Stockholder's Derivative Actions by Holders of Convertible Debentures

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STOCKHOLDER'S DERIVATIVE ACTIONS BY
HOLDERS OF CONVERTIBLE DEBENTURES

Recently there has been a significant increase in the marketing of convertible debentures.\(^1\) This may perhaps be explained by the convertible debenture's unique combination of advantages, for it offers both the security characteristic of a straight bond and the growth opportunity associated with an equity investment. Typically the convertible debenture investor receives not only a fixed periodic interest payment and the promise to pay the face value of the debenture on a specified maturity date\(^2\)—benefits commonly given straight bondholders—but also the convertibility feature which enables him, at his option and under specified conditions, to convert the debenture into another form of security, usually common stock.\(^3\) Rights provided by the law of contracts and negotiable instruments protect the investor should the corporation

\(^1\) The following statistics give the volume of all long-term debt securities which were registered with the SEC in recent years. The part of this long-term debt which was issued in convertible debentures is also listed to show its relative increase over these years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Convertible Debentures</th>
<th>All Long-Term Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>$1,264,000,000</td>
<td>$13,720,000,000</td>
</tr>
<tr>
<td>1966</td>
<td>1,872,000,000</td>
<td>15,561,000,000</td>
</tr>
<tr>
<td>1967</td>
<td>4,475,000,000</td>
<td>21,954,000,000</td>
</tr>
<tr>
<td>1968 (6 mos.)</td>
<td>1,342,000,000</td>
<td>8,938,000,000</td>
</tr>
</tbody>
</table>


\(^2\) The interest rate obtainable on a convertible debenture is invariably lower than the rate payable on a straight debt security of the same company. This interest reduction—often two percentage points or more—represents the cost of the convertibility feature. *Id.* at 362.

\(^3\) Securities are normally convertible from date of issuance until maturity. In a few cases the conversion privilege will terminate before maturity of the security, if conversion into common stock presents a possible dilution problem which is discouraging common stock investors. Most convertible securities are convertible on the same terms throughout their life. For example, if convertible into common stock at $50 per share, a standard $1,000 bond would be exchanged into twenty common shares. A large number of convertible securities, however, provide for a diminishing conversion ratio. This would mean an increase at particular intervals in the price at which stock is to be purchased. *Id.* at 364–65.

For the purposes of this article it is assumed that the convertible debenture is convertible into common stock of the corporation. The analysis which follows, particularly in text accompanying notes 43–98 *infra*, does not necessarily apply to debentures convertible into securities other than common stock. The term "stock" in this article means common stock.
wrongfully disallow a conversion or fail to pay the interest or principal properly due to the investor. However, this protection is inadequate if the corporation suffers an injury which impairs the value of the conversion option. For example, some event may result in a significant decline in the value of the corporation's stock, causing the value of the stock to decline, and concomitantly decreasing the value of the conversion option. Assuming the causative event is one which gives rise to a claim for relief, should the corporation or its stockholders not bring an action to repair or recompense the damage, the convertible debenture holder would be without a remedy unless he too has the right to bring an action. This article examines the question of whether the holder of a convertible debenture has the right to bring a stockholder's derivative action in order to protect his interest in the corporation.

This article focuses on Federal Rule of Civil Procedure 23.1. That rule provides a particularly convenient vehicle for discussing the protective limitations which prevent abuse of the derivative action. Analogous protective limitations exist in the statutory or case law of most jurisdictions. Therefore the discussion here applies equally to actions brought in the courts of many states. Moreover, the economic and public policy arguments presented are applicable to actions in both federal and state courts.

I. THE DERIVATIVE SUIT

The stockholder's derivative action is a creation of equity. It was developed to allow shareholders "derivatively" or "secondar-
ily" to enforce a corporate cause of action when those managing the corporation refuse to do so. The right which is to be enforced belongs to the corporation. If the corporate officials refuse to assert it, the legal remedy available to the shareholders is therefore inadequate, and equity allows the shareholders to assert the action on behalf of the corporation. Since the injury to be remedied is corporate, any recovery is paid into the corporate treasury for the benefit of the corporation.

Derivative suits serve an important business function. Economic expansion has created a need for increased capital, and the public has proved a ready source of supply. Simultaneously there has been an increasing separation between shareholder ownership and management control of the corporation. Augmenting this increased separation has been the frequent use of subsidiary corporations for doing business. This has further served to centralize control apart from the investor-owner. Moreover, management has developed enhanced powers through its control of the corporate treasury, proxy mechanism, and inside knowledge of operations. Increased separation between owners and manage-

8 Because the derivative suit was "equitable" rather than "legal," it had been assumed that there was no constitutional right to a jury trial in a derivative action. Ross v. Bernhard, 403 F.2d 909 (2d Cir. 1968); Richland v. Crandall, 259 F. Supp. 274 (S.D.N.Y. 1966); 5 J. MOORE, FEDERAL PRACTICE ¶ 38.38 [4], at 308.11 (2d ed. 1971); Note, The Right to a Jury Trial in a Stockholder's Derivative Action, 74 Yale L.J. 725, 732 n.35 (1965). However, in Ross v. Bernhard, 396 U.S. 531 (1970), rev'g 403 F.2d 909 (2d Cir. 1968), the Supreme Court held that shareholders are entitled to a jury trial if the cause of action was one in which the corporation could have demanded a jury trial had it brought the suit.


10 Berle, Property, Production and Revolution, 65 COLUM. L. REV. 1, 2 (1965). As evidence of this, Berle discusses the large increase in productive property under corporate control, the growth in the number of new shareholders, and the important role which corporate securities play in individual wealth. See also Dykstra, The Revival of the Derivative Suit, 116 U. PA. L. REV. 74, 79 (1967).

