



Summer 6-1-1986

The Continuous Ownership Requirement: A Bar To Meritorious Shareholder Derivative Actions?

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Business Organizations Law Commons](#)

Recommended Citation

The Continuous Ownership Requirement: A Bar To Meritorious Shareholder Derivative Actions?,
43 Wash. & Lee L. Rev. 1013 (1986).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol43/iss3/9>

This Note is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

THE CONTINUOUS OWNERSHIP REQUIREMENT: A BAR TO MERITORIOUS SHAREHOLDER DERIVATIVE ACTIONS?

A shareholder derivative suit is an equitable action in which a plaintiff shareholder seeks to compel a corporation to assert a corporate right of action when corporate management wrongfully has refused to sue persons who have harmed the corporation.¹ The purpose of a shareholder derivative action is to provide a mechanism by which a shareholder may obtain relief for a wrong to the corporation when the corporation is under the control of the persons who have committed the wrong.² A plaintiff shareholder, how-

1. 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1821, at 294 (1982); 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5941.1, at 18-19 (perm. ed. 1984); 3B J. MOORE, Moore's Federal Practice 23.1-47 (2d ed. 1985). In *Hawes v. City of Oakland*, the United States Supreme Court established two prerequisites to the institution of a shareholder derivative action. *Hawes v. City of Oakland*, 104 U.S. 450, 460-61 (1881). The Court in *Hawes* stated that there must be a right of action existing for the corporation to redress a wrong that has caused serious harm to the corporation. *Id.* at 460. The *Hawes* Court stated that the wrongful act could be an action by corporate management that exceeds the authority conferred on management by the corporate charter or a fraudulent transaction involving management and third parties. *Id.* The *Hawes* Court also specified that a wrong may result through the oppressive acts of majority shareholders acting in the name of the corporation and violating the rights of other shareholders. *Id.* Under *Hawes*, a shareholder bringing a derivative action must show that he has exhausted all avenues of redress within the corporation before the shareholder may institute a suit that actually belongs to the corporation. *Id.* at 461. The Supreme Court also stated that a plaintiff must allege in his complaint that he was a shareholder at the time of the transaction of which he complains or that his shares devolved on him since the occurrence of the alleged wrong by "operation of law." *Id.*; see *infra* note 85 (defining "operation of law"). Finally, *Hawes* required that a plaintiff aver that the suit is not a collusive one to confer jurisdiction on a court otherwise not authorized to maintain the action. *Hawes*, 104 U.S. at 461.

The Supreme Court's purpose in *Hawes* was to prevent corporations from creating diversity jurisdiction by having a nonresident shareholder institute suit. *Id.* at 452-53. The United States Supreme Court adopted Equity Rule 94, the forerunner to Federal Rule of Civil Procedure 23.1, in 1882 as a codification of its decision in *Hawes*. WRIGHT & MILLER, *supra*, at § 1821. Equity Rule 27 replaced Equity Rule 94 in 1912. *Id.* In 1938, Equity Rule 27 became Rule 23(b) of the Federal Rules of Civil Procedure. *Id.* In 1966, the Advisory Committee on the Federal Rules determined that there should be a separate rule governing derivative actions and, therefore, adopted federal rule 23.1 to set forth requirements governing derivative suits. *Id.*; see *infra* notes 23-30 and accompanying text (discussing standing requirements under rule 23.1).

2. See FLETCHER, *supra* note 1, at § 5941.1, 19 (shareholders have right in equity to compel assertion of corporate right when corporation wrongfully refuses to sue). A shareholder derivative suit prevents a failure of justice when corporate managers refuse to prosecute an action. *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 319 (1936); *Dodge v. Woolsey*, 59 U.S. 331, 339 (1856). Generally, a corporation fails to assert a right of action because the wrongdoers are those in control of the corporation. *Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983); *Lewis v. Curtis*, 671 F.2d 779, 784 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); *Reilly Mortgage Group, Inc. v. Mount Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1076

ever, may not maintain a derivative action unless the plaintiff adequately represents the interests of the other shareholders in enforcing the rights of the corporation.³ Adequate representation requires that the plaintiff in a derivative suit have interests consonant with the shareholders whom the plaintiff purports to represent.⁴ To ensure that a plaintiff attempting to bring a shareholder derivative action possesses the requisite interest to bring an action on behalf of a corporation, a plaintiff must satisfy certain standing requirements before the plaintiff may maintain a derivative action.⁵

(D.C. Va. 1983). However, if the failure of corporate management to bring an action represents an honest business judgment, then a shareholder may not maintain a derivative action. *See Mills v. Esmark, Inc.*, 573 F. Supp. 169, 172 (D.C. Ill. 1983) (dismissing claim because defendants demonstrated that decision not to pursue suit was result of thorough investigation and good faith business judgment); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 515 (D.C.N.Y. 1976) (court should not interfere with judgment of corporate officers to not institute lawsuit absent allegation of fraud, dishonesty or other breach of trust or misconduct).

3. *See* FED. R. CIV. P. 23.1 (describing standing requirements in shareholder derivative suits). The United State Supreme Court, in *Cohen v. Beneficial Loan Corp.*, expressed the rationale behind requiring that a plaintiff in a derivative action fairly and adequately represent the interests of shareholders similarly situated. *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 549 (1949). The Court explained that a stockholder who brings suit on behalf of the corporation assumes a position of a fiduciary nature. *Cohen*, 337 U.S. at 549. The *Cohen* Court stated that a plaintiff in a derivative action sues not for himself but as the representative of other shareholders similarly situated. *Id.* The Court indicated that the adequate representation requirement attempts to impose responsibility and accountability on a plaintiff in a derivative action to ensure that he protects the interests of the other shareholders. *Id.* at 549-50.

4. *See* *Schupack v. Covelli*, 498 F. Supp. 704, 706 (W.D. Pa. 1980) (interests of plaintiff in derivative action should be consistent with those of shareholders that plaintiff purports to represent); *see also* *Blum v. Morgan Guar. Trust Co.*, 539 F.2d 1388, 1390 (5th Cir. 1976) (dismissing shareholder derivative action when plaintiff was unable to fairly represent other shareholders because of personal litigation with corporation); *G.A. Enter. Inc. v. Leisure Living Communities*, 517 F.2d 24, 25-26 (1st Cir. 1975) (plaintiff could not assure adequate representation of shareholders similarly situated because of relationship between plaintiff's principal and defendant). *See generally* FLETCHER, *supra* note 1, at § 5994, 266-68 (describing requirement of adequate representation in shareholder derivative actions); WRIGHT & MILLER, *supra* note 1, at § 1833, 392 (discussing fair and adequate representation by plaintiff in derivative action).

5. *See* FED. R. CIV. P. 23.1 (defining prerequisites for maintenance of shareholder derivative suit). The Federal Rules of Civil Procedure govern proceedings in federal courts and thus, federal courts require plaintiffs in derivative actions to comply with the standing requirements in federal rule 23.1. FLETCHER, *supra* note 1, at § 5981, 215. For a plaintiff in a derivative action to satisfy the standing requirements in rule 23.1, the plaintiff must demonstrate that he owned stock in the corporation at the time of the transaction of which plaintiff complains or that plaintiff's shares have since devolved upon plaintiff "by operation of law." FED. R. CIV. P. 23.1.1. "By operation of law" suggests a transaction in which a plaintiff became a shareholder through a nonconsensual transaction. WRIGHT & MILLER, *supra* note 1, at § 1828, 348. For example, "by operation of law" includes a bequest of stock by will. FLETCHER, *supra* note 1, at § 5981, 217; *see* *Perrott v. United States*, 53 F. Supp. 953, 956 (D. Del. 1944) (legatee permitted to maintain derivative action even though receipt of stock occurred after wrong of which he complained). Additionally, courts have found that rule 23.1 contains an implied requirement necessitating that the plaintiff maintain his status as a shareholder throughout the litigation. FLETCHER, *supra* note 1, at § 5981, 217; *see* *Lewis v. Knutson*, 699 F.2d 230, 238 (5th Cir. 1983) (finding implied requirement of continuous ownership in rule 23.1); *Issen v.*

While state law or the Federal Rules of Civil Procedure may govern the standing requirements for a derivative action, federal standing requirements generally do not differ from the standing requirements that the states impose upon a plaintiff attempting to bring a derivative action.⁶ Both state and federal law usually impose a requirement of contemporaneous ownership, which ensures that a plaintiff in a derivative action was a shareholder at the time of the alleged wrong.⁷ State and federal law also generally impose a requirement of continuous ownership, ensuring that the plaintiff maintains shareholder status throughout the pendency of the derivative action.⁸ When federal and state law differ with regard to the standing requirements in shareholder derivative actions, however, the state law controls if the plaintiff brings the action in state court.⁹ If the plaintiff brings the derivative action in federal court the doctrine that the United States Supreme Court enunciated in *Erie Railway Company v. Tomkins (Erie)*,¹⁰ becomes relevant.¹¹ The *Erie*

GSC Enter., 538 F. Supp. 745, 752 (N.D. Ill. 1982) (interpreting rule 23.1 to contain continuous ownership requirement); see *infra* note 6 (enumerating states following standing requirements of rule 23.1).

6. See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36, 48 (3d Cir. 1946) (law of Kentucky is in substance identical to federal rule governing derivative actions); *Hurt v. Cotton States Fertilizer Co.*, 145 F.2d 293, 295 (5th Cir. 1944) (whether court considers action in light of federal rule or Georgia law, plaintiff must allege shareholder status at time of transaction of which plaintiff complains or status thereafter by devolution of law); *Lawson v. Baltimore Paint & Chem. Corp.*, 298 F. Supp. 373, 375 (D.C. Md. 1969) (law of Maryland governing standing requirements in derivative actions is same as federal rule 23.1); *Pergament v. Frazer*, 93 F. Supp. 9, 12 (E.D. Mich. 1949) (federal rule and Michigan law impose same standing requirements on plaintiff in derivative action); FLETCHER, *supra* note 1, at § 5981, 215-23 (discussing standing requirement in derivative actions under federal rule and state law); WRIGHT & MILLER, *supra* note 1, at § 1826, 325-30 (describing federal-state conflict in derivative actions); MOORE, *supra* note 1, at 23.1-15 (discussing principles governing federal-state conflict in derivative actions); *infra* notes 10-20 and accompanying text (discussing *Erie* doctrine and its application to derivative suits).

7. See FLETCHER, *supra* note 1, at § 5981, 217-26 (federal and state cases and statutes enumerating standing requirements in derivative actions).

8. See *supra* note 6 (citing source in which to find federal and state cases and statutes enumerating standing requirements in derivative actions).

9. See *infra* notes 10-20 and accompanying text (discussing *Erie* doctrine in context of federal-state conflict over standing requirements).

