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## Aurora Credit Services, Inc. v. Liberty West Development, Inc.: An Analysis of Shareholder Derivative Suits in Closely Held Corporations

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*Aurora Credit Services, Inc. v. Liberty West  
Development, Inc.: An Analysis of Shareholder  
Derivative Suits in Closely Held Corporations*

I. INTRODUCTION

Corporate laws that govern derivative suits attempt to dictate the type of lawsuit a shareholder may file on behalf of a corporation. These laws often protect the corporation at the expense of individual shareholders. A problem arises when a closely held corporation, operated and controlled by the majority shareholders, suffers a harm caused by its own board members. A strict interpretation of corporate law requires a shareholder that wants to pursue this claim on behalf of the corporation to make demand on the board of directors. The board then has to agree to instigate an action against itself on behalf of the corporation for the harm it caused.<sup>1</sup> As a result of this problem, a conflict of interest arises for the board members to maintain their fiduciary duty to look after the corporation's best interests, but at the same time not agree to put themselves in a position to be held liable for the damages that they have caused. Hence, most directors or officers of closely held corporations do not agree to instigate the action demanded by the shareholder, and thus, the minority shareholders are left with little remedy. To resolve this concern, some courts have recognized "the right of a close corporation shareholder to sue directly, as an individual, on a cause of action which would normally have to be brought derivatively."<sup>2</sup>

In *Aurora Credit Services, Inc. v. Liberty West Development, Inc.*,<sup>3</sup> the Utah district court faced this exact problem. The court dismissed Aurora Credit Services' ("Aurora") direct claims against Liberty West Development ("LWD") and granted LWD's motion for partial

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1. The board of directors usually decides which claims the corporation will pursue. However, this "presents an obvious problem when the prospective lawsuit is against the directors themselves." FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.3, at 387 (Hornbook Series 2000).

2. 12B WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 59.11.50 (perm. ed., rev. vol. 2000).

3. 970 P.2d 1273 (Utah 1998).

summary judgment regarding the derivative claims. The Utah district court stated that Aurora did not have standing to sue derivatively. However, on November 24, 1998, the Utah Supreme Court reversed the lower court's decision and adopted an approach promulgated by the American Law Institute, which holds that under certain circumstances a minority shareholder in a closely held corporation can sue directly "on a cause of action which would normally have to be brought derivatively."<sup>4</sup> In the process of deciding the *Aurora* case, the Utah Supreme Court also held for the first time that a shareholder who sues a corporation directly has to satisfy the contemporaneous ownership requirement of Utah Rule of Civil Procedure 23.1.<sup>5</sup>

This Note will discuss why the Utah Supreme Court correctly decided to provide minority shareholders with a method of recourse other than a derivative suit, but will also illustrate the flaws in the court's holding that a direct action must now satisfy the contemporaneous ownership requirement. One such flaw is that the language the Utah Supreme Court used in fashioning the contemporaneous ownership requirement for direct actions was too broad and can be interpreted to apply not only to situations in which a minority shareholder is suing a closely held corporation directly, but also to any other direct action that a shareholder may file for unique wrongs sustained by that individual shareholder. Another problem with the court's holding is that the purpose of the contemporaneous ownership requirement in avoiding strike suits is not applicable to closely held corporations. This Note proposes that a shareholder of a closely held corporation should not be required to satisfy the contemporaneous ownership requirement when a direct action is substituted for a derivative action.

The analysis of the two *Aurora* holdings will proceed as follows: Part II of this Note provides a brief overview of corporate law, explains the distinguishing differences between a shareholder derivative suit and direct actions by shareholders against the corporation, and also provides an overview of the contemporaneous ownership re-

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4. 12B FLETCHER ET AL., *supra* note 2, § 59.11.50.

5. The contemporaneous ownership rule requires a shareholder to prove that she was a shareholder at the time the corporation was harmed in order to commence a derivative proceeding against the corporation. Utah R. Civ. P. 23.1; *see also* 13 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5981 (perm. ed., rev. vol. 1995).

quirement. Part III sets forth the facts of *Aurora* and briefly discusses the significance of the Utah Supreme Court's decision to allow minority shareholders to sue corporate officers directly. Part IV establishes the three options the Utah Supreme Court had in deciding the case and analyzes why the *Aurora* decision correctly allowed minority shareholders, under certain circumstances, to sue a closely held corporation directly. Part IV also analyzes why the Utah Supreme Court incorrectly applied the contemporaneous ownership requirement of Utah Rule of Civil Procedure 23.1 to direct actions filed by individual shareholders and why the court incorrectly assumed that the efficient market theory applies not only to publicly traded corporations, but also to closely held corporations. A brief conclusion will follow in Part V.

## II. BACKGROUND

### A. General Corporate Law

A corporation is a legal person separate from its shareholders and is entitled to its own profits and to the rights of any derivative action brought by shareholders on its behalf.<sup>6</sup> "A corporation is, in its very nature, an entity operating for the benefit of its stockholders."<sup>7</sup> An owner or shareholder of a corporation is one "who owns or holds a share or shares" in a corporation.<sup>8</sup> "The distinguishing characteristics of a corporation are that it is an artificial person, a legal entity, capable of acting through its corporate officers and agents, of suing, being sued, of taking and holding property, and of contracting in its own name, and of continuing to exist independent of individuals who compose it."<sup>9</sup>

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6. 19 AM. JUR. 2D *Corporations* § 2250 (1986) [hereinafter *Corporations*]; "A 'corporation' is an artificial person, which is created by law, or under authority of law, as a distinct legal entity with rights and liabilities which are independent from those of the natural persons composing the corporation." *Di Re v. Cent. Livestock Order Buying Co.*, 74 N.W. 2d 518, 523 (Minn. 1956); "A 'corporation' is a legal entity separate and distinct from its stockholders and continuity of its existence is not interrupted by change in stock ownership." *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867, 872 (9th Cir. 1949).

7. *See Van Meter v. Comm'r*, 61 F.2d 817, 819 (8th Cir. 1932).

8. *See* BLACK'S LAW DICTIONARY 1380 (7th ed. 1999).

9. 1 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5 (perm. ed., rev. vol. 1999); *see also* *Orlob v. Wasatch Mgmt.*, 33 P.3d 1078, 1082 (Utah Ct. App. 2001) (stating that a corporation "is an entity separate and distinct from its officers, shareholders, and directors and that they will not be held personally

*B. Shareholder Derivative Lawsuits Versus  
Shareholder Direct Lawsuits*

Because a corporation is a separate legal entity, the corporation's shareholders are generally not liable for any harm that the corporation may cause. Likewise, when a corporation is injured or harmed in any way the cause of action belongs to the corporation and not to the individual shareholders.<sup>10</sup> A shareholder in a corporation "may not bring suit, individually, when the whole body of stockholders is injured."<sup>11</sup> However, when "the injury is one to the plaintiff as a stockholder and to him individually, and not the corporation, as where the action is based on a contract to which he is a party, or on a right to which he is a party, or on a right belonging severally to him, or on a fraud affecting him directly, it is an individual action," and the shareholder can pursue this action directly.<sup>12</sup> Hence, when the corporation or entire body of shareholders is injured and the corporation fails to take action, the action still lies with the corporation and is derivative in nature,<sup>13</sup> but when the injury is to the stockholder individually, the action lies with the shareholder and is direct in nature.

As discussed previously, "courts allow derivative suits in order to avoid leaving directors in charge of whether to have the corporation

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liable for the corporation's debts and obligations"); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 348 (3d Cir. 2001) (citing *Barium Steel Corp. v. Wiley*, 108 A.2d 336, 341 (Pa. 1954) ("A corporation is a distinct and separate entity, irrespective of the persons who own all its stock.")).

