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Corporations - Shareholders - Power of the Majority to Ratify Director's Fraud

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CORPORATIONS—SHAREHOLDERS—POWER OF THE MAJORITY TO RATIFY DIRECTORS' FRAUD—Plaintiff, a stockholder in the Kroger Company, brought a derivative suit against a subsidiary of the company and certain officers and directors of both the parent and the subsidiary. It was alleged that Kroger's directors had fraudulently waived the company's preemptive right to a new issue of stock of the subsidiary and had then purchased the shares for their own accounts at a price far below the market value. The defendants answered that the sale had been ratified by a majority in interest of disinterested stockholders to whom all the details of the transaction had been explained, and denied plaintiff's right to bring a derivative suit without first having made a demand on the stockholders to take remedial action. The trial court dismissed the complaint and the court of appeals affirmed, holding that although a majority could not ratify a director's fraud over the objection of any of the stockholders, the plaintiff nevertheless lacked standing to sue without having made a prior demand on the stockholders. On appeal, *held,* affirmed as modified, one judge dissenting. A demand on the stockholders was a prerequisite to bringing the suit, because a majority in interest of the stockholders have the power to ratify the director's fraud so long as the ratification is by disinterested stockholders and there is no fraud in obtaining their vote. *Claman v. Robertson,* 164 Ohio St. 61, 128 N.E. (2d) 429 (1955).

The courts have long recognized the power of a majority in interest of the stockholders to determine corporate policy[1] but have not allowed

[1] Barnes v. Brown, 80 N.Y. 527 (1880); Gaines v. Gaines Bros. Co., 176 Okla. 583, 56 P. (2d) 863 (1936).

them to enrich themselves fraudulently at the expense of the minority.[2] Somewhere in between these two positions falls the problem presented by the principal case. In the leading case of *Continental Securities Co. v. Belmont*[3] the New York Court of Appeals held that a director's fraud can be ratified only by a unanimous vote of the stockholders. In so holding, the New York court distinguished contrary English authority,[4] but on somewhat questionable grounds.[5] Although this non-ratification rule has found support in other courts,[6] the strength of this support is diminished in so far as the rule has been invoked to decide cases in which the majority stockholders themselves were participants in the fraud and profited from it.[7] While only two American cases have been found which directly support the view of the principal case,[8] the doctrine of majority ratification appears to be the better view. It seems unreasonable to fear that adoption of this doctrine will encourage dishonesty on the part of corporate directors. Stockholders are not prone to ratify acts of directors which constitute a fraud on the corporation. And since ratification is a defense to the derivative suit, it would be necessary to establish clearly that the ratification was effectuated by fully informed stockholders who were not in any way implicated in the fraud. Adoption of this doctrine would avoid the inflexibility of the non-ratification rule, which prevents ratification even when sound business judgment would indicate that it is the wisest policy for the corporation to follow.[9] In addition, it would discourage suits by "strikers,"

[2] Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533 (1919); Klein v. Independent Brewing Assn., 231 Ill. 594, 83 N.E. 434 (1908).

[3] 206 N.Y. 7, 99 N.E. 138 (1912).

[4] Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843).

[5] The New York court interpreted Foss v. Harbottle, note 4 supra, to mean simply that a stockholder could not bring a derivative suit without making a prior demand on the stockholders for remedial action. The court said that this did not apply in the case of a director's fraud since such a fraud could never be ratified except by a unanimous vote of the shareholders. This interpretation is questionable since the English court stated that it would assume a wrong had been committed against the company by the directors, and then went on to deny plaintiff's standing to sue on the basis that any decree issued by the court would be nullified if a majority in interest of the stockholders ratified the acts.

[6] Pollitz v. Wabash R. Co., 207 N.Y. 113, 100 N.E. 721 (1912); Dana v. Morgan, (D.C. N.Y. 1914) 219 F. 313, affd. (2d Cir. 1916) 232 F. 85; Eshleman v. Keenan, 21 Del. Ch. 259, 187 A. 25 (1936); Chounis v. Laing, 125 W.Va. 275, 23 S.E. (2d) 628 (1942).

[7] Goodin v. Cincinnati & Whitewater Canal Co., 18 Ohio St. 169 (1868); Ford v. Ford Roofing Products Co., (Mo. App. 1926) 285 S.W. 538. See 53 HARV. L. REV. 1368 (1940).

[8] Kessler v. Ensley Co., (D.C. Ala. 1904) 129 F. 397; Mountain States Packing Co. v. Curtis, 86 Colo. 355, 281 P. 737 (1929). See also S. Solomont and Sons Trust v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E. (2d) 241 (1950), wherein the court affirmed the non-ratification rule enunciated in prior Massachusetts cases, but went on to say that, although there could be no ratification of a director's fraud over the objection of any of the stockholders, the majority in interest of the stockholders did have the power to decide whether or not the corporation should sue the directors. Although the court said this was a distinction of substance rather than form, it is clear that allowing the majority stockholders to decide to forego suit effectively emasculates the non-ratification rule in Massachusetts. See 64 HARV. L. REV. 334 (1950).

[9] For a discussion of the reasons which could make ratification of a director's fraudulent act desirable, see Kessler v. Ensley, note 8 supra.

holders of a small number of shares who are more interested in the large settlements sometimes made by corporations than they are in the welfare of the business.[10] Legislation designed to prevent some of these abuses by "strikers"[11] has been severely criticized[12] since it tends to make it difficult for any small stockholder to bring a derivative suit, regardless of the nature of the cause of action. Allowing a minority stockholder to bring an action which is opposed by the honest judgment of the majority stockholders would increase the need for this type of restrictive legislation. On the other hand, adoption of the doctrine of ratification leaves control of corporate policies in the owners of the corporation. In this manner the persons who have the most to gain by wise corporate policies will be the ones who will decide whether it is in the best interests of the corporation to assert its legal rights. This is a decision which is better left to the stockholders than to the courts.

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[10] The extent to which the stockholders' derivative suit has been abused is discussed in WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS, Special Committee on Corporate Litigation of the Chamber of Commerce of the State of New York (1944).

[11] The New York law, the first of this type, provides that unless a stockholder owns shares which either exceed fifty thousand dollars in market value or constitute over five percent of the total outstanding shares, the corporation may require him to give security for the reasonable expenses which may be incurred by the corporation in defending the suit, including attorney's fees, before he can maintain his action. 22 N.Y. Consol. Laws (McKinney, 1943; Supp. 1955) §61-b. As examples of substantially similar statutes, see N.J. Stat. Ann. (1939; Supp. 1955) tit. 14, §14:3-15; Pa. Stat. Ann. (Purdon, 1953) tit. 12, §1322.

[12] Hornstein, "New Aspects of Stockholders' Derivative Suits," 47 COL. L. REV. 1 (1947); Zlinkoff, "The American Investor and the Constitutionality of Section 61-B of the New York General Corporation Law," 54 YALE L.J. 352 (1945).