying this second prong, therefore, requires a plaintiff to plead specific facts demonstrating that the board failed to exercise either "procedural" or "substantive due care" with respect to the challenged transactions. *Grobow*, 539 A.2d at 189. In a subsequent decision, the Delaware Supreme Court created some question about the "substantive due care" aspect of *Aronson's* second prong, stating:

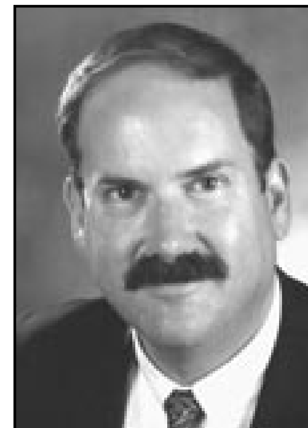
> As for the plaintiffs' contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care is the decision-making context in *process* due care only. Irrationality is the outer limit of the business judgment

(Continued on page 11)

Drafting and Enforcing Attorneys' Fees Clauses

The last twenty-five years have seen remarkable changes in business litigation. Probably foremost among these is the fast pace and related increased expense of litigation. Whereas two decades ago, it was not uncommon to take up to five years to get to trial (and sometimes, with appropriate waivers by counsel, even longer), now, with the advent of "Fast Track" rules statewide, it is fair to say that most cases reach trial in about a year.

While the speed of litigation has changed, the complexity of the issues involved in many cases — and the time it takes to resolve them — has not. If anything, issues have become more difficult. Combined with escalating hourly rates and increased office overhead expenses, the cost of litigation has become critical. Contributing to the expense is the fast and furious pace of completing discovery, conducting depositions, engaging in law and motion practice, and making the all-important motion for summary judgment or summary adjudication of issues, all before a fast-approaching trial date. In today's business litigation world, clients are receiving higher attorneys' fees statements, sooner. As a result, the ability to recover attorneys' fees has become a serious issue, and in many cases, it is a determinative issue in deciding whether to file and proceed with litigation.



William S. Garr

Attorneys' Fees Clauses and Claims

While sometimes available by statute, the majority of business litigation cases resulting in attorneys' fees claims and recovery involve the pleading, prayer and proof of an effective attorneys' fees clause. If provided for in the contract, an attorneys' fees clause — properly drafted — can cover both contractual and related tort claims. The clause can also govern the extent of recovery, such as, for example, the "actual" amounts incurred, not just a reasonable amount. A problem arises when, as is typical, the lawyer litigating the case is not the same lawyer who drafted the attorneys' fees provision. Put another way, the corporate lawyer drafting the attorneys' fees clause more often than not never experiences how the courts interpret it. (In fact, it is probably a good idea to pass this issue of the *ABTL Report* on to your business and corporate law partners, so they can read this article.) Before drafting an attorneys' fees provision, the differences in state court vs. federal court enforcement of such clauses should be noted.

Differences in Enforcement — Federal vs. State Court

A. California Law

Under California law, parties may allocate the recovery of attorneys' fees by contract. *See* Cal. Civ. Proc. Code §1021. If the recovery of attorneys' fees is provided for by contract, the prevailing party in an action may seek fees as an element of its post-trial costs. *See* Cal. Civ. Code §1717 and Cal. Civ. Proc. Code §1033.5(a)(10)(A). Moreover, California law now also provides for the recovery of contractual attorneys' fees *after trial* when enforcing a judgment. *See* Cal. Civ. Proc. Code §685.040.