11 See A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1967); Berle, supra note 10, at 4:
Most "owners" own stock, insurance savings and pension claims and the like, and do not manage; most managers (corporate administrators) do not own. The corporate collective holds legal title to the tangible productive wealth of the country—for the benefit of others.

12 The shareholder of a parent corporation is one more step removed from decisions made by the management of various subsidiaries of the parent.

13 See Painter, Double Derivative Suits and Other Remedies with Regard to Damaged Subsidiaries, 36 IND. L.J. 143 (1961).

14 For example, management has the support of the corporate treasury and legal staff if a derivative action is brought against it.

Voting by proxy is usually necessary in large corporations where voting shares are widely dispersed. The proxy mechanism is used for both election of directors and shareholder approval of various corporate matters. While it is a useful device, it also favors management in its operation more than corporate shareholders.
agers and expansion of management powers create a situation conducive to abuse of ownership interests by management.\textsuperscript{15} Given this situation it is important to provide the stockholder a means by which he can protect his investment. Otherwise the stockholder would be personally helpless against such acts as mismanagement of the business, misappropriation of assets, or dilution of outstanding shares by the fraudulent issue of additional shares.

There are several possible remedies to contain management abuses.\textsuperscript{16} First there is the possibility of voting out management. This might be an effective remedy for small corporations, but for many modern corporations this is unlikely in view of a large number of uninformed or uninterested shareholders each owning only a small portion of the total shares of the corporation. Moreover, management control of the proxy mechanism further handicaps the use of a voting remedy.\textsuperscript{17} A second possibility is for the shareholder to sell his stock. This is not an effective solution, however, for either the shareholder or the corporation. The injury to the corporation may already have had a detrimental effect on the value of the stock by the time a shareholder learns of any wrongdoing. Therefore, although a current sale would protect the shareholder from future diminution of the value of his stock, he would already have suffered a financial loss. Furthermore, the corporation would suffer injury without any prospect of compensation to its treasury. In fact, by selling his interest in the

\textsuperscript{15} Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541, 547 (1949). The Court noted:

As business enterprise increasingly sought the advantages of incorporation, management became vested with almost uncontrolled discretion in handling other people's money. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. The director was not subject to an effective accountability. That created strong temptation for managers to profit personally at expense of their trust.


\textsuperscript{17} See note 14 supra.
corporation, the shareholder may encourage future injuries because the party responsible for the injury may feel immune from accountability. Thus these two self-help remedies are of limited value, at best. The appropriate alternative seems to lie in judicial action. If there has been a direct injury to a shareholder's personal rights as defined by the articles of incorporation or state law, he can maintain a direct action against the party causing the injury. Quite often, however, the wrong will be to the corporation and will only indirectly affect the shareholder's rights. Hence, in this latter event, the courts will not allow a direct action to be brought by the shareholder. The stockholder's derivative action therefore is a necessary and useful device by which the shareholder can remedy his indirect loss.

The stockholder's derivative suit has been extremely useful and undoubtedly deserves the praise which has been bestowed upon it. Nevertheless, several dangers, three of which are pertinent here, are inherent in derivative actions. First, the derivative action...
can be conducive to "strike suits"—speculative actions brought by shareholders to harass a corporation for the ultimate purpose of achieving an out-of-court settlement, resulting in indirect gain to the plaintiff shareholders.\textsuperscript{20} Litigation of derivative suits can be quite expensive and time-consuming for corporate management. Consequently management may be anxious to settle prospective derivative suits even though the complaining shareholders would be unlikely to succeed on the merits of their case. Secondly, purchasers of stock may only be speculating in litigation or litigating purchased grievances if they buy stock motivated by the possibility of a successful derivative suit.\textsuperscript{21} Finally, derivative actions may give rise to collusive invocation of diversity jurisdiction. For example, a corporation unable to bring a cause of action into a federal court because it lacked diversity could agree with a shareholder having the necessary diversity to bring the action on behalf of the corporation through a shareholder’s derivative suit.\textsuperscript{22}

To provide a check against these possible abuses, the federal courts have developed restrictions upon derivative actions. In the case of \textit{Hawes v. Oakland} the Supreme Court specifically laid down requirements\textsuperscript{23} which were later adopted in Federal Equity Rule 27,\textsuperscript{24} Federal Rule of Civil Procedure 23 (b), and finally the present Federal Rule of Civil Procedure 23.1.\textsuperscript{25} These restrictions

\textsuperscript{20} See H. Henn, \textit{supra} note 4, § 359, at 752 n.22. It is generally accepted today that any settlement recovery must go to the corporation. See note 9 \textit{supra}. Thus the financial motivation for strike suits has been reduced to the expectation that the court will allow plaintiff's lawyer a generous fee out of any fund collected for the corporation or that the gain to the corporate treasury will be reflected in the market value of corporate stock.

\textsuperscript{21} Purchasers might be planning on bringing the derivative action themselves for a profitable out-of-court settlement or they might have knowledge that other shareholders intend to bring a derivative action, which if successful would greatly increase the value of the stock.


\textsuperscript{23} 104 U.S. at 460-62.

