Too Close For Comfort: Application of Shareholder’s Derivative Actions to Disputes Involving Closely Held Corporations

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TOO CLOSE FOR COMFORT: APPLICATION OF SHAREHOLDER’S DERIVATIVE ACTIONS TO DISPUTES INVOLVING CLOSELY HELD CORPORATIONS

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ABSTRACT

Should traditional shareholder’s derivative rules apply to close corporation disputes? The ALI has proposed that closely-held corporations may be treated as partnerships in the context of internal disputes. The rationale for shareholder derivative suit requirements – to protect creditors, to benefit all shareholders proportionate to their ownership interests, to discourage strike suits, and to permit the corporation to manage the suit and its resolution under court supervision – are less powerful in the context of closely held corporations. In fact, adhering to the requirements of shareholder’s derivative actions can increase the cost and complexity of suit, shift the expense of internal dissention to the corporation, and leave some members (for example, defrauded former shareholders) without a remedy. The ALI standards have been adopted, largely by judicial decision, in some states, rejected in others, and left unaddressed in California. This paper proposes that California adopt rules to adjudicate disputes in closely held corporations, and, by extension, LLCs.

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TOO CLOSE FOR COMFORT: APPLICATION OF SHAREHOLDER’S DERIVATIVE ACTIONS TO DISPUTES INVOLVING CLOSELY HELD CORPORATIONS

I INTRODUCTION

The rule of law has, in fact, very few rules. The reason is simple and straightforward: a rule that makes sense in one factual context makes less, if any, sense in another, and there are too many contexts for there to be a rule for each one. Accordingly, statutory and case law lay down a few rules or principles which are used as the framework for analysis of different fact patterns, with the goal of developing a body of law which makes sense, is consistent with the applicable rule or principle, and yields predictable results. From time to time, legislatures or courts re-examine whether a particular rule or principle continues to make sense in a particular context.

This article explores whether the time has come for California to examine whether the principles of shareholder’s derivative actions should continue to be given effect in the context of closely held corporations and, in passing, their kinfolk, limited liability companies. The question of whether those principles make sense to apply to such entities is not new, yet California has skirted the issue for years, if not decades. As a result, California law is inconsistent and its application unpredictable--the opposite of what the rule of law should be.

The journey will start with a look at a fairly typical fact pattern so it will be clear what the fuss is all about. Then, a survey of how other jurisdictions have analyzed the issue will follow, so that the various schools of thought can be evaluated. After examining California’s evasion of the issue, the journey will end with some ideas of what
the policies should be and how they should be implemented--and by whom. Hopefully, the powers that be--legislative and judicial--will take notice.

I. A CASE IN POINT

Athos, Porthos and Aramis were lawyers in Los Angeles. Tired of the stresses and strains of being sole practitioners, they decided to merge their practices together and formed a firm, Faith, Wine and Cologne (“FWC”), a Professional Corporation. Though they used a corporation as the legal vehicle, they saw themselves as partners. Like their French forebears, “One for all, and all for one” was their motto. They were each 33 1/3% shareholders, and all three were directors and officers.

After a few years, however, Aramis came to believe that “one for all and all for one” had become “three each for us and one for you”. Though financial matters were not his strong suit, Aramis became convinced that Athos and Porthos were lying to him, telling him that FWC was doing very poorly when, in fact they were secretly funneling firm revenues to themselves--improperly running personal expenses through the firm, making secret deals with clients whereby FWC wrote off the time while the clients performed work for Athos and Porthos personally, and using firm time and resources to tend to their personal investment portfolios. Aramis felt cheated.

Perhaps not-altogether surprisingly, Athos and Porthos thought they were the ones being victimized. Indeed, they thought not only that had Aramis shirked his obligation to devote full time to the FWC’s practice, but also that he had spent that “extra” time handling plaintiffs’ personal injury cases on the side, for his own personal benefit--and to add insult to injury, had used firm resources, such as computers, secretarial assistance, copiers, etc., to do it. Aramis was shocked when they raised this issue with him; he
claimed that they all had decided when they started that the firm would not do personal
injury work and that he could do it on his own so long as he still billed a reasonable “full-
time” complement of hours on firm matters.

Off to Los Angeles Superior Court they went. Aramis got there first, suing Athos,
Porthos and FWC. He named the firm as a nominal defendant because, he claimed, (a)
Athos and Porthos combined had two-thirds of the voting power and of course would do
nothing to address their own wrongdoing, and (b) they had caused the firm not to account
to him or to pay him his share of firm profits.

Athos and Porthos then hired counsel to represent them and the firm. But on
Aramis’s motion, the lawyer was disqualified because, the court held, a conflict of
interested existed since FWC’s interest would dictate that it should attempt to recover
whatever, if any, monies Athos and Porthos had siphoned off for themselves, whereas
Athos’s and Porthos’s interest would be for FWC not to do so. Since FWC was a
nominal defendant and could not afford to hire its own counsel, the court stayed the
action as to it.

But then a not-so-funny--at least, not to Athos and Porthos--thing happened.
When they tried to sue Aramis directly to recoup the monies he had allegedly deprived
the firm of through his “shadow practice”, the court held on demurrer that those claims
belonged to FWC and that only the corporation could assert them. Worse yet, the judge
ruled that Athos and Porthos could not sue derivatively on behalf of FWC because aside
from the action’s being stayed as to the firm, there were no “disinterested” directors who
could decide whether and what claims to assert. Athos and Porthos protested that the
court’s ruling put them in the unfair position of being sued but not able to sue for the
same sorts of alleged misdeeds just because Aramis had gotten to the courthouse first. They argued that they should be allowed to sue directly since the three of them were for all practical purposes partners and that shareholder’s derivative principles should not apply to closely held corporations such as FWC. The court disagreed.

Was the court right to adhere to the strict application of shareholder’s derivative principles to closely held corporations such as FWC? Or were Athos and Porthos correct that those principles should be relaxed in such circumstances? Or is the answer somewhere in-between? Exploring these questions, and recommending their answers, is the purpose of this article.

II. Setting the Table: The Legal Landscape

Shareholders have long been subject to the rule that disputes over corporate governance must be prosecuted as derivative actions. The articulated reasons for this requirement include (a) to protect creditors by insuring that recovery for misdeeds committed against the corporation redound to the benefit of the entity, (b) to benefit all shareholders proportionate to their ownership interests, (c) to discourage crippling strike suits, and (d) to permit the corporation to manage the suit and its resolution under court supervision. Historically, the sole exceptions were for “special injury” cases, i.e. instances where a shareholder had suffered some harm not shared with the corporation. Such special injury cases included, for example, employment-based breaches, wrongful refusals to issue or exchange stock, failure to pay declared dividends, fraud in the transfer of stock, etc. But for the most common source of shareholder dispute – alleged breaches of fiduciary duty resulting from fraud, misrepresentation, waste and the like – the sole remedy for a disgruntled shareholder was to sue in a derivative action.
The requirement that such claims be pursued as shareholder derivative actions results in odd and sometimes unwieldy results in the context of disputes regarding close corporations. Closely held corporations—those corporations with few shareholders, where management and ownership are often united and where there is a lack of ready market for the shares—are frequently managed more as partnerships than as corporations. Indeed, such businesses are often referred to as “incorporated partnerships” in recognition of their management and profit-sharing structures.\textsuperscript{1} Imposing the procedural and substantive constraints of derivative actions, therefore, sometimes inhibits, rather than promotes, a fair and efficient resolution of disputes between or among the “partners”, since partnership law is free of those constraints and therefore enables straightforward, direct litigation of the merits of the disputes.

