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Rule 10b-5 and the Stockholder's Derivative Action

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Mr. Lowenfels focuses on a new, emerging private cause of action under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder—a stockholder's derivative action initiated on behalf of a corporation which has been defrauded in the purchase or sale of securities. Though the stockholder's derivative suit has been traditionally governed by state law, compelling advantages accrue to the stockholder initiating action pursuant to this section and rule. The author concludes that as a result, a substantial body of fedral common law will develop around the section and rule.

I. Introduction

The Securities Exchange Act of 1934 provides a system for regulating securities trading practices in both the exchange and the over-the-counter markets. Designed to protect the interests of the investing public, the provisions of the act seek to curb misrepresentations and deceit, market manipulations and other fraudulent acts and practices, and to establish and maintain just and equitable principles of trade conducive to the maintenance of open, fair and orderly markets. Section 10(b) of the act is sweeping in its scope:

> Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[1]

Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to Section 10(b), is equally encompassing:

> It shall be unlawful for any person, directly or indirectly, by the use

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

> of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[2]

An examination of the above section and rule may lead one to believe, first, that they apply only to public dealings (*i.e.*, occurring on an exchange or in the over-the-counter markets) in securities, and, second, that they are enforcible only by governmental agencies. Beginning in 1946,[3] however, twelve years after the enactment of the act, the federal courts have consistently held that section 10(b) and rule 10b-5 are applicable to private dealings in securities[4] and that private persons have standing to sue to redress violations of rights granted by the above section and rule.[5]

This article focuses upon a new, emerging private cause of action based upon section 10(b) and rule 10b-5—a stockholder's derivative action initiated on behalf of a corporation which has been defrauded in connection with the purchase or sale of securities. Five reported cases, three decided in the last three months of 1964, have sustained a stockholder's derivative suit based upon section 10(b) and rule 10b-5.[6] The significance of these decisions becomes apparent, not only when one considers that the derivative suit has traditionally been an internal corporate matter governed exclusively by state law, but also when one focuses upon the compelling advantages which accrue to the stockholder initiating his derivative action pursuant to the above section and rule. Few of these advantages exist for the

2. 17 C.F.R. § 240.10b-5 (1951).

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

4. Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953). See also Baird v. Franklin, 141 F.2d 238 (2d Cir. 1944).

5. Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Beury v. Beury, 222 F.2d 464 (4th Cir. 1955); Fratt v. Robinson, *supra* note 4; Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). Professor Louis Loss, the leading commentator in the securities area, has called this recognition of implied liabilities "the most surprising development in the whole area of civil liabilities under the SEC status." 3 LOSS, SECURITIES REGULATION 1757 (1961).

6. Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964); McClure v. Borne Chem. Co., 292 F.2d 824 (3rd Cir. 1961); Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559 (S.D.N.Y. 1964); Dembitzer v. Republic Corp., CCH FED. SEC. L. REP. ¶ 91, 445 (S.D.N.Y. 1964); Stella v. Kaiser, 82 F. Supp. 301 (S.D.N.Y. 1948).

private plaintiff suing directly pursuant to section 10(b) and rule 10b-5 because the states do not impose the same restrictions upon direct action which they impose upon a derivative private action. First, instead of grappling with the infinitely complex problems of effecting jurisdiction and obtaining a suitable venue for trial under state law, the stockholder suing derivatively pursuant to section 10(b) and rule 10b-5 is able to utilize the nationwide jurisdictional and venue provisions of section 27 of the act. Second, instead of being required to post security for expenses, to obtain prior stockholder authorization for suit or being hamstrung by a short statute of limitations under state law, the stockholder suing derivatively pursuant to the above section and rule is able to circumvent each of these problems. Third, instead of being compelled to choose between a derivative suit pursuant to state law and a derivative suit pursuant to federal law, the stockholder who bases his derivative action on federal rights may join his state cause of action to the federal claim and maintain both in a federal court under the doctrine of pendent jurisdiction. The emergence of this stockholder's derivative action based upon section 10(b) and rule 10b-5 with its circumvention of restrictions so carefully erected by state legislatures and courts conflicts directly with strong state policies in favor of discouraging derivative plaintiffs. This conflict has important ramifications in certain areas of federalism, most particularly in the relations between state and federal courts. This article will examine some of these ramifications.

