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FURTHER PHASES OF DERIVATIVE ACTIONS AGAINST DIRECTORS*

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Two years ago I discussed the subject of current phases of derivative actions against directors.[1] My remarks were centered around the business judgment rule. Attention was called to the long series of decisions in which the courts have held that they will not interfere with the exercise of independent judgment by a company's board of directors. Attention was also called to the equally well-defined set of exceptions which illustrate the obverse of the rule, and to the cases which hold that the courts may intervene in the action of directors where fraud, outside domination, negligence, excess of charter powers, diversions of corporate opportunity, or the like, are involved.

In the past two years the steady course of decision in New York has been to apply the business judgment rule. I should like to illustrate this tendency from the recent cases before going on to other aspects with which I have been asked to deal; namely, ratification, directors' indemnity, and recent legislation.

A. RECENT APPLICATIONS OF BUSINESS JUDGMENT RULE

Some Aspects of Stock Options

On March 2, 1944, the Court of Appeals affirmed without opinion the summary judgment previously obtained by defendants in the action against directors of the United States Rubber Company.[2] The action was brought by a holder of ten shares out of the 1,710,592 shares of common stock of the company. The three causes of action attacked by the motion for summary judgment dealt with (1) a stock option granted to the president, (2) the

*Revised from an address before the Committee on Post-Admission Legal Education of the Association of the Bar of the City of New York, March 21, 1944. The author is obliged for helpful suggestions to his associates S. Hazard Gillespie, Jr., and Francis W. Phillips, both of the New York Bar.

[1]*Current Phases of Derivative Actions Against Directors* (1942) 40 MICH. L. REV. 1125.

[2]Diamond v. Davis, 38 N. Y. S. (2d) 103 (Sup. Ct. 1942), *aff'd*, 265 App. Div. 919, 39 N. Y. S. (2d) 412 (1st Dep't 1942), *aff'd without op.*, 292 N. Y. 552 (1944).

New Jersey law governing dividends on noncumulative preferred stock, and (3) payments to executives under a plan of supplemental compensation which the stockholders had approved. With respect to the validity of the corporate action taken, the opinion of special term is an interesting illustration of the weight attached to the disinterested action of directors as against the mere conclusory allegations of a protesting stockholder. The court rightly refused to apply the suggested rule of *Rogers v. Hill*,[3] in connection with the stock option, where the services rendered by the executive involved were of value and approval was given in good faith by directors and stockholders. The court's application of the presumption of honesty in the action of directors, together with the credit accorded to the documentary evidence they were able to adduce under Rule 113, gives new value to summary judgment as an aid to quick disposition of the less meritorious type of action against directors.[4]

Another aspect of stock options arose in a suit against directors of Remington-Rand Inc.[5] The third cause of action in the complaint involved a stock option granted by the directors and ratified by the stockholders, where the executives receiving the option were already under contract of employment; and it was held that plaintiffs' affidavits contained sufficient facts to entitle them to a trial and to prevent summary judgment. But in a companion motion in the same case involving the second cause of action, the defendant director obtained summary judgment upon a showing that the option was granted concurrently with the making of a contract of employment, and that the option price was above the then market value. Under such circumstances it was held that conclusory allegations by the plaintiff as to excessiveness of the compensation comprised in the option could not overcome the business judgment rule. Similarly, the United States District Court for the Eastern District of Pennsylvania first enjoined the Edward G. Budd Manufacturing Company from granting stock options to executives and employees, on the theory that the recipients undertook no obligation to continue in the company's employ for any specified period of time, and that consequently a

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[3]289 U. S. 582, 53 Sup. Ct. 731 (1933). *See* 38 N. Y. S. (2d) 103, 113 (Sup. Ct. 1942).

[4]*Cf.* Levine v. Behn, 282 N. Y. 120, 25 N. E. (2d) 871 (1940), where the documentary evidence left a triable issue as to the exercise of independent judgment by the directors; and Winkelman v. General Motors Corp., 44 F. Supp. 960, 973 (S. D. N. Y. 1942) where the record of directors' action was not complete.

Cf. Washington, *Stockholders' Derivative Suits* (1940) 25 CORNELL L. Q. 361, 373, suggesting, on the basis of Levine v. Behn, 282 N. Y. 120, 25 N. E. (2d) 871 (1940), that summary judgment will rarely be effective in derivative actions.

[5]Abrams v. Allen, 36 N. Y. S. (2d) 170, 174 (Sup. Ct. 1942).

waste of corporate property appeared to be involved. Subsequently, the same court dissolved the injunction upon a showing that the plan had been amended to require the recipient to remain in the company's employ for a period of a year after issuance of the option.[6] Under the changed circumstances, the same judge held that a reasonable relationship now existed between the value of the options and the consideration to be received therefor by the company, and declined to accept expert testimony tendered by the plaintiff that the options as such had a specified value per share. He said:

> The burden is on a minority stockholder of a corporation who seeks to have the courts intervene in corporate management and restrain action approved by the board of directors, to establish that such action transcends the point where the will of the majority may properly be imposed on the minority. Unless this be so, the floodgates would be opened to a surge of litigation by which the courts would be called upon to review the action of corporate directors with respect to all contracts of employment and an unlimited number of other matters.[7]

Many of the efforts by minority stockholders to bring up for judicial review questions of corporate management have had to go to trial. Such are the recent suits involving the Curtiss-Wright Corporation bonus and retirement plans; the sale of Bareco Oil Company stock by Barnsdall Oil Company, and the purchase of stock for retirement by the Pullman Company.[8] In the *Barnsdall Oil Company* case, while pointing out that the price for which the stock was sold might have appeared inadequate by certain selected criteria, the court also found that the transaction was not collusive nor the consideration so grossly inadequate as to indicate fraud; and added:

> Regardless of the ultimate results of a particular corporate transaction, all that the law requires is that it shall have been initiated and consummated honestly and in good faith. In the management of corporate affairs directors and officers have a wide measure of discretion. Mere differences of judgment are not sufficient to warrant equity interference.[9]

Interlocking Directorates

A leading case with respect to the liability of directors is *Everett v.*

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[6]Holthusen v. Edward G. Budd Mfg. Co., 52 F. Supp. 125 (E. D. Pa. 1943), *mod.* 53 F. Supp. 488 (E. D. Pa. 1943).

[7]53 F. Supp. 488, 490-1 (E. D. Pa. 1943).

[8]*See* Meyers v. Cowdin, 47 N. Y. S. (2d) 471 (Nolan, J., Spec. Term, Westchester Co. 1944); Diston v. Loucks, N. Y. L. J. July 30, 1941, p. 230 (Bernstein, J., Spec. Term, N. Y. Co.), *aff'd,* 264 App. Div. 758, 35 N. Y. S. (2d) 715 (1st Dep't 1942); Barry v. Avery, N. Y. County Clerk's Index No. 1018-1942, decision filed July 2, 1942 (Dineen, J., Spec. Term, N. Y. Co.).

[9]N. Y. L. J. July 30, 1941, p. 230, citing Leslie v. Lorillard, 110 N. Y. 519, 532, 18 N. E. 363, 365 (1888); Flynn v. Brooklyn City R.R., 158 N. Y. 493, 507, 53 N. E. 520,

Phillips[10] in which, by a bare majority, the Court of Appeals sustained the Appellate Division for the Second Department in reversing the special term, and directed dismissal of the action. As the holder of 100 shares out of 400,000 shares of the participating stock of Empire Power Corporation, which had also outstanding 77,000 shares of 6% cumulative preferred stock and 400,000 shares of common stock, plaintiff sued the directors of the company for damages in respect of loans made by the company to Long Island Lighting Company, which plaintiff charged were *ultra vires* and were made for the indirect benefit of the defendant directors. It would seem that the defendant directors, who with their families owned all the common stock and large amounts of the preferred and participating stock of Empire Power Corporation, also owned or controlled a majority of common stock of Long Island Lighting Company, and that defendants themselves were a majority of the directors of the Long Island company. When in 1930 it appeared that the Long Island company owed banks $10,500,000 on unsecured short term notes and that its financial position was not entirely safe or sound, the defendants permitted the corporation to lend the Long Island Lighting Company $5,330,000 on unsecured notes, which were made repayable within a year by reason of the restrictions of Public Service Law Section 69 upon borrowings for a longer period, but were regularly removed. The majority opinion laid weight upon the clause in the certificate of incorporation providing that contracts between the corporation and any other corporation should not be affected or invalidated by the fact that one or more of the directors of plaintiff's company were directors of the other contracting corporation.

