

FINLEY V. SUPERIOR COURT FOR THE COUNTY OF ORANGE

80 Cal.App.4th 1152, 96 Cal.Rptr.2d 128 (Cal. App. 2000)

Several related homeowners associations used homeowner-paid assessments to make contributions to a political action committee to support a local Orange County ballot measure. Plaintiffs, who are members of the homeowners associations, challenge these contributions as ultra vires, illegal, and in violation of their constitutional rights to free speech and association. [...]

I. FACTUAL BACKGROUND

United Laguna Hills Mutual (United), Third Laguna Hills Mutual (Third), and another association not a party to this action are the homeowners associations for different portions of Leisure World, a senior citizens community in Laguna Hills.

Golden Rain Foundation of Laguna Hills (Golden Rain) functions as a sort of master homeowners association. Each of the homeowners associations at Leisure World is a voting "corporation member" of Golden Rain; each of their respective homeowner members is a nonvoting "member" of Golden Rain. (We will refer to United, Third, and Golden Rain collectively as the Associations.) The Associations are nonprofit mutual benefit corporations.

Leisure World is near the El Toro Marine Corps Air Station. [...] Proposals that this closed military base be converted into a commercial airport have generated considerable local controversy. Measure S, an initiative which would have impeded or prevented the airport conversion, qualified for the March 1996 Orange County ballot. Taxpayers for Responsible Planning – Yes on Measure S (Taxpayers) is a political action committee which – needless to say – supported Measure S.

Between January 1995 and January 1996, the Associations contributed a total of \$542,361 to Taxpayers. This money came from assessments they had collected from their homeowner members. Taxpayers used the money to support Measure S.

After this action was filed, each of the Associations formed its own special litigation committee. Each committee was made up of three members of the board of directors who had not become members until after this action had been filed. The committees retained separate legal counsel; in person or through counsel, they interviewed witnesses and reviewed all pleadings, motions, and discovery in this action. The special litigation committees all concluded that the prosecution of this action was not in the best interests of the Associations.

II. PROCEDURAL BACKGROUND

The plaintiffs in this action are Warren T. Finley, as trustee of the James and Sylvia Henderson 1977 Trust, Donald H. Rez, as trustee of the Rez Family Trust and Donald Firestone. Each of them allegedly is a member of one or more of the Associations.

The defendants are the Associations and certain members of their respective boards of directors who allegedly authorized the contributions (collectively, the Directors).

Plaintiffs' complaint, as subsequently amended, was asserted derivatively, on behalf of the Associations. It alleged five causes of action against the Directors: (1) for recovery of the contributions, on the grounds that they (a) violated the Davis-Stirling Common Interest Development Act [...], (b) violated the Associations' governing documents, (c) breached the Directors' fiduciary duties, (d) constituted a waste of corporate assets, and (e) were ultra vires; (2) for conversion; (3) for recovery of the contributions, on the grounds that they violated the constitutional rights of dissenting members of the Associations; (4) for injunctive relief; and (5) for violation of civil rights [...].

[...]

V. THE BUSINESS JUDGMENT RULE DEFENSE

Plaintiffs contend they were entitled to summary adjudication on defendants' business judgment rule defense.

Under the business judgment rule, a director cannot be held liable for actions taken in good faith which he or she believes, based on a reasonable investigation, to be in the best interests of the corporation. [...]

Plaintiffs argue the business judgment rule does not apply to actions which are ultra vires or illegal. In an unpublished portion of this opinion, however, we held that, on this record, the contributions were neither ultra vires nor illegal. Accordingly, even assuming, for purposes of argument, plaintiffs have correctly stated the law, they were not entitled to summary adjudication on this defense.

VI. THE SPECIAL LITIGATION COMMITTEE DEFENSE

[...]

Plaintiffs' primary argument is that a special litigation committee defense has not been recognized, and should not be recognized, in California. Plaintiffs waived this contention by failing to raise it below. As an alternative ground, however, and because this issue seems likely to loom large on remand, we hold that the special litigation committee defense is legally valid in California.

A number of other states (or federal courts applying the law of other states) have recognized a special litigation committee defense. This defense arises out of the interplay between the business judgment rule and the requirement in a stockholder's derivative action that the plaintiff must have made a demand on the board of directors to have the corporation pursue the action. [...] Thus, it has been held that, once a duly appointed committee of disinterested directors reasonably determines that it is not in the best interests of the corporation to pursue the claims asserted in the derivative action, that decision is protected by the business judgment rule. The trial court must determine, as a matter of fact, whether the committee members were disinterested and whether they conducted an adequate investigation. If it answers yes to both questions, however, it must dismiss the derivative action. [...]