\textsuperscript{24} Equity R. 27, 226 U.S. 656 (1912), read:

\begin{quote}
Every bill brought by one or more stockholders in a corporation against the 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 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.
\end{quote}

\textsuperscript{25} Fed. R. Civ. P. 23.1 reads:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the
of course apply only to actions brought in federal courts. Since 1941, however, many state legislatures have passed statutes or issued rules of procedure which limit derivative actions. Many of these states have patterned their procedural rules after the approach adopted by the Federal Rules of Civil Procedure in the former 23(b) and present 23.1.26

II. PROCEDURAL LIMITATIONS ON THE STOCKHOLDER'S DERIVATIVE SUIT

A. Contemporaneous Ownership

The contemporaneous ownership limitation on the shareholder's derivative suit requires not only that plaintiff be a shareholder at the time of suit but also that the plaintiff have been a shareholder in the corporation at the time of the transaction of which he complains or that his shares thereafter devolved on him by operation of law.27 This requirement was originally adopted to protect the federal courts from collusive invocation of diversity jurisdiction by corporations seeking access to a federal forum.28 It has subsequently been promulgated by many state courts and legislatures to deter "a subsequent purchaser of shares from 'speculating in litigation' or 'litigating purchased grievances.'"29 The contemporaneous ownership requirement makes litigating purchased grievances more difficult because it would be necessary for the subsequent purchaser to join with a party who meets the

plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

26 See note 6 supra.
27 Fed. R. Civ. P. 23.1 reads in part:
[T]he complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law . . .
29 H. HENN, supra note 4, § 362, at 766. See Sullivan, supra note 16, at 601. See also note 21 supra.
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requirement in whose name both could sue. This is possible but arguably more difficult than suing in one's own name.\textsuperscript{30} Generally, the courts have broadly construed the definition of ownership, thereby including equitable owners.\textsuperscript{31} At least two states,\textsuperscript{32} however, have taken a much more conservative approach in delineating a contemporaneous ownership requirement. They have required that plaintiff prove he was a registered shareholder at the time the wrong was committed against the corporation. Also, the amendment to optional Section 43A of the Model Business Corporation Act requires that a shareholder be "of record" to meet the requirement of contemporaneous ownership.\textsuperscript{33} The requirement of either registered ownership or ownership of record provides a simple test for determining ownership for purposes of the contemporaneous ownership test, but it can be argued that these tests are too restrictive. One critic has pointed out that there is little evidence that nonrecord holders who have brought derivative actions under standard contemporaneous ownership clauses have abused this right.\textsuperscript{34} Thus he feels that the more restrictive "phrases are the products either of a general hostility to derivative suits or of an exaggerated fear of purchased litigation."\textsuperscript{35}

B. Exhaustion of Intracorporate Remedies

Another limitation requires that the plaintiff in a stockholder's derivative action must exhaust all intracorporate remedies. He must allege in his complaint that he has made a prior demand on management or, when necessary, on the other shareholders or members for the action he desires. He must also state the reason for his failure to obtain such action or why he failed to make the demand.\textsuperscript{36} This may reduce the motivation to abuse the derivative

\textsuperscript{30}To escape the limitation of the contemporaneous ownership rule, some subsequent purchasers have urged courts to accept a "continuing wrong theory." Under this theory the wrong that has been perpetrated on the corporation is deemed continuing and it is possible for any plaintiff who becomes a shareholder at any time during the continuation of the wrong to sue derivatively. Palmer v. Morris, 316 F.2d 649 (5th Cir. 1963). In Palmer, the challenged transaction took place before plaintiff acquired his shares of stock, but the corporation made payments under the terms of this transaction subsequent to plaintiff's acquisition. The court ruled that plaintiff had standing to sue. In Bateson v. Magna Oil Corp., 414 F.2d 128 (5th Cir. 1969), the court allowed an action by a longtime shareholder who had inadvertently sold his shares but purchased others before suing, on the basis that the wrong was a continuing one, and he was not estopped by his knowledge of the alleged wrong when he purchased the later shares.

\textsuperscript{31}See notes 44-57 and accompanying text infra.

\textsuperscript{32}CAL. CORP. CODE § 834 (West Supp. 1972); WIS. STAT. ANN. § 180.405 (1957).

\textsuperscript{33}ABA-ALI MODEL BUS. CORP. ACT § 43A (optional section) (1969).

\textsuperscript{34}See Dykstra, supra note 10, at 97.

\textsuperscript{35}Id.

\textsuperscript{36}This specific requirement originated in courts of equity. The rationale was that an exhaustion of intracorporate remedies was proof of the inadequacy of the legal remedy and
action, for management, if the demand has merit, can sue in its own name, thus precluding the derivative action. Moreover, if a majority of the board of directors rejects plaintiff's demand in the exercise of honest business judgment, the shareholder-plaintiff may not bring a derivative action. If the shareholders as a whole ratify the directors' alleged wrongful conduct or refusal to sue, they thereby destroy any cause of action on the part of dissenting shareholders, thus clearly avoiding the possibility for abuse.

C. Supervision by the Court

Rule 23.1 also requires that an action not be dismissed or compromised unless the court gives its approval. The court can direct that other shareholders be notified of any such settlement. The requirement of court approval of a voluntary dismissal or settlement discourages strike suits because it prevents a shareholder from suing and settling out of court in some hidden or secret manner. In addition, the court can prevent an out-of-court settlement which would be unfair to the other shareholders of the corporation. Court supervision also provides a means of independently justifying for the equitable remedy of a derivative action. When there is hostility on the part of management because management is the alleged wrongdoer or is under the control of the alleged wrongdoer, the demand requirement is excused. Smith v. Sperling, 354 U.S. 91 (1957); Campbell v. Loew's Inc., 36 Del. Ch. 563, 134 A.2d 852 (Ch. 1957); Reed v. Norman, 48 Cal. 2d 338, 309 P.2d 809 (1957); Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), cert. denied sub nom. Scurlock v. Meltzer, 379 U.S. 841 (1964). The requirement of a demand on shareholders must be met when the other shareholders could effectively ratify the alleged wrong. The number of shareholders necessary to ratify an alleged wrong can vary anywhere from a mere majority to unanimous shareholder approval. See Note, 32 N.D.L. REV. 125 (1956). See also Mayer v. Adams, 37 Del. Ch. 298, 141 A.2d 458 (Sup. Ct. 1958); Politiz v. Wabash R.R., 207 N.Y. 113, 100 N.E. 721 (1912). The courts may show a great deal of flexibility in cases dealing with shareholder demand, since an indiscriminate insistence on this requirement could discourage meritorious actions. Thus in Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965), the court held that it would be too onerous a burden to require the plaintiff to meet the shareholder demand requirement when the corporation involved had 48,000 shareholders.

