Comment

SHAREHOLDER VALIDATION OF DIRECTORS' FRAUDS: THE NON-RATIFICATION RULE v. THE BUSINESS JUDGMENT RULE

SHAREHOLDER derivative suits attacking allegedly "fraudulent" transactions between a corporation and its directors present two important and related issues which a court may be required to resolve preliminary to its consideration of the alleged wrongdoing.[1] The first of these threshold questions is whether the plaintiff shareholder must demand intracorporate redress from the directors or the body of shareholders before the merits of the controversy will be decided by the court. Since demand of this kind contemplates some action or response from the addressees, and since the demand issue is usually raised by preliminary motion,[2] the court must decide early in the litigation what effect such action or response would have on the substantive rights of plaintiff shareholders. The capacity of the addressees to determine the rights of plaintiffs through response to the demand for intracorporate redress is dependent upon the applicability of one of two doctrines: the "non-ratification" rule or the "business judgment" rule. Thus, as a second issue, the court must determine whether either doctrine applies.[3] Since the question of their applicability is usually raised in connection with whether demand is necessary, the two issues are interdependent.

The "non-ratification" rule is a familiar bromide in the field of corporate law.[4] Numerous cases hold that a majority of shareholders cannot

[1] For an excellent discussion of the problems involved in shareholders' derivative suits to enforce alleged corporate causes of action against directors for self-dealing see Claman v. Robertson, 164 Ohio St. 61, 128 N.E.2d 429 (1955). See also Feuer, *Liabilities of Directors and Officers*, 5 N.Y.L.F. 127 (1959); Landstrom, *Ratification by Majority Stockholders—A Problem in Corporate Democracy*, 31 B.U.L. REV. 165 (1951); Note, 46 CALIF. L. REV. 119 (1958); Note, 29 COLUM. L. REV. 338 (1929); Note, 53 HARV. L. REV. 1368 (1940); Note, 4 U. CHI. L. REV. 495 (1937); Note, 83 U. PA. L. REV. 56 (1934).

[2] See text accompanying note 16 *infra*.

[3] A recent treatment of the non-ratification rule and the demand requirement appears in Note, 63 COLUM. L. REV. 1086 (1963). The business judgment question has been considered only recently. See *id.* at 1087.

[4] *E.g.*, Hodgman v. Atlantic Refining Co., 300 Fed. 590 (D. Del. 1924); Ford v. Ford

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ratify directors' frauds,[5] and courts applying the "non-ratification" rule often have used language so broad as to imply that once the directors' acts are termed "fraudulent", ratification by a mere majority of shareholders is impossible, notwithstanding that the shareholders may be disinterested, uncontrolled, and completely apprised of all relevant facts.[6] Apparently opposed to the foregoing rule, in cases where the board of directors cannot act because interested or controlled, is the proposition that a disinterested majority of shareholders may prevent a derivative action attacking even a "fraudulent" directors' transaction by exercising "business judgment" in determining that declining to sue is the course of action most advantageous to the corporation.[7]

Thus the two doctrines—when viewed in cases in which there is an interested or controlled majority of the board of directors but a disinterested and uncontrolled majority of shareholders—appear to be directly opposed. The "non-ratification" rule allows attack upon "fraudulent" directors' transactions by the shareholders, while the "business judgment" rule prevents such attack. Because of the difference in result depending upon the choice of rules, the doctrines should differ in principle. However, it is submitted that the "non-ratification" and "business judgment" rules are supported by the same rationale and that an application of either should yield the same result when the board of directors is disqualified and a disinterested or uncontrolled majority of shareholders exists.

Roofing Co., 285 S.W. 538 (Mo. App. 1926); Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912). See Note, 4 U. CHI. L. REV. 495 (1937).

[5] Whether a transaction is "unfair" rather than "fradulent" seems to be a matter of degree. See Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201 (1890) (sale of property by shareholder-director to his corporation held not to be so excessive as to be fraudulent). Although disclosure of all the circumstances by the director may help uphold the transaction, it will not necessarily change the quality from fraudulent to unfair. Shelensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793 (1960) (dictum that neither full disclosure nor shareholder assent can convert the quality of a transaction); *cf.*, Hodgman v. Atlantic Refining Co., *supra* note 5 (failure to disclose and stating of half-truths amounted to fraud). See generally, Note, 61 HARV. L. REV. 335 (1948).