II. The Type of Case

Rule 10b-5 is all embracing. It applies to any person, insider or outsider, natural or artificial. It applies to any security, equity or debt, whether or not exempted from registration, whether or not traded on a national securities exchange or in the over-the-counter markets, and whether or not the issuer is engaged solely in intrastate commerce. It applies to both purchases and sales, and it reaches frauds, misrepresentations and half truths, whether or not they are sufficient to sustain a common law action for fraud and deceit, and whether or not they are made through the use of the mails or the facilities of interstate commerce or of a securities exchange, so long as an interstate facility is used in connection with the purchase or the sale. Clauses 1 and 3 of the rule contain express references to fraud. In clause 1 devices and schemes to defraud are declared unlawful, and in clause 3 acts and practices which operate as a fraud are declared unlawful. Clause 2, however, is aimed particularly at misstatements, half truths and non-disclosures. There is nothing on

the face of clause 2 which refers to an intent to defraud.[7]

Five reported cases, three decided in the last three months of 1964, have expressly sustained the right of a stockholder to sue derivatively on behalf of his corporation pursuant to section 10(b) and rule 10b-5. In *Ruckle v. Roto American Corp.*,[8] plaintiffs asserted that certain insiders, by means of material omissions in their disclosures to the corporation's board of directors, defrauded the corporation and caused it to issue securities designed to perpetuate the insiders' control. In *McClure v. Borne Chemical Co.*,[9] plaintiffs charged that they had been fraudulently deprived of their preemptive rights with respect to 10,000 shares of the corporation's stock, that said shares were sold at an improperly low price, and that the defendants engaged in certain manipulative practices affecting the market price of the shares. In *Dembitzer v. The First Republic Corp.*,[10] plaintiffs contended that the individual defendants, all insiders, had caused the corporation to circulate a fraudulent prospectus as a result of which the corporation was induced to sell stock to the defendants in exchange for property worth far less than the stock. In *Kane v. Central American Mining & Oil, Inc.*,[11] the complaint asserted that defendants, who were the sole officers and directors of the corporation, looted the corporation and caused it to issue four million shares of stock to themselves for little or no consideration. In *Stella v. Kaiser*,[12] the defendants were charged with deliberate and negligent waste of the corporation's funds in a futile attempt to stabilize the stock preparatory to a public offering.[13]

In each of the above cases, with the exception of *Stella* which focussed upon the sections of the act dealing with manipulations in auction markets, the basis for the derivative action was that dominating insiders had induced the corporation to issue shares to themselves or their designees at inadequate prices. Each complaint charged injury to the corporation as a defrauded seller. It would appear that similar actions could be initiated where insiders issued inordinate amounts of options to themselves on particularly favorable

7. ISRAELS, SEC PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 140 (1962).

8. *Supra* note 6.

9. *Supra* note 6.

10. *Supra* note 6.

11. *Supra* note 6.

12. *Supra* note 6.

13. It is interesting to speculate as to just what extent the emergence of these derivative actions pursuant to § 10(b) and rule 10b-5 will limit the "privity" doctrine enunciated in Joseph Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952) and Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). For a discussion of this problem, see 3 Loss, *op. cit. supra* note 5, at 1767-71 (1961).

terms. Similarly, suits could be maintained on behalf of corporations induced by insiders motivated by selfish ends to purchase shares at extraordinarily high prices. Such complaints would assert injury to the corporation as a defrauded purchaser.

In the recent case of *O'Neill v. Maytag*,[14] plaintiff, a stockholder of National Airlines, brought a derivative action pursuant to section 10(b) and rule 10b-5 on behalf of National against a number of its directors and officers and against Pan American World Airways, Inc. In 1958, National had issued 400,000 shares of its Common Stock to a trustee for the benefit of Pan American and Pan American in return had issued 400,000 of its shares to a trustee for the benefit of National. In 1960, the Civil Aeronautics Board found this cross-ownership not to be in the public interest and ordered the companies either to sell or to re-exchange the stock.[15] In compliance with this order, a series of exchanges were consummated in 1963 at a one-to-one ratio. Plaintiff alleged that on the basis of New York Stock Exchange quotations certain Pan American shares given up by National were worth 12,906,400 dollars while the shares of its own stock received in return were worth only 11,115,000 dollars. Plaintiff further alleged that the individual defendants had induced National to pay this premium in order to eliminate a large block of stock which threatened their control of National. In a 2-1 decision, Judge Hays dissenting, the United States Court of Appeals for the Second Circuit held that plaintiff did not state a claim cognizable under section 10(b) and rule 10b-5 because no deception had been perpetrated by the defendants. The court qualified its holding by stating that non-verbal acts may amount to deception and that deception may not be required in cases involving securities brokers, dealers, or investment advisers.

O'Neill is the first derivative action initiated on behalf of a corporation as a defrauded purchaser pursuant to section 10(b) and rule 10b-5 to be decided by a United States Court of Appeals. The deception standard, together with the qualifications enunciated by the court, may prove difficult to apply in the future. In any event, the substantive development of principles based on rule 10b-5 in this derivative area may well be extended beyond what is at present foreseeable. The point to be emphasized here, however, is that if one can tailor his derivative action to fit the broad language of rule 10b-5 he will be the beneficiary of a number of important advantages which are discussed in this article.

14. 339 F.2d 764 (2d Cir. 1964).
15. 31 C.A.B. 198 (1960).

