A Stockholder May Sue In The Name Of The Corporation For Acts Committed Before He Became A Stockholder

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Importance of the Subject

MAY a stockholder sue in the name of the corporation for acts done before he became a stockholder? Our corporation law furnishes no direct answer to this all-important question, but our Supreme Court has consistently denied such a right to stockholders. This doctrine has become so much taken for granted that no dissenting opinion has been written to challenge the majority view. This is, to say the least, surprising when we consider that practically every leading authority on Corporation Law in the United States holds the contrary view.

Contrary Views

The question is all-important in the Philippines because at present corporations are rapidly becoming a leading factor in the development of commerce and industry. Corporations of all sorts, have increased in number everywhere in the Islands. Corporation stock are changing hands every day. Consequently, new stockholders are made every day. These stockholders may find that the officers of the corporations have made questionable transactions which have prejudiced the corporation. As a result, they may realize that because of losses sustained through these undercover transactions, the corporation is not as financially strong as it was made to appear. Naturally, these new stockholders would now like to question these acts of the officials. They want to know whether they may legally do something to remedy the injury that has been done to the corporation.

The question was first squarely answered by the Supreme Court in the leading case of *Pascual vs. Orozco, 19 Phil. 82,* which may therefore be considered the principal authority on this point in the Philippines. The ruling was subsequently affirmed in *Everett vs. Asia Banking, 49 Phil. 512* and more recently in *Angeles vs. Santos, 36 O. G. 40, 921.*

The Pascual vs. Orozco Case

In order that the doctrine laid down may be better understood we shall state the essential facts of the case. The plaintiff, Pascual, became a stockholder of the Banco-Español-Filipino on November 13, 1903. The defendants were the members of the Board of Directors of said corporation. The plaintiff stockholder sued the defendant directors alleging two causes of action, to wit: 1st: That the defendants deducted their respective compensation from the gross income of the corporation instead of deducting the same from the net profits as provided for in the by-laws. The plaintiff claims that by so doing, the directors had been defrauding the bank and

its stockholders of ₱20,000 per annum. As a second cause of action, Pascual claims that this fraud was also practiced by the previous Board of Directors (defendants' predecessors) from 1899 to 1902. That during the latter period, the defendants were officials (not directors) in the bank who knew of such misappropriation and were in a position to inform the stockholders about it but failed to do so through sheer negligence. For such failure to take action, the plaintiff also sought damages for injury done to the corporation during these years, which, as may be noted, was prior to the date he became a stockholder.

It was in denying the plaintiff's second cause of action that the Court first laid down as a doctrine that a suing stockholder must have been such at the time of the commission of the improper acts complained of by him.

Requisites for Stockholder To Sue

That a stockholder may bring a suit in the name of the corporation is a well settled principle both here and in the United States. But this right may be exercised only under certain circumstances and subject to certain conditions. The weight of authority holds that the following are the indispensable requisites:

(1) Plaintiff must be a stockholder at the time the suit is brought. (*Scolan vs. Snow, 2 App. Cases 137; Fletcher Cyclopedia Corporations, Vol. 6, p. 6881*).

(2) The matter complained of must be a breach of duty on the part of the officers of the corporation. (*Dodge vs. Woolsey 18 How. 331; Atwol vs. Merriweather decided in England in 1867*).

(3) Sufficient efforts must be exerted to have the corporation bring the action and the corporation must fail and refuse to demand redress or must be unable to do so. (*Hawes vs. Oakland 104 U. S. 450; 26 L. ed. 827; Hersey vs. Veazie, 24 Me. 4; 41 Am. Dec. 364n*).

(4) There must be substantial injury to the stockholders. (*Nathan vs. Thompkins, 82 Ala. 437; 2 So. 747*).

(5) Action must be brought in good faith. (*Thompson on Corporations, Vol. 4, Sec. 4553; O'Connor vs. Virginia Passenger & Power Co., 92 N. Y. Suppl. 525*).

(6) Stockholder must not have become such for the mere purpose of bringing the suit. (*Home Fire Insurance Co. vs. Brer, 60 L. R. A. 92*).

To these our Supreme Court, by its decision in *Pascual vs. Orozco*, has added another, the absence of which in this particular instance proved fatal to the plaintiff's suit in spite of the presence of all the other requisites above enumerated. As previously stated this condition added by the P. I. Supreme Court is:

"That the stockholder suing in the name of the corporation must have been such at the time the act complained of took place."

Basis of Court's Decision

The Court based its decision on the 94th Equity Rule, adopted by the U. S. Supreme Court on January 23, 1883. This rule, which, as the P. I. Supreme Court admitted, was a mere rule of pleading, is worded as follows:

"Every bill brought by one or more stockholders in a corporation against the corporation and other parties, founded on rights which

may properly be asserted by the corporation, must be verified by oath, and *must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains*, or that his shares had devolved upon him by operation of law, and that the suit is not a collusive one to confer on a court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action."

