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NOTES

SHAREHOLDERS' RIGHT TO DIRECT RECOVERY IN DERIVATIVE SUITS

Direct recovery to stockholders in a derivative action is the exception rather than the rule. A stockholders' derivative suit is one brought for the benefit of a corporation by one or more of its stockholders who bring the action on behalf of stockholders as a class to enforce a corporate cause of action which the officers and directors have failed or refused to bring.

Corporate recovery is generally grounded on the theory that the wrong was done to the corporation, not to its stockholders either individually or collectively,¹ and that the recovery is an asset of the corporation.²

Since the topic of derivative suits involves many aspects, this paper will be concerned only with circumstances under which direct recovery to stockholders, rather than to the corporation, may be allowed.

Derivative suits giving rise to direct recovery most frequently involve those situations in which the majority owners have voted themselves excessive salaries³; have converted assets of the corporation to their own

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1. *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N.E. 193 (1909).
 2. *Liken v. Shaffer*, 64 F. Supp. 432 (N.D. Iowa 1946).
 3. *Matthews v. Headley Chocolate Co.*, 130 Md. 623, 100 Atl. 645 (1917).

use⁴; have sold corporate offices or control of the corporation⁵; or have breached their fiduciary duty in other ways, such as taking a corporate opportunity for themselves⁶ or profiting from personal dealing with their own corporation.⁷

The equities involved when these various wrongs to the corporation have been committed, result in allowance of direct recovery to the stockholders in exceptional circumstances.⁸ In such cases, each stockholder who is to recover receives a percentage of what the total recovery to the corporation would have been, in the proportion that his stock ownership bears to the total stock outstanding.⁹ The underlying theory of direct recovery might well be summed up thusly: "Every suit in a derivative capacity necessarily includes a suit in an individual capacity as well,"¹⁰ and "There is something abnormal in a judgment that allows the persons who did the fraudulent thing to share in the recovery for their guilt."¹¹

Historically, the idea of a direct recovery appears to have evolved from the right of stockholders to force distribution of assets of a defunct corporation. In 1855, stockholders of a corporation whose charter had been forfeited were successful in gaining a court order for liquidation and distribution of the assets by the trustee¹²; then in *Bailey's Appeal*,¹³ in 1880, minority stockholders gained an order that the majority holders who had fraudulently liquidated the firm and acquired its assets held the assets as trustees and must account to the minority.

The next step in the evolution of the direct recovery theory was for the court to appoint a receiver, in proper cases, when corporations were involved in disputes between groups of stockholders, with pro-rata distribution of assets.¹⁴ From there it was an easy step to the awarding of direct recovery to stockholders even where the corporation was a going concern and to be continued as such. Probably the first case of this type was *Eaton v. Robinson*,¹⁵ where direct recovery was ordered to make it unnecessary for the minority to resort to another suit to compel the defendant majority shareholders, who were also officers and directors and who had voted themselves excessive salaries, to distribute the fund.

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4. *Dill v. Johnston*, 72 Okla. 149, 179 Pac. 608 (1919).
 5. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); *Commonwealth Title & Trust Co. v. Seltzer*, 227 Pa. 410, 76 Atl. 77 (1910).
 6. *Young v. Columbia Oil Co. of West Virginia*, 110 W. Va. 364, 158 S.E. 678 (1931).
 7. *Spaulding v. North Milwaukee Town-Site Co.*, 106 Wis. 481, 81 N.W. 1064 (1900).
 8. *Von Arnim v. American Tubeworks*, 188 Mass. 515, 74 N.E. 680 (1905); *Geltman v. Levy*, 11 App. Div. 2d 411, 207 N.Y.S.2d 366 (1960).
 9. *DiTomasso v. Loverro*, 250 App. Div. 206, 293 N.Y.S. 912, 276 N.Y. 551, 12 N.E.2d 570 (1937).
 10. *May v. Midwest Refining Co.*, 121 F.2d 431 (1st Cir.), *cert. denied*, 314 U.S. 668 (1941).
 11. *Hyde Park Terrace Co. v. Jackson Bros. Realty Co.*, 161 App. Div. 699, 146 N.Y.S. 1037 (1914).
 12. *Bacon v. Robertson*, 18 How. 480 (1855).
 13. *Bailey's Appeal*, 96 Pa. 253 (1880).
 14. *Miner v. Belle Isle Ice Co.*, 93 Mich. 97, 53 N.W. 218 (1892); *Davis v. Gemmill*, 73 Md. 530, 21 Atl. 712 (1891).
 15. *Eaton v. Robinson*, 19 R.I. 146, 31 Atl. 1058 (1895); *cf.*, *Fougeray v. Cord*, 50 N.J.Eq. 185, 24 Atl. 499 (1892); *but cf.*, *Laurel Springs Land Co. v. Fougeray*, 50 N.J. Eq. 756, 26 Atl. 886 (1893).

