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Liabilities Of Directors And Officers* Part 2**

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LIABILITIES OF DIRECTORS AND OFFICERS*
PART II**

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VIII. SALE OF CONTROL

IT not infrequently occurs that a management group, in office by virtue of ownership of a sufficient block of stock to assure control of the corporation, sells such stock to another group which desires to acquire control and the powers of management. The sale of the controlling block of stock brings with it, customarily, the resignations of management and the election of the purchasers or their nominees to the directorships—a matter readily accomplished through a one-at-a-time procedure. "The general rule is that a stockholder may dispose of his stock at any time and at such price as he chooses."[151] And there is nothing inherently improper in the sale of stock by those possessing control: in fact, transfer of control may serve the desirable end of bringing to the corporation fresh ideas for improving its business. But the basic strictures upon those in a fiduciary capacity, with an obligation to serve and conserve the interests of the corporation and

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** Part I, published in the April 1959 issue of the NEW YORK LAW FORUM, discussed the following subjects:

Management Responsibility
Negligence and Business Judgment
Ultra Vires Acts
The Principle of "Undivided Loyalty"
Corporate Opportunities
Reliance upon Specialists as Affecting Duty

151 Benson v. Braun, 155 N. Y. S. 2d 622, 625 (1956). See generally, Hill, "The Sale of Controlling Shares," 70 HARV. L. REV. 986 (1957).

its stockholders, are applicable to the sale of control. The possibilities of damage to those interests, and of serving self-interest as against the corporate interests, inhere in such sale and the sellers must act carefully to prevent damage and must avoid conflicts of interest.

If nothing is done to injure the corporation and its stockholders, controlling stockholders (usually the management) may sell their shares and may demand and receive a premium representing "control value," without incurring liability to the corporation or minority stockholders.[152] It is unobjectionable, and indeed normally expected, that those selling controlling shares resign as directors to facilitate the taking over of control by the purchasers, although, since resignation for payment is a misuse of corporate office, the receipt of a price for the controlling shares greatly in excess of their apparent value may prompt inquiry as to whether the price reflects such payment: if otherwise explicable (e.g., appreciation in value of real property not reflected on corporate books, growth value, type of business, distinctive features of corporation), the basis for complaint is removed.[153]

The selling group should, however, in certain circumstances, be alert to the possibility that the purchasing group is predatory and that the corporation may suffer at its hands. Where the price paid for the stock is within a fair range of its value (e.g., less than book value though higher than market) and the sellers have no knowledge of the true intentions of the purchasers (viz., to loot the company) and "no substantial warning thereof," no duty of inquiry is imposed.[154] "The risk reasonably to be perceived defines the duty to be obeyed."[155] Where the "circumstances surrounding the proposed transfer" are "such as to put a prudent man on his guard," then, in the absence of a "reasonably adequate investigation" which would "convince a reasonable person that no fraud is intended or likely to result," the sellers will be liable for the resultant damage—looting of the corporation by the purchasers. The following combinations of facts have been held to be sufficiently suspicious of possible unworthy motives as to impose such duty of investigation: (a) inordinately high compensation for

[152] Benson v. Braun, *id.;* Stanton v. Schenck, 140 Misc. 621, 251 N. Y. S. 221 (1931).

[153] Benson v. Braun, *supra,* note 151; see Gerdes v. Reynolds, 28 N. Y. S. 2d 622, 653 (1941).

[154] Levy v. American Beverage Corp., 265 App. Div. 208, 38 N. Y. S. 2d 517 (1st Dept., 1942).

[155] Gerdes v. Reynolds, *supra,* note 153, quoting from Palsgraf v. Long Island R. R. Co., 248 N. Y. 339, 344, 162 N. E. 99, 100 (1928).

the shares sold; (b) request by purchaser for seller's assistance in obtaining immediate control of the directorate; (c) lack of visible means by which the purchaser can finance the transaction and request by purchaser that seller convert some corporate assets into cash prior to the sale.[156]

Moreover, in line with basic principle that corporate assets may not be disposed of for the private benefit of fiduciaries, it is held that where the price ostensibly paid only for the controlling block of stock includes, indirectly, payment for intangibles possessed by the corporation and which the corporation will lose as the result of the sale, the seller must account for so much of the price as reflects the value of the intangibles. This was the ruling in the recent case of *Perlman* v. *Feldman.* Steel was then in short supply, and a steel corporation, which allocated its production of steel sheets to steel product manufacturers, had used its market leverage: (1) to secure from prospective customers, in return for firm commitments to them for future production, interest-free advances, which it used to finance improvements in existing plants and for expansion; and (2) in an effort to build a market for its products in a geographical area surrounding that which it customarily supplied, with the expectation that it might continue to retain the new customers even after steel became more abundant. Defendant, president of the corporation and holder (with family and associates) of 37% of its stock (working control), sold the stock (book value $17; market never more than $12) for $20 per share, to a syndicate consisting of end-users of steel who were interested in securing a source of supply in the tight steel market. Their intention was, as defendant knew, to allocate a substantial portion of the corporation's production among themselves, which would necessarily decrease or eliminate the corporation's use of its market leverage as theretofore. In effect, the corporation's product, in the tight market, commanded "an unusually large premium, in one form or another," and defendant, a fiduciary, had "appropriated to himself the value of this premium" and sold it with his stock to the syndicate. He was required to account for such portion of the price as was allocable to the value of this premium, i.e., as represented control over the steel corporation's steel output.[157]

[156] Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E. D. Pa., 1940).
[157] Perlman v. Feldmann, 219 F. 2d 173 (2d Cir., 1955), cert. den., 349 U. S. 952 (1955).

Of course in the circumstances of the cases under discussion the purchasing group which loots the corporation or which acts in such way as to deprive the corporation of assets—whether tangible or intangible—theretofore possessed, would be liable for its conduct. The above cases deal, however, with the liability of the selling group to account, and it is evident that an accounting to the corporation which has suffered the deprivation would benefit the purchasing group, through its stock ownership (over and above the benefit obtained from its original wrongful conduct). For that reason the *Insuranshares* case, which required defendants (the selling group) to account to the corporation, for neglect of their duty of inquiry as to the purchasers' intentions,[158] has prompted the suggestion that the selling group which has paid the damages should have a lien upon the shares sold and in the hands of the wrongdoing purchasers for the amount by which the value of such shares increased by reason of the corporate recovery.[159]

The *Perlman* case presented a different and somewhat unusual situation. The total price paid by the purchasing group in effect represented payment for assets which may be graphically represented as follows:

	(X = Amount for selling group's shares.	
P (total price)		(A = Amount apportioned to selling group's stock.
	(Y = Amount for corporate intangibles.	
		(B = Amount apportioned to stock of all other stockholders.

The court appreciated that to have the selling group account to the corporation for Y would (a) return to the purchasing group, indirectly, that part of the purchase price represented by A; and, at the same time, (b) deprive the selling group of that part of Y, viz. A, to which it was—as a matter of arithmetic—entitled. While the court was not actually concerned about the selling group which was involved in a breach of duty, its basic problems were to avoid recoupment by the purchasing group of part of the purchase price and at the same time to have the corporate stockholders (other than the selling group) receive

158 See note 156, *supra*.
159 54 HARV. L. REV. 648, 655.

at least that proportion of Y that their stock represented, viz. B. The court solved this problem by directing, though the suit was derivative in nature, i.e., brought on behalf of and in the right of the corporation, that plaintiff stockholders have recovery from the selling group (defendants) in their own right (judgment was to go to plaintiffs and "those whom they represent," i.e., the stockholders other than the purchasing group) of so much of the "premium value" (or Y) as was represented by "their respective stock interests" (viz., B). It noted that: "Defendants cannot well object to this form of recovery, since the only alternative, recovery for the corporation as a whole, would subject them to a greater total liability."[160] In so ruling, the Court, of course, ignored the general principle (as the dissenting opinion noted)[161] that a corporation, whose asset is in effect sold, should itself receive the proceeds of the sale. Moreover, by by-passing the corporation and directing that recovery go to stockholders, the court in effect provided for distribution of corporate assets to stockholders without reference to the corporation's financial condition or the rights of creditors.[162] The first criticism is technical, but not without weight. The second does, of course, raise a serious question: No problem is presented if the corporation has a surplus, but the rights of creditors may be affected if the situation is otherwise. The court's decision while solving one problem has raised others, but it appears practical and the other problems are soluble in other ways, e.g., if creditors' rights are affected, by a suit by creditors (or a receiver or trustee in bankruptcy on their behalf) to recoup, to the extent necessary to satisfy their claims, both A and B, or Y, from those who have received those sums.

IX. Use of Corporate Funds in Proxy Contests

It is basic doctrine that the expenditure of corporate funds by directors must be designed to serve the corporate interest, i.e., have a corporate purpose, and that such expenditure to serve the personal

160 See note 157, *supra,* at 178. See the computations made by the lower court on remand of the case, 154 F. Supp. 436 (D. Conn., 1957). The court found that the "premium value" was $5.33 per share, or a total of $2,126,280.91. The shares which were the subject of the purchase were excluded from the recovery, and the aforementioned sum was thus reduced to $1,339,769.62 which was the amount of the judgment recovered by the plaintiffs for themselves and "those whom they represent" (pp. 446-7). See 71 Harv. L. Rev. 1559 (1958).

161 See note 157, *supra,* at 180.

162 68 Harv. L. Rev., 1274, 1277.

interests of the directors is unauthorized, i.e., ultra vires, and productive of liability. Since stockholders' meetings are in various circumstances required, e.g., for election of directors, for approval of action proposed by directors, such as the sale of corporate assets, stock reclassification, merger or consolidation, or in situations in which a disinterested quorum of the board is unavailable, it is plain that the expenses of such meetings—the costs of a proper notice of meeting, and the matters to be acted on thereat, of hiring a meeting place, and of soliciting proxies to procure a quorum or sufficient stock representation—are proper charges upon the corporate treasury, if—as all corporate expenditures are required to be—they are reasonable in amount.[163] It is indeed doubtful that a court would attempt to substitute its judgment as to the reasonableness of such expenditures for the judgment of the directors, exercised in good faith, in such situations, except possibly where the purpose, absent a disinterested quorum of the board, is to secure stockholder approval of transactions in which directors are personally involved.[164]

A problem arises, however, in connection with meetings for the election of directors, where stockholders offer an opposition slate and a contest ensues. If the issue is only as to which group of individuals or faction is to retain or obtain the reins—and perquisites—of office, expenditures to resolve it (which, it would seem, would include all costs beyond those of sending the initial notice and of the meeting place) promote personal and not corporate interests, and are not proper charges upon the corporate treasury.[165] A corporate purpose, however, is found where the contest involves the policies pursued by management, where those policies are questioned by the opposition and where it becomes necessary to advise the stockholders of such policies and the considerations on which they are based. Expenditures made by the management to persuade stockholders of the correctness of its position and to enlist support for its policies—through the election of the management slate—as against those proposed by the opposition are properly charged to the corporation.[166] While in theory the distinc-

163 See Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N. Y. 168, 128 N. E. 2d 291 (1955); Lawyers' Advertising Co. v. Consolidated Ry., 187 N. Y. 395, 80 N. E. 199 (1907).

164 In the latter circumstance the court may well inquire whether expenditures beyond those deemed reasonable in amount were not designed to "sell" the stockholders on a proposal intended to serve the personal interests of the directors. See Rosenfeld v. Fairchild Engine & Airplane Corp., 116 N. Y. S. 2d 840, 849 (1952).

165 See note 163, *supra*.

166 Rosenfeld v. Fairchild Engine & Airplane Corp., *supra*, note 163; Hall v.

tion between a "question of corporate policy" and a "mere matter of personnel" is sound, its elusive nature has been indicated: in practice, questions of policy generally come up, not abstractly, but "in the form of whether the directors who stand for the given policy shall be re-elected to office."[167]

What is the position, with respect to reimbursement for expenditures, of the opposition faction, which has locked horns with management in the arena of ideas and policy, provoking a conflict serving to define and sharpen issues and contribute to their understanding by the body of stockholders, and which may, indeed, have persuaded many, perhaps a majority, of the stockholders of the correctness of its views? The opposition slate and the stockholders supporting it, though perhaps serving the interests of the corporation and the stockholders, are in the position of mere volunteers acting without corporate authorization and without right to call upon the corporate treasury for the expenses they incur. It has, however, been held that where the opposition has been successful and where the vote of new directors to reimburse themselves and their supporters for the expenses of the contest is then submitted to and confirmed by a majority of stockholders, reimbursement is permissible.[168] The dissenting opinion, in *Rosenfeld* v. *Fairchild Engine & Airplane Corp.*,[169] which recently so ruled, suggests, not without force, that the apparent concession by

Trans-Lux Corp., 20 Del. Ch. 78, 171 Atl. 226 (Ch., 1934); Steinberg v. Adams, 90 F. Supp. 604 (S. D. N. Y., 1950); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del., 1944).