(Continued on page 8)

Drafting and Enforcing Attorneys' Fees
Continued from page 7

If broad enough, a contractual attorneys' fees clause may also cover tort claims related to the contractual dispute. *Allstate Insurance Co. v. Loo*, 46 Cal.App. 4th 1794 (1996) (holding that the language "any lawsuit or other legal proceeding" to which "this agreement gives rise" was broad enough to encompass tort claims); and *Lerner v. Ward*, 13 Cal.App. 4th 155 (1993) (fees recoverable on contractual claims as well as for fraud claims). Importantly, California law also provides that attorneys' fees provisions are, in fact, to be read broadly and are to be liberally construed. *Pacific Custom Pools, Inc. v. Turner Construction Co.*, 79 Cal.App. 4th 1254 (2000) (language provided for fee recovery if a specified party succeeded in defending against a claim; court held that recovery should be had when that party successfully "prosecuted" its claim). *See also* Cal. Civ. Proc. Code §1032.

The foregoing ability to contract out of the general American rule regarding attorneys' fees recovery is limited by California Civil Code §1717. Section 1717 prohibits a dominant contracting party from solely limiting attorneys' fees relief to itself. Rather, Section 1717 provides for attorneys' fees reciprocity. In other words, the benefits of an attorneys' fees provision should be mutual, and if they are not, they will be so construed pursuant to Section 1717. In all cases, the court must still determine who is the "prevailing party." It is also important to note that attorneys' fees claimed solely pursuant to Section 1717 are limited to attorneys' fees required to litigate the *contractual claims* only. *Santisas v. Goodin*, 17 Cal.4th 599, 615 (1998). Attorneys' fees claimed for *tortious conduct* are allowed as costs pursuant to Cal. Civ. Proc. Code §§1032 and 1033.5(a)(10)(A). *Id.* (*Note*: a technically different standard regarding the interpretation of "prevailing party" may apply in pure contractual, versus pure tort, fee recoveries, which complex discussion is beyond the scope of this article.)

B. Federal Law

Federal courts may also enforce an attorneys' fees clause in a contract, although, in the absence of such a contract (rule or statute) so authorizing fees, each party must bear its own attorneys' fees. *Sheet Metal Workers' Int'l Ass'n Local Union No. 359 v. Madison Indus., Inc.*, 84 F. 3d 1186, 1192 (9th Cir. 1996). Moreover, because most business litigation in federal court arises out of either diversity jurisdiction or supplemental jurisdiction, federal courts generally look to the law of the state governing the contract. *Marsu v. Walt Disney Co.*, 185 F. 3d 932, 939 (9th Cir. 1999). However, federal courts tend to be more protective of the general American rule restricting attorneys' fees, and will refuse to enforce a contractual attorneys' fees clause if an award of fees would be either "inequitable" or "unreasonable." *De Blasio Constr. Inc. v. Mountain States Constr. Co.*, 588 F. 2d 259, 263 (9th Cir. 1978). While federal courts seem to have more latitude in interpreting and enforcing attorneys' fees provisions, a federal court must award fees when an inequity would not result. *Anderson v. Melwani*, 179 F. 3d 763 (9th Cir. 1999).

Drafting

To avoid the reciprocity problems of Section 1717, *supra*, a properly drafted attorneys' fees provision should be mutual. The language should also be broad enough to encompass "any lawsuit or legal proceeding" to which "this agreement gives rise." *Allstate, supra*. An attorneys' fees clause should also be *specific*, for example, it should provide for the recovery of "actual" attorneys' fees, not just "reasonable" attorneys' fees. Additionally, a properly drafted attorneys' fees provision should also cover costs. In fact, so as not to be limited to a statutory list of costs, the recovery of expenses should be provided, "whether or not otherwise recoverable as allowable costs." *Compare* Cal. Civ. Proc. Code §1033.5, *et al.* Finally, the lawyer drafting an effective attorneys' fees clause should consider coverage for delayed or subsequent litigation, such as might happen once an initial action is over. An example of this would be where a contractual provision provides for fees and costs in a non-judicial foreclosure proceeding, yet later, the lender becomes embroiled in defending against a Truth In Lending Act ("TILA") lawsuit brought by the consumer for improper disclosures. In this example, attention should be given in drafting the attorneys' fees clause so that recovery of fees may be obtained for not only enforcing the contract, but also, for defending against any action involving the contract.

