The Federal Courts as an Effective Forum in Shareholders' Derivative Actions

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INTRODUCTION

The corporate structure, as we know it in the United States today, is an uneasy balance between the conflicting rights and desires of several groups. The constant pressure of these various groups to compel corporate action favorable to a particular group is not always apparent to outsiders, but it is a factor of the greatest importance in determining the direction of corporate policy.

The groups involved in corporate operations are generally listed as being four in number: the stockholders, those persons who have invested funds in the corporation with the expectation of receiving a fair return; the employees, those persons who today are the most organized of the groups through labor unions; the creditors, the group who through substantial investments of one kind or another make the expansion of corporate activities possible; and the public, the long-suffering consumer group that provides the corporation with a market for its products and a showcase for its philanthropic activities.

To this enumeration the writer would add a fifth group having a direct interest in corporate activity and a reason for seeking to direct the policy of the corporation to the fulfillment of its own ends. This, of course, is the management of the corporation, a highly trained professional executive group that operates entirely separate and apart from the stockholder group in the large corporation, and which has ends in mind which do not always square with those of the "ownership" class.

It seems fruitless to restate the various interests and desires of the particular competing groups here. This has been done often and well in recent years.1 It should be emphasized, how-

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ever, that we have not and perhaps never will reach that utopian situation in which the corporation will be able to satisfy completely all of these groups at one and the same time. The present situation is one where the corporation reacts to the pressures of the competing groups through a constant process of adjustment. The line of corporate progress is not one straight path to the end, but is rather a series of deviations from this path towards the interests of one or more of the particular groups—a series of swings back and forth across the basic line causing one at times to wonder whether or not the end is clearly in view.

In this process of progress, the interests of some of the competing groups will of necessity be subordinated to those of the temporary victor—a process by which some one or more will be hurt. The purpose of this article is to focus upon one group, the stockholders, and to examine the situation where this group has been hurt by those actions of management constituting an abuse of its powers. Specifically, the writer intends to examine the availability and suitability of the federal courts as a forum for the effective redress of these wrongs.

BACKGROUND

In the early days of industrial development and expansion, the individual possessing limited capital could expand his sphere of operations by joining with one or more persons similarly situated in a pooling operation. A unit was formed—the corporation—consisting of the sum of its parts; a sum which could accomplish that which its components individually could not. The owners of the respective interests were, for the most part, also the operators of the enterprise, and at this point we have no separation or competition between ownership and control of the corporation. As the operation prospered and further expansion was contemplated, additional capital became necessary. In the usual case, this required the addition to the corporation of persons who were not interested to any great extent in the routine of the entity, but who were only interested in receiving a suitable return on the capital invested. As the corporation becomes larger and larger, more and more the stockholders become simply investors, persons who make available capital to the corporation without participating substantially in the management thereof. As the representation of the stockholder's interest in the corporation achieves a value of its own, quite apart
from that which it represents, and as the transfer of the stock becomes a simple and ordinary process, we find that a new class has been developed within the corporate framework. The investor-stockholder now possesses ownership, but does not have control of the operation of the corporation.2

This situation is a natural product of the development of corporate enterprise, but it reflects a basic change in both the theory and the nature of the corporate device. This too has its effects: "Generally what is good for the stockholders is good for their corporation, and conversely what is good for the corporation is good for its stockholders. But what is good, in business as in morals, is not always beyond debate. Differences of opinion as to the proper course of corporate conduct are therefore inevitable." The development of differences of opinion as to the course of corporate conduct is not the only effect, however. With the creation in the corporation of a new professional management group to steer its economic course, the stockholders have made possible the situation where the dog may bite the hand that feeds it. The management group has the tremendous power of the purse which it may exercise, as well as inside knowledge of the operations and intentions of the corporation. This concentration of power constitutes a severe test of the honesty and integrity of the managing group, and it is to be deplored, but expected, that some will succumb to the forbidden fruit.4 This paid group of professional managers may impinge upon the rights of the stockholders in many ways profitable to themselves.5

When there is such malfeasance on the part of the officers and/or directors of a corporation, the stockholders are faced

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3. ROHLICH, LAW AND PRACTICE IN CORPORATE CONTROL 96 (1933).
4. "Executive power in a corporation must be vested in directors or some equivalent group of managers, who generally will act with conscience and integrity in the interest of the stockholders — the owners of the enterprise. Some corporate managers, however, may be expected to yield to the temptation that goes with opportunity for personal profit." Hornstein, New Aspects of Stockholders' Derivative Suits, 47 COLUM. L. REV. 1, 30 (1947).
5. "Court records are replete with illustrations of intracorporate abuse. 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 such abuse the form of legality." Hornstein, The Counsel Fee in Stockholder's Derivative Suit, 39 COLUM. L. REV. 784 (1939). For a survey of state legislation declaring a standard of conduct for corporate managers, see Hornstein, Legal Controls for Intracorporate Abuse — Present and Future, 41 COLUM. L. REV. 405, 429 et seq. (1941).
with the necessity of finding a remedy which will effectively correct the wrong done. The scope of the available remedies is small indeed, both in number and in effectiveness. Perhaps the first thought of the average stockholder is to “throw the rascals out.” This, of course, is easier said than done. The electoral process by which the stockholder in theory is enabled to choose the management of his corporation proves in practice to be something of an illusory remedy. With the great increase in size of the modern corporation has come a concomitant increase in the number of stockholders, each of whom will own only a relatively small number of the shares of the corporation. This fact, together with the device of proxy voting, makes but a hollow shell out of the once effective control device of the stockholder’s power of the ballot.