167 Hall v. Trans-Lux Corp., 20 Del. Ch. 78, 84, 171 Atl. 226, 228 (Ch., 1934). Where there is ostensibly a contest over policy, a court may well inquire as to the reasonableness of expenditures to determine whether funds have not in fact been used, at least in part, in the personal interests of the directors. For example, a distinction might well be made between distribution of printed matter and the employment of professional proxy solicitors. The latter would appear to go beyond the purpose of providing information on issues and involve merely obtaining votes in the personal interests of the directors. See Friedman, "Expenses of Corporate Proxy Contests," 51 COL. L. REV. 951, 954-5 (1951). In the dissenting opinion in Rosenfeld v. Fairchild Engine & Airplane Corp., supra, note 163, it is said: "There is a difference between hiring solicitors merely to follow up proxy notices so as to obtain a quorum, and a high pressure campaign to secure votes by personal contact" (309 N. Y. at 182, 128 N. E. 2d at 295). But *cf. In re Zickl,* 73 N. Y. S. 2d 181 (1947).

168 Rosenfeld v. Fairchild Engine & Airplane Corp., *supra,* note 163; Steinberg v. Adams, 90 F. Supp. 604 (S. D. N. Y., 1950). Where "the expenditures (of the successful insurgent group) were not incurred in connection with a matter of corporate policy, but in a campaign directed to a change of personnel and to defame some of the directors personally," reimbursement is not permissible. Cullom v. Simmonds, 285 App. Div. 1051, 139 N. Y. S. 2d 401 (2d Dept., 1955).

169 See note 163, *supra.*

the prevailing opinion that the directors alone could not authorize reimbursement substantiates its view that the expenditures had no corporate purpose, and if this be true, even stockholder ratification is ineffectual since only stockholder unanimity, not merely a stockholder majority, may validate ultra vires acts. However, the action by the opposition slate in offering critical examination of, and alternatives to, management policies, was in the interest of the corporation, as vouchsafed by the adoption of the alternative policies through the vote of stockholders: reimbursement for expenses could not initially be enforced, not because of absence of corporate purpose but because the action had been volunteered and had not previously been authorized. Theoretically the new directors in voting for reimbursement authorized, *nunc pro tunc*, expenditures not in their own interest but for a corporate purpose. On this basis, however, subsequent stockholder approval of the reimbursement would scarcely appear necessary, and by relying thereon,[170] the prevailing opinion did, as the dissent was quick to point out, involve itself in conceptual inconsistency. The court's conclusion does appear sound, upon the analysis furnished above, which suggests that stockholder approval is not requisite to the validity of the directors' vote for reimbursement.[171]

Even if, moreover, the opposition faction is unsuccessful, it might be urged that its presentation of policy issues has served corporate interests, and that therefore its expenses should be reimbursed, particularly where it appears that its views have the approval of a substantial number—though less than a majority—of the stockholders.[172]

170 The court in Steinberg v. Adams, *supra*, note 168, also placed reliance on stockholder approval.

171 To the extent, of course, that the expenses may be deemed to have been incurred in the personal interest of the new directors, their vote for reimbursement would be invalid; and in such case, not even majority stockholder approval would suffice to give it validity, since majority stockholders cannot approve a gift of corporate funds.

Another problem with respect to these cases suggests itself. Even assuming the successful opposition slate had theretofore been serving the corporate interests, such services were volunteered and, ordinarily, are not retroactively compensable. See BALLANTINE, CORPORATIONS (1946) § 75. But a distinction may properly be made between services and expenditures with respect to which, where success establishes corporate purpose, it may be said that the circumstances imply a promise of repayment. *Cf.* Jervis, "Corporation Agreements to Pay Directors' Expenses in Stockholders' Suits," 40 COL. L. REV. 1193, 1199-1200 (1940).

172 See Friedman, *supra*, note 167, at 963.

An interesting, though only superficially related, question was presented in Kaufman v. Wolfson, 153 F. Supp. 253 (S. D. N. Y. 1957). In connection with a proxy fight for control of Montgomery Ward & Co., the Wolfson insurgent group caused corporations under their control (1) to purchase (prior to the proxy fight) Montgomery Ward

Since it is unlikely that a victorious management, except one bent on obtaining the good will of the opposition, would vote reimbursement to it, it would be obliged to attempt to subsume its claim under recognized precepts, unless new regulations were to be provided by statute. So far as recognized precepts are concerned, the claim would appear to have three strikes against it: (1) The opposition faction volunteered its effort and expenses. (2) The argument that a corporate purpose was served gains vitality only from success:[173] failure tends to negate, entirely or almost so, corporate benefit and to make corporate purpose uncertain if not illusory. (3) There is absent such official action as would serve to place the stamp of approval upon the expenditures.[174]

These points are of course no answer as to what the law should be. The major problem in allowing reimbursement to an unsuccessful opposition would be the tendency to encourage indiscriminate attempts to wrest control from management under the pretext of significant policy deficiencies. This problem would scarcely seem to be answered by the suggestion that reimbursement be dependent upon the opposition faction obtaining a certain percentage, e.g., ten or fifteen per cent, of the votes,[175] since opposition factions, because of control of blocks of stock or otherwise, generally have some fair assurance of obtaining a minimum percentage of the total votes. Yet to retain the status quo does appear to result in unfair discrimination against the small stockholder group which may have just grievances, but not the financial

stock and (2) to contribute to the expense of the proxy fight. The court found that the purchases and the contributions were designed to further the selfish interests of the corporations since a Wolfson management, if installed, would cause Montgomery Ward to buy their products. The Wolfson attempt failed, however, and the stock which the corporations had acquired was then sold at a profit which was in excess of the contributions to the proxy fight. In a derivative suit on behalf of the corporations to recover the amount of the contributions, the court held for plaintiff. It said that the stock acquisitions were proper but the contributions were not in furtherance of a "legitimate business function." And it refused to credit the profit on the stocks purchased and sold against the contributions made.

The decision is difficult to understand. If the finding had been that no corporate interest, but only the personal interests of the Wolfson group, were being served in both the stock purchases and the contributions, the court's conclusion would be acceptable. The contrary finding should have supported the propriety not only of the stock purchases but of the contributions as well. See 71 HARV. L. REV. 1354 (1958).

173 In Steinberg v. Adams, *supra,* note 168, the court said: "An analogy may be found in the reimbursement of the successful stockholder who brings a derivative action for the benefit of the corporation" (90 F. Supp. at 608).

174 Reimbursement was disallowed in Phillips v. United Corp., Civ. No. 40-497 (S. D. N. Y., 1948), app. dism., 171 F.2d 180 (2d Cir., 1948).

175 See Friedman, *supra,* note 167, at 963-4.

means to articulate them properly in the effort to remove from office a management that may be improvident or worse. Perhaps a method may be devised for sifting the worthy from the unworthy contest in advance—so that those whose contests have substantial merit may have assurance that their reasonable expenses will be paid from the corporate treasury. A useful analogy here is to matrimonial actions in which temporary alimony and counsel fees are allowed at the outset, where the court is convinced, on preliminary papers, that there is reasonable probability of success. It would seem possible for statutes to give power to courts, under rules carefully prescribed, to make discretionary determinations of the merit and utility of a proposed contest, and if favorably disposed, to direct that the reasonable expenses of the opposition faction, win or lose, be paid from the corporate treasury. A negative determination would, of course, not foreclose the contest (just as it does not foreclose continued prosecution of the matrimonial action), but it would mean that reimbursement would be conditioned upon ultimate success.

X. USE OF INSIDE INFORMATION IN STOCK TRANSACTIONS

At Common Law

THE positions occupied by directors and officers give them, naturally, a distinct advantage over the mere shareholder in acquiring information with respect to the condition, affairs and prospects of their corporation. While their knowledge may not remain exclusive for too long, particularly in the light of the practices and requirements of corporate reporting, at least in respect of corporations whose stocks are listed on a national exchange, these "insiders" are frequently able to capitalize on advance knowledge they obtain by purchases or sales of corporate stock at values which do not reflect their "inside information." Such purchases or sales of stock obviously do not affect, one way or the other, the assets of the corporation, and trading in the corporate stock is not a normal function of a corporation, and so it might appear that this utilization of information obtained in a fiduciary capacity for the personal benefit of the fiduciary, though it gives the fiduciary an advantage not shared by the ordinary stockholder, is nothing concerning which the corporation might complain.

However, a stockholder, who sold his stock to the corporate fiduciary without knowledge of the inside information and who would not have sold at the arranged price had he had such knowledge, has a grievance which he may be expected to advance. If the corporate fiduciaries have engaged in affirmative misrepresentation, a clear case in "fraud and deceit" would be available: indeed, any affirmative and deliberate conduct calculated to deceive the stockholder as to the true value of his stock would be actionable.[176] But supposing the fiduciary has engaged in no affirmative misconduct, and the stockholder's grievance is limited to the fiduciary's failure to reveal "inside information" unknown to the stockholder, bearing on the value of the shares sold. It has been said[177] that the results reached in the cases are dependent upon the particular court's conception as to the scope of the fiduciary duty: That those—a "minority"—which say it extends not only to the corporation but to the individual stockholders as well, will make mere silence, or a failure to disclose, a basis for liability.[178] That those—a "majority," in which the New York courts are included —which limit the fiduciary duty to the corporation, hold that mere failure to disclose the "inside information" will afford no basis for liability.[179] That a third doctrine, adhered to by some courts—the

176 Von Au v. Magenheimer, 126 App. Div. 257, 110 N. Y. S. 629 (1908). In this case, in which the defendants (directors) undertook to explain to the plaintiff (the selling stockholder) the condition of the company, but failed to tell the whole truth, the court said a case of "fraud and deceit" was established. It also appeared that defendants had so managed the corporate affairs as to apparently depress the value of the stock. The court, saying that defendants' relationship to plaintiff was "in a sense fiduciary," held: "Having the power to manage the affairs of the corporation as to affect the value of her shares, they owed her the duty to refrain from intentionally abusing that power actually or apparently to depress the value of those shares for the purpose of acquiring them at an underevaluation" (110 N. Y. S., at 636). See also, Newman v. Baldwin, 13 Misc. 2d 897, 898, 902, 179 N. Y. S. 2d 19 (1958).

177 5 Syracuse L. Rev. 71 (1953).

178 Oliver v. Oliver, 118 Ga. 362 (1902); Blazer v. Black, 196 F. 2d 139 (10th Cir., 1952); Amen v. Block, 234 F. 2d 12 (10th Cir., 1958); Dawson v. National Life Ins. Co., 176 Iowa 362 (1916); Jacquith v. Mason, 99 Neb. 509 (1916). In one case this principle was extended so as to impose upon the defendant director the obligation to explain, as well, the significance of the facts disclosed. Hotchkiss v. Fischer, 16 Pac. 2d 531 (Kan., 1932), commented upon in 46 HARV. L. REV. 847 (1933).

179 In Fischer v. Guaranty Trust Co., 259 App. Div. 176, 18 N. Y. S. 2d 328, *aff'd*, 285 N. Y. 679 (1941), the court said that the "weight of authority," to which it gave adherence, was that a director, making an offer to purchase stock from a stockholder, "has discharged his duty when he refrains from active wrongdoing" (18 N. Y. S. 2d, at 334).

In Chenery Corp. v. Securities and Exchange Commission, 128 F. 2d 303 (D. C. Cir., 1942), rem. on other grounds, 318 U. S. 80, 63 S. Ct. 454 (1943), the Court of Appeals said (128 F. 2d at 307):

"The great weight of authority is that a director is not the trustee of stockholders in dealing with one of them for the purchase of his stock, as the term 'trustee' is ordinarily used. At most, the relationship is a circumstance which may enter into the question of actionable fraud or deceit. The textwriters, too, all agree that the general rule is that, while directors occupy a trust relation to the corporation, the same relation "special facts" doctrine—recognizes that the fiduciary obligation is limited to the corporation, but imposes nevertheless an obligation to disclose the "inside information" to the stockholder in special circumstances, e.g., where the defendant owned the majority of the stock and, at the time of the purchase, was in sole control of the corporate management.[180]

Actually, the precise state of the New York law cannot be determined from the cases. In *Saville* v. *Sweet*,[181] deliberate misrepresentation was found, but the Court said plaintiff had no need of establishing a "technical case of fraud and deceit," because: "The relationship between plaintiff and defendants was like that of a fiduciary." Moreover, while *Fischer* v. *Guaranty Co.*,[182] which is relied upon for the statement that New York adheres to the "majority" rule, does give lip-service thereto, the finding was that the stockholder had made an independent investigation and did not rely on any confidential (or fiduciary) relationship. Referring to the *Saville* case, the Court, in *Fischer*, spoke of "specific circumstances" under which a relationship, akin to that of trustee to cestui, may exist as between a director and a "particular stockholder."[183] It must at least be said, therefore, that New York's supposed adherence to the "majority" doctrine has not served to exclude its similar adherence to the "special facts" doctrine. The supposed adherence to the "majority" rule is, moreover, rendered doubtful by the New York courts' apparent recognition of a fiduciary duty extending to stockholders.[184]

To be distinguished from the cases above discussed are those in which, pursuant to a plan to obtain the stock of a company, third persons offer to buy stock from controlling stockholders at one price

does not exist as to stockholders—at least in the sale and purchase of their stock. Fletcher on Corporations, § 1168; Thompson on Corporations, § 1258; Cook on Corporations (4th Ed.), 622; Taylor on Corporations (5th Ed.), § 698; Beach on Corporations, §§ 246, 614. Indeed, so far as we are able to find, no case has gone to the length of holding a director accountable to a stockholder in the purchase and sale of shares of stock except where fraud or some form of overreaching is shown as the inducing cause of the transaction (citing many cases from various jurisdictions)."

