IN THE SUPREME COURT OF MISSISSIPPI

VENNIT B. MATHIS, II	**APPELLANT**
VS.	**CASE NO. 2008-CA-00620**
ERA FRANCHISE SYSTEMS, INC., ET AL.	**APPELLEES**

I. CERTIFICATE OF INTERESTED PERSONS

The undersigned counsel of record certifies that the following listed persons have an interest in the outcome of this case. These representations are made in order that the Justices of the Supreme Court and/or the Judges of the Court of Appeals may evaluate possible disqualification or recusal.

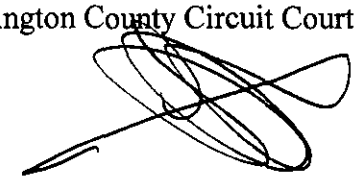
1. Vennit B. Mathis, II ("Mathis"), Appellant;
2. Sam S. Thomas and Eddie J. Abdeen, Attorneys for Appellant;
3. ERA Franchise Systems, Inc.("ERA"), Appellee;
4. Cendant Corporation, Cendant Finance Holding Company, LLC and Cendant Real Estate Services Group, LLC, the ascendant corporate parents of ERA Franchise Systems, Appellee;
5. Christopher A. Shapley, Robert L. Gibbs, Steven J. Allen and Joseph Anthony Sclafani, Attorneys for ERA Franchise System, Inc., Appellee;
6. Mark Warren ("Warren"), Appellee;
7. Real Estate Professionals of Central Mississippi, LLC, Appellee ("REP-Central");
8. Rick D. Patt, Attorney for Warren and REP-Central;
9. H. Stuart Irby ("Irby"), Appellee;
10. Real Estate Professionals of the Pine Belt, LLC, Appellee ("REP-Pine Belt");

11. Dennis L. Horn and Erik M. Lowery, Attorneys for Irby and REP-Pine Belt;

12. Jackie R. Hill ("Chip Hill"), Appellee, *pro se*;

13. Pamela Hill, Appellee, *pro se*; and

14. Honorable Robert Evans, Covington County Circuit Court Judge



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IV. STATEMENT OF THE ISSUE(S)

1. Whether ERA and the other Appellees (through their separate joinders to ERA's 12(b)(6) motion) have waived the right to assert the affirmative defense that Mathis lacks standing to prosecute certain claims that arise out of, among other things, alleged wrongs ERA and the other Appellees have perpetrated against Real Estate Professionals, LLC ("REP"), a closely held limited liability company in which Mathis and Irby are each 50% equity owners.

2. Whether, under Mississippi law, a trial court, in relation to a closely-held corporation, has the discretionary authority to 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 the creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons ("Closely-Held Corporation Direct Action Doctrine").

3. Whether, if Mathis establishes the conditions for invoking the doctrine (set forth in the preceding paragraph), Mathis is entitled to utilize the Closely-Held Corporation Direct Action Doctrine to obtain an individual recovery for the claims of REP against ERA, Irby and the other Appellees that are in the nature of derivative claims.

4. Whether all of the claims asserted by Mathis are derivative claims of REP.

V. STATEMENT OF THE CASE/OPERATIVE FACTS

A. Background/Procedural History.

The following background/procedural facts have bearing on and/or are pertinent to the issues raised in this appeal, including the issue of whether ERA and the other Appellees have waived any right they may have had to contest whether Mathis has individual standing to assert the claims of REP that are derivative in nature:

1. At all times relevant hereto Mathis was a 50% equity owner/member of REP, a closely-held limited liability corporation, which operated a real estate brokerage business as an ERA franchisee. At a time when Irby was the other 50% equity owner of REP and Chip Hill was an agent of REP, Irby and Chip Hill transferred the assets of REP to Appellees REP-Central and REP-Pine Belt (entities formed by Irby, Chip Hill and Warren, who was also an employee and/or agent of REP, and in which Mathis had no equity ownership) and, with ERA's full knowledge, approval and participation, began conducting a real estate brokerage business utilizing the ERA trademark. (R. 17-21 – Complaint of Mathis);

2. On May 8, 2003, Mathis filed his complaint in this action in the Covington County Chancery Court. Relying upon *Derouen v. Murray*, 604 So. 2d 1086, 1091 n. 2 (Miss. 1992), Mathis sought, among other things, to have the trial court declare that he was entitled to obtain an individual recovery on the claims of REP that were derivative in nature (that arose out of the breaches of fiduciary and other duties of Irby and Chip Hill described herein). (R. 22-23 – Mathis's Complaint at Count I). Mathis sought to proceed under *Derouen, supra*, so that, among other things, Irby, the other 50% equity owner/member of REP, would not benefit from any recovery of damages by REP that flowed from Irby's breaches of duty to REP, including the transfer of REP's assets to REP-

Central and REP-Pine Belt and the subsequent conduct of REP's real estate brokerage business those such entities;

3. In June of 2003, Irby, REP-Pine Belt and ERA moved to stay this action because of an interpleader action ERA filed in the United States District Court for the Southern District of Mississippi styled, " ERA Franchise Systems, Inc. v. Real Estate Professionals, LLC, et al.", Civil Action No. 3:02CV171WS.(R.35-40). Thereafter, Mathis filed his response in opposition to that motion and the trial court denied the stay request on October 9, 2003. (R.154-163 and 258-263, respectively). The federal court then granted the motion to dismiss of Mathis, ruling that no federal jurisdiction existed;

4. On or about June 11, 2003, ERA filed its answer to Mathis's Complaint, counterclaims and cross-claims. (R.41-61). ERA asserted Mathis lacked standing as its fourth affirmative defense. (R.41);

5. On or about June 16, 2003, Warren and REP-Central filed their answer to Mathis's Complaint. (R.65-77). Consistent with the answer filed by ERA, Warren and REP-Central asserted Mathis lacked standing as their fourth affirmative defense. (R.66);

6. On or about June 18, 2003, Irby and REP-Pine Belt filed their answer to Mathis's Complaint. (R.80-89). However, neither Irby nor REP-Pine Belt asserted Mathis lacked standing to file the asserted claims;

7. Active Participation in the Discovery Process by Appellees Prior to ERA's Removal, Subject Matter Jurisdiction Motion and Related Interlocutory Appeal to this Court:

a. On June 30, 2003, Chip Hill was deposed by all parties. (R.860-862);

b. On or about September 5, 2003, ERA noticed the deposition of Mathis and, along with the other Appellees, subsequently deposed Mathis on or about October 14, 2003. (R.164-165;

171-172; 242-243; 248-249);

c. On September 10, 2003 Irby and REP-Pinebelt served interrogatories and requests for production of documents upon Mathis pursuant to M.R.C.P. 33 and 34, respectively. (R.166-167);

d. On September 11, 2003, ERA served written discovery on certain of the other Appellees. (R.168-169);

e. On or about September 11, 2003, ERA served a subpoena duces tecum upon Vennitt Mathis, Sr. and Mid-South Services, Inc. (R.285-290);

f. On September 15, 2003, ERA served written discovery on Mathis. (R.173-174);

g. On September 22, 2003, ERA, along with certain of the other Appellees, noticed the deposition of Vennit B. Mathis, Sr. (Mathis's father). (R.244-245; 246-247);

h. On September 29, 2003, ERA served its responses and objections to the written discovery of Mathis. (R.250-251);

i. On September 29, 2003, REP-Central served written discovery on Mathis. (R.252-253);

j. On October 14, 2003, Irby and REP-Pine Belt served their responses and objections to the written discovery of Mathis. (R.266-267); and

k. On October 30, 2003, ERA filed a discovery motion in relation to its written discovery served upon Mathis. (R.301-303).

8. On November 10, 2003, the trial court entered an agreed scheduling order wherein the parties (except for Chip Hill and Pamela Hill) agreed to various pre-trial deadlines (amendments, experts, discovery, etc.) tied to a trial date of May 10, 2004. (R.371-376);

9. On November 24, 2003, without ever having filed an answer to Mathis's Complaint,

Chip Hill and Pamela Hill filed a Chapter 11 Bankruptcy Petition in the United States Bankruptcy Court for the Southern District of Mississippi, Case No. 03-55758. (R.382);

10. On December 19, 2003, ERA removed this action to the United States District Court for the Southern District of Mississippi on the basis of the Hill bankruptcy proceeding. (R.409);

11. On March 25, 2004, Mathis was granted relief from the automatic stay as to the Hill's bankruptcy proceeding to proceed to reduce his claim to judgment against the Hills. (R.437-440);

12. On May 4, 2004, the United States District Court for the Southern District of Mississippi granted the Motion to Remand and/or Abstain of Mathis. (R.407-418);

13. On May 10, 2004, ERA filed a Motion to Transfer Civil Action to Circuit Court asserting the Covington County Chancery Court lacked subject matter jurisdiction to preside over the claims asserted by Mathis. (R.421-428);

14. On or about May 17, 2004, Irby, Warren, REP-Pine Belt and REP-Central joined in ERA's subject matter jurisdiction motion. (R.429-432);

15. On or about December 7, 2004, Warren served written discovery on Mathis. (R.476-477);

16. On December 30, 2004, Warren served his responses and objections to Mathis's written discovery. (R.478-479);

17. After a hearing on ERA's subject matter jurisdiction motion (which Mathis opposed), the Covington County Chancery Court denied the motion and, after ERA perfected an interlocutory appeal and the briefing scheduled was completed by the parties, this Court, on June 22, 2006, handed down its decision in *ERA Franchise Systems, Inc. v. Mathis*, 931 So. 2d 1278, 1281 (Miss. 2006) which transferred this action to the Covington County Circuit Court. (R.441-449);

18. On October 20, 2006, the Covington County Circuit Court entered an agreed

scheduling order tied to a January 7, 2008 trial date. (R.627-631);

19. On or about May 29, 2007, Irby and REP-Pine Belt served their responses and objections to requests for admission of Mathis. (R.724-740);

20. On or about June 12, 2007, Irby and REP-Pine Belt filed a motion for extension of time to respond to the second requests for production and interrogatories of Mathis. (R.739-741);

21. On July 16, 2007, Mathis filed a motion to amend the scheduling order because, among other things, Irby, Warren, REP-Central and REP-Pine Belt had failed to produce the accounting and financial information Mathis had requested in discovery for the purpose of supplementing its expert designation/damage calculation. (R.742-776);

22. On or about July 26, 2007, Irby and REP-Pine Belt served their responses and objections to Mathis's second set of written discovery. (R.777-778);

23. On July 31, 2007, over four years after Mathis had filed his complaint in this action, ERA filed, pursuant to M.R.C.P. 12(b)(6), its Motion to Dismiss for Lack of Standing. (R.779-782);

24. On August 1, 2007, Irby and REP-Pine Belt served written discovery on Mathis. (R.890-891);

25. On August 23, 2007, Irby and REP-Pine Belt joined in ERA's Motion to Dismiss for Lack of Standing. (R.892-893);

26. On August 27, 2007, ERA noticed its lack of standing motion for hearing on October 12, 2007. (R.896-897);

27. On October 3, 2007, Warren and REP-Central joined in ERA's Motion to Dismiss for Lack of Standing. (R.908-910);

28. On October 5, 2007, Irby designated an expert witness. (R.914-916);

29. On October 11, 2007, Mathis served, via fax and mail, a written response to ERA's

lack of standing motion. (R. 919-925).

