

Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?

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I. INTRODUCTION

In corporate law, there are two avenues through which a shareholder may attempt to sue a corporation in which the shareholder has stock: a direct or a derivative cause of action.¹ A direct action is a claim asserted by a shareholder to remedy a personal injury suffered by that shareholder.² A derivative shareholder action is a claim brought by a shareholder on behalf of a corporation to remedy an injury suffered by the corporation when the corporation's directors or officers have failed to do so.³

Different tests exist to determine whether a shareholder may sue a corporation directly rather than derivatively, and state law determines which test is to apply.⁴ This Note analyzes the three most commonly used tests as applied in Delaware, Illinois, and Indiana. These states in particular are discussed because courts in Delaware, Illinois, and Indiana have decidedly chosen one test to apply and have sufficiently developed the case law to allow for an analysis of the three tests.

Part III.A of this Note investigates the direct harm test as applied in Delaware and the Delaware courts' inability to apply the direct harm test with clarity. Part III.B examines the special injury test used by courts in Illinois and highlights the lack of decisiveness within Illinois case law as to whether a special injury is one that is suffered by shareholders in general, or only by the specific shareholder who brings the suit. Part

1. Patrick M. Garry et al., *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D. L. REV. 275, 279 (2003–04).

2. Daniel S. Kleinberger & Imanta Bergmanis, *Direct vs. Derivative, or "What's a Lawsuit Between Friends in an 'Incorporated Partnership?'"*, 22 WM. MITCHELL L. REV. 1203, 1207 (1993) [hereinafter Kleinberger & Bergmanis, *What's a Lawsuit*].

3. Susanna M. Kim, *Conflicting Ideologies of Group Litigation: Who May Challenge Settlements in Class Actions and Derivative Suits?*, 66 TENN. L. REV. 81, 104 (1998).

4. Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63, 70 (2006) [hereinafter Kleinberger, *Direct Versus Derivative*] (explaining that whether a suit is derivative or direct is governed by the law of the jurisdiction in which the corporation is organized).

III.C explores the duty owed test as applied in Indiana and the exception the Indiana Supreme Court created for closely-held corporations, which allows for more successful direct shareholder claims.

Through this analysis, it appears that the duty owed and direct harm tests lead to the most shareholder success in direct shareholder litigation. However, the duty owed test is the least arbitrary, and most clearly defined and applied. Therefore, courts should apply the duty owed test to determine whether a shareholder claim states a direct cause of action.

II. BACKGROUND

A. Differences Between Derivative and Direct Shareholder Claims

In corporate law, shareholders have the power to sue the corporations in which they own stock through two different means: direct shareholder suits and derivative shareholder suits.⁵ In general, criteria vary for determining whether a shareholder has the authority to file a direct, rather than derivative, claim.⁶ However, the ability to bring a direct suit is important to a shareholder. This is because the remedies and procedural steps involved in direct actions are more beneficial to shareholders than the remedies and procedural steps in derivative actions.⁷

In a derivative lawsuit, shareholders bring an action on behalf of the corporation for a wrong to the entity itself.⁸ As a result, all damages received in a derivative suit belong to the corporation and not the individual shareholder bringing the suit.⁹ In a direct action, on the other hand, a shareholder brings an action against the corporation for an injury to the shareholder itself, and not the corporation as a whole.¹⁰ Therefore, in a direct shareholder action the court awards all damages directly to the shareholder or shareholders participating in the action.¹¹ Although shareholders tend to have a preference for direct suits because of their ability to receive damages directly and to avoid procedural requirements such as demand,¹² courts generally require that shareholders sue derivatively.¹³ This is intended to prevent multiplicity of lawsuits by shareholders, to protect corporate creditors by giving the money back to the corporation,

5. Garry et al., *supra* note 1, at 279.

6. Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 359 (1994) (explaining that “[c]ourts and commentators employ a variety of rubrics in determining whether a particular action should be brought as a direct or as a derivative action”).

7. See Jason M. Tanguay, *Minority Shareholders and Direct Suits in Closely Held Corporations Where Derivative Suits Are Impractical: Durham v. Durham*, 5 PIERCE L. REV. 469, 472 (2007) (arguing that shareholders prefer direct over derivative suits because derivative suits require shareholders to abide by pleading requirements, such as first making demand on the corporation, and in derivative suits courts award proceeds to the corporation rather than the shareholder).

8. Garry et al., *supra* note 1, at 279.

9. Tanguay, *supra* note 7, at 470.

10. Garry et al., *supra* note 1, at 279–80.

11. See Tanguay, *supra* note 7, at 472 (stating that “it is clear why shareholders would rather bring direct suits” due to the lack of procedural requirements and ability to recover personally).

12. See *infra* note 24 and accompanying text for an explanation of the demand requirement applied in derivative litigation.

13. Tanguay, *supra* note 7, at 471–72.

to protect the interests of all shareholders by increasing the value of their shares, and to benefit the injured shareholders specifically by increasing the value of their shares.¹⁴

1. Derivative Shareholder Claims

Derivative shareholder claims allow shareholders to sue on behalf of the corporation in order to enforce a right of the corporation that the entity itself has failed to assert.¹⁵ Through the use of derivative litigation shareholders have the ability to assert claims against directors, management, other shareholders, or even third persons.¹⁶ However, shareholders most often assert derivative suits against “corporate insiders” such as officers, directors, and large shareholders.¹⁷

Derivative shareholder suits serve two primary functions: compensation and deterrence.¹⁸ Often at issue in derivative suits are the past actions of the corporation’s own officers and directors, who are not likely to assert an action against themselves.¹⁹ Therefore, derivative suits have a deterrent effect because they alert officers and directors to the fact that shareholders may hold them liable to the corporation for their actions even if they fail to do so themselves.²⁰ Derivative suits also aid in compensating the injured corporation and shareholders by allowing shareholders a means to restore what the corporation has lost.²¹ Typically, courts hold that shareholders should bring a suit derivatively if a claim involves a breach of the directors’ fiduciary duties of care and loyalty.²² This could entail “grossly negligent mismanagement, waste of corporate assets, excessive compensation, usurpation of corporate opportunity, and . . . general self-dealing.”²³

Although derivative law suits aid shareholders by compensating and deterring, there are procedural hurdles that shareholders must first overcome in order to bring a derivative suit against a corporation. In order to sue derivatively, a shareholder must first make a written demand on the board of directors.²⁴ Demand is a pre-suit requirement that before a shareholder institutes a derivative action, the shareholder must explain the claim to the

14. *Id.*

15. Andrew J. Sockol, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 TUL. L. REV. 1095, 1096 (2003) (discussing the purpose of derivative suits).

16. Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1345 (1993).

17. *Id.* (noting that derivative suits are most often directed at “corporate insiders who have injured the business, either by intentional abuse of the corporate form for personal gain or by negligent ‘garden variety mismanagement’”).

18. *Id.*

19. Kim, *supra* note 3, at 104 (arguing that although shareholders can direct derivative suits at third parties, shareholders most often direct them at the officers and directors of the corporation because these parties “are not likely to redress the wrongs themselves”).

20. *See id.* (explaining that derivative suits deter managerial misconduct by providing shareholders with the power to protect the interests of the corporation).

21. *Id.* at 105 (noting that the derivative suit is the only remedy shareholders have to compensate the corporation for damages that it suffered).