The court also cited cases which upheld the "special facts" doctrine (128 F. 2d, at 308).

180 Strong v. Repide, 213 U. S. 419 (1909).

181 234 App. Div. 236, 254 N. Y. S. 768 (1932), *aff'd*, 262 N. Y. 567 (1933).

182 See note 179, *supra*.

183 Fischer v. Guaranty Trust Co., *supra*, note 179.

184 Von Au v. Magenheimer, *supra*, note 176; Saville v. Sweet, *supra*, note 181; Sautter v. Fulmer, 258 N. Y. 107 (1932). See generally, Spellman, Corporate Directors (1931) § 247, p. 614 *et seq.*

and from other stockholders at a lesser price. It appears that the controlling stockholders have no duty to advise the other stockholders of the higher price they are obtaining, and, in the absence of deception or misleading conduct, they will have no liability. If, however, the control group represents or states facts from which the other stockholders may infer that they are being offered the same price as the control group, and they sell on that assumption (reliance), the control group will be liable in such amounts as will give the other stockholders their proportion of the excess received by the control group.[185] It may be observed that in these cases no "inside information" in relation to internal corporate condition, affairs or prospects is involved, and there appears to be no basis here for requiring disclosure by the control group of such price as they may receive. If, however, the control group aids the third persons in their negotiations with the other stockholders through deception, then, of course, an independent basis for liability is offered.

The cases involving the use of "inside information" by fiduciaries present other considerations. Those which have been above discussed concern, not corporate rights, but the rights of the selling stockholder vis-a-vis the purchasing fiduciaries. The corporation, it is indicated, acquires no rights since corporate assets and interests remain unaffected.[186] And where, in the case of a corporation whose stock is on a national securities exchange, the fiduciary does not deal directly with the stockholder but merely, prompted by advance "inside information," acquires some of the stock regularly offered for sale by stockholders, or sells some of his own stock to those who have offered to buy stock of his corporation, the transaction, handled through brokers, would appear to be insulated from liability.[187] It is understandable

[185] Sautter v. Fulmer, 258 N. Y. 107 (1932); see also Dunnett v. Arn, 71 F. 2d 912 (10th Cir., 1934); Roby v. Dunnett, 88 F. 2d 68 (10th Cir., 1937), cert. den. 301 U. S. 706 (1937).

[186] See Ashman v. Miller, 101 F. 2d 85, 89-90 (6th Cir., 1939):

"Ordinarily a director may deal in the securities of his corporation without subjecting himself to any liability to account, for the corporation as such has no interest in its outstanding stock or dealings in its shares among its stockholders. Bisbee v. Midland Linseed Products Company, 8 Cir., 19 F. 2d 24; Dupont v. Dupont, 3 Cir., 256 F. 129."

[187] Securities and Exchange Commission v. Chenery Corp., 318 U. S. 80, 63 S. Ct. 454 (1943).

In Carpenter v. Danforth, 52 Barb. 581, 586 (New York, 1868), the Court said: "As to stocks which have a regularly quoted price or market value, parties generally sell and buy them with reference to *this* price or value, rather than with reference to that (absent circumstances such as referred to in the footnote to the foregoing sentence) the seller to or the purchaser from the fiduciary should have no claim. And yet to permit the fiduciary to benefit personally because of knowledge which comes to him as such—to give him advantages not shared by other stockholders of the corporation—does appear to offend both reason and principle. The fiduciary concept has indeed frequently been expressed in terms which forbid, to directors and officers, the utilization of "the influence and advantage of their offices for any but the common interest."[188] Since the corporation represents the "common interest," the method of equalizing the advantage is to allow recovery by the corporation from the fiduciary of the benefits he obtained through his use of "inside information," i.e., information acquired by reason of his position. While the principle seems clear, it does not seem to have been applied in specific terms in common law cases in any situation such as that now under discussion.[189]

their real value, or any opinion of their real value founded on a knowledge or supposed knowledge of the conditions of the corporations or their affairs."

See also Walker, "The Duty of Disclosure by a Director Purchasing Stock from his Stockholder," 32 YALE L. J. 637 (1923).

A basis for liability may be provided by the Securities Exchange Act of 1934, § 18 (15 U. S. C. A. § 78r), which provides in substance, in respect of filed reports and documents, that if they are false or misleading and a purchase or sale is made in reliance at a price affected by the statement, there is liability, unless those responsible for the statement acted in good faith and without knowledge that the statement was false or misleading.

188 Bailey v. Jacobs, 325 Pa. 187, 189 Atl. 320, 324 (1937). In Blum v. Fleishhacker, 21 F. Supp. 527 (N. D. Cal. S. D., 1937), *aff'd,* 109 F. 2d 543 (9th Cir., 1940), it is said (21 F. Supp. at 531): "A director or other corporation officer will not be permitted to derive any personal profit or advantage by reason of his position distinct from his co-shareholders." See also: Lofland v. Cahill, 13 Del. Ch. 384, 118 Atl. 1, 8 (1922); Pasadena Mercantile Finance Corp. v. De Besa, 122 Cal. App. 575 (1932).

The dissenting opinion in Securities and Exchange Commission v. Chenery Corp., *supra,* note 187, states in part (318 U. S. at 97):

"The grounds upon which the Commission made its findings seem clear enough to me. Accepting, as the Court does, the fiduciary relationship of these respondents in managing the Commission proceedings, it follows that their peculiar information as to the stock values under their proposed plan afforded them opportunities for stock purchase profits which other stockholders did not have. While such fiduciaries, they bought preferred stock and then offered a reorganization plan which would give this stock a book value of four times the price they had paid for it. What the Commission has done is to say that no such reward shall be reaped by the fiduciaries. At the same time they are permitted to recover the full purchase price with interest. To permit their reorganization plan to put them in the same position as the old stockholders gives to these fiduciaries an unconscionable profit for trading with inside information.

"I can see nothing improper in the Commission's findings and determinations."

189 See Securities and Exchange Commission v. Chenery Corp., *supra,* note 187.

One lower court did, however, hold that a fiduciary, who had acquired corporate

However, that principle does appear to provide the conceptual basis for § 16(b) of the Securities Exchange Act of 1934,[190] dealing with what has been called "short-swing" profits.[191]

"Short-Swing" Profits

Section 16(b) of the Securities Exchange Act of 1934[192] provides that a director, officer or beneficial owner of more than 10% of any class of "equity security," registered on a national securities exchange, is liable to the corporation for any profit realized from a purchase and sale or a sale and purchase of any equity security of the corporation within a six-month period (the "short-swing"). On its face the statute appears clear enough. An appreciation of the questions it necessarily raises but leaves unanswered is provided by the cases which have considered them.

1. *"Objective" rule.* Although the purpose of the statute is to prevent "insiders" from unfairly utilizing information obtained by reason of their relationship to the company, the rule applied is "objective," i.e., it is applicable whether or not inside information was actually available, obtained or utilized.[193] As has been said: "Abuse of

stock because of inside information that the corporation intended to buy its own stock in such quantities that the market price would increase, was obliged to account to the corporation for profits made in his purchase and sale of that stock. Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 Atl. 2d 5 (1949). The defendant was confidential secretary to a director and officer, and since he had acquired knowledge of the secret information in that capacity, the Court likened his position to that of a fiduciary. The Court predicated liability on the ground of "abuse" of the relation of trust and confidence or "breach of duty." The Court's reasoning has been criticized on the ground that from the mere use of the confidential information for personal profit, it did not follow that there was a breach of duty: neither loss to the corporation nor "conflict of interest" in the usual sense was shown. 63 HARV. L. REV. 1446 (1950). The Court did not, indeed, clarify the basis for its statement that there was a breach of duty. However, if it be accepted as a guiding principle that a fiduciary should not be permitted to derive personal advantage by reason of his position distinct from his co-shareholders in the corporation (see prior footnote), it is evident that the principle was violated in this case.

190 15 U. S. C. A., § 78n.

191 "Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions to aid them in their market activities." *Stock Exchange Practices,* REPORT OF THE COMMITTEE ON BANKING AND CURRENCY, SEN. REP. No. 1455, 73rd Cong., 2d Sess. (1934) 55.

192 See note 190, *supra.*

193 Smolowe v. Delendo, 136 F. 2d 231 (2d Cir., 1943), cert. den. 320 U. S. 751; Walet v. Jefferson Lake Sulphur Co., 202 F. 2d 433 (5th Cir., 1953), cert. den. 346 U. S. 820. Motives and purposes being immaterial, fact that purchases and sales were made for accommodation of clients (but not as broker) is no defense. Arkansas Louisiana Gas Co. v. W. R. Stephens Invest. Co., 141 F. Supp. 841 (W. D. Ark., 1956).

corporate position, influence and access to information may raise questions so subtle that the law can deal with them effectively only by prohibitions not concerned with the fairness of a particular transaction."[194]

2. *Persons covered:* (a) Since form may not rise over substance, the corporate by-law "officer" designations are not conclusive. Not all those so designated are "officers" under the Act. Thus, an assistant secretary may have been appointed at a branch office for convenience of executing documents; or an assistant treasurer's duties may be confined to the mechanics of handling accounts. Since their functions do not involve participation in policy formulation or activities corresponding to those of their chiefs, they are not "officers" under the Act.[195] On the other hand, a person not designated in the by-laws as an "officer" but performing "functions" corresponding to those performed by an officer, may be included as such under the Act,[196] particularly if his duties are "of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions."[197]

(b) The Act covers not only the short-swing purchases and sales of officers and directors, but as well those of the owner of more than 10% of any class of equity security. A court in Arkansas has held that the statute is applicable to such 10% owner only if he was such prior to and independently of such transactions.[198] The Second Circuit Court of Appeals has held that the "purchase," as the result of which the person became a 10% owner, may itself be regarded as one prong of the purchase and sale which produces liability.[199]

194 Securities and Exchange Commission v. Chenery Corp., 318 U. S. 80, 92, 63 S. Ct. 454 (1943), *supra*, note 187.

195 Lockheed Aircraft Corp. v. Campbell, 110 F. Supp. 282 (S. D. Cal., 1953); Lockheed Aircraft Corp. v. Rathman, 106 F. Supp. 810 (S. D. Cal. 1952). These cases approve and follow Commission Rule X-3B-2.

196 Commission Rule X-3B-2.

197 Colby v. Klune, 178 F. 2d 872 (2d Cir., 1949). This case, it will be noted, offers a test not merely in terms of general "functions" as does the Commission Rule, but in terms of the possibility of obtaining confidential information. The Commission has not amended its rule but has cautioned that the court's determination would prevail and that the word "officer" may encompass a broader class than might appear from its rule. SEC. EX. ACT. REL. 4754 (1952) 2.

198 Arkansas Louisiana Gas Co. v. W. R. Stephens Invest. Co., *supra*, note 193.

199 Stella v. Graham Paige Motors Corp., 232 F. 2d 299 (2d Cir., 1956), cert. den. 352 U. S. 831 [aff'g 132 F. Supp. 100, and adopting the reasoning in 104 F. Supp. 957 (S. D. N. Y., 1952)]. It may be noted that in the Arkansas case, *id.*, there was a re-

(c) It appears that early drafts of the bill that later became law provided for liability by persons who acted upon information disclosed by insiders. But such provision was eliminated. In one case a partnership—Lehman Brothers—bought and sold securities, in a short-swing, in a company in which one of the partners was a director. It was held that only the director-partner's share of the profits, and not all the partnership's profits, was recoverable.[200] But the Court left for the future its decision in the following situations (not presented by the facts in the case): (a) where the director-partner had been instrumental in causing the partnership to effect the short-wing transaction, and (b), where the director-partner was in essence the representative of the partnership on the board of directors. While, therefore, the question whether or not the purchase and sale was induced by information disclosed by an insider is immaterial,[201] inquiry with respect to the relationship between the insider and the person who engaged in the short-swing transaction may still be open. Where, for example, a director-husband manages his wife's affairs and in her name and with her money engages in a short-swing transaction for her benefit, the question is open as to whether or not there is liability. Similarly, where a wife owns a large block of stock in a company in which she is represented on the board by her husband. But it would appear that if a director-husband merely discloses inside information to his wife, who then independently engages in a short-swing transaction, there would be no liability.[202]

3. *"Short-Swing."* The statute specifies a sale and purchase or purchase and sale within six months, and just as the "objective" rule makes it immaterial that inside information may not actually have been utilized, so where the purchase and sale were not within six months, there would be no liability under the statute even though inside information were utilized. Moreover, by definition, "purchase" includes a contract to buy,[203] and there can be but one purchase of a given security. Therefore, the sending of a notice of the exercise of an option, pursuant to an employment contract, which under the con-

covery of $61,000. Had the Second Circuit rule been applied, the recovery would have been $231,000.

200 Rattner v. Lehman, 193 F. 2d 564 (2d Cir., 1952).

201 This, indeed, is only consonant with the "objective" rule discussed above.

202 But all "insider's" short-swing profits are recoverable even in community property states. Walet v. Jefferson Lake Sulphur Co., 202 F. 2d 433 (5th Cir., 1953), cert. den. 346 U. S. 820.

203 Securities Exchange Act of 1934, § 3(a)(13), 15 U. S. C. A. § 78.

tract effects an irrevocable liability to take and pay for the stock, constitutes the "purchase," even though the actual transfer and payment for the stock is postponed to a later date. It follows that a sale within six months of the receipt of the stock but more than six months after the sending of the notice is not within the statute.[204] It will be observed that since the officer-employee was committed by the sending of the notice (even though he did not then take and pay for the stock), he in effect held the stock, so far as speculative purposes were concerned, for a period longer than six months.