10. See *Richardson v. Ariz. Fuels Corp.*, 614 P.2d 636, 638 (Utah 1980) ("The stockholder . . . has no right, title or interest whatsoever in the claim itself—whether the action is brought by the corporation or by the stockholder on behalf of the corporation . . . the plaintiff shareholder recovers nothing and the judgment runs in favor of the corporation.").

11. *Corporations*, *supra* note 6, § 2245; "The only two exceptions to the general rule that shareholders cannot pursue individual causes of action against third parties for wrongs or injuries to the corporation that result in the diminution or destruction of the value of their stock are: (1) a plaintiff alleges an injury separate and distinct to himself; or (2) the injuries arise out of a special duty running from the alleged wrongdoer to the plaintiff." *Id.* § 2245 (Supp. 2001) (citing *Energy Investors Fund, L.P. v. Metric Constructors, Inc.*, 525 S.E.2d 441 (N.C. 2000)).

12. *Richardson*, 614 P.2d at 639 (citing 12B FLETCHER ET AL., *supra* note 2, § 5911).

13. "A stockholder's derivative action is an action brought by one or more stockholders of a corporation to enforce a corporate right or remedy a wrong to the corporation in cases where the corporation, because it is controlled by the wrongdoers or for other reasons, fails and refuses to take appropriate action for its own protection." *Corporations*, *supra* note 6, § 2250; see also *Crosby v. Beam*, 548 N.E.2d 217, 219 (Ohio 1989) ("A derivative action allows a shareholder to circumvent a board's refusal to bring a suit on a claim.").

sue either the directors themselves or a party who controls the directors.”<sup>14</sup> Courts have ruled that “[a] diminution in value of a shareholder’s stock is a loss recoverable only by the corporation and does not give rise to an individual cause of action. Thus, courts have held that a shareholder does not have standing to bring a direct cause of action when the damage alleged is the diminished value of corporate shares.”<sup>15</sup> Stated another way, “[a]n action brought by a stockholder is derivative if the gravamen of the complaint is injury to the corporation or to the whole body of its stock or property and not injury to the plaintiff’s individual interest as a stockholder.”<sup>16</sup>

In its classic form, a derivative suit involves two actions brought by an individual shareholder: (i) an action against the corporation for failing to bring a specified suit and (ii) an action on behalf of the corporation for harm to it identical to the one which the corporation failed to bring. . . . Since any judgment runs to the corporation, shareholder plaintiffs at best realize an appreciation in the value of their shares.<sup>17</sup>

Utah Rule of Civil Procedure 23.1 lists the procedural requirements that a derivative lawsuit must meet prior to the court hearing the action. Rule 23.1 states:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership devolved on him by opera-

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14. GEVURTZ, *supra* note 1, § 4.3.8, at 425.

15. *See* Lochhead v. Alacano, 697 F. Supp. 406, 411 (D. Utah 1988).

16. *Corporations*, *supra* note 6, § 2250; “[A]n individual stockholder has no right to bring an action in his own name and in his own behalf for a wrong committed solely against the corporation.” *Id.* § 2245.

17. *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982) (citation omitted); “A derivative suit permits a shareholder to sue on behalf of the corporate entity to remedy or prevent a wrong to the corporation. A derivative action is an exception to the usual rule that a corporation’s board of directors manages it or supervises its management and thereby controls its decisions.” *Schumacher v. Schumacher*, 469 N.W.2d 793, 798 (N.D. 1991) (quoting F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS § 8.11 (3d ed. 1987)); *see also* GEVURTZ, *supra* note 1, § 4.3.1(b), at 392 (“[A] derivative suit is two suits in one: An action against those who breached their duty to the corporation, and an action against the corporation to compel the company to pursue this claim.”).

tion of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.<sup>18</sup>

A careful reading of the rule shows that the shareholder must (1) show that she was a shareholder at the time the corporation suffered harm; (2) show that the action is not a collusive one intended to obtain jurisdiction in a federal court;<sup>19</sup> (3) demand that the corporation pursue the claim or show why such demand would be futile; and (4) show how the shareholder will be able to adequately represent all similarly situated shareholders.

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18. Utah R. Civ. P. 23.1. See also Federal Rule of Civil Procedure 23.1 which states, in almost identical language to the Utah rule:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the *plaintiff* complains or that *the plaintiff's* share or membership thereafter devolved on *the plaintiff* by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Fed. R. Civ. P. 23.1 (emphasis added).

19. This requirement is not applicable to the *Aurora* case because the action was filed in state court.

A major requirement that the Utah legislature has enacted through Utah Rule of Civil Procedure 23.1 is referred to as the contemporaneous ownership requirement.<sup>20</sup> This requirement is patterned after a similar requirement contained in the Federal Rules of Civil Procedure. It provides that a shareholder may not commence “or maintain a derivative proceeding unless the shareholder was a shareholder of the corporation at the time of the act or omission complained of.”<sup>21</sup> “The primary purpose for the contemporaneous ownership rule is to prevent ‘strike suits,’ where individuals purchase shares in a corporation with litigious motives.”<sup>22</sup> Stated another way, the contemporaneous ownership doctrine prevents courts “from being used to litigate purchased grievances or from becoming a party to speculative suits against corporations.”<sup>23</sup>

The contemporaneous ownership requirement is premised upon the “efficient market theory,” which presupposes that all stock is traded on an efficient market. Without the contemporaneous ownership requirement, “subsequent purchasers of shares could reap a windfall from any recovery in a derivative proceeding which was not considered in the purchase price of their shares.”<sup>24</sup> The efficient market theory “posits that the price of a security reflects all publicly available information about a firm, and that prices react almost instantaneously and in an unbiased manner to any new information.”<sup>25</sup> “Researchers agree that the efficient capital market model accurately represents the pricing behavior of stocks.”<sup>26</sup> The contemporaneous ownership requirement relies on the efficient market theory because it assumes that when a new stockholder buys into a corporation that all material, relevant information will be used to price the stock in an efficient market. Thus, if the corporation is involved in outstanding litigation, the stock price will already reflect the litigation. Therefore,

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20. Other state legislatures have also enacted the contemporaneous ownership requirement. *See, e.g.*, Del. Ct. Ch. R. 23.1. *See also* HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS § 362 (3d ed. 1983) (“Perhaps the most important qualification placed upon a plaintiff-shareholder in a derivative action is that of ‘contemporaneous-shareownership.’”).

21. 13 FLETCHER ET AL., *supra* note 5, § 5981.

22. *Id.* § 5981.10.

23. *See* Bateson v. Magna Oil Corp., 414 F.2d 128, 131 (5th Cir. 1969).

24. 13 FLETCHER ET AL., *supra* note 5, § 5981.10.

25. Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 374–75 (1984).

26. *Id.* at 374.



according to the contemporaneous ownership requirement, if stockholders were allowed to buy the stock after the “time of the act or omission complained of,”<sup>27</sup> then stockholders would receive a windfall if they also were able to participate in the recovery of the litigation.<sup>28</sup>

Another major requirement of Utah Rule of Civil Procedure 23.1 is that the complaint must allege the efforts of the plaintiff to make demand on the directors to enforce the right that belongs to the corporation, or, if demand is not made, the “reasons . . . for not making the effort.”<sup>29</sup> The demand requirement “is not merely a technical pleading hurdle; it is based on a fundamental tenet of American corporate law that places the responsibility for making decisions in the hands of the board of directors.”<sup>30</sup> However, once the directors refuse to comply with the demand, “[a] derivative action allows a shareholder to circumvent a board’s refusal to bring a suit on a claim.”<sup>31</sup> However, if a derivative action is in fact brought and an advantageous outcome results, any proceeds belong to the corporation and not to the individual shareholder.

