UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 37 | Number 3 Article 8

4-1-1959

Corporations -- Corporate Action for Mismanagement Precluded Where Sole Stockholder Has No Standing in Equity to Sue

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There is an appalling lack of authority on the problem of whether there can be a subsequent liability on an owner of chattels cast ashore by an Act of God. Regardless of how this problem is resolved it does not appear that the case will be ripe for a limitation of liability. If there is a subsequent liability the defendant will be faced with privity or knowledge; if there is not a liability there is no cause to limit.[20]

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Corporations—Corporate Action for Mismanagement Precluded Where Sole Stockholder Has No Standing in Equity to Sue

Park Terrace, Inc. v. Burge,[1] a recent case of first impression, has added a third decision to the *Park Terrace* litigation.[2] In the present case the two defendants had been original shareholders of Park Terrace, Inc. The capital structure of the corporation provided that one class of stock would be called "preferred." All the shares of this class were held by the Federal Housing Administration.[3] In addition there were two other classes of stock, Class A and Class B. The Class B

[20] "The doctrine of limitation of liability presupposes that a liability exists which is to be limited, but if no liability exists, there is nothing to limit." In the Matter of Cherokee Trawler Corp., 157 F. Supp. 414, 419 (E.D. Va. 1957).

[1] 249 N.C. 308, 106 S.E.2d 478 (1959). Action was commenced on November 3, 1953.

[2] The first case, Lester v. McLean, 242 N.C. 390, 87 S.E.2d 886 (1955), involved a claim of alleged fraud raised by McLean as a defense to an action brought by the two defendants in the principal case to recover the purchase price of the Class A stock. The court found that there had been no fraud and rendered judgment against McLean.

The second case, Park Terrace, Inc. v. Phoenix Indem. Co., 241 N.C. 473, 85 S.E.2d 677 (1955), *remanded on rehearing*, 243 N.C. 595, 91 S.E.2d 584 (1956), concerned an action brought by the corporation against a building construction company owned by the two defendants in the principal case for alleged failure to build the housing in accordance with FHA specifications. On rehearing the court handed down a unique opinion stating that the legal entity of the corporation was suspended when the number of stockholders was reduced to less than three. This decision was widely criticized. Latty, *A Conceptualistic Tangle and the One- and Two-Man Corporation*, 34 N.C.L. REV. 471 (1956). After this decision the North Carolina Legislature enacted a statute which provided that the existence of a corporation was not impaired by the acquistion of all the shares by one or two persons. N.C. GEN. STAT. § 55-3.1 (Supp. 1957). N.C. Sess. Laws 1957, ch. 550, § 3½, in referring to the amending act, provides: "This Act shall not affect adjudicated rights." In light of this provision, it seems possible to argue that the legal entity of Park Terrace, Inc. was suspended for all purposes by the decision in Park Terrace, Inc. v. Phoenix, *supra*, and thus that the "corporation" would have no standing to bring this present action. However, it is submitted that § 3½ was included only to preclude relitigation by the "corporation" against Phoenix, and was not intended to affect its status with respect to other rights. Thus, Park Terrace, Inc. would be deemed to have had "uninterrupted existence and to have possessed uninterrupted capacity to act as a corporation" in all respects, limited only by the fact that the corporation's rights have been adjudicated as against Phoenix.

[3] In this manner FHA could step in and control the corporation in the event of default in the mortgage which it insured. Upon payment of the mortgage debt, the preferred stock could be redeemed at any time by the corporation.

stock was called common stock, but in fact it was set up with the characteristics of preferred.[4] Under the charter the Class A was the only true common stock, and it was given exclusive voting privileges.[5] Each of the defendants owned one third of the A stock, and both of them were directors of the corporation. The remaining A stock was held by another party who was the third director. In 1950,[6] the two defendants also held all the outstanding shares of Class B stock, the subscription price of which had never been fully paid. Pursuant to a unanimous vote by the directors, the corporation repurchased and cancelled all the outstanding B stock for an amount in excess of the original par value subscription price.[7] Circumstances indicated that the payment of this price was against the best interests of the corporation. Subsequently, in 1951, McLean inspected the corporate properties and purchased all of the Class A common stock.