The term "gift", or "waste", of corporate assets is not clearly defined. However, it appears to be associated with, if not synonomous with, transactions which are termed fraudulent. See, *e.g.*, Gottlieb v. McKee, 107 A.2d 240 (Del. Ch. 1954) (if directors' acts amounted to a gift of corporate assets, the ratification by the stockholders amounted to nothing); Brewer v. Boston Theatre, 104 Mass. 378 (1870) (held that appropriation of corporate property by some of the corporators cannot be authorized or ratified); Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A.2d 862 (1952) (ratified directors' stock option plan upheld after determination that the terms were not so unequal as to amount to waste).

See cases cited note 4 *supra*, and Note, 53 HARV. L. REV. 1368 (1940).

[6] See text accompanying notes 19 & 20 *infra*.

[7] See text accompanying notes 29–38 *infra*.

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THE DEMAND REQUIREMENT: RAISING THE ISSUES

The necessity of a shareholder's showing that he has exhausted all the means within his reach to obtain redress within the corporation as a prerequisite to bringing a derivative suit was first pointed out by the Supreme Court in *Hawes v. Oakland.*[8] This requirement was adopted by the Court, on the heels of its decision in *Hawes,* in Equity Rule 94,[9] the terms of which may now be found in Federal Rule 23(b).[10] The principal reason for requiring the complaining shareholder to seek satisfaction within the corporation, as stated in *Hawes,* is to prevent collusive suits.[11] Other courts have required demand on the theory that the majority of the managers of the corporation, having the power to operate the company,[12] ought to be given the opportunity to correct any intracorporate difficulties before a minority shareholder can bring his grievances before a court.[13] This latter rationale is supported by the statement that the court will not interfere with the internal management of the corporation.[14]

Because of the demand requirement of the Federal Rules and of most

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[8] 104 U.S. 450 (1881). Included in the demand requirement as stated in *Hawes* is the necessity of the shareholder's showing that he has exhausted all the means within his reach to obtain redress within the corporation. This requirement was stated as satisfiable by the making of "an earnest effort with the managing body of the corporation to induce remedial action on their part." And, "if time permits or has permitted," the complaining shareholder must show that he has made an "honest effort" to obtain relief from the shareholders as a body. *Id.* at 460–61.

[9] 104 U.S. ix (1882).

[10] FED. R. CIV. P. 23(b):

> 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 shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

The requirement that internal remedies be exhausted is in effect in a majority of jurisdictions in the United States. See Comment, 48 MICH. L. REV. 87 (1949).

[11] 104 U.S. at 459. See also, Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 464–65 (1903) (citing *Hawes* as to the Court's opposition to derivative suits because of their tendency to be collusive as a vehicle for parties to get into the federal courts.) However, California, Ohio and New York now require demand only upon directors. See Note, 63 COLUM. L. REV. 1086, 1092 (1963).

[12] Whether the body of shareholders has the power to act in relation to the business of a corporation is the critical question in determining whether there can be ratification or an effective exercise of business judgment. See text accompanying notes 25–29 and 38–43 *infra.*

[13] See, *e.g.,* Babcock v. Farwell, 245 Ill. 14, 91 N.E. 683 (1910) (held that even if a right of action existed in the corporation because of fraudulent transactions between directors, the shareholders might have sought cancellation of the alleged wrongful contract); Dunphy v. Travelers' Newspaper Ass'n, 146 Mass. 495, 16 N.E. 426 (1898) (the right of a single shareholder at any time to launch the corporation into litigation was termed contrary to the fundamental principles of corporate organization).

[14] See, *e.g.,* United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917).

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states,[15] the defendant usually will raise the issue on preliminary motion, most often a motion to dismiss.[16] The court must then decide whether to waive the demand requirement. This it may do upon finding adequate excuse—such as the interest of a majority of the addressees[17] or the absolute lack of capacity of the addressees to prevent derivative suits.[18] The capacity of the addressees to prevent such suits will depend, in turn, upon that group's right to ratify or effectively exercise business judgment in declining to sue. Thus the court will have to decide on preliminary motion whether demand will be viewed as (1) merely a procedural prerequisite for the maintenance of a derivative suit, or (2) an offer to the addressees to ratify the action complained of, or (3) an offer to the addressees to exercise business judgment in declining to sue. It is in this way that the demand requirement is a vehicle for presenting the court with a choice between the non-ratification and business judgment rules.