A minority of states have recognized a modified version of the special litigation committee defense. These states require the trial court to scrutinize the committee's decision independently; they vary as to the precise degree of scrutiny required. (*Joy v. North* (applying Connecticut law; trial court is to weigh likely recovery, discounted by the probability of liability, against the costs to the corporation of continuing the action),⁸ *Zapata Corp. v. Maldonado* [Delaware] (trial court is to apply its own "independent business judgment"); *Houle v. Low* [Massachusetts] (trial court must determine whether committee's decision was "reasonable and principled"); *In re PSE & G Shareholder Lit.* [New Jersey] (trial court must determine whether committee's decision was "reasonable and principled"); *Alford v. Shaw* [North Carolina] (trial court must consider totality of circumstances, including committee's report, in deciding whether directors' action was "just and reasonable"); *Lewis v. Boyd* [Tennessee] (trial court must determine whether committee's decision was "reasonable and principled").)

Iowa recognizes the defense but holds that, if the board has a majority of interested directors, it cannot make a valid delegation to a special litigation committee. In that event, the trial court may appoint a "special panel," which may determine whether the derivative action is in the best interest of the corporation. [...] As far as we are aware, there is no court which has refused to recognize the defense at all.

⁸ *Joy v. North* has since been overruled by statute. (Conn.Gen.Stat. Ann. § 33-724.)

A considerable number of states have codified the special litigation committee defense. [The court cites statutes in Alaska, Arizona, Connecticut, Florida, Georgia, Idaho, Maine, Minnesota, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Texas, Virginia, and Wisconsin] Of these, all but the Alaska and Minnesota statutes are based on section 7.44 of the American Bar Association's 1984 Model Business Corporations Act, which adopts the original, unmodified version of the defense.

Plaintiffs claim the validity of the special litigation committee defense is an open question in California. The Ninth Circuit, however, has twice held that the California Supreme Court would recognize the defense. [...] Decisions of the federal courts interpreting California law, although not binding on us, are persuasive. [...]

The only California decision concerning the defense is *Will v. Engebretson & Co.* In *Will*, a stockholder's derivative action, the corporation filed a motion for summary judgment, asserting the special litigation committee defense. [...]

Plaintiffs read *Will* as declining to decide whether the special litigation committee defense is valid. We disagree. [...] What the *Will* court did decline to decide was which version of the defense may be asserted – the majority (and Model Act) "one-step" version, in which the court decides only whether the committee was disinterested, acted in good faith, and investigated adequately, or the minority "two-step" version, in which the court must additionally apply its own business judgment. Under *Will*, however, the special litigation committee defense, in some form, is valid in California.

Plaintiffs argue there is no reported case in which the special litigation committee defense has been used by a homeowners association. They fail to explain, however, why it could not be. Here, each of the Associations was incorporated as a nonprofit mutual benefit corporation. Thus, basic principles of corporate law apply to them. Such principles specifically include the business judgment rule as well as the principle that the directors may delegate their authority to a committee.

Plaintiffs also assert that the special litigation committee defense "cannot be... used to exculpate directors from liability for *ultra vires*, illegal or unconstitutional acts." As we have already held, plaintiffs were not entitled to summary adjudication of their claim that the contributions were *ultra vires* or illegal. But more to the point, plaintiffs appear to be confusing two distinct exercises of business judgment. First, defendants invoke the business judgment rule to protect their decision to make the contributions. We may assume, without deciding, the business judgment rule would not apply to this decision if the contributions were *ultra vires* or illegal. Second, defendants invoke the business judgment rule to protect the special litigation committees' decision that this derivative action is not in the best interest of the Associations. Even assuming the underlying contributions were *ultra vires* or illegal, the decision not to pursue a derivative action regarding them was not *ultra vires*, illegal, or unconstitutional; thus, this decision was entitled to the protection of the business judgment rule.

[...]

The premise of plaintiffs' argument is that the "sole purpose" of the defense "is to dispose of meritless shareholder 'strike suits' without the need for a full trial." The defense, however, has consistently been viewed as a confluence of the business judgment rule and the demand requirement. As such, its main purpose, like theirs, is to further the fundamental principle that those best suited to make decisions for a corporation – including the decision to file suit on its behalf – are its directors, not its stockholders or the courts. [...] To serve this purpose, the defense must be allowed whenever it is shown that a committee of disinterested directors acting in good faith has determined a derivative action is not in the best interests of the corporation – if possible, on motion, but if necessary, in a full trial. [...]