

## DISTINGUISHING BETWEEN DIRECT AND DERIVATIVE SHAREHOLDER SUITS

Ownership of shares of stock in a corporation gives rise to certain legal rights,<sup>1</sup> for example, the right to inspect the corporate books and records in good faith and at reasonable times.<sup>2</sup> If a shareholder is denied this right, he may sue the corporation to compel its directors to permit him to examine the books.<sup>3</sup> Such a suit is clearly a "direct action," that is, a suit by the shareholder in his own right to redress an injury sustained directly by him for which he is entitled to personal relief.<sup>4</sup> On the other hand, if a director converts corporate assets, the corporation is injured directly, while the shareholders suffer only indirectly through a decrease in the book value of their stock. The corporation may sue and recover its misappropriated assets,<sup>5</sup> and its recovery will also repair the shareholders' indirect injury. If the corporation is unwilling to sue, however, a shareholder may be able to "instigate" a suit to enforce the corporate cause of action;<sup>6</sup> any amount recovered will not go directly to the plaintiff-shareholder but will be added to the assets of the corporation.<sup>7</sup> Such a suit on behalf of the corporation is clearly a "derivative suit."<sup>8</sup> But between the definitive poles of the direct action to reify a shareholder's right of inspection and the derivative suit to recover lost corporate assets lies a blurred area where, because both the shareholder and the corporation have been significantly injured, it becomes difficult to distinguish between a "personal right" and a "corporate cause of action." In order to arrive at a sensible distinction in this hazy area, it is necessary to examine the doctrinal basis for derivative suits, the motivating policy considerations, and the legal incidents which follow from characterizing a particular cause of action "direct" or "derivative."

<sup>1</sup> See 13 FLETCHER, PRIVATE CORPORATIONS § 5717 (rev. ed. 1961).

<sup>2</sup> Kahn v. American Cone & Pretzel Co., 365 Pa. 161, 74 A.2d 160 (1950); see Ruby v. Penn Fibre Bd. Corp., 326 Pa. 582, 585, 192 Atl. 914, 916 (1937); PA. STAT. ANN. tit. 15, § 2852-308 (1958).

<sup>3</sup> Kahn v. American Cone & Pretzel Co., *supra* note 2.

<sup>4</sup> See Rogers v. American Tobacco Co., 143 Misc. 306, 257 N.Y. Supp. 321 (Sup. Ct.), *aff'd mem.*, 233 App. Div. 708, 249 N.Y. Supp. 993 (1931).

<sup>5</sup> See Anderson v. Derrick, 220 Cal. 770, 32 P.2d 1078 (1934); Grimes v. Brammer, 214 Iowa 405, 239 N.W. 550 (1931); Hirshberg v. Appel, 266 Mass. 98, 164 N.E. 915 (1929).

<sup>6</sup> The shareholder must allege a demand on the directors to sue, or show sufficient reason for not making such a demand. See Hawes v. Oakland, 104 U.S. 450 (1882); Bartlett v. New York, N.H. & H.R.R., 221 Mass. 530, 109 N.E. 452 (1915); Glenn v. Kittanning Brewing Co., 259 Pa. 510, 518, 103 Atl. 340, 342-43 (1918). Some jurisdictions also require a demand on the shareholders. See Pomerantz v. Clark, 101 F. Supp. 341, 344 (D. Mass. 1951); Continental Sec. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).

<sup>7</sup> See Knapp v. Bankers Sec. Corp., 230 F.2d 717, 720 (3d Cir. 1956); Liken v. Shaffer, 64 F. Supp. 432, 441 (N.D. Iowa 1946). *But cf.* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

<sup>8</sup> See Liken v. Shaffer, *supra* note 7.