37 Ash v. International Business Machines, Inc., 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966) (holding that minority stockholder lacked standing to maintain a derivative suit against another corporation for a Clayton Act violation, in the absence of showing that the refusal of directors to sue in corporate behalf was fraudulent or collusive or represented anything worse than unsound business judgment honestly exercised in corporate interest); Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957) (holding that if a majority of the board, admittedly honest and uninvolved in the alleged wrongs, refuses to bring a suit, complaining shareholders' judgment as to the need to bring that suit cannot replace the directors' judgment); Issner v. Aldrich, 254 F. Supp. 696 (D. Del. 1966) (holding that if shareholder does not allege that directors have been guilty of some misconduct, directors' refusal to sue falls within the business judgment rule barring stockholder's derivative action).

38 See note 36 supra.

suring that the payment of out-of-court settlements is to the corporate treasury and not to the plaintiff. Finally, supervision provides some assurance that attorney fees are limited to a reasonable amount.

**D. Security for Expenses**

Several states have enacted statutes which enable courts to require that plaintiff-shareholders with small interests in the corporation give security for corporate expenses in derivative action litigation. The first statute of this type was enacted in New York in 1944 in reaction to the Wood Report. Under typical security-for-expense statutes, the court will require the plaintiff-shareholder to post security upon demand by the corporation only if his interest in the corporation is below a certain prescribed level. Thus the plaintiff is required to bear, at least initially, the burden of both the defendant's and his own litigation expenses. The purpose of these statutes is to make the derivative suit more difficult, thus discouraging frivolous or improperly motivated suits which do not have substantial probabilities for success. The rationale behind applying these statutes only to small shareholders is the implicit assumption that the larger the shareholder the more likely it is that he is acting in good faith.

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41 The report examined 1,266 suits filed by shareholders in New York City, Kings County, and United States District Court for the Southern District of New York during the years 1932 to 1942. Although the report examined the costs and abuses of derivative suits, its impact was lessened by a lack of candor and objectivity. Supposedly the report was to suggest possible changes in law or procedure which would allow for remedying of corporate wrongdoing while lessening the amount of groundless and costly litigation of this type. In reality, the report became a brief on the alleged need for reducing litigation by stockholders. Special Committee on Corporate Litigation, Chamber of Commerce of the State of New York, Survey and Report Regarding Stockholders' Derivative Suits (1944). See Dykstra, supra note 10, at 76. See also Hornstein, The Death Knell of Stockholders' Derivative Suits in New York, 32 Calif. L. Rev. 123 (1944).

42 Representative statutes include: ABA-ALI Model Bus. Corp. Act § 43A (optional section) (1969) (where plaintiffs own less than 5 percent of outstanding shares or voting trust certificates, unless either of these has a market value in excess of $25,000); N.Y. Bus. Corp. Law § 627 (McKinney Supp. 1972) (less than 5 percent of any class of outstanding shares or voting trust certificates or beneficial interest in shares representing less than 5 percent of any class of such shares, unless the market value of such interest is in excess of $50,000); Wis. Stat. Ann. § 180.405 (1957) (less than 3 percent of outstanding shares of any class, with no alternative dollar amount).

43 The rationale that large shareholders are less likely to bring derivative actions invites
E. The Shareholder Requirement

The limitations discussed above would not necessarily bar any bondholder, corporate noteholder, or convertible debenture holder from bringing a stockholder's derivative action. However, the shareholder requirement of the contemporaneous ownership limitation may present difficulties. As mentioned above, Rule 23.1 requires a plaintiff to have been a shareholder at the time of the transaction of which he complains. Thus the right of the holder of a convertible debenture to bring a shareholder's derivative suit will depend on how, for these purposes, the law defines shareholder. Most legislatures and courts have been inclined to construe the meaning of shareholder very broadly. For example, the majority rule is that not only those who hold legal title but also equitable owners of stock can bring a stockholder's derivative action. Equitable owners allowed to bring suit have included a stockholder who has been enjoined from voting, beneficiaries of inquiry. There appears to be no evidentiary support for the assumption that a derivative action brought by a large shareholder is more likely to be brought in good faith or more likely to be meritorious than an action brought by a small shareholder. Moreover, most of the large corporations in the United States have thousands of shares outstanding and personal interest of one shareholder is necessarily quite small despite a large recovery for the whole corporation. Zinkoff, The American Investor and the Constitutionality of Section 61-b of the New York General Corporation Law, 54 YALE L.J. 352, 384-90 (1945). One possible escape for a plaintiff shareholder is to find other shareholders to join as coplaintiffs since the sum of the equity interest can be used to meet the statutory requirements. See Baker v. Macfadden Publications, Inc., 300 N.Y. 325, 90 N.E.2d 876 (1950); Weinstein v. Behn, 68 N.Y.S.2d 199 (Sup. Ct. 1947), aff'd mem., 272 App. Div. 1045, 75 N.Y.S.2d 284 (1947). See also Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949), where the Court upheld the constitutionality of the New Jersey security-for-expenses statute, N.J. REV. STAT. ANN. § 14A:3-6 (1969). The statute was held to be within the police power of the state, involving no impairment of obligation of contract, and denying neither due process of law nor equal protection of the law on the grounds that it treated all small shareholders alike.