In sustaining the judgment of dismissal, the chief judge pointed out the infinitesimal personal interest of the plaintiff and the above provision of the charter, because

> within limits prescribed by law these define to whom the power of control is entrusted, its scope and the manner in which it must be exercised. Directors are elected by the holders of stock which have voting rights. Here the certificate of incorporation of Empire Power Corporation provides that only the holders of common stock shall have voting rights.[11]

524 (1899); Pollitz v. Wabash R.R., 207 N. Y. 113, 124, 100 N. E. 721, 724 (1912); Rous v. Carlisle, 261 App. Div. 432, 434, 26 N. Y. S. (2d) 197, 200 (1st Dep't 1941), *aff'd,* 290 N. Y. 869, 50 N. E. (2d) 250 (1943); Holmes v. Saint Joseph Lead Co., 84 Misc. 278, 147 N. Y. Supp. 104, *aff'd,* 163 App. Div. 885, 147 N. Y. Supp. 1117 (1st Dep't 1914).

[10] 288 N. Y. 227, 43 N. E. (2d) 18 (1942), *aff'g* 261 App. Div. 1082, 26 N. Y. S. (2d) 881 (2d Dep't 1941), *which rev'd* 22 N. Y. S. (2d) 852 (Sup. Ct. 1940).

[11] 288 N. Y. 227, 233, 43 N. E. (2d) 18, 20.

In dealing with the responsibility of defendant directors in view of their personal interest, the majority said:

> In a long line of decisions this court has held directors who control corporate action responsible for dereliction of duty where they have used the property of the corporation or managed its affairs to promote their own interests, disregarding the interests of the corporation. Power of control carries with it a trust or duty to exercise that power faithfully to promote the corporate interests, and the courts of this State will insist upon scrupulous performance of that duty. Yet, however high may be the standard of fidelity to duty which the court may exact, errors of judgment by directors do not alone suffice to demonstrate lack of fidelity. That is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs.[12]

Dealing with the dual position of the defendants as controlling directors of both companies, the majority said:

> The dual position of the directors making the unprejudiced exercise of judgment by them more difficult, should lead the courts to scrutinize these transactions with care. [Citations] It does not, however, alone suffice to render the transactions void, and the provision of the certificate of incorporation of Empire Power Corporation expressly authorizing the directors to act even in matters where they have dual interest, has the effect of exonerating the directors, at least in part, "from adverse inferences which might otherwise be drawn against them." Spiegel v. Beacon Participations, 297 Mass. 398, 417, 8 N. E. 2d 895, 907.[13]

As evidence of the defendants' good faith the majority pointed to the fact that they would stand to lose by the failure of the loans more than they could have gained through the loans themselves, by reason of the defendants' greater stock interest in Empire Power Corporation. Acknowledging that the evidence demonstrated that the defendants acting as directors of the borrower borrowed moneys from the plaintiff's company in the belief that the loan promoted the interests of the borrower and its stockholders, the court nevertheless said that the evidence failed to show that the defendants acting as directors of the lender "did not decide upon sufficient grounds that the loans would also promote the interests of the lender and its stockholders."[14]

On that basis the majority, wisely, it is submitted, determined to leave the matter where the decision of the directors of the plaintiff's company left it. The minority, recognizing the business judgment rule, held that on the

[12] *Id.* at 232, 43 N. E. (2d) at 19.
[13] *Id.* at 236-7, 43 N. E. (2d) at 22.
[14] *Id.* at 237, 43 N. E. (2d) at 22.

facts a breach of the directors' fiduciary duty had been established by reason of the interrelationship of their individual pecuniary interests.[15] No doubt an important factor in *Everett v. Phillips* was the provision in the charter which permitted contracts between the corporation and other corporations in which its directors might be interested.

Yet it is of interest to note that a somewhat similar result was reached by the Appellate Division for the First Department in *Marony v. Applegate*.[16] This was an action by a 28% stockholder of New York Transit Company against its directors for mismanagement, particularly in relation to three other companies of which some of the defendants were also directors, and which in conjunction with New York Transit Company operated connecting pipelines more or less as a single system. The close relationship of the business of these companies justified a joint central office and the pooling of certain joint expenses. The defendants, while at no time a majority of the board of directors of the associated companies, were a majority of the officers of the other companies. The trial court found no fraud or bad faith on the part of the defendants, but disagreed with them as to the allocation of joint expenses; while recognizing the business judgment rule, it determined that the position of the defendants as fiduciaries of the associated companies required that rule to be disregarded, and that on the basis of allocation which the trial court approved, New York Transit Company had paid $11,409.44 too much within the period of limitations. It further found that the defendants as directors of New York Transit Company did not use reasonable business judgment. Hence it surcharged the defendants personally in that amount. Reversing this determination, the appellate division said:

> But assuming that under the present circumstances the stricter rule, that where directors are serving conflicting interests their dealings are subject to close scrutiny, was to be applied, we think that the directors here have met any burden such a rule would place upon them. In applying such scrutiny, a court would be required to take into consideration all of the business considerations involved which might ameliorate or otherwise affect any conflict of interests. We think that the proper rule to be applied here may be put concretely by stating that if the directors of New York Transit showed they were guided by the financial necessities of the situation, and not by any ulterior motive, and were attempting to faithfully serve the interests of their own company, and not merely to serve the financial necessities of the other companies in the group to the detriment of New York Transit, they should be protected in their

[15]*Id.* at 237, 43 N. E. (2d) at 22.
[16]266 App. Div. 412, 42 N. Y. S. (2d) 768 (1st Dep't 1943).

actions and decisions.[17]

This is a most interesting illustration of the business judgment rule, and one which, while it clearly reaches the right result, is close to the borderline of the question.

Dismissal of Unwarranted Suits

Attention has been called[18] to the disproportionate burden placed upon the courts by the number of derivative actions which reach them for trial. Such a disproportion was only to be expected from the triviality of the proprietary interest of the immediate plaintiffs as compared with the vastness of scope embraced in the charges which rather unconsidered rules of pleading permitted rather irresponsible plaintiffs to make. In recent years, the New York courts have exercised the rights which the New York practice gives them with respect to unsubstantiated allegations of the complaint in minority stockholders' actions. In this type of decision the highest court dismisses the claim of the minority owner without opportunity on his part to furnish proof of allegations which are deemed too general and conclusory. Thus, it has been held that allegations in a minority stockholder's complaint that the defendant directors by common accord combined their voting strength so as to cause the appointment of directors to corporate positions paying "very lucrative emoluments" are insufficient by themselves to indicate wrongdoing by any individual, and that the mere charge of "excessive" salary is in such context insufficient.[19] As a matter of pleading, the propriety of the action of directors in determining to make use of a surplus for paying accumulated dividends instead of retiring a loan, cannot be called in question.[20] So, mere conclusory allegations that directors of a company became parties to and ratified a conspiracy to defraud it of $1,234,383.42 owing it from a third party, and attempted to conceal this supposed fraud by omitting any proclamation thereof from the annual report to stockholders, and that the defendants were aware of the supposed fraud and failed to take steps

[17]*Id.* at 426, 42 N. Y. S. (2d) at 782. Gamble v. Queens County Water Co., 123 N. Y. 91, 99, 25 N. E. 201, 202 (1890), was regarded by the court as setting forth the applicable rule, and the requirement of some reasonable proportion between benefits and burdens, as laid down in Globe Woolen Co. v. Utica Gas & Electric Co., 224 N. Y. 483, 490, 121 N. E. 378, 380 (1918), was applied by the appellate division upon the facts of the particular case.

[18]Carson, *op. cit. supra* note 1, at 1158-9.

[19]Oshrin v. Celanese Corp., 291 N. Y. 170, 51 N. E. (2d) 694 (1943).

[20]Weinberger v. Quinn, 264 App. Div. 405, 409, 35 N. Y. S. (2d) 567 (1st Dep't 1942), *aff'd*, 290 N. Y. 635, 49 N. E. (2d) 131 (1943), calling attention to the burden imposed on the corporation by G. C. L. § 61a and to the singularity of such a complaint on behalf of 50 shares out of 7,818,959 shares.

to rectify the matter, *etc.*, are justifiably held to state no cause of action.[21]

Again the Court of Appeals has recently held that allegations in a minority stockholder's complaint that certain defendants had "caused" the making of employment contracts; that certain contracts and payments "were not bona fide"; that certain transactions were a subterfuge to enable a defendant to "procure a gratuitous gift of corporate property with the full knowledge" of other defendants; that certain payments "were grossly excessive" and the like, failed to state a cause of action against directors, officers and third parties.[22] Citing the leading cases on the business judgment rule, the court said:

> The statements of conclusions which express no more than a difference of opinion between a stockholder and directors as to the value of an employee's services or the expediency of his employment—whether it will advance the corporation's interests—will not serve in a complaint as sufficient in law to put a director on the defensive. Nor may judicial process be invoked to challenge the judgment of directors except when fraud is alleged or conduct so oppressive as to be its equivalent, and *facts* are pleaded which afford a basis for such allegations.[23]

Other holdings to the same effect can be found in abundance in the highest court of New York and in the lower courts.[24]

Decisions of this character on the pleadings are continually interlarded with decisions of the same nature after trial. Thus, in a minority stockholder's

[21]Lifshutz v. Adams, 290 N. Y. 707, 49 N. E. (2d) 635 (1943).