Next to come to mind is generally the stockholder’s “escape hatch” — his power to dispose of his shares of ownership in the corporation. This can hardly be described as an effective remedy, however, since the injury to the corporation through the mismanagement or malfeasance of the management group is certain to have an adverse effect on the value of the stock owned by the shareholder. He is, in a sense, merely cutting his losses by retreating from the scene of the crime. The ordinary shareholder with but a minute interest in the affairs of the corporation and an overriding interest in the security and prosperity of his investment will normally choose this, the easy way out. As a result of this usual reaction on the part of the stockholders, the management group is oftentimes emboldened to continue or expand its efforts to profit at the expense of the corporation, its shareholders, employees, and creditors, and, of course, the public. The depredations perpetrated on the corporation may, in this situation, never come to the attention of the public, or, indeed, to the attention of the employees or creditors of the corporation. Skill in malfeasance is just as necessary and profitable as in other areas. In fairness, it may be said that the stockholder who holds only a minor interest in the corporation is probably best advised to take this course of action, for it provides him with the greatest protection at the lowest cost and

6. The number of stockholders in the United States increased from 6,490,000 in 1952 to 12,490,000 in 1959. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 470 (1959).

removes him from the possibility of being twice burnt by the same blowtorch.

This rather jaundiced view of the self-help remedies available to the injured stockholder clearly indicates that he cannot in the usual case protect himself against the wrongdoing of management. The alternative is the intervention of the courts to protect such shareholders and to remedy the wrongs committed. Obviously the courts possess the means of doing this, but there has been, over the years, a certain reluctance on the part of the courts to inject themselves into the complexities and problems of conduct of corporate affairs. This reluctance is probably an outgrowth of the judicial feeling that courts are not regulatory bodies, that only in extremely rare situations can they become involved in the supervision of the conduct of private enterprise, and that the power of the courts should be invoked only when there has been a wrong that the court is capable of righting. This is not to say that the courts have been unaware of the problems of the defrauded stockholder or that the courts have turned their collective backs upon the injured party in such cases. It does mean, however, that the path to the attainment of judicial intervention in corporate affairs is one fraught with much difficulty and expense.

The courts will readily open their doors to a stockholder who can show that a personal right of his has been invaded by the action of the corporation or individual members of its management. In modern corporate affairs, however, this is a relatively rare situation. Generally the wrong complained of is not a direct injury to any one or more of the stockholders, but is rather a wrong to the corporation that indirectly affects the interest of the stockholder in the corporation. It is to correct this situation, where a direct action is not available to the stockholder, that the derivative action comes into play.

**DERIVATIVE ACTIONS**

As is indicated above, the general category of malfeasance on the part of corporate directors and officers today consists of actions which directly injure the corporation and only in-

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9. For a discussion of the development of equitable control over corporate action, see Rohrlich, *Law and Practice in Corporate Control* 96 et seq. (1933).
directly the stockholder. When the particular wrong is committed, the corporation is, of course, entitled to bring an appropriate action against the wrongdoers—the directors, officers, and/or third persons involved. This right is personal to the corporation, as it is the wronged party. However, more than one hundred years ago it was recognized by the courts that the corporation, for reasons which might be perfectly honest, or on the other hand completely sinister, might choose not to institute the action necessary to remedy the wrong. Where the alleged wrongdoers are in positions of control over corporate activity, it is not difficult to see why such an action might not be commenced. At this point, and because of these facts, equity intervened with a realistic solution to the dilemma of the aggrieved stockholders and created a method of enforcement of the corporate right by the stockholders. This is known as the stockholder's derivative action.10

It is important to note the technique. The courts did not choose to ignore the corporate entity and extend the right of the corporation to its members, nor did they create a separate and independent cause of action on the part of the stockholders. The method chosen was to allow one or more of the stockholders to proceed on behalf of the corporation to enforce the existing corporate right. A clear understanding of this distinction makes the solution both a recognition of the traditional legal structure of the corporation as an entity entirely separate and distinct from its stockholder members, and a recognition of the need for some degree of control by the stockholders over the management of the corporation.

At the outset it must be remembered that the stockholder’s derivative action is but a procedural device for the enforcement of substantive rights existing independently of the means of enforcement. The derivative action does not create nor confer upon a stockholder any substantive cause of action. This right of action will exist by statute or decision of the particular state governing the activities of the corporation, if it exists at all. The means of enforcing the right—the procedural implementation of the right—will be governed by the particular rules of the state court or by the statute and rules governing the federal courts, depending upon the choice of forum. Our interest here is in such an action brought in the federal courts, and thus it

must be remembered that whether or not the stockholder-plain-
tiff has a cause of action that may be enforced by a stockholder's
derivative action in the federal courts is determined by the ap-
plicable state law.\textsuperscript{11}

The traditional situations in which the stockholders have
been authorized to bring a derivative suit are described in \textit{Hawes
v. Oakland,}\textsuperscript{12} as follows:

"Some action or threatened action of the managing board
of directors or trustees of the corporation which is beyond
the authority conferred upon them by their charter or other
source of organization;

"Or such a fraudulent transaction completed or contem-
plated by the acting managers, in connection with some other
party, or among themselves, or with other shareholders as
will result in serious injury to the corporation, or to the
interests of the other shareholders;

"Or where the board of directors, or a majority of them,
are acting for their own interest, in a manner destructive of
the corporation itself, or of the rights of the other share-
holders;

"Or where the majority of shareholders themselves are
oppressively and illegally pursuing a course in the name of
the corporation, which is in violation of the rights of the
other shareholders, and which can only be restrained
by the aid of a court of equity."

In recent years there has appeared a number of restrictions
on the right of a stockholder to bring a derivative action.\textsuperscript{13}
These limitations, generally achieved by state statutes, are based
upon a feeling that the derivative action has been used as the
vehicle for "strike" actions against corporations — actions de-
signed solely as attempts to enrich a stockholder who brings a
nuisance suit challenging a legitimate action of the corporation.
Without doubt this has happened, but the extent of the reaction
seems to be out of all proportion to the purported evil. The
effect of statutes such as the New York "security-for-expense"