## I. A POLICY APPROACH

A stock certificate represents the shareholder's pro rata interest in the net assets of the corporation, and any injury to the corporation is immediately reflected by a diminution in that interest. Nevertheless, the corporation and its shareholders are legally separate and distinct.<sup>9</sup> "[I]t leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."<sup>10</sup> Regard for the corporate personality demands that suits to redress corporate injuries which secondarily harm all shareholders alike be brought only by the corporation.<sup>11</sup> That a shareholder may be precluded from bringing a direct action for damages to his ownership interest was first established in *Smith v. Hurd*,<sup>12</sup> in which it was held that when a corporation is injured through the negligence of its directors, a cause of action exists only in favor of the corporation, even though the shareholders are also injured. Underlying this refusal to pierce the corporate veil are policy considerations which justify and support the integrity of the corporate entity. Above all, a corporate recovery restores the fund out of which creditors of the corporation are to be paid.<sup>13</sup> In addition, one corporate action avoids the multiplicity of suits which might otherwise be brought by individual shareholders.<sup>14</sup> Payment into the corporate treasury rather than into shareholder pockets benefits all shareholders equally and enables the corporation to continue to provide an investment channel for their risk capital. To permit proportionate individual recovery for damages to the corporation would in effect be a judicial determination to distribute corporate assets either as a dividend or in partial liquidation. Such a distribution might be an invasion of directors' discretion<sup>15</sup> or invalid<sup>16</sup>—as a dividend, in terms of a balance sheet surplus standard<sup>17</sup> or a net profits test,<sup>18</sup> or in partial liquidation, if such distribution would have required shareholder ratification or if no fund existed out of which such distribution could lawfully be

<sup>9</sup> *Smith v. Hurd*, 53 Mass. (12 Met.) 371, 384-85 (1847).

<sup>10</sup> *Klein v. Board of Tax Supervisors*, 282 U.S. 19, 24 (1930) (Holmes, J.).

<sup>11</sup> See *Grimes v. Brammer*, 214 Iowa 405, 239 N.W. 550 (1931); *Smith v. Hurd*, 53 Mass. (12 Met.) 371 (1847).

<sup>12</sup> 53 Mass. (12 Met.) 371 (1847).

<sup>13</sup> *Watson v. Button*, 235 F.2d 235, 237 (9th Cir. 1956) (dictum); *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717, 720 (3d Cir. 1956); *Liken v. Shaffer*, 64 F. Supp. 432, 441 (N.D. Iowa 1946); *Niles v. New York Cent. & H.R.R.R.*, 176 N.Y. 119, 122-23, 68 N.E. 142, 143-44 (1903).

<sup>14</sup> See, e.g., *Watson v. Button*, *supra* note 13, at 237 (dictum).

<sup>15</sup> See *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717, 720 (3d Cir. 1956); *Dodge v. Ford Motor Co.*, 204 Mich. 459, 500-02, 170 N.W. 668, 682 (1919); *Gordon v. Elliman*, 306 N.Y. 456, 459, 119 N.E.2d 331, 334 (1954).

<sup>16</sup> See *Keenan v. Eshleman*, 23 Del. Ch. 234, 251, 2 A.2d 904, 911 (Sup. Ct. 1938).

<sup>17</sup> E.g., N.Y. STOCK CORP. LAW § 58.

<sup>18</sup> E.g., N.J. STAT. ANN. § 14:8-19 (1939).

made.<sup>19</sup> Thus, to determine whether a particular claim for relief should be enforced through a direct action or derivatively, it must be ascertained whether the situation in question calls for the maintenance of the corporate personality to protect creditors, to avoid multiple suits, or to continue corporate control over the disposition of invested capital.

Characterization of an action as direct or derivative carries with it legal incidents which implement these policy considerations and which highlight the competing interests involved. If a suit is characterized as derivative, any amount recovered belongs to the corporation<sup>20</sup> and is thereby made subject to the claims of creditors. Such a characterization may eliminate multiple litigation in two ways: a successful defense will enable the defendant to interpose a *res judicata* bar to all other derivative suits on the same cause of action,<sup>21</sup> and "strike suits" may be discouraged in those jurisdictions having security-for-expenses legislation.<sup>22</sup> If plaintiff chooses to post the required security, derivative-suit characterization may ultimately cause him to indemnify the defendants for their litigation expenses and counsel fees.<sup>23</sup> When a suit is characterized as direct, the amount recovered goes straight to the shareholder;<sup>24</sup> therefore, the shareholder would especially prefer direct-action characterization when any corporate recovery would be certain to pass immediately to creditors or when the alleged wrongdoer, although able to satisfy a judgment in an amount due one shareholder, would be unable to satisfy the entire corporate claim. A direct-action characterization might also be sought either because the plaintiff is no longer a shareholder in the corporation—hence, unable to maintain or benefit from a derivative suit—or because the corporation itself no longer exists. Where a shareholder is unable or chooses not to meet the costs imposed by an applicable security-for-expenses statute,<sup>25</sup> he would be compelled either to seek a direct-action characterization or to forego his litigation. In addition, a derivative-suit characterization may mean that the corporation would be an indispensable party to the action;<sup>26</sup> if jurisdiction over the corporation could not be obtained, the shareholder would be forced to seek a direct-action characterization or bring a derivative suit in federal court under the nationwide-service provision.<sup>27</sup> Absent