The demand requirement assumes that the shareholder is dealing with a disinterested board when seeking to have the corporation bring suit because of the alleged wrong. A disinterested board is a board that does not have any type of conflict of interest in deciding upon the corporation’s claim. The disinterested board would therefore consider the plaintiff’s complaint and make a decision that is best for the corporation.

In addition to these requirements, many states have enacted laws that require plaintiffs to post security for costs of the lawsuit if the plaintiff owns less than five percent of the outstanding shares.<sup>32</sup> The purpose of these statutes is also to prevent strike suits or actions that

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27. 13 FLETCHER ET AL., *supra* note 5, § 5981.

28. Once the corporation recovers proceeds through the litigation, the stock price will increase, thus resulting in a windfall to the shareholder.

29. UTAH R. CIV. P. 23.1.

30. Johnson v. Hui, 752 F. Supp. 909, 911 (N.D. Cal. 1990) (demand excused when six of eight directors were accused of illegal activity (citing *In re BankAmerica Sec. Litig.*, 636 F. Supp. 419, 420 (C.D. Cal. 1986)).

31. Crosby v. Beam, 548 N.E.2d 217, 219 (Ohio 1989).

32. *See, e.g.*, Shapiro v. Magaziner, 210 A.2d 890, 894 (Pa. 1965); *see also* Haberman v. Tobin, 626 F.2d 1101 (2d Cir. 1980); Levine v. Bradlee, 378 F.2d 620, 623 (3d Cir. 1967); Mintz v. Allen, 254 F. Supp. 1012 (S.D.N.Y. 1966); Tyler v. Gas Consumers Ass’n, 229 N.Y.S.2d 169 (N.Y. Sup. Ct. 1962).

have the sole purpose of winning large attorney's fees, but with no intention of benefiting the corporation.<sup>33</sup> “[S]uch strike suits were usually brought by shareholders with only a small financial stake in the corporation and who, therefore, had little to lose by starting an action.”<sup>34</sup> As previously stated above, a strike suit is defined as “a suit by a holder of a miniscule interest in the corporation to harass and coerce the directors into a settlement far out of proportion to the minority shareholder’s financial interest in the object of the suit.”<sup>35</sup>

### *C. Closely Held Corporations*

A closely held corporation has been defined in a number of ways.<sup>36</sup> “By definition, a close corporation is one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, bought or sold.”<sup>37</sup> The definition of a closely held corporation that is adopted for the purposes of this Note is found in *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, which states

33. See *Levine*, 378 F.2d at 624.

34. *Id.*

35. *Petty v. Bank of N.M. Holding Co.*, 787 P.2d 443, 452 (N.M. 1990).

36. See *Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964); see also *W & W Equip. Co. v. Mink*, 568 N.E.2d 564, 570 (Ind. Ct. App. 1991) (“A close corporation is one which typically has relatively few shareholders and whose shares are not generally traded in the securities market.” (citing O’NEAL & THOMPSON, *supra* note 17, § 1.02)); *Berremman v. W. Publ’g Co.*, 615 N.W.2d 362, 367–68 (Minn. Ct. App. 2000) (defining close corporation as a corporation with few shareholders, no public market for its stock, active shareholder management within the corporation, and shareholder income derived primarily from salary not dividends); *Thisted v. Tower Mgmt. Corp.*, 409 P.2d 813, 820 (Mont. 1966) (noting “that a close corporation is one in which management and ownership are ‘substantially identical to the extent that it is unrealistic to believe that the judgment of the directors will be independent of that of the stockholders’”(citation omitted)); *Landstrom v. Shaver*, 1997 SD 25, 561 N.W.2d 1, 13 n.15 (1997) (“Typical attributes of a close corporation are that: (1) the shareholders are few in number, often two or three; (2) the shareholders usually live in the same geographical area, know each other, and are well acquainted with each others’ skills in regards to the corporation; (3) all or most of the shareholders are active in the business usually serving as directors or officers or as management; and (4) there is no established market for the corporate stock.” (citing *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987)); *Simmons v. Miller*, 544 S.E.2d 666, 674–75 (Va. 2001) (asserting that “the most precise definition [of a close corporation] may be imperfect to every occasion”; however, the court noted that the corporation in question had “a small number of shareholders with no active trading market for their shares, and substantial majority stockholder participation in the management, direction, and operations of the corporation”); *Masinter v. Webco Co.*, 262 S.E.2d 433, 435 (W. Va. 1980) (“A ‘close corporation’ has been defined as a corporation with a small number of shareholders whose shares are not generally traded in the securities market.”); BLACK’S LAW DICTIONARY 341 (7th ed. 1999) (“A corporation whose stock is not freely traded and is held by only a few shareholders.”).

37. *Jaffe Commercial Fin. Co. v. Harris*, 456 N.E.2d 224, 231 (Ill. App. Ct. 1983).

that a close corporation is defined as a corporation with: “(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.”<sup>38</sup> Generally, a publicly held corporation is at the opposite end of the spectrum in that it has a large number of shareholders, a national market on which its stock is traded, and less majority participation in the management and operation of the corporation. The differences between a publicly held corporation and a closely held corporation explain why in certain circumstances differing laws should be applied regarding shareholder derivative lawsuits and the contemporaneous ownership requirement.

### III. *AURORA* AND ITS IMPLICATIONS

Dennis W. Gay, James Hogle, Jr., and two other individuals formed LWD in 1986 to develop an office complex in Ogden, Utah.<sup>39</sup> To finance the office complex, LWD borrowed money using the office complex as collateral.<sup>40</sup> Both Gay and Hogle controlled the operation of LWD—Hogle was president of LWD from 1986 to 1991 and Gay served as CEO from 1990 until the company’s dissolution.<sup>41</sup>

By 1990, the initial loan used by LWD to finance the office complex was in arrears.<sup>42</sup> LWD also owed on several other outstanding loans, and there were several liens placed against the office complex.<sup>43</sup> During this same time period, Hogle was also suffering from personal financial distress.<sup>44</sup> For example, “Union National Bank of Chicago sued Hogle for an unrelated debt and obtained a money judgment against him.”<sup>45</sup> In February of 1991, while Hogle was still president of LWD, he “executed a security agreement in favor of the Federal Deposit Insurance Corporation (“FDIC”) in which he pledged his 2,500 shares of LWD stock as collateral for the

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38. 328 N.E.2d 505, 511 (Mass. 1975).

39. *Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc.*, 970 P.2d 1273, 1275 (Utah 1998).

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

judgment.”<sup>46</sup> At the time of the pledge, Hogle valued the pledged LWD stock at \$200,000.<sup>47</sup>

Subsequently, in November of 1991, Aurora bought a “package of assets from the FDIC at a judgment auction.”<sup>48</sup> Included in this package was the judgment that the FDIC had against Hogle.<sup>49</sup> Upon purchasing the assets, Aurora approached Hogle in December of 1991 and offered to settle the entire judgment, which was at that point approximately \$125,000, for \$87,500.<sup>50</sup> Hogle never responded to Aurora’s offer.<sup>51</sup> In January of 1992, Aurora received the formal assignment from the FDIC of the Hogle judgment, “including its security interest in Hogle’s LWD stock.”<sup>52</sup> Shortly thereafter, Aurora notified LWD and Gay of the security interest it received from the FDIC in Hogle’s LWD shares.<sup>53</sup> In April 1993, Aurora foreclosed on its interest in the LWD stock, thereby becoming a stockholder of the corporation.<sup>54</sup>

In early 1991, Restaurant Store & Equipment Supply Co. (“Restaurant Co.”) sued LWD and obtained a judgment for the nonpayment of a contract.<sup>55</sup> Shortly thereafter, a writ of execution was obtained, a levy was recorded on the office complex, and on May 15, 1991 the office complex was sold to Restaurant Co. at a sheriff’s sale.<sup>56</sup> The sheriff recorded the sale and notified LWD of its six-month statutory right of redemption.<sup>57</sup> LWD never redeemed the property because less than a week after the property was sold to Restaurant Co., the property was sold to XM International (“XMI”), a partnership formed by Gay and George Bybee.<sup>58</sup>

Despite the sale of the property to Restaurant Co. and then to XMI, LWD represented to Aurora that it still owned the property

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46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* at 1275–76.

