IN THE SUPREME COURT OF THE STATE OF NEVADA

PARAMETRIC SOUND CORPORATION, TB HOLDINGS, INC., KENNETH POTASHNER; ELWOOD NORRIS; SETH PUTTERMAN; ROBERT KAPLAN; ANDREW WOLFE; and JAMES HONORE, Petitioners, vs. THE EIGHTH JUDICIAL DISTRICT COURT, in and for the County of Clark, State of Nevada, and THE ELIZABETH GONZALEZ, District Judge, Respondents, and VITIE RAKAUSKAS, individually and on behalf of all others similarly situated, and Intervening Plaintiffs RAYMOND BOYTIM and GRANT OAKES, Real parties in interest.	No. 66689 District Court No. A-13-686890-B Dept. No. XI

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PRINCIPLES OF CORPORATE GOVERNANCE

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THE AMERICAN LAW INSTITUTE

PRINCIPLES OF CORPORATE GOVERNANCE
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Volume 2

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§§ 7.01–7.25

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be non-ratifiable. However, under § 75(4)(c) of the Companies Act, 1980, today a shareholder of a British corporation may petition the court to cause an action to be brought in the company's name. This revision followed the recommendations of the Jenkins Committee, which urged that the litigation remedies available to a shareholder be expanded (1) to allow a remedy in respect of an isolated act (as opposed to only a continuing course of oppression) and (2) to authorize injunctive relief to restrain the commission or continuance of an act. Similarly, in Australia, a shareholder may now petition the court for an order regulating the affairs of the corporation. See [Australian] Companies Act, 1981, § 320. Section 320 gives the court wide remedial authority over both "oppressive" conduct and unfair self-dealing. See H.A.J. Ford, Principles of Company Law (3rd ed. 1982) at 452–60. See also Re Bright Pine Mills Pty Ltd., [1969] VR 10002 (expropriation of corporate opportunity and inaction by other directors actionable under § 320).

In Canada, the rule in *Foss v. Harbottle* has been legislatively reversed, and the new Canadian Business Corporations Act broadly authorizes an action in the corporation's right that the individual shareholder may commence with judicial approval. See Canadian Business Corporations Act, ch. 33, §§ 232, 233 (1975). Several Canadian provinces have enacted similar legislation. See Hansen, Annual Survey of Canadian Law—Corporation Law, 10 Ottawa L. Rev. 617, 674–87 (1978). Although the scope of these new statutes in Great Britain, Australia, and Canada is still unsettled and evolving, the common pattern in each case is to accord considerable discretion to the court in determining whether to permit the suit to proceed. This produces a result that is functionally similar to the screening stage that Part VII provides.

Analysis and Recommendation

§ 7.01 Direct and Derivative Actions Distinguished

(a) A derivative action may be brought in the name or right of a corporation by a holder [§ 1.22], as provided in § 7.02 (Standing to Commence and Maintain a Derivative Action), to redress an injury sustained by, or enforce a duty owed to, a corporation. An action in which the holder can prevail only by showing an injury or breach of duty to the corporation should be treated as a derivative action.

(b) A direct action may be brought in the name and right of a holder to redress an injury sustained by, or enforce a duty owed to, the holder. An action in which the holder can prevail without showing an injury or breach of duty to the corporation should be treated as a direct action that may be maintained by the holder in an individual capacity.

(c) If a transaction gives rise to both direct and derivative claims, a holder may commence and maintain direct and derivative actions simultaneously, and any special restrictions or defenses pertaining to the maintenance, settlement, or dismissal of either action should not apply to the other.

(d) In the case of a closely held corporation [§ 1.06], the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.

Comment:

a. Comparison with present law. Subsections (a) and (b) of § 7.01 state the traditional common law rule by which direct and derivative actions are distinguished. Although the rules stated in Subsections (c) and (d) relate to issues that courts have less frequently faced, they are consistent with the trend of recent decisions.

b. Implementation. Section 7.01 can be implemented by judicial decision.

c. Characterization of an action. All decisions are in fundamental agreement with the basic distinction made by § 7.01(a) and (b): a wrongful act that depletes corporate assets and thereby injures shareholders only indirectly, by reason of the prior injury to the corporation, should be seen as derivative in character; conversely, a wrongful act that is separate and distinct from any corporate injury, such as one that denies or interferes with the rightful incidents of share ownership, gives rise to a direct action. Sometimes this result has been justified in terms of an "injury" test that looks to whose interests were more directly damaged; at other times, the test has been phrased in terms of the respective rights of the corporation and its shareholders; but regardless of the verbal formula employed, the results have been substantially similar. See Welch, Shareholder Individual and Derivative Actions: Underlying Rationales and the Closely Held Corporation, 9 J. Corp. L. 147 (1984).

Although some discrepancies exist in the case law, most courts have properly considered actions such as the following as direct actions: (1) actions to enforce the right to vote, to protect preemptive rights, to prevent the improper dilution of voting rights, or to enjoin the improper voting of shares; (2) actions to compel dividends or to protect accrued dividend arrearages; (3) actions challenging the use of corporate machinery or the issuance of stock for a wrongful purpose (such as an attempt to perpetuate management in control or to frustrate voting power legitimately acquired by existing shareholders); (4) actions to enjoin an ultra vires or unauthorized act; (5) actions to prevent oppression of, or fraud against, minority shareholders; (6) actions to compel dissolution, appoint a receiver, or obtain similar equitable relief; (7) actions challenging the improper expulsion of shareholders through mergers, redemptions, or other means; (8) actions to inspect corporate books and records; (9) actions to require the holding of a shareholders' meeting or the sending of notice thereof; and (10) actions to hold controlling shareholders liable for acts undertaken in their individual capacities that depress the value of the minority's shares. See Reporter's Note 1. In some instances, actions that essentially involve the structural relationship of the shareholder to the corporation (which thus should be seen as direct actions) may also give rise to a derivative action when the corporation suffers or is threatened with a loss. One example would be a case in which a corporate official knowingly acts in a manner that the certificate of incorporation denied the official authority to do, thereby violating both specific restraints imposed by the shareholders and the official's duty of care. In such cases, the plaintiff may opt to plead either a direct or a derivative action, or to bring both actions simultaneously, unless the court finds that the plaintiff is unable to provide fair and adequate representation pursuant to § 7.02(a)(4) (Standing to Commence and Maintain a Derivative Action).

