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CORPORATIONS-SHAREHOLDERS' DERIVATIVE SUITS-WHEN DEMAND ON SHAREHOLDERS IS A PREREQUISITE TO MAINTENANCE OF SUIT

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CORPORATIONS—SHAREHOLDERS' DERIVATIVE SUITS—WHEN DEMAND ON SHAREHOLDERS IS A PREREQUISITE TO MAINTENANCE OF SUIT—A shareholder's derivative suit is an equity proceeding instituted by a shareholder on behalf of himself and all other shareholders to assert corporate rights.[1] Both the corporation and the parties allegedly liable to the corporation are necessary parties.[2] The question to be considered in this comment is, when must the plaintiff shareholder show that he sought redress for the corporation through collective action of the shareholders and failed to secure it? As a preliminary matter, we may ask what sort of collective action the shareholders are expected to take. A few authorities suggest that the shareholders, as a body, bring suit against the directors where misconduct by the directorate is alleged;[3] but such a suit would also be derivative, and its advantages over the ordinary derivative suit are not apparent. The common suggestion is that the shareholders will act in a meeting and either adopt a resolution directing the management to bring suit or elect a new management pledged to do so.[4]

1 Glenn, "The Stockholder's Suit—Corporate and Individual Grievances," 33 YALE L.J. 580 at 580-81 (1924).

2 13 FLETCHER, CYC. CORP., perm. ed., §§5944, 5953 (1943).

3 Caldwell v. Eubanks, 326 Mo. 185, 30 S.W. (2d) 976 (1930) contains such a suggestion. 72 A.L.R. 628 (1931), annotating the above case, states, "The cases are uniform in holding that there must be a request that the stockholders as a body sue the directors, or that an action be brought for their benefit, before an individual shareholder may bring an action in the interest of the corporation,—unless such a request would be useless and unavailing." The vast majority of the cases cited have been examined, but no further recognition of the suggestion was discovered.

4 Tuscaloosa Mfg. Co. v. Cox, 68 Ala. 71 (1880); Miller v. Murray, 17 Colo. 408, 30 P. 46 (1892); Alexander v. Searcy, 81 Ga. 536, 8 S.E. 630 (1888); Dunphy v. Traveller Newspaper Assn., 146 Mass. 495, 16 N.E. 426 (1888); Wolf v. Penn. Ry. Co., 195 Pa. St. 91, 45 A. 936 (1900).

A. The Problem in Perspective

The problem under discussion is created by an apparent clash between two policies of the law. The first is a judicial reluctance to interfere with internal corporate affairs. This attitude may be derived from the time-honored equity approach to partnership accounting petitions which generally refuses to undertake an accounting between partners without dissolving the firm, on the theory that partners must solve internal disputes to be successful.[5] In any event, a corporate directorate is given a rather wide managerial discretion and its decisions on internal policy enjoy a judicial presumption of validity.[6] Hence the courts say in countless derivative suits that the plaintiff must show that he has exhausted his remedies within the corporation, and, to that end, must either show a wrongful refusal by the corporate management to cause the corporation to sue, or establish that such demand would be futile.[7] When one reflects that there will almost always be a dissenting minority of shareholders who disapprove of managerial decisions and considers the need for rapid and authoritative decisions in the present-day business world, such an approach clearly makes sense. The principal argument for requiring an appeal to majority shareholders is that this too is part of the process of handling corporate affairs within the corporation.[8] Other factors casting doubt on the desirability of derivative suits are judicial experience that counsel may induce such suits to collect fees, which the corporation usually pays,[9] and that, in the federal courts, corporations themselves employ the derivative suit as a means of invoking diversity jurisdiction in suits which the management really wishes to bring.[10] Such abuses, of course, encourage restrictions on the derivative suit remedy. The second general policy is to give an effective remedy to shareholders whose interests are being jeopardized by the activities of an unscrupulous management or strangers whom the management refuses to sue. These are precisely the situations which called the derivative suit into being, and it would hardly be argued that such a remedy is unnecessary; however, the protective screen built by the law to protect honest management from being harassed acts in these cases

[5] Lord v. Hull, 178 N.Y. 9, 70 N.E. 69 (1904).

[6] 5 FLETCHER, CYC. CORP., perm. ed., §2104 (1943).

[7] 13 FLETCHER, CYC. CORP., perm. ed., §5945 (1943).

[8] Hawes v. Oakland, 104 U.S. 450 at 460-61, 26 L. ed. 827 (1881).