52. *Id.* at 1276.

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

and that it was trying to sell the property.<sup>59</sup> Furthermore, LWD told Aurora that it “expected to recover \$800,000 to \$1,000,000 of equity in the property.”<sup>60</sup> These representations were made to Aurora until July 7, 1993.<sup>61</sup>

After receiving the news that LWD no longer owned the property, Aurora filed a complaint in Utah district court on August 5, 1994.<sup>62</sup> Aurora later amended its complaint on October 17, 1994, “asserting both derivative and direct claims alleging that Gay negligently and intentionally mismanaged LWD, breached his fiduciary duties, and wasted corporate assets.”<sup>63</sup> The Utah district court dismissed Aurora’s direct claims on December 12, 1994 and on December 20, 1995 granted LWD’s motion for partial summary judgment holding that Aurora did not have standing to sue because “Aurora was not a shareholder of LWD when the alleged injury occurred.”<sup>64</sup> Aurora moved to amend its complaint after both the motion dismissing its direct claims and the summary judgment motion dismissing its derivative claims were granted.<sup>65</sup> Both motions were denied, so Aurora appealed to the Utah Supreme Court.<sup>66</sup>

On November 24, 1998, the Utah Supreme Court reversed the judgment of the lower court.<sup>67</sup> The two issues that the Utah Supreme Court decided in *Aurora* were of first impression in the state of Utah. The court held that in a closely held corporation a minority shareholder could proceed directly against corporate officers.<sup>68</sup> The court also held that the contemporaneous ownership requirement, which prior to this judgment applied only to derivative suits, applied to suits filed as direct actions.<sup>69</sup> The court’s holding does allow for certain exceptions to the contemporaneous ownership requirement given the appropriate circumstances; however, these exceptions are irrelevant for the purpose of this Note because this Note proposes

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59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.* at 1282.

68. *Id.* at 1281.

69. *Id.*

that the contemporaneous ownership requirement should never apply to direct actions in a closely held corporation. This Note will proceed to analyze the two holdings of the Utah Supreme Court and discuss the reasons why the Utah Supreme Court correctly held that a minority shareholder in a closely held corporation could sue the corporation directly. This Note will also discuss why the Utah Supreme Court incorrectly applied the contemporaneous ownership requirement to direct actions filed by individual shareholders in a closely held corporation.

#### IV. ANALYSIS

The Utah Supreme Court's decision in *Aurora* should have a decided impact on how corporate matters are resolved. Many officers and directors of closely held corporations could face direct litigation for any type of mismanagement of corporate assets. Ultimately, the *Aurora* decision blurred what had previously been a clear distinction between direct lawsuits and derivative lawsuits.<sup>70</sup> The *Aurora* decision will allow what were in past decisions derivative actions to be filed as direct actions by an individual shareholder against a closely held corporation. The decision will also deny recovery to any shareholder of a closely held corporation that buys into the corporation at a price that was not set by an "efficient market" by not allowing the shareholder to recoup the difference in price from the corporation as the result of advantageous litigation. In consequence, this Note recommends that the Utah Supreme Court in future decisions not apply the contemporaneous ownership requirement to direct actions of shareholders in closely held corporations.

##### *A. Closely Held Corporations and Derivative Lawsuits*

Based on prior Utah precedent, the *Aurora* claims were clearly derivative in nature. In Utah, "mismanagement of the corporation gives rise to a cause of action in the corporation, even if the management results in damage to stockholders by depreciating the value of the corporation's stock."<sup>71</sup> Prior to the *Aurora* case, Utah law was very clear as to the differences between a derivative and direct action.

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70. Richardson v. Ariz. Fuels Corp., 614 P.2d 636 (Utah 1980).

71. *Id.* at 640 (citing Morris v. Ogden State Bank, 28 P.2d 138 (Utah 1934) (citing 3B JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 23.1.16[1] (2d ed. 1980) and 12B FLETCHER ET AL., *supra* note 2, § 5911)).

The Utah Supreme Court in *Richardson v. Arizona Fuels Corp.* stated:

Suits which are said to be derivative, and therefore come within the rule [Utah Rule of Civil Procedure 23.1], are those which seek to enforce any right which belongs to the corporation and is not being enforced, such as the liability of corporate officers or majority shareholders for mismanagement, to recover corporate assets and related claims, to enforce rights of the corporation by virtue of its contract with a third person, and to enjoin those in charge of the corporation from causing it to commit an ultra vires act. On the other hand, if the injury is one to the plaintiff as a stockholder and to him individually, and not to the corporation, as where the action is based on a contract to which he is a party, or on a right belonging severally to him, or on a fraud affecting him directly, it is an individual action.<sup>72</sup>

The Utah Supreme Court's holding that minority shareholders in a closely held corporation can sue the corporate officers directly will drastically affect corporate officer decision-making because directors of closely held corporations will now possibly be sued directly for any mismanagement of corporate assets. Prior to the *Aurora* case, courts across America adopted one of three approaches in dealing with shareholder lawsuits in closely held corporations.

*1. Traditional approach of treating closely held corporations by the letter of the law*

The traditional approach, adopted by, among other states, Delaware, is that the rules that apply to large publicly held corporations should also apply to closely held corporations, meaning that shareholder derivative laws apply to closely held corporations.<sup>73</sup> An important case in the development of the traditional approach is *Maki v. Estate of Ziehm*.<sup>74</sup>

In *Maki*, two shareholders equally owned a closely held corporation. Shareholder A died and Shareholder B filed suit against the es-

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72. *Id.* at 639 (quoting MOORE ET AL., *supra* note 71, ¶ 23.1.16[1]).

73. *See* Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379 (7th Cir. 1990) (holding that the state of Delaware is not ready to loosen the derivative action requirements in a closely held corporation setting).

74. 391 N.Y.S.2d 705, 707 (App. Div. 1977) (holding that the claim of misappropriation of corporate funds may not be addressed in a direct action by a stockholder, but must be brought in the name of the corporation, since the damages, if any, belong to the corporation).

tate of Shareholder A claiming, “the decedent misappropriated the assets of the corporation to his own use.”<sup>75</sup> The court dismissed Shareholder B’s claims, holding that Shareholder B could not bring the claim individually.<sup>76</sup>

The *Maki* court held that “a derivative action is the appropriate vehicle for the protection of the rights of the corporation’s creditors, since corporate liabilities must be extinguished before any corporate assets may be distributed to the stockholders.”<sup>77</sup> Otherwise, a shareholder could use a direct action against the corporation to circumvent the liabilities that the corporation has to its creditors and all benefits from the direct action would be received by the shareholder.<sup>78</sup>

The Utah Supreme Court recognized this important principle in the case of *Richardson v. Arizona Fuels Corp.*, where it stated that the direct action, if not used correctly, “and in lieu of a derivative action, is likely to result in grave injustices, not the least of which is the diversion of assets recovered in a lawsuit from creditors of a corporation to stockholders thereby reversing the long established substantive rules of law” that a creditor has priority over a shareholder “to the assets of an insolvent corporation.”<sup>79</sup> Hence, allowing only derivative actions as an exclusive remedy when the corporation has been damaged protects “the interests of all parties harmed by damage to the corporation.”<sup>80</sup>

The reasoning of the *Maki* court, however, is flawed because it does not take into account all types of circumstances that may be present in a given action involving a closely held corporation. By requiring a shareholder of a closely held corporation to file a derivative action for any harm that the corporation sustains, the court is impliedly holding that the procedural requirements of a derivative action must be met prior to the commencement of the action. Thus, the shareholder would first have to make demand upon the officers or directors of the corporation, which in this case was the decedent’s estate. The estate of the decedent has a conflict of interest in deciding between the best interests of the estate and the best interests of

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75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. 614 P.2d 636, 640 (Utah 1980).

