Chapter 8: Corporations

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§8.1. Derivative suit: Necessity of demand upon the shareholders. In the 1950 decision *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*,¹ the Massachusetts Supreme Judicial Court held that a vote by a majority of the stockholders of a corporation, undominated and uncontrolled, acting reasonably and in good faith, could bar the bringing of a derivative suit by the minority shareholders, regardless of the nature of the cause of action.² The rationale of this holding was that from a business viewpoint it is not always best to insist upon all one's legal rights and since honest and intelligent men may differ as to business policy the will of the majority, acting fairly, should control. The question of the scope of the holding in the *Solomont* case has presented more problems for the federal court than it has for the Massachusetts state courts.

In the 1951 decision of the Federal District Court, *Pomerantz v. Clark*,³ Judge Wyzanski, construing the *Solomont* case, held that Massachusetts law required that a minority shareholder, wishing to bring a shareholders' derivative suit, must appeal to the corporate directors, or, if they are disqualified, to the corporate shareholders, to decide not only if the particular claim has merit but also if the corporate welfare is best promoted by suing upon it. Furthermore, the fact that the shareholders of the corporation were numerous and scattered throughout the country and that few attended meetings or even signed proxies, did not excuse the demand requirement.⁴ The *Pomerantz* decision seemed like a logical extension of the *Solomont* decision. If a majority of the stockholders, not under the control of the wrongdoers, could bar a shareholders' derivative suit for business reasons, why would not a minority stockholder, wishing to embark the corporation into litigation, be first required to obtain the concurrence of a majority of

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² It is sometimes held in other jurisdictions that an application to the shareholders is necessary in the case of voidable transactions but unnecessary in the case of fraudulent transactions on the basis that a majority of the shareholders cannot ratify fraudulent conduct. See Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).
⁴ The company involved in the Pomerantz case was John Hancock Mutual Life Insurance Company with millions of policyholders.
the owners of the corporation? Ultimately they will be required to bear the expenses of litigation and will be affected by its outcome.

The first crack in the holding of the Pomerantz case appeared in the 1962 decision of the United States Court of Appeals, Halprin v. Babbitt. In the Halprin case, the basic question was whether a minority shareholder could maintain a derivative suit when the majority, after being notified of the cause of action, failed to act. In other words, does Massachusetts law require express authorization by the majority for the maintaining of the suit before the minority shareholder can proceed? In answering this question in the negative the Court stated:

We believe that the form should be a demand that the majority cause proceedings to be instituted and that the purposes are two. The first is to permit the majority to take some sort of affirmative action itself. The second is to permit the majority to decide, as in Solomont, that no action be taken by anybody. But if the majority does neither, we do not think that the minority is powerless to proceed merely because, to quote the district court, it failed to obtain “express authorization from the majority.”

In a 1964 decision of the United States Court of Appeals, Levitt v. Johnson, the court went out of its way, with very strong dicta, to further debilitate the holding in the Pomerantz case. In the Levitt case the court took the position that the Solomont case did not require that in all instances a minority shareholder must appeal to the majority for action prior to bringing a derivative suit. In its opinion the court stated:

The fact that a majority of informed disinterested stockholders might decide, for reasons discussed in Solomont, that a suit should not be prosecuted, does not mean that they must be fully instructed in every instance before the suit is instituted. As we pointed out in Halprin v. Babbitt... the minority does not have to obtain the express authorization of the majority before suit is commenced. The demand upon the majority, in other words, does not have this broad purpose. Neither of the limited purposes we outlined in Halprin could be accomplished in any real sense unless the demand evoked a full and fair consideration of the issues, in depth, by the other stockholders. If their number is small, as in Halprin, and the minority could reasonably be expected to put its case before them, it should be obliged to do so. However, on the allegations of the present complaint not only would such a burden be enormous, but no disclosure that plaintiff could be expected to make would be likely to persuade a majority to take over the action, or, conversely, permit an informed decision by the majority that the action be not instituted.