10. 304 U.S. 64 (1938).

11. *Id.* at 64; see MOORE, *supra* note 1, at 23.1-19 (explaining federal-state conflict and applicability of *Erie* doctrine in context of shareholder derivative actions). The United States Supreme Court promulgated the *Erie* doctrine in 1938 in *Erie Railway Company v. Tomkins*. See *Erie Railway Co. v. Tomkins*, 304 U.S. 64, 78 (1938) (promulgating *Erie* doctrine). The *Erie* doctrine requires that a federal court sitting in a case based on diversity jurisdiction apply the law of the state except in matters governed by the Federal Constitution or by Acts of Congress. *Erie*, 304 U.S. at 78. The *Erie* Court reasoned that to allow a federal court to apply federal law in cases brought on the basis of diversity jurisdiction would encourage citizens not otherwise eligible to avail themselves of a federal rule more favorable than the applicable state law. *Erie*, 304 U.S. at 76. Moreover, the *Erie* Court asserted that federal supervision over state legislative or judicial action infringed upon the autonomy and independence of the States. *Erie*, 304 U.S. at 78-79. Thus, the *Erie* doctrine sought to avoid imposition of federal common law

doctrine requires that in a federal court action in which jurisdiction is based on diversity of citizenship, state law will govern the substantive aspects of the suit and the Federal Rules of Civil Procedure will govern the procedural aspects of the action.¹² Disagreement exists, however, as to whether Federal Rule of Civil Procedure 23.1, which governs standing in derivative actions, is substantive or procedural for purposes of the *Erie* doctrine.¹³ Finding meritorious arguments for both positions, the Advisory Committee for the Federal Rules of Civil Procedure decided not to take a position on whether rule 23.1 is procedural or substantive.¹⁴ The Advisory Committee further indicated that the Supreme Court should not decide the procedural-substantive question *ex parte* but, instead, should leave resolution of the question to judicial decision in a litigated case.¹⁵ The Advisory Committee's decision to forego resolution of the *Erie* issue with regard to standing has not yielded a consistent result because courts have failed to reach a definitive conclusion as to the nature of the standing requirements in rule 23.1.¹⁶

Lower federal courts generally have interpreted federal rule 23.1 to be a rule of procedure because the rule affects only a plaintiff's capacity to sue

on the states by requiring federal courts to apply the applicable state law in cases brought in federal court on the basis of diversity of citizenship. *Erie*, 304 U.S. at 79. However, the Supreme Court recognized that in claims involving federal questions, courts should render their decisions in accordance with the applicable federal law in order to promote the uniformity of federal law throughout the States. *Erie*, 304 U.S. at 75. The *Erie* Court also asserted that when there existed a conflict between an applicable state law and a federal rule that the federal rule governed in matters of procedure and the state rule governed the substantive aspects of the action. *Erie*, 304 U.S. at 78.

The selection of the governing rule in diversity suits when a federal rule conflicts with an applicable state law is often a threshold question in derivative suits. Harbecht, *The Contemporaneous Ownership Rule in Shareholders' Derivative Suit*, 25 U.C.L.A. L. REV. 1041, 1044-45 (1978). The threshold question focuses on whether the standing requirements in derivative actions are procedural or substantive for purposes of determining the applicable law. See *infra* notes 12-20 and accompanying text (analyzing *Erie* considerations in shareholder derivative actions). See generally Ely, *The Irrepressible Myth of Erie*, 87 HARV. L. REV. 693 (1974) (discussing *Erie* doctrine); Hill, *The Erie Doctrine and the Constitution*, 53 NW. U. L. REV. 427 (1958) (analyzing *Erie* doctrine).

12. See MOORE, *supra* note 1, at 23.19-23.1-22 (discussing disagreement as to nature of derivative suit). Since the decision of the Supreme Court in *Erie*, the necessity of distinguishing substance from procedure has become extremely significant. Comment, 38 Mich. L. Rev. 724, 726 (1940). The *Erie* Court held that federal courts must apply the substantive law of the states. *Erie*, 304 U.S. at 78. However, the *Erie* decision did not affect federal power over procedure in the federal courts. See *Erie*, 304 U.S. at 92 (Reed, J., concurring). Thus, the ability to distinguish between substance and procedure is significant in determining whether a federal court should apply state law or federal law.

13. *Erie*, 304 U.S. at 78. See WRIGHT & MILLER at § 1829, 354-67 (describing arguments as to whether rule governing derivative actions is substantive or procedural).

14. FED. R. CIV. P. 23.1 advisory committee note.

15. *Id.*; see MOORE, *supra* note 1, at 23.1-27 (discussing Advisory Committee's decision not to resolve whether standing requirements in derivative actions are substantive or procedural). PROCEDURAL).

16. See *infra* notes 17-19 and accompanying text (discussing conflict as to whether standing requirements in derivative actions are substantive or procedural).

and not the substantive cause of action.¹⁷ Courts holding that rule 23.1 is substantive note that imposition of rule 23.1 may deny a plaintiff standing in a federal court when the same plaintiff would have standing to bring the action in state court.¹⁹ Thus, rule 23.1 bears directly on a plaintiff's substantive rights because rule 23.1 may act as a complete bar to a derivative action depending upon the court in which a plaintiff institutes suit.²⁰ Other courts have avoided entirely the *Erie* question in derivative actions by finding that state law standing requirements are identical to the standing requirements of

17. Harbecht, *supra* note 11, at 1045; *see* Pioche Mines Consol., Inc. v. Dolman, 333 F.2d 257, 265 (9th Cir. 1964) (defining rule 23.1 as rule of procedure); Harris v. Palm Springs Alpine Estates, 329 F.2d 909, 912-13 (9th Cir. 1964) (interpreting standing requirements in rule 23.1 to be procedural); MOORE, *supra* note 1, at 23.1-19 nn.10-11 (listing federal courts that define rule 23.1 as rule of procedure). One commentator has suggested that the derivative action is a procedural mechanism by which to enforce substantive rights. SULLIVAN, *The Federal Courts as an Effective Forum in Shareholders' Derivative Actions*, 23 La. L. Rev. 580, 585 (1962). The right to maintain a derivative action exists by statute or case law of the state governing the activities of the corporation. *Id.* The means of enforcing the right are procedural and will be determined according to the federal rules governing federal courts if an action is brought in a federal court. *Id.* Some courts that apply the federal rule in cases of inconsistent state law justify application of the federal rule as reliance on a higher authority. *Gallup v. Caldwell*, 120 F.2d 90, 95 & n.3 (3d Cir. 1941); *see* Wright & Miller, *supra* note 1, at § 1829, 356-57 (citing *Gallup v. Caldwell*). In *Gallup v. Caldwell*, the United States Court of Appeals for the Third Circuit asserted that there exists a strong presumption that the Supreme Court, in promulgating the Federal Rules of Civil Procedure, regarded rule 23.1 as a rule of procedure which should not affect the substantive rights of litigants. *Gallup*, 120 F.2d at 95 & n.3 (3d Cir. 1941). *Cf.* Sullivan, *supra*, at 585-86 (derivative action is procedural device). *But see infra* notes 18-20 *infra* (courts that have found federal rule 23.1 to be substantive).

18. *See* Home Fire Ins. Co. v. Barber, 67 Neb. 644, 657, 93 N.W. 1024, 1029 (1903) (asserting that rule governing standing in derivative actions is substantive). In *Home Fire Insurance Co. v. Barber (Home Fire)*, the Nebraska court found that the purpose of federal equity rule 94, a predecessor to federal rule 23.1, went far beyond the prevention of collusive jurisdiction. 67 Neb. at _____, 93 N.W. at 1029. The *Home Fire* court stated that the rule had its foundation in a principle of equity. *Id.* The court explained that if the rule was no more than jurisdictional, the rule would only prevent derivative suits when the plaintiff had the same citizenship as the corporation. *Id.* The *Home Fire* court concluded, however, that the rule must be more than jurisdictional because the rule applied whether the plaintiff could have brought suit or not, thus evincing some purpose other than procedure. *Id.*; MORE, *supra* note 1, at 23.1-19 (listing cases finding that rules governing standing in derivative actions are substantive); Wright & Miller, *supra* note 1, at § 1829, 355-56 (several considerations lend support to characterization of rule 23.1 as substantive for *Erie* purposes).

19. WRIGHT & MILLER, *supra* note 1, at § 1829, 359. Professors Wright and Miller explain that if rule 23.1 bars a plaintiff from bringing a derivative action in federal court that the plaintiff would have been able to bring in state court absent the requirements of federal rule 23.1, then rule 23.1 infringes on state-created substantive rights. *Id.* at 358-59. Thus, to regard rule 23.1 as procedural would undermine the policy objective of *Erie*, which sought to promote identity of outcome between federal and local courts in the same state. *Id.* at 359; *see also* MOORE, *supra* note 1, at 23.1-23 (rule 23.1 goes beyond procedure and involves substantive issue if applied in federal and state courts with inconsistent results).

20. WRIGHT & MILLER, *supra* note 1, at 359; MOORE, *supra* note 1, at 23.1-23.

federal rule 23.1, so no conflict exists.²¹ Many state courts and legislatures have actually adopted standing requirements similar to the requirements provided in rule 23.1 and, therefore, no problem arises in deciding whether to apply state or federal law to determine a plaintiff's capacity to sue in those jurisdictions.²²

Assuming that federal rule 23.1 controls, a plaintiff in a shareholder derivative action must satisfy two requirements before a court will accord the plaintiff standing to assert a claim on behalf of a corporation.²³ First, rule 23.1 requires that a plaintiff in a derivative action must have been a shareholder at the time of the transaction of which the plaintiff complains.²⁴ Courts commonly refer to the requirement of stock ownership at the time of the alleged wrong as the "contemporaneous ownership" requirement.²⁵ The contemporaneous ownership requirement prevents litigious persons from buying stock after a corporate wrong for the sole purpose of bringing derivative suits in an effort to extract money from the corporation.²⁶ The second requirement of rule 23.1 expressly requires that a plaintiff in a derivative action must be a shareholder at the commencement of the litigation

21. See, e.g., *Schilling v. Belcher*, 582 F.2d 995, 999-1000 (5th Cir. 1978) (in absence of conflict between federal standing requirements and Florida law there exists no need to decide whether rule 23.1 standing requirements are substantive or procedural); *Gallup v. Caldwell*, 120 F.2d 90, 95 (3d Cir. 1941) (deferring to federal law without resolving *Erie* problem of whether rule 23.1 is substantive or procedural); *McQuillen v. National Cash Register Co.*, 112 F.2d 877, 882 (4th Cir.) (deferring to federal standing requirements as higher authority), *cert. denied*, 311 U.S. 695 (1940).