\textsuperscript{11} Swanson v. Traer, 354 U.S. 114 (1956).
\textsuperscript{12} 104 U.S. 450, 452 (1881).
\textsuperscript{13} See de Capriles, \textit{Fifteen Year Survey of Corporate Developments, 1944-}
\textit{1959, 13 VAND. L. REV. 1, 15 (1959)}; Katz, \textit{The Philosophy of Midcentury Cor-
poration Statutes, 22 LAW & CONTEMP. PROB. 177, 184-185 (1958)}; Hornstein,
\textit{New Aspects of Stockholders' Derivative Suits, 47 COLUM. L. REV. 1 (1947).}
provision\textsuperscript{14} is to make even more difficult the prosecution of a proper derivative action, and thus the ultimate result is the removal from the rolls of stockholder remedies one that has proved over the years its effectiveness to control abuses of corporate power.\textsuperscript{15}

In addition to the ever-growing list of statutory restrictions, there are many other practical factors that tend to limit the usefulness of the derivative action as a stockholder protective device.\textsuperscript{16} The cost of such actions is, of course, great, and is unfortunately out of all proportion to the individual monetary advantage to be gained by the successful prosecution of the action. Even though it is uniformly held that a stockholder who is successful in a derivative action may recover from the corporation the cost of the suit, including attorney fees, the risk of losing such a complicated and difficult action weighs heavily against the utilization of the device.\textsuperscript{17} The natural disinclination of the average stockholder to take the offensive and bring a derivative action is understandable, and this also amounts to a built-in limiting device.\textsuperscript{18} Management with the treasury of the corporation behind it is obviously in a strong position in such suits,\textsuperscript{19} and when all else fails, the management may "buy out" the plaintiff-stockholder by offering to compromise the action. This may occur either by purchase of the stockholder's shares at a greatly increased price, or by arranging to reimburse the

\textsuperscript{14} N. Y. General Corp. Law § 61-b (1945); see Hornstein, The Death Knell of Stockholders' Derivative Suits in New York, 32 CALIF. L. REV. 123 (1944); Frampton, Indemnification of Insiders' Litigation Expenses, 23 LAW & CONTEMP. PROB. 325 (1958).


\textsuperscript{16} Stockholders are reluctant to sue, among other reasons, because "they usually know that the evidence is almost exclusively in the control of those who are charged with delinquency; that those same individuals are likewise in control of the funds of the corporation and may apply them in defense of their acts, whether those acts are innocent or wrongful; that in seeking a remedy the stockholder will be met with every obstacle and procedural delay that the ingenuity of skilled counsel can devise ..." Dresdner v. Goldman Sachs Trading Corp., 240 App. Div. 242, 269 N.Y. Supp. 360, 364 (1934).

\textsuperscript{17} See Hornstein, The Counsel Fee in Stockholder's Derivative Suits, 39 COLUM. L. REV. 784 (1939).

\textsuperscript{18} "It is all very well to say that the minority stockholder has his redress if his company is being managed in an adverse interest. He hasn't ... Litigating against one of these powerful systems is an expensive business. The pitfalls and delays are endless. It is a luxury reserved for the large holders and then only when they have plenty of money and infinite patience," Untermyer, Some Needed Legislative Reforms in Corporate Management, An Address, quoted in ROHLICH, LAW AND PRACTICE IN CORPORATE CONTROL 140, n. 105 (1933).

corporation for its loss on very favorable terms. It is a rare stockholder who, when presented with one of these offers, will not seek the course of least resistance, and this merely increases the freedom of action of the management of the corporation. Despite these inherent defects it seems that the number of stockholder's suits are increasing. This should come as no great surprise, however, for weak as it may be and despite all of its limitations, the stockholder's derivative action remains as the best of the available remedies for mismanagement or malfeasance on the part of corporate management.

JURISDICTION

The stockholder's derivative action may be brought either in a proper state court or, if the requisites are met, in an appropriate United States district court. The choice of the party.

20. "Tested functionally, the stockholder's suit — while better than nothing — is of a low degree of efficacy. Passing over wrongs which go unredressed because they are undiscoverable or so complicated that they cannot be unraveled before the applicable statute of limitations has run, and passing also the technical difficulties of establishing the wrong to the satisfaction of the court — in short, even where these two hurdles could be or have been successfully overcome, the stockholder's suit is still ineffective. When the complainant has an airtight case and the defendants are convinced of it, efforts will usually be made by the latter to effect a settlement, sometimes described as 'buying-off' the complainant stockholder." Hornstein, Legal Controls for Intracorporate Abuse — Present and Future, 41 COLUM. L. REV. 405, 425 (1941).


22. "For some time one such sanction has been the stockholders' suit, characterized by jurists and scholars alike as a 'wholesome' if inadequate remedy to expose corruption in the directing of corporate activities; this sanction not only has resulted in substantial recoveries, but has had an even more important effect in deterring would-be malefactors." Hornstein, New Aspects of Stockholders' Derivative Suits, 47 COLUM. L. REV. 1, 31 (1947).

23. In addition to the stockholder's derivative action, New York has created a director's derivative action (N.Y. Gen. Corp. Law §§ 60-61 (1943)) designed to achieve the same end, and freed from the usual restrictions. "The apparent absence of other case law on the director's derivative action in New York is somewhat surprising in view of its potentialities as an instrument for enforcing the fiduciary obligations of management in corporations where there is minority representation on the board." de Capriles, 1959 Annual Survey of American Law, Business Organization, 35 N.Y.U. L. REV. 613, 628-629 (1960). The New York Court of Appeals has recently held that the director's derivative action is based upon public policy, and that "the statutory authorization for suits by directors seeks to achieve the same end of vindicating the corporation's rights by a method less subject to the risk of abuse." Tenney v. Rosenthal, 6 N.Y.2d 204, 160 N.E.2d 403, 189 N.Y.S.2d 158 (1959).

24. New York has been a favorite place for the commencement of derivative actions due to the concentration there of a large number of corporate directors. In an eleven-year period 1,128 stockholder's derivative actions were filed in the state courts of New York County compared to 130 filed during the same period in United States District Court for the Southern District of New York. After the passage of the New York "security-for-expense" statute, the actions in the state courts fell to an average of two per year, while in the federal court the average
ticular forum, state or federal, involves many considerations. As has been pointed out above, no substantive advantage accrues to such a suit brought in federal court since the law governing the merits of the case will be the appropriate state law. The modern procedural rules applicable in the federal court and especially the extensive discovery procedure, constitute, however, an attractive inducement to the attorney considering a forum for a derivative action. The factors governing this choice of forum are, however, so numerous and to such a great extent a part of the strategy of particular cases as to make treatment here impossible. Rather, we will concern ourselves with the attorney who has made a preliminary determination that his suit is an appropriate one for submission to a federal court, and will investigate the problems he must face before his aim may be realized.