80. GEVURTZ, *supra* note 1, § 4.3.1(a), at 391.



the corporation. Assuming that the decedent's estate does not agree to bring the suit, the shareholder would have to file a derivative action against the estate to recover for the mismanagement of the assets. However, if any judgment is recovered through litigation, the judgment will be the property of the corporation and thus will revert back to the defendants in the litigation proceedings.<sup>81</sup> Thus, unlike a direct action that results in a possible recovery by the individual shareholder,<sup>82</sup> any recovery of a derivative action belongs to the corporation whether it is a publicly held or closely held corporation.<sup>83</sup> Therefore, although the derivative action may provide a remedy for shareholders in a publicly held corporation, it can hardly be argued that the same type of remedy is available for shareholders in a closely held corporation.<sup>84</sup>

## 2. *Closely held corporations treated like partnerships*

Another approach quite different than the traditional approach is to not apply derivative rules to any type of closely held corporation.<sup>85</sup> The important case of *Donahue v. Rodd Electrotype Co. of New England* held that a closely held corporation is essentially an incorporated partnership and thus minority shareholders should have the right to sue individually.<sup>86</sup>

In *Donahue*, a minority shareholder brought an action against the officers and directors of a closely held corporation seeking to rescind the corporation's purchase of an officer's shares.<sup>87</sup> The *Donahue* court reasoned that the similarities in business forms between a partnership and a closely held corporation did not warrant a great disparity in their legal treatment.<sup>88</sup> The court noted that many other

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81. The rationale of courts in allowing the proceeds to revert back to the defendants is twofold: (1) the interests of other parties including creditors outweighs recovery by an individual shareholder and (2) the previous action should provide an incentive to the board of directors to change future conduct. *Id.* § 4.3.1(b).

82. *Id.* § 4.3.1(a).

83. *Crosby v. Beam*, 548 N.E.2d 217, 221 (Ohio 1989).

84. *See infra* Part IV.B.1.

85. *See Kirk v. First Nat'l Bank of Columbus*, 439 F. Supp. 1141 (M.D. Ga. 1977); *see also Jorgensen v. Water Works, Inc.*, 582 N.W.2d 98 (Wis. Ct. App. 1998).

86. *Donahue v. Rodd Electrotype Co. of New Eng.*, 328 N.E.2d 505, 512 (Mass. 1975).

87. *Id.* at 508.

88. *Id.* at 512, 515; *see also Crosby*, 548 N.E.2d at 220 ("Close corporations bear a striking resemblance to a partnership. In essence, the ownership of a close corporation is lim-

courts have ruled that the “close corporation is often little more than an ‘incorporated’ or ‘chartered’ partnership.”<sup>89</sup> The *Donahue* court further stated that “[m]any close corporations are ‘really partnerships, between two or three people who contribute their capital, skills, experience and labor.’”<sup>90</sup> By so holding that a closely held corporation is in essence a partnership, the rule allows courts to convert “all intracorporate disputes that would be normally characterized as derivative actions into direct actions whenever the case involves a closely held corporation.”<sup>91</sup>

Some of the policy reasons promulgated by the *Donahue* court involved the fact that because “stockholders in [a] close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another,” the procedural rules of derivative lawsuits would be inapplicable in a closely held corporate setting where corporate shareholders are little more than incorporated partners.<sup>92</sup> Other courts have asserted that “[w]here several owners own an enterprise together (as they usually do in a close corporation), their relationship should be considered a fiduciary one similar to the relationship among partners.”<sup>93</sup> Even Chief Justice Burger, who at the time was a judge on the D.C. Circuit, voiced his stance on the matter by stating that

[in] an intimate business venture such as this, stockholders of a close corporation occupy a position similar to that of joint adventurers and partners. While courts have sometimes declared stockholders ‘do not bear toward each other that same relation of trust and confidence which prevails in partnerships,’ this view ignores the practical realities of the organization and functioning of a small . . . corporation organized to carry on a small business enterprise in

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ited to a small number of people who are dependent on each other for the enterprise to succeed. Just like a partnership, the relationship between the shareholders must be one of trust, confidence and loyalty if the close corporation is to thrive.”); AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01 cmt. e (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

89. *Donahue*, 328 N.E.2d at 512.

90. *Id.* at 512 (citing *Kruger v. Gerth*, 16 N.Y.2d 802, 805 (1965)).

91. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 88, § 7.01 cmt. e.

92. *Donahue*, 328 N.E.2d at 515.

93. *Noakes v. Schoenborn*, 841 P.2d 682, 687 (Or. Ct. App. 1992) (quoting O’NEAL & THOMPSON, *supra* note 17, § 8.08(3)).

which the stockholders, directors, and managers are the same persons.<sup>94</sup>

Furthermore, the *Donahue* court recognized that another governing body, namely the Internal Revenue Service, has through statute recognized that Subchapter S corporations are usually closely held corporations and for tax purposes are treated exactly like a partnership.<sup>95</sup>

Although the reasoning of the *Donahue* court is persuasive, the law should not be changed to treat closely held corporations as partnerships and exempt shareholders from the derivative lawsuit requirements in all circumstances. Similar to the partnership form and unlike a publicly traded corporation, a shareholder in a closely held corporation does not have the flexibility or remedy of trading his shares in the corporation in a public market. However, despite these disadvantages, the corporate form should govern in most circumstances and the desire of the corporation's founders in choosing the corporate form over the partnership form should be respected.<sup>96</sup>

Furthermore, it is important to consider the interests and rights of creditors "since corporate liabilities must be extinguished before any corporate assets may be distributed to the stockholders."<sup>97</sup> Finally, allowing a closely held corporation to be treated as a partnership may give rise to a multiplicity of actions depending on the number of shareholders in the corporation. Directors and officers could be sued for any type of mismanagement of assets no matter how nominal the value. For these reasons, the closely held corporate form should not be treated as a partnership in shareholder proceedings.

### 3. *The moderate approach of the American Law Institute*

The American Law Institute has promulgated a more moderate middle approach. The American Law Institute's proposal developed

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94. *Donahue*, 328 N.E.2d at 513 (quoting *Helms v. Duckworth*, 249 F.2d 482, 486 (D.C. Cir. 1957)).

95. *Id.* at 512 n.12.

96. *See* *Richards v. Bryan*, 879 P.2d 638, 648 (Kan. Ct. App. 1994). Advantages of the corporate form include: "(a) Power to take, hold, and convey property in the corporate name; (b) Power to sue and to be sued in the corporate name; (c) Centralization of management in the board of directors; (d) Ready transferability of interests; (e) Perpetual succession; and (f) Limited liability." HENN & ALEXANDER, *supra* note 20, § 79.