[22]Kalmanash v. Smith, 291 N. Y. 142, 51 N. E. (2d) 681 (1943) (Certain-teed Products Corporation).

[23]*Id.* at 155, 51 N. E. (2d) at 687. The opinion in this case deals with other interesting problems of pleading in derivative actions.

[24]Rous v. Carlisle, 290 N. Y. 869, 50 N. E. (2d) 250 (1943), *aff'g* 261 App. Div. 432, 26 N. Y. S. (2d) 197 (1st Dep't 1941), dealt with the insufficiency of allegations in a minority stockholder's complaint involving Consolidated Edison Co. of New York with respect to the manner in which that company and its subsidiaries financed six bond issues aggregating $255,000,000 principal amount. *See also* Rous v. Carlisle, 14 N. Y. S. (2d) 498 (Sup. Ct. 1939); Hoffman v. Abbott, 180 Misc. 590, 40 N. Y. S. (2d) 521 (Sup. Ct. 1943) (General Electric Co.), followed in a subsequent motion addressed to an amended complaint, N. Y. L. J. March 2, 1944; Smith v. Baillie, 44 N. Y. S. (2d) 217 (Sup. Ct. 1942) (Blue Ridge Corp.), *aff'd*, 266 App. Div. 950, 44 N. Y. S. (2d) 264 (1st Dep't 1943) dealing with payments made to a supposedly dominating corporation for management services; Dworetzky v. Douglas, N. Y. L. J. Aug. 15, 1942, p. 355 (Benvenga, J., Spec. Term, N. Y. Co.), N. Y. L. J. Oct. 15, 1942, p. 1031 (Pecora, J., Spec. Term, N. Y. Co.); Growney v. Block, N. Y. L. J. March 3, 1944, p. 848 (Shientag, J., Spec. Term, N. Y. Co.); Gladshire Frocks, Inc. v. Robin Redbreast Hosiery Co., Inc., N. Y. L. J. Feb. 25, 1944, p. 741 (Shientag, J., Spec. Term, N. Y. Co.); Coane v. American Distilling Co., N. Y. L. J. Oct. 16, 1942, p. 1048 (Walter, J., Spec. Term, N. Y. Co.), N. Y. L. J. April 5, 1944, p. 1326 (McGeehan, J., Spec. Term, N. Y. Co.); Scholen v. Armsby (Sperry Corp.), N. Y. L. J. Aug. 11, 1942, p. 319 (Bernstein, J., Spec. Term, N. Y. Co.); Spinella v. Heights Ice Corp., N. Y. L. J. Sept. 14, 1943 (Null, J., Spec. Term, N. Y. Co.).

action involving Curtiss-Wright Corporation the court dismissed the action on the plaintiff's case, where the gist of the charge was the commission of crimes by employees of the corporation to which the directors caused the corporation to plead guilty, and the failure of the directors to press a claim for reimbursement and damages against certain employees involved whose fines were paid by the corporation.[25] In another case,[26] a minority stockholder's action on behalf of Paramount Pictures, Inc., plaintiffs sought to compel the directors to account and restore to the corporation $100,000 paid out of corporate funds to labor union officials, which plaintiffs contended was a bribe, but which defendants said and the court found on the evidence was a mere submission to illegal exaction not inconsistent with corporate purposes. The opinion contains a careful review of the evidence as to the nature of the payments. It goes on to say that the right of the plaintiffs to relief must depend upon whether a payment of corporate funds by way of submission to illegal exaction must be classed as an act within the discretion of the management or as an act which is *ipso facto* and necessarily a diversion of funds from legitimate purposes. The court said:

> I purposely avoid using the phrase *ultra vires* because the many senses in which that phrase is used in different connections in cases and text books make for confusion rather than clarity. The distinction I intend is between acts which divert corporate funds from corporate purposes, and thus violate the implied trust upon which corporate funds are held, and acts which are the result of judgment and discretion as to how corporate funds shall be used in furtherance of corporate purposes.[26a]

The court disposes of this question as follows:

> I conclude, therefore, that a payment of corporate funds by way of submission to an illegal exaction is not *ipso facto* or necessarily a diversion of such funds from legitimate corporate purposes and consequently is not *ipso facto* or necessarily a breach of the implied trust upon which such funds are held. Whether or not in any particular instance there should be submission and payment or stout resistance thus necessarily must rest in the discretion of the persons constituting the management of the corporation like other business questions in general, and while abuses of that discretion undoubtedly may be reviewed and corrected by the courts, it would require something more than the mere fact of the

[25]Gilbert v. Curtiss-Wright Corp., 179 Misc. 641, 38 N. Y. S. (2d) 548 (Sup. Ct. 1942), citing Hornstein v. Paramount Pictures, Inc., 37 N. Y. S. (2d) 404, 414 (Sup. Ct. 1942).

[26]Hornstein v. Paramount Pictures, Inc., 37 N. Y. S. (2d) 404 (Sup. Ct. 1942), *aff'd*, 266 App. Div. 659, 41 N. Y. S. (2d) 210 (1st Dep't 1943), *aff'd* by Ct. of Appeals, N. Y. L. J., May 27, 1944, p. 2056.

[26a]37 N. Y. S. (2d) 404, 414.

submission and payment to call forth an exercise of the Court's power, and the mere fact of submission and payment is all that plaintiffs here have.[27]

Types of Managerial Judgment Sustained

Similarly, the Appellate Division for the First Department has just affirmed a decision of special term[28] holding that the directors of Socony-Vacuum Oil Company were not liable for their action in causing the company to join with other large oil companies in buying "distressed" gasoline in a manner held by the United States courts to be in violation of the Sherman Act. Pointing out that the defendants acted honestly in what they believed to be the best interest of the company, did not have reason to believe that the buying program violated the Sherman Act, and gained no personal advantage at the expense of the corporation, the court held that the directors were entitled to the presumption that their actions were fair and honest. The argument for plaintiff was that, regardless of the ordinary rule with respect to the exercise of business judgment, the directors were absolutely liable for having committed acts prohibited by statute. The violation of statute had in this case been established by the United States Supreme Court.[29] Notwithstanding this fact, the court held that the directors were not liable because they did not know or have reason to believe that the acts which they authorized would be in violation of statute, and distinguished cases in which the transactions involved were obviously *ultra vires* or in violation of statute. In the case of statutory violation as in that of *ultra vires* or ordinary negligence, the court held that the test was one of reasonable care.

In *Mason v. Richardson*,[30] the Court of Appeals has recently affirmed a holding of the appellate division, which distinguished among the liability of a director of Columbia Broadcasting System who obtained a profit in violation of what the court held to be a business opportunity belonging to his company; the liability of a non-director who made a similar profit out of the same business opportunity; and the liability of the other directors who made no profit but permitted the non-director to make a profit at the expense of the company. Since the action of the directors who did not profit appeared "to have been guided by what they determined to be the best interest of

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[27]*Id.* at 417.

[28]Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N. Y. S. (2d) 270 (Sup. Ct. 1942), *aff'd without op.*, 267 App. Div. 890, citing Blaustein v. Pan-American Petroleum & Transport Co., 263 App. Div. 97, 31 N. Y. S. (2d) 934 (1st Dep't 1941).

[29]United States v. Socony-Vacuum Oil Co., 310 U. S. 150, 60 Sup. Ct. 811 (1940).

[30]Mason v. Richardson, 262 App. Div. 186, 28 N. Y. S. (2d) 537 (1st Dep't 1941), *aff'd*, 289 N. Y. 541, 43 N. E. (2d) 526 (1943).

the corporation," they were held not liable, as was the non-director who made a profit. The result was a modification of the trial court's decision, in the light of the business judgment rule.

Similar action by the Appellate Division for the First Department occurred in an interesting case which showed an apparent confusion of personal interests with the corporate form.[31] The plaintiff was a holder of 40% of the stock of Tubular Textile Machinery Corporation and the action was brought under General Corporation Law, sections 60 and 61. The plaintiff had invested $125,000 upon a personal arrangement with one of the defendants, pursuant to which a corporation was formed in which this defendant and his sons became directors. There were no meetings of stockholders or directors for six years. Plaintiff complained that the defendants violated the arrangement between them for division of the stock interest and caused themselves to be paid excessive salaries. The evidence showed that the defendants had received in six years compensation amounting to $256,460, which was 44% of the gross income, despite deficits in the income account. The trial court, upon ample evidence, held the defendants liable for return to the corporation of all except $121,000 of their earnings. The court fixed the salaries for each defendant for each year in accordance with its view of the fair and reasonable value of the services rendered. In modifying this judgment the appellate division increased the allowance for salaries from $121,000 to $159,035, holding that the action of special term was "an undue curtailment of the power of the directors to adequately compensate the corporate officers and executives by granting increases in salary commensurate with the volume of business done." The appellate division also found the fees awarded to the successful plaintiff's attorney to be excessive and reduced them to $25,000 for the plaintiff and $1,000 for each intervenor.