Recognizing this problem, in 1992 the American Law Institute (ALI) instituted standards that would permit courts the discretion to allow direct actions by shareholders of close corporations if the policy reasons otherwise requiring derivative actions (i.e., avoiding a multiplicity of actions, protecting creditors and benefiting all shareholders proportionately) were absent.\textsuperscript{2} The ALI’s recommendations created a flurry of activity among jurisdictions and legal commentators, with a split among those jurisdictions where the issue was raised as to whether to adopt the ALI’s approach.

\footnotesize{\textsuperscript{1} William Mead Fletcher, 8 FLETCHER Cyclopedia of the Law of Private Corporations \textsection 3997.20 (Perm. Ed. 2001) ("The term incorporated partnership has been used in reference to close corporations and generally denotes a corporate entity in which the participants interact in a manner akin to partners."); Frank H. Easterbrook & Daniel R. Fischel, Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, 297 (1986) ("That closely held corporations are really ‘incorporated partnerships’ is a common refrain.")

\textsuperscript{2} Principles of Corp. Governance: Analysis and Recommendations, A.L.I. \textsection 7.01(d) (1994).}
Through the years, however, both California’s legislature and its courts, though (1) recognizing the unique aspects of closely held corporations while (2) being avid protectors of minority shareholder rights, have been deafeningly silent—even evasive—on the issue. As a result of this reticence, it is almost serendipitous whether a California shareholder in a closely held corporation will enjoy the more efficient remedies enjoyed in other jurisdictions.

III. DISCUSSION: TO PERMIT, OR NOT PERMIT, DIRECT SHAREHOLDER ACTIONS IN CLOSE CORPORATION DISPUTES

A. The Traditional Distinction Between Shareholder’s Derivative and Shareholder’s Direct Suits

Under the traditional approach, the question of whether to permit a shareholder to sue directly depended on the nature of the harm alleged. If the harm were to the corporation (so that any shareholder harm was indirect), shareholders could pursue the claim only as a derivative action. The recovery, if any, went to the corporation which suffered the harm, not to the shareholder. The shareholder’s recovery was only indirect, i.e., the corporation’s recovery resulted in an increase in his/her proportionate share value.

By contrast, in those instances in which the shareholder had a direct right that was infringed – for example, the corporation’s refusal to pay a declared dividend, its failure to observe a shareholder’s preemptive or voting rights, or its failure to guard a shareholder/employee’s employment rights – such cases could be pursued as direct

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actions since the shareholder had suffered a “special” or “distinct” injury.\(^4\) The American Law Institute suggested that the distinction between direct and derivative actions be based upon whether a shareholder could establish a right to recover without showing a loss to the corporation; if the shareholder could recover only by showing a harm to the corporation (that may also have harmed the shareholder) the action was derivative.\(^5\) However, if a recovery could be granted to the shareholder without showing a harm to the corporation, then the action would be direct.\(^6\) A disgruntled shareholder could pursue directly, then, only those actions in which the shareholder held a legal right separate from any corporate right. But for the majority of corporate disputes – those in which shareholders claim a loss resulting from breach of fiduciary duty, fraud or misuse of corporate assets - the only remedy was a derivative action.

For the traditional corporation – complex, often publicly-traded companies where management and ownership roles are segregated – the shareholder’s derivative requirement makes good sense. The typical shareholder’s derivative action statute mandates that complaining shareholders first make a demand on the corporation; if the


\(^6\) *Principles of Corporate Governance: Analysis and Recommendations*, A.L.I., § 7.01(b) (2004).

Comment c lists the following actions as direct:

1. To enforce voting rights, to prevent improper voting, to protect against dilution, or to protect preemptive rights;
2. To compel the payment of dividend or to protect dividend arrearages;
3. To challenge the improper use of managerial power to perpetuate management or to frustrate voting by shareholders;
4. To prevent ultra vires or unauthorized acts;
5. To prevent oppression of, or fraud against, minority shareholders;
6. To compel dissolution or the appointment of a receiver;
7. To challenge the unlawful expulsion of shareholders through mergers, redemptions, or other means;
8. To inspect corporate books and records;
9. To require the holding of a shareholders’ meeting or the sending of notice of such a meeting; and
10. To hold controlling shareholders liable for actions taken in their individual capacities that reduce the value of minority shares.
demand is refused, or if the demand would be futile, the shareholder can then petition the court. The action can proceed then, but only if the court determines that the shareholder can represent the interests of other shareholders and is satisfied that there is a legitimate basis for the suit. Thus, shareholder’s derivative suits are typically subjected to much closer court supervision than other disputes, further reducing the risk of vexatious litigation.7

These requirements have numerous benefits. Requiring that complaining shareholders first make a demand on the corporation gives the corporation the opportunity to take corrective action, including suing the wrongdoer(s) itself. Requiring that shareholders get court approval reduces the opportunity for strike suits. Requiring

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7 See, e.g., Cal. Corp. Code § 800:

(a) As used in this section, “corporation” includes an unincorporated association; “board” includes the managing body of an unincorporated association; “shareholder” includes a member of an unincorporated association; and “shares” includes memberships in an unincorporated association.

(b) No action may be instituted or maintained in right of any domestic or foreign corporation by any holder of shares or of voting trust certificates of the corporation unless both of the following conditions exist:

(1) The plaintiff alleges in the complaint that plaintiff was a shareholder, of record or beneficially, or the holder of voting trust certificates at the time of the transaction or any part thereof of which plaintiff complains or that plaintiff’s shares or voting trust certificates thereafter devolved upon plaintiff by operation of law from a holder who was a holder at the time of the transaction or any part thereof complained of; provided, that any shareholder who does not meet these requirements may nevertheless be allowed in the discretion of the court to maintain the action on a preliminary showing to and determination by the court, by motion and after a hearing, at which the court shall consider such evidence, by affidavit or testimony, as it deems material, that (i) there is a strong prima facie case in favor of the claim asserted on behalf of the corporation, (ii) no other similar action has been or is likely to be instituted, (iii) the plaintiff acquired the shares before there was disclosure to the public or to the plaintiff of the wrongdoing of which plaintiff complains, (iv) unless the action can be maintained the defendant may retain a gain derived from defendant's willful breach of a fiduciary duty, and (v) the requested relief will not result in unjust enrichment of the corporation or any shareholder of the corporation; and

(2) The plaintiff alleges in the complaint with particularity plaintiff’s efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort, and alleges further that plaintiff has either informed the corporation or the board in writing of the ultimate facts of each cause of action against each defendant or delivered to the corporation or the board a true copy of the complaint which plaintiff proposes to file.”

