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The Contemporaneous Ownership Rule In New York

Through a shareholders' derivative action, one or more shareholders of a corporation may bring suit to enforce a corporate right when the corporation, by its board of directors, refuses to take appropriate action to pursue such right for its own gain or protection.[1] The courts devised this right in order to provide judicial access for any shareholder who had suffered an indirect injury because of the diminished value of his holdings in the corporation, but who could not compel the board of directors to bring suit.[2] Both courts and legislatures have adopted rules designed to clarify the limited purpose of derivative actions and curtail potential abuses.[3]

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1. *See* Price v. Gurney, 324 U.S. 100, 105 (1945). *See generally* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS §§ 358-376 (2d ed. 1970); N. LATTIN, THE LAW OF CORPORATIONS 410-62 (2d ed. 1971). *See also* Green v. Victor Talking Mach. Co., 24 F.2d 378, 380-81 (2d Cir. 1928). In the United States, the courts created the "derivative" right to accommodate "the concept of the corporation as a separate right-holding entity" and "the idea that the shareholder had a right to judicial protection of his interests when jeopardized by a defaulting management." Prunty, *The Shareholders' Derivative Suit: Notes On Its Derivation*, 32 N.Y.U.L. REV. 980, 992 (1957).

2. Before the federal courts may entertain a shareholders' derivative action, the complaint must include allegations of the efforts made, if any, to compel the board of directors or shareholders of the corporation to take appropriate action for the protection of the corporation. FED. R. CIV. P. 23.1. The failure to make a prior demand on the directors or shareholders is generally excused if the directors or shareholders themselves are the alleged wrongdoers. *See* Smith v. Sperling, 354 U.S. 91 (1957) (directors approved contract injurious to corporation). In New York, the complaint in a shareholders' derivative action must allege any efforts made to secure action by the board of directors and, if no efforts were made, the reasons for such inaction. N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963). No demand need be made on the shareholders of the corporation. *Id.* The failure to make a prior demand on the board of directors is excused if such demand would be futile. *See* Continental Secs. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912) (alleged wrongdoers controlled the corporation).

If the corporation does take the appropriate action, a derivative action is no longer necessary. If the board of directors' decision not to institute a suit was made with sound business judgment, a derivative action will be dismissed in most instances. *See* Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980). The exception to this principle is the case in which the directors are alleged to have authorized or approved the transaction and are defendants in the suit. *Id.* at 58-62. *See generally* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit*, 75 NW. U.L. REV. 96, 98-105 (1980).

3. *See, e.g.*, Ross v. Bernhard, 396 U.S. 531 (1970) (indicating that the corporation is

The contemporaneous ownership rule ("Rule"), one of the more problematic of these formulations, has been codified in the Federal Rules of Civil Procedure[4] and legislatively or judicially adopted in some form by most states.[5] In New York, the Rule is

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a necessary party to a derivative action); Dodge v. Woolsey, 59 U.S. 331, 344-45, 356 (1855) (emphasizing the requirement that the shareholder demand corporate action prior to his institution of the derivative suit); Paulson v. Margolis, 234 A.D. 496, 255 N.Y.S. 568 (1st Dep't 1932) (indicating that the corporation is a necessary party to a derivative action). FED. R. CIV. P. 23.1 (complaint must allege that the action is not a collusive one to gain jurisdiction; action may not be "dismissed or compromised" without court approval); N.Y. BUS. CORP. LAW § 626(d) (McKinney 1963) (court approval required before the action may be "discontinued, compromised or settled"); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1979-1980) (plaintiff in a shareholder's derivative action who holds less than 5% of any class of shares must post security for the corporation's reasonable expenses, including attorney's fees, unless such shares have a fair market value in excess of fifty thousand dollars). *See also* note 37 and accompanying text *infra*.

4. FED. R. CIV. P. 23.1 provides:

> 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 thereafter devolved on him 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 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.

The federal courts' contemporaneous ownership rule originated in Hawes v. Oakland, 104 U.S. 450 (1881). *See* notes 8-10 and accompanying text *infra*. The Court codified the *Hawes* decision a year later as Equity Rule 94. *See* 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.01[4] (2d ed. 1979). *See also* Venner v. Great N. Ry., 209 U.S. 24 (1908); City of Quincy v. Steel, 120 U.S. 241 (1887). In 1912, Equity Rule 94, in a slightly modified form, became Equity Rule 27. 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.01[4] (2d ed. 1979). In 1938, Equity Rule 27 became Rule 23(b) of the Federal Rules of Civil Procedure. *Id.* In 1966, Rule 23 was revised and renumbered to become present Rule 23.1. *Id.* As part of this most recent revision, the rules governing derivative suits were separated from the rules governing class actions, and provisions which had dealt with settlements and dismissals of class actions were incorporated into the derivative suit rule. *Id.* The purpose of this final change was to restrict strike suits. *Id.* *See* notes 12-13 and accompanying text *infra*.

5. Each of the following jurisdictions has enacted a contemporaneous ownership statute similar to FED. R. CIV. P. 23.1: Connecticut, CONN. GEN. STAT. Ann. § 52-572j

embodied in section 626(b) of the Business Corporation Law:

(West Supp. 1980); Delaware, DEL. CODE ANN. tit. 8, § 327 (1974) (also DEL. CH. CT. R. 23.1 adopted by the Chancellor Dec. 29, 1947); Florida, FLA. STAT. ANN. § 607.147 (West 1977); Georgia, GA. CODE ANN. § 22-615 (1977); Illinois, Act of July 9, 1975, § 45a, Ill. Ann. Stat. ch. 32, § 157.45a (Smith-Hurd Supp. 1980-1981); Iowa, IOWA CODE § 496A.43 (1975); Kentucky, KY. REV. STAT. § 271A.245 (Supp. 1978); Louisiana, LA. CODE CIV. PRO. ANN. art. 596 (West 1960); Massachusetts, MASS. GEN. LAWS ANN. ch. 156B, § 46 (West 1970) (applies only to actions against "stockholders, directors or officers of the corporation as such"); Michigan, MICH. COMP. LAWS ANN. § 450.1491 (1973); Mississippi, MISS. CODE ANN. § 79-3-93 (1972); Missouri, MO. ANN. STAT. § 507.070 (Vernon 1952); Montana, MONT. REV. CODES ANN. § 15-2243 (1967); Nebraska, NEB. REV. STAT. § 21-2047 (1977); New Jersey, N.J. STAT. ANN. § 14A:3-6 (West 1969 & Supp. 1979-1980); New Mexico, N.M. STAT. ANN. § 53-11-47 (Supp. 1979) (also N.M. R. CIV. P. 23.1, adopted Nov. 1, 1978); New York, N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963); North Carolina, N.C. GEN. STAT. § 55-55 (1975); North Dakota, N.D. CENT. CODE § 10-19-48 (1976); Ohio, OHIO R. CIV. P. 23.1; Puerto Rico, P.R. LAWS ANN. tit. 14, § 2203 (1978); Rhode Island, R.I. GEN. LAWS § 7-1.1-43.1 (1970); Tennessee, TENN. CODE ANN. § 48-718 (1979); Texas, TEX. BUS. CORP. ACT ANN. art. 5.14 (Vernon 1980); West Virginia, W. VA. CODE § 31-1-103 (1975); Wyoming, WYO. STAT. § 17-1-141.1 (Supp. 1979).

Each of the following jurisdictions has enacted a contemporaneous ownership statute similar to FED. R. CIV. P. 23.1, but each statute expressly provides for a "continuing wrong" exception to the general rule, *see* notes 74-90 and accompanying text *infra*: Maine, ME. REV. STAT. ANN. tit. 13-A, § 627 (1974); Wisconsin, WIS. STAT. ANN. § 180.405 (West 1957).

Both the California and the Pennsylvania contemporaneous ownership statutes are significantly different from the federal rule. CAL. CORP. CODE § 800 (West 1977) provides that one who was not an owner at the time of the alleged wrong may, after a preliminary showing to the court of five factors, in the court's discretion, maintain a derivative action. The statute provides a continuing wrong rationale and specifically grants standing to beneficial owners of shares. Pennsylvania has both a statute, PA. STAT. ANN. tit. 15, § 1516 (Purdon 1967 & Supp. 1979-1980), and a court adopted rule, PA. R. CIV. P. 1506. Rule 1506, which was adopted in 1952, is essentially similar to FED. R. CIV. P. 23.1. Section 1516, which was enacted in 1963 as P.L. 1355 § 1 and which is narrower in scope than Rule 1506, applies only to suits against officers, directors, or former officers or directors of a corporation. The section provides that the court may, upon preliminary showings of a strong prima facie case and of injustice if a derivative suit is not permitted, allow suit to be maintained even though the contemporaneous ownership criterion is not satisfied. For further discussion of the California and Pennsylvania statutes, see notes 94-97 and accompanying text *infra*.

Each of the following states has, by order of its highest court, adopted a procedural rule similar to FED. R. CIV. P. 23.1: Alabama, ALA. R. CIV. P. 23.1; Arizona, ARIZ. R. CIV. P. 23.1; Arkansas, ARK. R. CIV. P. 23.1; Colorado, COLO. R. CIV. P. 23.1; Indiana, IND. TRIAL RULE 23.1; Kansas, KAN. CIV. PROC. R. 60-223a; Minnesota, MINN. R. CIV. P. 23.06; Nevada, NEV. R. CIV. P. 23.1; South Dakota, S.D. R. CIV. P. 15-6-23.1.

Maryland has adopted, by case law, a contemporaneous ownership rule similar to the federal rule. Eisler v. Eastern States Corp., 182 Md. 329, 35 A.2d 118 (1943).