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<sup>19</sup> See BAKER & CARY, *CASES AND MATERIALS ON CORPORATIONS* 1239 (3d ed. 1959).

<sup>20</sup> See cases cited note 7 *supra*.

<sup>21</sup> *Liken v. Shaffer*, 64 F. Supp. 432, 443-44 (N.D. Iowa 1946).

<sup>22</sup> *E.g.*, N.Y. GEN. CORP. LAW § 61-b. See generally BAKER & CARY, *op. cit. supra* note 19, at 678.

<sup>23</sup> *E.g.*, N.Y. GEN. CORP. LAW §§ 63-66.

<sup>24</sup> See *Smith v. Sperling*, 354 U.S. 91, 99 (1957) (Frankfurter, J., dissenting).

<sup>25</sup> See Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1, 3, 5, 31 (1947).

<sup>26</sup> See, *e.g.*, *Keeler v. Schulte*, 47 Cal. 2d 801, 306 P.2d 430 (1957); *Carruthers v. Jack Waite Mining Co.*, 306 N.Y. 136, 116 N.E.2d 286 (1953) (dictum); 13 FLETCHER, PRIVATE CORPORATIONS § 5997 (rev. ed. 1961).

<sup>27</sup> 28 U.S.C. § 1695 (1958); see *Smith v. Sperling*, 354 U.S. 91 (1957). See generally Kessler, *Corporations and the New Federal Diversity Statute: A Denial of Justice*, 1960 WASH. U.L.Q. 238; Weiner, *Jurisdiction Over the Beneficiary Corporation in Stockholders' Suits*, 22 VA. L. REV. 153 (1935); Note, 44 YALE L.J. 1091 (1935).

such circumstances which make a direct recovery desirable, a shareholder would benefit from a derivative-suit characterization which would place the proceeds of suit under corporate control as a continuing investment and would enable him, if successful, to recoup his counsel fees.<sup>28</sup>

In any event, to determine the proper characterization of a shareholder's suit, a court should evaluate the particular competing interests of the plaintiff shareholder, the alleged wrongdoer, and the corporate creditors in terms of the policy considerations and their concomitant legal incidents.

## II. THE POLICIES IN CONTEXT

### A. Compelling Declaration of Dividends

While it is agreed that a suit to compel payment of a declared dividend is a direct action to enforce the "creditor"-shareholder's claim,<sup>29</sup> there is a division of authority as to proper characterization of a suit to compel declaration of a dividend.<sup>30</sup> Nondeclaration of dividends, if unjustified, injures the shareholders by constricting or postponing the return on their investment; the corporation is injured by having a dividend policy that fails to attract new capital. In *Knapp v. Bankers Sec. Corp.*,<sup>31</sup> it was held that since dividends are an incident of stock ownership and any improper refusal to declare them results in a distinct injury to the shareholder, a suit to compel declaration is a direct action. In support of such a characterization it has been noted that the corporation is enriched rather than harmed by a retention of corporate assets.<sup>32</sup> But in *Knapp* one of the grounds of complaint was that nondeclaration of dividends would subject the corporation to a surtax<sup>33</sup> so that instead of being enriched by the retention, the corporation would only be transferring funds to the government rather than distributing them to its shareholders.

In a suit to compel declaration of a dividend, a court will grant relief only if there is a fund lawfully available.<sup>34</sup> Corporate creditors would be unaffected by a direct-action characterization, even if the declaration would result in an impairment of the capital cushion under some variation of the net profits test, since any distribution ordered will be in accord with the dividend law of the jurisdiction in question which presumably has taken into account the creditors' interest. A multiplicity of suits to compel dec-

<sup>28</sup> See *Neuberger v. Barrett*, 180 Misc. 222, 223, 39 N.Y.S.2d 575, 576-77 (Sup. Ct. 1942); *BAKER & CARY, op. cit. supra* note 19, at 717.