22. Brandi, *supra* note 6, at 360.

23. *Id.*

24. CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 369 (Aspen Publishers 2006).

board of directors and ask the board to pursue the claim itself.²⁵ If the board declines, then the shareholder may challenge the board's demand refusal as a breach of fiduciary duty.²⁶ Subsequently, only if the court finds that the directors' decision is not protected by the business judgment rule may the shareholder then pursue the original claim as a derivative action.²⁷

2. Direct Shareholder Claims

A direct shareholder action is a claim by a shareholder to redress a personal injury for which the shareholder is entitled to relief.²⁸ The purpose of a direct shareholder suit is to compensate a shareholder for suffering a harm that the corporation itself has not suffered.²⁹ Due to the exclusivity of the harm, courts allow shareholders to sue the corporation directly on their own behalves.³⁰

Shareholders tend to prefer direct suits for multiple reasons. First, direct suits, unlike derivative, do not require shareholders to comply with pleading requirements such as making a written demand on the board of directors to pursue the claim.³¹ Second, in a direct suit the shareholder is able to personally recover damages rather than the court awarding damages directly to the corporation.³² Third, unlike during the demand process of a derivative claim, if a suit involves a direct cause of action, there is no threat to the shareholder that a special committee formed by the corporate directors will decide that the action is not worth pursuing.³³

In general, courts allow shareholders to sue directly if a claim involves the deprivation of shareholders' voting rights, denial of rights to inspect the corporation's books and records, suits to compel the declaration of dividends, claims that officers or directors induced a shareholder to sell his stock, or an attempt to compel the declaration of dividends.³⁴ Courts allow shareholders to bring these types of suits directly because in all of these examples, the shareholder is injured directly and independently of any injury

25. *Id.*

26. *Id.* at 369.

27. *Id.*

28. Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. PA. L. REV. 1147, 1147 (1962).

29. See Kleinberger & Bergmanis, *What's a Lawsuit*, *supra* note 2, at 1207, 1214 (noting that a direct action is one that vindicates some personal right of the shareholder, while derivative claims vindicate the rights of the corporation).

30. See *id.* at 1207–08 (explaining that when a shareholder is injured directly, the shareholder has the right to sue in a direct action).

31. See Tanguay, *supra* note 7, at 471–72 (stating that in derivative suits “shareholders usually must conform to pleading requirements”).

32. *Id.* at 472.

33. *Id.*; see also James L. Rudolph & Gustavo A. del Puerto, *The Special Litigation Committee: Origin, Development, and Adoption Under Massachusetts Law*, 83 MASS. L. REV. 47, 47–48 (1998) (explaining that special litigation committees are independent committees formed by corporations to determine whether a derivative claim should be pursued or dismissed, and that because most jurisdictions recognize a special litigation committee's authority to make this decision, the corporation can use the committee as a tool to avoid litigation by a shareholder).

34. Brandi, *supra* note 6, at 360.

to the corporation.³⁵ Although courts seem to have reached a general consensus on which types of claims are inherently direct, the criteria courts use to determine whether a suit is direct or derivative varies, and because of this, results can vary as well.³⁶

B. The Three Tests Used to Determine Whether an Action Is Direct or Derivative: Direct Harm, Special Injury, and Duty Owed

In the United States, jurisdictions tend to use three tests to determine whether a shareholder has the right to bring a cause of action as a direct, rather than derivative, suit.³⁷ These tests are: direct harm, special injury, and duty owed.³⁸ The following Parts will introduce each of these tests.

I. Direct Harm

In jurisdictions that use the direct harm approach, courts determine whether the corporation or the shareholder was harmed first.³⁹ If the shareholder was injured first, then the shareholder may choose to sue directly; however, if the corporation is harmed first, then the shareholder must bring the claim derivatively.⁴⁰ Standing is the basis for this distinction.⁴¹ This is because if the shareholder alone is the injured party, then the shareholder is the correct party to bring suit to redress the harm.⁴²

A very clear, albeit uncommon, example of this type of harm is a corporate manager fraudulently inducing a person to decrease or increase his ownership of the corporation.⁴³ The result of this inducement would be an injury to the shareholder and not the corporation, and therefore the shareholder would be able to bring a direct action against the corporation in order to have his own personal injury remedied.⁴⁴ In contrast, if the harm at issue involves the mismanagement of the corporation by the corporate directors, the harm would not be direct because the directors harmed the corporation directly and any harm to the shareholders is only an indirect result of the harm to the corporation.⁴⁵

The American Law Institute (ALI) has suggested that courts use the direct harm test to determine whether a claim is direct or derivative.⁴⁶ The ALI states that a claim

35. See Kleinberger & Bergmanis, *What's a Lawsuit*, *supra* note 2, at 1207–08 (stating that direct claims are allowed where the shareholder asserts a personal right based upon a direct harm to the shareholder, not as a consequence of any damage to the corporation).

36. See Brandi, *supra* note 6, at 359–60 (arguing that despite the variety in the tests used, there has been little inconsistency in the results).

37. Kleinberger, *Direct Versus Derivative*, *supra* note 4, at 88.

38. *Id.*

39. *Id.*

40. See *id.* (stating that if the damages to the shareholder were not incidental to any damages to the corporation, then the cause of action is direct).

41. *Id.* at 91 (arguing that the distinction between direct and derivative suits is a question of standing, and standing is a question of who was injured).

42. Kleinberger, *Direct Versus Derivative*, *supra* note 4, at 91–92.

43. *Id.* at 89.

44. See *id.* (contrasting mismanagement of an entity and a situation where a manager fraudulently induces a person to become an owner to show that the latter is harm directly to the shareholder and therefore should be resolved in a direct action).

45. *Id.*

46. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(a)

involves a direct cause of action if the shareholder can prove injury without having to prove damage to the corporation.⁴⁷ However, the ALI asserts that if the shareholder can recover only by showing that the corporation was injured, then the suit is derivative.⁴⁸

2. *Special Injury*

Under the special injury test, a claim is direct only if the shareholder has suffered an injury that is separate and distinct from any injury suffered by the corporation.⁴⁹ This rule requires a specific analysis of the alleged injury to the shareholder.⁵⁰ Some jurisdictions require that the special injury be unique from any injury to the corporation.⁵¹ Other jurisdictions apply a stricter standard requiring that the special injury not only be distinct from an injury suffered by the corporation, but also from any injury suffered by all other shareholders of the corporation.⁵² For example, under the more strict special injury test, harm to a shareholder caused by diminution in share price does not constitute a direct cause of action because the harm affects all shareholders alike.⁵³ The most common examples of distinct and separate injuries that truly affect only one shareholder are injuries to a shareholder under a separate contract with the corporation, or claims that a corporation singled out a shareholder specifically for mistreatment.⁵⁴

The Delaware Supreme Court combined both special injury approaches by defining a special injury as an injury that is “not suffered by all stockholders generally or where the wrong involves a contractual right of the stockholders, such as the right to vote.”⁵⁵ The Delaware Supreme Court has held that claims of stock dilution and reduction in

(1992); Glen G. Morris, *Shareholder Derivative Suits: Louisiana Law*, 56 LA. L. REV. 583, 588 (1996).

47. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(a) (1992).

48. *Id.*

49. Kleinberger & Bergmanis, *What's a Lawsuit*, *supra* note 2, at 1249.

50. Jonathan Shub, *Distinguishing Individual and Derivative Claims in the Context of Battles for Corporate Control: Lipton v. News International, PLC*, 13 DEL. J. CORP. L. 579, 586 (1988) (noting that when courts apply the special injury test in Delaware, they conduct an analysis of the specific shareholders' alleged injury).

51. *See* 19 AM. JUR. 2D *Corporations* § 1939 (2004) (referencing *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 470–71 (Cal. 1969) (noting that an individual cause of action exists when the injury suffered is distinct from any injury suffered by the corporation); *Strougo v. Bassini*, 282 F.3d 162, 175 (2d Cir. 2002) (applying Maryland law supporting direct shareholder claims when the alleged injuries were to the “shareholders alone and not the [corporation]”)).

