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Survival of Rights of Action After Corporate Merger

A corporation, like a natural person, may sue anyone who wrongs it, even its own officers or directors. When the corporate directors approve such legal action, the suit is deemed "primary."

1 When they do not approve, as might happen if a board member is the prospective defendant,2 one or more shareholders may be able to sue on behalf of the corporation.3 Such actions, devised by the equity courts,4 are termed "derivative."

Once a corporation ceases to exist, most courts permit neither

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1. The directors' approval is normally needed for primary suits. See United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); 2 W. Fletcher, Cyclopedia of the Law of Private Corporations § 535 (rev. vol. 1969).
2. The corporate officers, directors, and controlling shareholders are usually defendants in derivative suits, but an eligible shareholder may derivatively sue other parties who have wronged the corporation. But see Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746, 760 n.82 (1960) (arguing that the derivative suit is an improper procedure for claims against third parties).
3. In some circumstances, courts will not permit derivative suits. For example, if a disinterested board of directors, exercising reasonable business judgment, decides not to pursue an action, shareholders may not bring it derivatively. See, e.g., Ash v. International Business Machs., Inc., 353 F.2d 491, 492-93 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); Swanson v. Tracer, 240 F.2d 854, 858-59 (7th Cir. 1967); H. Ballantine, Ballantine on Corporations § 147 (rev. ed. 1946). Cf. Burks v. Lasker, 441 U.S. 471 (1979) (the decision of independent directors to terminate a nonfrivolous derivative suit is not inconsistent with the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 through -52 (1976)).
5. It is important to distinguish between corporate causes of action and personal (or direct) causes of action. When the basis of the suit is a wrong to the corporation, the cause of action is corporate; a shareholder may pursue such a claim only through a derivative suit. See, e.g., Press v. Marvalan Indus., Inc., 468 F. Supp. 1072, 1078 (S.D.N.Y. 1979). When the gravamen of the action is injury to a shareholder as an individual, he must pursue the action directly, not derivatively. See, e.g., Polakoff v. Delaware Steeplechase & Race Assn., 254 F. Supp. 574, 580 (D. Del. 1966); 13 W. Fletcher, supra note 1, § 5911 (rev. vol. 1976). See generally Note, Distinguishing Between Direct and Derivative Shareholder Suits, 110 U. Pa. L. Rev. 1147 (1962). The distinction is difficult to apply; there are "'borderline cases which are more or less troublesome to classify.'" Eisenberg v. Flying Tiger Line, Inc., 451 F.2d 267, 269 (2d Cir. 1971) (quoting 13 W. Fletcher, supra note 1, § 5911). Yet, the distinction is important, even for actions under the federal securities laws. See 13 W. Fletcher, supra note 1, § 5923.2. A table highlighting the differences between derivative and class suits is provided in Kennedy, Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study, 14 Hous. L. Rev. 769, 778-80 (1977). Class suits and derivative suits have important tactical differences: [A] derivative suit may be essential for rescission. And a derivative suit can have the important tactical advantage of relieving plaintiff from the cost of giving notice of pendency, which would fall on him in a class action, but such notice is not required in a derivative case. Moreover, a derivative suit does not have requirements like numerosity (which may be unattainable when the acquired company was closely held) and predominance of common questions over individual questions. Fed. R. Civ. P. 23(a)(1), (b)(3).
primary nor derivative suits to be brought in its name. If a merger precipitates that corporate demise, courts usually hold that standing to sue, like other assets of the "merged" corporation, passes to the surviving corporation. This Note ponders the merit of that rule of passage.

Section I categorizes the cases defining the rule of passage. Some courts have steadfastly adhered to the rule and denied standing to the merged corporation's shareholders. Other courts, fearing that the rule would preclude meritorious actions, have created exceptions allowing these shareholders to sue despite the merger. Unfortunately, no court has provided satisfactory criteria for determining

Nor does it permit opt outs . . . , which reduce potential recovery and settlement recovery and leverage.


6. This Note will not use "merger" in the technical sense of that term; rather, it will use the term to describe any transaction that unites two or more corporations into a single surviving corporation. Professor Conard has used the term "fusion" to express the same idea. See A. Conard, Corporations in Perspective § 119 (1976). The corporation that operates the business after the merger will be called the "surviving corporation" or "survivor." The corporation that ceases to exist because of the transaction will be called the "merged" corporation.

Although there are numerous variations, most corporate mergers follow three basic patterns. First, "statutory mergers" or "consolidations" are one-step joinders of two corporations into a surviving corporation by operation of state statutory law. See, e.g., ABA-ALI Model Bus. Corp. Act §§ 71-72 (1953). Second, in a "share exchange," one corporation trades some of its shares for all or most of the shares of the other, which then becomes a subsidiary. The parent then votes to merge the subsidiary into itself. See, e.g., ABA-ALI Model Bus. Corp. Act § 72-A (1953). Third, in a "sale of assets" substantially all assets of one corporation are exchanged with the survivor for cash, shares, or other property. The former corporation is then liquidated, and the cash, shares, or property are distributed to the shareholders of that corporation. (Sales of assets are not always followed by liquidation of the seller, but this Note will consider only those sales that are.) See, e.g., ABA-ALI Model Bus. Corp. Act § 79 (1953). See generally A. Conard, supra, § 119. See also I.R.C. § 368(a)(1)(A)-(C) (tax-free reorganizations).

Some courts attach great significance to the form of the merger. See, e.g., Hariton v. Arco Elec., Inc., 40 Del. Ch. 326, 182 A.2d 22 (Ct. Ch. 1962), affd., 41 Del. Ch. 74, 188 A.2d 123 (Sup. Ct. 1963). Other courts have been more flexible and have treated transactions that amount to a merger as mergers. See, e.g., Turner v. Bituminous Cas. Co., 397 Mich. 406, 244 N.W.2d 873 (1976). In treating the rule of passage some cases draw distinctions based on the form of the merger. See, e.g., Massachusetts cases cited in note 16 infra. In general, though, the different forms of merger have been, and should be, treated alike with regard to the issue of this Note. Compare, e.g., Schlick v. Castle, 19 F.R. Serv. 2d 642 (S.D.N.Y. 1974) (statutory merger), with Platt Corp. v. Platt, 21 A.D. 2d 116, 249 N.Y.S.2d 75 (1964), affd., 15 N.Y.2d 705, 204 N.E.2d 495, 256 N.Y.S.2d 335 (1965) (sale of assets). Both cases are discussed in notes 44-45 infra and accompanying text.