Because of the limited jurisdiction of the United States courts, the primary determination to be made is whether the suit is within the jurisdiction over the subject matter of the federal courts. For the most part, this determination is made as in all other cases sought to be brought in the federal courts. The fact that stockholders' derivative actions may be brought in the federal courts does not create a new basis of jurisdiction. This type of action may be brought only if there exists a statutory basis for the exercise of jurisdiction by the federal court. Almost without exception, derivative actions must qualify as diversity cases or there will not be jurisdiction. Diversity, of course, means diversity of citizenship — all parties on one side of the case being diverse in citizenship from all of the parties on the other side of the controversy.

Keeping in mind that the corporation is an indispensable party, then, the plaintiff will name as defendants the corporation and all of the alleged wrongdoers, whether directors, of...
ficers, or third persons. Generally such suits will include both representatives of corporate management and collaborating third persons. The citizenship of each of these defendants must be diverse from that of the plaintiff.

The necessity of joining the corporation as a party defendant may create a jurisdictional problem. The historical treatment of corporations for diversity purposes has been a strange story of judicial uncertainty and indecision. Originally corporations were not considered to be citizens for purposes of diversity, and the citizenship of all of the stockholders controlled. This doctrine soon gave way to an expedient determination that corporations were not citizens for diversity purposes, but that the citizenship of each of the stockholders of the corporation would be conclusively presumed to be that of the state of creation of the corporation. This presumption governed the diversity status of corporations for many years until Congress, in an effort to reduce the number of diversity cases in the federal courts, in 1958, decreed that a corporation should be deemed to be a citizen of any state in which it has been incorporated and of the state in which it has its principal place of business. The apparent effect of this amendment is that when a corporation is incorporated in a state other than that of its principal place of business, for diversity purposes, it is a citizen of at least two states—the state of incorporation and the state in which it has its principal place of business. If a particular corporation has been incorporated under the laws of more than one state, then it should be deemed to be a citizen of each of such states. It should be


29. This fiction was established in Marshall v. Baltimore & Ohio R.R., 57 U.S. 314 (1853). The reason for this judicial gymnastic was the fact that consideration of the citizenship of the individual stockholders of a corporation for diversity purposes effectively prevented corporations from suing and being sued in the federal courts. With the growth of the corporation as an important economic factor in the United States this situation could not be tolerated, but the courts of this day and age were not willing to take the ultimate step of declaring that an inanimate person could have citizenship for diversity purposes. The device of the conclusive presumption was evolved to solve the problem.

30. 28 U.S.C. § 1332(c) (1958), as amended by Act of July 25, 1958, § 2, 72 Stat. 415. The legislative history of this act indicates the desire of Congress to correct "the evil whereby a local institution, engaged in local business and in many cases locally owned, is enabled to bring its litigation into the Federal courts simply because it has obtained a corporate charter from another State." U.S. CODE CONG. & AD. NEWS 3099, 3101-3102 (1958).

31. The problem of the corporation incorporated under the laws of two or more states created a difficult jurisdictional question for the federal courts. Was the citizenship of the stockholders to be presumed to be that of each of the states of incorporation or merely that of the state of first incorporation? Quite naturally
emphasized that the state of incorporation and the state of principal place of business are not alternatives; the corporation should be deemed a citizen of each and every one of these states. Essentially, this would limit the freedom of a stockholder-plaintiff to elect the federal courts as the forum for his suit, since jurisdiction fails if there be identity between the citizenship of the plaintiff and any one of the states of which the corporation is deemed to be a citizen.

The term "principal place of business" is a troublesome one in the extreme. We are told that this is a factual question to be determined on the basis of the circumstances of each case, but what this really means is that there can be no certainty as to this point until the court has ruled on the question. There is no safe test by which the attorney for the plaintiff may evaluate the situation in his particular case, and because of this he may find, after commencing suit in a federal court, that his determination of the corporation's principal place of business does not accord with that of the particular judge involved, and as a result no diversity of citizenship exists. It seems incredible that a matter of such basic importance as the determination of the court's jurisdiction over the subject matter should be left in such a nebulous state. While paying lip-service to the rule that jurisdiction either exists or it does not, the courts are forced to determine the question on the basis of a standard which may


33. The legislative history of the amendment rationalizes the choice of this test as follows: "The proposal to rest the test of jurisdiction upon the 'principal place of business' of a corporation has ample precedent in the decisions of our courts and in Federal statutes such as the provisions of the Bankruptcy Act (11 U.S.C. § 11 [1958]). There is thus provided sufficient criteria to guide courts in future litigation under this bill." U.S. Code Cong. & Ad. News 3099, 3102 (1958).

34. The "circumstances" to be considered are apparently the character of the corporation, its purposes, the kind of business in which it is engaged, the situs of its operations, a general survey of the corporation's activities, and a comparison of its activities at each place in respect to their character, importance and amount. Moesser v. Crucible Steel Co. of America, 173 F. Supp. 953 (D.C. Pa. 1959). This determination may well require more time and effort than the sub-
mean either nothing or whatever one wishes to read into it. In short, this is a trap for the unwary, and one that in a doubtful case requires the plaintiff to guess as to whether the federal court has jurisdiction to hear and determine his case. We may develop some sort of a workable standard to assist in making this vital determination, but such a standard is in the future. For the present we are left to our own devices, a situation which has not proved to be notably successful in the past.35

When the determination is made that diversity of citizenship exists on the face of the complaint, the attorney for the stockholder is faced with still another possibility which may bring an abrupt end to his progress in the federal court. This hidden menace is known as the doctrine of realignment of parties. As stated in Indianapolis v. Chase National Bank,36 "Diversity jurisdiction cannot be conferred upon the federal courts by the parties' own determination of who are plaintiffs and who defendants. It is our duty, as it is that of the lower federal courts, to 'look beyond the pleadings and arrange the parties according to their sides in the dispute.'"

