Indiana Law Journal

Volume 30 | Issue 1 Article 7

Fall 1954

Nonapplicability of "Security for Expenses" Legislation to Minority Stockholders' Dividend Suits

NONAPPLICABILITY OF "SECURITY FOR EXPENSES" LEGISLATION TO MINORITY STOCKHOLDERS' DIVIDEND SUITS

The usual state general corporation statute confers few rights upon stockholders,[1] while at the same time entrusting the directors with great powers in the management of the corporation[2] and the declaration of its

---

shall be entitled to a continuance of said case for not to exceed four days." IOWA CODE ANN. §777.18 (1946).

62. The two way exclusion of evidence provided for in the Indiana law merely aggravates the problems arising under alibi legislation; the alibi law has the potentiality of becoming a liability to the prosecutor rather than an asset.

1. The Indiana general corporation law is illustrative. The act provides that the rights and powers of stockholders shall be those provided in the articles of incorporation or expressed by the board of directors prior to the issuance of the shares involved. IND. ANN. STAT. §25-205 (Burns Supp. 1953). There are no preemptive rights unless stated in the articles of incorporation or in a resolution of the board of directors. *Ibid.* Voting rights are given unless the articles of incorporation provide otherwise. *Id.* §25-207. The right to adopt the by-laws must be expressed in the articles of incorporation. IND. ANN. STAT. § 25-220 (Burns 1933). Any amendment of the articles of incorporation must be adopted by those stockholders entitled to vote. *Id.* § 25-222. Merger and consolidation must similarly be approved. IND. ANN. STAT. §§25-231, 25-232 (Burns Supp. 1953). A stockholder who dissents to a merger or consolidation may demand payment for his shares. *Id.* §25-236. The sale, lease, exchange, mortgaging or pledging of all or substantially all of the corporate assets must have the approval of the stockholders. *Id.* §25-238. A dissenting stockholder from such sale may receive payment for his shares. *Id.* §25-240. Stockholders must also approve a voluntary dissolution of the corporation. *Id.* §25-241.

For an enumeration of the general powers and rights of stockholders see 13 FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS §5717 (Wolf 1943).

2. See *e.g.,* IND. ANN. STAT. §25-208 (Burns Supp. 1953); N.Y. GEN. CORP. LAW §27 (Supp. 1953); DEL. CODE ANN. tit. 8, §141 (1953).

dividends.[3] Courts have generally shown reluctance to intercede in the exercise of directors' duties on the theory that such interference would reduce the responsibility resided in directors by state law.[4] The resulting lack of authority on the part of the stockholder in the affairs of the corporation amounts to an almost complete lack of control over the property which he has furnished the corporation.[5]

3. See *e.g.*, IND. ANN. STAT. §25-211 (Burns 1933); N.Y. STOCK CORP. LAW §58 (1951); DEL. CODE ANN. tit. 8, §170 (1953).

4. "The law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation." Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

One court indicated that directors will be held liable if they fail to exercise ". . . the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs. . . ." Hun v. Cary, 82 N.Y. 65, 71, 37 Am. Rep. 546, 548 (1880). Again equitable relief will be granted when the directors have acted in bad faith, are guilty of fraud or breach of trust. Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 196, 123 N.E. 148, 152 (1919). Another view is that the care required is that of any reasonably prudent officer under similar circumstances. Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938). A provision in the articles of incorporation may relieve the directors from certain liability. Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942).

For discussions of the role of directors in corporate affairs see SPELLMAN, CORPORATE DIRECTORS §6 (1931); POMEROY'S EQUITY JURISPRUDENCE §§1089-1091 (5th ed., Symons, 1941); 6 THOMPSON, CORPORATIONS §4520 (3d ed. 1927); Carson, *Current Phases of Derivative Actions Against Directors,* 40 MICH. L. REV. 1125, 1128-1131 (1942); Carson, *Further Phases of Derivative Actions Against Directors,* 29 CORNELL L.Q. 431 (1944); Uhlman, *The Duty of Corporate Directors to Exercise Business Judgment,* 20 B.U.L. REV. 488 (1940).

Reluctance of courts to interfere with corporate affairs is discussed in Comment, 48 MICH. L. REV. 87, 88 (1949); Note, 64 HARV. L. REV. 299 (1950).

For a consideration of the hesitancy of courts to interfere with discretion of directors in the declaration of dividends see BALLANTINE, CORPORATIONS §231 (1946); 11 FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS §5325 (Perm. ed. 1932); STEVENS, PRIVATE CORPORATIONS §99 (2d ed. 1949).