4. *Transactions Covered.* (a) *Stock dividends and warrants.* Where a corporation declares stock dividends or issues warrants, evidencing rights to subscribe to stock, ratably to stockholders, the stockholder-recipients clearly do not acquire the stock or warrants by "purchase," and a sale within six months is not within the Act.[205] It will be observed that the recipient's interest in the corporation is not altered by the receipt of the stock dividend or warrants, and when he sells them he is in effect selling a part of an interest in the corporation that he had owned all the time. But acquisition of warrants by an officer pursuant to an employment contract is a "purchase."[206] Here there is no ratable issue, and the officer is paying for the warrants with his services—just as though he were paid fully in cash for those services and he purchased the warrants with part of that cash.

(b) *Gifts.* Suppose a director-father purchases stock and gives it to his son who sells it—all within six months. If the gift is *bona fide,* it is not a "sale,"[207] and accordingly the transaction would not be within the Act. However, if the donee of the gift is in effect the *alter ego* of the donor (i.e., where the gift is not *bona fide*), the sale by the donee will be treated as if made by the donor.[208]

(c) *Conversions, Exchanges, Reclassifications.*

(i) The voluntary conversion of convertible preferred stock into common is a "purchase"—a purchase of the common stock with the preferred—and a sale of the common stock within six months is within the statute. This is so even though the corporation had served

204 Blau v. Ogsbury, 210 F. 2d 426 (2d Cir., 1945).

205 Shaw v. Dreyfus, 172 F. 2d 140 (2d Cir., 1949), cert. den. 337 U. S. 907.

206 Blau v. Hodgkinson, 100 F. Supp. 361 (S. D. N. Y., 1951); Truncale v. Blumberg, 80 F. Supp. 387 (S. D. N. Y., 1948).

207 Shaw v. Dreyfus, *supra,* note 205.

208 Truncale v. Blumberg, 83 F. Supp. 628 (S. D. N. Y., 1949); s. c. 80 F. Supp. 387 (S. D. N. Y., 1948), *supra,* note 206.

notice to redeem the preferred—as the result of which the option to convert became operative. The conversion is deemed voluntary, rather than forced, because the "insider" was not obliged to convert: he might, alternatively, have redeemed or merely sold his stock.[209] The notion that action taken is "voluntary" where a choice is offered *and required* is carried over into other situations. Thus, where, pursuant to a plan approved by stockholders, a parent corporation of non-wholly-owned subsidiaries issues its stock in exchange for the outstanding stock of the subsidiaries, the acquisition by an "insider" of the parent's stock in exchange for his stock in a subsidiary is by "purchase": he had the choice of dissenting from the plan and receiving in cash the appraised value of his stock.[210]

(ii) Customarily an exchange of stocks involves no change in proportional interest in the company. And, generally, such exchange is not deemed a "sale" or a "purchase," as the case may be. But this is not necessarily so. Circumstances may offer possibilities for speculative gain from the exchange even though as a result there is retained an unchanged proportional interest in the company, and, in such case, a "sale" or "purchase" may be recognized. The following instances are illustrative:

The "A" Corporation owns more than 10% of the "X" Corporation's stock. (Therefore, A is an "insider" as to X.) A organizes the "B" Corporation, and exchanges all of its X stock for all B's authorized stock. A is not deemed to have "sold" its X stock for B stock; there was merely a "transfer between corporate pockets."

But suppose A then does the following: (1) distributes some of its B stock to its (A's) stockholders, retaining, however, sufficient B stock to control B (which owns more than 10% of X), and, therefore, to continue, "indirectly," as an X "insider"; (2) purchases additional X stock; and (3) exchanges the newly acquired X stock for additionally authorized B stock. Suppose further that as the result of this last exchange, A retains precisely the same proportional interest

209 Park & Tilford, Inc. v. Schulte, 160 F. 2d 984 (2d Cir., 1947), cert. den. 332 U. S. 761. In this case, at the time of the conversion, the common stock into which the conversion was made had a greater market value than the preferred, so that an advantage was obtained by making the conversion. In the recent case of Ferraiola v. Newman, 259 F. 2d 342 (6th Cir., 1958), where, because of an undilutable conversion privilege, the preferred shares sold at a price equivalent to the common (although the redemption price was less), the Court, finding that the transaction was not "of a kind which can possibly lend itself to the speculation encompassed by Section 16(b),"—distinguishing Park & Tilford— held that the conversion was not a purchase.

210 Blau v. Hodgkinson, 100 F. Supp. 361 (S. D. N. Y. 1951).

(now indirect) in the X stock, as it held (directly) prior to the exchange. However, it appears that there had developed a market in the B stock that had previously been distributed to A's stockholders, and advantage could be taken of the market fluctuations. A's newly acquired X stock had been purchased at one price. Though when it later exchanged this X stock for newly authorized B stock its proportional interest in X (through B) remained the same, in receiving the B stock, it was receiving marketwise (because of the then market for the B stock) more than it had paid for said X stock. Accordingly the exchange was deemed a sale by A of the X stock.[211]

In another case, a majority stockholder of $5 par common stock (the rest of the stock being publicly held), prior to marketing his stock, and to improve its marketability, caused the corporation (at a meeting duly called) to reclassify the stock, so that for each share of $5 par common, the stockholders would receive one share of $1 par common and one share of $7 preferred. Pursuant to this plan of reclassification, the stocks were duly exchanged and within a month the majority stockholder sold his newly acquired shares. If the latter shares were acquired by "purchase," a transaction within the Act would have occurred. But the Court held that the exchange did not involve a "purchase." Two circumstances *combined* to immunize the transaction: (1) In making the exchange, the majority stockholder's position in the company remained unchanged; *and* (2) the reclassified stock that had been acquired was not *then* "seasoned" or "readily marketable." The Court's conclusion, basically, was predicated on its realization that the reclassification involved "could not possibly lend itself to the speculation encompassed by § 16(b)."[212]

5. *Exceptions.* Section 16(b) itself states that it is inapplicable where "the security is acquired in good faith in connection with a debt previously contracted."[213] Preferred stock is not a creditor's interest or "debt," but an equity interest, and accordingly the exception does not cover the voluntary conversion of preferred stock into common stock.[214]

It is also provided that the statute "shall not apply to foreign or domestic arbitrage transactions," unless in contravention to Com-

211 Blau v. Mission Corp., 212 F. 2d 77 (2d Cir., 1954), cert. den. 347 U. S. 1016.
212 Roberts v. Eaton, 212 F. 2d 82 (2d Cir., 1954), cert. den. 75 S. Ct. 44.
213 See note 190, *supra.*
214 See note 209, *supra.*

mission regulations.[215] A Commission rule (X-16D-1) withdraws this exception when officers and directors are involved but it still protects 10% stockholders. Where dividends were declared by a corporation, a sale by such 10% stockholder, on the record date, of stock including the right to the dividend, and a simultaneous purchase of the same number of shares shorn of that right (and therefore at a lesser price) was held to be an arbitrage transaction.[216] It will be observed that in this fashion the stockholder obtained a capital gain in lieu of ordinary income from receipt of a dividend, but the transaction (and the tax benefit) could not possibly have been inspired by inside information.

6. *Exemptions.* Exemptions, when valid, have the same effect as exceptions but they have a different source and specific criteria for validity. The statute itself creates exceptions. Exemptions, while authorized by the statute, are creations of the Securities Exchange Commission. The Commission may exempt transactions "as not comprehended within the purpose of this subsection (i.e., 16(b))." Exemptions so created must be consistent with the statute,[217] must not reduce liability thereunder,[218] and are subject to judicial review.[219] But acts in good faith in conformity with Commission rules are not liability producing, even though the rule is later declared invalid.[220]

(a) Rule X-16-B-3 (as amended in 1952) exempted stock acquired pursuant to a "bonus, profit-sharing, retirement or similar plan." The Commission had interpreted this rule to include stock acquired pursuant to a Restricted Stock Option Plan.[221] The court agreed with the Commission's interpretation of the rule and it, too, found that the stock acquired under the Plan was exempted by the rule. However, the court expressed its doubts about the rule's validity since its broad language might permit acts by insiders sought to be prevented by the statute. Nevertheless, since the transaction was undertaken in good faith and in conformity with the Commission rule, the court held there was no liability.[222]

215 § 16(d), 15 U. S. C. A. § 78n.
216 Falco v. Donner Foundation, 208 F. 2d 600 (2d Cir., 1953).
217 Smolowe v. Delendo, *supra*, note 193.
218 Rattner v. Lehman, *supra*, note 200.
219 Greene v. Dietz, 247 F. 2d 689 (2d Cir., 1957).
220 Securities Exchange Act of 1934, § 23a, 15 U. S. C. A. § 78.
221 In 1956, subsequent to the transaction in the case under discussion, the rule itself was specifically amended to cover stock acquired pursuant to non-transferable options.
222 Greene v. Dietz, *supra*, note 219. See also Gruber v. Chesapeake & Ohio Ry. Co., 158 F. Supp. 593 (N. D. Ohio 1958).

(b) Rule X-16-B-6 (1950) provides in substance that where stock is acquired pursuant to an option held more than six months (e.g., under an employment contract), and is then sold within six months, there can be a recovery of either (1) the price received on sale less the lowest price of the security within six months prior to or after the sale, or (2) the actual profit, whichever is less.

Example: An officer, in an employment contract, is given an option to buy stock at $4 per share, exercisable within two years. He exercises his option 1-½ years later and immediately sells the stock for $15. The "lowest price" of the stock was $10 within six months before and six months after the sale. The maximum recovery from him is $5 per share.

If, in the above example, the officer was not permitted to exercise the option until one year and three months after he obtained it, and on that day the market price of the stock was $14, the increment from $4 (the option price) to $14 (i.e., $10) would be deemed "the value of the option, as represented by long-term increment, to which the defendant [officer] was entitled pursuant to the option agreement by virtue of his continued services to the company," i.e., $10 would represent part of his cost (as represented by services rendered). Therefore, the actual profit would be $15 less $4 (cash paid) less $10 (value of services), or $1. The recovery would thus be limited to $1 per share.[223]

(c) Exemptions are also created where securities are obtained in redemption of other securities (X-16B-5), or in connection with exchanges pursuant to mergers or consolidations (X-16B-7), under conditions specifically provided, in substance that the exchanges affect only the form of the securities, and that there be no substantial change in the proportionate equity ownership of the securities. These rules must, of course, be read in the light not only of the limitations written into them but of the cases involving exchanges of stock discussed above.

7. *Estoppel.* Acts of the corporation itself, which might appear to preclude suit by a stockholder, constitute no defense. Thus a corporation's settlement of its own action against an "insider" for a small percentage of the "insider's" readily calculated liability was no bar to a subsequent stockholder's action—for reasons of "public

223 Steinberg v. Sharpe, 95 F. Supp. 32 (S. D. N. Y. 1950), *aff'd*, 190 F. 2d 82 (2d Cir., 1951).

policy."[224] In the same vein it has been held that the general principle that a determination by directors reasonably exercised not to bring (or continue prosecution of) suit bars a stockholder's action,[225] is inapplicable to § 16(b) which makes the stockholder's right to sue (after demand upon and refusal by the corporation, or the equivalent thereof) absolute.[226] Though a corporation, with the approval of stockholders, conceived and initiated a plan whereby the majority stockholder (another corporation) sold its stock, all but a small portion of which it held for more than six months, the majority stockholder was required to account for the profit on the small portion of the shares it had held for less than six months.[227]

It appears from these cases that the conduct of a corporation, whether by authority of its directors or its stockholders, cannot estop a suit by a stockholder to recover upon a transaction forbidden by § 16(b).[228]

8. *Recoverable Profits.* In this aspect of the statute's application, too, the courts have been quite strict. It is understandable that the courts should not be guided by particular stock certificates involved in a transaction: a purchase and sale within six months is within the statute, though the sale was not of the same certificates but of certificates that had been held for more than six months prior to the sale. Shares of stock are alike and interchangeable.[229] But, so as to recover all possible profits, the court has adopted the rule "of lowest price in, highest price out—within six months," which, when there are several transactions, excludes offsetting losses against profits.[230] To illustrate: An insider may engage in the following transactions:

224 Blau v. Hodgkinson, *supra,* note 206, at 371.

225 See note 290, *infra.*

226 Pellegrino v. Nesbit, 203 F. 2d 463 (9th Cir., 1953).

227 Magida v. Continental Can Co., 231 F. 2d 843 (2d Cir., 1956), cert. den., 351 U. S. 972 (1956). But *cf.,* Consolidated Engineering Corp. v. Nesbit, 102 F. Supp. 112 (S. D. Cal. 1951).

228 This appears to be a variance from common law principle. But even in common law cases a determination by disinterested directors not to sue a fiduciary for a recoverable profit appears not to be within their prerogatives (see note 291, *infra*). However, such cases involve private profits made in breach of duty, and it may well be urged that the directors' judgment should control where the insider has innocently (i.e., without actual use of inside information) engaged in a transaction forbidden by § 16(b). On the other hand, to give effect to such argument would necessarily involve the courts in an inquiry which, in constructing the "objective" rule, they have refused to undertake.

