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Ralph M. Carson

Member of the New York bar

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Recommended Citation
Ralph M. Carson, CURRENT PHASES OF DERIVATIVE ACTIONS AGAINST DIRECTORS, 40 MICH. L. REV. 1125 (1942).
Available at: https://repository.law.umich.edu/mlr/vol40/iss8/2

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CURRENT PHASES OF DERIVATIVE ACTIONS
AGAINST DIRECTORS*

Ralph M. Carson†

In assuming to discuss in this place some of the current phases of stockholders' derivative actions against directors of corporations, I shall try to keep a course between two extremes. On the one hand, it is of little use to fulfill the easy duty of enunciating general rules of law, stated in such a form that both parties in a contested cause may equally invoke them. Nor, on the other hand, is it of much value to fill an hour's time with details of cases recently decided which, although interesting in themselves, resist general application. What I shall try instead is to run over with you the main lines of decision emerging from recent derivative actions, using the facts for illustration only; and in doing so I must bear in mind that I am speaking to an audience of technicians. Indeed, I see among the audience some faces which have appeared on the opposite and wrong side of the counsel table in some of the suits which might arise for discussion here, in some that are pending; which perhaps will appear in others that may be only meditated. Hence, anything I may say this evening must be subject to the caution that it is wholly without prejudice. If the text of my remarks shall appear hereafter in the brief of some future adversary on behalf of an unexpected and (needless to say) unjustified application to new facts, then let it be understood that my future interpretation of this text will be equally authoritative with the text itself.

Justice Rosenman pointed out in a lecture to the Practicing Law Institute last January that the derivative action was first used in England in 1828. Lord Lyndhurst held that out of two hundred or more shareholders in an iron and coal company five might properly bring a

*Substance of remarks made April 7, 1942, at the Association of the Bar of the City of New York, on the program of the Committee on Post-Admission Legal Education.
†A.B., J.D., Michigan; B.A., Oxford. Member of the New York bar.—Ed.
representative action to replenish the common fund by compelling the directors to restore thereto that part of £25,000 withdrawn to acquire from one Flattery mines for which only £10,000 were paid.\(^1\) By 1855 the jurisdiction of equity to entertain such actions was fully established, in the view of the United States Supreme Court;\(^2\) and by 1882 that Court, by rule embodying the former practice, laid down the requirements of contemporary ownership and prior demand for the bill in a stockholder’s action founded on rights which might properly be asserted by the corporation.\(^3\) The possible abuse of this form of action in litigation brought “expressly to annoy and vex the company” was foreseen by the Supreme Court in 1884,\(^4\) and yet as late as 1896 President Hadley of Yale was able to write:

“... Perhaps the most serious among all the evils under which American business suffers is the lack of clear understanding as to directors’ responsibilities.”\(^5\)

The prominent member of the New York bar who recently recalled to us this state of affairs is among those who have done much to correct it. Indeed it may not unreasonably be said that the correction has gone too far. Strong support could be found for the view expressed by Dean Pound in 1936 that stockholders’ suits for mismanagement “have been abused quite as much as the powers of directors they have intended to restrain.”\(^6\) The number of such suits has greatly increased, and the size and scale of some has increased even more. The English law on the subject up to 1910 could be stated in a page of Halsbury’s *Laws of England*, with reference to twenty-nine decided cases. But in this country the precedents were many times more numerous even before 1910, and the volume of this litigation continues to swell.

In consequence of this severe course of instruction, directors of corporations are now so far from being in doubt as to their responsibilities as to have attained the learning of the English law student who

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\(^1\) Hichens v. Congreve, 4 Russ. 562 at 575-576, 38 Eng. Rep. 917 (1828). It does not appear that the corporation was a party. The next case seems to be Foss v. Harbottle, 2 Hare 46, 67 Eng. Rep. 189 (1843).

\(^2\) Dodge v. Woolsey, 18 How. (59 U. S.) 331 at 341 (1855).

\(^3\) Equity Rule 94, October Term 1881 (104 U. S. ix) carried into Equity Rule 27 of the Rules of 1912 and Rule 23(b) of the Federal Rules of Civil Procedure.

\(^4\) Dimpfell v. Ohio & M. Ry., 110 U. S. 209 at 210, 3 S. Ct. 573 (1884). This was not an action against directors.

\(^5\) Quoted by David L. Podell in lecture of November 25, 1940, to the Practicing Law Institute, New York.

sought a certificate for having read in the chambers of a barrister. He was refused because the record showed that the student had appeared in chambers only twice during the whole year. He pleaded, however, that he had learned a great deal by reading the barrister’s opinions. Asked what he had read,

"‘Well, the first time I read a long opinion of yours on the liabilities of executors,’ said the student.

‘Well, what did I say?’ asked the barrister.

‘I don’t exactly remember,’ replied the student, ‘but I do remember that when I had finished reading it I said to myself: “Well, I’m blest if I’ll ever be an executor.”’

‘And what did you learn the next time?’ asked the barrister.

‘Well, I read a long opinion of your on the liabilities of trustees.’

‘And what did I say?’

‘Well, I don’t exactly remember,’ replied the student, ‘but I do remember when I had finished reading it I said to myself, “Well, I’m blowed if I’ll ever be a trustee.”’

‘Sir,’ said the barrister earnestly, ‘You shall have your certificate. Your answers show that you have acquired a sound and discriminating knowledge of the principles of equity, which, whether you become a barrister or not, will be of the greatest value to you throughout the rest of your life.’”

While this may well be the state of mind of honest directors unable to see the value of those prerogatives of the legal profession which permit a claim to be asserted first and the basis for its assertion later ascertained by a protracted interrogation of defendants having other and more legitimate calls upon their time and energies; while it is also difficult for laymen unaware of the economic basis of the legal profession to see the necessity for indefinite multiplication of suits by different stockholders against the same directors on the same matter—in spite of these grounds of misunderstanding of the law by the world of corporate business, nevertheless certain other things are also clear. It is clear that the stockholder’s derivative suit is an absolutely necessary arm of equity jurisdiction and that, when used with justice and restraint, it has both public and private value. It is clear too that the

7 Quoted by Crew, The Whole Duty of a Director 4 (1929).
8 Thirteen separate suits have now been brought against directors of the United States Rubber Company upon its bonus plan and certain preferred dividends. Twenty suits are pending, in consolidated form, against directors of Radio Corporation of America, many of them stimulated by an offer of settlement.
courts are developing and do continually apply rules of decision by which honest directors exercising their own judgment with reasonable care on matters of choice and judgment in the corporate affairs, within the restrictions of its charter and not in violation of positive statutory restriction, are in no danger of accountability in actions of this type. The very nature of the form of action as a device of equity to compel compliance by directors with their obligations insures acceptance by the courts of the consequences of honest business judgment.

I propose this evening to outline briefly the business judgment rule, and then to examine the exceptions thereto and certain applications thereof, all as illustrated by recent cases. If time remains I will in conclusion refer to recent developments in practice involved in the presentation of these questions.

I

Business Judgment Rule

A good statement of the business judgment rule applicable to the actions of directors of a corporation was made by the Court of Appeals in 1890 in Gamble v. Queens County Water Co.: 9

"I think that where the action of the majority is plainly a fraud upon, or, in other words, is really oppressive to the minority shareholders, and the directors or trustees have acted with and formed part of the majority, an action may be sustained by one of the minority shareholders suing in his own behalf and in that of all others coming in, etc., to enjoin the action contemplated, and in which action the corporation should be made a party defendant. It is not, however, every question of mere administration or of policy in which there is a difference of opinion among the shareholders that enables the minority to claim that the action of the majority is oppressive, and which justifies the minority in coming to a court of equity to obtain relief. Generally, the rule must be that in such cases the will of the majority shall govern. The court would not be justified in interfering even in doubtful cases, where the action of the majority might be susceptible of different constructions. To warrant the interposition of the court in favor of the minority shareholders in a corporation or joint-stock association, as against the contemplated action of the majority, where such action is within the corporate powers, a case must be made out which plainly shows that such action is so far opposed to the true interests of the

9 123 N. Y. 91 at 98; 25 N. E. 201 (1890).
corporation itself as to lead to the clear inference that no one thus acting could have been influenced by any honest desire to secure such interests, but that he must have acted with an intent to subserve some outside purpose, regardless of the consequences to the company and in a manner inconsistent with its interests. Otherwise the court might be called upon to balance probabilities of profitable results to arise from the carrying out of the one or the other of different plans proposed by or on behalf of different shareholders in a corporation, and to decree the adoption of that line of policy which seemed to it to promise the best results, or at least to enjoin the carrying out of the opposite policy. This is no business for any court to follow."

