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# Corporations -- Shareholders' Derivative and Direct Actions -- Individual Recovery

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tend to indicate bad faith as the primary motive for the majority's selling itself the stock.

The ease with which the majority of a close corporation can "freeze out" the minority in the above hypothetical situation as well as in many other seemingly valid corporation transactions leads to the conclusion that a change in the law may be desirable to protect the interests of the minority. One remedy might be to allow a minority stockholder in a close corporation appropriate legal relief upon his proof that the corporate transaction in question, engineered by the majority, is one which means gain to the majority at the expense of a loss by the minority. As an extra safeguard, the minority plaintiff should possibly be required to make a sworn allegation that there is no sufficient business reason for the action of the majority and that the motivation for the transaction is a bad-faith one designed to "freeze out" the minority. However, the minority should not be forced to prove this negative allegation; rather, the contrasting presence of a sufficient business reason and good faith should be an affirmative defense for the majority in this action.<sup>50</sup>

The change suggested above is a radical departure from the present case law as outlined in this Note, and is a change which surely can be effected only by legislation. It is believed that this new remedy would prevent many of the "freeze outs" which now go unredressed without unduly impairing the efficiency of corporation management.

GASTON H. GAGE

### Corporations—Shareholders' Derivative and Direct Actions—Individual Recovery

In recent case of *Watson v. Button*,<sup>1</sup> the former owner of one half of a corporation's stock brought suit against the corporation's former general manager who had owned the other one half of the stock to recover the amount misappropriated by the former general manager prior to their sale of the corporation to its present owners. The plaintiff and defendant had agreed to be jointly liable for the corporate debts, and, as a term of the sale, the general manager secured a release from the purchasers discharging him from any claims and demands existing against him in favor

<sup>50</sup> Cf. S. B. No. 49, N. C. Gen. Assembly, Sess. 1955 § 55-46 (h) (not enacted), which refers to a shareholder's remedy for the dilution of his holdings by the issuance of shares at an inadequate price. This omitted subsection of the proposed Business Corporation Act would have put on defendant majority the burden of proving that the offering price of shares is fair if the complaining minority show all of the following: (1) the absence of a ready and adequate market for the sale of shareholders' offer rights; (2) notification by the complaining shareholder to the corporation in writing of his inability to purchase his pro rata share and of his belief that the offer price is low enough to unfairly dilute his holdings; (3) evidence tending to show previous efforts by the directors, officers, or dominant shareholders to purchase his shares.

<sup>1</sup> 235 F. 2d 235 (9th Cir. 1956).

of the corporation. The misappropriation was discovered after the sale.

The court recognized that, as a general rule, any cause of action for misappropriation of corporation assets by a director belongs to the corporation and not to its shareholders. The reasons for this rule are: it prevents a multiplicity of suits; it protects corporate creditors by putting the proceeds of the recovery back into the corporation treasury; and it protects all shareholders equally by increasing the value of their shares. However, the court allowed recovery by the plaintiff in an individual action because the reasons for the general rule did not exist in this case. There could be no multiplicity of suits since there were only two shareholders; creditors would not be prejudiced because the plaintiff and defendant were obligated by agreement to be jointly liable for the corporate debts; and a recovery by the corporation would not benefit the injured former shareholder because the plaintiff and defendant had sold their shares.

Few rules of corporation law are more generally recognized and applied than the one relied upon by the defendant in this case: a shareholder has no direct, individual right of action against corporate officers for wrongs to the corporation merely because his investment has been depreciated in value due to their misconduct.<sup>2</sup> The rule has been defended by the courts for a number of reasons.<sup>3</sup> The shareholder's remedy is by a derivative suit in equity if the corporation management fails or wrongfully refuses to bring suit on the corporate right of action. The basis of equitable relief was found in the absence of any adequate remedy at law.<sup>4</sup> The proceeds of such a suit go to the corporation, which increase its assets, and, thus, increase the value of the shareholder's stock.

