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tract for services. In each case where the warranty was extended into a new area the court first determined that the consumer was at a disadvantage for he lacked the knowledge to make his own determinations. The courts then considered the burden that the liability would place on the supplier. If this burden was similar to that placed on a vendor then liability was imposed. Another consideration has been whether the type of control the supplier of services had over the results was similar to the control that the vendors and manufacturers had over their goods. If the same type of factors are out of the control of both then there should not be a distinction made between the types of transactions involved.

The consumer of services has been ignored by those who have professed to protect consumers. He is not as well protected by legislation as is the consumer of goods and he is not as well protected with respect to the types of warranties that the courts will impose. Legislation to protect the service consumer can be directed at various goals. As in the proposed New York Mechanics Licensing Acts, the legislation can be aimed at solving the safety problems alone or alternatively at the collective problems of safety, economic and quality protection. Even without legislation, judicially imposed warranties need not be limited to sales transactions but can be used in service transactions. Not only can the parts be warranted but the services can be warranted as well. The protection offered the consumer of services must equal those given to the goods consumer where the needs and problems are the same.

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DEMISE OF THE DOCTRINE OF *CAPITAL WINE AND SPIRIT V. POKRASS*

INTRODUCTION

A stockholder's derivative action is a form of suit available to shareholders to vindicate a corporate claim and thereby protect their interest in a corporation when corporate management breaches its trust or is careless in managing the business of a corporation.[1] When a corporation has an action against a party it is management's duty to bring a *direct* action to recover the damages owed to the corporation. However, if management refuses to bring suit, only then can a stockholder bring a *derivative* action against management for these damages.

In *Pollitz v. Gould*[2] such an action was brought by a stockholder of the Wabash Railroad Company to set aside as fraudulent a transfer and exchange of stock. The question presented to the Court of Appeals was whether a stock-

1. Chaplin v. Selznick, 186 Misc. 66, 58 N.Y.S.2d 453 (1945).
2. 202 N.Y. 11, 94 N.E. 1088 (1911).

holder may bring an action of this character for the purpose of avoiding an improper transaction consumated at the expense of the corporation before he acquired his stock. It is important to note that the question presented did not involve any incidental considerations such as, the fact that the prior holder of the stock consented to the transaction or the fact that plaintiff's subsequent acquisitions of the stock were accompanied by any circumstances which would render it inequitable for him to seek relief.

The court first established that a stockholder has an indivisible interest in the property and assets of a corporation represented by certificates of stock, and that this interest is transferred to the subsequent holder of these certificates with their sale.[3] They went on to say that it would seem to be clear that a right of action by or in behalf of the corporation for fraud to set aside a conveyance of its assets in which a stockholder has this indivisible interest is also transferrable with his certificates.[4] The court was unable to see any real or substantial distinction by virtue of which a stockholder transferring his certificates would transfer all of his indivisible interest in bonds or real estate on hand, but would not transfer his interest in a right of action to recover bonds or real estate which had been fraudulently withdrawn from the possession of the corporation.[5] If the subsequent holder by acquiring the certificate does acquire this latter interest, it seems to follow that he may if necessary, on behalf of the corporation, assert or prosecute an action to protect and enforce this right of action.[6]

Pollitz v. Gould, therefore, established the rule that a stockholder transferring his stock in a corporation transfers all his rights in a corporation including the right to bring a derivative action to enforce these rights. Between the time *Pollitz v. Gould* was decided and the General Corporation Law was amended in 1943 a common practice had developed whereby individuals having found a corporation where mismanagement had occurred would purchase a minimal stock interest in this company.[7] Being stockholders of this corporation they would then bring a derivative action to enforce the rights of the corporation against its management. These same individuals aware that in most instances the cost to management of defending the suit would far exceed any recoverable damages, would approach management to negotiate a settlement for not prosecuting. Damages recovered if a derivative action had been brought would have been ratably distributed among all the stockholders. The proceeds from these secret settlements were not. Furthermore, in many instances no real wrongs had been committed by management yet these individuals were bought off in order to protect the corporation's good will. The dangers and inequities in such secret settlements are obvious. In an attempt to curb these strike suits, while at the same time allowing stockholders with a legitimate claim to bring suit against manage-

3. *Id.* at 15, 94 N.E. at 1091 (1911).
4. *Id.*
5. *Id.*
6. *Id.* at 16, 94 N.E. at 1092 (1911).
7. I. Kantrowitz and S. Slutsky, White New York Corporations (1947) § 61, at 21.2.