5. See BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY c. 1 (1948).

Certain writers have drawn a comparison between the corporation and the communist form of government: "It is an odd paradox that a corporate board of directors and a communist committee of commissars should so nearly meet in common contention. The communist thinks of the community in terms of a state; the corporation director thinks of it in terms of an enterprise; and though this difference between the two may well lead to a radical divergence in results, it still remains true that the corporation director who would subordinate the interests of the individual stockholder to those of the group more nearly resembles the communist in mode of thought than he does the protagonist of private property." *Id.* at 278.

One writer sees in the corporation the characteristics of a dictatorship: "It [a corporation] is bureaucracy in its most rampant form. It may be characterized as dictatorship for the reason that the essential factor which distinguishes a democracy from a dictatorship is not present; namely, consent of those governed to the personnel and policies of those governing and a regular technique for discovering and making effective that consent." Pinney, *The Nature of the Corporation,* 14 TEMPLE U.L.Q. 443, 472 (1940).

These comparisons, while perhaps overdrawn, do indicate the lack of stockholder control over the corporation. A person who realizes that a stockholder has little voice in the management of a corporation may hesitate to purchase stock since his purchase money may constitute a gift more than an investment. But at the same time the separation of ownership and control makes for a growth of industry not possible if the invest-

The position of a minority stockholder may be further weakened by the application of the so-called "Security for Expenses" legislation[6] to dividend suits.[7] These statutes require the posting of a bond only when suit is brought in the right of the corporation by the owners of less than the specified percentage of the corporation's stock.[8] The acts are designed primarily to curb "strike" suits which are those brought to harass directors often with the motive of obtaining improper settlement.[9] The presump-

ing public had to assume the burden of management. BERLE AND MEANS, *loc. cit. supra* at 5.

6. Several states have enacted this type of legislation. See CAL. CORP. CODE ANN. §834 (1949); MD. ANN. CODE GEN. LAWS art. 16, §206 (1951); N.J. STAT. ANN. §14:3-15 (Supp. 1949); N.Y. GEN. CORP. LAW §61-b (Supp. 1953); PA. STAT. ANN. tit. 12, §1322 (Supp. 1949); WIS. STAT. §180.13(3) (1945).

The New Jersey law typically provides that: "In any action instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of shares, or of voting trust certificates representing shares, of such corporation having a total par value or stated capital value of less than five per centum (5%) of the aggregate par value or stated capital value of all the outstanding shares of such corporation's stock of every class . . . unless the shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars ($50,000.00), the corporation in whose right such action is brought shall be entitled, at any stage of the proceeding before final judgment, to require the complainant or complainants to give security for the reasonable expenses, including counsel fees, which may be incurred by it in connection with such action. . . . The amount of such security may thereafter, from time to time, be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or is excessive. . . ." This New Jersey law was held constitutional in Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949).

The New York statute was upheld in Lapchak v. Baker, 208 N.Y. 89, 80 N.E.2d 751 (1948). For a discussion of the New York provision see Note, 23 ST. JOHN'S L. REV. 296 (1949).

7. The term "dividend suit," as used in this note refers to an action to compel the declaration of dividends. The New York Court of Appeals recently affirmed the application of its security for expenses law to minority stockholder's dividend suits. Gordon v. Elliman, 119 N.E.2d 331 (N.Y. 1954).

8. Lennan v. Blakely, 80 N.Y.S.2d 288 (Sup. Ct. 1948). For a discussion of security for expense laws see Note, *Security For Expenses Legislation—Summary, Analysis, and Critique*, 52 COL. L. REV. 267 (1952); Comment, *Recent Developments in the California Law of Shareholders' Derivative Suits*, 1 U.C.L.A.L. REV. 79 (1953).

The New York and Maryland statutes are compared in Note, 8 MD. L. REV. 241 (1944). This type of legislation has been held applicable in derivative suits brought in the federal courts. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949). See for a treatment of this aspect Notes, 1 RUTGERS L. REV. 117 (1947); 23 ST. JOHNS L. REV. 296 (1949).

9. In giving executive approval to the New York statute Governor Dewey stated, "In recent years a veritable racket of baseless lawsuits accompanied by many unethical practices has grown up in this field. Worse yet, many suits that were well based have been brought not in the interest of the corporation or of its stockholders, but in order to obtain money for particular individuals who had no interest in the corporation or in its stockholders. Secret settlements—really payoffs for silence—have been the subjects of common suspicion." PUBLIC PAPERS OF THOMAS E. DEWEY 255 (1944).