In addition, the statute has provisions requiring the posting of bonds. Cal. Corp. Code § 800 (c) et seq.
coordination of actions prevents a multiplicity of suits from numerous shareholders. Requiring that claims be pursued derivatively protects creditors by giving them priority; i.e., by requiring that the recovery go to the corporation, who in a dissolution or liquidation must satisfy creditors before making distributions to shareholders. Similarly, the shareholder’s derivative process protects non-litigant shareholders by ensuring that the benefits of any recovery go to the corporation and thus are shared proportionately. Court supervision of the filing and progress of the action reduces the risk of abuses. All of these laudable goals are furthered by the requirement that shareholders pursue derivative actions in the traditional fashion.

But this model runs into difficulty when dealing with smaller businesses. Following the traditional shareholder’s derivative approach in resolving disputes in close corporations grafts an unwieldy framework onto what often are really partnership disputes. Athos, Porthos and Aramis, because they incorporated (or formed a limited liability company, had they chosen that vehicle) for such purposes such as tax, insurance, or employee benefits advantages, wound up with their dispute wedged into a process designed to shield corporations from nuisance suits by shareholders. Though this process is of real value to a large, diversified corporation, how did the shareholder’s derivative requirements help FWC? By compelling Aramis to first make a demand on the corporation (i.e. Athos and Porthos?), who will presumably deny the demand? By making Aramis then demonstrate that he is a “representative” of the shareholders? (Aramis cannot, of course, represent the other shareholders; they’re the persons with

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8 Waller v. Waller, 49 A.2d 449, 452 (Md. 1946).
9 Id.
10 Id.
whom he has the dispute. The unhappy shareholders represent their own interests.) By requiring that he post bond? (To protect the allegedly wrongdoing shareholders?) But Aramis was smart; by getting to the courthouse first and suing the entity as a defendant, alleging (correctly) that demand on the directors to cause the entity to act would have been futile, he was able to avoid the application of derivative principles to his complaint while saddling Athos and Porthos with those requirements, effectively preempting their claims. Athos and Porthos, under the traditional system, were able to neither file a direct cause of action (because Aramis’s alleged conduct also harmed the corporation) nor file derivatively.

The rationale behind the shareholder’s derivative requirement is nonsensical in this context. Why not, in these circumstances, simply recognize that a shareholder in a close corporation, where ownership and management are united, may sue directly for harms to his investment interest in the corporation? This was the approach taken by the court in *Watson v. Button*.11

B. **Possible Solution: Allowing Direct Shareholder Actions For Wrongs to the Corporation**

*Watson v. Button*12 involved a corporation with two equal shareholders, who sold the business. After the sale, one of the two former shareholders claimed that the other former shareholder had embezzled corporate funds and obtained a release of any corporate obligations from the buyers. The disgruntled former shareholder sued the embezzling former shareholder for misappropriation of corporate assets. The claim, in alleging harm to the corporation, could traditionally be pursued only as a derivative

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12 *Id.*
action. This was impossible in the case, of course, since the complaining party was no longer a shareholder and could therefore not make a shareholder’s demand on the corporation.\textsuperscript{13} The federal appellate court, applying Oregon law, acknowledged that the case fell within the traditional profile of a shareholder’s derivative action, citing authority from that state’s Supreme Court:\textsuperscript{14}

> It is a well-established general rule that a stockholder of a corporation has no personal right of action against directors or officers who have defrauded or mismanaged it and thus affected the value of his stock. The wrong is against the corporation and the cause of action belongs to it. Any judgment obtained by reason of such wrongs is an asset of the corporation which inures first to the benefit of creditors and secondly to stockholders.

Despite that, the \textit{Watson v. Button} court permitted a direct action by the disgruntled former shareholder against his former co-shareholder. The court reasoned that the traditional purposes for the general rule requiring that such claims be filed derivatively (to avoid a multiplicity of suits, to protect corporate creditors and to benefit all shareholders proportionately) were inapplicable to the case. Since the two parties were the only shareholders at the time of the misappropriation, there could be no other shareholders making claims or requiring protection. Corporate creditors were adequately protected since the two former shareholders were liable for previously existing corporate debts, and, even if they were not, creditors could probably not pursue a claim for corporate misappropriation.\textsuperscript{15} Thus, “[t]he only right apparently would be to enforce the corporate cause of action, but that was given up by the present owners of the corporation

\textsuperscript{13} \textit{Id.} at 236-37.

\textsuperscript{14} \textit{Smith v. Bramwell}, 31 P.2d 647, 648 (footnote omitted) (Or. 1934).

when they purchased it."\textsuperscript{16} Consequently, the court allowed the action since no other shareholder or creditor could pursue a claim to recover the loss.

Following Watson v. Button, the ALI codified this approach in its recommendations:

In the case of a closely held corporation [§ 1.06], the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons. § 7.01(d)\textsuperscript{17}

The ALI noted that the most important result of characterizing an action as direct or derivative is the tendency for derivative actions to be more complex procedurally and to restrict the eligibility of the shareholders to pursue claims.\textsuperscript{18} In the case of close corporations, the ALI noted the rationale of Donahue v. Rodd Electrotype Co. of New England\textsuperscript{19} that “the partnership and the closely held corporation were virtually interchangeable business forms, and thus a significant difference in their legal treatment was not warranted.”\textsuperscript{20} Supporting the right of direct action for traditionally derivative claims were the following considerations: First, the likelihood of having a disinterested board was smaller in close corporations where the majority shareholders often controlled management. Second, the idea that a corporate injury was separate from a stockholder injury was a fiction when applied to corporations with only a handful of stockholders.

\textsuperscript{16} Id. at 237, note omitted.
\textsuperscript{17} Supra note 2.
\textsuperscript{18} Id. at 20, comment d.
\textsuperscript{19} 328 N.E.2d 505 (Mass. 1975).
\textsuperscript{20} Supra note 2 at 21, comment e.
Third, the procedural rules of derivative actions “often make little sense in the context of a dispute between persons who are effectively incorporated partners.” While acknowledging the need to protect corporate creditors, the ALI adopted what it termed the “compromise” position articulated in *Watson v. Button*. While many of the decisions focus on the right of minority shareholders to pursue claims against controlling shareholders, the concept has been extended to circumstances like *Watson v. Button*, where there are equal, deadlocked shareholders. For example, courts in various jurisdictions have held that a 50% shareholder in a close corporation can bring an individual action against the other 50% shareholder(s) “if it can demonstrate either a loss peculiarly to itself and different than that suffered by the corporation, or where the remaining 50% shareholder committed the actionable acts in his or her capacity as a director or officer of the corporation.”

