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CORPORATIONS — CONDITIONS UNDER WHICH SETTLEMENT OF CORPORATE CLAIMS WILL NOT PREVENT A STOCKHOLDER'S DERIVATIVE SUIT ON SUCH CLAIMS — In the recent case of *United States Lines, Inc. v. United States Lines Co.*[1] the plaintiff was a minority

[1] (C. C. A. 2nd, 1938) 96 F. (2d) 148.

stockholder in United States Lines, Inc., whose only asset was a minority stock interest in the United States Lines Company. A majority of the stock in both companies was owned by the International Mercantile Marine Company. An action originally brought by the United States Lines, Inc., but settled out of court, was sought to be continued by the plaintiff, who alleged: (1) that the Marine Company and its subsidiaries had entered into fraudulent contracts with the United States Lines Company and had made excessive charges, amounting to several million dollars, payable to the Marine Company and its subsidiaries; (2) that a settlement was approved by the majority (consisting of shares owned by the Marine Company) of United States Lines, Inc., whereby the suit was to be dismissed and the shareholders of United States Lines, Inc. were given the option of trading their shares for junior preferred stock of United States Lines Company; (3) that the expense was to be borne by the Marine Company and it was to pay the debts of United States Lines, Inc., amounting to about $40,000. The court held that the plaintiff might continue the derivative action because it did not clearly appear that the settlement was advantageous to the corporation and its stockholders.[2]

It is well established that a settlement or compromise is within the power of management of the corporate business and affairs so that it rests with the directors, in the exercise of their honest judgment, to decide when a compromise or settlement shall be made, and the exercise of their authority to make such a compromise or settlement will bar a stockholder's derivative action on the claim.[3] Exceptional cases such as a release by the directors of one of their own number, or a shareholder on his stock subscription, etc., which do not bar a stockholder's derivative action, cannot be attributed to general lack of authority on the part of the directors but rather to the presence of other determining factors.[4] Fraud and bad faith are the most general limitations on the

[2] The court said, 96 F. (2nd) 148 at 152: "We do not say that the stock owned by the defendants could not be voted in favor of the settlement, but hold that the settlement effected by a majority consisting mainly of the defendants who were in control of the corporation should not be sanctioned without clear proof that it was advantageous to the corporation and its stockholders."

[3] 2 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., §§ 528, 529 (1931). And see infra, note 5.

[4] It is to be noted that although the directors have such authority generally, the problem arises as to whether, under special facts and in particular situations, that authority shall not be held to be lacking. See infra, notes 16, 18, 19, 20, 21, 22, 23, 24, 25.

Generally the president of a corporation, by virtue of his office only, does not have authority to make corporate settlements or compromises. Dickinson v. Citizens' Ice & Fuel Co., 139 Minn. 201, 165 N. W. 1056 (1918); Indianapolis Rolling-Mill v. St. Louis, Ft. S. & W. Ry., 120 U. S. 256, 7 S. Ct. 542 (1887). But from the

authority of the directors.[5] But actual fraud is not always required, and it has been said that a corporate settlement will be conclusive "In the absence of the finding of bad faith on the part of the directors, or an intentional disregard of the interests of the corporation confided to their care. . . ."[6] It is apparently on this latter requirement that the court in the principal case decided in favor of the stockholder.[7] Although no evidence of actual fraud was produced, it was apparent that the directors and majority of stockholders were motivated by their desires for personal gains and not to serve the best interests of the

nature of his management of the business the authority may be implied. Chicago, B. & Q. R. R. v. Coleman, 18 Ill. 298 (1857); Browne-Brun Wholesale Grocery Co. v. Hinton, 179 Ark. 831, 18 S. W. (2d) 369 (1929).

Nor do secretaries have such authority except as may be implied from the course of business. Moshannon Land & Lumber Co. v. Sloan, 109 Pa. St. 532 (1885); Stanton v. Occidental Life Ins. Co., 81 Mont. 44, 261 P. 620 (1927).

The same rule applies to general managers of the business although from their conduct of the business implied authority may be more easily implied. See: Salt Lake Valley Loan & Trust Co. v. St. Joseph Land Co., 73 Utah 256, 273 P. 507 (1928); Baker v. Coleman Abstract Co., (Tex. Civ. App. 1923) 248 S. W. 412.

The majority of stockholders, as such, have no authority to compromise or settle corporate claims because the claim belongs to the corporation. Harris v. Pearsall, 116 Misc. 366, 190 N. Y. S. 61 (1921).

It has been held that a release by a stockholder who has brought a derivative action is no bar to a later derivative action because the right is in the corporation even though the action is brought by a minority stockholder. Beaudette v. Graham, 267 Mass. 7, 165 N. E. 671 (1929). But in Babcock v. Farwell, 245 Ill. 14 at 40-41, 91 N. E. 683 (1910), the court says, "The theory of a stockholder's suit is, that the stockholder has sustained a wrong through the injurious effect upon his stock by the wrong done to the corporation. If he has himself consented to or participated in the acts constituting such wrong, or has waived his right to object to them, he cannot afterwards maintain a bill, on account of such transactions, for the benefit of the corporation or of other stockholders."