Let us assume this situation: P, a stockholder in the X corporation and a citizen of State A, brings a stockholder's derivative action against the X corporation, deemed to be a citizen of states B and C, Y, a citizen of state B, and Z, a citizen of state D. On the face of the complaint it appears that diversity jurisdiction exists. However, if the X corporation should be realigned as a party plaintiff, then diversity would fail since a citizen of state B would then be found on each side of the controversy in violation of the complete diversity rule.37 This has, in the past, been a most difficult situation, for the determination as to whether the parties were to be realigned was a most delicate question.38 In a stockholder's derivative action the right which

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35. As to whether the Bankruptcy Act provides sufficient criteria for determining this question, see Comment, 58 COLUM. L. REV. 1287, 1295 (1958); and Harker v. Kopp, 172 F. Supp. 180 (D.C. Ill. 1959).
37. See note 26 supra.
38. In the difficult and complicated case it is not a simple matter to determine where the "collision of interest" exists between multiple parties. "It must be ascertained from the 'principal purpose of the suit,' . . . and the 'primary and controlling matter in dispute.' . . ." Indianapolis v. Chase National Bank, 314 U.S. 63, 69 (1941).
the plaintiff is seeking to enforce is that of the corporation. Normally the corporation would be the party plaintiff, but because of refusal on the part of management, the stockholder is acting for the corporation. However, since the judgment will bind the corporation and a judgment if recovered will run in favor of the corporation, the corporation is denoted as an indispensable party and must be joined in the action.\footnote{39} Does the fact that the corporation has failed or refused to enforce its cause of action indicate that it is antagonistic to one of its stockholders who brings the action for the corporation? This is the very crux of the problem. If the corporation is antagonistic to the plaintiff-stockholder, then it is properly joined as a party defendant and diversity exists. If, on the other hand, the corporation is not deemed to be antagonistic to the stockholder and since the cause of action is that of the corporation, it should properly be realigned as a party plaintiff with the result that diversity will be destroyed.\footnote{40}

In the most recent case in which this problem was considered by the Supreme Court,\footnote{41} the holding was that, absent collusion, if the corporation refuses to act to enforce its rights, regardless of reason, then it is antagonistic to the stockholder attempting to enforce such right and is therefore properly designated as a party defendant.\footnote{42} In the illustration we have used above, this

\footnote{39. See note 27 supra.}

\footnote{40. "The cause of action which such a plaintiff brings before the court is not his own but the corporation's. It is the real party in interest and he is allowed to act in protection of its interest somewhat as a 'next friend' might do for an individual, because it is disabled from protecting itself. If, however, such a case as this were treated as other actions, the federal court would realign the parties for jurisdictional purposes according to their real interests. In this case, which is typical of many, this would put (the corporation) on the plaintiff's side... and jurisdiction would be ousted. ... But jurisdiction is saved in this class of cases by a special dispensation because the corporation is in antagonistic hands." Koster v. Lumbermens Mutual Co., 330 U.S. 518, 522-523 (1947).}

\footnote{41. Smith v. Sperling, 354 U.S. 91 (1957).}

\footnote{42. The court dealt with the issue of antagonism as follows: "There will, of course, be antagonism between the stockholder and the management where the dominant officers and directors are guilty of fraud or misdeeds. But wrongdoing in that sense is not the sole measure of antagonism. There is antagonism whenever the management is aligned against the stockholder and defends a course of conduct which he attacks... It seems to us that the proper course is not to try out the issues presented by the charges of wrongdoing but to determine the issue of antagonism on the face of the pleadings and by the nature of the controversy... The management may refuse or fail to act for any number of reasons. Fraud may be one; the reluctance to take action against a close business associate may be another; honest belief in the wisdom of the course of action which the management has approved may be still another; and so on. "As the court said in Delaware & Hudson Co. v. Albany & S.R. Co., 213 U.S. 435, 451, where the management was deemed to be antagonistic to the stockholder, 'The attitude of the directors need not be sinister. It may be sincere.' Whenever
would mean that there would be no realignment of the corporation and diversity jurisdiction would be preserved. It should be observed, however, that this was the decision of a court split five to four on this issue. Mr. Justice Frankfurter in the course of the dissenting opinion describes the majority opinion in this language: "The court thus makes the exception the rule, and by confounding the requirements for establishing a substantive cause of action with the requirements of diversity jurisdiction, it overturns a half-century's precedents in this court." 43

At the moment, and it is a moment of doubtful length, it would appear that a victory has been won by the stockholders. The spectre of realignment in a stockholder’s derivative action has now faded into the background. If there is no evidence of collusion between the corporation and the stockholder, whereby the stockholder is bringing the suit because the corporation could not do so in a federal court, diversity being lacking, 44 it seems that every such action will be within the jurisdiction of the federal courts, or rather, the corporate defendant will not be realigned in such cases, thereby destroying the requisite diversity. Under the antagonistic standard used by the court, whenever a stockholder’s derivative action can be brought, i.e., whenever the corporation refuses to act, then antagonism auto-