[9] "Survey and Report regarding Stockholders' Derivative Suits" at p. 11, SPECIAL COMMITTEE ON CORPORATE LITIGATION, N.Y. STATE CHAMBER OF COMMERCE (1944).

[10] Hawes v. Oakland, 104 U.S. 450, 26 L. ed. 827 (1881).

as a cloak for the wrongdoer, leaving the wronged shareholder confronted by a legal obstacle course.[11]

It is suggested that the question before us should be approached with the above policies in view, and that a derivative suit plaintiff should be required to appeal to shareholders before obtaining judicial redress for the corporation only if the value of such an appeal in encouraging the settlement of corporate problems within the business outweighs the inconvenience thus imposed on the plaintiff. It should also be remembered that, whatever solution is reached, it should be as definite as possible. The less the clarity of the law, the more numerous will be the cases in which the expense and delay of a demand on shareholders is needlessly incurred, or the expense and delay of discovering that such a demand should have been made is suffered.

B. *The Authorities Examined*

To our question—when must the plaintiff show an unsuccessful attempt to obtain redress through shareholders in order to maintain a derivative suit—the cases give several answers. First, some courts have stated categorically that no demand on shareholders is necessary;[12] these cases appear to rule as a matter of law that the directorate is created to decide whether the corporation should sue, while the shareholders' meeting is not. Where the corporation is a large one and shares are diversely held, a shareholders' meeting is really an assembly of the management's proxy committee, and if the management has already refused to bring suit, their employees will hardly take a different stand. Should plaintiff attempt to present his case to a diverse group of shareholders before the meeting and thus obtain their proxies himself, he

[11] See the detailed requirements of Federal Rule 23(b), 28 U.S.C., §723 (1941). A plaintiff must present a complaint which: (1) is verified by oath; (2) avers that plaintiff owned his shares when the wrong to the corporation took place, or that they have since devolved upon him by operation of law; (3) avers that the action is not a collusive one to confer diversity jurisdiction; (4) states specifically the steps taken to obtain action by management and shareholders if necessary. This is the rule of Hawes v. Oakland, 104 U.S. 450, 26 L. ed. 827 (1881) in codified form: Quincy v. Steel, 120 U.S. 241 at 245-49, 7 S.Ct. 520 (1887); Wathen v. Jackson Oil & Refining Co., 235 U.S. 635 at 639-40, 35 S.Ct. 225 (1914). The latter case traces the codification to Equity Rule 27, and the exact language of Equity Rule 27 is repeated in Rule 23 (b).

[12] Reed v. Hollingsworth, 157 Iowa 94 at 106, 135 N.W. 37 (1912); Hazard v. Durant, 11 R.I. 195 at 202-03 (1877); Orlando Orange Groves Co. v. Hale, 107 Fla. 304 at 315-16, 144 S. 674 (1932), [the opinion on re-hearing, 119 Fla. 159 at 168-69, 161 S. 284 (1935) is more conservative, however, pointing out that the defendants were majority shareholders which would have made an appeal to shareholders idle].

would be involved in a project requiring substantial effort and expense. These considerations support the view that an appeal to shareholders should not be required. Query, however, whether such a doctrine is sustainable where the corporation is owned by a small number of shareholders who have an active interest in its affairs. The courts taking the above view apparently have not dealt with such cases, but the matter seems arguable. It is probably true that a demand for suit by the corporation could be made on a compact group of shareholders with little difficulty; but on the other hand, the fewer and the more active in corporate affairs the shareholders are, the more likely it is that the management which has refused to sue will reflect their views. In terms of the policy considerations discussed previously, these courts have apparently concluded that the desirable end of settling corporate grievances within the corporation is not served substantially by requiring an appeal to shareholders after the management has refused to sue.

A second rule has been adopted by the bulk of the American cases, following, either expressly or in fact, the language of the United States Supreme Court in the case of *Hawes v. Oakland*:[13] ". . . it is . . . important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances. . . . If time permits . . . he must show, if he fails with the directors, that he has made an honest effort to obtain action by the shareholders as a body, in the matter of which he complains. And he must show a case, if this is not done,

