

California Law Review

VOLUME XXXII

JUNE, 1944

NUMBER 2

The Death Knell of Stockholders' Derivative Suits in New York

*George D. Hornstein**

NEW YORK legislation has usually been so carefully considered that for many years it has served as a wholesome model for other states. This enviable position has been due, in part, to the salutary activities of its Law Revision Commission, which studies proposed legislation, invites discussion, and makes recommendations based thereon, a democratic practice calculated to produce sound legislation. Suspicion therefore results when, as has just happened at the last session of the New York legislature, a bill virtually strangling stockholders' derivative suits, is tossed into the legislative hopper too late for a public hearing and without the recommendation of this non-partisan body.

Nor was this bill sponsored by any bar association. In fact, it was forcefully condemned by the only bar association which had had an opportunity to vote on it in the few days between its late introduction and its hasty passage by the legislature.¹ It was also unequivocally disapproved by every other bar association which thereafter voted on the proposed law while it was pending before the governor.² Emphatic objection to the legislation was also registered

*A.B., 1924, College of the City of New York; LL.B., 1926, Columbia University. Columbia University Fellow, 1926-1927. Member of the New York and Federal Bars. Author of *Legal Controls for Intracorporate Abuse—Present and Future* (1941) 41 COL. L. REV. 220, *Corporate Control and Private Property Rules* (1943) 92 U. OF PA. L. REV. 1, and numerous other articles in legal periodicals.

¹New York County Lawyers' Association, Committee on State Legislation, Report No. 285, March 9, 1944. The bill was introduced on Feb. 28, 1944, passed the Senate on March 15, 1944, and the Assembly on March 17, 1944.

²Association of the Bar of the City of New York, meeting of the Committee on State Legislation held March 16, 1944; Federal Bar Association of New York, New Jersey and Connecticut, meeting held March 27, 1944. Attention was called to the bill, but no comment expressed by the New York State Bar Association, Circular No. 98, March 7, 1944, at 339-340.

by the A.F. of L., the C.I.O., the American Investors Union, and New York's non-partisan Citizens' Union.³

The law, as signed by the governor, who denied a request for a public hearing,⁴ reads as follows:

§61-b. *Security for expenses.* In an action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five per centum of the outstanding shares of any class of such corporation's stock or voting trust certificates, unless the shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which it may become subject pursuant to section sixty-one-a of this chapter, to which the corporation shall have recourse in such amount as the court having jurisdiction shall determine upon the termination of such action. The amount of such security may thereafter 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.⁵

Simply stated, the law—insofar as it concerns a publicly owned corporation—bars stockholders from maintaining a derivative suit on its behalf unless they are the holders⁶ of stock having a market value of more than \$50,000. The apparent alternatives are mere camouflage. One alternative, 5 per cent of the outstanding stock, is meaningless since 5 per cent of the stock would always be worth more than \$50,000 in a corporation having more than one million dollars in assets. The second alternative, a bond for reasonable expenses, including attorney's fees, which may be incurred by *all* the defendants in connection with the action, is bound to be so high (a hundred thousand dollars would be moderate in any sizable case) that very few individuals could possibly raise the bond.⁷ Moreover, if they could,

³ PM, March 26, 1944, at 12; April 12, 1944, at 11.

⁴ PM, April 4, 1944, at 11.

⁵ N. Y. Laws, c. 668, signed April 9, 1944.

⁶ Presumably an equitable owner of more than \$50,000 worth of stock would be barred unless he could put up bond.

⁷ The Report, *infra* note 10, at 114, admits that "the defendants are normally in control of the corporation"; so it may be assumed that they will cause the corporation "to require" the plaintiff to give security—when failure of the plaintiff to comply automatically defeats the suit. With respect to the amount of bond, the Report itself states,

they would rarely be willing to risk it, for experience has demonstrated that many unquestionably meritorious suits have been lost on numerous technical grounds. For example, meritorious suits now pending may be lost because of this new requirement, if held constitutional, that the complainants put up bond in an amount beyond their means.

Significant, pragmatic illustration of the operation of the law may prove illuminating. So in a case such as *Cwerdinski v. Bent* (Bethlehem Steel Corp.) where the stockholders—after trial—won a recovery amounting to \$1,105,821.37 for the corporation (which represented an enhancement in value of the complainants' stock of \$3.60)—had this new law been in effect, the complainants would first have had to put up bond and then, after being *successful* on behalf of the corporation, the complainants would have been required to pay \$135,243.28 in counsel fees and disbursements to those defendants who were exonerated—on a plea of the Statute of Limitations. It should be noted that the successful defense was not that the wrongs had not been committed, but that they were not discovered in time.⁸ Can it seriously be contended that a law which will operate in this way is intended to encourage maintenance of meritorious claims?

On the contrary, the new law effectually bars stockholders who own less than \$50,000 worth of stock in a large corporation from suing their fiduciaries for misconduct, however flagrant.

In view of the patent and brazen deviations from normal procedure and in view of the dangerous test—a certain amount of wealth—as a requisite for recourse to the courts, one cannot help inquiring, "Who did sponsor this law which in its protection of corporate man-

p. 8, that the cost to the corporation alone was more than \$100,000 in the cases of *Kirby v. Schenck* (Loew's, Inc.) and *Heller v. Boylan* (American Tobacco Co.), and to certain of the defendants in *Cwerdinski v. Bent* (Bethlehem Steel Corp.)

⁸ *Cwerdinski v. Bent* (1937, N.Y. 30271); see also N.Y.L.J., Dec. 26, 1941, at 2129. In such a suit as *Donovan v. Atlas Corporation* (Securities-Allied Corporation) (1934, N.Y. 34032), where one of the defendants had acquired 97 per cent of the stock by the time the wrongs were uncovered, and the remaining 3 per cent of the stock had a market value of slightly less than \$50,000, it would have been necessary—had this law then been in effect—to put up bond for approximately \$300,000 (the estimated cost to defendants of defending the suit to the close of plaintiff's case) before the suit could be maintained. What stockholder, regardless of how much he had been wronged, would put up bond in that amount when he knew that there were several defenses—entirely apart from the merits—which might defeat the suit at the close of trial?

agements out-Delaware's Delaware?"⁹

The bill was avowedly based on and was introduced simultaneously with the release of a purportedly non-partisan Survey and Report by a Special Committee on Corporate Litigation of the Chamber of Commerce of the State of New York, a private organization.¹⁰ The motives of the Chamber have been questioned by several editorial writers who point out that the Chamber's members include men who have been named as defendants in stockholders' derivative suits, that some of these suits are still pending, and that the new law is retroactive and applies to pending litigation.¹¹ But while these relationships normally make one wary, this article will weigh the validity and accuracy of the Report as a social and legal document, for it should be judged apart from any selfish motives which may have inspired its sponsors.

