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SHAREHOLDER DERIVATIVE ACTIONS: A MODEST PROPOSAL TO REVISE FEDERAL RULE 23.1

Robert A. Kessler*

The purpose of this article is to suggest the addition of two words, "if necessary"—or better yet, the phrase "if necessary under the law of the forum state"—to clause (1) of Federal Rule of Civil Procedure 23.1.¹ This Rule sets forth the requirements for a shareholder's derivative action² in the federal courts.

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¹ Rule 23.1 currently provides that:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

It is interesting to note that the current Rule does not expressly require the plaintiff to allege that he is presently a shareholder. See deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1227 (10th Cir. 1970). This requirement is made explicit in N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963). See generally 19 C.J.S. Corporations § 824, at 228–29 (1940).

To make it clear that the purpose of the amendment is to adopt the essential policy of Erie R.R. v. Tompkins, 304 U.S. 64 (1938) (A federal judge in a diversity case should decide exactly as his state court counterpart would.), the language could perhaps be further clarified by adding the wording: "if necessary under the law which the forum state would apply." The "state judge role" test is set forth in Sampson v. Channell, 110 F.2d 754 (1st Cir. 1940). cert. denied, 310 U.S. 650 (1940) and Griffen v. McCoach, 313 U.S. 498 (1941).

Applying the law of the forum state, as proposed, generally accords with federal treatment of related security-for-expenses statutes. See H. Henn, LAW OF CORPORATIONS 784, n.9 (2d ed. 1970) [hereinafter cited as Henn].

² See generally H. Ballantine, LAW OF CORPORATIONS ch. 11 (rev. ed. 1946) [hereinafter cited as Ballantine]; Henn, supra note 1, at 749-53; N. Lattin, LAW OF CORPORATIONS ch. 8 (2d ed. 1971) [hereinafter cited as Lattin].
As thus amended, the Rule would require the shareholder commencing such an action to allege: "(1) [only if necessary under the law of the forum state] that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law. . . ." The object of the proposed change is, of course, to incorporate state law into the contemporaneous share ownership requirement imposed by the Rule on plaintiffs bringing actions in behalf of their corporations.

If adopted, the revision will have a twofold effect: first, it will allow a shareholder, even though he purchased his shares after the wrongdoing for which he seeks a recovery for the corporation, to maintain the action in the federal courts of those states where he would be allowed to do so in the state court, i.e., to use the practitioner's terms, a "subsequent shareholder" will be allowed to sue. Second, and more importantly, it will permit intervention of noncontemporaneous shareholders and aggregation of their shareholdings for the purpose of avoiding a statutory requirement that plaintiffs post security where they do not own a certain percentage, or value, of the corporation's outstanding shares.

Although, as is usual in such matters, the decisions are not in complete agreement, the prevailing interpretation of the Rule as presently phrased ignores contrary state practice in both situations. It is submitted that this interpretation is not only incorrect, but may even be unconstitutional, and that the Rule itself may be void as exceeding the Supreme Court's rulemaking power. If any of these contentions is correct, the Rule must be amended. It is further submitted that even if the Rule is not void, it should still be amended in order to overrule these anti-state law decisions because they are inconsistent with the federal policy expressed in *Erie Railroad Co. v. Tompkins,* in other Federal Rules, and in Rule 23.1 itself. The ultimate argument for the proposed amendment is, as it always should be, that the change will do justice, in this case by providing a forum for redressing state-created claims where no state court may be able to do so.

This article discusses the present Rule and its interpretation, examines the arguments put forth by authorities who favor the status quo, and explores the arguments advanced here for the proposed change.

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3 See notes 17, 27-28, 38 and accompanying text infra.

4 304 U.S. 64 (1938).
I. THE PRESENT RULE AND ITS INTERPRETATION

A. History

Rule 23.1 is the Federal Rule of Civil Procedure governing shareholder derivative actions. It imposes a number of requirements on a shareholder plaintiff bringing an action to vindicate corporate rights where the corporation refuses to do so.

In addition to requiring a demand on the directors and "if necessary" on the shareholders, or suitable excuses where such demand has not been made, conditioning the action on the typical class action showing of adequate representation, and limiting the settlement of derivative actions, the Rule requires the verified complaint to allege:

(1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have.\(^5\)

The Rule was adopted by the Supreme Court in 1966 on the recommendation of the Advisory Committee on Civil Rules,\(^6\) appointed by the Chief Justice\(^7\) pursuant to statutory authorization given to the Judicial Conference of the United States, of which the Chief Justice is Chairman, to make a continuous study of the Federal Rules.\(^8\) Although the Advisory Committee's explanatory notes regarding amendments to other Rules adopted at the same time were frequently quite elaborate, all that was said about new Rule 23.1 was:

A derivative action by a shareholder of a corporation or by a member of an unincorporated association has distinctive aspects which require the special provisions set forth in the new rule. The next-to-the-last sentence recognizes that the question of adequacy of representation may arise when the plaintiff is one of a group of shareholders or members. Cf. 3 Moore's Federal Practice, par. 23.08 (2d ed. 1963).