229 Smolowe v. Delendo, *supra,* note 193; Gratz v. Claughton, 187 F. 2d 46 (2d Cir., 1951), cert. den. 341 U. S. 920 (1951).

230 Smolowe v. Delendo, *supra,* note 193; Arkansas Louisiana Gas Co. v. W. R. Stephens Invest. Co., *supra,* note 193; Gratz v. Claughton, *id.*

Date	*Purchase or Sale*	*No. of Shares*	*Price*
January	P	10	$1,000
February	P	10	1,500
March	S	10	1,600
April	S	10	900

It is evident that the insider netted no profit from these transactions. But under the rule of "lowest price in" ($1,000), "highest price out" ($1,600), "within six months," he has effected a recoverable profit of $600. The losses on the other transactions (in the same amount) may not be offset against the profits.

9. *Right to Sue:* Section 16(b) confers on "the owner of any security" the right to bring action on behalf of the corporation, if the corporation fails or refuses to bring suit within 60 days after request. Rule 23(b) of the Federal Rules of Civil Procedure, which requires plaintiff to have been a stockholder at the time of the transaction,[231] is inapplicable to a § 16(b) suit, and it is immaterial when plaintiff acquired his stock.[232]

While normally compliance with the 60-day rule is required, the corporation only and not the "insider" has status to raise the question,[233] and the stockholder may bring action prior to the expiration of 60 days, where he alleges a demand on the corporation to bring action within a lesser specified period to avoid the statute of limitations and the corporation's failure to comply.[234] A demand on the corporation to bring suit is excused where the defaulting insider controls the corporation, since demand would be futile.[235]

10. *Statute of Limitations:* Section 16(b) provides that "no suit shall be brought more than two years after the date such profit was realized." But where the "insider" failed to comply with § 16(a), requiring filing of statements of changes in ownership of securities within 10 days after close of month in which changes took place, one court held this was a fraudulent concealment which tolled the limita-

231 Fed. Rules of Civil Procedure, Rule 23(b).

232 Blau v. Mission Corp., 212 F. 2d 77 (2d Cir., 1954), cert. den. 347 U.S. 1016 (1954); Magida v. Continental Can Co., *supra*, note 227; Dottenheim v. Murchison, 227 F. 2d 737 (5th Cir., 1955), cert. den. 351 U. S. 919; Benisch v. Cameron, 81 F. Supp. 882 (S. D. N. Y. 1948).

233 Henss v. Schneider, 132 F. Supp. 60 (S. D. N. Y. 1955); Benisch v. Cameron, *id.*; Grossman v. Young, 72 F. Supp. 375 (S. D. N. Y. 1947).

234 Benisch v. Cameron, *supra*, note 232; Grossman v. Young, *id.*

235 Grossman v. Young, *supra*, note 233; Netter v. Ashland Paper Mills, 19 Fed. Rules Dec. 529 (S. D. N. Y. 1956).

tions statute until discovery of the fraud.[236] Another held that in view of the clear language of the statute, it could not be tolled, but that the facts might be examined to determine whether they warranted a plea of estoppel against the limitations defense.[237]

Comment

The subject of "short-swing" profits has been discussed at some length since it is an important aspect of the problem of the liability of officers and directors. Although the application of the statute, under the "objective" rule, is absolute, it does have a basis in common law principle that an officer or director may not use his position to obtain advantages not shared by other stockholders.[238] And the refusal of the courts to permit their decisions under the statute to turn upon the question whether or not inside information has, in the particular case, been used, may perhaps be justified on the ground that it is impractical for a court to make such inquiry and attempt to reach a conclusion thereon—that too many subtleties would be involved,[239] and the door would be left open for abuse that could not be detected.[240]

It has been suggested, in criticism of § 16(b), that "recovery under the section aids not the persons injured—those who bought from or sold to the insider—but the corporation, which suffered no injury."[241] However, the person who "bought from or sold to the insider" may not have suffered injury. If he has, he may have an independent remedy.[242] So far as the corporation is concerned, it may be said, in support of its right to recover the profits, that the fact that it suffered no injury is immaterial; that it is sufficient that the fiduciary is presumed to have made a personal profit from knowledge acquired in his official position; and that such profit is recoverable by the corporation even though the corporation could not itself have engaged in the activity from which the profit was made.[243] Moreover, though

236 Grossman v. Young, *supra,* note 233.

237 Carr-Consolidated Biscuit Co. v. Moore, 125 F. Supp. 423 (M. D. Pa. 1954).

238 See note 188, *supra.*

239 See note 194, *supra.*

240 See Smolowe v. Delendo, *supra,* note 193, at p. 235.

241 See Loss, *Securities Regulation* (1951), 1. 579. Mr. Loss there merely is summarizing the objections made by others to the statute. That he does not agree with the objection referred to is suggested by his statement (fn. 401, p. 579): "The argument that recovery goes to the wrong person does not hold water. The corporation itself is selected for want of any practicable alternative. Moreover, Section 16(b) does not preclude the person who bought from or sold to the insider from recovering under other aspects of the SEC statutes."

242 See note 187, *supra.*

243 See notes 96, 97 *supra.*

it may not be customary for a corporation to buy and sell its own stock, such transactions are not precluded if a surplus is available, and, in any event, permitting the corporation to recover the profit made by the fiduciary only gives to the corporation the benefit of transactions engendered by intangibles (knowledge, information, and the right and power to determine its course of action) it possesses and which are not the private property of the fiduciary.

As has been indicated, Section 16(b) is not applicable where the purchase and sale are separated by more than six months, even though it could be shown that inside information was in fact utilized by the insider. While recovery by the corporation has in an analogous situation been denied,[244] it would seem that common law principle would amply support corporate recovery in such case. It should, moreover, be noted that Section 16(b) does not apply at all to securities traded in the over-the-counter market. A determination, without regard to Section 16(b), that there may be corporate recovery of profits made by insiders through the actual use of inside information, would serve, at least in part, to plug this loophole.

XI. Responsibility for Dividend Payments

The corporate directors determine whether, when and in what amount dividends should be declared and paid to stockholders.[245] In making such determination directors must consider applicable statutes, which may include not only the law of the state of incorporation but the law where the company does business.[246] But the directors' responsibility does not end with a determination of the absence of statutory prohibition. The directors' obligation to exercise their discretion reasonably requires a proper balance between the reasonable expectations of stockholders for dividends and the reasonable needs of the business, existing and future, and, in that behalf, consideration must be given to "earnings, surplus, current and fixed assets and liabilities, the nature of the business and probable fluctuations in earnings, demands for new capital, competitive conditions in the industry," etc.[247]

[244] See note 187, *supra*.

[245] Liebman v. Auto Strop Co., 241 N. Y. 427 (1926).

[246] E.g., the New York dividend statutes are applicable to a corporation doing business in New York. New York Stock Corporation Law, § 114.

[247] Gordon v. Elliman, 306 N. Y. 456, 467 (1954); Equitable Life Assurance Society of the United States v. Union Pacific Railroad Co., 212 N. Y. 360 (1914); Nauss v. Nauss Bros. Co., 195 App. Div. 318, 187 N. Y. S. 158 (1st Dept., 1921); Baker

Statutory Prohibitions: The corporation was devised to shield the investor-stockholders from personal liability to creditors, and, as a counter-balance, creditors, even without benefit of a statute dealing specifically with dividends, were given a measure of protection against distributions to stockholders by prohibitions against fraudulent transfers—distributions when the corporation was insolvent or which would produce insolvency.[248] Statutory limitations upon dividend distributions are general and are varied. Typical are: (a) The New York statute which prohibits the declaration or payment of a dividend when it would result in a reduction of the value of the corporation's assets to an amount less than the aggregate amount of its debts and liabilities including capital, i.e., a dividend may be declared only from "surplus."[249] (b) The Delaware statute which also provides that dividends may be declared and paid out of net assets in excess of capital, but goes on to provide that, if there be no such excess, the dividend distribution may be made from the corporation's "net profits for the fiscal year then current and/or the preceding fiscal year."[250]

The particular statutes and decisions in the state or states whose law may be applicable must, of course, be examined to determine the scope of or limitations upon the statutory prohibitions and the extent of the directors' liability for statutory violation. For example:

(1) In New York, the "surplus" from which a dividend may be paid without violation of the statute may be "paid-in surplus," as where stock is issued at a price above par, may be "earned surplus," as where it is derived from undistributed profits, may represent an increase in valuation of land or other assets made upon a revaluation of the company's property,[251] and may even be a surplus created by a reduction in capital.[252] In Delaware and most other states, however, dividends may not be paid out of unrealized appreciated assets.[253] Moreover, in Delaware, in ascertaining whether there are funds available for dividends, the entire amount paid in for stock, though in

v. Cohn, 42 N. Y. S. 2d 159, *mod. and aff'd*, 292 N. Y. 570 (1942); Dodge v. Ford Motor Co., 204 Mich. 459, 170 N. W. 668 (1919).

248 See Weiner, Theory of Anglo-American Dividend Law, 29 Col. L. Rev. 461, 463-4 (1929).

249 New York Stock Corporation Law, § 58; see Randall v. Bailey, 288 N. Y. 280 (1942).

250 Delaware General Corporation Law, § 170.

251 Randall v. Bailey, *supra*, note 249.

252 Per New York Stock Corp. Law, §§ 35 and 36(4)(s). See N. Y. Stock Corp. Law §§ 38(6), 58; Roberts v. Roberts-Wicks Co., 184 N. Y. 257 (1906).

253 Kingston v. Home Life Ins. Co. of Am., 11 Del. Ch. 258, 101 Atl. 898 (1917), *aff'd*, 11 Del. Ch. 428, 104 Atl. 25 (1918); 50 Yale L. J. 306.

excess of par value, represents capital: no paid-in "surplus" is available.[254]

(2) Many courts have held that violation of the statutory prohibitions creates automatic liability on the part of directors.[255] This—that good faith and absence of negligence was no defense—was the law in New York[256] until, by an amendment in 1939 to § 58 of the Stock Corporation Law it was provided that directors are absolved from liability where they affirmatively show they had reasonable grounds to believe and did believe that the dividend would not impair capital.[257] In Delaware a director is fully protected in relying in good faith upon corporate books of account, statements prepared by officers or other pertinent facts.[258] And, generally, without regard to such exculpatory provisions, statutory violation is not held negligence per se, good faith and due care being a defense.[259]

(3) In New York the directors' liability, to the corporation or its creditors, is for the "loss" sustained by payment of dividends in violation of the statute.[260] This "loss" is the amount by which the

254 Peters v. U. S. Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (1921). In general, the Delaware courts hold that dividends may be declared only out of profits, and invested capital should be kept intact. Wittenberg v. Federal Mining & Smelting Co., 15 Del. Ch. 147, 138 Atl. 352 (1926), s. c. 15 Del. Ch. 351, 133 Atl. 48, *aff'd,* 15 Del. Ch. 409, 138 Atl. 347 (1927); Pennington v. Commonwealth Hotel Const. Corp., 17 Del. Ch. 394, 155 Atl. 514 (1931).

255 See, e.g., Crane-Johnson Co. v. Commission of Internal Revenue, 105 F. 2d 740 (8th Cir., 1939); Southern California Home Builders v. Young, 45 Cal. App. 679, 188 Pac. 586 (1920).

256 Quintal v. Greenstein, 142 Misc. 854, 256 N. Y. S. 462 (1932), *aff'd,* 236 App. Div. 719, 257 N. Y. S. 1034 (1932); Cowin v. Jonas, 43 N. Y. S. 2d 468 (1943), *aff'd,* 267 App. Div. 947, 48 N. Y. S. 2d 460 (1944), *aff'd,* 293 N. Y. 838 (1944); *cf.,* Diamond v. Davis, 38 N. Y. S. 2d 103 (1942), *aff'd,* 265 App. Div. 919, 39 N. Y. S. 2d 412, *aff'd,* 292 N. Y. 554 (1944).

257 The "affirmative" showing by directors is, of course, made after proof that there has been an impairment of capital. There is a presumption that the declaration and payment of dividends are proper and legal. Plaintiff has the burden of overcoming presumption and showing amount of impairment. Gallagher v. New York Dock Co., 19 N. Y. S. 2d 789 (1940), *aff'd,* 263 App. Div. 878, 32 N. Y. S. 2d 348 (1942), app. den. 263 App. Div. 957, 32 N. Y. S. 2d 1021; 288 N. Y. 737 (1942); Newfield v. Stieglitz, 47 F. Supp. 885 (D. C. N. Y. 1942), *aff'd,* 137 Fed. 2d 437 (2d Cir., 1943). But if a condition of impairment is shown to exist at a given time (e.g., at the end of three successive years), it will be presumed to continue until a contrary condition is shown. (It is not necessary to show condition as of date of declaration or payment of each dividend.) Irving Trust Co. v. Gunder, 152 Misc. 83, 271 N. Y. S. 795 (1934).

258 Delaware General Corporation Law § 172; see Stratton v. Anderson, 278 Mich. 499, 270 N. W. 764 (1936).

259 Medford Trust Co. v. McKnight, 292 Mass. 148, 197 N. E. 649 (1935); Branch v. Kaiser, 291 Pa. 543, 140 Atl. 498 (1928); Blythe v. Enslen, 209 Ala. 96, 95 So. 479 (1922).