This action was brought in the name of the corporation to recover the entire amount paid to defendants for repurchase of their B stock. Plaintiff alleged that the defendants, as former directors, had breached their fiduciary duty to the corporation. No creditors' rights were involved. FHA, the preferred stockholder, was not a party to this action and had never complained of any of the defendants' activities.[8] At the close of the plaintiff's evidence, the defendants' motion for nonsuit was granted. On appeal, the court affirmed. The court held that where, for several reasons, the sole shareholder is prohibited from bringing a derivative action, the corporation itself may not maintain the

[4] The Class B stock was given preferences both as to liquidation and to dividends, while it was deprived of any voting rights.

[5] These voting rights were subject, however, to the right of FHA to assume exclusive voting control should the corporation ever be in default in its mortgage payments.

[6] The facts in this case arose under the old North Carolina Corporation Act. However, there appears to be no change in the new act that would modify the rationale of the principal case. Logically, then, a similar cause of action arising after July 1, 1957, would be treated in the same manner.

[7] The repurchase price paid by the corporation was $221,000. This was $27,558 more than the par value of the stock. See Park Terrace, Inc. v. Burge, 249 N.C. 308, 311, 106 S.E.2d 478, 480 (1959). In their brief, defendants claim that the price paid to them was not excessive because they had given the corporation land appraised at a value of $60,000 in return for stock with a par value of only $23,660; also because the construction company owned by defendants had made two voluntary reductions in the contract price for the buildings totalling $146,774. Brief for Appellee, p. 10. However, it is interesting to note that defendants, acting as directors, refused to repurchase for an offered price of $500 the 70,151 shares of B stock (par value of $70,151) which had been given to the architect in partial payment for his services. Subsequently, defendants individually bought the stock for $500, and these shares were included in the stock which was later sold to the corporation for a price in excess of par value. These facts point to the underlying philosophical problem involved in the *Park Terrace* litigation, *i.e.*, the intrinsic difficulty of applying a corporation act, designed to regulate large widely held corporations, to a small close corporation.

[8] The record of the trial court discloses that FHA was at all times informed as to the stock transactions and financial status of the corporation. Record, pp. 48-53.

cause of action in its own name since all proceeds recovered by it would inure to the benefit of the ineligible shareholder.[9]

In disregarding the separate corporate entity, the court relied heavily upon the leading case of *Home Fire Ins. Co. v. Barber*,[10] which sets forth the following doctrine:

> When a corporation comes into equity and seeks equitable relief, we ought to look at the substance of the proceeding, and, if the beneficiaries of the judgment sought have no standing in equity to recover, we ought not to become befogged by the fiction of corporation individuality, and apply the principles of equity to reach an inequitable result.[11]

It appears from the decision in the principal case that the *Home Fire* doctrine has been unequivocably adopted in this jurisdiction. It becomes important, therefore, to examine the conditions which rendered the sole shareholder in the principal case so devoid of any standing in equity that suit by the corporation was precluded in order to prevent his indirect participation in the recovery. These conditions were: (1) McLean was not a stockholder at the time of the transaction on which the claim is based, (2) he had obtained his shares by voluntary purchase and not by operation of law, (3) the stock that McLean held was "guilty" stock, the former owners of which had participated in the alleged wrong. In addition to these three disqualifying factors, the action was not brought by the corporation for the benefit of creditors or for the purpose of asserting or endeavoring to protect a title to property, but solely as a suit in equity as the representative of its sole stockholder.[12]

It is a well established rule that one who was not a stockholder at the time of the transaction of which he complains has no standing to bring a derivative action in the federal courts.[13] This limitation, known

[9] At the outset of its opinion, the court stated: "Therefore, the plaintiff corporation had no stockholders with voting rights other than those who as officers and directors authorized the purchase by the corporation of the B stock from these defendants. Consequently, it would seem that neither the plaintiff corporation nor the holders of the A stock could thereafter attack the validity of the transaction unless the corporation in doing so was acting in behalf of creditors." 249 N.C. at 312, 106 S.E.2d at 481. This would imply that no wrong had ever been done to the corporation. However, the court did not decide the case on this ground, but based its decision upon the rationale that the lack of equitable standing on the part of the sole shareholder precluded suit in the corporate name regardless of the merits of the question as to whether or not the corporation had ever been wronged.

[10] 67 Neb. 644, 93 N.W. 1024 (1903).

[11] *Id.* at 669, 93 N.W. at 1033.

[12] When the corporation sues upon legal titles or rights, the distinction of entities is observed, but when it sues upon equities of the whole body of stockholders the courts look to their equities. FLETCHER, PRIVATE CORPORATIONS § 41 (perm. ed. 1931).