Decisions in both Delaware and New York have held that an action may be treated as direct, even though the principal injury is to the corporation, if there is "also special injury to the individual stockholder." Elster v. American Airlines, Inc., 34 Del.Ch. 94, 100 A.2d 219, 222 (1953); 12b Fletchers Cyclopedia Corps., § 5912, p. 431 (Perm. Ed., Rev. Vol. 1984). Originally, these cases involved circumstances in which there was a special dual relationship between plaintiff and defendant, such as a contractual relationship, or in which the latter acted with deliberate intent to harm the former. See Reporter's Note 3. Delaware has, however, extended this doctrine to apply to circumstances in which one shareholder suffers an injury separate and distinct from the other shareholders. See Bokat v. Getty Oil Company, 262 A.2d 246, 249 (Del.1970). One important application of this principle arises when actions are taken by the board to devalue the stock or to dilute the control held by a shareholder who has legitimately acquired a controlling interest in the corporation. See Condec Corp. v.

Lunkenheimer Co., 43 Del.Ch. 353, 230 A.2d 769 (1967). Cases have disagreed whether actions taken to dissuade a takeover attempt, such as the issuance of a "poison pill" security, also trigger this rule. See Reporter's Note 3. Under § 7.01(b), the relevant inquiry should be whether an injury is suffered by the shareholder that is not dependent on a prior injury to the corporation. When, for example, the defensive tactic interferes with voting decisions, including the solicitation of proxies, the shareholder should be able to bring a direct action. Similarly, if the defensive action restricts other basic rights inherent to the shares (such as alienability), then standing to bring a direct action exists. This does not mean, however, that the plaintiff is entitled to relief on the merits. The propriety of defensive actions taken to thwart a tender offer or other corporate control contest is addressed by §§ 6.01 and 6.02, and not by this Section, which deals instead only with the appropriate form of action that can be brought.

d. Relevant criteria. Section 7.01 does not attempt an exhaustive catalogue of direct versus derivative shareholder actions. Commentators have recognized that close questions can arise whether a particular right or claim belongs more to the corporation or to its shareholders. See, e.g., J. Bishop, The Law of Corporate Officers and Directors; Indemnification and Insurance 3–10 (1981). In borderline cases, the following policy considerations deserve to be given close attention by the court:

First, a derivative action distributes the recovery more broadly and evenly than a direct action. Because the recovery in a derivative action goes to the corporation, creditors and others having a stake in the corporation benefit financially from a derivative action and not from a direct one. Similarly, although all shareholders share equally, if indirectly, in the corporate recovery that follows a successful derivative action, the injured shareholders other than the plaintiff will share in the recovery from a direct action only if the action is a class action brought on behalf of all these shareholders.

Second, once finally concluded, a derivative action will have a preclusive effect that spares the corporation and the defendants from being exposed to a multiplicity of suits.

Third, a successful plaintiff is entitled to an award of attorneys' fees in a derivative action directly from the corporation, but in a direct action the plaintiff must generally look to the fund, if any, created by the action.

Finally, characterizing the suit as derivative may entitle the board to take over the action or to seek dismissal of the action (subject to the conditions set forth in § 7.05 and §§ 7.07–7.13). Thus, in some circumstances the characterization of the action will determine the available defenses.

In practice, the most important result of characterizing an action as direct or derivative is the tendency for derivative actions to be more complex procedurally and to impose additional restrictions on the eligibility of the plaintiffs who may maintain them. For these reasons, the plaintiff usually wishes to characterize the action as direct, while the defendant prefers to characterize it as derivative. In general, courts have been more prepared to permit the plaintiff to characterize the action as direct when the plaintiff is seeking only injunctive or prospective relief. In such situations, the policy considerations favoring a derivative action are less persuasive, because typically the requested relief will not involve significant financial damages against corporate officials, the period in which the corporation is exposed to multiple suits will be relatively brief, and the relief will benefit all shareholders proportionately.

e. Closely held corporations. In some circumstances, the normal policy reasons for requiring a plaintiff to employ the form of the derivative action may not be present or will be less weighty, even though the action alleges in substance a corporate injury. In an important decision, the Massachusetts Supreme Judicial Court ruled that a closely held corporation may be treated as essentially an incorporated partnership, and granted a minority shareholder the right to sue individually. See Donahue v. Rodd Electrotype Company of New England, Inc., 367 Mass. 578, 328 N.E.2d 505 (1975). The rationale of *Donahue* was that the partnership and the closely held corporation were virtually interchangeable business forms, and thus a significant difference in their legal treatment was not warranted. In evaluating the logic of *Donahue*, it must be recognized that there are valid arguments on both sides of this question. On the one hand, the likelihood of a disinterested board is far smaller in such firms because the majority stockholders are likely also to be the firm's managers. Similarly, the concept of a corporate injury that is distinct from any injury to the shareholders approaches the fictional in the case of a firm with only a handful of shareholders. In addition, the procedural rules often applicable to derivative actions—such as a requirement that the plaintiff shareholder post a security-for-expenses bond—often make little sense in the context of a dispute between persons who are effectively incorporated partners. These rules were essentially intended to protect public corporations against "strike suits" by plaintiffs holding only a nominal interest in the firm. On the other hand, those decisions that have reached contrary results to *Donahue* have emphasized that a corporate recovery benefits creditors, while a direct recovery does not. See Maki v. Estate of Ziehm, 55 A.D.2d 454, 391 N.Y.S.2d 705, 707 (3d Dep't 1977).