While the corporate action there sought to be impeached was taken by stockholders, the same principle applies in favor of the action of directors acting for stockholders. As was said by Justice Cardozo at Special Term in New York County,

"... A contract made by a corporation within the scope of its chartered powers may not be set aside merely because some stockholders believe it to be unwise. There must be either fraud or conduct so manifestly oppressive as to be equivalent to fraud. [citations] No charge of fraud is made. There is no claim that the price of 90 was fixed by the directors with any furtive purpose to benefit themselves or to despoil the company. There is not even a claim that any better price could be obtained. There is merely the assertion of the plaintiffs' disagreement with the directors as to the expediency of the transactions. [citations] Because of this diversity of view, the court is asked to revise the judgment of the directors, and substitute its conclusion for theirs. In the language of Peckham, J., in Gamble v. Queens County Water Co., ... 'This is no business for any court to follow.'"¹⁰

On this basis the court refused to set aside a contract between the corporation and its bankers for the issuance of corporate notes to be purchased by the bankers at ninety, together with certain options and other clauses.

In a recent decision of the United States District Court for Delaware granting summary judgment to directors of a holding company charged in a stockholders' derivative action with responsibility for ex-

orbitant expenditures, the federal court stated the rule in terms of a New Jersey decision as follows:

"... In a purely business corporation ... the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors?;

and in terms of a Delaware case, as follows:

"... it is not their [the courts’] function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve." 11

The common-sense basis of such a rule was indicated recently by Justice Collins at Special Term in New York County:

"... If every time a stockholder disagreed with the wisdom or good judgment of the directors as to purchases made or prices paid, &c., he could successfully maintain a stockholders’ action, corporate businesses would soon be managed and run by the courts instead of the directors, to whom the law intrusts their management." 12

This rule is one of constant application. It was most recently invoked by the Appellate Division, First Department, in reversing by a bare majority the trial court’s judgment for an accounting at the suit of a stockholder. 13

The basis of the rule is, of course, that the matters confided to the determination of corporate directors are matters of choice and discretion, resting in sound policy based upon their knowledge of the business, so that within the limits of personal honesty and statutory law the

determination is for the directors alone. They are not in the position of trustees of an express trust, but are fiduciary agents. While trustees of an express trust are personally liable for losses arising from an infraction of their trust deed, regardless of good faith, directors are not so liable if acting in good faith and with due care.¹⁴ Notwithstanding a corporate director is tantamount to a trustee with respect to the quality of his duty, since he is held "in official action, to the extreme measure of candor, unselfishness and good faith."¹⁵

In the application of this rule corporate directors are aided by the presumption that their action on behalf of the corporation has been honest and proper. As was said at Special Term in a recent case granting summary judgment to directors of a corporation, "the presumption that the directors acted honestly and in good faith must prevail," in the absence of proof by the complaining stockholders that ulterior purpose or self-interest motivated their action.¹⁶

II

EXCEPTIONS TO BUSINESS JUDGMENT RULE; AREAS OF NONAPPLICATION

Since the statement of the general principle does not mean much without an understanding of its exclusions and inclusions, I shall now take up matters to which the business judgment rule does not apply, and discuss in turn fraud, domination of directors by outside parties, ultra vires and the like, the corporate opportunity cases, and negligence. Also to be considered under this heading is a spurious exception continually invoked by counsel for minority stockholders by virtue of which the directors are accused of negligence and inattention because they are not fortunate enough to have minds that work in the same way as the minds of plaintiff's counsel.

A. Fraud

It is of the very essence of the business judgment rule that it cannot apply to cases in which the directors of a corporation are guilty of fraud or similar action taken in their own interest and adversely to the corporate interest. In the vivid language which the English judges use; “the director is really a watch-dog, and the watch-dog has no right, without the knowledge of his master, to take a sop from a possible wolf.” The kind of fraud which imposes liability upon a director is, in the language of the same judge, playing “ducks and drakes with the company’s property”; it is real fraud, either positive deception or concrete breach of fiduciary duty. It is not enough for plaintiffs to charge directors with fraud “adverbially,” as a recent decision on summary judgment put it. Curiously enough, and I believe your own observation will bear me out, the attribution of fraud adverbially to corporate directors is the main ingredient of complaints in minority stockholders’ actions. Yet in very few of these actions in which the plaintiffs have succeeded has fraud either actual or constructive been found.

B. Directors Subject to Outside Domination

Another obvious exception to the business judgment rule arises where the directors have not exercised their own judgment but have submitted to the domination and control of others; and again, curiously enough, such an allegation is a favorite staple of minority stockholders’ complaints. This allegation also is usually not the ground of recovery where there has been recovery. The outside bankers were held not to have dominated the directors in the Guaranty Trust Company case, nor to have dominated the directors in the St. Louis-San Francisco Railway Company case, nor to have dominated the directors in the Hoe & Co. case; nor was the supposedly dominant stockholder found to have controlled the directors in the General Motors case or in the United States Rubber Company case.

A main ground of decision in the Blaustein case was the finding of the trial court that the majority stockholder of Pan-American Petroleum and Transport Company dominated the action of the directors through its nominees on the board; and it was this finding which the Appellate Division by a bare majority reversed. The question here was a close one, and it may be worth-while to look at the reasoning of the appellate court. Justice Dore for the majority said:

"In the final analysis, the trial court seemed to rest its decision on what it referred to as the frailities of human nature. The court said it was inconsistent with 'all human experience' that when Seubert, Barkdull and Stephens walked into a Pan Am board meeting they could forget they were directing heads of Indiana. The issue, however, in each case is not to be decided on general views of human nature but on the particular facts established in each case showing the type, character, standing, experience, integrity, ability and the action taken by the particular directors involved. . . .

"On this record, we hold plaintiffs have failed to establish by a preponderance of the credible testimony that Indiana, as majority stockholder, so usurped the functions of the board of directors of Pan Am in the transactions attacked that they failed to exercise their independent judgment in good faith. . . .

"The directors here attacked were first rate men of outstanding experience, ability and recognized character individually and as officers of the oil business in the United States. Neither in the prolonged examinations before trial nor in the direct or cross-examinations at trial was anything established to impugn their integrity, competency or ability. Nothing was adduced to show that any of them, including McKeever, who was never connected with Indiana, and Carroll, who was never an Indiana director or officer, were not acting with an honest desire to serve the corporation's interest." 20

At the time of the transaction in question Indiana held ninety-six per cent of the stock of Pan-American and had nominated six of the nine members of Pan-American's board, four of these six being directors of Indiana. With reference to the relationship thus shown the trial court, Justice Rosenman, had said:

"This interlocking set-up, alone, had all the potentialities of domination and control by Indiana. It would have been almost

contrary to normal assumptions to expect that when a conflict in interest between Indiana and Pan Am arose, these six men would have divorced themselves from consideration of the welfare of Indiana and would have concentrated wholly on the interest of Pan Am. Relationships, such as these men bore to the dominant corporation, are realities motivating business conduct, which loom up clearly to any one intent on looking through the fog of intercorporate artificialities."  

The Blaustein case is expected to be argued in the Court of Appeals this autumn, and the decision of that court will be of interest as indicating how concrete the proof must be on a close issue of fact with reference to asserted outside domination over corporate directors. Regardless of the proper solution of the question of fact presented in that particular case, it would seem that the majority opinion is right in holding that "the fiduciary theory will not be employed merely to enable a minority to dictate corporate policies."  