ment, the New York legislature enacted section 61 of the General Corporation Law.[8]

"Had the legislature really been concerned with the so-called abuses of stockholder suits, the remedy was obvious: to bar 'secret settlements' ".[9] Instead, section 61 of the General Corporation Law, now section 626 of the Business Corporation Law enumerates a series of prerequisites that a stockholder must fulfill before having standing to bring a derivative suit. One of these requires that when a stockholder brings an action in the right of a corporation it must appear that the plaintiff was a stockholder at the time of the transactions of which he complains, or that his shares or his interest therein devolved upon him by operation of law.[10] The purpose of this requirement was to prevent an individual from buying into a large publicly held corporation solely for the purpose of bringing a derivative suit, while still allowing an injured stockholder who owned stock at the time the wrong was committed to bring an action for the benefit of the corporation.

CAPITAL WINE & SPIRIT CORPORATION V. POKRASS

In *Capital Wine & Spirit Corporation v. Pokrass*,[11] a direct action was brought by a corporation to recover from its former officers and directors for misappropriation and waste of assets. Joseph Sachs, the corporation's sole stockholder at the time the action was brought, had acquired his interest in the corporation after the wrongs complained of occurred. The Supreme Court, Appellate Division, First Department, held that the contemporaneous ownership requirements of section 61 of the General Corporation Law [the predecessor of section 626][12] would have precluded Sachs from bringing a derivative action to redress these wrongs and therefore he should not be allowed to recover under the guise of a direct action what he would have been prevented from recovering through a derivative action. To support their holding, the court cited Justice Pound's opinion in *Home Fire Insurance Company v. Barber*,[13] where he stated that "where all the present stockholders are so circumstanced that no relief should be afforded them in a court of equity, the corporation may not recover for their benefit."

In so deciding the *Pokrass* case the court did not properly interpret section 626 in light of its legislative purpose, nor did they make the distinction be-

8. N.Y. Gen. Corp. Law, § 61 (McKinney 1943). Now, N.Y. Bus. Corp. Law § 626(b) (1963). Hereinafter referred to as section 626.

9. *See Hornstein, New Aspects of Stockholders' Derivative Suits*, 47 Col. L. Rev. 1 (1947). *See* N.Y. Law Rev. Comm. Rep. Leg. Doc. No. 65(j) (1942); N.Y. Law Rev. Comm. Rep. Leg. Doc. No. 65(c) (1945).

10. § 626(b) (McKinney 1967).

11. 277 App. Div. 184, 98 N.Y.S.2d 291 (1st Dept. 1950), *aff'd* 302 N.Y. 734, 98 N.E.2d 704, *mot. den.* 302 N.Y. 840, 100 N.E.2d 37 (1951). Hereinafter referred to as Pokrass.

12. Section 61 General Corporation Law (McKinney 1943).

13. 67 Neb. 644, 93 N.W. 1024, 60 L.R.A. 927, 108 Am. St. Rep. 716 (1903). Hereinafter referred to as Barber.

tween an affirmative defense to a derivative action and a prerequisite that is necessary to give plaintiff standing to bring this action.

Barber stated that when all the stockholders of a corporation are equitably estopped from bringing a derivative suit that the corporation cannot recover for their benefit through a direct suit. This, however, is true notwithstanding the existence of section 626. Section 626 states what a plaintiff must do to have standing to bring a derivative suit. It has nothing to do with equitable considerations. It merely lists requirements a plaintiff must fulfill. If a plaintiff is in fact equitably estopped, as it appears Sachs was in *Pokrass*, then the case should be decided on these equitable grounds and not confused with section 626 considerations, particularly when the action involved is brought by the corporation directly and not by a stockholder derivatively.

The facts in *Pokrass* show that Sachs was equitably estopped from bringing a derivative action for he knew the true value of the company's assets when he purchased its stock. Since Sachs had acquired his interest after the wrongs complained of occurred he also could not fulfill the contemporaneous ownership requirements of section 626 and was therefore *statutorily* precluded from bringing a derivative suit. In deciding *Pokrass*, the court failed to make the distinction between being equitably estopped and being statutorily precluded from bringing suit. The court reasoned that Sachs did not own his stock at the time the wrongs complained of occurred and therefore could not fulfill the contemporaneous ownership requirements of section 626. Since Sachs was the sole stockholder, there were no other stockholders who could bring suit. The court then concluded that since there were no stockholders who could bring suit, it would be inequitable to allow the corporation to sue directly for the benefits of the suit would go to the same stockholder who could not sue derivatively. To support this position, the court cited *Barber*.