The purpose of the Chamber's investigation was ostensibly "to determine the advisability of possible changes in law or procedure which would [1] facilitate the correction of wrong-doing in corporate affairs but [2] reduce groundless and costly litigation of this type" (p. 1) (numerals in brackets supplied by the present writer). *Both* aspects of this situation could with profit have been studied, since the corporation is such an integral part of our whole democratic structure that any suggestions to improve its operation would well repay the serious thought and effort of legal scholars and of all Americans

⁹ Earlier straws in the same direction were N. Y. Laws 1941, c. 209, 350, making provision for directors' indemnity, and N. Y. Laws 1942, c. 851, shortening the Statute of Limitations (cutting the period to six years after fraud, not after its discovery, and to three years after non-fraudulent waste). The directors' indemnity legislation, like the currently discussed statute, was neither sponsored nor recommended by the Law Revision Commission. The Law Revision Commission did consider the Statute of Limitations and recommended a longer period than that adopted. N. Y. Leg. Doc. (1942) 65 E.

¹⁰ Survey and Report regarding Stockholders' Derivative Suits (1944). There was only one important departure by the Legislature from the recommendation in the Report. The Report urged barring suit by minority stockholders unless they put up bond or owned 5% of the outstanding stock of the corporation. The Chamber of Commerce, at its meeting adopting the Report, added a second alternative—or unless they owned stock having "a value in excess of \$100,000." The Legislature changed the second alternative to "a market value in excess of fifty thousand dollars."

The same Report also recommended a companion law, likewise passed by the Legislature and signed by the Governor, N. Y. Laws, c. 667. This law changes the New York rule in *Pollitz v. Gould* (1911) 202 N. Y. 11, 94 N. E. 1088, and now requires stock ownership by the plaintiff at the time of the transaction on which the complaint is based.

¹¹ PM, March 12, 1944, at 12; N. Y. Post, April 12, 1944, at 29; to the same effect, see *Your Investments* (March 1944) 31, published by AMERICAN INVESTORS UNION.

jealous to safeguard the values of our democracy. The study was extensive and apparently not hampered by financial limitations. Yet not a word appears in the Report suggesting "possible changes in law or procedure which would facilitate the correction of wrong-doing in corporate affairs." The entire Report is devoted to the alleged need for reducing litigation by stockholders.

Appended to the Report are the results of the Survey, embodied in charts which are tremendously impressive—in point of size of paper used. An examination of the charts, however, immediately discloses that they are—in the language of the *Mikado*—"merely corroborative detail, intended to give artistic verisimilitude to an otherwise bald and unconvincing narrative." Serious scholarly consideration can scarcely be given to charts which are careful to list the number of shares outstanding, the number owned by the complainant stockholder, the names of attorneys on both sides, but omit to mention the nature of the wrongs complained of, the grounds on which unsuccessful suits were defeated, the circumstances surrounding the "discontinuance" of suits, which sometimes do appear in the files.

Moreover, the statistical summary utterly fails to support the thesis of the Report—that the results do not justify stockholders' actions (pp. 6-7). During the period covered by the survey, there were more than a half-million actions of all kinds commenced in New York County, Kings County, and the U. S. District Court for the Southern District of New York (pp. 3-4). Only 1,266 were stockholders' suits; of these, 693 involved closely held corporations and 573 involved publicly held corporations (p. 6). Of the suits involving the closely held corporations, 5 per cent resulted in recoveries or were settled with court approval, as against 8 per cent for the publicly held corporations (p. 32). Even more significant—and equally flattering to the record of stockholders' suits in publicly held corporations—is comparison with a set of figures not given in the Report, but appearing in a well-known study of litigation in the Supreme Court of New York County, which disclosed that of all actions in that court—including commercial, negligence, and other torts—less than 5 per cent *reach* the trial tribunal.¹²

If we include in recoveries not only judgments after trial or on court-approved settlements, but also all other settlements, the figures

¹² McCook, address delivered Jan. 27, 1933, reprinted in *FOURTEEN YEARS OF JUDICIAL SERVICE* (1933) 152.

for recoveries in suits involving publicly held corporations would go up to 31½ per cent. This figure is reached by adding to the 8 per cent previously noted, a figure of 10 per cent for "settlements" without court approval,¹³ and half of the 27 per cent total of "discontinued" cases (pp. 32-33).¹⁴

The Report's figures have also been analyzed by the American Investors Union, which points out that there were recoveries in 62 per cent of all cases in which issue was joined, and concludes that "to be successful in two cases out of three is certainly an outstanding record since it would be naive to insist that unless every case is won, stockholders' suits serve no purpose."¹⁵

Analysis of the Report proper is made difficult by the fact that it is not written in any logical order. It is a complete hodgepodge, as a glance at its Table of Contents immediately discloses. Employing obvious propaganda devices¹⁶ and adopting the strategy usually employed in the defense of stockholders' suits, its primary purpose appears to be the creation of "atmosphere".

This article, in an attempt to make order out of chaos, will consider under the following heads material which embraces, it is believed, the most significant phases jumbled in the Report:¹⁷ (A) the intracorporate abuse complained of; (B) character of the complainant, as distinguished from that of the complaint; (C) cost to the community of supplying tribunals for the trial of these suits; (D) features of derivative litigation in which the Report concedes "there is much room for improvement" and the action (non-action) thereon suggested by the Report; (E) other abuses disturbing to the fiduciary defendants; (F) other abuses not disturbing to the fiduciary defendants; (G) the recommendation of the Report.

