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Corporations - Derivative Suits - Stockholder Demand as Condition Precedent

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CORPORATIONS—DERIVATIVE SUITS—STOCKHOLDER DEMAND AS CONDITION PRECEDENT—A derivative suit alleging directors' fraud was brought by a minority shareholder, but there was no allegation of a demand for relief having been made on the corporation's stockholders prior to bringing the suit. The plaintiff did allege, however, that it was useless and impossible for him to make demand on the stockholders because the complaint charged directors' fraud which was a void act beyond the power of the stockholders to ratify, and secondly because it would be highly unreasonable to require plaintiff to make a demand for relief on more than 100,000 stockholders of the corporation. Delaware Chancery Rule 23(b)¹ requires that a plaintiff in order to bring a derivative suit must allege with particularity his efforts to obtain the relief sought from the directors of the corporation and "if necessary" from the stockholders, or his reasons for failing to make such demand. The lower court held that plaintiff's allegations were insufficient to excuse the condition precedent of stockholder demand established by the chancery rule, and dismissed the bill.² On appeal, *held*, reversed, with petition for reargument denied. The Delaware chancery rule does not require a useless act and when directors' fraud, which is beyond the power of the stockholders to ratify, is alleged

¹ Court of Chancery Rules, rule 23(b), 13 Del. Code Ann. (1952) 122 provides: "The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the stockholders such action as he desires . . . or the reasons for not making such effort."

² *Mayer v. Adams*, (Del. Ch. 1957) 133 A. (2d) 138. Compare *Campbell v. Loew's, Inc.*, (Del. Ch. 1957) 134 A. (2d) 565, for a picture of the uncertainty in the Chancery Court concerning the proper application of rule 23(b) prior to the decision in the principal case.

stockholder demand is not "necessary." *Mayer v. Adams*, (Del. 1958) 141 A. (2d) 458.

American courts are divided on the subject of stockholder demand as a condition precedent to the derivative suit. One group follows the so-called English rule,³ which states that a prior demand on the stockholders is a condition precedent to bringing a derivative suit only when the acts complained of are ratifiable by the shareholders.⁴ The other view, the American or federal rule, was founded on the same theory as the English rule,⁵ but subsequent development has made it more stringent.⁶ The American rule now requires prior demand on the stockholders before bringing suit even though the acts complained of are not ratifiable,⁷ but the courts in applying this rule have held that stockholder demand will be excused in certain circumstances where it would be "totally useless."⁸ The English rule appears to be the better view of the stockholder demand requirement since it is based on the sound principle that it is unnecessary to require demand if the stockholders cannot block the derivative suit.⁹ This is the case when a void act which the shareholders cannot ratify, such as fraud, is alleged. Prior to adoption of chancery rule 23(b)

³ An old English case, *Foss v. Harbottle*, 2 Hare 461, 67 Eng. Rep. 189 (1843), is the first case stating the rule of stockholder demand. *Continental Securities Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912), 51 L.R.A. (n.s.) 112 (1914), is the leading American case applying the English rule. See also *Fisher v. National Mortgage Loan Co.*, 132 Neb. 185, 271 N.W. 433 (1937).

⁴ As to what acts are ratifiable, see *Keenan v. Eshleman*, 23 Del. Ch. 234, 2 A. (2d) 904 (1938); 6 UNIV. CHI. L. REV. 269 (1939); 53 HARV. L. REV. 1368 (1940).

⁵ *Hawes v. Oakland*, 104 U.S. 450 (1881), the leading case on the American rule of stockholder demand, cited and approved *Foss v. Harbottle*, note 3 *supra*.

⁶ See *Escoett v. Aldecross Country Club*, 16 N.J. 438, 109 A. (2d) 277 (1954), for an excellent summary of this development. See also 72 A.L.R. 628 (1931).

⁷ The primary justification which the courts give for requiring stockholder demand when the acts complained of are not ratifiable is that a majority of the stockholders may be able to rectify the wrong (i.e., by removing the directors, ordering an accounting or taking the suit over in their own right) even though they could not ratify it. See *Caldwell v. Eubanks*, 326 Mo. 185, 30 S.W. (2d) 976 (1930); 3 MOORE, FEDERAL PRACTICE 3528-3530 (1948). Experience, however, has shown that any such rectification is extremely unlikely to occur, particularly in larger corporations. See *Carroll v. New York, New Haven & Hartford R. Co.*, (D.C. Mass. 1956) 141 F. Supp. 456, noted in 55 MICH. L. REV. 450 (1957), for a striking example of the impossibility of stockholder rectification of corporate injuries. Only one state, Massachusetts, has gone beyond stockholder rectification as the reason for requiring demand, to the extreme position that a majority of the stockholders could actually veto a derivative suit even though they do not have the power to ratify the acts complained of. See *Stickells*, "Derivative Suits—The Requirement of Demand Upon the Stockholders," 33 BOST. UNIV. L. REV. 435 (1953).