260 New York Stock Corporation Law § 58.

dividend paid exceeded the amount of "surplus" available at the time of impairment—not necessarily the full amount of the dividend.[261] The general tendency is in this direction,[262] but many statutes are stricter, holding the directors liable for the full amount of the dividend, and even for all debts of the corporation then existing or later incurred while insolvency or impairment of capital continued.[263] On the other hand, it has been held that no recovery at all should be allowed where the corporation was not insolvent and the funds were not needed to pay creditors.[264]

The Right to Dividends: As already indicated, the responsibility of directors is not met by mere absence of violation of statutory prohibitions: the considerations pertinent to the directors' proper exercise of discretion have been mentioned. Since, moreover, the matter is one of business judgment and the courts' inclination is not to interfere, it generally will do so only in extreme cases where it finds abuse of discretion or bad faith.[265] When a court does take matters into its own hands, at the suit of a stockholder, it substitutes "its judgment ad hoc for that of the directors in the conduct of its (the corporation's) business."[266]

XII. LOANS TO DIRECTORS, OFFICERS AND STOCKHOLDERS

A CORPORATE loan to a director, officer or stockholder necessarily raises questions of interest to persons who may be concerned, viz., (1) to creditors interested in the preservation of corporate assets

261 Greene v. Boardman, 143 Misc. 201, 256 N. Y. S. 340 (1932). A stockholder may bring a derivative action to recover the loss—as may also a creditor, or receiver or trustee in bankruptcy. Walker v. Man, 142 Misc. 277, 253 N. Y. S. 458 (1931); New York General Corporation Law § 60; New York Stock Corporation Law § 58. There need be no allegation that there are creditors who were such at the time of impairment. Quintal v. Greenstein, *supra*, note 256. There can be no ratification by stockholders of an improper dividend declared in violation of Stock Corporation Law § 58. Cowin v. Jonas, 43 N. Y. S. 2d 468 (1943), *aff'd*, 267 App. Div. 947, 48 N. Y. S. 2d 460 (1944), *aff'd*, 293 N. Y. 838 (1944).

262 See Model Business Corporation Act § 25; 9 U. L. A. pp. 39, 77.

263 BALLANTINE, LAW OF CORPORATIONS (Rev. Ed., 1946), § 254.

264 Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 8 N. E. 2d 895 (1937).

265 Lesnik v. Public Industrials Corp., 144 F. 2d 968, 978 (2d Cir. 1944); Lowry v. Farmers' Loan & Trust Co., 172 N. Y. 137 (1902). Whether dividends are being improperly withheld may depend on whether the surplus alleged to be available is in the form of idle cash or is represented by items of buildings, machinery, equipment, inventory, bills receivable, etc. Ochs v. David Maydole Hammer Co., 138 Misc. 665, 246 N. Y. S. 539 (1930). Facts supporting charges of bad faith, etc., must be alleged. A mere charge of bad faith is insufficient. Nauss v. Nauss Bros. Co., 195 App. Div. 318, 187 N. Y. S. 158 (1st Dept., 1921).

266 Gordon v. Elliman, *supra*, note 247.

sufficient to pay debts, (2) to the body of stockholders (as represented by the corporation) interested in the devotion of corporate funds for usual corporate purposes and the advancement of corporate interests. The problem may become serious where the loan is not from surplus but invades capital (except for the fact that on the books the debt owing the corporation is an "asset"), particularly if it is not amply secured. Moreover, to favor with corporate largesse particular stockholders, or directors or officers, creates inequality of treatment: corporate assets are supposed to be devoted to purposes whose benefits are shared by all stockholders alike and which do not advantage some stockholders (or directors or officers) over others. Again, if the object of borrowing by directors or officers is to use the corporate funds for personal gain, a more serious conflict with principles applicable to fiduciaries is produced.

The above comments suggest the problems created by corporate loans. It is said that, apart from statute, and in the absence of breach of trust, a director or officer may borrow money from his corporation.[267] There are, conceivably, situations in which it might be in the corporate interest to lend money to an officer in straitened circumstances: his peace of mind might have significant bearing on his usefulness. As in the case of any transaction with the corporation, the loan if made should be passed on by disinterested directors,[268] who, presumably, would exercise good faith and due care in authorizing the loan. If the circumstances indicate lack of diligence or good faith, or involve self-dealing, an accounting for the profits made with the use of corporate funds will be required.[269] A loan not in the interest of the corporation and its stockholders, but for the personal and private advantage or gain of an officer, constitutes an improper diversion of corporate funds.[270] Since directors may not authorize loans to an officer for his private gain, so they may not ratify as "loans" funds previously misappropriated for such purpose by such officer.[271] It has, on the other hand, been held that a loan of corporate surplus funds, at interest, to controlling directors, may not be challenged, absent fraud, where it is not shown that the corporation might have profited to an extent

267 Davies v. Meisenheimer, 254 Wis. 419, 37 N. W. 2d 93; 3 Fletcher, Cyclopedia, Corporations, § 955.

268 Garrison Canning Co. v. Stanley, 133 Iowa 57, 110 N. W. 171 (1907); Felsenheld v. Block Bros. Tobacco Co., 119 W. Va. 167, 192 S. E. 545, 123 A. L. R. 334 (1937); Shaw v. McShane, 50 S. W. 2d 278, 282 (1932).

269 Backus v. Finkelstein, 23 F. 2d 357 (D. Minn., 1927).

270 Milam v. Cooper Co., Inc., 258 S. W. 2d 953 (Tex. 1953).

271 Bailey v. Jacobs, 325 Pa. 187, 189 Atl. 320 (1937).

greater than the interest paid from the investment of such funds elsewhere.[272]

Statutes: About half the states have statutes pertaining to loans by corporations. These statutes vary considerably. Some prohibit loans to directors and officers; some to stockholders; others to both. The prohibition may not be absolute: loans may be permissible if specified conditions are met. Some provide rights of action to creditors; others to the corporation; still others to both. Statutory provisions granting rights (e.g., to corporations) may be extended (to creditors) by judicial interpretation. Courts may differ in their opinions as to what constitutes a "loan."[273] It is evident, accordingly, that regard must be had to the law—statute and decisional—of the particular state whose law is applicable to answer questions raised in a given situation. Indeed the law of more than one state may be involved. New York courts, for example, will require adherence to the New York statute with respect to unlawful loans by foreign corporations transacting business in that state,[274] and will also enforce the statutes of the foreign state where applicable.[275]

The differences between the statutes may be exemplified by comparison of the New York and Delaware laws. New York prohibits loans to "stockholders";[276] Delaware prohibits loans to "directors and officers."[277] In New York, directors or officers making or assenting to the loan are liable to the extent of the loan and interest for all corporate debts contracted prior to repayment; the statute is not clear whether repayment of the loan terminates liability, but a lower court case has recently held that it does.[277a] In Delaware, officers making or assenting to the loan are liable "until the repayment of the sum loaned with interest." In New York only creditors—and not stockholders—may enforce the liability.[278] In Delaware, a stockholder's derivative action to recover the amount loaned on behalf of the corporation is authorized.[279] Since "assent" to the loan is required for

272 Felsenheld v. Block Bros. Tobacco Co., 119 W. Va. 167, 192 S. E. 545 (1937).

273 See "General Effect of Statutes Prohibiting Corporate Loans to Directors, Officers and Stockholders," 48 MICH. L. REV. 213 (1949).

274 New York Stock Corporation Law, § 114.

275 Braman v. Westaway, not officially reported, 60 N. Y. S. 2d 190 (1945).

276 New York Stock Corporation Law, § 59.

277 Delaware Corporation Law, § 143.

277a Storer v. Ripley, 171 N. Y. Supp. 2d 14 (1958).

278 Flexner v. B. T. Babbitt, Inc., 290 N. Y. 604 (1943); Stolz v. Ginsberg, 217 App. Div. 70, 215 N. Y. S. 927 (1926), *aff'd,* 245 N. Y. 519; Walters v. Spalt, 80 N. Y. S. 2d 681 (1948); *cf.,* Murray v. Smith, 224 N. Y. 40 (1918).

279 Maclary v. Pleasant Hills, 109 A. 2d 830, 836 (Del. Ch. 1954); National Lock Co. v. Hogland, 101 F. 2d 576 (7th Cir., 1939).

liability under the statute, it appears that an officer or director who took no active part in the management and did not know of the loan is not liable thereunder.[280] However, lack of knowledge of the statutory prohibition is immaterial.[281]

Liability under statutes is absolute despite good faith and due care. On the other hand, as already indicated, breach of fiduciary principle will invoke liability even in the absence of statute or where the precise terms of the statute are inapplicable. And the remedies of creditors, applicable generally, may, in the absence of statute, be available if the "loan" made is really in the nature of a withdrawal (e.g., is not fully secured) *and* creates insolvency, or is made when the corporation is insolvent. The statutes were doubtless intended to add to the protection of creditors and stockholders against diversion and misuse of corporate funds. The diversity of the statutes and their interpretation have, however, produced a veritable legal jungle. The field is one which is ripe for re-evaluation and the general adoption of a uniform statute.

XIII. Minority-Stockholder Suits

The liability of directors and officers for dereliction of duty is normally a liability running to the corporation, but, since those who may have been derelict continue, frequently, to remain in control of the corporation and are not likely to bring action against themselves, it is generally left to minority stockholders to seek appropriate redress. In a minority-stockholder's action, the corporation, though the real party plaintiff in interest, becomes a nominal defendant, and relief in its favor against the other defendants is requested. Because of the need for such procedure, which did not fit the form of "legal actions," the minority-stockholder's suit, even if it sought merely the recovery of damages, and equitable relief in a substantive sense was not required, became cognizable only in equity: the suit has been called an "invention of equity."[282] The stockholder acts in default of action by the corporation, to set the "machinery of justice in motion."[283]

280 Murray v. Smith, *supra,* note 278.

281 Maclary v. Pleasant Hills, *supra,* note 279.

282 Koster v. Lumberman's Mutual Casualty Co., 330 U. S. 518 (1947). The suit appears to have been used initially in the cases of Hichens v. Congreve, 4 Russ. 562, 38 Eng. Rep. 917 (Ch. 1828), and Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843). See Hays, *A Study in Trial Tactics: Derivative Stockholders' Suits,* 43 Col. L. Rev. 275 (1943).

283 Chaplin v. Selznick, 186 Misc. 66, 58 N. Y. S. 2d 453 (1945).

The corporation which is to receive the proceeds of the recovery, if any, is a necessary party to the suit.[284] Though this requirement may, in a case, for example, where delinquent directors or officers are not available for suit in a jurisdiction in which the corporation does business, prejudice the possibility of effective action,[285] efforts to correct this situation[286] have not been successful.

Where a majority or more of the directors of a corporation are involved in the alleged dereliction, it is recognized that it would be futile for a minority stockholder to demand that the corporation bring suit, and accordingly such demand is unnecessary.[287] Otherwise a demand is necessary, and the stockholder may then sue only if (1) the demand is refused and (2) the refusal is not "based upon the exercise of reasonable discretion,"[288] or is due to bad faith, or because the board was subjected to improper control or was not otherwise in a position to exercise fair and independent judgment.[289] Thus an independent majority of directors, acting in good faith and exercising reasonable business judgment, may foreclose a suit by a minority stockholder even though the substantive basis for the proposed action is meritorious.[290]

284 Noel Associates, Inc. v. Merrill, 184 Misc. 646, 53 N. Y. S. 2d 143 (1944); Bachrach v. General Inv. Corp., 29 F. Supp. 966 (S. D. N. Y. 1939); White v. British Type Investors, 130 N. J. Eq. 157, 21 A. 2d 681 (1941).

285 See Freeman v. Bean, 243 App. Div. 503, 276 N. Y. Supp. 310 (1st Dept., 1934), *aff'd*, 266 N. Y. 657, 195 N.E. 368 (1935). In the federal courts, by specific statute, 28 U. S. C. A. § 112, a stockholders' suit may be brought in any district in which the corporation, as plaintiff, might have brought suit, and in such case the corporation, though not doing business in the jurisdiction, may be brought in as a party defendant. This statute obviates part of the problem since, under it, the directors may be sued where they reside, though the corporation is non-resident. But it obviates the problem in part only, since the plaintiff stockholder would have to be a non-resident to create the necessary diversity of jurisdiction. *Cf.*, Philipbar v. Derby, 85 F. 2d 27 (2d Cir. 1936).

286 41 Col. L. Rev. 548.

287 Craftsman Finance Co. v. Brown, 64 F. Supp. 168 (S. D. N. Y. 1945); Loew v. Interlake Iron Corp., 270 App. Div. 858, 60 N. Y. S. 2d 772 (1946).

288 Koral v. Savory, 276 N. Y. 215, 218 (1937).

289 J. C. F. Holding Corp. v. General Gas & Electric Corp., 181 Misc. 283, *aff'd*, 267 App. Div. 863 (1944); Kessler & Co. v. Ensley Co., 129 Fed. 397, 408-9 (C. C. N. D. Ala., 1904).

In Massachusetts the stockholder has the additional burden, prior to bringing suit, of resorting to the body of stockholders at a stockholders' meeting and putting the matter whether or not suit should be brought to the stockholders' vote, unless he can show that the majority of voting shares is under the control of the alleged wrongdoers. See Carroll v. New York, New Haven & Hartford R. R., 141 F. Supp. 456 (D. Mass., 1956); 55 Mich. L. Rev. 450 (1957).