52. *Id.* (referencing *John R. Behrmann Revocable Trust v. Szaloczi*, 74 P.3d 371, 374 (Colo. App. 2002) (stating that a stockholder may maintain a personal action for an injury caused to him as a stockholder if the injury is unique to himself and not suffered by the other stockholders)); *see also* Shub, *supra* note 50, at 586 (noting that Delaware courts, when applying the special injury test, have held that a shareholder may bring a direct suit if the court finds the alleged injury was one not suffered by any other shareholder).

53. *PricewaterhouseCoopers, LLP v. Massey*, 860 N.E.2d 1252, 1260 (Ind. App. 2007) (citing Seventh Circuit opinion).

54. *See* Shub, *supra* note 50, at 593–94 (discussing the court's dilemma in determining whether plaintiff was litigating as a corporate raider or “prosecuting a claim as an aggrieved shareholder”).

55. *In re Tri-Star Pictures, Inc.*, Litig., 634 A.2d 319, 330 (Del. 1993). Note that the Delaware courts no longer use the special injury test. In *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004), the Delaware Supreme Court stated that for an action to be direct, the analysis must turn on who suffered the harm.

voting power are both causes of action that fall within the special injury category.⁵⁶ The ALI states that a shareholder's loss of wages or other income from the corporation is also an example of a special injury suffered by a shareholder that warrants direct action.⁵⁷

3. *Duty Owed*

The final test used by jurisdictions in the United States is the duty owed test. This test requires the court to determine two things: first, whether a duty was breached, and second, to whom that duty was owed.⁵⁸ This involves an examination of whose rights the shareholder is asserting.

Under the duty owed test a claim is direct if the right asserted by the shareholder "flows from the breach of a duty owed directly to the plaintiff independent of the plaintiff's status as a shareholder, investor, or creditor of the corporation . . ."⁵⁹ Therefore, a claim is direct if the corporation or director infringes on a primary or personal right belonging to the shareholder derived from "the corporation's articles of incorporation, state law, agreements among shareholders, or between the corporation and its shareholders."⁶⁰ All of these different rights fall within the duty owed category because they are rights and duties owed to the shareholder and not primary rights of the corporation.

Under the duty owed test a shareholder may bring a direct action even if the same wrong injured the corporation as well.⁶¹ For example, a shareholder may sue directly for breach of a contract to which the shareholder is a party, despite the fact that the corporation may have a cause of action for the same breach.⁶² As long as the injury results from a violation of a duty owed to the shareholder in circumstances independent from the plaintiff's status as a shareholder, the claim is direct.⁶³

56. *In re Tri-Star Pictures*, 634 A.2d at 330.

57. 19 AM. JUR. 2D *Corporations* § 1938 (2004).

58. Kleinberger, *Direct Versus Derivative*, *supra* note 4, at 106 (stating that courts applying the duty owed test first "identify[] the duty allegedly breached and then ask[] to whom that duty is owed or whose rights are infringed").

59. *Id.* at 107 (quoting *Branch v. Ernst & Young*, No. Civ. A. 93-10024-RGS, 1995 WL 791941, at *2, *4, *6 (D. Mass. Dec. 22, 1995)).

60. *Id.* at 106.

61. See 19 AM. JUR. 2D *Corporations* § 1940 (stating that as long as the shareholder suffered an injury due to a violation of a special duty owed to a shareholder by a wrongdoer, the claim can be direct, even if the corporation was injured by the same wrong).

62. *Id.*

63. *Id.*

III. ANALYSIS

*A. The Direct Harm Test Applied in Delaware**1. Application of the Direct Harm Test*

Until recently, courts in Delaware applied the special injury test.⁶⁴ However, in the 2004 case of *Tooley v. Donaldson*,⁶⁵ the Delaware Supreme Court rejected the special injury test and adopted the direct harm approach instead.⁶⁶ The court stated that “[i]n our view, the concept of ‘special injury’ that appears in some Supreme Court and Court of Chancery cases is not helpful to a proper analytical distinction between direct and derivative actions. We now disapprove the use of the concept of ‘special injury’ as a tool in that analysis.”⁶⁷

Delaware’s new direct harm test is based purely on, first, “who suffered the alleged harm,” and second, “who would receive the benefit of any recovery or . . . remedy.”⁶⁸ In regards to the first prong, the determination involves which person or entity has suffered the alleged harm: the shareholder or the corporation.⁶⁹ Although in *Tooley* the court held that the special injury test was no longer applicable in Delaware, in its opinion the court used language reminiscent of the prior test. The court stated that “[t]he stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.”⁷⁰

Unfortunately, the court’s application of the direct harm test in *Tooley* did not shed light on how successful shareholders will be in bringing direct shareholder claims under this new test. This is because in *Tooley*, the court found that the shareholder’s claim was neither derivative nor direct because the claim was not yet ripe.⁷¹ Therefore the plaintiffs failed to state a claim of injury to either the corporation or its shareholders.⁷²

That same year, the Delaware Court of Chancery applied the Delaware Supreme Court’s holding from *Tooley* and found that a shareholder’s claim was derivative rather than direct.⁷³ In *In re Syncor International Corp. Shareholders Litigation*,⁷⁴ a group of former shareholders sued Syncor International Corporation (Syncor) claiming that they did not receive adequate consideration for their shares in the merger of Syncor and Cardinal.⁷⁵ The founder and former chairman of Syncor caused Syncor to make a

64. See Kleinberger, *Direct Versus Derivative*, *supra* note 4, at 103 (noting that the Delaware Chancery Court applied the special injury test until it found it ineffective in application and instead began to use the direct harm approach).

65. *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004).

66. Kleinberger, *Direct Versus Derivative*, *supra* note 4, at 104.

67. *Tooley*, 845 A.2d at 1035.

68. *Id.* at 1033 (holding that the correct test must turn solely on the two inquiries).

69. *Id.* at 1036.

70. *Id.* at 1039; see *supra* Part II.B.2 (discussing the special injury test and the language used by special injury jurisdictions).

71. *Tooley*, 845 A.2d at 1039.

72. *Id.*

73. *In re Syncor Int’l Corp. S’holders Litig.*, 857 A.2d 994, 997–98 (Del. Ch. 2004).

74. *Id.* at 994.

75. *Id.* at 995.

settlement of \$2.5 million with the United States Department of Justice.⁷⁶ The shareholder plaintiffs claimed that because of this misconduct and the money owed, Syncor renegotiated a merger agreement with Cardinal causing a decrease of \$83.9 million in consideration to the Syncor shareholders for their shares.⁷⁷ The shareholders claimed that this action harmed them directly.⁷⁸

The *Syncor* court stated that in order to make a determination as to whether a suit should be direct or derivative, the court must first look to the nature of the wrong and to whom the relief should go.⁷⁹ The court further stated that the shareholder's alleged injury must be independent of any injury to the corporation.⁸⁰ Under the facts of this case, the court believed that the conduct of the former founder and chairman of Syncor represented a breach of the duty of loyalty owed to the corporation, but not to the shareholders directly.⁸¹ The misconduct caused injury to Syncor as a result of the settlement fees with the Department of Justice and a lower negotiated merger price with Cardinal.⁸² Therefore, the *Syncor* court held that the suit was derivative and not direct.⁸³

Although the *Syncor* court used the direct harm test from *Tooley*, it still failed to clearly apply the test. By focusing on the dictum in *Tooley* where the court stated that a direct claim must be independent of any alleged injury to the corporation, the *Syncor* court relied upon the special injury test.⁸⁴ Therefore, in *Syncor*, a Delaware court blurred the line between direct harm and special injury once again.