The issue promises to expand from corporate law to the law of business organizations generally. The rise of LLCs and limited partnerships, with their hybrid characteristics of corporations and partnerships, have made them attractive alternatives to corporations. As with closely-held corporations, LLCs and limited partnerships are generally owned by few members who are often involved in management, often with no ready market for membership interests. Whether to permit LLC members or limited partners to sue directly instead of derivatively is an issue that has already been

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21 *Id.*

22 *Id.*

encountered, with some jurisdictions debating whether to permit direct suits by LLC members\(^\text{24}\) or by limited partners.\(^\text{25}\)

C. **Trend: ALI Approach Remains a Minority View**

While the ALI approach has been recommended for more than a decade, it remains a minority position.\(^\text{26}\) Of the thirty-seven states that have considered the issue, sixteen have adopted the ALI approach by permitting direct suits, while twenty states have held that the traditional shareholder’s derivative requirement applies, and in one jurisdiction the decisions appear inconsistent. States permitting direct shareholder actions in close corporation disputes include Arizona,\(^\text{27}\) Georgia,\(^\text{28}\) Kansas,\(^\text{29}\) Indiana,\(^\text{30}\)

\(^{24}\) See, e.g., *Stoker v. Bellemade*, LLC, 615 S.E.2d 1, 8 (Ga. Ct. App. 2005), partially rev’d on other grounds, *Bellemade, LLC v. Stoker*, 631 S.E.2d 693 (Ga. 2006) (“With respect to the two-member LLCs at issue ... [s]ince both members of the LLC in each claim are parties to the suit, we find no danger of multiple suits and no concern that a recovery would prejudice the rights of the other member. Moreover, a direct suit with all the members joined may prevent a defendant member from inappropriately sharing in the recovery, while providing an appropriate recovery to a plaintiff member who would gain no benefit from a derivative recovery on behalf of the LLC given the lack of a ready market for closely held LLC interests. Finally, as to protection of LLC creditors, the record does not reflect any evidence of existing creditors, and none of the members have offered evidence of existing creditors.”) For a discussion of the issue generally, see Daniel S. Kleinberger, *The Closely Held Business Through the Entity-Aggregate Prism*, 40 WAKE FOREST L. REV. 827, 852. See also Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63 (2006) and James R. Burkhard, *May a Member of an LLC or a Limited Partner Bring a Breach of Fiduciary Duty Claim against Those Controlling the LLC or Partnership as a Diversity Action?*, 23 REV. OF LITIGATION 239 (2004); Sandra K. Miller, *What Buy-out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?* 38 Hav. J. on Legis. 413.

\(^{25}\) Mieuli v. DeBartolo, not reported in F.Supp.2d 2001 WL 777091 (N.D. Cal. 2001) (refusing to allow a limited partner to sue directly for breach of fiduciary duty).


Massachusetts, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Texas, and Utah. States


In re Ziehm’s Estate, 79 Misc. 2d 467 (1974) (in a Surrogate’s Court matter, the court permitted a direct suit by a 50% shareholder against the estate of the other 50% shareholder, noting that “in a small closely owned corporation, a claim such as this may be brought in the petitioner’s own individual capacity rather than in the form of a derivative suit, since it is petitioner who, if his allegations are true, would be injured directly. Given the fact that the only other shareholder is petitioner makes it clear that it is the petitioner who would be solely injured by the alleged loss or conversion of these said assets.”).

Norman v. Nash Johnson & Sons Farms, Inc., 537 S.E. 2d 248 (N.C. App. 2000) (Minority shareholders of closely held corporation could sue both directly and derivatively for breach of fiduciary duty and related claims against the majority shareholders).

Balvik v. Sylvester, 411 N.W.2d 383 (N.D. 1987) (permitting direction action by minority shareholder from alleged corporate freezeout); Schumacher v. Schumacher, 469 N.W.2d 793 (N.D. 1991) (trial court abused its discretion by prohibiting minority shareholders of closely held corporation from suing directly for breach of fiduciary duty).


Watson v. Button, 235 F.2d 235 (9th Cir. 1956) (applying Oregon law); Noakes v. Schoenborn, 841 P.2d 682 (Or. App. 1992) (former minority shareholders of closely held corporation could bring their suit for breach of fiduciary duty and related causes of action derivatively or directly).

Brown v. Stewart, 557 S.E.2d 676, 685 (S.C. App. 2001) (noting general rule requiring derivative actions absent special injury, but notes that shareholders may sue directly “for losses suffered by the corporation if the underlying reasons for requiring a derivative action are absent” while declining to exercise its discretion where factors not present). But cf., Babb v. Rothrock, 401 S.E.2d 418 (S.C. 1991) (finding, without deciding whether shareholder can sue directly, that it would be improper to allow exception to general rule requiring derivative actions since corporate creditors would be jeopardized). But see Arndt v. First Interstate Bank of Utah, N.A., 991 P.2d 584 (Utah 1999) (declining to apply the principle to allow direct suits by limited partners) and GLFP, Ltd. V. CL Management, Ltd., 163 P.3d 636 (Utah App. 2007) extending the right of direct action for limited partner alleging breach of fiduciary duty). For a discussion see Robbie G. Yates, Aurora Credit Services, Inc. v. Liberty West Development, Inc.: An Analysis of Shareholder Derivative Suits in Closely Held Corporations, 2002 B.Y.U. L. REV. 175 (2002); Peter H. Donaldson, Breathing Life Into Aurora Credit Services, Inc. v. Liberty West Development, Inc.: Utah’s Close Corporation Exception to the Derivative Lawsuit Requirement and the Case for Strong Fiduciary Duties in Close Corporations, 2002 Utah L. Rev. 519 (2002).
rejecting the ALI recommendation and instead requiring the traditional shareholder’s derivative approach include Alaska,43 Alabama,44 Arkansas,45 Colorado,46 Delaware,47 Florida,48 Illinois,49 Iowa,50 Louisiana,51 Maryland,52 Minnesota,53 Mississippi,54


44 McDonald v. U.S. Die Casting & Development Co., 541 So.2d 1064 (Ala. 1989) (minority shareholder can sue majority for fraud only if there is a special injury not suffered by other shareholders). Green v. Bradley Constr., Inc., 431 So.2d 1226 (Ala. 1983) (unclear whether corporation was closely held, however court held that minority shareholder could sue only derivatively for fraud unless suffering a direct injury).

45 Hames v. Cravens, 966 S.W.2d 244, 247 (Ark., 1998) (minority shareholders of closely held corporation have no right to sue directly for breach of fiduciary duty).