7. Rights of action of the surviving corporation pose no special problem. After the merger, the surviving corporation may pursue any claims it had before the merger. See 2 A. Bromberg, supra note 5, § 6.5(273).

I. CONTOURS OF THE RULE OF PASSAGE

A. The Rule of Passage, Applied Strictly

The rule of passage, as applied by a majority of courts, can be expressed as follows: After a merger, the merged corporation's rights of action vest in the surviving corporation, "which may bring suit thereon in its own name, and no right of action remains in the [merged] corporation." Courts have proposed three explanations for the rule. One is that it merely applies the statutory principle that assets of all kinds pass to the surviving corporation. A second ex-


10. Damages recovered in derivative suits are normally paid to the corporate treasury. See A. CONARD, supra note 6, § 249, at 395; Grenier, Pro Rata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Corporate Justice, 19 WASH. & LEE L. REV. 165, 165 (1962). A pro rata recovery, however, directly pays each stockholder a pro rata share of what would have been a corporate recovery. See note 5 infra. Furthermore, the derivative suit may have substantial advantages for the plaintiff over a class action. See note 5 supra.


For exemplary statutes, see DEL. CODE ANN. tit. 8, § 259(a) (Michie 1974); N.Y. BUS. CORP. LAW § 906(b)(2) (McKinney 1963). ABA-ALI MODEL BUS. CORP. ACT § 76(d) (1953) provides:

Such surviving or new corporation shall thereupon and thereafter possess all the rights,
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...planation, offered by the Eighth Circuit, is that corporate causes of action pass by common law as well as statute. Finally, in several cases involving sales of assets, courts have held that passage of the cause of action was a term of the sale agreement. In one case, for instance, the court held that where a sale agreement covered "all the assets, property, plant and business" of the selling corporation, those assets included a cause of action for waste of corporate property.

Whatever the authority for transferring the merged corporation's cause of action — statute, common law, or agreement — applying the rule of passage also denies the merged corporation's shareholders standing to maintain a derivative suit. Courts have given several explanations for this result. Some have denied derivative standing because the merged corporation, in whose name the shareholders sue, no longer owns the cause of action. For example, in Arnstein v.

13. See Sun Pipe Line Co. v. Altes, 511 F.2d 280, 283 (8th Cir. 1975); Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 741 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966). Since corporations are creatures of statute, the court's characterization of the rule of passage as one of common law seems anomalous. The court was extending to corporations the common law doctrine that tort claims vindicating property rights survive the death of the injured person.

14. Since state merger statutes apply only to formal statutory mergers, the sales agreement may control cases where the merger takes the form of a sale of assets. See generally note 6 supra.


17. These shareholders would have standing if they carried over as shareholders of the surviving corporation. See Gabhart v. Gabhart, 267 Ind. 370, 390-91, 370 N.E.2d 345, 357 (1977). But the suit would be on behalf of the surviving corporation, which, under the rule of passage, would succeed to the merged corporation's cause of action.

Bethlehem Steel Corp., the court reasoned:

Since whatever right of action the New Jersey corporation had against its directors passed to the Delaware corporation, the New Jersey corporation after the merger could not have instituted this action. Then it follows that if the corporation itself was barred because its right of action was transferred to another corporation, the stockholders of the New Jersey corporation were without derivative status.

Some courts have not even reached the question of who owns the claim. They have denied derivative suits because the merged corporation — the ultimate plaintiff — no longer exists, leaving no corporation on whose behalf the shareholders can sue derivatively. A derivative action might also fail under the “continued ownership” doctrine, which requires plaintiffs in derivative suits to own shares in the corporation throughout the litigation. Finally, courts have denied standing on the theory that dissenters’ rights statutes provide the exclusive remedy for aggrieved shareholders. Thus, strict app.
plication of the rule of passage precludes both primary and derivative actions in the merged corporation's name.

Nor can the surviving corporation be certain of its ability to bring an action that has passed from the merged corporation. As a primary suit, the surviving corporation may pursue the action unless it is itself the defendant. For derivative suits, one might suppose that, since the surviving corporation can bring a primary action, the surviving corporation's shareholders could bring a derivative action. But the contemporaneous-ownership rule (not to be confused with the continued-ownership rule) requires that derivative shareholder plaintiffs have been shareholders when the wrong occurred. Notwithstanding occasional contrary dicta, that rule limits stand-
ing to carryover shareholders of the surviving corporation: those who also held shares in the merged corporation when the challenged transaction occurred.\textsuperscript{31}

B. The Rule of Passage, with Exceptions

Many courts have found the destruction of opportunities to maintain derivative suits unduly harsh. Sensing possible inequities in giving corporate managers the power to destroy the derivative claims of minority shareholders, they have sought ways around the rule of passage. Some have found justifications for giving shareholders of merged corporations continued standing to maintain derivative suits. One has given those shareholders a new, direct action. But rare indeed is the case that offers standards for determining when an exception to the rule of passage is appropriate.

1. Cases Preserving Derivative Suits

Cases allowing shareholders of merged corporations to maintain derivative suits have offered three sources of authority: state statutes allowing continued corporate existence after a merger, the federal securities laws, and general powers of equity. The different techniques merit brief comparison.

If a corporation is a party to litigation when it is merged out of existence, substituting the surviving corporation might disrupt the litigation. Thus, most states have statutes permitting litigation to continue in the name of the merged party.\textsuperscript{32} Several courts have used these statutes to allow shareholders' suits to continue

\footnotesize{substantially identical to the federal rule). Nevertheless it seems that the "operation of law" language is designed principally for inheritances, not for mergers. Compare Phillips v. Bradford, 62 F.R.D. 681, 685 (S.D.N.Y. 1974), with Emporium Capwell Co. v. Anglim, 140 F.2d 224, 226 (9th Cir.), cert. denied, 322 U.S. 752 (1944) (transfer of stock in merger was not "by operation of law" for tax purposes). See generally Harbrecht, supra note 29, at 1057-60.