22. See Harbecht, *supra* note 11, at 1043 nn.7 & 10 (citing state cases and decisions adopting provisions in federal rule 23.1); MOORE, *supra* note 1, at 23.1-17-23.1-19 n.6 (enumerating states that have adopted standing requirements of federal rule 23.1); see also 14 GA. CODE ANN. § 14-2-123 (1982) (adopting federal rule 23.1 as law of state); N.J. STAT. ANN. § 14A:3-6 (West 1959) (same); N.C. GEN. STAT. § 55-39.1 (1982) (same); *Schilling v. Belcher*, 582 F.2d 995, 1000 (5th Cir. 1978) (holding that no conflict exists between Florida law and federal rule 23.1); *Metal Tech. Corp. v. Metal Techniques Co.*, 74 Or. App. 297, ___, 703 P.2d 237, 242 (1985) (finding that although no statutory rules exist in Oregon governing standing in derivative actions, general principles of standing are consistent with federal rule 23.1); *Lewis v. Anderson*, 453 A.2d 474, 476 (1982) (finding that Delaware law is consistent with standing requirements in federal rules).

23. See FED. R. CIV. P. 23.1 (defining standing requirements in derivative action); *infra* note 26 and accompanying text (describing standing requirements of rule 23.1).

24. FED. R. CIV. P. 23.1(1).

25. See *Hawes v. Oakland*, 104 U.S. 450, 461 (1881) (setting forth requirement of ownership contemporaneous with wrong); *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) (federal rule 23.1 contains contemporaneous ownership requirement); Harbecht, *supra* note 11, at 1041 (crediting *Hawes* Court with initial enunciation of contemporaneous ownership requirement).

26. See Harbecht, *supra* note 11, at 1042 (contemporaneous ownership requirement is means of discouraging purchase of shares primarily to instigate derivative litigation); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741-43 (1975) (contemporaneous stock ownership is necessary to dissuade nuisance suits); see also *Independent Investors Protective League v. Time, Inc.*, 50 N.Y.2d 259, 263, 406 N.E.2d 486, 488 (1980) (contemporaneous ownership requirement originated to preclude manufacture of diversity jurisdiction but now requirement seeks to inhibit speculation in litigation).

and implicitly requires that a plaintiff retain stock ownership for the duration of the suit.²⁷ The continuous ownership requirement seeks to ensure that the real interest motivating a plaintiff in a derivative action is redress for a wrong to the corporation and not merely receipt of a personal recovery.²⁸ Rule 23.1 does not, however, expressly set forth a "continuous ownership" requirement.²⁹ Most state and federal courts have inferred the continuous ownership requirement from the provision in rule 23.1 stating that a plaintiff in a derivative action may not maintain the action unless the plaintiff adequately represents the interests of other shareholders.³⁰ Courts have asserted that the continuous ownership requirement is necessary because the policy behind the standing rules for rule 23.1 requires that a plaintiff maintain a proprietary interest in the corporation while the derivative action is pending.³¹ Absent a proprietary interest in the corporation, courts explain,

27. See FED. R. CIV. P. 23.1 (listing standing requirements in shareholder derivative actions); *Lewis v. Chiles*, 719 F.2d 1044, 1047 (9th Cir. 1983) (plaintiff in shareholder derivative action must retain ownership of stock for duration of lawsuit); *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) (stock ownership requirement continues during pendency of lawsuit). *But see* *Zauber v. Murray Savings Assn.*, 591 S.W.2d 932, 938 (Tex. Civ. App. 1979) (court must determine whether disposition of stock was voluntary or involuntary before dismissing shareholder derivative action for lack of continuous ownership). See *infra* notes 102-110 and accompanying text (discussing *Zauber*).

28. See FED. R. CIV. P. 23.1 (enumerating standing requirements for plaintiff in derivative action).

29. FED. R. CIV. P. 23.1.

30. See *supra* note 8 and accompanying text (discussing implied continuous ownership requirement in federal rule 23.1); *Schilling*, 582 F.2d at 999 (language of rule 23.1 providing that derivative action be brought by one or more shareholders implies requirement of continuous ownership); *Lewis v. Chiles*, 719 F.2d 1044, 1047 n.1 (9th Cir. 1983) (implying continuous ownership requirement from provision abating action if plaintiff does not adequately represent interests of shareholders similarly situated); *Schupack v. Covelli*, 498 F. Supp. 704, 705 (W.D. Pa. 1980) (rule 23.1 contains implied requirement of continuous stock ownership); *Orenstein v. Compusamp*, 19 Fed. R. Serv.2d 466, 468 (S.D.N.Y. 1974) (shareholder must retain stock throughout derivative action even though rule 23.1 does not specifically require continuous ownership); *Harbecht*, *supra* note 11, at 1043 (listing number of states that have adopted standing requirements of federal rule 23.1); see *MOORE*, *supra* note 1, at 23.1-16-23.1-17 (same).

31. See *Portnoy v. Kawecky Berylco Indus., Inc.*, 607 F.2d 765, 767 (7th Cir. 1979) (nonshareholder or one who loses shareholder interest might not pursue vigorously shareholder derivative action); *Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727, 735-36 (3d Cir. 1970) (only indirect benefit that plaintiff will receive as shareholder justifies standing in derivative action), *cert. denied*, 401 U.S. 974 (1971); *Metal Tech. Corp. v. Metal Techniques Co.*, 74 Or. App. 297, 703 P.2d 237, 242 (1985) (plaintiff must be shareholder throughout action to have incentive to litigate fully and fairly); *FLETCHER*, *supra* note 1, at § 5939, 13 (describing nature of derivative action). In a shareholder derivative action, the shareholder is only a nominal plaintiff. *Id.* The substantive claim belongs to the corporation. *Id.* When a plaintiff does not seek to assert a right of action for the benefit of the corporation, the action is not derivative. *Id.* Although the injury to the corporation may result in indirect injury to the shareholder, the injury to the shareholder is regarded as insufficient to give rise to a direct cause of action by the shareholder. *Id.* at 16, *citing* *Burden v. Erskine*, 264 Pa. 584, 586, 401 A.2d 369, 370 (1979). When a shareholder loses possession of his stock interest in a corporation, he loses possession of that which conferred upon him the standing to maintain a derivative action. *FLETCHER*, *supra*, at 13. Thus, courts have inferred a requirement in rule 23.1 that a shareholder maintain his interest in the corporation while the derivative action is pending.

the plaintiff has no stake in the outcome of the litigation and, therefore, may not fairly and adequately defend the rights of the corporation or the other shareholders whose interests the plaintiff purports to represent.³² Furthermore, the only right that a plaintiff in a derivative suit possesses is a secondary right derived from his status as a shareholder.³³ Thus, if a plaintiff does not retain shareholder status, the plaintiff does not retain the right to pursue an action that derives from that status.³⁴

While courts generally hold that a derivative action will cease if the plaintiff loses shareholder status during the course of the litigation, some courts have begun to focus on the manner in which the plaintiff lost shareholder status when deciding whether the court should permit the plaintiff to continue the litigation.³⁵ A small number of courts make a distinction between voluntary and involuntary loss of shares, fashioning an exception to the standing requirement of continuous ownership when the plaintiff involuntarily has lost shares in the corporation on whose behalf the plaintiff brought the action.³⁶ Recently, a California state court, in *Gaillard v. Natomas Company*,³⁷ held that the continuous ownership requirement did not deprive a plaintiff of standing to maintain a derivative action when the plaintiff lost shareholder status by the involuntary divestment of stock

32. See *supra* note 31 and accompanying text (explaining rationale behind implying existence of continuous ownership requirement in rule 23.1).

33. MOORE, *supra* note 1, at 23.1-41. Professor Moore stated that rule 23.1 specifically is limited to shareholder suits to enforce rights that are secondary in nature. *Id.* at 23.1-40. If a plaintiff seeks to enforce primary rights, rule 23.1 is not applicable. *Id.* at 23.1-41. In *Kauffman v. Dreyfus Fund, Inc.*, the United States Court of Appeals for the Third Circuit explained that, as a secondary right, a derivative action is limited to the plaintiff's need as a shareholder to protect his interest as a shareholder. *Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727, 737 (3d Cir. 1970); see *Portnoy v. Kawecky Berylco Indus., Inc.*, 607 F.2d at 767 (describing secondary nature of shareholder derivative suits). The Seventh Circuit in *Portnoy v. Kawecky Berylco Indus., Inc.* explained that the rationale underlying derivative actions is that the shareholder has reason to litigate vigorously the action because the shareholder will receive an indirect benefit from a judgment favorable to the corporation. *Portnoy*, 607 F.2d at 767; see *Lewis v. Chiles*, 719 F.2d at 1047 (derivative action reflects shareholder's real interest in increasing value of plaintiff-shareholder's stock).

34. See *supra* notes 31-32 and accompanying text (discussing secondary nature of plaintiff's rights in shareholder derivative action).

35. See, e.g., *Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270, 1273 (S.D.N.Y. 1983) (court must consider several factors before dismissing derivative action upon plaintiff's loss of stock ownership); *Gaillard v. Natomas Co.*, 173 Cal. App. 3d 410, 219 Cal. Rptr. 74, 78 (1985) (holding that upon involuntary loss of stock ownership court should not necessarily abate derivative action); *Zauber v. Murray Savings Assn.*, 591 S.W.2d 932, 937-38 (Tex. Civ. App. 1979) (recognizing distinction between voluntary and involuntary disposition of shares in corporation for purposes of standing in a derivative action); *infra* notes 37-86 and accompanying text (discussing *Natomas*); *infra* notes 102-126 and accompanying text (discussing *Arnett* and *Zauber* cases).

36. See *infra* notes 37-86 and 102-126 and accompanying text (discussing cases that recognize distinction between voluntary and involuntary loss of shareholder status).

37. 173 Cal. App. 3d 410, 219 Cal. Rptr. 74 (1985), *review denied*, January 16, 1986 (cite not available).

through a forced sale.³⁸ The California state court decided the case under the law of California.³⁹ The *Natomas* court acknowledged that no California decisions concerning the continuous ownership requirement existed.⁴⁰ In *Natomas*, though, a California state court of appeals held that imposing a continuous ownership requirement was inequitable when a plaintiff in a derivative action involuntarily lost shareholder status.⁴¹

In *Natomas*, the plaintiff, Gaillard, was a minimal stockholder in the Natomas Company (Natomas).⁴² In 1983, the board of directors of Natomas entered into a merger agreement with Diamond Shamrock Corporation (Diamond), which Natomas' shareholders subsequently approved.⁴³ Prior to the effective date of the merger, Gaillard filed a derivative suit challenging the "golden parachute" agreements⁴⁴ that the merger agreement provided for certain officers and directors of Natomas.⁴⁵ In the complaint, Gaillard alleged that Natomas' directors breached a fiduciary duty by negotiating the "golden parachute" agreements and recommending that the Natomas shareholders approve the payments.⁴⁶ Additionally, Gaillard alleged that she was

38. *Natomas*, 219 Cal. Rptr. 74, 76.