The New York Court of Appeals recognized this strike suit problem in Lapchak v. Baker, 298 N.Y. 89, 95, 80 N.E.2d 751, 753 (1948). See also Ballantine, *Abuses of Shareholders' Derivative Suits: How Far is California's New "Security for Expenses" Act Sound Regulation?*, 37 CALIF. L. REV. 399 (1949); Bowes, *Should New York's "Security* tion embodied in these laws is that if the interest of a stockholder is less than the minimum amount he is acting in bad faith in bringing the suit.[10] The requirement of security was intended to discourage the bad faith suit.

The advocates of the proposal that the minority stockholder should be required to post security in a dividend action contend that such a proceeding is within the policy of "Security for Expenses" legislation since it may possibly be utilized as a strike suit.[11] It is further maintained that a dividend action amounts to a derivative suit because it is actually brought against the directors of the corporation to enforce a corporate right.[12] Other authorities assert that the characteristics of a dividend action make it unsuitable for strike suit purposes, and, moreover, that it is a proceeding by the plaintiff in his own right, and that of his class, against the corpora-

---

for Expenses" Act be Amended?, 2 SYRACUSE L. REV. 37 (1950); De Capriles and Prunty, *Corporations*, 29 N.Y.U.L. REV. 556, 557 (1954); Notes, 53 COL. L. REV. 437, 439 (1953); 19 BROOKLYN L. REV. 312 (1953).

10. Governor Dewey pointed out that the New York law was not intended to ". . . bar any action . . . [or] . . . bar any right. It simply requires that the plaintiff represent a certain minimum of interest in the corporation or that he put up security for costs and expenses which will be incurred if his case is determined to be unfounded . . . Even if the stockholder owns only a tiny percentage or only $5.00 worth of stock, it still should be simple to bring an action without putting up security. If his action has any merit at all, it should be easy enough to interest others who hold at least 5%, or stock valued at $50,000.00." PUBLIC PAPERS OF THOMAS E. DEWEY 255-256 (1944).

The problem as it exists in another jurisdiction is discussed in Ballantine, *supra* note 9, at 403.

For an analysis favorable to the acts see Carson, *Further Phases of Derivative Actions Against Directors*, 29 CORNELL L.Q. 431 (1944). For a criticism of the laws see Bowes, *supra* note 9, at 37; Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944); Zlinkoff, *The American Investor and the Constitutionality of Section 61-b of the New York General Corporation Law*, 54 YALE L.J. 352 (1945); Note, 24 N.Y.U.L.Q. REV. 395 (1949).

The effect of the statutes on derivative suits is discussed in Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COL. L. REV. 1 (1947).

The New York courts will permit the plaintiff to solicit other stockholders to join. Neuworth v. Wyman, 119 N.Y.S.2d 266 (Sup. Ct. 1953). In this connection see De Capriles and Prunty, *Corporations*, 29 N.Y.U.L. REV. 556, 557 (1954); Note, 52 COL. L. REV. 267, 279 (1952).

11. See Gordon v. Elliman, 119 N.E.2d 331 (N.Y. 1954) in which a minority stockholder, holding less than 5%, and less than $50,000 worth, of corporate stock, brought a dividend action against a corporation and its directors. The corporation's motion to require plaintiff to post security because of Section 61-b of the New York General Corporation Law was granted by the trial court. The order was affirmed by the New York Court of Appeals by a four to three decision.

12. Courts in at least two jurisdictions have held that a dividend action is a derivative suit. Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482 (1939); Jones v. Van Heusen Charles Co., 230 App. Div. 694, 246 N.Y. Supp. 204 (1930).

Dividend suits are described as derivative in 11 FLETCHER, *op. cit. supra* note 4, §5326.

One writer points out that the decisions in the cases above antedated the "Security for Expenses" statutes and that the failure to distinguish had no effect on the rights of parties. Note, 38 CORNELL L.Q. 244, 251 (1953).

tion rather than one brought in the right of the corporation.[13] An analysis of the various types of actions available to a minority stockholder to protect his interests should be helpful in determining which assertions are correct.