[13] This rule was originally established to prevent collusive transfers in order to get a corporate controversy into a federal court on the ground of diversity of citizenship. DOBIE, FEDERAL PROCEDURE § 175 (1928); 25 VA. L. REV. 100 (1938).

as the contemporaneous ownership rule, was inaugurated by the federal courts in the case of *Hawes v. Oakland*,[14] and has since been enacted into Federal Rule of Civil Procedure 23(b).[15] A number of states have passed similar statutes,[16] and several states have adopted the rule by way of decisional law.[17] North Carolina has sometimes been included in this latter classification by text writers.[18] However, this would seem to be erroneous since the precise question has never been directly passed on in this jurisdiction.[19]

In some states the rule is well settled that a stockholder may bring a derivative action even though he purchased his shares after the transaction complained of.[20] It is not certain as to which is the majority view because many of the cases in which the contemporaneous ownership rule is said to apply have rested upon fundamental principles of equity,[21] and the shareholder could have been precluded from maintaining the suit—because of participation, acquiescence, estoppel or laches—without relying on the theory that the shareholder was barred merely because his stock was purchased subsequent to the alleged wrong.

One New York case[22] has gone so far as to extend the contemporane-

[14] 104 U.S. 450 (1881).

[15] Authorities have held that rule 23(b) is procedural rather than substantive. FLETCHER, PRIVATE CORPORATIONS § 5943 (perm. ed. 1943).

[16] *E.g.*, 24 CALIF. CORP. CODE § 834; 4 DEL. CODE ANN. tit. 8, § 327 (1953); N.J. STAT. ANN. § 14:3-16 (Supp. 1958); PA. STAT. ANN. tit. 12, § 1321 (1953).

[17] Boldenwick v. Bullis, 40 Colo. 253, 90 Pac. 634 (1907); News-Journal Corp. v. Gore, 147 Fla. 217, 2 So. 2d 741 (1941); Alexander v. Searcy, 81 Ga. 536, 8 S.E. 630 (1889); Goldberg v. Ball, 305 Ill. App. 273, 27 N.E.2d 575 (1940); Clark v. American Coal Co., 86 Iowa 436, 53 N.W. 291 (1892); Jepsen v. Peterson, 69 S.D. 388, 10 N.W.2d 749 (1943); Pitcher v. Lone Pine Surprise Consol. Min. Co., 39 Wash. 608, 81 Pac. 1047 (1905).

[18] Sykes, *Right of Stockholder To Attack Transactions Occurring Prior to His Acquisition of Stock*, 4 MD. L. REV. 380, at 381 (1940).

[19] The derivative action involving this problem, Moore v. Mining Co., 104 N.C. 534, 10 S.E. 679 (1889), was ultimately decided on the grounds that the party seeking to bring the action was not shown to be a bona fide stockholder and was also charged with laches.

In the principal case the court quotes as follows from the *Home Fire* decision: '[A] purchaser of stock cannot complain of prior acts and management of the corporation. . . .' 249 N.C. at 314, 106 S.E.2d at 482. However, this can only be construed as dictum, and it appears that purchase of the stock subsequent to the wrong was of no more than secondary importance among the several circumstances which precluded suit by the corporation because of the lack of equitable standing on the part of the sole shareholder.

[20] Parsons v. Joseph, 92 Ala. 403, 8 So. 788 (1891); Just v. Idaho Canal & Improvement Co., 16 Idaho 639, 102 Pac. 381 (1909); Mason v. Carrothers, 105 Me. 392, 74 Atl. 1030 (1909); Forrester v. Mining Co., 21 Mont. 544, 55 Pac. 229 (1898); North v. Union Sav. & Loan Ass'n, 59 Ore. 483, 117 Pac. 822 (1911); Roberson v. Draney, 53 Utah 263, 178 Pac. 35 (1919); Bank of Mill v. Elk Horn Coal Co., 133 W.Va. 639, 57 S.E.2d 736 (1950).

[21] *E.g.*, Boldenwick v. Bullis, 40 Colo, 253, 90 Pac. 634 (1907) (transferor had participated in the wrong, and laches); Alexander v. Searcy, 81 Ga. 536, 8 S.E. 630 (1889) (acquiescence and laches); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903) (transferor had participated in the wrong).