39. *Natomas*, 219 Cal. Rptr. at 78; see CAL. CORP. CODE § 800(b)(1) (1977 & Supp. 1985) (California law governing derivative actions).

40. *Natomas*, 219 Cal. Rptr. at 81. The *Natomas* court noted that a New York court had found that California law permitted the survival of corporate causes of action when suit was pending at the time of merger. *Id.*; see *Abrams v. Occidental Petroleum Corp.*, 20 Fed. R. Serv.2d 170, 175 (S.D.N.Y. 1975) (New York court interpreting California corporations law).

41. *Natomas*, 219 Cal. Rptr. at 76. The plaintiff in *Natomas* lost shareholder status through the involuntary divestment of stock upon completion of a merger. *Id.* at 75.

42. *Id.* at 75. The corporation involved in *Natomas*, the Natomas Company, was a publicly held California corporation prior to the company's merger with New Diamond Corporation in 1983. *Id.*

43. *Id.* at 75. New Diamond Corporation was formed in May 1983 for purposes of the merger with the Natomas Company. *Id.* at 75 n.4. Diamond Shamrock Corporation subsequently renamed itself New Diamond Corporation. *Id.* In May 1983, New Diamond Corporation attempted a hostile takeover of Natomas. *Id.* In order to avoid a hostile takeover, the board of directors of Natomas reached a merger agreement with New Diamond. *Id.* After negotiating the merger agreement, the board of directors recommended that the Natomas shareholders approve the merger. *Id.*

44. See *id.* The *Natomas* court described "golden parachutes" as payments guaranteed to an officer of an acquired corporation to assure that the officer will receive financial compensation in the event that the position of the officer changes upon completion of the merger. *Id.* Golden parachute agreements, however, are not always exacted as part of a merger agreement. See SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER 427 (R. Winter, M. Stumpf, G. Hawkins) (1984 Supp.) (describing golden parachute agreements). Rather, corporations often execute golden parachute agreements in anticipation of events that may have an adverse effect upon an officer's position. *Id.* at 426-27.

45. *Natomas*, 219 Cal. Rptr. at 76. In *Natomas*, the plaintiff named as defendants in the derivative suit Natomas Company, Diamond Shamrock Corporation, and American Company, Ltd. *Id.* Gaillard also named the nineteen members of the Natomas board of directors as defendants. *Id.*

46. *Id.* In the complaint in *Natomas*, the plaintiff alleged that the merger agreement between Natomas and New Diamond Corporation provided a golden parachute payment of \$15 million to five officers and directors of Natomas. *Id.* Plaintiff Gaillard further alleged that each

a shareholder of record at the time of the transaction of which Gaillard complained and at the time of the filing of the complaint.⁴⁷

When the Natomas/Diamond merger became effective, New Diamond Corporation forced Gaillard and all other common stockholders to exchange shares of Natomas stock for common stock in the New Diamond Corporation.⁴⁸ Subsequently, the trial court sustained defendants' demurrer to Gaillard's complaint, finding that Gaillard no longer had standing to maintain the derivative action because she was not a shareholder of Natomas.⁴⁹ Gaillard appealed the trial court's dismissal of the complaint to the First District Court of Appeal in San Francisco.⁵⁰ On appeal, the California District Court of Appeal considered whether a shareholder who has satisfied the contemporaneous ownership requirement under section 800(b)(1) of the California Corporations Code⁵¹ has standing to maintain a derivative action following the involuntary loss of shareholder status.⁵² The *Natomas* court found that the California statute clearly stated that the plaintiff must be a shareholder "at the time" of the alleged wrongdoing but contained no express requirement of continuous stock ownership.⁵³ In refusing to imply

of the directors had breached a fiduciary duty to the shareholders of Natomas by negotiating, approving, and recommending the golden parachute payments. *Id.* at 75.

47. *Id.* at 75.

48. *Id.* Upon completion of the merger, New Diamond became the sole shareholder of Natomas Company and the shareholders of Natomas held stock in New Diamond. *Id.* at 75-76.

49. *Id.* at 76. The *Natomas* court stated that the trial court had based the decision to sustain defendants' demurrer on a Delaware case, *Lewis v. Anderson*. *Id.*; see *Lewis v. Anderson*, 453 A.2d 474, 480 (1982) (holding that plaintiff lost standing to maintain derivative suit when plaintiff lost shareholder status as result of merger). The California District Court of Appeal in *Natomas* rejected the trial court's reliance on the decision of the Delaware court in *Anderson*, asserting that California affords a more liberal construction to the standing requirements in derivative actions and, therefore, the Delaware decision did not bind a California court. *Id.*; *Anderson*, 453 A.2d at 477-78 (interpreting standing requirements Delaware law imposes upon plaintiff in derivative action).

50. *Id.* at 75.

51. CAL. CORP. CODE § 800(b)(1) (1977 & Supp. 1986). Section 800(b)(1) of the California Corporations Code provides, in part, that a plaintiff in a derivative action must allege in the complaint that he was a shareholder at the time of the transaction of which plaintiff complains or that plaintiff's shares thereafter devolved upon plaintiff by operation of law from one who was a shareholder at the time of the transaction. *Id.* Compare CAL. CORP. CODE § 800(b)(1) (1977 & Supp. 1986) (California law governing standing in derivative actions contains no provision requiring that plaintiff in derivative action adequately represent those whom he purports to represent) with FED. R. CIV. P. 23.1 (federal rule governing standing in shareholder derivative suits contains provision that plaintiff adequately defend interests of other shareholders from which courts infer continuous ownership requirement).

52. *Natomas*, 219 Cal. Rptr. at 76; see *infra* notes 53-55 and accompanying text (discussing *Natomas* court's construction of § 800(b)(1) of California Corporation Code).

53. *Id.*; CAL. CORP. CODE § 800(b)(1) (1977 & Supp. 1986). In interpreting the language of § 800(b)(1), the *Natomas* court proceeded under the principle that the expression of certain requirements in a statute necessarily precludes the inclusion of requirements not explicitly stated. *Id.* Therefore, because § 800(b)(1) expressly required ownership "at the time" of the alleged transaction, and made no provision for continuous stock ownership, the *Natomas* court asserted

such a provision from the language of section 800(b)(1), the *Natomas* court reasoned that a requirement that a plaintiff bringing a derivative action must maintain shareholder status throughout the course of the litigation would create a situation in which a shareholder could file a derivative action, undertake extensive discovery and financial expense, and yet be precluded from proceeding further because the shareholder involuntarily lost shareholder status.⁵⁴ The *Natomas* court stated that the legislature could not have intended that a court dispose of an alleged wrong in such an inequitable manner.⁵⁵

After concluding that imposition of the continuous ownership requirement would be inequitable, the *Natomas* court rejected as unpersuasive defendants' arguments that jurisdictions outside of California require continuous ownership of stock by a plaintiff in a derivative action.⁵⁶ The court found that the cases upon which defendants relied to support a continuous ownership requirement were distinguishable from the *Natomas* case.⁵⁷ Specifically, the *Natomas* court rejected defendants' reliance on *Schilling v. Belcher Oil Co.*,⁵⁸ a case decided by the United States Court of Appeals for

that the court could not presume that continuous stock ownership was a requirement for maintaining a derivative action. *Id.*

54. *Id.*

55. *Id.* at 76. Upon further examination of legislative intent, the *Natomas* court concluded that the predecessor to section 800 of the California Corporations Code, section 834, did not contain a continuous ownership requirement. *Id.* at 77; see CAL. CORP. CODE § 834 (1972), repealed by CAL. CORP. CODE § 800(b)(1) (1977 & Supp. 1986) (current California law governing standing in shareholder derivative actions). The *Natomas* court found that section 834 of the corporations code included a contemporaneous ownership requirement only to prevent individuals from acquiring stock for the sole purpose of bringing a derivative suit. *Id.* The *Natomas* court also found that the legislature patterned subsequent revisions to section 800 after the Model Business Corporation Act, which contains no requirement of continuous stock ownership. *Id.*; see ABA MODEL BUSINESS CORPORATION ACT § 49 (1975) (describing standing requirements for plaintiffs in derivative actions). Moreover, the court in *Natomas* found that the legislative changes to section 800 since 1975 were made to relax the contemporaneous ownership requirement. *Id.* The *Natomas* court concluded, therefore, that the legislature could not have intended to include a continuous ownership requirement that would tend to restrict the capacity of a plaintiff to maintain a derivative action. *Id.* The *Natomas* court also rejected defendant's reliance on cases that the defendants contended required a restrictive interpretation of section 800 of the corporations code. *Natomas*, 219 Cal. Rptr. at 77; see *Mueller v. MacBan*, 62 Cal. App. 3d 258, 269, 132 Cal. Rptr. 222, 232 (1976) (case upon which defendants based argument that code contained requirement of continuous stock ownership); *Stockton v. Ortiz*, 47 Cal. App. 3d 183, 195, 120 Cal. Rptr. 456, 462 (1957) (same). The *Natomas* court found that the cases defendants cited were inapposite to *Natomas* because in defendants' cited cases plaintiffs were not shareholders at the time of the wrongful transaction. *Id.*

56. *Natomas*, 219 Cal. Rptr. at 78; see *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) (no conflict exists between Florida law and federal rule 23.1 in that both contain implied continuous ownership requirement).

57. *Id.* at 78-79; see *infra* notes 58-74 and accompanying text (distinguishing *Natomas* case from cases that defendants cited for support).

