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CORPORATIONS—DERIVATIVE STOCKHOLDERS' SUITS—STANDING OF SUBSEQUENT TRANSFEREE OF "TAINTED SHARES"—In a derivative suit the plaintiff, a minority stockholder, sought an accounting by officers and directors for salaries he alleged they had illegally caused the corporation to pay to themselves. The defendants' answer averred that all the alleged wrongful acts complained of occurred before the plaintiff acquired his stock, and that his vendor had acquiesced. It appeared from the record that the plaintiff's vendor had been an officer in the corporation prior to the time when the payments complained of occurred; that during his incumbency he had himself received payments similar to those in question, and that at a stockholders' meeting, subsequent to the payments to the defendants, but prior to the assignment of his stock to the plaintiff, he had suggested that the directors' salaries be increased. The trial court dismissed the case for want of equity. On appeal, *held*, affirmed. *Russell v. Louis Melind Co.*, (Ill. App. Ct. 1947) 72 N.E. (2d) 869.

The court's reasoning was that by virtue of the assignment of the stock certificate to the plaintiff he acquired only those rights which were held by his predecessor in title, and that he therefore could not bring a derivative action when his transferor was personally disqualified. This approach, though difficult to justify logically, has gained practically unquestioned acceptance.[1] The court

[1] 1 MORAWETZ, PRIVATE CORPORATIONS, 2d ed., § 267 (1886); 13 FLETCHER, CYCLOPEDIA CORPORATIONS, perm ed. § 5980 (1943); Babcock v. Farwell, 245 Ill. 14 at 40, 91 N.E. 683 (1910). The question involved is actually part of a broader issue, namely, whether the subsequent transferee of shares can ever bring a derivative suit based on transactions which occurred prior to the time he acquired his shares. Of course, if the jurisdiction is one which holds that the subsequent transferee has no right to sue under any circumstances, the issue of the principal case becomes entirely academic. For discussions of the broader issue see 148 A.L.R. 1090 (1944); 68 U.S.L. Rev. 169 (1934); Seasongood, "Right of a Stockholder Suing in Behalf of a Corporation to Complain of Misdeeds Occurring Prior to his Acquisition of Stock," 21 HARV. L. REV. 195 (1907).

said further that the knowledge and conduct of the vendor were charged to the plaintiff, and he was therefore estopped from suing. The theory of the stockholder's derivative suit is that the stockholder is not suing in his own right, but is merely setting the wheels of justice in motion with reference to a cause of action belonging to the wronged corporation, and the court of equity will take jurisdiction to prevent a failure of justice.[2] If this is true, his right to sue must arise from his proprietary relation to the corporation, that is, as part owner he has the right to insist that the corporation take advantage of the cause of action which has arisen in its favor. On the basis of general doctrines of equity he will not be heard if he has disqualified himself by participation, approval, or acquiescence in the wrong.[3] But these are personal disqualifications, and there is no apparent reason why they should adhere to the purchaser of the "tainted shares," even if he takes with notice of the disqualification of his vendor. There is certainly no obvious basis on which he can be charged with the knowledge and conduct of his vendor if he has no actual knowledge of the vendor's disqualification, since, until he purchases the stock, he has no legal right to examine the records of the corporation. Yet the decision in the principal case represents the general rule,[4] and it has yielded only in a few jurisdictions in cases where the plaintiff showed that he took without knowledge of the disqualification.[5] That the rule has been relaxed in favor of purchasers without knowledge points to the probable basis of the doctrine. It is likely that the chancellor has held that the disqualification automatically passes with the share because of the fear that otherwise the stockholder who has acquiesced, or perhaps even participated, in the wrong might be able to cause the transaction to be questioned later through the medium of his vendee.[6] It should be noted,

[2] 4 POMEROY, EQUITY JURISPRUDENCE, 5th ed., 278 (1941); Holmes v. Camp, 180 App. Div. 409, 167 N.Y.S. 840 (1917).

[3] Dimpfel v. Ohio & M. Ry. Co., 110 U.S. 209, 3 S. Ct. 573 (1884); Parsons v. Joseph, 92 Ala. 403, 8 S. 788 (1890).

[4] Where the transferor of the plaintiff's stock was a member of the board of directors whose negligence had caused loss to the bank, the New York Supreme Court said: "Parties who deal in certificates of stock have long been protected by the law upon principles analogous to those that apply to commercial paper . . . [citing cases]. Where stock is purchased in good faith, it does not carry with it any taint due to any negligence on the part of a former owner of the stock who may have been guilty of negligence causing a loss to the bank." Harris v. Pearsall, (N.Y. Sup. Ct. 1921) 116 Misc. 366 at 389. The statement, however, was dictum, and apparently stands alone.

[5] Parsons v. Joseph, 92 Ala. 403, 8 S. 788 (1890); 13 FLETCHER, CYCLOPEDIA CORPORATIONS, perm ed., § 5866 (1943).

[6] It should be emphasized that the point in question in this note is a different case from that wherein the subsequent transferee has no cause of action because of the fact that the transaction, prior to his acquisition of the stock, has been unanimously approved by the stockholders. In the principal case the result achieved is, that although the corporation has a good cause of action, it may not be asserted by the plaintiff, whose transferor was disqualified. It may, presumably, be asserted by other stockholders not laboring under a similar disability. In the hypothetical case just stated, however, the transaction has been ratified by the unanimous consent of the stockholders, and the result is that the corporate cause of action has been extinguished. In such a case it would clearly make no difference how innocently or ignorantly the subsequent stockholder purchased his stock, for there is no substituting cause of action.

also, that the doctrine seems to be in harmony with the current trend growing out of a desire to halt abuses of the derivative suit device, which appears to be toward ever stricter limitations on the right of the stockholder to sue on a corporate cause of action.[7]

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[7] E.g., Goldberg v. Ball, 305 Ill. App. 273, 27 N.E. (2d) 575 (1940), decided by the same court which decided the principal case, relying on its own decision in Bilhuber v. Bilhuber-Wawak Co., 245 Ill. App. 552 (1927); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903), and federal cases. In the Goldberg case recovery was denied on the grounds that the plaintiff had acquired his stock after the transaction. This decision, if followed by the Illinois Supreme Court, apparently aligns that state with those jurisdictions which follow the federal rule, though until this time it had been assumed that Illinois was of the opposite view. The trend is legislative as well as judicial, several states having followed the example set by New York in 1944 when it enacted § 61b of its general corporation law, N.Y. General Corp. Law, (McKinney, 1947 Supp.) § 61-6. For discussion of this trend see 8 MD. L. REV. 241 (1944); Hornstein, "New Aspects of Stockholders' Derivative Suits," 47 COL. L. REV. 1 (1947).