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## CORPORATIONS-DERIVATIVE SUITS-WHO IS A SHAREHOLDER UNDER FEDERAL RULE 23 (b)

Kent Chandler, Jr.  
*University of Michigan Law School*

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CORPORATIONS—DERIVATIVE SUITS—WHO IS A SHAREHOLDER UNDER FEDERAL RULE 23 (b)—Plaintiff brought suit in a federal district court to enforce the rights of defendant, an Illinois corporation, to monies allegedly embezzled by its president and to certain shares of stock allegedly issued to him illegally. The complaint alleged that plaintiff, a Delaware corporation, “is now and has been at all times hereinafter complained of the owner of 6538 shares of the common stock of . . . defendant herein.”<sup>1</sup> Defendant, showing by affidavit that plaintiff had never been a shareholder of record, moved to dismiss the complaint for failure to meet the requirements of federal rule 23 (b).<sup>2</sup> The court granted the motion, holding that plaintiff’s status as shareholder was governed by the law of the state of incorporation, and Illinois law required that a shareholder bringing a derivative suit be one of record.<sup>3</sup> On appeal, *held*, reversed. The word “shareholder” in rule 23 (b) includes the equitable owner, who also is permitted to sue under Illinois law. Further, who is a shareholder under rule 23 (b) is a question to be determined irrespective of local law.<sup>4</sup> *H.F.G. Co. v. Pioneer Pub. Co.*, (C.C.A. 7th, 1947) 162 F. (2d) 536.

Early federal cases, in contrast to the majority state rule, apparently required that a shareholder in a derivative suit be one of record.<sup>5</sup> Later decisions,

<sup>1</sup> Principal case at 537.

<sup>2</sup> “In an action brought to enforce a secondary right on the part of one or more shareholders . . . the complaint shall . . . aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains. . . .” Rule 23 (b), Federal Rules of Civil Procedure of 1938, 28 U.S.C. (1940) § 723c et seq.

<sup>3</sup> *H.F.G. Co. v. Pioneer Pub. Co.*, (D.C. Ill. 1946) 7 F.R.D. 366.

<sup>4</sup> Concurring opinion held the question one of substantive law but concurred since Illinois law was in accord. Principal case at 541.

<sup>5</sup> 2 MOORE, FEDERAL PRACTICE 2263 and note 81 (1938); contra, *Citizens’ Sav. & T. Co. v. Illinois C. R. Co.*, (C.C.A. 7th, 1910) 182 F. 607, holding stock certificate merely evidence of ownership and beneficial owner may sue derivatively.

however, clearly established that the right to maintain such a suit was not restricted to the registered shareholder.<sup>6</sup> While cases arising under rule 23 (b) have reached the same result,<sup>7</sup> that result has largely depended upon the effect given to *Erie R. Co. v. Tompkins*,<sup>8</sup> which gave rise to the problem whether the provisions of rule 23 (b) are to be deemed procedural and hence governed by federal interpretation, or substantive and hence by applicable state law.<sup>9</sup> Decisions upon this point remain conflicting. The problem has not always been recognized,<sup>10</sup> and in many cases where it has, courts have found a decision upon the point unnecessary because of the conformity of local law.<sup>11</sup> Where state law is in conflict, some courts have vigorously asserted the procedural character of rule 23 (b),<sup>12</sup> while others in reaching the same result have indicated some doubt.<sup>13</sup> Although there is considerable authority upholding the substantive nature of the rule,<sup>14</sup> the recent trend is toward the view that it

<sup>6</sup> *Arcola Sugar Mills Co. v. Burnham*, (C.C.A. 5th, 1933) 67 F. (2d) 981 (pledgee); *Starrett Corp. v. Fifth Ave. & Twenty-Ninth St. Corp.*, (D.C. N.Y. 1932) 1 F. Supp. 868 (holder of shares still in transferor's name); *Willcox v. Harriman Securities Corp.*, (D.C. N.Y. 1933) 10 F. Supp. 532 (former stockholders induced by fraud to exchange stock).

<sup>7</sup> *Richardson v. Blue Grass Mining Co.*, (D.C. Ky. 1939) 29 F. Supp. 658, *affd.*, (C.C.A. 6th, 1942) 127 F. (2d) 291 (plaintiffs entitled to 50 per cent of capital stock, but not shareholders of record); *Gallup v. Caldwell*, (C.C.A. 3d, 1941) 120 F. (2d) 90 (allegations of ownership plus papers submitted to show equitable ownership of 100 shares); *Goldstein v. Groesbeck*, (C.C.A. 2d, 1944) 142 F. (2d) 422 (double derivative suit); *Hurt v. Cotton States Fertilizer Co.*, (C.C.A. 5th, 1944) 145 F. (2d) 293 (residuary legatee); *Craftsman Finance & Mortgage Co. v. Brown*, (D.C. N.Y. 1945) 64 F. Supp. 168 (equitable owners under unexecuted stock exchange agreement); *contra*, *Bankers National Corp. v. Barr*, (D.C. N.Y. 1945) 7 F.R.D. 305 (stock held through nominee).