5 303 F.2d 138 (1st Cir. 1962).
6 Id. at 141.
8 Id. at 818.
§8.2

CORPORATIONS

If the dicta in the *Levitt* case may be considered to constitute a reliable prediction, the interpretation of the *Solomont* case in the federal court is now as follows: If the majority shareholders are so numerous and scattered that they could not practically, as a body, make a decision whether to bring the suit or refrain from bringing the suit, *Solomont* does not require an appeal to them as a condition precedent to bringing the suit. If the group is sufficiently small that an appeal must be made and is made, and no decision by the majority is forthcoming, the minority shareholder may proceed with the action.

§8.2. Derivative suit: Rule 23(b) of the Federal Rules of Civil Procedure. Rule 23(b) of the Federal Rules of Civil Procedure provides in part:

The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort. [Emphasis supplied.]

Rule 23(b) had its origin in the United States Supreme Court decision, *Hawes v. Oakland*. The *Hawes* case established the principle that a minority shareholder wishing to sue on behalf of his corporation in a federal court must first exhaust his available remedies within the corporation.

He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court. If time permits or has permitted, 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, where it could not be done, or it was not reasonable to require it. [Emphasis supplied.]

Following *Erie R.R. v. Tompkins* the question has arisen concerning the extent that Rule 23(b) is affected by particular state law. Since all states, absent evidence of futility, require a demand upon the corporate directors as a condition precedent to the bringing of a derivative suit, this aspect of Rule 23(b) creates little problem. Since, however, the states are split on the question of when a minority shareholder must make a demand upon the majority shareholders as a condition precedent to bringing the suit, the question posed is whether Rule 23(b) creates at least a minimum requirement for demand upon the shareholders in cases brought in the federal courts, or whether the “if necessary” phrase of Rule 23(b) incorporates state law. The cases dealing with the question have been far from harmonious.

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1 104 U.S. 450, 26 L. Ed. 827 (1881).
2 Id. at 461, 26 L. Ed. at 832.
3 304 U.S. 64, 8 Sup. Ct. 877, 82 L. Ed. 1188 (1938).
4 While the phrase “if necessary” has been interpreted by a few courts as incor-
While the particular point has not been a focal point of any decision of the United States District Court in Massachusetts or the United States Court of Appeals of the First Circuit, the language of Judge Wyzanski in the recent case of *Levitt v. Johnson* indicates that he would view Rule 23(b) as establishing a federal demand requirement apart from state law. After listing the reasons set forth by the plaintiff for his failure to make a demand upon the shareholders, Judge Wyzanski stated:

> The complaint complies with Fed. Civ. Proc. Rule 23(b). It meets the *procedural obligation* to set forth with particularity the reasons for plaintiff not making an effort to obtain action from the shareholders. . . .

The problem is whether plaintiff, in addition to fulfilling the *procedural requirements* of the aforesaid Rule 23(b), has also fulfilled, in the terminology of Hausman v. Buckley, 2nd Cir. 299 F.2d 696, 701, *the “substantive” conditions precedent* with respect to the obligations, if any, of a shareholder, in a derivative action, to make a demand upon his fellow shareholders.

The position of Judge Wyzanski on this matter as expressed in the *Levitt* case would seem to be the correct one. The most logical interpretation of the phrase “if necessary” is that when a demand upon the directors would be obviously futile or when a demand upon the directors has been made and they have refused to act, exhaustion of administrative remedies within the corporation would then make necessary a demand upon the shareholders. If valid reasons exist for not making such a demand, or if such a demand has been made and no action has been taken by the shareholders, these matters must be set out in the complaint with particularity.

Such an interpretation has not only a logical basis but an historical basis as well.\(^7\)

6 Id. at 447.
7 "First, since the rule is the origin of the demand requirement, it seems unlikely that its authors contemplated existing state-made excuses. Second, because the Rule of Decisions Act, Rev. Stat. §721 (1875), did not apply to courts of equity, the
§8.3. Derivative suit: Law governing shareholder demand where action brought under federal statute. In the case of *Levitt v. Johnson* the plaintiff, a minority shareholder in a Massachusetts corporation, brought a derivative suit in the United States District Court for Massachusetts complaining that the directors and others injured the corporation by violations of the Federal Investment Company Act of 1940. The United States District Court granted the defendant's motion to dismiss the complaint on the basis that the defendant, while fulfilling the procedural requirements of Rule 23(b) of the Federal Rules of Civil Procedure, had failed to comply with the requirements of Massachusetts law that a demand be made upon the shareholders of the corporation. In so holding Judge Wyzanski stated:

Reference to the law of the state of incorporation to determine whether a stockholder has the substantive right to bring a derivative action for his corporation remains appropriate even if the claim which the corporation has against the alleged wrongdoer is based on a federal statute. It is that principle which explains the opinion of Justice Brandeis in United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 264, 37 S. Ct. 509, 510-511, 61 L. Ed. 1119 [1124-1125 (1917)] that "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation."4

In vacating the judgment of the district court and remanding the action for further proceedings, Judge Aldrich of the United States Court of Appeals stated that the position of the district court "negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation."5 In distinguishing in a footnote the *United Copper Securities* case, the court stated:

On the one hand, the policy of the antitrust laws is the preservation and protection of competition in our economy in its broadest

Supreme Court's rule-making power, see Act of August 23, 1842, §6, 5 Stat. 518, combined with the federal courts' autonomy in making substantive law under the prevailing influence of Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842) would have made application of state law, even if it had existed at the time Equity Rule 94 was adopted, unnecessary. Finally, the Hawes opinion itself [referring to the case of Hawes v. Oakland, note 1 supra, the case creating the demand requirement] suggests federal criteria consonant with equitable notions of fair procedure for excusing demand on the shareholders and these criteria give content to the phrase 'if necessary.' 104 U.S. 450, 460-461 (1881)." Note, 63 Colum. L. Rev. 1086, 1090 n.36 (1963).

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3 For a discussion of the operation of Rule 23(b) of the Federal Rules of Civil Procedure, see §8.2 supra.
5 *Levitt v. Johnson*, 334 F.2d 815, 819 (1st Cir. 1964).
Those laws are thus geared to the protection of competing businesses, as businesses, whether in the corporate form or not. On the other hand, the policy of the Investment Company Act is to provide a comprehensive network of restrictions upon the organization, operation and management of investment companies to the end that the individual investors might be protected.6

It is difficult to say how seriously this footnote distinction should be taken. The court is not clear whether it would apply the holding of the United Copper Securities case (and hence Massachusetts law on demand requirements) if a derivative suit arises under an antitrust act.

While it is realistic today to ignore the corporate entity for some purposes when dealing with "incorporated partnerships," the distinction set out in the footnote in the Levitt case goes too far in ignoring the corporate entity in a public issue corporation. Obviously Congress may expressly create the right in a shareholder to maintain an action on behalf of his corporation for a federally created wrong.7 No doubt such an intent might even be implied when the predominant purpose of the legislation is to protect a shareholder interest rather than a corporate interest as such. In such event there ought not to be any demand requirement, state or federal.8 When, however, the right created can be enforced only by the corporation, either directly or by virtue of a derivative suit, whether compliance with Rule 23(b) of the Federal Rules of Civil Procedure will be sufficient should not depend upon reading into the statute some overriding concern by Congress for the individual shareholder.

§8.4. Inspection of stockholder lists: Interpretation of statutory language. General Laws, Chapter 155, Section 22, provides in part as follows:

The stock and transfer books of every corporation, which shall contain a complete list of all stockholders, their residences and the amount of stock held by each, shall be kept at an office of the corporation in the commonwealth for the inspection of its stockholders . . . . If any officer or agent of a corporation having charge of such . . . books . . . refuses or neglects to exhibit them or to submit them to examination as aforesaid, he or the corporation shall be liable to any stockholder for all actual damages sustained by reason of such refusal or neglect, and the supreme judicial or

