

# THE REVIVAL OF THE DERIVATIVE SUIT

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## INTRODUCTION

In April, 1961, the *Wall Street Journal* took note of a phenomenon on the litigation scene, the increase in stockholders' derivative suits.<sup>1</sup> Approximately five years later, the *Journal* carried a second account concerning this development.<sup>2</sup> The more recent article observed whimsically:

Those corporate executives who have seen angry stockholders only as hecklers at annual meetings ought to be thankful. A growing number of company officers and directors are having to argue with irate shareholders in court—and if they lose the argument it can cost them not merely their composure, but big money.<sup>3</sup>

The report went on to state that, while no count was available as to the number of executive liability suits currently being litigated, lawyers and corporate representatives agreed that the number is growing rapidly.

Examination of West's *Seventh Decennial Digest* for the years 1956-66 suggests that the consensus referred to is founded in fact.<sup>4</sup> A casual count reveals that in excess of 470 derivative suits are reported in those volumes. This represents an increase of approximately 160 cases over the number reported for the prior decade in the *Sixth*

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<sup>1</sup> *Wall Street Journal*, April 27, 1961, at 1, col. 6.

<sup>2</sup> *Id.* June 29, 1966, at 1, col. 6.

<sup>3</sup> The article also noted that most derivative actions are based on state laws which, though they differ in specifics, as a "general rule . . . provide that an executive is liable for damage to his company only if he does not use 'ordinary or reasonable care' in managing it." The article then observed:

The trouble for executives, lawyers say, is that courts are becoming more strict in defining what is "ordinary and reasonable" care in running a business. "What the courts accepted as ordinary or reasonable 10 years ago might be negligence today," says Herbert Brook, a Chicago attorney and insurance law specialist.

Mr. Brook and other lawyers who take this view concede they can't point to specific cases to illustrate it because the precise acts or failures to act alleged in executive-liability cases are hardly ever the same from one case to another. But they, and some corporate executives, point to other evidence of what they consider an increasingly solicitous attitude by courts towards small stockholders bringing suits.

*Id.*

<sup>4</sup> SEVENTH DECENNIAL DIGEST, 1956-66 (West).

*Decennial Digest*.<sup>5</sup> When it is realized that the cases referred to in the digests represent only a fraction of such litigation, it is apparent that derivative actions by stockholders are indeed big business.

It may, of course, be argued that the increase in derivative suits simply reflects the increase in the number of corporations currently being formed.<sup>6</sup> This, however, is only part of the story. It is the contention of this article that such actions have flourished because they serve a basic and increasing need in the contemporary economy. It is further contended that this basic need has recently received tacit, if not overt recognition from the judiciary and, to a lesser extent, from various legislatures. Because of this recognition, litigants currently walking the derivative road will occasionally find that they can plow through or avoid hurdles which were previously insurmountable.

The hurdles referred to are neither simple nor insignificant. They carry such names as "security for expenses," "contemporaneous ownership" and "demands on directors and shareholders." They are, for the most part, the by-products of the "strike suit" and represent reactions to abuse of the judicial process by stockholders whose motive in bringing suit is personal gain rather than corporate benefit.

Because this abuse has been very real, it would be unfair to conclude that such reactions are unjustified. Unfortunately, however, they too often have taken the form of general and indiscriminate hostility to the derivative suit—a hostility shared, and sometimes promoted, by the organized bar. Dean Rostow sensed this fact when he wrote:

[O]ne would expect those concerned for the integrity and future of private business institutions to applaud the intrepid souls who ferret out corporate wrongdoing, and risk their own time and money against a contingency of being rewarded, if in the end sin is found to have flourished. Not at all. Such men are not treated as honored members of the system of private enterprise, but as its scavengers and pariahs. Their lawyers rarely become presidents of bar associations, or trustees of charitable bodies. They receive no honorary degrees. At best they are viewed as necessary evils, the Robin Hoods of the business world, for whom a patronizing word may sometimes be said, when they succeed in revealing some particularly horrendous act.

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<sup>5</sup> SIXTH DECENNIAL DIGEST, 1946-56 (West). The number of suits is based upon the derivative actions cited under Corporations, key numbers 202-14, 307-23.

<sup>6</sup> During 1965, 203,897 new corporations (statistics courtesy of Dun & Bradstreet, Inc.) were incorporated in the 50 states, an all-time high for a single year. Nineteen sixty-six promises to be another record-breaker. More than 20,000 new corporations were incorporated during March, establishing a new high for a single month. The total for the first quarter of 1966 (56,472 companies incorporated), is 2,536 higher than the total for the first quarter of 1965. 24 CORP. J. 366 (1966).

The Dean went on to note that courts and legislatures share this unfriendly attitude towards stockholder suits.

Many judges dismiss them on any plausible technical ground. Procedural obstacles bristle, and are relentlessly enforced. The substantive doctrines of law, and especially the wide scope given to the directors' "business judgment," make liability infrequent. Both statutes and judge-made law treat as dubious, or worse, the professional stockholders' suit against those who misuse other peoples' money.<sup>7</sup>

These attitudes reached their peak in 1944 when a Special Committee on Corporate Litigation for the Chamber of Commerce of the State of New York<sup>8</sup> issued a study, directed by Franklin S. Wood, entitled *Survey and Report Regarding Stockholder's Derivative Suits*.<sup>9</sup> The study surveyed 1,266 suits filed by shareholders in New York County, Kings County and the U.S. District Court for the Southern District of New York during the years 1932-42. While the report unquestionably highlighted costs, problems and abuses related to derivative suits, its effectiveness was diminished by its lack of candor and objectivity. Its purported objective was "to determine the advisability of possible changes in law or procedure which would facilitate the correction of wrong-doing in corporate affairs but reduce groundless and costly litigation of this type."<sup>10</sup> In reality, it ignored "the correction of wrong-doing in corporate affairs" and became, in fact, a brief on "the alleged need for reducing litigation by stockholders."<sup>11</sup>

Despite its obvious bias the study had some immediate impact, for it induced the New York legislature to enact the first "security for expenses" statute.<sup>12</sup> Although discussion of this measure and

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<sup>7</sup> Rostow, *To Whom and For What Ends Is Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY* 49 (E. Mason ed. 1959).

<sup>8</sup> Professor Hornstein has noted a communication sent by the Springfield (Ill) Chamber of Commerce to the Editor of *Forbes Magazine*, published in that magazine, May 15, 1944, at 10, which states:

The N.Y. State Chamber of Commerce, to which you credit this action, is not in fact a state chamber at all and is indeed entirely different from most chambers of commerce. It is a strictly New York organization composed largely of the extremely conservative corporation and financial interests of that city.

Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 *COLUM. L. REV.* 1, 2 n.8 (1947).

<sup>9</sup> For a highly critical comment on the report, see Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 *CALIF. L. REV.* 123 (1944).

<sup>10</sup> SPECIAL COMMITTEE ON CORPORATE LITIGATION OF THE CHAMBER OF COMMERCE OF THE STATE OF NEW YORK, *SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS* 1 (1944).

<sup>11</sup> Hornstein, *supra* note 9, at 127.

<sup>12</sup> N.Y. BUS. CORP. LAW § 627. Also see N.Y. GEN. CORP. LAW § 61-b.

others which copied it is reserved until later,<sup>13</sup> it is appropriate to observe at this juncture that such enactments are the most oppressive of the various obstacles which confront shareholder plaintiffs.

### THE CURRENT ROLE OF THE DERIVATIVE SUIT

In view of these obstacles, it is surprising that the number of derivative suits is increasing. The explanation, as indicated, is two-fold: first, such suits are being called upon to play an increasingly essential role in our economy; second, there is a growing judicial and legislative awareness of this role, an awareness which has permitted increased flexibility in the technical structure of the derivative suit. One critic, commenting on the importance of shareholder actions, has observed that they are "the most important procedure the law has yet developed to police the internal affairs of corporations."<sup>14</sup> On the same subject, Judge Rifkind, although noting that such suits are generally "slow, cumbersome and expensive to all concerned,"<sup>15</sup> expressed the following opinion:

Despite the numerous abuses which have developed in connection with suits they have accomplished much in policing the corporate system especially in protecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders. They have discouraged membership on boards by persons not truly interested in the corporation. . . . The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to managements and outsiders. Corporate attorneys now have an arsenal of authorities to support their cautioning advice to clients who may be disposed to risk evasion of the high standard the courts have imposed upon directors.<sup>16</sup>

A random sampling of approximately 325 derivative actions confirms the validity of Judge Rifkind's observations. It portrays many instances in which shareholders successfully challenged or stated good causes of action for excessive salaries,<sup>17</sup> the issuance of stock

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<sup>13</sup> See text accompanying notes 91-125 *infra*.

<sup>14</sup> Rostow, *supra* note 7, at 48.

<sup>15</sup> *Brendle v. Smith*, 46 F. Supp. 522, 526 (S.D.N.Y. 1942).

<sup>16</sup> *Id.* at 525-26.