31. Carryover shareholders have even been permitted to pursue an action pending before the merger. For example, one Ninth Circuit case refused to allow a derivative action that shareholders had initiated before a merger, Niesz v. Gorsuch, 295 F.2d 909 (9th Cir. 1961), but a later opinion in the same case permitted shareholders of the surviving corporation to intervene as parties-plaintiff in the action. DePinto v. Provident Sec. Life Ins. Co., 323 F.2d 826, 832 (9th Cir. 1963), cert. denied, 376 U.S. 950 (1964). The court used the principle of relation back to avoid operation of the statute of limitations. See generally Albert v. Salzman, 41 A.D.2d 501, 504, 344 N.Y.S.2d 457, 461, appeal denied, 33 N.Y.2d 520, 352 N.Y.S.2d 1025 (1973) (intervention permissible in an action that had been dismissed); Platt Corp. v. Platt, 21 A.D.2d 116, 121, 249 N.Y.S.2d 75, 80 (1964), aff'd, 15 N.Y.2d 705, 204 N.E.2d 495, 256 N.Y.S.2d 335 (1965) (upon merger, substitution of new parties is permissible). See also Malcolm v. Cities Serv. Co., 2 F.R.D. 405, 407 (D. Del. 1942) (where plaintiff-representative in a class action sold her stock, other shareholders were entitled to notice before dismissal and to relation back to meet the statute of limitations); Richman v. Felmus, 8 A.D.2d 985, 190 N.Y.S.2d 920 (1959) (intervention allowed in a derivative suit only for those shareholders with contemporaneous ownership).

32. See note 22 supra.
after the merger. 33 For example, in Abrams v. Occidental Petroleum Corp., 34 a derivative action was pending when the corporation merged with another. The court relied on former California General Corporation Law § 4116, typical of these statutes, which provided:

Any action or proceeding pending by or against any constituent corporation may be prosecuted to judgment, which shall bind the consolidated or the surviving corporation, or the consolidated or surviving corporation may be proceeded against or substituted in its place. 35

Emphasizing that the survivor "may" be substituted, the court ruled that the pending cause of action need not abate or pass. 36 The Abrams exception to the rule of passage is quite narrow: it excepts only actions commenced before the merger. Moreover, some courts have further limited this exception to claims not against the surviving corporation. 37

Broader exceptions to the rule of passage are found in cases that rely on either the securities laws or general powers of equity. In Miller v. Steinbach, 38 an example of the cases resting on federal securities law, 39 the plaintiff had been a shareholder of the merged corporation. He sued that corporation's officers and directors for numerous violations of the federal securities laws. Federal Rule of Civil Procedure 17(b) provides that the law of the state of incorporation determines a corporation's capacity to sue in federal court; 40 yet the court held that "where an action is based on the federal securities


34. 20 F.R. Serv. 2d 170 (S.D.N.Y. 1975).

35. CAL. CORP. CODE § 4116 (West 1955), amended and recodified, CAL. CORP. CODE § 1107 (West 1977). The court also quoted DEL. CODE ANN. tit. 8, § 261 (Michie 1974), which is to the same effect.

36. 20 F.R. Serv. 2d at 173. Strangely enough, the Abrams court did not indicate who would receive the recovery.


laws, state substantive or procedural laws may not impede the application of the federal statute." 41 Consequently, the court disregarded the rule of passage, allowed the suit to proceed, and endorsed a pro rata recovery 42 for the shareholders of the merged corporation. 43

Other courts have used their equitable powers to create exceptions to the rule of passage. For example, the plaintiffs in *Schlick v. Castle*, 44 former shareholders of the merged corporation, sued its

The federal courts need not abide by state rules of standing or capacity in applying a federal statute. In *J.I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964), the Court stated that in administering the federal securities laws, the courts have a duty to "be alert to provide such remedies as are necessary to make effective the congressional purpose." Since federal law is supreme, U.S. CONST. art. VI, cl. 2, such remedies need not conform to state law. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478 (1977) ("[t]he existence of a particular state law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy . . . ."); note 25 *infra.* *Cf.* *Evmar Oil Corp. v. Getty Oil Co.*, [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,358, at 93,234 (C.D. Cal. 1978) (derivative antitrust claim under federal law).

Recently, however, the Supreme Court has become inclined to read the scope of the securities laws more narrowly. At one point in the development of federal securities jurisprudence, it seemed that the broad scope of those laws would obviate the need for significant reliance on the not-as-liberally-applied state-law theories. Professor Loss observed in 1969 that "the implication of a private action under Rule 10b-5 has already displaced and federalized a great deal of state law, not only in the area of deceit but also with respect to the duties of officers and directors to the corporation and its stockholders." 6 L. Loss, SECURITIES REGULATION 3870 (2d ed. Supp. 1969).

It is now clear that those laws will not displace the state law of fiduciary obligation. In denying a claim that a squeeze-out merger violated rule 10b-5, the Supreme Court held that the rule does not amount to a "federal fiduciary principle." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977). The *Santa Fe* ruling will force some plaintiffs who might formerly have brought federal-securities-law actions to seek redress under state law. *Cf.* *Cort v. Ash*, 422 U.S. 66, 78 (1975) (state remedies are considered in deciding whether to imply a private right of action under a federal statute).


42. See note 55 *infra.*


Policy and equitable considerations weigh heavily in favor of rather than against the conclusion that the causes of action against the defendants did not become obliterated by the merger of the wronged corporation into another corporation. To hold that a merger would have the effect of destroying such causes of action would be tantamount to paving the way for deliberate corporate pillaging by management and then for the immunization
former directors and the surviving corporation, asserting violations of federal securities laws and state fiduciary obligations. Judge Frankel refused to apply the rule of passage to deny the merged corporation's shareholders the opportunity to sue: "It seems incongruous and inequitable that former directors and the surviving corporation should be immune from suit for fraud in a merger because the merged corporation in technical terms no longer exists, when the fraud under attack was the very means by which the merged corporation's existence was ended."\footnote{Note: Footnotes are not included in the natural text representation.}

2. A Case Creating a Direct Shareholder Action

In general, when a corporation has suffered injury, shareholders lack standing to sue directly, either as individuals or as a class. They must sue derivatively on behalf of the corporation.\footnote{See note 5 supra.} In *Kirk v. First National Bank*,\footnote{47. 439 F. Supp. 1141 (M.D. Ga. 1977).} a federal district court departed from that rule and allowed former shareholders of a merged corporation to sue directly on corporate claims. The shareholders of Wright Contracting Company had sold their shares in response to a tender offer by the Hardaway Company. Subsequently, the former Wright shareholders discovered that their ex-president had violated his fiduciary duties.

The plaintiffs conceded they lacked standing to sue derivatively on the corporate claim against the ex-president, and sued directly instead. The court recognized that the claim belonged to the corporation and therefore that the shareholders could normally bring it only derivatively. Nevertheless, the court allowed a direct suit be-
cause it found that none of the dangers motivating the requirement of a derivative claim were present. According to the court, the dangers of allowing a direct action are: (1) recovery by a party not actually injured; (2) multiple lawsuits; and (3) prejudice to creditors and unrepresented shareholders. The court first noted that the plaintiffs had actually been harmed: because of the undiscovered breach of fiduciary duty, they had not received fair value for their shares. Second, no additional lawsuits were possible since all shareholders of the Hardaway Company, the surviving corporation, lacked contemporaneous ownership. Finally, the court determined that an individual suit would not seriously prejudice corporation creditors or unrepresented former shareholders.