The Non-Ratification Rule

The basic difficulty presented by the usual statement of the non-ratification rule is the ambiguity of the "fraud" which is not ratifiable by a mere

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[15] See notes 10 & 11 *supra*.

[16] *E.g.*, Fleming v. Black Warrior Copper Co., 15 Ariz. 1, 136 Pac. 273 (1913) (demurrer); Mayer v. Adams, 135 A.2d 119 (Del. Ch. 1957), *rev'd*, 141 A.2d 458 (Del. Sup. Ct. 1958) (motion to dismiss); Gottlieb v. McKee, 107 A.2d 240 (Del. Ch. 1954) (motion to dismiss); Brewer v. Boston Theatre, 104 Mass. 378 (1870) (demurrer); Caldwell v. Eubanks, 326 Mo. 185, 30 S.W.2d 976 (1930) (demurrer); Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912) (motion for judgment on the pleadings).

[17] Demand may be excused where there is an interested majority of addressees, Fleming v. Black Warrior Copper Co., *supra* note 16 (demand would be futile because alleged wrongdoers were majority of shareholders as well as directors); *accord*, Daniel v. Briggs, 279 Mass. 87, 180 N.E. 717 (1932); Von Arnim v. American Tube Works, 188 Mass. 515, 74 N.E. 680 (1905); Hill v. Erwin Mills, Inc., 239 N.C. 437, 80 S.E.2d 358 (1954); *but cf.*, Mayer v. Adams, *supra* note 16. See also Note, 46 CALIF. L. REV. 119 (1958). However, where the interested directors are also shareholders, the court may conclude that, as shareholders, they may vote to ratify transactions between themselves, as directors, and the corporation. See, *e.g.*, Bjorngaard v. Goodhue County Bank, 49 Minn. 483, 52 N.W. 48 (1892) (stated that shareholders do not stand to each other in a fiduciary relation within the rule applicable to directors); Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201 (1890) (director said to have acted as shareholder in transaction with corporation which was upheld).

The excuse because of the interest of the directors or shareholders has been said to be grounded upon the idea that to ask interested parties to bring suit against themselves would be an absurd requirement. See Rothwell v. Robinson, 39 Minn. 1, 38 N.W. 772 (1888). See also, Comment, 33 N.Y.U.L. REV. 71 (1958).

Another excuse which may be accepted for failure to make demand against shareholders is the wide dispersion and great number of shareholders. See Gottesman v. General Motors Corp., 268 F.2d 194 (2d Cir. 1959).

[18] See text accompanying notes 48–50 *infra*.

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majority of the shareholders.[19] An examination of the cases reveals that most situations to which the rule has been applied have involved an interested majority of the shareholders.[20] This fact implies that it is not ratification of "fraudulent" transactions which is objectionable, but, rather, potential "fraud" in the vote to ratify.[21] If there were agreement that this was the extent of the non-ratification rule, there would be little ground for criticism; for it is obviously sound to prevent an interested majority of shareholders from validating wrongdoing in which they may have had a part in their capacity as directors. However, the language of the decisions goes further and states the general principle that if the *transaction* is "fraudulent", a mere majority of the shareholders cannot ratify. An example of such language appears in *Brewer v. Boston Theatre*,[22] a derivative suit against officers of the defendant company to recover profits allegedly gained through leasing corporate property to secret confederates. The defendant officers also constituted a majority of the shareholders. The court held that the plaintiff minority shareholders were not required to make demand upon the board of directors or shareholders because of the interest of those groups. But the language of the decision does not limit incapacity to ratify to an *interested* majority of shareholders:

> [T]he indirect appropriation of the common property, profits or means of profit, to their own benefit, by *any portion* of the corporators, in fraud of their associates, is equally incapable of being authorized or ratified by the vote of a majority of the corporators, or by any act or omission of the corporate body.[23]

Cases applying the non-ratification rule to situations clearly involving a disinterested majority of shareholders are few.[24] However, one of the leading authorities for the non-ratification rule did involve a disinterested

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[19] See Landstrom, *supra* note 1; Note, 53 HARV. L. REV. 1368 (1940); Comment, 33 N.Y.U. L. REV. 71 (1958); 4 U. CHI. L. REV. 495 (1937).

