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## STOCKHOLDER'S RIGHT TO SUE FOR WRONGS TO CORPORATION COMMITTED PRIOR TO HIS ACQUISITION OF STOCK

BY JAMES T. KROCK, '23

It is a well-accepted principle of law that a stockholder has, with certain limitations, a right to sue for transactions against the corporation. The books are replete with decisions upon this point based upon the reasoning that stock in a corporation is personal property and an injury to such property gives rise to a cause of action. Before discussing the matter at hand it might be well to review, somewhat, the law upon this subject.

Generally speaking, the primary right to sue rests with the corporation, that the corporation is the proper party to bring suit to redress a wrong committed against it.<sup>1</sup> This is obvious by reason of the fact that a corporation being a separate, distinct entity,<sup>2</sup> an artificial being constructed by law, owns its property and is subject to a degree to the same liabilities and has the same rights as a human person.

However, due to the fact that the mind of the corporation, the *animus contrahendi*, if you will, is composed of more than one person, namely, the directors, officers and stockholders, the human element crept in and made necessary a modification of the rule. Cases arose where the incentives of the governing body were antagonistic to, or to say the least, in conflict, with the rights of the corporation, for instance, where a rival corporation has obtained a majority of stock in another corporation, elected a board of directors of its own choosing and then sought to take advantage of the other corporation. Certainly the corporation thus imposed upon would have the right to sue; but the question is, who would bring the suit?

The law, in its wisdom, has adapted itself to meet this situation by allowing a suit to be brought, in behalf of the corporation, by a stockholder. As a prerequisite to the bringing of such an action, it is necessary for the stockholder to make a demand upon the corporation<sup>3</sup> unless such a demand is shown to be useless or futile.<sup>4</sup> Some states hold that a demand upon the directors is sufficient,

<sup>1</sup> *Elmergreen vs. Weimer*, 138 Wis. 112.

*Dousman vs. The Wisconsin and Lake Superior Mining and Smelting Co.*, 40 Wis. 418.

<sup>2</sup> *Button vs. Hoffman*, 61 Wis. 20.

<sup>3</sup> *Elmergreen vs. Weimer*, 138 Wis. 112.

<sup>4</sup> *Eschweiler vs. Stowell*, 78 Wis. 316.

while others contend that a demand must also be made upon the stockholders. It is also generally held that the corporation be made a party defendant to the suit.<sup>3</sup>

In thus working out the problem the courts have proceeded on the theory that actions by the corporation are actions resting primarily on the fundamental right to redress a wrong and as such, are cognizable at law.<sup>5</sup> In allowing a stockholder to sue, the decisions rest upon the equitable principle that "equity regards as done that which ought to be done." So where wrongs have been done to the corporation the right to sue rests primarily with the corporation in a suit at law, whereas, when the corporation refuses to act and the stockholder sues the action is in equity.<sup>6</sup> Furthermore, where there is a wrong which peculiarly affects the stockholder, where it is a wrong to himself personally apart from the wrong to the corporation, equity allows the stockholder to bring an action and allows him to bring it also in behalf of all others similarly situated.<sup>6</sup>

Thus we are brought to the crux of the situation, to the precise question involved in this article, namely, "Where a stockholder acquires stock subsequent to the time when the transactions complained of were committed, may he sue because of such wrongs?"

This is a debatable question, one which has perplexed the courts of various states and courts of federal jurisdiction. The courts of the United States have settled it in one way, which decisions some state courts have followed as precedent while by others they have been rejected. The supreme court of Wisconsin has never been called upon to decide the question. It is not for us to decide or to settle that which has puzzled the minds of some of the greatest justices; but we can review the authorities and there see before us the combined effect and the reasoning that caused it, from which we can draw our own conclusions.

Although the number of decisions upon this point is comparatively small, nevertheless it will be found that there is a clean-cut division in the authorities. On the one hand are found the decisions of the federal courts with the decisions of the state courts which have followed the federal rule; on the other, the decisions of the state courts which have refused to follow the

<sup>5</sup> *Converse vs. United Shoe Mchy. Co.*, 185 Mass. 422, 70 N. E. 444.

<sup>6</sup> *Dousman vs. The Wisconsin and Lake Superior Mining and Smelting Co.*, 40 Wis. 418.

*Converse vs. United Shoe Mchy. Co.*, 209 Mass. 539, 95 N. E. 929.

federal rule. Wisconsin, as has been said before, has not ruled upon the question.