A typical illustration of the business judgment rule is *Gluck v. Otis*,[32] where the appellate division reversed a judgment entered by special term and dismissed the complaint in an action by a stockholder of British Type Investors holding 983 out of 1,198,000 outstanding shares. The general charge of plaintiffs was that the defendants as officers and directors of their company improvidently invested in the stock of other companies in order that the defendants might become officers of and receive salaries from those companies. In particular, the plaintiffs claimed that the motive of the defendants in securing salaries to themselves was established by the fact that

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[31]Baker v. Cohn, 266 App. Div. 715, 40 N. Y. S. (2d) 623 (1st Dept 1943) *mod'g* 42 N. Y. S. (2d) 159 (Sup. Ct. 1942).

[32]Gluck v. Otis, 265 App. Div. 244, 38 N. Y. S. (2d) 541 (1st Dep't 1942).

they had no other means of livelihood and that the holding company would have been better served if the subsidiaries had been wound up. The appellate division held that neither of these criticisms was valid, pointing out that the wisdom of hindsight is not a proper touchstone for liability. The plaintiffs also charged mismanagement upon the basis of the unsuccessful operation of their company and its subsidiaries. With respect to this charge, the appellate division pointed out that the defendants had made no profits at the expense of the corporation (except for their salary) and that liability was to be established, not by proving losses, but by proving lack of ordinary diligence in management. Finding that the investments criticized were made after careful investigation and upon competent advice, the appellate division refused to find the defendants liable for negligence and said that there was

> . . . no reason to deprive them of all salary unless success, rather than the exercise of ordinary prudence and diligence, is held to be indispensable to the right of compensation.[33]

Further development of a course of decision already well marked out appears in *Levy v. American Beverage Corporation*,[34] where the appellate division again reversed a finding of special term on the evidence. The special term held majority stockholders of American Beverage Corporation liable to minority stockholders on the theory that they had violated their fiduciary duties in permitting the sale of majority control to parties with whose corporate interests the defendants as majority stockholders rejected a merger but to whom they offered to sell their stock for cash. No notice of this sale was given to the minority stockholders, and the transaction turned out to be disastrous to American Beverage Corporation. The trial court held defendants liable for fraud and negligence. The appellate division rejected the findings, holding there was no evidence of actual fraud, and also held that as a matter of law a majority stockholder is not a fiduciary for other stockholders by reason merely of his stock ownership and may sell his stock to a stranger in the absence of notice of facts which made the transaction wrongful by "the test of common honesty."[35]

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[33]*Id.* at 248, 38 N. Y. S. (2d) at 544.

[34]265 App. Div. 208, 38 N. Y. S. (2d) 517 (1st Dep't 1942), *rev'g* 29 N. Y. S. (2d) 550 (Sup. Ct. 1941).

[35]265 App. Div. at 218, *distinguishing* Insuranshares Corp. of Delaware v. Northern Fiscal Corp., 35 F. Supp. 22 (E. D. Pa. 1940), where the sale of corporate control carried immediate power of sale of readily saleable securities, the sellers received a price beyond the market value of their holdings, and the sellers also agreed to procure the resignation of directors. *See also* Gerdes v. Reynolds, 28 N. Y. S. (2d) 622 (Sup. Ct. 1941).

An unusually well-considered decision in a minority stockholders suit against the directors of Erie Railroad Company, just rendered after trial, applies the business judgment rule to the action of railway directors in arranging with underwriters for a form of financing which the Interstate Commerce Commission disapproved for lack of competitive bidding. The directors later sold securities of a somewhat similar form upon competitive bidding. Although recognizing that the Interstate Commerce Commission had in fact substituted its judgment for that of the directors, the court still refused to hold them personally liable in damages, indicating that a mistake by directors in the exercise of honest business judgment does not by any means necessarily imply negligence and that the standard is one of reasonable diligence rather than of the maximum possible diligence.[35a]

Accounting Questions under Bonus Plans

Questions of corporate accounting, more particularly as they affect supplemental compensation plans of a corporation, seem to be of increasing occurrence. In a case involving the Curtiss-Wright Corporation,[36] the operation of the corporate bonus plan with respect to including the earnings of a subsidiary, taking into net earnings payments by foreign governments to defray the cost of special facilities, computing income taxes after the deduction of the bonus fund, and the like was approved by the trial court on evidence which showed that the directors had taken the advice of independent auditors and which convinced the court of the reasonableness of the result. Regarding the defendants' failure to deduct from earnings intercorporate dividend taxes and certain depreciation items, the court said:

> Determination of such matters is peculiarly within the province of the directors, and was committed to the auditors designated by stockholders, in determining earnings, for the purpose of computation of incentive compensation. Their determination as to such matters may not be disturbed, in the absence of fraud or illegality.[36a]

In other words, where independent accounting advice is obtained, the directors, if acting in good faith, should not be subjected to personal liability even if that advice is proved wrong, in the opinion of the court, upon the balance of the evidence as to accounting opinion. This was the rule applied by the Appellate Division for the Second Department, reversing the

[35a]Casey v. Woodruff, N. Y. L. J. May 16, 1944, p. 1896, col. 1 (Shientag, J., Spec. Term, N. Y. Co.).
[36]Meyers v. Cowdin, 47 N. Y. S. (2d) 471 (Nolan, J., Spec. Term, Westchester Co. 1944).
[36a]*Id.* at 476.

special term, in *Chelrob v. Barrett,* which involved the rates charged on an intercompany sale of gas.[37] Plaintiffs were preferred stockholders of subsidiary companies, and defendants included the parent Long Island Lighting Company, other subsidiaries, and the directors of three companies. The action was dismissed as to the directors without prejudice upon a finding that they were not guilty of fraud, bad faith, overreaching or negligence. Finding, however, that the parent company dominated the subsidiaries and dictated the election of the directors and officers of the various companies, special term refused to apply the business judgment rule in full, and reviewed the propriety of the intercompany arrangements. In reversing the judgment which resulted as against two of the subsidiaries, the appellate division held that the determination of the rate was in the realm of business judgment and that under such circumstances the factors which should go into the computation in arriving at a rate and the weight to be accorded to each were exclusively for the determination of the individual directors, acting in good faith, for ". . . when directors act in good faith it is not within the judicial province to say whether one accountancy method rather than another should be employed."[38] In view of the exculpation of the directors, it was held, a fiduciary rule might not be imposed upon the corporate defendants.

This principle would appear to have been departed from in the recent case of *Mann v. Luke,*[39] perhaps because the question was presented by motion directed to the pleading where the fair intendment rule assisted the plaintiff. This action involved the bonus plan of West Virginia Pulp & Paper Company, which plaintiff (holding 100 shares out of 902,432 outstanding) attacked with some specific charges of improper payments, one or two specific charges of miscomputation, and numerous extremely general charges of miscomputation which would involve a revision of the whole income account. The complaint alleged that the bonus was distributed to the officers and directors of the company and that the defendants as officers and directors permitted it to be wrongfully calculated, in violation of the plan and of sound accounting practice.[40] It may have been by virtue of this allegation that the court not only held some extremely general charges of miscomputation to be

[37]Chelrob v. Barrett, 265 App. Div. 455, 39 N. Y. S. (2d) 625 (2d Dep't 1943), *rev'g* 177 Misc. 521, 31 N. Y. S. (2d) 259 (Sup. Ct. 1941), *modified on other grounds,* 266 App. Div. 669, 39 N. Y. S. (2d) 625 (2d Dep't 1943).

[38]265 App. Div. at 457, 39 N. Y. S. (2d) at 627.

[39]Mann v. Luke, 44 N. Y. S. (2d) 202 (Sup. Ct. 1943).

[40]*Id.* at 206.

sufficiently specific but laid down a general rule which would seem certainly to be too broad:

> All directors are liable for moneys paid to themselves or to others as a result of such miscomputations, regardless of good faith or the absence of fraud or negligence.[41]

In such an action, said the court, the business judgment rule does not apply. In a later passage the court defended the result reached on the ground that the allegation in the complaint that the defendants themselves participated in the miscalculations and benefited therefrom made them liable as for unjust enrichment "regardless of bad faith or negligence."[42]

Assuming that the alleged miscomputations by virtue of which the directors, among others, received enhanced compensation under a bonus plan were approved by independent auditors, and that the directors are found to have acted in good faith without negligence, the rule indicated in *Mann v. Luke* probably does not represent the law of New York. However, a like standard was applied by a federal court in New York in the most interesting case of *Winkelman v. General Motors Corporation*,[43] involving the bonus plan of that company. This was a consolidation of actions by plaintiffs, holding in the aggregate 90 shares out of 44,000,000 General Motors shares outstanding, for mismanagement with respect to a bonus plan which had been in force with the approval of stockholders since 1918, the original charge having been fraud and excessiveness of compensation, and the substituted charge which largely occupied the trial having been for violation of correct accounting theory in the computation of the bonus. The amounts dealt with by this bonus plan were large, the compensation to the leading executives was very high, and the performance of the company was exceptional by reason in large part of efficient management.[44] The long trial involved numerous complicated transactions, and the extensive opinion and findings well illustrate the immense burden which suits of this character, instituted by persons having an infinitesimal stake in the outcome, impose upon the courts.[45] In

41*Id.* at 207, citing Gallin v. National City Bank, 152 Misc. 679, 276 N. Y. Supp. 696 (Sup. Ct. 1934), 155 Misc. 880, 281 N. Y. Supp. 795 (Sup. Ct. 1935), and Epstein v. Schenck, 35 N. Y. S. (2d) 969 (Sup. Ct. 1939).

