Michigan Law Review

Volume 52 | Issue 5

1954

CORPORATIONS-SHAREHOLDERS-SETTLEMENT OF DERIVATIVE SUITS UNDER THE FEDERAL RULES

George S. Flint
University of Michigan Law School

CORPORATIONS—SHAREHOLDERS—SETTLEMENT OF DERIVATIVE SUITS UNDER THE FEDERAL RULES—Plaintiff, a minority stockholder in the Kaiser-Frazer Corporation, objected to the approval by a federal district court of a settle-

ment in a stockholder's derivative action against various directors of the company and several firms in which they were interested. The compromise covered a series of similar suits filed in state and federal courts, involving contracts negotiated by the directors with defendant companies and alleged manipulations through security purchases preceding a projected issue of stock in 1948. The court had approved the compromise under rule 23(c) of the Federal Rules of Civil Procedure.[1] Plaintiff contended that the settlement was collusive and a fraud on other members of the class represented by defendant stockholder in the compromise negotiations. On appeal from the judgment approving the compromise, *held,* affirmed, one judge dissenting. The policy underlying rule 23(c) is best served if the interests of the corporation are protected; where the trial court has exercised adequate supervision over the terms of a settlement, its findings are conclusive absent clear error. *Masterson v. Pergament,* (6th Cir. 1953) 203 F. (2d) 315, cert. den. 346 U.S. 832, 74 S.Ct. 33 (1953).

Stockholders' derivative actions have had a checkered career in the United States.[2] The possibilities of bad faith inherent in derivative suits were early recognized in the courts,[3] and both courts and lawyers have tended in this century to look upon all such actions with a jaundiced eye.[4] The growing distinction between ownership and control, however, has made the derivative suit a needed check on the acts of management, especially where interlocking directorates are involved.[5] Various methods of eliminating such abuses of derivative actions as nuisance or "strike" suits and fraudulent settlements have

[1] "Dismissal or compromise. A class action shall not be dismissed or compromised without the approval of the court. If the right sought to be enforced is one defined in paragraph (1) of subdivision (a) of this rule notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. If the right is one defined in paragraphs (2) or (3) of subdivision (a) notice shall be given only if the court requires it." 28 U.S.C. (1946) 3290.

[2] Although it is often stated that Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (1843), laid the foundation for the derivative action, the earlier New York case of Robinson v. Smith, 3 Paige Ch. (N.Y.) 222 (1832), allowed stockholders to sue where the corporation through its directors had refused to do so. The Virginia court in one old case refused to recognize the action: "I will also add that, if any class or set of individuals are so peculiarly circumstanced, as that their interests should conflict with those of the majority of the society, while they have undoubtedly contracted to be bound by the suffrages of that *majority,* they are also protected from oppression by the liberty guaranteed them, of withdrawing from the institution altogether." Currie v. Assurance Society, 4 H. & M. (Va.) 315 at 352 (1809). See Beaudette v. Graham, 267 Mass. 7, 165 N.E. 671 (1929), on effect of settlement as res judicata against corporate rights.

[3] Hawes v. Oakland, 104 U.S. 450 (1881).

[4] ". . . Unfortunately, those constantly affiliated with large corporate interests have developed the habit of placing all complaining stockholders in the same category. To the large corporation law offices in the neighborhood of Wall Street or State Street or LaSalle Street, every stockholders' suit is ipso facto a strike suit. . . . So intensified has become the rancor of this attitude, that the upstart who dares to question the conduct of corporate affairs is cast outside the pale of common decency. . . ." Berlack, "Stockholders' Suits: A Possible Substitute," 35 MICH. L. REV. 597 at 605 (1937).