III. JURISDICTION AND VENUE

Among the first problems to confront the stockholder who initiates his derivative cause of action pursuant to state law are those relating to jurisdiction and venue. As a rule plaintiff will prefer to commence suit in the courts of the state wherein he resides. This is the jurisdiction in which his attorney practices, this is the law with which his attorney is familiar, and this proximity will prove highly convenient in the day to day conduct of the suit. If the individual defendants are residents of the state in which he resides, plaintiff should have little difficulty in effecting service of process. Where, however, none of these defendants or only one or two of the less solvent defendants reside in his state, plaintiff is faced with a problem. In most states, if the defendant is a nonresident, a court can acquire jurisdiction in personam only if the defendant appears or is personally served within the state. To obtain jurisdiction in rem or quasi in rem, plaintiff must attach property of the defendant located within the state and recovery is limited to the property attached. Moreover, in a derivative suit the corporation in whose behalf plaintiff is suing is an indispensable party to the action. If the corporation was incorporated in a foreign jurisdiction and is neither licensed to do business nor doing business in the state wherein plaintiff resides, the corporation cannot be personally served within this state.[16]

Plaintiff may determine that his best chance of obtaining jurisdiction over all of the defendants exists through a suit in the federal courts.[17] For convenience, and because in diversity cases the federal courts will be guided by the substantive law of the forum state, plaintiff prefers to sue in the federal district court of the district in which he resides. Assuming the 10,000 dollar jurisdictional requirement poses no problem, plaintiff still must effect personal service upon the individual defendants within the territorial limits of the state in which the district court is held.[18] If the defendants do not enter this state, personal service cannot be effected. If any of the defendants or the corporation is a citizen of this state, the jurisdictional requirement of complete diversity of citizenship between all plaintiffs and all defendants is lost.

Plaintiff may now determine that his only chance is to sue the defendants anywhere in the nation where he can obtain jurisdiction.

16. Jurisdiction in personam over such a foreign corporation may, however, be based upon a general appearance, prior express assent or "implied consent" (*e.g.*, under a nonresident motorist statute).

17. One advantage is that under 28 U.S.C. § 1695 (1959), the corporation may be served "in any district where it is organized or licensed to do business or is doing business."

18. FED. R. CIV. P. 4(f).

He is prepared to surrender the advantages and the convenience of a suit in his home state. Assuming complete diversity of citizenship exists between plaintiff on one hand and the corporation and the individual defendants on the other hand, plaintiff may determine to sue in the district wherein the corporation resides.[19] In many cases, however, it will be almost impossible to effect personal service upon the individual defendants within the territorial limits of this state. As a last alternative, plaintiff may determine to sue in the federal district court of the state or district in which the defendants reside. If the defendants reside in different states, however, plaintiff will be obligated to choose which defendant he wishes to sue unless he is willing to finance more than one lawsuit.

The preceding paragraphs in no way exhaust the problems relating to jurisdiction and venue facing the stockholder suing derivatively under state law. They are designed merely to outline the complexity of certain issues in this area and to serve as a background of comparison for the discussion of similar problems under section 27 of the act.

Section 27 reads in relevant part as follows:

> Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.[20]

Under section 27, plaintiff may sue in the district in which he resides provided an act or transaction constituting a violation of section 10(b) and rule 10b-5 occurred there. And pursuant to the legislative purpose of providing an accessible forum for imposing the standards of the act, telephone calls from the forum district,[21] transmission of written confirmations,[22] mailings designed to lull the victims into inaction[23]—all have been held by the courts to be sufficient to support venue. Moreover, it is not even required that the telephone calls or mailings themselves be fraudulent or deceptive. As the

19. Under 28 U.S.C. § 1401 (1959), stockholders may sue in any district "where the corporation might have sued the same defendants."

20. Securities Exchange Act of 1934, § 27, 63 Stat. 107 (1949), 15 U.S.C. § 78aa (1958).

21. Matheson v. Armbrust, *supra* note 4. Clapp v. Stearns & Co., 229 F. Supp. 305 (S.D.N.Y. 1964).

22. Hooper v. Mountain States Sec. Corp., *supra* note 5.

23. United States v. Riedel, 126 F.2d 81 (7th Cir. 1942).

Court of Appeals for the Fifth Circuit wrote in *Hooper v. Mountain States Securities Corp.*:

> The fraudulent scheme need not be hatched in the forum district. Nor is it necessary that a false or deceptive or fraudulent paper be sent or statement made through the use of the mails. . .
>
> We think that any use of instrumentalities of the mails or other interstate facilities made within the forum district constituting an important step in the execution of the fraudulent, deceitful scheme or in its consummation is sufficient.[24]

In the event no "act or transaction constituting the violation"[25] occurred in his home district, plaintiff may still maintain suit there against any defendant who is "found or is an inhabitant or transacts business"[26] within the district. Here again the courts have followed the legislative purpose of providing an accessible forum for imposing the standards of the act. The incrustations and restrictions which have grown up around the traditional "doing business" test have not been extended to the words "transacts business."[27] It was held in one case that the president of a Delaware corporation and a Nevada corporation with their principal places of business in Arizona was subject to suit in Pennsylvania on the ground that his selling stock to persons in that state by use of the mails, interstate telegrams and long-distance telephone calls constituted the transaction of business in that state. The court wrote:

> The quantum of business which must be transacted in a district to permit the laying of venue therein is less than the 'doing business' necessary to warrant a finding that the defendant is present, or is to be found, in the district for jurisdictional purposes. . . .
>
> Furthermore, the mere solicitation of orders which are subject to acceptance or rejection in another state, from which the goods are shipped directly, may constitute 'transacting business' for venue purposes.[28]

Similarly, a salesman in the Maryland branch office of a District of Columbia partnership who had some transactions with residents of the District, sent all his orders to and received confirmations from the main office within the District, mailed literature into the District with some regularity, and on occasion visited the main office

24. 282 F.2d 195, 204-05 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).
25. Securities Exchange Act of 1934, § 27, 48 Stat. 881, as amended, 15 U.S.C. § 78aa (1958).
26. *Ibid.*
27. Kane v. Central Am. Mining & Oil, Inc., *supra* note 6, at 566.
28. SEC v. Wimer, 75 F. Supp. 955, 962 (W.D. Pa. 1948); See 3 Loss, *op. cit. supra* note 5, at 2009-15.

"transacted business" for venue purposes within the District of Columbia.[29]

Possibly because of the relative ease of satisfying either the "act or transaction constituting the violation" or the "transacts business" tests to establish venue, only one reported case has been decided pursuant to section 27 and its almost identical counterpart in the Securities Act of 1933[30] dealing definitively with the word "found" and no reported cases have been decided pursuant to these sections dealing definitively with the word "inhabitant" for venue purposes. In *United Industrial Corp. v. Nuclear Corp.*,[31] the court reasoned that "found" had the same meaning for venue purposes in section 27 as it had for service of process purposes in that section and for purposes of attachment of property under section 3506 of the Delaware Code.[32] "Since a defendant can be 'found' for purposes of service under Section 27 only in a place where he is subject to *in personam* service," the court wrote, "the same requirement exists insofar as venue is concerned. Plantiff's argument that defendant can be found within this District merely because he had property here is not acceptable."[33]

Section 27 contains a further provision which permits extraterritorial service of process "in any other district of which the defendant is an inhabitant or wherever the defendant may be found." This provision presents no problem of interpretation in its application to individual defendants. Jurisdiction is established by personally serving these defendants anywhere within the nation where one can find them. A defendant can be "found" for purposes of service pursuant to section 27 in any place where he is subject to in personam service.[34] Service upon a corporation, however, presents a slightly more complicated question. It is settled that a corporation can be an inhabitant only in the state of its incorporation.[35] The word "found," however, requires interpretation for corporate jurisdictional purposes. In *Kane v. Central American Mining & Oil, Inc.*, Judge Weinfeld analyzed the meaning of "found" as used in section 27 for jurisdictional purposes. He concluded that he was dealing with "a built-in venue and process provision of the act which omitted any reference to 'doing business.' "[36] The court compared the service of process provision in

29. Uccellini v. Jones, 182 F. Supp. 375 (D.C. Cir. 1960).
30. Securities Exchange Act of 1933, § 22, 48 Stat. 86, 15 U.S.C. § 77v (1958).
31. 237 F. Supp. 971 (D. Del. 1964).
32. DEL. CODE ANN. tit. 10, § 3506 (1953).
33. United Industrial Corp. v. Nuclear Corp., 237 F. Supp. 971 (D. Del. 1964).
34. *Ibid.*
35. Sperry Products v. Association of Am. R.R., 132 F.2d 408 (2d Cir. 1942).
36. 235 F. Supp. 559, 566 (S.D.N.Y. 1964).

section 27 with the closely parallel section 12 of the Clayton Act construed by the United States Supreme Court in *United States v. Symphony Corp.*:[37]

> Section 27 here under consideration has an even broader venue provision than that contained in Section 12 of the Clayton Act in that it also supports venue in the district where the violation occurred. Considering the broad remedial objective of the 1934 Act, it would be an anomaly to expand the venue provision and at the same time to contract service of process amenability. The conclusion is warranted that 'found' in Section 27 is to be given at least the same broad content as that accorded it in the Clayton Act.[38]

Judge Weinfeld went on to hold that a Panamanian corporation created to exploit mining concessions in Honduras; which had been occupied during its three year period of existence primarily with raising capital to exploit its concessions; which had neither mined any property nor promoted any sales of property anywhere in the world; whose principal officers and entire Board of Directors were residents of New York; which carried on corporate activities in New York; which retained a New York attorney who rendered continual corporate legal services in New York; which held three stockholders' meetings and one meeting of directors within New York; which prepared and mailed the notices for these meetings from New York; which mailed further communications to its stockholders from New York bearing a New York return address; and which prepared a registration statement in New York for filing with the Securities and Exchange Commission, was probably not "doing business" within New York in the traditional sense, but was "found" in New York for purposes of service of process pursuant to the act.

