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Corporations - Actions between Shareholders and Officers or Agents - Whether Personal Recovery by Former Shareholder Is Allowable in Actions against Officer for Misappropriation of Corporate Assets

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A possible solution to the problem in the instant case was given in the case of *Furst v. Brady*,⁹ where the deceased non-resident motorist carried an insurance policy which protected him from loss due to his automobile accident. The court there treated the policy as an asset in the state where the suit was brought and allowed recovery against an ancillary administrator. In the case at hand, the deceased had a similar policy, and the claimants attempted to have an ancillary administrator appointed for purposes of reaching this policy to satisfy their claims in their home state. The court did not allow this appointment, and refused to treat the policy as an asset in the state where suit was brought, thereby turning away from the above suggested solution.

The increasing use of automobiles and accidents connected therewith seems to point to the necessity of a new concept in the law, especially since the more violent the accident the greater the chance of death for those involved. Therefore, the frequency of these deaths will give rise to more and more actions similar to the instant case. The legislature of Ohio, appreciating these facts and recognizing the need for conferring such jurisdiction, has followed the modern trend and passed an amendment to its so-called substituted service statute and personal representatives of deceased non-resident motorists may now be served in that manner.¹⁰ The most salient aspect of this case lies in the fact that the legislature recognized the inadequacy in its state law and immediately stepped into the breach and remedied the situation.

N. A. ZIMMERMAN

CORPORATIONS—ACTIONS BETWEEN SHAREHOLDERS AND OFFICERS OR AGENTS—WHETHER PERSONAL RECOVERY BY FORMER SHAREHOLDER IS ALLOWABLE IN ACTIONS AGAINST OFFICER FOR MISAPPROPRIATION OF CORPORATE ASSETS—The United States Court of Appeals for the Ninth Circuit was recently faced with the problem of whether a former shareholder might be allowed an individual recovery against an officer of the corporation in the case of *Watson v. Button*.¹ Therein, the former owner of one-half of the corporate stock brought an action against the former gen-

1939, Art. 56, § 186.189; Mich. Stat. Ann., 1949 Cum. Supp., § 9.2103; Neb. Rev. Stat. 1943, Vol. 2, Ch. 25, Art. 5, § 25-530 as amended in 1949; Thompson's Laws N. Y., 1945 Supp., Vehicle and Traffic Law, § 52, p. 725; Wis. Stats. 1949, Ch. 85 § 85.05(3). The constitutionality of these statutes has been upheld in such cases as: *Plopa v. DuPre*, 327 Mich. 606, 42 N. W. (2d) 777 (1950); *Leighton v. Roper*, 300 N. Y. 434, 91 N. E. (2d) 876 (1950).

⁹ 375 Ill. 425, 31 N. E. (2d) 606 (1940), noted in 19 CHICAGO-KENT LAW REVIEW 293.

¹⁰ Legislative Acts and Joint Resolutions of the State of Ohio, 1955-56, p. 49.

¹ 235 F. (2d) 235 (1956).

eral manager, who had owned the balance of the stock, to recover the amount misappropriated by the defendant prior to the sale of the entire corporate stock to its present owners.² The district court awarded a personal judgment for the total amount of the defalcation to the plaintiff and the reviewing court affirmed when it concluded that an individual recovery is allowable, as an exception to the general rule, where the parties are jointly responsible for the corporation's liabilities resulting from such misappropriations, and the rights of creditors and other shareholders are not prejudiced.³

Generally, the individual shareholders have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock.⁴ Rather, the wrong is said to be primarily against the corporation, and incidentally against the owners. A suit to redress such a wrong must instead be brought by the corporation or by a shareholder in a derivative suit on behalf of the corporation.⁵

Any judgment obtained by reason of such wrongs is an asset of the corporation which inures first to the benefit of creditors,⁶ and secondly to the shareholders. This rule is based on the principle that where such an injury occurs, each shareholder suffers relatively in proportion to the number of shares he owns, and each will be made whole if the corporation obtains restitution or compensation from the wrongdoer.⁶ Since it is usually conceded that the corporation has a cause of action, direct relief to the shareholders might double the defendant's liability⁷ and, if recovery should be denied the corporation, the conduct of its business and rights of its creditors might be jeopardized.⁸ The single action in favor of the corporation is also said to be more convenient than the multiplicity of suits

² In July of 1954, all of the stock was sold to third parties. Defendant secured, as part of the sale, an agreement from the purchasers to release and discharge him from any claims and demands existing against him in favor of the corporation, thus precluding an action by the corporation or its present shareholders to enforce the corporate cause of action.

³ The court expressly stated that the plaintiff cannot bring a derivative action since he is no longer a shareholder. However, the court treated this case as a derivative action, and concluded that it falls within an exception to the general rules of recovery applicable in stockholders' derivative suits.

⁴ *Smith v. Hurd*, 12 Metc. (Mass.) 371 (1847), is the leading case.

⁵ *Green v. Victor Talking Machine Co.*, 24 F. (2d) 378 (1928); *Smith v. Hurd*, 12 Metc. (Mass.) 371 (1847); *Massachusetts v. Davis*, 140 Tex. 398, 168 S. W. (2d) 216 (1942).