In fact, the rationale of *Barber* does not apply for *Barber* dealt with equitable considerations and not statutory requirements such as those of section 626. If the court had said that since Sachs was *equitably* estopped from bringing a derivative suit and that since there were no other stockholders who could bring suit that it would be inequitable for the corporation to recover directly (for the benefits of the suit would go to one who is equitably estopped from bringing suit), then the case would have been properly decided.

The following example should show why this distinction between an equitable estoppel to a cause of action and a statutory preclusion from bringing a cause of action is so important:

> Assume, for instance, that a director of a closely held corporation wastes assets. The stock is then sold to a single buyer, who upon discovering the misdeeds, finds that he has not received fair value for the purchase price. The buyer cannot sue the sellers since they did not commit any fraud; he has no direct action against the guilty party since a suit for mismanagement must be brought by or in the name of

> the corporation 3 Fletcher, Corporations § 1282 (1947); he cannot bring a derivative action because of § 61; and under the *Pokrass* decision the corporation itself cannot sue. Thus although a clear case for recovery on equitable grounds is established, the buyer must placidly accept his loss.[14]

If *Pokrass* had been properly decided, that is, solely on equitable considerations, this result could not occur and the corporate plaintiff having established a valid cause of action would be permitted to recover.

Although the court in *Pokrass* did not make the necessary distinction between an equitable estoppel to a cause of action and a statutory prerequisite to bringing a cause of action they did prevent Sachs from what appears to be an inequitable recovery. The problem caused by *Pokrass* arises when it is cited as authority in a decision where there are no equitable considerations present that might otherwise preclude a plaintiff from recovering. By using the *Pokrass* rationale in deciding an action brought directly by the corporation where but for the contemporaneous ownership requirements the plaintiff could bring suit, the court effectively precludes recovery in situations where section 626 has no application. In the words of Justice Shientag, dissenting in *Pokrass*,

> Section 61 of the General Corporation Law [section 626] applies only to a derivative stockholder's suit and not to a suit brought by a corporation on its own behalf. This is true notwithstanding the fact that one stockholder owns the entire capital stock which he purchased after the commission of the wrongful acts complained of.[15]

Development and Demise of the Pokrass Doctrine

It took the New York courts over a decade to ultimately reach Justice Shientag's conclusion. The following cases while not exhaustive, exemplify the development of the court's reasoning in finally coming to his conclusion.

The first case to be decided on the authority of *Pokrass* was ***Diamond v. Diamond***.[16] Plaintiff, having received her 50% stock interest in closely held corporation from her husband's estate, brought a derivative action against the owner-director of the other 50% to have restored to the corporation money which had been diverted by the concerted effort of plaintiff's husband and the defendant director. The evidence established that the diversion had been with the full knowledge of plaintiff, that she had relied on the acts done by her husband as her agent, that she had participated in the acts complained of and that she had benefited thereby.[17] The court held that plaintiff was not entitled to recover again through the subterfuge of a derivative action, amounts which had been diverted with her participation.[18] To support this holding the court

14. Note, 65 Harv. L. Rev. 345 (1951).
15. 277 App. Div. 184, 190, 98 N.Y.S.2d 291, 297 (1st Dept. 1950).
16. 200 Misc. 1055, 107 N.Y.S.2d 508 (Sup. Ct. N.Y. County Part VI 1951). Hereinafter referred to as Diamond.
17. *Id.* at 1057-68, 107 N.Y.S.2d at 511-520.
18. *Id.* at 1070, 107 N.Y.S.2d at 521.

relied on the *Pokrass* case as supporting the *Barber* doctrine which in turn precluded recovery on equitable grounds.[19] It is not readily ascertainable why the *Pokrass* case, which involved a direct suit, was used to decide the *Diamond* case, which was a derivative action.

Because *Diamond* was decided so soon after *Pokrass* and because *Diamond* relied so heavily on *Pokrass* to support its holding, subsequent decisions by the New York courts usually cited both cases simultaneously for the holding that a suit cannot be brought by a corporation for the benefit of its stockholders when such stockholders would be estopped from instituting suit themselves in the corporation's behalf. This multiple citation as authority for the same rule of law has thoroughly confused the law in this area since *Pokrass* involved a direct action by a corporation where the plaintiff was statutorily estopped and *Diamond* involved a derivative suit where the plaintiff was equitably estopped.