Recovery

Finally, keep in mind that attorneys' fees, if recoverable, are only awarded on noticed motion after the underlying litigation has been concluded. Therefore, throughout the adversary process, detailed time entries should be kept by all counsel. Increasingly, courts require "itemization," not "lumping," of tasks performed, along with similar detail regarding the hours and amounts spent on each. Keeping track of time in this manner also enables the moving party to more easily "redact" inapplicable or privileged items on the attorneys' fees statements submitted to the court.

— William S. Garr

P.O. Box 351649
Los Angeles, California 90035
(323) 939-1999 • FAX: (323) 935-6622
e-mail: abtl@attbi.com • www.abtl.org

□ **OFFICERS**
Robert S. Span
President
(213) 683-6253

Alan E. Friedman
Vice President
(213) 243-2517

Jeff S. Westerman
Secretary
(213) 617-9007

Patrick A. Cathcart
Treasurer
(213) 623-7777

□ **BOARD OF GOVERNORS**
Debra Albin-Riley • Hon. Valerie Baker • Michael K. Brown
Joanne E. Caruso • Hon. Florence-Marie Cooper
Hon. Larry Crispo • Andre J. Cronthall • David P. Enzminger
Michael K. Grace • Allen B. Grodsky
Hon. Jeffrey Johnson • Paul R. Kiesel • Hon. George King
Edward A. Klein • Joel Krischer • Steven G. Madison
Hon. A. Howard Matz • Mark R. McDonald
Kathleen M. McDowell • Hon. Anthony Mohr
Michael A. Sherman • Steven E. Sletten • Julia B. Strickland

□ **EXECUTIVE DIRECTOR**
Rebecca Lee Cien

□ **EDITOR**
Denise M. Parga

□ **CONTRIBUTING EDITORS ON THIS ISSUE**
Scott H. Carr • William S. Garr • Allen B. Grodsky
Kent A. Halkett • Rex S. Heinke • Sandra M. Lee
Cliff Meyer • Eric S. Waxman

□ **MANAGING EDITOR**
Stan Bachrack, Ph.D.

Class Certification and Evidentiary Objections to Motions: Sav-on Drug Stores, Inc. v. Superior Court, Case No. S106718

The California Supreme Court has granted review in a case involving the certification of a plaintiff class in an overtime wage case. The plaintiffs in *Sav-on Drug Stores, Inc. v. Superior Court* consist of approximately 1500 current and former operating managers ("OMs") and assistant managers ("AMs") of Sav-on Drug Stores, Inc. ("Sav-On") in California. They allege that Sav-on misclassified them as exempt from California's overtime wage requirements, and they seek wages, penalties, and declaratory and injunctive relief. An employee is exempt from California's overtime wage requirements if, among other things, the employee spends more than 50% of his or her working time on intellectual, managerial, or creative work. Cal. Wage Order No. 7-98, Cal. Code Regs tit. 8, § 11070(1)(A)(1); *Ramirez v. Yosemite Water Company*, 20 Cal.4th 785 (1999).

Rex S. Heinke

The trial court certified a class of plaintiff OMs and AMs, finding that whether each plaintiff was exempt raised common questions of law or fact that predominated over individual issues. The Court of Appeal, however, reversed, directing the trial court to enter an order denying class certification. *Sav-On Drug Stores, Inc. v. Superior Court*, 97 Cal. App. 4th 1070 (2002). The Supreme Court granted review on July 17, 2002.

There are literally hundreds of overtime "misclassification" class actions pending in California trial courts, and more are being filed every day. Because of the growing number of these cases, the Supreme Court's guidance on the propriety of such class certification and the appellate standard of review for class certification will be of great interest to both plaintiffs and defendants.

Sav-on Drug Stores also raises important issues involving the waiver of evidentiary objections to evidence submitted to support motions.