<sup>8</sup> 304 U.S. 64, 58 S.Ct. 817 (1938), decided after the promulgation of the federal rules but before they took effect.

<sup>9</sup> For discussion of the nature of rule 23 (b) see Ilsen, "Recent Cases and New Developments in Federal Practice and Procedure," 16 ST. JOHNS L. REV. 1 at 40 (1941); 38 COL. L. REV. 1472 at 1480 (1938); 41 COL. L. REV. 104 at 115 (1941); 9 UNIV. CHI. L. REV. 308 at 312 (1942); 2 MOORE, FEDERAL PRACTICE 2250 et seq. (1938) and *id.* (1946 Supp.) 87 et seq.

<sup>10</sup> *Richardson v. Blue Grass Mining Co.*, (D.C. Ky. 1939) 29 F. Supp. 658.

<sup>11</sup> *Craftsman Finance & Mortgage Co. v. Brown*, (D.C. N.Y. 1945) 64 F. Supp. 168; *Hurt v. Cotton States Fertilizer Co.*, (C.C.A. 5th, 1944) 145 F. (2d) 293.

<sup>12</sup> *Piccard v. Sperry Corp.*, (D.C. N.Y. 1941) 36 F. Supp. 1006; *Perrott v. U.S. Banking Corp.*, (D.C. Del. 1944) 53 F. Supp. 953.

<sup>13</sup> *Summers v. Hearst*, (D.C. N.Y. 1938) 23 F. Supp. 986; *Cohen v. Young*, (C.C.A. 6th, 1941) 4 FED. RULES SERV. 23 b. 1, case 3, p. 412 reversed, (C.C.A. 6th, 1942) 127 F. (2d) 721. Both cases relied on the authority of the Supreme Court to promulgate rules of procedure.

<sup>14</sup> *Gallup v. Caldwell*, (C.C.A. 3d, 1941) 120 F. (2d) 90; *Bankers National Corp. v. Barr*, (D.C. N.Y. 1945) 7 F.R.D. 305. Both cases refer to CONFLICT OF LAWS RESTATEMENT, § 182 (1934): "Whether a person is a shareholder . . . is determined by the law of the state of incorporation." See also references cited in note 9, *supra*.

is procedural.<sup>15</sup> A final decision either way as to rule 23 (b) as a whole would seem complicated by its different effects upon the provisions of clause (1). A procedural holding, for example, would result in protecting the interest of an equitable shareholder, but at the same time would deprive a shareholder of a right enjoyed in a majority of state courts to enforce corporate recovery for transactions occurring prior to acquisition of ownership.<sup>16</sup> One court has reached a compromise solution by holding clause (1) substantive as to the status of a shareholder but procedural as to time of ownership.<sup>17</sup> In the principal case, inasmuch as the court reversed the holding of the lower court as to Illinois law, it might have declined to express an opinion as to the procedural nature of rule 23 (b). The issue, however, was raised below, so the court took occasion to declare itself in favor of the procedural view.<sup>18</sup> In view of the conflicting decisions in federal courts it would seem a settlement of the question must await judicial decision by the Supreme Court.<sup>19</sup>

*Kent Chandler, Jr.*

<sup>15</sup> 28 U.S.C.A., 1947 Spec. Pamphlet, §§ 721-723 at 22.

<sup>16</sup> See states listed 148 A.L.R. 1090 et seq. (1944), also 13 FLETCHER, CORPORATIONS, §§ 5980, 5981 (1943), id. (1947 Supp.) 31, 32. It should be noted that N.Y. [22 N.Y. Consol. Laws (McKinney, Supp. 1947), § 61] and N.J. [N.J. Rev. Stat. (Cum. Supp. 1945) 14:3-16] have joined the states following federal rule 23 (b).

<sup>17</sup> Bankers National Corporation v. Barr, (D.C. N.Y. 1945) 7 F.R.D. 305. If rule 23 (b) is finally held substantive, Advisory Committee proposes amending it to render clause (1) inoperative in jurisdictions where state law permits subsequent shareholder to sue. 28 U.S.C.A., 1947 Spec. Pamphlet, §§ 721-723 at 22.

<sup>18</sup> Principal case at 539, apparently following Perrott v. United States Banking Corp., (D.C. Del. 1944) 53 F. Supp. 953 at 956, in supporting the position of Judge Clark, who argued that in order to maintain the integrity of the federal rules "a strong presumption should be indulged in that matters included in them as procedural are to be so held by the courts." "The Tompkins Case and the Federal Rules," 1 F.R.D. 417 at 421 (1940).

<sup>19</sup> 28 U.S.C.A., 1947 Spec. Pamphlet, §§ 721-723 at 22.