It is usually said that, where the possibility of domination of corporate directors by an outside party is shown, then the outside party becomes potentially a fiduciary and must, together with the directors, assume the burden of proof to justify the action in question. This was the basis of the decision of the trial court in the Blaustein case and, while not questioned as a matter of principle by the Appellate Division, did not prevent a reversal on the same facts. If shown by concrete proof to have dominated a board of directors, a third party becomes a fiduciary accountable together with them. Such was the situation, in part at least, in two cases recently decided, viz. one in California on behalf of stockholders of Hearst Consolidated Publications, and one in a United States District Court for Pennsylvania involving Pennroad Corporation. In the California case holders of stock in Hearst Consolidated Publications, Inc. sought, in an action against its directors, William Randolph Hearst and various corporations controlled by Mr. Hearst directly or indirectly, to review transactions leading up to the formation of Hearst Consolidated Publications, Inc. in 1930 and numerous intercompany transactions thereafter. While finding no fraud in any of these transactions and good faith in most, the Superior Court of the State of California for Los Angeles County found liability in certain transactions between the corporations of which plaintiffs were stockholders and other corporations owned directly or indirectly by the defendants and having control through stock ownership of plaintiffs' corporation. The court based its findings of liability upon the absence of evidence of arms'-

length dealing in intercompany transactions. It refused to make a general finding of domination of Hearst Consolidated Publications, Inc., in all intercompany relationships, by Mr. Hearst and others, saying:

"... A finding of domination cannot be based upon a psychologic or legalistic theory. I do not believe, as the stockholders appear to, that directors live in some state of mental and moral anemia, with no minds of their own, and consequently are subservient to the appointing power, or that domination is presumed to go with the power of appointment. Stockholders frequently combine to elect directors in order to assure their corporation of honest and independent management. That, I believe, is their usual purpose in combining." 28

In the *Pennroad* case, which was an action by holders of voting trust certificates of Pennroad Corporation against its former directors and the Pennsylvania Railroad, a federal court for Pennsylvania found on the evidence that the Pennroad Corporation was organized by the railroad, furnished with directors who were also directors of the railroad, and used as an instrumentality of the railroad in the transactions in which liability was found. 24

It is noteworthy that in both these cases the court found good faith of the corporate directors to have little relevance, once concrete facts had been established from which flowed the conclusions of domination and control of the corporate directors from outside. In California Judge Shinn said that the bases of liability were unfairness and the use of fiduciary influence, and that good faith was not in the circumstances the ultimate test. In Pennsylvania Judge Welsh, having determined liability in certain of the transactions, disclaimed any purpose to impugn the personal honor of the defendants and said:

"... The chancellor hopes no unkind conclusions will be drawn from these findings because he asserts with all positiveness no such conclusions are warranted." 25

C. *Ultra Vires and Violation of Statute*

Where the action of the directors of a corporation is outside the corporate powers, necessarily there is no room for the principle that they are protected in the exercise of the discretion confided to them by the stockholders. Nevertheless, in the absence of some adverse personal

28 Mann v. Hearst, Superior Court of California, Los Angeles County, Sept. 1941, Shinn, J., not yet reported.
25 Id. at 630.
interest on the part of directors or plain notice that they are exceeding their powers, it would seem probable that they are not liable for corporate action purely on the ground of ultra vires. In the transaction in the Guaranty Trust Company case in which Justice Shientag imposed liability, he expressly refused to rest such liability upon his finding that the transaction (a purchase of bonds by a New York bank with an option to the seller to repurchase them at the same price in six months) was outside the corporate powers, a finding which the court observed did not rest upon any case directly in point. The same conclusion was reached with reference to the asserted illegal payment of dividends of the United States Rubber Company, by Justice Hammer, in the absence of evidence of bad faith and negligence.

I believe no authority will be found for holding corporate directors liable for honest action on their part taken without negligence outside the corporate powers, despite the fact that in many cases liability of directors for ultra vires acts has been asserted by way of dictum and sometimes imposed. Where it has been imposed, it will be found that the actions condemned were so grossly negligent as not to be consistent with an honest mistake of judgment. However, where the action of directors is taken in violation of a statutory direction or prohibition, then it probably results in liability on their part to the extent of any loss to the corporation, regardless of their good faith. It has been so held in a case involving violation of investment clauses of the New York Insurance Law, and in a case of loans made by a state bank in violation of the New York Banking Law. Likewise with respect to the rate of dividends permitted by the position of a company’s capital account, an external standard is supplied by the law, and the exercise of honest business judgment in another direction is probably not a protection against liability. In the action brought against former directors of Bush Terminal Company in respect of dividends, Justice Walter found that the valuations of the assets justified the dividends. However, he said that the business judgment rule did not apply to its full extent and that:

“... When directors have in fact exercised an informed judgment with respect to the value of the company’s assets, the courts

29 Broderick v. Marcus, 152 Misc. 413, 272 N. Y. S. 455 (1934).
obviously will be exceedingly slow to override that judgment, and clear and convincing evidence will be required to justify a finding that such judgment was not in accordance with the facts. In the last analysis, however, the issue, in any case in which it is claimed that dividends have been paid out of capital, is the value of the assets and the amount of the liabilities to creditors and stockholders at the times the dividends were declared and paid."

D. Diversions of Corporate Opportunity

The rule which requires the director of a corporation to manage its affairs with the highest degree of fidelity and single-mindedness not only prevents him from taking money out of the till but makes him liable for any profits earned by him personally from the exploitation of an opportunity or expectancy to which, under all the circumstances, the corporation had the superior right. In the easily recognized language of Justice Cardozo, a trustee (which a corporate director is in respect of the quality of his duty) is held to something stricter than the morals of the market place; his standard must be not honesty alone, "but the punctilio of an honor the most sensitive"; and equity will meet with uncompromising rigidity any attempt "to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions."

While plaintiff stockholders have shown a strong affinity for these phrases, the courts have in their application to the practical problems of corporate management looked sharply at the question whether the opportunity for profit was one which, as a matter of equity, did belong to the corporation. In Hauben v. Morris, minority stockholders of Industrial Finance Corporation sought to hold directors liable for the profits of the sale by them to the corporation of debenture stock thereof which it had previously sold to a third party subject to a repurchase agreement. Before retirement of the stock the third party sold it to a syndicate composed of defendant directors, instead of to the corporation; the defendants sold to the corporation at the specified redemption price; and the profits claimed in the action were the premium and the accrued dividends. The trial court held the defendants liable for these profits.

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The Appellate Division reversed, finding upon an analysis of the facts that the third party might well not have sold to the corporation and that earlier redemption of the stock might not have been to the corporate interest. The conclusion was that the directors are not trustees for the corporation in such a case unless the circumstances imposed upon them a "mandate" to buy for the corporation. The Court of Appeals affirmed without opinion.

Great stimulus to claims of diversion of corporate opportunity in minority stockholders' cases was given by the success of such a claim in the Delaware case involving Loft, Inc. According to the findings, the president of the corporation there knew that it needed a cola drink and had under consideration the purchase of Pepsi-Cola for that purpose; the opportunity to acquire Pepsi-Cola was actually tendered to the corporation, but rejected; thereupon the Pepsi-Cola business was acquired by the president privately and developed by him through the use of the corporate facilities in very great part. This would seem a strong case, and the language of the Delaware court imposing liability under those circumstances, which is the language of general fiduciary obligation, cannot be applied without change to different facts.

As Hauben v. Morris indicates, the New York court has been critical of claims based upon alleged diversion of corporate opportunity. In the suit against the National City Bank directors, the defendants were held not liable to the corporation for a profit made by them personally on the acquisition of portions of a new stock issue purchased by National City Company from the issuer and sold by it to a private list including the defendants, where a profit was made both by National City Company and by some of the directors. Justice Dore pointed out that there was no proof that the company could have made a larger profit and no indication that its own transaction was impaired. In the case against directors of Guaranty Trust Company and Guaranty Company, a similar conclusion was reached by the court in a similar transaction which differed principally in that the defendant directors bought their stock directly from the same bankers who sold to Guaranty Company for the purpose of public issue. His discussion of the evidence emphasizes that the offering made by Guaranty Company was as large as it could handle and that the defendant directors did not compete with it in the market.

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On this question of the proprietary right of the corporation in a business opportunity, one of the closest issues which has been drawn was drawn in the Blaustein case to which I have so frequently referred. There the judgment of the trial court to the effect that the directors of Pan-American Petroleum and Transport Company had, under the domination of the majority stockholder, deprived it in favor of that stockholder of various facilities necessary for an effective economic performance by the corporation, rested on the substantial basis of a contract made February 17, 1933, between the corporation and the majority stockholder to which the plaintiffs were parties. Holding the majority stockholder to have become a fiduciary of Pan-American by reason of its domination, the trial court took this agreement as the measure of the corporation's right as seen by the parties at the time, and enforced this right, in certain particulars, not because the individual directors profited personally but because they appropriated for the majority stockholder certain transactions and profits held to belong to the corporation. The majority in the Appellate Division disagreed with this view. Despite the 1933 contract, the Appellate Division pointed out that the action was brought by the plaintiffs, not to enforce the contract, but to punish a breach of trust, and held that the agreement could not deprive the directors of their "duty to manage the corporation in the exercise of their own judgment and discretion in the light of facts and conditions faced when they were called upon to act."

