CHAPTER EIGHT

SHAREHOLDER SUITS

Section 8.01 Shareholder Actions Against Corporation, Generally

There are three basic types of lawsuits between a shareholder and the corporation:

A. The first occurs when a shareholder seeks to enforce a personal right against the corporation. In such a case, a shareholder may sue the corporation is his/her individual capacity and any remedy accrues to the shareholder's personal benefit. Such actions include lawsuits to require inspection of corporate records, lawsuits to recover dividends already declared, and lawsuits to enforce contractual rights between a shareholder and a corporation. Individual suits are discussed in Section 8.02 of this Chapter.

B. The second type of shareholder lawsuit occurs when a shareholder sues a third party (including a corporate officer or director) seeking to enforce a right held by the corporation, or all shareholders as a group. In such a case, after demand, the shareholder sues the third party, but includes the corporation as a nominal defendant. Such lawsuits are known as "derivative" lawsuits. Derivative lawsuits are discussed in Section 8.04 of this Chapter.

C. The third type of lawsuit between a shareholder and the corporation is a judicial appraisal action described in RCW 23B.13.300. Such suits arises out of a shareholder's right to dissent pursuant to RCW 23B.13.020. Such lawsuits must be initiated by the corporation. Judicial appraisal actions are discussed in Section 8.05 of this Chapter.

Lastly, there has been a trend toward permitting individual actions between shareholders of closely held corporations in situations where, in a more widely-held corporation, such claims could only be brought derivatively. This trend is discussed in Section 8.03 of this Chapter.

Section 8.02 Individual Claims

A. General rule - shareholders may not sue individually to enforce rights of corporation or of all shareholders, as a group.

As a general rule, a shareholder may not sue a third party directly to enforce a right possessed by the corporation.

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

A shareholder may only sue a third party to enforce an individual

right owned by that shareholder.

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

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

For instance, a shareholder who is seeking to recover for corporate waste or for the misappropriation of corporate funds may do so only derivatively. RCW 23B.07.400; *Smith v. Bramwell*, 146 Or 611, 31 P2d 647 (1934).

There are at least four reasons underlying this basic rule:

> In the instant case, the reasons requiring derivative suits do not exist. The reasons underlying the general rule are that 1) it prevents a multiplicity of lawsuits by shareholders; 2) it protects corporate creditors by putting the proceeds of the recovery back in the corporation; 3) it protects the interests of all shareholders by increasing the value of their shares, instead of allowing a recovery by one shareholder to prejudice the rights of others not a party to the suit; and 4) it adequately compensates the injured shareholder by increasing the value of his shares. (citations omitted) *Thomas v. Dickson*, 250 Ga 772, 774, 301 SE2d 49, 51 (1983).

Even though a shareholder owns substantially all of a corporation's stock, the shareholder still may not bring an individual action, but instead, must assert such claims in a derivative lawsuit. *Zimmerman v. Kyte*, 53 Wash App 11, 765 P2d 905 (1988); *Dale v. City Plumbing & Heating Supply Co.*, 112 Ga App 723, 146 SE2d 349 (1965).

This is true even when the injury to the corporation has brought about a decrease in the value of the shareholder's shares. *Lee v. Mitchell*, 152 Or App 159, 953 P2d 414 (1998); *Weiss v. Northwest Acceptance Corp.*, 274 Or 343, 546 P2d 1065 (1975). *But see: Wills v. Nehalem Coal Co.*, 52 Or 70, 96 P 528 (1908).

B. Individual contract claims against corporation.

A shareholder may enter into a contract with, or loan money to, the corporation in the shareholder's individual capacity in much the same manner as may any other corporate creditor. *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934); *Grunden v. German*, 110 Wash 237, 188 P 491 (1920); *Bellaire Securities Corp. v. Brown*, 124 Fla 47, 168 So 625 (1936). When a shareholder sues to enforce that contract or to foreclose on corporate property, the shareholder does so in an individual capacity. *Myers v. Indiana Mining Co.*, 86 Or 664, 168 P 719 (1917). But, a corporation's debt to a shareholder may sometimes be subordinated to the corporation's third party debts. RCW 23.72.010 *et seq*; 11 USC § 510; *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 44, 444 P2d 564 (1968); *Gannett Co. v. Larry*, 221 F2d 269 (2d Cir 1953); *Taylor v. Standard Gas Co.*, 306 US 307 (1939); H.W. BALLANTINE, BALLANTINE ON CORPORATIONS § 129 (1946).

C. Claims when third party owes direct duty to both corporation and shareholder.

If a third party owes a direct duty the shareholder, the shareholder has an individual claim against a third party, rather than a derivative claim, even though the third party may also owe a duty to the corporation.

> It is well-settled that only a corporation and not its shareholders can complain of an injury sustained by, or a wrong done to, the corporation. However, this general principle has no application where the wrongful acts are not only against the corporation but are also violations of a duty arising from contract or otherwise owed directly by the wrongdoer to the shareholder. A suit brought by a shareholder on a personal claim is distinguishable from a proceeding to recover damages or other relief for the corporation. (citations omitted) *Adair v. Wozniak*, 23 Ohio St3d 174, 492 NE2d 426, 428 (1986).

See also: Wills v. Nehalem Coal Co., 52 Or 70, 96 P 528 (1908).

"It is well settled that an individual cause of action can be asserted when the wrong is both to the stockholder as an individual and to the corporation." *Far West Federal Bank, SB v. Office of Thrift Supervision-Director*, 119 F3d 1358, 1364 (9th Cir 1997)(permitting a direct action by shareholders against third party).

A breach of duty to the corporation by a third party may also give rise to a claim by an individual shareholder when the third party owes some "special duty" to the shareholders or if the shareholders sustains a "special injury."

> While a stockholder cannot generally sue as an individual for damages arising from a contract between the corporation and a third party, a

> stockholder may sue individually when the injury resulted from the violation of a special duty to the stockholder that was independent from his status as a stockholder, even when the corporation may have a similar cause of action. (citation omitted) *Hanson v. Shim*, 87 Wash App 538, 551, 943 P2d 322, 329 (1997).

The Delaware courts have address the issue of "special injury" on several occasions.

> In *Elster v. American Airlines, Inc.*, Del Ch, 100 A2d 219 (1953), this Court held that an individual action may be maintained if the stockholder sustained a "special injury" and in *Moran* the standard was articulated as follow:
>
> > To set out an individual action, the plaintiff must allege either an injury which is separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation.
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> *Moran v. Household International, Inc.*, 490 A2d at 1070. Most recently, the Delaware Supreme Court explained:
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> > In comparing the two-prong test of *Moran* with the definition of the term "special injury" in *Elster*, it appears that the term encompasses both prongs of the *Moran* test. That is, a plaintiff alleges a special injury and may maintain an individual action if he complains of an injury distinct from that suffered by other shareholders or a wrong involving one of his contractual rights as a shareholder. Moreover, while *Moran* serves as a quite useful guide, the case should not be construed as establishing the only test for determining whether a claim is derivative or individual in nature. Rather, as was established in *Elster*, we must look ultimately to whether the plaintiff has alleged "special injury" in whatever form.
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> *Rabkin v. Philip A. Hunt Chemical Corp.*, 547 A2d 963, 968-9 (Del Ch 1986)(also quoting *Lipton & Ceasar v. News International*, 514 A2d 1075, 1078).

A shareholder may have an individual claim when both the corporation and the shareholder are parties to a contract with a third party and the third party breaches that contract. *Sacks v. American Fletcher National Bank and Trust Co.*, 258 Ind 189, 279 NE2d 807 (1972); *Fleming v. Reed*, 77 NJL 563, 72 A 299 (1909). This may also true where the shareholder guarantees a corporate debt. *Knauf Fiber Glass, GmbH v. Stein*, 622 NE2d 163 (Ind 1993).

> As an exception to the general rule, a stockholder may maintain an action in his own right against a third party (although the corporation may likewise have a cause of action for the same wrong) when the injury to the individual resulted from the violation of some special duty owed to the stockholder but only when that special duty had its origin in circumstances *independent* of the stockholder's status as a stockholder. (emphasis in original) *Hunter v. Knight, Vale & Gregory*, 18 Wash App

> 640, 646, 571 P2d 212, 216 (1977).

In such a case, both the shareholder and the corporation have a claim against the third party.

***D. Individual claims for declared dividends*.**

Generally, a shareholder has no right to force a corporation to declare a dividend. *Zidell v. Zidell, Inc.*, 277 Or 413, 560 P2d 1086 (1977); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917). Yet, if a shareholder has a contract right to require the corporation to declare a dividend, the shareholder's claim is an individual action. *Walters v. Center Electric, Inc.*, 8 Wash App 322, 506 P2d 883 (1973).

Once a dividend is declared by the board of directors, the right to payment is a personal right in the person who owned the stock on the date that the dividend was declared. RCW 23B.06.400(5); *McJannet v. Strehlow Supply Co.*, 25 Wash 2d 468, 171 P2d 684 (1946); *Gellerman v. Atlas Foundry & Machine Co.*, 45 Wash 114, 87 P 1059 (1906).