48 Orlinsky v. Patraka, 971 So.2d 7996(Fla. App. 2007).

49 Small v. Sassman, 713 N.E.2d 1216 (ll. App. Ct. 1999); Frank v. Hadesman & Frank, Inc., 83 F.3d 158, 162 (7th Cir. 1996) (applying Illinois law, the court acknowledged that the “American Law Institute recognizes that § 7.01(d) is not the majority position [see Reporter’s Note 4 to that section]; the ALI simply commended the idea to the states. We have predicted that Delaware would not follow § 7.01(d). Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379 (7th Cir. 1990). Illinois likewise lacks any support for this approach. Perhaps the state ultimately will elect to join the minority; perhaps adherents of § 7.01(d) will swell and become the majority. Only state legislatures and state courts have the authority to change state law.”).


53 P.J. Acquisition Corp. v. Skoglund, 453 N.W.2d 1 (Minn. 1990); Wessin v. Archives Corp., 592 N.W.2d 460 (Minn. 1999).
Missouri, Nebraska, New York, Oklahoma, South Carolina, South Dakota, Virginia, Wisconsin In some states, the issue has been approached but remains undecided, sometimes with the courts’ speculation about whether the state will follow the ALI recommendation. In other jurisdictions, including Idaho, the decisions appear inconsistent.


56 Trieweiler v. Sears, 689 N.W.2d 807, 828 (Neb. 2004) (minority shareholder in closely held corporation had no right to individual action for fraud absent a harm “peculiar to him or her alone.”

57 Wolf v. Rand, 685 N.Y.S.2d 708 (App. Div. 1999); Henneberry v. Sumitomo Corp. of America, 415 F.Supp.2d 423, 439 (S.D.N.Y. 2006) (shareholder of non-publicly traded corporation had no right under New York law to sue directly for breach of fiduciary duty absent a special injury, and [this rule applies regardless of whether the corporation is a larger, publicly traded corporation, or a closely held corporation [citation].”)


61 Simmons v. Miller, 544 S.E.2d 666, 675 (Va. 2001) (“[w]e decline to adopt a closely held corporation exception to the rule requiring that suits for breach of fiduciary duty against officers and directors must be brought derivatively on behalf of the corporation and not as individual shareholder claims. Adherence to the general rule without this proposed exception prevents multiplicity of lawsuits by shareholders. A recovery by the corporation protects all shareholders as well as creditors. Finally, as expressed in Bagdon, consistent application of commercial rules promotes predictability. If shareholders and the corporation desire to vary commercial rules by contract, they are free to do so.’”); Casden v. Burns, 504 F.Supp.2d 272 (N.D. Ohio 1007) (applying Va. law).

62 Notz v. Everett Smith Group, Ltd., 754 N.W.2d 235, 242 (Wis. App. 2008) (unclear whether corporation was closely held, however court holds generally that absent direct injury, claims of breach of fiduciary duty must be brought derivatively and not directly).

63 Steelman v. Mallory 716 P.2d 1282 (Idaho 1986) (permitting direct action by minority shareholder in alleged corporate freezeout). Cf. McCann v. McCann, 61 P.3d 585 (Idaho 2002) (sole minority shareholder had no right to sue directly for breach of fiduciary duty and related claims absent showing of special injury, even when he was the only shareholder so situated) and Mannos v. Moss, 155 P.3d 1166 (Idaho 2007).
1. States Following the Traditional Derivative Requirement for Shareholder Suits

For the states following the traditional requirement that shareholders pursue claims in a derivative action, the reasons generally cited include the need for predictability and consistency in commercial transactions. They assert that there is great value in promoting consistency and predictability in corporate law and that those goals are furthered by retaining traditional procedural rules, particularly where business formation decisions may have depended on the distinctions. One court, in declining to apply the ALI approach, noted that “[c]orporations are not partnerships” and observed that “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.”

In addition, these states reason, creditors are better protected in shareholder derivative actions. Shareholder derivative actions ensure that creditors receive court-supervised priority, a safeguard not available when shareholders sue directly. Put differently, these courts believe that even when closely held corporations are involved, monies recovered from directors, officers, or shareholders whose conduct harmed the corporation should go to the entity so that they are available to satisfy creditors, leaving the wronged shareholder with the benefit of his bargain, i.e., more valuable shares.

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64 See, e.g., Durham v. Durham, 871 A.2d 41, 46 (N.H. 2005); Wessin v. Archives Corp., 592 N.W.2d 460, 466 (Minn. 1999).

65 Bagdon v. Bridgestone/Firestone, Inc. 916 F.2d 379, 384 (7th Cir. 1990) (applying Delaware law).
Some courts reason that the notion of permitting shareholders to sue directly for an indirect harm on the theory that shareholders in close corporations are more like partners in partnerships is a false premise. To the contrary, they opine that while partners may have remedies for premature dissolution or may create provisions to value and pay a partnership share over time without liquidating the business, no such protections are in place for close corporations. Accordingly, they assert, permitting direct actions may have the effect of forcing the majority shareholders to buy out minority shareholders over a litigation threat. 66 Thus, if a shareholder sues directly for a harm to the corporation, it may have the effect of terminating a viable business or forcing an involuntary liquidation of its assets. 67 Such risks could have been negotiated in a partnership agreement, so the reasoning goes, but would not have been part of any shareholders’ agreement. Thus, they believe, permitting shareholder direct actions may have the effect of an early termination of a business, or it may provide a shareholder with powerful leverage to extract a settlement in a way not envisioned at the time the business was incorporated. Indeed, even without risk of a business termination, permitting direct suits forcing payouts to shareholders is sometimes seen as an invasion of the directors’ discretion.

Further, preventing a shareholder from disregarding the corporate entity, it is reasoned, may encourage communication among corporate leaders. 68 It avoids a potential for abuse merely because of differences of opinion over, for example, corporate strategy. 69 A successful shareholders’ derivative suit benefits all shareholders in

67 Id. at 15 (S.D. 1997).
68 Wessin v. Archives Corp., 592 N.W.2d 460, 467 (Minn. 1999).
69 Landstrom v. Shaver, 561 N.W.2d 1, 14 note 16 (S.D. 1997).
proportion to their ownership shares, rather than rewarding the plaintiff shareholder in a direct action. In other words, adhering to a derivative requirement protects all shareholders, not simply those suing.

Countering arguments that shareholder derivative suits in close corporation disputes have the effect of benefiting any wrongdoing shareholders who would otherwise be defendants in a direct action, courts have reasoned that such shareholders are simply seeing a proportionate return on assets that were theirs in the first place. Payment to the corporation permits the corporation to provide the investment channel. Otherwise, the court would be making a judicial determination to distribute corporate assets, in effect, as dividends or partial liquidations, usurping the board’s role. Finally, the distinction over direct and derivative actions is seen as circular if the traditional standards do not remain in place. That is, shareholders do not suffer direct harm unless given a right of action. If given a direct cause of action (as the ALI proposes), shareholders then have a direct right of action in a case where the harm simply is not direct.