However, in at least two general classes of cases, the shareholder has been allowed to recover directly. First, in a number of cases where a shareholder has brought a derivative action for the benefit of the corporation, courts have denied the usual relief to the corporation and granted recovery directly to the injured shareholder. In *Brown v. DeYoung*,<sup>5</sup> a minority of injured shareholders brought a derivative suit against the

<sup>2</sup> See Annot., 167 A. L. R. 279 (1947).

<sup>3</sup> *Mente & Co. v. Louisiana State Rice Milling Co.*, 176 La. 475, 146 So. 28 (1933) (The primary injury is to the corporation and only incidental to the shareholders; no "privity" between the wrongdoer and the shareholder exists); *Green v. Victor Talking Machine Co.*, 24 F. 2d 378 (2d Cir.), cert. denied, 278 U. S. 602 (1928) (recovery by the corporation will protect all shareholders equally and remedy the injury to the shares); *Wells v. Dane*, 101 Me. 67, 63 Atl. 728 (1905) (multiplicity of suits); *White v. First Nat'l Bank*, 252 Pa. 205, 97 Atl. 403 (1916) (recovery by the shareholder may result in double liability on the part of the defendant since the corporation may also have a cause of action); *Dorrah v. Pemiscot County Bank*, 213 Mo. App. 541, 256 S. W. 560 (1923) (for protection of creditors); *BALLENTINE, CORPORATIONS* § 143 (rev. ed. 1946) (confused damage problems, and extending the duty of management beyond that owed the corporate entity).

<sup>4</sup> *BALLENTINE, CORPORATIONS* § 145 (rev. ed. 1946).

<sup>5</sup> 167 Ill. 549, 47 N. E. 863 (1897).

corporation and its officers for excessive salaries paid to the officers with the consent of the majority shareholders. The court said that the proper course in these suits, to compel restoration to the corporation of moneys improperly appropriated, may very well be, as a general rule, to require that the misappropriated funds be paid to the corporation rather than to the injured shareholders personally. Yet where the effect of such a decree is to benefit the shareholders who assented to and participated in the misappropriation of the funds, as well as to benefit shareholders innocent of complicity in the transaction, the court held that the decree should be so framed as to benefit only the innocent shareholder. Complete and perfect relief to those who are entitled to it is all that ever ought to be given in equity.

In *Mathews v. Headley Chocolate Co.*,<sup>6</sup> minority shareholders brought a derivative suit to recover excessive salaries paid to directors and officers. The majority shareholders had sold their shares and the buyers and the minority shareholders maintained the suit. The court held that subsequent shareholders, assignees of the wrongdoers, cannot recover, since they had lost nothing. But suit can be maintained in the name of the corporation for the benefit of minority shareholders, and recovery will be granted to the extent of their proportionate injury.

In *Joyce v. Congdon*,<sup>7</sup> a derivative suit was brought against officers and directors who were also majority shareholders, to cancel certain stock purchased with corporate funds and distributed to the majority shareholders. The court held that although recovery will generally go to the corporation, and not to the minority shareholders personally, if such recovery would result in a shareholder's receiving a portion thereof to which he was not entitled, equity will look beyond the corporate entity and decree the recovery to the individual shareholders entitled thereto.

And in *Alexander v. Quality Leather Goods Corp.*,<sup>8</sup> a derivative suit was brought against the corporation's officers for injuries to the minority shareholders when the corporation was dissolved through fraud. The court held that although this is a derivative suit, in which judgment is sought for the corporation, where only one shareholder is interested in a derivative suit, and all creditors have been paid, the court will give judgment to the shareholder instead of the corporation because there is no reason why the court cannot select the parties who are entitled to benefit, and withhold beneficial results from those guilty of fraud or culpably negligent.

In the recent case of *Perlman v. Feldmann*,<sup>9</sup> minority shareholders brought a derivative suit against a former dominant shareholder and

<sup>6</sup> 130 Md. 523, 100 Atl. 645 (1917).