The plaintiffs assert that substantial evidence supports the trial court's ruling that whether each plaintiff is exempt from California's overtime wage requirements raises common questions that predominate over individual issues. Among other evidence, the plaintiffs point to the interrogatory responses of the two named plaintiffs, listing the tasks they perform as an OM and an AM and the time spent on those tasks, and stating that Sav-on has a policy of having its OMs and AMs spend a majority of their time performing non-exempt tasks. The plaintiffs also point to declarations from two general managers ("GMs") and one OM, listing the tasks performed by AMs and opining that all AMs perform the same tasks in all Sav-on stores. In addition, the plaintiffs cite evidence that Sav-on classified all its OMs and AMs as exempt on a group basis, and that Sav-on subsequently re-classified its AMs as non-exempt in December 1999. The plaintiffs argue that this evidence demonstrates that the actual tasks performed by OMs and AMs and the amount of time spent on those tasks raise common questions that predominate over individual issues, so class certification was appropriate.

Sav-on argues that substantial evidence does not support the trial court's ruling because the plaintiffs' evidence is conclusory and insubstantial when considered in light of the undisputed evidence submitted by Sav-on. Sav-on points to the declaration of one of its human resources managers, discussing the many differences among Sav-on's approximately 300 stores in Southern California, including differences in size, format (*i.e.*, stand-alone stores, express stores, or combination stores), and hours of operation. This declaration discusses how the differences among Sav-on's stores affect the actual tasks performed by OMs and AMs and the amount of time spent on those tasks. Sav-on also points to 51 declarations from OMs and AMs, listing the tasks each performs and the time spent on those tasks, and discussing how the tasks they perform are affected by variables such as the management style of the GM, the experience level of the OM or AM, or the level of employee turnover in their particular store. Sav-on argues that these declarations demonstrate that the actual tasks performed by OMs and AMs vary significantly from manager to manager and store to store, and therefore that each plaintiff's exemption cannot be determined on a classwide basis.

Sandra M. Lee

The plaintiffs also argue that the Court of Appeal applied an erroneous test in holding that the trial court abused its discretion in certifying the class. Specifically, the plaintiffs assert that the Court of Appeal required them to prove at the certification stage that Sav-on's exemption policy was "right as to all members of the class or wrong as to all members of the class." The plaintiffs argue that this standard improperly requires a merits analysis at the certification stage. The plaintiffs also argue that this standard is contrary to California public policy favoring class actions to protect employees who might not otherwise bring their claims.

Sav-on responds that the Court of Appeal did not, in fact, require that all class members be identically situated; it merely applied the well-established predominance standard and held that the class members' claims were not sufficiently similar to merit class treatment. Sav-on also asserts that public policy favors class certification only when the predominance requirement has been met, and that certifying a class absent such predominance places an undue burden on defendants and forces expensive settlements of meritless actions. In addition, Sav-on argues there is no evidence that the plaintiffs in this case would not pursue their claims individually, since their attorneys would be entitled to fees by statute if they prevailed and the individual claims are likely to be substantial.

The plaintiffs argue that the Court of Appeal improperly applied a *de novo* standard. They claim the Court reweighed the evidence and found Sav-on's evidence to be more credible than the plaintiffs' evidence.

Sav-on argues that the Court properly applied the substantial evidence standard of review, because even under that standard, an appellate court must review the entire record and consider whether the trial court's ruling was reasonable in light of that record. Sav-on argues that when the plaintiffs' evidence is viewed in the context of Sav-on's evidence, it is clear that the plaintiffs' evidence is too conclusory and insubstantial to sustain the trial court's ruling, because the tasks and the amount of time spent on them vary so much from employee to employee.

In the trial court, the plaintiffs also filed written objections to the 52 declarations submitted by Sav-on. The trial court did not specifically rule on those objections, and the plaintiffs did not raise their objections orally at the class certification hearing. The trial court did, however, state in its written order granting certification that it was relying on "admissible evidence."