2. States Adopting the ALI Approach

Rationales in favor of adopting the ALI approach generally start with a historical look at the origin of shareholder’s derivative suits. These lawsuits were originally direct and equitable in nature, filed as equivalent to the concept of trust beneficiaries. In close corporations, an increasing number of jurisdictions see the shareholders – particularly

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majority shareholders – as fiduciaries of one another.\textsuperscript{74} This implies a direct duty that should, logically, be enforceable by a direct cause of action. One court noted that “the concept of a corporate injury that is distinct from any injury to the shareholders approaches the fictional in the case of a firm with only a handful of shareholders.”\textsuperscript{75}

Further, as a practical matter, proponents of the ALI option see the shareholder’s derivative requirements as inadequate. For example, in a close corporation, it is unlikely that a board will be composed of disinterested directors.\textsuperscript{76} Thus, the demand requirement of shareholder derivative statutes under these circumstances is likely to be a worthless exercise. To the contrary, it is, at best, unlikely that the board of a closely held corporation will be disinterested\textsuperscript{77} and, at worst, the board will be controlled by the very shareholders with whom a minority shareholder would be feuding. Litigation involving closely-held corporations, it is argued, is likely the “outgrowth of a dispute among competing factions of shareholders. As a result, the shareholders’ votes will be influenced, if not dictated, by their established alliances rather than by any objective assessment of the company’s interest.”\textsuperscript{78} Particularly in jurisdictions that permit the

\begin{itemize}
\item \textsuperscript{74} John A. Gebauer, Action in Own Name by Shareholder of Closely Held Corporation, 10 A.L.R.6\textsuperscript{th} 293, §§ 6-10 (2006).
\item \textsuperscript{75} Aurora Credit Servs, Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1280-81 (Utah 1998) citing Principles of Corp. Governance: Analysis and Recommendations, A.L.I. § 7.01(d) comment e (1994).
\item \textsuperscript{76} *Principles of Corp. Governance: Analysis and Recommendations*, A.L.I. § 7.01(d) comment e (1994); Durham v. Durham, 871 A.2d 41, 46 (N.H. 2005).
\item \textsuperscript{77} Olga N. Sirdoeva-Paxson, Judicial Removal of Directors: Denial of Directors’ License to Steal or Shareholders’ Freedom to Vote? 50 HASTINGS L.J. 97, 152 n.246.
\end{itemize}
board to take over a shareholder’s derivative action and file voluntary dismissals, this would be a hollow remedy for the complaining shareholder. In such cases the board, controlled by the majority shareholders, could take over the litigation from the complaining shareholder and simply dismiss it.

Even if the shareholder’s derivative action is prosecuted, critics of the derivative requirements charge, to what benefit will the complaining shareholder be entitled? The very wrongdoers, if they are shareholders, will share in any judgment. This result would be avoided by permitting shareholders to sue directly and permit a recovery only to parties who demonstrate harm resulting from wrongful conduct.

Jurisdictions adopting the ALI recommendation to give courts discretion to treat shareholder litigation in closely-held corporations as direct suits note that the policy reasons for requiring that shareholder litigation be pursued derivatively are often absent in the context of closely-held corporations. For example, there is often no meaningful risk of a multiplicity of suits when few shareholders are involved. The ALI guidelines would give courts the discretion to permit direct suits when a multiplicity of suits constituted no risk, but also to deny the direct suit if such a risk existed.

Further, ALI proponents note that the goal of encouraging intracorporate resolution of disputes is not necessarily furthered by the requirement that actions be pursued derivatively; if the shareholder of a close corporation had the power to resolve the matter internally, there would have been no need for a suit. The very nature of a close corporation – including the relationships among the shareholders and the unity of

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ownership and management interests - makes an internal resolution of disputes less likely. 80 Further, a “suit to rectify serious wrongs can hardly be viewed as interfering with the proper management of the business.” 81 The policy of encouraging intra-corporate resolution of disputes promoted by shareholder’s derivative requirements is less likely to be furthered by their application in the context of close corporations.

The ALI notes that “(i)n some circumstances, characterizing the action as direct will also be fairer to the defendants, such as when the defendants wish to file a counterclaim against the plaintiff, because the general rule is to prohibit counterclaims in a derivative action (citation).” 82 Some have noted that applying the ALI rule permitting direct suits would be appropriate only for those disputes involving bad faith and not for disagreements over management. 83 This aspect should reduce, then, the risk of strike suits and provide equivalent protection as is otherwise given under the shareholder’s derivative requirement.

The need for predictability and adherence to precedent, cited by proponents of the traditional shareholder’s derivative requirement, is less important in the context of close corporations, claim ALI proponents. 84 Because of the small number of shareholders and existing relationships, the need for strict adherence to corporate law precedent is of less importance than the timely and direct resolutions of disputes. Adherence to corporate

80 James R. Burkhard, May a Member of an LLC or a Limited Partner Bring a Breach of Fiduciary Duty Claim Against Those Controlling the LLC or Partnership as a Diversity Action? 23 REV. OF LITIG. 239, 251 (2004).
81 Id. at 252 (footnote omitted).
83 Daniel S. Kleinberger & Imanta Bergmanis, Direct vs. Derivative, or “What’s a lawsuit Between Friends in an ‘Incorporated Partnership?’”, 22 WM. MITCHELL L. REV., 1203, 1269.
law procedure is not, in their view, a value more important than that of permitting a forum for the resolution of disputes in a context appropriate for closely held corporations.

Further, proponents of the ALI approach note that absent an agreement to the contrary, permitting direct suits would shift the cost of the litigation to the parties themselves (unlike the case with shareholder’s derivative actions, which shifts costs to the corporation). In a direct A v. B suit, each party must bear its own attorneys’ fees rather than being able to look to the corporation for indemnification. This makes the direct suit model consistent with the American approach to having each party bear its own attorneys’ fees, absent agreements to the contrary. Finally, permitting direct suits would not increase the number of claims, proponents of the ALI claim, but, rather, would simply change the way that they are brought.

D. *California’s Middling—Or Is It Muddling-- Path*

California has not directly decided the issue of whether to permit shareholders in close corporations to sue directly for corporate harm. There is a partial parallel issue in *Jones v. H.F. Ahmanson & Co.* where a minority shareholder sued on the basis that the majority shareholders breached their fiduciary duty to the minority shareholders, diminishing the market (and therefore value) of the minority shareholders’ holdings. The majority stockholders of a closely-held savings and loan association exchanged their shares for shares in a newly-formed holding company, with the result that 85% of the association’s shares were controlled by the holding company. The holding company then

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87 460 P.2d 464 (Cal. 1969).
pledged the association’s assets as security for the holding company’s debt and made a public offering of the holding company’s shares, the value of which derived from the association’s assets. Minority shareholders were not given an opportunity to exchange their shares. The exchange left minority shareholders with no ready market for their shares which, after the exchange and encumbrance as security, left them with diminished share value.

