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NOTES

PERSONAL RECOVERY BY SHAREHOLDERS FOR INJURY TO CORPORATION

Few rules of corporation law are more generally recognized and applied than the rule of the leading case *Smith v. Hurd*¹ that a shareholder may not ordinarily recover damage for shrinkage in the value of his shares caused by negligent or intentional injury to the corporation.² Sometimes courts are satisfied to base this rule upon the separate entity of the corporation: the *primary* injury is said to be to the corporation; the injury to the shareholder is only *incidental* or *remote*, one which he suffers only in common with other shareholders; there is no

¹ 12 Met. (Mass.) 371 (1847).

² *Anderson v. Derrick*, 220 Cal. 770, 32 P. (2d) 1078 (1934); *Greenwood v. Greenblatt*, 173 Ga. 551, 161 S.E. 135 (1931); *Niles v. N.Y.C. & H.R.R.R. Co.*, 176 N.Y. 119, 68 N.E. 142 (1903).

"privity" between the shareholder and the wrongdoer.³ Frequently, however, reasons of a more practical character are given. Since it is usually conceded that the corporation has a cause of action, direct relief to the shareholders might double the defendant's liability.⁴ And if recovery should be denied the corporation, the conduct of its business and rights of its creditors might be jeopardized.⁵ In any event, the single action in favor of the corporation is said to be more convenient than the multiplicity of suits which might result from a recognition of direct liability to shareholders.⁶ And finally it is pointed out that the shareholder needs no direct cause of action: recovery by the corporation will normally remedy also the injury to the shares;⁷ and if the directors fail to prosecute the corporation's claim, the right of a shareholder to maintain a derivative suit for the benefit of the corporation is universally recognized.⁸

In a number of cases an exception to the rule denying direct recovery to the shareholder has been recognized in situations where the defendant is said to have violated not only a duty to the corporation but also an independent duty to a particular shareholder, arising out of some special relation, fiduciary or contractual.⁹ Thus individual recovery has been given to a parent corporation against one of its directors for colluding in or negligently failing to prevent the looting of its subsidiary.¹⁰ And similarly where the shareholder was a decedent's estate and the defendant its unfaithful administrator.¹¹ Decisions such as these raise difficult problems as to the amount of damages. In *General Rubber Co. v. Benedict*,¹² Chief Judge Cardozo pointed out that a cumulation of the defendant's liability might be avoided or minimized by taking into account in computing

³ *Mente & Co. v. La. State Rice Milling Co.*, 176 La. 475, 146 So. 28 (1933).

⁴ *White v. First National Bank*, 252 Pa. 205, 97 Atl. 403 (1916).

⁵ *Dorrah v. Pemiscot County Bank*, 213 Mo. App. 541, 256 S.W. 560 (1923); *Beeber v. Wilson*, 285 Pa. 312, 131 Atl. 854 (1926).

⁶ *Wells v. Dane*, 101 Me. 67, 63 Atl. 728 (1905).

⁷ *Green v. Victor Talking Machine Co.*, 24 F. (2d) 378 (C.C.A. 2d 1928), cert. denied, 278 U.S. 602; *Wells v. Dane*, 101 Me. 67; 63 Atl. 728 (1905).

⁸ See 13 Fletcher, *Cyclopedia of the Law of Corporations* (perm. ed. 1933), §§ 5939 et seq.; Glenn, *The Stockholder's Suit—Corporate and Individual Grievances*, 33 Yale L.J. 580 (1924).

⁹ *Chase National Bank v. Sayles*, 30 F. (2d) 178 (D.C.D.R.I. 1927) (general business agency); *Meyerson v. Franklin Knitting Mills*, 185 App. Div. 458, 172 N.Y. Supp. 773 (1918) (contract made on sale of defendant's shares to plaintiff); *Keating v. Hammerstein*, 125 Misc. 334, 209 N.Y. Supp. 769 (1921) (defendant had established trust for benefit of plaintiffs, reserving voting power of the shares settled); *Kono v. Roeth*, 237 App. Div. 252, 260 N.Y. Supp. 662 (1932) (pledge).

See also *Camp v. Gress*, 250 U.S. 308 (1919) (contract); *Ritchie v. McMullen*, 70 Fed. 522 (C.C.A. 6th 1897) (pledge); *Rogers v. Penobscot Mining Co.*, 154 Fed. 606 (C.C.A. 8th 1907) (contract). Cf. *Eden v. Miller*, 37 F. (2d) 8 (C.C.A. 2d 1930).

In *Vierling v. Baxter*, 293 Pa. 52, 141 Atl. 728 (1928), this rule was applied although the basis of the special relation is difficult to discover.