IV. PRIOR DEMAND, SECURITY FOR COSTS, STATUTE OF LIMITATIONS

Once having resolved whom he is able to sue and where he is able to sue them from the viewpoint of jurisdiction and venue, the stockholder who initiates his derivative cause of action pursuant to state law is faced with certain additional problems. First, he must allege with particularity in his complaint that he has exhausted his remedies within the corporation by making a sufficient demand upon the directors to sue or giving sufficient reason for not so doing.[39] And if in the honest and impartial opinion of the directors, the best

37. 333 U.S. 795 (1948).

38. 325 F. Supp. 559, 566-67 (S.D.N.Y. 1964).

39. Wathen v. Jackson Oil & Refining Co., 235 U.S. 635 (1915); Hawes v. Oakland, 104 U.S. 450 (1881); Stone v. Holly Hill Fruit Prods., Inc., 56 F.2d 553 (5th Cir. 1932).

interests of the corporation do not justify the derivative action, their decision is a bar to plaintiff's suit.[40] Second, in certain instances plaintiff must also apply to the stockholders as a body. He must attempt to convene a stockholders' meeting so that a majority of shareholders, if not implicated in the wrong, may vote upon the question of suit.[41] This latter requirement is particularly burdensome and often results in large expenditures of time and money. Moreover, the law of certain jurisdictions effectively bars a derivative action unless it is approved by an independent majority of stockholders.[42] Third, in certain jurisdictions if plaintiff does not hold a required percentage of the corporation's outstanding shares, or the shares held by plaintiff do not have a certain market value, plaintiff is required to post a bond as security for the estimated expenses of those defending the suit.[43] It should be emphasized that a security-for-expense requirement creates a liability. When a bond is posted and the derivative suit is unsuccessful for any reason, including a failure on technical grounds that do not go to the merits, the corporation has recourse to the security for indemnification of its own litigation expenses and those expenses for which it might be ordered by a court to reimburse its directors, officers and employees. Fourth, in certain jurisdictions plaintiff may be hamstrung by a short statute of limitations designed especially to discourage derivative actions.[44] Finally, plaintiff may be faced with the antiquated requirements of an ancient state code of procedure with circumscribed rights of pleading and discovery.[45]

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40. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Post v. Buck's Stove & Range Co., 200 Fed. 918 (8th Cir. 1912).

41. Hawes v. Oakland, *supra* note 39; Yates Ranch Oil & Royalties v. Jones, 100 F.2d 419 (5th Cir. 1938); Stone v. Holly Hill Fruit Prods. Inc., *supra* note 39.

42. Hausman v. Buckley, 299 F.2d 696 (2d Cir.), *cert. denied*, 369 U.S. 885 (1962); S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1950).

43. Statutory provisions to this effect have heen adopted in California, CAL. CORP. CODE § 834; Maryland, MARYLAND RULES OF PROCEDURE 328 (1963); New Jersey, N.J. REV. STAT. § 14:3-15 (1945); New York, BUS. CORP. LAW § 627; Pennsylvania, PA. STAT. ANN. tit. 12, § 1322 (1959); Wisconsin, WIS. STAT. § 180.405(4) (1957).

44. Michigan has a statute of limitations which provides in substance that no director shall be held liablc for any delinquency in his fiduciary duties "after six years from the date of such dclinquency, or after two years from the time whcn such delinquency is discovcred by one complaining thereof, *whichever shall sooner occur* (emphasis added)." MICH. STAT. ANN. § 21.47 (1963). See also Wolf v. Thomas, 271 F.2d 634 (6th Cir. 1959). In New York, old § 48(8) of the Civil Practice Act imposed a special statute of limitations of six years on any legal or equitable action brought by or on behalf of a corporation against a director, officer or stockholder. The principal effect of § 48(8) was to remove the normal ten year limitation that existed for suits in equity. On September 1, 1963, this ten year statute of limitations for suits in equity was shortened to six years.

45. In Massachusetts, for example, there is no provision for oral interrogatories. MASS. ANN. LAWS ch. 231, § 61 (1956). In New York, an attorney cannot depose a

If plaintiff, still attempting to base his derivative cause of action upon state law, is able to satisfy the monetary and diversity jurisdictional requirements of the federal courts, his only advantage will be utilization of the liberal pleading and discovery procedures of the Federal Rules of Civil Procedure. Each of the other problems discussed above will continue to plague him. Prior demand,[46] security for expenses[47] and statutes of limitation[48] are all matters of "substance" under the doctrine of *Erie R.R. v. Tompkins*,[49] and hence will be applied in the federal courts in diversity cases in the identical manner in which they would be applied in a state court.