<sup>7</sup> 114 Wash. 239, 195 Pac. 29 (1921).

<sup>8</sup> 150 Misc. 577, 269 N. Y. Supp. 499 (Sup. Ct. 1934).

<sup>9</sup> 219 F. 2d 173 (2nd Cir. 1955).

principal officer of the corporation to recover personal profits from the sale of controlling stock which resulted in the corporation's loss of the right to control distribution of the product in a period of shortage. The minority shareholders sought to recover their share of the profits in the sale. The court allowed recovery directly to the minority shareholders because a recovery by the corporation would only subject the defendants to a greater total liability, from which culpable parties would be benefited.

The effect of the decisions in the first class of cases seems to create a "hybrid" of the derivative suit and the personal action which could be technically called a derivative suit with direct recovery to the injured shareholders. The courts seem to be justified in giving such an equitable recovery because the conventional derivative action, in which the corporation retains the proceeds of the judgment, while giving the complaining shareholder an adequate remedy, allows unjust enrichment of the wrongdoers.<sup>10</sup>

The second class of cases consists of at least three situations in which the injured shareholder is allowed to maintain an individual action in his own behalf, whether the corporation has a separate right of action or not.

(1) Where the injury to the corporation is also a direct and personal injury to the shareholder, resulting in a depreciation in the value of his shares, courts have held that this personal tort gives rise to an individual right of action. The fact that the corporation's assets have been injured does not preclude the shareholder's suit if he was injured by: fraudulent representations inducing him to form a corporation which failed by reason of the fraud;<sup>11</sup> dissemination of false statements about the corporation, to depreciate the value of the plaintiff's shares so the corporate officers could buy it from him at a low price;<sup>12</sup> or inducing voluntary bankruptcy by fraud.<sup>13</sup> Probably, in any case where the directors' acts amount to a tort against the shareholder, injury to the corporation will be no defense to his individual action.

(2) Where there is some special relationship between the plaintiff shareholder and the wrongdoer, arising out of fiduciary or contractual agreements, independent of the normal shareholder and director relationship, individual suits have been allowed because of a breach of such agreements. For example, in *Ritchie v. McMullen*,<sup>14</sup> where the director

<sup>10</sup> There does not appear to be any provision in the present North Carolina Statutes or in the proposed 1957 Corporation Code dealing with this problem.

<sup>11</sup> *Sutter v. General Petroleum Corp.*, 28 Cal. 2d 525, 170 P. 2d 898 (1946).

<sup>12</sup> *Coronado Development Corp. v. Millikin*, 175 Misc. 1, 22 N. Y. S. 2d 670 (Sup. Ct. 1940).

<sup>13</sup> *Adams v. Clark*, 239 N. Y. 403, 146 N. E. 642 (1925).

<sup>14</sup> 70 Fed. 522 (6th Cir. 1897); See also, *Kono v. Roeth*, 237 App. Div. 252, 260 N. Y. Supp. 662 (1st Dept. 1932); (where there was a breach of a personal con-

was a pledgee of the injured shareholder's stock, his misconduct resulting in a depreciation in the value of the plaintiff's shares, amounted to a breach of the pledge agreement and an individual suit was allowed.

(3) If the plaintiff has parted with his shares *because* of the misconduct of the directors, an individual suit is allowed for the fraud or coercion that induced him to part with his stock. A derivative suit is no longer possible since he is no longer a shareholder, and he could not benefit from another shareholder's derivative suit which would give the proceeds to the corporation of which he is no longer a member. In *Von Au v. Magenheimer*,<sup>15</sup> the defendants took excessive salaries, refused to pay dividends, and committed waste, as a part of a successful attempt to force the plaintiff to sell his shares. An individual action by the injured ex-shareholder was allowed. Other cases allow an individual suit where the plaintiff is forced to sell his shares.<sup>16</sup> The economic coercion or fraud used by the defendants in these cases amounts to a personal wrong against the plaintiff, separate and distinct from the wrong against the corporation, and the courts allow an individual suit, and the fact that the corporation has a right of action also, is no defense to the injured party's suit.