4244 N. Y. S. (2d) 202, 209, citing Lord Mansfield in Moses v. Macferlan, 2 Burr. 1005, 97 Eng. Rep. R. 676 (1760). Mann v. Luke has been followed at special term in a motion on the amended complaint in Alexander v. Anderson (Bendix Corp.), N. Y. L. J. Dec. 8, 1943 (Eder, J.), *aff'd*, N. Y. L. J. Ma 27, 1944, p. 2056. *See also* Tarlow v. Archbell, 47 N. Y. S. (2d) 3 (Sup. Ct. 1943) (Philip Morris Corp.).

4344 F. Supp. 960 (S. D. N. Y. 1942).

44So found by the court (Finding 48).

45See (1942) 40 MICH. L. REV. 1125, 1158-9.

some of the transactions the court found what it considered to be self-dealing, a situation which would of course exclude the business judgment rule. In one of those instances, which involved payment out of the bonus fund to numerous executives, including some directors, of stock having a value of $1,540,830, the corporate action which was testified to as justifying the payment was not recorded in the minutes. On that point the court made a comment which will be suggestive to corporation lawyers:

> Directors and officers who pay themselves large sums out of the corporate treasury for some extraordinary purpose should see to it that they are formally authorized to make the payment, if they expect to justify it at some future date. They make the record of what they do at the time it is done and the record should be specific, complete and unambiguous, where their interests conflict with those of the corporation.[46]

Other points in this interesting case involved the questions of accountancy alluded to above. For instance, on a profit made by the corporation in the sale of stock for bonus purposes to General Motors Management Corporation, which profit was itself treated as income subject to bonus, the court disagreed with the figure of $10,057,599.48, stated as the profit, held liable for the bonus paid in respect thereof three directors who as officers had most to do with the selection of the stock on which the profit was computed, and held not liable the other directors who voted to approve the bonus calculation contained in this profit.[47] The court was of the opinion that, if this profit were included in income as a result of honest exercise of business judgment by disinterested executives, it should not surcharge the defendants in respect of the bonus thereon. But the court criticized the manner in which the stock to be sold to the Management Corporation was selected and put into the account for that purpose, reaching the conclusion from his independent review of the books that this was arbitrarily and wrongfully done for the purpose of enhancing the apparent profit. He also held that certain credits entered in the account should not have been included in the computation of profit. Although all the transactions in the account were known to and were approved by Haskins & Sells, who as independent auditors certified the resultant figure, the court felt that the executives held liable had even better knowledge of the matters criticized by the court. Because the outside accountants assumed some independent responsibility, the court held that the other directors who relied upon their certification, having no

[46]44 F. Supp. 960, 973 (S. D. N. Y. 1942).
[47]*Id.* at 985-6.

personal knowledge of their own, were not liable. The three executives held liable were held liable for the full bonus on the profit in question, *viz.* approximately $1,000,000, although the proportion thereof which they as bonus recipients got was inconsiderable. The fact that the profit arose as a result of a transaction in treasury stock did not itself give rise to liability, in the opinion of the court, because at the date of the transaction (1930-1) much accounting opinion supported the treatment which Haskins & Sells approved.

A more dubious holding in this case had to do with another series of transactions in treasury stock which occurred in 1933-9 and which consisted in treating the savings effected by the corporation in awarding stock as bonus at a higher value than cost, as additional income on which a bonus was paid. This treatment had the approval of the independent auditors, Haskins & Sells, for the whole period. It also had the approval of the finance committee of the corporation, consisting of directors the majority of whom received no bonus, and after 1937 had the approval of the bonus and salary committee, consisting of directors of whom none received bonus. The court found that after 1932 the preponderance of accounting theory was against taking profits on treasury stock into the income account, and, despite the certification of the company's auditors, surcharged six of the directors personally for the resulting excess in the bonus, *viz.* $1,249,943, which was distributed to thousands of employees, including three of the six directors. This was done notwithstanding a provision in the bonus plan which made the determinations of the governing committees conclusive. The argument that the decision of the committees in this matter was within their sound discretion, the court answered by pointing out that more than half of the finance committee and of the bonus and salary committee were, from time to time, officers or directors of the Dupont Company, and that the Dupont Company excluded from the bonus base and from income profits on treasury stock.[48]

With deference to the court which decided this case, I believe the decision on this last point gives inadequate recognition to the business judgment rule

[48]*Id.* at 993. The Dupont Company plan of course operated under different circumstances and presented different questions and was in other ways different from the General Motors plan, as the same judge recognized in excluding the Dupont Company plan from evidence when it was offered by the plaintiffs. This fact makes the reference to procedure under that plan extremely questionable as a means of disposing of the business judgment rule. In connection with the settlement of this case, 48 F. Supp. 490, 498 (S. D. N. Y. 1942), the trial court acknowledged that it was arguable whether the opinion of accountants with respect to the treatment of profits on treasury stock had actually crystallized in 1932 or prior to 1938.

and is not in accord with the law of New York, although I have called attention to several decisions at special term which point the same way but which are out of harmony with the reasoning of the appellate courts.[49] Only fraud or conduct so manifestly oppressive as to be equivalent to fraud will suffice to take a case out of the business judgment rule, according to *Gamble v. Queens County Water Co.*,[50] which is continually applied today. It is interesting in this connection to note that the charge of excessiveness of the defendants' compensation as such, was rejected by the court in the *Winkelman* case.[51] On the company's record of performance the court held that salary and bonus totalling $500,000 for the chief executive in prosperous years, was not excessive *per se*, and that the salary and bonus allotments "were earned by the recipients," although noting that this did not save them from the consequences of miscalculation of bonus. This holding poses the same question as does *Mann v. Luke*,[52] whether, where the defendant charged is a fiduciary but has not been guilty of negligence or bad faith, a new category of liability without fault has arisen, *viz.* liability to return such amounts of bonus received by the defendant or by others as the court, upon balancing competing accounting theories, shall hold to have been paid in violation of the general terms of a corporate bonus plan. I predict that the suggested liability will not ultimately be sustained in the breadth just indicated, at least. The decisions will probably resolve themselves around the degree of care which the court believes that the director has exhibited in each situation.

To sum up this aspect of the matter, one of the best statements of the advantages and disadvantages of derivative actions against directors as a means of policing corporate management is that recently made by a federal judge in an action in which there was granted for the first time by the federal court a stay of proceedings pending determination of actions earlier brought in the state court. Expressing the opinion that this type of action presented a unique problem, the court said:

> Despite the numerous abuses which have developed in connection with such suits they have accomplished much in policing the corporate system especially in protecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders. They have discouraged membership on boards by persons not truly interested in the

[49]See notes 39 and 42 *supra*.
[50]123 N. Y. 91, 98, 25 N. E. 201, 202 (1890).
[51]44 F. Supp. 960, 970 (S. D. N. Y. 1942).
[52]44 N. Y. S. (2d) 202 (Sup. Ct. 1943).

corporation. To counterbalance these benefits, to some extent they have resulted in the substitution of irresponsible dummy directors for inattentive directors. The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to managements and outsiders. Corporate attorneys now have an arsenal of authorities to support their cautioning advice to clients who may be disposed to risk evasion of the high standard the courts have imposed upon directors.

Whether from this larger point of view the stockholder's derivative suit is still socially an uneconomical device for policing corporate management, it is difficult to estimate. That it is slow, cumbersome and expensive to all concerned, if the calculation is limited to the actual cases which reach the courts, cannot be doubted.[53]

B. Ratification

Some discussion of ratification by the stockholders as a means of curing defects in corporate action is appropriate here. A leading case is *Putnam v. Juvenile Shoe Corporation*,[54] where the Supreme Court of Missouri dealt with the effect of action at a special meeting of stockholders which ratified and approved the action of the board of directors in paying $50,000 supplemental compensation to the officers and employees of the company, the directors' resolution having authorized the president to apportion the $50,000 and the president having apportioned $41,100 to himself and five other directors. The board consisted of nine. The stockholders' meeting was held after the institution of a minority stockholder's suit to recover the bonus. Plaintiff voted his shares against ratification at the stockholders' meeting, and argued that the vote was not binding upon him. The court held that the bonus paid was beneficial to the corporation and not in itself a fraud upon dissenting stockholders. Pointing out that courts may not substitute their judgment for that of stockholders as to what is good business policy, in the absence of fraud, the court said that there was no evidence of fraud in this case; and that, where only 217 shares out of a total of 5,500 shares outstanding object to the payment of such a bonus

> . . . it is the most convincing proof, not only of absence of fraud, but also of the benefits honestly and reasonably to be expected to flow from such practice.[55]

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[53]Brendle v. Smith, 46 F. Supp. 522, 525 (S. D. N. Y. 1942).
[54]307 Mo. 74, 269 S. W. 593 (1925).
[55]*Id.* at 92-93, 269 S. W. at 597.

