

DERIVATIVE LAWSUITS

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1. Generally

As a general rule, a shareholder may not directly sue a third party to enforce rights held by the corporation – only the corporation can sue to enforce its own rights.

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All authorities agree that a stockholder, as such, cannot maintain an action against a third party, either for a breach of contract between such third party and the corporation of which he is a stockholder, or for an injury to the corporation or its property. All such wrongs must be redressed by the corporation itself and in the corporate name. *Ninneman v. Fox*, 43 Wash 43, 45, 86 P 213, 213 (1906).

A shareholder may not bring an individual action in such circumstances, even if the shareholder owns substantially all of the corporation's stock. *Zimmerman v. Kyte*, 53 Wash App 11, 765 P2d 905 (1988). A shareholder may not enforce a corporate right by means of a lawsuit brought in an individual capacity – all such actions must be brought derivatively.

Whenever a cause of action exists primarily in behalf of the corporation against directors, officers, and others, for wrongful dealing with corporate property, or wrongful exercise of corporate franchises, so that the remedy should regularly be obtained through a suit by and in the name of the corporation, and the corporation either actually or virtually refuses to institute or prosecute such a suit, then, in order to prevent a failure of justice, an action may be brought and maintained by a stockholder, or stockholders, either individually or suing on behalf of themselves and all others similarly situated, against the wrongdoing directors, officers, and other persons; but it is absolutely indispensable that the corporation, itself, should be joined as a party, usually as a co-defendant. That the plaintiff should allege and prove that application was made to the directors or managing body, and a reasonable notice, request, or demand that they institute proceedings on the part of the corporation against the wrongdoers, and their refusal to do so after such reasonable request or demand, is but a statement of a general rule. *Wills v. Nehalem Coal Co.*, 52 Or 70, 87, 96 P 528, 534 (1908).

See also: *Dant & Russell, Inc. v. Ostlind*, 148 Or 204, 35 P2d 668 (1934); *Smith v. Bramwell*, 146 Or 611, 31 P2d 647 (1934); *Stewart v. King*, 85 Or 14, 166 P 55 (1917); *Goodwin v. Castleton*, 19 Wash 2d 748, 763, 144 P2d 725, 732 (1944).

Typically, a derivative lawsuit is brought by a shareholder because the corporation will not bring a lawsuit against a third party on its own behalf. *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946). If a shareholder demands that the corporation itself bring a lawsuit – and the corporation agrees and files the demanded lawsuit against the third party in the corporation's own name – no derivative lawsuit is necessary or permitted.

Thus, in order for a complaint to state a cause of action entitling the stockholder to relief, it must allege two distinct wrongs: The act whereby the corporation was caused to suffer damage, and a wrongful refusal by the corporation to seek redress for such act. *James Talcott, Inc. v. McDowell*, 148 Fla 2d 36, 38 (Fla App 1962).

But when a shareholder makes a demand for the corporation to sue and the corporation refuses to bring suit – and that refusal is itself improper – the shareholder is

permitted to file a "derivative" lawsuit against the third party wrongdoer.

In a derivative lawsuit, a shareholder sues both the corporation and the third party wrongdoer. The third party is the "real" defendant – the corporation is included in the lawsuit only as a nominal defendant. In a derivative lawsuit, the plaintiff-shareholder seeks a remedy against the third party defendant only – the plaintiff does *not* seek damages from the corporation, even though the corporation is a defendant. In fact, the plaintiff shareholder usually is not personally entitled to any damages awarded – any funds recovered from the “true” defendant are usually only payable to the corporation. The only exception is that the plaintiff may be awarded attorney fees out of the funds received by the corporation. *Hoekstre v. Golden B. Products, Inc.*, 77 Or App 104, 712 P2d 149 (1985), *review denied*, 300 Or 563, 715 P2d 94 (1986).

Most cases hold that in a derivative suit, the corporation is a necessary party. *Howell v. Fisher*, 49 NC App 488, 272 SE2d 19 (1980); *Rose v. Schantz*, 56 Wis2d 222, 201 NW2d 593, 598 (1972).

It is settled beyond dispute that in a derivative suit on behalf of a corporation against third persons or against officers or directors of the corporation, the corporation is a necessary party. It is, in fact, inherent in the nature of the suit itself that it is the corporation whose rights are being redressed rather than those of the individual plaintiff. It follows that the corporation is regarded as the real party in interest. *Morgan v. Robertson*, 271 Ark App 461, 609 SW2d 662, 663 (1980).

Another court has said:

Primarily the right of action for wrongs suffered by the corporate interests is in the corporation, and an action for such wrongs cannot be maintained by a stockholder, however injuriously it may affect him, unless he alleges such fraud on the part of the corporation and complicity in the alleged wrongs as would seriously affect his interest; and, in such a case, it is indispensable that the stockholder make the corporation a party defendant to such a proceeding. This is to say that, where the corporation refuses to sue, a stockholder may, by complying with the conditions prescribed in Code § 22-711, bring such an action for the benefit of the corporation, but to the stockholder's action the corporation is not merely a proper party, but is an essential, indispensable party, and a failure to make the corporation a party is not a mere defect of parties, but leaves the stockholder without a cause of action and the court without jurisdiction. (citations omitted) *Smyly v. Smith*, 216 Ga 529, 529, 118 SE2d 188, 189 (1961).

NOTE: Some cases hold that the joinder of the corporation as a party may not be required when it is not pragmatic to do so, such as when the corporation has ceased to exist or been liquidated. *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972).

In a legal sense, the shareholder and corporation stand in the position of guardian ad litem and ward.