The court has inherent power to provide for the conduct of the proceedings in a derivative action, including the power to

\(^5\) FED. R. CIV. P. 23.1(1).
\(^7\) See announcement of the Chief Justice of the United States, Apr. 4, 1960.
determine the course of the proceedings and require that any appropriate notice be given to shareholders or members.\(^9\)

The Advisory Committee’s comment sheds little light on the purpose of the particular requirements of the Rule, and on their proper interpretation.

Rule 23.1 is a “spin-off” from old Rule 23(b), under which most of the cases were decided, and which read:

(b) Secondary Action by Shareholders. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.\(^10\)

Manifestly, the requirement of allegations of both share ownership and noncollusion are identical in the old and new Rules.

The meaning of the pleading requisites is plain enough in a single plaintiff action. The notes of the 1946 Advisory Committee, which recommended retention of Rule 23(b) in the form it kept until the spin-off, reveal the Rule’s history, its purpose, and the problems that it raised. Since the revised Rule carries over the substance of the old one, these comments are significant in the interpretation of the new one.

The Note\(^11\) gives the history of the Rule, and, rather sur-
priscingly, itself raises the question of the constitutionality of the Rule's contemporaneous ownership requirement under the *Erie* doctrine, which requires federal courts to apply state substantive law in diversity cases. As the Note puts it:

If it is a matter of substantive law or right, then under *Erie R. Co. v. Tompkins* clause (1) may not be validly applied in cases pending in states whose local law permits a shareholder to maintain such actions, although not a shareholder at the time of the transactions complained of. ¹²

The Note goes on to discuss the cases decided prior to 1946 and the state statutes similar to the Rule, continuing to focus on the "substance versus procedure" problem raised by *Erie*. The history of the Rule, even though spanning a long time, is simple. As the Committee indicates:

In *Hawes v. Oakland* (1882) 104 U.S. 450, the Court held that a shareholder could not maintain such an action unless he owned shares at the time of the transactions complained of, or unless they devolved on him by operation of law. At that time the decision in *Swift v. Tyson* (1842) 16 Peters 1, was the law, and the federal courts considered themselves free to establish their own principles of equity jurisprudence, so the Court was not in 1882 and has not been, until *Erie R. Co. v. Tompkins* in 1938, concerned with the question whether *Hawes v. Oakland* dealt with substantive right or procedure.

Following the decision in *Hawes v. Oakland*, and at the same term, the Court, to implement its decision, adopted Equity Rule 94, which contained the same provision above quoted from Rule 23 F.R.C.P. The provision in Equity Rule 94 was later embodied in Equity Rule 27, of which the present Rule 23 is substantially a copy. ¹³

Cases interpreting the predecessor of Rule 23(b), according to the Note, treat the *Hawes* rule as establishing a "principle" of equity, as dealing not with jurisdiction but with the "right" to maintain an action, or as saying that the defense under the equity rule is analogous to the defense that the plaintiff has no "title," therefore resulting in a dismissal "for want of equity." This interpretation would suggest, albeit weakly, that the Rule is substantive. The Note concludes by saying that the more recent cases show the question to be a debatable one, and although there

¹² *Id.* at 23.1–13.

¹³ *Id.*
is respectable authority for either view, the recent trend is toward the view that Rule 23(b) is procedural.\textsuperscript{14}

The Note refuses to take sides in the controversy, counseling that the matter be "left to await a judicial decision in a litigated case."\textsuperscript{15} If that decision holds that the Rule is substantive, the Note then advises that "the rule should be amended by adding a provision that Rule 23(b)(1) does not apply in jurisdictions where state laws permits [sic] a shareholder to maintain a secondary action, although he was not a shareholder at the time of the transaction of which he complains." In short, if the Rule were held substantive, the Note, in effect, proposes the change suggested in this article. The Supreme Court, however, has not yet resolved the question in any litigated case.