43. Id. at 95-97.

44. "Since the decision of this court in Dodge v. Woolsey . . . the frequency with which the most ordinary and usual chancery remedies are sought in the Federal courts by a single stockholder of a corporation who possesses the requisite citizenship, in cases where the corporation whose rights are to be enforced cannot sue in those courts, seems to justify a consideration of the grounds on which that case was decided, and of the just limitations of the exercise of those principles. "This practice has grown until the corporations created by the laws of the States bring a large part of their controversies with their neighbors and fellow-citizens into the courts of the United States for adjudication, instead of resorting to the State courts, which are their natural, their lawful, and their appropriate forum. . . . A corporation having such a controversy, which it is foreseen must end in litigation, and preferring for any reason whatever that this litigation shall take place in a Federal court, in which it can neither sue its real antagonist nor be sued by it, has recourse to a holder of one of its shares, who is a citizen of another State. This stockholder is called into consultation, and is told that his corporation is called into consultation, and is told that his corporation has rights which the directors refuse to enforce or to protect. He instantly demands of them to do their duty in this regard, which of course they fail or refuse to do, and thereupon he discovers that he has two causes of action. . . . [The overburdened courts of the United States have this additional important litigation imposed upon them by a simulated and conventional arrangement, unauthorized by the facts of the case or by the sound principles of equity jurisdiction." Hawes v. Oakland, 104 U.S. 450, 452 (1881). Out of this case arose the procedural limitations on the right of stockholders to bring derivative actions which were formalized in former Equity Rule 27 and the present Rule 23(b) of the Federal Rules of Civil Procedure.
matically exists. This result seems questionable regardless of one's personal feelings as to the liberality which should be afforded stockholders in bringing derivative actions. The majority decision apparently identifies the corporation with the management to the extent that it places the corporation itself in the position of being an active wrongdoer. In fact, this is not so. The corporation itself is a neutral agent. Management in this day and age certainly should be considered as having an existence separate and apart from that of the corporation — the status long accorded to the stockholders. If a wrong has been committed, it is not that of the corporate entity, but it is an act or omission by individual officers and/or directors. It is unrealistic to attach such significance to the inanimate corporation and to say that the corporation is antagonistic to a stockholder, when, in fact, the antagonism exists between the stockholder and the individuals who comprise the corporate management. If we were to slice through the gloss placed upon the corporate entity by the excessive and misguided use of fictions, we would surely come to the conclusion that the corporation should in all cases be made a party plaintiff in stockholder's derivative actions. Through the application of simple logic, it is difficult to reach any result other than that the entity that is alleged to have been injured, that "owns" the cause of action, and that will receive the benefit of a favorable judgment must be a party plaintiff in such suits. If, in fact, the stockholder is acting in a capacity somewhat similar to that of a "next friend," then this belief is strengthened, for is there any situation in which the "next friend" and the real party in interest are found on opposite sides of the controversy?  

The situation is one that leaves much to be desired. Ill-advised classifications of parties do not aid the cause of the stockholder. A decision not based upon reality or perception of the real nature of the controversy in a stockholder's derivative action merely serves as an invitation to attack upon the doctrine enunciated and a compounding of the already difficult position of the stockholder.

In addition to meeting the standards of diversity jurisdiction, the stockholder must also satisfy the amount in controversy re-

46. The same test of antagonism was applied in the companion case of Swanson v. Traer, 354 U.S. 114 (1957). The dissent in Smith v. Sperling also applies to Swanson v. Traer.
quirement. The jurisdictional amount necessary to confer jurisdiction on the federal court in all diversity cases, including derivative actions, is $10,000.00, exclusive of interest and costs.\textsuperscript{47} The test as to the presence of the required amount in controversy is the amount of damage asserted to have been sustained by the corporation as a result of the alleged wrongdoing.\textsuperscript{48} Rarely will the amount in controversy be a factor limiting the use of the stockholder's derivative action, for the simple reason that in order to arouse a stockholder to take action, the wrong must almost of necessity be very substantial, certainly in excess of the jurisdictional amount. This, then, should prove to be no detriment to the effectiveness of the stockholder's remedy in the federal courts.

A limiting factor of much more importance is the necessity of obtaining personal jurisdiction over all of the defendants. In the usual situation, the stockholder will be attempting to obtain some form of redress of a personal nature from the wrongdoing parties, and this, of course, requires that the court first obtain personal jurisdiction over all of the defendants, including the stockholder's corporation. The factor that makes satisfaction of this requirement difficult is the territorial limitation on service of process issuing out of the federal courts. Under Rule 4(f),\textsuperscript{49} service of summons must normally be made within the state in which the particular district court is sitting. This means that all defendants must be served within this particular state—a task that is not too easily performed today. If anything, it is probably more unusual than not to find all of the defendants in a case such as a stockholder's derivative action subject to service within the boundaries of a single state.

Congress has made available in the stockholder's derivative action a relaxation of this normal rule, one that does much to solve the service problem, by authorizing service of process on the corporation in any district where it is organized or licensed to do business or is doing business.\textsuperscript{50} It is unfortunate that the statute is phrased in terms of "district" rather than "state,"\textsuperscript{51} but it seems reasonably clear that the intent was to authorize

\textsuperscript{49} Fed. R. Civ. P., Rule 4(f).
\textsuperscript{50} 28 U.S.C. § 1695 (1948).
\textsuperscript{51} The use of the term "district" is common in venue statutes, and, in fact, the language of Section 1695 is almost identical with that used in Section 1391(c) dealing with residence of corporations for venue purposes.
service within any state wherein the corporation is incorporated, is licensed to do business or is actually doing business. Perhaps the reason for this relaxation is that the corporation, although an indispensable party, is not one of the active contestants. This provision has the effect of expanding personal service to some extent, but does not affect the basic requirement that all of the defendants be served within the state in which the court is sitting. 52

When coupled with the requirement that there is a basis for the exercise of jurisdiction over each defendant in the particular state, this limitation on the scope of service presents one of the most severe restrictions upon the right of a stockholder to bring a derivative action in a federal court. This is especially true when the problem is considered in the context of the venue requirements.

VENUE

Although venue means place of trial, 53 in practice it means the place where suit may be commenced, unless the defendants consent to the action being brought in a place of improper venue. 54 Venue is not a phase of jurisdiction over the subject matter, as was at one time thought, but is a personal privilege granted to defendants as a protection against oppression. 55 As used in the federal courts, however, it has become a device by which the business of the courts may be controlled—strict venue provisions limit the number of suits, liberal venue provisions will result in an increase in the number of cases coming before the courts. This was recognized at an early date, and Congress has seen fit to retain a rather limited form of venue as a control device.