ALASKA STAT. § 10.15.200 (1968) governs actions brought by a member or shareholder to vindicate a right of a cooperative; it requires contemporaneous ownership but employs the continuing wrong rationale. Alaska has no statute or rule governing shareholders' derivative actions brought to vindicate a right of a corporation.

> [In a shareholders' derivative action], it shall be made to appear that the plaintiff is . . . a holder ["of shares or of voting trust certificates . . . or of a beneficial interest in such shares or certificates"[6]] at the time of bringing the action and *that he was such a holder at the time of the transaction of which he complains, or that his shares or his interest therein devolved upon him by operation of law.*[7]

This comment analyzes the development and operation of the Rule; the circumstances in which application of the Rule operates to deny legal relief to aggrieved shareholders; and the circumstances in which the operation of the Rule, in conjunction with other statutes, results in arbitrary, disparate treatment of shareholders. Finally, the comment proposes a modification of the New York statute to create a presumption in favor of application of the Rule, but to allow a shareholder to rebut the presumption in cases in which application of the Rule would result in an injustice.

I. Evolution of the Contemporaneous Ownership Rule in New York

The contemporaneous ownership rule originated in 1881 with the Supreme Court's opinion in *Hawes v. Oakland*;[8] the Court held that, to sue derivatively in federal court, a plaintiff-shareholder must have owned his shares at the time of the alleged wrongs, or his shares must have subsequently devolved upon him by operation of law.[9] The decision in *Hawes* was

6. N.Y. Bus. Corp. Law § 626(a) (McKinney 1963).

7. N.Y. Bus. Corp. Law § 626(b) (McKinney 1963) (emphasis added). New York courts have permitted derivative actions brought by holders of shares which passed to the holders by virtue of either testate or intestate succession after the date of the transaction which provides the basis for their complaint. *See, e.g.*, Phillips v. Bradford, 62 F.R.D. 681 (S.D.N.Y. 1974); Salter v. Columbia Concerts, Inc., 191 Misc. 479, 77 N.Y.S.2d 703 (Sup. Ct. N.Y. County 1948). *Cf.* Hirshfield v. Briskin, 447 F.2d 694 (7th Cir. 1971) (stock ownership which was litigated subsequent to the death of the testator and was settled by an agreement between the executor and the plaintiff "sufficiently approximated a devolution by operation of law" to satisfy requirements of Rule 23.1 of the Federal Rules of Civil Procedure). *But see* Myer v. Myer, 271 A.D. 465, 66 N.Y.S.2d 83 (1st Dep't 1946) (acquisition of shares by a trust agreement cannot be considered a transfer by operation of law), *aff'd per curiam*, 296 N.Y. 979, 73 N.E.2d 562 (1947).

8. 104 U.S. 450 (1881).

9. *Id.* at 461. *See* note 4 *supra.*

designed to deal with a problem unique to the federal system: the practice of obtaining federal diversity jurisdiction in a derivative action simply by transferring shares to a nonresident who would then bring the action.[10]

After *Hawes*, several state courts, although not faced with the specific jurisdictional issue that gave rise to the Supreme Court decision, adopted the contemporaneous ownership rule in an attempt to eliminate certain abuses associated with derivative litigation.[11] The derivative strike suit was of particular concern. In a strike suit, the plaintiff initiated a shareholder's derivative action to gain a lucrative personal settlement, rather than to benefit the corporation.[12] The corporation might be forced into such a settlement, even if the suit had no substantive basis, in order to prevent expensive and protracted litigation, to protect the corporation's public and private image, and to preclude possible exposure of important corporate secrets.[13] Further, even

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10. Hawes v. Oakland, 104 U.S. 450, 453, 459-60 (1881). *See* City of Quincy v. Steel, 120 U.S. 241, 244-45 (1887). *See generally* Seasongood, *Right of a Stockholder, Suing in Behalf of a Corporation, to Complain of Misdeeds Occurring Prior to His Acquisition of Stock*, 21 HARV. L. REV. 195, 198-200 (1907); Note, *Corporate Incapacity to Sue Where Stockholders Would Be Barred From Suing Derivatively—The Vicarious Incapacity Rule: A Public Interest Exception*, 54 B.U.L. REV. 355, 367-68 (1974); 23 TEMP. L.Q. 82, 82-84 (1949).

11. *See, e.g.*, Boldenweck v. Bullis, 40 Colo. 253, 90 P. 634 (1907) (purchase of stock for purpose of litigating past transactions should not be encouraged); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903) (application of the Rule prevents unjust enrichment of subsequent purchaser).

Other courts rejected adoption of the Rule. *See, e.g.*, Montgomery Light Co. v. Lahey, 121 Ala. 131, 25 So. 1006 (1899) (Rule is one of practice and not a general principle of law); Just v. Idaho Canal & Improvement Co., 16 Idaho 639, 102 P. 381 (1909) (Rule is one of federal practice and should only be applied in state courts when stock was purchased for purpose of bringing suit or when vendor was estopped from bringing suit); Appleton v. American Malting Co., 65 N.J. Eq. 375, 54 A. 454 (1903) (innocent purchaser should not be estopped) (dictum); Rafferty v. Donnelly, 197 Pa. 423, 47 A. 202 (1900) (right to sue on behalf of the corporation is an incident of stock ownership).

12. "A 'strike suit' is an action brought by a security holder, not in good faith, but, through the exploitation of its nuisance value, to force the payment of a sum disproportionate to the normal value of his interest as the price of discontinuance." Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308, 1308 (1934) (footnotes deleted). *See* Myer v. Myer, 271 A.D. 465, 66 N.Y.S.2d 83 (1st Dep't 1946), *aff'd per curiam*, 296 N.Y. 979, 73 N.E.2d 562 (1947).

13. One commentator noted:

> While the derivative action serves a useful purpose, it is susceptible to abuse by "strike-suits" or "blackmail by litigation" when brought by small shareholders and their attorneys primarily to enrich themselves. Derivative actions, whether

if the suit were meritorious, the corporation and the shareholders as a group would not benefit from the litigation if the proceeds of the settlement were to go to the individual plaintiff. A contemporaneous ownership rule eliminates the possibility that a plaintiff will purchase shares, *after* an alleged corporate wrongdoing, for the sole purpose of threatening or initiating a strike suit.

Another concern underlying adoption of the Rule was fear of potential unjust enrichment to the subsequent purchaser who, at the time of his stock purchase, had knowledge of prior corporate wrongdoing or knowledge of the corporate worth subsequent to the wrongdoing.[14] This concern was enunciated in an early federal case:

> [T]he purchaser of stock in a corporation is not allowed to attack the acts and management of the company prior to the acquisition of his stock; otherwise, we might have a case where stock duly represented in a corporation consented to and participated in bad management and waste, and, after reaping the benefits from such transactions, could be easily passed into the hands of a subsequent purchaser, who could make his harvest by appearing and contesting the very acts and conduct which his vendor had consented to.[15]

> legitimate or not, are often protracted, time-consuming for corporate management, and very expensive. Nuisance actions, private settlements with the corporation buying off the complainant, and other misuses of the derivative remedy led to various restrictions being placed upon it.

H. Henn, Handbook of the Law of Corporations § 358, at 752 (2d ed. 1970) (footnotes deleted). *See* note 4 *supra*.

14. *See* United Elec. Secs. Co. v. Louisiana Elec. Light Co., 68 F. 673 (C.C.E.D. La. 1895); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903). In *Barber*, Dean Pound's decision indicated that the purpose of the federal rule was not limited to jurisdictional problems but was also based on preventing equity from being used to achieve unjust results. *Id.* at 657-58, 93 N.W. at 1029. This view predated the incorporation into the federal rule of other sections which indicate this intent more clearly. *See* note 4 *supra*.

15. United Elec. Secs. Co. v. Louisiana Elec. Light Co., 68 F. 673, 675 (C.C.E.D. La. 1895). In *United Electric*, the plaintiff, who was a stockholder in the defendant company, sued to have a receiver appointed to manage the defendant. The court found the plaintiff to be a "bona fide stockholder" of the defendant company with standing to sue. *Id.* Although the case was not a derivative action, the court, in dictum quoted herein, expressed its concern that a purchaser of shares might be unjustly enriched if contemporaneity of ownership were not a prerequisite to a derivative suit. In *United Electric*, the court appears to focus on possible collusion: a seller reaps the benefits of his wrongdoing and "easily" passes his stock to a litigious purchaser. *Id.*

In the situation in which the purchaser has knowledge of prior

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The dictum from *United Electric* was quoted and explained in Dean Pound's decision in Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903). Although *Barber*, too, was not a derivative action, the court found that "the stockholders [were] the real and substantial beneficiaries of a recovery," *id.* at 670, 93 N.W. at 1033, and therefore focused upon the stockholders' standing to challenge corporate wrongdoing which had occurred prior to their stock acquisition.

In *Barber*, the defendants had been incorporators and stockholders of the plaintiff company. Defendant Barber, as secretary and general manager of the plaintiff company, had controlled its management. In order to retain control of the corporation, the defendants bought out a rival faction using funds borrowed from banks. To repay these loans, however, the defendants borrowed from the corporation without proper security. These and other loans remained on the plaintiff's books while the defendants received profits and divideneds on the stock purchased. Barber then sold all stock in the plaintiff corporation to one Funkhouser and his associates, pursuant to a contract that also required Barber to present Funkhouser with an accurate and complete financial statement for the company.

After transfer of control, the new management sued in the corporate name to recover for losses to the corporation caused by Barber's mismanagement in collecting profits on the stock bought with corporate funds, and for other acts of mismanagement and conversion. The plaintiffs did not allege that the financial statement was inaccurate. The court noted that "a purchaser of stock cannot complain of the prior acts and management of the corporation," *id.* at 656, 93 N.W. at 1028, quoted from *United Electric*, and then explained the applicability of the *United Electric* dictum to this case:

> [T]he present stockholders are contesting acts through which they get title to a large portion of their stock, and acts which those through whom they derived the greater part of the remainder could not have challenged because they participated therein, and, by contesting these acts, which did not injure any of the present stockholders in the least, are recovering back a large part of the purchase price of stock which was admittedly worth all that they paid for it.