By allowing a direct suit on a corporate claim, Kirk dramatically departs from traditional corporate principles. Even the cases relying solely on equitable powers to circumvent the rule of passage have heeded the distinction between direct and derivative actions. Kirk thus highlights both the frustration courts have felt with the rule's equitable exceptions with the related doctrines of corporate law.

3. Gabhart and the Quest for Standards

While each of these justifications for evading the rule of passage has allowed courts to achieve intuitively attractive results, none by its logic offers a principled explanation of when the exception should or should not apply. Criteria are needed for determining when an

49. See note 29 supra and accompanying text.
50. The court reasoned that no prejudice to the creditors would result because the corporation would not have been able to recover regardless of this suit. As to other former shareholders, the court argued that any prejudice would be no more serious than that in a typical class action.
51. Independent Investor Protective League v. Time, Inc., 66 A.D.2d 391, 412 N.Y.S.2d 898 (1979), also merits mention. The court allowed the merged corporation's former shareholders to initiate a direct action to redress mismanagement that had occurred before the merger. The mismanagement claim — unlawful depression of stock value by the directors — should have been deemed derivative, but unlike Kirk, this court did not describe the claim as derivative.

One inexplicable case allowing an individual claim is Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969), modified, 478 F.2d 1281 (2d Cir. 1973). The court argued that "when a corporation becomes non-existent" because of a merger, "the corporate right to sue devolves upon the shareholders" of the defunct corporation. 298 F. Supp. at 102. The court cited Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), and Bacon v. Robertson, 59 U.S. (18 How.) 480 (1856), but both are readily distinguishable: In Vine, the court allowed a class action since only the Class A shareholders had been injured, and Bacon involved not a merger but a dissolution. A true dissolution (as opposed to, e.g., a sale of all assets followed by a dissolution in order to effectuate a merger, see note 6 supra) requires an altogether different analysis. In a dissolution, the enterprise comes to an end. There is no "surviving" enterprise to which the right to sue could pass. Since the authority that it cites is not supportive, the statement by the Gerstle court is of dubious validity.
52. Two recent cases have acknowledged the need for equitable exceptions without sug-
exception is proper. The Indiana Supreme Court recently addressed this problem in *Gabhart v. Gabhart*. The court acknowledged that the rule of passage generally controls, but relied on equitable considerations to carve out an exception:

[A] Court of Equity may grant relief, pro rata, to a former shareholder, of a merged corporation, whose equity was adversely affected by the fraudulent act of an officer or director and whose means of redress would be cut off by the merger, if there is no shareholder of the surviving corporation eligible to maintain a derivative action for such wrong and said shareholder had no prior opportunity for redress by derivative action against either the merged or the surviving corporation.

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*Gabhart* properly recommended pro rata recovery for plaintiffs.
falling within the exception, but it defined the exception too nar-
rowly. Principally concerned with the derivative suit's deterrent
function,56 the court wanted only to guarantee that some party
would be eligible to bring suit. Accordingly, the exception applies
only when no shareholder of the surviving corporation can main­
tain the suit derivatively on behalf of the survivor and no share­
holder of the merged corporation had a prior opportunity to bring the claim.57
Yet a derivative suit is more than a deterrent. It also compensates
wronged shareholders. The next Section develops standards for excep­
tions to the rule of passage that reflect both the compensatory and
deterrent functions of derivative suits.

II. CRITERIA FOR EXCEPTIONS TO THE RULE OF PASSAGE

The courts have failed to develop adequate standards for decid­
ing the scope of the rule of passage. Indeed, some courts have not
even considered that exceptions may be proper, but instead have ap­
plicated the rule of passage mechanically, denying standing to the
merged corporation's shareholders.58 Those courts may have over­
looked the importance of the derivative actions they were thwarting.
Derivative suits, a minority shareholder's principal defense against
majority abuses,59 serve two important policies. First, they compe­
sate the corporation for wrongs suffered,60 giving redress that may be
an important asset of the corporation.61 Second, they deter miscon­
duct by the corporate management, such as violations of fiduciary

indispensable party, see, e.g., Tryforos v. Icarian Dev. Co., 518 F.2d 1258, 1264 (7th Cir. 1975),
cert. denied, 423 U.S. 1091 (1976), should also be excused. Since the federal courts are to
apply the indispensable party rule in "equity and good conscience," Fed. R. Civ. P. 19(b),
strict adherence to the joinder and service requirements is not necessary. See Weinert v. Kinkel,
(Del. Ch. 1978) (denying service of process on a merged corporation).

56. The court expressed "concern . . . that when the cause of action is against directors or
majority shareholders, the wrongdoers may insulate themselves from liability by means of a
merger." 267 Ind. at 390, 370 N.E.2d at 357. The court did not mention protection of minority
shareholders' investments as a basis for its exception.

57. The court based its reasoning on the vicarious incapacity principle, which provides that
a corporation may not sue on a claim if none of its shareholders are eligible to pursue that
claim derivatively. See text at note 74 infra. Thus, the court assumed that if none of the
surviving corporation's shareholders had contemporaneous ownership, the survivor itself
would be ineligible to sue. But see text at note 77 infra.

58. See, e.g., Niesz v. Gorsuch, 295 F.2d 909 (9th Cir. 1961).


60. Derivative suits are sometimes misused by shareholders who bring specious actions in
the hope of obtaining a quick and lucrative settlement from the corporate treasury. Such
"strike suits" naturally harm, rather than compensate, the corporation. See Blue Chip Stamps
U.S. 541, 548 (1949); F. Wood, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVA-
TIVE SUITS (1944).

Courts should not apply the rule of passage in disregard of those policies. Derivative suits are creations of equity, and equitable principles should dictate exceptions to the rule of passage when necessary to achieve an equitable result. Unfortunately, the equitable result is often hard to ascertain. Standards are needed if judges are to reach consistent results and if those affected are to be able to predict the legal outcome. This Section proposes such standards for exceptions to the rule of passage. The proposed standards examine the relationship between the prospective defendant and those managing the merging corporations. For claims against parties at arm's length from either corporation's management, courts should apply the rule of passage. However, if the potential defendant is closely associated with the management of both corporations, the action should not pass, and the merged corporation's shareholders should be permitted to pursue the defendant derivatively.