¹⁰ *General Rubber Co. v. Benedict*, 215 N.Y. 18, 109 N.E. 96 (1915).

¹¹ *Matter of Auditore*, 249 N.Y. 335, 164 N.E. 242 (1928).

¹² *Supra*, note 10.

the shareholder's damage the fact that the corporation has as one of its assets a cause of action for the injury to it. The greater the value of this cause of action, the less will be the shareholder's damages. If the persons liable to the corporation and to the shareholder are identical, this suggestion might conceivably reduce damages almost to a nominal sum, but in most cases recovery has apparently been given without any such reduction of damages.¹³

In any event, the creation of this and other related problems¹⁴ by a recognition of a personal cause of action in the shareholder is both unfortunate and unnecessary. The want of a duty running to shareholders has certainly not been the most persuasive reason for the denial of such a cause of action in the ordinary case. Indeed, one of the most frequent cases is that where the defendant is a director, and directors are said for many purposes to be in a fiduciary relation not only to the corporation but also to its shareholders. Furthermore, no exception is usually made in favor of a shareholder who alleges that the defendant was motivated by a desire to injure him.¹⁵ The statements as to absence of duty or privity in cases like *Smith v. Hurd* are only statements of the results of decisions reached upon other grounds. The availability of the derivative remedy and the serious inconvenience and possible injustice inherent in the recognition of a direct remedy also, furnish the strongest argument against such recognition, and this whether or not some special relation to the plaintiff shareholder exists.¹⁶ Some courts may have been influenced by these considerations since in some cases they have strictly limited the class of special duties or relations which will justify direct recovery.¹⁷ Another possible solution of the

¹³ *Meyerson v. Franklin Knitting Mills*, 185 App. Div. 458, 172 N.Y. Supp. 773 (1918); *Keating v. Hammerstein*, 125 Misc. 334, 209 N.Y. Supp. 769 (1921).

¹⁴ A paradoxical situation arises when the defendant is insolvent at the time the shareholder's suit is brought. Since the corporate cause of action is of only speculative value, under the damage rule laid down by Chief Judge Cardozo, the shareholder to whom some special duty was owed could recover full damages. Then, if the defendant subsequently became solvent, he might be forced to pay judgments in favor of both the corporation and the stockholder, and the latter would thus be doubly compensated.

¹⁵ *Green v. Victor Talking Machine Co.*, 24 F. (2d) 378 (C.C.A. 2d 1928), cert. denied, 278 U.S. 602; *Wells v. Dane*, 101 Me. 67, 63 Atl. 728 (1905); *Seitz v. Michel*, 148 Minn. 474, 181 N.W. 106 (1921).

Compare Stidham v. State Bank, 126 Kan. 336, 600, 268 Pac. 106, 594 (1928), where recovery was given to a bank shareholder for slander of the soundness of the bank, alleged to have been uttered for the purpose of ruining the plaintiff among others.

¹⁶ Cf. notes 28 Harv. L. Rev. 409 (1915); 38 Yale L.J. 965 (1929).

¹⁷ Thus in *Boatright v. Steinite Radio Corp.*, 46 F. (2d) 385 (C.C.A. 10th 1931), although the plaintiff and the defendant had entered into a joint venture pursuant to which the corporation had been organized, the plaintiff was refused recovery for injury due to the defendant's failure to perform obligations undertaken in the original agreement with the plaintiff. Accord: *Smith v. Bramwell*, 146 Ore. 611, 31 P. (2d) 647 (1934) (rotting trust agreement).

In a number of cases the plaintiff has relied on a contract only. Thus in *Olson v. Ostby*, 178 Ill. App. 165 (1913), the defendant had promised the plaintiff not to compete with the corporation; and in *Van Boskerck v. Aronson*, 197 N.Y. Supp. 809 (1923), the complaint of a

problem lies in staying the shareholder's individual suit until a suit for the benefit of the corporation might be prosecuted, but there has been no suggestion of this possibility in the cases.

It is only where the derivative remedy will not cure the injury to the plaintiff that the recognition of a direct action may be desirable.¹⁸ This is frequently the case where the shareholder has parted with his shares after the injury took place. Of course, that fact alone will not permit recovery by the former shareholder.¹⁹ But, for example, where the plaintiff had pledged his shares with the defendant who had despoiled or mismanaged the corporation for the purpose of reducing the value of the shares and acquiring them by sale under his pledge,

stockholder was held insufficient although alleging a promise by the defendant to the plaintiff that the defendant would properly conduct the corporate affairs. See also *Hodge v. Meyer*, 252 Fed. 479 (C.C.A. 2d 1918). These cases, however, involve an additional problem in that the contracts may be viewed as contracts for the benefit of the corporations. As to such contracts, where the beneficiary has a cause of action on the contract, recovery by the promisee presents special difficulties. See Restatement of Law of Contracts (1932), § 135, comment b.

