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## Corporations - Stockholders' Suit - State Security for Expenses Statute Is Inapplicable in Stockholders' Derivative Suit in Federal Court for Violation of Securities Exchange Act Provision and Regulation Thereunder

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CORPORATIONS—STOCKHOLDERS' SUIT—STATE SECURITY FOR EXPENSES STATUTE IS INAPPLICABLE IN STOCKHOLDERS' DERIVATIVE SUIT IN FEDERAL COURT FOR VIOLATION OF SECURITIES EXCHANGE ACT PROVISION AND REGULATION THEREUNDER.

*McClure v. Borne Chemical Co. Inc.*, (3d Cir. 1961).

Plaintiffs brought a shareholders' derivative suit in the United States District Court for the Eastern District of Pennsylvania, stipulating that the corporate cause of action arose from the violation of Section 10 (b),<sup>1</sup> the implementing regulation thereunder,<sup>2</sup> and Section 29 (b)<sup>3</sup> of the Securities Exchange Act of 1934. Defendants moved to require Plaintiff shareholders to post security for expenses, including reasonable attorneys' fees. It was claimed by defendants that state law determines whether a plaintiff may be required to post security and, since both Pennsylvania, the state in which the trial court sits, and New Jersey, the state of incorporation and principal place of business of the Borne Chemical Company, Inc., have security for expenses statutes,<sup>4</sup> defendants were entitled to the posting of security. The district court denied the motion and defendants appealed. The United States Court of Appeals, Third Circuit, affirmed, *holding* that shareholders are not required to post security for expenses, including reasonable attorneys' fees, when they seek to enforce a corporate cause of action arising from a violation of the criminal provisions of the Securities Exchange Act of 1934. *McClure v. Borne Chemical Company, Inc.*, 292 F.2d 824 (3d Cir. 1961), *cert. denied* 30 U.S.L. Week 3194 (U.S. Dec. 12, 1961).

The derivative suit, an equity created remedy, has long been the means by which minority stockholders have been able to assert their interest in the corporation against the wrongdoings of entrenched management and third parties. Licensing the owners of a small interest to bring a suit on behalf of the entire corporation, however, gave rise to many abuses, and equity, on its own initiative was forced to impose limitations.<sup>5</sup> The latest effort in this direction, the security for expenses requirement, was inaugurated on the state level by the New York legislature in 1944,<sup>6</sup> and since then, New Jersey, Pennsylvania, Maryland,

1. Securities Exchange Act of 1934, § 10, 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958).

2. 17 C.F.R. § 240.10b-5 (1949). The regulation, in general, makes it unlawful to engage in fraudulent practices in connection with the purchase or sale of any security when the mails, facilities of national securities exchanges, or instrumentalities of interstate commerce are used.

3. Securities Exchange Act of 1934, § 29, 48 Stat. 903 (as amended by 52 Stat. 1076 (1938), 15 U.S.C. 78cc(b) (1958)). This section declares the invalidity of any contract which violates the provisions of the Act or regulations thereunder.

4. PA. STAT. ANN. tit. 12, § 1322 (Supp. 1960); N.J. REV. STAT. § 14:3-15 (Supp. 1960).

5. *E.g.*, stockholders had to exhaust intracorporate remedies, *Hawes v. City of Oakland*, 104 U.S. 450, 26 L. Ed. 827 (1882); they had to own stock at the time of the transaction complained of, *Home Fire Ins. Co. v. Barber*, 67 Neb. 644, 93 N.W. 1024 (1903); *FED. R. CIV. P. 23(b)*. See Note, 45 CALIF. L. REV. 80 (1957).

6. N.Y. GENERAL CORPORATION LAW § 61-b.

Wisconsin, and California have enacted similar laws.<sup>7</sup> In general, these statutes provide that when shareholders attempt to enforce a corporate cause of action and hold less than a specified percentage of the outstanding stock, or stock of less than a specified market value, the corporation can require them to post a bond to secure payment of the expenses of the corporation, including reasonable attorneys' fees, incurred as a result of the litigation. Upon termination of the action, the corporation may have recourse to the security in such amount as the court having jurisdiction may determine.<sup>8</sup> California's provision is unique in that it is not mandatory, and security will only be ordered if, after notice and hearing, it is determined either that there is no reasonable probability that the suit will benefit the corporation or that an individual defendant did not participate in the transaction complained of. The avowed purpose of these enactments was to prevent the so-called "strike suit" and to discourage stockholders who, without a thought of recovery, would bring such a suit with the hope that management would "buy them off" by entering into a secret settlement.<sup>9</sup> However it has been contended that these statutes result in the virtual elimination of the derivative suit<sup>10</sup> and it would seem that this argument is not without persuasiveness for only five states have followed New York's lead. In *Cohen v. Beneficial Industrial Loan Corporation*,<sup>11</sup> the Supreme Court upheld the validity of the New Jersey statute against attacks on constitutional grounds.