58. 582 F.2d 995 (5th Cir. 1978). In *Schilling v. Belcher*, the plaintiff had brought a derivative action for breach of fiduciary duty that was pending on appeal when the Coastal States Gas Corporation purchased all of the outstanding stock of Belcher Oil Company. *Id.* at

the Fifth Circuit.⁵⁹ In *Schilling*, the Coastal States Gas Corporation purchased all of the outstanding stock of Belcher Oil Company, including the plaintiff's shares.⁶⁰ At the time of the purchase, a derivative action for breach of fiduciary duty was pending on appeal.⁶¹ The Fifth Circuit held that upon disposition of stock in the Belcher Oil Company the plaintiff lost standing to maintain the derivative action.⁶² The California District Court of Appeal found that unlike the plaintiff in *Natomas*, who was forced to exchange shares of *Natomas* because of the merger with Diamond, the plaintiff in the Fifth Circuit case voluntarily had sold her stock pending appeal.⁶³ In addition, the *Natomas* court distinguished the Fifth Circuit's opinion because the plaintiff in *Schilling* instituted the derivative action in federal court on the basis of diversity of citizenship while *Natomas* was a California state court action.⁶⁴ The *Natomas* court explained that no conflict existed between the standing requirements of federal rule 23.1 and Florida law in *Schilling* and, therefore, the Fifth Circuit had imposed the implied continuous ownership requirement of rule 23.1.⁶⁵ Since the plaintiff in *Natomas* instituted suit in a state court, the *Erie* doctrine did not require the *Natomas* court to apply federal rule 23.1.⁶⁶

999. The defendants in *Schilling* moved to dismiss the action on grounds that plaintiff had lost standing to further prosecute a derivative action on behalf of the corporation. *Id.* The United States Court of Appeals for the Fifth Circuit granted defendants' motion to dismiss plaintiff's claim. *Id.*

59. *Natomas*, 219 Cal. Rptr. at 78; see *Schilling*, 582 F.2d at 999 (case upon which *Natomas*' defendants relied for proposition that jurisdictions other than California require plaintiffs in derivative actions to maintain continuous stock ownership for duration of derivative action).

60. *Schilling*, 582 F.2d at 999.

61. *Id.*

62. 582 F.2d at 1002.

63. *Natomas*, 219 Cal. Rptr. at 78; see *Schilling*, 582 F.2d at 999 (noting plaintiff *Schilling*'s disposition of stock pending appeal).

64. *Natomas*, 219 Cal. Rptr. at 78; see *Schilling*, 582 F.2d at 999 (noting that plaintiffs brought claim in federal court based on diversity of citizenship); see *supra* notes 10-20 and accompanying text (discussing federal-state conflict and *Erie* doctrine in context of standing requirements in derivative actions).

65. *Natomas*, 219 Cal. Rptr. at 78. In *Schilling*, the court noted that the Florida law governing shareholder derivative suits imposes upon a plaintiff in a derivative action the same requirements as federal rule 23.1. *Schilling*, 582 F.2d 995, 1002; see *Natomas*, 219 Cal. Rptr. at 78 (noting that *Schilling* court held Florida law consonant with federal rule 23.1).

66. *Natomas*, 219 Cal. Rptr. at 78. Unlike the court in *Natomas*, most state courts apply the standing requirements of federal rule 23.1 in shareholder derivative actions. See *Bachrach v. General Inv. Corp.*, 29 F. Supp. 966, 967 (S.D.N.Y. 1939) (continuous ownership of stock is requirement under rule 23.1 and under New York case law); *Vista Fund v. Garis*, 277 N.W.2d 19, 23 & n.6 (Minn. 1979) (Minnesota statute is identical to federal rule 23.1 requiring continuous ownership of stock); *Gresov v. Shattuck Denn Mining Corp.*, 40 Misc.2d 569, 571, 243 N.Y.S.2d 760, 763 (1963) (plaintiff in derivative action must be shareholder continuously from time of alleged improper acts until after judgment); *Sorin v. Shahmoon Indus., Inc.*, 30 Misc.2d 429, 432, 220 N.Y.S.2d 760, 784 (1961) (plaintiff must be shareholder up to and including time of judgment).

After rejecting defendants' reliance on the Fifth Circuit's decision in *Schilling* for the proposition that jurisdictions outside of California require continuous ownership of stock, the *Natomas* court also rejected defendants' reliance on *Niesz v. Gorsuch*,⁶⁷ a Ninth Circuit decision.⁶⁸ In *Niesz*, United Security Life entered into a merger agreement with Provident Life Insurance Company.⁶⁹ Four months prior to completion of the merger, plaintiff, a holder of United Security Life shares, had instituted a derivative suit for alleged breaches of fiduciary duty unrelated to the merger.⁷⁰ In *Niesz*, the United States Court of Appeals for the Ninth Circuit held that upon completion of the merger the plaintiff lost shareholder status and, therefore, standing to maintain the derivative action because he no longer had a proprietary interest in the corporation.⁷¹ The California Appellate Court distinguished the Ninth Circuit case from the *Natomas* case on several points.⁷² The *Natomas* court asserted that, unlike the merged corporation in the Ninth Circuit case, *Natomas* did not cease to exist but became a subsidiary of the acquiring corporation.⁷³ Thus, while the cooperation of the surviving corporation in maintaining the derivative action was feasible in *Niesz* because the plaintiff in *Niesz* did not allege that the corporation engaged in any wrongdoing, the cooperation of Diamond in maintaining a suit against itself was unlikely.⁷⁴ Therefore, to bar the derivative suit in *Natomas* would be to deny relief to Gaillard and all similarly situated shareholders.⁷⁵ The *Natomas*

67. 295 F.2d 909 (9th Cir. 1961).

68. *Natomas*, 219 Cal. Rptr. at 78; see *Niesz v. Gorsuch*, 295 F.2d at 909 (case upon which *Natomas*' defendants relied for proposition that when plaintiff loses shareholder status upon completion of merger plaintiff also loses capacity to maintain derivative action).

69. *Niesz*, 295 F.2d at 911.

70. *Id.*

71. See *id.* at 295 F.2d at 913 (plaintiff lost capacity to maintain derivative action upon completion of merger).

72. *Natomas*, 219 Cal. Rptr. at 78; see *infra* notes 73-74 and accompanying text (drawing distinction between *Natomas* and *Niesz* decisions).

73. *Natomas*, 219 Cal. Rptr. at 78. In *Niesz v. Gorsuch* the corporation on whose behalf plaintiff had brought a derivative action was acquired by merger and could no longer be a party to the suit. *Niesz v. Gorsuch*, 295 F.2d 909, 911 (9th Cir. 1961). The United States Court of Appeals for the Ninth Circuit stated that the claim upon which the plaintiff had brought suit then belonged to the acquiring corporation because it had gained all of the assets of the acquired company. *Niesz*, 295 F.2d at 912. The Ninth Circuit held that the plaintiff, having become a shareholder of the acquiring corporation during the course of the merger, could not sue derivatively for the acquiring corporation's benefit if the acquiring corporation refused to intervene as plaintiff. *Id.* at 914.

74. *Natomas*, 219 Cal. Rptr. at 78.

75. *Natomas*, 219 Cal. Rptr. at 78-79; see *Niesz*, 295 F.2d at 913 (enumerating means available for saving cause of action upon abatement of derivative action). The Ninth Circuit in *Niesz* found two means by which the action could have continued after the merger and plaintiff Gorsuch's loss of standing. *Niesz*, 295 F.2d at 913. First, the surviving corporation could have intervened as party plaintiff. *Id.* The second alternative would have been for a shareholder of the surviving corporation to intervene as party defendant and then later join the surviving corporation. *Id.* The *Natomas* court found that the intervention of Diamond Shamrock as party plaintiff, however, was unlikely. *Natomas*, 219 Cal. Rptr. at 79. The *Natomas* court explained

court also recognized that the shareholder in the Ninth Circuit brought a derivative action alleging that the directors of the corporation had breached their fiduciary duty in actions unrelated to the merger while Gaillard based the derivative action in *Natomas* entirely upon the acts of management in connection with the merger.⁷⁶ The *Natomas* court explained that to bar the maintenance of a derivative action challenging the wrongful acts of management in concluding a merger because of the merger itself would lead to an inequitable result.⁷⁷

In support of the decision to allow Gaillard to maintain the derivative action, the *Natomas* court emphasized that a derivative suit is an equitable action and, therefore, in interpreting section 800 of the California Corporations Code the court must take into account the fairness of requiring continuous stock ownership.⁷⁸ The defendants in *Natomas* contended that an alternative to the maintenance of the present lawsuit existed in the form of a "double derivative" lawsuit.⁷⁹ The California Appellate Court defined a double derivative lawsuit as an action brought by a shareholder of a parent or holding company to enforce a cause of action in favor of the subsidiary company.⁸⁰ The *Natomas* court explained that in a double derivative suit the shareholder maintains a derivative action on behalf of the subsidiary when the directors of both the parent and the subsidiary have refused to enforce the action.⁸¹ In rejecting the double derivative suit as an alternative in

that, in *Niesz*, the plaintiff had not alleged that the surviving corporation had participated in the transactions of which plaintiff complained. *Id.* Thus, the *Natomas* court recognized the possibility of the surviving corporation in *Niesz* maintaining the action. *Id.* In contrast, the *Natomas* court noted that the plaintiff in *Natomas* had named the surviving corporation, Diamond, as a defendant allegedly responsible for the wrongful acts of which the plaintiff complained. *Id.* Thus, the *Natomas* court found that little possibility existed for the intervention of Diamond as a plaintiff to maintain the action against itself. *Id.*

76. *Natomas*, 219 Cal. Rptr. at 79.

77. *Id.* The *Natomas* court asserted that to hold that the merger could have the effect of destroying Gaillard's action would be equivalent to insulating management from liability by virtue of the merger which management had arranged. *Id.*; see also *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 591 n.12 (5th Cir. 1974) (inequitable to bar suit questioning legality of merger based on fact that merger results in loss of plaintiff-shareholder's interest in merged corporation); *Ramsburg v. American Inv. Co.*, 231 F.2d 333, 339 (7th Cir. 1956) (when merger achieved during action seeking to enjoin merger, court should preserve plaintiff-shareholder's status pending outcome of injunction proceeding); *Schlick v. Castle*, 19 Fed. R. Serv.2d 642, 644 (S.D.N.Y. 1974) (inequitable that former directors and surviving corporation are immune from derivative action for fraud in merger because merged corporation and plaintiff's interest therein no longer exist).

78. *Natomas*, 219 Cal. Rptr. at 79; see *supra* notes 75-77 and accompanying text (discussing *Natomas* court's equitable considerations); see *supra* note 55 and accompanying text (indicating *Natomas* court's liberal interpretation of legislative intent behind section 800 of California Corporation Code).

79. *Natomas*, 219 Cal. Rptr. at 79-80; see *infra* text accompanying notes 80-81 (defining double derivative suit).

80. *Natomas*, 219 Cal. Rptr. at 79-80 n.7; see also *WRIGHT & MILLER*, *supra* note 1, at § 1821, 294-95 (defining double derivative suit); *MOORE*, *supra* note 1, at 23.1-70 (same).

81. *Natomas*, 219 Cal. Rptr. at 79-80 n.7.