In concluding that minority shareholders had a direct cause of action against the majority, the California Supreme Court held that majority shareholders owe fiduciary duties to minority shareholders. Minority stockholders have a direct action for the harm done to the value of their own shares; a right distinct from any corporate claim of diminished stock value, thus:

Although (the plaintiff) does allege that the value of her stock has been diminished by defendants’ actions, she does not contend that the diminished value reflects an injury to the corporation and resultant depreciation in the value of the stock. Thus the gravamen of her cause of action is injury to herself and the other minority stockholders. *Id.* at 107.

*Jones v. H.F. Ahmanson & Co.* is notable, then, for holding that in California, majority shareholders of a close corporation owe fiduciary duties to the minority and that the minority may sue directly for the diminished value of the minority shares. In *Jones v. H.F. Ahmanson & Co.*, however, the minority shareholders suffered a harm peculiar to themselves. The holding does not answer the question of whether shareholders may sue directly for a harm that diminishes the value of a closely-held corporation, including (but not limited to) that shareholder’s interest.

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88 *Id.*
The issue was presented in *Jara v. Supreme Meats, Inc.* There, the Court held that a minority shareholder had an individual cause of action for breach of fiduciary duty to recover allegedly excessive salaries which two of the shareholders of a successful corporation paid to themselves. The Court of Appeals expressly followed the reasoning of the California Supreme Court in *Jones*, noting that the “gravamen of Jara, Sr.’s complaint is that he was deprived of a fair share of the corporation’s profits as a result of defendants’ generous payment of executive compensation to themselves…These payments gave rise to an injury to Jara, Sr., as an individual.”

The *Jara* court read *Jones* as permitting a personal action where “‘a majority stockholders’ breach of a fiduciary duty to minority stockholders which resulted in the majority stockholders retaining a disproportionate share of the corporation’s ongoing value.”

While *Jara* presented the court with a classic case in which to apply the ALI standards, it limited its holding short of those recommendations. Instead of holding that a shareholder of a close corporation may sue as long as the ALI considerations are satisfied (i.e. permitting direct suits where there was no risk of a multiplicity of actions, no prejudice to the interests of corporate creditors and no interference with the rights of all shareholders to participate in a recovery), the court instead held that the minority shareholder in *Jara* had a direct cause of action for breach of fiduciary duty because he himself was injured by the majority shareholders’ excessive salaries even though the corporation had thrived. The court implied that the allegedly excessive salaries to

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90 *Id.* at 1258.
91 *Id.* at 1257-58 citing *Pareto v. F.D.I.C.*, 139 F.3d 696, 699-700 (9th Cir. 1998) (applying California law).
controlling shareholders did not harm the corporation itself, but instead operated as a mechanism to distribute disguised dividends to the majority shareholders at the expense of the minority shareholder. Since the company “experienced extraordinary growth” and since the plaintiff “did not claim that the company would have experienced still greater prosperity and growth if the salaries had been smaller,” then, the court concluded, the harm was to the individual and not to the company.

The Jara court’s analysis works only if it is assumed that paying excessive compensation to majority shareholders does not harm the corporation. If the corporate assets could not have been used more profitably to increase corporate wealth, then the only loser is the uncompensated minority shareholder who has, in effect, lost out on what should have been a dividend distribution. However, the court’s analysis fails if one views the payout of excessive compensation as a loss even to a highly successful corporation. Simply because the company in Jara was very profitable, it does not follow that it could not have been even more profitable had the assets not been paid out as excessive compensation to controlling shareholders. If so, then the harm is not simply to a minority shareholder who lost out on a profit distribution, but to a corporation whose controlling shareholders put personal wealth ahead of their fiduciary duty to the corporation. While the Jara court, then, adopted many of the same considerations as the ALI in permitting a direct shareholder action it limited its holding to cases involving specific alleged breaches of fiduciary duty, and not mismanagement or fraud.

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93 The policies (of requiring derivative actions) “find little or no application in the present case. The objective of preventing a multiplicity of lawsuits and assuring equal treatment for all aggrieved shareholders does not arise at all when there is only one minority shareholder. The objective of encouraging intracorporate resolution of disputes and protecting managerial freedom is entirely meaningless where the defendants constitute the entire complement of the board of directors and all the corporate officers. And the
Other California cases have muddied the waters, reaching inconsistent conclusions concerning whether a shareholder of a close corporation may sue directly for breach of fiduciary duty, fraud or malfeasance. Most decisions after Jones but before Jara held that there was no right of direct actions in closely held corporation disputes. In an unpublished opinion, the California Court of Appeals, Second District held that a shareholder of a closely-held corporation could sue directly for breach of fiduciary duty, noting that “it is immaterial that the Defendants’ conduct may have injured the corporation as well as the Plaintiff.” Yet in another unpublished opinion, that same district held that shareholders of a closely held corporation could not sue directly for breach of fiduciary duty. That court held that the principal detriment resulting for misuse of corporate funds “is to the corporation and its ability to fund corporate activities and to eventually pay dividends to the shareholders. The diminution in the value of the shares is secondary.”

Similarly, in Nelson v. Anderson, the court denied a minority shareholder the right to sue the majority shareholder directly for alleged breaches of fiduciary duty. “A derivative action may appear...to be an empty formality when there are only two shareholders, and one of them is the alleged wrongdoer,” the court admitted; however, the policy of preserving corporate assets for the benefit of creditors has, at best, a very weak application where the corporation remains a viable business.” Id. at 1259.

94 Id. at 1254-55.
95 Id. at 1256.
98 Id.
“[f]ailure to comply with the requirements of the [shareholder’s derivative] statute deprives a litigant of standing.”\textsuperscript{100} The issue was also suggested, but not decided, in a California Supreme Court case where the court reaffirmed the rule that majority shareholders of a close corporation owe fiduciary duties to the minority, but left undecided the issue of whether the shareholder had a right to sue directly instead of derivatively.\textsuperscript{101} And a federal court deciding a California case held that minority shareholders suing for breach of fiduciary duty had no right to sue directly, noting that “[i]f a corporation suffers a direct injury to the whole of its assets, any corresponding injury to the value of an individual stockholder’s shares (assuming the stockholder suffers no truly independent injury), is merely incidental to, or an indirect result of, the direct injury to the corporation’s assets. An action by stockholders for that injury must be brought derivatively if at all.”\textsuperscript{102}