97. *Maki v. Estate of Ziehm*, 391 N.Y.S.2d 705, 707 (App. Div. 1977).

primarily because of a landmark case that was decided in 1956 by the Ninth Circuit.<sup>98</sup> In *Watson v. Button*, the court held that a direct action may be substituted for a derivative action when a multiplicity of actions will not result from the ruling, the corporate creditors will not be hurt, and all stockholders will benefit equally from the direct ruling.<sup>99</sup> The American Law Institute, following the *Watson* precedent, states:

In the case of a closely held corporation . . . 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.<sup>100</sup>

In adopting this rule the American Law Institute stated “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.”<sup>101</sup> In essence, what the American Law Institute and the *Watson* court have done is incorporate three policy requirements that determine when minority shareholders in closely held corporations must sue derivatively. The American Law Institute and *Watson* then state that when the facts of each individual case satisfy the three policy requirements of the above-cited passage, a derivative lawsuit is no longer warranted and a direct action should be allowed. It is important to note that not only does the American Law Institute recommend that a direct claim be substituted for a deriva-

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98. *Watson v. Button*, 235 F.2d 235 (9th Cir. 1956).

99. *Id.* at 237 (involving two shareholders one of which misappropriated the assets of the corporation at the expense of the other shareholder).

100. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 88, § 7.01(d).

101. *Id.* at cmt. e; *Schumacher v. Schumacher*, 469 N.W.2d 793, 798 (N.D. 1991) (holding that a minority shareholder in a closely held corporation may bring a direct action rather than a derivative action). Recent decisions that have recognized the right of a shareholder of a close corporation to sue directly include: *Orsi v. Sunshine Art Studios, Inc.*, 874 F. Supp. 471 (D. Mass. 1995); *Johnson v. Gilbert*, 621 P.2d 916, 918 (Ariz. Ct. App. 1980); *Thomas v. Dickson*, 301 S.E.2d 49, 51 (Ga. 1983); *Steelman v. Mallory*, 716 P.2d 1282 (Idaho 1986); *Barth v. Barth*, 659 N.E.2d 559 (Ind. 1995); *Richards v. Bryan*, 879 P.2d 638, 648 (Kan. Ct. App. 1994); *Horizon House-Microwave, Inc. v. Bazy*, 486 N.E.2d 70, 74 (Mass. App. Ct. 1985); *Yackel v. Kay*, 642 N.E.2d 1107 (Ohio Ct. App. 1994); *Noakes v. Schoenborn*, 841 P.2d 682 (Or. Ct. App. 1992).

tive claim, but the Institute also recommends that any action be exempt “from those restrictions and defenses applicable only to derivative actions.”<sup>102</sup> Thus, a direct action that is used in place of a derivative action does not need to follow the procedural requirements of a derivative action.

The balanced approach that the American Law Institute promulgates is correct in not making every action a direct action, but in allowing the courts to have discretion to decide when the three policy requirements are met and then to treat the closely held corporation accordingly. However, the rationale of the first policy requirement of avoiding a multiplicity of actions may be misplaced because in a closely held corporation there are usually very few shareholders, and where there are few shareholders (each of whom may bring one claim), there cannot be a multiplicity of actions, so the policy requirement results in a non-issue. In contrast, avoiding a multiplicity of actions does matter in a publicly held corporation because it would be overwhelming for both the courts and the individual corporation to have a different lawsuit by every shareholder over the same claim. The second policy requirement respects the *Maki* court in protecting creditors’ interests before the interests of the individual shareholders. Finally, the third requirement ensures that not only will the shareholder bringing the action benefit from the decision of the court, but also ensures that other shareholders are protected in the recovery process.

*B. The Aurora Court’s Partial Adoption of the  
American Law Institute’s Proposal*

The Utah Supreme Court partially adopted the American Law Institute’s proposal as stated above. The court held that “a court may allow a minority shareholder in a closely held corporation to proceed directly against corporate officers.”<sup>103</sup> However, the court also held that “permitting a shareholder to proceed directly for claims against a closely held corporation does not exempt the shareholder from the contemporaneous ownership rule.”<sup>104</sup> Unlike the American Law Institute’s recommendation that direct actions not be

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102. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 88, § 7.01(d).

103. *Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc.*, 970 P.2d 1273, 1281 (Utah 1998).

104. *Id.*

subject to the “restrictions and defenses applicable only to derivative actions,”<sup>105</sup> the Utah Supreme Court requires direct actions to now jump through the procedural requirement of the contemporaneous ownership rule. The remainder of this Note will show why the Utah Supreme Court was correct in its first holding of allowing derivative actions to be substituted with direct actions in the case of a closely held corporation.<sup>106</sup> This Note will also discuss why the Utah Supreme Court was incorrect when it applied the contemporaneous ownership requirement to direct proceedings in a closely held corporation.

*1. The Utah Supreme Court correctly allowed minority shareholders to sue a closely held corporation’s officers directly*

The Utah Supreme Court correctly held that a minority shareholder in a closely held corporation should be able to file a direct action instead of a derivative action against the corporation’s officers. Furthermore, the Utah Supreme Court correctly held that in a direct action the minority shareholder is not required to meet “many of the procedural requirements of a derivative action.”<sup>107</sup> However, the court should have also held that the contemporaneous ownership requirement does not apply to direct actions filed against closely held corporations.

“[T]he procedural rules often applicable to derivative actions—such as a requirement that the plaintiff post a security-for-expenses bond—often make little sense in the context of a dispute between persons who are effectively incorporated partners.”<sup>108</sup> Furthermore, it is difficult to envision a minority shareholder required to make demand on the closely held corporation’s board, where the board may have very well caused the harm the corporation suffered. “[T]he likelihood of a disinterested board is far smaller in [a closely held corporation] because the majority stockholders are likely also to be the

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105. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 88, § 7.01(d).

106. Recently, the Utah Supreme Court attempted to distinguish part of its correct holding in *Aurora*. See *Arndt v. First Interstate Bank of Utah, N.A.*, 991 P.2d 584, 588 (Utah 1999) (“The injury alleged in *Aurora Credit* was suffered uniquely by *Aurora Credit* and therefore was much more direct than is a typical derivative claim.”); see also *Warner v. DMG Color, Inc.*, 20 P.3d 868, 873 (Utah 2000).

107. *Aurora*, 970 P.2d at 1281.

108. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 88, § 7.01 cmt. e.

firm's managers."<sup>109</sup> Thus, as previously discussed, a conflict of interest arises for the board members to maintain their fiduciary duty to look after the corporation's best interests, but at the same time not agree to sue themselves and be held liable for the damages that they have caused. Hence, most directors or officers do not agree to instigate this action.

A new problem arises after demand is made upon the corporation's board and the action is refused by the board. The shareholder's only remedy is to file a derivative action. However, as discussed previously, any recovery or judgment that is awarded from the derivative lawsuit belongs to the corporation and not to the individual shareholder.<sup>110</sup> A number of courts have recognized that "it is often difficult and futile to bring a derivative action against a closely held corporation"<sup>111</sup> because "[e]ven if a minority shareholder overcomes procedural hurdles in a derivative action, a strong disadvantage is that any recovery accrues to the corporation and hence remains under the control of the [majority shareholders, the] very parties who may have been defendants in the litigation."<sup>112</sup> This is why some courts have permitted "oppressed minority shareholders to bring direct suits for breaches of fiduciary duties the majority shareholders owe minority shareholders even though the plaintiffs' grievance is based primarily on damage to the corporation. Courts need not ignore the reality that the litigation is really a dispute among shareholders."<sup>113</sup> "Thus, a derivative remedy is not an effective remedy because the wrongdoers would be the principal beneficiaries of the recovery."<sup>114</sup>

Another important policy implication in favor of adopting the American Law Institute's approach is the fact that a shareholder in a closely held corporation typically "has a substantial percentage of his personal assets invested in the corporation."<sup>115</sup> In contrast to a

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109. *Id.*

110. *See Crosby v. Beam*, 548 N.E.2d 217, 221 (Ohio 1989).