On the question of ratification, the court said there was no doubt that plaintiff would be bound if it had occurred before the filing of his suit, and then pointed out that certain cases in New York and elsewhere, which denied the right to ratify after action was commenced, involved actual fraud. The court said that stockholders must be held to have power to dispose of the suhject-matter of the suit by ratification, even after suit is filed, in the absence of fraud; that the action of the directors was at most voidable; and that the stockholders should have power to ratify action of the directors taken for the benefit of the corporation, even after suit has been filed.[56]

This case has been followed in New York in a minority stockholder's suit charging waste.[57] At an annual meeting of stockholders following the execution of the contract of sale of stock attacked in the action, the stockholders ratified the resolution theretofore adopted by the board which charged against capital surplus a net deficit in earned surplus resulting from the sale and from the reduction in value of the remaining stock hold. Out of 1,503,288 shares represented at the meeting, 2,515 shares voted against ratification. The court said that, since the contract under attack was neither fraudulent nor collusive, the vote was effective to bar the action, notwithstanding objection that the notice was inadequate and that the action had been commenced before ratification was attempted.

In principle, reference to and vote by the stockholders upon matters attacked in a derivative action is the ideal solution, since the stockholders as the owners of the business ought to know and be allowed to say whether they wish the litigation to continue in their name. In practice, directors attacked by derivative action have not sufficiently availed themselves of this protection. The reason, I believe, is that they feel themselves to he caught in a vise. On the one hand, the ratification will be ineffective except upon adequate disclosure, and until the trial they cannot be certain just what the plaintiff's proof will be. After the trial, should the plaintiff he successful, it is frequently felt that ratification is no longer available because, in view of the court's decision, it would be tantamount to a gift.[58] In addition, the

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[56]*Id.* at 95-96, 269 S. W. at 598-9.

[57]Diston v. Loucks, N. Y. L. J. July 30, 1941, p. 230 (Bernstein, J., Spec. Term, N. Y. Co.), *aff'd,* 264 App. Div. 758, 35 N. Y. S. (2d) 715 (1st Dep't 1942). Fraud and collusion on the part of the directors in selling assets of the company were also charged, but the trial court held that the charge was without foundation.

[58]Rogers v. Hill, 289 U. S. 582, 591, 53 Sup. Ct. 731, 735 (1932) and Gallin v. National City Bank, 152 Misc. 679, 704-6, 273 N. Y. Supp. 87 (Sup. Ct. 1934), both decided with reference to compensation claimed to be excessive. However, until actual entry of judgment (which does no doubt merge the cause of action) it would seem that the cause of action is still open to discharge by ratification notwithstanding a decision

complaints in certain cases involving executive compensation are so stated as to invoke the principle of *Rogers v. Hill*,[59] so that a trial is required to determine whether the compensation received by executives was out of all proportion to the services rendered. Finally, a number of decisions have thrown doubt, unjustifiably it is believed, upon the validity of ratification of any corporate transaction that may be questioned. In connection with the Bethlehem Steel Corporation bonus, the New Jersey court enjoined a stockholders' meeting which was to take a vote on the bonus plan attacked, with the extraordinary statement that the vote would have no influence upon the right to relief of even a single stockholder who suffered injury by "unlawful conduct."[60] Moreover, the New York cases make it clear that defendants cannot always obviate a trial by referring to the stockholders as a class the matters which minority stockholders attack. For example, in *Continental Securities Co. v. Belmont*,[61] the issuance to bankers of 15,000 shares of the company's stock as compensation for services was attacked in the complaint as a gift and a fraud, and by way of dictum the Court of Appeals said that the transaction attacked fell within the class of void acts which the stockholders cannot ratify. In that and other cases which have discussed the possibility of stockholders' ratification, the question arose upon a defense to the effect that no suit lay because plaintiff had not attempted to obtain remedial action by the stockholders. In *Pollitz v. Wabash R. Co.*,[62] however, where 79% of the stock and 73% of the debenture bonds ratified the transaction attacked, the defense of ratification pleaded was held insufficient because the transaction as described by the defendants was voidable, whereas that described by the plaintiff was void. Again, in a very complicated situation in which the defendants in a derivative suit sought to obtain the abatement of the suit but not the extinction of the claims, by a settlement providing for a distribution of stock and payment of expenses, which settlement was approved by a vote of 4,456 shares against 3,550 shares (excluding the votes of all interested parties) at a stockholders' meeting called to consider the settlement pursuant to the recommendation of a com-

adverse to the defendants, as was indicated by the holding of the court on a question of settlement after decision but before judgment. Winkelman v. General Motors Corp., 48 F. Supp. 490, 494 (S. D. N. Y. 1942).

[59] 289 U. S. 582, 53 Sup. Ct. 731 (1932).

[60] Berendt v. Bethlehem Steel Corp., 108 N. J. Eq. 148, 152, 154 Atl. 321 (1931).

[61] 206 N. Y. 7, 18, 99 N. E. 138, 142 (1912). *See also* Pollitz v. Wabash R. Co., 207 N. Y. 113, 127, 100 N. E. 721, 725 (1912); Quintal v. Kellner, 264 N. Y. 32, 36, 189 N. E. 770, 772 (1934); Godley v. Crandall and Godley Co., 212 N. Y. 121, 131, 133, 105 N. E. 818, 822 (1914) (past services).

[62] 207 N. Y. 113, 100 N. E. 721 (1912).

mittee of disinterested directors, the Second Circuit Court of Appeals nevertheless refused to treat the ratification as fully effective on account of the predominating influence of interested parties in obtaining it, and allowed the suit to be continued by another stockholder in the form of a double derivative action.[63]

Thus, somewhat general language in old leading cases, employed with reference to conclusory allegations such as are no longer regarded with favor in derivative actions, has tended to discourage the bar from availing itself of the procedure of ratification to its full extent. It is to be anticipated that, with increasing application of the business judgment rule, the class of transactions which are held to be voidable and so subject to ratification will be expanded,[64] and that decision by the owners of the business as to whether litigation instituted in their name shall be continued will, upon adequate disclosure of the material facts, be encouraged.

By a process which may be considered to lie deeper in judicial psychology than it does in logic, stockholders' ratification has sometimes been effective with the courts in inducing application of the business judgment rule to the action of directors where the ratification was not deemed effective as a ratification.

C. Recent New York Legislation

Directors' Indemnification

Legislation providing that corporations might indemnify their directors for the reasonable expenses of a successful defense of derivative actions was enacted in New York in 1941 following the decision by former Judge Crouch as referee in the *New York Dock* case[65] that no legal obligation for such reimbursement is implied in New York law. The defendants were directors who had successfully defended suit by a minority stockholder of New York

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[63]United States Lines, Inc. v. United States Lines Co., 96 F. (2d) 148 (C. C. A. 2d, 1938).

[64]See Putnam v. Juvenile Shoe Corp., 307 Mo. 74, 269 S. W. 593 (1925), where the transaction attacked involved self-dealing; Diamond v. Davis, 38 N. Y. S. (2d) 103, 113 (Sup. Ct. 1942), *aff'd*, 265 App. Div. 919, 39 N. Y. S. (2d) 412 (1st Dep't 1942), *aff'd without op.*, 292 N. Y. 552 (1944) (stock option to executive); Epstein v. Schenck, 35 N. Y. S. (2d) 969, 978 (bonus payments under contract); Bull & Co., Inc. v. Morris, 132 Misc. 509, 230 N. Y. Supp. 122 (Sup. Ct. 1928), *aff'd*, 226 App. Div. 868 (1st Dep't 1929), (payment of stock to executive for services); Lewis v. Matthews, 161 App. Div. 107, 112-3, 146 N. Y. Supp. 424, 428 (1st Dep't 1914) (salaries to executives); Kranich v. Bach, 209 App. Div. 52, 204 N. Y. Supp. 320 (1st Dep't 1924) (alleged illegal and excessive salaries). *Cf.* Washington, *Stockholders' Derivative Suits* (1940) 25 Cornell L. Q. 361, 372.

[65]N. Y. Dock Co., Inc. v. McCollum, 173 Misc. 106, 16 N. Y. S. (2d) 844 (Sup. Ct. 1939).