[13] 104 U.S. 450, 26 L. ed. 827 (1881). These cases specifically endorse Hawes v. Oakland: Miller v. Murray, 17 Colo. 408, 30 P. 46 (1892); Alexander v. Searcy, 81 Ga. 536, 8 S.E. 630 (1888); Stedtfeld v. Eddy, 45 Idaho 584, 264 P. 381 (1928); Latimer v. Richmond R.R. Co., 39 S.C. 44, 17 S.E. 258 (1892); Allen v. Montana Refining Co., 71 Mont. 105, 227 P. 582 (1924); Ulmer v. Maine Real Estate Co., 93 Maine 324, 45 A. 40 (1899); Albers v. Merchants' Exchange, 45 Mo. App. 206 (1891); North v. Union Savings & Loan Assn., 59 Ore. 483, 117 P. 822 (1911); New Birmingham Iron & Land Co. v. Blevens, 12 Tex. Civ. App. 410, 34 S.W. 828 (1896); Elliott v. Puget Sound Wood Products Co., 52 Wash. 637, 101 P. 228 (1909); Rathbone v. Gas Co., 31 W.Va. 798, 8 S.E. 570 (1888); McCampbell v. Fountain Head Ry. Co., 111 Tenn. 55, 77 S.W. 1070 (1903). Less satisfactory support for the Hawes case is found in the following cases: Iron Hall v. Baker, 134 Ind. 293, 33 N.E. 1128 (1892); Merrimon v. Southern Paving & Construction Co., 142 N.C. 539, 55 S.E. 366 (1906); Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 274 P. 597 (1929); Wolf v. Penna. R.R. Co., 195 Pa. St. 91, 45 A. 936 (1900). A doctrine similar to the Hawes rule is stated in these cases: Tuscaloosa Mfg. Co. v. Cox, 68 Ala. 71 (1880); Beckett v. Planters' Warehouse Co., 107 Miss. 305, 65 S. 275 (1914); Va. Passenger & Power Co. v. Fisher, 104 Va. 121, 51 S.E. 198 (1905).

where it could not be done, or it was not reasonable to require it."[14] By this view, demand on shareholders is required with three exceptions: where time does not permit it; where an appeal to shareholders cannot be made; and where it would be unreasonable to require such an appeal. The first exception refers to cases where the delay incident to seeking action by shareholders would render a final judgment for plaintiff an ineffectual remedy.[15] It is not clear what is meant by the exception that application to shareholders is excused where it "could not be" made. If this language refers to a case of impossibility in fact, no examples thereof have been discovered. A possible example would be a case where the corporate records have been lost or destroyed and it is not known who the shareholders are.[16] If something less than strict impossibility is referred to, this exception would seem to blend imperceptibly into the third, namely, that demand on shareholders is not necessary where it is unreasonable to require it. The cases do not indicate clearly the situations which fall within the third exception. It is generally accepted that no demand is necessary where the wrongdoers whom plaintiff wishes to sue are majority shareholders;[17] presumably the same would be true where the directorate which refuses to sue comprises the majority shareholders. Some of the cases requiring an appeal to shareholders have involved rather small corporations with few shareholders, though the opinions do not always stress this fact.[18] In the federal courts, no demand is required if the current management controls a substantial block of shares and the remaining shares are diversely held making an extensive proxy fight necessary.[19] There is authority both ways on the question of whether mere diversity of share ownership excuses demand.[20]

[14] Hawes v. Oakland, 104 U.S. 450 at 460-61, 26 L. ed. 827 (1881).

[15] Passmore v. Allentown & Reading Traction Co., 267 Pa. St. 356, 110 A. 240 (1920) is such a case.

[16] Hifler v. Calmac Oil & Gas Corp., 258 App. Div. 78, 10 N.Y.S. (2d) 531 (1940) involves substantially these facts but New York does not follow the Hawes case.

[17] Allen v. Montana Refining Co., 71 Mont. 105 at 122-23, 227 P. 582 (1924); North v. Union Savings & Loan Assn., 59 Ore. 483, 117 P. 822 (1911); Moore v. L.&R. Electric Ry. Co., 80 W.Va. 653, 93 S.E. 762 (1917); McCampbell v. Fountain Head Ry. Co., 111 Tenn. 55 at 68-69, 77 S.W. 1070 (1903); Beckett v. Planters' Warehouse Co., 107 Miss. 305, 65 S. 275 (1914).

[18] One which does not is Caldwell v. Eubanks, 326 Mo. 185, 30 S.W. (2d) 976 (1930); for one which does see Miller v. Murray, 17 Colo. 408, 30 P. 46 (1892).

[19] Delaware & Hudson Co. v. Albany & Susquehanna Ry. Co., 213 U.S. 435 at 452, 29 S.Ct. 540 (1909).