Natomas, the court stated that if Gaillard brought the action as a double derivative suit, a court would dismiss the action as moot.⁸² The *Natomas* court explained that a double derivative suit in the *Natomas* case would present a situation in which a corporation sued itself for the corporation's own benefit because of acts the corporation performed.⁸³ Moreover, the *Natomas* court stated that the filing of a double derivative suit by Gaillard would not have satisfied the contemporaneous ownership requirement of section 800 of the Corporation's Code.⁸⁴ The court determined that Gaillard was not a shareholder of Diamond at the time of the merger of which she complained and, therefore, a court would not have granted Gaillard standing to bring a double derivative action because Gaillard would not have satisfied the contemporaneous ownership requirement.⁸⁵ Therefore, the court in *Natomas* reversed the trial court's judgment of dismissal and concluded that when a plaintiff in a derivative action involuntarily loses shareholder status and abatement of the action leaves no feasible alternative remedy, the court should allow the action to proceed in the interests of equity.⁸⁶ Several cases support the *Natomas* court's decision providing that in a situation in which a defendant may gain from allegedly wrongful conduct upon abatement of plaintiff's derivative action, a court should allow the action to continue.⁸⁷ In

82. *Id.* at 80.

83. *Id.*

84. *Id.* In addition to finding that the filing of a double derivative suit would not satisfy the contemporaneous ownership requirement of section 800 of the California Corporation Code because Gaillard was not a shareholder in Diamond at the time of the merger of which she complained, the *Natomas* court also indicated that by filing a double derivative suit Gaillard would be subject to the assertion of defenses to which she was not previously subject. *Id.* Specifically, the *Natomas* court stated that if Gaillard filed a double derivative suit, she would be subject to the equitable defense of unclean hands. *Id.*

85. *Natomas*, 219 Cal. Rptr. at 80. The "operation of law" exception to section 800 of the California Corporations Code allows a plaintiff who acquires stock through a nonconsensual transaction after the alleged wrong has occurred to proceed with a derivative action. CAL. CORP. CODE § 800(b)(1) (1977 & Supp. 1986); WRIGHT & MILLER, *supra* note 1, at § 1828, 348. For example, the beneficiary of a will acquires shares through operation of law. See Phillips v. Bradford, 62 F.R.D. 681, 685 (S.D.N.Y. 1974) (court permitted beneficiary of will to sue as substitute plaintiff for redress of pre-acquisition wrongs). By operation of law implies the absence of voluntary action and, therefore, courts generally do not regard mergers and consequent transfers of stock to be "by operation of law." See United States v. Seattle-First National Bank, 321 U.S. 583, 587-88 (1944) (when merger occurs through voluntary acts of corporation, transfer of shares as consequence of merger not "by operation of law"); Emporium Capwell Co. v. Anglim, 140 F.2d 224, 226 (9th Cir. 1944) (transfer of stock to individual shareholders in connection with merger not exempt from stamp tax that exempts transfer of stock "by operation of law"); Weil v. United States, 115 F.2d 999, 1002 (9th Cir. 1940) (transfer of bonds to trustees not "by operation of law" when consent of two-thirds of certificate holders was necessary to effect passage of title). The "operation of law" exception guards against the possibility that a plaintiff acquired shares for the purpose of instituting a derivative lawsuit. WRIGHT & MILLER, *supra*, at § 1828, 348-49.

86. *Natomas*, 219 Cal. Rptr. at 80.

87. See Albert v. Salzman, 41 A.D.2d 501, 504, 344 N.Y.S.2d 457, 461 (1973) (court should allow derivative action to proceed when abatement of action would deprive shareholders

Albert v. Salzman,⁸⁸ a New York court noted concern over dismissing a meritorious derivative action because the plaintiff lost shareholder status when no feasible alternative existed.⁸⁹ In *Albert*, the court found that a plaintiff who had sold stock obtained in a merger subsequent to initiation of a derivative action could not proceed with the litigation.⁹⁰ The New York court, however, allowed another plaintiff to intervene and continue the litigation.⁹¹

In addition to considering whether alternative means exist by which to continue a derivative action, courts may take into account whether an alternative action would be barred by the statute of limitations.⁹² In *Abrams v. Occidental Petroleum Co.*,⁹³ the defendants argued that plaintiffs lacked standing to bring a derivative action because plaintiffs were no longer shareholders of Old Kern Corporation, having surrendered their shares in Old Kern for shares in Tenneco upon completion of a merger agreement.⁹⁴ The defendants in *Abrams* contended further that only New Kern, the surviving corporation, or New Kern's shareholders could reinstitute the suit.⁹⁵ The *Abrams* court, however, noted that if the court abated the existing derivative action, future action instituted by New Kern would be subject to dismissal based on the statute of limitations.⁹⁶ The New York court held that allowing the entire action to fail would be grossly inequitable.⁹⁷ Thus, the

of feasible alternative remedy); *Abrams v. Occidental Petroleum Co.*, 20 Fed. R. Serv.2d 170, 175 (S.D.N.Y. 1975) (court considered whether statute of limitations would bar plaintiffs from seeking redress for wrongs to corporation if court dismissed derivative action).

88. 41 A.D.2d 501, 344 N.Y.S.2d 457 (1973).

89. *Albert*, 344 N.Y.S.2d at 461.

90. *Id.*

91. *Id.* The court in *Albert v. Salzman* explained that the directors of Odell Corporation, the corporation in which plaintiff Albert was a shareholder, conducted a series of private negotiations with various officers of the Papercraft Corporation and as a result, the two corporations entered into a merger agreement. *Id.* at 459-60. Plaintiff Albert brought a derivative action alleging that the directors of Papercraft had gained illegal profits in connection with the merger. *Id.* at 458. The defendants moved to dismiss Albert's complaint on the grounds that Albert had sold his stock after Albert had instituted the suit. *Id.* The *Albert* court conceded that Albert could no longer maintain the derivative action. *Id.* However, the court allowed the intervention of Fine, another stockholder in Odell, to continue the action against the defendant directors. *Id.* at 462. The *Albert* court reasoned that a court should not preclude a valid action from proceeding because of the disqualification of the original plaintiff when another means is available for continuing the action. *Id.* The *Albert* court stated that a court invariably grants intervention for the purpose of survival of a derivative action. *Id.*

92. See *Abrams v. Occidental Petroleum Co.*, 20 Fed. R. Serv.2d 170, 175 (S.D.N.Y. 1975).

93. 20 Fed. R. Serv.2d 170 (S.D.N.Y. 1975).

94. *Abrams*, 20 Fed. R. Serv.2d at 170.

95. *Id.* at 172.

96. *Id.* at 175.

97. *Id.* at 173, 175. The *Abrams* court based the decision to allow plaintiffs to maintain the action after completion of a merger depriving plaintiffs of shareholder status on section 261 of title 8 of the Delaware Corporation Code. *Id.* at 173; DEL. CODE ANN. tit. 8, § 261 (1975). The *Abrams* court indicated that section 261 provided, in part, that any action pending at the

Abrams court allowed the plaintiffs to continue maintenance of the derivative action despite plaintiffs' technical loss of shareholder status.⁹⁸

The decisions of the *Natomas*, *Abrams*, and *Albert* courts recognizing an exception to the continuous ownership requirement in cases in which abatement of a derivative action would be inequitable are contrary to the great weight of established precedent.⁹⁹ Presently, a majority of courts hold that upon any disposition of a plaintiff's stock a court must dismiss a derivative action.¹⁰⁰ In recent years, however, several courts have recognized a distinction between the voluntary and involuntary loss of stock as a significant element in determining whether a plaintiff may proceed with a derivative action upon loss of shareholder status.¹⁰¹ For instance, a Texas court of appeals, in *Zauber v. Murray Savings Association*,¹⁰² asserted that when a plaintiff involuntarily loses shareholder status during the pendency of a derivative suit, the plaintiff may proceed with the derivative action.¹⁰³

In *Zauber*, the defendant Board of Directors authorized a reverse stock split¹⁰⁴ which rendered void the plaintiff's shareholder

time of the merger by or against a corporation that is a party to the merger shall be prosecuted as though the merger had not taken place. 20 Fed. R. Serv.2d at 173 n.2; DEL. CODE ANN. tit. 8, § 261 (1975).

98. *Id.* at 176.

99. *See, e.g.*, *Metal Techniques Corp.*, 74 Or. App. 297,_____, 703 P.2d 237, 242 (1985) (requiring ownership of stock for duration of shareholder derivative litigation); *Lewis v. Anderson*, 453 A.2d 474, 476 (Del. 1982) (general principles of Delaware law require that plaintiff maintain shareholder status during shareholder derivative litigation); *Yanow v. Teal Indus., Inc.*, 178 Conn. 263,_____, 422 A.2d 311, 323 (1979) (plaintiff must maintain shareholder status continuously until court renders judgment in derivative action); *Polish Am. Pub. Co. of Detroit v. Wojcik*, 280 Mich. 466,_____, 273 N.W. 771, 774 (1937) (court may dismiss shareholder derivative suit if plaintiff's stock passes from plaintiff during litigation); MOORE, *supra* note 1, at 23.1-17-23.1-19 (listing state court decisions and statutes that have adopted federal rule 23.1, which includes implied continuous ownership requirement); *infra* note 100 (federal courts upholding federal rule 23.1 with implied requirement of continuous stock ownership).

100. *See Lewis v. Chiles*, 719 F.2d 1044, 1047 (9th Cir. 1983) (equitable principles dictate that plaintiff retain ownership during litigation); *Lewis v. Knutson*, 699 F.2d 230, 238 (5th Cir. 1983) (only continuous proprietary interest serves to justify standing in derivative suit); *Portnoy v. Kawecky Berylco Indus., Inc.*, 607 F.2d 765, 767 (7th Cir. 1979) (shareholder who loses shareholder interest during suit may lose incentive to prosecute and, therefore, may not adequately defend the interests which he purports to represent); *Overberger v. BT Financial Corp.*, 106 F.R.D. 438, 441 (W.D. Pa. 1985) (plaintiff bringing derivative suit must remain shareholder throughout pendency of litigation).

101. *See Natomas*, 219 Cal. Rptr. at 76 (recognizing distinction between voluntary and involuntary loss of shareholder status); *Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270, 1274 (S.D.N.Y. 1983) (plaintiff in derivative action retains standing if loss of shareholder status is involuntary); *Zauber v. Murray Savings Assn.*, 591 S.W.2d 932, 938 (Tex. Civ. App. 1979) (recognizing possibility of maintenance of derivative suit if loss of shareholder status was involuntary); *infra* notes 102-126 and accompanying text (discussing *Arnett* and *Zauber*).

102. 591 S.W.2d 932 (Tex. Civ. App. 1979).

103. *Id.* at 932, 937-38.