30. At the October 12, 2007 hearing on ERA's lack of standing motion, Mathis argued, in addition to his argument based on *Derouen v. Murray*, 604 So. 2d 1086, 1091 n. 2 (Miss. 1992), that ERA and the other Appellees had waived any right they had to assert Mathis lacked standing to pursue the claims set forth in his complaint. Specifically, Mathis, through his counsel, argued, in pertinent part, as follows:

> One point I would add, though, is this suit was filed on May 8, 2003. And I would hand the Court Mississippi Credit Center, Inc. v. Horton [MS Credit Center v. Horton, 926 So. 2d 167 (Miss. 2006)] and suggest to the Court, based on paragraph 41 ... that we're kind of late here arguing something that should have been dealt with long ago. And I'd like the record to reflect that that argument is made to Your Honor as well when it [this action] goes to high street [referring to the instant appeal].

(R.Vol. 8 – Hearing Transcript at p. 12).

31. On January 23, 2008, the trial court issued a letter ruling granting ERA's Motion to Dismiss for Lack of Standing and directing that ERA prepare an order for circulation among counsel and presentation to the court. (R.943-944);

32. On February 11, 2008, Mathis filed a Motion for Clarification of Court's Ruling and Request for Status Conference. (R.929-932). Through such motion, Mathis sought, among other things, (1) to have the trial court clarify its ruling as it only addressed the claims of Mathis against ERA despite the other Appellees having joined in ERA's lack of standing motion; and (2) to have the trial court determine whether M.R.C.P. 54(b) treatment of its ruling would be appropriate as ERA was resistant to Mathis being able to obtain an appeal as a matter of right as opposed to having to seek an interlocutory appeal. (R.930). Irby, REP-Pine Belt, Warren and REP-Central joined in Mathis's motion. (R.939-942;952-955);

33. On March 14, 2008, the trial court entered its Partial Judgment of Dismissal and

Certification Pursuant to M.R.C.P. 54(b). (R.956-959). The trial court, having considered ERA's Motion and Memorandum, the joinders therein filed by the other Appellees, Mathis's response in opposition and all of the arguments of the parties presented at the October 12, 2007 hearing, found, among other things, that Mathis "lacked standing to pursue any claims against any Defendant [Appellee]" that were "in the nature of derivative claims belonging to [REP]" and that all of the Plaintiff's claims against ERA were derivative. (R.956); and

34. After the entry of such judgment, Mathis timely perfected his appeal to this Court. (R.960-961).

B. Facts and Claims Pled in the Complaint.

As alleged in the complaint filed in this action, Mathis is and was at all times pertinent hereto a 50% equity owner/member in REP, a closely-held limited liability corporation. (Paragraph 11 - R. 17-18). REP held an ERA franchise, evidenced by a Renewal Membership Agreement ("Franchise Agreement"). (Para. 11 - R. 17-18). When Mathis became an equity owner of REP, Mathis personally guaranteed the obligations of REP to ERA under the Franchise Agreement.(Para. 11 - R. 17-18). After Mathis made his equity investment in REP, Chip Hill, a co-owner of REP and the licensed real estate broker through whom REP conducted business, induced Mathis to make working capital loans to REP that totaled several hundred thousand dollars. (Paras. 11-12 - R. 17-18)[1].

Subsequent to Mathis becoming an equity owner of REP, Chip Hill and Pamela Hill sold their equity interest in REP to Irby but remained employees and/or agents of REP. (Para. 13 - R.18).

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[1] After Mathis made his equity investment in REP and had made various working capital loans to REP, Chip Hill induced Mathis to make additional loans to him, as well as REP, by representing to Mathis that he would transfer ownership in various parcels of real property held in Chip Hill's name in addition to paying back the loaned funds. In reliance on Chip Hill's representation, Mathis made the additional loans.(Paras. 12 - R. 18).

Thereafter, Chip Hill, Irby, and Warren, who was an employee and/or agent of REP[2], formed REP-Central and REP-Pine Belt and transferred the assets of REP to such entities thereby converting REP's assets and excluding Mathis from the business of REP. (Para. 13 - R. 18-19). In addition to the individual Appellees/Defendants transferring the hard assets of REP, as well as the real estate listings of REP, to REP-Central and REP-Pine Belt, such Appellees/Defendants induced the real estate sales agents of REP to terminate and/or otherwise not honor their agent contracts with REP and to become real estate agents for REP-Central and REP-Pine Belt. (Para. 14 - R. 19).

The individual Appellees/Defendants thereafter began conducting a real estate brokerage business through REP-Central and REP-Pine Belt with REP's misappropriated franchise rights, including the use of the ERA logo. (Para. 15 - R. 19-20). REP-Central and REP-Pine Belt began earning commission revenue from the sales of real estate and allowed monies owed to ERA for the use of its logo, etc. to accumulate as debt in REP. (Para. 15 - R. 19-20)[3].

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2 As a matter of fact and law, the relationship between REP (as principal) and Chip Hill, Pamela Hill (after they sold their equity interest in REP), Warren and Irby, who was also a licensed real estate agent and/or broker, (as agents) was fiduciary in nature. *Van Zandt v. Van Zandt,* 86 So.2d 466, 469 (Miss. 1956)(relationship existent between principal and agent is fiduciary one, demanding conditions of trust and confidence).Such Appellees/Defendants, as agents of REP, had a duty to act in the best interest, and not to the detriment of, REP, their principal. *Estate of Hardy v. Seay*, 805 So.2d 515, 519 (Miss. 2002); *Van Zandt*, 86 So. 2d at 470 (agent owes duty of utmost loyalty and good faith to his principal).

3 Through its counter-claim, ERA is seeking to hold Mathis liable under his personal guarantee for any and all damages ERA has asserted it sustained arising out of the alleged breach of the Franchise Agreement. (Paras. 31-32 of ERA's Counter-Claim – R. 107-108; and Para. 16 of Mathis's Complaint – R.20-21). While this appeal is "on the record", what is particularly egregious is that counsel for Irby, Mr. Dennis Horn, Esq., has informed the undersigned counsel that, during the pendency of this action, ERA has granted REP-Central (which conducts business in the Metro Jackson Area) a new ERA franchise agreement. REP-Central's website corroborates this fact. See www.jacksonera.com, including the corporate overview portion of such site, where Warren states, among other things, that REP is one of REP-Central's

All of the wrongful conduct of the individual Appellees/Defendants, as well as Appellees/Defendants REP-Central and REP-Pine Belt, took place with ERA's full knowledge, approval, and participation. (Paras. 13 and 16 - R. 19-21). As a result, ERA has wrongfully and knowingly joined in and/or conspired with Chip Hill, Warren and Irby, as well as the other Appellees/Defendants, to breach the fiduciary duty and other duties owed REP and Mathis. *Knox Glass Bottle Co. v. Underwood*, 89 So. 2d 799, 820 (Miss. 1956)(person who knowingly assists fiduciary in committing breach of trust is himself guilty of tortious conduct and is liable for harm thereby caused).

Based on the foregoing core set of facts, Mathis has asserted claims and/or seeks relief in his complaint as follows:

1. A declaratory judgment:

a. That, pursuant to *Derouen v. Murray*, 604 So. 2d 1086, 1091 n. 2 (Miss. 1992), Mathis can raise the derivative claims that belong to REP as a direct action, including the claims against Appellees Chip Hill, Pamela Hill, Warren, Irby and ERA for: breach of the fiduciary duty owed REP and Mathis (by virtue of REP's status as a closely-held limited liability corporation), violation of the duty of loyalty, care, and fair dealing, as well as usurpation of REP's corporate opportunities, and tortious interference with REP's contracts and/or business advantage arising from the transfer of REP's assets to Appellees REP-Central and REP-Pine Belt and causing REP's sales agents to terminate and/or otherwise not honor their contracts with REP and to become sales agents for such Appellees. (Count I – Para. 20.a. – R. 22);

b. That ERA is estopped from attempting to enforce the guarantee that Mathis signed,

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predecessors.

wherein he personally guaranteed the debt of REP to ERA, as a result of ERA knowingly joining in the breaches of duty to REP and Mathis (Count I – Para. 20.b. – R. 22-23); and

c. That REP-Central and REP-Pine Belt are corporate opportunities of REP or, alternatively, that Mathis owns 50% of such entities and/or the assets of such entities (Count I – Para. 20. c. - R. 23);

2. Breach of Fiduciary Duty to REP and Mathis (Count II – Paras. 21-24 - R. 23-24);

3. Joining in Breach of Fiduciary Duties to REP and Mathis (Count III – Paras. 25-27 - R. 24-25);

4. Violation of Duty of Care, Duty of Loyalty, Duty of Fair Dealing, and Usurpation of Corporate Opportunity in relation to REP (Count IV– Paras. 28-30 - R. 25-26);

5. Tortious Interference with Contract (REP's contracts)(Count V– Paras. 31-33 - R. 27);

6. Interference with Prospective Business Advantage (REP's business advantage)(Count VI – Paras. 34-36 - R. 27);

7. Civil Conspiracy and/or Aiding and Abetting (in relation to the various counts asserted in the complaint)(Count VII – Paras. 37-39 - R. 28);

8. Accounting (for all of the money and assets embezzled from REP, as well as the profits of REP-Central and REP-Pine Belt)(Count VIII – Paras. 40-41- R. 28);

9. Constructive Trust (in relation to all profits made from the wrongful conduct of the defendants and in relation to the parcels of real estate Chip Hill promised to transfer to Mathis)(Count IX – Paras. 42-44 - R. 29);

10. Breach of Contract to Convey Real Estate (Mathis seeks specific performance in relation to Chip Hill's agreement to transfer parcels of real estate to Mathis)(Count X – Paras. 45-46

- R. 29-30);

11. Equitable Conversion (in relation to the parcels of real estate Chip Hill agreed to transfer to Mathis)(Count XI – Paras. 47-49 - R. 30); and

12. Breach of Contract - ERA (ERA's breach of REP's Franchise Agreement and Mathis's related personal guarantee to ERA)(Count XII – Paras. 50-54 - R. 30-31)[4].