[20] *E.g.*, Fleming v. Black Warrior Copper Co., 15 Ariz. 1, 136 Pac. 273 (1913); Eshleman v. Keenan, 187 Atl. 25 (Del. Ch. 1936) (voting trust for majority of shares: trust voted by corporation controlled by interested directors); Klein v. Independent Brewing Ass'n, 231 Ill. 594, 83 N.E. 434 (1907); Von Arnim v. American Tube Works, 188 Mass. 515, 74 N.E. 680 (1905); Brewer v. Boston Theatre, 104 Mass. 378 (1870); Crowe v. Consolidated Lumber Co., 239 Mich. 300, 214 N.W. 126 (1927); Miner v. Belle Isle Ice Co., 93 Mich. 97, 53 N.W. 218 (1892); Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818 (1914); *cf.*, cases cited note 24 *infra.*

[21] See Claman v. Robertson, 164 Ohio St. 61, 72, 128 N.E.2d 429, 436 (1955); Note, 4 U. CHI. L. REV. 495 (1937).

[22] 104 Mass. 378 (1870).

[23] *Id.* at 395. (Emphasis added.)

[24] *E.g.*, Dana v. Morgan, 219 Fed. 313 (S.D.N.Y. 1914), *aff'd*, 232 Fed. 85 (2d Cir. 1916); Mayer v. Adams, 141 A.2d 458 (Del. Sup. Ct. 1958); Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).

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majority of shareholders. In *Continental Securities Co. v. Belmont*,[25] a gift of corporate assets to a director in the guise of a sale of stock was alleged. The court overruled defendant's motion for judgment on the pleadings on the ground that the plaintiffs were not required to make demand upon the shareholders. The court held that since the shareholders could not ratify, demand would be of no avail. Incapacity to ratify was said to result from the fact that "stockholders cannot act in relation to the ordinary business of a corporation"[26] because no such authority is conferred by statute. However, the board of directors in *Belmont* apparently was disinterested and thus able to conduct the company's "ordinary business",[27] and the court noted that shareholders do have authority to ratify acts of directors when the board is disqualified because of interest. Thus the rationale of the *Belmont* case is not the nature of the directors' wrongdoing. Rather, lack of power in the shareholders to ratify is explained by their incapacity to exercise business judgment.[28] Thus, under the *Belmont* rationale, if the board of directors is disqualified, the shareholders may have the power to ratify.[29]

Recently the Supreme Court of Ohio, in *Claman v. Robertson*,[30] held that a disinterested majority of shareholders can ratify directors' frauds, provided there is no fraud in the vote to ratify.[31] A shareholder vote to

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[25] 206 N.Y. 7, 99 N.E. 138 (1912).

[26] *Id.* at 16, 99 N.E. at 141.

[27] In *Belmont* the court determined that the shareholders did not there have the power to act in relation to the ordinary business of the corporation. Since the court stated that one of the rare instances in which the shareholders may so act is when the board is disqualified because of interest, it may be assumed that the board in *Belmont* was not disqualified because of interest.

[28] See text accompanying note 26 *supra*. To say that stockholders "cannot act in relation to the ordinary business of a corporation" is to say that they cannot exercise business judgment. See discussion of business judgment, text accompanying notes 38–43 *infra*.

[29] In American Life Insurance Co. v. Powell, 80 So. 2d 487 (Ala. 1954), a derivative suit charging directors and officers with misconduct in profiting personally from transactions between the company and its customers, it was argued that the shareholders were powerless to act because the management of a corporation is vested by statute in the board of directors. The court, in sustaining the defendants' demurrer which charged plaintiff with failure to make demand upon the shareholders, stated:

> The argument impresses us as rather sophistical. It may be conceded that power by its very nature is indivisible, that if it resides in one body it does not reside in another. But this reasoning applied to its logical conclusion in the case at hand would not mean that [plaintiffs] could bring this action without appeal to the stockholders, but would mean that they could not bring it at all. For if the power to sue on corporate causes of action rests exclusively and irremediably only in the board of directors, no individual stockholder or group of stockholders could institute such an action.... Yet the books are replete with cases where such persons have sued on corporate causes of action.