\textit{B. Relation to the Intervention Rule}

Rule 23.1 does not expressly deal with the problem of a shareholder who wishes to join in prosecuting an already pending derivative action. Intervention, the procedure whereby a nonparty has himself added as a party to a pending lawsuit, is governed in the federal courts by Federal Rule of Civil Procedure 24.\textsuperscript{16} In its

\textsuperscript{14} Id. at 23.1- 16.
\textsuperscript{15} Id.
\textsuperscript{16} Rule 24. as amended in 1966. reads as follows:

(a) Intervention of Right. Upon timely application anyone shall be permitted to intervene in an action: (1) when a statute of the United States confers an unconditional right to intervene; or (2) when the applicant claims an interest relating to the property or transaction which is the subject of the action and he is so situated that the disposition of the action may as a practical matter impair or impede his ability to protect that interest, unless the applicant's interest is adequately represented by existing parties.

(b) Permissive Intervention. Upon timely application anyone may be permitted to intervene in an action: (1) when a statute of the United States confers a conditional right to intervene; or (2) when an applicant's claim or defense and the main action have a question of law or fact in common. When a party to an action relies for ground of claim or defense upon any statute or executive order administered by a federal or state governmental officer or agency or upon any regulation, order, requirement, or agreement issued or made pursuant to the statute or executive order, the officer or agency upon timely application may be permitted to intervene in the action. In exercising its discretion the court shall consider whether the intervention will unduly delay or prejudice the adjudication of the rights of the original parties.

(c) Procedure. A person desiring to intervene shall serve a motion to intervene upon the parties as provided in Rule 5. The motion shall state the grounds therefor and shall be accompanied by a pleading setting forth the claim or defense for which intervention is sought. The same procedure shall be followed when a statute of the United States gives a right to intervene. When the constitutionality of an act of Congress affecting the public interest is drawn in question in any action to which the United States or an officer, agency, or employee thereof is not a party, the court shall notify the Attorney General of the United States as provided in Title 28. U.S.C. § 2403.
present form, in addition to cases in which a United States statute grants the right, the Rule allows intervention (a) of right when "the applicant claims an interest relating to the property or transaction which is the subject of the action and he is so situated that the disposition of the action may as a practical matter impair or impede his ability to protect that interest," unless his interest is already adequately represented by the existing parties; and (b) by permission, i.e., in the discretion of the court, when the "applicant's claim or defense and the main action have a question of law or fact in common."

Neither the present Rule nor its predecessors, which were less liberal in conferring the privilege, expressly deal with intervention in a shareholder's derivative action. Furthermore, neither the Advisory Committee's 1966 Note nor earlier comments, are enlightening on the matter. It is generally held, nonetheless, that a shareholder desiring to intervene on the plaintiff's side must meet the requirements of Rule 23.1 as to share ownership at the time of the transaction of which he complains.17

It should be noted that this result is hardly mandated by Rule 24, which says nothing about intervention in a shareholder's derivative action, or by Rule 23.1 itself, since the latter pointedly uses the singular "plaintiff" in imposing its requirement of contemporaneous ownership, rather than the plural "all plaintiffs."

It would, therefore, seem enough, under Rule 23.1, if any plaintiff, either original or by intervention, was a shareholder at the time of the alleged wrong. This interpretation is consistent with cases allowing intervening shareholders who do meet the contemporaneous ownership requirement to "save" an action brought by shareholders who were not qualified under the Rule.18 Accordingly, even if the matter is truly procedural, and hence governed exclusively by the Federal Rules, where the action is

17 Thus, the district court in Hirshhorn v. Mine Safety Appliances Co., 101 F. Supp. 549 (W.D. Pa. 1951), aff'd, 193 F.2d 489 (3rd Cir. 1952), cert. denied, 346 U.S. 866 (1953), stated:

Furthermore, it may be noted that Rule 23(b)(1) requires that a plaintiff in a stockholder's derivative action be "a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law." This requirement is equally applicable to intervenors. Winkelman v. General Motors Corporation, D.C. S.D. N.Y. 1942, 44 F. Supp. 960. See 2 Barron and Holtzoff 568 (Rules ed. 1950).

brought in a federal court, intervention by noncontemporaneous shareholders should be allowed where at least the original plaintiff or one of the intervenors can meet the contemporaneous ownership requirement of Rule 23.1.