VI. SUMMARY OF THE ARGUMENT

This action has been pending since **May 8, 2003**. In June of 2003, ERA and Warren and REP-Central filed their respective answers and asserted as their respective fourth affirmative defense that Mathis lacked standing to assert the claims in the complaint. Despite the assertion of this affirmative defense in June of 2003, neither ERA nor any of the other Appellees sought to terminate this litigation on the basis of Mathis's alleged lack of standing until **July 31, 2007**, when ERA filed its Motion to Dismiss for Lack of Standing pursuant to M.R.C.P. 12(b)(6) and to which the other Appellees filed a joinder. In the intervening **four years** between Mathis filing his complaint and ERA filing its dismissal motion, **ALL** of the Appellees actively participated in the litigation process, as set forth in the "Background/Procedural History" of this Brief. Under such circumstances, all Appellees have waived their right to seek a dismissal of this action based upon Mathis's alleged lack of standing.

Alternatively, this appeal raises an unsettled question of law that needs to be resolved by this

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[4] In addition to the breach of contract action asserted against ERA in relation to the breach of REP's Franchise Agreement and the related personal guarantee of Mathis, Mathis has also asserted claims for breach of contract against Chip Hill and Irby in relation to loans Mathis made to Chip Hill and/or Irby as a result of Mathis pledging a $100K CD as collateral for a loan that Chip Hill and Irby represented the proceeds of which would be used as working capital for REP. (Counts XIII and XIV- R. 32-33).

Court. In 1992, Justice Robertson opined that this Court takes the view that, in the context of a closely-held corporation and where certain factors are met, a 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. *Derouen v. Murray*, 604 So. 2d 1086, 1091 n. 2 (Miss. 1992) ("Closely-Held Corporation Direct Action Doctrine"). Since *Derouen, supra*, this Court has not directly addressed the Closely-Held Corporation Direct Action Doctrine.

At the trial court level, ERA and the other Appellees (through their joinders in ERA's arguments) have focused solely on Mathis's failure to comply with the procedural pre-requisites for initiating a derivative action on behalf of a limited liability company (pre-suit written demand requirement, etc.). *Miss. Code Ann.§* 79-29-1102 (1972, as amended). Mathis stipulates that he made no such demand. However, Mathis is not asserting a derivative action on behalf of REP and/or otherwise seeking to have the Court "legislate from the bench" by engrafting into the pre-suit demand requirement of the Mississippi Code a futility of demand provision which exists in the derivative action statutes adopted by many states (other than Mississippi). Rather, Mathis seeks to have this Court rule whether the Closely-Held Corporation Direct Action Doctrine, which has been adopted in many states and which is discussed in *Derouen, supra*, is the rule of law in Mississippi and allows Mathis, if the *Derouen* factors can be met, to pursue REP's claims that are derivative in nature as a direct action.

For the reasons set forth herein, this action presents a text book example of why the Closely-Held Corporation Direct Action Doctrine should be directly adopted by this Court as part of its decision in this action.

VII. ARGUMENT

A. Standard of Review.

For purposes of a 12(b)(6) motion, the Court assumes the factual allegations in the complaint are true, construes them in a manner most favorable to the non-movant and decides if the facts alleged could give rise to an actionable claim. *Tucker v. Hinds County*, 558 So. 2d 869, 872 (Miss. 1990). Applying such standard to Mathis's Complaint, along with the argument and authorities cited to the trial court, ERA's motion to dismiss should have been denied. Respectfully, for the reasons set forth herein, Mathis asserts the trial court erred in failing to do so.

B. ERA and the Other Appelles Waived the Affirmative Defense that Mathis Lacked Standing to Pursue the Claims Asserted in the Complaint that are Derivative in Nature Due to Their Unreasonable Delay in Asserting the Defense through ERA's Motion to Dismiss.

In *MS Credit Center, Inc. v. Horton*, 926 So. 2d 167 (Miss. 2006), this Court held, in the context of whether the defendant waived the right to compel arbitration, as follows:

> We do hold however that-absent extreme and unusual circumstances-an eight month unjustified delay in the assertion and pursuit of **any affirmative defense or other right which, if timely pursued, could serve to terminate the litigation**, coupled with active participation in the litigation process, constitutes **waiver as a matter of law**.

MS Credit Center, Inc. v. Horton, 926 So. 2d 167, 181 (Miss. 2006)(emphasis added). The *Horton* Court further held that to pursue an affirmative defense or other such right means to plead it, bring it to the court's attention by motion, and request a hearing. Since *Horton, supra*, this Court has correctly applied the waiver principle in the context of defenses based upon insufficiency of process, insufficiency of service of process and even to immunity under the Mississippi Tort Claims Act ("MTCA"), *Miss. Code Ann. §* 11-46-1, et seq. *Estate of Grimes v. Warrington*, 982 So. 2d 365,

370-371 (Miss. 2008); *East Mississippi State Hospital v. Adams*, 947 So. 2d 887, 891 (Miss. 2007)(insufficiency of process and insufficiency of service of process).

In this case, there can be no legitimate dispute that ERA and the other Appellees have waived their right, as a matter of law, to defend this action on the basis of Mathis's lack of standing. While ERA and the other Appellees (with the exception of Irby and REP-Pine Belt)[5] asserted lack of standing as an affirmative defense in their separate answers, ERA (and the other Appellees through their joinders to ERA's motion) did not seek dismissal of Mathis's claims for lack of standing until over four years AFTER ERA filed its answer in this action. Moreover, not only did ERA and the other Appellees fail to timely and reasonably pursue the issue of Mathis's alleged lack of standing, as addressed in *Horton, supra*, they ALL actively participated in the litigation process. As set forth herein[6], ERA and the other Appellees, among other things, all conducted discovery; ERA removed this action to federal court; after remand, ERA filed a motion to transfer this action to circuit court (to which the other Appellees filed a joinder); and, after the motion was denied, ERA even perfected an interlocutory appeal to this Court on the transfer/subject matter jurisdiction issue (without ever having filed a motion and/or otherwise pursued any right as to Mathis's alleged lack of standing). Under such circumstances, ERA and the other Appellees have waived any right they had to seek dismissal of this action based on Mathis's alleged lack of standing.

C. The Viability Under Mississippi Law of the Closely-Held Corporation Direct Action Doctrine Relied Upon by Mathis to Directly Assert the Claims of REP that are Derivative in Nature.

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[5] Irby and REP-Pine Belt did not even raise Mathis's lack of standing in their Answer. Despite this fact, Mathis's claims against them that were derivative in nature were dismissed.

[6] See the Background/Procedural History section of this Brief for a complete description of the Appellees' participation in the litigation process in this action.

1. The Closely-Held Corporation Direct Action Doctrine Discussed by the *Derouen* Court.

As the *Derouen* Court observed:

> In the case of a closely-held corporation ... the chancery 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 the creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.

Derouen v. Murray, 604 So. 2d 1086, 1091 n. 2 (Miss. 1992)(quoting, American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* §7.01(d) (hereinafter, "Principles of Corporate Governance"))(Pursuant to M.R.A.P 28(f), Mathis has attached section 7.01 of the Principles of Corporate Governance, including the related comments as an addendum at the end of this Brief). Based upon *Derouen*, Mathis seeks to directly assert claims of REP that are derivative in nature against the Appellees and has specifically requested declaratory relief in relation thereto. (See Count I – Para. 20 a. of Mathis's Complaint - R. 22). If this Court adopts and/or reaffirms the Closely-Held Corporation Direct Action Doctrine discussed by the *Derouen* Court, then there can be no doubt that Mathis has stated actionable claims against ERA and the other Appellees that arise out of claims of REP that are derivative in nature.

2. The Policy Considerations Behind the Principles of Corporate Governance Related to Closely-Held Corporations.

The reasoning behind allowing shareholders in a closely held corporation to bring suit individually stems from the fact the shareholders of this type of corporation have very direct obligations to one another. *See Redecker v. Litt*, 699 N.W.2d 684, 2005 WL 1224697 *5-6 (Iowa App. Ct. May 25, 2005). Further, the policy reasons for imposing the institution of a derivative suit

in cases involving publicly held corporations tend to be absent in suits involving close corporations due to the close identity between shareholders and managers. *See, Redecker,* 699 N.W.2d 684, 2005 WL 1224697 at *5 and Principles of Corporate Governance, §7.01 cmt. e. As this Court observed, in relation to a closely-held corporation,

> Management typically operates in an informal manner, more akin to a partnership than a corporation. The traditional view that shareholders have no fiduciary duty to each other, and transactions constituting "freeze outs" or "squeeze outs" generally cannot be attacked as a breach of duty of loyalty or good faith to each other, is outmoded.