> [A] dividend properly declared by the directors of a corporation cannot subsequently be revoked; and that persons who are shareholders at the time the dividend is declared have a legal claim against the company for the payment of the amount of the dividend; and that, after profits have been set apart and appropriated to the payment of the dividends, they belong to the shareholders, and cannot be recalled, even though the company should suffer losses and become insolvent before the dividend is actually paid. *Albany Fertilizer & Farm Improvement Co. v. Arnold*, 103 Ga 145, 148, 29 SE 695, 696 (1897).

See also: Mann-Paller Foundation, Inc. v. Econometric Research, Inc., 644 F Supp 92 (1986); *Cowin v. Bresler*, 741 F2d 410 (DC Cir 1984); *Cole Real Estate Corp. v. Peoples Bank and Trust Co.*, 160 Ind App 88, 310 NE2d 275 (1974).

***E. Inspection of corporate records*.**

Cases brought to force a corporation to grant a shareholder access to corporation records, brought under common law or under earlier versions of the inspection statute, were typically brought as mandamus actions. *State ex rel Paschall v. Scott*, 41 Wash 2d 71, 247 P2d 543 (1952); *State ex rel Grismer v. Merger Mines Corp.*, 3 Wash 2d 417, 101 P2d 308 (1940). Under the present statute, RCW 23B.16.040, it would appear that a shareholder can bring such a claim as an individual action in his/her own name. Other states permit this such suits. *Babbitt v. Pacco Investors Corp.*, 246 Or 261, 425 P2d 489 (1967).

F. Action seeking judicial dissolution.

Another action which may be brought individually, rather than derivatively, is an action pursuant to RCW 23B.14.300(2) which seeks the judicial dissolution of the corporation, the appointment of a receiver, the repurchase of shares, the removal of a director, or other relief specified in the statute. Both are actions to enforce individual rights, not derivative rights. *Ostlind v. Ostlind Valve, Inc.*, 178 Or 161, 165 P2d 779 (1946).

G. Action to compel stock transfer.

If a shareholder seeks to compel a corporate officer to register a stock transfer, the shareholder should bring a mandamus action against the officer. *Hern v. Looney*, 90 Wash App 519, 959 P2d 1116 (1998).

Section 8.03 Special Case - Closely Held Corporations

For close corporations, some states apply different rules to determine whether a shareholder's claim is an individual claim or if it must be brought derivatively.

> Where majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit, such breach, absent legitimate business purpose, is actionable. Where such breach occurs, the minority shareholder is individually harmed.
>
> Accordingly, we hold that claims of a breach of fiduciary duty alleged by minority shareholders against shareholders who control a majority of shares in a close corporation, and use their control to deprive minority shareholders of the benefits of their investment, may be brought as individual or direct actions and are not subject to the provisions of [the civil court rules related to derivative lawsuits]. *Crosby v. Beam*, 47 Ohio St3d 105, 548 NE2d 217, 221 (1989).

See also: Steelman v. Mallory, 110 Idaho 510, 716 P2d 1282 (1986).

In such circumstances, other courts grant a minority shareholder of a close corporation the option of asserting such claims either directly or derivatively.

> When the majority shareholders of a closely held corporation use their control over the corporation to their own advantage and exclude the minority from the benefits of participating in the corporation, absent a legitimate business purpose, the actions constitute a breach of their fiduciary duties of loyalty, good faith and fair dealing. Because actions such as those alleged in this case result in both derivative and individual harm, an action brought by minority shareholders may proceed as a derivative or a direct action. *Noakes v. Schoenborn*, 116 Or App 464, 472, 841 P2d 682, 687 (1992).

See also: Wulf v. Mackey, 135 Or App 655, 899 P2d 755, *review denied*, 322 Or 168, 903 P2d 886 (1995).

Other courts reject applying different rules in the case of close corporations and require that such lawsuits be filed derivatively, unless the minority shareholder has suffered a "special injury" or can allege a "special duty."

> Ohio, like a few other states, has expanded the "special injury" doctrine into a general exception for closely held corporations, treating then as if they were partnerships. The American Law Institute recommends that other states do the same. *Principles of Corporate Governance* § 7.01(d) and pp. 22-25 (comment), 30-36 (reporter's note). The premise of this extension may be questioned. Corporations are *not* partnerships. Whether to incorporate entails a choice of many formalities. Commercial rules should be predictable; this objective is best served by treating corporations as what they are, allowing the investors and other participants to vary the rules by contract if they think deviations are warranted. So it is understandable that not all states have joined the parade.
>
> Delaware, for one, has not. When the controlling stockholder of a family corporation transferred its assets for independent consideration, Delaware required the minority investors to pursue derivative litigation, observing that the value of the minority shares went down only to the extent the corporation as an entity was worth less. When the owner of 95% of a closely held firm's stock proposed to liquidate the corporation at what the minority thought was an inadequate price, Delaware again required the minority to bring the objection derivatively. In neither case did the Chancellor think it important that the wrong alleged involved the controlling stockholder enriching itself at corporate expense, or that the corporation was closely held. The author of the leading treatise treats [the second Delaware case cited] as establishing the proposition that the closely held nature of the corporation is irrelevant to the distinction between direct and derivative actions. (citations omitted) *Bragdon v. Bridgestone/Firestone, Inc.*, 916 F2d 379, 383-4 (7th Cir 1990), *cert denied*, 500 US 952 (1991).

See also: Frank v. Hadesman & Frank, Inc., 83 F3d 158 (7th Cir 1996).

This author has been unable to find a Washington case which directly addresses the rule to be applied in disputes initiated by a shareholder of a closely held corporation.

> **NOTE:** Often, controlling shareholders will also control the corporation in their capacity as officers and directors. When control persons transfer corporate assets to themselves for inadequate consideration, it may be difficult to discern whether they did so as controlling shareholders (giving rise to a direct action) or as officers and directors (giving rise to a derivative action only). Direct actions by minority shareholders against those in control of the corporation should be pled as actions against a controlling shareholder for the breach of fiduciary duty owed as a "controlling shareholder"; actions pled against control persons in their capacity

as officers or directors will likely be construed as a derivative claim only. This is particularly true if Washington does not follow the ALI approach by adopting different rules for closely held corporations.

Section 8.04 Derivative Lawsuits

A. Generally.

The Washington courts have long held that a shareholder may not directly sue a third party to enforce a right held by the corporation.

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

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

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

See also: Goodwin v. Castleton, 19 Wash 2d 748, 763, 144 P2d 725, 732 (1944); *Opportunity Christian Church v. Washington Water Power Co.*, 136 Wash 2d 116, 238 P2d 641 (1925); *Dant & Russell, Inc. v. Ostlind*, 148 Or 204, 35 P2d 668 (1934); *Smith v. Bramwell*, 146 Or 611, 31 P2d 647 (1934).

Typically, a derivative lawsuit is brought by a shareholder because the corporation has not, and will not, initiate a lawsuit against a third party on its own behalf. *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946). If a shareholder demands that the corporation initiate a lawsuit in

its own name, and if the corporation agrees and subsequently files the demanded lawsuit against the third party in the corporation's own name, no derivative lawsuit is necessary or permitted.

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

But when a shareholder makes demand and the corporation refuses to bring a lawsuit, and that refusal is itself improper, courts will permit the shareholder to seek to enforce the corporate right through a "derivative" lawsuit.

In a derivative lawsuit, a shareholder sues both the corporation and a third party. The third party is the "real" defendant; the corporation is included in the lawsuit only as a nominal defendant. In a derivative lawsuit, the plaintiff-shareholder seeks a remedy against the third party defendant only; the plaintiff does not seek damages from the corporation, even though the corporation is a defendant. In fact, the plaintiff shareholder usually is not personally entitled to any damages awarded; any funds recovered from that third party are usually payable only to the corporation.

Most cases hold that the corporation is a necessary party in a derivative lawsuit. *Howell v. Fisher*, 49 NC App 488, 272 SE2d 19 (1980); *Rose v. Schantz*, 56 Wis2d 222, 201 NW2d 593, 598 (1972); *Smyly v. Smith*, 216 Ga 529, 118 SE2d 188, 189 (1961).

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

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

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

> As frequently expressed judicially, a stockholder bringing a derivative action occupies a strictly fiduciary relationship to the corporation whose interests he assumes to represent, and his position in the litigation is in a legal sense the precise equivalent of that of a guardian ad litem, while

> the position of the corporation is the equivalent of the status of a ward or beneficiary. *Goodwin v. Castleton*, 19 Wash 2d 748, 763, 144 P2d 725, 732 (1944).

Another case states that in a derivative action, "the corporation is the real party in interest and the minority stockholder who brings the action is at best only a nominal plaintiff seeking to enforce the right of the corporation against a third party." *Walters v. Center Electric, Inc.*, 8 Wash App 322, 506 P2d 883, 888 (1973). *See also: Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Cohen v. Beneficial Industrial Loan Corp.*, 337 US 541 (1949).