The principal case does not come directly within either of the two classes of cases that have allowed personal recovery by the shareholder. It seems to create another situation in which an individual suit is proper; i.e., when the shareholder has parted with his shares without knowledge of the wrongdoing (if he had parted with his shares because of the wrongful acts, it could be classified as a case under the second class), and the reasons for the general rule do not exist, individual suit by the injured party is proper. The results of the principal case, and of the cases in both of the classes cited herein, seem to be desirable and relatively free from theoretical difficulty.

The real objection to permitting a shareholder to recover directly for his proportionate share of the damage inflicted upon the corporation of which he is a member is not that the injury was done to the corporate entity rather than to him, but that the result of such recovery is a return

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tract), *General Rubber Co. v. Benedict*, 215 N. Y. 18, 109 N. E. 96 (1915); *Camp v. Gress*, 250 U. S. 308 (1919); *Rogers v. Penobscot Mining Co.*, 154 Fed. 606 (8th Cir. 1907).

<sup>15</sup> 126 App. Div. 257, 110 N. Y. Supp. 629 (2nd. Dept. 1908), *aff'd*, 196 N. Y. 510, 89 N. E. 1114 (1909).

<sup>16</sup> *Hammer v. Werner*, 239 App. Div. 38, 265 N. Y. Supp. 172 (2d. Dept. 1933) (directors purchased treasury stock without letting plaintiff participate in the purchase price on a pro rata basis, at an inadequate price, forcing the price of the shares down, and the plaintiff sold); *Stinnett v. Paramount-Famous Lasky Corp.*, 37 S. W. 2d 145 (Tex. Com. App. 1931) (directors formed a conspiracy to boycott the corporation for the purpose and with the result of forcing plaintiff to sell his shares).

of corporation assets to shareholders without first satisfying corporate creditors.<sup>17</sup> The ultimate problem before the courts is how to protect the interests of all the parties involved: the corporation, its creditors, and its shareholders. Where there is a loss or destruction of corporate assets as a result of misconduct of directors and officers, the claims of creditors must be given first consideration, but recovery should be permitted to the extent necessary to protect innocent shareholders.

The court said in *Brown v. DeYoung*,<sup>18</sup> "Perhaps for the reason that no such case was ever before complained of, we have been referred to no authority, and know of none, for affording certain relief to the innocent shareholder without giving the culpable one what he is not entitled to, as would be the result if the money be decreed to be paid, generally, into the corporate treasury. But the lengthening reach of equity into the manifold intricacies of modern business should not be drawn back simply for lack of authoritative decision to guide us, where reason and every equitable consideration point the way with so much clearness."

From the above, it can be seen that courts have refused to be restrained by lack of precedents where inequitable results would be reached if they followed the general rule. Many variations of the circumstances in the above cases may arise in the future in which shareholders will have been defrauded by directors and officers. If the courts will be guided more by equitable principles than by general rules, the injured parties will be able to receive a more complete and perfect relief.

Whether or not it would be wise to allow an individual suit, or to require a derivative suit, is not clear in all circumstances. An individual action should not be disallowed because the corporation has a separate right of action, when the wrongful acts of the directors amount to a separate and distinct injury to both the corporation and the shareholder. But if the injury to the corporation's assets could be said to be an injury to the shareholder only in his capacity as a shareholder, it seems that the derivative suit (which gives direct recovery to the shareholder if necessary), is the best solution to the problem, unless, as in the principal case, the shareholder has parted with his shares without knowledge of the directors' wrongful acts. In case of the latter situation, there seems to be no reason for not allowing an individual suit if creditors are not prejudiced, and the complaining shareholders are the only ones injured by the misconduct.

RICHARD R. LEE

<sup>17</sup> STEVENS, CORPORATIONS § 167, at 792 (2d ed. 1949).

<sup>18</sup> 167 Ill. 549, at 558, 47 N. E. 863, at 866 (1897).