C. Relation to State Security-for-Expenses Statutes

A number of states have enacted security-for-expenses statutes.\(^{19}\) The purpose of such statutes is to discourage "strike" suits,\(^{20}\) derivative actions brought by shareholders to harass the management, or worse yet, to blackmail the corporation or its directors into buying them off.\(^{21}\) Typically, security-for-expenses

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\(^{19}\) A few of these security-for-expenses statutes (CAL. CORP. CODE § 834 (West 1955), NEV. REV. STAT. § 41.520 (1969)) allow the court to require the posting of security irrespective of the plaintiff's shareholdings. Most statutes, however, allow the plaintiff, or plaintiffs, to escape the requirement where he, or they, own a certain percentage of the outstanding stock or stock having a certain value. See, e.g., COLO. REV. STAT. § 31-4-21 (1963); FLA. STAT. § 608.131 (1956); MD. RULES CIV. P. § 328(b) (1971); NEB. REV. STAT. § 21-2047 (1970); N.J. STAT. ANN. § 14A:3-6 (1969); N.Y. BUS. CORP. LAW § 627 (McKinney 1963), as amended, (McKinney 1965); N.D. CENT. CODE § 10-19-48 (1960); PA. STAT. ANN. tit. 15, § 1516(a) (1967); TEX. BUS. CORP. ACT art. 5.14 (Supp. 1973); WASH. REV. CODE § 23A.08.460 (1965); WIS. STAT. § 180.405 (1953). See generally 13 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 5971 (perm. ed. rev. vol. 1970).

The ABA-ALI Model Bus. Corp. Act § 49 (1969) is of the latter variety, and, accordingly, more states can be expected to enact similar provisions in the future. The additional interpretive problem under the Federal Rule, that of the right of an equitable owner to sue (see note 125 infra), will be exacerbated if this is done, since the Model Act provision restricts suit to holders "of record," i.e., denies the right to equitable owners (although it also allows suit by holders of voting trust certificates).

It is also interesting to note that the ABA Committee's Comment to § 49 expressly characterizes the section as "procedural." 2 MODEL BUS. CORP. ACT ANN. 33 (1971). This will pose no insoluble interpretive problem for federal courts, since many rules characterized as "procedural" under state law are considered "substantive" for Erie purposes. See, e.g., Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949); Ragan v. Merchants Transfer & Warehouse Co., 337 U.S. 530 (1949); Guaranty Trust Co. v. York, 326 U.S. 99 (1945). It may, however, confuse judges and lawyers who are still hesitant to accept the propositions that laws can be both "substantive" and "procedural" at the same time, and that the determination of whether a particular rule is to be applied in a federal court does not depend on a simplistic dichotomy between the two categories.

Minor problems, which could be resolved by a simple directive in the Federal Rule to apply state law in this entire area, but which, under the present phrasing of the Rule, may generate interpretative difficulty, can arise under statutes such as those of Pennsylvania and Texas. The former excuses the contemporaneity requirement where the plaintiff shows a "strong prima facie case in favor of the claim asserted on behalf of the corporation and that without such suit serious injustice will result" (PA. STAT. tit. 15, § 1516(a) (1967)); and the latter provides that the security-for-expenses statute is not to affect the right granted under the Texas Rule of Civil Procedure that allows a person to make an affidavit of inability to give security. (TEX. BUS. CORP. ACT art. 5.14 (Supp. 1973)). See generally 2 MODEL BUS. CORP. ACT ANN. 29-87 (1971).

statutes require a shareholder who owns insignificant amounts of stock\textsuperscript{22} to post security, where the corporation so demands, to cover the corporation's expenses under director-indemnification statutes. Since these statutes generally place no limit on the amount that the court may require the plaintiff to post,\textsuperscript{23} the deterrent effect on plaintiffs contemplating suit is obvious.

Since the security-for-expenses statutes penalize the poor plaintiff with a good claim, but not the rich plaintiff with a bad claim, the wisdom of such statutes may be doubted.\textsuperscript{24} The theory, however, is that plaintiffs with substantial holdings are less likely to bring frivolous suits. If the theory is correct, it should make no difference when the plaintiffs acquired their shares, and some courts have so held.\textsuperscript{25}

But, even where state law has allowed noncontemporaneous intervening shareholders to make up the necessary minimum percentage or share value in order to avoid the impact of secur-

\textsuperscript{22} Compare, however, such statutes as those of California and Nevada, cited in note 19 supra.

\textsuperscript{23} See HENN, supra note 1, at 784; MOORE, supra note 9, \textsection 23.1-15[3], at 23.1-85. But cf. CAL. CORP. CODE \textsection 834 (West 1955).