Id. at 494.

[30] 164 Ohio St. 61, 128 N.E.2d 429 (1955).

[31] *Id.* at 72, 128 N.E.2d at 436.

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ratify the directors' acts was held to preclude the derivative suit in the absence of a further demand upon the body of shareholders to rescind ratification.[32] The court recognized the "so-called New York rule" of the *Belmont* case (that the actual fraud of directors cannot be ratified by a majority of shareholders, however disinterested they may be),[33] but decided it was not wise to "adopt a rule which will inevitably plague both the courts and the corporations of this state in 'strike' litigation."[34]

The *Claman* holding avoids examination of the transaction to determine whether it is "fraudulent" or merely "voidable". If there is a disinterested majority of shareholders, their decision not to sue prevails and such verbal distinctions are unnecessary. However, with perhaps one exception,[35] other courts have failed to take so clear a stand on the question of ratification of directors' frauds, perhaps because few cases actually involve a vote to ratify by a disinterested majority of shareholders.

Although the *Claman* court viewed the question of ratification as distinct from the question of business judgment,[36] the power to ratify was said to be dependent upon the ability of the shareholders to exercise a disinterested judgment.[37] Thus, while the court avowed a distinction between the two concepts, the similarity in the underlying rationale of *Claman* and the *Belmont* requirement for ratification (*i.e.,* that the shareholders have the power to act in relation to the business of the corporation in such circumstances) suggests that the doctrines are not distinguishable, except by name. Most important in the view of both courts is the disqualification of the board of directors and the existence of a disinterested majority of shareholders to function in the absence of a qualified board. Perhaps a closer look at the business judgment rule and decisions attempting to distinguish between business judgment and ratification will strengthen the conclusion that the two concepts are fundamentally inseparable.

The Business Judgment Rule

Generally, the management of a corporation is the province of the board of directors, subject, in some instances, to the ultimate control of the shareholders.[38] Because of the right of the majority of directors to

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[32] Note that demand is no longer a statutory prerequisite to a derivative suit in Ohio. OHIO REV. CODE ANN. § 2307.311 (Baldwin 1955).

[33] 164 Ohio St. at 69, 128 N.E.2d at 434.

[34] *Ibid.*

[35] Mountain States Packing Co. v. Curtis, 281 Pac. 737, 86 Colo. 355 (1929) (sale of assets to director found fraudulent, but ratification by disinterested majority held to prevent derivative suit).

[36] 164 Ohio St. at 73, 128 N.E.2d at 436.

[37] *Id.* at 72, 128 N.E.2d at 436.

[38] The majority of corporation acts give the board of directors the power to manage

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decide questions of corporate policy,[39] courts have refused to interfere with such intracorporate decisions. This principle may be referred to as the "business judgment rule as applied to decisions by boards of directors." However, if the board of directors cannot take action, then a decision by a disinterested majority of shareholders may bind the corporation and be as impervious to attack as a decision by a qualified board. This principle may be denominated the "business judgment rule as applied to shareholders." Even though such power seldom exists in the body of shareholders[40] (the power to conduct the ordinary business of the corporation being, by statutory provision, in the hands of the directors[41]) there is authority, both decisional[42] and in reason, for recognizing such power in limited situations. One supporting argument is that directors' transactions with their corporation are not in the nature of the "ordinary business" of the corporation and consequently are not within the sole province of the board of directors. Even stronger is the argument that when the board of directors is disqualified there is no means of conducting the ordinary

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the business and affairs of the corporation. See, *e.g.*, DEL. CODE. ANN. tit. 8, § 141 (1963); Illinois Business Corporation Act of 1933, § 33, ILL. REV. STAT. ch 32, § 157.33 (1963); MODEL BUS. CORP. ACT ANN. § 33 (1960). See generally, 2 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 505 (1954).

There are numerous acts of directors which, by statute or by the certificate of incorporation, are made subject to the consent of the shareholders. *E.g.*, MODEL BUS CORP. ACT ANN. § 5 (purchase of corporations own shares), § 67 (consolidation or merger) (1960). As to other matters if the board is disqualified from acting, the only group which can effectively carry on is the shareholders. See text accompanying notes 40–43 *infra*.