104. *Id.* at 937. In a reverse stock split, a corporation generally reclassifies its shares at a ratio above the largest minority holding and then eliminates the fractional shares. *M. Lipton &*

status.¹⁰⁵ The *Zauber* court explained that the state statute governing standing requirements in derivative actions imposed requirements on a plaintiff in a derivative action similar to the requirements set forth in rule 23.1 of the Federal Rules of Civil Procedure, including a requirement of continuous stock ownership.¹⁰⁶ Nevertheless, the court in *Zauber* determined that rather than automatically dismissing a derivative action upon loss of plaintiff's shareholder status, a court should inquire into the cause of the deprivation of plaintiff's status.¹⁰⁷ In *Zauber*, the court acknowledged that when a plaintiff voluntarily disposes of stock during the course of the litigation, the plaintiff loses standing to maintain the action because the plaintiff's interests are no longer consistent with the interests of the corporation.¹⁰⁸ However, the *Zauber* court found that when the plaintiff loses shareholder status involuntarily through actions of corporate defendants, a court must determine whether the defendants acted with a valid business purpose or merely to defeat plaintiff's standing to maintain the suit.¹⁰⁹ The *Zauber* court stated that if a court of equity

E. Steinberger, TAKEOVERS & FREEZEOUTS (1986), § 9.03[3] at 9-13. A reverse stock split may require a charter amendment to reduce the number of authorized and outstanding shares. Dykstra, *The Reverse Stock Split—That Other Means of Going Private*, 53 CHI. KENT L. REV. 1, 3 (1976) (explaining reverse stock splits and consequences thereof); Lawson, *Reverse Stock Splits: The Fiduciary's Obligations Under State Law*, 63 CAL. L. REV. 1226, 1227 (1976) (same). Commentators explain that by authorizing a reverse stock split, a corporation can reduce the number of shares so that the minority shareholders have less than one share. Dykstra, *supra*, at 3; Lawson, *supra*, at 1227. The corporation then purchases the fractional shares and deprives the minority shareholders of continuing ownership. Dykstra, *supra*, at 3.

105. *Zauber*, 591 S.W.2d at 934. In *Zauber*, the stockholders held a meeting at which the stockholders authorized a reverse stock split by which one share of stock was to replace ten shares. *Id.* The plaintiff in *Zauber*, *Zauber*, was not present at the shareholders' meeting at which the shareholders authorized the reverse stock split. *Id.* The amended by-laws of the corporation provided that cash would be exchanged for fractional shares. *Id.* At the time of the alleged wrongful transaction, Murray Financial Corporation held 99,972 shares of the stock of Murray Savings & Loan, plaintiff *Zauber* held 6 shares, and another individual owned 22 shares. *Id.* After *Zauber* filed suit, Murray Financial purchased the 22 shares. *Id.* Upon completion of the reverse stock split, plaintiff would retain less than one share of stock which would effectively eliminate the plaintiff's shareholder status. *Id.* The plaintiff in *Zauber* refused to accept the cash payment. *Id.*

106. *Id.* at 936. The *Zauber* court noted that Article 5.14(B) of the Texas Business Corporation Act establishes standing requirements for derivative suits similar to the requirements of federal rule 23.1. *Id.*; see FED. R. CIV. P. 23.1 (federal rule governing derivative suits); 3A TEX. BUS. CORP. ACT ANN. art. 5.14(B) (Vernon 1980) (Texas law governing standing in shareholder derivative actions).

107. *Zauber*, 591 S.W.2d at 936-37.

108. *Id.* at 937.

109. *Id.* at 936-37. The *Zauber* court cited an Illinois case, *Teschner v. Chicago Title & Trust Co.*, to support the proposition that improper conduct on the part of corporate management may render the consequences of the conduct void. *Id.* at 938; see *Teschner v. Chicago Title & Trust Co.*, 59 Ill. 452, 458-59, 322 N.E.2d 54, 57 (1974) (court upheld reverse stock split when plaintiff failed to show improper purpose on part of defendant corporation). The Illinois court in *Teschner* stated that corporate action generally may terminate the interests of minority stockholders. 59 Ill.2d at 456. The *Teschner* court cautioned, however, that if improper conduct underlies a corporate action, a court may declare it invalid. *Id.* at 457. In

finds that no valid business purpose existed, the court must consider the loss of plaintiff's shareholder status insignificant and allow plaintiff to proceed with the derivative action.¹¹⁰

While the *Zauber* court focused on whether the defendants acted with a valid business purpose in causing a plaintiff to lose shareholder status, a New York court examining the voluntary-involuntary distinction for standing requirements in shareholder derivative suits concluded that three elements must exist before a court allows a plaintiff to proceed with a derivative action when the plaintiff loses shareholder status during the pendency of the litigation.¹¹¹ In *Arnett v. Gerber Scientific, Inc.*,¹¹² plaintiffs brought a derivative action in the United States District Court for the Southern District of New York alleging that the majority shareholders of Camsco, Incorporated breached a fiduciary duty in consummating a merger that plaintiffs claimed

Teschner, the court upheld a reverse stock split that resulted in the loss of plaintiff's shareholder status because the plaintiff failed to introduce evidence of an improper purpose on the part of the defendants for the reverse stock split. *Id.* at 459.

While the controlling shareholders of a corporation should not be hampered in managing the corporation, neither should minority shareholders be forced to relinquish interest in a corporation unless the proposed action has a genuine business purpose beyond the desire to freeze out minority shareholders. Comment, *Recent Developments in the Law of Corporate Freezeouts*, 15 B.C. IND. & COM. L. REV. 1252, 1256 (1973). Many states now allow shareholders to sue in equity to enjoin corporate action when bad faith or fraud can be shown. *Id.* at 1256. Ascertain the validity of the majority's purpose in conducting corporate affairs is very complex. Vorenberg, *Exclusiveness of the Dissenting Shareholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1193 (1963). Courts seeking to determine the validity of corporate conduct weigh the sufficiency of the business reason for the corporate action of which a minority shareholder complains against the harm the corporate action will cause the minority shareholder. *Close Corporations—Bad Faith of Majority*, 35 N.C. L. REV. 271, 273 (1957) [hereinafter cited as *Close Corporations*]. For instance, a court may find that the majority lacked a valid business purpose if a plaintiff shows that a transaction caused a substantial gain to majority shareholders and a concomitant loss to the minority shareholders without advantage to the corporation. *Close Corporations, supra*, at 273; see *Gaines v. Long Mfg. Co.*, 234 N.C. 340, 67 S.E.2d 350, 354 (1951) (court held that facts alleged were sufficient to show that issuance of stock that caused substantial decrease in value of plaintiff's stock was unnecessary). Courts also have questioned the motive of the majority when a transaction that resulted in a gain to the corporation could have been achieved by means less harmful to the minority shareholders. *Close Corporations, supra*, at 273; see *Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236, 240 (Del. 1953) (majority could have been more fair to minority without damaging interests of corporation by purchasing shares of minority at a higher price); Vorenberg, *supra*, at 1194-1204 (analyzing cases in which validity of business purpose is at issue).

110. *Zauber*, 591 S.W.2d at 938. The *Zauber* court explained that to allow the involuntary disposition of plaintiff's stock to preclude maintenance of a derivative action without inquiring as to whether corporate management acted with a valid business purpose would allow intentional destruction of plaintiff's shareholder status for the sole purpose of defeating plaintiff's standing to maintain a suit. *Id.* at 937-38.

111. See *Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270, 1274 (S.D.N.Y. 1983) (describing elements court should consider when determining whether to abate derivative action upon plaintiff's loss of shareholder status).

112. 566 F. Supp. 1270, 1273 (S.D.N.Y. 1983).

was not in the best interests of the corporation.¹¹³ As a remedy, the plaintiffs in *Arnett* sought, *inter alia*, rescission of the merger.¹¹⁴ The defendants in *Arnett* challenged plaintiffs' standing to bring a derivative action because plaintiffs would lose shareholder status after the merger.¹¹⁵ In analyzing the case, the district court first noted that federal law applied in *Arnett* because the plaintiffs sued derivatively under federal antitrust law.¹¹⁶ The *Arnett* court explained that a shareholder's capacity to vindicate a federally created corporate right is a right conferred solely by federal law and that Congress could not have intended that enforcement of federal law vary from state to state because of differing state policies regarding shareholder derivative actions.¹¹⁷ The *Arnett* court reasoned, therefore, that federal rule 23.1 governed plaintiffs' capacity to maintain a derivative action.¹¹⁸ After concluding that rule 23.1 was applicable, the district court in *Arnett* reasoned that denying plaintiffs standing to maintain a derivative action would allow an inequitable situation to exist in which corporate management could engage in wrongful conduct, so long as the wrongful conduct caused shareholders to lose shareholder status.¹¹⁹ Thus, the district court in *Arnett* denoted three

113. *Arnett*, 566 F. Supp. at 1271. The plaintiffs in *Arnett v. Gerber, Scientific Inc.* were minority shareholders in Camsco, Inc., a corporation whose majority shareholder was Sulzer Brothers Ltd. *Id.* at 1271. Three named individual defendants were employees of Sulzer and members of Camsco's board of directors. *Id.* Corporate defendants included Gerber Scientific, Inc. (GSI), a publicly-owned holding company, and Gerber Garment Technology, Inc. (GGT), a wholly-owned subsidiary of GSI. *Id.* As part of a plan of GSI and GGT to drive Camsco out of business in order to monopolize the market, GGT purchased Sulzer's interest in Camsco. *Id.* Subsequently, Camsco merged with Newco. *Id.* Sulzer consummated the sale of its interest to GGT despite repeated assurances to the board of directors of Camsco that Sulzer would not sell its share of Camsco to GGT. *Id.* Plaintiffs and other minority shareholders were to receive cash upon surrender of their stock certificates in Camsco. *Id.* Before surrendering their stock certificates, plaintiffs brought a derivative action on behalf of Camsco. *Id.*

114. *Id.* The plaintiffs in *Arnett* sought money damages and divestiture of Camsco by the acquiring corporation, GGT. *Id.* Alternatively, the *Arnett* plaintiffs sought rescission of the merger. *Id.*

115. *Id.* at 1271.

116. *Id.* at 1278; see Clayton Act, 15 U.S.C. § 18 (1982) (prohibiting acquisition by corporation of whole or part of assets of another corporation when effect may substantially lessen competition or tend to create monopoly); Securities Exchange Act, 15 U.S.C. § 10(b) (1982) (preventing manipulative or deceptive practices in connection with purchase or sale of securities); Sherman Act, 15 U.S.C. § 2 (1982) (prohibiting monopolies in restraint of trade or commerce); see *Orenstein v. Compusamp*, 19 Fed. R. Serv.2d 466, 467 (S.D.N.Y. 1974) (federal law controls whether plaintiff has standing to bring derivative action under rule 23.1 when plaintiff's cause of action is for violation of federal laws).

