

4-1-1964

Corporations—Entity Theory—Derivative Actions—Pro Rata Individual Recovery.— Shlensky v. South Parkway Bldg. Corp.

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Recommended Citation

Robert J. Muldoon Jr, *Corporations—Entity Theory—Derivative Actions—Pro Rata Individual Recovery.— Shlensky v. South Parkway Bldg. Corp.*, 5 B.C.L. Rev. 773 (1964), <http://lawdigitalcommons.bc.edu/bclr/vol5/iss3/22>

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particularly so when such policy is the product of a "federal public policy" declared as legislation, the express purpose of which is to promote labor organization.

In conclusion, it is submitted that the utilization of the injunctive device to deny unions the right to picket on shopping center property is not an abridgement of the constitutionally guaranteed right of freedom of speech. Since the *Vogt* decision, it is not doubted that prohibitions against picketing will be sustained where the manner in which the picketing is conducted or the attainment of the picketing objective would prevent effectuation of a state's public policy formulated pursuant to a valid exercise of its police power.²⁸ Certainly, a policy protecting the integrity of a non-employer's property rights is such a valid public objective,²⁹ and is not such a choice, as between the competing interests of the union and of the property owner, as to be "so inconsistent with rooted traditions of a free people"³⁰ as to be unconstitutional.

VINCENT A. SIANO

Corporations—Entity Theory—Derivative Actions—Pro Rata Individual Recovery.—*Sblensky v. South Parkway Bldg. Corp.*¹—In a prior action, minority shareholders brought a derivative suit against the corporation's directors. The trial court decided for the plaintiffs, and ordered an accounting from the defendant directors of transactions which led to corporate losses. On appeal, the intermediate appellate court reversed. Plaintiffs then appealed to the Supreme Court of Illinois which reversed the intermediate decision and reinstated the trial court's decree for an accounting. On remand, the trial court ordered an accounting which, however, was never made since both sides agreed to a compromise whereby the defendants agreed to buy the shares of the minority holders at five times their value, and to pay all legal and court costs. At this point, a third party, owner of forty-five shares, petitioned to intervene on grounds that the compromise imperiled an adequate recovery on the part of the corporation. The court denied the petition and approved the compromise. The instant case is the petitioner's appeal, in which, Burke, P. J., dissenting, it was HELD: The lower court erred in approving the compromise inasmuch as it varied from the Supreme Court's order for an accounting, and in denying the intervenor's petition inasmuch as his ownership of forty-five shares gave

²⁸ "Today, the Court signs the formal surrender . . . State courts and state legislatures are free to decide whether to permit or suppress any particular picket line for any reason other than a blanket policy against all picketing. . . ." *Teamsters Union v. Vogt, Inc.*, supra note 10, at 297 (dissenting opinion). See Jones, *The Right To Picket—Twilight Zone of the Constitution*, 102 U. Pa. L. Rev. 995 (1954).

²⁹ "[A] state, in enforcing some public policy, whether of its criminal or civil law, and whether announced by its legislature or its courts could constitutionally enjoin peaceful picketing aimed at preventing effectuation of that policy." *Teamsters Union v. Vogt, Inc.*, supra note 10, at 293.

³⁰ Supra note 16, at 479.

¹ —Ill. App.—, 194 N.E.2d 35 (1963).

him the requisite standing to enter the action to protect the right of the corporation to recover as opposed to the type of pro rata individual recovery found in the compromise.

This Illinois case is perhaps less noteworthy for its narrow procedural compass than for the substantive issue, never realistically confronted by the court, of pro rata individual recovery in derivative actions. This note, then, looks to the status of such recovery both generally and in Illinois, placing it in the context of the entity theory of corporations and the nature of derivative action.

Never fond of formal metaphysics, lawyers tend to leave disputes concerning the nature of corporate personality to their more philosophically inclined brethren.² Practical men, they have chosen to treat the corporation as a real thing, an entity apart from its component members.³ On this basis, the concept of corporate personality serves as a

convenient figure of speech used to describe [the corporation] as a legal unit, a separate concern with a capacity to hold property and make contracts like a person, to sue and be sued and to continue to exist, notwithstanding changes of its shareholders or members.⁴

The claimed resemblance to the human person, however, is not total. For while a living human being will rarely find his independent individuality legally dispensed with, the state-created corporation at times finds its legal personality disregarded for a number of reasons.⁵ The basis for thus limiting the extent of the entity theory of corporate personality rests on implicit judicial realization that "despite its long history of entity, a corporation is at bottom but an association of individuals united for a common purpose."⁶ When the common purpose tends to defeat social goods and is thus at odds

² Metaphysical and jurisprudential problems arising from attempts to define the philosophical nature of the corporation are exhaustively reviewed in 1 Fletcher, *Cyclopedia Corporations*, 86 (rev. vol. 1963). Also see Dewey, *Historic Background of Corporate Legal Personality*, 35 *Yale L. J.* 655 (1926), which traces the entity theory back to the metaphysically rich thirteenth century; and 1 Hornstein, *Corporation Law and Practice* 16 (1959) which quotes Bracton's analogy of the corporation to the shepherd's flock which endures, despite the changes in its woolly personnel.