The following year in 2005, the Court of Chancery revisited the issue of whether to dismiss a direct shareholder action for alleging a derivative claim. In *In re J.P. Morgan Chase & Co. Shareholder Litigation*,⁸⁵ shareholders claimed that their corporation paid too high a premium for a merger with a target bank.⁸⁶ The plaintiffs claimed that they did not receive their fair share from the merger and the merger diluted their collective ownership percentage.⁸⁷

The court acknowledged that the relevant inquiry post-*Tooley* must be, first, who suffered the alleged harm, and second, who would receive the benefit of the remedy or recovery.⁸⁸ However, once again, the court focused on the special injury language from *Tooley*, requiring that the shareholder demonstrate a personal injury without showing any injury to the corporation.⁸⁹ The *J.P. Morgan* court continued to use special injury language, stating that to show a direct harm using the *Tooley* test, the "stockholder must demonstrate . . . that he or she can prevail without showing an injury to the

76. *Id.* at 996.

77. *Id.*

78. *In re Syncor*, 857 A.2d 994.

79. *Id.* at 997.

80. *Id.*

81. *Id.*

82. *Id.* at 998.

83. *In re Syncor*, 857 A.2d at 997.

84. *See supra* Part II.B.2 (discussing how the special injury test requires a special harm to the shareholder distinct from any harm to the corporation and sometimes other shareholders as well).

85. *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808 (Del. Ch. 2005).

86. *Id.* at 812.

87. *Id.*

88. *Id.* at 817.

89. *Id.*

corporation.”⁹⁰

Applying the first prong of *Tooley*, the *J.P. Morgan* court found that the injury to the shareholders for the excessive merger exchange ratio and dilution of the value of their stock was only a natural consequence of the initial harm to the corporation as a whole.⁹¹ As a result, the cash overpayment did not harm the shareholders directly, so the claim was derivative.⁹² Although the Court of Chancery blended direct harm and special injury in stating the test, the court clearly applied the new direct harm test in holding that the claim was derivative by concluding that the corporation, not the shareholders, was the party directly harmed.

After this string of cases in which Delaware courts denied shareholder claims brought directly, the Delaware Supreme Court found in two cases that shareholders correctly alleged direct claims against corporations. In *Gentile v. Rossette*,⁹³ the CEO, Rossette, wished to liquidate the promissory notes the corporation gave to him in consideration for the capital he invested.⁹⁴ However, the corporation needed to issue more outstanding stock to do so than the corporate certificate allowed.⁹⁵ The board of directors held a shareholder meeting in which the shareholders voted to increase the outstanding common stock from 10 million shares to 60 million shares, although the board did not disclose to the shareholders the reason for the increase.⁹⁶ This sudden increase in outstanding shares caused the value of the stock to decrease and the CEO to become the majority shareholder.⁹⁷ The shareholders alleged that this injured them directly because the issuance of stock to the CEO reduced the value and voting power of their interest while it increased the value and voting power of the CEO’s controlling interest.⁹⁸

The *Gentile* court recognized that claims of corporate overpayment normally are derivative because the harm is a direct harm to the corporation.⁹⁹ However, the court stated that in a transaction that involves both corporate overpayment, which harms the corporation directly, and diminution in the shareholders’ voting power, which harms the shareholder directly, the claim may be both derivative and direct.¹⁰⁰ This is because the loss of voting power harms the shareholders uniquely and individually, while the controlling shareholder correspondingly benefits by the gain in voting power.¹⁰¹ Because the shareholders suffered harm directly and because they would be the sole beneficiaries of any remedy, the court found that the claim was sufficiently direct.¹⁰² However, the court did state that the harm to the shareholders resulted from the breach of the CEO’s

90. *In re J.P. Morgan Chase*, 906 A.2d at 817 (quoting *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004)).

91. *Id.* at 818 (citing *Agostino v. Hicks*, 845 A.2d 1110, 1119 (Del. Ch. 2004)).

92. *Id.*

93. *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006).

94. *Id.* at 95.

95. *Id.*

96. *Id.*

97. *Id.* at 93.

98. *Gentile*, 906 A.2d at 93.

99. *Id.* at 99.

100. *Id.* at 99–100.

101. *Id.* at 100.

102. *Id.* at 103.

duty to avoid causing a transaction that would benefit the majority shareholder at the expense of the minority.¹⁰³ By basing the decision not only upon the direct harm to the shareholders, but also on the duty owed, the Supreme Court of Delaware once again blurred the lines of the test it applied. Although the Supreme Court of Delaware held that it would only apply the direct-harm test, the *Gentile* court digressed from this standard and also applied the duty owed test to make its determination.

Similarly, the following year in *Gatz v. Ponsoldt*,¹⁰⁴ the Delaware Supreme Court once again found that a suit was direct because the wrong at issue affected the voting power of the minority shareholders.¹⁰⁵ Here the defendant acquired, through a series of transactions, a sizeable minority interest in the corporation that gave him de facto control.¹⁰⁶ The defendant converted his de facto control into a majority interest and simultaneously merged the entity with another corporation.¹⁰⁷ These transactions caused the plaintiffs, who were previously the majority shareholders in the first corporation, to become minority shareholders in the new corporation.¹⁰⁸

The *Gatz* court found that the defendant's actions amounted to an expropriation of economic value and voting power because it caused the majority shareholders to become minority shareholders by diluting the value of their stock and voting power.¹⁰⁹ The court stated that when the controlling shareholder increases his percentage of stock ownership at the public shareholders' expense, a "separate and distinct harm results to the public shareholders, apart from any harm caused to the corporation and from which the public shareholders may seek relief in a direct action."¹¹⁰ As a result, the *Gatz* court found that the plaintiffs had correctly asserted the claim as a direct cause of action.¹¹¹

2. *Synthesis of the Delaware Case Law*

In *Tooley*, the Supreme Court of Delaware outwardly rejected the special injury test and held that Delaware courts should apply the direct harm test.¹¹² Delaware's direct harm test requires a two-pronged analysis, first asking who suffered the alleged harm, and second, who would benefit from the recovery.¹¹³ Although the Delaware Supreme Court clarified that the direct harm test is the appropriate test to apply, the language used by both the Supreme Court and the Court of Chancery shows that the line drawn among special injury, direct harm, and duty owed is blurred.¹¹⁴ However, the cases themselves

103. *Gentile*, 906 A.2d at 103.

104. *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007).

105. *Id.* at 1281.

106. *Id.* at 1268.

107. *Id.*

108. *Id.*

109. *Gatz*, 925 A.2d at 1280–81.

110. *Id.* at 1274 (referring to holdings in *In re Tri-Star Pictures, Inc.*, 634 A.2d 319 (Del. 1993), and *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006)).

111. *Id.* at 1281.

112. *See supra* notes 64–69 and accompanying text (explaining the transition in the Delaware case law from a special injury test to a direct harm test).

113. *See supra* note 68 and accompanying text (discussing Delaware's new two-pronged direct harm test).

114. *See supra* notes 70, 84, 89–90, 103 and accompanying text (mentioning the Delaware courts' failure to strictly apply the direct harm test alone).

show a commonality—when a corporation issues shares to a controlling shareholder, and as a result causes the public shareholders to then become minority shareholders, the Delaware courts will hold that a direct harm has occurred to the shareholders because of their lost voting power.¹¹⁵ In these actions Delaware courts will allow shareholders to sue directly.¹¹⁶

B. The Special Injury Test Applied in Illinois

1. Application of the Special Injury Test

In Illinois, courts apply the special injury test to determine if a claim is a direct cause of action.¹¹⁷ These courts have held that an injury is special if it is “separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder.”¹¹⁸ However, in application of this principle, the case law shows a discrepancy over whether the special injury test requires the injury to be one distinguished solely from any injury to the corporation, or also from any injury suffered by other shareholders as a whole.¹¹⁹

In *Spillyards v. Abboud*,¹²⁰ the defendant directors entered into an agreement to allow another corporation to purchase 5.7 million shares of new common stock in their company.¹²¹ However, the directors put a condition on the sale that the other corporation was required to vote its common stock for the nominees chosen by the defendant directors for the available board of director positions.¹²² A shareholder sued, claiming that the directors’ actions constituted self-dealing and entrenchment.¹²³ The shareholder further argued that these actions directly impaired his voting rights and as a result his claim should be an individual cause of action.¹²⁴

The *Spillyards* court responded by holding that in order to sue individually, a plaintiff must allege a special injury.¹²⁵ The court defined a special injury as one that is separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of the shareholder such as a right to vote or to assert majority control.¹²⁶ The court further acknowledged that entrenchment claims, such as the one alleged here,

115. See *Gentile*, 906 A.2d at 102–03 (holding in these cases that because the shareholder plaintiffs’ voting power was affected, the claims sufficiently demonstrated a right to a direct cause of action).