Even if the objects stated in the contract seemed to the parties the best course at the time, said the court:

"... neither that agreement nor any other contract between such parties could be made the inflexible rule of corporate policy from which directors could not deviate without breach of duty. Corporate management is vested by law in the corporation's directors and no such contract can bind directors to predestined action irrespective of their own judgment and discretion."

The essential conflict in this situation between the doctrine of diversion of corporate opportunity and the business judgment rule is shown in the conclusion of the Appellate Division:

"... In the final analysis on the facts disclosed, the decree substitutes the court's judgment for that of the directors and in its present form draws the court more and more deeply into the directorial management of the oil business, balancing the proba-

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bilities of profitable results, decreeing those which seem to the
court to promise best results where there is a difference of opinion
between minority and majority directors, and enjoining others.
No case has been made out which plainly shows that the action
taken was 'so far opposed to the true interests of the corporation itself
as to lead to the clear inference that no one thus acting could have
been influenced by any honest desire to secure such interests, but
that he must have acted with an intent to subserve some outside
purpose, regardless of the consequences to the company and in a
manner inconsistent with its interests.'"

Essential to this conclusion, of course, were the findings that the in­
dividual defendants made no personal profit, that they acted in good
faith, and that the majority stockholder did not dominate the cor­
poration.

A well-known case in which liability has been imposed upon direc­
tors for diversion of corporate opportunity is *Irving Trust Co. v. Deutsch.* A substantial block of stock in a company owning patents
essential to the business of the corporation involved was offered to the
corporation, rejected for lack of funds, and thereafter acquired by cer­
tain directors personally. It was held that their profits in the trans­
action belonged to the corporation. Although the directors sought to
arrange that the corporation might have 'the benefits intended by its
own originally contemplated purchase, and although the finding of the
trial court that the corporation could not afford the purchase was left
undisturbed, nevertheless the rule of undivided loyalty seemed to the
United States Circuit Court of Appeals to require surrender of the
profits. But the bankers who had proposed the transaction to the cor­
poration, and then carried it out with the defendants, were held not
liable to account, since they had the right to sell to whomever they
could. This decision was rather close to the line, and has not been fol­
lowed by the New York courts in situations of comparable difficulty on
their own facts. In so far as the rule of *Irving Trust Co. v. Deutsch*
is more severe than that of the state courts, it should no longer govern

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38 Id., 263 App. Div. at 130, quoting Gamble v. Queens County Water Co.,
123 N. Y. 91 at 99, 25 N. E. 201 (1890).
39 (C. C. A. 2d, 1934) 73 F. (2d) 121, reversing (D. C. N. Y. 1932) 2 F.
S. Ct. 405 (1935).
40 It is distinguished in Blaustein v. Pan-American Petroleum & Transport Co.,
263 App. Div. at 120, 31 N. Y. S. (2d) 934 (1941), and in Litwin v. Allen,
(N. Y. Co. Spec. Term, 1940) 25 N. Y. S. (2d) 667 at 687; it is disregarded in
Hauben v. Morris, 255 App. Div. 35, 5 N. Y. S. (2d) 721 (1938), although cited
below, 161 Misc. 174 at 181, 291 N. Y. S. 96 (1936).
in actions in the New York federal courts, by virtue of the rule in *Erie R. R. v. Tompkins.*

The theory of diversion of corporate opportunity underlies a very recent decision by Justice Shientag involving directors of the American Metal Company, Ltd. This was a derivative suit on behalf of the Metal Company against directors and officers for diversion to their own profit of the development and operation of a molybdenum mine at Climax, Colorado. The Metal Company, among other things, bought and sold the base metals, copper, zinc and lead, but until the transactions in suit had not been interested in molybdenum. An offer of a new source of molybdenum was made to the corporation, and it signed contracts for the acquisition thereof and advanced money for the development of the enterprise. When the enterprise was entered upon, the participation therein for the company was fixed at seventy per cent and thirty per cent for the management. At some time in 1917 this ratio was changed so that the company had but ten per cent and the management ninety per cent; proportionate stock interests were assigned to the company and to the directors upon the incorporation of Climax Molybdenum Company in 1918; the success of the Climax Company was uneven, but from 1934 on it made phenomenal profits.

In applying the doctrine of corporate opportunity, Justice Shientag pointed out that the rule is clear where the property involved is essential to the existence of the corporation, but that greater difficulty arises where the property is merely one in which the corporation "has an interest or tangible expectancy." As guides to determine whether the corporation has an interest or tangible expectancy in any property or venture so as to make it a corporate opportunity, the court suggested that the following circumstances, among others, have to be considered:

1. The nature of the property involved, whether it was unique or of special value or something that could be acquired by anyone in the market.

2. Whether or not it was within the scope and line of business of the corporation.

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41 304 U. S. 64, 58 S. Ct. 817 (1938); West v. American Telephone & Telegraph Co., 311 U. S. 223 at 236, 61 S. Ct. 179 (1940).
"3. The manner in which the opportunity came to the officer or director—whether in his official or in his individual capacity.

"4. The financial ability and the adequacy of the facilities and resources of the corporation to acquire and exploit the enterprise.

"5. The actual use of the funds and resources of the corporation in the acquisition and development of the corporation.

"6. Whether or not the officer or director acted in good faith, in the interests of the corporation, or whether he was guided by his own personal advantage."

The opinion shows that a substantial factor in the court’s conclusion was the defendants’ use of the name, good will and connections of the American Metal Company in developing their enterprise, which was thus developed at the expense of the corporation, much like the development of the Pepsi-Cola business in the Guth case.

E. Negligence of Directors

Directors naturally cannot avail themselves of the business judgment rule where they have not in fact exercised any judgment at all on the point in controversy. Thus in the Hearst Consolidated Publications case the California court felt obliged to set aside the acquisition by the corporation of certain newspapers from a corporation controlled by Mr. Hearst, because of excessiveness of price and lack of arms-length dealing, despite the fact that the directors were shown by the minutes to have approved the transaction. Said the court:

"Ordinarily this fact would have great weight, but in this case it has but little. There were important facts which the directors did not know. They had made no investigation of values. They did not know of the seriousness of the situation caused by the advances and loans that had been made upstream and of the increasing difficulty on that account; ... They had at best an imperfect knowledge that they were purchasing papers that had been sustaining heavy losses for many years or of what those losses had been." 45

Similarly directors are not exonerated in the exercise of even a disinterested business judgment if they have been careless—have failed to exercise the prudence and degree of care which would be exercised in the circumstances by a reasonable man protecting his own interests. Thus the directors of Reynolds Investing Company were held respon-

45 Mann v. Hearst, Superior Court of the State of California, Los Angeles County, Sept. 1941, page 203 of memorandum opinion of Shinn J., not yet reported.
sible for the extraordinary frauds perpetrated by third parties upon the corporation through the device of acquiring their stock and using their portfolio of securities to pay the purchase price, where the directors themselves disposed of their stock to the same third parties at a price held to be excessive and an essential feature of the bargain was the immediate resignation of the directors and officers. Conceding that majority stockholders have a right to sell their stock even though such a sale ultimately brings about a change in the directorate, considering also that officers and directors have a right to resign their posts, Justice Walter nevertheless found that these circumstances together with excessive price charged the directors and officers with notice of the intention of the purchasers to loot the corporation.

The court called attention to the fact that by their resignations the officers and directors of the company placed in the control of their successors the custody and possession of negotiable securities of a value twice the agreed purchase price. He said:

"... For fiduciaries confronted with such a realization, I gravely doubt whether it is sufficient that they truthfully can say they actually knew nothing against the character of the purchasers or of their nominees, or even that they had affirmative evidence that the purchasers were of good reputation. A man dealing with his own affairs may be as confiding and trusting as he pleases, and may be grossly negligent without being guilty of bad faith; but a fiduciary charged with the care of the property of others must be reasonably vigilant, and will not be heard to say that he did not know what the circumstances plainly indicated or that his faith in people was such that obvious opportunities for wrongdoing gave him no inkling that wrongdoing might be done, and schemes to acquire the stock of corporations by using assets of the corporation to pay the purchase price did not originate in the year 1937."