Dock Company Inc. in which $11,000,000 damages was claimed against them. Upon receiving demand from the directors for payment of their legal expenses, aggregating $86,755.14, the corporation sought a declaratory judgment with respect to its obligations. Judge Crouch held there was no legal obligation. He said that the rule of indemnification in agency would not apply, since the analogy of principal and agent is not a conclusive one for directors of a corporation whose status is *sui generis* and whose office is a creature of the law. He also held that there was no equitable obligation, unless the defendant director could show that in his own defense he had conserved some substantial interest of the corporation which otherwise might not have been conserved, or brought to it some definite benefit which otherwise might have been missed.[66] In the particular case, the referee held that no substantial benefit had accrued to the corporation from the directors' successful defense because the receivership sought by the plaintiff was merely incidental to relief claimed against the directors and in favor of the corporation. Dealing with the argument of social necessity for indemnification of directors, the judge referred to language employed by Mr. Justice Douglas before his appointment to the bench:

> Making it easier for the legitimate plaintiff and harder for the illegitimate . . . involves extensive reexamination and refashioning of procedural devices to admit of more specialized treatment of these types of cases. . . . And it certainly would embrace a reconsideration of the control over costs or security for costs.[67]

In April, 1941, there became effective in New York amendments to the General Corporation Law which this decision inspired. Section 27a permits the inclusion in the certificate of incorporation or in the by-laws of a provision that directors shall be indemnified by the corporation against expenses actually and necessarily incurred in connection with the defense of actions in which they are sued by reason of their being or having been directors, except in relation to matters as to which they shall be adjudged liable for negligence or misconduct in the performance of their duties as directors. Effective April 14, 1941, there was also added section 61a, which permits the trial court to assess against the corporation as special costs of the action, in the same manner as statutory taxable costs, the reasonable expenses, including attorney's fees, of any party plaintiff or defendant incurred in connection with the successful prosecution or defense of the action, whether the action was brought by the Attorney General, by the corporation or a

[66] *Id.* at 111, 16 N. Y. S. (2d) at 849.
[67] Douglas, *Directors Who Do Not Direct* (1934) 47 HARV. L. REV. 1305, 1327-8.

creditor, receiver or trustee in bankruptcy thereof, or by a director or officer as permitted by sections 60 and 61 of the General Corporation Law, or whether it was brought by a minority stockholder in accordance with the established practice in equity. Section 61a also permits the trial court to impose upon the corporation the reasonable expenses, including attorney's fees, of parties in cases where they have been successful *in part* or where the action has been settled with the approval of the court having jurisdiction.[68]

This legislation only responded to the general impression that it is unfair to ask directors to bear the expense of defending stockholder's suits which turn out to be groundless.[69] As a result of proceedings under the statute it has been held that the "final judgment" stated in section 2 of the Act as the point at which the Act shall not be effective with respect to pending actions, means the judgment after trial, not that following appeal.[70] In a separate action by the same directors for reimbursement for expenses of their defense on the basis of a common-law right, the court, following the *New York Dock Company* case, held that no such common-law right existed and dismissed the complaint.[71] It has also been held that the statute did not, in the proper exercise of judicial discretion, permit the payment of the counsel fees of the defendant directors in connection with the settlement of a derivative action where the circumstances showed insufficient benefit to the corporation.[72]

In view of the general impression at the bar that derivative actions against directors are commonly brought by holders of infinitesimal proportions of

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[68]Similar provision has been made in the corporation laws of many states, *e.g.* c. 125 of the Laws of Del. (1943), *amending* Del. Rev. Code (1935) § 2034, which defines the powers of corporations created under Delaware law.

[69]See Washington, *Litigation Expenses of Corporate Directors in Stockholders' Suits* (1940) 40 Col. L. Rev. 431, discussing New York Dock Co., Inc. v. McCollum, 173 Misc. 106, 16 N. Y. S. (2d) 844 (Sup. Ct. 1939).

[70]Matter of Bailey, 265 App. Div. 758, 40 N. Y. S. (2d) 746 (1st Dep't 1943), *aff'd,* 291 N. Y. 534, 50 N. E. (2d) 653 (1943), *rev'g* 178 Misc. 1045, 37 N. Y. S. (2d) 275 (Sup. Ct. 1942) (Bush Terminal Co.).

[71]Bailey v. Bush Terminal Co., 46 N. Y. S. (2d) 877 (Sup. Ct. 1943), *aff'd,* 267 App. Div. 899 (1st Dep't, Mar. 24, 1944). *See also* Hayman v. Morris, 37 N. Y. S. (2d) 884 (Sup. Ct. 1942), holding that enactments awarding attorneys' fees and including them in the classification of costs are valid exercises of police power, and that the New York Legislature may impose costs of this character upon foreign as well as domestic corporations. The total allowances to defendants' attorneys for costs and disbursements in this case were $37,003.26.

[72]Neuberger v. Barrett, 180 Misc. 222, 39 N. Y. S. (2d) 575 (Sup. Ct. 1942), following Washington, Corporate Executives' Compensation (1942) c. 20, citing this case, Special Term in Kings County has, it is believed, erroneously refused an allowance under GCL § 61a to successful director defendants on the theory that their success conferred no pecuniary benefit on the corporation. *Drivas v. Lekas,* N. Y. L. J. May 26, 1944, p. 2047 (F. E. Johnson, J.).

the company's stock, very largely for the benefit of their attorneys, whose fees in the event of success are disproportionate, the feeling soon arose that the legislation just discussed operated inequitably in imposing the cost of a successful defense on all the stockholders through the corporation, and that security for costs should be exacted from plaintiffs whose proportion of stock holdings was not sufficient to make the filing of a complaint in their own right economically plausible. An investigation of the subject was set on foot by the Chamber of Commerce of the State of New York, which appointed a special committee for the purpose toward the end of 1942. Counsel retained by that committee rendered on February 5, 1944, a report which (exclusive of appendices and charts) filled a brochure of 117 pages and conclusively demonstrated the abuses existing in this type of action.[73] The analysis made in this report of filed cases in New York County and Kings County and in the United States District Court for the Southern District of New York showed that recoveries and settlements which might be deemed to represent a recovery in part were more than twice as numerous (in proportion to the number of actions brought) in the case of small and closely held corporations as they were in the case of publicly held corporations.[74] In both types of action the percentage of the recoveries was very small. This study also showed that in the leading cases in which recoveries obtained by settlement or pursuant to judgment have been claimed to sanction the procedure in derivative actions as now existing, the corporations involved have been outstandingly successful in their accomplishment under the management attacked; that the executive compensation involved in such cases has not been held to be wrong in principle or to be excessive; and that recoveries granted directors

> were the product of an extraordinarily severe rule which holds directors to almost absolute liability for accuracy in the computation of profits under such a plan, even as to matters which have gone unperceived by trained accountants, and are more matters of accounting practice than of law.[75]

The Chamber of Commerce survey also concluded upon an examination of all the recorded cases, what every practitioner has known, that the com-

[73]Wood, Survey and Report Regarding Stockholders' Derivative Suits (New York State Chamber of Commerce, 1944).

[74]*Id.* at 30-5.

[75]*Id.* at 39. This summary has been criticized with respect to the holding in Winkelman v. General Motors Corp., 44 F. Supp. 960 (S. D. N. Y. 1942), in which the trial court held that certain of the defendants had "taken advantage of their position of influence to the detriment of the corporation" (at 970) and in divers connections applied the business judgment rule (*e.g.* at 968, 1003). See, however, note 48 *supra.*

pensation of successful plaintiffs' attorneys is wholly disproportionate to any legitimate interest involved on the plaintiffs' side.[76] While this is obvious on the face of the matter, it seems to me also true, although less evident, that the compensation of successful plaintiffs' attorneys is disproportionate to any benefit conferred on the stockholders as a whole by the successful plaintiff. Most members of the bar will agree with the statement made by counsel to the Chamber of Commerce, based upon a summary of the allowances made to plaintiffs' attorneys in 13 cases of judgment after trial and 33 cases of settlements approved by the court, in these three jurisdictions, during the period 1932-1941:

> These fees are among the largest possible for practitioners in any field of law. Any lawyer representing a stockholder, however small, in a corporation where a "situation" is apparent has an opportunity to earn or share in these. His own professional qualifications are unimportant, for if the case appears to be colorably well founded, trial counsel of better standing and ability is available. If it is not, there is still some chance of a nuisance value settlement. With the wide range of financial transactions with which large corporations are concerned and some ingenuity in finding reasons to criticise them, it is not surprising that the flimsiest foundation of fact is not too weak for many attorneys to base a hope of rewards of these proportions.[77]

The conclusion reached by the survey was that the great majority of derivative actions against directors are proved ultimately to be unfounded; that in many cases they are brought by stockholders who bought their shares just before beginning suit; that the majority of plaintiffs in these actions hold so few shares of the corporation involved that they may be said to have little or no personal interest in the outcome; that the actions are prosecuted principally for the benefit of plaintiffs' attorneys; and that litigation of this character has become costly and burdensome to the majority of stockholders both by reason of the time required by officers and directors in defending the actions and by reason of the effect of General Corporation Law section 61a transferring the cost of defense to the whole body of stockholders.