A. Claims Against Parties at Arm’s Length from the Merged Corporation’s Management

The principal justification for the rule of passage is that it enforces the intent of the merging corporations. They have presumably agreed to pass the action and have ordered their risks and prices accordingly. One can fairly assume that the parties to a merger intend all assets of the merged corporation that are not explicitly

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62. Brendle v. Smith, 46 F. Supp. 522, 526 (S.D.N.Y. 1942); Rostow, To Whom and For What Ends is Corporate Management Responsible?, in THE CORPORATION IN MODERN SOCIETY 48 (E. Mason ed. 1959). Fiduciary breaches and unauthorized actions can often be remedied through derivative suits. In Dykstra, The Revival of the Derivative Suit, 116 U. PA. L. REV. 74, 77-78 (1967), Professor Dykstra listed “instances in which shareholders successfully challenged or stated good causes of action.” These were actions for excessive salaries, the issuance of stock for no or insufficient consideration, diversion of corporate business opportunity, misapplication of funds, secret profits, excessive stock options, violations of contractual arrangements, improper individual claims as opposed to corporate claims for surrender [sic] shares, the unlawful purchase by a corporation of its own securities, illegal payment for shares in another corporation, sale of control, improvident loans and the abuse of a subsidiary by the parent. Id. Shareholders may also bring derivative suits under the federal securities laws. See 13 W. FLETCHER, supra note 1, § 5923.2 (rev. vol. 1970).

In some cases, though, indemnity agreements or insurance may undercut the deterrent function of derivative suits. See generally W. Knepper, LIABILITY OF CORPORATE OFFICERS & DIRECTORS §§ 16-17 (1969); G. Washington & J. Bishop, Indemnifying the Corporate Executive (1963).

63. See note 4 supra and accompanying text.

64. This Note will use the term “management” to describe those persons who control the merged corporation. Officers, directors, and principal shareholders are prime candidates for the management. However, a director who has a conflict of interest will not always infect the corporation’s decisionmaking. See, e.g., Burks v. Lasker, 441 U.S. 471 (1979). Control would be a factual issue in each case.

65. Courts have found several sources of legal authority for the rule. See text at notes 11-16 supra. This Section discusses equitable concerns that determine when the rule should apply.
excepted to pass to the survivor. Thus, the parties would negotiate over a cause of action like any other asset during price negotiations. They would similarly bargain for undiscovered causes of action, realizing that latent assets and liabilities may surface after the merger. Absent an agreement to the contrary, the surviving corporation bases its purchase price on an assumption that it can sue on later-discovered causes of action. Similarly, in accepting the offer, the merged corporation assumes the risk of losing valuable causes of action. In this risk allocation, the merged corporation surrenders its rights of action to the survivor whether or not such rights are apparent at the time of merger.

That justification for the rule of passage supports the rule's consistent application — and the corresponding impairment of derivative standing — when a claim's potential defendant is at arm's length from the merged corporation's management. In such a case, the

66. In effect, the surviving corporation purchases the assets of the merged corporation in any type of merger, since it surrenders cash, stock, or other property to the merged corporation or its shareholders. See generally note 6 supra. If the parties do not intend that all assets pass, they may except an asset, such as a cause of action, from the passage. See note 44 supra.

67. Indeed, some causes of action are so integrally connected with other assets that it would be senseless to distinguish them. For example, when the surviving corporation bargains to acquire accounts receivable, it is likewise bargaining for the right to enforce those receivables in litigation.

68. Some commentators attack the bargain justification as fictional. See Rosenfeld v. Black, 336 F. Supp. 84, 91 (S.D.N.Y. 1972); The Supreme Court, 1973 Term, 88 HARV. L. REV. 13, 235 n.51. They do so because the notion that the survivor can bargain for latent causes of action troubles them. Their objection is answered, though, by viewing the bargain as a risk allocation.

69. A second, though less significant, justification for the rule of passage is that it may be more efficient to charge a going concern with prosecuting a lawsuit than to prolong the corporation's life for purposes of litigation. The active management of the survivor can probably better make the necessary discretionary decisions during the litigation.

Other justifications for the rule are less forceful. Some have argued that it would be difficult to locate former shareholders of a publicly held corporation so as to allow them to recover. But with computerized records, this obstacle is insignificant. See Rosenfeld v. Black, 336 F. Supp. 84, 91 (S.D.N.Y. 1972); The Supreme Court, 1973 Term, supra note 68, at 235 n.51. Another argument for passage is that since the plaintiff-corporation no longer exists, it may not sue, and, thus, the action should pass to a party able to do so. Such an argument was rejected in Marco v. Sachs, 201 Misc. 934, 936-37, 109 N.Y.S.2d 226, 228-29 (Sup. Ct. 1951), aff'd, 279 A.D. 1085, 113 N.Y.S.2d 449 (1955), aff'd, 304 N.Y. 912, 110 N.E.2d 737 (1953), based on a continued-corporate-existence statute. See note 22 supra. But even if such a statute does not apply, the argument is weak for its rigid formalism. In light of the possibility of pro rata recovery, see note 55 supra, the practical barriers to allowing a suit by a defunct corporation can be surmounted.

70. Arm's-length status would need to be judged on the facts of each case. The term "arm's length" has no magical significance here; the essential inquiry is whether the merged corporation's management has a personal or financial interest in seeing the litigation resolved in favor of the defendant. Alternatively phrased, one might ask whether the management exercises independent judgment regarding the merits of the suit and acts on that judgment.

The problem of defining arm's-length relationships arises in various other legal settings. For examples of how Congress has handled it, see I.R.C. § 267 (disallowance of losses, etc. between related taxpayers); 11 U.S.C.A. § 101(25) (West Supp. 1979) (definition of "insider" in Bankruptcy Act). Cf. note 89 infra (arm's-length concept used in defining "complete fairness").
directors of the merged corporation should adequately represent the
corporation's interest in the claim. Free from any conflicting motive,
the management will exact fair consideration from the survivor for
conveying the action, thus reimbursing the corporation's shareholders
for their loss.