Both positions have merit, and § 7.01(d) therefore takes a compromise position. Essentially, § 7.01(d) follows the position taken by the Ninth Circuit in Watson v. Button, 235 F.2d 235 (9th Cir.1956), which found that the usual policy reasons requiring an action that principally alleges an injury to the corporation to be treated as a derivative action are not always applicable to the closely held corporation. The facts of *Watson* are illustrative: a multiplicity of actions could not have resulted in that case, because there were only two shareholders; creditors could not have been injured, because each shareholder had agreed to be individually liable for corporate debts; finally, an individual recovery would not have prejudiced the rights of any other shareholders. Other decisions have expanded upon *Watson*'s holding and allowed the action to be pleaded as a direct one in cases involving considerably more shareholders. See Reporter's Note 4. Although § 7.01(d) does not follow the fullest potential reach of *Donahue* to the extent of converting all intracorporate disputes that would be normally characterized as derivative actions into direct actions whenever the case involves a closely held corporation, it gives the court discretion to treat the action as direct if the policy considerations enumerated in Comment *d* are satisfied. In general, when a direct action is brought on behalf of the entire class of injured shareholders and the corporation's solvency is not in question, there is less reason to insist that the action be brought derivatively. The court should then have equitable power to treat the action as direct if the corporation is closely held, thereby avoiding procedural hurdles that were not designed to apply in such a case. If necessary, the court can still protect creditors of the corporation by directing that adequate provision be made for the firm's creditors out of any recovery.

The chief consequence of characterizing an action as direct will be to exempt the plaintiff from those procedural requirements—for example, demand, security for expenses, verification of the complaint—that many jurisdictions apply only to derivative actions. In addition, because a direct action, unlike a derivative action, may not be terminated on the basis of a board recommendation or shareholder action, the provisions of §§ 7.07–7.13 will not be applicable to an action so characterized as direct. Construing an action as direct will preclude the use of a special litigation committee; thus, the court should consider in making this decision whether the subject corporation has a disinterested board that should be permitted to consider the action's impact on the corporation. Because the court is instructed under § 7.01(d)(iii) to ensure a "fair distribution" of the recovery among all interested persons, reasonable notice to such other persons is required.

In some circumstances, characterizing the action as direct will also be fairer to the defendants, such as when the defendants wish to file a counterclaim against the plaintiff, because the general rule is to prohibit counterclaims in a derivative action. See Welch, supra, at 190–91, 328 N.E.2d 505. Also, in a direct action, each side must normally bear its own legal expenses, and the plaintiff, if successful, cannot ordinarily look to the corporation for attorney's fees. Such a rule seems more appropriate in cases that fundamentally involve disputes between a limited number of "partners" in a closely held firm. Section 1.06 defines a "closely held corporation" in terms of "a small number" of shareholders and the absence of an active trading market. Another factor that also has relevance is the existence of a substantial overlap between the shareholders and management, thereby permitting the firm's earnings to be paid out in substance either as salary or dividends. See Donahue v. Rodd Electrotype, supra, at 511; Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577, 583 (1964). See also F.H. O'Neal & R. Thompson, O'Neal's Close Corporations: Law and Practice, § 2.02 (2d ed. 1985).

f. Overlap of direct and derivative actions. In many cases, a wrongful act will both deplete corporate assets and deprive shareholders of a personal right attaching to their shares. One illustration is the recurring situation in which the plaintiff alleges both that voting rights were infringed and that the underlying transaction on which the shareholders voted was unfair to the corporation. Another illustration is the case of a wrong that might in theory be characterized either as direct or derivative (such as a threatened or continuing ultra vires act); in such an instance, the plaintiff might be entitled to seek an injunction in a direct action and to seek a monetary recovery in a derivative action. No policy suggests that the plaintiff should be forced to elect between these remedies. Section 7.01(c) thus adopts the majority rule that a direct action is not precluded simply because the facts also give rise to a derivative action. When such parallel actions are brought, a dismissal of the derivative action should not bar the continued prosecution of the direct action. Section 7.01(c) does not address the issue of whether a recovery in one parallel action should be offset in any way against the other.

In theory, parallel direct and derivative actions brought by the same shareholder involve a potential conflict of interest (both for plaintiff and plaintiff's counsel), insofar as the same plaintiff is both suing the corporation and seeking to represent it in the derivative action. See Reporter's Note 6. Most federal decisions have found this potential conflict to be more theoretical than real, but it is recognized that the court may disqualify a plaintiff from representing the corporation when a genuine antagonism exists between the plaintiff's dual roles, on the ground that the plaintiff cannot then "fairly and adequately" represent the corporation. See § 7.02(a)(4). If, for example, the court believed that the primary motivation for the derivative action was to obtain information otherwise protected by the attorney-client privilege, but available in a derivative action, in order to use this information in the direct action against the corporation, then the plaintiff should be found unable to "fairly and adequately" represent the interests of the corporation. In general, however, combining direct and derivative actions both conserves judicial resources and serves the interests of the shareholders not represented in the direct action. In particular, it guards against the risk of inconsistent verdicts, since if the two actions were not combined, and the corporation were held liable in the direct action (or otherwise experienced a direct or indirect loss, including the costs of the litigation), it would not be able to pass on these costs to the responsible corporate officials if they were found not liable in a subsequent derivative action. By combining the two actions—the direct and the derivative action—this danger is reduced and the transaction costs of legal enforcement are minimized. See also § 7.18(d) (defendants may be held liable for corporation's legal expenses incurred in connection with certain breaches of the duty of loyalty).