The minority stockholder can, on the one hand, bring an action against either the directors or the corporation, depending upon who is at fault, for a violation of his personal rights as an owner of corporation stock.[14] This may be a suit at law for damages or in equity for the proper equitable relief. For example he can sue the directors for wrongful refusal to transfer stock, for violation of his voting privileges, or for refusal to allow inspection of the corporate books.[15] If he pursues the enforcement of rights of other stockholders as well as his own, his action will be considered a class suit,[16] and members of the class may intervene.[17]

In addition to personal and class suits, the minority stockholder can bring a derivative action if he meets the necessary requirements.[18] This suit must be brought in equity against the directors for breach of duty

13. *See* Gordon v. Elliman, 119 N.E.2d 331 (N.Y. 1954) (dissenting opinion); Swinton v. W. J. Bush & Co., 102 N.Y.S.2d 994 (1951). See also Notes, 41 CALIF. L. REV. 546, 548-549 (1953); 53 COL. L. REV. 437, 438-439 (1953); 38 CORNELL L.Q. 244, 250 (1953); 22 FORD. L. REV. 97, 100 (1953); 4 SYRACUSE L. REV. 165 (1952).

14. BALLANTINE, CORPORATIONS § 143 (1946); 13 FLETCHER, *op. cit. supra* note 1, §5915; STEVENS, *op. cit. supra* note 4, §167.

15. 13 FLETCHER, *op. cit. supra* note 1, §5919.

16. The class suit originated in equity to eliminate multiple litigation and to simplify the procedure in those cases in which members of a class are too numerous to be named as parties. STEVENS, *op. cit. supra* note 4, §167. The term "class suit," as used in this note, includes only those actions by a plaintiff in his own right as a member of his class of stock. It does not include derivative suits, which are also considered class actions.

For a discussion of class suits see Note, *Recurrent Problems in Action Brought on Behalf of a Class,* 34 COL. L. REV. 118 (1934).

17. "A stockholder may intervene as an individual, under the codes, where he has an interest to be protected in the suit, but a cross-complaint in intervention by one stockholder, in a suit begun by another, must be germane to it." 13 FLETCHER, *op. cit. supra* note 1, at 293. See also Note, 34 COL. L. REV. 118, 124 (1934).

The plaintiff remains in control of the suit, but if he does not prosecute with due care those who intervene can assume the control. Note, *Right to Control of Class Suits,* 5 WYO. L.J. 126, 129 (1951).

18. The derivative suit originated in England. Hitchens v. Congreve, 4 Russ. 562, 38 Eng. Rep. 917 (1828); Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843). Leading cases indicating the development in the United States are Robinson v. Smith, 3 Paige Ch. 222 (N.Y. 1832); Dodge v. Woolsey, 18 How. 331 (U.S. 1855); Hawes v. Oakland, 14 Otto 450 (U.S. 1881). For a discussion of the development see Koessler, *The Stockholder's Suit: A Comparative View,* 46 COL. L. REV. 238, 239 (1946).

The derivative suit gained prominence after the congressional investigations in the 1930's. Hornstein, *Rights of Stockholders in the New York Courts,* 56 YALE L.J. 942 (1947). For a general discussion of the derivative suit see BALLANTINE, CORPORATIONS c. XI (1946); 13 FLETCHER, *op. cit. supra* note 1, c. 58 pt. XXXIII; STEVENS, *op. cit. supra* note 4, §§167-174; Glenn, *The Stockholder's Suit—Corporate and Individual Grievances,* 33 YALE L.J. 580 (1924).

owed to the corporation.[19] A stockholder must show that unless he is permitted to bring such suit an injury to the corporation will remain unredressed.[20] The corporate cause of action is, of course, the first prerequisite.[21] This exists when some duty owed to the corporation, which is expressly enumerated in the general corporation statute, the articles of incorporation, or the corporation by-laws, or which is affixed by the common law, is violated by the directors to the consequent detriment of the corporation.[22] Exemplary of such wrongs committed by directors are failure to sue a third party, improper use of corporate funds, and mismanagement.[23] It must also be shown that the plaintiff-stockholder has been injured,[24] but the harm to him, arising through the ownership of stock, necessarily is indirect.[25] It would seem correct to assert that the injury to the corporation calling for relief in a derivative action must consist in a reduction of the corporate assets. This appears to be the only way in which the corporation could be directly and the stockholder indirectly injured in the same transaction.[26]

Contemporaneous ownership is often required. That is, the plaintiff must have been a stockholder at the time of the transaction or transactions which caused the harm.[27] This rule is instrumental in curbing strike suits.[28] A last requirement is that the plaintiff must show that he

19. "The right which the stockholder seeks as plaintiff to enforce is not his; hence no common law court could hear him." *Id.* at 582.