<sup>17</sup> *Smith v. Dunlap*, 269 Ala. 97, 111 So. 2d 1 (1959); *Bachelor v. Brentwood Lanes, Inc.*, 369 Mich. 155, 119 N.W.2d 630 (1963).

for no or insufficient consideration,<sup>18</sup> diversion of corporate business opportunity,<sup>19</sup> misapplication of funds,<sup>20</sup> secret profits,<sup>21</sup> excessive stock options,<sup>22</sup> violations of contractual arrangements,<sup>23</sup> improper individual claims as opposed to corporate claims for surrender shares,<sup>24</sup> the unlawful purchase by a corporation of its own securities,<sup>25</sup> illegal payment for shares in another corporation,<sup>26</sup> sale of control,<sup>27</sup> improvident loans<sup>28</sup> and the abuse of a subsidiary by the parent.<sup>29</sup> While this catalogue of misbehavior is "old hat" to lawyers familiar with corporate activities, it, nonetheless, serves as a sharp reminder that, day in and day out, the derivative action plays the role of "corporate policeman." There may be substitutes for the derivative suit, but so far none has been introduced that could be effectively implemented.

It is because the derivative suit is a needed policeman that it has refused to die. Developments over the past few decades have accentuated that need. These developments are perhaps best summarized in Professor Berle's observation that since 1932 "the trend toward dominance of that collective capitalism we call the 'corporate system' has continued unabated."<sup>30</sup> As evidence of this conclusion, Berle notes the significant increase in the amount of productive property under corporate control,<sup>31</sup> the growth in the number of shareholders,<sup>32</sup>

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<sup>18</sup> *Ruckle v. Roto Am. Corp.*, 339 F. Supp. 559 (S.D.N.Y. 1964); *McDonnell v. Birrell*, 196 F. Supp. 496 (S.D.N.Y.), *aff'd sub nom. McDonnell v. Tabah*, 297 F.2d 731 (2d Cir. 1961).

<sup>19</sup> *Higgins v. Shenango Pottery Co.*, 279 F.2d 46 (3d Cir. 1960); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939); *Zampetti v. Cavanaugh*, 406 Pa. 259, 176 A.2d 906 (1962).

<sup>20</sup> *Winter v. Farmers Educ. & Co-op. Union of America*, 259 Minn. 257, 107 N.W.2d 226 (1961).

<sup>21</sup> *Albert v. Black Motor Co.*, 357 S.W.2d 714 (Ky. 1962). For further developments in this case, see *Black Motor Co. v. Hill*, 372 S.W.2d 801 (Ky. 1963); *Black Motor Co. v. Greene*, 385 S.W.2d 954 (Ky. 1964).

<sup>22</sup> *Teren v. Howard*, 322 F.2d 949 (9th Cir. 1963); *Kerbs v. California E. Airways*, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952).

<sup>23</sup> *Lait v. Leon*, 40 Misc. 2d 60, 242 N.Y.S.2d 776 (Sup. Ct. 1963).

<sup>24</sup> *Christie v. Fifth Madison Corp.*, 35 Misc. 2d 570, 231 N.Y.S.2d 541 (Sup. Ct. 1962).

<sup>25</sup> *Propp v. Sadacca*, 40 Del. Ch. 113, 175 A.2d 33 (Ch. 1961).

<sup>26</sup> *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966).

<sup>27</sup> *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955).

<sup>28</sup> *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946 (4th Cir. 1964).

<sup>29</sup> *Ripley v. International Rys. of Cent. America*, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960). For further developments, see 12 N.Y.2d 814, 187 N.E.2d 131, 236 N.Y.S.2d 64 (1962).

<sup>30</sup> Berle, *Property, Production and Revolution*, 65 COLUM. L. REV. 1, 2 (1965).

<sup>31</sup> "Outside of agriculture, well over ninety percent of all the production in the country is carried on by more than a million corporations." *Id.* at 2.

<sup>32</sup> A New York Stock Exchange publication entitled *SHAREOWNERSHIP U.S.A.* (1966) estimates on the basis of a 1965 census that there are approximately 20,120,000 shareowners in the United States. *Id.* at 11.

and the expanding role played by corporate securities as a component of individual wealth.<sup>33</sup> His analysis of these facts strengthens the thesis he first espoused in 1932, that the corporate economy has, in large part, separated ownership from control.<sup>34</sup>

Berle recently phrased this conclusion in the following terms:

[M]ost "owners" own stock, insurance savings and pension claims and the like, and do not manage; most managers (corporate administrators) do not own. The corporate collective holds legal title to the tangible productive wealth of the country—for the benefit of others.<sup>35</sup>

Although Professor Berle's views have been subjected to frequent attack, few writers have challenged his thesis of the separation of ownership from control.<sup>36</sup> He seems to be on solid ground when he observes that the chasm between the two is widening. Each year financial institutions, such as savings and loan associations, mutual funds, trust departments, insurance companies and banks, are acquiring an increasing number of shares in our largest corporations.<sup>37</sup> Of necessity, such acquisitions serve to remove productive property and its control one step further from those whose wealth is invested in these institutions.

Coupled with this development is the fact that subsidiary corporations have become an increasingly popular means of doing business.<sup>38</sup>

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<sup>33</sup> The property system as applied to productive assets breaks down (as of the end of 1963) as follows: 525 billion dollars of shares of corporate stock; 210 billion dollars in fixed income financial assets (federal, state and local government securities, corporate and foreign bonds, life insurance values, etc.); and 360 billion dollars in liquid assets, chiefly cash in banks. These figures mean that, far and away, the largest item of personally owned "property" representing productive assets and enterprise is in the form of stock of corporations. In addition, a substantial amount of other assets held by individuals consists of claims against intermediate financial institutions—banks, insurance companies and the like, whose holdings include large amounts of corporation stocks, bonds and securities. "Individually-owned" enterprise is thus steadily disappearing.

Berle, *supra* note 30, at 3.

<sup>34</sup> See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

<sup>35</sup> Berle, *supra* note 30, at 4.

<sup>36</sup> See Harbrecht, *The Modern Corporation Revisited*, 64 COLUM. L. REV. 1410 (1964).

<sup>37</sup> Berle notes:

No one really knows the exact percentage of institutional holdings of stocks. Mutual investment funds are wholly invested in stock: They are reported to aggregate about \$29 billion. No figures are available on pension trust holdings and insurance company holdings (such holdings are small due to statutory limitation on this kind of investment). A sophisticated guess on the generous side would be total holdings of around \$50 billion or less than 10% of the value of outstanding stocks—hence the rough estimate. The percentage is probably slowly rising.

Berle, *supra* note 30, at 14 n.39.

<sup>38</sup> See Painter, *Double Derivative Suits and Other Remedies with Regard to Damaged Subsidiaries*, 36 IND. L.J. 143 (1961).

While this phenomenon has many ramifications, it is sufficient to observe that it too serves to centralize control and to separate it from the ultimate investor.

Because of these developments, it might be assumed that legislatures would have acted to increase the safeguards surrounding managerial discretion. With the exception of the various measures enacted to regulate securities,<sup>39</sup> such an assumption would be erroneous. In fact, recently adopted corporate codes have had the opposite impact for they have characteristically enhanced the authority of officers and directors<sup>40</sup> without the inclusion of counter-balancing provisions designed to assure the proper discharge of increased power. Typically, they provide that "the business and affairs of a corporation shall be managed by a board of directors."<sup>41</sup> This provision has been buttressed by statutes or by authorized articles of incorporation which specifically provide for broad managerial discretion in respect to property,<sup>42</sup> dividends,<sup>43</sup> capital,<sup>44</sup> compensation,<sup>45</sup> indemnification,<sup>46</sup> preemptive rights,<sup>47</sup> by-laws<sup>48</sup> and delegation of authority.<sup>49</sup>

Although the primary concern of this article is with the shareholder-management relationship, it is appropriate to observe that the power structure referred to has implications which extend far beyond the immediate concerns of these two groups. Policy decisions which determine plant location, production level, diversification, investments, prices, wages, union relationships and dividends have an obvious impact on employees, consumers and communities, and on the economic and social well-being of the society at large. It is recognized, of course, that management's freedom of choice as to these matters is not

<sup>39</sup> See Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1964); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-jj (1964); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79a-z (1964); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (1964); Investment Company Act of 1940, 15 U.S.C. § 80a (1964); Investment Advisers Act of 1940, as amended, 15 U.S.C. § 80b (1964); Chap. X of the Bankruptcy Act, 52 Stat. 882, 11 U.S.C. §§ 501-676 (1964).

<sup>40</sup> For critical comment, see Harris, *The Model Business Incorporation Act—Invitation to Irresponsibility?*, 50 NW. U.L. REV. 1 (1955); Note, *Economic Institutions and Values: Fiduciary Responsibility of Corporate Officers and Directors*, 36 NOTRE DAME LAW. 343 (1961).

<sup>41</sup> See ABA-ALI MODEL BUS. CORP. ACT § 33 (1966). In *Economic Institutions and Values*, *supra* note 40, at 357, it is stated that "thirty-one states have statutes providing for the creation of a board of directors in which corporate management powers are to reside."

<sup>42</sup> See ABA-ALI MODEL BUS. CORP. ACT §§ 4(d)-(e) (1966).

<sup>43</sup> See *id.* § 40.

<sup>44</sup> See *id.* §§ 14-15, 17-19, 41.

<sup>45</sup> See *id.* § 33. The final sentence in this section provides, "The board of directors shall have authority to fix the compensation of directors unless otherwise provided in the articles of incorporation."

<sup>46</sup> See *id.* § 4(o).

<sup>47</sup> See *id.* § 24.

<sup>48</sup> See *id.* § 25.