The case most vividly showing the inequities in the *Pokrass* rationale is *Ford Tank Maintenance v. Ford.*[20] The sole stockholder in a corporation purchased his interest on July 1, 1959. Subsequently, it was discovered that the former officers and directors had unlawfully withdrawn assets from the corporation. Because the purchaser did not own his stock when the wrongs complained of occurred, section 626 precluded him from suing derivatively. A direct action was therefore brought by the corporation in its own name to recover the assets allegedly withdrawn.

In denying recovery, the court stated that since the sole stockholder could not sue derivatively the corporation could not sue directly for the benefit of the suit would inure to the identical plaintiff who was barred from recovering derivatively.[21] To support this position the court cited *Pokrass.*[22]

The court did note that if there was fraud with respect to the sale of the corporation that the stockholder could collect directly in a fraud action.[23] If fraud could be proven, recourse would be available to the stockholder. The difficulty with this decision, which is based on *Pokrass*, is twofold. First of all, fraud, if it did occur, is difficult to prove. More important, however, is the problem raised when fraud has not occurred.

By saying that a plaintiff can only recover if actionable fraud has been committed, is to open the door to transactions where something less than actionable fraud is committed and then the corporation is sold to an unsuspecting buyer. The buyer has no recourse through a derivative action because of the contemporaneous ownership requirements of section 626 likewise he has no recourse through a direct action because of *Pokrass* and now *Ford*; and because no actionable fraud has been committed he has no recourse through a fraud action.

19. *Id.* at 1071, 107 N.Y.S.2d at 522.
20. 24 Misc. 2d. 261, 203 N.Y.S.2d (Sup. Ct. Sp. Tm. N.Y. County Part I 1960). Hereinafter cited Ford.
21. *Id.* at 489, 490, 203 N.Y.S.2d at 543.
22. *Id.*
23. *Id.*

Therefore, although an unsuspecting buyer has been injured, he is left without recourse.

As previously stated, most of the difficulty in this area of the law occurred because the court in *Pokrass* did not make the necessary distinction between equitable estoppel and statutory estoppel. If they had, they could not have applied the rationale of the *Barber* decision to section 626. In 1964, in a decision affirmed by the Court of Appeals, the Appellate Division finally made this necessary distinction and has hopefully eliminated the problems caused by *Pokrass*.

Platt v. Platt[24] involved an action by a corporation against its former officers and directors for alleged wrongful acts, for derelictions in duties and for damages thereby sustained. At the time of the commencement of the action there were pending plans for the merger of the plaintiff corporation. To insure that the stockholders would not lose their cause of action because of the merger, the class A stockholders had the following incorporated into the merger agreement:

> (4) The proceeds of any action at law or equity brought by or on behalf of the corporation now known as The Platt Corporation shall be distributed among the Class A Common stockholders as of record date . . . . The surviving corporation shall bear the expense of said actions against former officers and directors . . . but all attorneys fees shall be paid out of the proceeds.

The defendants urged that the consummation of the merger had disabled plaintiff from continuing with the maintenance of the action "not because of the effect of the consolidation on the corporation's rights, but because plaintiff's stockholders disposed of the stock in the consolidation."[25] Defendants therefore moved to dismiss the action under section 626 on the ground that plaintiff did not have capacity to sue. The defendants did not challenge the sufficiency of plaintiff's allegations, but contended that the efficacy of the cause of action has been destroyed by the disposition of the stock of plaintiff's stockholders in connection with its merger into the other corporation. It was not disputed by the defendants, that, but for the merger consummated subsequent to the commencement of the action, the plaintiff would have been able to maintain this action on the basis of the allegations of the complaint. The court said that nothing is lost by a merger of corporations, and that any right which lawfully belonged to the merged corporation can be asserted by the possessor corporation, unless bound by the contemporaneous ownership provisions of section 626. It was upon these provisions that defendant relied, stating that the cause of action to recover for the alleged wrongs to the plaintiff no longer exists because plaintiff presently has no stockholder who held stock at the time of the alleged wrongful acts and who could maintain a derivative action to recover for such wrongs. In support of their position defendants argue that the effect of the

24. 21 A.D.2d 116, 249 N.Y.S.2d 75 (1st Dept. 1964). Hereinafter referred to as Platt.
25. *Id.* at 120, 249 N.Y.S.2d at 79.

merger agreement was to transfer all of plaintiff's issued and outstanding stock to the successor corporation after the commission of the alleged wrongs. Inasmuch as the surviving corporation would be precluded from maintaining a stockholder derivative action because of the contemporaneous ownership provisions, the plaintiff may not now continue with the action.