(Continued on page 12)

Measure of Damages

Continued from page 1

February 21, 2000, the transfer agent had all documents necessary from the plaintiff in order to effectuate the transfer of shares. As of that date, the share price was $120 - $125. On February 25, 2000, the share price reached a high of $243.50. On March 6, 2000, the publicly traded corporation announced a secondary stock offering, which included the participation of the top executives with both the acquired company and the acquiring company. As of that date, the stock was trading at $220. Plaintiff finally received his shares on March 9, 2000. As of that time, the stock was trading at $190 per share. Upon receiving his stock certificates, plaintiff changed his mind and decided to immediately sell only one-half of his shares and to retain the other one-half based, in part, upon statements made by his friend, the CEO of the acquired company, indicating that the corporation was financially secure. As of the date set for trial, plaintiff still retained 28,000 shares of stock, and the market price declined to less than one dollar per share. In the legal action that was filed, plaintiff alleged that the stock certificates were wrongfully withheld, and that the delay occurred due to actions of the acquired company, the acquiring company and the transfer agent. The primary difficulty in attempting to resolve the matter arose not from a determination of liability, but rather in how to value the loss given the rapidly fluctuating stock price during the relatively short period of time of the delay. Consequently, depending upon which dates were chosen for use in measuring the delay, the plaintiff's damages ranged from $0 to $8,000,000. Thus, for the parties to mediate a resolution which was mutually satisfactory, a fair and equitable method of calculating the stock loss had to be determined. While this article discusses various methods used for calculating stock loss when interference occurs, additional damages may be available depending upon the specific jurisdiction and causes of action involved. Such additional damages may include damages for emotional distress, lost interest, lost dividends and legal fees as well as punitive damages.

Interestingly, California law is relatively silent on how to adequately measure damages for the wrongful interference with one's ability to trade stock. In *Wong v. Paine, Webber, Jackson & Curtis* 208 Cal. App. 2d 17 (1962), the court was confronted with a situation involving a stock broker's conversion of shares to his own use, which he was to have purchased for his client. Ultimately, the court concluded that the action was governed by California Civil Code § 3336 which read (and still reads):

> "The detriment caused by the wrongful conversion of personal property is presumed to be: first — the value of the property at the time of the conversion, with the interest from that time, or, an amount sufficient to indemnify the party injured for the loss which is the natural, reasonable and proximate result of the wrongful act complained of and which a proper degree of prudence on his part would not have averted; and second — a fair compensation for the time and money properly expended in pursuit of the property."

In applying this statute, the court concluded that since plaintiffs could have purchased replacement stock at the time they learned of the conversion, they reasonably should have borne the burden of any loss should the stock price have declined while, conversely, they could have reaped the benefit if the stock price increased, as it did. Thus, the *Wong* court placed the burden upon the plaintiffs to take action to purchase additional stock. The result reached in *Wong* is considered by many to be flawed in several respects and, thus, has not been often followed by other jurisdictions. There are myriad reasons why this is so.

Initially, *Wong* forces an injured plaintiff to expend additional sums of money, without regard to his financial ability, in order to protect a culpable defendant from any further losses. Thus, *Wong* places substantial burdens on the innocent party for the protection of the wrongdoer. Moreover, *Wong* does not account for current market conditions where stock values fluctuate substantially on any given trading day, nor does *Wong* take into consideration what a party is to do when he ultimately expects to receive his stock certificates, but the certificates are unreasonably delayed. *Wong* also fails to allow the injured party any time to evaluate market trends before being required to purchase replacement stock. This absence of a "reasonable time" factor differentiates *Wong* from the approach utilized in many other jurisdictions. Under the rule described in *Wong*, as applied to the factual scenario described above, the plaintiff would have been forced to purchase additional shares at a cost of approximately $8,000,000 to "protect" the culpable defendants. Thus, the general rule for damages arising from conversion as set forth in *Wong* is neither reasonable nor feasible in many situations.

