Maryland Law Review

Volume 4 | Issue 4 Article 3

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David S. Sykes

RIGHT OF STOCKHOLDER TO ATTACK TRANSACTIONS OCCURRING PRIOR TO HIS ACQUISITION OF STOCK

By DAVID S. SYKES*

An analysis of the decisions dealing with the question of whether or not a subsequent stockholder may attack, in a derivative action, transactions occurring prior to his acquisition of stock shows that the weight of authority and sound reason support the stockholder in such a suit.[1]

The following jurisdictions allow such a suit to be maintained by a subsequent stockholder if he be not barred by laches, estoppel or otherwise:[2] England, Alabama, California, Idaho, Illinois, Maine, Michigan, Montana, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Utah and Delaware.

A number of State Courts, however, have followed the rule promulgated by the Supreme Court of the United States,[3] which requires that in a secondary action by a stockholder it must be alleged, *inter alia,* that he was a stockholder at the time of the transaction of which he

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* Of the Baltimore City Bar. A. B., 1932, Johns Hopkins University; LL. B., 1935, University of Maryland.

[1] BALLENTINE, PRIVATE CORPORATIONS (1927) 625; MACHEN, CORPORATIONS (1908) Sec. 1169; 4 COOK, CORPORATIONS (8th ed. 1923) 3220; 1 MORAWETZ, PRIVATE CORPORATIONS (2d ed. 1886) 254, Sec. 266; MOORE, FEDERAL PRACTICE (1938) 2253; 9 FLETCHER, CYCLOPEDIA OF CORPORATIONS (1920) Sec. 5980, 5981.

[2] Seaton v. Grant, L. R. 2 Ch. 459; Parsons v. Joseph, 92 Ala. 403, 8 So. 788 (1891); Harvey v. Meigs, 17 Cal. App. 353, 119 Pac. 941 (1911); Scully et al. v. Auto Finance Co., 11 Del. Ch. 355, 101 A. 908 (1917); Just v. Idaho Canal Co., 16 Idaho 639, 102 Pac. 381 (1909); Chicago v. Camerson, 22 Ill. App. 91, aff. 120 Ill. 447, 11 N. E. 899 (1886); Mason v. Carrothers, 105 Me. 392, 74 A. 1030 (1909); German Corp. v. Negaunee German Aid Soc., 172 Mich. 650, 138 N. W. 343 (1912); Forrester v. Boston Mining Co., 21 Mont. 544, 55 Pac. 229 (1898); Winsor v. Bailey, 55 N. H. 218 (1875); Appleton v. American Malting Co., 65 N. J. Eq. 375, 54 A. 454 (1903); Pollitz v. Gould, 202 N. Y. 11, 94 N. E. 1088 (1911); Dissette v. Publishing Co., 9 Ohio Circ. Ct. (N. S.) 118 (dicta); North v. Union Savings & Loan Assn., 59 Ore. 483, 117 Pac. 822 (1911); Rafferty v. Donnelly, 197 Pa. 423, 47 A. 202 (1900); Robertson v. Draney, 53 Utah 263, 178 Pac. 35 (1919).

[3] Originally Equity Rule 94, promulgated by the Supreme Court of the United States January 23, 1882. By amendment of 1912 this Rule was slightly changed and became known as Equity Rule 27. It is now Rule 23 (b) of the Rules of Civil Procedure for the District Courts of the United States, which Rules were adopted by the Supreme Court pursuant to the Act of June 19, 1934, Chapter 651 (48 Stat. 1064).

complains, or that his stock thereafter devolved on him by operation of law. The following states have been generally cited as requiring that the stockholder complainant be a stockholder as of the time of the transaction complained of:[4] Colorado, Georgia, Iowa, Kentucky, Nebraska, New Mexico, North Carolina and Washington.

Many of the decisions of the above enumerated courts could have rested upon basic principles of equity, and the stockholder could have been precluded from maintaining the suit upon the particular facts of the case upon such grounds as estoppel, acquiescence, or laches, without relying on the principle that the stockholder was barred merely because he acquired his stock subsequent to the contested transaction. These cases will be discussed elsewhere.

Some text writers have placed Maryland within this group of so-called "minority cases," on the strength of the language of the Court in *Matthews v. Headley Chocolate Co.*[5] This case will be analyzed later in this article, and the writer hopes to demonstrate that such a construction is untenable.

The starting point for the weighing of these two opposing views must necessarily involve a consideration of the basic rights of a stockholder in the assets of a corporation and the duties of the management of the corporation to him.