⁶ *Massachusetts v. Davis*, 140 Tex. 398, 168 S. W. (2d) 216 (1942); see also the note in 40 Calif. L. Rev. 127 (1952).

⁷ *White v. First National Bank*, 252 Pa. 205, 97 A. 403 (1916).

⁸ *Dorah v. Pensicot County Bank*, 213 Mo. App. 541, 258 S. W. 560 (1923); *Beeber v. Wilson*, 285 Pa. 312, 131 A. 854 (1926).

which might result from a recognition of direct liability to the shareholders.⁹

This general rule is not affected by the mere fact that the complaining shareholder owns all, or substantially all of the stock,¹⁰ or that the defendant acted with malice toward the individual shareholder, since the ill will of a wrongdoer toward a stockholder and his motive in wrongdoing does not change his liability for injuries which remain injuries to the corporation rather than to the individual shareholder.¹¹

This rule is not universal, however. The courts have recognized at least three situations which raise possible exceptions to the general rule. The first of these situations arises where the individual has parted with his shares, without knowledge of the prior wrongful misappropriation of corporate assets by the directors. It has been held that the individual could recover from the directors the amount by which the misappropriation had reduced the value of his prior shareholdings.¹² In these instances, the former shareholder has been given a personal right of action on the theory that the misappropriation has wrongfully affected him in a manner different from its effect on the shareholders generally in that he has been fraudulently induced or coerced into selling his shares.¹³

Another situation in which an individual recovery has been allowed is where it appears that the injury to the shareholder resulted from the violation of some special relationship, fiduciary or contractual, owed the shareholder by the wrongdoer. In these instances, although the corporation also may have a cause of action growing out of the same wrong, the injury has its origin in circumstances independent of the plaintiff's status as a shareholder, and he may maintain an action in his own right

⁹ *Wells v. Dane*, 101 Me. 67, 63 A. 324 (1905).

¹⁰ *L. J. Sigl Inc. v. Bresnahan*, 216 App. Div. 634, 215 N. Y. S. 735 (1926) (98% ownership by plaintiff); *Lockhart v. Moore*, 25 Tenn. App. 456, 159 S. W. (2d) 438 (1941) (complete ownership of stock); *Stinnett v. Paramount-Famous Lasky Corp.*, Tex. Com. App., 37 S. W. (2d) 145 (1931) (all but one share held by plaintiff).

¹¹ *Boatright v. Steinite Radio Corp.*, 46 F. (2d) 385 (1931); *Green v. Victor Talking Machine Co.*, 24 F. (2d) 378 (1928); *Shenberg v. DeGarmo*, 61 Cal. App. 326, 143 P. (2d) 74 (1943); *Compare Stidham v. State Bank*, 126 Kans. 336, 268 P. 106 (1928), where recovery was allowed a bank shareholder for slander of the bank alleged to have been uttered for the purpose of ruining the plaintiff among others.

¹² *Backus v. Kirsh*, 264 Mich. 73, 249 N. W. 469 (1933); *Coronado Development Corp. v. Milliken*, 175 Misc. 1, 22 N. Y. S. (2d) 670 (1940); *Von Au v. Magenheimer*, 126 App. Div. 257, 110 N. Y. S. 629 (1908); *Stinnett v. Paramount-Famous Lasky Corp.*, Tex. Com. App., 37 S. W. (2d) 145 (1931).

¹³ See note 9, ante, and see *Wells v. Dane*, 101 Me. 67, 63 A. 324 (1905), wherein the court said, "That a shareholder has parted with his stock does not deprive him of his right to sue . . . directors who have unlawfully taken advantage of their position to his detriment."

in addition to the corporate right of action.¹⁴ Thus, for example, individual recovery has been awarded where the shareholder was a decedent's estate, and the defendant its unfaithful administrator,¹⁵ or where the director was a pledgee of the plaintiff's shares.¹⁶

At this point, it is important to note that the preceding two situations have dealt with the circumstances under which a direct cause of action in the shareholder will be enforced *in addition to* the corporate right of action. In these instances, although the cause of action may have arisen out of the transaction whereby the shareholder acquired his stock, or out of other circumstances dependent on the fact that he owns the stock, he acts in his individual capacity rather than on behalf of the corporation; he is personally a party to a contract, or an individual victim of a tortious injury.¹⁷ It is clear that he has an individual right of action, and the suit brought by him would not constitute a derivative suit.¹⁸ In the true stockholders derivative suit, the plaintiff is merely an instigator moving the court to action in behalf of the corporation.¹⁹ Thus it can readily be seen that these instances, referred to as "exceptions", are not really exceptions at all, but a recognition of the individual's separate and independent cause of action.

