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Derivative actions help shareholders in small companies, too

By Brian Danitz

A derivative action allows an individual shareholder to step into the shoes of the company to protect it from faithless officers and directors who by law are fiduciaries. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991). As stated by the California Supreme Court, "shareholders may ... bring a derivative suit to enforce the corporation's rights and redress its injuries when the board of directors fails or refuses to do so." *Grosset v. Wenaas*, 42 Cal. 4th 1100, 1108 (2008).

Recent mega settlements demonstrate the vitality of derivative actions involving large, publicly traded companies; however, derivative actions are also essential for the protection of small, privately held companies. Recent high-profile settlements include the following:

- In November, Superior Court Judge Brian C. Walsh granted final approval of a settlement related to allegations of a pattern of sexual harassment and discrimination at Google that will establish a **$310 million** fund for diversity and inclusion initiatives, and end mandatory arbitration in harassment, discrimination, and retaliation disputes. *In re Alphabet Inc. Shareholder Deriv. Litig.*, 19CV341522 (Santa Clara Sup. Ct.).
- In April, U.S. District Judge Jon S. Tigar granted final approval to a **$320 million** settlement relating to Wells Fargo's unfair sales practices and fake accounts scandal. *In re Wells Fargo & Co. Shareholder Deriv. Litig.*, 3:16-cv-05541-JST (N.D. Cal.).
- Also in April, U.S. District Judge Claudia Wilken granted final approval to a **$175 million** settlement relating to alleged violations of the Controlled Substances Act and the failure of McKesson's board to enforce a compliance program to prevent suspicious orders for opioids. *In re McKesson Corp. Deriv. Litig.*, 4:17-cv-01850 (N.D. Cal.).
- In January, defendants settled for **$286 million** in a shareholder derivative suit alleging that the directors of Vereit/American Realty Capital Properties breached their fiduciary duties in connection with an alleged scheme to artificially inflate stock prices. *Witchko v. Schorsch, et al.*, 1:15-cv-06043-AKH (S.D.N.Y.).

These high-profile cases exemplify how derivative actions can address mismanagement at large companies. The recent case of *Tribble v. Gerrans*, CIV1803695, in Marin County Superior Court, shows that derivative cases can help small companies too, and confirms that investors in privately held companies have rights equal to any shareholder on Wall Street.

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San Rafael-based medical device company Sanovas, Inc. is a private company funded, in large part, through the retirement funds of its investors. In *Tribble*, several shareholders sued after a federal grand jury indicted founder and CEO Lawrence J. Gerrans for siphoning millions in company funds for his personal use. The indictment accused Gerrans of using these funds to purchase a home and pay for "a $55,732 lady's diamond ring, spa treatments, luxury vacations," and other personal expenses.

The derivative complaint alleged that Gerrans' misconduct resulted from the absence of internal controls at Sanovas, and that Gerrans dominated and controlled the company by unilaterally appointing the board of directors. Plaintiffs further claimed that Gerrans and his handpicked successor entered into a series of self-dealing transactions, including Gerrans' own Separation Agreement, which threatened to further harm the Company by paying out millions to Gerrans.

In cases involving self-dealing, the defendants bear the burden of proving that the transactions were entirely fair to the company. "[T]he burden is on the director or [controlling] stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein." *Burt v. Irvine Co.*, 237 Cal. App. 2d 850-52 (1965) (citing *Pepper v. Litton*, 308 U.S. 295, 306 (1939)).

The superior court granted plaintiffs' request for a temporary restraining order, stopping all payments to Gerrans and his successor. With the TRO in place, plaintiffs negotiated a settlement with the company's current management. Under the settlement, Sanovas agreed to implement significant corporate governance reforms designed to increase oversight and accountability, including: (i) adding directors to create a majority independent board of directors; (ii) creating an audit committee with oversight responsibilities; (iii) holding annual shareholder meetings to vote for directors; (iv) holding regular noticed board meetings; (v) providing written updates to shareholders; (vi) implementing information sharing with the independent directors; and (vii) appointing one of the derivative plaintiffs as a board observer. The company also agreed that the plaintiffs could continue to prosecute the civil case against Gerrans on behalf of the company. These reforms, entered by the superior court as a stipulated judgment in February, helped to "right the ship" at the company and to regain the confidence of its investors. These results could only be achieved through a derivative case on behalf of the company.

In the federal criminal trial, the jury found Gerrans guilty on all counts, including wire fraud and money laundering, and on November 4, the district court entered judgment, sentencing Gerrens to imprisonment for a term of 135 months. *U.S. v. Gerrans*, 3:18-cr-00310-EMC (N.D. Cal.). On December 9, the district court entered a preliminary forfeiture order in the amount of $2.5 million, and restitution in the amount of $3.3 million, to be returned to the company. ■

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