A. *The intracorporate abuse complained of*

Normal discretion would indicate that one should not "overdo a

¹³ Some settlements without court approval are in the form of payment to the corporation, e.g., payments of over a million dollars in settlement of suits on behalf of Chase National Bank, even though subsequent litigation resulted in a settlement with court approval whereby an additional \$2,500,000 was paid into the bank's assets. New York Times, April 15, 1937, at 1.

¹⁴ The Report, at 33, indicates that as many as 50% of the discontinuances may represent private settlements.

¹⁵ *Your Investments*, *supra* note 11, at 27.

¹⁶ Institute for Propaganda Analysis, Inc., 1 HOW TO DETECT PROPAGANDA (1937) no. 2.

¹⁷ Excepted is discussion dealing with the Pollitz v. Gould problem. *Supra* note 10.

good thing." It is one thing to argue "this man did not commit the murder charged" and quite another to contend that "no man ever committed murder." Yet this is the error into which the Report has fallen. The Report purports to state the subject matter of the 46 "successful" actions which its study disclosed. Considering the 13 suits wherein the complainants were successful after trial, it generalizes that "the chief opportunity for profit in this field is finding a 'situation' where the management or directorate can be mulcted on some technical, arbitrary, or vicarious rule of absolute liability, regardless of their honesty, fairness, or good judgment" (p. 36). Insofar as concerns the 33 actions settled with court approval, it states that "in none of them has bad faith or actual fraud on the part of the management been found or suggested" (p. 10).

Obviously there is something wrong with the summaries just quoted, since anyone familiar with the New York law—which is well established—knows that directors and officers are held liable only (1) where guilty of fraud, bad faith, or overreaching, or (2) in the absence of bad faith, where guilty of negligence so gross as to amount to a breach of faith.¹⁸ They are not held liable in negligence for honest errors of business judgment.¹⁹

The first generalization—as to the 13 suits terminating in judgment after trial—resulted from the Report's (p. 36) taking out of its context a passage from an article on Trial Tactics.²⁰ The Report's generalization is proven false by cases listed in the Report itself (pp. 9-10, 37-41). As typical, the reader should compare the Report's summary (pp. 9, 39) with the original opinion in *Winkelman v. General Motors*,²¹ the suit involving the largest recovery sustained in a derivative action in New York. The discrepancy between the Report's generalization and the 13 cases thus summarized is caused, for example, by disapproval of "salary grabs" in small corporations (p. 26),

¹⁸ Hornstein, *Legal Controls for Intracorporate Abuse—Present and Future* (1941) 41 COL. L. REV. 405, 412. Theoretically, directors and officers are also accountable for *ultra vires* acts, but modern charters are so broad that this basis of liability now rarely occurs. An example of it did occur in *Litwin v. Allen* (Sup. Ct., 1940) 25 N. Y. S. (2d) 667, where liability was imposed for an arrangement found by the trial court to be both *ultra vires* and "so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice." *Ibid.* at 699.

¹⁹ *Chelrob, Inc. v. Barrett* (1943) 265 App. Div. 455, 39 N. Y. S. (2d) 625. The Report itself devotes a chapter, at 103-111, to demonstrating that, under New York law, directors are not held to the "Strict Fiduciary Doctrine."

²⁰ *Cf. Hays, A Study in Trial Tactics* (1943) 43 COL. L. REV. 275, 281.

²¹ (S.D.N.Y., 1942) 44 Fed. Supp. 960.

but inability to see the analogy in improper payments of million dollar bonuses to officers in large corporations (pp. 9, 37-39). The Report similarly condemns the "fairly crude freeze-outs of minority stockholders" prior to 1930 (pp. 26-27), but itself says that a modern stockholder who does not like the way the corporation has been or is being run can sell his stock (p. 17).²² The Report by implication would advise you that if you do not like the way Hopson is looting your corporation (Hopson is used as an illustration because even the Report recognizes his behavior as improper, p. 91), do not indulge in "the anarchy of individual action" (p. 55) by going to court to protect your rights (and those of thousands of others); leave the field clear to him. The Report omits to point out that sale of your stock is no remedy, since the injury to the corporation may be reflected in the market value of the stock.

The inaccuracy of the Report's second generalization—as to the actions settled with court approval—can be learned only by examination of the court files or, in a few instances, in reported opinions. It may reasonably be assumed, however, that defendants do not settle for a considerable sum—sometimes running into millions of dollars—suits against them which cannot possibly be successful, as would be the case if the Report's generalization were correct. If we look, for example, at the two settled suits to which the Report calls especial attention because each occupied the time of one Part of the Supreme Court for more than a year (pp. 8, 83), we find that each suit was on behalf of an investment trust, and in both cases bad faith and outright fraud were charged, and in both cases the settlement was effected after the court had held that the complainants had made out a *prima facie* case.²³

It is difficult to understand how any informed student could have drawn the conclusions stated in the Report in view of the fact that the S.E.C. investigation of investment trusts disclosed that—in this field alone—of seven billion dollars invested in the ten years preceding the investigation, over \$1,100,000,000 was lost as a direct result

²² This is reported to have been a very persuasive argument in the Legislature. PM, March 16, 1944, at 10.

²³ The suit in *Donovan v. Atlas Corporation* (Securities-Allied Corporation), *supra* note 8, was instituted before the S.E.C. exposure, but the latter affords a convenient reference wherein many of the wrongs complained of are set forth. Report of the S.E.C. on Investment Trusts and Investment Companies, H. R. Doc. No. 279, 76th Cong., 1st Sess. (1940) pt. III, *passim*. The wrongs as to which the stockholders in General Investment Corporation were held to have made out a *prima facie* case are summarized in New York Times, Sept. 27, 1941, at 23.

of looting and "faithless management," defined as loss "due to a management acting for its own interests either in bad faith or with wanton disregard of the rights of the investors."²⁴

The misconduct disclosed by the Investigation ranged from acts which are questionable, such as salary grabs (including "option war-wants" and "pension" arrangements) down to acts which a layman considers equivalent to outright theft, such as the unloading on a corporation by its management of securities at many times their actual value, or unsecured "loans" by the corporation to financially irresponsible borrowers—where the borrower was a director, officer, dominant stockholder (perhaps of a class of stock "under water"), or another corporation in which one or more of them was interested.