The cases involving pledges have been particularly interesting in this connection. *Ritchie v. McMullen*, 79 Fed. 522 (C.C.A. 6th 1897), the leading case for the whole "special duty" exception, was a case of this type. The court first found a special duty as follows: "In the case under review there was a privity between Payne, Burke, and Cornell, on the one hand, and Ritchie, on the other, created by the pledges of the stock. The bailee owes a direct duty to the pledgor to be reasonably careful that no harm shall come through his custody to the subject-matter of the pledge . . ." (p. 533). But the court added, "It is true that the obligations of the pledgee of the stock to the pledgor would not be violated by the pledgee if the stock held in pledge suffered a loss in value through negligence of the pledgee in acting as a director of the company or through ill-advised or negligent voting of other stock owned by him . . ." (p. 534). This dictum was followed in *Milliken v. McGarrah*, 159 App. Div. 725, 149 N.Y. Supp. 484 (1913). But in the *Ritchie* case the court indicated that recovery could be had if the pledgor proved in addition an intention on the part of the pledgee to acquire the plaintiff's shares after having depressed their value by injuring the corporation. That this intention justifies the recognition of a direct cause of action where the plaintiff continues to own the shares is very questionable and seems inconsistent with the cases cited in note 15 with respect to the effect, in other situations of an intention to injure the plaintiff.

¹⁸ This is the case where the corporation has or may have no cause of action against the defendant. *General Rubber Co. v. Benedict*, 215 N.Y. 18, 109 N.E. 96 (1915), might have been put upon a narrower ground which would bring it within this class of cases. The defendant was a director of the plaintiff holding company but not of the subsidiary whose assets were taken. It was doubtful whether the defendant had actually colluded in the looting of the subsidiary, in which case the subsidiary could recover from him, or whether the defendant had merely been negligent in not discovering the defalcation. In the latter case, the subsidiary would have no cause of action against him and it would generally be agreed that there would be no bar to the parent's action.

In *Cazeaux v. Mali*, 25 Barb. (N.Y.) 578 (1857), the plaintiff shareholder was permitted to recover from corporate directors who had caused a shrinkage in the market value of his shares by issuing a large number of additional shares which the court said were void. The court thus assumed that the corporation had no cause of action.

¹⁹ *Wells v. Dane*, 101 Me. 67, 63 Atl. 728 (1905). Cf. *Hammer v. Werner*, 239 App. Div. 38, 265 N.Y. Supp. 172 (1933).

it is generally said that if the plaintiff had thus lost his shares, he may recover.²⁰ And similarly a former shareholder may recover for a conspiracy to boycott the corporation for the purpose and with the result of forcing him to sell his shares.²¹

There have been considered thus far only cases dealing with the circumstances under which a direct cause of action in the shareholder will be enforced *in addition to* the corporate cause of action. In some circumstances, also, courts have granted recovery to a shareholder *in lieu of* corporate recovery. This has been where the defendants themselves owned a large part of the shares or where many shareholders had acquiesced in the defendants' conduct. In some cases this transmutation of the corporate right into a right in an objecting shareholder, proportionate to his holdings, has been made at the request of the shareholder.²² From the viewpoint of the plaintiff this relief is the equivalent of a decree ordering restitution and the distribution of a dividend. Because of the conduct of the defendants—frequently the improper appropriation of profits in the form of unauthorized salaries—these courts, in effect, recognize here an exception to the usual rule that courts will order the distribution of a dividend only in extreme cases. In other cases, however, direct relief to the shareholder has been denied.²³ This relief, of course, should not be given in cases where the distribution would violate rights of creditors or would jeopardize the future conduct of the corporate business.

In a number of cases, however, where a shareholder has brought a derivative suit for the benefit of the corporation, the courts, at the request of the defendants, have denied the usual relief to the corporation and granted recovery for the personal benefit of the nominal plaintiff in an amount proportionate to his holding of shares.²⁴ Where all of the shares are owned by plaintiff and de-

²⁰ See *Ritchie v. McMullen*, 79 Fed. 522 (C.C.A. 6th 1897).

²¹ *Stinnett v. Paramount-Famous Lasky Corp.*, 37 S.W. (2d) 145 (Tex. Com. App. 1931). To the same effect is *Von Au v. Magenheimer*, 126 App. Div. 257, 110 N.Y. Supp. 629 (1908), *affd.* 196 N.Y. 510, where, as part of a successful conspiracy to induce the plaintiff to sell his shares, the defendants took unauthorized salaries.