In Morawetz on Private Corporations[6] it is said:

> "It has been pointed out that the estate of a corporation is to be treated as that of a continuing institution, irrespective of the members at any particular

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[4] Boldenweck v. Bullis, 40 Col. 253, 90 Pac. 634 (1907); Alexander v. Searcy, 81 Ga. 536, 8 S. E. 630 (1889); Clark v. American Coal, 86 Iowa 436, 53 N. W. 291 (1892); Neff v. Gas & Electric Shop, 232 Ky. 66, 22 S. W. (2d) 265 (1929), noted (1930) Ky. L. J. 387; Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N. W. 1024 (1903); Rankin et al v. Brewery & Ice Co. et al., 12 N. M. 54, 73 Pac. 614 (1903); Moore v. Silver Valley Mining Co., 104 N. C. 534, 10 S. E. 679 (1890); (this case hardly belongs in this classification although textwriters generally place it there); Pitcher v. Lone Pine-Surprise Consol. Min. Co., 39 Wash. 608, 81 Pac. 1047 (1905).

[5] 130 Md. 523, 102 A. 920, L. R. A. 1918C 1181 (1917).

[6] MORAWETZ, *op. vit. supra*, n. 1, Sec. 265.

> time composing it. Each share represents an interest in the entire concern, and the several holders are entitled to equal rights irrespective of the time when they acquired their shares. Causes of action belonging to the corporation increase the value of the corporate estate, and must be treated like any other assets; when enforced, they inure to the benefit of all the stockholders without distinction. It is plain, therefore, that a stockholder has an interest in all causes of action belonging to the corporation, whether they arose before or after he purchased his shares. If the courts decline to protect this interest in any particular case, their refusal must be based upon some principle of public policy, or the personal disqualification of the plaintiff."

The same writer, along with others,[7] criticizes a rule which would cut off the rights of the transferee of shares of stock, rights which were allowed the assignor and which were inherently in the stock.

> "If purchasers were disqualified from protecting their interests under these circumstances, the transferable value of shares might be impaired, and the loss would fall upon the innocent holders who were wronged."[8]

Before a suit may be maintained by a stockholder in behalf of the corporation for wrongs committed against it, all courts agree that the proper foundation must be established. Efforts must be first made to have the wrong redressed through the corporation, and the bill of complaint must allege that a demand has been made upon the board of directors or other managing body to act for the corporation and that no action has been taken; or, failing to allege such a demand, it must fully set forth the reason for such failure, such as that because of the adverse interest of the majority of the board of directors or other managing body such a demand would be futile.[9]

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[7] Seasongood, *Stockholder Suing for Corporation* (1907) 21 Harv. L. Rev. 195.

[8] MORAWETZ, *op. cit., supra*, n. 1, Sec. 266.

[9] MACHEN, *op. cit., supra*, n. 1, Sec. 1145 *et seq.;* Booth v. Robinson, 55 Md. 419, 439 (1881).

It is also essential that such a complainant be free from any disqualification. He must be a bona fide stockholder;[10] a mere nominee representing a rival company is not a bona fide stockholder.[11] He must not have been guilty of any conduct amounting to participation, acquiescence, estoppel or laches.[12] So too, having taken the stock subject to all of its infirmities, the complainant stockholder must necessarily be barred by the conduct of his predecessor in title such as participation, acquiescence, estoppel or laches, for the sale of stock cannot pass any greater rights than those possessed by the vendor.[13]

The right of the stockholder to sue in behalf of the corporation, thus limited by the established principles of equity jurisprudence, is necessary for the protection of the corporation from the fraud, breach of fiduciary obligation, or oppressive conduct by those in control of the corporation. If the stockholder has complied with all of the preliminary requirements above mentioned, he should be allowed to maintain his secondary action regardless of the time of his purchasing the stock of the corporation. Allowing such an action must have only the most salutary effect in deterring and preventing unlawful acts by those in control of the corporation which might accrue to their own advantage and be adverse to the interests of the corporation and its minority stockholders. To disallow such an action would be to offer opportunity to the wrongdoers to hide behind the cloak of technicality to protect their illgotten gains.

The Federal Rule[14] (Equity Rule 94) was promulgated immediately after the Court had decided the case of *Hawes v. Contra Costa Water Co.*[15] That decision, and the rule embodying it, was the Court's manifestation of its displeasure at stockholders, under the doctrine of *Dodge v.*

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[10] Moore v. Silver Valley Mining Co., *supra*, n. 4.