B. *Character of the complainant*

It is accepted as sound psychology for defendants in a criminal case to "try" everyone but the accused, and it occasions no surprise to find a defendant in a stockholder's derivative suit attempting the same strategy. However, it is to be regretted that, adopting the strategy usually employed in the defense of stockholders' suits, the Report, instead of discussing the "correction of wrongdoing in corporate affairs" as it presumably set out to do (p. 1), proceeds instead to "try" the complainant.

It seems that "stockholder indignation at corporate management has ceased to exist except in the imagination of their professional protectors" (p. 48). Therefore, but inconsistently, the Report is impartially critical both of the professional litigant, like Venner, and of the modern "one-suit" complainants (pp. 45-46). The Report baldly asserts that in a publicly owned corporation, the individual interest of the individual stockholder is "too small to indicate legitimate personal interest" (p. 21).

The Report questions the typicalness of the present writer's experience as to the background of a suit,—that a client-stockholder consults his attorney on what to do when he learns his corporation is being looted,—and instead the Report substitutes another,—wherein the client is sought out by a customer's man. Although the latter picture is repudiated by the Report's own caustic references

²⁴ HEARINGS BEFORE SUBCOMMITTEE OF THE COMMITTEE ON BANKING AND CURRENCY on Sen. 3580, 76th Cong., 3d Sess. (1940) 788-817. Can the authors of the Report plead ignorance of this disclosure to which attention was specifically called by the present writer in the article cited *supra* note 18, at 443?

elsewhere to purchases of stock for purpose of commencing suit (pp. 13-14), to lawyer-plaintiffs (p. 45), to complainants who are relatives of lawyers (p. 45), the Report winds up in the conclusory crescendo that "derivative actions have come to harbor as a matter of course solicitation and inducement in bringing them, champerty and maintenance in their prosecution, the brokerage of litigation in their trial, and division of fees with laymen at their conclusion" (p. 48). Since considerably less than the offenses charged should result in any attorney involved being charged with and disbarred for unprofessional practices, the reliability of the Report's picture may be seriously doubted.

The stockholder is given Hobson's choice—no choice. First, he is reviled by the Report for "a disposition to allow a questioned corporate action to take place and bring suit for damages afterward" (pp. 82, 25, 11), as if corporate management contemplating skulduggery announces it in advance. If a stockholder does not join in a pending suit, his failure is construed as lack of sympathy with the suit (p. 56, n. 34). If he does intervene, he is ridiculed; "The known existence of a pending action to protect a pro-rata six dollar interest, instead of satisfying such stockholders that action on their part is unnecessary, drives them to a lather of activity to duplicate it" (p. 47). Those who do not intervene, but later protest an inadequate settlement, are characterized as "Johnny-come-latelies" (p. 92). Enough has been quoted, it is believed, to indicate that the Report relies heavily on the well-known propaganda device of "name-calling", rather than on a sincere effort to evaluate or suggest proper remedy for some abuses which do exist.

C. Cost to the community

The Report is much disturbed by the cost of stockholder litigation to the community (pp. 8-9).

Some stockholders' suits do take considerable time in trial, usually the result of dilatory tactics on the part of defendants who hope to tire out the plaintiff or his attorneys, or who hope that the trial judge may die or resign or become impatient of a trial which is deliberately made to look interminable. The results, however, warrant the cost to the community, both because of the amount recovered and the number of parties affected, to say nothing of the deterrent effect upon other would-be wrongdoers. In such a suit as *Winkelman v. General Motors*, which did take several months to try and which

the Report cites as illustrative of the petty amounts at stake—a total of 8 cents per share of stock (p. 49), the recovery amounted to \$4,500,000 (\$3,705,000 after allowances to complainants' counsel) and over 350,000 stockholders were benefited. The Report misapplies the old maxim "*de minimis non curat lex*." If collective benefit were ignored and only individual benefit considered, with equal logic to that exemplified in the Report, one would say, "Why waste time and expense to the Government in prosecuting an official charged with taking a \$10,000,000 bribe? After all, it amounts to less than 8 cents a person per capita in the United States."

The two cases specifically cited by the Report as of the greatest "cost" to the public, because in each case the trial "occupied the time of one Part of the Supreme Court for more than a year" (pp. 8, 83), actually were on trial for 73 court days and 100 court days, respectively, and were settled for \$1,500,000 and \$1,375,000, respectively, after the plaintiffs' case had been presented and the court had held that a *prima facie* case had been established. The present writer can testify that in the first of these cases, on behalf of Securities-Allied Corporation, the leisurely course was vigorously objected to by the plaintiffs. In that suit, in addition to the four complainants, 733 other small stockholders (who had not joined in the suit) also benefitted because they had been stockholders at the time the corporation was dissolved six years previously (one of the acts complained of). In the suit involving General Investment Corporation, the corporation itself joined in the suit on trial—after a change of management.²⁵

It is significant that legislation to eliminate stockholders' suits was not considered necessary while they could be avoided by "private settlements." Huge recoveries, as a result of trial or *public* settlement, have suddenly made the men of finance conscious of their responsibility to the "public"—that the community be spared the expense of these suits. If, in this sudden interest in economy, the courts are to be closed to litigants, would it not be more logical to bar suits by stockholders in closely held corporations, where the Report admits "the amounts involved are limited" (p. 31). The total of recoveries in all the suits involving closely held corporations will

²⁵ N. Y. Times, March 17, 1938, at 29 (change of management). The courts refused to permit the corporation to join in the stockholders' suit, *General Investment Corp. v. Addinsell* (1938) 255 App. Div. 319, 7 N. Y. S. (2d) 377, but permitted a joint trial of the stockholder's suit and one subsequently instituted by the corporation itself.

probably not equal the recovery of \$23,104,565 in the *Pennroad* case alone.²⁶ But no, the theory of the Report is that in the closely held corporation where the defendants are not only managers, but also stockholders, complainants must be allowed recourse to the courts (p. 31); in the publicly held corporation where the defendants are only managers—frequently have no money of their own invested in the corporation—the managers are the ones who need protection.

D. Features of derivative litigation in which "there is much room for improvement."

After listing three specific features of derivative litigation in which "there is much room for improvement" (p. 25), the Report proceeds not to suggest specific correction of the specific abuses, but to urge that litigants be deprived of access to the courts (unless they put up a prohibitive bond).