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

The development of derivative lawsuits is discussed in *Ross v. Bernard*, 396 US 531 (1970), in *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946), and in Prunty, *The Shareholders' Derivative Suit: Notes on Its Development*, 32 NYU L REV 980 (1957).

B. Equitable action; extraordinary remedy.

A derivative lawsuit is an equitable action. *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032 (1987), *amended*, 750 P2d 1032 (1988); *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Moore v. Los Lugos Gold Mines*, 172 Wash 570, 601, 21 P2d 253 (1933); *Elliott v. Puget Sound Wood Products Co.*, 52 Wash 637, 101 P 228 (1909); *Barrett v. Southern Connecticut Gas Co.*, 172 Conn 362, 374 A2d 1051 (1977); *Florik v. Florida Land Sales Board*, 206 So2d 41 (Fla App 1968); *Rebstock v. Lutz*, 39 Del Ch 25, 158 A2d 487 (1960); *Schultz v. Highland Gold Mines Co.*, 158 F 337 (D Or 1907). This is true even though the only relief sought on behalf of the corporation is money damages and even though the corporation, if it had brought the lawsuit itself, would have brought the case as an action at law. *Griffin v. Carmel Bank & Trust Co.*, 510 NE2d 178 (Ind App 1987). There may be a right to a trial by jury under the Seventh Amendment if the corporation's claim against the true defendant is an action at law. *Ross v. Bernhard*,

396 US 531 (1970).

A derivative lawsuit is an extraordinary remedy which generally is available to shareholders only when they have no other right to redress. *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972); *Bell v. Arnold*, 175 Colo 277, 487 P2d 545 (1971); *Winter v. Farmers Educational & Cooperative Union of America*, 259 Minn 257, 107 NW2d 226, 233 (1961). "Derivative suits are disfavored and may be brought only in exceptional circumstances." *Haberman v. Washington Public Power Supply System*, 109 Wash 2d 107, 147, 744 P2d 1032, 1060 (1987), *amended*, 750 P2d 254 (1988). This is true, in part, due to the strong judicial tendency to defer to the business judgment of corporate management and, in part, due to perceived abuses which may occur in a derivative suit, particularly derivative lawsuits against public corporations. As a consequence, courts impose a number of procedural requirements regarding derivative lawsuits, some of which have been codified in RCW 23B.07.400 and Superior Court Civil Rules (CR) § 23.1. *See also:* Federal Rules of Civil Procedure Rule 23.1.

C. Who may bring suit: contemporaneous ownership of shares.

In order to bring a derivative lawsuit over a transaction, a person must be a shareholder of the corporation at the time of the transaction. *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946).

RCW 23B.07.400(1) provides:

> A person may not commence a proceeding in the right of a domestic or foreign corporation unless the person was a shareholder of the corporation when the transaction complained of occurred or unless the person became a shareholder through transfer by operation of law from one who was a shareholder at that time.

Superior Court Civil Rule 23.1 contains a similar requirement. CR 23.1 provides:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . , the complaint shall be verified and shall allege (a) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (b) that the action is not a collusive one to confer jurisdiction on a court of this state which it would not otherwise have.

A person need not necessarily be a shareholder of record in order to bring a derivative lawsuit. An equitable interest may be sufficient. *Rosenfeld v. Schwitzer Corp.*, 251 F Supp 758 (SD NY 1966)(construing Indiana law). A widow's community property interest in stock has been

held sufficient to enable her to bring a derivative lawsuit. *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972). A person with a security interest in the corporation's stock may bring suit either individually or derivatively. *Gustofson v. Gustofson*, 47 Wash App 272, 734 P2d 949 (1987).

Some courts hold that a beneficiary of a trust which owns shares may initiate a derivative lawsuit. *Edgeworth v. First National Bank of Chicago*, 677 F Supp 982 (SD Ind 1988). Other courts have held that beneficiaries lack standing to bring a derivative lawsuit. *Matties v. Seymour Manufacturing Co.*, 270 F2d 365 (2nd Cir 1959), *cert denied*, 361 US 962 (1960).

One older case indicates that despite not owning the shares at the time of the wrongdoing, a shareholder may bring a derivative lawsuit if "the wrongful acts were effectually concealed, and it appeared that the effects of the mismanagement continued to the stockholder's injury." *Davis v. Harrison*, 25 Wash 2d 1, 11, 167 P2d 1015, 1019 (1946).

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

In a theoretical sense, this ownership requirement exists because the person who acquires stock after the alleged wrongdoing has presumably paid a price for that stock which reflects the wrongful act. *See: Colville Valley Coal Co. v. Rogers*, 123 Wash 360, 212 P 732 (1923). In a practical sense, courts (and now the Legislature) imposed this requirement to prevent a person from "buying" a derivative lawsuit. *Rosenthal v. Burry Biscuit Corp.*, 60 A2d 106, 111 (Del Ch 1948).

Not only must a person be a shareholder at the time that the allegedly improper transaction occurred, the plaintiff must usually be a shareholder at the time the derivative lawsuit is filed and continue on as a shareholder throughout the course of the lawsuit. Most cases hold that a representative plaintiff must retain ownership of the stock for the duration of the litigation. *Metal Tech Corp. v. Metal Teckniques Co., Inc.*,

74 Or App 297, 703 P2d 237 (1985); *Zauber v. Murray Savings Ass'n*, 591 SW2d 932 (1980).

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

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

In some situations, such as a freeze-out merger involving improper conduct, the improper conduct itself results in the loss of owner status. In such situations, some courts have relaxed the requirement of contemporaneous ownership in such circumstances. *See, for example: Gailland v. Natomas Co.*, 173 Cal App 3d 410, 219 Cal Rptr 74 (1985); *Schreiber v. Carney*, 447 A2d 17, 22 (1982); *Gabhart v. Gabhart*, 267 Ind 370, 370 NE2d 345, 358 (1977).

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

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

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

As a general rule, a creditor lacks standing to bring a derivative action. *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032 (1987), *amended*, 750 P2d 1032 (1988).

D. Who may bring suit: representative plaintiff.

Both Washington's Superior Court Civil Rule 23.1 and Rule 23.1 of the Federal Rule of Civil Procedure require that a person bringing a derivative lawsuit "fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."

The United States Supreme Court has discussed the rationale underlying the rule that a plaintiff-shareholder be representative of the other shareholders:

> He sues, not for himself alone, but as representative of a class comprising all who are similarly situated. The interests of all in the redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity. And while the stockholders have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self-chosen representative and a volunteer champion. The Federal Constitution does not oblige the state to place its litigating and adjudicating processes at the disposal of such a representative, at least without imposing standards of responsibility, liability and accountability which it considers will protect the interests he elects himself to represent. *Cohen v. Beneficial Industrial Loan Corp.*, 337 US 541, 549-50 (1949).

A corporate director may qualify as a representative shareholder. *Dotlich v. Dotlich*, 475 NE2d 331 (Ind App 1985). The most important consideration is whether or not the shareholder bringing the derivative lawsuit has an economic interest antagonistic to innocent shareholders. *Newell Co. v. Vermont American Corp.*, 725 F Supp 351 (ND Ill 1989). "Courts have found inadequacy of representation based on conflict of interest when the shareholder plaintiff had personal entanglements adverse to the interest of the other shareholders." *Sonkin v. Barker*, 670 F Supp 249, 251 (SD Ind 1987). Whether or not a plaintiff is an adequate representative "is firmly committed to the discretion of the trial court, reviewable only for abuse." *Smith v. Ayres*, 977 F2d 946, 948 (5th Cir 1992).

E. Demand requirement.

Demand is another important procedural precondition to filing a derivative lawsuit. The "demand requirement is intended to allow the corporation the opportunity to take over a suit brought on its behalf." *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 153, 744 P2d 1032, 1063 (1987), *amended*, 750 P2d 1032 (1988).

Before initiating a derivative lawsuit, a shareholder must make demand on the corporation that the corporation itself institute proceedings against the alleged wrongdoer.

> Courts of equity are swift to protect helpless minorities of stockholders of corporations from oppression and fraud of majorities. But the legal relations into which the members of a corporation enter into require them to seek redress of supposed wrongs done them as stockholders from its officers, and from the corporation itself, before applying elsewhere. Stockholders in a corporation impliedly agree, when they join it, to act in the corporate business through officers chosen to represent them, or by vote at meetings of the members regularly called; and so, if they deem themselves aggrieved as shareholders by the dealings of others with it, or by the acts of its managers, they are bound to seek their remedy through corporate channels; First, by application to the officers in charge; and, failing there, secondly, to the corporation itself, at a meeting of its members. If they can obtain justice at the hand of neither, the courts are open for their relief. It would be contrary to the fundamental principles of corporate organizations to hold that a single shareholder can at any time launch the corporation into litigation to obtain from another what he deems to be due it, or to prevent methods of management which he thinks unwise. *Elliott v. Puget Sound Wood Products Co.*, 52 Wash 637, 642, 101 P 228, 230 (1909)(quoting from *Dumphy v. Traveler's Newspaper Ass'n.*, 146 Mass 495, 16 NE 426).