³ 1 Fletcher, *supra* note 2, at 87.

⁴ Ballantine, *Corporations* 287 (rev. ed. 1946).

⁵ See Berle, *The Theory of Enterprise Entity*, 47 *Colum. L. Rev.* 343, 352 (1947) for summary of instances of disregard of corporate entity; 1 Fletcher, *supra* note 2, at 166; and O'Neal, *1 Close Corporations* 21 (1958), who declares that the separate personality of a corporation (. . . whether . . . close or publicly held) will be disregarded . . . whenever the corporate form is employed to evade an obligation, . . . to perpetrate a fraud or crime, or to gain an unjust advantage or commit an injustice.

Ballantine, however, disregards the language of disregarding the corporate entity: The problems involved, however, are to be solved not by "disregarding" the corporate personality, but by a study of the just and reasonable limitations upon the exercise of the privilege of separate capacity under particular circumstances in view of its proper use and functions.

Ballantine, *supra* note 4, at 292-3.

⁶ Berle, *supra* note 5, at 352.

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with the legal policy underlying the very creation of a corporation,⁷ the courts dispense with allegiance to a philosophic theory, and breach the wall of entity in getting to the trouble within.

An example of such a disregard of the corporate entity arises in the problem of pro rata individual recovery in shareholders' derivative actions. Equity devised the derivative action, in which the plaintiff shareholders represent the corporation, to protect the corporation in the event its officers or directors fail to do so.⁸ Thus, the right of action and the consequent recovery belong to the corporation in its status as a separate entity.⁹ Furthermore, the social interest in protecting the rights of the corporation's creditors provides another leg upon which the traditional restriction of recovery to the corporation stands.¹⁰ The reason for this, of course, is to avoid defrauding creditors who might not have their just claims satisfied should the courts allow the recovery realized to be distributed to individual members of the corporation. The combination of entity theory¹¹ and protection of creditors accounts for the "vast majority"¹² of cases holding that corporate recovery is the only permissible outcome of a derivative action.¹³ Equitable demands, however, have at times required relaxation of the rigors of an entity-based concept of derivative action. Allowing individual pro rata recovery by the complainant minority is such an exception.¹⁴

When a corporate dispute ends with an agreement to liquidate, pro rata distribution of assets is logically necessary, if only because no corpora-

⁷ Stevens, *Private Corporations* 96 (2d ed. 1949).

⁸ The American idea of allowing a derivative action has been traced to a dictum of Chancellor Kent, in *Attorney General v. Utica Ins. Co.*, 2 Johns. Ch. *371 (N.Y. 1817). Cf. Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U.L. Rev. 980 (1957). Also, see *Smith v. Hurd*, 12 Metc. 371 (Mass. 1847) (lack of privity between shareholder as individual and directors precludes any standing for shareholders except as representatives of the corporation); *Liken v. Shaffer*, 64 F. Supp. 432 (N.D. Iowa 1946) (injury to corporate property grounds the action, not injury to the individual). Also, 3 Pomeroy, *Equity* § 1095 (5th ed. 1941); 13 Fletcher, *supra* note 2, at 641; Stevens, *supra* note 7, at 798; Ballantine, *supra* note 4, at 334.

⁹ Where, however, the wrong complained of against the directors does not affect the corporation itself but touches an individual shareholder's interest, direct action in the individual's own name is permitted. Cf. *Ritchie v. McMullen*, 79 Fed. 522 (6th Cir. 1897) (directors intentionally allowed minority shareholder's stocks, which they held as pledgees, to depreciate in value); *Southern Pacific Co. v. Bogert*, 250 U.S. 483 (1919) (majority shareholders reorganized corporation so as to eliminate minority holders, although there was no discernible damage done to the corporation from the reorganization). For an analysis of situations where the same action of the directors affects both the corporation and the individual shareholder, see Ballantine, *supra* note 4, at 335.

¹⁰ See *Smith v. Hurd*, *supra* note 8, at 385; also, Stevens, *supra* note 7, at 799.

¹¹ Prunty, *supra* note 8, at 989 et seq., finds the original theoretical basis of the derivative suit not to be contemporary "abstractions" about the corporate entity, but rather the theory of a trust relationship between directors and shareholders. He indicates, however, the later emphasis on the concept of entity which gradually predominated.