The three features specified are (1) duplicate actions, (2) allowance of extravagant fees, and (3) settlements without notice (p. 25). Are they uncorrectible?

(1) The Report discusses but is unable to suggest any specific cure for "duplicate actions". Over two years ago, the present writer pointed out this abuse and suggested an inexpensive and practicable remedy to limit the institution of concurrent suits (thereby also disposing of many problems in consolidation and stay). To avoid the claim that the complainant in a subsequent suit in the same court was not aware of an earlier suit which had been instituted, rules might require that in a stockholder's derivative suit the first defendant named be the corporation on behalf of which suit is brought, that a copy of the complaint be filed with the Court Clerk immediately after service upon the first defendant served, that a list of these derivative suits be indexed under the names of the nominal defendant corporations in a special register open to public inspection, and that no subsequent suit on behalf of the corporation be brought without special leave of court. Not only would secret suits (and settlements) then be impossible, but a prospective suitor could readily learn whether any prior suit had been brought; if it had, his remedy would then be by way of intervention, at which time he could point out

²⁶ *Overfield v. Pennroad Corporation* (E.D. Pa. 1941) 42 Fed. Supp. 586, (E.D. Pa. 1943) 48 Fed. Supp. 1003. The total is computed in *New York Times*, Jan. 20, 1943, at 27.

what he thought were weaknesses in the original complaint or in the manner of prosecuting the action that he would seek to cure. The nature of his criticism might be the basis for determining whether he should be allowed to intervene, and the extent of the control, if any, he should exercise over subsequent prosecution of the suit.²⁷

Is the Report's reluctance to mention this solution or to sponsor any other effective remedy due to awareness that such multiple suits "handicap the prosecution of the case on the merits" (p. 75)?

(2) The Report considers *in extenso* fees awarded successful counsel in the prosecution of these suits, and implies, without stating directly, that their award has not been on a moderate scale (p. 9).²⁸

Last year, the present writer suggested enactment of a "costs" statute requiring that fiduciaries adjudged guilty of breach of trust reimburse the corporation for the cost of obtaining redress from them, an expense which in some cases amounts to hundreds of thousands of dollars.²⁹ If the fiduciary defendants, rather than the corporation, paid these fees, (a) not only would the expense of successfully prosecuting the suit fall on those responsible for making suit necessary, but (b) there is no doubt that they would question excessive fees, if such were proposed.

Although the Report keeps recurring to the subject of fees, it makes no suggestion for correction of the present practice, because—it states—there is (a) some evidence of a tendency of appellate courts to limit counsel fees to reasonable figures, and (b) "too-rigid regulation of allowances . . . might conceivably be an encouragement of extortionate private settlement of claims in which all stockholders have an interest" (p. 11). Only one case is cited to support the first reason assigned (p. 78) and that the case of a corporation *not* publicly owned. This leaves only the second reason which is inconsistent with the position taken by the Report on the feature next to be discussed.

²⁷ Hornstein, *Problems of Procedure in Stockholder's Derivative Suits* (1942) 42 COL. L. REV. 574, 581.

²⁸ The Report, at 79-81, lists tables of cases showing the ratio to the recoveries of the allowances to complainant's counsel. Half of these duplicate tables of cases in earlier articles by the present writer. Discrepancies are due to conflicting figures in the court records as to the amount of recovery, and the inclusion of disbursements in the record of allowances for "counsel fee and other compensation." Cf. Hornstein, *Counsel Fee in Stockholder's Derivative Suits* (1939) 39 COL. L. REV. 784, 814; Hornstein, *op. cit. supra* note 27, at 587.

²⁹ Hornstein, *Directors' Expenses in Stockholders' Suits* (1943) 43 COL. L. REV. 301, 315-316.

(3) The Report discusses but discreetly avoids condemnation of "private settlements" (pp. 89-93). This follows the party line of fellow-travellers by limousine. When the Law Revision Commission in 1942 proposed that, to correct this unquestioned abuse, New York adopt a provision comparable to Federal Rule 23(c), "substantial opposition developed against this on the part of corporations and defendants' attorneys" (p. 89), and the Law Revision Commission recommendation did not become law. At that time, the present writer pointed out that the possibility of secret settlements in the New York State courts is one reason why defendants preferred the state courts and frequently decided not to transfer to the federal court causes which are removable to it.³⁰

While the Report records the Hopson (Associated Gas & Electric system) cases as "the only concrete examples of actions of probable merit having been stifled in this manner" (p. 91), the present writer, confining his examination to the 46 cases listed in the Report in which publicly-owned corporations obtained recoveries either on judgment or court-approved settlement, finds no less than nine recoveries in which numerous earlier secret settlements were uncovered. For example, in the case of one corporation three earlier suits were "privately" settled³¹ before the trial which the Report cited as an example of protracted trials so costly to the public (p. 8). The public trial resulted in a settlement—after completion of the plaintiffs' case—of \$1,500,000 paid to the corporation.

Earlier settlements without court approval have not always been for trifling sums. In at least three corporations, sums approximating a million dollars—for each corporation—were paid *out of the corporate treasury* in settlement of suits brought on its behalf against the individuals who had wronged it.³² May the Report's reluctance to interfere with "private settlements" result from the fact that, of

³⁰ Hornstein, *op. cit. supra* note 27, at 591.

³¹ Ottenheimer v. Securities-Allied Corporation (1932, N.Y. 9103); Rottenberg v. Securities-Allied Corporation (1933, N.Y. 18898); Gurin v. Odum (1934, N.Y. 10890). All the foregoing suits were referred to in the complaint in Donovan v. Atlas Corporation (Securities-Allied Corporation), *supra* note 8.

³² American Tobacco Co.: New York Times, July 29, 1939, at 30; March 11, 1941, at 41; see also Heller v. Boylan (Sup. Ct., 1941) 29 N. Y. S. (2d) 653, 694, *aff'd* (1941) 263 App. Div. 815, 32 N. Y. S. (2d) 131.

Associated Gas & Electric Co. system: New York Times, Jan. 1, 1941, at 21; see also Report, *supra* note 10, at 54.