Similarly in the Guaranty Trust Company case the court found negligence in one of the transactions attacked despite the fact that two of the defendants held liable had as members of a private banking firm entered into the same transaction for their own account in an even larger amount, and thus given the best possible proof that their decision as directors was made with the same care that they gave to their own affairs. The transaction was a purchase of Missouri Pacific bonds with an option to the seller to buy them back at the same price within six months, the bonds in the meantime yielding five and one-half per cent

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to the purchaser. They fell in price during the six months, the option to repurchase was not exercised, and Guaranty Trust Company sustained a loss through its wholly-owned subsidiary Guaranty Company. The imposition of liability in these circumstances, despite substantial evidence in the testimony of the defendants as to the factors which they considered made the transaction a prudent one, and despite the acquisition of the same securities on the same terms by two defendants for their own account, has sometimes been said to indicate the development of a doctrine of negligence per se. I do not think this is the case. Analysis of the facts will show that the court concluded the transaction to be ultra vires the corporation, the form of transaction was conceded to be a unique one, and there was no evidence that counsel had been consulted. Perhaps also the view that directors of a banking corporation are required to exercise a higher degree of diligence than other directors had something to do with the result. Where on the other hand it appeared from an analysis of the deliberations of the directors' executive committee that proper attention had been given to all relevant factors, the same court exonerated the defendants in respect of their approval of certain banking loans, even though the loans were unusual in character and ultimately resulted in large losses.

The degree of care which will be held an adequate discharge of a director's duty of course varies with the circumstances. In sustaining the action of directors of Guaranty Trust Company, Justice Shientag reviewed in detail statistical material and considerations of policy which came before the directors in connection with a loan made in 1930 and a public auction in 1935 of the collateral securing the loan. Each of these was a complicated transaction. A less detailed showing would probably be sufficient. In sustaining the action of the directors of St. Louis-San Francisco Railway Company in voting to acquire shares of the Chicago Rock Island & Pacific Railroad Co. in 1926, Justice Valente first dealt with the charge that the directors were under the domination of the chairman of the board, and then said:

"... It is true that the directors did not individually make excessive statistical examination into the wisdom of the purchase. They did, however, pass upon the broad question of policy and use their independent judgment."

49 Lonsdale v. Speyer, 174 Misc. 532 at 542, 19 N. Y. S. (2d) 746 (1938),
The point of time at which the actions of directors must be looked at in order to determine whether or not they exercised judgment with due care is of course the time at which they acted, not some subsequent time. This rule is universally applied. It has been well said that a wisdom developed after an event, and having it and its consequences as a source, is a standard no man should be judged by; \textsuperscript{50} and that, while prescience is always desirable, the failure to foresee what at best is uncertain does not give rise to liability. \textsuperscript{51} The uniform application of the rule, however, does not prevent minority stockholder plaintiffs from adopting with equal regularity the other view, and attacking corporate action on the basis of hindsight. In the epilogue to War and Peace, Tolstoi explains that the development of causation in history requires you to know how things turned out before you can find out what preceding events are significant; and I suppose that directors of corporations cannot claim to be exempt from the kind of thinking which is used to explain Napoleon.

For the honor of the profession, it is valuable to know that a finding of negligence or due care in the action of directors will sometimes turn on whether they have consulted counsel. Weight was given to the advice of counsel by Justice Froessel in finding directors not liable in respect of a friendly receivership proceeding which was the basis of complaint in the Hoe case; \textsuperscript{52} and by the Appellate Division, Second Department, in sustaining the action of the directors of National Investors Corporation in settling a suit brought against it; \textsuperscript{53} and by Justice Hammer in holding the directors of United States Rubber Company not liable in respect of a stock option plan for employees or of a bonus plan for employees; \textsuperscript{54} and by the California court in sustaining certain transactions between Hearst Consolidated Publications, Inc. and Star Holding Company, in the former of which the defendant W. R. Hearst had a substantial interest and the latter of which was wholly

\textsuperscript{50} Costello v. Costello, 209 N. Y. 252 at 262, 103 N. E. 148 (1913).
\textsuperscript{52} Chance v. Guaranty Trust Co., (N. Y. S. Ct. 1941) 32 N. Y. S. (2d) 412 at 419.
owned by him.55 While critical of loose practice in the handling of interest on intercompany transactions, Judge Shinn sustained the defendant directors in respect of them because of the approval of counsel. He said:

"I have held that when Consolidated became Star’s banker, banking methods should have been adopted and in a loose fashion they were. Perhaps Mr. Neylan was not as severe in those matters as he should have been, but on the other hand he may have been as severe as counsel who now criticize his actions would have been had they been in his position and had his understanding of the situation. Perhaps not—it is not important. But the thing that is important is that Mr. Neylan approved of these purchases of stock by subsidiaries and of the payment of the money to Star, which of course necessarily had to be done after the sales were made. I will not repeat what I have said of his interest in Consolidated and his devotion to his duties."56

Where, on the other hand, legal questions arose and the record did not show that advice of counsel was taken, the courts have adverted to this item as an indication of negligence. This was one of the bases for the imposition of liability with respect to the granting of a repurchase option by the defendants in the Guaranty Trust Company case, where there was no showing either way on the point.57 So in the Reynolds Investing Company case, the failure to consult counsel regarding an unusual offer for the purchase of stock conditioned upon the immediate resignation of directors and officers was mentioned as a ground of directors’ liability.58 In the Blaustein case the advice of counsel taken by the directors of Pan-American Petroleum & Transport Company with reference to the effect of the Texas antitrust laws upon the policy which they adopted did not satisfy the trial court because he found that the counsel consulted was not independent and had a personal interest in the transaction; but this view of the matter was not adopted by the majority of the Appellate Division, who in sus-

55 Mann v. Hearst, Superior Court of the State of California, Los Angeles County, 1941, not yet reported; p. 113 of memorandum opinion.
56 Id.
57 Litwin v. Allen, (N. Y. Co. Spec. Term, 1940) 25 N. Y. S. (2d) 667 at 699. This type of option, like the resale option, was held to be ultra vires a New York bank.
Directors may in the exercise of due care properly rely in reaching their conclusions upon information furnished and conclusions expressed by the management of the corporation, as was held in the Guaranty Trust Company case. In the words of Lord Halsbury, it is not to be expected of a director "that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself." Another basis for directors' reliance which is turning up more and more frequently in the more complicated cases is the audit of competent outside accountants. The National City Bank case made clear that even directors acting in good faith could not safely distribute supplemental compensation to officers upon the basis merely of a net amount prepared for them by officers and employees who themselves participated in the distribution, where it turned out that there were errors in the computation. Failure of the defendants to entrust the computation of the supplemental compensation fund to disinterested persons (said the referee)

"... constituted a breach of their duty as directors and subjects them to liability for the restoration of moneys improperly paid through such erroneous computations of the management fund."

But where directors have taken the precaution to employ independent auditors, they should not be under liability for miscomputations. Justice Valente said in the Loew's Inc. case, distinguishing the National City Bank case:

"... In the instant case there was furnished an independent audit by a firm of certified public accountants. Plaintiffs charge that this firm was too complacent and adopted the rules suggested by the parties interested, without using its own judgment. It would be unreasonable to expect a board of directors to recheck the work of the independent auditors by still another firm. This would lead to an endless chain and would be entirely impracticable.

