THE CONTINUOUS OWNERSHIP REQUIREMENT IN SHAREHOLDER DERIVATIVE LITIGATION: ENDORSING A COMMON SENSE APPLICATION OF STANDING AND CHOICE-OF-LAW PRINCIPLES

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I. INTRODUCTION

In federal court, as well as in most state courts, a shareholder of a corporation can step into the shoes of the corporation and sue in its name. A shareholder typically initiates such a suit when the value of the corporation and its stock is compromised. One common example is if a director purchases an important corporate asset for a fraction of its fair market value. If the same director has control of the corporation or its board, the corporation may "choose" not to file a lawsuit against the director alleging breach of fiduciary duty, self-dealing, or other business transgressions. In the meantime, if the value of the corporation's stock has decreased, shareholders will want to see that loss returned to the company.

When a shareholder decides to file suit in the name of the corporation, the resulting lawsuit is commonly referred to as a "derivative action." Such actions are authorized by Federal Rule of Civil Procedure 23.1 (hereinafter "FRCP 23.1") in federal court and by similar rules and statutes in state courts.[1] Any relief obtained by the shareholder "takes the form of a judgment against [the] defendant that is obtained by the stockholders but runs in

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1. Federal Rule of Civil Procedure 23.1 also covers double derivative actions "in which a stockholder of a parent corporation brings suit to redress a wrong allegedly done to a subsidiary corporation owned by the parent." 7C CHARLES A. WRIGHT, ARTHUR R. MILLER, & MARY K. KANE, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1821, at 6-8 (3d ed. 2007).

favor of the corporation."[2]

Under FRCP 23.1, one requirement is that the "complaint must be verified and must . . . allege that the plaintiff was a shareholder . . . at the time of the transaction complained of, or that the plaintiff's share or membership later devolved on it by operation of law."[3] This requirement is known as the "contemporaneous ownership requirement"[4] and many state statutes contain similar limiting language.[5] The contemporaneous ownership requirement is intended to prevent "strike suits" by parties who could not have been injured by the conduct at issue.[6]

2. Id.

outcome of the case. This fundamental principle of standing is sufficient to sustain the continuous ownership requirement. Because a court's jurisdiction over an action depends on the standing of the plaintiff to pursue the action, each court would necessarily apply the ordinary principles of standing to determine whether a plaintiff who is no longer a shareholder may nonetheless continue to pursue the action. Applying these principles of standing will not only clarify the source of the continuous ownership requirement but provide consistency and clarity in an otherwise murky area of the law.

II. THE EVOLUTION AND VARYING RATIONALES FOR THE CONTINUOUS OWNERSHIP REQUIREMENT IN FEDERAL AND STATE COURTS

Numerous federal and state courts have adopted the continuous ownership requirement.[15] However, as mentioned above, these courts have relied on varied rationales to explain the source of the continuous ownership requirement. Some courts, even in the absence of a strong textual basis, conclude that the requirement is implicit in the rules and statutes that authorize derivative litigation.[16] Others recognize that the continuous ownership requirement is not required by the text or rationale of the civil rules and analogous state statutes, but nonetheless adopt the continuous ownership requirement on the ground that it is fundamental to a state's substantive law.[17] Some acknowledge that the continuous ownership requirement is related to the named plaintiff's standing to maintain the derivative suit.[18] Still others, although a minority, reject the continuous ownership requirement[19] despite the fact that the named plaintiff in a derivative action is then permitted to proceed with a lawsuit when that plaintiff will not derive a benefit from any relief that is granted to the corporation, which is of course the real party in interest in the lawsuit.[20] Several illustrative cases demonstrating the evolution

15. See infra notes 21–31 and accompanying text.
16. See infra notes 36–39 and accompanying text.
17. See infra notes 57–64 and accompanying text.
18. See infra notes 65–68 and accompanying text.
19. See infra notes 76–93 and accompanying text.
20. See generally 7C WRIGHT, supra note 1, at § 1822 (stating that "the corporation in

and varying rationales for the continuous ownership requirement, are discussed briefly below.

A. Federal courts

Numerous federal courts have adopted the continuous ownership rule,[21] and one of the seminal opinions on the subject is Lewis v. Chiles[22] out of the Ninth Circuit. Although the plaintiff in Chiles was a stockholder of Fred Meyer when he filed suit, he sold his stock during the discovery stage of the lawsuit.