111. *Richards v. Bryan*, 879 P.2d 638, 647-48 (Kan. Ct. App. 1994) (concluding that "if a corporation is closely held, a court in its discretion, may treat an action raising derivative claims as a direct action" (quoting AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(d), at 713 (Tentative Draft No. 11, 1991))).

112. *Schumacher v. Schumacher*, 469 N.W.2d 793, 798 (N.D. 1991).

113. *Id.*

114. *Crosby*, 548 N.E.2d at 221.

115. *Donahue v. Rodd Electrottype Co. of New Eng.*, 328 N.E.2d 505, 514 (Mass. 1975) (citing *Galler v. Galler*, 203 N.E.2d 577, 583-84 (1965)).

shareholder of a publicly held corporation, the minority shareholder cannot sell his stock for market value on a public stock exchange. Furthermore, just as a partner in a partnership “cannot transfer his interest in the partnership so as to give his assignee a right to participate in the management or business affairs of the continuing partnership without the agreement of the other partners” so too can a closely held corporation’s shareholders impose restrictions on the sale of any stock of the corporation.<sup>116</sup> The minority shareholder’s only recourse is to deal with the wrongdoing majority shareholders.<sup>117</sup> Where a shareholder in a large, publicly held corporation can find many interested people or entities willing to buy his stock, the minority shareholder in a closely held corporation is “trapped in a disadvantageous situation from which he cannot be easily extricated” because there is generally no available market for his shares.<sup>118</sup> Thus, it is very difficult for a minority shareholder in a closely held corporation to regain her investment when the majority shareholders harm the corporation in some way.

Despite these very persuasive arguments in favor of adopting the American Law Institute’s approach, many courts have sharply criticized the American Law Institute’s proposal. In *Bagdon v. Bridgestone/Firestone, Inc.*, the court stated:

Ohio, like a few other states, has expanded the ‘special injury’ doctrine into a general exception for closely held corporations, treating them as if they were partnerships. . . . The American Law Institute recommends that other states do the same. The premise of this extension may be questioned. Corporations are not partnerships. Whether to incorporate entails a choice of many formalities. Commercial rules should be predictable; this objective is best served by treating corporations as what they are, allowing the investors and other participants to vary the rules by contract if they think deviations are warranted. So it is understandable that not all states have joined the parade.<sup>119</sup>

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116. *See id.* at 512 n.13 (citations omitted).

117. *Id.* at 515.

118. *See Crosby*, 548 N.E.2d at 220.

119. *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 383–84 (7th Cir. 1990) (citations omitted). In a recent decision, the Virginia Supreme Court adopted the rationale of the *Bagdon* court and rejected the American Law Institute’s proposal. *See Simmons v. Miller*, 544 S.E.2d 666, 675 (Va. 2001).



Furthermore, in *Landstrom v. Shaver*,<sup>120</sup> the South Dakota Supreme Court argued that minority shareholders in closely held corporations are adequately protected by putting the proceeds of recovery back into the corporation because the value of the minority shareholder's stock is restored to its original value.<sup>121</sup> The *Landstrom* court also held that allowing the recovery to inure to the corporation guarantees the protection of all shareholders and creditors and respects the separate and distinct features of the corporate entity.<sup>122</sup> The *Landstrom* court categorically rejected the American Law Institute's proposal by reasoning that the Institute's position would potentially allow minority shareholders to force majority shareholders "by litigation (or even in some cases, the threat of it) to buy out the minority shareholders' shares 'which corporate law rarely if ever requires.'"<sup>123</sup>

In summary, both courts argued that maintaining respect for the corporate entity is of supreme importance. The *Bagdon* court argued that corporate law should be predictable, and the *Landstrom* court further asserted that all shareholders and creditors should be protected in any action that is filed to remedy a corporate harm. The *Landstrom* court felt that minority interests were adequately protected by the requirement that proceeds of the action flow directly to the corporation because the value of all shares, including those belonging to minority shareholders, would be increased. The *Landstrom* court also expressed concern regarding the possibility of majority shareholders being forced into buying out minority shareholders' ownership interests under the threat of litigation.

Nonetheless, the Utah Supreme Court was correct to adopt the American Law Institute's proposal because it allows courts to use their own discretion in taking into account the factors emphasized by both the *Bagdon* and *Landstrom* courts. The American Law Institute's approach still protects creditors before shareholders and also requires that one shareholder not be able to recover proceeds at the expense of another. In addition, the *Bagdon* court's argument that the corporate form must be respected is not without blemish. The *Bagdon* court, by holding that a corporation should never be treated

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120. 1997 SD 25, 561 N.W.2d 1 (1997).

121. *Id.* at 15.

122. *Id.* at 14.

123. *Id.* at 15 (citation omitted).

as a partnership, impliedly held that a closely held corporation should always be governed by the same rules that govern publicly traded corporations. While such a position may be reasonable and fitting in most circumstances, this Note has offered various circumstances under which the rules that apply to publicly held corporations should not be applied to closely held corporations. For example, the *Landstrom* court concluded that receiving an appreciation in the value of her shares through the recovery process is the only remedy available to a minority shareholder.<sup>124</sup> But this view fails to take into account the crucial factor of control; majority shareholders are ultimately in charge of the proceeds recovered by the corporation. The majority shareholders, who are the wrongdoers in the lawsuit, are also the principal beneficiaries because they control the recovery's ultimate use. The minority shareholder is therefore left powerless and with little remedy. Typically a minority shareholder is someone who "has a substantial percentage of his personal assets invested in the corporation."<sup>125</sup> These minority shareholders are left with two options: they can (1) hope that the recovery proceeds are used by the majority shareholders in a manner that will ultimately increase the value of the corporation, or (2) sell their stock in the corporation because of strained relations with the majority shareholders. Many minority shareholders may be unwilling to explore the first option because of distrust arising from mismanagement by the majority shareholders in the first instance. The only remaining course of action then becomes the second option. "Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority stockholder may be compelled to deal with the majority."<sup>126</sup> Hence, the most plausible method of recourse available to a minority shareholder will likely be to sell her shares to the majority shareholders with the majority holding all or most of the bargaining power with regard to price. The end result would be the opposite outcome of what the *Landstrom* court intended, but this time it would be the minority shareholder being forced to sell her shares to

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124. *Id.*

125. *Donahue v. Rodd Electrotpe Co. of New Eng.*, 328 N.E.2d 505, 514 (Mass. 1975) (citing *Galler v. Galler*, 203 N.E.2d 577, 583-84 (1965)).

126. *Id.* at 515.

the majority shareholders, a result “which corporate law rarely if ever requires.”<sup>127</sup>

*2. The Utah Supreme Court incorrectly applied the contemporaneous ownership doctrine to direct lawsuits*

The *Aurora* court incorrectly held that “permitting a shareholder to proceed directly for claims against a closely held corporation does not exempt the shareholder from the contemporaneous ownership rule.”<sup>128</sup> In essence, what the court said was that now not only derivative actions, but also all direct actions by shareholders against closely held corporations must meet the contemporaneous ownership requirements of Utah Rule of Civil Procedure 23.1.

The purpose of the contemporaneous ownership requirement “is to prevent ‘strike suits,’ where individuals purchase shares in a corporation with litigious motives. In the absence of the contemporaneous ownership rule, subsequent purchasers of shares could reap a windfall from any recovery in a derivative proceeding which was not considered in the purchase price of their shares.”<sup>129</sup> Stated another way, the contemporaneous ownership requirement is intended to (1) prevent individuals from buying a stock and then pursuing litigation on matters that occurred prior to their ownership of the stock,<sup>130</sup> (2) prevent shareholders from buying into a corporation at a devalued price and then receiving a windfall from advantageous litigation on matters that occurred prior to their ownership of the stock,<sup>131</sup> and (3) prevent a multiplicity of suits being filed by various stockholders.<sup>132</sup>

It was incorrect for the Utah Supreme Court to apply the contemporaneous ownership requirement to direct actions filed against closely held corporations.<sup>133</sup> The contemporaneous ownership requirement is not the only way to protect closely held corporations

127. *Landstrom*, 561 N.W.2d at 15 (quoting *Frank v. Hadesman & Frank, Inc.*, 83 F.3d 158, 162 (7th Cir. 1996)).

