

## Derivative Claims: Not Just for Shareholders Anymore

Recent decisions complicate derivative standing issues

---

BY SEAN T. CARNATHAN

LITIGATION NEWS ASSOCIATE EDITOR

**D**etermining whether a claim for corporate wrongdoing is direct or derivative can be a complicated question. Recent court decisions highlight yet another analytical puzzle: Who has standing to bring derivative claims? Not just shareholders, but also former shareholders, board members, and creditors have brought actions as putative corporate champions, achieving mixed results.

to the involuntary disenfranchisement or to prosecute an action commenced afterward, if the "court finds that the holder is better able to represent the interests of the shareholders than any other holder who has brought suit."

Courts in Indiana and North Carolina have embraced similar rules, allowing claims when to do otherwise would result in unjust enrichment, although a more recent decision of the

Indiana Supreme Court appears to limit resolution of such derivative claims to valuation in the context of an appraisal proceeding. *Alford v. Shaw*; *Fleming v. International Pizza Supply Co.*

"The rule denying standing to stockholders to pursue derivative claims following a merger is both fair and reasonable," says Jesse A. Finkelshtein, Wilmington, DE, a member of the

(Turn to page 3—Derivative Claims)

---

---

*"Allowing derivative claims by creditors means that legitimate causes of action are more likely to be brought."*

---

This year, the California Supreme Court concluded that a former shareholder lacked standing to bring a derivative action, even though he was disenfranchised during the action by a merger to which he did not consent. *Grosset v. Wenaas*. The continuous ownership rule requires that derivative plaintiffs own shares at the time of the challenged conduct and for the duration of the litigation, on the ground that the plaintiff should have a personal stake in the potential recovery.

The rule also recognizes that the directors normally manage the company. Shareholders who have been involuntarily disenfranchised commonly enjoy appraisal rights and, thus, can ask the court to determine the fair value of their shares.

The American Law Institute (ALI), in its Principles of Corporate Governance, has nevertheless recommended a different approach. The ALI principles permit a former shareholder to continue an action commenced prior

---

## Derivative Claims

(continued from page 1)

Section of Litigation's Corporate Counsel Committee. "A derivative claim is a corporate asset, and any right of a stockholder to pursue a recovery for the benefit of the corporation should not continue after the individual no longer has an indirect interest in a benefit that flows solely to the entity. Any legitimate interest is fully protected by his ability to argue the value of the derivative claim should be considered in an appraisal proceeding," Finkelstein says.

A non-shareholder board member recently asserted a derivative claim against his fellow board members. The Delaware Supreme Court recently rejected the board member's standing argument, concluding that there was no "failure of justice" sufficient to require recognizing director standing, where the shareholders could bring any claim. "While the court clearly gave us a fair hearing," says J. Travis Laster, Wilmington, DE, who represented the plaintiff board member, "we believe that the 'complete failure of justice' standard is too high, does not recognize the importance of a director's right to sue, and also suggests that some injustice is acceptable."

The ALI agrees with Laster and recommends standing for directors to bring derivative actions in its Principles of Corporate Governance. At least three jurisdictions (see citations below), including New York, Pennsylvania, and Indiana, recognize standing for directors to bring derivative actions.

As the New York Court of Appeals once explained, "the right to bring suit has been granted in order to facilitate and improve the director's performance of the 'stewardship obligation' which he owes to the corporation and its stockholders and to protect him from possible liability for failure to proceed against those responsible for improper management of the corporate affairs." *Tenney v. Rosenthal*.

Creditors of insolvent companies have fared better in asserting derivative claims. Last year, the Delaware Supreme Court recognized standing for creditors, holding that shareholders of an insolvent corporation no longer have an economic interest in the corporate entity—only its creditors do. *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*. "Allowing derivative claims by creditors means that legitimate causes of action are more likely to be brought," says John R. Burns, Fort Wayne, IN, Co-Chair of the Section's Bankruptcy and Insolvency Litigation Committee. Claims in bankruptcy are subject to court oversight, and Burns favors "giving life to the opportunity to recover funds for creditors."

On the other hand, as Judge Richard Posner recently observed, "[t]he filing of lawsuits by a going concern is properly inhibited by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm deals (including government) and by the cost of litigation. The trustee of a defunct enterprise does not have the same inhibitions." *Maxwell v. KPMG LLP*. □

---

### Resources:

*Grosset v. Wenaas*, 2008 Cal. LEXIS 1414 (Cal. Feb. 14, 2008).

*Alford v. Shaw*, 398 S.E.2d 445 (N.C. 1990) (rejecting continuous ownership requirement).

*Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997) (adopting ALI rule permitting director derivative actions).

*Fleming v. International Pizza Supply Co.*, 676 N.E.2d 1051 (Ind. 1997).

930 A.2d 92 (Del. 2007) (creditor derivative actions).

*Tenney v. Rosenthal*, 6 N.Y.2d 204 (1959).

ALI Principles of Corporate Governance Vol. 2, § 7.02(c) (1992 & Supp. 2006).

*Maxwell v. KPMG LLP*, 520 F.3d 713 (7th Cir. 2008) (creditor claims).