<sup>49</sup> See *id.* §§ 38, 44.

completely unrestricted, but neither is it as limited as some would suggest. As Carl Kaysen has observed in respect to competition, which is often considered the prime regulator of choice:

[N]o real firm functions in markets operating with the sureness, swiftness, and freedom from frictions that would eliminate the discretion of management entirely and make the firm merely an instrument which registered the forces of the market.<sup>50</sup>

Given the complex and sophisticated world in which corporations must operate, centralization of decision-making is understandable and necessary. Merely because centralization is understandable and necessary, however, does not mean that it can, or should, be ignored. How the decision-making power is used is important to each of us, and may well turn on the extent to which those who wield the power must account for its use.

It is in the context of such accountability that we must view the derivative suit. That management has largely escaped ownership control should not lessen its responsibility to shareholders, nor should it obviate the need to explain and justify its conduct. Rather, the contrary is true, for as ownership's voice recedes, the need for vigilance increases, and accompanying that vigilance must be the means to bring "to book" those who misuse their power.

This, in essence, is the case for the derivative suit. Though it is an awkward, costly, and intricate mechanism, it continues to be "the chief regulator of corporate management."<sup>51</sup> The developments re-

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<sup>50</sup> Kaysen, *The Corporation: How Much Power? What Scope?*, in *THE CORPORATION IN MODERN SOCIETY* (E. Mason ed. 1966).

<sup>51</sup> *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 548 (1949). Mr. Justice Jackson, writing for the Court, also observed:

As business enterprise increasingly sought the advantages of incorporation, management became vested with almost uncontrolled discretion in handling other people's money. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. The director was not subject to an effective accountability. That created strong temptation for managers to profit personally at expense of their trust. The business code became all too tolerant of such practices. Corporate laws were lax and were not self-enforcing, and stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust.

Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own . . . . This remedy, born of stockholders helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests . . . .

Unfortunately, the remedy itself provided opportunity for abuse, which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value,

*Id.* at 547-48.



ferred to, such as the separation between ownership and control and the increased concentration of power in management, make the derivative action increasingly necessary. They further dictate that legislators and courts weigh with care impediments to the effective employment of shareholder actions. As Judge Frank has observed:

An economy like ours, which thrives on the fact that thousands of persons of modest means invest in corporate shares, will be poorly served if our courts regard with suspicion all minority stockholders' suits, and, therefore, out of a desire to discourage such suits, apply to them unusually strict pleading rules, thus tending to thwart judicial inquiries into the conduct of wrongdoing, controlling stockholders. The unfortunate consequence will be that those in control may be immunized from effective attacks on their misdeeds, and as a result, the small investors will lose confidence in all corporate managements, the honest as well as the dishonest.<sup>52</sup>

#### *Some Illustrative Cases in the Federal Courts*

An increasing number of courts appear to be heeding Judge Frank's admonition. While the course of litigation is uneven, numerous opinions reflect a conscious desire not to burden unduly those who attempt to negotiate the shoals of a derivative suit, and the impact of these opinions has been to relieve the burden of procedural rules and statutory demands.<sup>53</sup>

A recent Supreme Court decision, *Surowitz v. Hilton Hotels Corp.*,<sup>54</sup> illustrates this trend. In this derivative action the plaintiff charged that the defendant officers and directors had defrauded the corporation of several million dollars by engaging in stock manipulation in violation of the Securities Act of 1933,<sup>55</sup> the Securities Exchange Act of 1934<sup>56</sup> and the Delaware General Corporation Law.<sup>57</sup> The complaint was signed by counsel in compliance with Rule 11 of the

<sup>52</sup> *Subin v. Goldsmith*, 224 F.2d 753, 767 (2d Cir. 1955) (dissenting in part).

<sup>53</sup> Dean De Capriles has noted, in reference to recent derivative suit statutes (especially "security for expenses" statutes) that, "There have been . . . some judicial decisions tending to soften the burden of the new legislation; other decisions tend to aggravate it. It is fair to say, however, that the past fifteen years have seen a significant change in this aspect of shareholders' control of management." De Capriles, *Fifteen-Year Survey of Corporate Developments, 1944-59*, 13 VAND. L. REV. 1, 15 (1959).

<sup>54</sup> 383 U.S. 363 (1966).

<sup>55</sup> 15 U.S.C. § 77a-aa (1964).

<sup>56</sup> 15 U.S.C. §§ 78a-jj (1964).

<sup>57</sup> DEL. CODE ANN. tit. 8, §§ 101-368 (1953).

<sup>58</sup> Rule 11 provides in part that:

The signature of an attorney constitutes a certificate by him that he has read the pleading; that to the best of his knowledge, information, and belief there is good ground to support it; and that it is not interposed for delay. . . .

Federal Rules of Civil Procedure,<sup>58</sup> and, as required by Rule 23(b),<sup>59</sup> plaintiff Mrs. Surowitz verified the complaint, stating "that some of the allegations were true and that she on 'information and belief,' thought that all the allegations were true."<sup>60</sup> Pursuant to defendant's motion, the trial judge required Mrs. Surowitz to submit to an oral examination by defense counsel, in the course of which it became evident that the petitioner did not understand the complaint and had little knowledge concerning the facts alleged. Upon motion, the district court dismissed the case, holding that Mrs. Surowitz's affidavit was false and that thus there had been no real compliance with Rule 23(b). This determination was sustained by the Court of Appeals for the Seventh Circuit.<sup>61</sup>

On appeal to the Supreme Court, the dismissal was reversed and remanded for trial on the merits. Note was taken of the fact that, while Mrs. Surowitz had little formal education and was handicapped in her use of the English language, she did know that her son-in-law, a Harvard Law School graduate, thought something was wrong, and that these suspicions were shared by another attorney with whom he consulted. It was further observed that these suspicions were not allayed by investigation or by consultation with defendant's lawyers.

Mr. Justice Black, speaking for the Court, stated:

It is difficult to believe that anyone could be shocked or harmed in any way when, in the light of all these circumstances, Mrs. Surowitz verified the complaint, not on the basis of her own knowledge and understanding, but in the faith that her son-in-law had correctly advised her either that the statements in the complaint were true or to the best of his knowledge he believed them to be true.<sup>62</sup>

He further observed that Rule 23(b) was not designed to bar derivative suits but only to discourage "strike suits," and realistically noted that the record in the case reveals "the inescapable fact this is not a strike suit or anything akin to it."<sup>63</sup> Mr. Justice Black then expressed concern that the opinion of the Court of Appeals would mean that a shareholder such as "Mrs. Surowitz, who is uneducated generally and illiterate in economic matters, could never under any circum-

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<sup>59</sup> Pursuant to the changes in the Rules of Civil Procedure which became effective July 1, 1966, Rule 23(b), as amended, is now numbered Rule 23.1. It provides in part that

the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains . . . , and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. . . .

<sup>60</sup> 383 U.S. at 365.

<sup>61</sup> 342 F.2d 596 (7th Cir. 1965).

<sup>62</sup> 383 U.S. at 370-71.

<sup>63</sup> *Id.* at 371.

stances be a plaintiff in a derivative suit brought in the federal courts to protect her stock interests.”<sup>64</sup>

“We cannot,” Justice Black wrote,

construe Rule 23 or any other one of the Federal Rules as compelling courts to summarily dismiss . . . cases like this where grave charges of fraud are shown by the record to be based on reasonable beliefs growing out of careful investigation. The basic purpose of the Federal Rule is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. Rule 23(b), like other civil rules, was written to further, not defeat the ends of justice.<sup>65</sup>

The liberal, non-technical approach to derivative pleading reflected in the above opinion is consistent with the attitude the judiciary has taken generally in respect to shareholders' suits filed pursuant to acts administered by the Securities and Exchange Commission.<sup>66</sup> It is accurate to observe that, because of judicial receptivity to such actions, the securities acts are having an enormous impact on management fiduciary responsibility, particularly in relation to matters concerning issuance and reacquisition of corporate stock.

A case which further illustrates the pattern of derivative actions under the federal security acts is *McClure v. Borne Chemical Co.*<sup>67</sup> Suit was filed in the Western District of Pennsylvania, on behalf of a New Jersey corporation. Since both Pennsylvania and New Jersey had “security for expenses” statutes,<sup>68</sup> the defendants moved to have plaintiffs post a bond for expenses, including attorney’s fees. The trial judge denied the motion and his denial was sustained by the Court of Appeals for the Third Circuit.

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<sup>64</sup> *Id.* at 372.

<sup>65</sup> *Id.* at 373.

<sup>66</sup> See, e.g., *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir. 1961); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960); *Pappas v. Moss*, 257 F. Supp. 345 (D.N.J. 1966); *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966).

<sup>67</sup> 292 F.2d 824 (3d Cir. 1961), *cert. denied*, 368 U.S. 939 (1961) (applying Securities Exchange Act of 1934 § 10(b) as implemented by SEC Rule 10b-5).

<sup>68</sup> N.J. STAT. ANN. § 14:3-15 (Supp. 1966); Pa. P.L. 364, art. V, § 516 (1933).