SITUATIONS IN WHICH DIRECT RECOVERY ALLOWED

Situations in which courts have allowed direct recovery may be divided generally into two broad classes—those in which the corporation is no longer a going concern or is to be liquidated,¹⁶ and those in which the corporation is a going concern and the intention is to continue it as such. In this latter category the purpose of direct recovery is to limit recovery to the innocent shareholders¹⁷ and to insure that they receive it.¹⁸

When recovery is limited to innocent stockholders, three types of situations are generally encountered: (1) some of the shareholders have assented to the wrongdoers' acts or have waived their rights, and thus are not entitled to participate in recovery¹⁹; (2) the plaintiffs and the defendants own all of the stock, and recovery to the corporation would merely result in defendants' reimbursing themselves to the extent of their stock interest²⁰; and (3) shares of the defendants have been sold to outsiders who would then get an undeserved windfall if recovery were ordered to the corporation.²¹

In the first broad class, in which the corporation is not a going concern or is to be liquidated, direct recovery is awarded on the reasoning that the corporation, being dissolved, has no use for money, except for distribution to its stockholders²²; no advantage can be gained by payment to the corporation²³; and payment direct to the stockholders will avoid circuitry.²⁴

In the second broad class, in which the corporation is to continue as a going concern, direct recovery as a means of insuring that the plaintiff stockholders receive the money awarded is usually necessary where the wrong-doing defendants control the corporation. This was the case in *Davis v. Gemmell*,²⁵ where liquidation of the company was ordered, and in *Eaton v. Robinson supra*,²⁶ where the corporation was allowed to continue. Many such cases involve situations in which there are only a few stockholders, the majority have voted themselves excessive salaries,²⁷ and remain in control of the firm. The effect of direct recovery is actually a court declaration of a dividend,²⁸ and while it can be argued that this is a sequestration of corporate property,²⁹ courts have met this with the contention that to pay the money back to the corporation would be to

16. *Supra* note 7.

17. *Brown v. DeYoung*, 167 Ill. 549, 47 N.E. 863 (1897).

18. *Backus v. Finkelstein*, 23 F.2d 357 (Minn. 1927).

19. *Bailey v. Jacobs*, 325 Pa. 187, 189 Atl. 320 (1937).

20. *Crichton v. Webb Press Co., Ltd.*, 113 La. 167, 36 So. 926, 67 L.R.A. 76, 104 Am. Rep. 500 (1904).

21. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955).

22. *Supra* note 7.

23. *Sale v. Ambler*, 335 Pa. 165, 6 A.2d 519 (1939).

24. *Shanik v. Empire Power Corp.*, 58 N.Y.S.2d 176, *aff'd*, 296 N.Y. 664, 69 N.E.2d 818 (1945).

25. *Davis v. Gemmell*, 73 Md. 530, 31 Atl. 712 (1891).

26. *Supra* note 15.

27. *Supra* note 17.

28. *Baillie v. Columbia Gold Mining Co.*, 86 Ore. 1, 166 Pac. 965 (1917).

29. *Supra* note 15.

return it to the custody and control of those from whom recovery is had.³⁰

In limiting recovery to the innocent stockholders, courts are merely acting to avoid placing "the undeserving upon equality with the meritorious,"³¹ which would be the result of the court ordered recovery to the corporation in any of the three general situations.