²² *Peoples' Trust Co. v. O'mera*, 204 App. Div. 268, 197 N.Y. Supp. 795 (1922); *Eaton v. Robinson*, 19 R.I. 146, 31 Atl. 1058 (1895); *Ritchie v. People's Telephone Co.*, 22 S.D. 598, 119 N.W. 990 (1909); *Nichols v. Olivia Veneer Co.*, 139 Wash. 305, 246 Pac. 941 (1926).

The same result has been reached in two cases by imposing liability for conversion of the plaintiff's shares. *Kickbusch v. Ruggles*, 105 S.C. 525, 90 S.E. 811 (1916); *Equitable Trust Co. v. Columbia National Bank*, 145 S.C. 91, 142 S.E. 811.

²³ *Miller v. Crown Perfumery Co.*, 125 App. Div. 881, 110 N.Y. Supp. 806 (1908); *Baillie v. Columbia Gold Mining Co.*, 86 Ore. 1, 166 Pac. 965 (1917).

²⁴ *Brown v. De Young*, 167 Ill. 549, 47 N.E. 863 (1897); *Matthews v. Headley Chocolate Co.*, 130 Md. 523, 100 Atl. 645 (1917); *Joyce v. Congdon*, 114 Wash. 239, 195 Pac. 29 (1921). But see *Birkmire v. Campus Realty Corp.*, 223 App. Div. 226, 227 N.Y. Supp. 653 (1928), *revd.* 253 N.Y. 598, on dissenting opinion below. Cf. *Havens v. Buchnell Stock Yards Co.*, 274 Ill. App. 497 (1934), where the court apparently misunderstood the reasoning underlying *Brown v. De Young*.

defendants and where rights of creditors are not prejudiced, as in *Brown v. De Young*,²⁵ this remedy affords a sensible short-cut. It is frequently also a convenient way to avoid benefiting other shareholders who have no standing to object to the defendants' acts. One instance of its application is in connection with promoters' frauds, avoiding the unjust aspect of *Old Dominion Copper Co. v. Bigelow*,²⁶ where a promoter was required to return his secret profit to the corporation although 13-15 of its shareholders were unjustly enriched thereby.²⁷

Some courts, however, have refused to effect such a change of corporate rights into rights of a shareholder, and one case has brought out a possible danger.²⁸ It may be undesirable to put a premium on efforts of corporate managers to secure releases from other shareholders when a vigilant holder has threatened or brought a derivative suit. While respect for the separate legal entity of the corporation should not preclude decisions such as *Brown v. DeYoung*, the desirability of this result in varying circumstances can be determined only by a careful balancing of a number of conflicting considerations.

²⁵ *Supra*, note 24.

²⁶ 203 Mass. 159, 89 N.E. 193 (1909).

²⁷ See note, 47 Harv. L. Rev. 1031 (1934); 26 Ill. L. Rev. 340 (1931).

²⁸ In *Harris v. Rogers*, 190 App. Div. 208, 179 N.Y. Supp. 799 (1919), the plaintiff had brought a derivative stockholder's suit asking damages for the benefit of the corporation for negligence of the defendants who were former directors. The defendants, with the cooperation of the present directors, had secured releases from most of the shareholders. The defendants pleaded these releases and the court, in spite of the prayer of the complaint, provided that the defendant should be liable only for a pro rata share of the damages otherwise recoverable, based upon the number of shares which he had originally held, not including shares purchased after the alleged negligence from one of the guilty directors. The plaintiff appealed, insisting that he was entitled to relief pursuant to his prayer, his motive presumably being in order to secure for the corporation damages in an amount which would increase the value of all of his shares including those recently purchased. The Appellate Division, while indicating that it might approve in some cases of the type of relief given, questioned whether it might be granted in a derivative suit. This query suggests a view that individual relief may be given to a shareholder only at his request and the defendants have no standing to insist that the relief take this form. The judgment was affirmed, however, on the ground that the plaintiff, having accepted satisfaction of the judgment as given (although purporting to reserve rights) was precluded from taking the appeal.

The plaintiff then brought a second derivative suit, this time against the present directors, alleging that they had been unfaithful to the corporation in aiding in the solicitation of releases of the liability of their predecessors. In upholding the complaint, the trial court strongly criticized the action of the trial judge in first case. *Harris v. Parrsall*, 116 Misc. 366, 190 N.Y. Supp. 6 (1921). Admitting that the conduct of the directors was improper, it may be questioned whether the court was correct in holding that the plaintiff had a standing to bring the derivative suit. So far as his original holdings were concerned, satisfaction of the first judgment cured the injury to him, and it is generally recognized that a shareholder who acquires shares from a person barred by collusion or acquiescence from suing to remedy the wrong to the corporation, is likewise barred, at least if he purchased with knowledge, of the facts requiring the barring of his transferor.