For example, suppose Mr. Welsh has sold defective equipment,
under warranty, to \( M \) Corporation. Suppose further that the directors of \( S \) Corporation and \( M \) Corporation negotiate a merger: \( S \) will
survive and \( M \)'s shareholders will receive \$100 for each share of \( M \).
If \( M \)'s directors are at arm's length from Welsh, then, upon comple­
tion of the merger, the right to bring an action for breach of war­
ranty should pass from \( M \) to \( S \). This result is fair, because in paying
\( M \)'s shareholders for their stock, \( S \) purchases and \( M \) sells the right
to sue Mr. Welsh, just as \( S \) purchases and \( M \) sells the other assets of
\( M \). On these facts, the rule of passage sensibly presumes that the
\$100 per share sufficiently compensates \( M \)'s shareholders for losing
this right of action, since the disinterested business judgment of \( M \)'s
directors is presumptively valid. 71

Although this analysis establishes the general desirability of the
rule of passage when the merged corporation's management is at
arm's length from the defendant, two specific situations deserve fur­
ter attention. The first arises when the surviving corporation is the
defendant. If the cause of action passes in that case, the surviving
corporation will be unwilling and, indeed, unable to pursue it: a cor­
poration may not sue itself. 72 The survivor's only motive for paying
fair value for the claim would be to settle it. If the parties are at
arm's length it makes good sense to assume that they do in fact nego­
tiate a settlement.

A second special problem arises in some mergers due to the
vicarious incapacity principle, which states that a corporation may
not sue if none of its shareholders is eligible to bring a derivative
suit. The principle originated in Home Fire Insurance Co. v. Bar­
er, 73 where Dean Roscoe Pound, then a commissioner of the Ne­
braska Supreme Court, argued that if the stockholders “have no
standing in equity to entitle them to the relief sought for their bene­
fit, they cannot obtain such relief through the corporation or in its
own name. . . . It would be a reproach to the courts of equity if this

71. “[T]he law will not hold directors liable for honest errors, for mistakes of judgment,
when they act without corrupt motive and in good faith . . . . And that is true even though the
errors may be so gross that they demonstrate the unfitness of the directors to manage the
72. See note 27 supra.
73. 67 Neb. 644, 93 N.W. 1024 (1903).
were not so." 74 At least one court has applied this principle to hold that if none of a corporation's stockholders meets the contemporaneous-ownership requirement, 75 the corporation itself may not sue. 76

But when a merger involves no carryover shareholders, application of the contemporaneous-ownership and vicarious incapacity rules seems to subvert the rule of passage by passing the action to a party unable to bring it. Returning to the previous example, suppose that M Corporation, which has a right of action against Welsh, sells all its assets (including rights of action) to S Corporation. If none of M's shareholders carries over as a shareholder of S, so that none of S's shareholders satisfies the contemporaneous-ownership requirement, Welsh might argue that the vicarious incapacity principle bars the suit by S. Yet such an application of vicarious incapacity would be improper, since it would not advance the purpose of the contemporaneous-ownership requirement: to avoid unjustly enriching parties who suffered no harm. 77 When a merger conveys causes of action, the negotiated price reflects any anticipated recovery, and no unjust enrichment occurs.

B. Claims Against Parties Within Arm's Length of the Merged Corporation's Management

Directors, officers, and principal shareholders are liable to their corporation for breaches of fiduciary duty. When such breaches occur, innocent shareholders may sue derivatively to recover damages for the corporation. The guilty parties certainly should not be able to use their authority or influence in the corporation to compromise such rights of action and escape personal liability. 78

Nevertheless, a merger may present an opportunity for the merged corporation's management to insulate itself or some close associate 79 from liability. 80 If a right of action against the merged cor-

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75. See text at note 29 supra.
77. The requirement does have other purposes. Most notably, it has been used to combat strike suits and collusive efforts to acquire diversity of citizenship. The irrelevance of those purposes to mergers is demonstrated in Note, Corporate Incapacity to Sue Where Stockholders Would Be Barred from Suing Derivatively — The Vicarious Incapacity Exception, 54 B.U. L. Rev. 355, 374-77 (1974). The Note concludes that "it is not necessary to mechanically apply the vicarious incapacity rule; it is feasible for a court to apply the rule only when the purpose of preventing unjust enrichment is actually advanced." Id. at 377.
79. Although this Subsection's textual discussion is limited to the most egregious situation — where the merged corporation's management is itself the defendant — the analysis extends easily to all situations where the defendant is not at arm's length from the merged corporation's management. See note 70 supra.
poration's management passes to the surviving corporation, a new party will have responsibility for pursuing the claim to judgment. The guilty management may find the surviving corporation a more agreeable adversary than its own shareholders: if the survivor has a close relationship with the management, it may hesitate to pursue the action vigorously.

Allowing the guilty management to insulate itself from liability through a merger undermines both purposes of derivative suits: deterrence of misconduct and compensation for injury. For example, suppose that Clytemnestra is the chairman of the board and majority shareholder of Mu Corporation, and she has profited by appropriating a corporate opportunity. Minority shareholder Agamemnon is a potential plaintiff in a derivative action against Clytemnestra requiring her to account to the corporation for her profits. While Agamemnon journeys to the courthouse to file a suit, Clytemnestra sells all of Mu Corporation's assets to Sigma Corporation, which is controlled by her housemate, Aegisthus. Immediately after the sale, Mu Corporation is liquidated. If the cause of action against Clytemnestra passes to Sigma Corporation by this merger, Clytemnestra will escape liability and Agamemnon will probably not be compensated.

These circumstances pose a classic case for an exception to the rule of passage. The example suggests that reference to the law of fiduciaries' conflicts of interest may aid in defining such an exception. Courts usually defer to the business judgment of corporate officers and directors. But when those fiduciaries have adverse interests, such as personal contracts with the corporation, their business judgment on that matter is presumed invalid.

While courts have applied various standards in analyzing conflict of interest transactions, the modern trend is to judge them by a "complete fairness" test. For example, in *Hirshfield v. Briskin*, the possibility that appraisal would provide adequate compensation is discussed in the text at notes 108-16 infra. The example is couched in terms of a cause of action that predates the merger. The analysis that follows, however, applies equally well when the cause of action arises out of the merger.