In another decision, the court stated:

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

If the corporation accedes to the shareholder's demand and files a lawsuit against the alleged wrongdoer in the corporation's name, no derivative lawsuit is necessary or permitted.

This was true at common law. The Washington Act now requires that a derivative lawsuit complaint "must allege with particularity the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored or why a demand was not made." RCW 23B.07.400(2).

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

> It does not follow from what has been said in this connection, however, that a stockholder or a minority group of stockholders may impose their unbridled wills upon the officers or directors of a corporation by launching the corporation into litigation for the purpose of obtaining for it certain benefits which the complaining parties deem to belong or be due to the corporation. Business policy may dictate that, under certain

> circumstances, it would be unwise or unprofitable to insist upon one's rights, and accordingly the directors of a corporation or the majority of its stockholders may decline to bring or maintain a suit which a single stockholder of a minority group believes should be instituted. *Goodwin v. Castleton*, 19 Wash 2d 748, 762, 144 P2d 725, 732 (1944).

If the corporation's decision not to sue is a decision supportable by the business judgment rule, courts will not permit a shareholder to override this decision and proceed with a derivative lawsuit.

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

See also: Opportunity Christian Church v. Washington Water Power Co., 136 Wash 2d 116, 238 P2d 641 (1925); *When Should Courts Allow the Settlement of Duty-of-Loyalty Derivative Suits?*, 109 HARV L REV 1084 (1996); Kinney, *Stockholder Derivative Suits: Demand and Futility where the Board Fails to Stop Wrongdoers*, 78 MARQ L REV 172 (1994).

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

For instance, in *Auerbach v. Bennett*, 47 NY2d 619, 419 NYS 2d 920, 393 NE2d 994 (1979), the court upheld the business judgment of a committee of disinterested directors not to pursue a lawsuit against management involved in foreign bribes and kickbacks, finding that the committee believed that in relation to the likelihood of success that such a lawsuit would be too costly and disruptive to management and that the adverse publicity would damage the corporation's business.

In another case, a court upheld the authority of the board of directors to delegate the corporation's response to a shareholder derivative lawsuit to a committee of disinterested directors. After the committee concluded that the officers and directors against whom the

allegations of wrongdoing were directed had acted in good faith, the court upheld the committee's determination that the lawsuit be dismissed. *Millsap v. American Family Corp.*, 208 Ga App 230, 430 SE2d 385 (1993).

A discussion of the role of special litigation committees appears in Murdock, *Corporate Governance - The Role of Special Litigation Committees*, 68 WASH L REV 79 (1993).

If the business judgment rule does not support a board's decision not to pursue corporate claims against a third party, a shareholder may sue derivatively. Such derivative lawsuits often involve allegations of wrongdoing by the corporation's directors, management and/or controlling shareholders.

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

One Delaware decision discussed futility of demand under Delaware law:

> This Court, in determining whether a pre-suit demand would have been futile, must decide:
>
> > [W]hether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.
>
> *Aronson v. Lewis*, 473 A2d 805 (1984). To successfully maintain a stockholder derivative claim where pre-suit demand was not made, a plaintiff must plead particularized facts sufficient to create a reasonable doubt that the business judgment rule protects the challenged corporate transaction. A plaintiff may adequately plead demand futility by satisfying either prong of the two-prong test of *Aronson*. (some citations omitted) *Kahn v. Roberts*, [1993-4 Transfer Binder] FED SEC L RPTR (CCH) ¶ 98,201 (Del Ch February 28, 1994).

RCW 23B.07.400 does not specify the form of demand. Some cases have held that "demand need not assume any particular form or recite any specify language." *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 51 Misc2d 188, 273 NYS2d 16, 24 (1966). In 1990, amendments to the Revised Model Business Corporation Act, not adopted in Washington, included a requirement that demand be in writing. RMBCA § 7.40(1). *See:* 45 BUS LAW 1241 (1990).

Other cases require that the demand contain sufficient information

so that the board of directors can properly evaluate the claim. *Renfro v. Federal Deposit Insurance Corp.*, 773 F2d 657 (5th Cir 1985). *See also:* Official Comment to RMBCA § 7.42. "At a minimum, a demand must identify the alleged wrongdoers, describe the factual basis of the wrongful acts and the harm caused to the corporation, and request remedial relief." *Allison on behalf of General Motors Corp. v. General Motors Corp.*, 604 F Supp 1106, 1117 (D Del 1985).

F. Burden of proof.

In a derivative lawsuit, the plaintiff has the burden of proving (i) a breach of fiduciary duty to the corporation by an officer or director, and (ii) the breach of fiduciary duty was the proximate cause of the losses sustained. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Leppaluoto v. Eggleston*, 57 Wash 2d 393, 357 P2d 725 (1960); *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658, *review denied*, 85 Wash 2d 1016 (1975).

G. Recovery belongs to corporation, not plaintiff-shareholder.

Since a derivative suit is one filed on behalf of the corporation, generally it is the corporation which is entitled to the recovery of any damages awarded. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972); *Lynch v. Patterson*, 701 P2d 1126 (Wyo 1985); *American Timber & Trading Co. v. Niedermeyer*, 276 Or 1135, 558 P2d 1211 (1977); *Ross v. Bernhard*, 396 US 531 (1969).

Under exceptional circumstances, however, a court will permit direct recovery by the shareholders. For instance, if the majority shareholder participated in the wrongful act, the court may conclude that recovery by the corporation would be unjust because the majority shareholder would be rewarded by a pro rata distribution of the derivative lawsuit proceeds. *American Timber & Trading Co. v. Niedermeyer*, 276 Or 1135, 558 P2d 1211 (1977).

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

> receiving a portion thereof to which he was not entitled, then a court of equity will look beyond the corporation and award the recovery to the individual stockholders entitled thereto. However, when third-party rights of higher priority, such as those of corporate creditors or claimants, are involved, then a judgment in favor of the stockholders, which would prejudice such rights, would be improper. (citations omitted). *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 519-520, 728 P2d 597, 608-9 (1986), *review denied*, 107 Wash 2d 1022 (1987).

See also: LaHue v. Keystone Investment Co., 6 Wash App 765, 496 P2d 343 (1972); *Joyce v. Congdon*, 114 Wash 239, 195 P 29 (1921).

H. Settlement - court approval required.

At common law, the plaintiff-shareholder could continue, compromise, abandon or discontinue a derivative lawsuit at pleasure until another shareholder was joined as a party or until an interlocutory judgment was entered. *Goodwin v. Castleton*, 19 Wash 2d 748, 765, 144 P2d 725, 733 (1944); *Albrecht v. Bauman*, 130 F2d 452 (DC Cir 1942)(interpreting Delaware law).

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

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

> A proceeding commenced under this section may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interest of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected. RCW 23B.07.400(3).

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

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

In approving a settlement, the court need only determine whether

the parties acted in good faith and whether the payment offered is adequate.

l. Attorney fees.

Although neither RCW 23B.07.400, nor § 7.40(d) of the Revised Model Act on which it is modeled, mention the power of the court to award of attorneys fees to a successful plaintiff-shareholder, the Comments to RMBCA § 7.40(d) state:

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

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

Prior to adoption of the current Act, the Washington courts held that, in its discretion, a trial court could award attorney fees to a successful plaintiff-shareholder, but only if the action was prosecuted, not nominally, but actually in the corporation's behalf. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Leppaluoto v. Eggleston*, 57 Wash 2d 393, 357 P2d 725 (1960). A trial court could also award attorney fees to the successful plaintiff-shareholder if a specific "common fund" is created for the benefit of the plaintiff and other shareholders. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Seattle Trust & Savings Bank v. McCarthy*, 94 Wash 2d 605, 617 P2d 1023 (1980). These rules likely continue to apply under the 1990 Act.

Attorney fees may not be awarded, however, where the most substantial benefit of the litigation inures to the benefit of the shareholder/plaintiff, rather than to the corporation itself. *Gustofson v. Gustofson*, 47 Wash App 272, 734 P2d 949 (1987); *Joyce v. Congdon*,

114 Wash 239, 195 P 29 (1921); *Serbick v. Timpte-Pacific, Inc.*, 88 Or App 633, 746 P2d 1167 (1987); *Delaney v. Georgia-Pacific Corp.*, 279 Or 653, 569 P2d 604 (1977). Likewise, attorney fees may not be recoverable when a lawsuit is a direct/individual action by the shareholder, rather than a derivative action. *Chiles v. Robertson*, 96 Or App 658, 774 P2d 500, *review denied*, 308 Or 592, 784 P2d 1099 (1989).

If the defendant prevails in a derivative lawsuit, the court may require the plaintiff to pay defendant's reasonable expenses and attorney fees if the court "finds that the proceeding was commenced without reasonable cause." RCW 23B.07.400(4).

