

1890

A Plea for an Extension of the Rights of Minority Stockholders

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A P L E A
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M I N O R I T Y S T O C K H O L D E R S .

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Frank E. Thomas, LL. B.

One of the most important branches of our legal jurisprudence is that department known as, "The Law of Corporations," which is everywhere and every day more and more demanding the attention of thinking people, because of the active part it now takes in nearly all business enterprises of the present century.

It may truly be said that in early colonial times, there were no business corporations of any description. The clothing worn was either imported from foreign countries, or consisted of home-spun garments, which were almost universally made by hand, thus doing away with the necessity for manufactories, while railroad, telegraph and telephone companies had not yet come into existence. But, as the laws of the nation commenced to extend over a larger expanse of territory, the condition of the people and of the country itself began to change, as a result of which, the laws of the nation and of the separate states have been continually developing, new ones being added and old ones amended or stricken out, as best served the purposes of the times. With the growth of the commercial interests, came a cry for the revision and extension of

the laws of commerce. Moreover, as business increased and new inventions were discovered, capitalists soon became anxious to invest their money in profitable business enterprises, but unless they could to a certain extent be protected by the law, they refused to so use their capital. But the old saying that "where there is a will there is a way" soon became apparent in this case, for the law of corporations very soon became established, and to-day occupies one of the most important branches of our jurisprudence.

In speaking of this department of the law, I shall not endeavor to treat of the whole subject at large as it is too vast to permit of my doing so; many volumes having already been written upon it, although the law itself has been in force but a short period of time. I have therefore chosen as a fit subject for discussion the relations of the directors to the stock-holders, with a view to pointing out what rights, if any, the minority stock-holders have or ought to have against the directors or other stock-holders for wrongs committed by them. Who the directors are and the nature of their office, are the questions to which we must necessarily devote our present attention.

The directors may be said to be themselves owners of

stock, of the corporation. They are chosen by the other stock-holders to conduct the affairs of the organization. And are, in one sense of the word, the Supreme managing officers thereof. Unless a provision of the statute, or the charter or by-laws of the corporation places some restriction upon them, their power may be said to be one of almost unlimited jurisdiction. When spoken of with reference to the relations which exist between them and the other stockholders, they are universally mentioned as trustees. They are not however in a strict sense true trustees either with the corporation or the stockholders themselves as their true "cestuis que trust" since neither the legal title to the corporation property nor to the stock is vested in them.

In ex parte Chippendale, 4 DeG.M. & G, 19, Turner J. speaking of the relations between the directors and the company said:

"Although directors undoubtedly stand in the position of agents and cannot bind their company beyond the limits of their authority, they also stand in some degree in the position of trustees. There is no inconsistency in this double view of the position of directors. They are agents and cannot bind their company beyond their powers. They are trustees

and are entitled to be indemnified for expenses incurred by them within the limits of their trust. They are bound to observe the limits placed upon their powers in the charter. And, if they transcend such limits and cause damage, they incur liability. If they act fraudulently, or do a willful wrong, it is not doubted that they may be held for all the damage they cause. But, if they act in good faith within the limits of their powers, using proper prudence and diligence, they are not responsible for mere mistakes or errors of judgment."

The board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds toward his principal. In the first place, in the strict relation of principal and agent, all the authority which the latter is empowered to exercise is **derived** either from an express or implied delegation from the former. Secondly, in corporate bodies the powers of the directors are in a very important sense original and undelegated. Neither do the stockholders confer, nor can they revoke these powers. They are derivative only in the sense of being received from the state, being embodied in

the articles of incorporation. When convened as a board, the directors are the primary possessors of all the powers which the charter confers. Chief Justice Himman says:

"Indeed joint stock companies in modern times are nothing but commercial partnerships, which have taken the form of corporations for the greater facility of transacting business, and to prevent a dissolution of the concern by those numerous events which are so liable to work a dissolution of a partnership composed of a greater number of individuals."

They must have applied to them principles making them accountable like all trustees, or the grievance would be intolerable, since otherwise a majority of the stockholders acting through the directors, who would thus cease to be in fact what the law considers them--the agents of the whole body of stockholders--and would become the private agents of the majority, might set the minority at defiance and manage the affairs for their own supposed benefit and the benefit of the majority who appointed them. "Pratt vs. Pratt & Co., 33 Conn 453."