44 See notes 27-35 and accompanying text supra.

45 There has been much disagreement concerning whether federal or state law governs this determination. Compare HFG Co. v. Pioneer Publishing Co., 162 F.2d 536 (7th Cir. 1947), in which the court held the question to be procedural, therefore to be determined without regard to local law with Gallup v. Caldwell, 120 F.2d 90 (3d Cir. 1941), in which the court held that the issue of who is a shareholder is substantive and must be determined by the local law of the state of incorporation. The prevailing view today is that the question is substantive. See 3B J. MOORE, FEDERAL PRACTICE §23.1.17, at 23.1-154 (1969), arguing that the opinion in the HFG Co. case confused the question as to the procedural character of the original rule 23(b) with the substantive issue of whether an equitable owner can sue. See also 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1826, at 327 (1972). Thus under Erie R.R. v. Tompkins, 304 U.S. 64 (1938), if the action is based upon substantive federal law, the court will look to federal law to determine the meaning of shareholder. Hoff v. Sprayregan, 52 F.R.D. 243 (S.D.N.Y. 1971); Blau v. Mission Corp., 212 F.2d 77, 79 (2d Cir.), cert. denied, 347 U.S. 1016 (1954). If the case is in federal court under the diversity jurisdiction, however, substantive state law will be determinative. Rosenfeld v. Schwitzer Corp., 251 F. Supp. 758 (S.D.N.Y. 1966).

46 Dykstra, supra note 10, at 94.

47 W. FLETCHER, supra note 4, at § 5976. N. LATTIN, supra note 14, at 421.

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stock held in trust, owners of stock held on margin, holders of preferred stock, legatees of stock who only had equitable title thereto, and pledgees of shares. Justification allowing equitable owners to bring suit has usually rested upon the equity tradition of stockholder's derivative actions. Moreover, although the corporation might reasonably require an inflexible basis of ascertaining shareholder identity for the purposes of certain intracorporate activities, such as payment of dividends and eligibility to vote, a rigid definition is not required for stockholder's derivative actions.

A broad interpretation of the shareholder requirement is also reflected in the fact that courts have allowed "double derivative actions." A double derivative action is invoked when the owner of shares in a parent corporation sues a fourth party on behalf of a subsidiary. It has been pointed out that multiple derivative actions are also theoretically possible if there is a chain of proprietary interest.

III. THE CONVERTIBLE DEBENTURE HOLDER AND STOCKHOLDER'S DERIVATIVE ACTIONS

A. Recent Case Law

There is remarkably little law on the question of the status of the holder of a convertible debenture for purposes of determining

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52 Hurt v. Cotton States Fertilizer Co., 145 F.2d 293, 295 (5th Cir. 1944).
54 As mentioned earlier, stockholder derivative actions originated in equity courts. See note 7 supra. Equity courts were also willing to look to beneficial interests in the stock rather than disallow the derivative action because the plaintiff was not the holder of the legal title to the stock. See notes 47-53 and accompanying text supra.
55 Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A.2d 112 (Ch. 1948). The court apparently thought that voting, payment of dividends, and appraisal proceedings are regular corporate activities and an inflexible list of stockholders to provide certainty was necessary.
57 Saltzman v. Birrell, 78 F. Supp. 778 (S.D.N.Y. 1948) ("There is no sound reason why if a double derivative is permissible, a triple derivative should not be, and indeed, Marcus v. Otis, 168 F.2d 649, decided by the Court of Appeals of this Circuit on May 20, 1948, tacitly assumes their validity.").
standing in a shareholder’s derivative suit. What law there is, however, indicates that standing will be allowed. In *Hoff v. Sprayregan*, a federal district court held:

While a convertible debenture of the kind in question is obviously a hybrid, the interest of its holder in the corporation’s stock is sufficient for our purposes to satisfy the requirement of Rule 23.1.

While this statement seems perfectly straightforward, its precedential value may be severely limited. In the first place, plaintiffs in *Sprayregan* had exercised their option to convert and were, without question, stockholders at the time of suit. As to their status at the time of the wrongs complained of, the court held in the alternative that the wrong continued after the time of their exercise of conversion rights. By the court’s alternative holding, then, plaintiffs were also clearly stockholders at the time of the wrong complained of. Thus, the decision did not rest solely on the holding that the owners of convertible notes were stockholders for purposes of Rule 23.1.

As to the former holding regarding the status of convertible debenture holders, the court supported its result on two grounds. The action was based on an alleged violation of the Securities Exchange Act of 1934, which includes convertible debentures within its definition of “equity security”; and the court found it appropriate to look to the substantive law of the case in order to determine the meaning of shareholder for procedural purposes. Additionally, the court relied heavily on *Entel v. Guilden*, in which the holder of a warrant had been held to be a shareholder.

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59 *Id.* at 247. The notes in question were $22,000 worth of 6 percent convertible subordinated debentures, convertible for a limited period of time into common stock of the corporation at the rate of one share per seven dollars principal amount.
61 *Id.* § 78c(a)(1).
62 52 F.R.D. at 247. This decision can be criticized on the grounds that the term “shareholder” in Rule 23.1 arguably has a purpose of limitation, while “equity security” in the Securities Exchange Act of 1934 is to be broadly interpreted. Characterizations in one statute should not necessarily be determinative out of context.
64 A warrant is a right to purchase a specified number of shares from a corporation for a specified price within a given time limit. Warrants are quite often traded through a securities exchange or over the counter, in a similar fashion to convertible debentures. Thus warrant owners have the option of exercising the purchase right, letting it expire, or selling it to another investor. The choice will depend upon various market considerations. The only substantive difference between a warrant and a convertible debenture is that the former is a pure conversion right while the latter also includes a creditor-debtor relationship. See generally Vernava, *Stock Options: Corporate, Regulatory and Related Tax Aspects*, 30 U. PITI. L. REV. 197 (1968); Katzin, *supra* note 1; ABA-ALI MODEL BUS. CORP. ACT § 18A (1969); N.Y. BUS. CORP. LAW § 505 (McKinney 1963), as amended, (McKinney Supp. 1972).
Convertible Debentures

within the meaning of Rule 23.1. *Entel* dealt with a cause of action arising under the Investment Company Act of 1940,\(^65\) and the court had found justification for its result in the "broadly remedial" purposes of the Act.\(^66\) Thus, what case precedent there is to support the *Sprayregan* holding seems clearly distinguishable from *Sprayregan* on its facts.

