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Corporations - Stockholder's Suit - Necessity of Demand on Other Stockholders in Derivative Action

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CORPORATIONS—STOCKHOLDER'S SUIT—NECESSITY OF DEMAND ON OTHER STOCKHOLDERS IN DERIVATIVE ACTION—In two related cases, a holder of common stock brought a derivative suit against the directors of his corporation claiming their illegal acts had deprived the corporation of assets. On defendants' motion to dismiss and for summary judgment, *held,* judgment for the defendants. Plaintiff's failure to allege either that he had presented his claim to the stockholders at a stockholders' meeting or that a majority of the stockholders' votes were under the control of the directors defeated his action. *Carroll v. New York, New Haven & Hartford R.; Glenmore v. Alpert,* (D.C. Mass. 1956) 141 F. Supp. 456.

There are three main approaches which our courts have adopted in determining whether a demand on the body of stockholders is necessary before bringing a derivative suit.[1] One group of cases supports the view that no demand is necessary. Included in this category are those cases which hold affirmatively that demand is not required[2] and also those which in effect hold no demand necessary by failing to mention the requirement.[3]

1 Demand on the directors is not within the scope of this note.

2 Reed v. Hollingsworth, 157 Iowa 94, 135 N.W. 37 (1912); Hazard v. Durant, 11 R.I. 195 (1877).

3 Eston v. Argus, Inc., 328 Mich. 554, 44 N.W. (2d) 154 (1950); Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (1927). On the basis of the Delaware case, a subsequent federal diversity case stated in dicta that Delaware had no requirement of demand. Tobelmann v. Missouri Kansas Pipeline Co., (D.C. Del. 1941) 41 F. Supp. 334. A later federal diversity case held, however, that the Sohland case was an application of the English rule. Steinberg v. Hardy, (D.C. Conn. 1950) 90 F. Supp. 167. See note 7 infra.

The reasoning in the cases which reject the need for demand is that the stockholders, having no control over the immediate management of the corporation, could do nothing even if they were so disposed.[4] The cases which are silent on the demand requirement may be explained in certain instances by the fact that the defendants held a majority of the stock,[5] or that the court was applying the English rule, discussed below, basing its decision on a finding that the act could not be ratified.[6] The second approach may be termed the English rule.[7] Under this approach, if action taken by the directors is merely voidable, and therefore capable of ratification by the majority stockholders, demand must be made on the stockholders, for they might otherwise ratify the act after commencement of the suit.[8] If the act is void, however, and therefore cannot be ratified, demand is not necessary.[9] The third approach, or the American rule, stipulates more generally that before bringing the derivative suit the stockholder must seek redress within the corporation. This includes the making of demand on the other stockholders except when time does not permit, when it cannot be done, or when it is not reasonable to require it.[10] It is probable that no distinction was intended between the English rule and the American rule in the early cases,[11] and some courts have interpreted the exceptions to the American rule as having the effect of establishing in substance of the English rule.[12] One important difference does, however, exist between the two doctrines. Under the American rule, demand must be made even if the acts are not ratifiable if stockholders can elect new directors in a timely manner,[13] while under the English rule, if the acts in question are not ratifiable, no demand is necessary regardless of the possible election of new officers.[14] Demand is usually justified as being instrumental in preventing vexatious suits against the corporation, encouraging settlement of problems within the corporation, and permitting management to

4 Reed v. Hollingsworth, note 2 supra. These cases have involved only large corporations. It is questionable whether these courts would do the same with a corporation having a small, compact body of stockholders capable of exercising actual control. See 48 MICH. L. REV. 87 (1949).

5 See Price v. Standard Oil Co., 55 N.Y.S. (2d) 890 (1945).

6 Steinberg v. Hardy, note 3 supra, referring to Sohland v. Baker, note 3 supra.

7 This rule was enunciated in Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843), the landmark case on the requirement of demand on stockholders bringing a derivative suit. The leading case in this country on this approach is Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912). See 51 L.R.A. (n.s.) 112 (1914).

8 Hayman v. Brown, 176 Misc. 176, 26 N.Y.S. (2d) 898 (1941).

9 As to what types of acts are ratifiable, see 13 FLETCHER, CYC. CORP. §5795 (1943); 53 HARV. L. REV. 1368 (1940); 51 L.R.A. (n.s.) 112 (1914).

10 Hawes v. Oakland, 104 U.S. 450 (1881). See 72 A.L.R. 621 (1931).

11 Hawes v. Oakland, note 10 supra, cited Foss v. Harbottle, note 7 supra, as controlling, and Continental Securities Co. v. Belmont, note 7 supra, expressly stated that it was not in conflict with the Hawes case. See also 51 L.R.A. (n.s.) 112 (1914).

12 Fisher v. National Mortgage Loan Co., 132 Neb. 185, 271 N.W. 433 (1937).

13 Miller v. Murray, 17 Colo. 408, 30 P. 46 (1892).

14 Continental Securities Co. v. Belmont, note 7 supra, the leading case on the English rule in this country, notes that election of new directors is normally not a sufficient reason for requiring demand on stockholders.

make rapid and authoritative decisions without being harassed by the dissenting minority.[15] Arguments against requiring a demand include the difficulties and expense in actually reaching the other stockholders[16] and the difficulty in presenting and obtaining an understanding in a stockholders' meeting of the complex problems involved in these suits.[17] In some jurisdictions the courts have gone beyond the American rule and have made demand almost an absolute necessity.[18] Massachusetts, the jurisdiction involved in the principal case, falls into this category, as it allows only two rather narrow exceptions to the requirement: (1) when the defendants control the majority of stock, and (2) when a lapse of time would defeat the suit.[19] The federal district court in the principal case narrowed the exception even farther, stating that the only exception to the requirement in Massachusetts was that made in the case of majority control.[20] An early Massachusetts decision indicated in its dicta that Massachusetts would follow the English rule.[21] The only Massachusetts case cited, however, in the principal case held that when the majority chose not to sue, the minority was so bound, and a derivative suit was precluded even if the acts were not ratifiable, thus going well beyond the English rule.[22]

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