The Court in *Cohen* also ruled that a security for expenses statute is part of the "substantive" law of the state and is therefore applicable

7. N.J. REV. STAT. § 14:3-15 (Supp. 1960); PA. STAT. ANN. tit. 12, § 1322 (Supp. 1960); MD. R. OF P. 328; WIS. STAT. ANN. § 180.405(4) (1957); CAL. CORP. CODE § 834 (Supp.).

8. See Note, *Security for Expenses Legislation — Summary, Analysis, and Critique*, 52 COLUM. L. REV. 267 (1952); see also Note, *Stockholders' Derivative Suits*, 12 U. FLA. L. REV. 196 (1959), for discussions on how these statutes differ. The New York requirement applies only where the holdings of the plaintiff or plaintiffs do not exceed five per cent of any one class of stock or a total market value of fifty thousand dollars; New Jersey sets the minimum requirement at five per cent of all outstanding shares of every class; Pennsylvania follows the New York statute in applying the five per cent standard but has no exception based on market value; Maryland has a twenty five thousand dollar limit, but if the plaintiff is a nonresident, security may be required regardless of his holdings; Wisconsin's statute, applies only to holders of less than three per cent of any class of stock. These security for expense statutes should be distinguished from the common law rule that permits a successful plaintiff in a derivative suit to recover the expenses of litigation if the action results in a tangible benefit to the corporation. *Bosch v. Meeker Cooperative Light and Power Ass'n*, 257 Minn. 362, 101 N.W.2d 423 (1960).

9. See Wood, *Survey and Report Regarding Stockholders' Derivative Suits*, 82 (Chamber of Commerce of State of New York 1944); see also Governor Dewey's memorandum accompanying N.Y. GENERAL CORPORATION LAW § 61-b.

10. See Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944); Hornstein, *The Future of Corporate Control*, 63 HARV. L. REV. 476 (1950). At p. 480, the author did express some favor for the California statute as compared with the New York type when he stated that it demonstrates "that killing the patient is not the only way to stop a fever". See also Ballantine, *Abuses of Stockholders' Derivative Suits: How far is California's New "Security for Expenses" Act Sound Regulation*, 37 CALIF. L. REV. 399 (1949).

11. 337 U.S. 541, 69 S. Ct. 1221 (1948).

in a diversity suit in a federal court.<sup>12</sup> Lower federal courts, without exception, however, have refused to hold these statutes applicable in non-diversity federal cases,<sup>13</sup> even where the complaint alleged that jurisdiction depends on a federal statute as well as on diversity of citizenship.<sup>14</sup> The present case exemplifies the general problem of determining when a state law should be applicable in nondiversity litigation in a federal court.<sup>15</sup> Specifically, plaintiffs sought recovery on behalf of their corporation in a civil action based upon a violation of criminal provisions of the Securities Exchange Act of 1934, which provisions are completely silent as to the requisites to the maintenance of a derivative suit in such circumstances. No doubt a private right of action can be inferred from a violation of the provisions,<sup>16</sup> but to what extent the exercise of this can be restricted by state procedural limitations is another question.

Congress has provided in the Rules of Decision Act,<sup>17</sup> that state laws should be regarded as rules of decision in civil actions in the federal courts "in cases where they apply," except where the United States Constitution, treaties, or congressional acts otherwise require or provide. Whether state law is applicable in diversity proceedings depends upon whether or not the law is "substantive" or "outcome deter-