Id. at 656-57, 93 N.W. at 1029.

Thus, *Barber* construes the *United Electric* language to support the theory that a contemporaneous ownership rule is necessary to prevent a purchaser from gaining a rebate on his purchase price. Since Funkhouser knew the state of the plaintiff's finances when he bought the stock, allowing the corporation to recover for Barber's mismanagement would amount to allowing Funkhouser and his associates to recover part of their purchase price. At the time of suit, Funkhouser and his associates were the only holders of stock in the plaintiff corporation and therefore would be unjustly enriched by any increase in the value of their stockholdings.

In 1974, the Supreme Court in Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703 (1974), relied on *Barber* in dismissing a suit brought in the name of the corporation by the present owner of 99% of the shares of the corporation to recover for acts of mismanagement that had occurred prior to the plaintiff's purchase. The Court found that the plaintiff-shareholder could not have sued derivatively since it would have been the principal beneficiary of any recovery and should be precluded "from reaping a windfall by enhancing the value of its bargain." *Id.* at 716. Thus, the unjust enrichment rationale has been acknowledged and affirmed by the Supreme Court as underlying the federal contemporaneous ownership requirement of Fed. R. Civ. P. 23.1.

For a further discussion of *Bangor Punta*, see note 66 *infra*.

wrongdoing, this statement appears to attack possible collusion between a seller and a purchaser of shares: a seller who participates in corporate mismanagement for his own personal benefit might then sell his shares to a knowing purchaser who could sue derivatively and expect a lucrative personal settlement. In the situation in which the purchaser has knowledge of the corporate worth, the statement appears to attack possible inequitable gain to the purchaser through a rebate on his purchase price: a purchaser might pay a price reflecting the diminished value of the stockholdings and then later sue derivatively, thereby either increasing the value of his holdings or obtaining a lucrative personal settlement.[16]

Other courts justified adoption of the Rule under a theory that the right to sue derivatively is personal to the shareholder at the time of injury and is not transferable to a subsequent purchaser.[17] These courts reasoned that the right to sue derivatively accrues only to those shareholders who voted against, or expressed disapproval of, the corporate transaction now the subject of the lawsuit, and that, therefore, the right to sue cannot be transferred to subsequent purchasers.

Prior to *Hawes*, the New York trial and intermediate appellate courts had refused to require contemporaneous ownership;[18] *Hawes* did not cause them to alter their position on the issue.[19]

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16. These theories of potential unjust enrichment appear to place a heavy burden on the prospective purchaser of shares to discover any prior corporate mismanagement before his purchase and either to refrain from purchasing or to adjust his purchase price accordingly. Once the purchase is completed, the purchaser can have no redress for prior mismanagement.

17. *See, e.g.*, Russell v. Louis Melind Co., 331 Ill. App. 182, 72 N.E.2d 869 (1947); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903). *See also* 23 Temp. L.Q. 82 (1949).

18. This line of cases began with Ramsey v. Gould, 57 Barb. 398 (N.Y. Sup. Ct. Tioga County 1870), which asserted that that when a plaintiff brings suit for alleged misconduct by company officers for acts done before the plaintiff purchased stock, "[t]he relative rights of the parties are the same as if the suit were brought by the plaintiff's vendor." *Id.* at 404. *See* Young v. Drake, 8 Hun. 61, 64 (N.Y. Sup. Ct. 2d Dep't 1876).

19. *See* Frothingham v. Broadway & Seventh Ave. R.R., 9 N.Y. Civ. Proc. R. 304, 304-15 (Sup. Ct. N.Y. County 1886); O'Connor v. Virginia Passenger & Power Co., 46 Misc. 530, 92 N.Y.S. 525 (Sup. Ct. Washington County), *aff'd*, 107 A.D. 630, 95 N.Y.S. 1149 (1905), *rev'd on other grounds*, 184 N.Y. 46, 76 N.E. 1082 (1906); Sayles v. Central Nat'l Bank, 18 Misc. 155, 158, 41 N.Y.S. 1063, 1063-64 (Sup. Ct. Oneida County 1896), *rev'd on other grounds sub nom.* Sayles v. White, 18 A.D. 590, 46 N.Y.S. 194 (4th Dep't 1897); Ervin v. Oregon Ry. & Navigation Co., 35 Hun. 544, 546-47 (N.Y. Sup. Ct. 1st

These New York courts viewed the right to sue derivatively as an integral and inseparable attribute of stock ownership.[20] To hold otherwise, stated one court, "would be reversing the rule that the transfer of property includes the ownership of all incidents thereto."[21]

In a 1911 decision, *Pollitz v. Gould*, the New York Court of Appeals endorsed the lower courts' opinions and rationale and rejected the contemporaneous ownership rule in derivative actions.[22] While recognizing the adoption of the Rule by both the Supreme Court and other state courts,[23] the court of appeals nevertheless concluded that the right to sue was a necessary incident of stock ownership that should not be cut off with the transfer of the stock: "As an original proposition it would seem to be clear that a right of action by or in behalf of the corporation for fraud . . . is part of its rights, property and assets in which a stockholder has this indivisible interest transferable by the transfer of his certificates."[24] Moreover, the court explicitly rejected the two arguments most often given to support the contemporaneous ownership rule. First, the court found inapposite the theory of unjust enrichment:[25] a stockholder might as easily have paid a premium for the stock in anticipation of the wrong

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Dep't 1885); Kingman v. Rome, Watertown & Ogdensburgh R.R., 30 Hun. 73, 73 (N.Y. Sup. Ct. 1st Dep't 1883).

These decisions are divided on the issue of whether a purchase with intent to sue affects the purchaser's rights. Two of them, in apparent reference to the strike suit, indicated that the contemporaneous ownership requirement might be applied if the shareholder purchased his interest for the specific purpose of bringing an action. O'Connor v. Virginia Passenger & Power Co., 46 Misc. 530, 536, 92 N.Y.S. 525, 528 (Sup. Ct. Washington County 1905); Sayles v. Central Nat'l Bank, 18 Misc. 155, 158, 41 N.Y.S. 1063, 1065 (Sup. Ct. Oneida County 1896). In Ramsey v. Gould, 57 Barb. 398 (N.Y. Sup. Ct. Tioga County 1870), however, an attorney had purchased stock for the specific purpose of bringing suit. The court held that this was no bar to action: "His buying the stock and bonds was no wrong done [to the defendants], with whatever intent it was done." *Id.* at 404. *Ervin v. Oregon Ry. & Navigation Co.* also indirectly supports the right to sue regardless of the intent with which after-acquired shares were purchased. 35 Hun. 544, 546-47 (N.Y. Sup. Ct. 1st Dep't 1885).

20. *See, e.g.*, Young v. Drake, 8 Hun. 61, 64 (N.Y. Sup. Ct. 2d Dep't 1876). *See also* cases cited in note 19 *supra*.

21. Frothingham v. Broadway & Seventh Ave. R.R., 9 N.Y. Civ. Proc. R. 304, 315 (Sup. Ct. N.Y. County 1886).

22. 202 N.Y. 11, 94 N.E. 1088 (1911).

23. *Id.* at 14, 94 N.E. at 1088.

24. *Id.* at 15, 94 N.E. at 1089.

25. *See* notes 14-16 and accompanying text *supra*.

being corrected and the stock's value increasing, as he might have adjusted the price downward.[26] Second, the court found totally without merit the theory that a stockholder must personally disapprove a corporate transaction in order to bring a derivative action and that this personal right of election is nontransferable,[27] the court maintained that the right is not personal, but attaches solely to the status of a stockholder.[28]

The *Pollitz* court made it clear, however, that in some special circumstances a contemporaneous ownership rule might be appropriate. The court suggested that it would apply the Rule if a stockholder gave "binding consent" to a particular transaction and subsequently sold his shares to a purchaser who intended to bring litigation attacking the same transaction.[29] Apparently, the court was concerned about possible collusion between the purchaser and the seller of the stock.[30]

The *Pollitz* rule remained law in New York[31] until 1944. In that year, the legislature, apparently accepting the recommendations of a New York Chamber of Commerce report that had demonstrated significant strike suit abuse within the state,[32] en-

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26. Pollitz v. Gould, 202 N.Y. 11, 16, 94 N.E. 1088, 1089 (1911).

27. *See* note 17 and accompanying text *supra*.

28. Pollitz v. Gould, 202 N.Y. at 18, 94 N.E. at 1089-90.

29. *Id.* at 16, 94 N.E. at 1089.

30. For a discussion of similar reasoning by another court, see note 15 and accompanying text *supra*.

31. *See, e.g.*, Continental Secs. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912); Osann v. Jones, 209 A.D. 9, 204 N.Y.S. 242 (2d Dep't 1924); Turner v. American Metal Co., 36 N.Y.S.2d 356 (Sup. Ct. N.Y. County 1942), *rev'd*, 268 A.D. 239, 50 N.Y.S.2d 800 (1st Dep't 1944), *appeal dismissed*, 295 N.Y. 822, 66 N.E.2d 591, (1946); Koch v. Estes, 146 Misc. 249, 262 N.Y.S. 23 (Sup. Ct. N.Y. County), *aff'd*, 240 A.D. 829, 266 N.Y.S. 1008 (1st Dep't 1933), *aff'd*, 264 N.Y. 480, 191 N.E. 525 (1934); Brennan v. Barnes, 133 Misc. 340, 232 N.Y.S. 112 (Sup. Ct. Albany County 1928).