J. Washington does not require plaintiff to post security.

Previously, the Washington derivative statute required that certain holders of small shareholdings in the corporation post security with the court when filing a derivative claim. RCW 23A.08.470; *Malott v. Randall*, 11 Wash App 433, 523 P2d 439 (1974). Neither the current Washington Act, nor CR 23.1, now contain any such requirement to post security.

K. Verification.

Civil Rule 23.1 provides:

> In a derivative action brought by one or more shareholders . . . the complaint shall be verified. . . .

"Verification is the confirmation of the correctness, truth or authenticity of the pleadings." *RCL Northwest, Inc. v. Colorado Resources, Inc.*, 72 Wash App 265, 271, 864 P2d 12 (1993). This Washington requirement conforms with Federal Rule of Civil Procedure 23.1. *Id.* Failure to verify may usually be cured, but if not cured before dismissal, the dismissal should be with "leave to replead or conditioned on a failure to cure within a reasonable period of time." *Id.*

L. Defenses.

Since a derivative action is one brought on behalf of the corporation, any defenses available to the defendant in a direct by the corporation would also be available to the defendant in a derivative action by a shareholder. *LaHue v. Keystone Investment Co.*, 6 Wash App 765, 496 P2d 343 (1972); *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946).

Thus, if the statute of limitations would bar a corporation from bringing such a lawsuit itself, the claim would not be revived merely because a shareholder brings the claim through a derivative lawsuit. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597

(1986), *review denied*, 107 Wash 2d 1022 (1987); *Davis v. Harrison*, 25 Wash 2d 1, 167 P2d 1015 (1946); *Teren v. Howard*, 322 F2d 949 (9th Cir 1963).

A derivative lawsuit is an equitable action. *Haberman v. Public Power Supply System*, 109 Wash 2d 107, 744 P2d 1032 (1987), *amended*, 750 P2d 1032 (1988); *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Moore v. Los Lugos Gold Mines*, 172 Wash 570, 601, 21 P2d 253 (1933); *Elliott v. Puget Sound Wood Products Co.*, 52 Wash 637, 101 P 228 (1909); *Barrett v. Southern Connecticut Gas Co.*, 172 Conn 362, 374 A2d 1051 (1977); *Florik v. Florida Land Sales Board*, 206 So2d 41 (Fla App 1968); *Rebstock v. Lutz*, 39 Del Ch 25, 158 A2d 487 (1960); *Schultz v. Highland Gold Mines Co.*, 158 F 337 (D Or 1907). As such, certain equitable defenses may apply.

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

> [S]hareholder derivative actions are inventions of courts of equity, and even though [plaintiff] is merely a nominal plaintiff bringing suit on behalf of [the corporation], equity requires that a shareholder derivative action cannot be maintained if the nominal plaintiff has unclean hands in connection with the transactions which are the bases for the litigation or has participated or acquiesced in, or benefited from the conduct of which he now complains. (citations omitted) *Forkin v. Cole*, 192 Ill App 3d 409, 548 NE2d 795, 805 (1989).

But see: Hilpert v. Yarmosh, 77 App Div 2d 608, 430 NYS2d 112, 113 (1980)("The `dirty hands' rationale therefore is inapplicable to plaintiff's representative capacity since the lawsuit is for the benefit of the corporation").

A defense of laches may also be available if the shareholder bringing suit delays too long after learning of the claim. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1979); *Teren v. Howard*, 322 F2d 949 (9th Cir 1963); *Gascue v. Saralegui Land & Livestock Co.*, 70 Nev 83, 255 P2d 335 (1953); *Gallup v. Pring*, 116 P2d 202 (Colo 1941); *Wills v. Nehalem Coal Co.*, 52 Or 70, 96 P 528 (1908). But laches does not apply until the shareholder learns of the claim. *Moore v. Los Lugos Gold Mines*, 172 Wash 570, 601, 21 P2d 253 (1933). Likewise, even though laches may apply to one shareholder, it may not apply to another shareholder who only recently learned of the claim. *Liken v. Shaffer*, 64

F Supp 432, 442 (ND Iowa 1946).

A shareholder who, with knowledge of the material facts, consents to, concurs in, acquiesces in or ratifies wrongful conduct cannot later bring a derivative lawsuit over than conduct. *Swafford v. Berry*, 382 P2d 999, 1002 (Colo 1963); *Dobry v. Dobry*, 324 P2d 534, 536 (Okla 1958); *Elster v. American Airlines, Inc.*, 100 A2d 219, 221 (Del Ch 1953).

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

Section 8.05 Dissenters' Rights

At common law, the merger of one solvent corporation with another solvent corporation required unanimous shareholder approval. *Pomierski v. W. R. Grace & Co.*, 282 F Supp 385, 394 (ND Ill 1967); *Reynolds Metals Co. v. Colonial Realty Corp.*, 41 Del Ch 183, 190 A2d 752, 755 (1963); *Shaffer v. General Grain, Inc.*, 133 Ind 598, 182 NE2d 461 (1962). By statute, all or nearly all states have abandoned this common law rule and now permit a merger by vote of less than all shareholders.

This true in Washington. The shareholders may vote (usually by voting group through a two-third majority vote) to merge a corporation with another corporation. RCW 23B.11.030. *See:* Section 12.02 of this book.

As a trade-off, shareholders who oppose the merger may require the corporation to repurchase their shares.

> At common law, unanimous shareholder consent was a prerequisite to fundamental changes in the corporation. This made it possible for an arbitrary minority to establish a nuisance value for its shares by refusal to cooperate. To meet the situation, legislatures authorized the making of changes by majority vote. This, however, opened the door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares, [sic] were widely adopted. *China Products North America, Inc. v. Manewal*, 69 Wash App 767, 773, 850 P2d 565, 568 (1993) (quoting from *Voeller v. Nielston Warehouse Co.*, 311 US 531, 535 n 6 (1940)).

This right to recover the shares' appraised value is known as "the right to dissent" and as "dissenters' rights."

> `Dissenting shareholders' rights' is a term of art that describes the right of dissenting minority shareholders in a merger to seek judicial appraisal of their shares, instead of being forced to accept the merger offer price that the majority of shareholders has accepted. *Shlens v. Egnatz*, 508 NE2d 44, 47 (Ind App 1987).

Dissenters' and appraisal rights are governed by the laws of the state creating the corporation, and if so required by that state's statutes,

the shareholders may need to file suit in that state's courts to seek appraisal of their shares. *Meade v. Pacific Gamble Robinson Co.*, 21 Wash 2d 866, 153 P2d 686 (1944); *Grant v. Pacific Gamble Robinson Co.*, 22 Wash 2d 65, 154 P2d 301 (1944).

Merger is not the only event which creates dissenters' rights. RCW 23B.13.020 gives a shareholder the right to dissent when any of the following extraordinary events occur: the consummation of certain plans of merger and plans of share exchange; the consummation of a sale of substantially all corporate assets; and enactment of certain amendments of the articles of incorporation which materially affect the rights of the dissenters' shares.

Not all mergers trigger to a right to consent. For instance, the right to dissent does not apply to a merger occurring solely to change the corporation's state of incorporation.

> The Legislature has enumerated certain specific corporate actions that would trigger dissenters' rights. The unifying feature of all such actions is that the action will result in a significant difference in the nature and scope of the business enterprise. While "merger" is listed as one of the triggering events, in this case there may be a merger as a matter of form but not as a matter of substance. CPNW, a Washington corporation, is being "merged" into the hollow shell of CPNA, a Delaware corporation, which was created for the sole purpose of changing corporate domicile. There is no change in assets or liabilities, there is no change in the management, personnel or nature of the business, and there is no significant change in corporate structure or the rights of shareholders. As they should, courts look to the substance and not merely the form. We conclude that although the legal mechanism the corporation proposes to achieve the change of corporate domicile may be a "merger", it does not constitute a "merger" in the business sense of the term, nor within the meaning of the statute, and so does not trigger dissenters' rights. *China Products North America, Inc. v. Manewal*, 69 Wash App 767, 775-6, 850 P2d 565, 569 (1993).

The right to dissent gives a dissenting shareholder the right to give up his/her stock in the corporation and, in exchange, receive payment equal to the "fair value" of the shares. RCW 23B.13.020(1). Normally, the right to dissent is the exclusive remedy available to a shareholder who objects to the merger. *Matteson v. Ziebarth*, 40 Wash 2d 286, 242 P2d 1025 (1952).

The effect of dissenter's rights "is to change the status of a dissenting shareholder to that of a creditor at least superior to the distributive rights of the remaining shareholders." *Flarsheim v. Twenty Five Thirty Two Broadway Corp.*, 432 SW2d 245, 253 (Mo 1968). RCW 23B.06.400(5) appears to place the debt to the dissenting shareholder at parity with the debts of the corporation's general, unsecured creditors, as

long as the creation of the debt to the dissenting shareholder does not render the corporation insolvent. But such debts may be treated as a preference under 11 USC § 547 or RCW 23.72.030.