Note was taken of the Supreme Court decision in *Cohen v. Beneficial Industrial Loan Corp.*,<sup>69</sup> which had held that "security for expenses" statutes are substantive law, and, under the *Erie* doctrine, applicable in diversity actions. However, since jurisdiction in the action before the court was predicated on a federal statute, and not on diversity of citizenship, *Erie* was held not to be controlling. The court, therefore, concluded that it could ignore the demands of Pennsylvania's "security for expenses" statute. It had greater difficulty in reaching this conclusion in reference to the New Jersey statute. Since New Jersey was the state of incorporation and the site of the company's principal office, that state had a "clear interest in the relationship between the shareholders and management of the corporation."<sup>70</sup> The court also was aware that in the *Cohen* case the Supreme Court had observed:

The very nature of the stockholder's derivative action makes it one in the regulation of which the legislature of a state has wide powers. Whatever theory one may hold as to the nature of the corporate entity, it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon state law and may be subject to most complete and penetrating regulation, either by public authority or by some form of stockholder action. . . . We conclude that the state has plenary power over this type of litigation.<sup>71</sup>

Although these factors gave the court pause,<sup>72</sup> it finally concluded that the limitation should not apply "when the corporate right that the plaintiff seeks to enforce derivatively arises under federal law."<sup>73</sup> In reaching this conclusion, Judge Biggs drew heavily upon the reasoning of the Second Circuit in *Fielding v. Allen*<sup>74</sup> and concluded that the "policy of uniformity within the federal system is stronger than any policy of conformity with local rules."<sup>74</sup> Judge Biggs then noted that this rationale was particularly appropriate in the instant case, in view of the fact that only a few states have adopted security statutes. These statutes differ from one another, further detracting from the uniformity essential to the federal statutory scheme. He observed:

[W]e do not believe that Sections 10(b) and 29(b) of the Securities Exchange Act should be construed as being superimposed upon the stockholder-management relationship de-

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<sup>69</sup> 337 U.S. 541 (1949).

<sup>70</sup> 292 F.2d at 831.

<sup>71</sup> 337 U.S. at 459-50.

<sup>72</sup> 292 F.2d at 831.

<sup>73</sup> 181 F.2d 163 (2d Cir. 1950) (New York "security for expenses" statute should not apply to a derivative action brought under the Interstate Commerce Act).

<sup>74</sup> 292 F.2d at 833.

financed by state security for expenses statutes, since the federal provisions are a part of a statutory scheme which had as its purpose the creation of a new federal law of management-stockholder relations and which, therefore, may not be subordinated to limitations such as security for expenses statutes, reflecting state policy in the same area.<sup>75</sup>

Pressing the theme of a "new federal" corporation law, the opinion noted:

That Act deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which theretofore had been almost exclusively the concern of the states. . . . It can be said fairly that the Exchange Act . . . constitutes far reaching federal substantive corporation law.<sup>76</sup>

No doubt, many congressmen who served in 1934 would be surprised to hear that the Securities Exchange Act, particularly section 10(b), had the broad sweep ascribed to it in the *McClure* opinion. In fact, it is difficult to find many contemporary writers willing to accept the full impact of this decision.<sup>77</sup> The court's emphasis on the need for uniformity within the federal system, however, did find ready acceptance, and for this reason, federal courts have not hesitated to hold inapplicable state laws which they feel unduly hamper the prosecution of derivative suits under the securities acts.

This approach was recognized by the Supreme Court, in dictum, in *J. I. Case Co. v. Borak*.<sup>78</sup> The complaint of the plaintiff stockholder alleged that a merger was effected through the use of misleading proxy statements, a violation of section 14(a) of the Securities Exchange Act.<sup>79</sup> Although the precise issue before the Court was limited to the permissible remedy under section 27 of the act,<sup>80</sup> the Court, after

<sup>75</sup> *Id.* at 834.

<sup>76</sup> *Id.*

<sup>77</sup> For criticisms of judicial expansion of section 10(b) and Rule 10b-5, see Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 *Nw. U.L. REV.* 627 (1963); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 *Nw. U.L. REV.* 185 (1964). For attitudes sympathetic to such expansion, see Fleischer, "Federal Corporation Law": *An Assessment*, 78 *HARV. L. REV.* 1146 (1965); Joseph, *Civil Liability Under Rule 10b-5—A Reply*, 59 *Nw. U.L. REV.* 171 (1964).

<sup>78</sup> 377 U.S. 426 (1964). This case has been extensively noted. See 50 *A.B.A.J.* 1170 (1964); Note, 52 *CALIF. L. REV.* 185 (1964); 64 *COLUM. L. REV.* 1336 (1964); 50 *CORNELL L.Q.* 370 (1965); Note, 59 *Nw. U.L. REV.* 809 (1965); Note, 42 *TEXAS L. REV.* 908 (1964); 37 *U. COLO. L. REV.* 160 (1964); Comment, 112 *U. PA. L. REV.* 456 (1964); 18 *VAND. L. REV.* 275 (1964); 9 *VILL. L. REV.* 330 (1964).

<sup>79</sup> 15 U.S.C. § 78n(a) (1964).

<sup>80</sup> 15 U.S.C. § 78aa (1964).

recognizing that the denial of derivative rights under section 14 would "be tantamount to a denial of private relief,"<sup>81</sup> observed:

[I]f federal jurisdiction were limited to the granting of declaratory relief, victims of deceptive proxy statements would be obliged to go into state courts for remedial relief. And if the law of the State happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated. *Furthermore, the hurdles the victim might face (such as separate suits, . . . security for expenses statutes, bringing in all parties necessary for complete relief, etc.) might well prove insuperable to effective relief.*<sup>82</sup>

The impact of this dictum is apparent in the First Circuit's decision in *Levitt v. Johnson*.<sup>83</sup> The complaint alleged violations of the Investment Company Act of 1940<sup>84</sup> by various directors of Fidelity Fund, Inc., a Massachusetts corporation. The trial court dismissed the suit solely because plaintiff failed to allege a prior demand upon stockholders.<sup>85</sup> In dismissing, Judge Wyzanski held that even though the claim was based on a federal statute, state law controlled stockholders' suits, and that law did not excuse plaintiff's failure to contact other owners.<sup>86</sup>

Judge Aldridge, speaking for the First Circuit, concluded that Massachusetts law did not apply. The policy of the federal Investment Company Act, concerned as it was with the public interest and the interest of investors, prohibited any "substantial stiffening of the conditions precedent to the bringing of stockholders' suits above normal requirements."<sup>87</sup> The opinion, drawing support from *J. I. Case Co. v. Borak*,<sup>88</sup> observed:

The district court's reasoning that since the stockholder's right is a derivative one his right to bring suit must be controlled by the local law of the state of incorporation in the absence of an explicit congressional direction to the contrary negates the intentment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation.<sup>89</sup>

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<sup>81</sup> 377 U.S. at 432 (1964).

<sup>82</sup> *Id.* at 434-35. (Emphasis added.)

<sup>83</sup> 334 F.2d 815 (1st Cir. 1964), *reversing* 222 F. Supp. 805 (D. Mass. 1963), *cert. denied*, 379 U.S. 961 (1965).

<sup>84</sup> 15 U.S.C. § 80a (1964).

<sup>85</sup> 222 F. Supp. at 812.

<sup>86</sup> *Id.* at 808-12, citing *S. Solamont & Son Trust, Inc. v. New England Theatres Operating Corp.*, 326 Mass. 99, 111, 93 N.E.2d 241, 247 (1950).

<sup>87</sup> 334 F.2d at 819.

<sup>88</sup> 377 U.S. 426 (1964).

<sup>89</sup> 334 F.2d at 819.

These cases, among others,<sup>90</sup> show that actions arising under the federal securities acts have become increasingly available to shareholders' actions under appropriate circumstances. They also rather clearly reflect the feeling that the policies articulated by these acts should not be unduly obstructed by state-imposed procedural requirements.

### *Security for Expenses*

Apart from actions predicated upon federal statutes, judicial attitudes towards the derivative suit reflect a more irregular pattern. Nonetheless, it is accurate to conclude that even here recent court decisions have generally refrained from extending legislative barriers to their utmost limits.

Cases dealing with state statutes requiring security for expenses illustrate the validity of this observation. Many decisions have eased the cost burdens which otherwise would have been imposed on shareholder plaintiffs. To appreciate the import of this fact, we must look briefly at the "security for expenses" statutes.

The first such statute was enacted in New York in 1944, in reaction to the Wood report.<sup>91</sup> It provided that a foreign or domestic corporation on whose behalf an action is brought could, at any stage in the proceedings before final judgment, require plaintiffs to give "security for the reasonable expenses, including attorney's fees" which might be incurred in connection with the action, provided that those bringing suit held "less than five per centum of the outstanding shares of any class of such corporation's stock" or unless the securities so held had "a market value in excess of fifty thousand dollars." The act also stipulated that the "amount of such security may . . . from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or is excessive."<sup>92</sup>

Once the New York legislature spoke, other states followed. New Jersey, Maryland, Wisconsin and Pennsylvania enacted security for expenses statutes the next year.<sup>93</sup> California, the fifth state

<sup>90</sup> See *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960); *Pappas v. Moss*, 257 F. Supp. 344 (D.N.J. 1966); *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966).

<sup>91</sup> See SPECIAL COMMITTEE ON CORPORATE LITIGATION OF THE CHAMBER OF COMMERCE OF THE STATE OF NEW YORK, SURVEY AND REPORT REGARDING STOCKHOLDER'S DERIVATIVE SUITS (1944), and text accompanying notes 8-13 *supra*.