As frequently expressed judicially, a stockholder bringing a derivative action occupies a strictly fiduciary relationship to the corporation whose interests he assumes to represent, and his position in the litigation is in a legal sense the precise equivalent of that of a guardian ad litem, while the position of the corporation is the equivalent of the status of a ward or beneficiary. *Goodwin v. Castleton*, 19 Wash 2d 748, 144 P2d 725, 732 (1944).

Another case states that in a derivative action, "the corporation is the real party in interest and the minority stockholder who brings the action is at best only a nominal plaintiff seeking to enforce the right of the corporation against a third party." *Walters v. Center Electric, Inc.*, 8 Wash App 322, 506 P2d 883, 888 (1973). See also: *Cohen v. Beneficial Industrial Loan Corp.*, 337 US 541 (1949).

A derivative claim is a claim of the corporation. *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032 (1987), *amended*, 750 P2d 1032 (1988). In one case, a derivative claim was barred when – after being apprised of the claim – the corporation sold all of its assets to a third party. The court found the corporation had sold all its assets – even the claim which was the subject of the derivative lawsuit. *Lewis v. Chiles*, 719 F2d 1044 (9th Cir 1983).

The development of derivative lawsuits is discussed in *Ross v. Bernard*, 396 US 531 (1970); *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946); Kaplan & Elwood, *The Derivative Action: A Shareholder's "Bleak House"?* 36 U BRITISH COL L REV 443 (2003); Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST L J 241 (1999); Prunty, *The Shareholders' Derivative Suit: Notes on Its Development*, 32 NYU L REV 980 (1957).

2. Equitable action; extraordinary remedy

A derivative lawsuit is an equitable action. *Schultz v. Highland Gold Mines Co.*, 158 F 337 (D Or 1907); *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032 (1987), *amended*, 750 P2d 1032 (1988); *Barrett v. Southern Connecticut Gas Co.*, 172 Conn 362, 374 A2d 1051 (1977); *Florik v. Florida Land Sales Board*, 206 So2d 41 (Fla App 1968); *Rebstock v. Lutz*, 39 Del Ch 25, 158 A2d 487 (1960). This is true even though the only relief sought on behalf of the corporation is money damages

and even though the corporation – if it had brought the lawsuit itself – would have brought the case as an action at law. *Griffin v. Carmel Bank & Trust Co.*, 510 NE2d 178 (Ind App 1987). However, there may be a right to a jury trial if the corporation's claim against the “true” defendant is an action at law. *Ross v. Bernhard*, 396 US 531 (1970).

A derivative lawsuit is an extraordinary remedy which is generally available only to shareholders and only when those shareholders have no other right to redress. *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972); *Bell v. Arnold*, 175 Colo 277, 487 P2d 545 (1971); *Winter v. Farmers Educational & Cooperative Union of America*, 259 Minn 257, 107 NW2d 226, 233 (1961).

Derivative lawsuits are disfavored by the courts. *Haberman v. Washington Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032, 1060 (1987), *amended*, 750 P2d 254 (1988). In part this is due to the courts' deference to the business judgment of corporate management. In part it is due to perceived abuses in derivative lawsuits – particularly against public corporations. Consequently, courts impose a number of procedural requirements on derivative lawsuits, some of which have been codified in ORS 60.261. *See also*: Federal Rules of Civil Procedure Rule 23.1.

NOTE: The Oregon Rules of Civil Procedure do not contain a provision comparable to FRCP 23.1.

3. Who may bring suit: contemporaneous ownership of shares

In order to bring a derivative lawsuit, a plaintiff must have been a shareholder at the time the improper transaction occurred. ORS 60.261(1); *Bank of Santa Fe v. Petty*, 116 NM 761, 867 P2d 431 (NM App 1993), *cert denied*, 117 NM 10, 868 P2d 655 (1994); *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946); *The Contemporaneous Ownership Rule in Shareholders' Derivative Suits*, 25 UCLA L Rev 1041 (1978).

A shareholder may also bring suit if he/she became a shareholder by operation of law from one who had been a shareholder at that time of the allegedly improper transaction. Examples include a beneficiary of a will or an ex-spouse after a divorce.

Whether the case is considered in the light of the Federal Rule or the Georgia Statute is immaterial because in each the allegation that the petitioner was a stockholder at the time of the transaction of which he complains, or that his shares have devolved upon him by operation of law, is required. *Hurt v. Cotton States Fertilizer Co.*, 145 F2d 293, 295 (5th Cir 1944), *cert denied*, 324 US 844 (1945).

A person need not be a shareholder of record in order to bring a derivative suit. An equitable interest may be sufficient. *Rosenfeld v. Schwitzer Corp.*, 251 F Supp 758 (SD NY 1966)(construing Indiana law). A widow's community property interest in stock has been held sufficient to enable her to bring a derivative lawsuit. *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972). A person with a security interest in stock may also bring suit derivatively. *Gustofson v. Gustofson*, 47 Wash App 272, 734 P2d 949 (1987).

ORS 60.261(4) specifically includes within the definition of shareholder: "a beneficial owner whose shares are held in a voting trust or held by a nominee on behalf of the beneficial owner." Oregon law is silent on whether a beneficiary of a trust – other than a voting trust – may initiate a derivative lawsuit. Some courts hold a beneficiary of a trust which owns shares may initiate a derivative lawsuit. *Edgeworth v. First National Bank of Chicago*, 677 F Supp 982 (SD Ind 1988). Other courts hold that beneficiaries lack standing to bring a derivative lawsuit. *Matties v. Seymour Manufacturing Co.*, 270 F2d 365 (2nd Cir 1959), *cert denied*, 361 US 962 (1960).