290 Hornstein v. Paramount Pictures, 37 N. Y. S. 2d 404, *aff'd*, 266 App. Div. 659, *aff'd*, 292 N. Y. 468 (1944); Clifford v. Metropolitan Life Ins. Co., 264 App. Div. 168, 34 N. Y. S. 2d 693 (1942); S. Solomont & Sons Trust, Inc. v. New England Theatres

This latter principle would appear to have limited application, however. Where the dereliction of the officers or the minority of directors consists of fraudulent diversion of corporate funds for their personal benefit, it is doubtful that the judgment of the presumably independent majority of directors not to sue would conclude the minority stockholder.[291] In *Epstein* v. *Schenck*,[292] the court pointed out that the contention that the refusal by directors, absent their misconduct, to bring suit, precluded the plaintiff stockholder, was "not entirely sound"; that there might well be cases where "notwithstanding the honest and deliberate determination of a governing body, judicial interference in a representative suit is justified"; that where there was a "clear cause of action," the refusal to enforce it may "constitute a breach of trust on the part of the directors"; and where there was such clear cause to recover "from certain persons who have received corporate funds to which they are not entitled, it is no answer on the part of the directors that they deemed it inexpedient to bring the action."

The above case—in which the court held that the failure to bring suit did not subject the directors to personal liability, and, on the other hand, did not bar the plaintiff from bringing suit—walks a legal tightrope. In effect the court held that the directors had abused their discretion, and the minority stockholder was not precluded; but the abuse was not so flagrant in the particular case as to warrant the imposition of liability upon the directors therefor.

While the above case represents an effort to qualify a principle which serves to limit access by minority stockholders to the courts, in general the courts and legislatures, reflecting the business and financial communities' distaste for the minority stockholder's suit, have seemingly combined to impose restrictions upon it—the direction of the effort being only occasionally relieved by a more "liberal" court decision. The primary areas in which these restrictions have been imposed are those involving the statute of limitations and those which

Operating Corp., 326 Mass. 99 (1950); Noble v. Farmers Union Trading Co., 123 Mont. 518, 216 P. 2d 925 (1950); Swanson v. Traer, 249 F. 2d 854 (7th Cir., 1958).

291 See Fleishhacker v. Blum, 109 F. 2d 543 (9th Cir., 1940), cert. den. 311 U. S. 726; Red Bud Realty Co. v. South, 96 Ark., 381, 131 S. W. 340 (1910); Shaw v. Straight, 107 Minn. 152, 119 N. W. 951 (1909). Compare, however, cases of claims involving *former* directors, where apparently the court is willing to abide by the judgment of the present directors. Rice v. Wheeling Dollar Savings & Trust Co., 130 N. E. 2d 442 (Ohio, 1954); Kessler v. Ensley, 123 Fed. 546 (C. C. N. D. Ala., 1903).

292 35 N. Y. S. 2d 969 (1939).

impose burdensome financial requirements upon the small stockholder as a condition to his prosecution of such suit as he may bring. Because of the prominence of New York as the financial capital of the country, the stockholders' action has tended to center in that state,[293] and our discussion of the trend noted above may, conveniently, be limited to the decisions handed down and the legislative action taken there.

Statutes of Limitation: When the corporation itself brings suit, it is, and always was, governed by the limitations statute applicable to the type of suit brought, i.e., whether at law for negligence ("injury to property") or money had and received ("contract"), etc., in which case the statute applicable to all such actions would govern, or for equitable relief, in which case the longer—ten-year—statute applied.[294] As already indicated, however, the stockholders' suit was necessarily in equity, and prior to 1937, it was assumed that the ten-year limitation statute applied to such suits.[295] However, in *Potter* v. *Walker*,[296] the court said that the statute which should govern the stockholders' suit should be that which would have applied had the corporation itself commenced the action. It held that the statutes applicable were six years where the cause was based on negligent "injury to property" (reduced to three years by a 1936 amendment to the Civil Practice Act[297]); six years where based on a "contract obligation or liability express or implied"[298]—which covered "money had and received"; and ten years[299] where "an accounting is necessary." Such accounting was deemed necessary where the suit was to recover profits made by directors and such profits were in excess of the damages sustained by the corporation by the directors' wrongdoing.[300] A situation where the "profits" were the same as the corporation's loss, and not in excess, would be one in which, e.g., fiduciaries acquire property for purpose of reselling same to corporation at an inflated price. The "profit" was money "had and received," and the six-year statute was applicable.[301]

293 See Hays, *supra*, note 282, at p. 277.

294 N. Y. CIV. PRAC. ACT, §§ 48, 49, 53. See 56 COL. L. REV. 106.

295 O'Brien v. Fitzgerald, 143 N. Y. 377, 382 (1894); Mason v. Henry, 152 N. Y. 529, 535 (1897).

296 276 N. Y. 15 (1937). See House, "Early Exoneration for Delinquent Directors in New York," 46 COL. L. REV. 377 (1946).

297 Sec. 49, subd. 6.

298 N. Y. CIV. PRAC. ACT, § 48, subd. 1.

299 N. Y. CIV. PRAC. ACT, § 53.

300 Goldstein v. Tri-Continental Corp., 282 N. Y. 21 (1939); Mencher v. Richards, 283 N. Y. 176 (1940); Dunlop's Sons, Inc. v. Spurr, 285 N. Y. 333 (1941).

301 Frank v. Carlisle, 261 App. Div. 13, *aff'd*, 286 N. Y. 586 (1941).

A situation where profits might exceed the loss to the corporation and the ten-year statute was applicable, was where directors organize a competing business and take for themselves opportunities to profit that belong to the corporation.[302]

The courts having thus revamped in favor of fiduciaries the law of limitations applicable to stockholders' suits, the Legislature carried the process a step further. By amendments to the Civil Practice Act in 1942, it was provided that in actions against directors and officers for accounting or fraud, or to enforce a liability at common law or by statute, the six-year statute applied,[303] but if the action was to recover for waste or injury to property, the three-year statute governed.[304]

It may be argued that, where the action is to impress a trust upon stock or other assets in the hands of wrongdoing fiduciaries, the ten-year statute is still applicable, since more than an accounting is required, and "equity's aid is demanded."[305] But the cases cited applied rules applicable prior to the 1942 amendment, and it appears that as to *directors and officers*—though not others, to whom the ten-year statute may still be applicable—the six-year statute will be applicable in this situation.[306]

Judge Rifkind summed up the situation when he said:

"The recent history of the law of limitations in New York has squeezed the stockholder into an ever narrower time vise."[307]

Security for Corporate Expenses: It should first be noted that the expenses of a corporation in a minority stockholders' suit are not limited to those incurred directly on its behalf. Even in the absence of statute, some courts, on the ground of "policy" or a belief that it was only "just," had held that directors and officers, who successfully vindicate their conduct in defending such suit against them, might obtain reimbursement of their expenses from the corporation.[308] New

302 Sialkot Importing Co. v. Berlin, 295 N. Y. 482 (1946).

303 N. Y. Civ. Prac. Act, § 48, subd. 8.

304 N. Y. Civ. Prac. Act, § 49, subd. 7. Where directors and officers use corporate funds to relieve themselves of personal obligations, the action is for money had and received, and is governed by the six-year statute. Croen v. Gottlieb, 166 N. Y. S. 2d 278 (1957).

305 Coane v. American Distilling Co., 298 N. Y. 197 (1948); McLear v. McLear, 291 N. Y. 809 (1944).

306 Augstein v. Levey, 3 App. Div. 2d 595, 162 N. Y. S. 2d 269, 274 (1957); Gottfried v. Gottfried, 269 App. Div. 413, 418, 56 N. Y. S. 2d 50, 55 (1945).

307 Truncale v. Universal Pictures Co., 76 F. Supp. 465, 467 (S. D. N. Y., 1948).

308 Figge v. Bergenthal, 130 Wis. 594, 625 (1907); Solimine v. Hollander, 129 N. J.

York and other states, however, had denied reimbursement on the grounds that the successful defense of the suit conferred no "benefit" upon the corporation and that the possibility of suit was one of the hazards assumed by directors in taking office.[309] Many states—New York included—now have statutes providing for reimbursement, except where the defendants are adjudged liable for misconduct or negligence. Most of such statutes merely confer upon the corporation the power to indemnify.[310] A New York statute authorizes a corporation, by its certificate of incorporation or by-laws, to provide for reimbursement.[311] Beyond that, and independent of such provisions, other New York statutes provide for court-ordered reimbursement,[312] where the director or officer is "successful in whole or in part," or where the action "has been settled with the approval of the court,"[313] but not where the director or officer is "adjudged" liable for negligence or misconduct.[314]

Thus, when a stockholder brings suit, the corporation may, if the

EQ. 264 (1941). See generally Annotation, 152 A. L. R. 909, 922-8; see also Mooney v. Willys-Overland Motors, Inc., 204 F. 2d 888, 899 (3rd Cir., 1953); Washington, "Litigation Expenses of Corporate Directors in Stockholders' Suits," 40 COL. L. REV. 431 (1940).

309 New York Dock Co. v. McCollum, 173 Misc. 106, 16 N. Y. S. 2d 844 (1939); Griesse v. Lang, 37 Ohio App. 553 (1941).

310 63 YALE L. J. 253, 254.

311 General Corporation Law, § 63. See Jervis, "Corporate Agreements to Pay Directors' Expenses in Stockholders' Suits," 40 COL. L. REV. 1193, 1199-1200 (1940).

312 General Corporation Law, §§ 64-68.

313 General Corporation Law, § 67.

314 General Corporation Law, § 64. Under this section it has been held that where it is found that defendant is guilty of misconduct, such finding satisfies the term "adjudged," and reimbursement must be denied even though the complaint is dismissed because the plaintiff stockholder is estopped to complain, by reason of knowledge, ratification and participation. Diamond v. Diamond, 307 N. Y. 263 (1954)—a four-to-three decision. Reimbursement has also been denied in a situation in which directors were named as defendants only for procedural purposes, no relief was sought from them, and it appeared that they actually joined in the prosecution of the action. In such case, their expenses were not incurred "in connection with the defense of such action," as required by the statute. Warnecke v. Forty Wall St. Building Inc., 183 N. Y. S. 2d 925 (1959). It should also be noted that the statutes providing for court-ordered reimbursement are inapplicable where the director or officer defends himself successfully against criminal charges arising from his corporate conduct. Matter of Schwarz v. General Aniline & Film Corp., 305 N. Y. 395 (1953). This latter ruling, it seems, would not preclude a corporation from authorizing reimbursement in criminal actions, by charter or by-law provision. *Id.*, at 405. And it may be urged that, even at common law, the right of reimbursement in such cases exists, on the theory that an agent is entitled to reimbursement for expenses incurred in carrying out the policies of his principal. See Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N. Y. S. 2d 270, *aff'd*, 267 App. Div. 890, 47 N. Y. S. 2d 589 (1st Dept., 1944); Bishop, Current Status of Corporate Directors' Right to Indemnification, 69 HARV. L. REV. 1057, 1075 (1956).

suit is not successful, incur not only expenses related to its limited role in such suit, but expenses arising out of its liability to reimburse the successful directors and officers. Such expenses, which of course include legal fees, may be considerable.

In 1944 the New York legislature enacted a statute providing that if the plaintiff stockholder or stockholders own less than five per cent of a class of stock, then, unless the shares have a market value in excess of fifty thousand dollars, the corporation is entitled to require the plaintiffs to provide security for the expenses it may incur, including counsel fees.[315] The security required to be furnished, upon application by the corporation, is designed, of course, to cover not merely the corporation's probable direct expense but the expense which the corporation may incur through reimbursement to defendant directors and officers, should the suit fail.[316]

It should be observed that the statute strikes only at the small stockholder. Stockholders meeting the statutory requirements may not be required to post security for expenses. Such stockholders, even if their suits should fail, may not (except for usual court costs) be required to pay the expenses incurred by the defendants in their defense.[317] The patent discrimination against the small stockholder was thought to be justified by the then not uncommon practice of private and secret settlement of stockholders' suits, by which the stockholder received payment for its discontinuance and the corpora-

[315] General Corporation Law, § 61-b. Other states soon followed suit, e.g., New Jersey (N. J. Stat. Ann. [Supp. 1946] tit. 14, §§ 3-15, added by N. J. Laws 1945, c. 131; see Cohen v. Beneficial Loan Corp., 337 U. S. 541 [1949]), Pennsylvania (Pa. Laws 1945, Act, No. 114), Maryland (Md. Stats., § 195, Art. 16, as amended by Stats. 1945, c. 989). The statutes apply to actions in the federal courts pending in such courts because of diversity of citizenship, but not to causes setting forth a federal question as a basis for federal jurisdiction. Fielding v. Allen, 181 F. 2d 163 (2d Cir., 1950), cert. den. 340 U.S. 817 (1950). It has been held that these statutes are ineffective in actions pending outside the state in which the statute was enacted, though the corporation involved was organized under the laws of that state. Berkwitz v. Humphrey, 130 F. Supp. 142 (N. D. Ohio, 1955).