***A. Steps required by statute*.**

If a corporation proposes to take a corporate action which will give rise to dissenters' rights and the action requires a shareholder vote, the corporation must notify its shareholders of the right to dissent before the shareholder meeting at which the vote is scheduled to occur. RCW 23B.13.200(1). In order to dissent under such circumstances, a dissenting shareholder must deliver a written notice to the corporation before the vote is taken. The written notice must include a demand for payment (promising to exchange the shareholder's stock for such payment) in the event the action is effectuated. RCW 23B.13.210(1).

If the shareholders fail to take the proposed action (*e.g.*, the proposal is defeated), the corporation need do nothing more with regard to any dissenting shareholder. But if the shareholders go forward with the vote and authorize the action giving rise to dissenters' rights, within ten days of the vote, the corporation must send a second notice, called a "dissenters' notice," to all shareholders who previously notified the corporation of their "dissent." In this "dissenters' notice," the corporation must: (i) state where and when the dissenting shareholder's stock certificates must be deposited; (ii) describe any transfer restrictions applicable to uncertificated shares; (iii), supply a form for demanding payment; and (iv) set a date by which the corporation must receive the payment demand (no less than 30 and no more than 60 days after the date the dissenters' notice is delivered to the dissenters). RCW 23B.13.220.

If the proposed action is taken without a shareholder vote, the corporation is required to inform its shareholders of the action taken and to deliver the "dissenters' notice," described above, to all shareholders entitled to assert dissenters' rights. RCW 23B.13.200(2).

> **EXAMPLE:** In the merger between a parent corporation and a subsidiary, 90% of which is owned by the parent corporation, neither shareholders of the parent nor shareholders of the subsidiary are entitled to vote on the merger. RCW 23B.11.040(1). Shareholders of the subsidiary, but not the parent, have the right to dissent. RCW 23B.13.020(1)(a)(ii). In such case, shareholders of the subsidiary would be entitled to receive a "dissenters' notice"

after the subsidiary's board of directors voted to merger.

Dissenters desiring payment are then required to send back a completed copy of the form for demanding payment and to deposit their shares with the corporation. RCW 23B.13.230.

The next step must occur within 30 days of the later of: (i) the effective date of the proposed action or (ii) the receipt of a proper demand for payment. At that point, the corporation is required to pay each dissenter who has complied with the requirements set out in the "dissenters' notice" the amount which the corporation estimates to be the "fair value" of the dissenters' shares, plus accrued interest. RCW 23B.13.250(1). Payment must be accompanied by the corporation's balance sheet, an explanation of how the corporation estimated fair value of the shares, an explanation of how interest was calculated, a statement of the dissenters' rights under RCW 23B.13.280, and a copy of RCW 23B.13.010 through RCW 23B.13.310. RCW 23B.13.250.

At that point if a dissenter disagrees with the corporation's estimate of "fair value," the dissenter may notify the corporation in writing of the dissenters' own estimate of fair value and demand payment of this (presumably higher) amount. RCW 23B.13.280(1). Unless the dissenter does so within 30 days, however, the dissenter waivers the right to demand an amount higher than the amount which was originally offered by the corporation. RCW 23B.13.280(2).

Once a dissenting shareholder sends a proper demand for the dissenter's estimate of "fair value," the corporation may either: (i) pay the (presumably higher) amount demanded; or (ii) commence a proceeding in superior court for the appraisal of the shares. RCW 23B.13.300(1). RCW 23B.13.300 goes on to provide:

> (5) The jurisdiction of the superior court in which the proceeding is commenced under subsection (2) of this section is plenary and exclusive. The court may appoint one or more persons as appraisers to receive evidence and recommend decisions on the question of fair value. The appraisers have the powers described in the court order appointing them, or in any amendment to the order. The dissenters are entitled to the same discovery rights as parties in other civil proceedings.
>
> (6) Each dissenter made a party to the proceeding is entitled to judgment (a) for the amount, if any, by which the court finds the fair value of the dissenter's shares, plus interest, exceeds the amount paid by the corporation; or (b) for the fair value, plus accrued interest, of the dissenter's after-acquired shares for which the corporation elected to withhold payment under RCW 23B.13.270.

If a corporation fails to commence such a proceeding within 60 days of receiving the dissenters' estimate of fair value, the corporation forfeits the right to file an appraisal action and instead is required to pay the dissenter the (presumably higher) amount demanded by the dissenter. RCW 23B.13.300(1).

B. Fair value.

As discussed above, once a shareholder dissents and demands payment for his/her shares, the corporation is required to pay the "fair value" of the shareholders stock, receiving in exchange the surrender of the shareholder's stock. If, using the procedures discussed above, the corporation and the shareholder are unable to agree on an amount constituting "fair value," the corporation must file an appraisal action asking the circuit court to determine fair value.

There is no "one size fits all" method for determining fair value. *Matter of Seagroatt Floral, Co., Inc.*, 78 NY2d 439, 583 NE2d 287, 290 (1991). Rather, there are several methods and the circumstances of each case will determine the weight given to each method. In a case involving dissenters' rights, the Washington Supreme Court has noted:

> No universal formula for determining the value of shares of a corporation can be stated. No two corporations are precisely alike, and a consideration that may be very influential in evaluating the shares of one may be meaningless with reference to another. *In re West Waterway Lumber Co.*, 59 Wash 2d 310, 320, 367 P2d 807, 813 (1962).

Another Washington decision stated: "What is meant by the `value' of the shares in [RCW 23B.13.010] is unclear, and has been for some time." *Robblee v. Robblee*, 68 Wash App 69, 77, 841 P2d 1289, 1294 (1992). *See also: Chatterton v. Business Valuation Research, Inc.*, 90 Wash App 150, 951 P2d 353 (1998); *In re Northwest Greyhound Lines*, 41 Wash 2d 672, 678, 251 P2d 607 (1952).

"Fair value" is defined in RCW 23B.13.010 to mean:

> "Fair value," with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

The language of RCW 23B.13.010 is taken from Revised Model Act § 13.01(3), the Comment to which states in relevant part:

> The definition of "fair value" in section 13.01(3) leaves to the parties (and ultimately to the courts) the details by which "fair value" is to be determined within the broad outlines of the definition. This definition thus leaves untouched the accumulated case law about market value, value

> based on prior sales, capitalized earnings value, and asset value. It specifically preserves the former language excluding appreciation and depreciation in anticipation of the proposed corporate action, but permits an exception for equitable considerations. The purpose of this exception ("unless exclusion would be inequitable") is to permit consideration of factors similar to those approved by the Supreme Court of Delaware in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), a case in which the court found that the transaction did not involve fair dealing or fair price: "In our view this includes the elements of rescissory damages if the Chancellor considers them susceptible of proof and a remedy appropriate to all the issues of fairness before him." Consideration of appreciation or depreciation which might result from other corporate actions is permitted; these effects in the past have often been reflected either in market value or capitalized earnings value.
>
> "Fair value" is to be determined immediately before the effectuation of the corporate action, instead of the date of the shareholder's vote, as is the case under most state statutes that address the issue. This comports with the plan of this chapter to preserve the dissenter's prior rights as a shareholder until the effective date of the corporate action, rather than leaving him in a twilight zone where he has lost his former rights, but has not yet gained his new ones.

A leading commentator has said that no one factor governs the determination of the fair value of the shares, but that speculative factors should not be considered. 12B FLETCHER CYC CORP § 5906.12 (Perm Ed 1993).

> The "fair value" of shares is not to be measured by any unique benefits that will accrue to the acquiring corporation, but rather is to be determined on the basis of what a reasonable and objective observer would consider to be a price that reflects the intrinsic value of the right of stock ownership, without regard to any subjective mental processes of the dissenting shareholders or any special benefits to be derived by the acquiring corporation. Also, the valuation must be made without consideration of the merger transaction which prompted the appraisal proceeding. (footnotes omitted) 12B FLETCHER CYC CORP § 5906.12 (Perm Ed 1993).

In determining fair value, several methods or values may be considered: market value, net assets value, and a third value, varyingly referred to as the earnings value, investment value, or enterprise value. "[T]he relative weight given each will depend on the circumstances of the case." *Columbia Management Co. v. Wyss*, 94 Or App 195, 199, 765 P2d 207, 210-1 (1988), *review denied*, 307 Or 571, 771 P2d 1021 (1989). The *Columbia Management* decision went on to say that in an appraisal action, the investment value will often be the most important.

> The most important factor in most cases, it pointed out, is investment or enterprise value, because that value reflects the business' worth as a going concern. The purpose of the appraisal statute is to ascertain what the dissenter actually loses because of his or her unwillingness to go along with the controlling shareholders' desires. The court refused to accept a minority discount because it would be a departure from that

> purpose. Such a discount affects market value more than investment value. The statute allows the majority to override the minority so long as it adequately protects the minority's interests. There would be no protection if the minority could be squeezed out for less than the real value of its interest. *Columbia Management Co. v. Wyss*, 94 Or App 195, 201-2, 765 P2d 207, 212 (1988), *review denied*, 307 Or 571, 771 P2d 1021 (1989)(discussing *Woodward v. Quigley*, 257 Iowa 1077, 133 NW2d 38 (1965).