In answering defendant's contention, the court made the distinction between an equitable estoppel and a statutory requirement which is a condition precedent to suit. They stated that, where causes of action against directors and officers for breach of contract or fiduciary duties are sought to be enforced by the corporation directly, that such causes of action exist independently of the provisions of section 626 and are not automatically or necessarily to be controlled by the limitations therein with respect to the maintenance of derivative actions.[26] Furthermore, while in a particular case, policy or equitable considerations may require that the rights of the corporation be equated with the rights of its stockholders and subject to the same statutory limitations, absent such considerations, the cases are to be treated no differently than any ordinary action to recover damages for injury to the assets or properties of the corporation.[27]

In essence the court has now adopted Justice Shientag's position that section 626 has nothing to do with actions brought directly by a corporation. Unfortunately the court continued by saying that, if equitable considerations so require, section 626 can be used as a bar to preclude recovery.[28] While the court properly distinguished between an equitable and a statutory estoppel, they went too far by saying that section 626 might be used as an equitable bar to preclude recovery. Section 626 has nothing to do with equitable considerations. As previously discussed this section was enacted to prevent strike suits and secret settlements. If recovery would be inequitable there are sufficient equitable defenses available, such as estoppel, which would preclude this result. Using this section to prevent an equitable recovery can only continue to cause problems like those raised by *Pokrass*.

CONCLUSION

While it does not appear that *Platt* has overruled *Pokrass*, it does seem to have sufficiently limited its holding so that if a case like *Ford* were to be decided today, the contemporaneous ownership requirement of section 626 would not be used to bar the corporation from recovering.

Although other jurisdictions have contemporaneous ownership statutes similar to New York's[29] no cases in these jurisdictions have been found that

26. *Id.*
27. *Id.* at 122, 249 N.Y.S.2d at 81.
28. *Id.* at 124, 249 N.Y.S.2d at 86.
29. *See e.g.* Del. Corp. Law § 327, Laws of N.J. Tit. 14, c. 3 §§ 15, 16, Calif. Gen. Corp. Law § 834.

come to the conclusion of *Pokrass*. Pennsylvania's contemporaneous ownership statute[30] has an interesting additional feature that allows a plaintiff, in the discretion of the court, to maintain his suit even though he did not own his stock at the time the wrongs complained of occurred, where, but for this requirement he could establish a valid cause of action and that if he is not allowed to bring suit serious injustice will result.

What Pennsylvania's statute has in effect done is ratify the public policy against the purchasing of law suits by requiring the shareholder bringing suit to have owned his stock at the time the wrong complained of occurred. However, the Pennsylvania legislature has recognized that this requirement should not be applied mechanically; that in a given situation a stockholder may not have intentionally purchased a law suit but in fact may have been injured, and that but for this ownership requirement he could establish a valid cause of action. In such instances, the court will allow a shareholder to maintain his suit even though he did not own his stock at the time the wrongs complained of occurred. This situation, however, is not to be confused with what happened in New York where equitable considerations were used to bar recovery. Here equitable factors are being considered to allow recovery. It would seem that if the New York legislature were to include such a provision in its contemporaneous ownership statute further inequitable decision such as *Ford* might be avoided.

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30. Pa. Bus. Corp. Law § 516 (Pa. Stat. Anno. 1966):
SUIT BY SHAREHOLDERS TO ENFORCE A SECONDARY RIGHT. In any suit brought to enforce a secondary right on the part of one or more shareholders against any officer, or director, or former officer or director of a corporation . . . because such corporation refuses to enforce rights which may properly be asserted by it, the plaintiff or plaintiffs must aver and it must be made to appear, that the plaintiff . . . was a shareholder . . . at the time of the transaction of which he complains, or that his shares . . . devolve upon him by operation of law from a person who was a shareholder . . . at such time: *Provided, however, that any shareholder . . . who except for this section would be entitled to maintain such a suit and who does not meet such requirements, may, nevertheless, in the discretion of the court, be allowed to maintain such suit on preliminary showing to the court . . . that there is a strong prima facie case in favor of the claim asserted on behalf of the corporation and that without such suit serious injustice will result.* [emphasis added].