32. Wood, *Survey and Report Regarding Stockholders' Derivative Suits* (Special Committee on Corporate Litigation of the Chamber of Commerce of the State of New York 1944). The study analyzed 1,266 shareholder derivative law suits filed in the Supreme Court of the New York Appellate Division for the first and second departments and the Federal District Court for the Southern District of New York from 1932 to 1942 and noted various problems and abuses related to these actions. It concluded that a number of strike suits had been initiated and suggested remedial legislative measures.

While relatively little history indicates the weight accorded the Wood report by the legislature, additional evidence supports a conclusion that the main purpose for enacting the statute was the prevention of strike suits. *See* Governor's Memorandum filed with Senate Bills, Nos. 1314 and 1315, April 9, 1944, *quoted in* W. CARY, CASES AND MATERIALS ON CORPORATIONS 932 (4th ed. 1969).

acted a contemporaneous ownership statute in substantially the form now included in section 626(b).[33] The New York statute, like the federal rule, is broad in scope: no shareholder may bring a derivative action to redress corporate wrongs occurring prior to the acquisition of his interest unless his interest devolved upon him by operation of law.[34]

In enacting the statute, the legislature failed to distinguish between shareholder investments in large and small corporations, although the Chamber of Commerce Report had proposed

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33. The rule is now embodied in § 626 of the New York Business Corporation Law which is entitled, "Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor." Section 626 provides:

> (a) An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor, by a holder of shares or of voting trust certificates of the corporation or of a beneficial interest in such shares or certificates.
>
> (b) In any such action, it shall be made to appear that the plaintiff is such a holder at the time of bringing the action and that he was such a holder at the time of the transaction of which he complains, or that his shares or his interest therein devolved upon him by operation of law.
>
> (c) In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort.
>
> (d) Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the shareholders or any class or classes thereof will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the shareholders or class or classes thereof whose interests it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable in the same manner as statutory taxable costs.
>
> (e) If the action on behalf of the corporation was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the corporation for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured shareholders only and limited to a recovery of the loss or damage sustained by them.

N.Y. Bus. Corp. Law § 626 (McKinney 1963) (originally §§ (a) and (b) were part of the Gen. Corp. Law § 61).

34.1 N.Y. Bus. Corp. Law § 626(b) (McKinney 1963).

such a distinction.[35] The legislature also rejected an alternative remedial proposal advanced by the New York Law Revision Commission that would have prohibited personal settlement or abandonment of derivative actions without prior court approval and notice to all shareholders.[36] A subsequent revision in 1961

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35. The Wood report concluded that derivative action abuses were more prevalent in large, publicly held corporations than in closely held corporations. *See* Wood, *supra* note 32, at 31. In a large corporation, corporate interests are often widely held and are readily transferable on the securities exchanges or over-the-counter markets. Shareholders generally take no active part in the corporate management and often invest relatively small amounts of money. Generally, a closely held corporation has few shareholders, and each shareholder has a substantial investment in the corporation. The shareholders generally invest not only money, but also time in the management of corporate affairs. In addition, access to shares by "outsiders" is limited: the shares are not publicly traded, and limitations on sales outside of the immediate group may exist. Accordingly, the New York legislature might have considered tailoring the contemporaneous ownership rule to large, publicly held corporations.

36. The Commission modeled its recommendation on the last sentence of Federal Rule 23.1. *See* note 4 *supra*. In addition, it proposed amending subdivision 3 of section 193 of the Civil Practice Act to permit, as a matter of right, intervention by another shareholder whenever the court determined that his interests were not being adequately represented.

The Commission's recommendations follow:

I. The enactment of the following new section 63 of the General Corporation Law:

> § 63. A derivative action heretofore or hereafter commenced by a stockholder or member of any domestic or foreign corporation shall not be discontinued or compromised nor dismissed by consent, by default or for failure to prosecute, without the approval of the court, after notice of the proposed discontinuance, dismissal or compromise shall have been given to the stockholders or members of the corporation in such manner as the court shall direct.

II. The amendment of subdivision 3 of section 193 of the Civil Practice Act to read as follows:

> 3. Where a person not a party to the action has an interest in the subject thereof, or in real property the title to which may in any manner be affected by the judgment, or in real property for injury to which the complaint demands relief, and makes application to the court to be made a party, it must direct him to be brought in by the proper amendment.
>
> In a derivative action heretofore or hereafter commenced by a stockholder or member of any domestic or foreign corporation, all other stockholders or members of the corporation shall be deemed persons interested in the subject of the action, but shall be permitted to intervene only upon timely application and if it appears that representation of their interests is or may be inadequate.

Reports, Recommendations and Studies of the New York Law Rev. Comm. [1942] Leg. Doc. No. 65(J) 471, 477-78 (emphasis deleted) [hereinafter cited as *Recommendations*].

did not affect the contemporaneous ownership requirement, but prohibited settlements without court consent and codified a judicial prohibition against individual recovery.[37]

Section 626(b) has thus remained substantially unchanged since 1944. Despite the fact that a strike suit may not be the motivation for a particular action, and that some inequities may occur when the Rule is applied,[38] the statute enumerates no exceptions and allows no additional circumstances to be considered in determining the shareholder's right to sue derivatively.[39]

II. Problems Caused by the New York Contemporaneous Ownership Statute

Section 626(b) of the New York Business Corporation Law may operate to deny relief to some aggrieved shareholders.[40]

Under New York law at the time of the Commission's recommendations, a class action brought by one class member was entirely within the control of the named plaintiff, subject only to intervention by another member of the class. Hirshfeld v. Fitzgerald, 157 N.Y. 166, 51 N.E. 997 (1898). Under this rule, the plaintiff was completely free to settle or discontinue the action. *Recommendations, supra* at 475.

This rule did not extend in its entirety to shareholders' derivative actions. While a shareholder-plaintiff could discontinue the action for private gain, Manufacturers' Mut. Fire Ins. Corp. v. Hopson, 176 Misc. 220, 25 N.Y.S.2d 502 (Sup. Ct. N.Y. County 1940), *aff'd*, 262 A.D. 731, 29 N.Y.S.2d 139 (1941), *aff'd*, 288 N.Y. 668, 43 N.E.2d 71 (1942), New York courts required judicial approval of a settlement of the action. *Recommendations, supra* at 475. Upon judicial approval, the settlement bound both the corporation and all other shareholders. Gerith Realty Corp. v. Normandie Nat'l Secs. Corp., 154 Misc. 615, 276 N.Y.S. 655 (Sup. Ct. N.Y. County 1933), *aff'd*, 241 A.D. 717, 269 N.Y.S. 1007 (1st Dep't 1934), *aff'd*, 266 N.Y. 525, 195 N.E. 183 (1935).

The Commission believed its proposal was necessary to avoid "[t]he institution of ill-considered or unwarranted suits, multiplicity of litigation, abuse of the stockholders' derivative action for *private gain*." *Recommendations, supra* at 475 (emphasis added).

37. Although the New York legislature initially failed to adopt the Commission's recommendations, the New York Court of Appeals, apparently recognizing the importance of the Commission's criticisms, reversed the rule that had previously permitted personal settlements of derivative actions. In Clarke v. Greenberg, 296 N.Y. 146, 71 N.E.2d 443 (1947), the court analogized the shareholder to a corporate fiduciary and held that any derivative recovery, whether by judgment, settlement, or compromise, belonged not to the individual shareholder but to the corporation, the real party in interest. This judicially created rule, together with the Commission's suggested prohibition against abandonment, compromise, or settlement of derivative actions without court approval, has since been adopted by the legislature as part of the New York Business Corporation Law. N.Y. Bus. Corp. Law §§ 626(d)-626(e) (McKinney 1963). *See* note 33 *supra*.

38. *See* notes 40-90 and accompanying text *infra*.

39. *See* note 33 *supra*.

40. *See* notes 43-49 and accompanying text *infra*.

Moreover, its application may result in the denial of relief to some shareholders while other shareholders, who either control the board of directors or are directors or officers of the corporation, may obtain relief.[41] Further, whenever the courts attempt, on a case by case basis, to avoid the inequities of the Rule, the results appear unpredictable and ambiguous.[42]

A. *Effective Denial of Any Legal Remedy*

The following hypothetical illustrates how section 626(b) can operate to deny judicial redress to an aggrieved shareholder. Alpha Corporation is owned by two investors: *A*, who owns a 45% interest, and *B*, who owns a 55% interest. The three member board of directors is elected and controlled by *B*. The corporation has been profitable over the last several years, and its shares should therefore be worth substantially more than *A*'s initial investment. Unknown to *A*, however, *B* has made personal use of the corporation's funds, thereby causing a depletion of the corporate assets and an undiscovered impairment of the value of *A*'s stock. *A* subsequently sells his shares to *C*, an innocent purchaser, without making any representations as to the value of the corporation's assets. When *C* eventually discovers *B*'s wrongful actions, he may have no legal remedy for the resulting decline in the value of his investment. *C* may not sue *A*, the seller, under a theory of fraud because *A* did not know of the wasting of assets.[43] Further, *C* cannot sue *B* for fraud because the latter

41. *See* notes 50-62 and accompanying text *infra*.

42. *See* notes 63-90 and accompanying text *infra*.

43. An action for intentional misrepresentation requires the following elements: a knowing, false representation, usually of fact, made by the defendant with intent to induce the plaintiff to act, resulting in justifiable reliance by the plaintiff and injury to him. *See, e.g.*, Channel Master Corp. v. Aluminium Ltd. Sales, Inc., 4 N.Y.2d 403, 151 N.E.2d 833, 176 N.Y.S.2d 259 (1958). *See generally* W. Prosser, Handbook of the Law of Torts § 105 (4th ed. 1971). *A* may have made some representation to *C* concerning the value of the shares, but *A* could not have intended to deceive *C* as to the value of the shares since *A* had no knowledge of their diminished value.