<sup>29</sup> See, e.g., *Independence Lead Mines Co. v. Kingsbury*, 175 F.2d 983 (9th Cir.), cert. denied, 338 U.S. 900 (1949).

<sup>30</sup> Compare *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717 (3d Cir. 1956), with *Gordon v. Elliman*, 306 N.Y. 456, 119 N.E.2d 331 (1954).

<sup>31</sup> 230 F.2d 717 (3d Cir. 1956). *Contra*, *Gordon v. Elliman, supra* note 30.

<sup>32</sup> *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717, 722 (3d Cir. 1956).

<sup>33</sup> *Id.* at 719; INT. REV. CODE OF 1954, § 531.

<sup>34</sup> See *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919) (by implication); *Gordon v. Elliman*, 306 N.Y. 456, 474, 119 N.E.2d 331, 343 (1954) (Fuld, J., dissenting).

laration of dividends is unlikely since the courts, reluctant to interfere with directors' business judgment, have placed a heavy burden of proof upon the plaintiff.<sup>35</sup> In addition, even if the characterization issue is not raised, the court is likely, in a successful suit, to provide for class distribution rather than just individual relief.<sup>36</sup> Therefore, the *res judicata* and security-for-expenses protection of derivative-suit characterization is unnecessary; and since a suit to compel declaration imposes no personal liability on directors, the diminished possibility of secret settlements makes almost superfluous the prohibitive strictures of a security-for-expenses statute,<sup>37</sup> although in some cases, as in *Knapp*, a defendant-director may be a majority shareholder whose income tax liability would be greatly increased by a dividend distribution,<sup>38</sup> thus making him more amenable to a secret settlement. Finally, there is no need for a derivative-suit label to keep the amount recovered within the corporation's management since the very purpose of the suit is to remove funds from corporate control. Thus, since there is a built-in protection for creditors, an inherent curb on multiple litigation, and an alleged need to withdraw funds from corporate management, a direct-action characterization is proper for a suit, normally a class suit, to compel declaration of dividends.

### *B. Breach of Covenant Not to Compete*

It is generally accepted that the characterization of suits for breach of contract depends primarily on the intention of the parties to the contract.<sup>39</sup> Although breach of a contract with a corporation usually gives rise to a corporate cause of action,<sup>40</sup> such a contract has sometimes been interpreted as a third party beneficiary contract in favor of the shareholders to permit them to maintain direct actions as the real parties in interest.<sup>41</sup> Conversely, a contract to which the corporation was not a party has sometimes been interpreted as a third party beneficiary contract in favor of the corporation to be enforced derivatively and not directly. This result has been reached in cases in which one shareholder, selling his shares to another, has covenanted not to compete with the corporation for a stated period of time;<sup>42</sup> since the agreement has usually not been explicit as to the cor-

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<sup>35</sup> See, e.g., *Conviser v. Simpson*, 122 F. Supp. 205 (D. Md. 1954); *Gottfried v. Gottfried*, 73 N.Y.S.2d 692 (Sup. Ct. 1947).

<sup>36</sup> See BALLANTINE, CORPORATIONS § 234 (rev. ed. 1946).

<sup>37</sup> *Gordon v. Elliman*, 306 N.Y. 456, 479-80, 119 N.E.2d 331, 345-46 (1954) (Fuld, J., dissenting).

<sup>38</sup> INT. REV. CODE OF 1954, § 301(c).

<sup>39</sup> See, e.g., *Marshfield Clinic v. Doege*, 269 Wis. 519, 526, 69 N.W.2d 558, 562 (1955).

<sup>40</sup> See *Green v. Victor Talking Mach. Co.*, 24 F.2d 378, 382 (2d Cir.), *cert. denied*, 278 U.S. 602 (1928); *Cullum v. General Motors Acceptance Corp.*, 115 S.W.2d 1196 (Tex. Ct. Civ. App. 1938).

<sup>41</sup> See *Fleming v. Reed*, 77 N.J.L. 563, 72 Atl. 299 (Sup. Ct. 1909); *Lovitt v. Illinois Sur. Co.*, 88 Misc. 100, 150 N.Y. Supp. 609 (Sup. Ct. 1914).