116. See *id.* at 91; *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007) (holding that a cause of action was direct because the defendants’ actions diluted the value of the shareholders’ stock and voting power).

117. *Willmschen v. Trinity Lakes Improvement Ass’n*, 840 N.E.2d 1275, 1281 (Ill. App. 2005).

118. *Spillyards v. Abboud*, 662 N.E.2d 1358, 1363 (Ill. App. 1996) (internal quotation marks omitted); see also *Trinity Lakes Improvement Ass’n*, 840 N.E.2d at 1281.

119. See *infra* notes 131, 135 and respective accompanying text (noting that some courts in Illinois have required the injury to be distinguishable from any injury to the corporation, and other courts in Illinois have held that the injury must be distinguishable from any injury from any other shareholder).

120. *Spillyards*, 662 N.E.2d at 1358.

121. *Id.* at 1362.

122. *Id.*

123. *Id.* at 1363.

124. *Id.* at 1363–64.

125. *Spillyards*, 662 N.E.2d at 1363.

126. *Id.*

are normally derivative.¹²⁷ However, the *Spillyards* court stated that when a shareholder also alleges that the entrenching activity directly impaired a right he possessed as a shareholder, such as a voting right, then the claim may be individual.¹²⁸

The court found that in this case, the new controlling shareholder's promise to vote for the board of directors' nominees jeopardized the shareholders contractual right to elect a board of directors.¹²⁹ Therefore the suit was correctly brought as a direct cause of action.¹³⁰ The court further stated that the claim was still a direct cause of action despite the fact that the wrong affected all of the shareholders equally, and not just the individual shareholder who brought the suit.¹³¹

In contrast, in *Small v. Sussman*,¹³² an Illinois appellate court found that a claim brought by a shareholder did not involve a special injury and therefore was derivative.¹³³ In this case, the plaintiff alleged that the controlling shareholder conducted corporate waste by paying businesses that the defendant owned an interest in excessive amounts of money from corporate funds for minimal services or services without value.¹³⁴ The *Sussman* court stated that in order for a claim to be direct, a shareholder must show that he or she suffered an individual injury which did not affect all shareholders as a whole.¹³⁵ The court then held that the alleged diversion of the corporate assets to companies in which the defendant held an interest is a classic example of an injury to the corporation because it would affect the company's performance directly and only affect shareholders indirectly.¹³⁶ Because there was no special injury suffered by the individual shareholder, the *Sussman* court found that the claim at issue was derivative.¹³⁷

The most recent Illinois case in which a court decided that a shareholder correctly brought a claim as a direct cause of action is *Willmschen v. Trinity Lakes Improvement Ass'n*.¹³⁸ In this case, the entity at issue was not a corporation, but rather a homeowners association.¹³⁹ However, the court held that in regards to a determination of whether a claim is direct or derivative, the same laws apply to homeowners associations as to corporations.¹⁴⁰ Here a homeowner sued the homeowners association board alleging a breach of the homeowners covenants because the board failed to properly maintain two lakes in the neighborhood.¹⁴¹ Because the homeowners association did not properly maintain the lakes, the plaintiffs alleged that the lakes were a public and private nuisance.¹⁴²

127. *Id.* at 1364.

128. *Id.*

129. *Id.*

130. *Spillyards*, 662 N.E.2d at 1364–65.

131. *Id.* at 1364.

132. *Small v. Sussman*, 713 N.E.2d 1216 (Ill. App. 1999).

133. *Id.* at 1220.

134. *Id.* at 1218.

135. *Id.* at 1220.

136. *Id.* at 1219–20.

137. *Sussman*, 713 N.E.2d at 1220.

138. *Willmschen v. Trinity Lakes Improvement Ass'n*, 840 N.E.2d 1275 (Ill. App. 2005).

139. *Id.* at 1277.

140. *Id.* at 1281.

141. *Id.* at 1277.

142. *Id.*

The *Trinity Lakes* court cited the previous standard created in *Spillyards*, and held that in order to sue directly, a plaintiff must allege a special injury that is “separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder, such as the right to vote or to assert majority control.”¹⁴³ The court found that in this case, the plaintiffs did allege a direct cause of action because out of the 200 properties in the association, only 19 homes bordered or had views of the lakes and thus the plaintiffs bore the brunt of the nuisance.¹⁴⁴ However, the court did not base this finding on the fact that the plaintiffs sufficiently showed a special injury, but rather that they showed a “direct harm to themselves.”¹⁴⁵ The *Trinity Lakes* court further stated that because the plaintiffs alleged a “sufficient individual harm,” the claim was a direct cause of action.¹⁴⁶

2. Synthesis of the Illinois Case Law

To sue directly in Illinois, a plaintiff must allege a special injury—an injury separate and distinct to the shareholder or a wrong involving a contractual right of a shareholder.¹⁴⁷ However, in Illinois there is disagreement over whether the special injury test requires an injury to be one that is separate from any injury to the corporation, or the corporation and all other shareholders as well. In *Spillyards*, an Illinois appellate court stated that a shareholder’s injury was still direct despite the fact that all of the minority shareholders suffered from the injury and not just the plaintiff.¹⁴⁸ In *Sussman*, however, the same Illinois appellate court held that in order for an injury to be a special injury, it must be separate from an injury that affects a shareholder only indirectly, or affects all shareholders as a whole.¹⁴⁹ As a result, in *Sussman*, the court applied a stricter standard and stated that a special injury must be one that injures the plaintiff alone.

Although courts in Illinois for the most part have applied the special injury test clearly, in *Trinity Lakes* the appellate court for the Second Circuit blurred the distinction. The court stated in *Trinity Lakes* that the claim at issue was direct because the plaintiffs’ alleged harm was “direct to themselves.”¹⁵⁰ This is not the language of the special injury test, but rather the direct harm test applied in Delaware. In Delaware the focus is on whom is harmed first, the corporation or the shareholder.¹⁵¹ In special injury jurisdictions the focus should not be on whom is harmed first, but rather whether the harm is one that is “separate and distinct” from any harm to the corporation and sometimes all other shareholders as well.¹⁵² Therefore, in *Trinity Lakes*, although the court correctly stated

143. *Trinity Lakes Improvement Ass’n*, 840 N.E.2d at 1281.

144. *Id.*

145. *Id.*

146. *Id.*

147. See *supra* note 126 and accompanying text (defining the special injury test in Illinois).

148. See *supra* note 131 and accompanying text (noting the broader holding in *Spillyards*).

149. See *supra* note 135 and accompanying text (discussing how some jurisdictions in Illinois require a shareholder to suffer an injury independently from any other shareholder).

150. See *supra* note 144 and accompanying text (discussing the court’s holding in *Trinity Lakes* and application of the special injury test to homeowners’ associations).

151. See *supra* Part III.A.1 (discussing the direct harm test applied in Delaware).

152. *Willmschen v. Trinity Lakes Improvement Ass’n*, 840 N.E.2d 1275, 1281 (Ill. App. Ct. 2005); see also *supra* Part III.B.1 (discussing the special injury test in Illinois).

the standard from *Spillyards*, the court also included language in its opinion that was not representative of the special injury test.