One case indicates that a shareholder may bring a derivative lawsuit after selling his shares if "the wrongful acts were effectually concealed, and it appeared that the effects of the mismanagement continued to the stockholder's injury." *Davis v. Harrison*, 25 Wash 2d 1, 11, 167 P2d 1015, 1019 (1946).

A shareholder who purchases all of the stock owned by an officer or director – with knowledge of the selling officer/director's wrongdoing – cannot cause the corporation to sue the selling officer/director for misconduct that occurred before the sale. *Damerow Ford Co. v. Bradshaw*, 128 Or App 606, 876 P2d 788 (1994). One court held that a shareholder who purchased shares knowing of a wrong could not later bring a derivative suit even though the wrongs continued to occur after the purchase. *Blum v. Morgan Guaranty Trust Co. of New York*, 539 F2d 1388 (5th Cir 1976).

In a theoretical sense, this ownership requirement exists because the person who acquires stock after the alleged wrongdoing has presumably paid a price for that stock which reflects the wrongful act. See: *Colville Valley Coal Co. v. Rogers*, 123 Wash 360, 212 P 732 (1923). In a practical sense, courts (and now legislatures) have

imposed this requirement to prevent a person from "buying" a derivative lawsuit. *Rosenthal v. Burry Biscuit Corp.*, 60 A2d 106, 111 (Del Ch 1948).

Not only must a person be a shareholder at the time that the allegedly improper transaction occurred, that person must usually be a shareholder at the time the derivative lawsuit is filed and continue on as a shareholder throughout the course of the lawsuit. *Metal Tech Corp. v. Metal Techniques Co., Inc.*, 74 Or App 297, 703 P2d 237 (1985); *Zauber v. Murray Savings Ass'n*, 591 SW2d 932 (1980).

One reason for this rule is that a shareholder who voluntarily sells his stock after the wrongful act is perceived to no longer adequately represent the interest of similarly situated shareholders. Another reason is that the person bringing the lawsuit must have a proprietary interest in the lawsuit. *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032 (1987), *amended*, 750 P2d 1032 (1988).

But there are exceptions. The Ninth Circuit permits a former shareholder to maintain a derivative lawsuit – at least where the rights of creditors and other shareholders are not prejudiced – when the former shareholder parts "with his shares without knowledge of prior wrongful misappropriation of corporate assets by the directors" and where "the misappropriation had reduced the value of his prior shareholdings." *Watson v. Button*, 235 F2d 235, 237 (9th Cir 1956).

In some situations – such as in a freeze-out merger involving improper conduct – the improper conduct itself causes the shareholder to lose ownership status. In such cases, some courts have relaxed the requirement of contemporaneous ownership.

The Delaware courts have recognized at least two exceptions to the contemporaneous ownership rule.

The two recognized exceptions to the rule are: (1) where the merger itself is the subject of a claim of fraud; and (2) where the merger is in reality a reorganization which does not affect plaintiff's ownership of the business enterprise. *Lewis v. Anderson*, 477 A2d 1040, 1046 n 10 (1984).

See also: Blasband v. Rales, 971 F2d 1034 (3rd Cir 1992); *Schreiber v. Carney*, 447 A2d 17 (1982).

In interpreting similar statutory language, the California Court of Appeals allowed a derivative lawsuit to proceed because the lawsuit alleged wrongful conduct in the

merger transaction. *Gaillard v. Natomas Co.*, 173 Cal App 3d 410, 219 Cal Rptr 74 (1985).

In a case alleging that a freeze-out merger had been used to insulate directors from a derivative lawsuit, the Indiana Supreme Court held that the derivative lawsuit could proceed, stating:

But, since no wrong should be without a remedy a Court of Equity may grant relief, pro rata, to a former shareholder, of a merged corporation, whose equity was adversely affected by the fraudulent act of an officer or director and whose means of redress otherwise would be cut off by the merger, if there is no shareholder of the surviving corporation eligible to maintain a derivative action for such wrong and said shareholder had no prior opportunity for redress by derivative action against either the merged or the surviving corporation. *Gabhart v. Gabhart*, 267 Ind 370, 370 NE2d 345, 358 (1977).

Other courts have refused to permit persons frozen-out as shareholders to maintain a derivative action. See for example: *Guenther v. Pacific Telecom, Inc.*, 123 FRD 341 (D Or 1987); *Bronzaft v. Caporali*, 162 Misc2d 281, 616 NYS2d 863 (1994); *Blasband v. Rales*, 971 F2d 1034 (3rd Cir 1992)(interpreting Delaware law); *Yanow v. Teal Industries, Inc.*, 178 Conn 263, 422 A2d 311 (1979).

4. Who may bring suit: representative plaintiff

Rule 23.1 of the Federal Rules of Civil Procedure requires that a person bringing a derivative lawsuit in federal court must "fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."

Neither the Oregon Business Corporation Act nor the Oregon Rules of Civil Procedure impose such a requirement on a person filing a derivative lawsuit in the Oregon state courts.

NOTE: Oregon imposes a requirement that a party filing a *class action* lawsuit "fairly and adequately protect the interests of the class." ORCP 32(A)(4). Generally, however, derivative lawsuits are not filed as class actions. But some lawsuits combine both a derivative claim filed by a single shareholder and collective individual shareholder claims filed as a class action. This may occur in a merger where directors allegedly breached their duty to the corporation in evaluating the value of the merger (a derivative claim) and then allegedly made false representations to the shareholders in recommended favorable action on the merger (an individual securities claim, which may be brought as a class action).

