

»Business Alert

October 2010— The California Court of Appeal Holds that a Shareholder of a Dissolved Corporation Has Standing to Pursue a Derivative Action

In *Favila v. Katten Muchin Rosenman LLP*, 188 Cal. App. 4th 189 (2d Dist. 2010), the California Court of Appeal recently held that although a corporation is dissolved, a shareholder continues to have standing to maintain a derivative action, which is an action by a shareholder on behalf of the corporation to defend the corporation's interests, such as in cases of director mismanagement. By affirming a shareholder's right to bring a derivative action, this holding provides clarity to the issue of what rights a shareholder retains following a company's dissolution.

This case arose from a disputed sale of one corporation's assets, those of Motion Graphix, to another company, Get Flipped. Motion Graphix was founded in 2000 by Richard Corrales, a former Los Angeles Times photographer, to capitalize on Corrales' patents for specialized 360° cameras and 3-D technology. Corrales formed Motion Graphix with Raleigh Souther, a former editor at the Los Angeles Times. Corrales originally held a majority 51% stake in the corporation, with Souther holding the remaining 49% minority interest.

In August of 2005, following a dispute about Corrales' right to engage in personal business uses of Motion Graphix's software codes, Corrales agreed to sell 80% of his shares in Motion Graphix to the company and to resign from his positions as director and officer. Within months of this agreement, in November of 2005, Corrales died of stomach cancer. In an apparent attempt to prevent Corrales' estate from receiving its fair share of the company's value, Souther incorporated Get Flipped in March 2006, as its sole shareholder, officer and director. Promptly thereafter, Souther orchestrated the sale of all of Motion Graphix's assets to Get Flipped for a mere \$5,000.00.

A year after asserting claims including conversion, fraud and breach of contract, Corrales' estate filed a derivative action on October 3, 2008 against Motion Graphix's attorneys, alleging legal malpractice and breach of fiduciary duty arising out of their representation of Motion Graphix. On March 4, 2009, the trial court sustained the attorneys' demurrer to the derivative action with leave to amend, ruling that the estate lacked standing to bring an action on behalf of a dissolved corporation under Corporations Code Section 800(b), which requires a shareholder to own stock during the pendency of litigation.

The Court of Appeal reversed, alternatively relying on Corporations Code Section 210, providing that a dissolved corporation continues to exist for the purposes of winding up its affairs, including prosecuting lawsuits to recover sums due or owing to it, or to recover the company's property. As such, Corrales' estate was entitled to pursue a derivative action on its behalf, as a shareholder of a dissolved corporation.

As a case of first impression in California, this holding is important to note because it affirms a shareholder's right to maintain a derivative action following a corporation's dissolution. This holding not only clarifies the derivative rights of shareholders, but also provides a cautionary note to corporate directors and officers seeking to oust a minority shareholder by dissolving a company and shifting its assets to a newly formed entity.

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