[After indicating that errors existed in the computation]

"Should the directors be charged with negligence in not discovering the failure to make the deductions which this opinion

directs? In the absence of a showing that their attention was
directed to these matters, it would be too much to expect that they
would do their own re-audit. Nor, of course, could it be expected
that they would consult still another firm to check upon the inde­
pendent auditors."68

So on motion for summary judgment by certain directors in the
General Motors Corporation case, the federal court said, with refer­
ence to their reliance upon the calculation of an employees’ bonus fund
by independent auditors:

"... These non-participating directors who served on the
Finance Committee were justified in relying on the figures pre­
sented by the accounting firm, and they cannot be charged with
either negligence or waste if the accountants’ calculations were in­
correct, either because the accountants did not adopt the proper
accounting method or practice, or otherwise erred in arriving at the
total of capital employed in the business. These three defendants
did not profit from any errors, assuming the accountants did
err."64

It has been suggested that directors are entitled to accept the judg­
ment and advice of their accountants even with reference to com­
cputations of capital and surplus entering into the right to declare dividends
on preferred stock,65 despite the authority to the effect that statutory
requirements with respect to dividends are absolute and liability for
violation may exist without fault.66

F. Judgment of Plaintiffs’ Counsel: A Spurious Exception

Where the business judgment rule is really applicable, much of the
attack on defendant directors by stockholders’ counsel is predicated on
the implied proposition that failure of the directors to adopt the same

63 Epstein v. Schenck, Special Term, N. Y. County, N. Y. L. J. January 21,
1939, p. 324:4 at 7, not officially reported.
at 833. In the decision handed down April 10, 1942, after trial (not yet reported),
the court departed substantially from this principle, upon a finding that the non­
recipient directors made independent decisions of policy, which were disapproved.
66 Quintal v. Greenstein, 142 Misc. 854, 256 N. Y. S. 462 (1932), affd. 236
App. Div. 719, 257 N. Y. S. 1034 (1932). In this action to recover a dividend paid
from capital in violation of the statute, the court struck out defenses of good faith, in­
19 N. Y. S. (2d) 789, affd. 263 App. Div. 878, 32 N. Y. S. (2d) 348 (1942),
on the other hand, the court found that there were earnings available for dividends.
standards of care and judgment that counsel do is a ground of liability. Fortunately this proposition is not true. Plaintiffs' counsel have the inestimable advantage of hindsight. By the nature of their employment they know which side to take and what decision ought to have been made. Counsel dealing with defendant directors must remember that the latter are not expected to attain the standard of prudence and foresight attained by counsel themselves; for otherwise, instead of being merely directors, they would be members of the bar. A federal judge in Kentucky, in passing on the liability of directors of a national bank for mismanagement, pointed out the difficulty of ascertaining the "reasonably prudent person" whom the law takes as the standard to determine the negligence of directors. He said:

"... Now, in my opinion, it is probable that the trier of the facts, in such a case, whether he be judge or juror, thinks, perhaps unconsciously, of himself as a reasonably prudent individual. ... The natural impulse of the judge trying such a case is to expect and demand a high degree of care on the part of such a bank director and to believe that the ordinary bank director is, as the judge is likely to conceive that he himself would be (and perhaps in fact would be) a very careful, conservative, prudent director. It is only natural for a judge to think of himself as a bank director of this ultraconservative type, rather than as a director of the average, ordinary type. He may forget that membership on a board of directors of a large city bank such as is involved here is usually and normally only one of many business activities in which such director is engaged. It may be thought that such a directorship is of sufficient importance to demand that the director give to it all of his thought, energy, and time, but that this is not the usual or ordinary practice is a fact of such general knowledge that the court must take judicial notice of it." 67

This language suggests the further thought that conformity of the directors' judgment with the opinion of the court itself is neither a necessary nor a proper test of due care. Judicial standards are not those of corporate management, and it would be a departure from his duty for a director to look at the questions presented to him for decision in the way a court is required to do.

III

APPLICATIONS OF BUSINESS JUDGMENT RULE

Every derivative action against directors in which the plaintiff is unable to show fraud, diversion of corporate property, negligence, violation of statute, ultra vires or the like, and which is therefore dismissed, is in a sense an application of the business judgment rule. However, there are some applications of special interest.

A. Executive Compensation

The determination of the proper compensation of employees, more particularly of officers vital to the success of the corporation, lies peculiarly within the sphere of the good judgment and discretion of the directors. This conclusion is the result of an attack vigorously pressed by minority stockholders upon the compensation policies of the larger corporations since 1931.

In the case of small companies, there had previously been a number of decisions holding the compensation of executives as fixed by the directors under varying circumstances to be reasonable in some cases, unreasonable in others. In all, Professor Washington in his book *Corporate Executives' Compensation* has collected forty-four of these decisions affecting small corporations. Of these, twenty-seven held the compensation reasonable, seventeen unreasonable. From a study of the cases, Professor Washington concludes that they furnish no clear line for classification of a given amount of compensation as reasonable or unreasonable, no definite ratio between the executives' salary and corporate earnings or any other figure. The figures of compensation held reasonable varied from $1500 to $24,800; those held unreasonable varied from $3600 to $29,076. The ultimate basis of decision where compensation was held unreasonable was, in the author's opinion, the bad faith of the defendants involved; apparently all but one of the seventeen cases determining compensation unreasonable involved self-dealing.69

The first of the large corporations to have its compensation policies attacked by minority stockholders was Bethlehem Steel Corporation, of which four stockholders in 1931 sued in the New Jersey court for a return of bonuses paid and an injunction against further payments.70

68 Page 250 (1942).
69 WASHINGTON, CORPORATE EXECUTIVES’ COMPENSATION 258 (1942).
70 Berendt v. Bethlehem Steel Corp., 108 N. J. Eq. 148, 154 A. 321 (1931), granting a preliminary injunction against the holding of a stockholders’ meeting to ratify the acts of the management.
In 1933 in the first American Tobacco case, *Rogers v. Hill*, the Supreme Court held that certain bonuses paid to officers of the American Tobacco Company, upon the basis of net profits fixed by a by-law adopted in 1912, were so large as to warrant investigation in equity to ascertain whether such bonuses bore a real relationship to services rendered. The largest amounts of bonus mentioned in the opinion were $447,870.30 in 1929 and $842,507.72 in 1930. Following this indication the New York court in the *National City Bank* case also held that certain of the figures of executive compensation there appearing were so large as to warrant judicial review, but took pains to add:

"... The inquiry is not merely to substitute the court's discretion for the discretion of the directors, if that has been honestly and fairly exercised."

So in the *General Motors* case, Judge Leibell on a preliminary motion indicated that those executives who from the period 1930 on received salary and bonus together exceeding $250,000 might upon a trial be found to have been overpaid. He granted the moving defendants summary judgment as to all except those persons, who were about eighteen in number. This again did not indicate liability in respect of the compensation of those persons. Still less did it mean that in all companies and under all circumstances $250,000 would be an allowable limit for executive compensation on an annual basis.

Curiously enough, none of the cases which have sought to review in equity the propriety of large amounts of compensation to corporate executives have resulted in a recovery upon this basis. Where recoveries have been had, they have been had on other grounds. The questions of compensation sent to the referee, Judge Laughlin, in the

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71 289 U. S. 582, 53 S. Ct. 731 (1933), approving the dissenting opinion of Judge Swan in (C. C. A. 2d, 1932) 60 F. (2d) 109 at 113.
72 Gallin v. National City Bank, 152 Misc. 679 at 706, 273 N. Y. S. 87 (1934). Compensation of the chief executive in three of the years exceeded $1,000,000. At 152 Misc. 703 Dore, J., summarizes the possible factors affecting the amount of executive compensation, and at pp. 706-707 the decisions dealing with the right of directors acting as a body in good faith to fix compensation for services.
74 In his decision after a full trial, Leibell, J., held that compensation to the executives of General Motors Corporation running up to $500,000 annually was not excessive in view of the testimony as to their services and the failure of plaintiffs to indicate any alternative measure of compensation. Winkelman v. General Motors Corp., April 10, 1942, not yet reported. The court said with respect to certain compensation on a scale running up to $1,000,000 annually, recovery of which was barred by the statute of limitations, that he would otherwise be inclined to hold that it was so large as to constitute a waste of corporate assets.
National City Bank case were resolved in favor of the defendants; it was held that none of the defendants authorized or permitted the payment of compensation so great as to constitute a gift or waste of corporate funds.\(^{75}\) In the second American Tobacco case Justice Collins in picturesque language announced his inability to fix a standard other than that adopted by the directors with respect to the amounts of compensation for services due to five officers of the company who received, in the form of salary and bonus together, amounts of compensation ranging around $200,000 in most cases but running up sometimes to $1,000,000 in the case of the president. The court said:

"... It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. ..."

"Courts are ill-equipped to solve or even grapple with these entangled economic problems. ... Courts are concerned that corporations be honestly and fairly operated by its [sic] directors, with the observance of the formal requirements of the law; but what is reasonable compensation for its officers is primarily for the stockholders.