[316] Lapchak v. Baker, 298 N. Y. 89, 80 N. E. 2d 751 (1948). It should be observed that only directors and officers may obtain reimbursement, and not, e.g., a parent company which may be named as a defendant. Accordingly, if such parent company alone is the defendant and directors or officers are not named as such, the security required would only cover the expenses of the corporation on behalf of which the suit is brought, and since the corporation is theoretically in a neutral position, its expense should be—and the security required would be—small. Fuller v. American Machinery & Foundry Co., 91 F. Supp. 710 (S. D. N. Y. 1950).

[317] The court may direct that the expenses be paid only out of the security furnished (Berger v. Ewing, 12 N. Y. L. J. 651, Feb. 21, 1949); and no security may be required of stockholders who meet the statutory requirements.

tion received nothing.[318] This was regarded as an "evil" whose suppression was rightful, and since the substantial majority of stockholders' suits were brought by small stockholders, the statute was directed to them.[319] The statute will forever remain a monument to misconception, since in no respect does it touch the "evil" of private settlement.[320] Such "evil" as inhered therein arose not merely from the questionable purposes of the stockholder bringing suit, but from the fact that faithless directors, facing large personal liability, were tempted to enter into a secret bargain with the stockholder as a way out.[321] But the statute strikes at *prosecution of the suit* by the small stockholder: it is not directed against connivance between the parties to effect a private and secret settlement.[322]

The strictures of the statute have to some extent been mitigated by court rulings that a plaintiff, directed to post security, be afforded the opportunity of seeking the joinder of additional plaintiffs sufficient to meet the statutory requirements. If such efforts are successful, the order requiring security will be vacated.[323] And, although a 1944 statute changed New York law so as to require that it appear that

318 Such private settlements were not prohibited. Manufacturers Mutual Fire Ins. Co. v. Hopson, 176 Misc. 220, 25 N. Y. S. 2d 502, *aff'd,* 262 App. Div. 731, 29 N. Y. S. 2d 139, *aff'd,* 288 N. Y. 668 (1941); see also Bernheim v. Wallace, 186 Ky. 159, 217 S. W. 916 (1920); White v. British Type Investors, Inc., 130 N. J. Eq. 157, 21 Atl. 2d 681 (1941); but *cf.,* Lewin v. N. Y. Ambassador, Inc., 189 Misc. 181 (1947). A private settlement would, of course, not bar suits by other stockholders, on behalf of the corporation. Manufacturers Mutual Fire Ins. Co. v. Hopson, *id.*

319 Its constitutionality was upheld in Lapchak v. Baker, *supra,* note 316. *Cf.,* Zlinkoff, The American Investor and the Constitutionality of Section 61-B of the New York General Corporation Law, 54 Yale L. J. 288 (1945).

320 Private settlements may, however, have been discouraged, at least indirectly, by the decision in Clarke v. Greenberg, 296 N. Y. 146 (1947), which holds that the proceeds of such settlement may, in a subsequent suit, be impressed with a trust in favor of the corporation, on the theory that since the settled suit had been brought on behalf of the corporation, it is entitled to the proceeds of the settlement. See also Young v. Higbee Company, 324 U. S. 204 (1945). It should be noted, however, that the efficacy of such proceeding, as in Clarke v. Greenberg, is dependent upon discovery; and the settlement may not only be private but secret, particularly in jurisdictions like New York where actions may be commenced and even maintained for some time, and then settled, without filing any papers.

321 See dissenting opinion of Judge Fuld in Gordon v. Elliman, 306 N. Y. 456, 479-80 (1954).

322 In the federal courts, a private settlement may not be effected because the complaint is required to be filed at the outset and, under Rule 23(c) of the Federal Rules of Civil Procedure, a stockholder's suit may not be "dismissed or compromised without the approval of the court" after notice to stockholders "in such manner as the court directs."

323 Baker v. MacFadden Publications, 300 N. Y. 325, 90 N. E. 2d 876 (1950); Neuwirth v. Wyman, 119 N. Y. S. 2d 266 (1953).

the plaintiff bringing suit "was a stockholder at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law,"[324] it has been held that the additional stockholders who join the plaintiff to meet the 5% or $50,000 requirements need not have held their stock at the time of the transaction.[325] These rulings may suggest that the courts apply the statute only reluctantly and in a fashion to reduce its hardship. But there is no consistent pattern. Comparatively recently the Court of Appeals, in a four-to-three decision, held that the statute, by its terms applicable only to actions "in the right of" the corporation, applied to an action by a stockholder to compel the declaration of dividends.[326]

Court-Approved Settlements

Like defendants in any litigation, directors and officers may offer to compromise the claims asserted against them in a minority stockholders' suit. As a practical matter, after due negotiation, a

[324] General Corporation Law, § 61; see Myer v. Myer, 296 N. Y. 979 (1947). This rule conforms with Fed. Rules of Civ. Proc. § 23(b). Before the amendment, the time when the plaintiff acquired his stock was immaterial. Pollitz v. Gould, 202 N. Y. 11, 94 N. E. 1088 (1911).

[325] Perry v. Shahmoon Industries, 172 N. Y. S. 2d 245 (1958). Noel Associates v. Merrill, 184 Misc. 646, 655, 53 N. Y. S. 2d 143 (1944); Fuller v. American Machine & Foundry Co., 95 F. Supp. 764 (S. D. N. Y. 1951). But see Richman v. Felmus, 182 N. Y. S. 2d 210 (1958). *Contra* (re Federal courts): Kaufman v. Wolfson, 136 F. Supp. 939 (S. D. N. Y. 1955); Elkins v. Bricker, 147 F. Supp. 609 (S. D. N. Y. 1956).

[326] Gordon v. Elliman, *supra,* note 321. The majority reasoned that the action was "in the right of" the corporation, since it involved charges of misconduct against directors relating to their duties to the corporation, viz., to see to it that the corporation operated under a suitable dividend policy. The dissenting opinion pointed out that the suit was *against* the corporation based upon the stockholders' implied contract right to receive dividends if the corporation's condition warranted it; that this was a matter to be determined in the directors' discretion, abuse of discretion creating a right in the stockholder to sue the corporation; and that if the stockholder was successful, the corporation would part with funds, not receive any. The dissenting opinion also stated that the policy of § 61-b was not involved since the action did not seek to hold the directors personally liable and they would not be tempted to buy off the plaintiff.

It may be observed that in making the last statement, the dissenting opinion accepted, unquestioningly, the supposed policy considerations prompting the enactment of § 61-b, viz., that it was directed against private settlements. As already indicated, while those policy considerations were given lip-service at the time, the connection between them and the statute as enacted is nebulous. Accordingly, the statement in the dissenting opinion that the directors would not be tempted to make a private deal scarcely advances the argument that § 61-b is inapplicable.

These criticisms are not intended to detract from the other arguments made in, and the conclusions of, the dissenting opinion, with which the author agrees.

In Knapp v. Bankers Securities Corp., 230 F. 2d 717 (3rd Cir., 1956), the Court refused to follow the reasoning of Gordon v. Elliman, and ruled that the security for costs statute (Pa.) was inapplicable to an action to compel declaration of dividends.

stipulation or agreement embodying proposed settlement terms is signed by the parties, including the corporation for whose benefit the suit is brought, and submitted to the court for approval. Normally, i.e., where the corporation is represented by disinterested directors, and they act in good faith and exercise their business judgment reasonably, an acceptance by a corporation of the terms of settlement of an action would conclude minority stockholders. But a minority stockholders' suit presupposes that there is no majority of disinterested directors, and the agreement of settlement made therein is in effect only the vehicle of advising the court of the precise terms offered by the allegedly wrongdoing defendants and of the fact that the plaintiff stockholders, who presumably are most conversant with the claims in suit and the prospects of recovery thereon, recommend approval of the proposed settlement.

Under the federal rules the court, prior to approval, is required to direct that notice be given stockholders of the proposed settlement.[327] State courts, to which settlement agreements are submitted for approval, also provide for such notice. This serves the purpose of affording stockholders, in addition to plaintiffs, the right to be heard, and serves as well the function of giving to the court the benefit of such further information, i.e., in addition to that which plaintiffs and defendants may furnish, bearing on the issues as they may have.[328] The court's duty, in connection with its determination whether or not to approve a settlement, is to protect the rights and interests of the corporation,[329] and such duty, of course, is not fulfilled by routine approval, but requires investigation into the facts and the applicable law. The court may, and frequently does, appoint a Special Master or Referee to make an initial investigation and recommendation, and may, and frequently does, defer notice to stockholders until affirmative recommendation is made.[330]

"The role of the court is to see that the compromise is fair and reasonable under the circumstances and that no collusion or fraud has been practiced in the consummation of the settlement. To do this the court must weigh the probabilities and possibilities of victory or

327 Federal Rules of Civil Procedure, Rule 23(c). This practice has developed in New York despite the absence of any mandatory requirement. *Cf.* Rule 8, N. Y. Rules of Civil Practice.

328 Cohen v. Young, 127 F. 2d 721, 725 (6th Cir., 1942).

329 *Ibid.;* Whitten v. Dabney, 171 Cal. 621, 632 (1915).

330 See Manufacturers Mutual Fire Ins. Co. v. Hopson, 176 Misc. 220, 25 N. Y. S. 2d 502, *aff'd,* 262 App. Div. 731, 29 N. Y. S. 2d 139, *aff'd,* 288 N. Y. 668 (1941).

defeat as indicated by the legal or factual situation presented."[331] This is not to say, however, that the court's inquiry must be as exacting as that involved where it is required to make a decision on the merits. "In weighing the benefits held forth by the agreement of settlement against benefits dependent on the likelihood of recovery upon the plaintiffs' cause of action, the courts cannot be expected to balance the scales with the nicety of an apothecary. The very object of a compromise 'is to avoid the determination of sharply contested issues.' "[332] Courts, in general, look favorably upon settlements of controversies,[333] for very practical reasons: "It is one thing to assert a claim and another thing to prove a claim to judgment. Furthermore, it is one thing to obtain a judgment, and quite another thing to collect it. Figures, however imposing, should not compel practical considerations to yield place to visions."[334] An appeals court will generally abide by a trial court's determination as to the fairness and adequacy of a settlement, unless there are no facts in dispute and the rules of law urged by an objector[335] are so clearly correct that approval constituted an abuse of discretion.[336]

XIV. CONCLUSION

THE exploration of the sensitive areas of the relationships between directors and officers, on the one hand, and their corporations and stockholders, on the other, here essayed, has had as its object, as indicated at the outset, the statement of applicable basic principles, but more particularly an interpretive analysis of current trends.

As the foregoing discussion indicates, there is a clearly discernible

331 Winkelman v. General Motors, 48 F. Supp. 490, 493 (S. D. N. Y. 1942); Fielding v. Allen, 99 F. Supp. 137 (S. D. N. Y. 1951); Neuberger v. Barrett, 39 N. Y. S. 2d 575 (1942).

332 Shielcrawt v. Moffett, 59 N. Y. S. 2d 619, 621 (1945); *In re* Prudence Co., 98 F. 2d 559, 560 (2d Cir., 1938), cert. den. 306 U. S. 636, 59 S. Ct. 485 (1938).

333 Williams v. First National Bank, 216 U. S. 582, 585, 54 L. Ed. 625, 631 (1910); Post v. Buck's Stove & Range Co., 200 Fed. 918 (8th Cir., 1912).

334 Karasik v. Pacific Eastern Corp., 180 Atl. 604, 609 (Del. 1935); Denicke v. Anglo California National Bank, 45 F. Supp. 524, *aff'd,* 141 F. 2d 285 (9th Cir.), cert. den. 323 U. S. 739, reh. den. 323 U. S. 816 (1944); *In re* Riggi Bros. Co., Inc., 42 F. 2d 174 (2d Cir. 1930).

335 Since all parties to the action normally recommend the settlement, the objector, if any, is usually a stockholder who has appeared in response to a notice. In one case, however, the settlement was proposed by the defendants, and approved by the court over the objections of the plaintiff. Denicke v. Anglo California National Bank. *Id.*

336 *In re* Prudence Co., Inc., *supra,* note 332; see Upson v. Otis, 155 F. 2d 606 (2d Cir., 1946), where the court said that (p. 612) "the liability of the individual defendants was indubitable and the amount of recovery beyond doubt greater than that offered in the settlement."

trend toward relieving directors and officers from liability, not merely by contracting substantive principle under which were formerly subsumed situations deemed liability-creating, but by diminishing periods of limitation and making the prosecution of minority stockholders' suits more burdensome. Standing almost alone against this trend is § 16(b) of the Securities Exchange Act of 1934 (with respect to "short-swing" profits), and the cases thereunder.

At the core is a conflict of philosophical principle—a clash between, on the one hand, those who, like Justice Cardozo, have insisted upon the highest standards of behavior from those entrusted with other people's money, and would deplore the contraction of sanctions against the violation of those standards, and, on the other hand, those who feel that individuals undertaking to guide the destiny of corporations require safeguards against the possibility of limitless attacks, the bases of which may be, and frequently are, dubious, and the purposes of which may be, and frequently are, ulterior, and who tend to view sympathetically the plight even of those fiduciaries who may have slightly strayed. Much may, of course, depend on a conscious or unconscious identification, for whatever reasons, with either those whose interests may have been betrayed or those against whom charges may be directed.

But for the student and the lawyer whose attention may be directed to problems in this field it may be less important (though by no means unimportant) to examine into subjective bases for trends, or counter-trends, than to be aware of their existence and become more appreciative of the delicate distinctions upon which decisions may turn. If this article contributes to such awareness and appreciation, it shall have served its purpose.