C. The Duty Owed Test Applied in Indiana

I. Application of the Duty Owed Test

Courts in Indiana apply the duty owed test to determine whether a shareholder suit is direct or derivative.¹⁵³ Courts make this determination based upon whether the corporation breached a duty owed to the shareholder.¹⁵⁴ However, in Indiana the legal rule that affects shareholder litigation the most is the rule involving closely-held corporations, which allows a shareholder to bring a claim directly, even though the claim is derivative on its face.¹⁵⁵

In *Sacks v. American Fletcher National Bank & Trust Co.*, the Indiana Supreme Court stated that in order for a claim to be direct there must be “a breach of a duty owed specially to the stockholder separate and distinct from the duty to the corporation.”¹⁵⁶ However, in this case the court did not determine whether a direct cause of action existed; rather, it remanded to the lower court to make this determination.¹⁵⁷

Twenty years later the Supreme Court of Indiana applied the test created in *Sacks* to determine that a claim was derivative. In *Barth v. Barth*, a shareholder sued a corporation and the majority shareholder claiming that the majority shareholder had engaged in self-dealing transactions that substantially reduced the value of the plaintiff’s shares of common stock by paying excessive salaries to himself, using corporate employees to perform free services on his home, and lowering dividend payments.¹⁵⁸ The Supreme Court of Indiana applied the *Sacks* test and found no breach of duty owed specifically to the shareholder separate and distinct from the duty to the corporation not to self-deal.¹⁵⁹ Although the court did not find a direct cause of action, the Indiana Supreme Court in *Barth* created a new exception to the rule.¹⁶⁰ The court stated that “[i]n the case of a closely-held corporation, the court in its discretion may treat an action raising derivative claims as a direct action” as long as the action would not expose the corporation or the defendant to a multiplicity of claims, materially prejudice the interests of creditors of the corporation, or interfere with the fair recovery of all interested parties.¹⁶¹

In *G & N Aircraft, Inc. v. Boehm*,¹⁶² applying this new exception, the Supreme Court of Indiana found that the plaintiff correctly brought the claim as a direct cause of action.¹⁶³ *G & N* involved a claim by a shareholder who alleged that the controlling shareholder of the company threatened to preclude dividends for at least three years if the

153. Kleinberger, *Direct versus Derivative*, *supra* note 4, at 106.

154. *Sacks v. Am. Fletcher Nat’l Bank & Trust Co.*, 279 N.E.2d 807, 811–12 (Ind. 1972).

155. *Id.*

156. *Id.*

157. *Id.*

158. *Barth v. Barth*, 659 N.E.2d 559, 560 (Ind. 1995).

159. *Id.* at 561 n.4 (explaining the *Sacks* test).

160. *Id.* at 562 (creating a new exception for direct suits involving closely-held corporations).

161. *Id.*

162. *G & N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227 (Ind. 2001).

163. *Id.* at 237.

plaintiff did not sell his shares and resign as vice president.¹⁶⁴

The *G & N* court clarified that the correct test to apply in Indiana to determine whether an action is direct is a test that “draws the distinction based on the rights the shareholder asserts.”¹⁶⁵ The court clarified that the rights of the shareholder may be derived from the articles of incorporation, bylaws, state corporate law, or agreements made among shareholders or between the corporation and shareholders.¹⁶⁶ Examples of these rights include the rights of shareholders to vote, compel dividends, prevent oppression or fraud against minority shareholders, inspect corporate books, and compel shareholder meetings.¹⁶⁷

Most importantly, after clearly stating that Indiana courts should apply the duty owed test based upon the rights owed to the shareholder, the *G & N* court rejected the direct harm and special injury tests used by other jurisdictions.¹⁶⁸ While the court acknowledged that other state courts use the direct harm test, the court stated that in most cases it is unclear whether the shareholder, the corporation, or both have suffered the direct harm, thus making it hard to distinguish who has been harmed directly.¹⁶⁹ The court also found fault in the special injury test, stating that some courts applying this test only allow direct causes of action if the shareholder’s injury is distinct from any injury sustained by other shareholders and the corporation.¹⁷⁰ The court rejected this rule, arguing that even though some injuries affect all shareholders, such as the refusal to convene an annual meeting, the claim still should be direct.¹⁷¹ Therefore, the court concluded that courts should base the determination of whether a claim is direct or derivative on the rights that the shareholder asserts.¹⁷²

In *G & N*, the court believed that the complaints against the defendant were all based upon actions the defendant took as an officer or director of *G & N*.¹⁷³ The court acknowledged that claims that officers or directors breached their fiduciary duties to the corporation are typically derivative because they assert breaches of duties owed to the corporation as a whole, not to the plaintiff.¹⁷⁴ However, the court concluded that the *Barth* exception for closely-held corporations applied in this case because none of the underlying reasons for requiring a derivative action were present.¹⁷⁵ There was no threat of a multiplicity of lawsuits because there were only three shareholders in the corporation, no creditor needing protection, and no evidence that the plaintiff’s recovery would interfere with the fair distribution of the benefits of the suit.¹⁷⁶ Therefore, the

164. *Id.* at 233.

165. *Id.* at 235.

166. *Id.*

167. *G & N Aircraft*, 743 N.E.2d at 234.

168. *See id.* at 235 (explaining that other jurisdictions base the determination on either whether the shareholder’s injury is distinct from any injury to the corporation, or whether the shareholder’s injury is distinct from any injury sustained by the corporation and all other shareholders).

169. *Id.*

170. *Id.* at 235.

171. *Id.*

172. *G & N Aircraft*, 743 N.E.2d at 235.

173. *Id.* at 236.

174. *Id.* at 237.

175. *Id.* at 237–38.

176. *Id.*

lower court was correct in allowing the plaintiff to bring his claim as a direct cause of action.¹⁷⁷

In a court of appeals case following *G & N* involving the self-dealing of officers and directors, the court made its decision based upon the determination of whether or not the entity at issue was a closely-held corporation.¹⁷⁸ In *Marcuccilli v. Ken Corp.*,¹⁷⁹ the plaintiffs alleged that the corporation loaned money on an annual basis to shareholders, officers, and directors at an interest rate below the market value without disclosing these actions to the minority shareholders.¹⁸⁰ The *Marcuccilli* court held that the minority shareholders' claim did not involve a breach of a duty to the shareholders separate and distinct from any duty owed to the corporation and its other shareholders.¹⁸¹ However, the *Marcuccilli* court looked to the *Barth* exception to see if the plaintiffs could still bring the claim directly, and found that permitting the plaintiffs to proceed with a direct action could lead to a multiplicity of litigation by other shareholders.¹⁸² Therefore, the court concluded that because the *Barth* exception did not apply, and because the injury did not involve a breach of a duty owed solely to the plaintiffs, the claim was derivative.¹⁸³

2. Synthesis of the Indiana Case Law

In Indiana, courts base the determination of whether a suit is direct or derivative on the determination of to whom the duty breached was owed.¹⁸⁴ If the duty was owed to the shareholder, then the suit is direct.¹⁸⁵ If the breach involved a duty owed to the corporation, then the claim is derivative.¹⁸⁶ However, although Indiana adopted the duty owed test to determine if a claim is direct, it is not this determination that affects the success of shareholder litigation the most in Indiana.¹⁸⁷ Rather, it is the *Barth* exception that has the largest effect on direct shareholder litigation.

In *Barth*, the Supreme Court of Indiana made it clear that if the case at issue involves a closely-held corporation, it is for the judge to decide whether a claim that is derivative in nature may be brought directly.¹⁸⁸ As a result, most cases on appeal involving a question of whether a claim is direct or derivative turn upon a *Barth* analysis, and not upon whether the alleged claim involves a duty owed.¹⁸⁹

177. *G & N Aircraft*, 743 N.E.2d at 238.