Fought v. Morris, 543 So.2d 167, 169-170 (Miss. 1989).

For the foregoing reasons, as well as those discussed in detail in the authorities cited herein, the Closely-Held Corporation Direct Action Doctrine addressed by the *Derouen* Court has been adopted by many jurisdictions. See *Cooper v. Rucci,* 2008 WL 942710 *5-7 (W.D. Pa. April 7, 2008)*; Vissa v. Pagano*, 919 A.2d 488, 494 n. 9 (Conn. App. Ct. 2007)(collecting cases and citing *Derouen, supra*); *Marsh v. Billington Farms*, LLC, 2006 WL 2555911 *9-11 (R.I. Aug. 31, 2006)(collecting cases and citing *Derouen, supra*); *Redecker v. Litt*, 699 N.W.2d 684, 2005 WL 1224697 *5-6 (Iowa App. Ct. May 25, 2005); *Trieweiler v. Sears*, 689 N.W. 2d 807, 837-838 (Neb. 2004);*Mynatt v. Collis*, 57 P.3d 513, 529-530 (Kan. 2002).

3. Application of the Closely-Held Corporation Direct Action Doctrine to this Action.

As set forth herein, REP is a closely-held limited liability corporation since Mathis and Irby (and at one time Hill) are the only equity owners of the company[7]. Between his investment in and

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[7] Under Mississippi law, shareholders in a closely-held corporation (defined as those having less than 50 shareholders) owe the corporation and one another a fiduciary duty. Such a duty requires a party to act in the utmost good faith. *Fought v. Morris*, 543 So.2d 167, 169-170 (Miss. 1989)(*Fought* specifically addressed a majority shareholder owing a fiduciary duty to minority shareholder(s)); *Covington v. Covington*, 780 So. 2d 665 (Miss. Ct. App. 2001)(noting duties owed to corporation

loans made to the business, Mathis has put several hundred thousand dollars into REP. Irby and Chip Hill, the real estate broker through whom REP conducted its real estate brokerage business, have transferred virtually all of the assets of REP to REP-Central and REP Pine Belt, entities formed by Chip Hill, Warren, and Irby to usurp the corporate opportunities of REP. Such entities are currently controlled by Warren, a former employee of REP, and Irby, who, as noted herein, is also a 50% equity owner in REP.

Since their formation, REP-Pine Belt and REP-Central have engaged in the real estate brokerage business using the ERA registered marks that were licensed to REP (although, as noted herein, ERA has, on information and belief, granted REP-Central its own franchise). Mathis has alleged that all of the foregoing wrongful conduct of Hill, Irby and Warren, along with REP-Central and REP-Pine Belt, has taken place with ERA's knowledge and/or participation and that ERA has wrongfully and knowingly joined in and/or conspired with Hill and/or other Appelles to breach the fiduciary duties and other duties owed Mathis and REP. *See Knox Glass Bottle Co. v. Underwood*, 89 So. 2d 799, 820 (Miss. 1956)(person who knowingly assists fiduciary in committing breach of trust is himself guilty of tortious conduct and is liable for harm thereby caused).

If Mathis is not allowed to proceed under the Closely-Held Corporation Direct Action Doctrine addressed in *Derouen, supra*, and adopted by many other jurisdictions, Irby, as a co-owner of REP, would benefit from his own wrongful conduct and share in any recovery of damages by REP that flowed from Irby's breaches of duty to REP, including the transfer of REP's assets to REP-

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and requiring reimbursement to corporation of improperly diverted funds).While REP is a limited liability company, the courts that have considered the issue have concluded the fiduciary duty that exists in the context of a closely-held company likewise exist in a closely-held limited liability company. *Maillet v. Frontpoint Partners, L.L.C.*, 2003 WL 21355218 * 3-4 (S.D. N.Y., June 10, 2003); *Anderson v. Wilder*, 2003 WL 22768666 * 3-6 (Tenn. Ct. App., Nov. 21, 2003).

Central and REP-Pine Belt and the subsequent conduct of REP's real estate brokerage business through such entities[8]. Such an unjust result is the very reason why this Court should adopt and/or reaffirm the Closely-Held Corporation Direct Action Doctrine addressed in *Derouen, supra*, and allow Mathis to directly pursue the claims of REP that are derivative in nature to the extent Mathis can establish the requirements set forth in *Derouen, supra*, for doing so as pled in Mathis's Complaint.

4. In the Alternative, Mathis Should Be Allowed to Amend His Complaint to Assert a Derivative Action.

Mathis has proceeded under *Derouen, supra*, in good faith reliance on the Derouen Court stating, "[w]e take the view of the Principles of Corporate Governance §7.01(d)"... All of this [proceeding under the Closely-Held Corporation Direct Action Doctrine] refers but to the form and procedure for litigating certain substantive claims...". *Derouen*, 604 So. 2d at 1091 n. 2. In the event the Court determines that the Closely-Held Corporation Direct Action Doctrine addressed in *Derouen, supra*, is no longer the "view" of this Court, Mathis should be allowed to amend his complaint to assert a derivative action on behalf of REP without having to make the written demand provided for in *Miss. Code Ann.§* 79-29-1102 (1972, as amended) and/or the Appellees otherwise

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[8] In addition to the fiduciary duties owed in the context of a closely-held corporation, a party owing such a duty is precluded from appropriating a business opportunity which in fairness should belong to the corporation (to whom the duty is owed). *Derouen v. Murray*, 604 So. 2d 1086 (Miss. 1992) (discussion of corporate officer duties, including the fiduciary duty to corporation and shareholders arising out of the duty of loyalty and fair dealing; corporate opportunity based on facts analogous to this case is also discussed);*Hill v. Southeastern Floor Covering, Inc.*, 596 So.2d 874, 877-878 (Miss. 1992)(noting that duty of good faith and loyalty may be breached through doctrine of corporate opportunity and discussing elements of doctrine); and *Anest v. Audino*, 773 N.E. 2d 202, 210-211 (Ill. Ct. App. 2002)(fiduciary cannot usurp business opportunity that was developed through use of corporate assets; and concept of usurpation of corporate opportunity applicable in context of limited liability company).

being allowed to assert any procedural and/or substantive defenses thereto, including the applicable statute of limitation.

As this Court long ago observed,

> Rules of practice and procedure are designed to secure the justice of the law, not to defeat it. The rules are valuable guides, and will ordinarily be adhered to and followed. But where the rules would defeat the justice of law, and bring about results not justified or intended by the substantive law, they may be subordinated to the primary purpose of the law, that is, the enforcement of rights or the redress of wrongs, in the interest of justice. Equity delights to do complete justice, and not by halves. Equity will not permit a wrong to go without a remedy. Equity does not worship at the shrine of technicalities. Equity regards substance rather than forms. Rights are to be secured in the courts, and rules of decision, or mere rules of procedure, are designed to secure justice.

Dogan v. Cooley, 185 So. 783, 789 (Miss. 1939). While a written demand upon Irby and/or Chip Hill would have been an exercise in futility (because they certainly would not have been in favor of REP filing suit against them), had all of the Appellees timely pursued their "lack of standing" defense through a motion to dismiss, Mathis could have cured and/or amended his complaint to assert a derivative action as an alternate theory of recovery. The Appellees' failure to do so not only constitutes a waiver as a matter of law, as discussed herein, but, at this juncture (more than five years from the date the complaint this action was filed), has made it impossible to obviate the procedural and other requirements of proceeding with a derivative action.

As set forth herein, the Court assumes the factual allegations in the complaint are true for the purpose of a 12(b)(6) motion. However, while ERA and the other Appellees deny any wrongdoing, NONE of them can dispute that: 1. Irby and/or Chip Hill (the broker of REP) transferred all of the assets of REP without consideration to REP-Central and REP-Pine Belt (entities in which Irby and Warren (and at one time Chip Hill) held equity ownership); 2. This transfer occurred at a time when Mathis owned 50% of REP (even Chip Hill admits this fact – (R.162-163)); 3. Mathis held no equity

ownership in REP-Central and REP-Pine Belt at the time of the asset transfer and/or at any time thereafter or before; and 4. After obtaining the assets of REP, REP-Central and REP-Pine Belt commenced business utilizing such assets, including the listing agreements of REP, (and REP-Central continues to do so – See www.jacksonera.com).

The Appellees should not be allowed to avoid having to answer for their wrongdoing by asserting procedural technicalities and/or other defenses that have nothing to do with the underlying substantive claims. As stated in *Dogan, supra*, the primary purpose of the law is the enforcement of rights or the redress of wrongs (in the interest of justice) and it would be unjust for Mathis to be sent home without a jury having ever considered any evidence supporting the allegations of wrongdoing pled in this action.

D. Mathis has Included Claims in His Complaint that are Not in the Nature of Derivative Claims of REP.

Clearly, Counts IX - XIV of Mathis's Complaint state claims that are not solely in the nature of derivative claims of REP. (R. 29-33). As to the breach of contract claim against ERA (Count XII – R. 30-31), such claim would be viable as to Mathis to the extent Mathis could establish breach of his personal guarantee, including the implied covenant of good faith and fair dealing contained therein.

The facts underlying Mathis's breach of contract claim against Irby and Chip Hill (Count XIV – R. 32-33), also support Mathis's individual claim for breach of fiduciary duty. As set forth herein, under Mississippi law, shareholders in a closely-held corporation such as REP owe the corporation **and** one another a fiduciary duty. Such a duty requires a party to act in the utmost good faith. *Fought v. Morris*, 543 So.2d 167, 169-170 (Miss. 1989).