Assume, however, that plaintiff determines to initiate his derivative cause of action pursuant to section 10(b) and rule 10b-5. The advantages are compelling. First, plaintiff will be able to utilize the Federal Rules of Civil Procedure with its liberal rules relating to pleading and discovery.[50] Second, plaintiff will not be required to post security for expenses.[51] Third, while plaintiff will be obliged to comply with rule 23(b) of the Federal Rules of Civil Procedure as regards prior demand upon directors and stockholders, the requirements of this rule are not nearly so demanding or restrictive as the requirements of certain states and foreign jurisdictions.[52] In Massachusetts, for example, a derivative action is barred unless it is approved by an independent majority of stockholders.[53] A similar rule prevails in Venezuela[54] and in Panama.[55] Pursuant to rule 23(b), however, demand upon stockholders is usually required only where a majority of the stockholders may ratify the alleged wrong.[56] And when such a demand would be "an idle ceremony" the plaintiff may forego this condition precedent to suit.[57] Fourth, the federal courts in applying rule 10b-5 may well choose to be guided by the traditional equitable doctrine of laches rather than a short state statute of

witness, as distinguished from a party, over the objection of opposing counsel without the court's permission upon a showing of good cause. N.Y. CIV. PRAC. LAW art. 31.

46. Hausman v. Buckley, *supra* note 42.

47. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949).

48. Guaranty Trust Co. v. York, 326 U.S. 99 (1945).

49. 304 U.S. 64 (1938).

50. FED. R. CIV. P. 8-10, 26-37.

51. Fielding v. Allen, 181 F.2d 163 (2d Cir.), *cert. denied sub nom.*, Ogden Corp. v. Fielding, 340 U.S. 817 (1950). See also McClure v. Borne Chem. Co., *supra* note 6.

52. Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

53. Carroll v. New York, N.H. & H.R.R., 141 F. Supp. 456 (D. Mass. 1956); S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., *supra* note 42.

54. Hausman v. Buckley, *supra* note 42..

55. Kane v. Central Am. Mining & Oil Co, Inc., *supra* note 6.

56. HENN, CORPORATIONS 577 (1961).

57. 3 MOORE, FEDERAL PRACTICE ¶ 23.19, at 3529 (1964).

limitations applicable only to derivative actions.[58] The reasoning in each of these cases is that the stockholder's derivative right, as well as the right of the corporation in whose behalf the stockholder is suing, are federal rights which should not be emasculated by the laws of fifty states and countless foreign jurisdictions. Hence, the restrictions in state or foreign law designed to limit the stockholder's derivative action are not applied to a derivative suit based upon section 10(b) and rule 10b-5.[59]

V. Pendent Jurisdiction

The stockholder who determines to base his derivative cause of action upon section 10(b) and rule 10b-5 is not obliged to abandon any grounds for recovery which he may have under state law. Pursuant to the doctrine of pendent jurisdiction, a federal court which would not otherwise have subject matter jurisdiction of a state-created ground for recovery may have such jurisdiction conferred upon it by virtue of the fact that the state-created ground for recovery is asserted together with a federal ground for recovery to vindicate a violation of the same right.[60] In addition, a federal court, which would not otherwise be a proper venue for adjudicating the state-created ground for recovery, may adjudicate the same provided venue for the federal ground for recovery is properly laid in that court.[61]

In the leading decision of *Hurn v. Oursler*,[62] a distinction was noted between a case where two distinct grounds for recovery in support of a single cause of action are alleged, only one of which presents a federal question, and a case where two separate and distinct causes of action are alleged, only one of which is federal in character. The court stated that in the former situation, if the federal question is not plainly wanting in substance, the federal court may retain and dispose of the case upon both the federal and non-federal grounds; but if two distinct causes of action are stated, the court may not adjudicate the non-federal cause of action.

A recent decision illustrates how far this proposition of law may be extended in the securities area for the benefit of the derivative plaintiff. In *Rogers v. Valentine*,[63] plaintiff alleged derivatively that

58. Holmberg v. Armbrecht, 327 U.S. 392, 395, 397 (1946); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960).

59. Levitt v. Johnson, *supra* note 52; Fielding v. Allen, *supra* note 51; Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559 (S.D.N.Y. 1964).

60. Hurn v. Oursler, 289 U.S. 238 (1933).

61. Bradford Novelty Co. v. Manheim, 156 F. Supp. 489 (S.D.N.Y. 1957); 1 Moore, Federal Practice ¶ 0.140(8), at 1339-40 (1961).

62. 289 U.S. 238 (1933).

63. CCH Fed. Sec. L. Rep. ¶ 91,473 (S.D.N.Y. 1964).

defendant (i) had violated section 16(b) of the act[64] by failing to file notices of purchases of securities as required by section 16(a) of the act[65] within ten days following the end of the month in which the purchases were consummated; and (ii) had violated fiduciary duties created by state law by selling control stock to outsiders at a premium. The court granted summary judgment for defendant with regard to the first allegation, but retained the second allegation for trial on the merits pursuant to the doctrine of pendent jurisdiction. This decision appears dubious on two grounds. First, any right of action which lies pursuant to section 16(b) of the act for recovery of short-term, insider, trading profits is entirely separate and distinct from a right of action charging breach of fiduciary duties through the sale of control stock at a premium. Second, the allegation that a late filing pursuant to section 16(a) of the act gives rise to liability under section 16(b) is "plainly wanting in substance."[66] There is absolutely no basis for such a contention in the statute.[67] Moreover, the experienced corporate practitioner is well aware that many reports filed pursuant to section 16(a) are filed after the ten day statutory period due to administrative carelessness or simply because the signatures required for these reports cannot always be expeditiously obtained. Section 16(b) liability has never been held to exist in such cases.