In some circumstances, liability can be established for negligent misrepresentation. Such liability may be found when a relationship of trust or confidence establishes a duty to represent accurately and that duty is breached. *See, e.g.*, International Prods. Co. v. Erie R.R., 244 N.Y. 331, 155 N.E. 662 (bailor-bailee relationship), *cert. denied*, 275 U.S. 527 (1927). Thus, to hold *A* liable for negligent misrepresentation, *A* must have had a duty to *C* to make any representation accurately. In the hypothetical seller-buyer relationship, however, it is unlikely that the existence of this duty would be found. *Compare*

was not a party to the sale.[44] *C* cannot cause Alpha Corporation to sue *B* since *C* cannot control the actions of the board of directors.[45]

Moreover, *C* cannot bring a derivative action. He is barred by section 626(b), and, therefore, he must bear the loss on his investment, even though he purchased his interest for investment, did not intend to initiate a strike suit, and was unaware of the wasting of corporate assets. Application of the contemporaneous ownership rule under these circumstances appears inequitable and does not further the legislative goal of preventing strike suits.

A recent Delaware case, *Nickson v. Filtrol Corp.*,[46] also illustrates this inequity. Two stockholders, Slick Corporation and one Nickson, brought a derivative action, alleging that the defendant directors had caused the Filtrol Corporation to purchase certain bonds, formerly held by one of the defendant directors, at an excessive price. Slick Corporation's action was dismissed for failure to meet the requirement of contemporaneous ownership[47] since Slick was not a stockholder in the defendant corpo-

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Dorsey Prods. Corp. v. United States Rubber Co., 21 A.D.2d 866, 251 N.Y.S.2d 311 (1st Dep't 1964) (negligent misrepresentations that induced plaintiff to enter distributorship agreement with defendant imply relationship of trust beyond ordinary buyer-seller relationship; nevertheless, *no duty* found since agreement contained disclaimer clause), *aff'd*, 16 N.Y.2d 925, 212 N.E.2d 435, 264 N.Y.S.2d 917 (1965) *with* Coolite Corp. v. American Cyanamid Co., 52 A.D.2d 486, 384 N.Y.S.2d 808 (1st Dep't 1976) (negligent misrepresentations that induced plaintiff to form corporation solely to market defendant's product imply confidential relationship *creating duty*). *See generally* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 107 (4th ed. 1971).

44. To hold a defendant liable for a misrepresentation made to a third party, the defendant must have made the misrepresentation to the third party for the dual purpose of having the third party repeat it to the plaintiff and having the plaintiff act thereon. *See, e.g.*, Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922). *See generally* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 107 (4th ed. 1971). Thus, for *B* to be found liable to *C* in an action for intentional misrepresentation brought by *C*, *B* would have had to have made false representations to *A* concerning the value of the shares for the purpose of having these falsities repeated to *C*, and in the hope that *C* would buy the shares on the strength of the misrepresentations. In the hypothetical posed, *B* made no such false representations; therefore, an action against him for misrepresentation would fail.

45. Under New York law, the affairs of a corporation, including any decision as to whether suit should be brought in the corporate name, are generally under the direction of its board of directors. N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1979-1980).

46. 262 A.2d 267 (Del. Ch. 1970).

47. Delaware's contemporaneous ownership statute, which is similar to New York's, provides:

ration when the defendant purchased the bonds. The Chancellor recognized that the contemporaneous ownership statute was aimed at "prevention of the evil of purchasing stock in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock,"[48] and made no finding that Slick Corporation had purchased Filtrol Corporation's stock for the purpose of bringing the suit.[49] Mechanical application of the contemporaneous ownership rule in this case may have resulted in an inequitable denial of legal relief to an injured stockholder.

B. *Disparate Treatment of Shareholders*

An inflexible contemporaneous ownership rule may also lead to disparate treatment of shareholders based solely on their positions in the corporation. For example, any shareholder who can control the corporation may cause the corporation to bring an action against the wrongdoers.[50] Accordingly, an investor who purchases a controlling interest after a wrongful transaction need not resort to a derivative action; therefore, the contemporaneous ownership rule is inapplicable to him. On the other hand, an investor who cannot control the corporation's board of directors can seek redress only by means of a derivative action, and, if he purchases the shares after the wrongful transaction,

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> In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law.

DEL. CODE ANN. tit. 8, § 327 (1974).

48. Nickson v. Filtrol Corp., 262 A.2d 267, 269 (Del. Ch. 1970) (quoting Newkirk v. W.J. Rainey, Inc., 31 Del. Ch. 433, 76 A.2d 121 (1950)).

49. *Id.* In addition, the plaintiffs charged that the directors had caused the corporation to continue to hold the bonds after their decline in value, resulting in additional corporate loss. The plaintiff also charged that, after the bond purchase, the defendants made fraudulent misrepresentations concerning the value of the bonds. The court rejected these arguments that the wrong continued or that new and independent wrongs occurred after the bond purchase and existed at the time that the plaintiffs did own the stock. *Id.* at 269-70. For a discussion of the continuing wrong doctrine, see notes 74-90 and accompanying text *infra*.

50. The New York State Constitution provides all corporations with the power to sue in all New York State courts. N.Y.S. CONST. art. 10, § 4. This same power is provided in the New York Business Corporation Law. N.Y. BUS. CORP. LAW § 202(a)(2) (McKinney 1963). *See* note 45 *supra*.

his action is barred by the contemporaneous ownership rule. Thus, shareholders who have suffered the same injury are, in effect, accorded different treatment.

Shareholders who are directors or officers of the corporation may avoid section 626(b); section 720 of the New York Business Corporation Law[51] permits an officer or director, among others, to bring suit against other officers and directors, if the suit alleges certain specific types of misconduct.[52] The plaintiff is not subject to the contemporaneous ownership rule; he has a statutory basis for his action and, therefore, is not bringing a shareholder's derivative action.[53] Accordingly, an investor who purchases his shares after the wrongful conduct may avoid the contemporaneous ownership requirement if he becomes an officer or director of the corporation and then initiates suit under section 720.[54]

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51. N.Y. Bus. Corp. Law § 720 (McKinney 1963 & Supp. 1979-1980) provides:

(a) An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief:

(1) To compel the defendant to account for his official conduct in the following cases:

(A) The neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge.

(B) The acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties.

(2) To set aside an unlawful conveyance, assignment or transfer of corporate assets, where the transferee knew of its unlawfulness.

(3) To enjoin a proposed unlawful conveyance, assignment or transfer of corporate assets, where there is sufficient evidence that it will be made.

(b) An action may be brought for the relief provided in this section, and in paragraph (a) of section 719 (Liability of directors in certain cases) by a corporation, or a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, under section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares thereof.

(c) This section shall not affect any liability otherwise imposed by law upon any director or officer.

52. Section 720 represents an exception to the general rule that a corporation's affairs are to be managed by its board of directors acting as a group. *See* notes 45 and 50 *supra*.

53. *See* Conant v. Schnall, 33 A.D.2d 326, 307 N.Y.S. 2d 902 (3d Dep't 1970); Alan v. Landau-Alan Gallery, Inc., 66 Misc. 2d 350, 320 N.Y.S.2d 853 (Sup. Ct. N.Y. County 1971). In *Conant*, the court decided that, because an action under § 720 is not derivative, "none of the traditional rules (e.g., demand, stock ownership, judicial approval of settlements) surrounding a derivative action apply." 33 A.D.2d at 328, 307 N.Y.S.2d at 904.

54. This alternative was noted by Professor Hornstein in his discussion of the con-

Section 720's discrimination in favor of the subsequent purchaser who becomes an officer or director has been justified on the theory that a shareholder who holds a significant corporate position will not have acquired his shares for the purpose of initiating a strike suit.[55] Particularly in small or closely held corporations, however, many investors who do not hold positions entitling them to invoke section 720 may be similarly devoid of improper motive.[56] In addition, not every investor will have the opportunity to become an officer or director. Thus, the contemporaneous ownership statute,[57] in conjunction with section 720, creates a situation in which some subsequent shareholders can bring suit, while others, who have suffered a similar injury, cannot.

This disparate treatment may be illustrated as follows: *A* purchases a 30% non-controlling interest in Alpha Corporation, while *B* purchases a 30% non-controlling interest in Beta Corporation. Each corporation has a three member board of directors. The Alpha directors are elected by straight ballot[58] while Beta's certificate of incorporation permits cumulative voting[59] in the

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temporaneous ownership requirement:

> Especial note should be made of the fact that although a stockholder is barred by this restrictive legislation, in my opinion a director is not; consequently in a small corporation, a stockholder who can have himself elected a director may thereafter sue as a director for wrongs before he became a stockholder, if the wrongs are within the statute of limitations. The suit is then not technically a stockholder's suit, but the redress in dollars will be even greater.

Hornstein, *Rights of Stockholders in the New York Courts*, 56 YALE L.J. 942, 951 (1947).

55. *See* 3 WHITE, NEW YORK CORPORATIONS ¶ 720.02 (13th ed. 1978).

56. *See* note 35 *supra*.

57. For the text of § 626(b), see note 33 *supra*.

58. Unless the certificate of incorporation expressly provides otherwise, each shareholder is entitled to cast one vote per each voting share for each nominee, and directors are elected by a plurality of votes cast. N.Y. BUS. CORP. LAW §§ 612(a), 614(a) (McKinney 1963 & Supp. 1979-1980). Under this straight ballot procedure, the controlling shareholders can elect the entire board of directors. In the hypothetical, therefore, *A* will not be able to elect any director. Although *A*, like *B*, owns 30 shares, *A* can cast only 30 votes for each of his nominees for director, while the controlling shareholders would be able to cast more than 30 votes for each of their nominees.