In other words, because both the underlying cause of action and any resulting recovery belong to the corporation and not to any individual plaintiff, a plaintiff who does not own any stock "could not benefit from any recovery" and therefore lacks standing to pursue the litigation.[28]

B. State courts

Many states have likewise adopted the continuous ownership requirement. Undoubtedly, on matters of corporate law, Delaware is extremely influential in guiding the decisions of other jurisdictions.[29] Accordingly, the discussion below begins with the leading Delaware opinion on the ownership requirement. Next, the discussion highlights California, Florida, and New Mexico among the many jurisdictions[30] that have adopted the continuous ownership requirement, providing a broad overview of each court's reasoning for the rule. Finally, the discussion turns to certain jurisdictions that have not adopted the continuous ownership requirement, particularly North Carolina, Alabama, and Pennsylvania, underscoring the controversy still present among different states.

1. Jurisdictions that Have Adopted the Continuous Ownership Requirement.

The Delaware Supreme Court first addressed the continuous ownership requirement in *Lewis v. Anderson*.[31] The plaintiff in *Anderson* alleged that various officers and directors of Old Conoco

28. Id.

29. See, e.g., *Dreiling v. Jain*, 93 P.3d 861, 864–65, 867–68 (2004) (citing Delaware case law regarding derivative actions).

30. See, e.g., *Sound Infiniti, Inc. v. Snyder*, 186 P.3d 1107, 1111 (Wash. Ct. App. 2008), review granted, 203 P.3d 379 (Wash. 2009) (Washington law); *A-Plus Janitorial & Carpet Cleaning v. Employers' Workers' Comp. Ass'n*, 936 P.2d 916, 923 (Okla. 1997) (Oklahoma law); *Christopher v. Liberty Oil & Gas Corp.*, 665 So. 2d 410, 411 (La. Ct. App. 1995) (Louisiana law); *Bronzaft v. Caporali*, 162 Misc. 2d 281, 283, 616 N.Y.S.2d 863 (N.Y. Sup. Ct. 1994) (New York law); *Grace Bros., Ltd. v. Farley Indus., Inc.*, 450 S.E.2d 814, 819 (Ga. 1994) (Georgia law); *White v. Banes Co.*, 866 P.2d Tc 11.4a Tf 0L8iM(ant966c8(ash.)4 0.00Y /3z)7(,131 u 8.Mxio)aw);

additional stock in March 2001.[41] Based on this short "lapse in ownership," the defendants filed a summary judgment motion asking the court to dismiss Goodwin's claims on standing grounds.[42] They did so, moreover, even though Goodwin specifically argued in response to the defendants' motion that he "did not realize that [his] sale of New Valley stock . . . might affect [his] standing as a plaintiff in this case."[43]

The court was not persuaded by Goodwin's argument. Citing Lewis v. Anderson[44] and its progeny, the court noted that the continuous ownership requirement "is a bedrock tenet of Delaware law and is adhered to closely."[45] The court acknowledged that § 327 "does not explicitly require continuous stock ownership to maintain a derivative action," but nonetheless concluded that the continuous ownership "requirement has been a staple of Delaware law for over two decades."[46] The court then held:

> The continuous ownership requirement. . . has been held applicable even in situations where individuals' stock ownership has been involuntarily terminated in, for example, cash-out mergers. Here, Goodwin voluntarily sold his shares. . .. [O]nce he did so, he lost standing to pursue this derivative litigation.[47]

requires only contemporaneous ownership, not continuous ownership.[51] More recently, in *Grosset v. Wenaas*,[52] the California Court of Appeal rejected *Gaillard* as "unpersuasive," and it declined to follow those cases from other jurisdictions "embracing the minority view."[53] Instead, the court adopted "the majority rule that continuous stock ownership is necessary for standing to pursue a derivative action."[54] The California Supreme Court granted review to consider the issue and agreed with the appellate court's reasoning, holding "as a matter of California law, that [the plaintiff] lacks standing to continue litigating this derivative action because he no longer owns stock in [the company] as a result of [a] merger."[55]

The Florida state appellate court reached a similar result in *Timko v. Triarsi*.[56]

or suffer from such actions."[67]