Bethlehem Steel Co.: New York Times, Dec. 27, 1941, at 23; see also N. Y. L. J., Dec. 26, 1941, at 2129.

course, no court could knowingly approve a settlement paid for by the corporation on whose behalf suit was brought? Such settlements are least expensive—in fact, no expense at all—to the defendant directors, and at the same time are sometimes effective to bar subsequent suit.³³

Not all secret settlements are effective as a defense, and in such cases are as unsatisfactory to the defendants as to the community. So, in one case, earlier private settlements exceeding a million dollars—in this instance, paid by defendants other than the corporation on whose behalf suit was brought—proved no bar to a subsequent successful suit in which \$2,500,000 additional was secured.³⁴

On the subject of “discontinued” cases, we find the Report admitting confidential information that somewhat less than 50 per cent of them were privately settled (p. 33). It assumes that there was no merit in any of these, but the present writer, on the contrary, believes it safe to assume some merit in any “discontinued” suit where the file contains the damning notation “All papers returned to attorneys.”

We learn from the Report, however, that “the policy of our law is and should be more concerned with the dispatch and termination rather than the continuance and maintenance of litigation” (p. 90), and consequently that “the vice of settlement of nuisance actions is not that they are settled without notice to stockholders, but that such actions can be freely brought in the first place” (p. 92).

E. Other abuses disturbing to fiduciary defendants

The Report also comments on a number of other abuses which disturb the fiduciary defendants.

It is shocked at the “amazing example” of lengthy examinations before trial, especially those which occurred in the General Investment Corporation case (pp. 61-62),—“merely one manifestation of the perversion of necessary remedial processes of law to the purpose of a free-for-all speculation in lawyers’ fees” (p. 66)—but omits to state that in that case the corporation (after a change of management) had joined with the complainant stockholders in the successful suit to compel delinquent fiduciaries to account. “Amazing” as may have been the examination before trial—the present writer is not familiar with that phase of the case—it could not have been so

³³ *Manufacturers Mut. Fire Ins. Co. v. Hopson* (Associated Gas & Electric Co. system) (1940) 176 Misc. 220, 25 N. Y. S. (2d) 502, *aff'd*, (1941) 262 App. Div. 731, 29 N. Y. S. (2d) 139, *aff'd*, (1942) 288 N. Y. 668, 43 N. E. (2d) 71.

³⁴ *New York Times*, April 15, 1937, at 1 (Chase Nat. Bk.).

shocking as the wrongdoing in the corporation disclosed in the S.E.C. Investment Trust Hearings.³⁵

The Report sheds crocodile tears (pp. 8, 88, 115) over the costs to the corporation which were imposed three years ago by N. Y. General Corporation Law §61-a, a law which, the Report states, "placed the burden of the expense of their defense where it next least fairly belonged" (pp. 20, 85). Unstated is the fact that §61-a, like the law presently under discussion, was rushed through the Legislature at the behest of corporate management—without a public hearing.

The legislation of three years ago, whose unfairness is now admitted by its proponents as well as its opponents,³⁶ is given as an excuse for more legislation which is even worse. If "unsuccessful" stockholder suits (remembering that failure in a majority of cases resulted from application of the Statute of Limitations or as a result of "settlement" just prior to adjudication of guilt) are costly to the corporation as the result of an ill-advised law, would not the reasonable solution be repeal or modification of that law rather than passage of still another which carries in its train greater inequities—even inequities?

F. Other abuses not disturbing to fiduciary defendants

It is very significant that no recommendations appear in the Report to correct conditions unfairly prejudicial to the complainant stockholder—even if he does own 5 per cent of the outstanding stock. The Report admits that the requirements for pleading the complaint in a stockholder's derivative suit are much stricter than in ordinary suits and come close to the line of requiring the pleading of evidence (pp. 60-61). Yet the Report offers no suggestions to alleviate or eliminate this injustice. It is also well recognized that the courts are continually increasing the amount of proof required.³⁷ The fact that most decisions in favor of the defendants resulted from application of the Statute of Limitations—that the wrongdoing had been kept concealed by an entrenched management—does not cause the authors

³⁵ Report of the S.E.C. on Investment Trusts and Investment Companies, *op cit. supra* note 23, at 497 *et seq.*

³⁶ Some failings and undesirable consequences of the earlier law were pointed out in an article by the present writer, Hornstein, *loc. cit. supra* note 29.

³⁷ See cases of reversal by appellate courts of judgments in favor of the complainants in the trial court. A list of such cases appears in the Report, *supra* note 10, at 41, n. 27.

of the Report any qualms.³⁸ Quite the contrary. In true Alice-in-Wonderland spirit, the Report says:

"The shortening of the period of limitations upon derivative actions is thus another recognition and consequence of the irresponsible and unfounded litigation in this field, and another reason that it seems particularly desirable that those initiating such litigation be made responsible for it to the extent of at least assuming reasonable costs in event of failure to prove their claims." (p. 95).

The pattern is simple: Shorten the Statute of Limitations. The action then being defeated on this technical ground, penalize the corporation to the extent of defendants' counsel fees expended to prevent the corporation from recovering its money. Once that is done, ask why have the corporation suffer twice? Is it not cheaper for the corporation to swallow its loss and prevent suits for recovery? This type of logic—reminiscent of the *Mikado*—apparently persuaded the New York Legislature. In addition to Justice being blindfolded, the scales of justice have now been taken from her.³⁹

G. *The recommendation of the Report*

The Report first explains that, as a result of the "historical development of New York decisions" (p. 16), any stockholder may institute suit, regardless of how little stock he owns. The implication that this is a freak concept of New York law is utterly unfounded. The concept that the size of plaintiff's interest cannot be a determining factor has also been adopted by the Supreme Court of the United States, which declared: "If otherwise entitled, they should not be

³⁸ Cf. New York County Lawyers' Association, Committee on State Legislation, Report No. 285, disapproving the legislation discussed in this article: "Defeat of a justified suit, stoutly prosecuted,—on the ground that the cause of action was discovered too late or, rather, too long successfully kept concealed by an entrenched management—is included presumably in the statistical summary cited to discredit stockholders' suits. To our minds the record of defeats in such actions proves little except their difficulty and the resourcefulness of the defendants' counsel."