¹² 69 Harv. L. Rev. 1314 (1956).

¹³ The grounds on which a derivative action may be maintained are extensively set out in *Hawes v. Oakland*, 104 U.S. 450, 460 (1881).

¹⁴ See Grenier, *Pro Rata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Corporate Justice*, 19 Wash. & Lee L. Rev. 165 (1962).

tion now exists capable of receiving the recovery.¹⁵ Some courts, however, have broadened the permissibility of pro rata recovery so as to allow it where a corporate recovery would unjustly benefit shareholders who participated in, or assented to, the mismanagement giving rise to the action.¹⁶ Thus, in *Perlman v. Feldmann*,¹⁷ the defendant, a former principal stockholder and director of the corporation, was required to account individually to the minority shareholders for an excessive profit he made in selling his majority shares to a new group of directors, in violation of his fiduciary duty to all the shareholders. To have required corporate recovery in this case would have been, in effect, a "kick-back" to the new purchasers of control, a result not favored by the court.

In *DiTomasso v. Loverro*,¹⁸ the New York court affirmed an individual pro rata recovery in a derivative action. The decision rested on the ground that the plaintiff was in reality the only party injured by the defendants' activity. Since he was the only substantial stockholder other than the defendants, to permit a corporate recovery would have the effect of benefiting the latter. By contrast, the Delaware court, in *Keenan v. Eshlemann*,¹⁹

¹⁵ The parties in the instant case at first attempted to base their compromise upon a discontinued liquidation procedure carried out in accordance with Ill. Rev. Stat. ch. 32, § 157.90:

The liquidation of the assets and business of a corporation may be discontinued at any time during the liquidation proceedings, in the following manner:

- (a) If the action shall have been instituted by a shareholder and it is made to appear to the court that the deadlock in the corporate affairs has been broken or the management or control of the corporation has been changed, the court, in its discretion, may dismiss the proceedings and direct the receiver to redeliver to the corporation all its remaining property and assets.

On the allowance of compromise settlements in derivative actions, and the restrictions surrounding them, see N.Y. Bus. Corp. Law § 626(d):

Such [derivative] action shall not be . . . compromised . . . without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the shareholders or any class or classes thereof will be substantially affected by such . . . compromise . . . , the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the shareholders or class or classes thereof whose interests it determines will be so affected; if notice is so directed to be given, . . . expense [of the notice] shall be awarded as special costs.

In the instant case, the compromise included plaintiff's counsel fees. The N.Y. Bus. Corp. Law § 626(e) expressly excludes the fees of counsel where the recovery is "for the benefit of injured shareholders only and limited to a recovery" of their loss, i.e., where pro rata recovery is involved.

¹⁶ See 13 Fletcher, supra note 2, at 646; also, Grenier, supra note 14, passim.

¹⁷ 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952 (1955). *Perlman* rests its allowance of pro rata recovery upon the theory of fiduciary responsibility of directors to shareholders, recalling the view of this as the historically original theory of derivative actions. Cf. Prunty, supra note 11. For a more recent treatment of fiduciary duty governing the transfer of corporate control, see *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962), noted in 4 B.C. Ind. & Com. L. Rev. 421 (1963) and 76 Harv. L. Rev. 834 (1963).

¹⁸ 250 App. Div. 206, 293 N.Y.S. 912 (1937), aff'd, 276 N.Y. 551, 12 N.E.2d 570 (1937).

¹⁹ 23 Del. Ch. 234, 2 A.2d 904 (1938).

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refused individual recovery to the plaintiffs, who alone had neither participated in nor assented to the defendants' wrongdoing. According to *Keenan*, pro rata recovery would "encourage fraud," would not reflect "the inherent nature of the wrong sought to be redressed," and would "weaken . . . a stockholder's action to correct a corporate wrong." In the face of these possibilities, the Delaware court declared its adherence to a policy of preserving "the fiction of corporate entity," and thus restricting all recoveries in derivative actions to the corporations themselves.²⁰

In recent years, the rule in the *Perlman* case has met with cautious but increasing approval.²¹ Phrased most conservatively, the rule might be stated thus: where allowance of corporate recovery would tend to benefit those involved in the wrongdoing, as, for example, permitting them to share in a dividend declared as a result of the recovery, then the court will at least consider the possibility of pro rata recovery, thus disregarding the corporate entity basis of the derivative action. Qualifying the rule, of course, is the restriction that allowance of pro rata recovery can be justified "only when the case is free from the complication of the claims of corporate creditors."²²