<sup>92</sup> Ch. 668, § 61-b, [1944] N.Y. Laws 1455 (amended by N.Y. BUS. CORP. LAW § 627 (Supp. 1966)).

<sup>93</sup> See ch. 989, [1945] Md. Laws 1727 (now Md. R. Civ. P. 238(b)); ch. 131, [1945] N.J. Laws 487 (now N.J. STAT. ANN. tit. 15, § 14:3-15 (Supp. 1966)); no. 114, [1945] Pa. Laws 253 (now PA. STAT. ANN. tit. 15, § 2852-516 (Supp. 1966)); ch. 462, [1945] Wis. Laws (now WIS. STAT. ANN. § 180.405 (1966)).

to follow, waited until 1949.<sup>94</sup> The measure then adopted was in certain respects less burdensome than those already in effect.<sup>95</sup>

Following this spate of activity, relative quiet prevailed for a time on the legislative front. Recently, however, the lawmakers in several additional states have promulgated security for expenses provisions.<sup>96</sup> These statutes were inspired by the amendment of the Model Business Corporation Act a few years ago to include such a measure as an optional section.<sup>97</sup>

Considering the hostility to the derivative suit that prevails in certain quarters, it is surprising that more states have not followed. Perhaps second thoughts have been promoted by the trends to which reference already has been made, and by the prompt and powerful criticisms which were directed towards earlier enactments.<sup>98</sup> Whether

<sup>94</sup> See ch. 499, [1949] Cal. Stat. 857 (now CAL. GEN. CORP. LAW § 834 (1955)).

<sup>95</sup> Under CAL. GEN. CORP. LAW § 834, security for expenses is not granted automatically upon motion by the defendants. The act requires that defendant's motion be predicated on

one or more of the following grounds:

- (1) That there is not reasonable probability that the prosecution of the cause of action alleged in the complaint against the moving party will benefit the corporation or its security holders;
- (2) That the moving party, if other than the corporation, did not participate in the transaction complained of in any capacity.

A hearing must be held on defendant's motion and, if the court determines after presentation of the evidence "that the moving party has established a probability in support of any of the grounds upon which the motion is based," it "shall fix the nature and amount of security to be furnished by the plaintiff for reasonable expenses, including attorney's fees. . . ."

<sup>96</sup> See ARK. STAT. ANN. 64-223 (Supp. 1966); COLO. REV. STAT. ANN. 31-4-21 (1963); FLA. STAT. ANN. § 608.131 (Supp. 1966); NEB. REV. STAT. § 21-2047 (Supp. 1963); N.D. REV. CODE 10-19-48 (1960); TEXAS BUS. CORP. ACT art. 5.14 (Supp. 1966); WASH. REV. CODE § 23A.08.460 (Supp. 1966) (effective July 1, 1967).

<sup>97</sup> See ABA-ALI MODEL BUS. CORP. ACT ANN. § 43A, ¶ 1 (1960). The security for expense portion of this optional section provides as follows:

In any action now pending or hereafter instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of less than five per cent of the outstanding shares of any class of such corporation or of voting trust certificates therefor, unless the shares or voting trust certificates so held have a market value in excess of twenty-five thousand dollars, the corporation in whose right such action is brought shall be entitled at any time before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including fees of attorneys, that may be incurred by it in connection with such action or may be incurred by other parties named as defendant for which it may become legally liable. Market value shall be determined as of the date that the plaintiff institutes the action or, in the case of an intervener, as of the date that he becomes a party to the action. The amount of such security may from time to time be increased or decreased, in the discretion of the court, upon showing that the security provided has or may become inadequate or is excessive. The corporation shall have recourse to such security in such amount as the court having jurisdiction shall determine upon the termination of such action, whether or not the court finds the action was brought without reasonable cause.

<sup>98</sup> See, e.g., Hornstein, *The Death Knell of Shareholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944); Zlinkoff, *The American Investor and the Constitutionality of Section 61-B of the New York General Corporation Law*, 54 YALE L.J. 352 (1945); Hornstein, *New Aspects of Stockholders' Derivative Suits*,



or not these factors explain why more such statutes have not been passed, they do explain why recent enactments and amendments to existing measures are less burdensome than their predecessors,<sup>99</sup> and why the judiciary has not interpreted these measures as oppressively as they might have done.

Pennsylvania's experience illustrates both legislative retrenchment and judicial restraint. The initial Pennsylvania security for expenses act imposed more severe restrictions than those of any other state, since it provided no alternative to the requirement that plaintiffs furnish security if they possessed less than five per cent of any outstanding class of stock.<sup>100</sup> In 1963, however, this condition was modified by an alternative provision: security should not be exacted if the market value of shares held by those instituting the derivative suit exceeds \$50,000.<sup>101</sup> In addition, and of even greater importance, the legislature modified the mandatory dictates of the earlier act by stipulating that:

[S]ecurity may be denied or limited in the discretion of the court upon preliminary showing to the court . . . that the requirement of security or full security would impose undue hardship on plaintiffs and serious injustice would result.<sup>102</sup>

Accompanying the subsection containing these provisions was another subsection which stated that "reasonable expenses, including attorneys' fees, of any party defendant incurred in connection with the successful defense of such suit shall be assessed upon the corporation . . .," and that the amount of "all such expenses so assessed shall be awarded as costs of the suit and be recoverable in the same manner as statutory taxable costs."<sup>103</sup>

Although the 1963 enactment is too new to permit assessment of its impact on litigation, one Pennsylvania case, *Shapiro v. Magazine*,<sup>104</sup> suggests it will be implemented with the judicial restraint to which reference has been made. Plaintiff, who held more than five

47 COLUM. L. REV. 1 (1947); Ballantine, *Abuses of Shareholders' Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CALIF. L. REV. 399 (1949); Bowes, *Should New York's "Security for Expenses" Act Be Amended?*, 2 SYRACUSE L. REV. 37 (1950).

<sup>99</sup> The Model Act's optional provision § 43A is somewhat less burdensome than many of the earlier security for expenses statutes in that it requires the posting of security if the market value is under \$25,000, rather than \$50,000. Three states, while adopting much of optional provision 43A, have omitted "attorney fees" from the expenses for which security must be posted. See COLO. REV. STAT. § 31-4-21 (1963); MD. R. CIV. P. 328(b) (1963); NEB. REV. STAT. § 21-2047 (Supp. 1963).

<sup>100</sup> Pa. Laws 1945, No. 114, at 253 (Now PA. STAT. ANN. tit. 12, § 1322 (Supp. 1966)).

<sup>101</sup> PA. STAT. ANN. tit. 15, § 2852-516B (Supp. 1966).

<sup>102</sup> *Id.* § 2852-516B (Supp. 1966).

<sup>103</sup> *Id.* § 2852-516C (Supp. 1966).

<sup>104</sup> 418 Pa. 278, 210 A.2d 890 (1965).

per cent of the outstanding shares of the defendant corporation was, nonetheless, ordered by the trial court to pay costs and reasonable counsel fees if, after taking a voluntary nonsuit, he again pressed the action. On appeal this determination was modified to exclude allowance of counsel fees.

In reversing this part of the order, the Pennsylvania Supreme Court rejected the defendant's argument that subsection C permitted a corporation to recover all expenses, including attorney's fees, from a losing plaintiff regardless of the size of his holdings.<sup>105</sup> On the contrary, the court held that the section was intended to encourage capable and responsible people to become officers and directors by "shifting the expenses of successful individual defendants *to the corporation, not to the losing plaintiff.*"<sup>106</sup> It is true, the court observed, that the newly enacted law does permit the corporation such recovery when the plaintiff holds "less than 5 per centum of the outstanding shares of any class of such corporation . . . unless the shares . . . have a fair market value in excess of fifty thousand dollars."<sup>107</sup> That provision must, however, be confined to its purpose of preventing strike suits, it being thought that such suits "were usually brought by shareholders with only a small financial stake in the corporation."<sup>108</sup> The opinion then added that security for expenses legislation "was not intended to discourage derivative actions generally, a result which would follow if appellees were to prevail . . ." <sup>109</sup>

While one may question the assertion that security for expenses measures "were not intended to discourage derivative actions generally," nonetheless, it is true that had the court ruled in accordance with defendant's wishes, a crushing blow would have been administered to such litigation. Taken in isolation, the section on which the defendants relied supported their position. Wisely, however, the court held back, recognizing that if attorney's fees and other expenses were to be imposed on a losing plaintiff in all derivative actions, a clearer legislative mandate was needed.

It would be inappropriate to conclude these comments on security for expenses statutes without a glance at later developments in New York, the state which gave birth to the device. The picture that emerges is somewhat murky. Despite recent changes in the corporation code,<sup>110</sup> the legislature has not seen fit to alter the conditions

<sup>105</sup> *Id.* at 281, 210 A.2d at 893.

<sup>106</sup> *Id.* at 282, 210 A.2d at 893. (Emphasis in original.)

<sup>107</sup> *Id.* at 283, 210 A.2d at 894.

<sup>108</sup> *Id.* at 284, 210 A.2d at 894.

<sup>109</sup> *Id.* at 285, 210 A.2d at 895.

<sup>110</sup> New York's current business corporation law became effective Sept. 1, 1963.

which were incorporated into the original enactment. Furthermore, certain judicial decisions have suggested a rather inflexible construction of these conditions, although other decisions have blunted the full impact of the act.