See also Hornstein, *Problems of Procedure in Stockholder's Derivative Suits,* 42 Col. L. Rev. 574 (1942).

20. Robinson v. Smith, 3 Paige Ch. 222, 232 (N.Y. 1832); cf. Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843); Kavanaugh v. Commonwealth Trust Co., 181 N.Y. 121, 124, 73 N.E. 562, 563 (1905).

21. See Koster v. Am. Lumberman's Cas. Co., 330 U.S. 518, 522 (1946); Kavanaugh v. Commonwealth Trust Co., 181 N.Y. 121, 124, 73 N.E. 562, 563 (1905). See also Glenn, *supra* note 18, at 581; Koessler, *supra* note 18, at 242-243.

22. This breach of duty can be committed by directors, officers, promoters and controlling stockholders. Ballantine, Corporations §143 (1946). The term "directors" as used in this note includes all those individuals.

23. Ballantine, Corporations § 143 (1946).

24. *Ibid.* See also Koessler, *supra* note 18, at 243.

25. Ballantine, Corporations §143 (1946); 13 Fletcher, *op. cit. supra* note 1, §5924.

26. Note, 40 Calif. L. Rev. 127, 129 (1952).

27. Hawes v. Oakland, 14 Otto 450 (U.S. 1881); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1025 (1903). Some jurisdictions do not require contemporaneous ownership. The federal rules impose the requirement. Fed. R. Civ. P. 23(b).

In those states where the rule of contemporaneous ownership prevails an exception is made when the shares have devolved upon the plaintiff by operation of law. Ballantine, Corporations §148 (1946). "Stockholder" has been interpreted to mean equitable owner as well as record owner. Rosenthal v. Burry Biscuit Corp., 60 A.2d 106 (Del. Ch. 1948). For a criticism of the California statute adopting the "contemporaneous ownership rule" see Comment, *Recent Developments in the California Law of Shareholders' Derivative Suits,* 1 U.C.L.A.L. Rev. 79 (1953).

28. This is pointed out in 23 Temp. L.Q. 82, 84 (1949). See also, 3 Stanford L. Rev. 151, 154 (1950).

has demanded appropriate action by the directors and by the stockholders as a body, or else convince the court that such demands, if made, would have been useless.[29] Demand on the stockholders is not required by the courts unless the stockholders as a body could have ratified the particular transaction.[30]

A derivative suit is brought in equity even though the corporate cause of action may be one ordinarily maintainable at law.[31] This is necessary because the stockholder is not suing in his right. The plaintiff-stockholder must bring the suit on behalf of himself, all other stockholders, and the corporation because the cause of action belongs primarily to the corporation and indirectly to all the stockholders.[32] The directors having committed the harm are the real defendants.[33] The corporation is a nominal defendant for the purpose of preventing other suits based on the same claim.[34] Other stockholders can intervene because they are interested parties.[35] The plaintiff usually is allowed to retain control of the suit,[36] but he assumes the position of a fiduciary to the corporation and the stockholders; any damages recovered must be turned over to the corporation.[37] The plaintiff gains financially only through a possible future dividend. His counsel fees are, of course, paid by the corporation if the suit is successful.[38] The corporation is directly benefited since its property

29. Toebelman v. Missouri-Kansas Pipe Line Co., 41 F.Supp. 334, 340 (D.C. Del. 1941). See also BALLANTINE, CORPORATIONS §146 (1946). For a general discussion of the demand prerequisite see Comment, 48 MICH. L. REV. 87 (1949).

30. *Id.* at 91.

31. See note 19 *supra.*

32. The complaint is brought by plaintiff in his own behalf and all other stockholders similarly situated. 13 FLETCHER, *op. cit. supra* note 1, §6004. It must allege a cause of action in favor of the corporation. *Id.* §6005.

33. Robinson v. Smith, 3 Paige Ch. 222, 231 (N.Y. 1832); see note 22 *supra.*

34. Myers v. Smith, 190 Minn. 157, 159, 251 N.W. 20, 21 (1933). The corporation is a passive party; its funds cannot be used to aid the actual defendants who are the directors. BALLANTINE, CORPORATIONS §154 (1946). An exception to the rule requiring the corporation to be a party defendant has been made where the corporation has been dissolved. 13 FLETCHER, *op. cit. supra* note 1, §5997. It has been asserted that the corporation might logically be considered the plaintiff since it receives any recovery made. Note, 66 HARV. L. REV. 342, 348 (1952).