The point was first raised in the United States Supreme Court in the case of *Hawes vs. Oakland*.<sup>7</sup> In that case the plaintiff was a stockholder in the Contra Costa Waterworks Co., a California corporation. The plaintiff was a citizen of New York and he brought a bill in equity in behalf of himself and all others similarly situated, against the company, the directors, and the City of Oakland to correct an alleged injury and to obtain relief therefrom. The complaint did not state that the plaintiff owned stock prior to the time the alleged acts were committed, but alleged that the company was furnishing the city with water beyond what the law required and that the directors, even after the plaintiff requested that it be not done, continued so to do to the injury of himself, other shareholders and the company. The lower court dismissed the bill and upon appeal the decision was affirmed, the higher court holding that no wrongful acts were shown and that the directors in California were better able to judge of affairs than was a citizen of New York. The court laid down several principles among which is the one that is the starting point for all of the law upon this subject, viz., "To enable a stockholder in a corporation to sustain in a court of equity in his own name, a suit founded on a right of action existing in the corporation, and in which the corporation itself is the appropriate plaintiff, there must exist as the foundation of the suit . . . an allegation that complainant was a shareholder at the time of the transactions of which he complains, or that his shares have devolved upon him by operation of law."

Immediately after handing down this decision the United States Supreme Court promulgated an additional equity rule,<sup>8</sup> now Rule No. 27, which is as follows:

Every bill brought by one or more stockholders in a corporation, against a corporation and other parties, founded on rights which may properly be asserted by the corporation, must be verified by oath and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law, and that the suit is not a collusive one to confer on a court of the United States, jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part

<sup>7</sup> 104 U. S. 450.

<sup>8</sup> Rule No. 94.

of the managing directors or trustees, and, if necessary, of the shareholders and the causes of his failure to obtain such action, or the reasons for not making such effort.

The case of *Dimpfel vs. Ohio, etc., Railroad Co.*<sup>9</sup> was decided on the authority of *Hawes vs. Oakland* and Mr. Justice Fields quotes from that case at some length. However, the Dimpfel case was decided, not so much on the point of whether or not the stockholders had a right to sue for acts done before they acquired stock, as it was on the point of estoppel in that they had waited three years and eight months before suing. Then too, the court dwells on the point that the complainants owned but fifteen hundred of a total of two hundred and forty thousand shares. The case of *Taylor vs. Holmes*<sup>10</sup> followed the *Hawes vs. Oakland* and the Dimpfel case, cited ante, but did not vary the stand of the United States Supreme Court. However, these three cases together with equity Rule 94 are the sources of whatever law there is in favor of not allowing a subsequent shareholder to sue for acts committed before he acquired his stock.

The courts of Colorado, Georgia, Indiana, Iowa, Nebraska, and Pennsylvania have followed the lead of the United States Supreme Court, while the courts of Alabama, Idaho, Maine, Michigan, Montana, New Hampshire, and New York take the view that in order to sue for acts committed prior to his acquisition of stock a stockholder need not show that he held stock at or before such time.

The Colorado supreme court in the case of *Boldenbeck vs. Bullis*<sup>11</sup> held that where a plaintiff stockholder had acquired his stock subsequent to a meeting of stockholders at which meeting the acts complained of were authorized, it appearing that the stock which he afterward purchased had participated in voting in favor of the authorization, such stockholder could not maintain the suit. The court cites *Hawes vs. Oakland* and other federal decisions; but it is easily to be seen that the decision rests mainly on estoppel.

In Georgia, in the case of *Alexander vs. Searcy*,<sup>12</sup> the main reason for the decision was that in waiting for from seven to fifteen years before bringing action for mismanagement the stockholder was estopped from bringing suit. The idea that he did not own stock at the time of the injury was supplementary

<sup>9</sup> 110 U. S. 209.

<sup>10</sup> 127 U. S. 489.

<sup>11</sup> 40 Colo. 253, 90 Pac. 634.

<sup>12</sup> 81 Ga. 536, 8 S. E. 630.

and although the court cites the federal rule with approval it nevertheless grounds its decision in an estoppel *in pais*.