[5] Donohoe v. Mariposa Land & Mining Co., 66 Cal. 317, 5 P. 495 (1885) (mortgage foreclosure); Hallenborg v. Cobre Grande Copper Co., 200 U. S. 239, 26 S. Ct. 236 (1905) (settlement with promoter); Pneumatic Gas Co. v. Berry, 113 U. S. 322, 5 S. Ct. 525 (1884) (release of directors); First Nat. Bank v. National Exch. Bank, 92 U. S. 122 (1875) (payment arising out of banking transaction so as to secure transfer of stock by another corporation); Barton v. Butler County Oil Co., 112 Kan. 436, 211 P. 608 (1922) (settlement of lease); Frankfort Bank v. Johnson, 24 Me. 490 (1844) (settlement of action against cashier); Chambers v. McKee & Bros., 185 Pa. St. 105, 39 A. 822 (1898) (settlement of debt from third party); Continental Ins. Co. v. New York & H. Ry., 187 N. Y. 225, 79 N. E. 1026 (1907) (dispute as to which of two corporations were to receive saving on a lease); Mendelson Bros. Factors v. Sachs, 253 App. Div. 270, 1 N. Y. S. (2d) 838 (1938) (settlement of action against former directors). See Independent Order of Foresters v. Scott, (Iowa 1936) 272 N. W. 68, for example of fraud.

[6] Chambers v. McKee & Bros., 185 Pa. St. 105 at 110, 39 A. 822 (1898).

[7] See supra, note 2.

corporation and its stockholders.[8] The situation in the *United States Lines* case is perhaps comparable to that in which the majority retain the consideration received from the settlement of the corporate claim. In such a case the minority should be allowed to recover their share.[9] Although the form of action and the parties to the action may be different, the results in the two cases stand upon substantially the same basis.[10] It seems, therefore, that the instant case can be said to be properly decided on the general rule that the best interests of the corporation must be looked to by the directors and the majority of the stockholders.

But the court in the *United States Lines* case bases its decision on the additional ground of inadequacy of consideration.[11] This appears contrary to the general rule that the courts will not inquire into the adequacy of the consideration in a compromise or settlement.[12] Although the possibility of recovery in this instance was enormous as compared with the consideration offered, such has been the case elsewhere without invalidating the compromise.[13] It is submitted that inadequacy of

[8] It is apparent from the facts that the only purpose of the majority of the stockholders in United States Lines Inc. in approving the settlement was to avoid the suit against themselves as the Marine Co.

[9] Menier v. Hooper's Telegraph Works, 30 L. T. R. (N. S.) (Ch.) 209 (1874).

[10] Ibid., at 211, the court says, "The plaintiffs say, and the litigation . . . is, that Hooper's Company, being the majority of the company, have procured that suit to be settled upon terms favourable to themselves, they getting a consideration for settling it, in the shape of a profitable bargain for the laying of a cable. I am of opinion that although it may be quite true that the shareholders may vote as they please, and for the purpose of their own interest, yet they cannot sell the assets of the company, and keep the consideration for that, but that they must allow the minority to have their share of any consideration which may come to them. I also entirely agree that under the circumstances the suit is properly instituted in the name of the plaintiff on behalf of himself and all the other shareholders."

The effect of the majority action in the United States Lines case was the same in that certain corporate assets were alleged to have been transferred to them in other corporations and they were attempting to prevent its recovery in the derivative suit by means of the settlement. The court's language, supra note 2, indicates that the very apparent injustice to the other stockholders is a determining factor in the decision.

[11] 96 F. (2d) 148 at 152: "Under the circumstances, to require the discontinuance of the derivative suit for a relatively small consideration, when the claims sought to be asserted through it are enormous, does not seem justifiable."

[12] Cases collected 12 C. J. 334 (1917), including exception where the consideration is so grossly inadequate as to render enforcement of the settlement unconscionable.

[13] The claim amounted to millions of dollars, but, as the court points out, damages are so highly speculative that it seems difficult to say that the consideration offered was not adequate if the whole proceeding was in good faith. See Barton v. Butler County Oil Co., 112 Kan. 436, 211 P. 608 (1922), where $35,000 was paid the corporation in settlement of its claim to an oil and gas lease which might have been of tremendous value.