35. They must obtain leave of the court. Glenn, *supra* note 18, at 583. See also Hornstein, *Problems of Procedure in Stockholder's Derivative Suits,* 42 COL. L. REV. 574, 575 (1942).

36. After others intervene they share in the control, 13 FLETCHER, *op. cit. supra* note 1, §6019, but the plaintiff continues to be *dominus litus.* BALLANTINE, CORPORATIONS §153 (1946).

37. Young v. Higbee Co., 324 U.S. 204 (1945); Clark v. Greenberg, 296 N.Y. 146, 71 N.E.2d 443 (1947); 23 N.Y.U.L.Q. REV. 192 (1948). See Notes 49 W. VA. L.Q. 176 (1943); 40 CALIF. L. REV. 127, 131 (1952). Direct relief may be allowed when there is dissolution or when circuity of action will be avoided. 13 FLETCHER, *op. cit. supra* note 1, §6028.

38. "The liberal allowance of counsel fees to the champion of the rights of a group is the dynamic factor giving the necessary impetus and incentive to the volunteer method of representation in class and derivative suits. Otherwise no one individual shareholder

is protected, its existence prolonged, and its management brought in check.

Just as in actions clearly derivative, the courts manifest great hesitancy in permitting interference with internal corporate affairs through dividend suits brought by minority stockholders.[39] The stockholder must bring the action in equity[40] as is required in a derivative suit.[41] It is necessary as a condition precedent to suit that the plaintiff, as a present stockholder of the company, make a demand upon the directors to declare dividends.[42]

In the absence of statute, charter provision, or by-law making the declaration of dividends mandatory,[43] the stockholder's successful maintenance of a dividend suit depends upon refusal by the directors to make a declaration; this refusal must amount to such an abuse of discretion as to constitute a fraud or a breach of good faith on the part of the directors.[44] Directors in declaring dividends have two considerations before them. They must be certain that the corporation has the financial ability,[45] and they must act in good faith toward the stockholders.[46] The

---

could afford to begin a suit of such size and difficulty or undertake to resist an affair settlement." BALLANTINE, CORPORATIONS §156 (1946).

39. See note 4 *supra*. There are conflicting policies involved: The corporation must be sound so that the public can deal with it safely, but yet there should be a reasonable division of the corporation's surplus earnings among the stockholders. Hiscock v. Lacy, 9 Misc. 578, 591, 30 N.Y. Supp. 860, 869 (1894).

40. Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919); Hiscock v. Lacy, 9 Misc. 578, 592, 30 N. Y. Supp. 860, 869 (1894). It is said that profits belong to the corporation and not to the stockholders individually, and thus there is no right enforceable at law for dividends. Gibbons v. Mahon, 136 U.S. 549, 558 (1890).

41. See note 19 *supra*.

42. If the stockholder can show that a demand would be futile, he need not make it. BALLANTINE, CORPORATIONS §234 (1946).

43. Crocker v. Waltham Watch Co., 315 Mass. 397, 53 N.E.2d 230 (1940) (involving charter provision); Lydia E. Pinkham Medicine Co., 303 Mass. 1, 20 N.E.2d 482 (1939) (involving by-law). As to statutory provisions making the declaration and payment of dividends mandatory see BALLANTINE, CORPORATIONS §233 (1946); 11 FLETCHER, *op. cit. supra* note 4, §5325.

For an analysis of the stockholders' problems in compelling declaration of dividends see Stirm, *Ability of Stockholders to Compel Directors of a Corporation to Declare Dividends,* 5 INTRA. (N.Y.U.) L. REV. 35 (1949). See also Notes, 64 HARV. L. REV. 299 (1950); 39 ILL. L. REV. 90 (1944).

Apparently mandatory provisions may be interpreted as not mandatory. See Rubens v. MarionWashington Realty Corp., 116 Ind. App. 55, 59 N.E.2d 907 (1945), 44 MICH. L. REV. 318.

44. See Hunter v. Roberts, Throp & Co., 83 Mich. 63, 71, 47 N.W. 131, 134 (1890); Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668, 682 (1919); Hiscock v. Lacy, 9 Misc. 578, 592, 30 N.Y. Supp. 860, 873 (1894); W.Q. O'Neall Co. v. O'Neall, 108 Ind. App. 116, 125, 25 N.E.2d 656, 660 (1940); City Bank Farmers Trust Co. v. Hewitt Realty Co., 257 N.Y. 62, 67, 177 N.E. 309, 311 (1931); 15 IND. L.J. 575 (1940).