[39] For a discussion of the majority power to control, in terms of business judgment, see Landstrom, *supra* note 1.

Although the "business judgment of the shareholders" is the subject under discussion, the term generally is applied to exercise of discretion by the board of directors. See, *e.g.*, Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903); Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957); Noble v. Farmers Union Trading Co., 123 Mont. 518, 216 P.2d 925 (1950).

[40] See text accompanying notes 26–29 *supra*.

[41] See note 38 *supra*.

[42] See, *e.g.*, Kessler v. Ensley Co., 123 Fed. 546 (C.C.N.D. Ala. 1903), 129 Fed. 397 (C.C.N.D. Ala. 1904), 141 Fed. 130 (C.C.N.D. Ala. 1905), *aff'd per curiam*, 148 Fed. 1019 (5th Cir. 1906), *cert. denied*, 205 U.S. 541 (1907).

In United Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917) the Supreme Court sustained defendants' demurrer to plaintiffs' complaint which attempted to enforce an alleged violation of the Sherman Act. Plaintiffs argued that they should prevail because the shareholders and directors refused to take action upon demand. The Court stated:

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, *in the absence of instruction by vote of the stockholders*. Courts interfere seldom to control such discretion *intra vires* the corporation ... and, as a rule, *only after application to the stockholders....*

244 U.S. at 263–64. (Emphasis added.)

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business of the corporation (even if directors' transactions are termed ordinary business) other than through the body of shareholders.[43] It is also reasonable from a practical point of view that a disinterested, well-informed body of shareholders be allowed to act for the corporation when the usual managers cannot do so.

THE BUSINESS JUDGMENT RULE v. THE NON-RATIFICATION RULE

The question arises whether the exercise of business judgment by a disinterested majority of shareholders will preclude a derivative suit attacking a director's allegedly fraudulent transaction.[44] It has been held that if the shareholders have no power to ratify frauds, they may not accomplish the same purpose through exercise of a business judgment not to sue.[45] However, as has been pointed out,[46] most of the cases so holding have not involved disinterested majorities of shareholders, so that the business judgment rule would be inapplicable notwithstanding the supposedly conflicting non-ratification rule. In determining whether to apply the business judgment rule, some courts have attempted to distinguish between the concepts of ratification of fraud and exercise of business judgment not to sue,[47] seemingly because of a belief that the non-ratification rule must be applied literally, *i.e.,* that frauds are non-ratifiable whether or not a disinterested majority is available. If this literal interpretation of the rule were assumed to be correct, the distinction between non-ratification and business judgment would become important: since a literal application

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[43] See Kessler v. Ensley Co. 123 Fed. 546, 558 (C.C.N.D. Ala. 1903); Note, 63 COLUM. L. REV. 1086, 1093 (1963).

[44] See generally, Landstrom, *supra* note 1; *Recent Cases,* 64 HARV. L. REV. 334 (1950).

[45] *E.g.,* Rogers v. American Can Co., 187 F. Supp. 532 (D.N.J. 1960), *aff'd,* 305 F.2d 297 (3d Cir. 1962) (shareholders' vote not to sue held not to bar derivative suit where antitrust violations were alleged and the shareholders were held to have no power to ratify); Von Arnim v. American Tube Works, 188 Mass. 515, 74 N.E. 680 (1905) (demurrer to derivative suit overruled on ground that shareholders' assent to illegal use of funds would not bind a protesting minority); *cf.,* Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962):

> Where waste of corporate assets is alleged, the court, notwithstanding independent stockholder ratification, must examine the facts of the situation. Its examination, however, is limited solely to discovering whether what the corporation has received [in return for services rendered] is so inadequate in value that no person of ordinary sound business judgment would deem it worth what the corporation has paid.

[46] See text accompanying note 20 *supra.*

[47] Kessler v. Ensley Co., 123 Fed. 546 (C.C.N.D. Ala. 1903); Mayer v. Adams, 141 A.2d 458 (Del. Sup. Ct. 1958); S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1950). See generally, Note, 53 HARV. L. REV. 1368 (1940).