Other jurisdictions have utilized alternative approaches in an effort to arrive at an equitable solution to this difficult problem. One of the oldest approaches is derived from a line of New York cases beginning with *Baker v. Drake,* 53 N.Y. 211 (1873). To pay homage to this line of cases, the rule articulated therein is referred to commonly as the "New York Rule." The New York Rule states that the damages to be awarded for conversion or other interference with stock are equal to the value of the highest price of the stock within a reasonable time after learning of the wrongful interference or conversion. Thus, in a rising market, the plaintiff would be granted a reasonable time from the date he learned of the interference to decide whether to retain or dispose of his stock. In a falling market, the New York Rule provides the plaintiff with the option of claiming the market value at the time of conversion or wrongful interference so that he is not penalized by the defendant's wrongful conduct. This is also the rule that is followed in many federal courts. (*See Schultz v. Commodity Futures Trading Commission,* 716 F.2d 136 (2d Cir. 1983).)

Thus, the New York Rule addresses many of the concerns inherent in the *Wong* decision. However, it raises a host of new potential concerns. For example, the New York Rule disregards the time between the date of conversion and the date the shareholder learns of the conversion. Therefore, the injured shareholder may be left without any remedy to take advantage of an increase in share price should it occur between the date of conversion and the date he learned of the conversion. In addition, some would argue that the reasonable time element under the New York Rule is ill defined, thus allowing for inconsistency of results between factually similar cases.

A variation of the New York Rule is utilized by several jurisdictions, including Pennsylvania, as set forth in *Fletcher v. Cobuzzi,* 510 F.Supp. 263 (W.D. Pa. 1981). Those jurisdictions provide that damages shall be calculated utilizing the highest value attained by the stock between the date of conversion and a reasonable time after notice to the plaintiff. Interestingly, the jurisdictions which apply this rule include the specific time frame excluded by the New York Rule while conversely choosing to ignore the period of time following the date the stockholder learned of the conversion. The purpose of this rule, as described by the *Fletcher* court, is to place the plaintiff in the same position as if the defendant had not interfered with the stock. This measure of damages has also been criticized. While this approach accounts for the time between the date of conversion and the date the plaintiff reasonably learned of such conversion, it still assumes that the plaintiff would have sold the stock at the highest price during that time frame. For this as well as many other reasons, most jurisdictions have rejected this variation on the New York Rule as a method for adequately assessing damages.

Some courts have awarded damages based upon the highest price of the stock from the date of conversion up through the time of trial. For example, Louisiana applies this rule as enunciated in *Quealy v. Paine Webber Jackson & Curtis, Inc.*, 475 So.2d 756 (1985). *Quealy*, while recognizing the "traditional" measure of damages for conversion as set forth in cases such as

(Continued on page 11)

Demand Requirement in Derivative Actions

Continued from page 7

> rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.

Brehm, 746 A.2d at 264. To the extent a lack of "substantive due care" still has vitality, a derivative plaintiff may be required to plead particularized facts showing that the transaction constituted waste. The showing required to demonstrate "corporate waste" is very high. As set forth in *Brehm*:

> "[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade… . If,…there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude ex post that the transaction was unreasonably risky. Any other rule would deter corporate boards from the optimal rational acceptance of risk, for reasons explained elsewhere. Courts are ill-fitted to attempt to weigh the "adequacy" of consideration under the waste standard or, *ex post*, to judge appropriate degrees of business risk."

Id., 746 A.2d at 263 (citing *Lewis v. Vogelstein*, 699, A.2d 327, 336 (Del. Ch. 1997) (citation omitted and italics in original). *See Brehm*, 746 A.2d at 262-3; *Stein*, 1985 Del. Ch. LEXIS 418 at *11; *cf. Katz*, 22 Cal. App. 4th at 1366 ("'A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be "attributed to any rational business purpose."'") (citations omitted).