6 Id. at 820 n.5. The court quoted this statement from the S.E.C. brief, filed as amicus curiae in this case.
7 See, for example, Securities Exchange Act of 1934, §16(b), 15 U.S.C. §78p(b) (1964), providing for the recovery for the benefit of a corporation of so-called "short swing profits" realized by an "insider" upon dealing in its stock.
8 See, for example, Blau v. Mission Corp., 212 F.2d 77, 79 (2d Cir. 1954), wherein the Court of Appeals of the Second Circuit held that the contemporaneous ownership of stock requirement of Rule 23(b) of the Federal Rules of Civil Procedure was inapplicable when the federal act (Securities Exchange Act of 1934, §16(b), 15 U.S.C. §78p(b) (1964)) itself provided that the suit could be brought for the benefit of the corporation "by the owner of any security."
superior court shall have jurisdiction in equity, upon petition of a stockholder, to order . . . said . . . books . . . to be exhibited to him . . . , but in an action for damages or a proceeding in equity under this section for neglect or refusal to exhibit for inspection the stock and transfer books, it shall be a defense that the actual purpose and reason for the inspection sought are to secure a list of stockholders for the purpose of selling said list or copies thereof or of using the same for a purpose other than in the interest of the applicant, as a stockholder, relative to the affairs of the corporation. [Emphasis supplied.]¹

Prior to 1923 the statutory right of a stockholder to examine stockholder lists was absolute.² By Acts of 1923, Chapter 172, the corporation was permitted to set up a shareholder's improper purpose as a defense to an application for inspection.³ Hence, in this respect, the cases decided prior to 1923 dealing with the statutory right of inspection of the stock and transfer books were rendered obsolete.⁴ Since the 1923 amendment two cases have been decided by the Supreme Judicial Court interpreting the limiting language of the statute, Hanrahan v. Puget Sound Power & Light Co.⁵ and the 1964 decision Donaldson v. Boston Herald-Traveler Corp.⁶

The situation in the Hanrahan case involved a possible merger battle. The stockholders seeking inspection planned to solicit proxies on behalf of a pro-private merger committee of whose members only one fourth were stockholders, the other members being in the investment banking or securities business. In holding that the corporation had not sustained its burden of proof that the purpose of the inspection was improper, the Court stated:

With the business merits of such a merger we are not concerned; that is a question for the stockholders to determine. All that we are concerned with is whether this objective is such a purpose as to fall outside the plaintiffs' interest "as a stockholder relative to

§8.4. ¹ The quoted provision has been unchanged by the new Massachusetts Business Corporation Law (G.L., c. 156B, §32) except that the new act substitutes the word "records" for "books" (in accord with modern techniques of electronic record-keeping), and provides that the stock and transfer records shall be kept in the Commonwealth at the corporation's principal office or at an office of its transfer agent or of its clerk or of its resident agent.
³ It was probably because of the result in the case of Shea v. Parker, note 2 supra, that Acts of 1923, c. 172, was enacted. The Shea case interpreted the earlier statute as allowing inspection of stockholder lists for any purpose. The information sought in the Shea case was for the plaintiff's use as a stockbroker. Hence the language of the statute, "... other than in the interest of the applicant, as a stockholder, relative to the affairs of the corporation," is appropriate.
⁴ The cases interpreting the shareholder's common law right to inspect the corporation's books and records (see for example, Varney v. Baker, 194 Mass. 239, 80 N.E. 524 (1907)) were obviously unaffected by Acts of 1923, c. 172. See Gavin v. Purdy, 335 Mass. 236, 139 N.E.2d 397 (1957), noted in 1957 Ann. Surv. Mass. Law §16.2.
the affairs of the corporation." Plainly a change in the manage-
ment and the policy of the corporation affects the plaintiffs' 
rights as stockholders and is certainly relative to the affairs of 
the corporation. . . . There is no evidence that they intend to use 
the list for commercial purposes such as the solicitation of stock-
holders for the purchase of other securities.7

The Court thus made it clear that the question of whether the de-
manding shareholder's purpose will ultimately be beneficial or detri-
mental to the corporation is not relevant on the issue of proper pur-
pose under the statute. What is relevant is that his purpose is germane 
to his position as a stockholder in the corporation. This point was 
underscored by the Supreme Judicial Court in the 1964 Donaldson 
case in the following language:

That the plaintiff had no suggestion for improvement in the man-
ner in which the newspaper was being run, or did not wish to talk 
to the president, or wanted the president's job . . . , or described his 
own motives as purely selfish does not render his purpose im-
proper. The solicitation of proxies in order to try to change man-
agement is a proper purpose.8

A second issue raised in the Donaldson case was whether attorney's 
fees could be recovered under the term "all actual damages," used in 
General Laws, Chapter 155, Section 22. On this point the Supreme 
Judicial Court sustained the position of the trial court that damages 
recoverable under the statute did not include attorney's fees. This 
position is consistent with the general rule in Massachusetts that no 
recovery may be had for counsel fees in the very action to redress a 
plaintiff's wrong as distinguished from other counsel fees which the 
plaintiff has been compelled to pay.9 The Court held that the legisla-
ture must be taken to have been aware of this principle and had it 
intended the statute to embrace attorney's fees it would have spec-
ifically so stated.