In *Baker v. MacFadden Publications, Inc.*,<sup>111</sup> for example, the New York Court of Appeals approved a trial court order which granted plaintiffs in a derivative action sixty days to join additional shareholders in order to avoid the necessity of posting security. By so deciding, the court gave support to a comparable position taken as early as 1944 by the Supreme Court of New York County in the case of *Noel Associates Inc. v. Merrill*.<sup>112</sup>

The Court of Appeals has not yet addressed itself to another, more controversial holding in the *Noel* decision—that shareholders added in an effort to meet the minimum five per cent or \$50,000 requirement of the security statute need not show that they owned their stock at the time of the alleged wrong. The relationship between the contemporaneous ownership requirement and the security for expenses statute, therefore, remains uncertain to this date. In 1959, the Appellate Division of the Second Department held in *Richman v. Felmus*<sup>113</sup> that only those interveners may become “parties to the first cause of action who owned some stock in April, 1952, the time of the transaction therein complained of . . . .”<sup>114</sup> The opinion went on to explain that if interveners did show that they owned a certain amount on the indicated date, any stock acquired subsequent to that date could be counted for purposes of meeting security requirements. The opinion made clear, however, that the security law could not be avoided by adding shareholders who had no stock at the time of the alleged wrong.

This clear-cut pronouncement did not persuade the Supreme Court of the First Department, which in the following year held directly to the contrary.<sup>115</sup> In so doing it chose to adhere to the reasoning of the *Noel* opinion<sup>116</sup> and quoted with approval the following observation:

If the Legislature had intended that the condition determining the right of a plaintiff to bring an action under section 61 [the contemporaneous ownership requirement] be read into the conditions determining the right of a defendant to obtain security under section 61-b—namely, that in both respects

<sup>111</sup> 300 N.Y. 325, 90 N.E.2d 876, 59 N.Y.S.2d 841 (1950).

<sup>112</sup> 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944).

<sup>113</sup> 8 App. Div. 2d 985, 190 N.Y.S.2d 920 (1959).

<sup>114</sup> *Id.* at 985, 190 N.Y.S.2d at 921.

<sup>115</sup> *Sorin v. Shahmoon Indus., Inc.*, 30 Misc. 2d 429, 220 N.Y.S.2d 760 (Sup. Ct. 1961).

<sup>116</sup> 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944).

all the shares owned by the plaintiff shall have been owned at the times of the wrongs complained of—the Legislature could have spoken clearly to that effect.<sup>117</sup>

The confusion exhibited by the New York courts is reflected in the efforts of the federal courts to apply the contemporaneous ownership requirement of Federal Rule 23.1 to the New York security for expenses statute in diversity cases. In the first case raising the question, the District Court for the Southern District of New York ruled that intervening shareholders need not show they were contemporaneous owners at the time of the alleged wrong.<sup>118</sup> Subsequently, however, other judges in the Southern District have ruled to the contrary, basing their decisions on a holding that the federal rules necessitated such a result.<sup>119</sup> This conclusion has generally been criticized as not being called for either by law or by policy.<sup>120</sup>

While it may be conceded that under the Supreme Court's ruling in *Cohen*,<sup>121</sup> federal courts should apply Rule 23.1 to diversity derivative actions, application of that rule does not require an interpretation forbidding joinder of subsequent shareholders. The letter of the rule is fulfilled if the plaintiff initiating the suit is a contemporaneous owner. Furthermore, if the plaintiff is able to marshal interveners possessing collectively \$50,000 worth of security or five per cent of any class of stock outstanding, it seems unlikely that the policy against "purchased grievances" would be seriously compromised. At least, the danger does not seem sufficient to warrant the serious interference which a contemporaneous ownership requirement would impose on "the more fundamental policy of allowing derivative suits as a check on the transgressions of corporate management."<sup>122</sup>

Although the question whether intervening shareholders need be contemporaneous owners remains confused, other aspects of the security for expenses statute are in clearer focus. It is now accepted practice to give a plaintiff time after he has filed his complaint to ascertain whether other shareholders will join.<sup>123</sup> It has also been held

<sup>117</sup> *Sorin v. Shahmoon Indus., Inc.*, 30 Misc. 2d 429, 439, 220 N.Y.S.2d 760, 791 (Sup. Ct. 1961), quoting *Noel Associates, Inc. v. Merrill*, 184 Misc. 656-58, 53 N.Y.S. 2d 153-54.

<sup>118</sup> *Fuller v. American Mach. & Foundry Co.*, 95 F. Supp. 764 (S.D.N.Y. 1951).

<sup>119</sup> *Elkins v. Bricker*, 147 F. Supp. 609 (S.D.N.Y. 1956); *Kaufman v. Wolfson*, 136 F. Supp. 939 (S.D.N.Y. 1955).

<sup>120</sup> See 45 CALIF. L. REV. 80 (1957); 69 HARV. L. REV. 1504 (1956); 104 U. PA. L. REV. 1108 (1956).

<sup>121</sup> *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949).

<sup>122</sup> 104 U. PA. L. REV. 1108, 1110 (1956).

<sup>123</sup> See *Himmelblau v. Haist*, 195 F. Supp. 356 (S.D.N.Y. 1961); *Breswick & Co. v. Briggs*, 138 F. Supp. 747 (S.D.N.Y. 1956); *Schreiber v. Butte Copper & Zinc Co.*, 98 F. Supp. 106 (S.D.N.Y. 1951); *Fuller v. American Mach. & Foundry Co.*, 97 F. Supp. 742 (S.D.N.Y. 1951); *Ratzkin v. Harris*, 219 N.Y.S.2d 665 (Sup. Ct.

on several occasions that he may have access to the corporation's list of stockholders in order to facilitate his solicitation.<sup>124</sup> Finally, it should be noted that federal courts have held that intervening stockholders, regardless of their domiciles, will not destroy existing diversity of citizenship for jurisdictional purposes.<sup>125</sup>

### *Contemporaneous Ownership*

The preceding discussion of the interaction between the rules requiring contemporaneous ownership and security for expenses, should not obscure the fact that the contemporaneous ownership requirement is, itself, a provision which, if narrowly construed, will preclude many derivative suits. This is especially true because the condition is two-pronged; plaintiff in a derivative action must allege ownership as of the time of the transaction of which he complains and as of the time of bringing suit.<sup>126</sup> In fact, he must, in the words of one court, retain his status "in the corporation, for whose benefit he sues, from the time the alleged improper acts occurred continuously and uninterrupted until after judgment is entered in the case."<sup>127</sup>

It is evident, therefore, that many cases will turn on the construction of the requirement, particularly on the breadth of meaning to be given to the word "shareholder." It is significant to note that such construction, generally speaking, has been as broad as can reasonably be justified. For example, enactments such as Federal Rule 23.1, which prescribe that plaintiff must aver that he was "a shareholder . . . at the time of the transaction . . . or that his share . . . thereafter devolved upon him by operation of law," have been interpreted to permit derivative suits by: beneficiaries of securities held in trust;<sup>128</sup>

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1961); *Christie v. Fifth Madison Corp.*, 124 N.Y.S.2d 492 (Sup. Ct. 1953); *Davidson v. Rabinowitz*, 140 N.Y.S.2d 875 (Sup. Ct. 1951).

The practice of allowing time to join additional plaintiffs in order to meet the requirements of the security for expenses statute gave rise to an interesting variation in *Tyler v. Gas Consumers Ass'n*, 34 Misc. 2d 947, 229 N.Y.S.2d 169 (Sup. Ct. 1962). The plaintiff shareholder was ordered to post \$40,000 or to bring in additional shareholders in order to meet the five per cent or \$50,000 statutory requirement. The plaintiff instead purchased sufficient shares to bring his personal holdings to more than the required five per cent. Defendant thereupon moved for dismissal of the complaint on the grounds that plaintiff had not fulfilled the terms of the order. Motion granted. For a critical evaluation of this ruling, see 47 *MINN. L. REV.* 1119 (1963).

<sup>124</sup> See *Baker v. MacFadden Publications*, 300 N.Y. 325, 90 N.E.2d 876 (1950); *Ratzkin v. Harris*, 219 N.Y.S.2d 665 (Sup. Ct. 1961).

<sup>125</sup> See *Himmelblau v. Haist*, 195 F. Supp. 356 (S.D.N.Y. 1961); *Weinstock v. Kallett*, 11 F.R.D. 270 (S.D.N.Y. 1951).

<sup>126</sup> 3 *MOORE, FEDERAL PRACTICE* ¶¶ 23.17-.18 (2d ed. 1966).

<sup>127</sup> *Gresov v. Shattuck Denn Mining Corp.*, 40 Misc. 2d 569, 570, 243 N.Y.S.2d 760, 763 (Sup. Ct. 1963); *accord*, *Sorin v. Shahmoon Indus., Inc.*, 30 Misc. 2d 429, 220 N.Y.S.2d 760 (Sup. Ct. 1961).