Irby and Hill induced Mathis to pledge a $100,000.00 certificate of deposit ("CD") as

collateral for a loan based upon the agreement that Irby and Chip Hill would repay the loan and their representation that the loan proceeds would be used as working capital for and/or to pay the financial obligations of REP. (R.33). While not specifically pled, Mathis pledged the $100K CD and Irby and Chip Hill obtained the subject loan at or about the same time Irby and Chip Hill caused the assets of REP to be transferred to REP-Central and REP-Pine Belt. (Mathis testified to this fact, along with ERA's involvement therewith, when ERA and the other Appellees deposed him back in 2003). Such facts, including Irby's failure to use the loan proceeds for working capital of REP and subsequent default on the loan (resulting in Mathis's loss of the $100K CD) constitute a breach of Irby's fiduciary duty to Mathis and a personal injury to Mathis that is separate and distinct from any damage sustained by REP.

In addition to Mathis's individual breach of fiduciary duty claim against Irby, Mathis has alleged ERA knowingly joined in, conspired with and/or aided and abetted Irby in his breach of fiduciary duty to Mathis. (Counts III and VII – R. 24-25 and 28). As a result, Mathis has likewise stated claims against ERA arising out of Mathis's individual breach of fiduciary duty claim that is not dependent upon the breach of fiduciary claims of REP that are derivative in nature.

All of the foregoing claims set forth in Mathis's Complaint state actionable claims that do not depend on the ability of Mathis to proceed under *Derouen, supra*. As a result, even if the Court rejects *Derouen, supra*, and Mathis's "waiver" argument, Mathis, at a minimum, still has viable claims against Irby, Hill and ERA.

IV. CONCLUSION

Mathis has demonstrated that the Appellees have waived any right they had to assert Mathis's lack of standing as a defense in this action. Alternatively, Mathis should be allowed to proceed under *Derouen, supra* and/or amend the Complaint, as discussed herein. As a result, the Court erred by

granting the Motion to Dismiss of ERA for Lack of Standing (to which the other Appellees filed a joinder). In any event, all of the claims of Mathis are not "derivative" in nature and therefore Mathis should be allowed to proceed as to those claims, which should be remanded to the trial court..

Respectfully submitted this the 24th day of October, 2008.

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CERTIFICATE OF SERVICE

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Principles of Corporate Governance: Analysis and Recommendations
As Adopted and Promulgated by The American Law Institute at Washington, D.C., May 13, 1992

Updated by the 2007 Pocket Part
Reporting All Cases Through November 2006

Part VII. Remedies
Chapter 1. The Derivative Action
§ 7.01 Direct And Derivative Actions Distinguished

Link to Pocket Part

(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, 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. 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 (Sup. Ct. 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 (Sup. Ct. 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 (1899).

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 (1963); Fontheim v. Walker, 141 N.Y.S.2d 62 (Sup. Ct. 1955); Davidson v. Rabinowitz, 140 N.Y.S.2d 875 (Sup. Ct. 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.2d 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. (12 Met.) 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.), cert. denied, 168 U.S. 710 (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. 48, 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 non-voting 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, 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, 1963). 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.

Research References

1. Digest System Key Numbers

Corporations ⚿207 1/2, 302(1).

2. A.L.R. Annotation

Stockholder's right to maintain (personal) action against a third person as affected by corporation's right of action for the same wrong. 167 ALR 279.

Pocket Part

CASE CITATIONS TO THE PRINCIPLES OF CORPORATE GOVERANCE: ANALYSIS AND RECOMMENDATIONS

C.A.3, 2002. Cit. in disc., cit. in ftn., subsec. (d) cit. and quot. in disc. and cit. in case cit. in disc. Trustees of trust that was minority shareholder of pharmaceuticals corporation brought, in part, derivative claims on behalf of corporation and trust against directors of corporation and purported trustees who attempted to purchase trust's stock shares, alleging, inter alia, breach of fiduciary duty of loyalty to corporation and trust. Reversing the district court's dismissal of the complaint and remanding, this court held, inter alia, that plaintiffs were excused from making demand on the corporation's board of directors because irreparable harm to the corporation would have resulted. The court left unresolved the issue of whether plaintiffs' action should have been treated as a direct action under Principles of Corporate Governance § **7.01.** Warden v. McLelland, 288 F.3d 105, 112, 113.

C.A.7, 1990. Subsec. (a) quot. in disc., subsec. (d), com. (e), and Rptr's Note cit. but not fol. (T.D. No. 8, 1988). Manager of incorporated automobile service store in which he owned stock sued majority shareholder, arguing, inter alia, that defendant violated the duty a controlling shareholder owed to the corporation and derivatively to plaintiff as minority shareholder by wrongly competing with the corporation. The trial court entered judgment on a jury verdict for plaintiff. Vacating and remanding, this court held that since plaintiff's claim was derivative under Delaware law because plaintiff's loss derived from injury to the corporation, the corporation was an indispensable party and the suit must be dismissed for lack of complete diversity of citizenship. The court refused to expand the "special injury" rule, which allowed a shareholder to litigate independently if the wrong to the corporation inflicted a distinct and disproportionate injury on the investor, into a general exception for closely held corporations, pursuant to which they would be treated as if they were partnerships. Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 381, 384, cert. denied 500 U.S. 952, 111 S.Ct. 2257, 114 L.Ed.2d 710 (1991).

C.A.7, 1996. Quot. in sup., subsec. (d) quot. but dist., cit. in disc., Rptr's Notes 1 and 4 cit. in disc. One of two principal shareholders in close corporation sued other principal after he unilaterally transferred all the business of the corporation to another entity. The district court dismissed the complaint, concluding that corporation, not plaintiff, was the real party in interest, and since both corporation and defendant were Illinois citizens, no diversity jurisdiction existed. Affirming, this court held that where, as here, the harm alleged ran to all investors, plaintiff was required to bring the claim as a derivative, not a direct, action. While, under certain circumstances, a derivative claim might be treated as a direct one, the court believed that this was not such a case, particularly since a federal court was an inappropriate forum in which to rewrite state corporate law. Frank v. Hadesman and Frank, Inc., 83 F.3d 158, 160-162.

C.A.7, 1997. Subsec. (d) cit. in case cit. in disc. A shareholder brought suit alleging that the corporation's president had masterminded a complicated scheme to upstream the assets of the corporation to other corporations controlled by the president. District court dismissed, holding that plaintiff's common-law fiduciary duty claims required plaintiff first to demand action from the corporation's board of directors. This court affirmed, holding, inter alia, that plaintiff should

have made demand upon the corporation's board, because making demand would have been a reasonable action, giving the board a chance to remedy the allegations or appoint a disinterested committee to investigate them. The court opined that the Indiana Supreme Court would be persuaded by the general trend in the law towards narrowing, if not eliminating, the exceptions from the demand requirement. It stated that it need not decide whether Indiana's highest court would go all the way to a universal demand requirement in order to decide that it probably would have wanted plaintiff to make demand here. Boland v. Engle, 113 F.3d 706, 713.

C.A.7, 1998. Cit. in disc. Nonparty shareholders challenged judgment approving a settlement in shareholders' derivative suit. Dismissing the action, the court held, in part, that nonparties were not entitled to appeal a decision in any class action; that nonparty shareholders could not appeal in a derivative action, as the true party in such an action was the corporation; and that existing caselaw to the contrary was overruled. Felzen v. Andreas, 134 F.3d 873, 875, cert. granted in part 524 U.S. 980, 119 S.Ct. 29, 141 L.Ed.2d 789 (1998).

C.A.10, 2004. Subsec. (d) cit. in ftn. Minority shareholder and former employee of close corporation brought suit in his individual capacity against majority shareholder/employee for breach of fiduciary duty. The district court granted defendant's motion for summary judgment on the ground that plaintiff failed to bring his suit as a derivative action on behalf of corporation, and denied plaintiff's motion to amend his complaint to state a derivative action. Affirming, this court refused to predict that the Colorado Supreme Court would adopt the holding of a Massachusetts case granting individual standing to shareholders in close corporations; therefore, plaintiff lacked individual standing to sue defendant for breach of fiduciary duty. Combs v. PriceWaterhouseCoopers LLP, 382 F.3d 1196, 1202.

S.D.Ind.1999. Quot. in case quot. in sup., subsec. (d) cit. in disc. and sup. Shareholder sued chief financial officer (CFO), among others, for professional negligence, breach of contract, fraud, and breach of fiduciary duty. After defendants removed the action, plaintiff moved to remand to state court on the ground that CFO's presence as a party defeated diversity jurisdiction. Granting the motion, the court held, inter alia, that defendants had failed to establish that CFO had been fraudulently joined, or that plaintiff was required to assert his claims as a derivative action. Conk v. Richards & O'Neil, LLP, 77 F.Supp.2d 956, 969, 970.

D.Mass.1995. Subsec. (d) cit. in law review cit. in sup. (Proposed Final D., 1992); com. (e) quot. generally in ftn. (Cit. as subsec. (d) cmt.) Minority shareholder of close corporation sued majority shareholders for breach of fiduciary duty in form of freeze-out, seeking, in part, direct relief. The court denied defendants' motion for partial summary judgment, holding, inter alia, that it might well be within court's power to grant plaintiff direct relief after trial of contested facts. It noted that it would be futile to require plaintiff to sue on corporation's behalf when only other shareholders were two individual defendants, since any recovery in derivative suit would return funds to defendants' control. Orsi v. Sunshine Art Studios, Inc., 874 F.Supp. 471, 475.

D.Nev.2005. Subsec. (d) quot. in sup. Minority shareholders of closely held corporation sued major shareholder who served as director of the corporation, alleging that he breached his fiduciary duties to them as minority shareholders. The court denied defendant's motion for summary judgment, holding, inter alia, that, as a matter of first impression under Nevada law, it would apply both policy-based and traditional exceptions for allowing direct actions in closely held corporations. The court concluded that this case was a proper one to treat as a direct suit, since all plaintiffs alleged the individual wrong of breach of fiduciary duty, all but one of the shareholders were parties to the suit, there were no outside creditors, and plaintiffs could not get adequate relief through a derivative suit, since relief to the corporation would mostly benefit defendant as the alleged wrongdoer in control of the corporation. Simon v. Mann, 373 F.Supp.2d 1196, 1199.