59. Cumulative voting in the election of directors permits a shareholder to cast an aggregate of votes equal to the product of the number of shares held and the number of directors to be elected. Thus, if Beta Corporation has 100 shares outstanding, *B* owns 30 shares, and three directors are to be elected, *B* may cast 90 votes. Cumulative voting affords minority interests the opportunity to be represented on the board of directors because the shareholder's cumulated votes may be cast entirely for one director. Accord-

election of directors. After investing, both *A* and *B* discover that the controlling shareholders wasted their respective corporation's assets and concealed this mismanagement from both *A* and *B* and from the former shareholders who sold their interests to *A* and *B*. The losses have substantially undermined the values of *A*'s and *B*'s respective stockholdings.

The contemporaneous ownership rule bars either *A* or *B* from bringing a shareholder's derivative action to compel the corporation to recover these losses. Since neither has control of his respective corporation, neither can cause the corporation to sue in its own name.[60] In addition, no suit may be maintained against the former shareholders since they neither participated in, nor knew of, the wrongful acts.[61] *B*, however, can elect himself as a director by cumulatively voting his shares, and, as a director, bring suit under section 720. *B* will thus be able to obtain relief. *A* cannot because he cannot elect himself as a director.[62] As this illustration demonstrates, the New York statutes may operate together arbitrarily to protect only certain

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ingly, *B* can cast all his 90 votes for his nominee. H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS 364 (2d ed. 1970).

The formula that determines the number of shares needed to elect a given number of directors when cumulative voting is permitted is as follows:

$$X = \frac{Y \times N^1}{N + 1} + 1$$

X = number of shares needed to elect a given number of directors; Y = total number of shares at meeting; N^1 = number of directors desired to elect; N = total number of directors to be elected. *See* Mills, *The Mathematics of Cumulative Voting*, 1968 DUKE L.J. 28 (discussing this basic formula and the mathematical problems involved in cumulative voting).

The number of shares necessary to elect one director is 26.

$$X = \frac{100 \times 1}{3 + 1} + 1$$
$$X = 26$$

By voting his 30 shares cumulatively, *B* can elect one director.

Cumulative voting is permitted in New York only if expressly provided for in a corporation's certificate of incorporation. N.Y. BUS. CORP. LAW § 618 (McKinney 1963).

60. *See* note 50 and accompanying text *supra*.

61. *See* note 43 and accompanying text *supra*.

62. If either investor can become a corporate officer, he can use § 720 to circumvent the contemporaneous ownership requirement. *See* text accompanying notes 51-54 *supra*.

investors.

C. *Judicial Approaches to Problems Caused by the Contemporaneous Ownership Rule*

The courts in New York have had occasion to reduce the disparity in the application of the Rule; these courts have extended the contemporaneous ownership rule to prohibit some suits brought by the corporation itself.[63] Other courts have mitigated the harshness of strict application of the Rule by permitting suits under the continuing wrong doctrine.[64] In either case, the judicial approach has been less than satisfactory.

Application of the contemporaneous ownership rule may have been carried to its extreme in the appellate division's decision in *Capitol Wine & Spirit Corp. v. Pokrass*.[65] In *Capitol Wine*, a shareholder had acquired 100% ownership of the corporation and, acting through its board of directors, had caused the corporation to sue its former officers and directors for an alleged misappropriation and wasting of corporate assets that had occurred prior to the shareholder's purchase. The court applied the contemporaneous ownership rule and dismissed the corporation's suit. The court reasoned that

> [i]f a corporation may not recover due to the fact that all of the "stockholders are so circumstanced that no relief should be afforded them. . ." it makes little difference whether they have become so circumstanced due to having ratified unanimously the acts of officers and directors, . . . or whether all of the stockholders would be prevented from suing by [the contemporaneous ownership rule].[66]

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63. *See* notes 65-72 and accompanying text *infra*.

64. *See* notes 74-90 and accompanying text *infra*.

65. 277 A.D. 184, 98 N.Y.S.2d 291 (1st Dep't 1950), *aff'd*, 302 N.Y. 734, 98 N.E.2d 704 (1951).

66. *Id.* at 187, 98 N.Y.S.2d at 294 (quoting Home Fire Ins. Co. v. Barber, 67 Neb. 644, 664, 93 N.W. 1024, 1031 (1903)). It should be noted that the majority relied heavily on Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903), which had, based on equitable principles of unjust enrichment, extended the rule to corporate actions in a case involving a similar situation. The predominant consideration was that none of the shareholders could have brought a derivative action individually and yet the entire recovery would have benefited them and no other shareholders. *Id.* at 664, 93 N.W. at 1031.

Justice Peck concurred in the result in *Capitol Wine* because "it would be inequita-

Justice Shientag's dissent emphasized that the sole purpose of the statute was to prevent certain derivative actions, not to curtail actions brought by the corporation itself.[67]

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ble and an unjust enrichment to permit" a corporate action which would benefit the sole shareholder, who had purchased his shares on the "basis of disclosed and guaranteed assets," by allowing him to "secure for himself through the medium of the corporation more than he bought." 277 A.D. 184, 189-90, 98 N.Y.S.2d 291, 297 (1st Dep't 1950) (Peck, J., concurring), *aff'd*, 302 N.Y. 734, 98 N.E.2d 704 (1951).

By a five to four majority, the Supreme Court in Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703 (1974), followed the reasoning of Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903) and *Capitol Wine* in applying the contemporaneous ownership requirement to a corporate action brought in federal court. In *Bangor Punta*, Amoskeag Company purchased 98.3% of the shares of Bangor & Aroostook Railroad from Bangor Punta Corporation through its wholly owned subsidiary, Bangor Punta Operations. Amoskeag later acquired additional shares of the railroad, giving it 99% ownership. Amoskeag then, under federal and state law, sued Bangor Punta Corporation and Bangor Punta Operations for various acts of mismanagement occurring during the years that the defendants controlled the railroad and before the plaintiff acquired its interest. The Court held that as to the causes of action under the federal antitrust and securities laws,

> where equity would preclude the shareholders from maintaining an action in their own right, the corporation would also be precluded. It follows that Amoskeag, the principal beneficiary of any recovery and itself estopped from complaining of petitioners' alleged wrongs, cannot avoid the command of equity through the guise of proceeding in the name of respondent corporations which it owns and controls.

417 U.S. at 713 (citations omitted).

This decision accords with *Barber* and *Capitol Wine*, but goes a step further than either of these cases. In both *Barber* and *Capitol Wine*, corporate suits were barred when the controlling shareholders owned 100% of the corporate plaintiffs. Thus, there were no minority shareholders in *Barber* or *Capitol Wine*. *Bangor Punta*, however, prohibited a corporate suit in a situation in which the controlling shareholder owned *less* than 100% of the shares, albeit only 1% less. In *Bangor Punta*, 20 minority shareholders could have satisfied the contemporaneous ownership requirement. *Id.* at 712 n. 8.

As the dissent in *Bangor Punta* indicated, although the majority purported to rely on *Barber*, dictum in *Barber* indicates a different result in a situation like *Bangor Punta*, which involves minority shareholders:

> [If any of the present shareholders may complain of prior acts of mismanagement,] "there can be no doubt of the right and duty of the corporation to maintain this suit. It would be maintainable in such a case even though the wrongdoers continued to be [shareholders] and would share in the proceeds."

Id. at 720 (quoting Home Fire Ins. Co. v. Barber, 67 Neb. 644, 655, 93 N.W. 1024, 1028 (1903)) (Marshall, J., dissenting). Thus, if any present shareholder held his shares at the time of the alleged wrongs, it would appear that *Barber* does not prohibit either a corporate or derivative action. In *Bangor Punta*, any of 20 minority shareholders could have sued derivatively. As the dissent notes, "It is ironic, then, to see the Court adopt a result which bars the corporation itself from bringing a suit which a minority shareholder could have brought in the corporation's behalf." *Id.* at 722 (Marshall, J., dissenting).

67. 277 A.D. at 190-91, 98 N.Y.S.2d at 297-98 (1st Dep't 1950) (Shientag, J., dissenting). Justice Shientag nevertheless suggested that in some instances the corporation

Neither the majority nor the dissent was concerned, however, with a more fundamental problem created by application of the Rule in *Capitol Wine.* By using the contemporaneous ownership rule to bar an action brought by a corporation, the shares of which were owned by a sole shareholder who had purchased his interest after the alleged wrong had taken place, the court created, in effect, three categories of shareholders: minority shareholders, shareholders owning 100% of the shares, and controlling shareholders owning less than 100% of the shares. After *Capitol Wine*, it appeared that, of these three groups, only controlling shareholders owning less than a 100% interest could avoid the contemporaneous ownership requirement by causing the corporation to bring suit in its own name. Thus, by creating these three categories, the court ensured disparate treatment of shareholders based on their relative ownership in the corporation. Further, by mechanically applying the Rule to a corporation, the court encouraged unthinking application in circumstances in which such application might deny legal relief to injured minority shareholders.

Fourteen years later, in *Platt Corp. v. Platt*,[68] *Capitol Wine* was distinguished, and the appellate division held the contemporaneous ownership rule applicable only in derivative actions. The action was brought by Platt Corporation which was controlled by Adson Industries, a corporation that had acquired its shares from one Platt, who had been the former president of the plaintiff corporation and who was a defendant in this litigation. After institution of the suit, Platt Corporation was merged into Adson Industries. The merger agreement, which was negotiated before the initiation of the litigation, included an undertaking by Adson Industries to bring suit against Platt and others and to tender the proceeds of the suit to the former Platt Corporation minority shareholders. After consummation of the merger, the defendants successfully moved to dismiss the action because the plaintiff corporation currently had no shareholder that had held

might be barred from recovery. *Id.*

For critical discussions of the decision, see 36 CORNELL, L.Q. 740 (1951); 65 HARV. L. REV. 345 (1951); 3 STAN. L. REV. 151 (1950).