To demonstrate a lack of procedural due care, plaintiff must plead *particularized facts* showing "gross negligence" in the directors' decision-making process. *Grobow*, 539 A.2d at 190. Here, the focus is on the board's "due care" and, in particular, on whether directors adequately informed themselves before taking the action challenged by the derivative plaintiff. "[I]n making business decisions, directors must consider all material information reasonably available… ." *Brehm*, 746 A.2d at 259. This does not mean that "the Board must be informed of *every* fact." *Id.* (italics in original). Rather, a board "is responsible for considering only *material* facts that are *reasonably available*, not those that are immaterial or out of the Board's reasonable reach." *Id.* (italics in original). In this context, material means "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking." *Id.* at 259 n.49. *See also Brehm*, 746 A.2d at 259 (plaintiff must plead "particularized facts [to] create a reasonable doubt that the informational component of the directors' decision-making process, *measured by concepts of gross negligence*, included consideration of all material reasonably available") (italics in original). Allegations of gross negligence relating to a director's duty of care will implicate considerations of statutes like section 102(b)(7) of the Delaware General Corporation Law that allows Delaware corporations to include in their certificate of incorporation a provision to "limit[] the personal liability of a director to the corporation or its stockholders for monetary damages" at least with respect to breaches of the duty of care. Del. General Corp. Law, § 102(b)(7) (2001); *see* generally *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223-24 (Del. 1999); *Orman*, 794 A.2d at 39-41; I Rodman Ward, Jr., *et al., Folk on the Delaware General Corporation Law*, § 102.15 (4th ed. 2003-1 Supp.).

Conclusion

Even in this era of heightened sensitivity to the conduct of directors, the demand rule provides an effective and necessary check on derivative litigation. As the Delaware Supreme Court pointed out in *Brehm*, courts should not confuse a board's failure to "establish and carry out ideal corporate governance policies" with the standards for personal liability of directors. 746 A.2d at 255-56 ("[T]he law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals . . . are highly desirable,…. [b]ut they are not required by the corporation law and do not define standards of liability"). Strict application of demand requirements, therefore, create:

> "[A] balanced environment which will: (1) on the one hand deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule."

Brehm, 746 A.2d at 255 (quoting *Grimes v. Donald*, 673 A.2d 1207, 1216-17 (Del. 1996)).

— Eric Waxman

Measure of Damages

Continued from page 10

Wong (the value of the property at the time of conversion), also recognized that such was an inadequate remedy where the chattel in question fluctuates substantially in market value. Thus, *Quealy* determined that when wrongful interference occurs, the damages should be measured by calculating the highest price between the date of such wrongful interference and the day before trial. Such method recognizes that the plaintiff should recover full value in a rising market, to compensate him for *any* potential loss. This approach has also been criticized in that, in practice, it assumes that the plaintiff would have sold his stock at the highest possible price. Supporters of this approach, however, argue that while it is unknown at what price the plaintiff would have ultimately sold his stock, he should receive all of the benefits of a rise in stock price because the decision to sell was taken out of his hands. Thus, the wrongdoer must suffer all consequences of stock price increases during the period of time in question.

Other jurisdictions advocate an approach which determines damages based upon the severity of the conduct causing the delay. In Texas, for example, with respect to chattels of fluctuating value such as stocks, some courts have determined that for simple negligence, or other unintentional interference, the stock will be valued as of the time of such wrongful act. However, in cases involving fraud, wilful wrong or gross negligence, the measure of damages has been described as the highest market value between the date of conversion and the date of filing of the suit. *Miller v. Kendall,* 804 S.W.2d 933 (1991); *Patterson v. Wizowaty,* 505 S.W.2d 425 (1974). However, even in Texas, there is a divergence of authority between the courts as to a single appropriate measure of such damages. In *Romano v. Dempsey-Tegler & Company,* 540 S.W.2d 538 (1976), the court added another factor, concluding that damages may be available for the highest intermediate value of the stock between the date of conversion and the time of trial where suit is promptly tried after filing. Iowa also follows the *Romano* approach. *Nelson v. All Am. Life & Fin. Comp.*, 889 F.2d 141 (8th Cir. 1989).