D.N.J.Bkrtcy.Ct.2001. Quot. in disc., subsec. (d) quot. in case quot. in disc. Chapter 11 debtor, as shareholder of dissolved closely held corporation, brought an adversary proceeding against other shareholders to recover compensatory and punitive damages for corporate mismanagement, fraud, and malicious interference with corporation's clients. Entering judgment for defendants, this court held, inter alia, that, because the corporation was now defunct, and any recovery could be fashioned to account for interests of the corporation's creditors and to distribute proceeds fairly among interested persons, it was immaterial whether plaintiff's action was treated as derivative or direct, and plaintiff's claims could be pursued without regard to the procedural hurdles normally required for shareholder derivative actions. In re Sharkey, 272 B.R. 574, 581, 582.

S.D.N.Y.2005. Com. (d) quot. in case quot. in disc. Chapter 11 debtor corporation sought to enforce automatic stay with respect to class action brought by shareholder against debtor's directors. Granting debtor's request for relief, the court held that shareholder's allegations stated a derivative, rather than a direct, action, since his claims were based on allegations of fraud and misrepresentation on the corporation that resulted in its diminution in value; therefore, the action was property of the reorganized debtor, and the plan injunction prevented shareholder from proceeding with the action. In re Worldcom, Inc., 323 B.R. 844, 850.

E.D.Pa.2006. Subsec. (d) cit. and quot. in disc. and sup. and adopted in cases cit. in disc. Minority shareholders of closely held corporation brought derivative suit against majority shareholders. This court denied defendants' motion to dismiss, holding that plaintiffs' failure to make a demand on corporation's board prior to filing suit was excused under § **7.01**(d) of the Principles of Corporate Governance. The court reasoned that, although plaintiffs failed to allege that a demand would have irreparably injured corporation, plaintiffs had explained with particularity in their response to the motion to dismiss that, with the exception of two shareholders who had settled their claims, all minority shareholders were represented in the action, and thus the absence of a pre-suit demand would not invite multiple actions, materially prejudice the interests of creditors or corporation, or interfere with a just recovery. Nedler v. Vaisberg, 427 F.Supp.2d 563, 570-573.

E.D.Va.1999. Subsec. (d) quot. in sup. Minority shareholder sued other shareholder, who was also a corporate director, for, inter alia, breach of fiduciary duty in connection with defendant's decision to issue 50,000 shares, which in turn caused plaintiff's ownership interest to be reduced to 1%. Denying defendant's motion for summary judgment on this count of the complaint, the court held, in part, that, while a cause of action for breach of fiduciary duty would normally be brought on behalf of the corporation, a minority shareholder in a closely held corporation was often entitled to assert such a claim individually. Byelick v. Vivadelli, 79 F.Supp.2d 610, 625.

Ark.1998. Subsec. (d) quot. in diss. op. (T.D.No. 11, 1991). Shareholders in a closely held corporation brought suit for fraud and breach of fiduciary duty against another shareholder, claiming that defendant intended to defraud them of proprietary information that they had contributed to the corporation. The trial court dismissed the complaint for lack of subject-matter jurisdiction, holding that it stated a stockholder's derivative claim and should have been filed in a chancery court. This court affirmed. The dissent argued that shareholders in a closely held corporation should be able to proceed directly against others who have caused injury to their interests in the corporation; in the instant case, it would be wrong to require plaintiffs to bring a derivative suit on behalf of the corporation so that the shares owned by defendant could benefit by a recovery from defendant. Hames v. Cravens, 332 Ark. 437, 966 S.W.2d 244, 250.

Conn.1996. Subsec. (d) quot. in ftn., com. (c) cit. in sup. Physician who was 50% shareholder of professional corporation brought derivative action against other physician-shareholder and a corporation employee, alleging conversion of corporate assets, tortious interference with business expectations, and violation of the state's unfair trade

practices act. Defendants had barred plaintiff from the practice after his estranged wife accused him of child sexual abuse. The trial court entered judgment for plaintiff; defendants' appeal was transferred to the supreme court. Affirming as to defendant shareholder and reversing as to defendant employee, the court held, inter alia, that plaintiff had standing to bring a derivative action because the injuries he alleged were not merely personal to him, but also constituted injuries to the corporation, and, notwithstanding plaintiff's status as one of only two shareholders, he fairly and adequately represented corporate interests that needed to be protected. Fink v. Golenbock, 238 Conn. 183, 200, 202, 680 A.2d 1243, 1253, 1255.

Del.1996. Cit. in disc., com. (a) cit. in in disc., coms. (c) and (d) quot. in disc. Shareholder who objected to new CEO's employment contract sued board of directors for abdication of directorial duty, waste, and lack of due care. The trial court dismissed the complaint. Affirming, this court held that, while certain claims could be both direct and derivative, plaintiff's abdication claim, which sought injunctive relief in the form of a declaration that the employment contract was invalid, was a direct claim and was properly dismissed, as board's decision to enter the contract was within its business judgment. As for the waste and due care claims, plaintiff, whose pre-suit demand for board action concerning the propriety of the contract had been rejected, could not now raise new claims arising out of the same contract without stating a reason, such as reasonable doubt as to board's ability to act independently, that would have excused him from bringing all his contract-based claims simultaneously. Grimes v. Donald, 673 A.2d 1207, 1213.

Del.2004. Subsec. (b) quot. in ftn. Minority shareholders brought a purported class action against board of directors, alleging that defendants breached their fiduciary duties by agreeing to a 22-day delay in closing a proposed merger, and claiming damages representing the time-value of money lost through the delay. The chancery court granted defendants' motion to dismiss. Affirming in part, this court held, inter alia, that plaintiffs' complaint stated neither a derivative nor a direct claim, and thus was properly dismissed. The court said that the proper analysis to distinguish between direct and derivative actions had to be based on determining who suffered the alleged harm--the corporation or the suing stockholder individually--and who would receive the benefit of the recovery or other remedy. Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1036, on remand 2005 WL 1252378 (Del.Ch.2005).

Del.Ch.1999. Rptr's Note 3 quot. in disc. Shareholders sought class certification in their action charging corporate officers with designing defensive measures to prevent a takeover and to entrench themselves in office. Entering judgment for plaintiffs, the court held that allegations that defendants' conduct effectively reduced plaintiffs' voting power were sufficient to support a direct as well as a derivative action. In re Gaylord Cont. Corp. Shareholders, 747 A.2d 71, 81.

Del.Ch.2004. Subsec. (b) quot. in sup. and cit. in ftn. After corporation filed for bankruptcy, former shareholder sued board of directors and investors, alleging that the prebankruptcy issuance of warrants to the investors pursuant to a subscription agreement transferred voting control of the corporation to the investors without compensation to shareholders and precluded the pursuit of other value-maximizing transactions. The chancery court dismissed, holding that plaintiff's complaint stated only derivative, as opposed to individual or direct, claims, and that the derivative claims were extinguished in bankruptcy. Agostino v. Hicks, 845 A.2d 1110, 1122.

Fla.App.2001. Cit. in disc., com. (f) cit. in disc. Following bankruptcy of corporation, shareholder sued the other shareholders for breach of the shareholder agreement. The trial court dismissed, holding that the stated claims could be brought only by a derivative action on behalf of the corporation. Reversing and remanding, this court held that plaintiff could sue for breach of the shareholder agreement, even though the injury complained of affected all of the shareholders equally. Harrington v. Batchelor, 781 So.2d 1133, 1135.

Ill.App.1999. Subsec. (d) cit. but not fol. Minority shareholder brought action against principal shareholder, alleging, among other things, that defendant had diverted corporate profits to other entities he owned. The trial court dismissed the complaint. Affirming, this court held, in part, that the injury claimed by plaintiff was an injury to the corporation, that the action was therefore derivative, and that the court had no discretion to treat a derivative action on behalf of a closely held corporation as a direct action. Small v. Sussman, 306 Ill.App.3d 639, 642-643, 239 Ill.Dec. 366, 368-369, 713 N.E.2d 1216, 1219-1220, appeal denied 186 Ill.2d 589, 243 Ill.Dec. 568, 723 N.E.2d 1169 (1999).

Ill.App.2001. Quot. in ftn. Limited-partner investors in partnership brought suit individually and derivatively on behalf of partnership against general partners for breach of fiduciary duty involving three financing transactions, alleging that the amount of money they received after partnership's sale was reduced because defendants caused partnership to pay one of the general partners excessive interest on the three transactions. The trial court entered judgment on a jury verdict for plaintiffs. Reversing in part and remanding, this court held that, since plaintiffs could prevail only by showing a breach of fiduciary duty to the partnership, they were required to bring their claims in a derivative action, thus entitling defendants to judgment as a matter of law with regard to plaintiffs' individual claims. LID Associates v. Dolan, 324 Ill.App.3d 1047, 1069, 258 Ill.Dec. 592, 610, 756 N.E.2d 866, 885.

Ind.1995. Subsec. (d) cit. and quot. in sup. and adopted, com. (e) cit. in sup., Rptr's Note 4 cit. in sup. A minority shareholder sued a closely held corporation and its majority shareholder, alleging breach of fiduciary duty. Trial court granted defendants' motion to dismiss, but the intermediate appellate court reversed, concluding that requiring a derivative action would exalt form over substance. This court vacated and remanded, holding that a shareholder in a closely held corporation who alleged misuse of corporate assets should be permitted to sue the corporation in a direct action in certain circumstances, rather than proceed with a derivative action. The court stated that shareholders in a close corporation stand in a fiduciary relationship to each other, and that shareholder litigation in the closely held corporation context will often not implicate the policies that mandate requiring derivative litigation when more widely held corporations are involved. Barth v. Barth, 659 N.E.2d 559, 560, 562-563, appeal after remand 693 N.E.2d 954 (Ind.App.1998). See case below.