"... In the circumstances, if a ceiling for these bonuses is to be erected, the stockholders who built and are responsible for the present structure must be the architects."\(^{76}\)

This decision was followed in the California case involving Hearst Consolidated Publications, Inc., where the trial court found that $500,000 a year paid to the principal executive with the approval of the board over a period of seven years was not unreasonable and, though more critical of the amounts received in relation to services by the sons of this executive, refused to impose liability in respect of them also.\(^{77}\)

The New York court upon the evidence held the compensation received by executives of Bethlehem Steel Corporation in amounts aver-


\(^{76}\) Heller v. Boylan, (N. Y. Co. Spec. Term, 1941) 29 N. Y. S. (2d) 653 at 679, 680, aff'd. (App. Div. 1941) 32 N. Y. S. (2d) 131. The total of Mr. Hill's executive compensation over the period 1929-1939 was about $6,500,000. Mr. Hill made the continuance of the bonus system of American Tobacco Company a condition of his continuance with the company, in communications to the stockholders during 1940-1942; and the stockholders' votes sustained the bonus system. WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 276-277 (1942); NEW YORK TIMES, April 2, 1942, p. 37:1.

\(^{77}\) Mann v. Hearst, Superior Court of California, Los Angeles County, Sept. 1941, Shinn, J., not yet reported.
aging up to $200,000 a year and in one case $798,000 a year, under a
bonus plan, was reasonable and not excessive. In the stockholder's
suit involving Loew's Inc. the New York court held that there was no
showing of improvidence on the part of directors in providing for per-
centage compensation to three executives which gave them twenty per
cent on the first $2,500,000 of profits computed after certain deduc-
tions and fifteen per cent thereafter. In the stockholders' action in-
volving the United States Rubber Company a plan of supplemental
compensation, including a stock option to one of the principal execu-
tives, was sustained on summary judgment as a proper exercise of the
discretion of directors.

So in the action involving Warner Bros. Pictures, Inc. a federal
court in Delaware sustained a settlement of a stockholders' derivative
action against the directors in respect of compensation to three execu-
tives jointly in the amount of $10,000 a week for a six-year contract
together with 90,000 shares of stock alleged to have been worth
$12,000,000 at the time of issuance in 1928, and also held that execu-
tive compensation in this amount was not as a matter of law a waste of
corporate assets. Following this decision a federal court in Maryland
sustained the action of the directors of National Cash Register Com-
pany in voting the principal executive an annual salary of $100,000 for
only a part of his time and in addition an option to purchase 50,000
shares of stock at a price which (in view of subsequent market levels)
made available to him a theoretical profit of $1,410,000. Judge Cole-
man's opinion, recognizing that a salary of $100,000 appears to the
average person to be more than liberal compensation, remarks that
"courts are not permitted to be controlled by this test any more than
by what the average judge, familiar with cases of the present kind,
might himself conclude to be adequate compensation."

The result of the authorities seems to be that, despite the rule to

78 Cwerdinski v. Bent, Special Term N. Y. County, Valente, J., N. Y. L. J.,
Dec. 26, 1941, p. 2129:4, not yet officially reported.
79 Epstein v. Schenck, Special Term N. Y. County, Valente, J., N. Y. L. J.
January 21, 1939, p. 324:4, not officially reported. There was substantial evidence of
stockholders' approval, and regard was paid to the high rate of compensation in the
cinema industry.
80 Diamond v. Davis, Jr., Special Term N. Y. County, Hammer, J., N. Y. L. J.
Feb. 14, 1942, p. 686:1. Ratification by the stockholders was also a basis of the
decision.
639 at 653, affirmed, (C. C. A. 4th, 1940) 112 F. (2d) 877, cert. denied, 311 U. S.
695, 61 S. Ct. 140 (1941).
the effect that executive compensation of a certain size in relation to the apparent effort and responsibility imposed will warrant an investigation in equity, directors exercising their judgment disinterestedly cannot be made liable to minority stockholders merely by virtue of the size of the compensation granted to executives. At least, no decision is known in which liability in such circumstances has been predicated merely upon the size of executive compensation approved by disinterested defendants. Liability, where imposed, is usually imposed upon the basis of self-dealing.

Liability in cases involving alleged unreasonableness of executive compensation is also imposed where the amount is not controlled by the independent judgment of directors. Thus the basis of the liability found in the National City Bank case was that while the distribution of management fund was made by disinterested directors, the computation thereof was delegated by them to interested officers and employees and the computation was erroneous. In the Loew's Inc. case, distinguishing that decision, the court held that the certificate of outside accountants protected the nonrecipient directors from liability for errors found to exist in the computation of a profit-sharing fund, but imposed liability upon the recipients as to three items erroneously computed.

Where plans of supplemental compensation are related to corporate earnings, questions of accountancy in the ascertainment of the earnings necessarily arise; and it is not unusual for minority stockholders, employing on a contingent basis attorneys who retain accountants on the same basis, to endeavor to bring into court the finer questions of


84 This is the result of the analysis of the decisions affecting small companies by Washington, Corporate Executives' Compensation 258 (1942). A case cited by him, Dwight v. Williams, 25 Misc. 667, 55 N. Y. S. 201 (1898), is a possible exception to the statement contained in the preceding sentence of the text.


86 Epstein v. Schenck, Special Term N. Y. County, Valente, J., N. Y. L. J., January 21, 1939, p. 324:4, not officially reported. The court refused to restate the profit-sharing account in other respects where the issue involved accounting methods about which there was a fair difference of opinion. The same judge later dismissed for insufficiency certain matters complained of by another stockholder in connection with the same profit-sharing contracts, where the allegations of the complaint did not sufficiently negative the proper exercise of business judgment by directors on accounting questions. Gottlieb v. Schenck, Special Term New York County, Valente, J., N. Y. L. J., March 3, 1942, p. 930:7, not yet officially reported.
accounting theory and found a representative judgment against directors on the judge's arbitrament of these matters. In such cases, the interplay of directors' business judgment with the certificate of independent accountants as to the correctness of the accounting practices followed opens new opportunities for the making of distinctions.\(^87\) Undoubtedly these distinctions will be resolved in the sense of the business judgment rule as outlined in existing decisions.

One of the most scholastic of the refinements yet raised by minority stockholders seeking perfectibility with the aid of accountants retained on a contingent basis has been whether bonuses computed on a basis of profit-sharing must themselves be deducted as an expense of the business in determining the bonus base.\(^88\) The attempt to bring up for judicial review such niceties of accountancy shows as well as anything else the great importance, first of a strict application of principles of business judgment by directors to these questions, and second of strict enforcement by the courts of the business judgment rule.

B. \textit{Necessity of Determination of Liability Before an Accounting}

The right of directors to be exonerated in respect of the proper exercise of the discretion delegated to them by the stockholders means that they should not be required to account in equity until a case has been made establishing a prima facie liability on their part for violation of this rule. This does not mean that they cannot be sued without a

\(^87\) See Diamond v. Davis, Jr., Special Term N. Y. County, N. Y. L. J., Feb. 14, 1942, p. 686:1 granting summary judgment against the plaintiffs; Gottlieb v. Schenck, Special Term New York County, N. Y. L. J., March 3, 1942, p. 930:7, dismissing the complaint in part for insufficiency. See on the other hand the opinion in Winkelman v. General Motors Corp., (D. C. N. Y., April 10, 1942), Leibell, J., not yet reported, holding liable for miscomputation both directors who received part of the compensation fund and directors who received none, with respect to some items where accounting practices followed had the approval of independent public accountants and of a majority of disinterested directors. In other items of the recovery the court found that there was self-dealing.