If the compromise would be binding otherwise, the consideration will usually be

consideration should only be considered as evidence tending to show fraud on the part of the directors or the majority in control. Of course, in the *United States Lines* case there was no consideration whatsoever moving to the wronged corporation. Since it was therefore not bound, plaintiff could have instituted another action in the name of the United States Lines Company, whose stock he would possess if the settlement were carried out. The court properly considers that factor in allowing plaintiff's double derivative action.[14]

Further limitations on the authority of the directors may be said to depend on particular classifications of the fact situations. A difficulty that seldom arises, but may present an obstacle to a corporate settlement, is found in the rule that corporate property may not be sold so as to prevent the corporation from continuing in business.[15] Generally, however, a corporate settlement is not within the rule, because the corporation is not completely disabled and the claim given up is not considered to be corporate property within the meaning of the rule.[16]

The fact that a majority of directors are in common to two corporations making a settlement apparently has no bearing on the question beyond the rule that all such contracts are voidable.[17] But when ratified by the majority stock interest in good faith, the minority are bound thereby.[18] Nor does the fact that the claim is of doubtful validity have any special effect on the case.[19]

It has been stated that the directors of a corporation cannot release corporate claims that are unknown at the time.[20] The problem, however, does not appear to be a special one of corporate law but rather merely a question of construction of the terms of the compromise or settlement.[21] Again, a board of directors is without power to release one of their number from his liability to the corporation for the misappropriation of the assets of a corporation to the use of the director sought to be released.[22] But there is no reason for such a rule if the corporate com-

no obstacle. In Post v. Buck's Stove & Range Co., (C. C. A. 8th, 1912) 200 F. 918, where friendship with laborers of the corporation was considered sufficient consideration for a claim of $750,000.

[14] 96 F. (2d) 148 at 152.

[15] 14 C. J. 866 (1919); 6 L. R. A. 678 (1890).

[16] Barton v. Butler County Oil Co., 112 Kan. 436, 211 P. 608 (1922). See also, Hallenborg v. Cobre Grande Copper Co., 200 U. S. 239, 26 S. Ct. 236 (1905).

[17] 114 A. L. R. 299 (1938).

[18] Continental Ins. Co. v. New York & H. Ry., 187 N. Y. 225, 79 N. E. 1026 (1907).

[19] Ibid., Farmers' Mut. Ins. Co. v. Meese, 49 Neb. 861, 69 N. W. 113 (1896).

[20] Davis v. Pendennis Club, 230 Ky. 465, 19 S. W. (2d) 1078 (1929).

[21] Mendelson Bros. Factors v. Sachs, 253 App. Div. 270, 1 N. Y. S. (2d) 838 (1938).

[22] State Nat. Bank v. Davidson, (Tex. Civ. App. 1927) 295 S. W. 311; Gilbert

promise was advantageous to the corporation and necessary to its operation.[23]

Another exception to the authority of directors and the corporation to settle claims is embodied in the rule against such settlement of a stockholder's liability on his stock subscription.[24] But in the majority of cases the rule does not apply. The director's discretion is controlling where it is "of advantage to the corporation" to make the settlement, and a minority stockholder cannot avoid it.[25] If it were not to the advantage of the corporation, the settlement would appear not to be binding in most cases anyway under the general rule setting up that requirement and good faith.[26]

It is submitted that the only means of determining the conditions under which a corporate settlement will not prevent a stockholder's derivative action on the claim is to consider all the facts and circumstances of each case. There is no hard and fast rule by which the problem can be determined. The result in any case will depend on the court's decision as to whether, considering all the circumstances, the compromise or settlement, at the time it was entered into, could reasonably be termed *advantageous* to the corporation and free from fraud. As in the *United States Lines* case, the courts are generally guided by a feeling, with varying degrees of vagueness, that the minority stockholders must have justice and fair play. The application of law to facts in reference to the principal problem, with the few exceptions set out, do not admit a more certain answer to the problem.

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v. Commercial Alliance Life Ins. Co., 173 N. Y. 455, 66 N. E. 133 (1903). And see California Canning Peach Growers v. Harris, 91 Cal. App. 654, 267 P. 572 (1928).

[23] Pneumatic Gas Co. v. Berry, 113 U. S. 322, 5 S. Ct. 525 (1884).

[24] Scott v. Marin, (C. C. A. 8th, 1927) 22 F. (2d) 779; Melvin v. Lamar Ins. Co., 80 Ill. 446 (1875); Topeka Mfg. Co. v. Hale, 39 Kan. 23, 17 P. 601 (1888); Richardson v. Devine, 193 Mass. 336, 79 N. E. 771 (1907); Cartwright v. Dickinson, 88 Tenn. 476, 12 S. W. 1030 (1890).

[25] Nettles v. Marco, 33 S. C. 47, 11 S. E. 595 (1890); Martin v. Cushwa, 86 W. Va. 615, 104 S. E. 97 (1920). To the same effect, see Thomas v. Wentworth Hotel Co., 16 Cal. App. 403, 117 P. 1041, 1046 (1911). In the Thomas case there is also a discussion of acquiescence of a stockholder as a bar to his later objecting to the compromise.

[26] Supra, note 5.