68. 21 A.D.2d 116, 249 N.Y.S.2d 75 (1st Dep't 1964), *aff'd*, 15 N.Y.2d 705, 204 N.E.2d 495, 256 N.Y.S.2d 335 (1965).

shares at the time of the alleged wrongful acts. In reversing the trial court's dismissal, the appellate division stated that the corporation had a separate right to sue even though none of the shareholders would have been able to sue derivatively.[69] The court noted that, in some cases, "policy or equitable considerations may require that the rights of a corporation be equated with the rights of its [shareholders] and that the corporate rights be subjected to the statutory limitations."[70] In the view of the *Platt* court, *Capitol Wine* was such a case because the latter action was brought for the exclusive benefit of the sole shareholder and, thus, would have resulted in unjust enrichment.[71] The court further reasoned that Adson Industries had not become the sole shareholder of Platt Corporation, but rather had eliminated all Platt Corporation stock through the merger. In addition, the real party in interest was found to be the class of shareholders who had exchanged their shares in Platt Corporation for shares in Adson Industries, since those shareholders were to receive the proceeds of any recovery.[72]

Platt is significant in that the court refused to apply the contemporaneous ownership rule mechanically to actions by corporations, but instead investigated the facts and circumstances of the case to determine the equities of the situation. Although a consideration of the equities might be appropriate in both derivative suits and corporate actions, *Platt* has not been so extended. As a result, some shareholders, those who control a corporation, are able to circumvent the contemporaneous ownership rule, while minority shareholders, who cannot cause the corporation to sue, will still be deprived of legal relief.[73]

Both state and federal courts, seeking to mitigate the harshness of the contemporaneous ownership rule, have occasionally resorted to the continuing wrong doctrine in order to permit a shareholder to bring a derivative action.[74] Under this doctrine, a

69. *Id.* at 121-22, 249 N.Y.S.2d at 80-81.

70. *Id.* at 121-22, 249 N.Y.S.2d at 81.

71. *Id.* at 122, 249 N.Y.S.2d at 81.

72. *Id.* at 123, 249 N.Y.S.2d at 82. For a discussion of *Capitol Wine* and *Platt*, see Note, *Demise of the Doctrine of* Capitol Wine and Spirit v. Pokrass, 18 BUFFALO L. REV. 184 (1969).

73. *See* notes 50-51 and accompanying text *supra*.

74. *See, e.g.*, Bateson v. Magna Oil Corp., 414 F.2d 128 (5th Cir. 1969) (suit permit-

shareholder may sue derivatively whenever he demonstrates that the alleged wrong was still occurring at the time he purchased his interest, regardless of when the wrongful conduct began. Courts have applied the "continuing wrong" theory upon a finding that the wrong "spans [the plaintiff's] ownership of stock or new elements in a pattern of wrongful conduct occur after acquisition, and the wrong has not completely occurred and been terminated prior to the stock acquisition."[75]

The continuing wrong rationale has been employed by New York courts on several occasions to satisfy the requirement of contemporaneous ownership. The courts appear to be willing to look for a continuing wrong whenever the facts of a particular case indicate that the plaintiff is not bringing a strike suit, that the plaintiff has no reason to expect that the value of his shares has been undermined by the defendant's actions, and that the plaintiff has no other basis of recovery against the defendant.[76]

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ted since payment of excessive salaries, personal use of corporate property, payment of prohibitive mortgage rate, and mismanagement of oil and gas property continued at time plaintiff reacquired the stock), *cert. denied*, 397 U.S. 911 (1970); Palmer v. Morris, 316 F.2d 649 (5th Cir. 1963) (allegations of exorbitant rentals pursuant to fraudulent transactions did not deal only with transactions that had completely occurred and been terminated prior to plaintiff's acquisition of the stock); *In re* Penn Central Transp. Co., 341 F. Supp. 845 (E.D. Pa. 1972) (although allegedly invalid lease was entered into by corporation before plaintiff acquired its stock, complaint alleged a continuing lease and a continuing injury; court noted that the danger of person "buying" a lawsuit was not present); Lavine v. Gulf Coast Leaseholds, 35 Del. Ch. 539, 122 A.2d 550 (1956) (illegal stock exchange not completed until approved by stockholders; since approval not given until after plaintiff became stockholder, he was not barred from suing); Maclary v. Pleasant Hills, Inc., 35 Del. Ch. 39, 109 A.2d 830 (1954) (issuance of stock was authorized, but certificates were not actually issued until 3 years later; transaction was not completed until certificates were issued; and plaintiffs, who had become equitably entitled to corporate stock between date of authorization and date of issuance, were entitled to maintain suit); Duncan v. National Tea Co., 14 Ill. App.2d 280, 144 N.E.2d 771 (1957) (when a shareholder has acquired his stock after the occurrence of alleged acts of mismanagement, he may maintain a derivative suit only if the mismanagement and its effects continued and were injurious to him, or the alleged mismanagement affected him specially); Koplar v. Rosset, 355 Mo. 496, 196 S.W.2d 800 (1946) (acts or irregularities, expenses pursuant to refinancing bonds, relied upon were continuing ones so [the Rule] would not apply).

75. W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5982 (Supp. 1979) (citing Spalitta v. National Am. Bank of New Orleans, 444 F.2d 291 (5th Cir.), *cert. denied*, 404 U.S. 883 (1971)).

76. *See* Ripley v. International. Rys. of Cent. America, 8 A.D.2d 310, 188 N.Y.S.2d 62 (1st Dep't 1959), *aff'd*, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960); Gluck v. Unger, 25 Misc. 2d 554, 202 N.Y.S.2d 832 (Sup. Ct. N.Y. County 1960); York Proper-

In these situations, the New York courts apparently have recognized that application of the contemporaneous ownership rule would penalize the subsequent purchaser of shares for failure to discover the wrong before his acquisition and would allow inequitable gains to the defendants.[77] Problems arise because no guidelines have been established for determining the existence of a continuing wrong. This leads to decisions which appear contradictory and provide no clear precedent for future application.

In *York Properties, Inc. v. Neidoff*,[78] the defendant directors defaulted on a corporate mortgage held by their daughter and against which the principal assets of the corporation had been pledged. Although the plaintiff acquired his 50% interest after the default, he did so prior to the foreclosure. The court held that the action could be maintained since it found a continuing wrong; the default, which was intended to force a sale of the corporate assets, was a single transaction that included the date of default and continued to the date of foreclosure.[79]

In *Gluck v. Unger*,[80] Green Company had acquired Olen Company through a merger. The directors of Green then sued Olen alleging fraud in the merger transaction. This suit was subsequently settled. The plaintiff in *Gluck*, who acquired his shares in Green Company sometime after the merger but before the settlement of the fraud action, then brought a derivative action against the Green directors alleging an improper settlement of the fraud action. The court held that a settlement which is a "cover-up of the original wrong is a new and independent wrong."[81] This statement can be interpreted either as a finding that the settlement was a "new" and separate wrong, unrelated to the merger or the fraud action in any way, or as a finding that the settlement was a "cover-up" or continuation of a series of wrongs beginning with the tainted merger. Under either inter-

ties, Inc. v. Neidoff, 10 Misc. 2d 439, 170 N.Y.S.2d 683 (Sup. Ct. N.Y. County 1957). *But see* Weinstein v. Behn, 65 N.Y.S.2d 536 (Sup. Ct. N.Y. County 1946), *aff'd*, 272 A.D. 1045, 75 N.Y.S.2d 284 (1st Dep't 1947). *See also* notes 15-16 and accompanying text *supra*.

77. *See* note 16 *supra*.

78. 10 Misc. 2d 439, 170 N.Y.S.2d 683 (Sup. Ct. N.Y. County 1957).

79. *Id.* at 441, 170 N.Y.S.2d at 686.

80. 25 Misc. 2d 554, 202 N.Y.S.2d 832 (Sup. Ct. N.Y. County 1960).

81. *Id.* at 557, 202 N.Y.S.2d at 834.

pretation, the result in *Gluck* is an example of a court avoiding mechanical application of the contemporaneous ownership rule.

In *Ripley v. International Railways of Central America*,[82] two appellate courts, like the court in *Gluck*, avoided application of the contemporaneous ownership rule by relying upon events occurring after the plaintiffs acquired their shares.[83] The appellate division found that payments under an unfavorable freight agreement, entered into prior to the time at which the plaintiffs had become shareholders, were "continuing wrongs," and therefore, the shareholders could sue derivatively.[84] On appeal, the court of appeals upheld, on a different ground, the shareholders' right to sue: the payments were not being made pursuant to the freight agreement, but rather, each payment was a separate transaction subject to suit by the shareholders on a theory of unjust enrichment.[85]

Other New York cases are difficult to reconcile with *Neidoff*, *Gluck*, and *Ripley*. In *White v. Phillips*,[86] for instance, the New York supreme court found that the failure to regain amounts illegally paid by the corporation on debts for which it was not obligated was not an independent wrong.[87] In *Chaft v. Kass*,[88] the appellate division found that continuing payments pursuant to an agreement to buy formulae and processes from the former sole shareholder of the corporation did not constitute a continuing wrong.[89] The court reasoned that the wrongdoing in making payments would have to be founded upon a setting aside of the contract which the court found to be more advantageous than an earlier licensing agreement that had been entered into while the original owner still owned all of the shares.[90]

82. 8 A.D.2d 310, 188 N.Y.S.2d 62 (1st Dep't 1959), *aff'd*, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960).