178. *Marcuccilli v. Ken Corp.*, 766 N.E.2d 444, 450 (Ind. Ct. App. 2002).

179. *Id.* at 444.

180. *Id.* at 446.

181. *Id.* at 451.

182. *Id.*

183. *See Marcuccilli*, 766 N.E.2d at 451 (explaining that because the *Barth* exception did not apply, the lower court properly dismissed the direct claim).

184. *See Sacks v. Am. Fletcher Nat'l Bank & Trust Co.*, 279 N.E.2d 807, 811–12 (Ind. 1972) (stating that a personal cause of action arises when breach of duty is to a stockholder, not the corporation).

185. *See supra* notes 154–66 and accompanying text (discussing the requirements of the duty owed test in Indiana).

186. *Id.*

187. *See supra* Part III.C.1 and accompanying text (discussing the application of the direct harm test in Indiana).

188. *See supra* note 161 and accompanying text (noting the exception for closely-held corporations created in *Barth*).

189. *See supra* text accompanying notes 178–83 for a discussion of *Marcuccilli v. Ken Corp.*, 766 N.E.2d

D. Comparison of Shareholder Success Bringing Direct Causes of Action Using the Direct Harm, Special Injury, or Duty Owed Tests

1. General Comparison of the Three Tests

In Delaware the courts determine whether a plaintiff may bring a suit directly rather than derivatively based on the answer to two questions: who suffered the alleged harm, and who would receive the benefit of any recovery or remedy.¹⁹⁰ In contrast, a claim in Illinois is direct if it involves a special injury that is separate and distinct from any injury suffered by other shareholders, or an injury involving a contractual right of a shareholder.¹⁹¹ In Indiana, the determination hinges on whether the claim at issue involves a breach of a duty owed to the shareholder, separate and distinct from any duty owed to the corporation.¹⁹² Although these tests use different language, in actual application the courts have blurred the lines among them. However, through looking at the general definitions of these tests and their application in these states it is possible to distinguish the three.

The direct harm test asks the question, “who [was] hurt first—the entity or its owner(s)?”¹⁹³ Therefore, at issue is whether the shareholder was injured before the corporation. In general, this is similar to the special injury inquiry into whether the harm was something “separate and distinct” from any injury suffered by the corporation. Both tests focus on the determination of whether the shareholder’s harm can be isolated in some way from any harm to the corporation. However, the direct harm test does not preclude the possibility that the corporation was harmed as well. On the other hand, the special injury test can preclude a claim from being direct if any other shareholder also suffered from the alleged harm. Therefore, the burden for the shareholder to meet the requirements of proving a special injury is more stringent than proving a direct harm.

The duty owed test, in contrast, involves a determination of what duty the corporation breached and to whom that duty was owed.¹⁹⁴ This requires a deeper analysis first into what duties corporations and their directors owe to shareholders. Although in Indiana the courts provide a list of sources which define the rights of shareholders (and therefore the duties owed to them),¹⁹⁵ the duty owed test still requires that, on a case-by-case basis, courts look to the actual corporate bylaws, articles of incorporation, or any agreement between the corporation and its shareholders to determine if the right at issue was a duty owed to the shareholder.

Because of this extra requirement, one could view the duty owed test as a more stringent burden for a shareholder to prove. However, in application, the results do not

444 (Ind. Ct. App. 2002); *G & N Aircraft v. Boehm*, 743 N.E.2d 227, 235 (Ind. 2001); *see also Riggins v. Rea Riggins & Sons, Inc.*, 738 N.E.2d 292 (Ind. Ct. App. 2000) (applying the *Barth* exception to hold that the claim could not be direct due to the threat of a multiplicity of suits); *Cutshall v. Barker*, 733 N.E.2d 973 (Ind. Ct. App. 2000) (finding that the defendants failed to show that a direct action would cause any of the negative results listed in the *Barth* exception so therefore the claim could proceed).

190. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004).

191. *Spillyards v. Abboud*, 662 N.E.2d 1358, 1363–64 (Ill. App. Ct. 1996).

192. *Sacks v. Am. Fletcher Nat’l Bank & Trust Co.*, 279 N.E.2d 807, 811–12 (Ind. 1972).

193. Kleinberger, *Direct Versus Derivative*, *supra* note 4, at 88.

194. *Id.* at 106.

195. *G & N Aircraft v. Boehm*, 743 N.E.2d 227, 235 (Ind. 2001).

vary based upon whether the duty owed or the direct harm tests are applied. This is because if a harm is direct, and affects a shareholder before any harm to the corporation itself, this harm necessarily would be caused by a breach of a duty owed to the shareholder. However, these two tests are distinguishable from a special injury jurisdiction, which requires the harm to be completely distinct from any harm suffered by the corporation or any other shareholder.

2. Blurred Lines in Delaware, Illinois, and Indiana

In actual application, courts have not clearly drawn the lines among these tests in Delaware, Illinois, or Indiana, and thus it is difficult to distinguish which specific test leads to the most shareholder success. In Delaware, although the Supreme Court flatly rejected the special injury test, courts still state that in order to have a direct claim, the injury must be one that is independent of any injury to the corporation.¹⁹⁶ The Delaware Supreme Court also held that a shareholder claim was direct because the shareholder suffered harm “uniquely and individually.”¹⁹⁷ By using this language, the court made a special injury distinction rather than one based on a direct harm. At issue was not whether the shareholder was harmed first and foremost before the corporation, but rather whether the shareholder suffered an injury completely distinct from any injury to the corporation.

In Illinois, courts apply the special injury test, defining a special injury as one that is separate and distinct from that suffered by other shareholders.¹⁹⁸ However, the courts also define a special injury as a wrong involving a contractual right of the shareholder, such as a right to vote or to assert majority control.¹⁹⁹ This definition combines the special injury and duty owed determinations because the focus is also on whether there was a duty owed to the plaintiff through a contractual right.

Furthermore, Illinois courts have held that when the injury at issue is to the corporation, and only indirectly to the shareholder, the claim is derivative.²⁰⁰ Although the Illinois courts still use the word “injury” in their definition, the courts in effect define the direct harm test and supplement the word “injury” for the word “harm.” What the courts really are saying is that when the shareholder suffers the harm only indirectly, and it is the corporation that is harmed first, then the claim is derivative. Therefore, it is clear that while Illinois courts apply the special injury test, they are still unable to disconnect this test completely from direct harm and duty owed.

Indiana courts have been the clearest. The Indiana Supreme Court not only stated that Indiana courts were to apply a duty owed test, but the court also explained why it believes that the other two tests lead to inaccurate and arbitrary outcomes.²⁰¹ The only evidence of blurred lines in Indiana is that the courts refer to the duty owed to the

196. *See In re Syncor Int'l Corp. S'holders Litig.*, 857 A.2d 994, 997 (Del. Ch. 2004) (stating that an injury must be independent of any injury to a corporation and finding that the injury at hand represented a breach of a duty to the corporation and was therefore derivative).

197. *Gentile v. Rosette*, 906 A.2d 91, 100 (Del. 2006).

198. *Spillyards v. Abboud*, 662 N.E.2d 1358, 1363–64 (Ill. App. Ct. 1996).

199. *Id.*

200. *Hamilton v. Conley*, 827 N.E.2d 949, 955 (Ill. App. Ct. 2005).

201. *See supra* notes 168–72 and accompanying text (discussing the reasoning in Indiana for application of the direct harm test).

shareholder as something separate and distinct from any duty owed to the corporation.²⁰² This sounds similar to the special injury test because of the “separate and distinct” language. However, it is still distinguishable because it is the duty owed that must be separate and distinct, not the injury. Therefore, Indiana is the jurisdiction that most clearly states its test and is the most able to retain this distinction in application.

