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Florida Appellate Court Adopts Test to Distinguish Direct Shareholder Actions From Derivative Actions

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Addressing what it acknowledged was a "murky question" under Florida law, Florida's Fourth District Court of Appeal recently outlined the test for determining when shareholders may maintain a direct action against a corporation and its directors, as opposed to a derivative action filed on behalf of the company. *Strazzulla v. Riverside Banking Co.*, Case No. 4D14-768 (Fla. 4th DCA Sept. 2, 2015), is a "must-read" for practitioners inasmuch as the court's opinion surveyed the law in this area and adopted a two-prong test requiring shareholders to allege both (i) a direct harm, and (ii) a special injury, to assert a direct action. Indeed, the opinion is one of the clearest statements yet by a Florida appellate court on when a corporation and its directors and officers may face direct actions by shareholders. **Background** In October 2012, the plaintiff shareholders sued Riverside Banking Company (the "Company") and two of its directors. Almost all of the Company's assets were held by its subsidiary, Riverside National Bank (the "Bank"). The plaintiffs alleged that the Bank began purchasing substantial quantities of risky asset-backed securities, including collateralized debt obligations, in the mid-2000s. In 2007, these same types of investments produced losses that led to the collapse

of Bear Stearns. In March 2008, after a shareholders' meeting for the Company, the plaintiffs allegedly approached the two director defendants and inquired whether the Bank owned assets similar to those held by Bear Stearns before its failure. Although the Bank did hold such risky assets, the defendants told the plaintiffs that the Bank only held municipal bonds, treasury notes, and other safe investments. Aside from another shareholder, only the parties to this litigation heard the alleged conversation. The alleged misrepresentations were critical, according to the plaintiffs, because the misstatements caused them to hold onto their shares in the Company and not participate in the Company's buyback program. At the time, that program offered shareholders $550 per share. The plaintiffs alleged that they collectively owned 11,000 shares of the Company's stock and that they therefore could have redeemed their shares for approximately $6 million. Later, the Bank's investments, including the high-risk investments, lost almost all of their value, which rendered the plaintiffs' stock in the Company worthless. In their suit against the Company and the two directors, the plaintiffs alleged claims of negligent misrepresentation and fraudulent misrepresentation. The trial court dismissed the action on the basis that the suit was premised on the gross mismanagement of the Bank's investments, which injured all of the Company's shareholders. Accordingly, the trial court found that the suit could only be maintained as a derivative action. **The Fourth District Court of Appeal Finds Plaintiffs Met Its Direct Action Test** The Fourth District Court of Appeal reversed and remanded the case. The court began its analysis by acknowledging that a direct action reflects an attempt by a shareholder to enforce a cause of action that belongs to that shareholder, whereas a derivative suit seeks to vindicate the corporation's interests. The court added that, while defining the two types of actions was relatively straightforward, "resolving the question whether an action should be brought as a direct or derivative action is not so clear." To answer that question, the court examined various appellate decisions and held that under Florida law, to maintain a direct action, shareholders must satisfy a two-prong test: (1) the shareholder must suffer a direct injury that does not arise from an injury suffered by the corporation; and (2) the shareholder must suffer a special injury that is distinct from an injury common to all shareholders. Otherwise, and absent the existence of any other special duty created by contract or statute, a shareholder must bring the action as a derivative suit on the company's behalf. Applying this framework to the case at hand, the court found that the plaintiffs satisfied the test for a direct action. First, the court determined that the alleged misrepresentations made to the plaintiffs constituted a direct harm since the resulting injury—their decision not to sell their shares through the buyback program—could not belong to the Company. Second, the court concluded that the plaintiffs' alleged injuries, which were based on their having been induced to hold onto their stock, were "distinct from any injury suffered by other shareholders, who did not receive these same representations." The court observed that, while the plaintiffs had alleged mismanagement of the Bank, those allegations were only used to put the plaintiffs' misrepresentation claims in context. In other words, the alleged misrepresentations, as opposed to any broader mismanagement of the Bank, formed the basis for the claims. **Conclusion** *Strazzulla* provides a clear framework for practitioners and courts to follow in determining whether a shareholder action is direct or derivative. The distinction between direct and derivative lawsuits is important for a number of reasons. For

example, a company facing a derivative action in Florida benefits from certain procedural protections, including the demand requirement and the ability to appoint a committee of independent directors to decide whether bringing a lawsuit is in the company's best interests. These protections are unavailable in direct actions. *Strazzulla v. Riverside Banking Co.*, Case No. 4D14-768 (Fla. 4th DCA Sept. 2, 2015)

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