This rule was apparently based on the decision of the Supreme Court in the case of *Hawes vs. Oakland* promulgated on January 16, 1882 (which was about a year before the 94th Equity Rule became enforced.) This decision was also quoted in the case of *Pascual vs. Orozco* as authority supporting the doctrine therein laid down. The plaintiff claimed that the 94th Equity Rule is a mere rule of procedure in the U. S. Federal Courts and hence could find no application here. The Court answered this objection by maintaining that although the 94th Equity Rule itself may be a rule of procedure, still, since the same doctrine was embodied in a Supreme Court decision, i.e., the *Hawes vs. Oakland* case, the U. S. Supreme Court must have intended it to be a matter of substantive law.

The Underlying Principle of the 94th Equity Rule

The objection to our Supreme Court's decision lies in the application of this 94th Equity Rule of the Federal Supreme Court without fully appreciating the reasons and circumstances behind its adoption.

Previous to the *Hawes vs. Oakland* case, it had been a common practice in the United States for stockholders to sell a few shares to individuals in another state in order to facilitate the filing of actions in the Federal Courts.

The reason for this practice is as follows: stockholders who wanted to bring an action against the Board of Directors or perhaps the corporation itself wanted to have their litigations decided by the Federal Court instead of the State Court. Presumably the reason for this preference was that the adjudications of the State Courts are not authoritative enough. But it was a rule in American legal procedure that the Federal Court could not acquire jurisdiction unless the controversy was between citizens of different states. Since most stockholders of corporations were citizens of the State of the corporation's domicile, their actions were barred from the Federal Courts. To circumvent this rule it became the practice to transfer shares to a few citizens of another State and make these stockholders bring the desired action. Since the controversy was now apparently between citizens of different States, the Federal Court was forced to entertain the suits. The result was the undesirable clogging of the already crowded calendar in the Federal Courts.

The practice became so notorious and had such undesirable effect on the calendars of the Federal Courts that the Supreme Court determined once and for all to put it to an end. It realized that the best remedy lay in discouraging actions by stockholders who become

such for the mere purpose of bringing in the Federal Courts an action desired by real stockholders but who were barred from bringing such action. With this end in view it laid down in the case of *Hawes vs. Oakland,* that before a stockholder may bring a suit in the name of the corporation, he must allege, among other things, that he was a stockholder at the time of the acts complained of. To make this more binding the Federal Supreme Court embodied it in its rules of procedure, a year later, as the 94th Equity Rule above quoted. In this wise, stocks may no longer be transferred to citizens of another State for the purpose of facilitating the filing of actions before the Federal Courts. Not being stockholders at the time the acts complained of took place, such "stockholders" were now barred from bringing the action.

This Rule Cannot Apply in the Philippines

This Rule cannot find application in the Philippines because the peculiar circumstances which justified its promulgation in the United States do not obtain here. We do not have the Federal and State Court set-ups which encourage the collusion sought to be avoided by this Rule in the United States. We do not have citizens of different States, actions between whom are cognizable only by the Federal Courts. In the Philippines no distinction is made between actions involving residents of the same province and those involving residents of different provinces. In this jurisdiction all civil actions are brought in the Court of First Instance of the province where the defendant resides or may be found or where the plaintiff resides at the election of the plaintiff (Rule 5, Sec. 1, New Rules of Court.) Hence there can be no collusive transfers to facilitate the bringing of actions. If such collusive transfers are not possible under the Philippine judicial system, why apply a rule precisely intended to prevent such collusive transfers? It is tantamount to trying to prevent an evil that cannot and does not exist.

It may be argued that the 94th Equity Rule should be applied in the Philippines to discourage actions brought by stockholders who become such in bad faith, i.e., for the mere purpose of bringing an action, either against the Board of Directors or any person connected with the corporation. (*O'Connor vs. Virginia Passenger & Power Co., 92 N. Y. Supp. 525*). This contention may be readily dismissed by observing that a stockholder may sue in bad faith if he has motives to do so, regardless of whether he became a stockholder before or after the acts complained of. Moreover the P. I. Supreme Court apparently did not intend to use that premise to support the doctrine it laid down. In the *Pascual vs. Orozco* case there was no indication of bad faith. In fact, the Court did not bother to find out whether the suit was in bad faith or not. It simply laid down as a legal dogma that irrespective of the good faith of the suing stockholder, he may not bring an action where the acts he complains of took place before he acquired his stocks.

The Court argued that to allow a stockholder to sue for acts committed before he became a stockholder, would give rise to the anomalous situation whereby a former stockholder acquiesced in certain acts only to have his successor contest the same acts. This ar-

gument will not stand close scrutiny. To all intents and purposes, it must be remembered that the corporation is a person apart and distinct from its stockholders. According to this argument the corporation is made to suffer for the lack of interest or perhaps the bad faith of other persons, i.e., its stockholders. The possibility arises that the previous stockholder was not interested enough to bring an action in the name of the corporation. More than that: he may have colluded in the wrongful acts. But why make the corporation suffer for this? Why deny the corporation the right to seek redress for wrongs done to it merely because it had the double misfortune of being powerless to bring an action and at the same time have stockholders not conscientious enough to come to its aid. It seems far more equitable to give the corporation every chance to obtain redress for the injuries done to it. Should such chance come in the guise of a stockholder acquiring his stocks subsequent to the acts complained of, but conscientious enough to defend the helpless corporation's interests by pleading its case before the courts of justice, there seems to be no valid reason why such an opportunity should be denied it.