The requirements of FRCP 23.1 will apply to derivative lawsuits filed in federal court – even lawsuits involving Oregon corporations. *See for example: Rothenberg v. Security Management, Inc.*, 667 F2d 958 (5th Cir 1982).

The rationale for the rule that a shareholder-plaintiff in a derivative lawsuit be representative of the other shareholders is set out in *Cohen v. Beneficial Industrial Loan Corp.*, 337 US 541 (1949):

Likewise, a stockholder who brings suit on a cause of action derived from the corporation assumes a position, not technically as a trustee perhaps, but one of a fiduciary character. He sues, not for himself alone, but as representative of a class comprising all who are similarly situated. The interests of all in the redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity. And while the stockholders have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self-chosen representative and a volunteer champion. The Federal Constitution does not oblige the state to place its litigating and adjudicating processes at the disposal of such a representative, at least without imposing standards of responsibility, liability and accountability which it considers will protect the interests he elects himself to represent. *Id* at 549-50.

A corporate director may qualify as a representative shareholder. *Dotlich v. Dotlich*, 475 NE2d 331 (Ind App 1985). The most important consideration is whether the shareholder bringing suit has an economic interest antagonistic to innocent shareholders. *Newell Co. v. Vermont American Corp.*, 725 F Supp 351 (ND Ill 1989). "Courts have found inadequacy of representation based on conflict of interest when the shareholder plaintiff had personal entanglements adverse to the interest of the other shareholders." *Sonkin v. Barker*, 670 F Supp 249, 251 (SD Ind 1987). Whether a plaintiff is an adequate representative "is firmly committed to the discretion of the trial court, reviewable only for abuse." *Smith v. Ayres*, 977 F2d 946, 948 (5th Cir 1992).

5. Demand requirement

Demand that the corporation itself bring a lawsuit against the alleged wrongdoer is another important procedural precondition to filing a derivative lawsuit.

Before initiating a derivative lawsuit, a shareholder must first make demand on the corporation that the corporation itself institute proceedings against the wrongdoers on its own behalf. *North v. Union Savings & Loan Ass'n*, 59 Or 483, 117 P 822 (1911). The "demand requirement is intended to allow the corporation the opportunity to take

over a suit brought on its behalf." *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 153, 744 P2d 1032, 1063 (1987), *amended*, 750 P2d 1032 (1988).

That the plaintiff should allege and prove that application was made to the directors or managing body, and a reasonable notice, request, or demand that they institute proceedings on the part of the corporation against the wrongdoers, and their refusal to do so after such reasonable request or demand, is but a statement of a general rule. *Wills v. Nehalem Coal Co.*, 52 Or 70, 87, 96 P 528, 534 (1908).

If the corporation accedes to such demand and files a lawsuit against the alleged wrongdoer, no derivative lawsuit is necessary or permitted.

ORS 60.261(2) provides:

A complaint in a proceeding brought in the right of a corporation must allege with particularity the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored or why a demand was not made. Whether or not a demand for action was made, if the corporation commences an investigation of the charges made in the demand or complaint, the court may stay any proceeding until the investigation is completed.

5.1 Business Judgment Rule. Even though it may have a valid claim against a third party, a corporation may decide not to sue. "Thus, the demand requirement implements "the basic principle of corporate governance that the decision of a corporation - including the decision to initiate litigation - should be made by the board of directors or the majority of shareholders.'" (citations omitted) *Kamen v. Kemper Financial Services, Inc.*, 500 US 102 (1991).

By its very nature, the derivative action impinges on the managerial freedom of directors. Hence, the demand requirement of Chancery Rule 23.1 exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits. Thus, by promoting this form of alternative dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations. *Crandon Capital Partners v. Shelk*, 219 Or App 16, 30, 181 P3d 773 (Or App 2008)(quoting *Aronson v. Lewis*, 473 A2d 805, 811-12 (Del 1984).

If the corporation's decision not to sue is a decision supportable by the business judgment rule, many courts will not permit a shareholder to override this decision and proceed with a derivative lawsuit. *Gleason v. International Multifoods Corp.*, 282 Or 253, 577 P2d 931 (1978). See also: *When Should Courts Allow the Settlement of Duty-of-Loyalty Derivative Suits?*, 109 HARV L REV 1084 (1996); Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ L REV 172 (1994).

The mere failure or refusal of the directors of a corporation to bring a suit does not give the right to do so to minority stockholders. The wisdom and expediency of a suit by a corporation must be left to the discretion of the directors. They may believe that a suit would not be productive, or that a satisfactory settlement can be secured, or that the publicity of a suit would be damaging to the future interest of the corporation. As said in the *Albright* case, *supra* [*Albright v. Fulton County Home Builders*, 15 Ga 485, 107 SE 335], they necessarily have a large discretion in that matter. In order for a minority stockholder to maintain an action of this character, it is imperative that fraud and complicity on the part of the directors must be shown. Even conversion of the property of the corporation by a third person gives no right of action to the stockholders, in the absence of an allegation of fraud or collusion on the part of the directors. (internal quotation marks omitted) *Peeples v. Southern Chemical Corp.*, 194 Ga 388, 394, 21 SE2d 698, 701 (1942).