<sup>42</sup> See *Olson v. Ostby*, 178 Ill. App. 165 (1913); *Marshfield Clinic v. Doege*, 269 Wis. 519, 69 N.W.2d 558 (1955).

poration's beneficiary status, the intention of the parties has had to be presumed. Violation of a covenant not to compete would ordinarily decrease the volume of the corporation's business, thereby cutting into its expected profits; it might ultimately lead to a capital impairment. Creditors who had relied on the current and projected stability of the corporation might be injured if any damages recovered in a suit for breach of the covenant were not channelled into the corporate treasury. Although multiple litigation is no problem since a direct action could be brought only by the purchasing shareholder or his assignees, derivative characterization is needed to retain any amount recovered as a continuing investment with the corporation and to vest in the corporation—and derivatively in all its shareholders—the right to seek an injunction against further competition by the defendant if the purchasing shareholder or his assignees do not sue. Money damages and injunctive relief running to the corporation will tend to preserve the market value of the stock as enhanced by the covenant; the purchasing shareholder will be able to retrieve his consideration through resale of the stock at its increased market price. Unless the contract stipulates that the cause of action for breach of the covenant is in the purchasing shareholder, the cause of action should usually be enforced by a derivative suit.<sup>43</sup>

### C. Decline in Market Value

In *Coronado Dev. Corp. v. Millikin*,<sup>44</sup> a direct action was held to be the only means to redress a decline in the market value of shares allegedly caused by the dissemination of false information about the corporation's financial position. However, a decline in market value will harm the corporation should it seek new capital through a public issue of stock. Moreover, this diminished market value is often accompanied by a decrease in book value which can be restored most appropriately by a corporate derivative recovery. The corporation is also likely to be incidentally damaged through an impaired credit rating.<sup>45</sup> A direct-action characterization in this situation involves a danger of multiple suits since all the shareholders will be injured by the market decline. Damages recovered for the decrease in market or book value, whichever is greater, should go to the corporation to enable it to reestablish its economic standing with its creditors and prospective shareholders; recovery by an individual shareholder lacks this bolstering effect.

### D. Stock Issued for Inadequate Consideration

Issuance of shares of stock for inadequate consideration—for a consideration less than par or, if no-par, less than the stated value—deprives

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<sup>43</sup> But see *Meyerson v. Franklin Knitting Mills*, 185 App. Div. 458, 172 N.Y. Supp. 773 (1918).

<sup>44</sup> 175 Misc. 1, 22 N.Y.S.2d 670 (Sup. Ct. 1940), *complaint dismissed for insufficient allegation as to damages*, 262 App. Div. 504, 30 N.Y.S.2d 548 (1941).

<sup>45</sup> See *id.* at 6, 22 N.Y.S.2d at 675.

the creditors of their proper cushion and can only be remedied by derivative suit against the directors to compel payment into the corporate treasury.<sup>46</sup> Such payment will also serve to equalize the capital base contributed by each class of shareholders, thereby returning those shareholders who paid fully for their shares to the *status quo ante*. However, when stock is issued for a consideration less than the market or book value but above par or stated value, there is no capital impairment which would harm creditors' interests. Further, since a solvent corporation has usually not been permitted to recover the amount unpaid on shares issued as fully paid,<sup>47</sup> there would be no derivative cause of action in such circumstances. If a plaintiff-shareholder's voting power is diluted by the issuance, thereby violating possible preemptive rights, appropriate relief—restoration of voting power—can be obtained in a direct action.<sup>48</sup> Thus, proper characterization in this area must ultimately depend on the nature of the injury alleged and the relief sought.<sup>49</sup>

### III. DIRECT RECOVERY IN SPECIAL SITUATIONS

#### *A. The Special Duty Doctrine*

The "special duty" doctrine first enunciated in *Ritchie v. McMullen*<sup>50</sup> provides that an act violating a special duty owed a shareholder, even though also injuring the corporation, constitutes a wrong to that shareholder enforceable in a direct action.<sup>51</sup> This special duty arises not from the normal director-shareholder relationship but from pledgor-pledgee relationships,<sup>52</sup> fiduciary relationships,<sup>53</sup> and contractual arrangements.<sup>54</sup> In *Ritchie v. McMullen*,<sup>55</sup> since the shareholder had pledged his stock with the directors as security for a loan, the requisite duty was found in a pledgor-pledgee relationship. The pledgee-directors obtained a court order for a judicial sale of the stock to satisfy the debts it secured. The pledgor-shareholder, alleging that the directors misused their powers to depress the value of the stock in order to force a sale and purchase it themselves,