\(^88\) Epstein v. Schenck, Special Term, New York County, N. Y. L. J., January 21, 1939, p. 324:4, not officially reported, and Winkelman v. General Motors Corp., (D. C. N. Y. April 10, 1942), Leibell, J., not yet reported, both held that such deduction need not be made from the bonus base. In each case independent public accountants approved the practice followed. Heller v. Boylan, (N. Y. Co. Spec. Term, 1941) 29 N. Y. S. (2d) 653 at 692, 704, affd. (App. Div. 1941) 32 N. Y. S. (2d) 131, held that the bonus should have been deducted as an operating expense like salary, the Supreme Court having held compensation under that particular bonus plan to be an operating expense, Rogers v. Hill, 289 U. S. 582 at 590, 53 S. Ct. 731 (1933), and the item not having been audited by outside accountants.
prior determination of their liability. It does mean that they cannot be made to account before a referee or master until wrongdoing has been established. This rule has recently been applied by the appellate courts in New York in reversing interlocutory judgments in stockholders' actions. 89

The same principle requires the granting of summary judgment to defendant directors where the plaintiff stockholder is unable to show the existence of facts which would make the business judgment rule inoperative. In such situations summary judgment is granted equally in the state and in the federal courts. 90 Where the plaintiff stockholder could show a triable issue as to whether the directors exercised an independent discretion, summary judgment has been denied. 91

C. Prior Demand

Since a claim for mismanagement or waste of corporate assets is itself a corporate asset, the business judgment rule requires that the giving of opportunity for suit to the board of directors of a corporation is a prerequisite to the exercise of equity jurisdiction at the suit of a minority stockholder, unless either the directors have wrongfully refused to bring suit or a demand upon them to do so would be futile. This principle was applied by the United States Supreme Court from the beginning, in the protection of its discretion against collusive suits; it has been embodied in the equity rules since 1881; and it now appears in the Federal Rules of Civil Procedure approved by the Supreme Court in 1937. 92

In view of the enormous multiplication of derivative actions in recent years, it is refreshing to hear the words of the Supreme Court spoken in 1881 on the necessity of prior demand. The case was in


91 Levine v. Behn, 282 N. Y. 120, 25 N. E. (2d) 871 (1941). Upon the trial the defendant directors received judgment upon a finding that in paying out of corporate funds a claim which was not legally due, they reasonably believed they were promoting the interests of the corporation. 174 Misc. 988, 21 N. Y. S. (2d) 805 (1940), affd. 262 App. Div. 729, 28 N. Y. S. (2d) 711 (1941), leave to appeal denied, 262 App. Div. 845, 29 N. Y. S. (2d) 146 (1941).

92 Rule 23(b); see note 3, supra, and Hawes v. Oakland, 104 U. S. 450 at 460-461 (1881).
equity in a United States court for California by a citizen of New York as stockholder in a California corporation, alleging that the directors had wrongfully permitted the corporation to give the City of Oakland free water for all municipal purposes whereas it was entitled only to receive free water in cases of fire or other emergency. The court said:

"... The directors are better able to act understandingly on this subject than a stockholder residing in New York. The great body of the stockholders residing in Oakland or other places in California may take this view of it, and be content to abide by the action of their directors.

"If this be so, is a bitter litigation with the city to be conducted by one stockholder for the corporation and all other stockholders, because the amount of his dividends is diminished? "This question answers itself. ..." 93

It has been suggested that this rule is not wholly one of procedure and that as a rule of substantive law 94 it must yield to the law of the state in which the federal court sits, under the principle of Erie R. R. v. Tompkins. 95 That contention has not yet been adopted by the federal courts. The conclusions reached in all the lower federal courts that Rule 23(b), as having been promulgated by the same Court which decided Erie R. R. v. Tompkins, must be deemed controlling until the Supreme Court otherwise decides. 96

Even the federal rule will not of course require prior demand where the directors are shown not to be free agents, as has been decided in some recent cases. 97 On the other hand, the principle of prior demand applies by virtue of judicial decision in the New York courts. The Appellate Division, First Department, has very recently reversed


95 304 U. S. 64, 58 S. Ct. 817 (1938).


97 Cohen v. Industrial Finance Corp., (D. C. N. Y. Jan, 16, 1942), Leibell, J., not yet reported; Dederick v. North American Co., (D. C. N. Y. March 17, 1942), Bright, J., not yet reported. A similar holding in Winkelman v. General Motors Corp., (D. C. N. Y., April 10, 1942), Leibell, J., not yet reported, with reference to one transaction which was not questioned until the trial and which the majority of the board did not know about, goes to the extreme limit in making an exception to Rule 23(b).
an interlocutory judgment against directors and dismissed the action for the reason, in part, that no prior demand was made upon the board of directors, of which a majority was disinterested. 98 Such a rule necessarily follows from the rule of substantive law well established in New York that directors exercising a disinterested discretion may properly surrender even a valid claim of the corporation or pay out of corporate funds an invalid claim against it. 99

IV

SOMEn CONCLUSIONS

The courts generally recognize that the application of the business judgment rule, which of course includes as a part the exceptions I have described, is essential to the maintenance of private enterprise. Just as it is vital to any system that fraud and other abuse be punished by the courts at the suit of a part owner of the enterprise, so it is indispensable that within the area of their competence and in the exercise of their functions boards of directors be free from judicial review or from the requirement that their determination in matters entrusted to them yield to the determination of others. While, as I have said, this general idea meets with universal acceptance, the first thing which strikes one in reading the cases is the immense burden which the courts have to sustain in applying the rule. Too many cases reach trial in which the plaintiff stockholder’s real complaint is that the directors were mistaken in their judgment. Every member of the bar with any experience will share, I believe, my general impression that three-quarters of the derivative actions brought are without foundation in the light of the business judgment rule, and result in no recovery. In the remaining one-quarter of the cases where some recovery is achieved, one-half or more of the matters complained of, by a generous computation, also fall within the area of reasonable business judgment and should never have been made the subject of suit.

The result is that in applying the business judgment rule the courts are subjected to a terrific burden in reviewing immense records of cor-

porate action which should not be before them at all. The long opinions recently handed down in complex stockholders' suits constantly call the attention of the bar to this fact. In the *Blaustein* case, for example, we are informed that the record comprised 10,631 pages in addition to 2,686 pages of examination before trial, and that there were 2,900 pages of briefs. In the Hoe & Co. case there were 6,000 pages of testimony and only 800 pages of briefs. In the General Motors case there were 6,733 pages of testimony and about 750 pages of briefs. In the *Hearst Consolidated Publications* case there were 5,581 pages of testimony, 11,482 pages of depositions, and 3,000 pages of briefs. I spare you the number and extent of the exhibits in these ambitious litigations.100

It is perfectly apparent from these figures that the review of corporate management which, despite the business judgment rule, is imposed upon the courts by the nature of the allegations that minority stockholders feel justified in making in their pleadings has proved to be a crushing labor. In passing, it is of interest to note how the New York and federal procedures have developed divergent techniques for dealing with this situation. The new federal rules contemplate informal and elastic pleadings, liberal examinations, and the use of summary judgment for disposition of unjust claims. The New York practice, on the other hand, has insisted upon a statement in the pleading of facts sufficient to show a breach of fiduciary obligation, the failure to exercise disinterested business judgment. This established rule has been adhered to with rigor in recent years by the New York courts as the flood of derivative actions becomes more impressive.101 So far have the state courts carried this rule that they refuse an examination before trial upon mere general statements of alleged wrongdoing in a derivative action.102 We can at present only note these divergent tendencies. It will be interesting to see how they will develop.

It is, of course, not my province here to suggest remedies for the...
evils which we all recognize to inhere in the present conduct of derivative actions. As the chairman of a New York company said to his stockholders last year, the problem still awaits a solution. The solution required is one which, while leaving a free judicial review for corporate transactions which pass beyond the business judgment rule, yet will produce a more automatic application of that rule so as to save from harassment and expense the directors entitled to its protection, from pre-emption and overwork the courts who are asked to review the business judgment of directors. A single idea that has been suggested in this direction I will mention, because it would seem to me as effective to close Pandora's box as the rule of Lord Lyndhurst was instrumental in opening it.

You will recall that in *Hichens v. Congreve* the jurisdiction of equity in a grievous situation was predicated upon the unreasonableness of asking that two hundred or more shareholders concur in separate suits, each for his aliquot part of £15,000 abstracted by the defendants. The noble lord would certainly not have intended that this principle of decision, perfectly just for an obvious case, become a universal rule of representative action by which a minority stockholder, no matter how tiny, might draw into the courts corporate transactions no matter how vast, to be determined upon considerations no matter how finely spun and ambiguous. The hypertrophy to which the stockholder's action has come inverts it from its original function. It can be restored perhaps by taking from the minuter aggregations of shares the abused privilege of representation. Should the principle be established, by rule or by statute, that a block of shares aggregating five per cent or less of the total outstanding stock of the company could not sue the directors on behalf of the corporation without the previous assent of a majority of the stock, at a special meeting called for that purpose, but would be restricted to a suit for its proportion of the loss alleged, there is reason to believe that we should soon have a healthier state of affairs in the field of derivative actions, and a readier and simpler application of the business rule.

103 4 Russ. 562, 38 Eng. Rep. 917 (1828), discussed at note 1, supra.