⁸ *Hawes v. Oakland*, note 5 *supra*. Stockholder demand under the American rule is generally held to be excused when a majority of the shareholders are involved in the acts complained of, or when there is insufficient time to make a demand on the stockholders because immediate injury to the corporation is threatened. See also *Hill v. Wallace*, 259 U.S. 44 (1922).

⁹ See generally, BALLANTINE, CORPORATIONS §146 (1946), for a discussion of the better approach to the stockholder demand requirement.

and this decision, the Delaware courts had not specifically ruled on the requirement of stockholder demand. The silence of the Delaware courts can be taken to mean that they either had no requirement of stockholder demand whatsoever,¹⁰ or that they followed the English rule.¹¹ The problem presented in the principal case is that chancery rule 23(b) is a prototype of federal rule 23(b), which is commonly considered a codification of the American rule on stockholder demand.¹² Thus it is arguable that the adoption of this provision carries with it adoption of the American rule. The Delaware court, however, wisely rejected this argument and interpreted the "necessary" proviso in rule 23(b) as requiring only circumstances similar to those required under the English rule. The court in reaching this decision points out that not even the federal courts are in complete harmony in applying the American rule,¹³ and that a state court is not bound to follow federal interpretation of a procedural rule when a conflict with substantive law would result.¹⁴ It is also pertinent for state courts to note that a federal court may be justified in interpreting the stockholder demand requirement more stringently than is necessary in a state forum because of a need to limit sham diversity jurisdiction through derivative suits.¹⁵ At least one state court, however, has felt that the adoption of rule 23(b) has bound the court to accept the American rule despite the fact that this rule is contrary to its prior practice and natural inclination.¹⁶ The principal case, therefore, by indicating that enactment of the federal rule does not necessarily require adoption of the American rule on stockholder demand, establishes a valuable precedent for state courts confronted with the problem of interpreting rule 23(b).

The practical question whether a stockholder demand requirement

¹⁰ The Delaware courts had never explicitly defined their position on stockholder demand, but their silence and customary practice indicated that there was no demand requirement prior to the adoption of rule 23(b). See, generally, *Sohland v. Baker*, 15 Del. Ch. 431, 141 A. 277 (1927); *Toebelmann v. Mo.-Kan. Pipeline Co.*, (D.C. Del. 1941) 41 F. Supp. 334.

¹¹ *Steinberg v. Hardy*, (D.C. Conn. 1950) 90 F. Supp. 167, interpreted the silence of the Delaware courts on stockholder demand as an acceptance of the English rule.

¹² *Escoett v. Aldecross Country Club*, note 6 *supra*.

¹³ Compare *Bruce & Co. v. Bothwell*, (S.D. N.Y. 1948) 8 F.R.D. 45, and *Steinberg v. Adams*, (S.D. N.Y. 1950) 90 F. Supp. 604.

¹⁴ The court pointed out that the adoption of the American rule would partially nullify the rule of substantive law in Delaware that the stockholders cannot ratify fraud. *Keenan v. Eshleman*, note 4 *supra*.

¹⁵ *Hawes v. Oakland*, note 5 *supra*, points out the undesirable use of derivative suits as a means of sham diversity jurisdiction. This practice was one of the reasons for the development of the American rule on stockholder demand in the federal courts.

¹⁶ *Escoett v. Aldecross Country Club*, note 6 *supra*. The adoption of rule 23(b) in this state was by legislative enactment rather than by court rules. Therefore, the court felt that the legislative intent forced them to accept the American rule. This problem of legislative intent would weaken the authority of the principal case in states where the legislature has adopted the federal rules.

should apply to widely-held corporations was not decided, however, by the instant case. In the setting of corporations with large numbers of stockholders, submission of a demand to the stockholders would be as expensive as a proxy fight, which the average plaintiff in a derivative suit can hardly afford.¹⁷ Yet there is only very meager authority which excuses stockholder demand because of the prohibitive cost involved in circulating the demand among thousands of shareholders.¹⁸ On the other hand there is considerable authority which, applying the American rule rather strictly, holds that the size of the corporate body and the expense to be incurred are not excuses for failing to make the demand.¹⁹ In jurisdictions where this remains an open question, courts which do not wish to bar legitimate derivative suits in widely-held corporations should treat the prohibitive cost of a stockholder demand as an additional limitation on the requirement, whether they have adopted the English or American rule. The court in the principal case uses language which indicates that it might consider prohibitive cost a valid additional limitation on stockholder demand.²⁰ If such a suggestion is followed in later decisions the instant case will have made two significant contributions in determining proper application of the stockholder demand requirement.

W. Stanley Walch, S.Ed.

¹⁷ See *Pomerantz v. Clark*, (D.C. Mass. 1951) 101 F. Supp. 341, for an excellent example of the expense involved in making a demand on the stockholders of a widely-held corporation.

¹⁸ *Berg v. Cincinnati, Newport & Covington R. Co.*, (E.D. Ky. 1944) 56 F. Supp. 842.

¹⁹ *Bruce & Co. v. Bothwell*, note 13 supra; *Pomerantz v. Clark*, note 17 supra; *Carroll v. New York, New Haven & Hartford R. Co.*, note 7 supra.

²⁰ Principal case at 461.