<sup>46</sup> See *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 15, 99 A.2d 236, 241 (Ch. 1953); *State ex rel. Weede v. Bechtel*, 244 Iowa 785, 56 N.W.2d 173 (1952); *Selman v. Allen*, 121 N.Y.S.2d 142 (Sup. Ct. 1953).

<sup>47</sup> See *BAKER & CARY, op. cit. supra* note 19, at 794, 827.

<sup>48</sup> See *Ames v. Voit*, 97 F. Supp. 89 (S.D.N.Y.), *rev'd on jurisdictional grounds sub nom. Ames v. Mengel Co.*, 190 F.2d 344 (2d Cir. 1951); *Horwitz v. Balaban*, 112 F. Supp. 99 (S.D.N.Y. 1949); *Hammer v. Werner*, 239 App. Div. 38, 265 N.Y. Supp. 172 (1933).

<sup>49</sup> See *Witherbee v. Bowles*, 201 N.Y. 427, 431-32, 95 N.E. 27, 28 (1911).

<sup>50</sup> 79 Fed. 522 (6th Cir.), *cert. denied*, 168 U.S. 710 (1897).

<sup>51</sup> *But cf. Smith v. Hurd*, 53 Mass. (12 Met.) 371 (1847).

<sup>52</sup> See *Ritchie v. McMullen*, 79 Fed. 522 (6th Cir.), *cert. denied*, 168 U.S. 710 (1897); *Kono v. Roeth*, 237 App. Div. 252, 260 N.Y. Supp. 662 (1932); *Cutler v. Fitch*, 231 App. Div. 8, 246 N.Y. Supp. 28 (1930).

<sup>53</sup> See *Blakeslee v. Sottile*, 118 Misc. 513, 194 N.Y. Supp. 752 (Sup. Ct. 1922).

<sup>54</sup> See *Meyerson v. Franklin Knitting Mills*, 185 App. Div. 458, 172 N.Y. Supp. 773 (1918).

<sup>55</sup> 79 Fed. 522 (6th Cir.), *cert. denied*, 168 U.S. 710 (1897).

counterclaimed against the pledgee-directors to repair this loss. The court held these allegations sufficient to support a direct action, probably because the pledgor, who was obliged to sell his shares, could not maintain a derivative suit<sup>56</sup> nor benefit from one brought by other shareholders. Presumably the corporation retained its cause of action<sup>57</sup> to protect creditors and the remaining shareholders. In view of the directors' intentional mismanagement, multiple liability does not seem harsh, for the directors would have been unjustly enriched had they fulfilled their alleged intention to purchase the pledgor's stock at its depressed value. There is no threat of multiple litigation in special-duty situations since the doctrine by its very nature can be invoked only by those privy to a recognized relationship.

In cases similar to *Ritchie*, the courts have usually adopted direct-action characterization only after finding intentional wrongdoing aimed at a particular pledgor-shareholder. In *Millikin v. McGarrak*,<sup>58</sup> another pledge situation, the cause of action was held to be solely derivative because the decrease in share value was caused by the pledgee-directors' negligence unaccompanied by any intent to profit by acquiring the pledgor's stock.<sup>59</sup> However, although the injured shareholder may be adequately protected through restoration of his share value in a derivative suit, if he has been forced to sell his shares, his only remedy lies in a direct action. His right to redress should not necessarily be lost by reason of a lack of specific intent on the part of the directors; nor are the directors' motives directly relevant to the policy considerations which support the interposition of the corporate entity.<sup>60</sup>

Some courts permit a shareholder who has not sold his shares, and can still maintain a derivative suit, to recover directly for acts done by a party who owed him a special duty.<sup>61</sup> The injured shareholder thus can reap a double recovery since he will also benefit from a derivative enforcement of the corporate cause of action. It is doubtful whether the imposition of multiple liability on the directors with its concomitant windfall to the injured shareholder is justifiable, notwithstanding its deterrent value.