Ultimately, whether the holder of a convertible debenture is deemed to be a shareholder appears to depend substantially on the policy considerations which the court finds to be important. The court in *Sprayregan*, for example, found that none of the policies behind the shareholder requirement of Rule 23.1 would be frustrated by allowing the plaintiffs to sue.\(^67\) Yet if one views a particular form of security as a bundle of legal rights and duties, it seems, as indicated by the court in *Entel*, that courts should not lightly go about changing the content of various bundles of legal rights and duties, each bundle being a different "mode of investment within the corporate framework," bought and sold with various expectation and reliance interests.\(^68\)

A situation analogous to that of the holder of convertible debentures was presented in *deHaas v. Empire Petroleum Co.*\(^69\) In that case the stockholder of a corporation extinguished in a merger was allowed to bring a derivative action on behalf of the surviving corporation, even though he was not a record shareholder of the surviving corporation, on the basis of his right to exchange his stock in the extinguished corporation for stock of the surviving operation. The court was explicit in its reasoning. The plaintiff, because he could at any time exchange his shares, was deemed to have an equitable interest in the stock of the surviving corporation; and this equitable interest was sufficient to satisfy the requirement of Rule 23.1.

It is well established, at least in federal law, that the equitable owner of stock is entitled to bring a shareholder's derivative action.\(^70\) Difficulty arises in determining whether the holder of a

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\(^66\) 223 F. Supp. at 133.
\(^67\) 52 F.R.D. at 247. The court noted the obvious substantiality of the $22,000 investment made by the plaintiffs in this case well before any of the events about which they sue. It is plain that their interest in the stock of the corporation from the inception of their investment was real and far weightier than that of a holder of, say, 100 shares who would unquestionably be entitled to maintain the action. To allow standing to plaintiffs like these generates no trace of the problems or evils against which Rule 23.1 is directed.

\(^68\) 223 F. Supp. at 131–32.

\(^69\) 435 F.2d 1223 (10th Cir. 1970).

\(^70\) HFG Co. v. Pioneer Publishing Co., 162 F.2d 536 (7th Cir. 1947); See notes 47–54 and accompanying text *supra*. 
convertible debenture has the type of interest in the stock of the corporation that can be called equitable ownership. The deHaas case would seem to support such a conclusion, if only by analogy: the right to exchange stock pursuant to a merger is arguably similar in nature to the rights inhering in a convertible debenture. While Sprayregan allowed the convertible debenture holder to bring a stockholder’s derivative suit, it did not directly state that the plaintiff was an equitable owner of stock in the corporation. It simply concluded that a convertible debenture is that type of investment in a corporation to which it would be appropriate to attach the right to bring a stockholder’s derivative suit. The court was obviously influenced by the fact that the plaintiff had some sort of interest in the corporation’s stock but apparently did not find it necessary to conclude that that interest be as direct as equitable ownership.

Indeed, some courts have explicitly held that the holder of a convertible debenture does not have an equitable interest in the corporation’s stock. The existence of equitable ownership requires the simultaneous existence of two estates in or titles to the same subject matter: the first is legal, vested in one person, and traditionally recognized only by courts of law; the second is equitable, vested in another person, and traditionally recognized only by courts of equity.\(^1\) Certainly it could be argued that the conversion feature of the convertible debenture results in precisely such a division of ownership, with the corporation holding legal title to the stock while the security owner holds the equitable title. Vesting of legal title in the security owner is contingent upon payment of the required conversion price. An analogy can be seen between this suggested division of ownership and that which courts recognize when stock is held on margin by a brokerage house.\(^2\) The few decisions on this issue, however, have refused to recognize that the conversion feature of a bond or warrant can give status to the holder as either a legal or equitable stockholder.\(^3\) Furthermore, these cases have held that this type of security holder’s interest is purely contractual, and until he exercises his conversion rights and demands his stock he has no

\(^1\) J. Pomeroy, A Treatise on Equity Jurisprudence § 147 (5th ed. 1941).

\(^2\) See note 50 and accompanying text supra. In the margin account, legal title to the stock would be held by the stockbroker, until such time as the equitable owner pays off the loan made to him by the broker to purchase the stock.

interest in the corporation as a stockholder.\textsuperscript{74} If a corporation failed to convert the bonds into stock upon demand by the security holder, a court of equity would probably refuse to give specific performance.\textsuperscript{75}

While these cases have held the holders of convertible debentures not to be equitable owners of stock, this should not be dispositive of the question of standing to bring a stockholder's derivative action. Most of the decisions involved attempts by bondholders to enforce personal rights as stockholders rather than derivative actions on behalf of the corporation. Because the Sprayregan court, the one court which has ruled directly on the issue in the context of the stockholder's derivative suit, did not confine itself to technical questions of ownership and fine classifications of equitable interests, it is appropriate to consider those policy issues which should influence a court in determining standing to bring a stockholder's derivative suit.