[11] Breeze v. Lone Pine-Surprise Consol. Min. Co., 39 Wash. 602, 81 Pac. 1050 (1905); Runcie v. Corn Exchange Trust Co., 6 N. Y. Supp. (2d) 616 (1938).

[12] Matthews v. Headley Chocolate Co., *supra*, n. 5.

[13] *Ibid.*

[14] *Supra*, n. 3.

[15] 104 U. S. 450, 26 L. Ed. 827 (1882).

Woolsey,[16] coming into the Federal Courts to enforce corporate causes of action when there would have been no jurisdiction in the Federal Courts had the corporation itself attempted to bring action. Supreme Court dicta in *Dimpfell v. Ohio & Miss. Ry. Co.*[17] and some state courts, apparently moved by other considerations, have treated this Rule as one of substantive law. That the Rule is merely one of procedure has been the view adopted by the majority of the state courts.[18] Some Federal Courts have also taken the view that the Rule was adopted only as a jurisdictional matter.[19]

In a recent treatise on the Federal Rules of Civil Procedure[20] it was said that if Rule 23 (b) "is substantive in character, then it is subject to challenge in the Federal Courts held in those states which have no such requirement, namely, the majority of American states. The reason for this is that the Federal Rules can validly regulate only procedure; and if the requirement is substantive, the Federal Courts must now apply the state common law by virtue of the doctrine of *Erie R. Co. v. Tompkins*."[21]

Such a contention was made in the recent Federal District Court case of *Summers et al. v. Hearst et al.*[22] and the court held that contention untenable. There the court indicated that it might have felt itself compelled to follow the New York case of *Pollitz v. Gould*,[23] regardless of the Federal general law, were it not for the fact that the principle of *Hawes v. Contra Costa Water Co.*[24] had been embodied in an equity rule promulgated by the Supreme

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[16] 18 How. 331, 15 L. Ed. 401 (1856).

[17] 110 U. S. 209, 28 L. Ed. 121, 35 S. Ct. 573 (1884); Venner v. Great Northern Ry. Co., 153 F. 408 (C. C. S. D. N. Y. 1907).

[18] *Supra*, n. 2. On this point see Seasongood, *supra* n. 7; and (1922) 6 Marquette L. Rev. 170.

[19] McQuillen v. National Cash Register Co., 22 F. Supp. 867 (D. Md. 1938); Hand v. Kansas City Southern Ry. Co., 55 Fed. (2d) 712, (S. D. N. Y. 1931); Lindsley v. Natural Carbonic Gas Co., 162 F. 954 (C. C. S. D. N. Y. 1908); Delaware & Hudson Co. v. Albany Susquehanna Ry. Co. et al., 213 U. S. 435, 53 L. Ed. 862, 29 S. Ct. 540 (1909).

[20] MOORE, *op. cit.*, *supra* n. 1, 2253.

[21] 304 U. S. 64, 82 L. Ed. 1188, 58 S. Ct. 817 (1938).

[22] 23 F. Supp. 986 (S. D. N. Y. 1938).

[23] *Supra*, n. 2.

[24] *Supra*, n. 10.

Court. In other words, the court held that the rule was not one of substantive law, but was merely procedure.

The very fact that this requirement has been made the subject of a rule of civil procedure for the lower Federal Courts by the Supreme Court of the United States, under authority granted to it by Congress, is answer enough to those who contend that this requirement is one of substantive law.

Most of the State decisions following the Federal Rule could have reached the same result, in perfect harmony with the decisions of the English or majority courts, upon well established principles of equity jurisprudence.

In the Nebraska case of *Home Fire Insurance Co. v. Barber*,[25] wherein Dean Pound, then Commissioner, vigorously championed the cause of the Federal Rule as one of substantive law, it was said:

> "In other words, the present stockholders are contesting acts through which they get title to a large portion of their stock, and acts which those through whom they derived the greater part of the remainder could not have challenged because they participated therein . . ."

In this case one of the stockholders who acted as agent for the sale of the stock, some of which was his own stock, was the alleged principal wrongdoer, and all of the other stockholders apparently had consented or acquiesced in the transaction contested. The opinion further stated:

> "It appears to be well settled, also, that stockholders who have acquired their shares and their interest in the corporation from the alleged wrongdoers and through the prior mismanagement have no standing to complain thereof."

Another reason why the court thought relief improper was that "it would enable them (present stockholders) to recover back a large part of the purchase money they paid and agreed to pay for the stock, notwithstanding the stock was worth all that they paid for it, and notwithstanding they obtained and now retain all that they bargained for."