As the court itself so appropriately observed: "In suits of this character the corporation itself and not the plaintiff stockholder is the real party in interest." (*See Purdy's Beach on Private Corporations, Sec. 554*). It is the corporation who has the right to bring action; and as a matter of fact, the stockholder brings the action not in his own right but by virtue of a right belonging to the corporation. He stands in the shoes of the corporation; therefore only those disabilities applicable to the corporation should be considered in representative suits like this. The fact that the stockholder suing in the name of the corporation was not injured (because he was not yet a stockholder at the time of the acts complained of), should not disqualify him from bringing the suit because such disability is personal to the stockholder who is not the real party in interest.

The statement quoted at the beginning of the foregoing paragraph is inconsistent with the conclusion of the Court expressed in the same decision as follows: "It is self-evident that the plaintiff in the case at bar was not, before he acquired in September, 1903, the shares which he now owns, injured or affected in any manner by the transactions complained of."

Precisely, the defendant was not injured; that is why he is not suing for himself. But the corporation was injured and is unable to bring the action. And that is why the stockholder is bringing the action in the name of the corporation who is the injured party, and who consequently is the real party in interest.

Authorities Support Contrary Rule

The doctrine laid down by the local Supreme Court becomes all the more untenable when we consider that leading authorities on Private Corporations, to say nothing of judicial pronouncements, are practically unanimous in supporting the contrary rule.

Fletcher, categorically states that "before a stockholder may bring a suit in the name of the

corporation he need not be a stockholder at the time the act complained of took place." (*6 Fletcher's Cyclopedia Corporations, 6883*). He explains that "the cases decided by the U. S. Supreme Court are not based on general principle but upon an Equity Rule (94th) adopted as a rule of practice merely to guard those courts against collusion of parties for the purpose of bringing cases within their jurisdiction. "This Equity Rule," he explains, "has been criticized as based in part on jurisdictional considerations which are *peculiar to Federal Courts* and as based in part on the common law doctrine of champerty and maintenance which have become *obsolete.*" (*See also 4 Cook on Corporations, 3284; Home Fire Ins. Co. vs. Booker, 60, L. R. A. 927*).

Fletcher advocates an even more sweeping rule than that mentioned at the beginning of this article: "By the weight of authority, in the absence of such a rule (the 94th Equity Rule) a stockholder is not precluded from suing in the name of the corporation by the mere fact that he purchased his shares after the transactions complained of, even though he may have known of them at the time of the purchase and even though he may have made the purchase for the purpose of acquiring a standing to sue, for the transfer of stock not only conveys to the transferee the ownership of the shares and the right to the future dividends thereon, but also places him upon an equal footing with the other stockholders with respect to its right to call the officers and agents of the corporation to account and to enjoin or set aside *ultra vires* transactions." (*Fletcher, supra; see also German Corp. of Neguanee vs. Neguanee German Aid Society, 172 Michigan 650; 138 N. W. 343*).

Thompson holds a similar opinion expressed as follows: "There is reasonable authority that it makes no difference as to the time when the stock was acquired . . " (*See also Mackay vs. Barnes, 64 Pac. 485; Texas vs. Hammersmith 66 N. E. 79, 912; Hanna vs. Lyon, 71 N. E. 778*).

"Reason for the doctrine followed in the Supreme Court is Equity Rule 94 adopted to prevent collusive suits . . " (*Elliot, on Private Corporations, 5th Ed. Secs. 423, 422, 427.*)

"The general rule is that a stockholder who pleads a good cause of action may maintain the same although he was not an owner of the stock at the time the breach of duty was committed as the cause of action accrued except in cases where it is shown that he purchased the stock with the purpose of bringing the suit or where his vendor for some reason was estopped from maintaining the action or the purchaser had notice of such bar." (*Thompson on Private Corporations, Vol. 4, Sec. 4632; Parsons vs. Joseph, 8 So. 788; Miller vs. Murray, 30 Pac. Rep. 46; Chicago vs. Cameron, 11 N. E. 899; Carson vs. Iowa City Gas Light, 45 N. W. 1068.*)

Conclusion

We see that in holding that a stockholder must be such at the time of the occurrence of the acts complained of before he can sue in the name of the corporation, the Court applied the 94th Equity Rule in the United States which was adopted to prevent collusive suits. We have also seen that this rule is not applicable in the Phil-

ippines because we do not have the dual judicial set-up of State and Federal Courts that make collusive suits possible. It has also been shown that leading authorities on the subject agree that such requisite is not necessary outside of the circumstance which warranted the adoption of the 94th Equity Rule. It is, therefore, submitted that it is to the best interests of corporations in the Philippines to abandon the doctrine laid down in the *Pascual vs. Orozco* case in order to give corporations every opportunity to recover for wrongs committed by their officers, agents, and third persons.

"A SYSTEM of procedure is perverted from its proper function when it multiplies impediments to justice without the warrant of clear necessity."—JUSTICE CARDOZO, *Reed vs. Allen, 286 U. S. 191, 209.*