128. *Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc.*, 970 P.2d 1273, 1281 (Utah 1998).

129. 13 FLETCHER ET AL., *supra* note 5, § 5981.10.

130. *See Noland v. Barton*, 741 F.2d 315, 317 (10th Cir. 1984).

131. *See Bank of Santa Fe v. Petty*, 867 P.2d 431, 434 (N.M. Ct. App. 1993).

132. *DLB Collection Trust v. Harris*, 893 P.2d 593, 597 (Utah Ct. App. 1995).

133. For example, the state of California has left broad discretion to the courts as to when the contemporaneous ownership requirement should be applied even to derivative proceedings. *See CAL. CORP. CODE* § 800(b)(1) (West 1990).

from strike suits. For example, as stated previously, many owners of closely held corporations:

impose restrictions on transfers to stock designed to prevent outsiders who are unacceptable to the other stockholders from acquiring an interest in the close corporation. These restrictions often take the form of agreements among the stockholders and the corporation or by-laws which give the corporation or the other stockholders a right of 'first refusal' when any stockholder desires to sell his shares.<sup>134</sup>

The contemporaneous ownership requirement's purpose of eliminating strike suits is moot in closely held corporations because two other factors already serve that purpose, namely, the lack of a public market for the trading of closely held shares and the small number of shares outstanding in a closely held corporation. These two factors make it virtually impossible for someone to buy into closely held stock and receive a windfall from advantageous litigation.

The contemporaneous ownership requirement is also based on the assumption of the "efficient market theory." The efficient market theory "posits that the price of a security reflects all publicly available information about a firm, and that prices react almost instantaneously and in an unbiased manner to any new information."<sup>135</sup> "Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."<sup>136</sup> The market acts "as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price."<sup>137</sup>

The contemporaneous ownership requirement relies on the efficient market theory because it assumes that when a new stockholder buys into a corporation, all material, relevant information will be used to price the stock in an efficient market. Thus, if there is out-

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134. *Donahue v. Rodd Electrotype Co. of New Eng.*, 328 N.E.2d 505, 512 n.13 (Mass. 1975).

135. *Dennis*, *supra* note 25, at 374-75; *see also* *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 975 (C.D. Cal. 1994) (stating that the efficient market theory holds that "all announcements of financial results and other developments are quickly incorporated into the ever-changing market price of the company's stock").

136. *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988).

137. *Id.* at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

standing litigation involving the corporation, the litigation will already be reflected in the stock price. Therefore, according to the contemporaneous ownership requirement, stockholders who buy stock after the “time of the act or omission complained of”<sup>138</sup> should not be able to participate in the recovery of the litigation. Otherwise, these stockholders would receive a windfall.

The Utah Supreme Court stated that the contemporaneous ownership requirement should apply to direct actions because of the assumption that any purchaser of the stock

who becomes an owner after the occurrence of wrongful corporate conduct paid a price for the stock reflecting the misdeed and that, therefore, the purchaser suffers no injury from the wrongful conduct. This assumption is equally as true for the purchaser of stock in a closely held corporation as in a large publicly traded corporation.<sup>139</sup>

Hence, the Utah Supreme Court assumes that just as publicly held corporate stock is traded on an efficient market, so too is closely held corporate stock. However, this assumption is in error. As stated previously the definition of a closely held corporation is a corporation with “(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.”<sup>140</sup> Focusing on element two of the definition shows that a closely held corporation has “no ready market for the corporate stock.”<sup>141</sup> Because a closely held corporation by definition does not have a ready market for its stock, it is incorrect to assume that after the wrong occurred, a purchaser of the stock “paid a price for the stock reflecting the misdeed.”<sup>142</sup> Thus, a shareholder that buys into a closely held corporation that suffers some type of harm will most likely buy in at a price that is greater than market value because the stock is traded on an inefficient market that has inadequate informa-

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138. 13 FLETCHER ET AL., *supra* note 5, § 5981.

139. *Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc.*, 970 P.2d 1273, 1281 (Utah 1998).

140. *Donahue v. Rodd Electrotpe Co. of New Eng.*, 328 N.E.2d 505, 511 (Mass. 1975); *see also* *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989) (“[A] close corporation is a corporation with a few shareholders and whose corporate shares are not generally traded on a securities market.”).

141. *Donahue*, 328 N.E.2d at 511.

142. *Aurora*, 970 P.2d at 1281.

tion to adjust the price downward. But if the corporation does not pursue the claim through litigation, the shareholder will not be able to recoup part of her investment because at the time the corporation was harmed she did not own the stock. More importantly, even the American Law Institute has recognized that in circumstances where (1) the wrongdoing was not made public, (2) the purchasing party did not know about the wrongdoing, or (3) the stock price did not reflect the wrongdoing, the contemporaneous ownership requirement should not be applied.<sup>143</sup>

Furthermore, even if closely held corporate stock were traded on an efficient market it still does not mean that the contemporaneous ownership requirement should apply to direct actions. In an efficient market the contemporaneous ownership requirement does not always prevent a windfall from accruing to the purchasing party. For example, even if the purchaser knows about the damage to the corporation, “this does not mean that the share price will incorporate a discount fully reflecting the damage. If the buyer expects that the corporation can recover compensation from the wrongdoer, then the price of the shares should reflect this potential recovery” discounted by the costs of the litigation and the possibility of non-recovery by the corporation.<sup>144</sup>

In situations in which the wrongdoing was not fully disclosed, courts should not assume there will be a windfall. Nor should courts assume that there is a windfall when the wrongdoing is disclosed, but the party purchasing control buys his or her shares from stockholders who were not the wrongdoers. After all, in this instance, the buyer presumably paid a price reflecting the possibility of corporate recovery.<sup>145</sup>

Hence, the Utah Supreme Court was wrong to assume that the efficient market theory applies to the trading of closely held corporate stock. For the above stated reasons, the contemporaneous ownership requirement should not apply to direct actions in closely held corporations.

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143. GEVURTZ, *supra* note 1, § 4.3.2 (citing PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 88, § 7.02(a)(1)).

144. *Id.*

145. *Id.*

## V. CONCLUSION

In conclusion, the Utah Supreme Court's holding in *Aurora* was correct insofar that it allows minority shareholders of closely held corporations to sue the corporation directly for injuries sustained by the corporation. However, the decision to require direct actions to meet the contemporaneous ownership requirement of Rule 23.1 was incorrect based upon the analysis in Part IV of this Note. The contemporaneous ownership requirement's purpose is to avoid strike suits and is based on the premise that all stock is traded on an efficient market. As Part IV of this Note illustrated, the small number of shares outstanding and the lack of a public market in a closely held corporate setting serve the purpose of eliminating strike suits. Thus, closely held corporations do not need to be governed by the contemporaneous ownership requirement. Furthermore, it is incorrect to assume that stock of a closely held corporation is traded on an efficient market because a closely held corporation by definition is a corporation that has "no ready market for the corporate stock."<sup>146</sup> Therefore, Utah courts in the future should not apply the contemporaneous ownership requirement to direct actions filed by minority shareholders of closely held corporations.

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146. *Donahue*, 328 N.E.2d at 511.