2. Jurisdictions that Have Rejected the Continuous Ownership Requirement

Other state courts have declined to adopt the continuous ownership requirement. The North Carolina Supreme Court did so, albeit in dicta, in Alford v. Shaw.[68] The court noted that section 55-55(a) of the North Carolina Code,[69] the statute under which the plaintiffs filed suit, only required contemporaneous ownership and said nothing about continuous ownership.[70] Instead, the court concluded, "[r]eading this statute in a reasonable light and giving it an ordinary meaning, we find there is no requirement of continuing share ownership in order for an individual who is a shareholder at the time of the transaction about which he is complaining and at the time the action is filed, to proceed with a derivative action."[71] In so concluding, the Alford court found persuasive the reasoning from the California Court of Appeals opinion in Gaillard, that the continuous ownership requirement could create "an anomalous result" in which a plaintiff files a suit, actively pursues it, and is precluded from proceeding years later by a merger.[72]

In Shelton v. Thompson,[73] the Alabama Supreme Court likewise declined to apply the continuous ownership requirement as stringently as other courts.[74] In Shelton, the plaintiffs lost their shareholder status because the corporation in which they held

67. Id.

68. 398 S.E.2d 445 (N.C. 1990). This holding is dicta because, as discussed in the text above, the Alford court also held that the suit could proceed under an exception to the continuous ownership requirement because the plaintiff's ownership was terminated as a result of the actions that formed the basis of the suit. Id. at 450.

69. That statute provided, in pertinent part:

> (a) An action may be brought in this State in the right of any domestic or foreign corporation by a shareholder or holder of a beneficial interest in shares of such corporation; provided that the plaintiff or plaintiffs must allege, and it must appear, that each plaintiff was a shareholder or holder of a beneficial interest in such shares at the time of the transaction of which he complains or that his shares or beneficial interest in such shares devolved upon him by operation of law from a person who was a shareholder or holder of a beneficial

wrongdoing in the challenged merger."[84] At least one federal court, applying Pennsylvania law, has similarly ruled.[85]

As the foregoing discussion shows, the majority of courts have adopted the requirement for continuous ownership. Nevertheless, some jurisdictions have not adopted the requirement, particularly for involuntary dispositions, leaving the law concerning the continuous ownership requirement unsettled.

III. BECAUSE THE RATIONALE FOR THE CONTINUOUS OWNERSHIP REQUIREMENT VARIES, SO TOO DOES THE APPLICATION OF CHOICE-OF-LAW PRINCIPLES TO THAT REQUIREMENT

Courts have reached different—and in some cases conflicting—results in determining what body of law governs whether a plaintiff in a derivative lawsuit must continue to own stock in order to maintain the suit. The most prevalent approach is the "internal affairs doctrine," which holds that the law of the state of incorporation governs the relationships between a company, its officers and directors, and its shareholders.[86] But that is a substantive rule, not a procedural one. If the underlying rationale for the continuous ownership requirement is a rule of civil procedure, such as FRCP 23.1, then that requirement ought to apply even if the state of incorporate does not recognize the

84. Id. at 126–27.

85. See Warden v. McLelland, 288 F.3d 105 (3d Cir. 2002) (rejecting the continuous ownership requirement because Pennsylvania law [illegible] Warde Tm 77nd in som Tc must co0 1(ntinuTj 0 Tc fC /rom recogniz0 T

continuous ownership requirement.[87] Otherwise, a court would be required to adjudicate a claim despite a plaintiff's apparent lack of standing and the corresponding inability to offer meaningful redress. As discussed below, courts have reached varied results when addressing such issues.

Starting with state courts, the Delaware Supreme Court's recent opinion in VantagePoint Venture Partners 1996 v. Examen, Inc.[88] provides a thorough and cogent discussion of the choice-of-law principles that Delaware has applied to these problems. Drawing on a wide range of applicable legal principles—including bedrock corporate law principles, traditional choice-of-law principles, and both the Due Process Clause and the Commerce Clause of the United States Constitution—the court concluded that the "conflicts practice of both state and federal courts has consistently been to apply the law of state of incorporation to the entire gamut of internal corporate affairs."[89] This is the internal affairs doctrine.[90]

Numerous state courts have applied the internal affairs doctrine with similar results. In Olympia Mining & Milling Company v. Kerns,[91] for example, the Washington Supreme Court held that whether the plaintiffs could "compel the defendant to respect their rights. . . is a question of Missouri law touching the internal affairs of a Missouri corporation."[92] In Grosset v. Wenaas,[93] the California Court of Appeal likewise concluded that the continuous ownership requirement is controlled by the law of the state of incorporation.[94] A leading treatise regarding corporate law similarly concludes that "[t]he law of the state of incorporation determines a plaintiff's standing to bring a derivative proceeding."[95] According to these courts and legal authorities, the

87. See infra notes 123 and accompanying text.

88. 871 A.2d 1108 (Del. 2005).