Perhaps the most widely litigated issue in this area of pendent jurisdiction at the present time is the question of whether or not extraterritorial service of process effected pursuant to the federal ground for recovery suffices to confer in personam jurisdiction with respect to the state ground for recovery. The authorities are split.[68] In *International Ladies Garment Workers Union v. Shields & Co.*,[69] plaintiff sued defendants for misrepresentations in connection with the sale of certain bonds alleging violations of the securities acts as well as state common law. The court held that although it had pendent jurisdiction of the ground for recovery under state law, such

64. Securities Exchange Act of 1934, § 16, 48 Stat. 896, 15 U.S.C. § 78p(b) (1958).

65. Securities Exchange Act of 1934, § 16, 48 Stat. 896, 15 U.S.C. § 78p(a) (1958).

66. Hurn v. Oursler, *supra* note 60.

67. Securities Exchange Act of 1934, § 16, 48 Stat. 896, 15 U.S.C. § 78p(a) & (b) (1958).

68. As authority for the proposition that a federal court cannot hear and determine the state ground for recovery unless it has independent jurisdiction of the person of the defendant, see Trussell v. United Underwriters, Ltd., 236 F. Supp. 801 (D.C. Colo. 1964); International Ladies Garment Workers v. Shields & Co., 209 F. Supp. 145 (S.D.N.Y. 1962); Phillips v. Murchison, 194 F. Supp. 620 (S.D.N.Y. 1961); Lasch v. Antkies, 161 F. Supp. 851 (E.D. Pa. 1958).

69. 209 F. Supp. 145 (S.D.N.Y. 1962).

pendent jurisdiction of the subject matter did not include pendent jurisdiction of the person. Thus, defendants who were served extraterritorially in connection with the federal ground for recovery could not be held to answer the common law claim. The court's reasoning was succinctly stated in the following paragraphs:

> To extend the rule of pendent jurisdiction to jurisdiction over the person calls into play different considerations. The doctrine of *Hurn v. Oursler* flows of necessity from the conception that there is but a single claim where a single right has been violated. Where the subject matter is a single claim and the court has jurisdiction of the claim it has jurisdiction of the whole subject matter. As we see here, however, there may be plural rights of action to enforce a single claim. As far as the court's jurisdiction of the subject matter is concerned, it has jurisdiction to enforce all those rights of action. The court's jurisdiction over the person, though, is usually limited by Rule 4(f) to jurisdiction over those who can be served within the state. While Congress has made an exception to that in the case of the federal right of action asserted here so far as the common law right of action is concerned, the limitation to those who can be served within the state still stands. There is no such compulsion of logic here as exists in the case of jurisdiction over the subject matter; a claim for the violation of a single right is indivisible but the rights to enforce it are divided at their creation into different rights of action.
>
> The result accords with what would be the natural intent of Congress. When Congress subjected those sued for a violation of the Securities Exchange Act to the necessity of responding to service made outside the state it would normally hesitate to force their appearance far from home to defend against demands under laws the degree of severity or intricacy of which were unknown to Congress.[70]

The majority view, however, appears to be that considerations of judicial economy and convenience of the parties which underlie the pendent jurisdiction doctrine require that extraterritorial service of process be sustained as to the nonfederal pendent claims.[71] As Judge Feinberg wrote in *Cooper v. North Jersey Trust Co.*:

> Reasons of judicial economy—which justify the judicially created doctrine of pendent jurisdiction—suggest sustaining the service of process as to the pendent nonfederal claims. See Note, 63 *Colum. L. Rev.* 762 (1963). The same basic facts will have to be presented on both federal and nonfederal theories. Service on the federal claims is proper and defense of these claims must, in any event, be made in this District.[72]

Such a view is extremely advantageous to the derivative plaintiff. So long as his federal ground for recovery is not "plainly wanting in

70. *Id.* at 148. (Emphasis added.)

71. Schwartz v. Eaton, 264 F.2d 195 (2d Cir. 1959); Kane v. Central Am. Mining & Oil, Inc., *supra* note 59. Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964); Townsend Corp v. Davidson, 222 F. Supp. 1 (D.N.J. 1963).

72. Cooper v. North Jersey Trust Co., *supra* note 71. (Emphasis added.)

substance,"[73] the stockholder may assert his rights derivatively pursuant to section 10(b) and rule 10b-5 and thereby obtain a federal forum to hear state-created grounds for recovery asserted against defendants immune from suit in a state court for lack of in personam jurisdiction.