117. 566 F. Supp. at 1272. The *Arnett* court noted that state standing rules apply to derivative actions involving state substantive claims. *Id.* The court further noted, however, that when a plaintiff in a derivative action brings a claim under federal law, federal law determines plaintiff's standing to assert the claim. *Id.* The court indicated that the plaintiffs in *Arnett* brought a derivative action under federal antitrust law and, therefore, the court should not apply New York state law to determine whether plaintiffs had standing to maintain the derivative action. *Id.*

118. *Id.* at 1272.

119. *Id.* at 1273.

elements the presence of which would accord a plaintiff standing to maintain a derivative action even though the plaintiff was no longer a shareholder.¹²⁰ The *Arnett* court stated that the first element was whether the plaintiff involuntarily lost stock ownership.¹²¹ The second element according to the *Arnett* court's formulation was whether the plaintiff's loss of stock ownership was related to the defendant's allegedly wrongful acts.¹²² The district court in *Arnett* articulated that the final element was whether the remedy sought would result in plaintiff regaining his shareholder status.¹²³ The *Arnett* court asserted that, when a court finds the three elements present, a court may decide that allowing plaintiffs standing to proceed with the litigation does not conflict with the continuous ownership requirement of rule 23.1.¹²⁴ The *Arnett* court stated that the purpose behind the implied continuous ownership requirement in rule 23.1 was to ensure that the plaintiff had an incentive to vigorously pursue the claim on behalf of the corporation.¹²⁵ The *Arnett* court emphasized that its decision did not undermine the purpose behind rule 23.1 because when the corporate injury and the shareholder's right to rescission arise out of the same transaction, the interests of the plaintiff are consistent with the interests of the corporation, which ensures that the plaintiff adequately will defend the corporation that the plaintiff purports to represent.¹²⁶

Courts increasingly have begun to recognize that, in the interests of equity, courts must sometimes fashion exceptions to the continuous ownership requirement.¹²⁷ Even state courts that strictly adhere to the implied

120. *Id.*; see *infra* text accompanying notes 121-123 (describing three elements courts should consider when determining whether to allow derivative action to proceed). The *Arnett* court expressed no opinion as to whether a plaintiff could maintain a derivative action if fewer than three of the enumerated elements were present. *Arnett*, 566 F. Supp. at 1273.

121. *Arnett*, 566 F. Supp. at 1273. The *Arnett* court explained that to allow a derivative action to be discontinued when a plaintiff involuntarily disposed of shares in a corporation would be tantamount to insulating corporate management from liability for wrongful acts when the wrongful acts deprived a shareholder of his stock. *Id.* The court in *Arnett* reasoned that it would be unconscionable to deprive a shareholder of standing to maintain an action before the shareholder can complain of management's wrongful conduct. *Id.*

122. *Id.* at 1273.

123. *Id.* at 1273. The rationale behind the third of the *Arnett* court's three elements, restoration of shareholder status, is presumably that a plaintiff who stands to regain shareholder status upon a favorable judgment has the requisite interest to prosecute the action zealously in accord with the policy behind the continuous ownership requirement. *Id.*

124. *Arnett*, 566 F. Supp. at 1273.

125. *Id.*

126. *Id.* The *Arnett* court reasoned that if the plaintiffs successfully obtained a favorable judgment, the court would restore plaintiffs' shareholder status and require defendants to pay damages to the corporation. *Id.* Therefore, the *Arnett* court concluded that refusing to dismiss the action did not violate the policy of rule 23.1 because plaintiffs had an incentive to prosecute the action vigorously. *Id.*; see also *Schupack v. Covelli*, 498 F. Supp. 704, 706 (W.D. Pa. 1980) (when shareholder's right to rescission arose out of alleged wrongdoing for which plaintiff brought derivative action, plaintiff's right to rescission sufficient to confer standing).

127. See *Natomas*, 219 Cal. Rptr. at 79 (recognizing exception to continuous ownership requirement when plaintiff involuntarily lost shareholder status through forced sale upon merger); *Albert*, N.Y.S.2d at 461 (allowing derivative action to proceed despite loss of share-

continuous ownership requirement of federal rule 23.1 have conceded that when corporate management performs acts for the sole purpose of depriving a plaintiff shareholder of standing to maintain an action, a court of equity must protect the shareholders by allowing the action to continue.¹²⁸ Allowing a plaintiff-shareholder to continue a derivative action in cases when corporate defendants wrongfully deprive a plaintiff of shareholder status does not contravene the policy underlying the continuous ownership requirement.¹²⁹ Requiring continuous stock ownership guarantees that a plaintiff in a derivative action will have a proprietary interest in the corporation that will motivate a plaintiff to engage in a zealous prosecution.¹³⁰ When a judgment

holder status when no feasible alternative remedy existed); *Abrams*, 20 Fed. R. Serv.2d at 175 (plaintiff may maintain derivative action in spite of loss of stock ownership when statute of limitations barred subsequent litigation).

128. See *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. Sup. 1970), *cert. denied*, 398 U.S. 921 (1971). In *Bokat v. Getty Oil Co.*, the Delaware Supreme Court recognized that, in extreme cases, equitable circumstances may justify permitting a plaintiff to maintain a pending derivative action despite the loss of shareholder status. *Id.* The *Bokat* court indicated that if a proposed merger was used to cover up wrongful acts of management, then a court of equity must protect the shareholders and permit the action to continue. *Id.*; see also *Independent Investors Protective League v. Time, Inc.*, 50 N.Y.S.2d 259, 263-64, 406 N.E.2d 486, 487 (1980) (court invoked equitable powers to allow shareholders to maintain derivative action after dissolution of corporation because management breached fiduciary duty in connection with takeover).

129. See *supra* note 31 and accompanying text (describing policies underlying continuous ownership requirement). The policy underlying the continuous ownership requirement seeks to ensure an adequate and vigorous representation of the corporation's right of action. See *Gresov v. Shattuck Denn Mining Corp.*, 40 Misc.2d 569, 571, 243 N.Y.S.2d 760, 763 (1963) (explaining logic behind continuous ownership requirement). The *Gresov* court explained that the plaintiff in a derivative action is suing as the representative of shareholders similarly situated. *Id.* Once a plaintiff in a derivative action loses his shareholder status he may lose his interest in the corporation. *Id.* A plaintiff may not prosecute an action as the representative of a class to which he does not belong and with whom he has no consistent interests. *Id.*; see also *Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270, 1273 (S.D.N.Y. 1983) (holding that minority shareholder frozen out by merger may retain standing without violating continuous ownership requirement); *Schupack v. Covelli*, 498 F. Supp. 704, 706 (1980) (allowing action seeking rescission of merger to continue despite loss of shareholder status did not undermine policy behind standing requirements); *Schreiber v. Carney*, 447 A.2d 17, 22 (Del. 1982) (equity interest in corporation remained the same and denial of standing would not advance stated purpose of rule when plaintiff's disposition of stock was involuntary); *Independent Investors Protective League v. Time, Inc.*, 406 N.E.2d 486, 488 (1980) (shareholder of allegedly wrongfully dissolved corporation had sufficient interest to satisfy spirit of rule 23.1).

130. See *Portnoy v. Kawecky Berylco Indus., Inc.*, 607 F.2d 765, 767 (7th Cir. 1979) (shareholder who loses shareholder interest during suit may lose incentive to prosecute action). The Seventh Circuit in *Portnoy* stated that the rationale underlying derivative actions is that the shareholder has reason to litigate vigorously the action because the shareholder will receive an indirect benefit from a judgment favorable to the corporation on whose behalf the plaintiff brings the claim. *Id.* The *Portnoy* court explained that financial benefit to a corporation ultimately benefits the shareholders of the corporation and thus, a judgment favorable to the corporation also is favorable to the stockholders. *Id.*; see *Lewis v. Chiles*, 719 F.2d 1044, 1047 (9th Cir. 1983) (derivative action reflects shareholder's real interest in increasing value of plaintiff-shareholder's stock).

in favor of the corporation could result in reinstatement of shareholder status, however, reinstatement provides an adequate incentive for a plaintiff to litigate zealously.¹³¹ Moreover, a derivative suit is equitable in nature and courts should perform more than a mere technical application of the continuous ownership requirement before abating a derivative action.¹³²

Since a derivative action is equitable in nature, a court must take into account the particular circumstances in each case when determining whether a court should preclude a plaintiff who loses shareholder status during the course of the litigation from proceeding with the action.¹³³ The *Natomas*, *Arnett*, *Zauber*, *Abrams*, and *Albert* courts have recognized that equitable considerations may outweigh a per se requirement of continuous stock ownership in every instance.¹³⁴ The absence of a present proprietary interest in a corporation does not necessarily mean that a plaintiff has no stake in the outcome of the litigation such that a plaintiff cannot adequately prosecute the corporation's right of action and represent the interest of similarly situated shareholders.¹³⁵ Thus, when a plaintiff loses shareholder status during the pendency of the litigation, courts should allow equity to be a factor in determining whether to abate a derivative action rather than mechanically applying the continuous ownership requirement which could result in an inequitable denial of standing.

LISA M. MILANI

131. See *Arnett*, 566 F. Supp. at 1273 (plaintiff who stands to regain shareholder status upon favorable judgment has adequate incentive to litigate vigorously); see *supra* notes 129-130 and accompanying text (policy behind continuous ownership requirement seeks to ensure adequate representation of shareholders' interests).

132. See *Natomas*, 219 Cal. Rptr. at 80 (mechanical application of federal rule 23.1 could create inequitable result of permitting defendant's wrongful conduct to go unredressed); *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. Sup. 1970) (equity may allow maintenance of derivative action despite plaintiff's loss of shareholder status); *Willcox v. Stern*, 273 N.Y.S.2d 38, 45, 219 N.E.2d 401, 405 (1966) (equitable considerations may lead to conclusion that shareholders of merged corporation do not always lose capacity to sue derivatively).

133. See *supra* text accompanying notes 109 & 121-123 (describing factors court should consider when determining standing of plaintiff upon plaintiff's loss of stock).

134. See *Arnett*, 566 F. Supp. at 1273 (noting distinction between voluntary and involuntary loss of shareholder status); *Abrams*, 20 Fed. R. Serv.2d at 175 (plaintiff may maintain derivative action in spite of loss of stock when statute of limitations bars subsequent reinstatement of suit); *Zauber*, 591 S.W.2d at 937-38 (recognizing distinction between voluntary and involuntary loss of plaintiff's shares during derivative action); *Natomas*, 219 Cal. Rptr. at 79 (holding involuntary loss of shareholder status may not be cause to abate derivative action); *Albert*, 344 N.Y.S.2d at 461 (allowing derivative action to proceed despite loss of shareholder status when no feasible alternative remedy existed).

135. See *supra* note 134 and accompanying text (loss of shareholder status does not necessitate abatement of action when failure to abate would not undermine purpose of continuous ownership requirement).