81. See text at notes 59-62 supra.
82. Agamemnon was excusably delayed on his way to the courthouse. See generally AESCHYLUS, AGAMEMNON in 1 GREEK TRAGEDIES (R. Lattimore trans. 1960). Compare E. O'NEILL, Mourning Becomes Electra (1931).
83. See note 6 supra.
84. The possibility that appraisal would provide adequate compensation is discussed in the text at notes 108-16 infra.
85. The example is couched in terms of a cause of action that predates the merger. The analysis that follows, however, applies equally well when the cause of action arises out of the merger.
86. See note 71 supra.
87. See Note, 61 HARV. L. REV. 335 (1948).
88. See 3 W. FLETCHER, supra note 1, § 921 (rev. vol. 1975). Such conflicts render the transaction voidable by the corporation. See id. § 913.
89. See H. HENN, supra note 9, § 238, at 467. Professor Henn characterizes the modern fairness test as follows: "Would an independent corporate fiduciary in an arm's length bargain
the controlling stockholders of Briskin Corporation approved a cor-
porate loan to another corporation that they personally controlled.
Upon default, the minority shareholder of Briskin sued the control-
ling stockholders derivatively for breach of fiduciary duty. Since the
defendants' personal interests conflicted with their fiduciary duties,
the court imposed liability for damages "unless defendants succeed
in 'overcoming the presumption against the validity of the transac-
tion by showing its fairness.' " 91

When the management or a close associate is the potential de-
fendant in an action by a merged corporation, the management has a
similar conflict of interest. As corporate officers, they seek recovery;
as individuals, they seek immunity. Because the management's
judgment on a merger might be tainted by this conflict, courts should
determine whether passage of the action to the surviving corporation
treats the shareholders with complete fairness. If not, the action
should not pass.

Complete fairness turns on whether the merged corporation sells
its right of action to the survivor for a fair price. 92 Unfortunately,
direct determination of the price's fairness is speculative and cum-
bersome. Parties to mergers do not specify how much is paid for
causes of action, and courts have no simple way to calculate that
amount. 93 Furthermore, it would be unwieldy to review the fairness
of the entire merger any time such a right of action were involved. 94
Yet the complete fairness test need not be cast aside. A court can
estimate the fairness of the purchase price by examining the relation-
ship between the potential defendant and the surviving corporation.
One can expect the survivor to bring legitimate claims that it ac-
quires, as long as it is at arm's length from the defendant. 95 And if the
survivor is apt to bring the action, the parties to the merger will ne-
gotiate a fair price for that asset. 96 Therefore, a court can presume

90. 447 F.2d 694 (7th Cir. 1971).
91. 447 F.2d at 697 (quoting Schlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 280-
81, 166 N.E.2d 793, 800 (1960)).
92. See Comment, Going Private — Juggling Shareholder Protection with Corporate Flexi-
bility: Will the States Drop the Ball?, 1978 Wis. L. Rev. 797, 807.
93. Even if such an allocation were possible, causes of action are notoriously difficult to
value. And the problem is particularly acute when the valuation is not of a particular cause of
action, but of a latent cause of action. See generally text at note 68 supra.
94. Such a view would undermine the business judgment rule. See note 71 supra. A
shareholder would thereby be able to force a review of the fairness of any merger by bringing a
suit, however specious, against the directors of the merged corporation.
95. Note that this test — whether the survivor is at arm's length from the defendant —
differs from the one presented earlier — whether the merged corporation's management is at
arm's length from the defendant. See note 70 supra.
96. This assumption merits brief elaboration. One might think that the manager-defend-
ant in the merged corporation would agree not to extract fair value from the survivor, in
that the survivor paid fair value for claims against parties at arm's length. On the other hand, the survivor will not sue parties with whom it has a close relationship and accordingly will not pay fair value for claims against such parties.\textsuperscript{97} In those cases, the merged corporation's shareholders will not be compensated for their loss.

Illustratively, reconsider the hypothetical in which Clytemnestra appropriated Mu Corporation's opportunity.\textsuperscript{98} Recall that Aegisthus, who controls the surviving Sigma Corporation, is the housemate of Clytemnestra, who controls the merged Mu Corporation. Since Clytemnestra and Aegisthus are not at arm's length, Sigma Corporation — controlled by Aegisthus — is unlikely ever to sue Clytemnestra for the wrongful appropriation. Thus, Sigma Corporation has no reason to pay fair value for the claim,\textsuperscript{99} and the liquidation payment to Agamemnon (a minority shareholder of the merged corporation) will not include fair consideration for his surrender of the cause of action.\textsuperscript{100} Agamemnon will only be compensated if he may pursue his claim despite the merger.

To summarize briefly, when the prospective defendant is not at arm's length from the \textit{merged} corporation's management, that management faces a conflict of interest. The outcome of such merger cases should be determined, as in other conflict-of-interest cases, by the standard of complete fairness. But a conventional approach to complete fairness — direct evidence of the adequacy of the purchase price — is cumbersome. Instead, courts should gauge fairness by looking to the relationship between the prospective defendant and the \textit{surviving} corporation. If those parties are at arm's length, the court should presume\textsuperscript{101} that complete fairness has been achieved and should apply the rule of passage. If they are not at arm's length, the court should create an exception to the rule of passage and let the

\textsuperscript{97} Cf. text at note 72 \textit{supra} (claims against the survivor).
\textsuperscript{98} See text at notes 82-84 \textit{supra}.
\textsuperscript{99} One could theorize that Aegisthus, via Sigma Corporation, has settled the claim with Agamemnon. As a practical matter, however, Agamemnon would probably not even be represented in the merger negotiations, so it is specious to say that Agamemnon has consented to a settlement.
\textsuperscript{100} Commentators have recognized that in situations of this type, the offered price is probably inadequate. Bradney & Chirelstein, \textit{Fair Shares in Corporate Mergers and Takeovers}, 88 \textit{Harv. L. Rev.} 297, 298 (1974); Comment, \textit{supra} note 92, at 807.
\textsuperscript{101} Because of the problems involved with allowing other types of proof, see notes 93 & 94 \textit{supra} and accompanying text, this presumption should be conclusive, not rebuttable.
shareholders of the merged corporation sue derivatively for damages.\textsuperscript{102}

\section*{C. \textit{Inadequate Alternatives to the Exception}}

Some courts have argued that alternative shareholder remedies render exceptions to the rule of passage unnecessary.\textsuperscript{103} They have pointed first to the possibility of direct attack on the merger. Non-consenting\textsuperscript{104} shareholders may be able to bring a direct suit against an illegal merger, seeking damages or injunctive relief.\textsuperscript{105} Fraud, bad faith, and lack of authority are well accepted as sufficient grounds for illegality.\textsuperscript{106} But suits based on illegality offer shareholders insufficient protection: a merger that causes hardship to some shareholders may nonetheless be legal.\textsuperscript{107} Thus, the opportunity for direct attack may be no opportunity at all.