[5] See BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

been tried in both state and federal jurisdictions and have been proposed by the writers.[6] Federal rule 23(c) is designed to prevent collusion in settlement by providing for notice to stockholders and the approval of the court, but it does not tend to discourage derivative actions.[7] Remedies other than requiring the approval of settlements by the court have been used in the past, with inconsistent results.[8] Where dismissal by the court on the merits is involved, however, it is held that rule 23(c) does not apply.[9] In the principal case the policy of the rule seems to have been properly effectuated.[10] The case suggests that collusive action in stockholders' suits may be prevented most effectively on the trial level, where the court is best equipped to examine all the facts in these often multi-faceted controversies. Certainly the application of the rule should be directed toward minimizing the cost to the corporation while affording adequate hearing to the dissenting stockholders.[11] The principal case, a strong one for reversal viewed strictly on the record, would seem to point emphatically to this conclusion. The philosophy of the court may be analogized to the usual reviewing policy toward the findings

[6] See, e.g., Berlack, "Stockholders' Suits: A Possible Substitute," 35 MICH. L. REV. 597 (1937) (state administrative tribunal advocated to prosecute and decide derivative actions); Pierce, "Security for Expenses in Stockholders' Derivative Actions," MICHIGAN LEGAL STUDIES, CURRENT TRENDS IN STATE LEGISLATION 388 (1952) (state statutes obligating suing stockholder to give security for expenses of the suit to the corporation); McLaughlin, "Capacity of Plaintiff-Stockholder to Terminate a Stockholder's Suit," 46 YALE L.J. 421 (1936) (advocating unanimous or majority vote on the contested act of directors).

[7] Some state statutes have this purpose. See Pierce, "Security for Expenses in Stockholders' Derivative Actions," MICHIGAN LEGAL STUDIES, CURRENT TRENDS IN STATE LEGISLATION 388 (1952). Hornstein has vigorously criticized the New York statute, which he states did not have support in the legal profession, but was rushed through under Chamber of Commerce auspices. Hornstein, "The Death Knell of Stockholders' Derivative Suits in New York," 32 CALIF. L. REV. 123 (1944).

[8] The usual procedure was entry of a consent judgment. Court supervision might or might not be a part of this. Fairly close scrutiny was exercised in Gerith Realty Corp. v. Normandie Nat. S. Corp., 154 Misc. 615, 276 N.Y.S. 655 (1933); Whitten v. Dabney, 171 Cal. 621, 154 P. 312 (1915) (the representative stockholder plaintiff was likened to guardian ad litem). The inadequacies of the former federal practice, especially regarding notice to stockholders, are exhibited by Rogers v. Hill, (D.C. N.Y. 1940) 34 F. Supp. 358.

[9] Massaro v. Fisk Rubber Co., (D.C. Mass. 1941) 36 F. Supp. 382; Hutchinson v. Fidelity Inv. Assn., (4th Cir. 1939) 106 F. (2d) 431.

[10] The only note appended to rule 23(c) in the report of the advisory committee on the federal rules is a citation to McLaughlin, "Capacity of Plaintiff-Stockholder to Terminate a Stockholder's Suit," 46 YALE L.J. 421 (1936). See H. Doc. No. 588, 75th Cong., 3d sess. (1938). McLaughlin criticizes the use of the consent judgment as a procedural device in settlement of the suits, since it can only be set aside on a showing of fraud or collusion, which are difficult of proof in the circumstances.

[11] Some courts have stressed the rights of the stockholders rather than those of the corporation. Massaro v. Fisk Rubber Corp., note 9 supra; Hutchinson v. Fidelity Inv. Assn., note 9 supra; May v. Midwest Refining Co., (1st Cir. 1941) 121 F. (2d) 431. The last-named case is of particular interest. The court denied the corporate right of action because the rescission asked would lead to an inequitable result, but granted the stockholder relief of $1,246.22 plus attorney's fees of $40,800.

of a master in equity of those of an administrative tribunal.[12] So long as the settlement is fair and in the ultimate corporate interest, it should be encouraged under the rule.

George S. Flint

[12] United States v. United States Gypsum Co., 333 U.S. 364, 68 S.Ct. 525 (1948). The court was construing federal rule 52(a), but its remarks have peculiar significance where the derivative suit is concerned. But see dissent in the principal case at 321.