### B. *The General Rubber Co. Doctrine*

A plaintiff damaged solely by an injury to the corporation may not necessarily be made whole by a derivative suit even though he is still a shareholder. In *General Rubber Co. v. Benedict*,<sup>62</sup> the plaintiff was a parent corporation of a subsidiary which had been defrauded by one of

<sup>56</sup> See *id.* at 533; *Hanna v. Lyon*, 179 N.Y. 107, 71 N.E. 778 (1904).

<sup>57</sup> See *Cutler v. Fitch*, 231 App. Div. 8, 246 N.Y. Supp. 28 (1930).

<sup>58</sup> 159 App. Div. 725, 144 N.Y. Supp. 964 (1913).

<sup>59</sup> See *Ritchie v. McMullen*, 79 Fed. 522, 534 (6th Cir.), *cert. denied*, 168 U.S. 710 (1897) (dictum).

<sup>60</sup> *Cf. Cutler v. Fitch*, 231 App. Div. 8, 246 N.Y. Supp. 28 (1930); *Blakeslee v. Sottile*, 118 Misc. 513, 194 N.Y. Supp. 752 (Sup. Ct. 1922).

<sup>61</sup> See *ibid.*

<sup>62</sup> 215 N.Y. 18, 109 N.E. 96 (1915).

its officers. A director of the parent knew of the officer's intended misappropriation, which would inevitably diminish the value of the parent's stock, but failed to disclose it. The parent corporation sued this director for negligent performance of his duties; the subsidiary had not yet sued its own officer or the parent's director. Since in a derivative suit upon the subsidiary's cause of action the officer might be judgment-proof or outside the jurisdiction, and the director might not be liable as a co-conspirator,<sup>63</sup> the court permitted the parent to bring suit directly against its director. The court pointed out, however, that if the parent corporation's loss could be entirely satisfied in a derivative suit, it would be able to recover only nominal damages in its own suit in order to avoid the unjustified profit of a double recovery. As an alternative to speculating about the results of a derivative suit, it might be possible to stay the direct action until decision in the derivative suit; however, this delay might be fatal to the direct action because of unavailable witnesses, stale evidence, and the like. Nevertheless, the core of the *General Rubber Co.* doctrine, which permits both a direct and derivative cause of action but only one recovery, should be used to alleviate the special duty doctrine's unduly harsh result of permitting direct recovery even though the plaintiff, still a shareholder in the injured corporation, may benefit from a derivative suit as well.

### C. Equitable Considerations and Fraud

Courts have also granted direct recovery for an act injurious to both the corporation and the shareholder when overtones of fraud have been present. In *Von Au v. Magenheimer*,<sup>64</sup> corporate officers induced a shareholder to sell his stock to them for less than its true worth by deliberately exaggerating to him the corporation's financial difficulties caused by their conversion of corporate assets without the shareholder's knowledge. In a suit by the former shareholder a direct recovery was allowed apparently on the basis of equitable considerations<sup>65</sup>—because plaintiff had suffered injury which a derivative suit could not redress—although this decision could also have been based on a fraud theory;<sup>66</sup> some courts have treated fraud as being a "breach of a special duty."<sup>67</sup>

Where a director or officer has induced a stock subscription with intent to misappropriate the invested property, the defrauded investor, now shareholder, has been permitted to bring a direct action to restore the former value of his stock decreased by the misappropriation.<sup>68</sup> This direct recovery has been rationalized on the theory that the misappropriation

<sup>63</sup> *Id.* at 24, 109 N.E. at 98.

<sup>64</sup> 126 App. Div. 257, 110 N.Y. Supp. 629 (1908), *aff'd mem.*, 196 N.Y. 510, 89 N.E. 1114 (1909).

<sup>65</sup> See *id.* at 268, 110 N.Y. Supp. at 636-37.

<sup>66</sup> *Id.* at 267, 110 N.Y. Supp. at 636.

<sup>67</sup> See *Vierling v. Baxter*, 293 Pa. 52, 141 Atl. 728 (1928).