Ind.2001. Subsecs. (a) and (b) quot. generally in disc., subsec. (d) cit. in case cit. in sup. Minority shareholder in closely held corporation sued majority shareholder and corporation, asserting claims for breach of fiduciary duty. The trial court entered judgment for plaintiff, and the court of appeals affirmed and remanded. Affirming in part, this court held, inter alia, that the facts supported a direct action by plaintiff against majority shareholder, and that plaintiff was not required to bring a derivative suit, since there was no potential for a multiplicity of shareholder suits, there was no evidence of any creditor in need of protection, and there was no concern that plaintiff's recovery would interfere with a fair distribution of the benefits of the suit. G & N Aircraft, Inc. v. Boehm, 743 N.E.2d 227, 234, 236.

Ind.App.1997. Com. (d) quot. in ftn. A shareholder brought direct and derivative claims against two other shareholders to recover monies that defendants had removed from corporate accounts. Affirming in part the trial court's entry of judgment for plaintiff, this court held, inter alia, that the trial court properly ordered defendants to reimburse the corporation and that, because plaintiff pursued a direct, as well as a derivative, cause of action, the trial court did not err in ordering the corporation to reimburse plaintiff the amounts he expended in paying corporate debts. The court noted in passing that the trial court could exercise its discretion to treat an otherwise derivative claim on behalf of a closely held corporation as a direct action if it entered a finding that to do so would not unfairly expose the corporation or defendants to a multiplicity of actions, materially prejudice the interests of creditors of the corporation, or interfere with a fair distribution of the recovery among all interested persons. DRW Builders, Inc. v. Richardson, 679 N.E.2d 902, 908.

Ind.App.1998. Subsec. (d) cit. and quot. in disc. Minority shareholder sued closely held corporation and majority shareholder for breach of fiduciary duty and fraud. The trial court dismissed the complaint, but this court reversed. The supreme court vacated and remanded. On remand, the trial court again dismissed. Affirming, this court held that the lower court did not abuse its discretion in refusing to allow plaintiff to raise derivative claims in a direct action where there was the potential for multiple lawsuits, creditors would be prejudiced as a consequence, and the maintenance of a direct action would result in an unfair distribution of corporate assets. Barth v. Barth, 693 N.E.2d 954, 956-958.

Ind.App.1998. Subsec. (d) quot. in case quot. in ftn. in sup. Minority shareholders in closely held corporation sued majority shareholders for fraud and breach of fiduciary duty. The trial court entered summary judgment for defendants. Affirming, this court held that plaintiffs' claims stemmed from the disputed value of their shares; therefore, the Indiana Dissenters' Rights statutes provided their exclusive remedy. Settles v. Leslie, 701 N.E.2d 849, 852.

Ind.App.2000. Quot. in case quot. in disc. Husband and wife brought a shareholder's derivative suit against a closely held corporation and its directors and brought a direct action against individual directors. Trial court dismissed plaintiffs' suits. This court affirmed in part, reversed in part, and remanded, holding, inter alia, that the trial court abused its discretion by dismissing plaintiffs' direct action against the individual defendants. There was no evidence that plaintiffs' direct action would prejudice creditors or interfere with a fair distribution of the recovery among all interested persons; moreover, since the plaintiffs and the individual defendants owned 95% of the corporation's shares, the chance that plaintiffs' direct action would unfairly expose the corporation or the individual defendants to a multiplicity of actions was very slim. Cutshall v. Barker, 733 N.E.2d 973, 983.

Ind.App.2001. Subsec. (d) cit. in case quot. in sup. Shareholder in closely held corporation that had filed for bankruptcy sued, among others, corporation's accountants, alleging conspiracy and misrepresentation. The trial court denied defendants' motion for summary judgment. Reversing, this court held that the claims asserted by plaintiff belonged to the corporation and had to be raised in a shareholder's derivative action rather than in a direct action. The court said that a direct action would fail to protect the corporation from multiple lawsuits, would materially prejudice the interests of creditors, and would interfere with a fair distribution of recovery among interested persons. Hubbard v. Tomlinson, 747 N.E.2d 69, 71.

Ind.App.2002. Subsec. (d) quot. in case quot. in sup. Minority shareholders of two closely held corporations brought actions against the corporations and their majority shareholders, alleging that majority shareholders breached their fiduciary duties by concealing certain transactions from plaintiffs. Affirming the trial court's dismissal of the actions, this court held, inter alia, that plaintiffs' claims that individual defendants engaged in self-dealing and collusion as officers, directors, and shareholders of the corporations pertained to the alleged damage suffered by the corporations as entities rather than to plaintiffs individually, and thus plaintiffs were precluded from maintaining direct actions against the individual defendants. Marcuccilli v. Ken Corp., 766 N.E.2d 444, 450.

Ind.App.2006. Applied in case cit. in disc. In a dispute between two businesses that owned equal shares of a limited-liability company, one business brought direct and derivative actions against other business's CEO for breach of fiduciary duty and self dealing in his role as company's co-manager. The trial court awarded damages in favor of plaintiff. Affirming, this court held, inter alia, that defendant acted willfully or recklessly in making a personal loan to other business and subsequently repaying the loan with funds rightfully belonging to company. In making its decision, the court concluded that plaintiff had standing to bring a direct fiduciary-duty claim against defendant because it was asserting a direct claim addressing a harm in its own name and not a derivative claim of corporate harm in the name of company under the guise of a direct claim. Purcell v. Southern Hills Investments, LLC, ___ Ind.App. ___, 847 N.E.2d

991, 1001.

Kan.2002. Subsec. (d) cit. in sup., com. (a) cit. in sup., com. (e) quot. in sup.; subsec. (d) cit. in sup. (T.D. No. 11, 1991). Truck company and its owner sued company's former officer and shareholder and officer's wife, seeking to recover money used by defendants for their own personal use and for punitive damages. Trial court awarded plaintiffs damages. This court affirmed, holding, inter alia, that since prior case entrusted decision of whether to allow a direct action involving a close corporation to the court's discretion, trial court did not err in using that case as an alternative basis for denying former officer's request for a setoff, even though trial court misinterpreted the "fair distribution of the recovery" prong of prior court's pertinent test. The court noted that all interested shareholders were parties to the suit, and individual recovery would not have prejudiced rights of nonparty shareholders and thus would not have interfered with fair distribution of recovery. Mynatt v. Collis, 274 Kan. 850, 57 P.3d 513, 529-530.

Kan.App.1994. Subsec. (d) quot. in sup. (T.D. No. 11, 1991), cit. generally in disc., and cit. generally in case quot. but not fol. Minority shareholder sued majority shareholders for, among other claims, breach of fiduciary duty by effectively freezing him out of management decisions and denying him a reasonably expected return on his investment in corporation. The trial court entered summary judgment against plaintiff, but this court reversed and remanded, holding, inter alia, that the trial court improperly required plaintiff to prove his entire case at summary judgment stage. The court held also that it could treat this suit raising derivative claims as a direct action for purposes of standing when plaintiff and his wife were corporation's only minority shareholders and when there was no indication that resolving the claims would prejudice interests of corporation's creditors. Richards v. Bryan, 19 Kan.App.2d 950, 879 P.2d 638, 647-648.

Minn.1990. Subsec. (d) cit. in diss. op. (T.D. No. 8, 1988.) Institutional shareholder sued officers and directors of corporation for breach of fiduciary duty, misuse of corporate assets, appropriation of corporate opportunities, and various instances of misconduct arising from the execution of vice president's employment and compensation agreements. The trial court entered summary judgment for defendants. Affirming in part, reversing in part, and remanding, this court held, inter alia, that plaintiff's complaint, which sought relief on behalf of corporation, was a derivative shareholder's action, and was barred to the extent it sought relief for any wrongdoing occurring before plaintiff became a shareholder. Dissent believed that the reasons for distinguishing between derivative and direct actions did not exist where, as here, the corporation was closely held, and that plaintiff could maintain an individual action under the provisions of Minn.Stat.Ann. § 302A. PJ Acquisition Corp. v. Skoglund, 453 N.W.2d 1, 14.

Minn.1999. Subsec. (d) quot. but not fol. Minority shareholders of closely held corporation brought direct action against corporation, majority shareholder, and corporate officer, alleging waste and misappropriation of corporate assets. The trial court dismissed, holding that plaintiffs' claims were derivative; the court of appeals reversed. Reversing and remanding, this court held, in part, that, despite the smaller number of shareholders in a closely held corporation, such shareholders were still subject to the derivative pleading requirements of Minnesota court rule governing derivative actions. Wessin v. Archives Corp., 592 N.W.2d 460, 466.

Minn.App.1998. Com. (d) cit. in case cit. in disc., com. (e) quot. in disc. Minority shareholders in closely held corporation sued corporation, majority shareholders, and corporate officer for fraud, misrepresentation, and breach of fiduciary duty. Plaintiffs also asserted a claim for violations of Minn.Stat. § 302A.751. The trial court granted defendants' motion for judgment on the pleadings on the ground that plaintiffs incorrectly pled derivative claims as direct claims. Reversing and remanding, this court held that, because plaintiffs alleged a combination of direct and derivative claims, they were entitled to proceed with their action. Furthermore, it would be inconsistent with the purposes of Minn.Stat. § 302A.751 to impose a derivative pleading requirement on shareholders in closely held corporations. Wessin v. Archives Corp., 581 N.W.2d 380, 385, 389, reversed 592 N.W.2d 460 (Minn.1999). See above case.

Miss.1992. Subsec. (d) quot. in ftn. (Prop. Final Draft, 1992). Corporate shareholder brought suit challenging the propriety of the actions of a coshareholder and fellow officer and director who, after sale of corporation's principal business operations, thereafter formed a new corporation that acquired first corporation's assets. Trial court dismissed, holding that plaintiff had released coshareholder and that the release was an accord and satisfaction and operated to discharge coshareholder from all personal obligations to plaintiff. Affirming in part, reversing in part, and remanding, this court held, inter alia, that plaintiff substantively pled and sought to prove that defendant breached his duty of fair dealing to the corporation; therefore, trial court erred in failing to regard plaintiff's suit as a derivative action on corporation's behalf against defendant, even though it was not labeled as such. Plaintiff's derivative claim was tried by implied consent, since defendant failed to object when plaintiff explored at trial the extent of defendant's dealings with corporation's former assets. Derouen v. Murray, 604 So.2d 1086, 1091.