Illustrations:

1. XYZ, Inc., issues a block of shares to A Corporation in order to thwart a pending proxy contest initiated by B Corporation, which recently acquired a majority interest in XYZ. B Corporation brings an injunctive action challenging both (i) the improper motivation for the share issuance (which frustrates the voting majority that B Corporation had recently acquired in XYZ) and (ii) the adequacy of the price paid by A Corporation for the shares. Although the second claim is derivative in character, the first claim, which seeks an injunction, is a direct one, because it asserts an improper attempt to dilute the plaintiff's voting rights in the corporation, and therefore alleges a special injury to the plaintiff shareholder. Thus, if under the applicable law of the jurisdiction the derivative action alleging the inadequacy in price must be dismissed for failure to meet some procedural requirement (e.g., B failed to make a demand on XYZ's board), B may still maintain its injunctive action for rescission as a direct action.

2. The facts being otherwise as stated in Illustration 1, XYZ, Inc., seeks to delay its annual meeting, scheduled for June 1, until October 15, to prevent B Corporation from voting its

newly acquired majority interest in XYZ. B Corporation's suit to prevent this postponement should be treated as a direct action, because it fundamentally concerns B Corporation's ability to exercise its individual voting rights.

3. An action is brought in the name of Small Corporation, a closely held corporation whose shares are not publicly traded, to obtain damages based on the repurchase by Small of its shares from a former controlling shareholder at a substantial premium over any previous purchase price. No other shareholders were permitted to sell their shares to the corporation at a similar price, although several so offered. Although this action would normally be considered derivative in character, because Small is closely held the court may balance the factors specified in § 7.01(d) in determining whether to characterize the action as direct or derivative and in deciding whether to order an individual or corporate recovery. The court may treat the action as a direct one and still order that all or some portion of the recovery be paid to Small to protect the interests of its creditors.

4. Target Corporation, which is listed on the New York Stock Exchange, proposes to adopt "shark repellent" measures intended to protect it from an imminent tender offer by Bidder, Inc. The New York Stock Exchange has informed Target that if it proceeds as planned Target's shares will be delisted, since the proposed action is in conflict with Target's listing agreement with the Exchange. At the time Shareholder A acquired shares in Target Corporation, Target represented to A that it would maintain its stock exchange listing. A may commence a direct or derivative action, or both, to enjoin the board's action, because the threatened delisting will cause a special injury to A (the loss of access to a trading market in breach of the representation) that under § 7.01(b) is independent from any injury to Target (which may also suffer injury to the extent that delisting restricts its ability to obtain equity capital, or make acquisitions, on attractive terms in the future).

5. The board of XYZ Inc. agrees to sell 80 percent of its assets to an unaffiliated purchaser. Although a vote is required by state law for the sale of "substantially all" of a corporation's assets, no shareholder vote is scheduled, because the board disputes the plaintiff's claim that the sale amounts to a disposition of substantially all of XYZ's assets. An action for an injunction against the sale should be treated as direct, on the theory that it involves the plaintiff's personal voting rights.

6. Target Corp., a publicly held corporation, issues a convertible preferred stock as a stock dividend to all shareholders. The security will become convertible at an attractive exchange rate that will allow shareholders to purchase the corporation's common stock at a price well below its recent market level, but only if any person acquires, or group of persons holds in concert, more than 20 percent of the corporation's common stock. Any such shareholder or group owning more than 20 percent may not, however, exercise this conversion option. Shareholder X currently owns 18 percent of the corporation's common stock and wishes to acquire more. Shareholder X may maintain a direct action to challenge the issuance under § 7.01(b), because to the extent that the issuance is improper X has experienced an independent injury. Similarly, other shareholders may maintain a direct action if they can demonstrate that the issuance of the new security significantly infringes their ability to pool their shares for voting purposes. (Section 7.01 does not address the board's authority to issue such stock, or the validity of such action, but only the question of the shareholder's standing.)

REPORTER'S NOTE

1. The following claims are among those that have been treated as giving rise to direct actions by the majority of modern decisions:

A. *A claim to dividends:* Knapp v. Bankers Sec. Corp., 230 F.2d 717 (3d Cir.1956); Doherty v. Mutual Warehouse Co., 245 F.2d 609 (5th Cir.1957); Tankersley v. Albright, 80 F.R.D. 441 (N.D. Ill. 1978). But see Gordon v. Elliman, 306 N.Y. 456, 119 N.E.2d 331 (1954). (The result in *Gordon* was effectively overruled by N.Y. Bus. Corp. Law § 627.) See H. Henn and J. Alexander, Handbook of the Law of Corporations and Other Business Enterprises, § 360, p. 1051 (3d ed. 1983).

B. *The right to inspect corporate books and records:* Kahn v. American Cone & Pretzel Co., 365 Pa. 161, 74 A.2d 160 (1950); Leisner v. Kent Inv., Inc., 62 Misc.2d 132, 307 N.Y.S.2d 293 (1970); Henn and Alexander, supra, § 199.

C. *The right to vote:* Reifsnyder v. Pittsburgh Outdoor Advertising Co., 405 Pa. 142, 173 A.2d 319 (1961); Lazar v. Knolls Cooperative Section No. 2, Inc., 205 Misc. 748, 130 N.Y.S.2d 407 (N.Y.Sup. 1954); Horwitz v. Balaban, 112 F.Supp. 99 (S.D.N.Y.1949); Eisenberg v. Flying Tiger Line, Inc., 451 F.2d 267 (2d Cir.1971).