12. The Court stated that the statute created a new liability by making the plaintiff liable for the expenses which the corporation incurs, and therefore is not a mere regulation of procedure. *Id.* at 555-56, 69 S. Ct. at 1230. In a subsequent case, a district court refused to extend *Cohen* and held that a security for expense statute of the state of incorporation is not applicable in the state of the forum, when the latter had no such statute. *Berkwitz v. Humphrey*, 130 F. Supp. 142 (N.D. Ohio 1955). Where a state also requires the plaintiffs in a derivative suit to have been stockholders at the time of the transaction complained of, the problem arises as to what extent a plaintiff who holds less than the required amount of stock can avoid posting of security by bringing suit first and later getting other stockholders to join him. In New York state courts the holdings of the additional plaintiffs could be added to that of the original plaintiff so as to avoid the posting of security even though the additional plaintiffs were not contemporaneous owners and even though New York has a statutory contemporaneous ownership requirement. But when a diversity action was brought in the federal court in New York, the leniency of the state courts was not followed and it was held that the similarly worded federal contemporaneous ownership mandate, Fed. R. Civ. P. 23(b), required that the prospective intervenors be shareholders at the time of the transaction complained of. *Kaufman v. Wolfson*, 136 F. Supp. 939 (S.D.N.Y. 1955).

13. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Fielding v. Allen*, 181 F.2d 163 (2d Cir. 1950), *cert. denied*, *Ogden Corp. v. Fielding*, 340 U.S. 817, 71 S. Ct. 46 (1950); *Hoover v. Allen*, 180 F. Supp. 263 (S.D.N.Y. 1960); *Breswick & Co. v. Briggs*, 136 F. Supp. 301 (S.D.N.Y. 1955); *Stella v. Kaiser*, 81 F. Supp. 807 (S.D.N.Y. 1948).

14. *Fielding v. Allen*, *supra*, note 13, at 166. The court stated that when the complaint sets forth a substantial claim under a federal statute, the reference to diversity is mere surplusage.

15. Defendants also argued that a security requirement should be imposed under "general federal equity law" but they cited no authorities and were unsuccessful. 292 F.2d 824, 835 (1961). Further, they argued that a security for expenses requirement should be implied from § 78j(b) by analogy to other provisions of the statute which couple security for expenses provisions with provisions granting private rights of action, but this contention too was rather summarily disposed of. 292 F.2d 824, 836 (1961).

16. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

17. 28 U.S.C. § 1652 (1958). This provision was originally enacted as part of the Federal Judiciary Act of Sept. 24, 1789 and since then there have been only minor changes.

minative".<sup>18</sup> Unfortunately, there is no "settled" test governing the applicability of state law in nondiversity actions. The federal courts have not hesitated to apply state statutes of limitation where Congress has been silent on the matter,<sup>19</sup> and this is so with respect to civil suits based on violations of Section 10(b) of the 1934 Act.<sup>20</sup> A state statute of frauds has been held applicable to bar an action to enforce an oral collective bargaining agreement under the Taft-Hartley Act.<sup>21</sup> Similarly, a state statute requiring the owner of land to reimburse one who in good faith took products from his land for expenses incurred in doing so as a condition to recovery of the value of such products was held applicable against the United States in a federal equity suit.<sup>22</sup> In a reorganization proceeding, whether certain persons had authority to act for their corporation was held to be within the realm of local law.<sup>23</sup> Thus it appears that the mere fact that an action is brought to enforce a federal right is not conclusive as to the inapplicability of these state security for expenses statutes. Compounding the difficulties here is the dictum of the Supreme Court in the *Cohen* case that the state has plenary power over a domestic corporation's stockholders' derivative suits.<sup>24</sup> It can be argued, therefore, that a security for expenses requirement affects the remedy and not the right, and in view of the policy of the courts to permit rights created by Congress to be enforced subject to restrictions of the states, these statutes should be held applicable here.

Although the matter has never been decided by the Supreme Court, several lower federal courts have decided that since diversity is not involved, these statutes are not applicable to civil actions based on violations of Section 10 (b).<sup>25</sup> It would seem that the difficulty of the problem generated this rather summary treatment. Possibly, the heart of the matter is the difference in policy involved in cases where the federal court's jurisdiction is based on diversity rather than on a federal question. With the former, the federal court's determination should be consistent with the internal law of the forum in which the court is sitting,<sup>26</sup> but with the latter, where paramount federal interests are involved, the

18. *Erie R.R. v. Tompkins*, 304 U.S. 64, 58 S. Ct. 817 (1938); *Guaranty Trust Co. v. York*, 326 U.S. 99, 65 S. Ct. 1464 (1945).