83. Even if these courts had applied the contemporaneous ownership rule, they would not have had to dismiss this derivative suit since two of the twenty-seven plaintiffs had owned shares in the defendant corporation at the time of the original wrongful conduct. *Id.* at 324, 188 N.Y.S.2d at 78.

84. *Id.* at 324, 188 N.Y.S.2d at 79.

85. 8 N.Y.2d 430, 445-46, 171 N.E.2d 443, 450, 209 N.Y.S.2d 289, 299-300 (1960).

86. 185 Misc. 960, 58 N.Y.S.2d 52 (Sup. Ct. N.Y. County 1945).

87. *Id.* at 961-62, 58 N.Y.S.2d at 53-54.

88. 19 A.D.2d 610, 241 N.Y.S.2d 284 (1st Dep't 1963).

89. *Id.* at 610, 241 N.Y.S.2d at 286.

90. *Id.*

White can be distinguished from *Gluck* and *Ripley* in that in *White* there was no subsequent act, but only a failure to take action, and from *Neidoff* in that in *White* there was no subsequent event like a foreclosure. *Chaft*, on the other hand, cannot be distinguished from *Gluck* and *Ripley* on the basis of subsequent action since in *Chaft* payments were made subsequent to the original agreement. The only distinction that can be drawn between *Chaft* and *Ripley* seems to be that, in *Chaft*, the court found the contract to be both advantageous and controlling, whereas, in *Ripley*, the court of appeals found the original agreement neither advantageous nor controlling. Thus, while some distinctions can be drawn between those cases that find a continuing wrong and those that do not, these distinctions do not seem significant enough to warrant different outcomes.

In sum, the continuing wrong doctrine mitigates injustice that might otherwise result from broad application of the contemporaneous ownership rule. The cases, however, give no clear indication of those circumstances that will compel application of the continuing wrong doctrine and those that will not. Plaintiff-shareholders are left with little guidance, and courts are forced to decide, on a case by case basis, as to whether a situation constitutes a continuing wrong.

III. A Proposed Legislative Solution

The New York legislature should attempt to correct the inequities resulting from application of the contemporaneous ownership rule. In determining the appropriate course to take, the legislature should recognize the continued necessity for the contemporaneous ownership rule and the ineffectiveness of the continuing wrong doctrine as a remedy for the problems engendered by the Rule. This comment urges a modification of section 626(b) of the New York Business Corporation Law to create a rebuttable presumption in favor of the contemporaneous ownership rule.

Although many of the abuses created by strike suits have been eliminated by sections 626(d) and (e) of the New York Business Corporation Law,[91] a contemporaneous ownership rule

91. *See* note 33 *supra*.

may still be necessary. Section 626(d) requires court approval for personal settlement or abandonment of shareholders' derivative actions, and 626(e) requires the suing shareholder to remit the proceeds of the action to the corporation so that all shareholders may benefit therefrom. Together, then, the sections prevent an individual from purchasing several shares of stock, commencing a derivative action, and then personally settling or abandoning that action for substantial personal gain. These sections, however, only apply after a derivative action is instituted. They do not affect prelitigation settlements. Without the contemporaneous ownership requirement, an individual could conceivably purchase several shares of stock, threaten a suit, and obtain a large out-of-court settlement from a corporation interested in preventing expensive and protracted litigation, maintaining its public and private image, or protecting trade secrets. Thus, the strike suit abuse at which the contemporaneous ownership rule was aimed might recur.[92]

Assuming the continued necessity for a contemporaneous ownership requirement, the hardships that the Rule causes must be considered. In order to mitigate the harshness of the Rule, the legislature could mandate application of the continuing wrong doctrine[93] whenever it is found that a shareholder held his shares during a period in which the alleged wrong continued and that adherence to the contemporaneous ownership rule would cause injustice. Three problems might result from such a statutory provision. First, a wrong does not continue in all situations. Therefore, relief would not be afforded to all injured shareholders. Second, merely enacting the continuing wrong doctrine would not provide standards or guidelines for identifying those situations that constitute a continuing wrong and therefore satisfy the contemporaneous ownership requirement. Third, statutory adoption might make strike suits more appealing; an investor could purchase shares after a wrongdoing began with the knowledge that he could threaten suit and obtain a personal settlement.

The most effective solution to the problems created by the

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92. *See* note 13 and accompanying text *supra*.

93. Maine and Wisconsin have statutorily adopted the continuing wrong doctrine. *See* note 5 *supra*.

Rule would entail amendment of the contemporaneous ownership statute to provide for equitable exceptions to its application. The Rule would continue to deter strike suits, while the amendment would permit the courts to allow suits to go forward in situations in which the Rule itself would work an injustice. Both Pennsylvania and California have enacted such modified contemporaneous ownership rules.[94] In these states, any shareholder may sue derivatively, regardless of when he acquired his corporate interest, if he demonstrates that denial of such an action would result in substantial injustice.[95] Both statutes require that the plaintiff show a strong prima facie case in favor of the derivative claim. Pennsylvania then requires proof that, without the suit, serious injustice would result.[96] California requires four specific additional showings: that no similar action has been, or is likely to be, instituted; that the plaintiff acquired his shares before public or private disclosure of the wrongdoing; that without the suit the defendant will be unjustly enriched by his own willful wrongdoing; and that the suit will not unjustly enrich the corporation or any shareholder thereof.[97] California provides courts with clear requisites for application of this modification

94. PA. STAT. ANN. tit. 15, § 1516(A) (Purdon 1967 & Supp. 1979-1980); CAL. CORP. CODE § 800(b)(1) (West 1977).

95. The Pennsylvania statute provides:

> [A]ny shareholder . . . who except for this [contemporaneous ownership] section would be entitled to maintain such a suit and who does not meet such requirements, may, nevertheless, in the discretion of the court, be allowed to maintain such a suit on preliminary showing to the court . . . that there is a strong prima facie case in favor of the claim asserted on behalf of the corporation and that without such suit serious injustice will result.

PA. STAT. ANN. tit. 15, § 1516(A) (Purdon 1967 & Supp. 1979-1980).

The California statute provides:

> [A]ny shareholder who does not meet such [contemporaneous ownership] requirements may nevertheless be allowed in the discretion of the court to maintain such action on a preliminary showing to and determination by the court . . . that (i) there is a strong prima facie case in favor of the claim asserted on behalf of the corporation, (ii) no other similar action has been or is likely to be instituted, (iii) the plaintiff acquired the shares before there was disclosure to the public or to the plaintiff of the wrongdoing of which plaintiff complains, (iv) unless the action can be maintained the defendant may retain a gain derived from defendant's willful breach of a fiduciary duty, and (v) the requested relief will not result in unjust enrichment of the corporation or any shareholder of the corporation.

CAL. CORP. CODE § 800(b)(1) (West 1977).

96. *See* note 95 *supra*.

97. *See* note 95 *supra*.

of the Rule, while Pennsylvania allows judicial flexibility in determining when to apply the equitable exception.

This writer has found no judicial interpretations of these statutes. It appears, however, that a shareholder suing in California is certain of what he must prove in order to avoid application of the Rule; in Pennsylvania the shareholder must foresee what the court will deem a denial of justice. On the other hand, a shareholder suing in California has an extremely heavy burden of proof. It may be difficult to prove that no similar actions are likely to be instituted and that no one will be unjustly enriched by the relief requested. In addition, a defendant is not necessarily unjustly enriched by wasting corporate assets. Therefore, his liability should not be premised on such enrichment.

To provide ease of application for courts, certainty of proof for plaintiffs, and equitable results, the New York legislature could supplement section 626(b) as follows:

> Any shareholder who does not meet the contemporaneous ownership requirements of this section may nevertheless be allowed, in the discretion of the court, to maintain such action on a preliminary showing to the court that there is a strong prima facie case in favor of the claim asserted on behalf of the corporation and that, without such suit, serious injustice would result.
>
> In determining whether justice requires maintenance of such action, the court should consider whether or not (1) a similar action has been or is likely to be instituted, (2) the plaintiff knew or should have known of the wrongdoing before he purchased his shares, (3) without the action the defendant will be unjustly enriched by the defendant's willful breach of a fiduciary duty, and (4) the requested relief will result in unjust enrichment of the corporation or of any shareholder.

In an attempt to reach a just result in each case, this proposed statute incorporates both the specific guidelines of the California statute and the flexibility of the Pennsylvania rule. The plaintiff must demonstrate a strong prima facie case plus serious danger of injustice if his case is barred. The court then must consider the enumerated factors; the presence or absence of one or more, however, is not necessarily dispositive of the plaintiff's claim to standing. This amendment would continue to deter strike suits, but strained interpretations of the contemporaneous ownership statute would no longer be necessary to prevent inequitable de-

nials of legal relief. In addition, since shareholders would no longer need to circumvent the Rule by use of section 720 or by controlling the board of directors, arbitrary treatment resulting from such circumvention would be alleviated.[98]

IV. Conclusion

The requirement of contemporaneous ownership in shareholders' derivative actions has been widely adopted by courts and legislatures. Although the contemporaneous ownership rule was originally designed to prevent abuse of federal diversity jurisdiction, it has functioned at the state level to curtail various derivative action abuses and improprieties. In New York, as in many other jurisdictions, however, the requirement may deny legal relief to innocent shareholders and, in conjunction with other statutes, may result in disparate treatment of shareholders depending upon their positions in the corporation. To prevent such inequities, the New York contemporaneous ownership statute should be amended so that courts may exempt shareholders from the contemporaneous ownership requirement if, after a consideration of all the relevant circumstances, it appears that justice so requires.

98. *See* notes 40-90 and accompanying text *supra*.