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of the non-ratification rule would render ineffective shareholder efforts to prevent suit in all cases of "fraud", a court seeking to allow shareholders to accomplish this result would be forced to turn to the seemingly different business judgment rule. Such a semantic distinction supports the real identity of the two principles. The *Belmont* decision was reached upon a finding that shareholders lacked capacity to conduct the business of the corporation. Proceeding from this premise, the *Belmont* court then determined that there could be no ratification of directors' frauds. But the rule was too broadly stated, so that later decisions began with the determination that there was "fraud" and concluded that therefore the transaction was open to attack notwithstanding shareholder action purporting to prevent attack. Consequently it appeared that the only way to avoid the literal application of the nonratification rule was to decide that the business judgment rule was somehow different.

Recently two courts have considered whether the doctrines are distinguishable in cases involving a disinterested majority of shareholders. In *Mayer v. Adams*,[48] the Supreme Court of Delaware held that an allegation of fraud was sufficient excuse for failure to make demand upon the shareholders. It had been argued that even though the shareholders could not ratify because of the allegation of fraud, the shareholders should be able to prevent the derivative action by an exercise of business judgment not to sue. The court refused to draw such a distinction, stating:

> [A] decision not to press a claim for alleged fraud committed by the directors means, in effect, that the wrong cannot be remedied. It is conceded that the wrong cannot be ratified by the majority stockholders, but it is said that refusal to sue is a different thing from ratification. Strictly speaking, this is true, but the practical result is the same.[49]

The technical ground for the *Mayer* holding was that shareholders do not have the power to exercise business judgment to effect the same practical result that ratification would yield. In effect, the *Mayer* decision stands for the proposition that if the shareholders have no power to ratify frauds, a fortiori they have no power to exercise business judgment in declining to sue. The court was opposed to recognizing such power in the shareholders because it would ". . . import into our law a procedure that would inevitably have the effect of seriously impairing the minority stockholder's now existing right to seek redress for frauds committed by directors of the corporation."[50]

Laudable as it may be to protect the minority shareholder from directors' frauds, the simple statement of this proposition does not recognize sufficiently the right of a disinterested majority of shareholders to

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[48] 141 A.2d 458 (Del. Sup. Ct. 1958).
[49] *Id.* at 461.
[50] *Ibid.*

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govern the corporation when the board is disqualified. Thus, while the *Mayer* decision rightly declines to distinguish between the power to ratify and the power to exercise business judgment, the resulting protection of the minority shareholder at the expense of the disinterested majority is unwarranted. The *Belmont* decision is cited in *Mayer* as "high authority" for the result.[51] However, the *Belmont* case held that the shareholders had no power to ratify *because* they had no power to exercise business judgment in the absence of a disqualified board of directors. Since the board *was* disqualified in *Mayer,* the holding that shareholder business judgment cannot prevent a minority suit *because* there could be no ratification is circular reasoning. The circle is started by the determination that the transaction was "fraudulent" in terms of the non-ratification rule formula. The circle may be broken by recognizing that terming the transaction "fraudulent" does not meet the policy issue raised, *i.e.,* will the court allow a disinterested majority of shareholders to overlook wrongdoing by a director even though it may silence the overruled minority?

On the other hand, in *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.,*[52] the Supreme Judicial Court of Massachusetts dismissed a derivative suit to enforce claims of the defendant corporation against directors,[53] basing the decision on the power of the shareholders to exercise business judgment in determining not to sue. The court refused to rest its decision upon any power to ratify, stating that "the question whether it is good judgment to sue is quite apart from the question of ratification."[54] Although the court said nothing more in support of this distinction, it supported the majority's power over the minority because it could

> perceive no reason why the usual rule recognizing that it is for the corporation to decide questions of business policy should be subject to an exception limiting the corporate power where a charge is made against an officer or director but where an independent, disinterested majority of the stockholders acting reasonably and in good faith have voted that in their judgment it is not in the best interest of the corporation to sue.[55]

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[51] *Id.* at 462. The court also relied on Keenan v. Eshleman, 23 Del. Ch. 234, 2 A.2d 904 (1938) which also relied upon *Belmont* and fails to discuss the existence of a disinterested majority. See Note, 63 COLUM. L. REV. 1086, 1095 (1963).

[52] 326 Mass. 99, 93 N.E.2d 241 (1950).