In the first category, that of waiver or assent, the situation generally involves wrongdoing by officers or directors of the corporation, with acquiescence or laches by part of the stockholders and objection by others,³² waiver of rights or settlement by some stockholders,³³ or a vote by some stockholders in favor of ratification and vote against ratification by others.³⁴ In such cases, it is obvious that those who acquiesced in or ratified the wrongful acts are not deserving of participation in recovery, and only by direct recovery can the purpose of awarding the deserving, and not the undeserving, be achieved.

In the second category, where plaintiffs and defendants own all of the stock, direct recovery combines the purpose of limiting recovery to the innocent stockholders with the purpose of insuring that these innocent stockholders receive the recovery, for here the wrong-doing defendants are also usually in charge of the corporation. The reasoning in the early case of *Eaton v. Robinson supra*,³⁵ has been followed in later cases in order to benefit only the innocent and not those who participated in the misappropriation.³⁶

The third category, where corporate recovery would mean a windfall to outsiders who bought their stock from the defendants, is illustrated by the recent case of *Perlman v. Feldmann*,³⁷ which allowed direct recovery of profits from the wrongful sale of control of the corporation, holding that the control was a corporate asset for which recovery could be granted. The dominant stockholders and a former officer had sold the controlling stock at a premium price to an end-user of the firm's product—and with control went the right to corner distribution of this product during a time of market shortage. The court held that the plaintiff stockholders were entitled to recover in their own right their pro-rata share of the amount the purchase price exceeded the market price, since the purchasers should not share in any judgment rendered.

OTHER FACTORS IN ALLOWANCE OF DIRECT RECOVERY

In awarding direct recovery, courts have not always ordered a money payment. In *Southern Pacific Co. v. Bogert*,³⁸ Southern Pacific reorganized a small subsidiary into a new company in which the minority stockholders

30. *Supra* note 18.

31. *Matthews v. Headley Chocolate Co.*, 130 Md. 623, 100 Atl. 645 (1917).

32. *Ibid.*

33. *Jenkins v. Bradley*, 104 Wis. 540, 80 N.W. 1025 (1899).

34. *Chounis v. Laing*, 125 W. Va. 275, 23 S.E.2d 628 (1942); but cf., *Keenan v. Eshelman*, 23 Del. Ch. 234, 2 A.2d 904 (1938).

35. *Supra* note 15.

36. *Supra* note 17.

37. *Supra* note 5.

38. *Southern Pacific Co. v. Bogert*, 250 U.S. 483 (1919).

received nothing. Southern Pacific was ordered to deliver to the minority stockholders of the old company their proportionate share of stock in the new company, plus dividends paid on the stock less an allowance for their share of cost of reduction of the floating debt. In *Samia v. Central Oil Co.*³⁹ three brothers who controlled a family-owned corporation used its credit to finance a corporation of their own, to which they diverted business. Their three sisters sued for damages to the family corporation. The court held that to require the brothers to hold the stock of the new corporation in trust for the family corporation would "unjustly enrich the principal wrongdoer," so instead ordered each brother to sell ten percent of his holdings to one of his sisters. This resulted in each member of the family holding the same interest in each corporation and dispensed with the need for payment of damages by the new firm to the family firm. The brothers, however, were also ordered to pay to the family firm the amount of expense accounts they were unable to justify and the amount of excessive interest charges caused the family firm by their "improper conduct."