But, whatever, the relations between the parties may be, and whether the directors and managers of corporations can in a strict sense be called trustees or not, there can be no doubt but that their character is a fiduciary one, they

being entrusted by others with powers which are to be exercised for the common and general interests of the corporation and not for their own private benefit.

Such directors or managers are in fact both trustees and agents of the bodies represented by them. They fall therefore within the rule which guards and restrains the dealings and transactions between trustee and cestui que trust, and agent and his principal. And also within the great principle by which equity requires that confidence shall not be abused by the party in whom it is reposed. This rule equity ~~this rule equity~~ tries to enforce by imposing a disability either partial or complete upon the party interested, to deal on his own behalf in respect to any matter involved in such confidence. Hence it is impossible for us to limit the duties of a director or manager of a corporation in this respect to some particular event: as for instance while they are acting as directors or managers under any special delegation of power or are in attendance of meetings of the board. Such a limit to the general scope of the rule would deprive it of almost all its value and usefulness, and would open an easy avenue of escape, thus facilitating innumerable evasions of its force. Justice Johnson in the case of Hoyle vs. Plattsburg R.R. Co.,

54 N.Y., 314 said:

"The fact that the powers of a director to act for or to represent the corporation may be so limited in respect to its being bound by his acts, does not furnish any ground for saying that his fiduciary capacity and consequent duties are subsequent to the same limit. On the contrary, these must be held to ~~continue~~ continue so long as his directorship continues." Moreover, many of our large and most useful enterprises of the present day as well as a variety of the different branches of business require for their existence and successful prosecution a large and permanent investment of capital. These are usually and most conveniently established and managed by means of corporate organization. The affairs of these corporations are, with but few exceptions intrusted to the exclusive management and control of the board of directors. Hence from the very nature of their position, there is an inherent obligation implied in the acceptance of such trust, not only that they will use their best efforts to promote the interest of the share-holders, but that they will in no manner use their positions to advance their own indi-

vidual interests as distinguished from that of the corporation. Also, that they will not acquire any interests in the corporation that will conflict with the fair and proper discharge of their duties."

Story's Equity Jurisprudence, Sec. 455 a, provides:

"That trustees and persons standing in similar fiduciary capacity, shall not be permitted to exercise their powers, and manage or appropriate the property of which they have control for their own profit or emolument"

Or, as it is sometimes expressed, shall not take advantage of their situation to obtain any personal benefit to themselves at the expense of their cestui que trust. The ultimate object for which every ordinary business corporation is formed, is the pecuniary profit which it is expected to realize to each of its individual members. These profits, usually called dividends, must of necessity be paid out of the fund which remains exclusive of the capital stock, after the expenses of the business have been paid. The doctrine upon this subject appears to me to be very fairly and correctly stated by Chancellor Walworth in his opinion rendered in the case of Scott vs. Eagle Insurance Company, 7 Paige, 203, where he says:

"As the directors are bound to exercise a proper discretion in making dividends of surplus profits, if they abuse that power of dividing the unearned premiums, without leaving a sufficient fund exclusive of the capital stock to satisfy the probable losses, they may in case of any extraordinary loss, which is sufficient to exhaust the whole capital and more, make themselves personally liable to the creditors of the company. On the other hand, should they without reasonable cause refuse to divide what is actually surplus profits, the stockholders are not without a remedy if they apply to the proper tribunal before the corporation has become insolvent. But to determine what the actual profits of the corporation are ^{is} often a matter of practical difficulty. Much of the confusion which arises ~~is~~ owing to the fact that a proper distinction is not made between the capital stock and the profits."

The term "capital stock" in the provision of the revised statutes, page 601, Sec. 2, prohibiting the directors of a company from making any dividends except from the surplus profits of a corporation, or from dividing, withdrawing or in any way paying to the stockholders any part of the capital stock of such corporation, means the property of

the corporation contributed by the stock-holders, or otherwise obtained to the extent required by its charter.