89. Id. at 1113 (internal quotation marks and citation omitted).

90. Id. In Rales v. Blasband, 634 A.2d 927 (Del. 1993), the Delaware Supreme Court likewise concluded that the shareholder demand requirement, which is a similar prerequisite to a derivative action, is a question concerning the internal affairs of a corporation and is therefore controlled by the law of the state of incorporation. Id. at 932 n.7.

91. 117 P. 260, 64 Wash. 545 (1911).

92. Id. at 549.

93. 35 Cal. Rptr. 3d 58 (Cal. Ct. App. 2006), rev. granted, 138 Cal. Rptr. 3d 609 (Cal. 2006), aff'd, 72 Cal. Rptr. 3d 129 (Cal. 2008).

94. Id. at 66–69.

95. 13 JENNIFER L. BERGER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE

court's analysis in *Kona* was predicated on *Erie* principles; the court did not discuss state choice-of-law issues or mention the internal affairs doctrine.[109]

The Ninth Circuit squarely addressed the application of the internal affairs doctrine in federal courts one year before deciding *Kona Enterprises*. In *Batchelder v. Kawamoto*,[110] the court explained:

> Under the "internal affairs" doctrine, the rights of shareholders in a foreign company, including the right to sue derivatively, are determined by the law of the place where the company is incorporated . . . . Consequently, Batchelder's prerogative to step into the shoes of the parent corporation as derivative plaintiff. . .must be determined by the law of the place of incorporation of the

a bond for the action to proceed in federal court.[113] The Court then touched on the question of whether the requirements of FRCP 23.1 were substantive or procedural.

> Rule 23 requires the stockholder's complaint to be verified by oath and to show that the plaintiff was a stockholder at the time of the transaction of which he complains or that his share thereafter devolved upon him

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than being dismissed, should be remanded to state court.[125]

These solutions merely highlight the problem with viewing the continuous ownership requirement as anything other than part of traditional notions of standing. Thus, following either of these approaches will merely perpetuate the confusion and differing results depending upon a plaintiff's choice of forum. The benefit of classifying the continuous ownership requirement as part of the bedrock requirement of standing to sue is that, in either federal court or state court, the result would be same. A plaintiff must—to use the *Timko* court's phrase—continue to have "a dog in the hunt" in order to sue derivatively on behalf of the corporation and maintain that suit.[126] This requirement should apply equally in state or federal court, thus avoiding the situation in which an action subject to removal on diversity grounds could have proceeded in the state court but would be subject to dismissal in the federal court.

V. CONCLUSION

For a derivative shareholder action, the overwhelming majority of jurisdictions have imposed the continuous ownership requirement. While the requirement itself is clear, the source of the requirement is not. Some courts have based the continuous

"personal stake" in the outcome of the case.

This fundamental principle of standing is sufficient to sustain the continuous ownership requirement. Because a court's jurisdiction over an action depends on the standing of the plaintiff to pursue the action, each court would necessarily apply the ordinary principles of standing to determine whether a plaintiff who is no longer a shareholder may nonetheless continue to pursue the action. If the plaintiff is no longer a shareholder because of the defendant's alleged wrongdoing, then the plaintiff should have standing. But if the plaintiff is no longer a shareholder for reasons unrelated to the defendant's alleged wrongdoing, then the plaintiff most likely lacks standing to pursue the claims.

As can be seen, proper application of the continuous ownership requirement is necessarily fact-specific and may vary from case to case. But the important point is that the answer will be (or at least should be) the same in both state and federal court. Thus, the ordinary application of fundamental principles of standing will not only clarify the source of the continuous ownership requirement but provide consistency and clarity in an otherwise murky area of the law.