[20] To the effect that it does: Berg v. Cincinnati, Newport & Covington Ry. Co., (D.C. Ky. 1944) 56 F. Supp. 842 at 845; Citrin v. Greater N.Y. Industries, Inc., (D.C. N.Y. 1948) 79 F. Supp. 692. To the effect that it does not: Toebelman v. Missouri-Kansas Pipeline Co., (D.C. Del. 1941) 41 F. Supp. 334 (dictum); Bruce & Co. v. Bothwell, (D.C. N.Y. 1948) 8 F. Rules Dec. 45 at 47.

There will thus be many marginal cases in which plaintiff, to be safe, must present his complaints to a shareholders' meeting if he sues in a court following the *Hawes* case. No statistics have been found on the number of cases in which this procedure has resulted in redress within the corporation. Substantial authority suggests that a shareholders' meeting is no place for dealing with such problems, because they are too involved for effective presentation at such a time.[21] The complexity of the proceedings in many derivative suits lends credence to this view. It is also significant that neither the *Hawes* opinion nor subsequent cases guided by it have dealt extensively with these questions; it seems to be assumed without analysis that the shareholders are a proper body to decide whether the corporation should sue. On the other hand, the *Hawes* case does stress the extent to which derivative suits have been abused in order to obtain diversity jurisdiction. It has been suggested that this fact, pertinent only in the federal courts, renders the *Hawes* doctrine a questionable rule for the states to adopt.[22]

In the light of *Erie Ry. Co. v. Tompkins*,[23] the question must be asked, is the *Hawes* doctrine a rule of substantive law or a rule of procedure? If the former, it cannot be applied if the governing state law takes a different view. There is no clear answer in the cases.[24]

The New York Court of Appeals, in the case of *Continental Securities Company v. Belmont*,[25] has stated a third rule, namely, that an appeal to shareholders is necessary only where (1) the injury to the corporation is one which the majority of the shareholders have the power to ratify, or (2) where for any reason the majority are in a position to cause the corporation to take prompt action. This is the doctrine of the English cases, and is favored by American text writers and a few

[21] Slutzker v. Rieber, 132 N.J.Eq. 406 at 410-11, 28 A. (2d) 525 (1942); Mason v. Harris, 11 Ch.Div. 97 (1879); COOK, STOCK AND STOCKHOLDERS, 3rd ed., §740 (1894).

[22] Baker v. Bankers Mortgage Co., 14 Del. Ch. 427 at 430-31, 129 A. 775 (1925).

[23] 304 U.S. 64, 58 S.Ct. 817 (1938) which held that federal courts in diversity cases must apply the substantive law of the states in which they sit.

[24] Venner v. Great Northern Ry., 209 U.S. 24 at 34, 28 S.Ct. 328 (1907) says that the rule of Hawes v. Oakland is a rule of equity as distinguished from a jurisdictional rule, and implies that it is a rule of substantive law; the federal courts seem to have treated state law as controlling in the following cases: Toebelman v. Missouri-Kansas Pipe Line Co., (D.C. Del. 1944) 41 F. Supp. 334; Craftsman Finance & Mortgage Co. v. Brown, (D.C. N.Y. 1945) 64 F. Supp. 168. Contra, 13 FLETCHER, CYC. CORP., perm. ed., §5943 (1943).

[25] 206 N.Y. 7, 99 N.E. 138 (1912).

decisions.[26] It clearly seems sensible to require plaintiff to present his case to a shareholders' meeting if shareholder ratification could extinguish the corporation's cause of action altogether. Otherwise, plaintiff's suit might be rendered futile by ratification pendente lite, or problems of res judicata might arise if a decree in favor of the corporation were entered before ratification took place.[27] Where the wrong to the corporation is such that it cannot be ratified over the dissent of a single shareholder, the *Belmont* case suggests that effective action by shareholders is unlikely.[28] There is, however, a strong suggestion in a recent case that action by shareholders might be required if plaintiffs themselves controlled a majority of the shares and no special circumstances existed making the calling of a shareholders' meeting difficult.[29] Thus far, this dictum seems to be the sole application of the second branch of the *Belmont* doctrine.[30] Hence, unless the plaintiffs are majority shareholders, it seems that they need only apply to shareholders if the claim which they seek to enforce could be extinguished by ratification.