Nor should the second alternative remedy, appraisal, preclude an exception to the rule of passage. Nearly all jurisdictions have dissenters' rights statutes authorizing shareholders who dissent from a merger to demand that the surviving corporation purchase their shares at fair market value, as determined by an appraiser.\textsuperscript{108} In theory, those statutes fully protect minority shareholders, since the

\begin{itemize}
\item \textsuperscript{102} Recovery would be on a pro rata basis. \textit{See} note 55 \textit{supra}.
\item \textsuperscript{103} \textit{See}, e.g., Gabhart v. Gabhart, 267 Ind. 370, 392, 370 N.E.2d 345, 358 (1977) (exception unavailable if shareholder had a "prior opportunity for redress").
\item \textsuperscript{104} In general, a corporation may not merge without the approval by vote of at least a majority of its shareholders. 15 W. FLETCHER, \textit{supra} note 1, § 7063 (rev. vol. 1973). Unless there is fraud, shareholders who have voted in favor of the merger may not question its validity. \textit{Id.} § 7146.
\item The opportunity to vote on a merger is not itself sufficient to protect each shareholder's investments. A controlling group could force an unfavorable agreement on the minority shareholder. Dissenters' rights statutes, designed to remedy this problem, are discussed in the text at notes 108-16 \textit{infra}.
\item \textsuperscript{105} \textit{See} 15 W. FLETCHER, \textit{supra} note 1, §§ 7157 (suit allowed), 7158 (injunctive remedy), & 7162.1 (damage remedy) (rev. vol. 1973).
\item \textsuperscript{106} \textit{Id.} § 7160. Though some courts have considered these shareholder suits to be derivative, \textit{see}, e.g., Lieferant v. Bartell, 36 Misc. 2d 477, 232 N.Y.S.2d 1003 (Sup. Ct. 1962), the better view treats them as personal rights. \textit{See} Eisenberg v. Flying Tiger Line, Inc., 451 F.2d 267 (2d Cir. 1971); H. BALLANTINE, \textit{supra} note 3, § 143, at 356-37; 15 W. FLETCHER, \textit{supra} note 1, § 7158 (rev. vol. 1973); 3B MOORE'S FEDERAL PRACTICE § 23.1-41 (1976). Treating such a claim as derivative would raise the very problem this Note addresses.
\item \textsuperscript{107} \textit{See} Gabhart v. Gabhart, 267 Ind. 370, 392, 370 N.E.2d 345, 357-58 (1977). For example, a merger may improve the company's profitability and thus have a legitimate motive, even though its effect is to squeeze out shareholders at an unfair price.
\item \textsuperscript{108} F. O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS § 5.27, at 326. \textit{See}, e.g., ABA-ALI MODEL Bus. CORP. ACT § 80 (1953), which provides, in part: Any shareholder of a corporation shall have the right to dissent from any of the following corporate actions:
\begin{itemize}
\item \textsuperscript{a} Any plan of merger or consolidation to which the corporation is a party; or
\item \textsuperscript{b} Any sale or exchange of all or substantially all of the property and assets of the corporation not made in the usual and regular course of its business, including a sale in dissolution, but not including a sale pursuant to an order of a court having jurisdiction in the premises or a sale for cash on terms requiring that all or substantially all of the net
appraiser is expected to weigh every item of value, including corporate causes of action, in deciding the worth of the dissenter's stock. Consequently, some courts have held appraisal to be the exclusive post-merger remedy for minority shareholders.

To see the error in that approach, one must recognize that appraisal is not an exclusive remedy in other contexts. Courts have consistently denied the exclusivity of appraisal when a federal securities claim is involved. And even for state law claims, the law on the strictness of the exclusivity is inconsistent. One court commented:

[T]here is no agreement among the authorities ... Some authorities appear to say that the statutory remedy of appraisal is exclusive. ... Others say that it may be disregarded and that equity may intervene if the minority is treated oppressively or unfairly, ... or if the merger is tainted with fraud or illegality.

But even if a state's law does make appraisal an exclusive remedy, a court should not construe it to mandate universal application of the rule of passage. First, causes of action are particularly hard to value, since recovery is speculative. Second, legislatures enacted appraisal statutes principally to eliminate injunctive suits that may delay the mergers; allowing the merged corporation's shareholders proceeds of sale be distributed to the shareholders in accordance with their respective interests within one year after the date of sale.

(c) Any plan of exchange to which the corporation is a party as the corporation the shares of which are to be acquired.

Section 81 of the Act outlines the procedure involved in electing the appraisal remedy.


110. See e.g., Loeb v. Shenley Indus., Inc., 285 A.2d 829, 830 (Del. Ch. 1971); Beloff v. Consolidated Edison Co., 300 N.Y. 11, 87 N.E.2d 561 (1949) (under a state statute now superseded, the court held the remedy to be exclusive even though it recognized that the appraisal did not in fact include the value of the cause of action). Cf. Albert v. Salzman, 41 A.D.2d 501, 505, 344 N.Y.S.2d 457, 461-62, appeal denied, 33 N.Y.2d 520, 352 N.Y.S.2d 1025 (1973) (remedy of accounting for gain received by the survivor is unavailable due to availability of appraisal). But cf. N.C. GEN. STAT. § 55-113(b) (1975) (appraisal remedy is "[i]n addition to any other right he (the shareholder) may have in law or equity").

111. See note 25 supra and accompanying text.


113. Accountants, recognizing the difficulty of such valuations, often relegate discussions of litigation to the footnotes of financial statements. See generally 3 AICPA PROFESSIONAL STANDARDS (CCH) §§ 4311-33 to -39, 4311-1 (FASB Statement No. 5, Appendix A and Interpretation No. 14). See also F. O'Neal, supra note 108, § 2.16.

114. At one time, unanimous consent of shareholders was required for merger. As corporations grew larger, this restriction seriously hindered mergers. To remedy the problem states...
a pro rata action for damages does not cause such a delay. Third, even if appraisal adequately compensates the shareholders, the rule of passage can destroy much of the derivative suit's deterrent value because the surviving corporation, not the defendant, bears the cost. Finally, some commentators have challenged the efficacy of appraisal in any context. In sum, neither appraisals nor direct attacks obviates the need for an exception to the rule of passage.

CONCLUSION

Courts have struggled with the rule of passage. Though they have often reached just results, no court has developed a fair and generalized standard for determining when the rule should and should not be applied. This Note has proposed such a standard. To decide whether a particular claim should pass by merger, one must answer two questions: (1) Does the merged corporation's management deal at arm's length with the prospective defendant? and (2) Does the surviving corporation deal at arm's length with the prospective defendant? If the answer to either question is "yes," the claim should pass to the surviving corporation. If the answer to both questions is "no," the action should not pass. Instead, the former shareholders of the merged corporation should be entitled to sue for damages in a derivative suit.