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[76]Wood, *op. cit. supra* note 73, at 78-84. For example, the recovery in the *General Motors* case, 44 F. Supp. 960 (S. D. N. Y. 1942), while one of the largest ever made, yielded to the 90 shares of stock which brought the action only 10 cents a share before corporate and individual taxes.

[77]Wood, *op. cit. supra* note 73, at 82. In defense of the action of the courts which have granted allowances to plaintiffs' attorneys, frequently much in excess of the value of the services rendered on any professional basis, I must say that, for one reason or another, the attorneys representing defendants have been usually of no assistance to the courts in appraising the value of the services of plaintiffs' attorneys.

Limitations on Stockholders' Suits

The Chamber of Commerce report proposed remedial legislation, supported by the cogent considerations set forth in the study. Such legislation was recommended by the Chamber of Commerce on the basis of its committee's report by a vote taken on March 2, 1944.[78]

The corrective measures enacted by the Legislature, which were signed by the Governor on April 9, 1944, were contained in two bills. The first, Chapter 667 of the Laws of 1944, amended General Corporation Law section 61 by adding thereto a new paragraph as follows:

> In any action brought by a shareholder in the right of a foreign or domestic corporation it must be made to appear that the plaintiff was a stockholder at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law.

The second, Chapter 668 of the Laws of 1944, provided that in any action instituted or maintained in the right of any foreign or domestic corporation, the corporation should be entitled at any stage of the proceedings before final judgment to require the plaintiff to give security for the reasonable expenses, including attorneys' fees, which might be incurred by the corporation and by the other defendants in connection with such action pursuant to General Corporation Law section 61a, in all cases where the plaintiff or plaintiffs held less than 5% of the outstanding shares of any class of stock or shares having a market value of $50,000 or less. Provision was made that the amount of the security might subsequently be increased or decreased in the discretion of the court.

Question has been raised as to the application of these new laws to pending cases and as to their constitutionality. They were expressed to take effect immediately upon approval, on April 9, 1944. So far as concerns the provision for costs, no reason appears for doubting that it will be immediately applicable to pending actions under the well-settled rule that legislation governing procedure or practice may be made so applicable and does not concern a vested right.[79] There appears to be no reason why the expenses which the court must direct the plaintiff to secure "at any stage of the proceedings before final judgment" should not include expenses theretofore incurred as well as those incurred after the enactment of the

[78]35 BULL. OF CHAMBER OF COMMERCE OF THE STATE OF N. Y. 442-55 (No. 9, March 1944).

[79]Matter of Davis, 149 N. Y. 539, 44 N. E. 185 (1896); Laird v. Carton, 196 N. Y. 169, 171-2, 89 N. E. 822, 823 (1909); Lazarus v. Metropolitan Elevated R. Co., 145 N. Y. 581, 585, 40 N. E. 240, 241 (1895); Schultz v. Third Ave. R. Co., 49 Super. Ct. 95, 96-7 (N. Y. 1883), deals with the point in express relation to security for costs.

statute. Criticism has been directed against the law on the ground that it divests the courts of their jurisdiction, in removing from them discretion as to whether or not to impose costs. This criticism seems groundless. Surely the Legislature has the power, when satisfied of the existence of an abuse, to regulate access to the courts by the regulation of costs.[80] The Legislature does not assume to tell the courts how much they shall determine would be the probable expense of the case to the corporation, since it cannot know and only the courts in a particular case can know the probable cost of defense and the defendants' chances of making the successful defense which is prerequisite to their recovery against the corporation under General Corporation Law section 61a. I cannot see that the legislation impairs the general jurisdiction in law and equity conferred upon the Supreme Court by the New York Constitution.[81]

Chapter 668, allowing a defendant corporation to require a plaintiff, whose economic interest in the outcome would not seem to justify the expense of litigation ultimately shown to be unwarranted, to give security for reasonable expenses, is a legitimate and even a necessary regulation, in view of the evidence of abuses which impelled its passage.

Chapter 667, which repeals the rule of *Pollitz v. Gould*,[82] is in principle a more radical enactment since it shuts off access to the courts on the part of stockholders with respect to transactions occurring before they acquired their stock. In effect, it holds that transfers of stock shall not, so far as procedure in the State of New York is concerned, carry with them rights based on causes of action which arose antecedently, and so changes the substantive law with respect to transfers occurring after April 9, 1944, in the State of New York, as well as procedural rights in respect of all stock transferred. The new law is, of course, nothing more than the adoption of the rule which has existed in the federal courts since 1881.[83] While substan-

[80]Compare the language of Mr. Justice Douglas referred to in note 67 above. Since the preparation of this article, the views here expressed have been confirmed in an opinion of Collins, J., in Schielcrawt v. Moffett (Corn Products Refining Company), N. Y. L. J. May 17, 1944, p. 1905, col. 7 (Spec. Term, N. Y. Co.), upon a motion noticed the day after announcement in the newspapers that General Corporation Law § 61b had been approved, upon the eve of trial of an action commenced four years previously. Much of the opinion is directed to plaintiffs' attack upon the reasonableness of the classification made by § 61b. Since the suit had been commenced before enactment of the law, the plaintiffs are given three months in which to bring in the number of shareholders which would suffice to dispense with security for costs. To the same effect is *Miller v. McClure,* N. Y. L. J., June 3, 1944, p. 2151 (Nolan, J., Special Term Westchester County).

[81]Art. VI, § 1.

[82]202 N. Y. 11, 94 N. E. 1088 (1911).

[83]Hawes v. Oakland, 104 U. S. 450, 1 Sup. Ct. 564 (1881); FED. RULES CIV. PROC. 23(b), carrying over Equity Rule 27 of 1912 and Equity Rule 94 of 1881.

tive in its underlying considerations, Chapter 667 is perhaps sufficiently a matter of procedure to be applicable at once to pending litigation. The principle applied by the federal courts prior to the enactment of the legislation in determining Rule 23(b) to be controlling, notwithstanding that the substantive law of the forum was to the contrary, is persuasive.[84]

As to whether these new enactments will be applied by the federal courts, there will certainly be controversy. It may be safely predicted that great effort will be made to carry corporate litigation into those courts, and that plaintiffs competent to create diversity jurisdiction will be at a premium. Nevertheless, experience with General Corporation Law section 61a suggests that section 61b will also be applied in the United States courts. Allowances under section 61a have been granted in unreported cases in the federal courts, which have also enforced the provision in the state procedure requiring non-residents to give security for costs.[85] In numerous cases involving other state statutes which imposed costs including attorneys' fees, the federal courts sitting in that state have enforced the statute on the ground that it constituted one of the conditions upon which companies did business in the state.[86]

It remains true, as pointed out by a distinguished judge in a decision rendered after the enactment of these bills, that the typical derivative stockholders' suit

> is at present the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations. We cannot therefore allow the prevailing mood of justifiable dissatisfaction with some of the temporary incidents of such suits to cause us to lose sight of certain deep-rooted, traditional concepts of the obligations of directors to their corporation and its stockholders.[87]

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[84]Summers v. Hearst, 23 F. Supp. 986, 992 (S. D. N. Y. 1938); Piccard v. Sperry Corp., 36 F. Supp. 1006 (S. D. N. Y. 1941), *aff'd*, 120 F. (2d) 328 (C. C. A. 2d, 1941); Gallup v. Caldwell, 120 F. (2d) 90, 95 (C. C. A. 3d, 1941); Perrott v. U. S. Banking Corp., 53 F. Supp. 953 (D. Del. 1944). This is already the indicated line of decision at Spec. Term. *Cf.* Klum v. Clinton Trust Co., N. Y. L. J. May 3, 1944 (N. Y. Co., McLaughlin, J.), applying § 61 to an existing action and dismissing it.

[85]Wood, Survey and Report Regarding Stockholders' Derivative Suits (1944) 18; Winkley Co. v. Bowen Mfg. Co., 180 Fed. 624 (C. C. N. D. N. Y. 1910); Leake v. N. Y. Central R. R., 26 F. Supp. 416 (N. D. N. Y. 1939); Cavicchi v. Mohawk Mfg. Co., 27 F. Supp. 981 (S. D. N. Y. 1939).

[86]Fidelity Mutual Life Assurance v. Mettler, 185 U. S. 308, 326, 22 Sup. Ct. 662, 669 (1902); Missouri K. & T. R. v. Cade, 233 U. S. 642, 651-2, 34 Sup. Ct. 678, 681 (1914); Sioux County v. National Surety Co., 276 U. S. 238, 243, 48 Sup. Ct. 234, 240 (1928); Pond v. Goldstein, 41 F. (2d) 76, 81 (C. C. A. 9th, 1930).

[87]Shientag, J., in Bayer v. Beran (Celanese Corp. of America), N. Y. L. J. April 20, 1944, p. 1532.

Nevertheless I believe that the new legislation is a necessary step toward cleansing this form of action from the speculative elements which disfigure it, since no sound reason can be advanced for permitting stockholders with an infinitesimal pecuniary stake to speculate for the benefit of their lawyers with the litigation of claims at the ultimate expense of the entire body of stockholders.