Another court has said:

It does not follow . . . that a stockholder or a minority group of stockholders may impose their unbridled wills upon the officers or directors of a corporation by launching the corporation into litigation for the purpose of obtaining for it certain benefits which the complaining parties deem to belong or be due to the corporation. Business policy may dictate that, under certain circumstances, it would be unwise or unprofitable to insist upon one's rights, and accordingly the directors of a corporation or the majority of its stockholders may decline to bring or maintain a suit which a single stockholder of a minority group believes should be instituted. *Goodwin v. Castleton*, 19 Wash 2d 748, 762, 144 P2d 725, 732 (1944).

Upon receipt of a shareholder demand, the board may refer the demand to a committee of disinterested directors. If this committee decides it is not in the best business interest of the corporation to sue, this business judgment will usually be upheld by the courts.

In a leading case, New York's highest court upheld the business judgment of a committee of disinterested directors not to pursue a lawsuit against management involved in foreign bribes and kickbacks, finding the committee believed the lawsuit's likelihood of success was too low relative to its cost, the expected management disruption, adverse publicity and damage to the corporation's business. The court said that "[w]hile the court may properly inquire as to the adequacy and appropriateness of the committee's investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment." *Auerbach v. Bennett*, 47 NY2d 619, 634, 419 NYS 2d 920, 393 NE2d 994 (1979).

Many courts follow the *Auerbach* rule and give great deference to the business judgment of the board. See: *Millsap v. American Family Corporation*, 208 Ga App 230, 430 SE2d 385 (1993); *Will v. Englebretson & Co.*, 213 Cal App3d 1033, 261 Cal Rptr

868 (1989); *Black v. NuAire, Inc.*, 426 NW2d 203(Minn App 1988); *Genzer v. Cunningham*, 498 F Supp 682, 686-9 (ED Mich 1980).

But not all jurisdictions so apply the business judgment rule. One commentator notes there “are at least five different standards being applied by various jurisdictions across the country.” Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST L J 241, 251 n 36 (1999).

For instance, other courts have applied a “modified business judgment rule.”

we shall apply a modified business judgment rule that imposes an initial burden on a corporation to demonstrate that in deciding to reject or terminate a shareholder’s suit the members of the board (1) were independent and disinterested, (2) acted in good faith and with due care in their investigation of the shareholder’s allegations, and that (3) the board’s decision was reasonable. *In re PSE&G Shareholder Litigation*, 173 NJ 258, 801 A2d 295, 312 (2002).

See also: *Lewis v. Boyd*, 838 SW2d 215 (Tenn App 1992); *Houle v. Low*, 407 Mass 810, 556 NE2d 51 (Sup Jud Ct 1990); *Alford v. Shaw*, 320 NC 465, 358 SE2d 323 (1987).

A discussion of the role of special litigation committees appears in Murdock, *Corporate Governance – The Role of Special Litigation Committees*, 68 WASH L REV 79 (1993) and in Crain, *Decisions of Special Litigation Committees: Solving the Problem of Control Under Texas Law*, 44 BAYLOR L REV 171 (1992).

One law review article argues the Delaware courts have heightened their scrutiny of director decisions to ignore shareholder demands to sue in response to the corporate scandals of 2001 and 2002. Horn, *Delaware Courts’ Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightening Judicial Scrutiny on Directors of Corporations*, 41 WILL L REV 207 (2005).

If the business judgment rule does not support a board's decision to forego corporate claims against a third party, a shareholder may sue derivatively. The business judgment rule will usually not apply if the people making the decision to sue or not sue are the same people who are alleged to have wronged the corporation. Derivative lawsuits often involve allegations of wrongdoing by the corporation's directors, management and controlling shareholders.

5.2 No demand required if futile.

ORS 60.261(2) provides:

A complaint in a proceeding brought in the right of a corporation **must allege with particularity** the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored **or why a demand was not made.** Whether or not a demand for action was made, if the corporation commences an investigation of the charges made in the demand or complaint, the court may stay any proceeding until the investigation is completed.

In *Crandon Capital Partners v. Shelk*, 219 Or App 16, 181 P3d 773 (Or App 2008), the court embarks on a lengthy analysis of whether the allegations of the complaint contained sufficient particularity to justify why demand was not made.

Many courts have held that demand is not required if demand would be futile. *North v. Union Savings & Loan Ass'n*, 59 Or 483, 117 P 822 (1911). "[D]emand typically is deemed to be futile when a majority of the directors have participated in or approved the alleged wrongdoing, or are otherwise financially interested in the challenged transactions." (citations omitted) *Kamen v. Kemper Financial Services, Inc.*, 500 US 102 (1991).

Demand is excused either where (1) the board is not disinterested or independent, or (2) the challenged transaction was not the product of a valid exercise of business judgment.

To excuse noncompliance with the prelitigation demand requirement, a plaintiff must be able to articulate particularized facts showing that there is a reasonable doubt either that (1) the directors are disinterested and independent for purposes of responding to the demand or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. If either prong is satisfied, demand is excused. *Crandon Capital Partners v. Shelk*, 219 Or App 16, 30, 181 P3d 773 (Or App 2008)(citing *Brehm v. Eisner*, 746 A2d 244, 256 (Del 2000)).

5.3 Form of demand. ORS 60.261 does not specify the form of demand. Some cases hold "demand need not assume any particular form or recite any specific language." *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 51 Misc2d 188, 273 NYS2d 16, 24 (1966). However, the 1990 amendments to the Model Act (not adopted in Oregon) require that the demand be in writing. RMBCA § 7.40(1). See: 45 BUS LAW 1241 (1990).