<sup>68</sup> See *Sutter v. General Petroleum Corp.*, 28 Cal. 2d 525, 170 P.2d 898 (1946); *Vierling v. Baxter*, *supra* note 67.

tion which injured the corporation was merely the culmination of the fraudulent act alleged by the shareholder which was actually perpetrated at the time the shareholder was induced to invest.<sup>69</sup> Absent fraudulent intent at that time, any subsequent depletion of corporate assets would not support a direct cause of action.<sup>70</sup> Since the defrauded shareholder could have maintained a derivative suit, it is questionable whether a direct action should be allowed in view of the possibility of a double recovery.<sup>71</sup> Moreover, if the wrongdoers are able to satisfy only one judgment, a shareholder's direct-action recovery prior to any derivative judgment would benefit him at the expense of corporate creditors—if the corporation was insolvent after the fraud—and the other shareholders.

#### D. Nonexistence of the Corporate Entity

Corporations sometimes terminate without first suing upon their causes of action.<sup>72</sup> In some of these cases the destruction of the corporate entity has been incident to an officers' plan to defraud the shareholders by misappropriating corporate assets.<sup>73</sup> Many states have enacted statutes which revive the corporate entity to enforce derivative causes of action which arose during its lifetime.<sup>74</sup> In the absence of such statutes courts have employed direct-action characterization to allow the wrong to be redressed. The special duty doctrine has been invoked when warranted by the facts,<sup>75</sup> or the courts have held that upon the corporation's death its rights passed to the shareholders on the theory that the misappropriated property was held by the corporation in trust for the actual owners, the shareholders.<sup>76</sup> One court has even permitted a direct action where a statute<sup>77</sup> existed authorizing suit in the corporate name;<sup>78</sup> but there was no danger of multiple litigation since the plaintiff and one of the defendants were the only shareholders in the former corporation.<sup>79</sup>

<sup>69</sup> See *Sutter v. General Petroleum Corp.*, *supra* note 68, at 531-32, 170 P.2d at 902.

<sup>70</sup> See *Sutter v. General Petroleum Corp.*, 28 Cal. 2d 525, 170 P.2d 898 (1946); *W. E. Hedger Transp. Corp. v. Ira S. Bushey & Sons*, 186 Misc. 758, 61 N.Y.S.2d 876 (Sup. Ct. 1945), *aff'd mem.*, 270 App. Div. 912, 61 N.Y.S.2d 882 (1946).

<sup>71</sup> *But cf.* *General Rubber Co. v. Benedict*, 215 N.Y. 18, 109 N.E. 96 (1915).

<sup>72</sup> See *Backus v. Kirsch*, 264 Mich. 73, 249 N.W. 469 (1933); *Smyth v. Kenwood Land Co.*, 97 Ore. 19, 190 Pac. 962 (1920).

<sup>73</sup> See *Jones v. Missouri-Edison Elec. Co.*, 144 Fed. 765 (8th Cir. 1906), *cert. denied*, 229 U.S. 615 (1913); *Kono v. Roeth*, 237 App. Div. 252, 260 N.Y. Supp. 662 (1932).

<sup>74</sup> *E.g.*, PA. STAT. ANN. tit. 15, § 2852-1111(B) (1958).

<sup>75</sup> See *Kono v. Roeth*, 237 App. Div. 252, 260 N.Y. Supp. 662 (1932).

<sup>76</sup> See *Gasque v. Ball*, 65 Fla. 383, 62 So. 215 (1913); *Smyth v. Kenwood Land Co.*, 97 Ore. 19, 190 Pac. 962 (1920).

<sup>77</sup> See COLO. REV. STAT. ANN. § 31-6-1 (1953).

<sup>78</sup> *Ward v. Graham-Jones Motor Co.*, 74 Colo. 145, 147, 219 Pac. 776, 777 (1923).

<sup>79</sup> *Ibid.*

## IV. CONCLUSION

Distinguishing between direct and derivative shareholder suits is not made easier by application of such question-begging phrases as "personal right" and "corporate cause of action." Proper characterization can only be effected by considering the possible results of each suit: an individual recovery may leave corporate creditors with unsatisfied claims or deprive shareholders of part of their investment; a derivative suit may be barred by *res judicata*, may be prohibitive by reason of a security-for-expenses statute, or may inadequately compensate shareholders for peculiar individual injuries.

*J. B.*