There does exist, however, a true exception to the general rule. In certain instances, where rights of creditors are not concerned, some courts have granted a personal judgment in favor of the complaining shareholder, *in lieu of recovery by the corporation*, for such injuries where it appeared that the wrongdoers themselves owned a majority of the

¹⁴ *Camp v. Gress*, 250 U. S. 308, 39 S. Ct. 478, 63 L. Ed. 997 (1919); *Blazer v. Black*, 196 F. (2d) 139 (1951); *Cutting v. Bryan*, 30 F. (2d) 754 (1929); *Chase National Bank v. Sayles*, 30 F. (2d) 178 (1927); *Hammer v. Werner*, 239 App. Div. 38, 265 N. Y. S. 172 (1933); *Kono v. Roeth*, 237 App. Div. 252, 260 N. Y. S. 662 (1932); *Blakeslee v. Sottile*, 118 Misc. 513, 194 N. Y. S. 752 (1922); *General Rubber Co. v. Benedict*, 215 N. Y. 18, 109 N. E. 96 (1915); *Vierling v. Baxter*, 293 Pa. 52, 141 A. 728 (1928); *Porter v. Healy*, 244 Pa. 427, 91 A. 428 (1914); *Cullum v. General Motors Acceptance Corp.*, Tex. Civ. App., 115 S. W. (2d) 1196 (1938).

¹⁵ *Matter of Auditore*, 249 N. Y. 335, 164 N. E. 242 (1928), wherein it was held that an administrator of a stockholder's estate was liable in damages to the estate for reducing the value of the stock because of his violation of trust by taking and applying to his own use all assets of the corporation of which he was also a director, and that a judgment for the corporation against such director for misappropriation of funds was no bar to proceedings against him as administrator for the resulting loss in value of decedent's stock.

¹⁶ *Ritchie v. McMullen*, 79 F. 522 (1897).

¹⁷ See *Berlack*, "Stockholders' Suits: A Possible Substitute", 35 Mich. L. Rev. 597 (1937).

¹⁸ See 18 C. J. S., Corporation, § 559, p. 1272; *Fletcher*, *Cyclopedia of Corporations*, Vol. 13, § 5921.

¹⁹ See cases cited in note 5, ante.

corporate stock,²⁰ or where the majority of the shareholders assented to the alleged misconduct.²¹ In all such cases, the courts have, as a short cut to justice, directed the payment to the objecting shareholder of his proportionate share of the amount found to be due to the corporation, on the theory that where substantially all other shareholders were defendants, or in *pari delicto* with them, to allow them the benefits resulting from a judgment in favor of the corporation would be to violate the "clean hands" doctrine. Some courts, however, have rejected this theory on the ground that to permit the defendants to retain part of the funds, in proportion to the stock of ratifying shareholder, would tend to encourage fraud, and would, in effect, permit ratification of illegal acts.²²

The court, in the instant case, apparently felt that a former shareholder, who parted with his shares without knowledge of the prior misappropriation of corporate assets by the directors, may recover personally *where the rights of creditors or other shareholders are not prejudiced*. This apparent limitation upon the individual's right of recovery seems quite unnecessary in this type of situation. As has been pointed out previously,²³ in these instances, the plaintiff is suing in his individual capacity and not on behalf of the corporation, thereby obviating any possible objections a corporate creditor might raise to a personal recovery by the shareholder. The court could more properly have decided the instant case by recognizing the plaintiff's individual cause of action against the errant director²⁴ instead of erroneously treating the problem as an exception to the general rule.

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²⁰ *Di Tomasso v. Loverro*, 250 App. Div. 206, 293 N. Y. S. 912 (1937); *Eaton v. Robinson*, 19 R. I. 146, 32 A. 339 (1895); *Joyce v. Congdon*, 114 Wash. 239, 195 P. 29 (1921).

²¹ *Matthews v. Headley Chocolate Co.*, 130 Md. 523, 100 A. 645 (1917). See also *Fletcher*, *Cyclopedia of Corporations*, Vol. 13, § 6028.

²² *Keenan v. Eshelman*, 23 Del. Ch. 234, 2 A. (2d) 904 (1938), 120 A. L. R. 227; *Miller v. Crown Perfumery Co.*, 125 App. Div. 881, 110 N. Y. S. 806 (1908); *Baillie v. Columbia Gold Mining Co.*, 86 Ore. 1, 166 P. 965 (1917); see *Fletcher*, *Cyclopedia of Corporations*, Vol. 13, § 6028; and note in 23 *Minn. L. Rev.* 973. Of particular importance to the Illinois practitioner is the fact that the law in this state is far from well settled. In *Brown v. DeYoung*, 167 Ill. 549, 47 N. E. 863 (1897), the court treated the misappropriated money as a fund out of which dividends should be declared, and awarded the innocent shareholders their proportionate share of the amount due to the corporation. In *Chicago Macaroni Manufacturing Co. v. Boggiano*, 202 Ill. 312, 67 N. E. 17 (1903), and in *Voorhees v. Mason*, 245 Ill. 256, 91 N. E. 1056 (1910), the court refused to follow the rule announced in the *DeYoung* case. However, it appears that the facts of the latter cases differ from those of the former in that the rights of creditors might have been prejudiced in the *Boggiano* and the *Voorhees* cases if an individual recovery by the shareholders had been allowed; however, in the *DeYoung* case, the creditors were adequately protected by existing corporate assets.

²³ See notes 9 and 10, *ante*.

²⁴ See note 10, *ante*.