Pro rata recovery has a long history in Illinois, the situs of the instant case. In 1897, in *Brown v. DeYoung*,²³ the Illinois Supreme Court, in a per curiam opinion incorporating that of the intermediate appellate court, held that when the effect of a corporate recovery would be to benefit those who were wrongdoers with respect to the injury which called forth the relief, then the award should be made to the individual stockholders who were innocent.²⁴ Five years later; however, in *Chicago Macaroni Co. v. Boggiano*,²⁵ the court refused to permit a pro rata recovery and required the offending director to reimburse the corporation itself for the amounts of salary he took without warrant. The distinction between the cases seems to be in the court's willingness in *Brown* to dispense with the demands of doctrinal consistency vis-à-vis strict entity theory, and to favor a pro rata recovery under a more flexible concept of equity. The problem appeared again in *Voorhees v. Mason*,²⁶ in which, relying on what appears to be a formalistic criterion, the court refused pro rata recovery on the grounds that the plaintiff's bill had

²⁰ Id. at 253, 2 A.2d at 912.

²¹ See Grenier, supra note 14, and 69 Harv. L. Rev. 1314, supra note 12.

²² Stevens, supra note 7, at 797.

²³ 167 Ill. 549, 47 N.E. 863 (1897).

²⁴ Emphasizing the equitable nature of the action, the *Brown* court declared: [E]quity, disregarding forms, and being observant only of requiring that to be done which is right, might be completely satisfied with the simpler requirement that the moneys to which the deserving shareholders are entitled should be paid directly to them.

Pointing out the lack of specific authority in the area, the court went on:

[T]he lengthening reach of equity into the manifold intricacies of modern business should not be drawn back simply for lack of authoritative decision to guide us, where reason and every equitable consideration point the way with so much clearness.

Id. at 558, 47 N.E. at 866.

²⁵ 202 Ill. 312, 67 N.E. 17 (1903).

²⁶ 245 Ill. 256, 91 N.E. 1056 (1910).

not called for it, with the implication that henceforth in Illinois derivative actions would follow the rule of *Chicago Macaroni* rather than that of *Brown*.²⁷ Despite the official frown on pro rata recovery in Illinois, a recent decision indicates that that state might in the future be forced to look more tolerantly upon it as a solution in some instances. In *Duncan v. National Tea Co.*,²⁸ the court, on the one hand, stressed the traditional concept that the individual has no standing in a derivative action except as a representative of the corporation. It went on to note, however, that shareholders who had participated in the activities causing injury to the corporation should be precluded from sharing in any way in benefits accruing from corporate recovery. It is conceivable that pro rata individual recovery could be, at times, the only satisfactory solution to an originally derivative action, especially in small close corporations where perhaps only one or two shareholders are innocent of involvement in the wrongdoing.

As far as can be seen from the tangled skein of facts in the instant case, allowance of pro rata recovery, in the form of the compromise settlement, would adequately conclude this action. The only objection to the compromise comes from an intervenor who has a foot in both camps. He claims standing on the basis of his ownership of forty-five shares in his own name. In addition to this, however, he controlled a forty percent interest in a partnership owning ninety-two percent of the majority holdings. His now deceased partner was one of the delinquent directors, and, as the dissent, on rehearing, points out, his status as a surviving partner obliges him to discharge partnership liabilities, including this one.²⁹

While the intervenor can validly claim the technical status of a minority holder representing the corporation, his long silence during the course of this decade of litigation, coupled with his allegation of the continuance of the partnership responsibilities in another recently decided case,³⁰ tips the equities against him. Since derivative actions are equity proceedings controlled by the court's discretion, denial of the intervenor's petition deprives him not of a right, but of an equitable forum which his ambiguous position does not appear to warrant. To permit an intervenor possessing such doubtful credentials to obstruct pro rata recovery in a situation which seems clearly to call for it appears to be a needlessly formalistic foreshortening of that "lengthening reach of equity" into complex business activities which the Illinois court once found so desirable.³¹

ROBERT J. MULDOON, JR.

Corporations—Liability of Directors—Illegal Stock Issue.—*Bay State York Co. v. Cobb*.¹—This is an action brought by a creditor to establish the indebtedness of the defendant-directors of a Massachusetts corporation

²⁷ The briefs in the instant case discuss *Brown* as if the *Voorhees* decision had no importance for the *Brown* rule.

²⁸ 14 Ill. App. 2d 280, 144 N.E.2d 771 (1957).

²⁹ *Shlensky v. South Parkway Building Corp.*, supra note 1, at 43.

³⁰ *Englestein v. Mackie*, 35 Ill. App. 2d 276, 182 N.E.2d 351 (1962).

³¹ *Brown v. DeYoung*, supra note 23, at 558, 47 N.E. at 866.

¹ — Mass. —, 195 N.E.2d 328 (1964).