3. Shareholder Success Within the Case Law

Within all three states, if a shareholder claims that the corporation, directors, or controlling shareholder infringed upon the shareholder’s voting rights, courts will allow the claim to be direct no matter which test is applied.²⁰³ Similarly, if a shareholder sues and claims that the controlling shareholder’s actions in a merger agreement led to either excessive corporate overpayment or low consideration, the claim will be derivative in all three jurisdictions.²⁰⁴

However, it seems as though shareholders are more successful in bringing direct causes of action in Indiana. This is not because the duty owed test itself is a broader test, opening the door for more direct shareholder suits. Rather, shareholders are more likely to be successful in Indiana because of the *Barth* exception, which leaves to the judge’s discretion the decision of whether a claim involving a closely-held corporation may proceed directly.²⁰⁵ However, other than this small exception, in application it makes little difference which test a court applies because in all three jurisdictions the end results are most often the same.

IV. RECOMMENDATION

While courts in Delaware, Illinois, and Indiana apply different standards to determine whether a claim is direct or derivative, the results tend to be similar. The reason for this is that courts in these three states have blurred the lines among the tests. While each jurisdiction claims to apply one test, all three jurisdictions alternate among the language of all three. It is this lack of distinction in actual application that causes similar results.

Regarding shareholder success, the only real way to determine if a shareholder might be more successful in one jurisdiction than another is to look at the plain language

202. *Sacks v. Am. Fletcher Nat’l Bank & Trust Co.*, 279 N.E.2d 807, 811–12 (Ind. 1972); *Marcuccilli v. Ken Corp.*, 766 N.E.2d 444, 447 (Ind. Ct. App. 2002).

203. *See Gentile v. Rosette*, 906 A.2d 91, 100–01 (Del. 2006) (holding that a claim was correctly brought directly because it involved shareholder voting rights); *Gatz v. Ponsoldt*, 925 A.2d 1265, 1277–78 (Del. 2007) (finding that the harm was direct because it involved minority shareholder voting rights); *Spillyards v. Abboud*, 662 N.E.2d 1358, 1363–64 (Ill. App. Ct. 1996) (stating that because the harm effectively took away the shareholder’s voting rights, the claim was direct); *G & N Aircraft v. Boehm*, 743 N.E.2d 227, 234 (Ind. 2001) (explaining that claims enforcing a shareholder’s right to vote may appropriately be brought as direct causes of action).

204. *See In re Syncor Int’l Corp. S’holders Litig.*, 857 A.2d 994, 997 (Del. Ch. 2004) (finding the claim was derivative because it involved unnecessarily low consideration for a merger agreement); *Small v. Sussman*, 713 N.E.2d 1216, 1220 (Ill. App. Ct. 1999) (holding that the majority shareholder’s misappropriation of corporate funds only invoked a derivative cause of action); *Barth v. Barth*, 659 N.E.2d 559, 560–61 (Ind. 1995) (stating that self-dealing by a majority shareholder showed no special duty owed to the plaintiff shareholder).

205. *Barth*, 659 N.E.2d at 562.

of the tests themselves and not the case law. A direct harm test adds a temporal element, requiring the shareholder to prove that he or she was injured before any injury to the corporation.²⁰⁶ This still allows a direct claim involving an injury that also affects the corporation, so long as the injury affects the shareholder before the corporation. The special injury test, on the other hand, requires that the injury suffered by the shareholder did not also injure the corporation or any other shareholder in some cases.²⁰⁷ Between these two tests, the direct harm test leads to the most shareholder success in direct actions because it does not require that the injury or harm be something specific to the shareholder bringing the suit alone rather than all shareholders as a whole.

Between the direct harm test and the duty owed test, the results are very similar. In general, if a shareholder suffers a direct harm, it is because a special right owed to the shareholder, and not the corporation, was breached. However, Indiana, in its rejection of the direct harm test, argued that under this test it can be unclear whether there has been direct damage to the shareholders, the corporation, or both.²⁰⁸ This argument highlights the fact that, although the results are similar between the direct harm and duty owed tests, the duty owed test provides a clearer standard and avoids discrepancies that could occur when attempting to determine who truly was harmed and in which order.

Courts will most often accept claims as direct in either a direct harm or duty owed jurisdiction. This is because these tests do not contain the extra prong of total exclusivity that the special injury test requires.²⁰⁹ Between Delaware and Indiana, it is more likely that a suit will be direct in Indiana where the courts have created a new exception: if the claim involves a closely-held corporation, the judge may allow a claim to be direct even if a duty owed to the shareholder is not at issue.

Furthermore, among the three tests, the duty owed test creates the clearest distinction as to whether a claim is direct or derivative. It does not require an analysis involving the other tests, and its requirements are very clear. If something is clearly stated as a shareholder right in either the corporate bylaws, articles of incorporation, or in an agreement between the shareholder and the corporation, and that right is infringed, then a shareholder may sue directly.²¹⁰ This test allows foreseeability for shareholders when determining whether they can bring their action directly, and it creates the clearest standard for the courts in making this determination.

The tests used in Delaware and Illinois inquire whether a special injury or direct harm resulted.²¹¹ However, these inquiries are simply obscure ways of asking whether the defendant infringed upon a specific right of the shareholder. The arbitrariness of these tests is displayed by the fact that Delaware and Illinois have been unable to apply the direct harm and special injury tests without blurring the lines among all three tests.

206. See *supra* note 39 and accompanying text (stating that the direct harm test requires an inquiry into who was harmed first and foremost, the corporation or the shareholder).

207. See *supra* note 51 and accompanying text (explaining that some jurisdictions applying the special injury test require the injury not only to not affect the corporation, but also no other shareholders other than the one asserting the claim).

208. *G & N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227, 235 (Ind. 2001).

209. See *Small*, 713 N.E.2d at 1220 (stating that a special injury is one that is individual to the shareholder bringing suit alone).

210. *G & N Aircraft*, 743 N.E.2d at 235.

211. See *supra* notes 68, 117 and respective accompanying text.

Because Indiana is the only jurisdiction that has been able to apply its own test without relying on the language of the others, and because Indiana has effectively created a test based upon tangible and defined rights, this is the test that will lead to more efficient and error-proof inquiries. Also, by creating the *Barth* exception, Indiana allows shareholders in closely-held corporations to sue directly and avoid the procedural requirements of derivative actions when a judge deems them unnecessary.²¹² This allows for flexibility in the process and more shareholder success. Therefore, courts should apply the duty owed test as adopted in Indiana when determining whether a shareholder suit is direct or derivative.

V. CONCLUSION

Within the world of shareholder litigation, the distinction between direct and derivative causes of action is critical. The implications of this distinction are significant because a direct shareholder action allows a shareholder to sue on his or her own behalf and recover directly without first having to make demand on the corporate board. Because of this importance, it is necessary for courts to clearly state the requirements for a direct shareholder suit to allow for predictability in the process.

In regards to the three tests currently used in the United States to determine whether a shareholder suit is direct or derivative, the two that will lead to the most shareholder success are the direct harm and the duty owed tests. Although these tests involve different inquiries, in effect they lead to similar results. However, between the two, the duty owed test provides the clearest and most direct inquiry into whether a claim should be direct rather than derivative.

The direct harm test asks a vague question: who was harmed first? This requires an unclear and unguided analysis. Attorneys can craft many arguments as to why one entity was harmed before another, therefore weakening the form of analysis. The duty owed test, on the other hand, provides for a less arbitrary inquiry, an easier means for shareholders to make this determination before bringing suit, and an opportunity for courts to provide a clear analysis when making their decisions. Therefore, courts should apply the duty owed test to determine whether a cause of action is direct or derivative.

212. *See supra* notes 160–61 and accompanying text (explaining the *Barth* exception).