Vice Chancellor Sanford in the case of *Barry v. Merchant's Exchange Company*, makes a clear and precise distinction between these terms, rendering extremely simple that which at first seemed to be difficult. He says the capital stock of a corporation is like that of a co-partnership or joint stock company, the amount which the partners or associates put in as their share in the concern. To this they add upon the credit of the company, from the means and resources of others, to such extent as their own prudence or the confidence of such other persons will permit. Such additions create a debt; they do not form capital. If successful in their career, the surplus over and above their capital becomes profits, and is either divided among the partners and associates or used still further to extend their operations.

I Sanford's Chancery, 307.

From what has already been said it will readily be inferred that the power of distributing the surplus profits of the business among the stockholders lies almost entirely within the discretion of the directors. Upon them rests

the duty of saying whether dividends shall or shall not be declared; when they shall be so declared; as well as the amount that is to be divided. Except in those cases where their authority is restricted either by statute or the articles of incorporation, their power according to the present law is without limitation and free from restraint. They are at liberty to exercise a very liberal discretion as to the manner in which the profits of the business of the corporation shall be disposed of. So long as they act in the exercise of an honest judgment, their power over their disposal is absolute. They may reserve of them whatever their judgment approves as necessary or judicious for repairs and improvements to the buildings or machinery, or to meet contingencies, both present and prospective which they think may possibly arise.

Their determination in respect to these matters, if made in good faith and for honest ends, though the result may show that it was injudicious, is final, and not subject to judicial censure. But, as the directors themselves usually hold the majority of the stock, it very often happens that they refuse to declare dividends when they can lawfully do so. Their object in so doing seems to be to compel those who are not within the ring or combination, to sell

their stock; or, as it is usually expressed, they freeze out these poor unfortunates by holding back that which rightfully belongs to them. After this freezing process or mild form of coercion has proved successful, and when the directors or their friends have gotten control of the stock, corporations which first proved a failure, soon spring into prosperous enterprises.

To accomplish their purpose and at the same time escape the clutches of the law, they are very careful to have their actions appear for the interest of the company and not for any individual member. Besides the scheme of reserving the surplus to make improvements, which are generally purely imaginary ones, the directors sometimes buy property for which they pay an exorbitant price, their main object being to rid themselves of the surplus profits. Another method resorted to is to either increase the salary of the present officers of the corporation or to establish new ones with large salaries attached. In the case of *Zeigler v. Hoagland*, 5 N.Y. Sup. 305, the plaintiff owned less than half the stock in a corporation and the defendant owned the residue. For many years plaintiff was one of the three trustees constituting the board, but the defendants, who were all of one family, were also elected trustees, and

and they elected themselves respectively, President, Secretary and treasurer. One of the defendants sought to buy plaintiff's stock, but he refused to sell, whereupon said defendant threatened to raise the salaries of the officers, which was done. In the next year, another refusal to sell was followed by another raise of salaries. So that, instead of \$1800.00 each per year--the salaries which had been paid for many years--the officers were to receive respectively; fifty thousand, thirty thousand and six thousand dollars and a further increase was threatened, with the statement that the power of the trustees to increase the salaries was unlimited.

Another company was controlled by the corporation, and the same officers were chosen and they voted themselves salaries respectively of; Seven Thousand Five Hundred, Six Thousand and One Thousand Dollars, though previously the officers of the company had served without pay. The business of both concerns was very profitable. The salaries voted were shown to be greater than the services were worth. The court held that the action of the trustees was fraudulent and that equity would restrain the payment of more than the real value of the officers' services. While the clear intention of the defendants was to enforce the plaintiff

to retire from the corporation, the court merely decided that in the present case, they had adopted an illegal method to accomplish their purpose, without passing upon the question whether the directors must divide the surplus earnings or not. Thus, no restrictions having been placed upon them, they could still refuse to declare dividends by using the profits to make so-called improvements, or by paying exorbitant prices for land, at the same time accomplishing their object, although in a slightly different manner.