By contrast, some cases post-\textit{Jones} cases have held that there is a direct cause of action for traditionally derivative causes of action in close corporations. \textit{Smith v. Tele-Communications, Inc.} held that when a corporate subsidiary was sold to its parent, depriving the minority shareholder of the tax benefits of the transactions, the shareholder had a direct cause of action.\textsuperscript{103} This case can be squared with \textit{Jones} in that the harm was suffered only by the minority shareholder, not the corporation. Taken further, the court

\begin{itemize}
  \item \textsuperscript{100} \textit{Id.} at 127.
  \item \textsuperscript{101} \textit{Stephenson v. Drever}, 947 P.2d 1301 (Cal. 1997) [\textbf{official cite}] (Close corporation with buy-sell agreement giving corporation the right to purchase shares on termination of shareholder’s employment. Held, fiduciary duty owed by majority shareholders to former employee/minority shareholder during the post-employment period during which the shares were valued for repurchase by the corporation.)
  \item \textsuperscript{102} \textit{Pareto v. FDIC}, 139 F.3d 696 (9\textsuperscript{th} Cir. 1998) (NB: It is unclear whether the corporation at issue was closely-held).
  \item \textsuperscript{103} \textit{Smith v. Tele-Communications, Inc.}, 134 Cal. App. 3d 338 (Cal. App. 1982).
\end{itemize}
in *Crain v. Electronic Memories & Magnetics Corp.*\(^{104}\) held that when the stock of a closely held corporation was rendered valueless by a financing scheme, the minority shareholders had a direct cause of action for breach of fiduciary duty against the corporation and the majority shareholder/holding corporation. And in a case squarely at odds with the traditional shareholder’s derivative requirement, a California Court of Appeal permitted a 50% shareholder (and former spouse of the other 50% shareholder) to sue individually on the allegation that she was deprived of her fair share of the corporate profits.\(^{105}\)

There is a similar lack of clarity in litigation involving other California business organizations. In *PacLink v. Superior Court*, the California Court of Appeals held that members of an LLC could not sue directly for an allegedly fraudulent transfer of company assets.\(^{106}\) *PacLink* may be distinguished since the minority members were not suing majority owners, but, instead, successor companies. Still, the court held, minority owners cannot sue for rights belonging to the company. Thus, because “members of the LLC hold no direct ownership interest in the company's assets…the members cannot be directly injured when the company is improperly deprived of those assets. The injury was essentially a diminution in the value of their membership interest in the LLC occasioned

\(^{104}\) 50 Cal. App. 3d 509 (1975).

\(^{105}\) *In re Marriage of Moca*, No. B181359, not reported in Cal.Rptr.3d, 2006 WL 847956 (Cal. App. 2006) (Court permitted shareholder to file a direct suit against a third party for his conduct in diminishing the value of the corporation).

\(^{106}\) *PacLink Communications Inter’l, Inc. v. Superior Court of Los Angeles County*, 90 Cal. App. 4th 958, 964 (2001). “In this case, the essence of plaintiffs' claim is that the assets of *PacLink-1* were fraudulently transferred without any compensation being paid to the LLC. This constitutes an injury to the company itself. Because members of the LLC hold no direct ownership interest in the company's assets the members cannot be directly injured when the company is improperly deprived of those assets. The injury was essentially a diminution in the value of their membership interest in the LLC occasioned by the loss of the company's assets. Consequently, any injury to plaintiffs was incidental to the injury suffered by *PacLink-1.*”
by the loss of the company's assets.” Consequently, any injury to plaintiffs was incidental to the injury suffered by [the LLC]”, therefore precluding a direct suit.\(^{107}\) Similarly, in federal litigation involving other California business organizations, a court held (in an unreported case) that a limited partner had no right to sue directly for breach of fiduciary duty resulting from alleged mismanagement, conversion, and self-dealing.\(^{108}\)

Taken together, the only conclusion that can be drawn is that most of the post-
\textit{Jones} cases deciding whether to permit shareholders of close corporations to file directly rather than derivatively for harm to the corporation and the shareholders’ interests have concluded that there is no such right. Some courts, however (including \textit{Crain} and \textit{Jara}), have reached opposite conclusions. Trying to reconcile the divergent interpretations, \textit{Jara} concluded that there is a direct right of action for breach of fiduciary duty but not for mismanagement or fraud. Other courts, in an attempt to reconcile the decisions, have misstated the case facts (\textit{e.g.} the \textit{Pareto} court’s observation that only the minority stock in \textit{Crain} was rendered worthless).\(^{109}\) In essence, California law on the subject remains inconsistent and unpredictable.

V. \textbf{WHAT SHOULD CALIFORNIA DO?}

There should be no reason why Athos and Porthos should have their hands tied while Aramis does not. Nor is there any reason why, even if the court lifts the stay as to FWC, the corporation should have to deplete its assets by hiring its own lawyer to sue, in all probability, all three of its owners. Thus, the application of traditional derivative

\(^{107}\) \textit{Id.}.


\(^{109}\) \textit{Pareto v. F.D.I.C.}, 139 F.3d 696, 700 (9\textsuperscript{th} Cir. 1998) (applying California law).
principles really makes no sense even conceding that such application leads to predictability of result—that the result is predictable doesn’t make it the right result. And while there is some inherent appeal to the “you chose corporate status, so you’re stuck with all of its aspects” argument, that appeal pales beside the need to have a fairer, more efficient way to have all the underlying disputes among the parties determined.

Whether the ALI recommendations are the answer, however, remains to be seen. Lawyers are generally apprehensive about laws or policies which are based on the discretion of courts; they prefer to have, if not rules, then procedures to get to the result. The task, then, becomes identifying the policies to be served, and then figuring out a process to best serve them.

It would seem that the ALI’s policies of not exposing the corporation to the risk of multiple suits, of not jeopardizing the rights of creditors, and of not interfering with a fair distribution of any recovery, are sound, but not necessarily complete. Other policies should include expeditious litigation of the merits (i.e., no procedural quagmires); not allowing wrongdoing directors or shareholders to use corporate assets to defend intentional tort claims for breach of fiduciary duty, waste, etc.; not jeopardizing the ability of the business to function or to collect its receivables; and, relatedly, preserving the value of the enterprise on a going-forward basis. There may be others as well that are less generally apparent.

What process is the best way to serve these policies? Ideally, that is for the legislature to determine, as that is not the function of the judicial system. Perhaps some process that takes into account the nature—intentional tort v. management issues—and probable validity of the competing claims, such as that used for an attachment, should be
required in order to bring a direct action or cross-action. Perhaps shareholder actions should have mandatory fee-shifting, or, in connection with a “probable validity” proceeding, the court should determine who, if anyone, can use corporate assets to prosecute and/or defend claims. Or perhaps in the context of close corporations, direct actions should be the rule rather than the exception, but on application of any of the combatants or of any creditor, the court can impose one or more provisional directors even if there is not the traditional deadlock, so that the combatants can’t throw out the baby—the corporation or LLC—with the bath water.

Although the solution is certainly open to, and indeed requires, serious debate, there can be no denying the problem. Yet California’s legislature and courts have been avoiding the subject for almost two decades since the ALI recommendations. That avoidance should stop so that shareholders in close corporations can deal with issues that arise among them with efficiency and clarity for themselves and for the customers and creditors of the corporation. The current situation is untenable, and California needs to step up and take a stand. If the legislature does not act, then the courts need to strongly and consistently take the approach of cases like Jara and Crain and allow the combatants to “duke it out” directly, with no procedural advantages to be gained by application of shareholder’s derivative principles established with a much larger and more formal organization in mind.