See also SPELLMAN, CORPORATE DIRECTORS §141 (1931); STEVENS, *op. cit. supra* note 4, §99; Massey, *Rights of Minority Stockholders,* 32 MICH. S.B.J. 12 (1953).

45. Corporate assets are considered a trust fund for creditors of the corporation, and they cannot be distributed to the stockholders if the creditors would be prejudiced. 11 FLETCHER, *op. cit. supra* note 4, §5329.

46. See the cases cited in note 44 *supra*.

stockholders have purchased stock in reliance that they will receive dividends.[47] The corporation, as a separate legal entity,[48] with, as some contend, an intent and conscience of its own,[49] cannot reasonably expect people to make investments without expectation of profit.

Since the stockholders may reasonably expect a return on their investments, some authorities maintain that a contract for payment of dividends exists between individual stockholders and the corporation. The dividend action, it is further asserted, is merely a suit in equity to obtain specific performance.[50] It is thus not an action in the right of the corporation but one personal to the stockholder. Since there is no express agreement as to when dividends will be declared,[51] the contract, if it exists, is one implied in law or fact. In a successful dividend action the equity court awards dividends on the finding that it would be an abuse of discretion by the directors and unfair to the plaintiff and his class if they failed to receive dividends. Inasmuch as this is consistent with the theory of a contract implied in law[52] a dividend suit could logically be termed a contract action.

The New York Court of Appeals rejected this argument in *Gordon* v. *Elliman*.[53] It is true that the courts have not in express terms referred to dividend proceedings as contract actions, but there has actually been no need for such characterization since a court of equity will allow the proper relief without regard to the theory of recovery.[54]

---

47. For an examination of the stockholder's position see Hammond, *The Stockholder's Stake in Corporate Profits*, 88 TRUSTS & ESTATES 566 (1949). A business corporation, after all, is organized and operated for the profit of the stockholders as is pointed out in Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668, 684 (1919).

48. See Israel, *The Legal Fiction of Corporate Entity and Modern Law*, 3 GA. B.J. 46 (1940).

49. See Pinney, *supra* note 5, for a good analysis of the corporate being.

50. BALLANTINE, CORPORATIONS §231 (1946).

51. This situation exists in the absence of charter provision, by-law, or statute making declaration of dividends mandatory. See note 43 *supra*.

52. "Contracts implied in law, or more properly quasi or constructive contracts, are a class of obligations which are imposed or created by law without regard to the assent of the party bound, on the ground that they are dictated by reason and justice, and which are allowed to be enforced by an action ex contractu. They rest solely on a legal fiction, and are not contract obligations at all in the true sense, for there is no agreement; but they are clothed with the semblance of contract for the purpose of the remedy, and the obligation arises not from consent, as in the case of true contracts, but from the law or natural equity . . ." 13 C.J. 244 (1917).

53. 119 N.E.2d 331 (N.Y. 1954).

54. See, *e.g.*, Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919); Hiscock v. Lacy, 9 Misc. 578, 30 N.Y. Supp. 860 (1894). In the Dodge case the directors of the Ford Motor Company were ordered to declare a dividend of $19,275,385.96. The surplus available for dividends was $111,960,907.53. The practice had been to declare dividends, but in ,1916 the directors decided to expand the plant and production so that a cheaper automobile could be sold. This would have benefited the public at the expense of the stockholders. Because the company could have well afforded to pay greater dividends

Whether the contract theory is accepted or rejected there are other more substantial considerations which advance the argument that a dividend suit is not derivative. The contention that the dividend suit is in the right of the corporation is based on the concept that the good faith declaration of dividends is a duty owed to the corporation; this duty is seen as enforced when the plaintiff stockholder brings a dividend suit. A factor militating against such contention is that although it is possible for the corporation to be injured by a failure to declare dividends,[55] the harm it receives is indirect and remote as compared with that to the stockholder. The interested stockholders would have failed to receive the very thing for which they invested their money. Further, any loss of corporate assets due to failure to declare dividends would probably be recoverable in a derivative suit based on charges of mismanagement.[56] Since the corporation suffers only indirect and remote injury, the primary cause of action appropriately attaches to the plaintiff stockholder and his class.

This conclusion is further substantiated when it is considered that the proceeds of the suit *i.e.*, the dividends ordered declared, go directly to the stockholders,[57] while in a derivative suit the benefit goes to the corporation. In addition, in a dividend suit only the class directly affected by the failure to declare dividends participates in the recovery, while in a derivative suit all the stockholders are advantaged through the benefit conferred on the corporation.