Some jurisdictions have allowed for damages to be based upon the highest value reached by the stock between the time of the wrongful interference and trial. *Ott v. Fox,* So.2d 836 (ALA.1978). Still others have based their damage calculation upon the highest value of the stock between the time of the wrongful interference and the entry of judgment. *Kaplan v. Cavicchia,* 107 N.J. Super. 201, 257 A.2d 739 (1969).

Part 2 will highlight additional recent developments in this area and their practical application.

— Scott H. Carr

Pending in the California Supreme Court
Continued from page 9

The plaintiffs argue that under *Biljac Associates v. First Interstate Bank*, 218 Cal. App. 3d 1410 (1990), the trial court's stated reliance on "admissible evidence" was sufficient to preserve their objections for review. The plaintiffs also argue that under the abuse of discretion standard of review, an appellate court may revisit evidentiary objections if necessary to affirm a trial court's order, because an appellate court must affirm the trial court on any theory of law applicable to the case, and must imply any findings necessary to support the trial court's order.

Sav-on argues that the plaintiffs' objections were based primarily on its alleged failure to disclose the identity of its declarants in response to the plaintiffs' discovery requests, and that the plaintiffs waived their objections by failing to bring a motion to compel with respect to that discovery. Sav-on also argues that the plaintiffs waived their objections because well-settled precedent establishes that an objection that is not ruled upon by the trial court, or at least pressed by the party asserting the objection at the hearing, is waived on appeal. Sav-on further argues that *Biljac* does not apply because it is limited to summary judgments where a *de novo* standard of review governs, and because the parties in *Biljac* did press their objections at the hearing. To the extent *Biljac* holds otherwise, Sav-on urges the Supreme Court to overrule it. Finally, Sav-on argues that evidentiary objections cannot be viewed as new theories of law or implied findings necessary to support a trial court's order, but are instead separate issues that must be ruled upon by the trial court or they are waived on appeal.

In sum, *Sav-on Drug Stores* presents the Supreme Court with an opportunity to consider (1) the nature and quantum of evidence necessary to certify a plaintiff class in an overtime exemption case; (2) the extent to which an appellate court can review the record in a class certification case; and (3) what it takes to preserve an evidentiary objection to a motion for appellate review. Whatever the Court rules will have a significant effect on the manner in which class action overtime "misclassification" cases are litigated. The Court's ruling will also have broader implications for the nature of appellate review of a trial court's class certification ruling, and for how evidentiary objections are handled during motion practice.

— Rex S. Heinke and Sandra M. Lee

IN MEMORIAM

MURRAY M. FIELDS

1909-2002

Murray M. Fields, one of the founders of the ABTL, passed away on December 20, 2002 at the age of 93. He was also one of the original partners of the firm now known as Buchalter, Nemer, Fields & Younger.

Murray was born in Brooklyn, NY in 1909, did his undergraduate work at Duke and Columbia and then attended New York University Law School at night. He was admitted to the New York Bar in 1935 and got a job as an associate where, as he liked to tell Buchalter associates, he made as much as $20 a week. Murray served as an MP in the Army in World War II and then came to California, where he was admitted in 1947. In 1948, he, Irwin Buchalter and Jerry Nemer formed the law firm which now bears their names.

Murray was one of the first lawyers to see a need for an association to deal with the unique problems of business litigators. Accordingly, in 1973 he co-founded the ABTL with 11 other attorneys. At age 89, Murray attended the 25th Annual ABTL meeting in Hawaii, where the Association gave him a standing, singing birthday greeting.

Murray continued to visit his firm until shortly before his death, including attending a gala 93rd birthday celebration in his honor. His wisdom, wit and charm remained with him until the end.

— Cliff Meyer

abtl REPORT

P.O. Box 351649
Los Angeles, California 90035

PRSRT STD
U.S. POSTAGE
PAID
INGLEWOOD, CA
PERMIT NO. 196