Other cases require that the demand contain sufficient information so that the board can properly evaluate the claim. *Renfro v. Federal Deposit Insurance Corp.*, 773

F2d 657 (5th Cir 1985). See also: Official Comment to RMBCA § 7.42. "At a minimum, a demand must identify the alleged wrongdoers, describe the factual basis of the wrongful acts and the harm caused to the corporation, and request remedial relief." *Allison on behalf of General Motors Corp. v. General Motors Corp.*, 604 F Supp 1106, 1117 (D Del 1985).

6. Recovery belongs to corporation – not plaintiff-shareholder

A derivative lawsuit is filed on behalf of the corporation. If the lawsuit is successful and damages recovered, those funds belong to the corporation, not the shareholder/plaintiff. *American Timber & Trading Co. v. Niedermeyer*, 276 Or 1135, 558 P2d 1211 (1977); *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Lynch v. Patterson*, 701 P2d 1126 (Wyo 1985); *Ross v. Bernhard*, 396 US 531 (1969).

Under rare circumstances, a court may permit direct recovery by shareholders. For example, if the majority shareholder participated in the wrongful act, a court may conclude recovery by the corporation would be unjust since the majority shareholder would be rewarded by a pro rata distribution of the derivative lawsuit proceeds.

American Timber & Trading Co. v. Niedermeyer, 276 Or 1135, 558 P2d 1211 (1977).

The general rule is that in a shareholder derivative action to enforce a corporate cause of action, the judgment belongs to the corporation rather than the individual stockholders. Nevertheless, a direct recovery to the stockholders may be permitted under exceptional circumstances, notwithstanding that such recovery amounts to a forced distribution of corporate assets to the stockholders.

If awarding a recovery to a corporation would result in a stockholder's receiving a portion thereof to which he was not entitled, then a court of equity will look beyond the corporation and award the recovery to the individual stockholders entitled thereto. However, when third-party rights of higher priority, such as those of corporate creditors or claimants, are involved, then a judgment in favor of the stockholders, which would prejudice such rights, would be improper. (citations omitted). *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 519-20, 728 P2d 597, 608-9 (1986), *review denied*, 107 Wash 2d 1022 (1987).

See also: *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972).

7. Settlement

At common law, a plaintiff-shareholder could continue, compromise, abandon or discontinue a derivative lawsuit at pleasure, at least until another shareholder was

joined as a party or until an interlocutory judgment was entered. *Goodwin v. Castleton*, 19 Wash 2d 748, 765, 144 P2d 725, 733 (1944); *Albrecht v. Bauman*, 130 F2d 452 (DC Cir 1942) (interpreting Delaware law).

In *Goodwin v. Castleton*, 19 Wash 2d 748, 144 P2d 725 (1944), the court held that since the underlying claim actually belonged to the corporation, the corporation retains the right to compromise or abandon the lawsuit at any time, subject to court approval.

Today by statute, once a derivative lawsuit is filed, any compromise or settlement of the lawsuit by anyone requires court approval.

A proceeding commenced under this section may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interest of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected. ORS 60.261(3).

In determining whether to approve such settlement, the court need not weigh all of the issues raised in the plaintiff-shareholder's complaint in order to evaluate each issue's likelihood of success.

The court may approve or it may disapprove the settlement. In either event, it is the action of the court and is binding on the parties concerned. Nor is the court under such circumstances required first to try out all the issues presented by the plaintiffs in the derivative action; on the contrary, the court may confine itself to the question as to whether the matters involved in such suit have, in good faith and for adequate consideration, been settled and compromised. This, in our opinion, constitutes the orderly manner of procedure, for, otherwise, the fruits of an advantageous settlement might be lost, the corporation exposed to the expense and embarrassment of protracted litigation, and the rights and property of the majority stockholders seriously jeopardized. *Goodwin v. Castleton*, 19 Wash 2d 748, 764, 144 P2d 725, 733 (1944).

In order to approve a settlement, the court need only determine whether the parties acted in good faith and whether payment is adequate.

8. Attorney fees

Neither ORS 60.261 – nor § 7.40(d) of the Revised Model Act from which it was taken – mention the award of attorney fees. However, the Comments to RMBCA § 7.40(d) state:

Section 7.40(d) does not refer to the award of expenses, including attorneys' fees, to successful plaintiffs. The right of successful plaintiffs in derivative suits to this recovery is so universally recognized, both by statute and on the theory of a recovery of a fund or benefit for the corporation, that specific reference was thought to be unnecessary. The intention is to preserve fully these nonstatutory rights of reimbursement. Therefore, no

negative inference should be drawn from section 7.40(d) as to the rights of plaintiffs to reimbursement. Official Comment to RMBCA § 7.40.

A shareholder's right to attorney fees is supported by two important policies. First, non-plaintiff/shareholders would be unjustly enriched by the plaintiff's efforts if they recovered without contributing to the litigation expenses. Second, the reimbursement of attorney fees and expenses encourages meritorious derivative lawsuits by shareholders whose expenses in bringing such lawsuits would normally exceed any increase in the value of their stock brought about by the lawsuit. *Neese v. Richer*, 428 NE2d 36, 39 (Ind App 1982).

Even prior to adoption of the current corporation statute, Oregon courts held that a plaintiff-shareholder was entitled to attorney fees chargeable against the corporation if the derivative lawsuit benefitted the corporation. *Hoekstre v. Golden B. Products, Inc.*, 77 Or App 104, 712 P2d 149 (1985), *review denied*, 300 Or 563, 715 P2d 94 (1986). This was true even if the outcome meant the corporation was likely to dissolve and liquidate. *Krause v. Mason*, 272 Or 351, 537 P2d 105 (1975).