RCW 23B.13.010(3) provides that fair value is to be determined "immediately before the effect date of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable." *See also: In re West Waterway Lumber Co.*, 59 Wash 2d 310, 367 P2d 807 (1962).

Factors which might be relevant to fixing fair value include, but are not limited to, the following:

> the price at which the shares had been selling; the amount, if any, of present share value increase or decrease because of anticipated future earnings of the corporation; corporate assets; corporate earnings or losses; corporate reputation; anticipated competition. ORS 60.551(4) excludes consideration of appreciation or depreciation in anticipation of the corporate action, unless it would be inequitable to exclude such appreciation or depreciation. *Stringer v. Car Data Systems, Inc.*, 314 Or 576, 587-8, 841 P2d 1183, 1189 (1992), *reconsideration denied*, 315 Or 308, 844 P2d 905 (1993).

In determining fair value, the Eleventh Circuit stated that determining fair value required an examination of "net asset value, investment value and market value in determining a stock's worth." *Multitex Corporation of America v. Dickinson*, 683 F2d 1325, 1328 (11th Cir 1983). This decision went on to state:

> Turning to the jury instructions actually given by the court below, we find them to be a proper statement of Georgia law. The district court instructed the jury that fair value represented
>
> > the price at which a willing seller and a willing buyer will be tried, both having original knowledge of the facts. Now a willing seller is one who desires, but is not obligated to sell, and a willing buyer is one who wishes to buy, but is under no obligation, compulsion or necessity to buy. Determination of the fair value of stock owned by Mr. Dickinson in Colormasters, Inc., as of the close of business on April 10, 1978, is necessarily based somewhat on assumption rather than absolute fact.
>
> The jury was also instructed that it should determine fair value "using as a guideline any and all evidence that [it] determined to accept which was legally presented . . . in Court."
>
> The willing seller/willing buyer standard has been found by Georgia courts to provide proper guidance to a jury when determining the "fair market value" of real property in condemnation proceedings. The

> standard has, however, also been recognized by the Georgia Supreme Court to "permit the proof of the varied elements of value; that is all the facts which the owner would properly and naturally press upon the attention of a buyer to whom he is negotiating a sale, and all other facts which would naturally influence a person of ordinary prudence desiring to purchase." Because all evidence of a stock's worth, whether compiled under a market value, investment value or net asset value approach, would naturally influence a buyer of stock, the jury was properly guided in its consideration of all such evidence under a willing seller/willing buyer standard. (citations & footnote omitted) *Multitex Corporation of America v. Dickinson*, 683 F2d 1325, 1329 (11th Cir 1983).

In determining fair value, a court must determine whether to apply a "minority" and/or a "marketability" discount.

A "minority discount" is a reduction in value "which recognizes that controlling shares are worth more in the market than are noncontrolling shares." *Columbia Management Co. v. Wyss*, 94 Or App 195, 204, 765 P2d 207, 213 (1988), *review denied*, 307 Or 571, 771 P2d 1021 (1989). *See also: Robblee v. Robblee*, 68 Wash App 69, 841 P2d 1289 (1992); *Tyron v. Smith*, 191 Or 172, 229 P2d 251 (1951).

A "marketability discount" is a reduction in value which recognizes that "interests in closely held business enterprises cannot readily be sold, they are less marketable and, therefore, less valuable than equivalent interests in companies whose securities are regularly traded in a recognized market." Haynesworth, *Valuation of Business Interests*, 33 MERCER L REV 457, 489 (1982).

Although each case turns on its own facts, in an appraisal action based on dissenters' rights, courts will often apply marketability discounts, but refuse to apply minority discounts.

> The minority discount recognizes that controlling shares are worth more in the market than are noncontrolling shares. Because the purchaser of the share will be the corporation, not an outsider, this recognition of decreased market value may not be appropriate. A leading authority on business valuation states that discounts of any sort are questionable in a dissenter's rights case:
>
> > There is less reason to discount the intrinsic value of stock in a dissenting shareholder valuation than in other types of transactions. The purpose of applying these discount variables is to determine the investment value of fair market value of a minority interest in the context of a hypothetical sale between a willing seller and buyer, a situation that does not exist in the dissenting shareholder situation.
>
> *Robblee v. Robblee*, 68 Wash App 69, 841 P2d 1289 (1992) (quoting from *Columbia Management Co. v. Wyss*, 94 Or App 195, 202-4, 765 P2d 207 (1988), *review denied*, 307 Or 571, 771 P2d 1021 (1989) and Haynesworth, *Valuation of Business Interests*, 33 MERCER L REV 457, 459 (1982).

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Columbia Management Co. v. Wyss, 94 Or App 195, 765 P2d 207 (1988), *review denied*, 307 Or 571, 771 P2d 1021 (1989) involved a corporate event which essentially squeezed-out a shareholder in a close corporation and gave him the right to dissent. In it, the court upheld the trial court's decision to apply a marketability discount, but overturned the trial court's application of a minority discount.

> [B]ecause a dissenting shareholder is exercising a right designed for his or her protection, and because the purchaser of the shares will be the corporation, not an outsider, this recognition of decreased market value may not be appropriate. "It is contrary to the purpose of the statute to discount the minority interest because it is a minority. This in effect would let the majority force the minority out without paying its fair share of the value of the corporation." (citation omitted) *Columbia Management Co. v. Wyss*, 94 Or App 195, 204, 765 P2d 207, 213 (1988), *review denied*, 307 Or 571, 771 P2d 1021 (1989).

But see: Perlman v. Permonite Manufacturing Co., 568 F Supp 222, 232 (ND Ind 1983), *affirmed*, 734 F2d 1283 (7th Cir 1984)(although discounts for minority interest, lack of marketability and lack of diversity are proper, a discount for capital gains tax liability is not).

The discount applied may be different in other contexts. For instance, in an action by a minority shareholder for oppressive conduct and breach of fiduciary duty by the majority shareholders (not an appraisal action), one court determined that the remedy would be the forced buyout of the minority's shares, and in determining value, upheld the trial court's refusal to apply either a minority or a marketability discount. *Chiles v. Robertson*, 94 Or App 604, 767 P2d 903, *reconsideration allowed in part, opinion modified*, 96 Or App 658, 774 P2d 500, *review denied*, 308 Or 592, 784 P2d 1099 (1989).

It is unclear whether an appraisal action filed under the statute is an equitable or legal action. *Chrome Data Systems, Inc. v. Stringer*, 109 Or App 513, 820 P2d 831 (1991).

Additional discussion of "fair value" appears in Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L J 613 (1998); Shishido, *The Fair Value of Minority Stocks in Closely Held Corporations*, 62 FORDHAM L REV 65 (1993); Edwards, *Dissenters' Rights: The Effect of Tax Liabilities on the Fair Value of Stock*, 6 DEPAUL BUS L J 77 (1993); Schlyer, *"Fair Value" Determination In Corporate "Freeze-outs," And In Security And Exchange Act Suits: Weinberger, Other, And Better Methods*, 19 VAL U L REV 521 (1985); *Valuation of Close Corporation Shares in Oregon*, 57 OR L REV 309 (1978).

C. Attorney fees.

RCW 23B.13.310 permits a court to assess attorney fees against either the corporation or the dissenter if the court finds that such party acted arbitrarily, vexatiously or not in good faith or, in the case of the corporation only, if the corporation did not comply with the dissenters' rights provisions of the Act. *Chrome Data Systems, Inc. v. Stringer*, 109 Or App 513, 820 P2d 831 (1991).

D. Appraisal action - exclusive remedy?

Generally, the appraisal remedy is the exclusive remedy available to dissenting shareholders. RCW 23B.13.020(2) provides:

> A shareholder entitled to dissent and obtain payment for the shareholder's shares under this chapter may not challenge the corporate action creating the shareholder's entitlement unless the action fails to comply with the procedural requirements imposed by this title, RCW 25.10.900 through 25.10.955, the articles of incorporation, or the bylaws, or is fraudulent with respect to the shareholder or the corporation.

But there nay be instance when the appraisal remedy may not be the exclusive remedy. RCW 23B.13.020(2) is substantially the same as the Revised Model Business Corporation Act § 13.02(b), the Comment to which states:

> But the prospect that shareholders may be "paid off" does not justify the corporation in proceeding unlawfully or fraudulently. If the corporation attempts an action in violation of the corporation law on voting, in violation of clauses in articles of incorporation prohibiting it, by deception of shareholders, or in violation of a fiduciary duty--to take some examples--the court's freedom to intervene should be unaffected by the presence or absence of dissenters' rights under this chapter. Because of the variety of situations in which unlawfulness and fraud may appear, this section makes no attempt to specify particular illustrations. Rather, it is designed to recognize and preserve the principles that have developed in the case law of Delaware, New York and other states with regard to the effect of dissenters' rights on other remedies of dissident shareholders. See *Weinberger v. UOP, Inc.*, 457 A2d 701 (Del 1983)(appraisal remedy may not be adequate "where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross or palpable overreaching are involved.") See also Vorenberg, "Exclusiveness of the Dissenting Stockholders' Appraisal Right," 77 HARV L REV 1189 (1964).