D. *A claim that a transaction will improperly dilute the shareholder's proportionate interest in the corporation or violate preemptive rights:* Bennett v. Breuil Petroleum Corp., 34 Del.Ch. 6, 99 A.2d 236 (1953); Sheppard v. Wilcox, 210 Cal.App.2d 53, 26 Cal.Rptr. 412 (1962); Condec Corp. v. Lunkenheimer Co., 43 Del.Ch. 353, 230 A.2d 769 (1967); Crane Co. v. Harsco Corp., 511 F.Supp. 294, 304 (D.Del.1981); Ames v. Voit, 97 F.Supp. 89, 92 (S.D.N.Y.1951), rev'd on other grounds sub nom. Ames v. Mengel Co., 190 F.2d 344 (2d Cir. 1951); Saigh v. Busch, 403 S.W.2d 559, 565 (Mo.1966). Although these cases have recognized that the shareholder who holds a majority of the stock may complain in its individual capacity about an attempt to dilute its control, fewer decisions have addressed the position of the minority shareholder, and some have not permitted minority shareholders to sue individually because of acts that "frustrate . . . [their] right to acquire additional shares by means of a tender offer." See Crane Co. v. Harsco Corp., supra, at 304. See also Reporter's Note 3.

E. *Claims that corporate officials sought to "entrench" themselves or manipulate the corporate machinery so as to frustrate plaintiff's attempt to secure representation or obtain control:* Claims of "entrenchment" are commonly recognized as individual in character (therefore justifying a direct right) when they impair some right that the shareholder possesses. See Avacus Partners, L.P. v. Brian, Fed. Sec. L. Rep. (CCH) ¶ 96,232 (October 24, 1990) ("a claim that the board improperly acted to entrench itself by issuing stock that impacts shareholders' voting power may state either an individual or a derivative claim"); Williams v. Geier, Del.Ch., C.A. No. 8456 (May 20, 1987) (allegation that a recapitalization plan impaired shareholders' voting power states an individual claim); Lipton v. News Int'l, Plc, 514 A.2d 1075, 1078–79 (1986). Thus, if the underlying claim is that the stock was issued at too low a price, the claim is derivative, but if the claim is that the motive was to dilute other shareholders' voting power, the claim is direct. Parallel actions asserting both such claims are, of course, possible.

F. *A claim that proposed corporate action should be enjoined as ultra vires, fraudulent, or designed to harm a specific shareholder illegitimately:* H. Ballantine, Ballantine on Corporations, § 144 (rev. ed. 1946); Crouse–Hinds Co. v. InterNorth, Inc., 518 F.Supp. 390, 401–04 (N.D.N.Y.1980), rev'd on other grounds, 634 F.2d 690 (2d Cir.1980); Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533, 63 L.Ed.2d 1099 (1919); Eisenberg v. Central Zone Property Corp., 306 N.Y. 58, 115 N.E.2d 652 (1953); Alexander v. Atlanta & West Point R.R., 113 Ga. 193, 38 S.E. 772 (1901); Eisenberg v. Flying Tiger Line, Inc., 451 F.2d 267 (2d Cir.1971); Lehrman v. Godchaux Sugars, Inc., 207 Misc. 314, 138 N.Y.S.2d 163 (N.Y. Sup. 1955). Conversely, actions to recover damages for a consummated ultra vires act have been viewed as derivative. See, e.g., Starbird v. Lane, 203 Cal.App.2d 247, 21 Cal.Rptr. 280 (1962); Morris v. Elyton Land Co., 125 Ala. 263, 28 So. 513 (1900).

G. *A claim that minority shareholders have been oppressed or that corporate dissolution or similar equitable relief is justified:* Fox v. 7L Bar Ranch Co., 198 Mont. 201, 645 P.2d 929 (1982); Davis v. Sheerin, 754 S.W.2d 375 (Tex.App.1988); Masinter v. WEBCO Company, 164 W.Va. 241, 262 S.E.2d 433 (1980); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Leibert v. Clapp, 13 N.Y.2d 313, 247 N.Y.S.2d 102, 196 N.E.2d 313 (N.Y. 1963); Fontheim v. Walker, 141 N.Y.S.2d 62 (N.Y.Sup. 1955); Davidson v. Rabinowitz, 140 N.Y.S.2d 875 (N.Y.Sup. 1951); Weston v. ACME

Tool, Inc., 441 P.2d 959, 962–64 (Okl. 1968).

H. *Claims that a proposed corporate control transaction, recapitalization, redemption, or similar defensive transaction unfairly affects the plaintiff shareholder:* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533, 63 L.Ed. 1099 (1919); Eisenberg v. Central Zone Property Corp., 306 N.Y. 58, 115 N.E.2d 652 (1953); Elster v. American Airlines, Inc., 34 Del.Ch. 94, 100 A.2d 219 (1953); Jones v. H. F. Ahmanson & Co., 1 Cal.3d 93, 81 Cal.Rptr. 592, 460 P.2d 464 (1969).

In a number of recent cases involving takeover defenses (whether "poison pills," "lock-ups," or some other tactic), the courts have frequently allowed the bidder to maintain a direct action seeking an injunction. See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del.1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.1985). Cf. Lipton v. News International, Plc, 514 A.2d 1075 (Del.1986). Apparently, the courts have assimilated the bidder in these cases under the "personal" injury rule discussed in Reporter's Note 3. Cf. Condec Corp. v. Lunkenheimer Company, 43 Del.Ch. 353, 230 A.2d 769 (1967).

As commentators have noted, the ease with which courts have regularly characterized actions to enjoin mergers, recapitalizations, and similar structural changes as direct may best be explained on the policy grounds that such actions "usually involved neither financial recovery to anyone nor financial motivation on the part of the shareholder." H. Henn and J. Alexander, supra, at 1050 n.24.