C. *Conclusions*

If, as suggested above, the basis for requiring plaintiff to seek redress through a shareholders' meeting is to encourage settlement of corporate problems within the corporation, the reason for the rule obtains in relatively few cases. The body equipped to decide whether the corporation should sue or not is the directorate. The complexity of the question, the mechanical difficulties of actually reaching the shareholders in a shareholders' meeting, the expense to the plaintiff, and the delay involved all suggest that an appeal to shareholders is an inconvenient and unsatisfactory method of causing the corporation to sue. If the shareholders may ratify and extinguish the corporation's claim,

26 Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843); Fisher v. National Mortgage Loan Co., 132 Neb. 185 at 198, 271 N.W. 433 (1937); a dissenting opinion by Stone, J. in Rogers v. Guaranty Trust Co., 288 U.S. 123 at 143-44, 53 S.Ct. 295 (1932) argues that demand on shareholders is not necessary in that case since ratification would not be possible, citing the Belmont case; STEVENS, PRIVATE CORPORATIONS, §164 (1936); BALLANTINE, CORPORATIONS, §146 (1946); 4 COOK, CORPORATIONS, 8th ed., §740 (1923); 51 L.R.A.(n.s.) 112 (1914).

27 Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843) argues that a subsequent ratification by majority shareholders could extinguish a decree previously rendered in favor of the corporation in a derivative suit.

28 206 N.Y. 7 at 16-17, 99 N.E. 138 (1912).

29 Hifler v. Calmac Oil & Gas Corp., 258 App. Div. (N.Y.) 78 at 86-87, 10 N.Y.S. (2d) 531 (1940).

30 Hayman v. Brown, 176 Misc. 176, 26 N.Y.S. (2d) 898 (1941) might be thought to deal with this problem but it is distinguishable since plaintiff was asserting a right personal to him rather than one in favor of the corporation.

it makes sense to find out before suing whether they will elect to do so or not, and that is the position of the *Belmont* case. Some authority suggests that courts following *Hawes v. Oakland* would require an appeal to shareholders in this situation,[31] and nothing in the language of that case suggests the contrary. Those jurisdictions holding that demand on shareholders is never necessary apparently have not considered cases where ratification by shareholders would extinguish the claim.

Should the courts go further and require an appeal to shareholders in some situations where ratification is impossible? It seems likely that such a course would be both effective and no great inconvenience to the plaintiff if majority shareholders are few in number, habitually attend shareholders' meetings, are not in collusion with the principal defendant, and if a shareholders' meeting could be held promptly. Perhaps such situations are uncommon but, if they did arise, a court following the *Belmont* case might well hold that majority shareholders could give prompt relief and should be consulted.[32] It is suggested that an appeal to shareholders should not be required in other situations even in the federal courts. The problem of the collusive suit to confer jurisdiction is dealt with elsewhere in the federal practice,[33] while counsel who abuse the derivative suit remedy should logically be dealt with through the law of maintenance.

Finally, we may ask whether the position suggested above offers a definite rule for the plaintiff's guidance. The approach proposed where ratification is not possible seems to be satisfactory, but it is not always easy to decide whether a corporate cause of action can be extinguished by ratification before the management has defended its refusal to sue.[34] Rather than forcing plaintiff to make this decision at his peril, it might

[31] 51 L.R.A.(n.s.) 112 (1914).

[32] The same should be true of closely analogous situations; for example, suppose a case in which there was no directorate but the shareholders ran the corporation themselves, or a case where plaintiffs themselves were majority shareholders and a meeting could be held promptly. Miller v. Murray, 17 Colo. 408, 30 P. 46 (1892) may have presented the latter facts.

[33] See note 11, supra.

[34] As to when ratification is possible, see the following: Continental Securities Co. v. Belmont, 206 N.Y. 7 at 18, 99 N.E. 138 (1912); Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843); Pollitz v. Wabash Ry. Co., 207 N.Y. 113 at 126-28, 100 N.E. 721 (1912); Keenan v. Eshleman, 23 Del. Ch. 234 at 245, 2 A. (2d) 904 (1938); Slutzker v. Rieber, 132 N.J.Eq. 406, 28 A. (2d) 525 (1942); Endicott v. Marvel, 81 N.J.Eq. 378 at 383-84, 87 A. 230 (1913).

be best to require defendants to plead possible ratification as a defense. If the court believed the contention sound, a continuance could be granted to allow management to present the issue to the shareholders via the usual proxy forms.[35]

It is believed that the foregoing rules would adequately serve both the policy of encouraging internal settlement of corporate problems and that of allowing a plaintiff with a meritorious claim on behalf of his corporation to litigate it with dispatch.

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[35] Managements have done so in the past, Slutzker v. Rieber, 132 N.J.Eq. 406, 28 A. (2d) 525 (1942); U.S. Steel Corp. v. Hodge, 64 N.J.Eq. 807, 54 A. 1 (1902).