Under an earlier version of the dissenter's right statute, the Washington Supreme Court held that the appraisal remedy was the exclusive remedy absent actual fraud.

> We are of the view that, under our own act, the statutory remedy is likewise exclusive as to unfairness or breach of fiduciary duty short of actual fraud. This is subject to the qualification, however, that the statutory remedy in not exclusive unless the facts concerning such unfairness or breach of fiduciary duty were known to the aggrieved stockholder at the time of the stockholders' meeting at with the corporate

> action was approved. *Matteson v. Ziebarth*, 40 Wash 2d 286, 297-8, 242 P2d 1025, 1033 (1952).

Some courts have used their equitable powers to protect minority shareholders in a squeeze-out situation. There has been an evolution on this issue over time.

Historically, fundamental corporate changes, such as mergers, could occur only with unanimous shareholder approval. Eventually, all states adopted statutes which permitted fundamental corporate change by a less than unanimous vote of the shareholders. Dissenters' rights were enacted to give an objecting shareholder the right to bail out of the fundamentally different corporation and the right to be paid the fair value of his/her shares. *Gabhart v. Gabhart*, 267 Ind 370, 370 NE2d 345 (1977).

Even though these statute allowed the majority the right to make fundamental changes over the objections of the minority, courts initially held that the majority shareholders could do so only for a "legitimate corporate purpose" and in a manner consistent with the majority's fiduciary duty to the minority shareholders. *See: Singer v. Magnavox Co.*, 380 A2d 969 (Del 1977).

> a scheme by a majority stockholder to freeze out a minority shareholder, when the plan lacks any legitimate corporate purpose, is a breach of the majority shareholder's fiduciary obligation to deal fairly with minority shareholders, and is fraudulent as against them. *Corbin v. Corbin*, 429 F Supp 276, 280 (MD Ga 1977).

Courts in Delaware and in a majority of other states eventually abandoned this "legitimate corporate purpose" rule. Instead, these courts held that a majority could freeze-out the minority for any reason, as long as the majority did so in a lawful manner, free from fraud. *Weinberger v. UOP, Inc.*, 457 A2d 701 (Del 1983). Thus, as long as the merger was lawful and free from fraud, the appraisal remedy was the only remedy available to the disaffected minority.

> While a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate. The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages. (citations omitted) *Weinberger v. UOP, Inc.*, 457 A2d 701, 714 (Del 1983).

The Revised Model Act adopted the *Weinberger* approach.

> A shareholder entitled to dissent and obtain payment for his shares under this chapter may not challenge the corporate action creating his entitlement unless the action is unlawful or fraudulent with respect to the shareholder or the corporation. RMBCA § 13.02(b).

The Comment to Revised Model Act § 13.02(b) states:

> But the prospect that shareholders may be "paid off" does not justify the corporation in proceeding unlawfully or fraudulently. If the corporation attempts an action in violation of the corporation law on voting, in violation of clauses in articles of incorporation prohibiting it, by deception of shareholders, or in violation of a fiduciary duty--to take some examples--the court's freedom to intervene should be unaffected by the presence or absence of dissenters' rights under this chapter. Because of the variety of situations in which unlawfulness and fraud may appear, this section makes no attempt to specify particular illustrations. Rather, it is designed to recognize and preserve the principles that have developed in the case law of Delaware, New York and other states with regard to the effect of dissenters' rights on other remedies of dissident shareholders. See *Weinberger v. UOP, Inc.*, 457 A2d 701 (Del 1983)(appraisal remedy may not be adequate "where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross or palpable overreaching are involved.") See also, Vorenberg, *Exclusiveness of the Dissenting Stockholders' Appraisal Right*, 77 HARV L REV 1189 (1964).

Despite language in most appraisal statutes which provide that the appraisal remedy is exclusive, numerous cases have held that courts retain their historic equitable power to protect minority shareholders from the majority's fraud and self-dealing. These cases have recognized equitable remedies other than appraisal. *Coggins v. New England Patriots Football Club*, 397 Mass 525, 492 NE2d 1112 (1986)(appraisal statute does not deprive courts of their equitable powers); *Bayberry Associates v. Jones*, 783 SW2d 553 (Tenn Sup Ct 1990)(despite appraisal statute, courts retain equitable right to assure fairness, including fair price and fair dealing); *Mullen v. Academy Life Ins. Co.*, 705 F2d 971 (8th Cir 1983)(appraisal not only remedy despite N.J. appraisal statute); *Joseph v. Shell Oil Co.*, 498 A2d 1117 (Del Ch 1985)(minority shareholders not limited to appraisal remedy which precludes imposition of adequate remedy for serious breaches of fiduciary duty); *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A2d 1099 (Del 1985)(allegations of bad faith manipulation and grossly inadequate price state claim for damages beyond appraisal); *Cede & Co. v. Technicolor, Inc.*, 542 A2d 1182 (Del Ch 1988)(damage claim and appraisal claim both permitted to go to trial).

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In *Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc.*, 532 A2d 1324 (Del Ch 1987), the Delaware Court of Chancery held that the minority shareholders were entitled to a preliminary injunction enjoining a squeeze-out merger noting that:

> As fiduciaries seeking to "cash out" the minority stockholders of a Delaware corporation in a non-arm's length merger, the defendants had a duty to be entirely and scrupulously fair to the plaintiffs in all respects. *Weinberger v. UOP, Inc.*, 457 A2d at 710. The majority stockholder was obliged not to time or structure the transaction, or to manipulate the corporation's values, so as to permit or facilitate the forced elimination of the minority stockholders at an unfair price. The corporation's directors were obliged to make an informed, deliberate judgment, in good faith, that the merger terms, including the price, were fair and that the merger would not become a vehicle for economic oppression. And finally, the directors (and the majority stockholder, to the extent that it involved itself in such matters) were obliged to disclose with entire candor all material facts concerning the merger, so that the minority stockholders would be able to make an informed decision as to whether to accept the merger price or to seek judicial remedies such as appraisals, an injunction, or a post-merger damage action.
>
> None of these fiduciary obligations were satisfied in this instance. Indeed, if one were setting out to write a textbook study on how one might violate as many fiduciary precepts as possible in the course of a single merger transaction, this case would be a good model. *Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc.*, 532 A2d 1324, 1335 (Del Ch 1987).

But a growing minority of states have held that the appraisal remedy is the sole remedy when the dispute in merely over price, even where the transaction involves self-dealing by the majority and even where the price offered is only a small fraction of the true value of the shares.

> Where the allegations show only a disagreement as to price, however, with no allegations that permit any inference of self-dealing, fraud, deliberate waste of corporate assets, misrepresentation, or other unlawful conduct, the remedy afforded by ORS 60.551 to 60.594 is exclusive. That is true even if the majority shareholders acted arbitrarily or vexatiously or not in good faith.
>
> It may be that the $0.002 offer was insulting to plaintiffs, and it may even have been motivated by bad faith. But, because the facts alleged in the complaint, if established, support no claim for damages apart from the fair value of the shares, we believe that the legislature intended that dissenting shareholders in the position of plaintiffs be limited to their remedies under the appraisal statutes. *Stringer v. Car Data Systems, Inc.*, 314 Or 576, 590-1, 841 P2d 1183, 1190-1 (1992), *reconsideration denied*, 315 Or 308, 844 P2d 905 (1993).

See also: Fleming v. International Pizza Supply Corp., 676 NE2d 1051 (Ind 1997)(appraisal action is exclusive remedy but minority can litigate fraud and breach of fiduciary duty claims in that action as effecting

fair value); *Brandt v. Travelers Corp.*, 44 Conn Sup 12, 665 A2d 616 (1995)(minority could not enjoin merger because appraisal is exclusive remedy); *Stepak v. Schey*, 51 Ohio St3d 8, 553 NE2d 1072 (1990)(remedy for breach of fiduciary duty involving only price that a shareholder receives is limited to appraisal statute); *Schloss Associates v. C & O Ry.*, 73 Md App 727, 536 A2d 147 (1988)(appraisal remedy wholly adequate in dispute essentially over price); *Green v. Santa Fe Industries, Inc.*, 70 NY2d 244, 514 NE2d 105 (1987) (appraisal adequate in dispute over mere inadequacy of price).

One Washington decision recognized the right of the board of directors to shift the balance of voting power, stating that "directors . . . may in the exercise of their honest business judgment adopt a valid method of eliminating what appears to them a clear threat to the future of their business by any lawful means." *Hendricks v. Mill Engineering & Supply Co.*, 68 Wash 2d 490, 495, 413 P2d 811, 813-4 (1966).

For a discussion of the exclusiveness of the appraisal remedy under an earlier version of Washington's statute, see *Appraisal Statutes - Remedies of Dissenting Shareholders*, 331 WASH L REV 113 (1956).