A more problematic line of cases, which is not here approved, has found that claims that corporate officials "looted" the corporation may be properly pleaded as direct actions. See Yanow v. Teal Industries, Inc., 178 Conn. 262, 422 A.2d 311 (1979); Traylor v. Marine Corporation, 328 F.Supp. 382 (E.D.Wis.1971); Crain v. Electronic Memories & Magnetics Corp., 50 Cal.App.3d 509, 123 Cal. Rptr. 419 (1975). Cf. Braasch v. Goldschmidt, 41 Del.Ch. 519, 199 A.2d 760, 765–67 (1964). In *Yanow,* the court in effect found that 19 separate transactions amounted to an integrated piecemeal liquidation of the corporation. *Yanow* and *Crain* do not seem consistent with the majority rule stated in § 7.01, unless they are to be explained on the theory that the transactions involved in the cases amounted in fact to a step-by-step liquidation of the corporation (without the requisite shareholder vote) or the shareholders were denied disclosures to which they were entitled on an individual basis. Absent such a de facto liquidation or disclosure violations, however, an action based on looting should be treated as derivative in character. See Rose v. Schantz, 56 Wis.2d 222, 201 N.W.2d 593 (1972).

The issue whether an action is to be characterized as direct or derivative should not generally affect the substantive rules applicable to the challenged transaction itself. Thus, for example, if under Part V (Duty of Fair Dealing) a particular type of transaction, once approved by disinterested directors or shareholders, can only be invalidated if found by the court to amount to waste, that legal rule should apply equally to direct and derivative actions brought to challenge such a transaction.

2. The basic principle that a shareholder may not sue in an individual capacity to recover damages to an ownership interest in the corporation when the alleged damages are attributable to a prior injury to the corporation can be traced back to Smith v. Hurd, 53 Mass. 371 (1847), and is today generally accepted. This principle is premised not only on the policy considerations noted in Comment *d*, but also on the argument that a double recovery might result if the defendant were liable to both the corporation and its shareholders on the same claim. See Note, Distinguishing Between Direct and Derivative Shareholders Suits, 110 U. Pa. L. Rev. 1147 (1962).

3. In determining the boundary between direct and derivative actions, courts have recognized that shareholders can suffer a "personal" injury that is distinct from any corporate injury, and so can be redressed through a direct action, even though the challenged transaction fundamentally involved corporate action. Historically, the first observable deviation from a strict interpretation of the rule that corporate injuries were only actionable through the form of the derivative action was the appearance of the "special duty" doctrine, which seems to have originated in Ritchie v. McMullen, 79 Fed. 522 (6th Cir. 1897), cert. denied, 168 U.S. 710, 18 S.Ct. 945, 42 L.Ed. 1212 (1897). Under this rule, an act violating a special duty owed to a shareholder could support a direct action, even though it principally injured the corporation. See also Cutler v. Fitch, 231 App.Div. 8, 246 N.Y.S. 28 (1930); Kono v. Roeth, 237 App.Div. 252, 260 N.Y.S. 662 (1932); Vierling v. Baxter, 293 Pa. 52, 141 A. 728 (1928); Liken v. Shaffer, 64 F.Supp. 432 (N.D.Iowa 1946). Originally, these cases involved corporate fiduciaries who occupied a dual relationship with the shareholder, such as director or officer, on the one hand, and guardian, trustee, pledgor, or pledgee, on the other. See In re Auditore's Will, 249 N.Y. 335, 164 N.E. 242 (1928); In re Shehan's Will, 285 App. Div. 785, 141 N.Y.S.2d 439 (4th Dep't. 1955). In addition, early decisions recognized that the shareholder could enforce explicit agreements or contracts with, or relating to, the corporation. See Meyerson v. Franklin Knitting Mills, 185 App. Div. 458, 172 N.Y.S. 773 (1st Dep't 1918). Later, an element of fraud or malice in the intent of the corporate official toward the shareholder was seen as also giving rise to a special duty. Over time, this rubric was expanded to cover the issuance of stock for a wrongful motive (such as to dilute the interest of a specific shareholder), or the making of intentionally or negligently deceptive misstatements to the shareholder in connection with a sale of stock. See Sutter v. General Petroleum Corp., 28 Cal.2d 525, 170 P.2d 898, 901 (1946); Bennett v. Breuil Petroleum Corp., 34 Del.Ch. 6, 99 A.2d 236 (1953); Howell v. Fisher, 49 N.C.App. 488, 272 S.E.2d 19 (1980). More recently this personal injury doctrine has been viewed as consisting of two "overlapping exceptions to the general rule: (1) where the shareholder suffered an injury separate and distinct from that suffered by other shareholders, and (2) where there is a special duty, such as a contractual duty, between the alleged wrongdoer and the shareholder." Hikita v. Nichiro Gyogyo Kaisha, Ltd., 713 P.2d 1197 (Alaska 1986). In *Hikita*, the Alaska Supreme Court recognized that a shareholders' agreement could support a direct action, even though

the duties in question related to the management of corporate affairs and the loss was directly experienced by the corporation. In contrast, earlier decisions appear to have required that the personal injury that supported the direct action be one that "does not work an injury to the corporation, but does work an injury to the minority shareholders." Liken v. Shaffer, supra, at 440.

In a leading modern case (which forms the basis for Illustration 1), the Delaware Chancery Court found that corporate officials owed a special duty to a corporate shareholder who had acquired a majority voting interest in the corporation, which duty was breached by a last-minute issuance of stock to another corporation to prevent the first corporation from exercising control by voting its majority interest at the annual meeting of shareholders. Condec Corp. v. Lunkenheimer Company, 43 Del.Ch. 353, 230 A.2d 769 (1967). See also Schnell v. Chris–Craft Industries, Inc., 285 A.2d 437 (Del.1971); Crouse–Hinds Co. v. InterNorth, Inc., 518 F.Supp. 390 (N.D.N.Y.1980), rev'd on other grounds, 634 F.2d 690 (2d Cir.1980); Crane Co. v. Harsco Corp., 511 F.Supp. 294, 304 (D.Del.1981). Because such a stock issuance injures the minority, but not the corporation, characterization of this type of case as direct seems sound and is consistent with the independent injury test of § 7.01(b).