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[25] *Supra*, n. 4.

The court, conceding that all of the present stockholders were barred from relief, held that the corporate entity should be disregarded and relief denied the corporation except as to items converted by the defendant.

Clearly had this suit been brought by a stockholder acquiring his stock under the circumstances of this case recovery could have been disallowed upon substantive equitable principles, and the court need not have discussed the Federal Rule. Since the suit was brought by the corporation, it became necessary to look behind the corporate entity and to preclude a recovery which would have been denied had the suit been brought by such a stockholder in behalf of the Corporation. However, it was hardly necessary for the court to have unqualifiedly held any subsequent stockholder disqualified from maintaining a derivative action merely because his stock might have been acquired after the contested transaction.

In the Georgia case of *Alexander v. Searcy,*[26] wherein it was erroneously said "the weight of authority seems to be that a person who did not own stock at the time of the transaction complained of cannot complain or bring suit to have them declared illegal," the stockholders had been guilty of acquiescence for seven to fifteen years; and there was not shown a demand upon the directors to conduct the litigation, nor was any reason for a failure to make such a demand shown. Although fault may be found with the invocation of the Federal Rule, there can be little doubt but that the courts applying the English rule would have come to the same conclusion upon the facts of the case.

In *Moore v. Silver Valley Mining Co.*[27] and in *Boldenweck v. Bullis*[28] wherein the complainants were held precluded from attacking the transaction complained of, the complainants were estopped by laches. In the former case the Court held that it was neither alleged that the plain-

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[26] *Ibid.*
[27] *Ibid.*
[28] *Ibid.*

tiff had sought redress within the corporation, nor that he had brought suit in the state wherein the corporation and all defendants, save one, were resident, nor did it appear plaintiff was a bona fide owner of stock. In the latter case plaintiff's stock appeared to have participated in the transaction contested.

In *Breeze v. Lone Pine-Surprise Consol. Min. Co.*[29] and in *Clark v. American Co.*[30] the plaintiff stockholders were not bona fide stockholders, a fact which would disqualify them under general principles of equity.

It is indeed to be regretted that the above courts have based their decisions upon a misapplication of a rule of practice[31] which was adopted to correct a jurisdictional matter, when such decisions could have been based upon sound principles of equity. By so misapplying this Rule, they have brought about a rule of substantive law which is clearly in disfavor among the majority of courts.[32]

In the beginning of this article the Maryland case of *Matthews v. Headley Chocolate Co.*[33] was referred to as being placed by some text writers within the minority rule. This suit was brought in equity *in the name of the corporation* against its former directors for an accounting of excessive salaries voted by them to two of their number as officers. As the case came before the Court of Appeals on the lower court's ruling on the demurrer to the bill, the question before that Court was whether or not the bill was maintainable in the name of the corporation.

The Court, in affirming the action of the lower court in overruling the demurrers to the amended bill of complaint, held that inasmuch as those who were the minority stockholders at the time of the transactions complained of were now able to have the suit brought in the name of the corporation, a suit so brought could be maintained so long as recovery was limited "to the extent of the proportions

[29] *Supra*, n. 11 (companion case to Pitcher v. Lone Pine-Surprise Consol. Min. Co., *supra*, n. 4).

[30] *Supra*, n. 4.

[31] MACHEN, *op. cit.*, *supra*, n. 1, Sec. 1171; MORAWETZ, *op. cit.*, *supra*, n. 1, Sec. 269; 8 FLETCHER, *op. cit. supra* n. 1, Sec. 5581.

[32] *Supra*, n. 2.

[33] *Supra*, n. 5.

of the sum recovered due such minority stockholders, if any, as are not barred by laches, limitations, acquiescence, or other way sufficient to bar them in equity, and anything recovered should be directed to be paid to them by the corporation."

The ruling of the Court of Appeals also precluded the purchasers of the controlling interest, who had caused the suit to be initiated in the name of the corporation and whose assignor had committed the alleged wrong, from sharing in the recoverey on the ground that they could not have any greater rights than their vendor. This part of the decision is indeed most interesting, but it is hardly within the scope of this article.

As stated before, the real question before the Court was whether or not the Corporation had stated a good cause of action, yet the Court in reaching its conclusion (which was undoubtedly most equitable under the particular facts of the case) discussed the authorities which unconditionally deny the right of a subsequent stockholder to maintain a suit in behalf of the Corporation for transactions committed prior to said stockholder's acquisition of stock. In the next succeeding paragraphs, the Court, without distinction, intermingled authorities apparently following the Federal Rule and those following the English or New York decisions. However, all of these cases cited have a "common denominator", to wit, "estoppel".