**B. Policy Considerations**

Strike suits, purchased litigation, and collusive invocation of diversity jurisdiction all are possible dangers inherent in derivative actions.\textsuperscript{76} Federal Rule of Civil Procedure 23.1 (with its requirements of contemporaneous ownership,\textsuperscript{77} exhaustion of intracorporate remedies,\textsuperscript{78} and supervision by the court\textsuperscript{79}), various state statutes of a similar nature,\textsuperscript{80} and state statutes requiring security for expenses\textsuperscript{81} protect the system from these inherent dangers. These rules and statutes with their numerous requirements would appear to be equally effective in protecting against abuses from derivative actions brought by holders of convertible debentures. It is not clear, however, that the shareholder require-
ment is as easily satisfied by the holder of a convertible debenture. Previous discussion pointed out that most legislatures and courts have been inclined to construe the word shareholder very broadly. This history of broad construction may be helpful in deciding whether convertible debenture holders possess the requisite interest in the stock of the corporation.

One policy behind the shareholder requirement is to insure that the plaintiff has an interest in the outcome of the litigation. Because a shareholder owns a share of the corporate assets, his interest is obvious and he is allowed to sue to protect this proprietary interest if the management of the corporation refuses to do so. Likewise, the holder of a convertible debenture has a substantial interest in the value of the corporate stock. He has in effect made two investments. He has purchased a senior security with a fixed income return, and he has purchased the right to convert the debenture into stock of the corporation at a set price. He can obtain an adequate remedy for injury to some of the incidents of his investment. However, the value of this right to convert is directly proportional to the value of the stock. If the value of the stock falls because of some injury done to the corporation, the value of the convertible debenture falls as well. The stockholder would have the right to bring a stockholder's derivative action to protect his interest if the management of the corporation refused to bring an action. The convertible debenture holder like a shareholder is vitally interested in the value of the corporation's stock. Like a shareholder, he too should be able to bring a derivative action, for his rights as a creditor will not protect his interest in the value of the stock. As was discussed

82 See notes 44-57 and accompanying text supra.
83 See notes 46-57 and accompanying text supra.
84 Watson v. Button, 235 F.2d 235 (9th Cir. 1956); Entel v. Guilden, 223 F. Supp. 129, 131 (S.D.N.Y. 1963); Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942). To be sure, the shareholder requirement also has a basis in the theory of corporate law. Conceptually the stockholder's derivative action is a procedural device enabling the owners of a corporation to enforce causes of action belonging to the corporation. If the derivative action is viewed simply as a means for the owner to protect his proprietary interest, then it might be argued that the holder of a convertible debenture, not being an owner of the corporation, should not be allowed to bring the suit. It is true that stockholders have certain rights—liquidation rights, dividend participation rights, and usually voting rights—which are not possessed by the convertible debenture holder. As a practical matter, however, the derivative suit is brought to protect not these perquisites of ownership but rather the value of the shareholder's investment. The holder of a convertible debenture has made an analogous investment (see notes 85-86 and accompanying text infra), and because of his interest in the value of the corporation's stock he may be as concerned as the stockholder in seeing that corporate causes of action are enforced.
85 Katzin, supra note 1, at 361.
86 See note 3 supra.
87 See notes 91-98 and accompanying text infra.
earlier, a personal cause of action may be impossible. Selling the convertible debenture is no remedy since its value may have declined because of the injury done to the corporation. It appears that the same policies which weighed in favor of allowing the stockholder to bring a derivative action should apply here.

Thus, a holder of a convertible debenture may be as vitally interested in the proper management of corporate assets as any true stockholder or equitable owner whose right to bring such an action has been recognized. Also it has been shown that many corporations issue convertible debentures to raise equity capital rather than to make the debenture more marketable. Thus, most corporations probably view the convertible debenture as a means of obtaining common-stock or equity investment. It would seem appropriate to encourage equity investment of this type by providing adequate protection to the investors in the form of a right to bring a stockholder's derivative action.

It may seem unfair to give the holder of a convertible debenture both the protection of a creditor and the protection of an equity investor. This particular investor has, however, paid for two different investments. The fact that both types of investments are combined into one package called a convertible debenture should not affect the availability of protective devices appropriate to each form of investment. As long as the investor has contracted for both types of investment and has expectation and reliance interests in each accordingly, it would follow that the necessary protections should be provided for both. Arguably the investor has assumed the risk of economic, business, and market uncertainties; however no investor should be deemed to have assumed the risk of actionable mismanagement. Thus all investors who have vital financial interests in the value of the corporation's stock should be considered shareholders and thus capable of bringing a derivative action.

It is important to note that it is the convertibility option of

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88 Sullivan, supra note 16, at 584. In cases where the harm is based upon a wrong to the incorporated entity as a whole (quite often a breach of some duty to the corporation), no personal cause of action is possible. A personal cause of action will only be allowed when the harm is a direct injury to the shareholder's individual right, i.e., breach of his membership contract.


90 The cost of the convertibility privilege is the difference in interest payments between a straight debenture and a convertible debenture. See note 2 supra.

91 Even if the convertible debenture is not a separable investment, it is clear that the convertible debenture holder who receives a smaller return than a straight bond- or noteholder has a vital interest in the stock of the corporation which bond- and noteholders in general do not share.
convertible debenture which justifies the remedy of a stockholder's derivative action. To illustrate this, it is instructive to analyze the ordinary bondholder's investment to determine if he has an interest sufficient to allow him to bring a derivative action. Initially there is a question as to whether the bondholder is even injured by a failure of management to enforce a corporate cause of action. As long as there exist sufficient corporate resources to pay the debenture holder his periodic interest payments and his principal at date of maturity he has not been harmed at all. In contrast, owners of corporate common stock and of rights convertible into common stock have been injured immediately if management refuses to enforce a corporate cause of action. This injury consists not only of the diminution of the corporate assets, of which they are owners, but also of the decline in the market value of their stock or stock rights.