VI. CONCLUSION

The effects of permitting a derivative suit with the attendant advantages based upon section 10(b) and rule 10b-5 may be far-reaching. As more and more actions are initiated and decided, a substantial body of federal common law will grow up around this section and rule. The extent to which this federal, common, corporate law will conflict with state law cannot be clearly predicted. The outlines of such a conflict, however, are already discernible in similar actions recently decided under the securities acts. In *J. I. Case Co. v. Borak*[74] plaintiff sued pursuant to section 14(a) of the act seeking to void a corporate merger on the grounds that the proxy material used in soliciting votes was misleading. The United States Supreme Court sustained the suit writing as follows:

> [W]e believe that the overriding federal law applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law. . . . [I]f the law of the state happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated. Furthermore, the hurdles that the victim might face (such as separate suits . . . bringing in all parties necessary for complete relief, etc.) might well prove insuperable to effective relief.[75]

Similarly, in *Levitt v. Johnson*[76] the United States Court of Appeals for the First Circuit resolved a conflict between the policies underlying the Investment Company Act of 1940 and the Massachusetts requirement of prior stockholder authorization for a derivative suit in the following words:

> [T]he question is whether the act contemplated or impliedly forbade the application to the assertion of derivative rights of what the court concluded to be a 'strict Massachusetts rule.' In this connection we note in section 1(b) a clear declaration of policy. The act is directed to 'the national public interest and interest of investors . . . adversely affected,' and its 'purposes . . . with which [its] provisions . . . shall be interpreted, are to mitigate and, *so far as is feasible, to eliminate* the conditions enumerated.' (ital. supplied.) We do not see how it can be gainsaid that any substantial

73. Hurn v. Oursler, *supra* note 60, at 246.
74. 377 U.S. 426 (1964).
75. *Id.* at 434-35.
76. *Supra* note 52.

> stiffening of the conditions precedent to the bringing of stockholders' suits above normal requirements would conflict with this broad declaration. The district court's reasoning that since the stockholder's right is a derivative one his right to bring suit must be controlled by the local law of the state of incorporation in the absence of an explicit congressional direction to the contrary negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation.[77]

Other potential areas of conflict are not difficult to foresee. First, the fact that a derivative suit, barred by a state statute of limitations, may be heard in a federal court under the doctrine of *Holmberg v. Armbrecht*[78] is likely to prove a future source of friction. Second, the lack of a security for expenses requirement in derivative suits based upon section 10(b) and rule 10b-5 may open a federal forum to certain plaintiffs who lack appreciable stockholdings and financial resources. This, like the *Holmberg* doctrine, may conflict with a strong state policy in favor of discouraging derivative suits. Indeed, the federal courts in sustaining a derivative action pursuant to section 10(b) and rule 10b-5 may well have opened a Pandora's box of problems. While the protection of the minority stockholder from the fraud of corporate insiders is a legitimate interest and should be upheld, the prevention of harassing "strike suits" is an equally legitimate interest worthy of protection.[79] Third, confidential corporate information, inaccessible to the derivative plaintiff under limited state rules of discovery, may be elucidated in a federal court under the liberal discovery provisions of the Federal Rules of Civil Procedure. Such information, particularly complex financial data, could tip the scales in plaintiff's favor in an action for corporate waste or mismanagement.

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77. *Id.* at 819.

78. 327 U.S. 392 (1946). This is the doctrine that in federal equity cases the court will be guided by the traditional standard of laches rather than a state statute of limitations.

79. Governor Dewey of New York, in submitting certain bills designed to curb derivative actions to the New York State Legislature, made the following comments: "These two bills represent an effort to meet the problem created by the baseless so-called 'strike' stockholder suit against corporation directors and officers.

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

. . .

These bills represent a healthy experiment in cleansing our law courts of disreputable practices . . . ." Memorandum filed with Senate Bills Nos. 1314, 1315 (April 9, 1944). Illustrative of the groundless "strike suit" which recent developments under § 10(b) and rule 10b-5 may engender is Leighton v. Paramount Pictures Corp., 340 F.2d 859 (2d Cir. 1965).

This conflict between federal and state law will lead inevitably to different decisions being rendered by state and federal courts in similar cases. The policies underlying *Erie R.R. v. Tompkins*,[80] which urge that for the same transaction the accident of a suit in a federal court instead of in a state court across the street should not lead to a substantially different result, will be undercut as derivative stockholders "statute shop" to bring their suits in the federal courts pursuant to section 10(b) and rule 10b-5. Moreover, one will be faced with an anomalous situation where stockholders of a corporate entity, authorized and created under state law, will be enforcing their derivative rights pursuant to a rule promulgated by a federal agency under powers granted by a federal statute. And under the doctrine of pendent jurisdiction federal judges will be deciding cases pursuant to peculiar state laws against defendants who have been drawn from all over the nation by the long-arm jurisdictional provisions of section 27 of the act. Finally, one may see a substantial number of additional cases burdening the federal courts as derivative stockholders strive to take advantage of the strong federal policies of preventing fraud and deceit in connection with the purchase and sale of securities embodied in section 10(b) and rule 10b-5.

80. 304 U.S. 64 (1938).