Cases have divided as to whether the issuance of a "poison pill" security can be challenged by a direct action on the grounds that it chills voting rights or restricts the alienability of the shareholder's stock. Compare Moran v. Household International, Inc., 490 A.2d 1059 (Del.Ch.1985), aff'd on other grounds, 500 A.2d 1346 (Del.1985) (direct action did not lie) with Duman v. Crown Zellerbach Corporation, 107 F.R.D. 761 (N.D.Ill. 1985) (direct action available). *Moran* relied on the fact that no proxy contest was then pending to find that voting rights had not been infringed by the issuance of a security that became convertible at a very attractive exchange ratio only if a shareholder crossed a defined stock ownership threshold. Thus, its holding that a direct action was not available because all existing shareholders were treated the same appears limited to those instances in which no existing shareholder has undertaken a control or proxy contest. Even as so limited, however, *Moran*'s focus on the similarity of treatment misses the central point that fundamental shareholder rights (e.g., voting and alienability) can be infringed by a variety of board actions that treat existing shareholders alike. For example, if the board attempted to provide by a bylaw, or through the issuance of new classes of shares, that shares became nonvoting on their transfer, this would treat all shareholders similarly, but would significantly restrict alienability. Subsequent to *Moran*, the Delaware Supreme Court indicated in Lipton v. News International, Plc, 514 A.2d 1075 (1986), that *Moran*'s test should not be overread or considered exclusive:

> [W]hile *Moran* serves as a quite useful guide, the case should not be construed as establishing the only test for determining whether a claim is derivative or individual in nature. Rather, as was established in *Elster*, we must look ultimately to whether the plaintiff has alleged 'special' injury, in whatever form.

Id. at 1078.

In *Lipton*, actions allegedly "designed to entrench management" were found to support a direct action when they gave one defendant sufficient voting power to veto all shareholder actions subject to a supermajority voting requirement.

Another category of cases meeting the "personal" injury standard is that involving direct actions against controlling shareholders for actions taken in either their individual or corporate capacities that forseeably depressed the value of the minority's shares. See Jones v. H. F. Ahmanson & Co., supra; Masinter v. WEBCO Company, 164 W.Va. 241, 262 S.E.2d 433 (1980). The result in *Jones* can be defended either on the theory that controlling shareholders owe such a "special duty" to minority shareholders in transactions affecting corporate control or on the theory that the challenged transaction was intended to depress the value of the minority's shares and thus transfer value to the majority.

4. In addition to Watson v. Button, 235 F.2d 235 (9th Cir.1956) and Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975), § 7.01(d) is supported by several other decisions that have also recognized that the special case of the closely held corporation justifies an exception to the general rule that only a derivative action may be used to seek redress of corporate injuries. See Crosby v. Beam, 47 Ohio St.3d 105, 548 N.E.2d 217 (Ohio 1989); Caswell v. Jordan, 184 Ga.App. 755, 362 S.E.2d 769 (1987); Steelman v. Mallory, 110 Idaho 510, 716 P.2d 1282 (1986); Miller v. Ruth's of North Carolina, Inc., 312 N.C. 494, 322 S.E.2d 557 (1984); Kirk v. First Nat'l Bank of Columbus, 439 F.Supp. 1141 (M.D.Ga.1977); Johnson v. Gilbert, 127 Ariz. 410, 621 P.2d 916, 917 (Ct. App.1980). See also Comment, Corporations—Shareholders' Derivative and Direct Actions—Individual Recovery, 35 N.C.L. Rev. 279 (1957). *Kirk* seems to expand upon *Watson* significantly because apparently there were in *Kirk* other shareholders in addition to the parties in the action. The *Kirk* court addressed this issue as follows:

> The substantive concerns caused by the presence of other injured former shareholders are that a *Watson*-type theory of recovery would generate a multiplicity of suits and would prejudice other former shareholders by diminishing the assets available for compensation of their injuries. However, both of these concerns are present in any class action type situation, where less than all injured parties request relief, and relief is not denied because of concern over multiplicity and diminution of assets. Indeed, far less drastic than denying relief would be to require plaintiffs in class action type situations to attempt joinder of all other injured parties. Yet Georgia law does not go even this far. Consequently, . . . this court can hardly conclude that these same concerns would prompt Georgia to reject plaintiffs' equitable theory of relief, a terribly burdensome result.

Id. at 1149.

The court also disposed of the potential injury to creditors by noting that an individual recovery by former shareholders did not itself preclude the right of the corporation to recovery; moreover, because no shareholders remained who had held shares at the time of the transaction, the resulting inability of the corporation to sue implied to the court that creditors, having no corporate recovery to look to, could not be prejudiced by an individual recovery.

For other, similar decisions involving closely held corporations, see Smith v. Tele-Communication, Inc., 134 Cal.App.3d 338, 184 Cal.Rptr. 571 (1982); Masinter v. WEBCO Co., 164 W.Va. 241, 262 S.E.2d 433 (1980); Dresden v. Willock, 518 F.2d 281 (3d Cir.1975); Atkinson v. Marquart, 112 Ariz. 304, 541 P.2d 556 (1975); Funk v. Spalding, 74 Ariz. 219, 246 P.2d 184 (1952); Matthews v. Headley Chocolate Co., 130 Md. 523, 100 A. 645, 650 (1917). Cf. Yanow v. Teal Industries, Inc., 178 Conn. 262, 422 A.2d 311 (1979). The results in W. E. Hedger Transportation Corp. v. Ira S. Bushey & Sons, Inc., 186 Misc. 758, 61 N.Y.S.2d 876 (1945) and Abelow v. Symonds, 38 Del.Ch. 572, 156 A.2d 416 (1959) are here disapproved.

In Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379 (7th Cir. 1990), the Seventh Circuit found that Delaware would not follow the standard proposed by § 7.01(d) and would insist that the action remain derivative even in the case of a corporation with only two shareholders. Delaware appears to have no recent case on this point, but some earlier Delaware decisions do indicate an unwillingness to relax the forms of the derivative action in the case of a closely held corporation. See DeMott, Shareholder Derivative Actions: Law and Practice, § 2.01 (1987).

5. Illustration 1 is based on Condec Corp. v. Lunkenheimer Company, 43 Del.Ch. 353, 230 A.2d 769 (1967). But see Moran v. Household International, Inc., 490 A.2d 1059 (Del.Ch. 1985), aff'd, 500 A.2d 1346 (Del.1985). Illustration 2 is based on Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437 (Del.1971). Illustration 3 is based on Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975); see also Estate of Schroer v. Stamco Supply, Inc., 19 Ohio App.3d 34, 482 N.E.2d 975 (1984). Illustration 4 involves facts similar to United Funds, Inc. v. Carter Prods., Inc., [1961–64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,288 (Md. Cir. Ct. May 16, 2000). Illustration 5 is supported by Katz v. Bregman, 431 A.2d 1274 (Del. Ch.1981). Illustration 6 is supported by Duman v. Crown Zellerbach Corporation, 107 F.R.D. 761 (N.D.Ill. 1985).

6. The ability of a shareholder in a proper case to bring either a direct or a derivative action, as provided for in § 7.01(c), is amply supported by case law. See Snyder v. Epstein, 290 F.Supp. 652, 655 (E.D.Wis.1968) (sale of corporate office gives rise to both direct and derivative actions); Bennett v. Breuil Petroleum Corp., 34 Del.Ch. 6, 99 A.2d 236, 241 (1953) (issuance of stock for improper purpose may be attacked by direct suit; issuance at insufficient price by derivative suit); Borak v. J. I. Case Co., 317 F.2d 838, 844–45 (7th Cir.1963), aff'd, 377 U.S. 426, 431, 84 S.Ct. 1555, 1559, 12 L.Ed.2d 423, 427 (1964). The rule that the plaintiff can generally bring both actions at the same time is also supported by authority. See In re TransOcean Tender Offer Securities Litigation, 455 F.Supp. 999, 1014 (N.D.Ill.1978) ("It is well-settled that shareholders have the right to bring direct and derivative actions simultaneously."); Liken v. Shaffer, 64 F.Supp. 432, 441 (N.D.Iowa 1946); Jones v. Missouri-Edison Electric Co., 144 Fed. 765, 777 (8th Cir.1906); C & S Land, Transportation & Development Corp. v. Yarbrough, 153 Ga.App. 644, 266 S.E.2d 508 (1980). The possibility of

double recovery is minimized in such situations by the likelihood that the two actions will have very different measures of damages, and that a corporate recovery, if any, may reduce the damages allowable in the individual action. Indeed, the possibility of a double recovery is even greater if the two actions are not joined but are heard separately by different courts in actions brought by different plaintiffs. For cases holding on their facts that an apparent conflict between the plaintiff's position as a direct litigant against the corporation and as a representative of the corporation in a derivative action was insignificant, see Bertozzi v. King Louie International, Inc., 420 F.Supp. 1166, 1179–80 (D.R.I.1976); Heilbrunn v. Hanover Equities Corp., 259 F.Supp. 936, 938–39 (S.D.N.Y.1966); In re TransOcean Tender Offer Securities Litigation, supra, at 1014. The apparently contrary results in G. A. Enterprises v. Leisure Living Communities, Inc., 517 F.2d 24 (1st Cir.1975) and Barrett v. Southern Connecticut Gas Co., 172 Conn. 362, 374 A.2d 1051 (1977) should be confined to their special facts and seen as instances in which the plaintiff did not meet the standard specified in § 7.02(a)(4). Finally, a direct action may be brought even when the plaintiff cannot represent the other shareholders adequately if the right at issue belongs to each shareholder individually (as in the case of voting rights). See Katz v. Bregman, 431 A.2d 1274 (Del.Ch. 1981).

7. A few decisions have permitted shareholders of a merged corporation to maintain a direct action for their loss of share value as a result of an alleged lack of care or diligence by directors in accepting a merger proposal. See Smith v. Van Gorkom, 488 A.2d 858 (Del.1985). Although the availability of a direct action to assert duty of care violations in the merger context is not addressed by this Section, an even more substantial obstacle may be the possible exclusivity of the appraisal remedy in such a case. See §§ 7.24 and 7.25.

ANALYSIS AND RECOMMENDATION

§ 7.02 Standing to Commence and Maintain a Derivative Action

(a) A holder [§ 1.22] of an equity security [§ 1.20] has standing to commence and maintain a derivative action if the holder:

(1) Acquired the equity security either (A) before the material facts relating to the alleged wrong were publicly disclosed or were known by, or specifically communicated to, the holder, or (B) by devolution of law, directly or indirectly, from a prior holder who acquired the security as described in the preceding clause (A);

(2) Continues to hold the equity security until the time of judgment, unless the failure to do so is

CERTIFICATE OF SERVICE

I hereby certify under penalties of perjury that on this date I served a true and correct copy of the foregoing document by sending the document via email to the addresses listed below.

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