Also, courts have awarded direct recovery over the protest of the plaintiff, either to avoid recovery to an undeserving stockholder,⁴⁰ or to avoid granting corporate relief which would be "wholly impracticable," as in *May v. Midwest Refining Co.*⁴¹ Here, Standard Oil Co. held 99.96 percent of the stock of Midwest, and at a stockholders meeting voted to sell the assets of Midwest at book value to itself and another subsidiary. Standard offered to pay the plaintiff his loss on the basis of his complaint—plus his costs, but May wanted to void the sale on the grounds that Standard, as majority stockholder, was in a fiduciary capacity. The court ruled that "to attempt to grant relief by annulling this sale made six years ago and restoring such a vast amount and diversity of property . . . is wholly impracticable." Adding that "an eighty-million-dollar egg cannot be unscrambled, and the expense and time involved in trying to do so would be so great as to amount to a denial of justice," the court ordered the direct recovery to the plaintiff, despite his protest. The recovery gave the plaintiff some \$43,000 in counsel fees and expenses, while the book value of his stock was roughly \$6,400.

Closely related to direct recovery in derivative suits is the allowance of a direct suit by a former stockholder, who cannot now bring a derivative suit but who has suffered a wrong while a stockholder. In one such case a former owner of one-half the stock of the corporation was allowed to recover, against the former owner of the other half of the stock, for misappropriation of assets prior to the sale to the present owners.⁴² In another case, a former stockholder, who complained of a breach of fiduciary relationship by the former directors, was allowed to bring a direct suit on

39. *Samia v. Central Oil Co. of Worcester*, 339 Mass. 124, 158 N.E. 471 (1959).

40. *Joyce v. Congdon*, 114 Wash. 239, 195 Pac. 29 (1921).

41. *May v. Midwest Refining Co.*, 121 F.2d 431 (1st Cir.), cert. denied, 314 U.S. 668 (1941).

42. *Watson v. Button*, 235 F.2d 235 (9th Cir. 1956).

grounds that the present sole stockholder bought with knowledge and thus no stockholder existed who could vindicate the wrong.⁴³

In allowing direct recovery in derivative suits, courts generally will not allow such recovery when there are any unpaid creditors, on the theory that recovery is an asset of the corporation, and to pay that recovery directly to stockholders leaving creditors unpaid would be fraudulent as to them,⁴⁴ but when no rights of creditors or of members of the general public are involved, then direct recovery is permissible.⁴⁵

CONCLUSION

What the attitude of the Wyoming court would be concerning the matter of direct recovery in a derivative suit is in doubt, since it has not yet been litigated, although there is dictum in one case⁴⁶ that the final relief belongs to the corporation and not to the stockholders. The majority of decisions allowing direct recovery have been handed down since that Wyoming dictum, however; and in addition to that given by the United States Supreme Court and several federal circuit courts, direct recovery has been granted by state courts in Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, New York, Pennsylvania, Rhode Island, Washington, West Virginia, and Wisconsin.

Pelzman v. Feldmann, supra,⁴⁷ one of the most recent cases allowing direct recovery, has been commented on as "making an impact on the legal fraternity,"⁴⁸ although possibly more for its corporate control aspects than for its direct recovery allowance. Concerning the rights of the minority to recover, one court commented on this case thusly:⁴⁹

Corporate law in general, and the status of the minority shareholder in particular, is in a constant state of flux. New formulae and rules giving recognition to changing concepts of business morality and the needs of a dynamic and complex industrial society are continually being adopted by our legislatures and courts. There can be little doubt that as ownership of American industry becomes more diverse greater rights and responsibilities will attach to the status of shareholders. . . .

The above-quoted comment that "corporate law is in a constant state of flux" indicates that direct recovery in derivative suits is a product not only of the expansion of the corporate system but also of a gradual change of law in regard to it. It would therefore seem likely that the Wyoming court would recognize these changes should the matter come before it.

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43. *Hammer v. Werner*, 239 App. Div. 38, 265 N.Y.S. 172 (1933).

44. *Supra* note 2.

45. *Peoples State Bank v. Jacksonian Hotel Co.*, 261 Ky. 101, 87 S.W.2d 1111 (1935).

46. *Smith v. Stone*, 21 Wyo. 62, 128 Pac. 612 (1912).

47. *Supra* note 5.

48. *Manacher v. Reynolds*, 165 A.2d 741 (Del. Ch. 1960).

49. *H. Y. Reifsnyder v. Pittsburgh Outdoor Advertising Co.*, 405 Pa. 148, 173 A.2d 319, 322 (1961).