The third issue raised in the Donaldson case was whether applica-
tion to the transfer agent to inspect the corporation's stockholder list 
was, under General Laws, Chapter 155, Section 22, an effectual ap-
lication.10 On this point the Court held that the transfer agent fell 
within the description of an "agent" having charge of such "books and 
records" under General Laws, Chapter 155, Section 22. While such a 
position creates little difficulty when the action brought by the plain-
tiff is merely to compel the corporation to exhibit the stockholder lists 
it is doubtful that, for purposes of recovering damages under General

ever, Malloy v. Carroll, 287 Mass. 376, 191 N.E. 661 (1934), wherein counsel fees in 
the very case were ordered paid by the defendants. The case was a suit in equity by 
plaintiffs to obtain reinstatement in a labor union and the Court described the 
circumstances as exceptional.
10 This question was left open in the Hanrahan case, 332 Mass. 586, 590 n.1, 126 
§8.5

CORPORATIONS

Laws, Chapter 155, Section 22, a transfer agent should be treated as such an agent of the corporation that notice to it of a demand would constitute notice to the corporation. The mere fact of physical custody of the stockholder list by the transfer agent should not so clothe it with authority to either comply or refuse to comply with the shareholder's demand.

§8.5. Directors' liability: Watered stock. The danger inherent in the use of par value stock in a small business corporation was again demonstrated in the 1964 decision Bay State York Co. v. Cobb.¹ In this case the Supreme Judicial Court affirmed the decree of the trial court imposing liability upon the directors, the sole stockholders, of a small business corporation,² to the extent of a debt owed to a creditor by the corporation, for issuing par value stock to themselves for less than the total amount of the par value.³

It makes little sense today for organizers of a small business corporation to create potential personal liability by committing themselves initially to pay for a high total amount of par value stock. Where property is to be used as the consideration for the stock, no par stock prevents the organizers from having to commit themselves to a particular valuation for the property at the time that the articles of organization are being prepared.⁴ If cash is the consideration it is usually preferable to use no par stock; if however par value stock is to be used, wisdom would generally dictate that the organizers issue only stock having a total par value equal to the amount of cash then to be paid rather than committing themselves to installments. If subsequently they wish to invest more money in the corporation they may then issue more stock.

If the defendants in the Bay State York Co. case had originally issued stock having a total par value equal to the cash they were then investing in the corporation they would not have incurred personal liability. They might later have purchased more stock for cash or property if they so desired. Their mistake was committing themselves initially to a large cash payment (all of which they did not pay) by issuing a large total amount of par value stock.

² G.L., c. 156, §36, imposes joint liability upon the directors of a corporation for issuing stock in violation of G.L., c. 156, §15. The comparable provision under G.L., c. 156B, is Section 60.
³ G.L., c. 156, §15, provides that par value stock may not be issued for less than par. The comparable provision under G.L., c. 156B, is Section 18.
⁴ While the stock in the Bay State York Co. case was purportedly issued for cash the defendants attempted to show that the corporation received an amount equal to total par value on the basis that the defendants, subsequent to incorporation, transferred an alcoholic beverage license to the corporation. Without deciding whether such a license would constitute an exchange of property for stock, the Court held that it could not be used to correct the initial underpayment because of noncompliance with G.L., c. 156, §10(c), which requires that the articles of organization describe in detail property which is received for stock. Since the stock was authorized only for cash, the license would not suffice.
⁵ Such property will later have to be valued for purposes of filing the statement of the condition of the corporation. See G.L., c. 156B, §109. For a discussion of this matter see Smith & Cavitch, Massachusetts Corporation Law §2.13[2][c][i] (1969).