In the normal diversity action there are two districts of proper venue — the district of residence of all plaintiffs and the

52. If plaintiff lays the venue of the action in the district of his residence, he need now be concerned only with the amenability of the defendants other than the corporation to service of process within that state. The corporation may be served quite easily. It is true, however, that the corporation will normally be subject to service in a wider number of states than an individual defendant so that this dispensation may not be the solution it appears to be at first glance.


district of residence of all defendants.\textsuperscript{56} In this area also, Congress has enacted a liberalizing provision for stockholders' derivative actions, providing as an additional place of venue the district of residence of the corporation.\textsuperscript{57} One would think that this was a simple proposition until the question of residence of a corporation for venue purposes is examined. Section 1391(c)\textsuperscript{58} indicates in very obtuse language that the residence of a corporation for venue purposes is any district in which it is incorporated, licensed to do business or is doing business.\textsuperscript{59} Such is the result of attempting to create an artificial "residence" for an inanimate being. In the stockholder's derivative action, this means that the plaintiff-stockholder has the following choices as to venue: the district of his residence, the district or districts in which his corporation was incorporated, any district in which his corporation is licensed to do business, any district in which his corporation is doing business, and the district of residence of all of the defendants. This is truly a plaintiff's dream, for this could conceivably include every district in the United States in the case of the large corporations with far-flung activities. Surely service of process can be obtained on all defendants in one of these districts.

To assure that this summarily disposes of the venue problem, however, underestimates the ingenuity and perseverance of defense attorneys, and the willingness of the courts to indulge in the judicial version of "Tinkers to Evers to Chance" — a double play and the side is retired. To some of the federal courts considering this problem, the phrase "where the corporation might have sued the same defendants," although appearing in a venue provision, implies that the corporation must have been able to bring the suit in the first instance from a diversity point of view. Consider this example: \textit{P}, a citizen of state \textit{X}, brings a stockholder's derivative action in state \textit{Y} against the \textit{A} corporation,

\begin{itemize}
  \item \textsuperscript{56} 28 U.S.C. § 1391(a) (1948).
  \item \textsuperscript{57}  Id. § 1401 provides as follows: "Any civil action by a stockholder on behalf of his corporation may be prosecuted in any judicial district where the corporation might have sued the same defendants." If the corporation were to sue the same defendants venue could be laid in the district of residence of all defendants, which district is also available in the suit by a stockholder, or in any district of residence of the corporation-plaintiff, which, but for the provisions of Section 1401, would not be available in an action brought by the stockholder.
  \item \textsuperscript{58}  Id. § 1391(c).
  \item \textsuperscript{59}  Section 1391(c) provides that "A corporation may be sued in any judicial district in which it is incorporated or licensed to do business or is doing business, and such judicial district shall be regarded as the residence of such corporation for venue purposes." The specific problem with this section is caused by the use of the phrase "may be sued" rather than "sue or be sued."
\end{itemize}
incorporated in state Y, and other defendants, one of whom is a citizen of state Y, and one of whom is a resident of state X. Venue can be justified here only on the basis that the corporation could properly have brought an action against the defendants in state Y, this being one place of residence for the corporation. But, say these courts, in this situation the corporation could not have sued these defendants anywhere in a federal court since diversity of citizenship is lacking, citizens of state Y being found on both sides of the controversy. Hence, the corporation could not have sued in state Y, nor may the plaintiff-shareholder. On the credit side of the ledger is the fact that this tortured logic has not been accepted by all of the courts, but the fact remains that at the moment there is a split of authority which tends to destroy the value of the liberalizing provision to the plaintiff. The existence of such procedural difficulties based upon an interpretation of statutes leads to the conclusion that there has been a notable lack of precision in drafting the pertinent statutes, resulting in the creation of problems which are pointless and which are merely sources of needless and prolonged confusion.

Under the present status of the law in this area, the only safe course is to be guided by the interpretation given in the particular district under consideration by the plaintiff. The best that can be said is that an attempt by Congress to enlarge the permissible places of good venue in stockholder's derivative actions may be frustrated by the unrealistic statutory interpretation utilized by some of the federal courts. The provision is a reasonable and helpful one. It recognizes that the action is that of the corporation, and but for the opposition of management, the action would be brought by the corporation.

Before leaving the venue problem, it might be well to mention the fact that there is no assurance that a case will be tried in the district in which it is brought. Section 1404(a) allows the transfer of a case to another district of proper venue in the

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62. "Like most procedural devices, its usefulness is susceptible to being nibbled away by those who regard it as an unwelcome stranger in an unsuitable environment." Montgomery Ward & Co. v. Langer, 168 F.2d 182 (8th Cir. 1948).

63. 28 U.S.C. § 1404(a) (1948).
interests of convenience of the parties. Although space will not permit a detailed treatment of this problem, it is one with which the attorney for the plaintiff must be familiar. Even though the suit is brought in a district of proper venue, the court may permit a transfer to another district if the facts indicate this second district to be a more convenient forum. This, of course, has been and will in the future be another tactical weapon in the arsenal of the defense attorney.

**Requirements of Rule 23 (b)**

In addition to complying with the jurisdiction, service, and venue requirements for bringing suit in the federal courts, the stockholder-plaintiff must also comply with the provisions of Rule 23 (b) governing stockholder derivative actions. The effect of Rule 23(b) is to create three conditions which must be met by a stockholder desiring to bring a derivative action in a federal court. The first requirement is that the stockholder must have been such at the time of the transaction about which he complains, or, if he was not, his stock must have been acquired thereafter by operation of law. This is one of the most bitterly contested provisions governing the right to bring a derivative action in the federal courts, and one for which many states have been roundly criticized. As with most restrictions, a reasonable argument can be made both pro and con. It does seem desirable that the plaintiff seeking to enforce the corporation's right be one who was a member of the corporation when the alleged wrongdoing occurred for, at least in theory, it is this group that has been fleeced by the management group. This argument would be strengthened if it were possible to say that one purchasing stock on the open market today has the means of reasonably determining whether management of the corporation has acted wrongfully in some prior transaction or operation. The realities of the situation, however, indicate that this is just not so. We have already indicated that the discovery of malfeasance on the part of management is one of the most difficult tasks of the stockholder group. How then can we, on the basis