<sup>128</sup> *Brown v. Dolese*, 38 Del. Ch. 471, 154 A.2d 233 (Ch. 1959); *Schlegel v. Schlegel Mfg. Corp.*, 23 App. Div. 2d 808, 258 N.Y.S.2d 587 (1965).

owners of stock held in street names;<sup>129</sup> pledgees of stock;<sup>130</sup> parties who have been induced by fraud to transfer legal title to others;<sup>131</sup> legatees of stock who only had equitable title thereto.<sup>132</sup> Furthermore, courts have consistently held that owners of stock in parent companies have sufficient interest in subsidiaries to enable them to maintain actions on behalf of the subordinate corporations; that is, they have been able to bring what is known as the "double derivative" suit.<sup>133</sup>

Because subsidiaries are, for a variety of reasons, a popular means of doing business, the latter development has considerable significance. As one judge has observed, the layers and layers of separate corporate entities, "pyramided in a form which centralizes control in the hands of a few," necessitates special vigilance by a court of equity "to protect the minority stockholders, whose money is in the control of those at the top but whose voice receives no attention through the maze."<sup>134</sup> Obviously, the double derivative stockholder's suit is one device—indeed, in the words of one writer, "the most significant and effective" device—by which the vigilance of courts of equity may be triggered into action.<sup>135</sup>

Accompanying the tendency to give a broad construction to the language of contemporaneous stockholder rules is the concept known as the "continuing wrong" theory. Under this theory plaintiffs are able to qualify as contemporary stockholders if they obtain ownership status *at any time* the alleged wrong may be considered still in effect. Two cases illustrate this point. In *Palmer v. Morris*,<sup>136</sup> the transactions of which plaintiff complained occurred before he acquired his stock, but payments were made on the basis of such transactions subsequent to his acquisitions. The court concluded that plaintiff had standing to sue. In another action, *Gluck v. Unger*,<sup>137</sup> it was alleged that a merger between the companies was wrongfully consummated. It was further alleged that a suit brought by the first corporation against the second corporation because of the merger resulted in a fraudulent

<sup>129</sup> *Braasch v. Goldschmidt*, 41 Del. Ch. 519, 199 A.2d 760 (Ch. 1964); *Gamble-Skogmo, Inc. v. Saks*, 35 Del. Ch. 503, 122 A.2d 120 (Sup. Ct. 1956).

<sup>130</sup> *Lowell Wiper Supply Co. v. Helen Shop, Inc.*, 235 F. Supp. 640 (S.D.N.Y. 1964).

<sup>131</sup> *Willcox v. Harriman Sec. Corp.*, 10 F. Supp. 532 (S.D.N.Y. 1933).

<sup>132</sup> *Hurt v. Cotton States Fertilizer Co.*, 145 F.2d 293 (5th Cir. 1944).

<sup>133</sup> *See, e.g.*, *Goldstein v. Groesbeck*, 142 F.2d 422 (2d Cir. 1944); *Kaufman v. Wolfson*, 132 F. Supp. 733 (S.D.N.Y. 1955); *Hirshorn v. Mine Safety Appliances Co.*, 54 F. Supp. 588 (W.D. Pa. 1944).

<sup>134</sup> *Blaustein v. Pan American Petroleum & Transp. Co.*, 174 Misc. 601, 665, 21 N.Y.S.2d 651, 711 (Sup. Ct. 1940).

<sup>135</sup> *Painter, Double Derivative Suits and Other Remedies With Regard to Damaged Subsidiaries*, 36 IND. L.J. 143, 144 (1961).

<sup>136</sup> 316 F.2d 649 (5th Cir. 1963).

<sup>137</sup> 25 Misc. 2d 554, 202 N.Y.S.2d 832 (Sup. Ct. 1960).

and unfair settlement. The court held that a plaintiff who acquired shares after the merger, but before the settlement, was a contemporaneous owner and thus had a right to bring an action.

While not all courts have been as ready to entertain suits under the "continuing wrong" approach,<sup>138</sup> it is evident that the theory has on occasion opened doors to plaintiffs who otherwise might have been barred. In addition, some legislatures have apparently adopted the concept, since the statutes of California,<sup>139</sup> Ohio<sup>140</sup> and Wisconsin<sup>141</sup> simply require that ownership be shown as of the time of the transaction complained of or "any part thereof."

Corresponding to the liberal treatment accorded to the meaning of the term "shareholder," is a recent law enacted by the Pennsylvania legislature modifying the contemporaneous ownership rule.<sup>142</sup> The statute gives a plaintiff the option of showing that he held "a beneficial interest" in shares as an alternative to the requirement that he aver that he was a stockholder at the time of the transaction of which he complains. Furthermore, the legislature included an "out" similar to the one already observed in connection with the security for expenses provision, for the ownership clause now provides:

that any shareholder or person beneficially interested in shares of the corporation, 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 injustices will result.<sup>143</sup>

In sharp contrast to this attitude is the requirement of some states that a plaintiff show he was a *registered* shareholder at the time of the actions of which he complains.<sup>144</sup> Also in contrast is a recent amendment of optional section 43A of the Model Business Corporation Act, adding the term "of record" to the requirement of contemporaneous ownership.<sup>145</sup> To date, it appears that only the state of Washington has adopted this precise phraseology.<sup>146</sup>

<sup>138</sup> See *Weinhaus v. Gale*, 237 F.2d 197 (7th Cir. 1956).

<sup>139</sup> CAL. CORP. CODE § 834.

<sup>140</sup> OHIO REV. CODE ANN. § 2307.311 (Page Supp. 1966).

<sup>141</sup> WIS. STAT. ANN. § 180.405 (1957).

<sup>142</sup> PA. STAT. ANN. tit. 15, § 2852-516 (Supp. 1966).

<sup>143</sup> *Id.*

<sup>144</sup> See, e.g., CAL. CORP. CODE § 834 (1955); WIS. STAT. ANN. § 180.405 (1957).

<sup>145</sup> ABA-ALI MODEL BUS. CORP. ACT § 12 (Supp. 1966).

<sup>146</sup> WASH. REV. CODE ANN. § 23A.08.460 (Supp. 1966) (effective July 1, 1967).

Although "registered" ownership and ownership "of record" add precision to the requirement, it may be that these phrases will prove too restrictive. Little evidence is available to suggest that non-record holders, who have been permitted to bring suit in the past under standard contemporaneous ownership clauses, have abused the right. Nor can it be shown that the real investment of a non-record holder in a corporation is necessarily less substantial than is the interest of many record holders. It would seem that these phrases are the products either of general hostility to derivative suits or of an exaggerated fear of purchased litigation.

#### *Demands on Directors and Shareholders*

Discussion of prevailing trends concerning conditions essential to the bringing of derivative suits would be incomplete without reference to the requirement relating to demands on directors and shareholders. This requirement dates back to the formative years in the history of shareholder suits and was first voiced by the Supreme Court in 1881 in the case of *Hawes v. Oakland*.<sup>147</sup> As now incorporated into the federal rules, it reads as follows:

The complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders . . . and the reasons for his failure to obtain the action or for not making the effort.<sup>148</sup>

Since this rule, or one comparable to it, has been adopted by legislative or judicial action in many states, its significance to derivative actions is readily apparent. That demand of some sort be a condition precedent to *most* derivative actions is a rule of considerable merit, for such actions should only be tolerated in the event the corporation refuses or is powerless to act on its own behalf. This observation, however, does not mean that proof of demand should *always* be a condition precedent, nor does it resolve questions relating to the nature of the demand or the parties to whom the demand should be addressed.

These factors are especially important since Federal Rule 23.1 allows much discretion to the courts. This rule does not per se require demand of either directors or shareholders, but merely insists that the plaintiff allege "with particularity the efforts" made to obtain action from the directors and "if necessary" from the shareholders.

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<sup>147</sup> 104 U.S. 450 (1882).

<sup>148</sup> FED. R. CIV. P. 23.1.



It then provides that he must explain the reasons, if he does not obtain action or does not make efforts to secure it. It is, of course, obvious that the rule anticipates that demand normally will be made, but it is also obvious that the rule recognizes exceptions to the requirement.

Because of this built-in flexibility, it is a mistake for courts to apply the rule, and those fashioned after it, in a mechanical manner. This fact is being increasingly recognized and observed. It is generally accepted, for example, that demand need not be made of directors personally involved in the alleged wrongdoing,<sup>149</sup> and demand on directors has also been viewed as superfluous where the alleged wrongdoer is the controlling shareholder.<sup>150</sup> Comparable flexibility may also be observed in cases concerned with demands on shareholders. In such instances, of course, the wise and reasonable use of judicial discretion is essential, for the indiscriminate imposition of this requirement could seriously impede or even prevent many meritorious derivative suits. Because of this danger, distinctions should be, and have been, recognized between closely-held and public corporations.<sup>151</sup> Note also has been taken of the degree of shareholder involvement in the alleged wrongdoing,<sup>152</sup> and some courts have realistically taken into account the realities of proxy control in ascertaining whether a demand on shareholders should be imposed as a condition precedent to bringing suit.<sup>153</sup>

It should be noted that the preceding paragraphs have been addressed to the issue of the necessity for demand, and not to the separate question of the effect of action taken by directors or shareholders pursuant to demand. Normally the question posed by such action has been whether or not the wrongs alleged could be ratified by the addressees of the demand. As has been stated, this is a separate question. If, however, courts are of the opinion that ratification of an alleged wrong, even by disinterested directors or shareholders, cannot prohibit a minority action, they should obviously take such a conclusion into account in ascertaining whether they should insist on a demand. Some courts have stated that this conclusion should preclude the need

<sup>149</sup> See 3 MOORE, FEDERAL PRACTICE ¶ 23.19 (2d ed. 1966) and cases cited therein.