There is some law in Indiana on this point which is found in the case of *Tevis vs. Hammersmith*.<sup>13</sup> In that case the complaint was attacked upon several grounds, one of which was that it was not stated therein that plaintiff owned the stock at the time of the alleged acts. The upper court held the complaint valid without touching upon this point. Upon a rehearing<sup>14</sup> the court held that the complaint sufficiently averred ownership at the time of the acts. In its decision the court very briefly discusses the form of the complaint and does not go into the reasoning of the proposition in which we are interested. So it is by mere inference only that Indiana lines up with the federal rule and holds that a stockholder must aver that he owned stock at the time of the acts of which he complains.

Iowa too, follows the federal rule in the case of *Clark vs. American Coal Co.*<sup>15</sup> The court quoted verbatim from the case of *Dimpfel vs. Railway Co.*, before cited; but in this Iowa case also there were other grounds for the decision and the reasoning upon our proposition is not of very great strength. Nebraska likewise follows this rule in the case of *Home Fire Insurance Co. vs. Barber*<sup>16</sup> but in that case the plaintiffs had bought their stock from the defendant and now sought to hold the defendant for wrongs to the corporation, and this decision, like some of the others, rests on an estoppel.

By far the strongest of the state court decisions following the federal rule is found in Pennsylvania in the case of *Wolf vs. Shortridge*.<sup>17</sup> This was an action for an accounting between the years of 1870 and 1896. The plaintiff had acquired his stock in 1892, 1893 and 1894. A demurrer to the complaint was sustained with leave to amend which was done so as to cover the years of 1894 to 1896. A demurrer to the amended complaint was overruled and judgment was given for the plaintiff when the defendant failed to answer over. On the defendant's appeal the court in reversing the judgment said, "The bill is radically defective. . . . Secondly, the plaintiff in February, 1892, bought stock in the lessor company and made further purchases in 1893 and 1894. He did not file his bill until 1898 and then he demanded

<sup>13</sup> 31 Ind. A. 281, 66 N. E. 79.

<sup>14</sup> 67 N. E. 912.

<sup>15</sup> 86 Iowa 436, 53 N. W. 291.

<sup>16</sup> 67 Neb. 644, 93 N. W. 1024.

<sup>17</sup> 195 Pa. 91, 45 Atl. 936.

an accounting back to 1870. The date was subsequently amended so as to begin in 1894, but the original demand is significant of the reckless disregard of important facts with which the whole bill is framed. His excuse, that he did not know of the matters complained of until 1894, is, under the circumstances, altogether too vague. He practically admits he has no real knowledge now. The management he attacks is *prima facie* in entire compliance with the agreement . . . the bill might well have been dismissed for laches." After this tirade the court goes on, "But thirdly, passing by the *subordinate* questions of parties and delay of seeking relief, the bill has no substantial foundation of fact to rest upon. . . ." Thus it is seen that the question of the acquirement of his stock subsequent to the alleged transactions was only a part of the foundation, a subordinate part as is stated by the court.

On the other hand the state courts which hold that a stockholder may sue for transactions occurring prior to the time when he acquired his stock are all based upon the theory that the federal rule as laid down by the court in the case of *Hawes vs. Oakland*, cited ante, followed by Rule 94 and adhered to ever since by our highest court, is a rule of practice merely, and not a general principle of law; and as such the state courts are not bound to follow it. This is the stand taken in the states of Alabama,<sup>18</sup> Maine,<sup>19</sup> Michigan,<sup>20</sup> Montana,<sup>21</sup> New Hampshire,<sup>22</sup> New York<sup>23</sup> and Idaho.<sup>24</sup>

The case of *Just vs. Idaho Canal Co.*<sup>25</sup> is perhaps the clearest and best reasoned case on the side of those advocating the right of a subsequent stockholder to sue and is representative to a degree of the stand taken in the states just named. In that case which was an action to collect a sum alleged to be due on a contract prosecuted by a stockholder for the use and benefit of the corporation, it was shown that the plaintiff's corporation and a competing corporation entered into a contract whereby a debt became owing to the plaintiff's corporation.

<sup>18</sup> *Montgomery Light Co. vs. Lahey*, 121 Ala. 131, 25 South. 1006; *Parsons vs. Joseph*, 92 Ala. 403, 8 South. 788.

<sup>19</sup> *Mason vs. Carrothers*, 105 Me. 392, 74 Atl. 1030.

<sup>20</sup> *Negaunee German Corporation vs. Negaunee German Aid Society*, 172 Mich., 650, 138 N. W. 343.

<sup>21</sup> *Forrester vs. Boston, etc., Co.*, 21 Mont. 544 at 565, 55 Pac. 229 and 353.