[53] The acts complained of were: purchasing notes from the corporation at a great discount, yielding directors large profits; carrying out a plan to gain control of the corporation by directors; settling certain antitrust suits by directors; and excessively compensating directors. *Id.* at 104–05, 93 N.E.2d at 243–44.

[54] *Id.* at 111, 93 N.E.2d at 247.

[55] *Id.* at 114, 93 N.E.2d at 249. Note that Von Arnim v. American Tube Works, 188 Mass. 515, 74 N.E. 680 (1905) and Brewer v. Boston Theatre, 104 Mass. 378 (1870) were distinguished on the ground that they were limited to situations involving interested majorities.

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From the preceding language it is apparent that the *Solomont* decision was not really based on a distinction between ratification and business judgment. If the result is to be the same, it *is* difficult to draw a conceptual distinction between the two doctrines. Assuming no conceptual distinction due to differences in labels, the differing results in cases such as *Mayer* and *Solomont* can be explained only on the basis of the policy consideration deemed most important in each case. Thus, in *Solomont,* the court believed that the presence of a disinterested majority of shareholders offered sufficient protection to the minority, while the *Mayer* court would protect the minority shareholder from feared majority oppression under seemingly similar circumstances.

CONCLUSION: THE RULE OF DISINTEREST AND INDEPENDENCE

In *Mayer,* the court excused demand and allowed the derivative suit, noting that there were over 100,000 widely scattered shareholders and that an unreasonable proxy fight inevitably would result from enforcement of the demand requirement.[56] Perhaps the underlying rationale of the *Mayer* decision, based on the foregoing, is that the holders of widely distributed stock are not in a position validly to exercise business judgment on an issue about which they have no knowledge other than that gained through proxy machinery, which is usually in the hands of the interested management. That the *Mayer* court feared management's influence on the shareholders' decision-making is indicated by the court's emphasis on the importance of the "minority stockholder's now existing right to seek relief for frauds committed by directors of the corporation."[57] Fear of "oppression" of the minority is contemplated in offering such protection. But the threat of such oppression could exist only if the shareholders were not in a position to render an objective business decision, not because the directors' acts were "fraudulent".

As the court in *Mayer* was fearful of management's influence upon the independence of the shareholders, the court in *Solomont* was convinced that there existed "an independent, disinterested majority of the stockholders acting reasonably and in good faith."[58] Consequently the *Solomont* court had no trouble overcoming the non-ratification barrier merely by brushing it aside summarily.

By burying the policy reasons for their decisions dealing with the non-ratification rule in result-stating formulas, the courts have effectively constructed a maze of verbiage difficult of penetration.[59] When this verb-

[56] 141 A.2d 458, 459–60 (Del. Sup. Ct. 1958).

[57] *Id.* at 461.

[58] 326 Mass. at 114, 93 N.E.2d at 249. See note 55 *supra.*

[59] See note 5 *supra* for discussion of some terms used by the courts in dealing with directors' "frauds".

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iage is torn down and it is determined that directors have been disqualified due to interest and that a disinterested majority of shareholders is in a practical position to render an objective decision not to sue, it will be found that the courts will uphold their decision, whether termed "ratification" or an exercise of "business judgment".[60]

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[60] As a practical matter the question arises when it will ever be in the best interests of a corporation not to take action against a self-dealing director. The cases following are illustrative of situations where a disinterested majority of a board of directors or shareholders could reasonably determine that it would be more harmful to take action than to do nothing: Kessler v. Ensley Co., 123 Fed. 546, 557 (C.C.N.D. Ala. 1903) ("[T]he stockholder of the Land Company, who voted ... not to authorize the suit to redress [the wrongdoing] may well have thought, on the whole, that it would not be advantageous ... and that ... [the suit would] entail useless cost and expense upon the corporation."); *accord,* Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903) (dictum); Hornstein v. Paramount Pictures, 37 N.Y.S.2d 404 (1942) (submission to extortion by director to avoid damaging strikes by labor union held not a crime and not giving rise to a claim enforceable by derivative action); Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201 (1890) (sale of water pipe facilities by a director-officer-shareholder to his corporation at a disputed profit held not subject to attack by derivative action because value of facilities to the water supply company was great).

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