<sup>150</sup> See *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946 (4th Cir. 1964). *Contra James Talcott, Inc. v. McDowell*, 148 So. 2d 36 (Fla. 1962).

<sup>151</sup> See *Levitt v. Johnson*, 334 F.2d 815 (1st Cir. 1964) (stressing the burden of making a demand on 48,000 stockholders, and contrasting the situation with that in *Halpin v. Babbitt*, 303 F.2d 138 (1st Cir. 1962) where one shareholder held 92% of all company stock); *Berg v. Cincinnati, N. & C. Ry.*, 56 F. Supp. 842 (E.D. Ky. 1944). *Contra Quirke v. St. Louis, S.F. Ry.*, 277 F.2d 705 (8th Cir. 1960); *Haffer v. Voit*, 219 F.2d 704 (6th Cir. 1955).

<sup>152</sup> See *Pioche Mines Consol. v. Dolman*, 333 F.2d 257 (9th Cir. 1964); *Cathedral Estates, Inc. v. Taft Realty Corp.*, 228 F.2d 85 (2d Cir. 1955); *Forbes v. Wilson*, 243 F. 264 (N.D. Ohio 1917).

<sup>153</sup> See *Gottesman v. General Motors Corp.*, 268 F.2d 194 (2d Cir. 1959).

for demand.<sup>154</sup> Others have noted that there may be merit, nonetheless, in having the alleged wrongs called to the attention of directors and shareholders.<sup>155</sup>

In appraising current attitudes towards demand, it is of more than passing interest to note that three significant industrial states, California, Ohio and New York, provide for demand on directors, but omit the need for demand on shareholders.<sup>156</sup> The Ohio and New York enactments are particularly significant. The legislature in Ohio spoke out within a few months after the state supreme court had imposed a rather rigid and far reaching shareholder demand requirement on derivative suit plaintiffs.<sup>157</sup> In New York, a demand upon shareholders clause was included in the study bill submitted to the legislature in 1960, but was removed from the bill presented for passage in 1961. This deletion purportedly followed public hearings at which it was argued that "demand upon shareholders was too onerous; particularly in the case of suit brought against directors and officers of large corporations with far flung shareholdings."<sup>158</sup> Since demand requirements were initially imposed by judicial decree,<sup>159</sup> it should not be assumed automatically that an approach to shareholders is unnecessary in these jurisdictions. It would appear, however, that the historical context in which the legislatures in Ohio and New York acted, makes their intent clear, and it also seems fair to conclude that the California legislature has voiced its policy with precision by its deliberate omission of a common requirement.

### *Expenses and Counsel Fees*

One additional development relating to derivative suits is worthy of note: the more realistic judicial position in reference to the allowance of expenses and counsel fees to successful plaintiffs.<sup>160</sup>

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<sup>154</sup> See, e.g., *Mayer v. Adams*, 37 Del. Ch. 298, 141 A.2d 458 (Sup. Ct. 1958); *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912).

<sup>155</sup> See *Rogers v. American Can Co.*, 305 F.2d 297 (3rd Cir. 1962).

<sup>156</sup> CAL. CORP. CODE § 834 (1955); N.Y. BUS. CORP. LAW § 626 (McKinney's 1963); OHIO REV. CODE ANN. § 2307.311 (Page Supp. 1966).

<sup>157</sup> *Claman v. Robertson*, 164 Ohio St. 61, 128 N.E.2d 429 (1955), which not only held demand was necessary, but also stated that a disinterested majority could ratify directors' frauds. See Note, *Shareholder Demand as a Condition Precedent to Derivative Suits—A Proposed Compromise*, 30 U. CINC. L. REV. 196 (1961).

<sup>158</sup> Hoffman, *The Status of Shareholders and Directors Under New York's Business Corporation Law: A Comparative View*, 11 BUFFALO L. REV. 496, 504 (1962).

<sup>159</sup> E.g., *Hawes v. Oakland*, 104 U.S. 450 (1881); *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912).

<sup>160</sup> For a general discussion of counsel fees in reference to derivative actions, see Hornstein, *Legal Therapeutics: The "Salvage Factor" in Counsel Fee Awards*, 69 HARV. L. REV. 658 (1956); Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784 (1939).

Early decisions took the position that only in the event the corporation gained pecuniary benefit from a derivative suit was plaintiff to be allowed expenses.<sup>161</sup> The emphasis was on tangible financial gain, and thus benefits of a non-financial nature were given but slight consideration. Furthermore, the emphasis referred to often meant that the time, experience and "know how" involved in an action went uncompensated.

Recognizing the restrictive nature of the pecuniary benefit approach, many courts have substituted a "substantial benefit" test.<sup>162</sup> This test does not limit inquiry to whether the corporation received direct financial gain from plaintiff's action, but rather permits investigation into direct and indirect, pecuniary and non-pecuniary, results. Under this approach, for example, courts have recognized benefits from a derivative suit which produced: the cancellation of a proposed issue of securities which would have upset the voting and redemptive rights of certain shareholders;<sup>163</sup> a temporary injunction restraining a corporation from paying certain sums of money;<sup>164</sup> the cancellation of a stock option plan;<sup>165</sup> the rescinding of share purchases by a corporation;<sup>166</sup> the enjoining of certain ultra vires acts;<sup>167</sup> and by implication, the invalidation of election of directors.<sup>168</sup>

These examples suggest that courts have found substantial benefit in instances where primary relief has been to stockholders and not to the corporation.<sup>169</sup> Furthermore, they show that the benefit concept is satisfied if the action compels the corporation to act within its authority even though no direct pecuniary advantages may result.<sup>170</sup> In addition, these cases reveal that courts are willing to grant expenses and legal fees even though the suits in question were settled before trial.<sup>171</sup> The test applied was whether the action taken was the product of plaintiff's initiative.

Although the more liberal judicial attitude toward plaintiff's expenses, including counsel fees, is to be commended, it should be recognized that a too liberal policy will encourage strike suits. It is essential,

<sup>161</sup> See, e.g., *Burley Tobacco Co. v. Vest*, 165 Ky. 762, 178 S.W. 1102 (1915).

<sup>162</sup> See, e.g., *Schechtman v. Wolfson*, 244 F.2d 537, 540 (2d Cir. 1957); *Permagament v. Kaiser-Frazer Corp.*, 224 F.2d 80 (6th Cir. 1965).

<sup>163</sup> *Berger v. Amana Soc'y*, 135 N.W.2d 618 (Iowa 1965).

<sup>164</sup> *Modern Optics Inc. v. Buck*, 336 S.W.2d 857 (Texas Civ. App. 1960).

<sup>165</sup> *Rosenthal v. Burry Biscuit Corp.*, 209 A.2d 459 (Del. Ch. 1949).

<sup>166</sup> *Denny v. Phillips & Buttorff Corp.*, 331 F.2d 249 (6th Cir. 1964).

<sup>167</sup> *Abrams v. Textile Realty Corp.*, 97 N.Y.S.2d 492 (Sup. Ct. 1949).

<sup>168</sup> *Bosch v. Meeker Coop. Light & Power Assn.*, 257 Minn. 362, 101 N.W.2d 423 (1960).

<sup>169</sup> See note 163 *supra*.

<sup>170</sup> See note 167 *supra*.

<sup>171</sup> See *Mintz v. Bohlen*, 210 A.2d 569 (Del. Ch. 1965); *Rosenthal v. Burry Biscuit Corp.*, 209 A.2d 459 (Del. Ch. 1949).

therefore, that many factors be appraised carefully in determining whether expenses should be allowed, and, if so, in what amount. To hold, for example, that the pecuniary benefit concept is too narrow does not mean that the reality of financial benefits should be ignored. Nor is it inappropriate to consider the good faith of the plaintiff and the substance of his complaint in ascertaining fees.<sup>172</sup> To these factors, of course, should be added traditional considerations such as the time fairly required, the intricacy and novelty of the issues, and the difficulty and expense encountered in ascertaining facts.<sup>173</sup> It is in the careful appraisal of these items that a balance can be struck between an overly restrictive approach which discourages and hampers corporate policing by shareholders, and a too generous approach which encourages nuisance actions.

#### CONCLUSION

The foregoing discussion of developments related to derivative suits has admittedly been predicated on a relatively close selection of cases. It is believed, however, that such cases are indicative of contemporary trends. If this reading is correct, it obviously will disturb those who hold that "every stockholders' suit is ipso facto a strike suit,"<sup>174</sup> and counter-measures which seek to hamper derivative plaintiffs are to be anticipated. To those impelled to seek such measures a word of caution is suggested. It is unlikely that those who control corporate property and policy will ever again be permitted the freedom of an earlier era. It may be a mistake, therefore, either to erect additional hurdles to the bringing of stockholders' suits or to fortify present ones. If such action is taken, alternative controls will certainly be created. Can anyone doubt that such alternative controls will take the form of federal government actions?

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<sup>172</sup> See *Eisenberg v. Central Zone Property Corp.*, 1 App. Div. 2d 353, 149 N.Y.S.2d 840 (1956).

<sup>173</sup> See *Angoff v. Goldfine*, 270 F.2d 185, 188-89 (1st Cir. 1959).

<sup>174</sup> Herlack, *Stockholders' Suits: A Possible Substitute*, 35 MICH. L. REV. 597, 605 (1937).