The bondholder may be indirectly hurt by management's refusal to bring a corporate cause of action if the injury to the corporation jeopardizes the required interest payments and principal repayment. An equitable remedy, though, such as a stockholder's derivative action, is neither necessary nor suitable for such an injury, for the bondholder has other legal and equitable remedies which adequately protect him. Should a corporation default when a payment is due, the bondholder has an action against the corporation based upon rights provided him by the law of contracts and of negotiable instruments.92 Protection for the bondholder prior to forfeiture can be provided by the terms of an indenture agreement.93 The agreement might limit the corporation in a number of ways in order to provide protection against possible default including limiting corporate borrowing, imposing a liabilities-to-assets margin requirement, limiting dividend payments, restricting share redemption or purchase, requiring the continuation of specific reserves, or limiting the amount of additional securities is-

92 See note 4 supra.
93 The indenture (often called a trust agreement or deed of trust) is a contract between the issuer and a trustee for the bondholders. The trustee, who is usually a financial institution, represents the numerous bondholders under a particular security issue. Indentures are subject to the particular requirements of the Federal Trust Indenture Act of 1939, 15 U.S.C. § 77aaa et seq. (1970). This Act requires that bonds, debentures, notes, and other debt securities, other than particularly exempted securities, which are offered to the public through the mail or interstate commerce be secured by a qualified indenture. To be qualified, the indenture must provide for an independent institutional trustee, which is subject to affirmative duties to protect the indenture security holder. Certain exculpatory provisions, which formerly limited the trustee's liability, are now prohibited. See also Garret, A Borrower's View of the Model Corporate Debenture Indenture Provisions, 21 BUS. LAW. 675 (1966); Rodgers, The Corporate Trust Indenture Project, 20 BUS. LAW. 551 (1965).
sued. If a potential bond purchaser did not find the provisions of a specific indenture agreement protective enough, he might have available the additional creditor protection of a mortgage bond, a bond of higher security of principal than a debenture.

There is a great deal of disagreement among the various states as to whether the officers of the corporation are liable to creditors for an injury primarily to the corporation. Where corporate mismanagement has resulted in the corporation's default on a payment, many states will allow a creditor to bring a creditor's bill on behalf of the corporation against corporate officers if the corporation has become insolvent through negligent management. If a corporation is solvent, there is no need to resort to the individual liability of officers. In many jurisdictions, to protect creditors to an even greater extent legislatures have enacted statutes which make directors, trustees, and officers personally liable for corporate debts if they have acted negligently.

IV. Conclusion

There are sound economic and public policy reasons for classifying the holder of a convertible debenture as a stockholder for purposes of bringing a stockholder's derivative action. The convertible debenture holder is an investor who has a substantial financial interest in the value of the corporation's stock. Since part of his investment represents the right to convert into common

95 A mortgage bond is secured by a mortgage or lien on property of the issuing corporation. Thus first mortgage bonds are usually the senior issue and would have preferred creditor status. H. Henn, supra note 4, § 156, at 281.
96 W. Fletcher, supra note 4, at § 1180.
97 The theory behind such a cause of action is that the right of the corporation to sue is a chose in action and therefore an equitable asset, which can be reached by a creditor's bill. See, e.g., A.B. Gochenour v. George & Francis Ball Foundation, 35 F. Supp. 508 (S.D. Ind. 1940), aff'd, 117 F.2d 259 (7th Cir.), cert. denied, 313 U.S. 566 (1941); Michelsen v. Penney, 10 F. Supp. 537 (S.D.N.Y. 1934); Pritchard v. Myers, 174 Md. 66, 197 A. 620 (1938); Pennsylvania Bank v. Hopkins, 111 Pa. 328, 2 A. 83 (1886).
98 A detailed description of the different types of statutes is impractical because of the great variety among jurisdictions. Generally the statutory scheme will incorporate one or more of the following remedial approaches:

(1) statutes creating liability where statutory conditions precedent to the right to do business have not been complied with or where all or a certain part of the stock has not been subscribed for or paid in;

(2) statutes providing that the violation of any of the provisions of the incorporation act, or of certain preceeding sections of the act, shall make directors or other officers personally liable;

(3) statutes making officers liable to creditors, or creditors and others, for negligence or other breach of duty;
stock, the corporation usually views him as a contributor to equity capital. Since his creditor status in terms of the debenture does not protect him from injury to the corporation which substantially damages the value of his convertible right, it is essential that law or equity provide some alternative protection. The right to bring a stockholder's derivative action would provide adequate protection and further serve the important public policy of encouraging capital contribution through convertible debentures. Moreover, what case law there is seems to support this position.

Strike suits, purchased litigation, and collusive invocation of diversity jurisdiction are all possible dangers inherent in derivative actions, but they are easily avoided in suits brought by holders of convertible debentures by the same devices used to prevent these dangers in the usual shareholder's derivative suit. While there seems to be no need to extend the availability of the derivative action to ordinary bondholders and other creditors of the corporation, it is an appropriate remedy for holders of convertible debentures.

—Robert A. Malstrom

(4) statutes creating personal liability where the debts exceed a certain amount;
(5) statutes making directors and other officers personally liable where they pay a dividend wrongfully;
(6) statutes making officers personally liable for failure to file annual reports; and
(7) statutes making corporate officers personally liable for false reports, certificates, statements, notices, or the like.

W. Fletcher, supra note 4, at § 1200. See also National Refractories Co. v. Bay State Builders' Supply Co., 334 Mass. 541, 137 N.E.2d 221 (1956).