³⁹ The message of Governor Dewey, explaining his approval of the bill, stated:

"In recent years, a veritable racket of baseless lawsuits, accompanied by many unethical practices, has grown up in this field. Worse yet, many suits that were well based have been brought, not in the interest of the corporation or of its stockholders, but in order to obtain money for particular individuals who had no interest in the corporation or its stockholders. Secret settlements—really payoffs for silence—have been the subjects of common suspicion."

The Governor thereupon signed the bill—not one which barred secret settlements—but which effectually barred suits, the well-based as well as the baseless.

denied the relief which would be accorded to one who owned more shares."⁴⁰

The Report thereupon makes a recommendation which stops just short of forbidding derivative suits altogether. It urges barring suit by minority stockholders unless they put up bond or own 5 per cent of the outstanding stock of the corporation (p. 21).⁴¹ In a large publicly owned corporation, either alternative is insuperable.⁴² Under the Report's recommendation, the suit on behalf of General Motors Corporation could not have been instituted unless the holders of over 2,000,000 shares (having a current market value of over \$100,000,000) joined.⁴³

Since, in a publicly owned corporation, it is notorious that rarely will any one person—not already in the management—own as much as 1 per cent of the outstanding stock, the recommendation of the Report, in practice, would be an absolute bar, unless stockholders owning 5 per cent of the stock could collectively be aroused to institute suit. Realistically, is this possible? It is well known that stockholders do not attend meetings, and the Report admits that the only way a complainant stockholder can attempt to inform the other stockholders is by a statement (of not more than 100 words) to be sent out together with other proxy material issued by the corporation (pp. 15, 25).

Firstly, a threat of prosecution for alleged libel might help discourage the complainant, especially since it would be no easy matter to state accurately in 100 words complicated legal transactions; the average complaint in a stockholder's suit runs to 10,000 words. Secondly, no matter how meritorious the complaint, it is well known that large stockholders will not sue for fear of reprisals and small stockholders will be reluctant to participate in a suit which will subject them to costs if it proves a failure—regardless of the reasons for the

⁴⁰ See *Ashwander v. T.V.A.* (1936) 297 U. S. 288, 318, *per* Hughes, C. J.

⁴¹ The alternative of owning stock having "a market value in excess of fifty thousand dollars" was added by the Legislature. *Supra* note 10.

⁴² The T.N.E.C. study disclosed that ownership of as little as 10% of the outstanding stock will give effective control of a corporation. T.N.E.C., Monograph No. 29 (1940) c. 6. There is a presumption of *control* in ownership of 10% of the stock of a public utility corporation,—the typical publicly held corporation. PUBLIC UTILITY ACT OF 1935, §2(a) (7) and (8), 49 STAT. 806, 15 U.S.C. (1941) §79b (a) (7) and (8). The practical impossibility of bond has already been demonstrated. *Supra* note 7.

⁴³ Of course, after E. I. du Pont de Nemours & Co.'s 27% interest in General Motors Corporation, no single stockholder in the latter corporation owns anything approaching 5% of the outstanding stock.

failure. If further deterrent be needed, there is the certainty that participation in a suit will result in their being called "strike-suitors", an epithet indiscriminately applied to anyone who has ever ventured to impugn the honesty of Hopson or any other defendant in a stockholder's derivative suit. One can imagine what other efforts corporate management will employ (at the corporate, *i.e.*, the stockholders' expense) to obtain immunity from suit when all they need succeed in doing is to discourage joinder by other stockholders.

The Report concedes that of the 46 *successful* suits, in only two did the complainants own as much as 5 per cent of the stock. In one, the complainant was both a director and the holder of more than 5 per cent of the stock,⁴⁴ and in the other the complainant owned 100 per cent of the preferred stock.⁴⁵ The Report does not give the market value of the shares, so that we cannot tell how many of the holdings of complainants in other cases could have come within the \$50,000 alternative which was added by the legislature. In one of the successful suits listed in the Report, although the stock owned by complainants originally cost more than \$50,000, by the time of suit, as a result of some of the wrongs complained of, the market value of the stock was less than that figure. Under the new law, if the directors can sufficiently deplete the assets of the corporation, they not only profit more, but can make themselves immune from suit. The theory is not new; under the Statute of Limitations if a wrong is not only committed, but also concealed—and concealed long enough—it also gives the guilty parties immunity from suit.

The scope of the research resulting in the Report apparently did not extend to a consideration of requiring, as did pre-war European countries, that directors deposit security for their acts as managers.⁴⁶ Not only the non-director stockholders so indiscriminately reviled in the Report, but directors also—rarely own as much as 1 per cent of the outstanding stock in a publicly held corporation.⁴⁷

* * *

The foregoing then is the achievement of the Report. It is to be regretted that, with the time and money available to and expended by

⁴⁴ *Andrews v. Hupp Motor Co.* (1934, N.Y. 20878) in the Report's list of settlements, at 51.

⁴⁵ *U. S. Lines, Inc., v. U. S. Lines Co.* (S.D.L. 57-195), also in the Report's list of settlements, at 51.

⁴⁶ See Hornstein, *op. cit. supra* note 18, at 426, n. 133.

⁴⁷ T.N.E.C., Monograph No. 29 (1940) xvi, summarized the result of its study, as follows:

the Special Committee on Corporate Litigation of the Chamber of Commerce responsible for the Report, the result is a work of epithet and sarcasm instead of a coherent and well-planned judgment of the place of the stockholder's suit or a suggestion of some better remedy for the evils it is designed to redress.

How does the new law it sponsored fit into our theories and ideals of legal philosophy?

The corporation is a self-governing sub-group within the "State" (term used in its broad sense), as distinctive as the Church. If law and order are to be preserved, there must be opportunity for "State" adjudication of conflict within the sub-group.

Despite the failings of the stockholder's suit as a means of corporate control—and the present writer has previously stated his belief that it is a very inefficient device,⁴⁸ it should be unnecessary at this late date to justify the importance of continuing untrammelled this carefully evolved judicial remedy—until some better device can be found to discourage and redress the intracorporate abuse whose existence in some corporations has been incontrovertibly demonstrated.

The corporation can act only as a unit, and the general rule is that a vote of the majority determines the corporate will and binds the corporation. Corporate theory, therefore, gives even admitted fraud the form of legality. More fundamental than the doctrine that the majority rules, therefore, is the principle that the corporate assets and profits must be honestly administered for the benefit of their owners, for *all* the stockholders.