The Court then stated:

> "If this was a suit by stockholders, it would seem to us to be clear that holders of stock who become such after the transactions complained of took place, should not be permitted to recover against the directors."

Chief Judge Boyd, in the same paragraph concluded that:

> ". . . those who held over 75 per cent of the stock were the same persons who constituted the board of directors, and it is clear under the authorities that they should not be given relief in a Court of Equity

from what they themselves did, when acting in the capacity of directors."

"We are also of the opinion that the assignees of Matthews are likewise not entitled to recover."

It is the writer's conviction that the Court of Appeals was not attempting to bring Maryland into the "minority camp" on the principle under discussion, but rather that the Court was following the well recognized principle of estoppel and the principle that the vendee acquires no greater right than those possessed by his vendor.

The taking of such a point of view would explain clearly the reasons for the Court's discussing a question otherwise irrelevant and it would furnish the basis for the unusual decree allowing recovery by the corporation as a trustee.

To take any other view would relegate that which the Court said relative to derivative suits by subsequent stockholders to the realm of dicta.[34]

An examination of the briefs in this case shows that counsel for appellants in their very learned brief cited the case of *Home Fire Insurance Co. v. Barber*, in support of their argument that if any relief was due, it should be granted only to a small minority of the stockholders individually and not to the assignees of Matthews who were bound by his acts. Counsel contended it would be unjust to grant a decree which would double the value of the stock of the vendees at the expense of the vendor; that such a decree would result in the assignees getting from Matthews a larger sum even than they paid him for his stock. That this result would be inequitable appellants cited the *Barber* case and the case of *Alexander, Trustee v. Searcy*, wherein, as the quoted paragraph in appellant's brief shows, the complainants sought to attack transactions which were brought about by their predecessors in title.

Nowhere in the brief is it intimated that a subsequent stockholder acquiring his stock from one who had not been

[34] But see Alexander v. Worthington, 5 Md. 471, 489 (1854) as to whether or not dicta become authoritative law in this state.

disqualified in any way could not maintain an action in behalf of the corporation.

The Court of Appeals followed the logical and well written brief of the appellants and approved of the principles therein stated and the cases therein cited, but, unfortunately, the Court, in dealing with the *Barber* case, went a great deal further than was necessary and proper in using the unqualified language that it used.

Should the question of the stockholder's right to sue, for transactions occurring prior to such stockholder's acquisition of stock, where such stockholder or his assignor has not been disqualified from suing by general principles of equity, arise in Maryland, it is hoped that the Court of Appeals will explain its language in the *Headley Chocolate* case. If it regards that language as dicta, it is hoped that it will rule contrary thereto.

It is true that the majority rule, permitting a subsequent stockholder to champion the cause of the corporation, affords an opportunity to a speculator to buy up a few shares of stock and maintain a "nuisance suit" for personal gain.

In answer to those who favor the minority rule because of this possibility of so-called "legalized blackmail", the writer again refers to Morawetz on Private Corporations,[35] wherein it is said:

> "Courts cannot investigate the secret intentions of parties, or refuse to protect their apparent and substantial rights by reason of some ulterior improper design. The purpose with which a shareholder obtained his shares and began the litigation should merely be considered as a circumstance tending to discredit his case."

It must be borne in mind that the relief sought in a minority stockholder's bill of complaint is on behalf of the Corporation, and, accordingly, any relief granted will inure to the benefit of the Corporation, the individual stockholder merely deriving an incidental benefit therefrom.

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[35] 1 MORAWETZ, PRIVATE CORPORATIONS (2d Ed. 1886) 254, Sec. 266.

Courts of Equity have erected a formidable barrier in front of stockholders' bills by requiring the stockholder to be free from any disqualification and to lay the proper foundation for the relief prayed.[36] If the stockholder is qualified, has exhausted his means of remedy within the corporation, and has shown a case of apparent and substantive rights, the right to relief to the Corporation should not be denied. The honest and faithful director will not complain if the suit will result in favor of the Corporation, and the director whose conduct constitutes the gravamen of the bill should not be heard to complain. The fact that some few suits may be instituted without foundation and for purely improper purposes, is not a sufficient reason to repudiate the majority rule and eliminate a strong deterrent to the disloyal and self-serving management.

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[36] *Supra, circa* notes 9 to 13.