Miss.2006. Quot. in case quot. but dist. Member of limited-liability company brought suit in chancery court against real-estate-franchising corporation, his former business partners, and others, seeking the right to bring derivative claims on behalf of company and asserting various other claims, including breaches of contract and fiduciary duties. The chancery court denied franchising corporation's motion to transfer the case to trial court. Reversing and remanding, this court held that the chancellor erred in denying the motion. The court concluded that plaintiff was asserting his own personal claims, in addition to company's claims, in a direct action that might benefit him alone, to the exclusion of company's other equity owner, and thus, as to the derivative claims through which plaintiff sought compensatory and punitive damages, plaintiff was pursuing a direct legal action rather than a true shareholder's derivative suit that would confer equity jurisdiction on the chancery court. ERA Franchise Systems, Inc. v. Mathis, 931 So.2d 1278, 1281.

Neb.2004. Subsec. (d) quot. in sup. and adopted in cases cit. in disc. Shareholder brought corporate derivative action on behalf of closely held corporation against the other two shareholders, asserting claims for breaches of fiduciary duty. The trial court entered judgment awarding damages to plaintiff in an individual capacity. Affirming in part as modified, this court held, inter alia, that the trial court acted within its discretion in permitting plaintiff an individual recovery, since there was no evidence that allowing such a recovery would unfairly expose the corporation or defendants to a multiplicity of actions, materially prejudice the interests of creditors of the corporation, or interfere with a fair distribution of the recovery. Trieweiler v. Sears, 268 Neb. 952, 983, 689 N.W.2d 807, 837.

N.H.2005. Subsec. (d) quot. in disc. and cit. generally in disc. Officer and shareholder of a corporation that operated a camp sued the other three officers and shareholders, requesting an accounting and alleging unlawful distributions, breach of fiduciary duty, and willful and wanton conduct. Trial court dismissed suit. This court vacated in part and remanded, holding, inter alia, that, in cases such as this one, where principles underlying a derivative proceeding were not served, the trial court should have the discretion to allow plaintiff to pursue a direct claim against corporate officers. While consistency in corporate law was important, a derivative suit involved burdensome, and often futile, procedural requirements when a minority shareholder sought to redress wrongful behavior by majority shareholders. Durham v. Durham, 151 N.H. 757, 871 A.2d 41, 45, 46.

N.J.Super.1999. Subsecs. (a)-(c) quot. in disc., subsec. (d) cit. and quot. in sup. and adopted, com. (e) quot. in sup. After 50% shareholder, who had filed derivative action against closely held corporation's chief operating officer for diversion of corporate opportunities, transferred all of her shares to her husband, the other 50% shareholder, as part of divorce settlement, chief operating officer moved for judgment on ground that former shareholder no longer had standing to maintain action. Reversing the trial court's grant of the motion and remanding, this court held that former shareholder could proceed by way of a direct action. Brown v. Brown, 323 N.J.Super. 30, 36-39, 731 A.2d 1212, 1215-1217, certification denied 162 N.J. 199, 743 A.2d 851 (1999).

N.C.App.2000. Cit. generally in disc., subsec. (d) adopted in case cit. in disc. and quot. in case quot. in disc. Minority shareholders of closely held corporation sued majority shareholders and others, asserting both individual and derivative claims for constructive trust and an accounting, breach of fiduciary duty, and civil conspiracy, among other claims. The trial court dismissed, holding, in part, that plaintiffs' individual claims were derivative in nature. Reversing in part, this court held, inter alia, that, under the circumstances of this case, plaintiffs could maintain their individual claims based on their allegations of defendants' wrongdoing, including the allegations of diversion of corporate assets and opportunities, in addition to bringing a derivative action on behalf of the corporation. Norman v. Nash Johnson & Sons' Farms, Inc., 140 N.C.App. 390, 537 S.E.2d 248, 256, 257.

N.D.1991. Subsec. (d) quot. in sup. (T.D. No. 11, 1991). Minority shareholders sued majority shareholders and corporation for breach of fiduciary duty toward plaintiffs, which resulted in plaintiffs' never receiving payment for their interest in the business. The trial court granted defendants' motion for severance of legal and equitable claims. Derivative and equitable claims were tried to the court, and dismissed, before the legal issues were tried before a jury. This court reversed and remanded for a jury trial on all issues, holding that claims of breach of fiduciary duty alleged by minority shareholders against controlling shareholders in a close corporation could be brought as an individual or direct action rather than as a derivative action. The court found no reason to depart from rule that jury must be allowed to decide legal issues before the trial court can dispose of any remaining equitable issues. Schumacher v. Schumacher, 469 N.W.2d 793, 798-799.

Or.App.1994. Com. (c) and Rptr's Note H cit. in disc. Investors who lost money that they had invested in a long-distance telecommunications company sued the company, its controlling shareholder, and company officers, alleging breach of fiduciary duties, RICO violations, and securities fraud in connection with a merger. The trial court granted defendants summary judgment. Affirming, this court held, inter alia, that, although plaintiffs had adequately pleaded breach of fiduciary duty, the only injury they alleged was the loss in value of their investments in the company before the merger; because plaintiffs had not pleaded a special injury, the court concluded that the claims they alleged were derivative, and they did not have standing to bring direct claims for breach of fiduciary duty. It also held that plaintiffs had not sufficiently pleaded that they had standing to assert their derivative claims. Loewen v. Galligan, 130 Or.App. 222, 882 P.2d 104, 112.

Or.App.1995. Subsec. (d) quot. and cit. but dist. Minority shareholder and former director of closely held corporation sued majority shareholders for breach of fiduciary duty after they removed him from board of directors, then sold corporation's assets and caused corporation to file for Chapter 7 bankruptcy. The trial court granted defendants' motion for summary judgment, holding that plaintiff could not bring a direct action against defendants, but had to assert his claim derivatively on behalf of the corporation. Reversing and remanding, this court held that a minority shareholder could bring a direct, rather than a derivative, action against majority shareholders if he alleged either harm to himself distinct from harm to the corporation or breach of a special duty owed by defendants to the shareholder, and that plaintiff was not required to prove that defendants personally profited at his expense. Wulf v. Mackey, 135 Or.App. 655, 660, 899 P.2d 755, 758.

Or.App.1998. Subsec. (d) cit. in ftn. Two shareholders with 50% control of corporation sued other 50% shareholder, his son, who was a corporate director, and others, alleging that plaintiffs had lost their control in the corporation. The trial court dismissed the complaint. Affirming in part, reversing in part, and remanding, this court held, inter alia, that plaintiffs could not recover directly for harms sustained by corporation; however, to the extent that son/director's alleged breaches of fiduciary duty, which included using corporate funds for the purpose of obtaining control of the corporation, caused harm to plaintiffs in their status as shareholders, plaintiffs could seek damages against him directly. Lee v. Mitchell, 152 Or.App. 159, 953 P.2d 414, 425.

S.D.1997. Subsec. (d) quot. in case quot. in disc. (erron. cit. as § 701(d)) and cit. generally but not fol. A minority shareholder in a jewelry manufacturing company sued the remaining shareholders, alleging an equitable claim of shareholder oppression and legal claims of breach of fiduciary duty, tortious interference with prospective economic advantage, negligence, and negligent misrepresentation. The trial court entered judgment on a jury verdict for the minority shareholder. This court affirmed in part and reversed in part, holding, inter alia, that the trial court erred in allowing plaintiff to proceed directly against defendants rather than requiring plaintiff to bring a shareholders' derivative action. Upon weighing the interests of the corporation and its majority and minority shareholders, creditors, and employees, the court declined to adopt the American Law Institute rule. The court stated that a significant defect in the ALI rule was that it failed to address whether a derivative suit could suffice to compensate the injured shareholder adequately. Landstrom v. Shaver, 561 N.W.2d 1, 13-15, appeal after remand 583 N.W.2d 643 (S.D.1998).

Utah, 1998. Subsec. (d) quot. in disc., coms. (c) and (e) cit. in disc. A shareholder in a closely held corporation sued the corporation and its officer, alleging corporation's wrongful transfer of its major real property asset. Trial court dismissed plaintiff's direct claims and granted defendants partial summary judgment on plaintiff's derivative claims. This court reversed, holding, inter alia, that a minority, noncontemporaneous shareholder could sue directly for corporate wrongdoing if the shareholder could show that one of the exceptions to the contemporaneous ownership rule applied. Aurora Credit Services v. Liberty West, 970 P.2d 1273, 1280-1281.

Utah, 1999. Com. (e) quot. in case quot. in disc. Limited partners sued bank for, in part, negligence and breach of fiduciary duty, alleging that defendant allowed general partner to divert partnership proceeds from "pooled income fund." Affirming the trial court's grant of bank's motion for judgment on the pleadings, this court held, inter alia, that plaintiffs' claims were derivative in nature, and that plaintiffs thus could not pursue the claims in their individual capacities. Arndt v. First Interstate Bank of Utah, N.A., 1999 UT 91, 991 P.2d 584, 588.

Va.2001. Subsec. (d) quot. in disc. Minority shareholder in a closely held corporation attempted to assert individual claims, distinct from derivative claims, on behalf of a corporation against a corporate officer and director for breach of fiduciary duty. Jury returned verdicts for plaintiff individually and in his derivative capacity, but trial court struck the jury verdict on the individual claim. This court affirmed in part, holding, inter alia, that trial court did not err in striking the jury's verdict. The court declined to adopt a closely-held-corporation exception to the rule requiring that suits for breach of fiduciary duty against officers and directors had to be brought derivatively on behalf of the corporation and not as individual shareholder claims. Simmons v. Miller, 261 Va. 561, 544 S.E.2d 666, 675.

(1994)

ALI-CORPGOV § **7.01**
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CERTIFICATE OF SERVICE

I, Sam S. Thomas, do hereby certify that I have this day mailed via United States Mail, postage fully prepaid, a true and correct copy of the above and foregoing document to:

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This the 24th day of October, 2008.

SAM S. THOMAS