The courts, accordingly, realizing the need for equitable control, have uniformly held that if a corporation has been injured and should sue, but refuses to sue, or is under the control of those who have wronged it, a stockholder may maintain a suit in equity on behalf of the corporation.

This right of the minority stockholder to safeguard his property

"The financial stake of officers and directors in their own corporations is relatively small. Officers and directors own 6 percent of the common stock and slightly over 2 percent of the preferred stock of the 200 corporations. One-half of the individual officers and directors own securities having a market value (as of September 30, 1939) of less than \$20,000 each. There were only 245 cases—or slightly more than 1 per company—in which a single officer or director held stock worth more than \$1,000,000 in his corporation."

And the smallest of these 200 corporations had assets of \$62,900,000. *Ibid.* at 349.

⁴⁸ Hornstein, *op. cit. supra* note 28, at 786.

interest by suit had been believed to be assured by provision in the New York state constitution forbidding interference with the court's equity jurisdiction⁴⁹ and by provisions in both the federal and the New York state constitutions prohibiting laws in violation of "due process" and "the equal protection of the laws."⁵⁰ Is not the spirit of the Constitution violated by a statute which is discriminatory and closes the courts to suitors less wealthy than others, by imposing prohibitive terms? It may be noted, moreover, that there is no reciprocal provision in favor of the complainant or the corporation; if the suit on its behalf is successful, the guilty defendant directors pay only the statutory "costs", although actual expenses, including attorneys' fees, in establishing misconduct may well have been much more and, in fact, may exceed the total recovery.

The closing paragraph of the Report, generously states its position to be that "If the transaction were one which it was beyond the power of a majority of stockholders to ratify, *and* if a substantial percentage of the stockholders agreed that suit should be brought, few would deny that it should be maintained without any security for costs or imposition of costs in the event of failure." (p. 117). The Report agrees that under the New York law the only transactions not capable of being ratified are breaches of trust, fraud and misappropriation (p. 24); but even as to these the new law demands either joinder by stockholders owning \$50,000 worth of stock or security for costs before the courts can be resorted to.

Realistically, limiting suits to complainants who already own \$50,000 worth of stock, aside from being clearly undemocratic, restricts suits to people with wealth who presumably can be persuaded not "to upset the apple cart." Under the new law, if the complainant owns \$50,000 worth of stock and persists in suit, he neither puts up bond nor pays attorneys' fees, even if he loses. If that is not "rich man's law," what is?

Relief may come from the Federal Courts if they adjudge this

⁴⁹ N. Y. CONST. (1938) art. VI, §1.

The new law—as recommended in the Report—is mandatory upon the court. The Report (pp. 18-19) had suggested as precedents two provisions making it *discretionary* with the court whether to require security for costs in proceedings against express trustees. The Report, of course, is careful not to carry the analogy to express trustees all the way. When the Report discusses the question of *liability* of directors, the distinction between trustees and directors is carefully pointed out, at 103-111.

⁵⁰ U. S. CONST. AMEND. XIV; N. Y. CONST. (1938) art. I, §§6, 11. See also *Blythe v. Enslin* (1929) 219 Ala. 638, 643, 123 So. 71, 75.

new law "procedural" and therefore not binding upon them. The present writer believes the law is procedural. The Report, however, apparently believes that the law should be considered "substantive" and therefore closes the doors of the Federal Courts, as well (p. 18). If its interpretation be sustained, lost would be our democratic tradition that "substantive" law at least applies equally to the rich and the poor.

Nor is the question of redress for wrongdoing the only matter at stake. It has always been recognized that stockholders' suits serve a double purpose. Even more important than the recoveries—which have been very substantial—is their deterrent effect in discouraging other would-be malefactors. The fear of such actions, a recent opinion confirmed, has undoubtedly prevented diversion of large amounts from stockholders to managements and outsiders.⁵¹

Since all means of control other than the stockholder's suit are expressly rejected by the Report (pp. 22-24, 116-117),⁵² the practical abolition of stockholders' suits constitutes an invitation to corporate management to repeat the scandalous behavior exposed during the past ten years in governmental investigations and in 46 successful civil suits in the three courts studied.

In a democracy, some means always develops to right wrongs, and the short-range approach evidenced by this new law will ultimately compel legislative regulation of corporations,⁵³ a suggestion which in the past has provoked corporate-management-inspired cries that such legislation would be "bureaucratic", "unprecedented in American Law", and "un-American".⁵⁴ Meanwhile, however, the suits now pending against delinquent fiduciaries will have been defeated and they will be secured in their ill-gotten gains. Should this new legislation be adjudged constitutional, in New York of literary interest only will be Judge Cardozo's oft-quoted statement of ethical standards:

"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of

⁵¹ See Rifkind, J., in *Brendle v. Smith* (S.D.N.Y. 1942) 46 F. Supp. 522, 525.

⁵² See also Hornstein, *op. cit. supra* note 18, at 451-454.

⁵³ The power to control without ownership is unregulated except for recent Federal regulation. Hornstein, *Corporate Control and Private Property Rules* (1943) 92 U. OF PA. L. REV. 1.

⁵⁴ These same individuals see nothing "un-American" in barring the courts to those who own less than \$50,000 worth of stock.

the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. *Wendt v. Fischer*, 243 N. Y. 439, 444, 154 N. E. 303. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."⁵⁵

The fact that, as stated in the opening of this article, New York legislation has frequently been a model for other states makes it important that legislators elsewhere understand the unreliable props for the legislation herein discussed. It is to be hoped no others will follow this example.[†]

⁵⁵ *Meinhard v. Salmon* (1928) 249 N. Y. 458, 464, 164 N. E. 545, 546.

[†]After this article was set up in print, the statute herein discussed was held constitutional by Justice Collins of the New York Supreme Court, *Shielcrawt v. Moffett*, N. Y. L. J., May 17, 1944, at 1905. The learned Justice, however, suggested appellate review of his ruling, questioned the wisdom of the legislation, and observed:

"It would be denying the obvious to deny that the dire effect of the statute—if not the deliberate purpose of it—is to bar many stockholders' actions by making them excessively costly and difficult."