In *Crandon Capital Partners v. Shelk*, 342 Or 555, 157 P3d 176 (2007), the Oregon Supreme Court affirmed the right of plaintiffs in derivative lawsuits to recover their reasonable attorney fees if the filing of the lawsuit conferred a benefit on the corporation – even a benefit that occurred outside the lawsuit itself. In *Crandon*, the plaintiffs sued to remove a merger target's takeover defenses, alleging that they were unlawful measures to entrench existing management, and to force that corporation's board to engage in negotiations with the other corporation. Before trial, the target stopped resisting the merger and the merger occurred.

In reversing the trial court's refusal to award attorney fees to the plaintiffs, the Supreme Court reviewed the history supporting awards of attorney fees in derivative cases and noted that a long line of cases have held that courts have the equitable power to award attorney fees to a shareholder who brings litigation that confers a common benefit on others, such as a corporation or its shareholders.

Under the common fund doctrine, plaintiffs who is legal efforts create, discover, increase, or preserve a fund of money to which others also have a claim, they recover the costs of their litigation, including their attorney fees, from the created or preserved fund. * * * [T]he doctrine is primarily employed to realize the broadly defined purpose of recapturing unjust

enrichment. * * * in other words, the doctrine is used to spread litigation expenses among all beneficiaries of a preserved fund so that litigant-beneficiaries are not required to bear the entire financial burden of the litigation while in active beneficiaries receive the benefits at no cost. *Crandon Capital Partners v. Shelk*, 342 Or 555, 566, 157 P3d 176 (2007) (quoting *Strunk v. PERB*, 341 Or 175, 181, 139 P3d 956 (2006)).

The Court also looked to a related equitable basis for an award of attorney fees – the “substantial benefit” theory – which originated in the idea that fees may be awarded when the benefit that was conferred was nonpecuniary, thus providing no fund from which to award fees.

Litigation which results in correcting abuses of [the union democratic] process frequently may not give rise to an ascertainable pecuniary benefit. But the fact that no money or property is involved does not detract from the importance of litigation. Those members of the union who in good faith seek to preserve internal democracy of their union should not have to bear the expense of a successful suit. *Crandon, supra* 342 at 566 (quoting *Gilbert v. Hoisting & Port. Engrs.*, 237 Or 130, 138, 384 P2d 136, 390 P2d 320 (1963), cert denied, 376 US 963 (1964)).

The Court held that the plaintiffs’ claim for attorney fees did not become moot when the underlying substantive claims became a moot. It therefore reversed.

On remand, the Court of Appeals stated:

It is well settled under Delaware law that to be entitled to fees under the substantial benefit doctrine, a party must demonstrate, as a preliminary matter, that “(1) the suit was meritorious when filed; (2) the action producing benefit to the corporation was taken by the defendants before a judicial resolution was achieved; and (3) the resulting corporate benefit was causally related to the lawsuit.” *United Vanguard Fund v. TakeCare, Inc.*, 693 A2d 1076, 1079 (Del 1997) (cited with approval in *Crandon II*, 342 Or at 567-68, 157 P3d 176). As the Delaware Supreme Court has explained:

“The reason for allowing an award of attorneys’ fees to plaintiff’s counsel where a defendant corporation takes steps to settle or moot a case and in so doing produces the same or similar benefit sought by the shareholder’s litigation is to prevent frustration of the remedial policy of providing professional compensation for such suits when meritorious. This rule insures that, even without a favorable adjudication, counsel will be compensated for the beneficial results they produced, provided that the action was meritorious and had a causal connection to the conferred benefit.” *Allied Artists Pictures Corp. v. Baron*, 413 A2d 876, 878 (Del 1980) (citations omitted).

The meaning of the “meritoriousness” requirement was fully explored in *Chrysler Corporation v. Dann*, 223 A2d 384 (Del 1966). There the court observed that to allow the award of fees upon the mere filing of a derivative action would encourage the filing of many baseless actions solely for the purpose of obtaining counsel fees — a clearly undesirable result. *Id* at 386-87. Rather, to justify an award of fees,

“the action in which they are sought must have had merit at the time it was filed. It may not be a series of unjustified and unprovable charges of wrongdoing to the disadvantage of the corporation. The plaintiff must have some factual basis at least for the making of the charges.” *Id* at 387.

On the other hand, the court expressly rejected the notion that the rule was so demanding as to require that the action, to be meritorious, must be capable of surviving a motion for summary judgment. *Id.* Rather, the court concluded:

"A claim is meritorious within the meaning of the rule if it can withstand a motion to dismiss on the pleadings if, at the same time, the plaintiff possesses knowledge of provable facts which hold out some reasonable likelihood of ultimate success. It is not necessary that factually there be absolute assurance of ultimate success, but only that there be some reasonable hope." *Id.*; see also *Kahan v. Rosenstiel*, 424 F2d 161, 167 (3d Cir), *cert den*, 398 US 950, 90 S Ct 1870, 26 L Ed2d 290 (1970) (noting that "[i]n several cases which became moot, courts have said suits were 'meritorious' if they could have survived a motion to dismiss").

We agree with the rationale expressed by the Delaware court and adopt its standard for determining the "meritoriousness" of the predicate litigation as applicable to "substantial benefit"-based attorney fee claims in Oregon. *Crandon Capital Partners v. Shelk*, 219 Or App 16, 27-29, 181 P3d 773 (2008).

Other cases hold that attorney fees may not be recoverable when a lawsuit's most substantial benefit inures to the benefit of the shareholder/plaintiff – rather than to the corporation itself. *Serbick v. Timpte-Pacific, Inc.*, 88 Or App 633, 746 P2d 1167 (1987); *Delaney v. Georgia-Pacific Corp.*, 279 Or 653, 569 P2d 604 (1977); *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987).