This case will serve to give us but a fair illustration of the manner in which the stockholders who are in a minority are forced not only to relinquish not only their claims to the surplus, but are also compelled to sell their stock and retire from the corporation. It is a fundamental principle of business that unless stock investments are paying dividends, the market value of the stock itself depreciates and soon becomes practically unsalable. Thus the directors by refusing to divide the profits, not only accomplish their purpose of freezing out those who cannot afford to stay in the corporation, but they also give to the outside world the impression that the corporation is a non-paying one, thereby enabling them to buy these stockholders' shares at a discount from the real value.

With such a state of affairs occurring almost daily, it is indeed strange that some law has not yet been passed which would not only act as a check upon the powers of the directors but would also tend to increase those of the minority stockholders. That the present law is defective is, I think, apparent to every fair minded person. But how to remedy the wrong, and at the same time do justice to the largest ^{number} ~~member~~, is the difficult problem which we have to solve. For unless we move with great caution and precision, we are liable to create a new evil equally as unjust as the one which we are trying to remedy. Therefore, if we were to substitute for the present law, a provision that the directors must declare dividends when the minority ask for a division, provided there be a surplus, it would very often happen that no provision would be made for future contingencies, as a result of which the corporation would be **liable** to go into insolvency. That it is often a wise policy, as well as shrewd business management to reserve the surplus for actual expected contingencies or for the purpose of making needed improvements is not denied. But as soon as they employ these methods not with the intention of benefitting the corporation itself, but simply to act as a shield for themselves while they deprive others of their lawful property, then it is that these stockholders have a

just right to complain. The difficulty with the present law is that the powers of directors or managers of corporations are too extensive; while those of the stockholders and especially those who are in a minority are not extensive enough.

No doubt the originators of the law thought this difficulty would be averted by placing the directors subject to the same rules as an ordinary trustee would be when holding a similar position. Indeed, many cases can be found containing dicta to the effect that the minority of the stockholders in a corporation have a remedy in chancery against the directors, whether individuals or corporations, assisting or confederating with them to prevent such corporations and the directors thereof from making any misapplication of their capital or profits, which might result in diminishing the dividends of stockholders or the value of their shares, if the acts intended to be done create what in law is termed a breach of trust or duty. These cases almost universally contain clauses to the effect that the directors will be held responsible for any misapplication of the surplus, but they do not provide that the dividends must be declared though there is an actual profit realized from the business. On the contrary, they leave

this entirely within the discretion of the directors themselves, who as we have already seen, very often use their power to further some nefarious schemes of their own.

If a provision modifying that part of the present law which relates to the powers and priveleges of officers of corporations should be made, whereby some more efficient check could be placed upon the directors, thus restricting their powers, much of the difficulty which we now encounter would henceforth be done away with.

In attempting to solve what the nature of these amendments shall be, we are at once confronted with numerous obstacles and difficulties, which require from us our most earnest and careful attention. After due consideration of this subject with a view to considering these difficulties as much as possible, I have ventured to suggest the following plan which would at least modify some of the evils now encountered, if, indeed, it did not abolish them. The plan is as follows:

First, The directors of all business corporations shall be appointed by the stockholders in the same manner as now provided for by law.

Second, These directors shall be the managers of the

corporation, upon whom will rest the responsibility of seeing that the business is carried on in a proper manner, and for the interest of the stockholders at large rather than for any one individual member.

Third, The relations between these directors and the other stockholders shall be considered to be the same as those which exist between a trustee and a cestui que trust, any failure to faithfully perform their duties to be considered as a breach of trust, and punished in like manner.

Fourth, Before any improvements can be made either to the buildings or machinery, or investments made in real estate or other property the consent of two-thirds of all the stockholders must be first obtained.

Fifth, The salary of no officer of the corporation shall be increased nor no new office shall be created without first obtaining the consent of two-thirds of the stockholders.

Sixth, Before any loan of money shall be made either to the corporation or by the corporation, the consent of two-thirds of all the stockholders must be first obtained.

Seventh, At the end of every year a meeting of all the stockholders shall be called to consider the advisability of dividing the surplus, instead of leaving the question of disposal entirely within the discretion of the directors as

provided for by the present law.

Eighth, Whenever two-thirds of all the stock-holders determine that a division of the surplus profits should be made, as well as the amount that should be distributed, it shall be the duty of the directors to declare such a dividend.