[22] Capital Wine and Spirit Corp. v. Porkrass, 277 App. Div. 184, 98 N.Y.S.2d 291 (1st Dep't 1950), *aff'd without opinion*, 302 N.Y. 734, 98 N.E.2d 704 (1951).

ous ownership rule to bar a suit by the corporation itself. This decision has been severely criticized.[23] The concurring opinion[24] of the presiding justice seems to have based the result of the decision upon the more logical ground that the sole shareholder had bought the corporation on the basis of disclosed assets, and to permit the corporation to sue under these circumstances would be inequitable in that it would allow the shareholder to recover more than he had bargained and paid for. It seems very doubtful whether stock ownership acquired subsequent to the wrong, by itself, should be sufficient reason to justify disregarding the corporate entity when the corporation is suing in its own name to recover for prior mismanagement.[25]

The second disqualifying factor—that McLean obtained his stock through voluntary purchase after inspection of the corporation property, rather than by operation of law—appears to be of much greater significance. Concerning this, our court stated: "To allow the plaintiff corporation to recover the consideration it paid to the defendants for the B stock would, in substance, allow the present stockholders of the plaintiff corporation to recover an amount in excess of the sum M. P. McLean, Jr., paid these defendants . . . ."[26] The true nature of his right and remedy was an individual action against the transferors of the stock for misrepresentation, or for breach of guarantee.[27] Such a claim had already been litigated and decided against McLean.[28] The courts should not allow a stock purchase grievance between the transferor and the transferee to be litigated in the corporate name merely because the grievant has acquired the controlling interest in the corporation. There has been no other case in North Carolina presenting this situation. However, the courts which have had occasion to pass upon this question have held in accord with the principal decision, that the shareholder is not entitled to avail himself of the corporation to secure for himself, through that medium, more than he bought.[29]

The fact that the stock purchased by McLean was "guilty" stock which had participated in the alleged wrong appears very important in the court's decision. This factor is closely related to the stock purchase grievance discussed above. It is well settled that a shareholder

This involved a New York statute, N.Y. GEN. CORP. LAW § 61, which is similar to FED. R. CIV. P. 23(b).

[23] Note, 36 CORNELL L.Q. 740 (1951); Comment, 65 HARV. L. REV. 345 (1951); Comment, STAN. L. REV. 151 (1950); Comment, 2 SYRACUSE L. REV. 166 (1950).

[24] Capital Wine and Spirit Corp. v. Porkrass, 98 N.Y.S.2d at 297 (Peck, J., concurring opinion).

[25] Authority cited note 22 *supra*.

[26] 249 N.C. at 313, 106 S.E.2d at 482.

[27] Capital Wine and Spirit Corp. v. Porkrass, 98 N.Y.S.2d 291 at 297 (1st Dep't 1950).

[28] Lester v. McLean, 242 N.C. 390, 87 S.E.2d 886 (1955).

[29] Matthews v. Headley Chocolate Co., 130 Md. 523, 100 Atl. 645 (1917); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903).

who himself has participated in the alleged wrongful conduct cannot thereafter attack it;[30] and, generally, subsequent purchasers of stock stand in no better position than their transferors.[31] Thus, the great weight of authority is to the effect that the transferee cannot sue if he has acquired his title from a shareholder who participated or acquiesced in the wrong.[32] However, where the shareholder was an innocent purchaser for value who had no notice of such participation or consent by his transferor, such an action has been allowed.[33] There is no mention in the principal decision whether or not McLean was aware of the circumstances surrounding the repurchase of the B stock. Presumably, he had access to all the financial records prior to his purchase of the corporation. It seems unlikely that any claim could be made that he did not have either actual or constructive notice. If the transferee of all the outstanding stock is barred from bringing an individual action because he has purchased "guilty" stock from the transferor, it would be clearly a perversion of justice to allow him to recover through use of the corporate form.[34]

It should be noted that the decision in the principal case has no effect upon the rights of creditors. The court emphasized the fact that creditors are in a protected category and would have had the right to enforce the payment of the original subscription price by way of a creditor's bill in equity.[35]

The result achieved in the principal case seems analogous to those decisions which prevent an individual from doing business as a corporation in a field in which he had personally agreed not to compete,[36] or which refuse to allow a corporate recovery on a fire insurance policy where the sole shareholder had deliberately set fire to the property in order to collect the insurance.[37] The decisions in these and all similar cases are founded on the basic premise that a shareholder should not

[30] Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819 (1954); FLETCHER, PRIVATE CORPORATIONS § 5862 (perm. ed. 1943).