Attorney fees are usually not recoverable in a direct action by a shareholder against other shareholders. *Chiles v. Robertson*, 96 Or App 658, 774 P2d 500, *review denied*, 308 Or 592, 784 P2d 1099 (1989).

9. Oregon does not require plaintiff to post security

The Oregon Business Corporation Act does not require a plaintiff to post security when filing a derivative claim. Some states have, or have had, such a requirement. See for example: *Malott v. Randall*, 11 Wash App 433, 523 P2d 439 (1974).

10. Oregon does not require verification of complaint

Federal Rules of Civil Procedure 23.1(b) requires that a derivative lawsuit complaint must be verified. This is also true in many other states, including Washington. See Wash Civil Rule 23.1.

"Verification is the confirmation of the correctness, truth or authenticity of the pleadings." *RCL Northwest, Inc. v. Colorado Resources, Inc.*, 72 Wash App 265, 271,

864 P2d 12 (1993). Failure to verify may usually be cured, but if not cured before dismissal, the dismissal should be with "leave to plead or conditioned on a failure to cure within a reasonable period of time." *Id.*

The Oregon Rules of Civil Procedure do not contain a specific rule for derivative actions. Therefore, no verification required for derivative lawsuits file in the Oregon state courts.

11. Equitable defenses

A derivative lawsuit is an equitable action. *Schultz v. Highland Gold Mines Co.*, 158 F 337 (D Or 1907); *Barrett v. Southern Connecticut Gas Co.*, 172 Conn 362, 374 A2d 1051 (1977); *Florik v. Florida Land Sales Board*, 206 So2d 41 (Fla App 1968); *Rebstock v. Lutz*, 39 Del Ch 25, 158 A2d 487 (1960). As such, certain equitable defenses may apply.

The defense of unclean hands may be available. *Roles v. Roles Shingle Co.*, 147 Or 365, 31 P2d 180 (1934); *Foy v. Klapmeier*, 992 F2d 774, 779 (8th Cir 1993); *Dobry v. Dobry*, 324 P2d 534 (Okla 1958); *Liken v. Shaffer*, 64 F Supp 432, 442 (ND Iowa 1946).

[S]hareholder derivative actions are inventions of courts of equity, and even though [plaintiff] is merely a nominal plaintiff bringing suit on behalf of [the corporation], equity requires that a shareholder derivative action cannot be maintained if the nominal plaintiff has unclean hands in connection with the transactions which are the bases for the litigation or has participated or acquiesced in, or benefitted from the conduct of which he now complains. (citations omitted) *Forkin v. Cole*, 192 Ill Ap3d 409, 548 NE2d 795, 805 (1989).

But see: Hilpert v. Yarmosh, 77 App Div 2d 608, 430 NYS2d 112 (1980)("The 'dirty hands' rationale therefore is inapplicable to plaintiff's representative capacity since the lawsuit is for the benefit of the corporation").

A defense of laches may also be available if the shareholder bringing suit delays too long after learning of the claim. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1979); *Wills v. Nehalem Coal Co.*, 52 Or 70, 96 P 528 (1908); *Teren v. Howard*, 322 F2d 949 (9th Cir 1963); *Gascue v. Saralegui Land & Livestock Co.*, 70 Nev 83, 255 P2d 335 (1953); *Gallup v. Pring*, 116 P2d 202 (Colo 1941). But laches does not begin to run until the shareholder learns of the claim. *Moore v. Los Lugos Gold Mines*, 172 Wash

570, 601, 21 P2d 253 (1933). Additionally, laches as to one shareholder may not apply to another shareholder who only recently learned of the claim. *Liken v. Shaffer*, 64 F Supp 432, 442 (ND Iowa 1946).

In addition to the equitable defenses, the underlying claim may also be subject to a statute of limitations. *Teren v. Howard*, 322 F2d 949 (9th Cir 1963). If the statute of limitations would bar a corporation itself from bringing the lawsuit, the claim is not revived merely because a shareholder brings the claim as a derivative lawsuit. But if the wrongdoers are directors, the statute may be tolled until at least some innocent director knows of the wrongdoing.

Courts have taken two positions on the issue of who needs to know of the wrongdoing before the statute of limitations begins to run: some courts have only required that a single disinterested director have knowledge of the wrongdoing; others that a majority of decision-makers have such knowledge. Oregon follows the more liberal of these two views – the disinterested majority version of the rule.

Under the disinterested majority version, a plaintiff benefits from a presumption that the cause of action does not accrue or the statute of limitations does not run so long as the culpable directors remain in the majority, *i.e.*, until the corporation has a disinterested majority of nonculpable directors. *FDIC v. Smith*, 328 Or 420, 427, 980 P2d 141 (1999).

A shareholder who with knowledge of the material facts consents to, concurs in, acquiesces in or ratifies wrongful conduct cannot later bring a derivative lawsuit over that conduct. *Swafford v. Berry*, 382 P2d 999 (Colo 1963); *Dobry v. Dobry*, 324 P2d 534, 536 (Okla 1958); *Elster v. American Airlines, Inc.*, 100 A2d 219 (Del Ch 1953).

Some state statutes dealing with derivative lawsuits contain specific provisions addressing the period in which such lawsuits may be brought. *See for example*: OCGA § 14-2-831(b)(Georgia's four-year period); *Norris v. Osburn*, 243 Ga 483, 254 SE2d 860 (1979).