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64. Although Section 1404(a) is not merely a restatement or codification of the doctrine of *forum non conveniens*, the tests laid down in the *forum non conveniens* cases are generally applied. See *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501 (1947); *Hoffman v. Blaski*, 363 U.S. 335 (1960).
of theory of implied knowledge, prohibit a stockholder from acting when he first obtains the necessary knowledge—a process that may take considerable time? The background of this rule is not difficult to perceive. It is the fear of the "strike suit" that influences both courts and legislatures to apply restrictions on the use of the derivative weapon. Unfortunately, the evidence of the extensive use of the derivative action as a "strike suit" is not readily available, except perhaps from sources whose impartiality is subject to a certain degree of doubt.67

 Granted that the stockholder's derivative action is subject to abuse—and I know of no procedural device that is not—would it not be better to require either ownership at the time of the alleged wrong or knowledge first obtained after the purchase of the stock? If the evil against which the rule is directed is the purchase of stock solely for the purpose of bringing a derivative action, would not the addition of the latter requirement prevent this without interfering with the proper exercise of the rights of a stockholder who is unfortunate enough to become a member of a corporation after a wrongful act has occurred but in time to suffer the consequences? It would seem that the only real merit to the rule as it exists is that it attempts to protect those stockholders who were the beneficiaries of the corporate trust at the time of the breach. The effect as to new stockholders is to extend the doctrine of \textit{caveat emptor} to unfortunate lengths, and to offer an unwise protection to directors and officers who fall prey to the temptations of management power.68

 The second requirement is one with which few would find fault, and it is, in fact, merely an expression of the traditional jurisdictional viewpoint of the federal courts. This requirement is that the stockholder's action not be the product of collusion between the stockholder and management to confer jurisdiction upon the court which would not otherwise exist.69 This rule en-

67. Note the following statement: "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." \textit{CHAMBER OF COMMERCE OF THE STATE OF NEW YORK, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS} 48 (1944).

68. It should be noted that this rule was first adopted in the federal courts in 1881 in the case of Hawes v. Oakland, 104 U.S. 450, and has been continued over the years first in the form of former Equity Rule 27, and most recently in Rule 23(b). It may well be time to reconsider the usefulness of this contemporaneous ownership rule as a necessary limitation on the amount of diversity litigation in the federal courts.

69. The conferring of jurisdiction on the federal courts by collusion is also
visions the situation where corporate management wishes to commence an action in a federal court against a third party, but is prevented from doing so because of lack of diversity of citizenship.\textsuperscript{70} It is doubtful if such a situation would arise in this day and age, and if, in a particular case, it was deemed necessary by management to have the action brought in federal court, where the corporation could not do so, the curse of collusion could be avoided and the end attained simply by "leaking" to the press the fact that a cause of action existed against the third party, but would not be enforced by the corporation for some reason deemed good and sufficient by the management. In the situation that causes real concern for the protection of stockholder's rights — abuse of power by the management group — there is little cause for concern that collusion will occur.

The third requirement of Rule 23(b) is that the plaintiff-stockholder must allege in his complaint that he has made an effort to secure the desired relief from the management group and the reasons why such relief was not obtained, or, in the alternative, must allege why no such effort was made by him. This constitutes a simple "exhaustion of remedies" requirement, and is certainly justified. The courts should not be called upon to intervene in internal corporate affairs until the stockholder has attempted to have his grievance adjusted internally. This is all well and good, but it will have little, if any, effect on the commencement of a proper stockholder's derivative action. The very reason for this remedy is that management is acting adversely to the interests of the stockholder and that he has no means of redress other than the courts. If the management group is involved in action detrimental to the interests of the corporation, and thus detrimental to the interests of the stockholders, obviously there will be no relief granted internally. The adversity of the situation effectively prevents internal solution of the dispute. Or, to put it more strongly, if management would adjust the grievance of a stockholder, then the particular situation is one not properly falling within the scope of the derivative action at all. As an inhibiting agent, this provision has been remarkably unsuccessful, and rightfully so. Applying the equitable maxim that equity does not require the doing of a useless act, the courts have almost universally held that the allegation of

\textsuperscript{70} See note 44 \textit{supra}.
adverse control of the corporation in the person of the alleged wrongdoers will satisfy this requirement. 71 It should be emphasized, however, that this is a necessary allegation, and the failure to so allege in the complaint will be grounds for a dismissal of the action. 72

Having met all of the requirements outlined above, the plaintiff in a stockholder's derivative action finds himself in full possession of the discovery tools available under the Federal Rules, 78 and through the judicious use of these tools he should be in a position to carry his case to trial and ultimately to victory as in any other case brought in the federal courts.

CONCLUSION

Under the very best of conditions the stockholder's derivative action is a most difficult type of action. It suffers the infirmities of lack of information, substantial expense, difficulty of proof, and the unfortunate situation of facing the full majesty of the corporate power in support of the very individuals who have wronged the corporation. It is not a perfect remedy by any means, but it is the only effective remedy available to the stockholder who wishes to raise his voice against an abuse of power by the management forces.

The federal courts are an available forum for such suits and Congress has attempted to make the task of bringing derivative actions into the federal courts an easier one than is the lot of the average case. That this has not succeeded completely is due to unfortunate lapses in statutory drafting which has opened the door to strained and restrictive interpretations on the part of some of the courts. Even without such interpretations it is not a simple matter to bring the stockholder's derivative action into the federal courts because of the exacting nature of the diversity, service and venue requirements, but the task is not hopeless by any means. In the case of the national corporation the federal courts are more readily available; it is in the more modest-sized corporation that the difficulties become acute. The most pressing need for the future is a provision making it possible to utilize a federal court in a stockholder's derivative action where

71. There is some justification for the statement of the dissenting opinion in Smith v. Sperling, supra, that the majority opinion confused this provision of Rule 23(b) with the requirements for diversity jurisdiction.
the geographical peculiarities of a given case make it impossible today for a stockholder to find a proper court either state or federal which might exercise jurisdiction. With the addition of such a provision, the federal courts would become a truly effective forum for the protection of stockholder rights.