<sup>22</sup> *Winsor vs. Bailey*, 55 N. H. 218.

<sup>23</sup> *Pollitz vs. Gould*, 202 N. Y. 11.

<sup>24</sup> *Just vs. Idaho Canal Co.*, 16 Idaho 639, 102 Pac. 381.

<sup>25</sup> 16 Idaho, 639, 102 Pac. 381.

The rival corporation obtained control of the plaintiff's corporation, elected a board of directors who thereafter refused to prosecute an action to collect the debt although requested so to do. The rival corporation demurred to the stockholder's complaint on the ground that one who acquires stock subsequent to injurious acts is not in a position to maintain an action based upon such acts. In support of this contention they cited federal cases heretofore discussed. The demurrer to the complaint was overruled and the defendant appealed. In affirming the lower court's decision, the Idaho Supreme Court, citing the decisions in the federal courts to the effect that the complaint must aver that the plaintiff acquired his stock previous to the time of the alleged transactions, said, "This is undoubtedly the rule in the federal courts; but it is a rule that has been adopted for the purpose of preventing a transfer of stock to a non-resident in order to enable him to bring the case in the federal courts. It is a rule of practice instead of a principle of law and is not applicable in the state courts."

Further along in the same decision the court, quoting from *Morawetz on Corporations*, Section 265, says, "A shareholder has an interest in all causes of action belonging to the corporation whether they arose before or after he purchased his shares. If the courts decline to protect this interest in any particular case their refusal must be based upon some principle of public policy, or the personal disqualification of the plaintiff." Then the court goes on to lay down the rule that a stockholder who pleads a good cause of action may maintain the same even though he was not an owner of stock at the time the breach of duty occurred, except in cases where it is shown that he purchased the stock with the intent and for the purpose of bringing suit, or where his vendor was for some reason estopped from maintaining the action and the purchaser had notice of such bar.

It is not within the purpose of this article to discuss at length the doctrine of *stare decisis*; sufficient is it to say that the state courts are not bound to follow as binding precedents, the rules of practice of the United States Supreme Court. That the rule as to suits by subsequent stockholders is a mere rule of practice is recognized by the United States Supreme Court in the decision of the case of *Corbus vs. Alaska Co.*<sup>28</sup> where it is said in speaking of the case of *Hawes vs. Oakland* cited ante, "The frequency with which the most ordinary and usual chancery remedies are

<sup>28</sup> 187 U. S. 455.

sought in the federal courts by a single stockholder who possesses the requisite of citizenship in cases where the corporation whose rights are to be enforced cannot sue in those courts, seems to justify a consideration of the grounds on which that case (*Hawes vs. Oakland*) was decided; and of the just limitation of the exercise of those principles"; and the court goes on to uphold that case. To a like effect is the case of *Delaware and Hudson Co. vs. Albany and Susquehanna R. R. Co.*,<sup>27</sup> where the court says, "The purpose of Rule No. 94 hardly needs explanation. It is intended to secure the Federal Courts from imposition upon their jurisdiction. . . ."

Thus we come to the question: Where will Wisconsin stand on this proposition? Will it follow the lead of the United States Supreme Court as did Pennsylvania and some other courts and hold that a stockholder must have acquired his stock prior to the acts complained of; or will our supreme court, following New York, Idaho, and the other state courts which have met this problem, hold that a stockholder's interest in all of the corporation's causes of action gives him a right to sue for acts committed against the corporation prior to the time of his acquisition of stock?

Although it is the purpose of this article to set forth the authorities upon both sides of this question, nevertheless it does seem to the writer, that in view of Section 1753 of the Wisconsin Statutes which provides that, "No corporation shall issue any stock or certificate of stock except in consideration of money or of labor or property estimated at its true money value, actually received by it, equal to the par value thereof. . . ." certainly a person receiving stock from the corporation, since he has to pay one hundred cents on the dollar for it, should be allowed, if he has no ulterior motive, to maintain suit for wrongs committed previous to his acquisition of stock. And further, it would seem to the writer that where a stockholder has purchased his shares from another, since he becomes interested in every phase of the corporation's welfare, a partaker in its liabilities as well as in its profits, he should be allowed to maintain an action to redress the wrongs to such corporation even though they occurred prior to the time when he acquired stock, always provided he is actuated by proper motives.

<sup>27</sup> 213 U. S. 435 at 446.