19. *E.g.*, *O'Sullivan v. Felix*, 233 U.S. 318, 34 S. Ct. 596 (1913); *Campbell v. City of Haverhill*, 155 U.S. 610, 15 S. Ct. 217 (1895).

20. *E.g.*, *Hooper v. Mountain States Securities Corporation*, 282 F.2d 195 (5th Cir. 1960) *cert. denied*, 81 S. Ct. 695 (1961); *Connelly v. Balkwill*, 174 F. Supp. 49 (N.D. Ohio 1959).

21. *Hamilton Foundry & Machine Co. v. Int'l Molders Union*, 193 F.2d 209 (6th Cir. 1951). See also *Rothenberg v. H. Rothstein & Sons*, 183 F.2d 524 (3d Cir. 1950).

22. *Mason v. United States*, 260 U.S. 545, 43 S. Ct. 200 (1923).

23. *Price v. Gurney*, 324 U.S. 100, 65 S. Ct. 513 (1945).

24. 337 U.S. at 549-50, 69 S. Ct. at 1227 (1948).

25. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Hoover v. Allen*, 180 F. Supp. 263 (S.D.N.Y. 1960); *Stella v. Kaiser*, 81 F. Supp. 807 (S.D.N.Y. 1948). Cf. *Loss, SECURITIES REGULATION* 1092, 1094 n. 493 (1951, Supp. 1955); 6 *MOORE, FEDERAL PRACTICE* ¶ 54.73 (2d ed. 1953).

26. See note 18 *supra*.

peculiarities of state law should not be permitted to disrupt national uniformity in the enforcement of federal rights. Indeed, the application of state statutes of limitation to federally based causes of action is justified on the ground that all states provide for such and therefore there is no discrimination in the enforcement of federal rights.<sup>27</sup> It is on this basis that the court here declined to hold the state security for expenses requirement applicable to plaintiffs' cause of action. Only six states have this peculiar and controversial restriction on stockholders' derivative suits, and to hold such a limitation applicable would disrupt the uniform enforcement of the federal rights arising from violation of the Securities Exchange Act provisions. But even though this seems to be the paramount consideration, the courts have not always treated it as such and much confusion exists.<sup>28</sup> Federal courts generally remain free to exercise their discretion in the resolution of questions of applicability of state law which arise incident to the interpretation and enforcement of federal statutes.<sup>29</sup> In certain situations state law is held applicable and in certain situations it is not and the only definite guide for a federal court in this area is prior federal court decisions. Since a decision by one lower federal court is not binding on another there is a real danger of conflict among the various federal circuits. In addition, when a question is presented anew to a federal court, it must on its own decide what policy considerations justify the applicability or inapplicability of that law. The undesirability of this ad hoc treatment may eventually prompt the Supreme Court to attempt to settle the difficulties with another "Erie type" test which would be used in non-diversity litigation. Perhaps that time has arrived, but it is not the purpose to here investigate what subtle pressures may again move the Court to enter such a vague and complex area. Considering the existing authorities<sup>30</sup> and the underlying policies involved<sup>31</sup> the court's decision has the attribute of consistency, but the general problem and dangers remain.

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27. *Campbell v. City of Haverhill*, 155 U.S. 610, 615, 15 S. Ct. 217, 219 (1895).

28. See Mishkin, *The Variousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797 (1957); Hill, *State Procedural Law in Federal Nondiversity Litigation*, 69 HARV. L. REV. 66 (1955). In the latter article a persuasive argument against the applicability in the federal courts of the state security for expenses statutes is made. FED. R. CIV. P. 23(b) states the conditions precedent for the maintenance of a derivative suit and if security for expenses were necessary, the rule would say so.

29. *Momand v. Twentieth-Century Fox Film Corp.*, 37 F. Supp. 649 (N.D. Okla. 1941).

30. See note 25 *supra*.

31. The court relied on the doctrine that state law cannot be interjected into the uniform equity jurisdiction of the federal courts in non-diversity cases. Also, Congress intended uniformity of enforcement of rights under the 1934 Act since it conferred exclusive jurisdiction in the federal courts. Further, this was not a situation where Congress acted with an established state doctrine in mind, for the first state security statute came ten years after the enactment of the Securities Exchange Act. Finally, there is a comprehensive body of federal law on the subject of derivative suits and so there is no necessity to resort to state law.