Ninth, If however the directors refuse to declare the dividend, when they can legally do so, it shall be the duty of the Judge of any Court of Record in this State, to appoint a referee to investigate into the affairs of the corporation whenever appealed too for assistance by a stockholder of the corporation.

Tenth, Upon the referees finding that a dividend can legally be declared it shall be his duty to command the directors to declare such a dividend.

Eleventh, Should any stock-holder refuse to accept his proportion of the surplus profits the amount of his share shall be placed to his credit on the books of the corporation and shall be considered as money advanced to the corporation by said stock-holder, to secure payment of which, a bond or other evidence of debt shall be issued by the corporation to the stock-holder, which shall bear the legal rate of interest

Twelvth, At all meetings held to consider the advisability either of making improvements or investments, of increasing

the salaries of the officers, of loaning or borrowing money or establishing new offices, or for declaring new dividends as provided for by sections four, five, six, seven, eight, nine, and ten, it shall be the duty of the treasurer of the corporation to make and file a correct report concerning the financial condition of said corporation.

Thirteenth, Should the treasurer through fraud or negligence, make and file a report which is not an accurate statement of the financial condition of the corporation he shall be held criminally liable for said offense.

Mr. Eugene D. Hawkins in his prize essay upon this subject when speaking of the legislation that is needed for the protection of minority stockholders expresses himself in the following manner:

"More adequate and summary protection from ultra vires acts would be afforded minority stockholders if the charters of corporations designated more specifically the powers conferred both upon the majority and the directors. If the right of visitation were extended so as to compel corporations to exhibit their affairs to state boards of commissioners and to apply to them as well as to a majority of stockholders before exercising any unusual authority conferred by the charter the minority stockholder would be safer than if alone, he were

obliged to fight his battle against the majority."

His suggestions concerning the charters of corporations is an excellent one, and any legislation tending to carry out his intention in this respect would be a step in the right direction.

But, as to the advisability of extending the right of visitation to State Boards of Commissioners, I beg to disagree with the learned gentleman for the following reasons;

Experience has already taught us that the work done and good accomplished by these boards of commissioners virtually amounts to nothing. They make their annual tour of inspection, hastily glance at the books of the concern, then depart to another part of the state to visit some other corporation the nature and object of whose business is entirely different from that of the one they last visited. Having completed their journey, they proceed to head quarters, make out their reports, and then do their only real work, viz; draw their salaries, a matter of importance which they never fail to perform.

Moreover, scarcely any two corporations keep their books exactly alike, for business men have their peculiarities, their own ideas as to book-keeping.

It would thus be a matter of very little difficulty for the officers of the corporation to so keep their books as to

make it almost impossible to detect any evidence of fraud except by the most careful and painstaking work of an expert.

That the commissioners would not have time to do their duty in such an instance, and that the officers would thus accomplish their wrongful purpose with comparative ease, is, I think, clear to every one.

Instead of having this State Commission would it not be preferable to have a committee of the stockholders appointed by their associates, whose duty would consist of examining the books of the concern, and reporting the results of their investigation to their fellow members? Certainly they would be more liable to understand the manner in which the books were kept, and would be interested to such an extent that they would make every effort on their part to discover any signs or indications of fraud.

While the suggestions I have made are probably defective in many particulars, yet should they or similar ones ever be adopted into our corporate laws, many of the difficulties which the corporate stockholders now encounter would be swept away.

For, by taking from the directors the power of having the entire control of the finances of the concern, and at the same time giving this privilege to the stockholders themselves the chances for freezing out any member is made more diffi-

cult if not, indeed, quite impossible.

Furthermore, by increasing the power of the Courts, so that they can interfere in all cases where they are appealed to for assistance by the stockholders, a check would thus be placed upon the directors, and many cases of unjust oppression which we now encounter would be done away with.

If we stop to consider how large a part of the business now done throughout the country is accomplished by means of corporations, the necessity of having this department of law as just and reasonable as possible will be at once apparent to all.

As the very key-stone to the existence of our National Government is the principle of distributing justice equally among all its citizens, it necessarily follows that our State laws must also be founded upon the same principle.

Frank E. Thomas.