Another distinguishing factor is that the dividend ordered declared by a decree favorable to the plaintiff is paid by the corporation. This liability of the corporation indicates that it is the real party defendant in a dividend suit. In a derivative action a corporation is only a nominal defendant, the directors being the ones against whom the suit is directed.

It should also be noted that, although the directors constitute the

---

than the $1,200,000 declared, the refusal to declare more was held an arbitrary refusal, not in the interest of the stockholders since a business corporation is organized primarily for the profit of the stockholders.

55. For example, the failure to pay dividends could result in the imposition of a penalty under the Internal Revenue Code for improperly accumulating surplus. INT. REV. CODE §§531-533 (1954). A corporation has an interest or concern regarding its dividend policy as it affects the market price of its securities, but any injury received by the corporation would be a consequence from injury to the individual stockholders. The stockholders would be the ones primarily hurt on the market by the failure to declare dividends, except when a new issue of stock is being sold. In that instance, injury received by the corporation could probably be redressed by a derivative suit.

56. If there were liability under the Internal Revenue Code corporate assets would be diminished, and a derivative suit could probably be maintained against the directors. *See* Gordon v. Elliman, 119 N.E.2d 331, 342 (1954) (dissenting opinion).

57. The court orders a specific amount to be distributed to the stockholders. Dodge v. Ford Motor Co., 204 Mich. 459, ——, 170 N.W. 668, 685 (1919); Kroese v. General Steel Castings Corp., 179 F.2d 760, 763 (3d Cir. 1946) *cert. denied* 339 U.S. 983 (1950).

management of the corporation and have the power as conferred by the general corporation statute to declare dividends,[58] there is a split of authority as to whether they are indispensable parties to a dividend action.[59] The better view is that they are not because it is the corporation which is primarily affected by a decree. A disposition of corporate property is involved, and the decree can be enforced by sequestration or other equitable means without the presence of the directors.[60] Declaring dividends under court decree is a purely ministerial act.[61]

For these reasons it must be concluded that an action to compel the declaration of dividends is not a derivative suit; it is rather a suit to enforce a right personal to the stockholder or to his class. It would follow that the plaintiff in such an action should not be required to post security for expenses of the corporation.

A most important consideration is that of the policy behind the "Security for Expenses" legislation. These laws have been enacted for the purpose of preventing strike suits.[62] A derivative suit is peculiarly susceptible to use as a strike suit. A minority stockholder could bring an action in bad faith upon some technical error made by directors with the intent of securing a money settlement. The defendant directors will often seek to settle out of court because a long and difficult suit would thus be avoided.[63] On the other hand, a dividend suit is not particularly adaptable for use as a strike suit. The burden of proof on the stockholder together with the expense of litigation are almost prohibitive of such suits; improper settlements are very unlikely. Directors would not be so inclined to settle since they could not be directly affected by an adverse decision. In a successful dividend suit the liability lodges entirely in the corporation while in a derivative action the directors may be personally involved.

The policy behind "Security for Expenses" legislation does not extend to dividend actions. These suits are not adapted for use as strike suits and an analysis of the nature of a dividend action indicates a striking

---

58. See notes 2 and 3 *supra*.

59. Schuckman v. Rubenstein, 164 F.2d 952 (6th Cir. 1947) (held indispensable); Kroese v. General Steel Castings Corp., 179 F.2d 760 (3d Cir. 1946) *cert. denied* 339 U.S. 983 (1950) (held not indispensable).

See Notes 26 IND. L.J. 79 (1950); 98 U. OF PA. L. REV. 753 (1950); 50 MICH. L. REV. 1102 (1952).

60. Note, 26 IND. L.J. 79, 82 (1950).

61. Kroese v. General Steel Castings Corp., 179 F.2d 760, 764 (3d Cir. 1946) *cert. denied* 339 U.S. 983 (1950). Of course, as one writer points out the enforcement of the decree would be more convenient if a majority were before the court. Note, 98 U. OF PA. L. REV. 753, 755 (1950).

62. See note 9 *supra*.

63. For a discussion of the considerations which may lead to settlements see Note, 54 HARV. L. REV. 833 (1941).

dissimilarity to derivative proceedings. This legislation, representing as it does, an innovation in the regulation of minority stockholders' derivative suits should be narrowly confined to those actions clearly in the right of the corporation.