[31] Russell v. Louis Melind Co., 331 Ill. App. 182, 72 N.E.2d 869 (1947); FLETCHER, PRIVATE CORPORATIONS § 5866 (perm. ed. 1943).

[32] *Ibid.*

[33] Parsons v. Joseph, 92 Ala. 403, 8 So. 788 (1891). See also Continental Sec. Co. v. Belmont, 83 Misc. 340, 144 N.Y. Supp. 801 (Sup. Ct. 1913).

[34] Matthews v. Headley, 130 Md. 523, 100 Atl. 645 (1917).

[35] 249 N.C. at 313, 106 S.E.2d at 481. The court cited N.C. GEN. STAT. § 55-65 (1950), which provides that holders of unpaid stock are liable for so much of the full amount of the shares as is needed to satisfy creditors. Under the new act the comparable section is N.C. GEN. STAT. § 55-53 (Supp. 1955), which would cover situations arising after July 1, 1957.

[36] Beal v. Chase, 31 Mich. 490 (1875); Kramer v. Old, 119 N.C. 1, 25 S.E. 813 (1896); A. Booth & Co. v. Siebold, 37 Misc. 101, 74 N.Y. Supp. 776 (Sup. Ct. 1902).

[37] Meily Co. v. London & L. Fire Ins. Co., 142 Fed. 873 (E. D. Pa. 1906), *aff'd*, 148 Fed. 683 (3rd Cir. 1906); D. I. Felsenthal Co. v. Northern Assur. Co., 284 Ill. 343, 120 N.E. 266 (1918); Kirkpatrick v. Allenania Fire Ins. Co., 102 App. Div. 327, 92 N.Y. Supp. 466 (Sup. Ct. 1905), *aff'd*, 184 N.Y. 546, 76 N.E. 1098 (1906).

be allowed to profit in his corporate capacity when he is guilty of some wrong, or is under some obligation, which would prevent him from so profiting in his individual capacity.[38]

It is submitted that the result and the rationale of the principal case are to be commended as a desirable advancement in North Carolina corporation law. Certainly the ultimate effect of this decision is in line with the traditional principle that equity will look to the substance of the proceeding rather than to the form. The courts have consistently utilized their power to disregard the corporate entity where the sole shareholder seeks to use his inside position to work fraud or injustice.[39] The totality of the circumstances in this case clearly establishes that the sole shareholder had no equitable standing. Any contrary result would have had the effect of erecting a statutory shield behind which individuals with "unclean hands" could enforce their disqualified claims in equity.

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Domestic Relations—Alimony Without Divorce and Absolute Divorce Based on Same Grounds

A wife in Missouri obtained a decree of separate maintenance on the ground of statutory desertion. Five years later she brought an action for absolute divorce based on the same ground. Her husband interposed as a defense the doctrine of election of remedies. *Held,* since an action for absolute divorce is not inconsistent with an action for separate maintenance based on the same ground, but is rather an action for further relief, the doctrine of election of remedies is not applicable. Consequently, the wife was granted an absolute divorce.[1]

Ordinarily there is no ban on successive divorce actions unless the doctrine of res judicata may be invoked as a bar thereto.[2] For a subsequent action to be precluded it must appear that a court of competent jurisdiction rendered a final decree on the merits in a prior action in which the same relief was sought.[3] Under this doctrine a decree of separate maintenance would not be a bar to a subsequent action for absolute divorce because the two remedies are not the same.[4] However, grounds litigated or questions determined in the separate maintenance proceeding are res judicata in a subsequent action for absolute divorce.[5] Thus, as of its date, a decree in favor of a wife in an action for separate

[38] Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 332 (1939).
[39] Pepper v. Litton, 308 U.S. 295 (1939); FLETCHER, PRIVATE CORPORATIONS § 41 (perm. ed. 1931).

[1] Prough v. Prough, 308 S.W.2d 294 (Mo. 1957).
[2] Meegan v. Meegan, 60 R.I. 131, 197 Atl. 221 (1938).
[3] Bidwell v. Bidwell, 139 N.C. 402, 52 S.E. 55 (1905).
[4] Jenkins v. Jenkins, 125 Cal. App. 2d 109, 269 P.2d 908 (1954)
[5] Gordon v. Gordon, 59 So. 2d 40 (Fla. 1952).