\textsuperscript{24} See MOORE, supra note 9, \textsection 23.1-15[3], at 23.1-82 to -85; Hornstein, New Aspects of Stockholders' Derivative Suits, 47 COLUM. L. REV. 1, 4–7 (1947); Kessler, Corporations and the New Federal Diversity Statute: A Denial of Justice, 1960 WASH. U.L.Q. 239, 257–58. It should be noted that in many states where he is excused from posting security, the plaintiff will not be liable for expenses, even though his suit was groundless. See Tyler v. Gas Consumers Ass'n., 35 Misc. 2d 801, 231 N.Y.S.2d 15 (Sup. Ct. 1962); Isensee v. Long Island Motion Picture Co., 184 Misc. 625, 54 N.Y.S.2d 15 (Sup. Ct. 1945). See also HENN, supra note 1, at 784.


A study of the workings of the New York security-for-expenses statute concludes that "in most cases, the sophisticated defendant will not make the motion [to compel posting of security]." A significant factor in their decision, according to the study (based largely on personal interviews), is the necessity of making the shareholder list available to the plaintiff when such a motion is made. Note, Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 COLUM. J. L. AND SOCIAL PROB. 50, 64 (1968). However, it was this author's understanding, based on discussions with practitioners, that "sophisticated" defendants merely deferred making the motion until it appeared that the real defendants, i.e. directors, would lose, since under N.Y. Bus. Corp. Law \textsection 627, the motion can be made by the corporation at any time before final judgment. Even if the study is correct, however, in New York the effect on case results of the First Judicial Department rule allowing noncontemporaneous shareholders to intervene cannot be discounted. See note 31 infra. Furthermore, in the other states which can be expected to enact security-for-expenses statutes now that they have received Model Act approbation, defendants may not be so "sophisticated." Accordingly, the importance of these statutes and their interpretation should not be underestimated.

It should also be noted that the results of the study might well have been distorted by the fact that prior to the decision in Stern v. South Chester Tube Co., 389 U.S. 911 (1968), disclosure of the shareholder list could have been avoided by removal to the federal court (As to the old rule, see Neuwirth v. Merin, 267 F. Supp. 333 (S.D.N.Y. 1967), holding the federal courts powerless to order examination of the shareholder list.).
ity-for-expenses statutes. The federal courts generally have imposed the contemporaneity requirement of Rule 23.1 on all intervenors where the purpose of intervention was to avoid these statutes. The result, of course, is to require the posting of security where it would not be mandated under state law.

This result can be justified by characterizing the requirement of Rule 23.1 as procedural, but this is no answer to the problem since the Rule must be procedural to be valid in the first place. However, since the Rule itself only requires the plaintiff (singular) to be a contemporaneous owner, and says nothing about intervenors, the federal courts’ requirement is not compelled by the Rule.

A leading case adopting the "procedural" rationale is *Kaufman v. Wolfson.* In *Kaufman* the court said:

In the instant case plaintiffs rely on the substantive state law that the claim can be maintained by plaintiffs who own in the aggregate $50,000 worth of stock and all but one of whom purchased their stock subsequent to the alleged injury. If, as was said in the *Cohen* opinion, Rule 23(b) prevents suit in the federal court by a group of subsequent purchasers all by themselves even though the state law would have permitted it, I can perceive no reason why Rule 23(b) should not prevent suit in the federal court by a group of subsequent purchasers and one contemporaneous owner even though the state law would have permitted it.

If the question of adding plaintiffs to make up a requisite aggregate value of stock held by plaintiffs had never come up, no one would have had the temerity to argue that Rule 23(b) F.R.C.P. permitted the joinder of plaintiffs who did not own stock at the time of the alleged injury. The mere fact that the New York courts construe the New York statutes as permitting such joinder for the purpose of making up the requisite $50,000 worth, has no tendency to alter the construction of Rule 23(b).

Thus, the court superimposed the contemporaneous ownership

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26 Intervention is generally allowed to avoid the security requirements of such statutes. See *Baker v. McFadden Publications, Inc.* 300 N.Y. 325, 90 N.E.2d 876 (1950); Annot., 69 A.L.R.2d 562, 576 (1960).


28 *Henn, supra* note 1, at 786.


30 Id. at 941.
requirement of the Federal Rule on the New York security-for-expenses statute, despite its concession that this decision was contrary to New York substantive law.\footnote{Ironically, a later New York State court decision, Richman v. Felmus, 8 App. Div. 2d 985, 190 N.Y.S.2d 920 (2d Dep't 1959), interpreted the New York statute to impose the same requirement of contemporaneous ownership on all intervenors. The present state of the law in New York is uncertain. In the Second Department contemporaneous ownership is required, while in the First Department it is not. Sorin v. Shahmoon Indus., Inc., 30 Misc. 2d 408, 220 N.Y.S.2d 760 (Sup. Ct. 1961); Noel Associates, Inc. v. Merrill, 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944). A provision in an earlier version of the Business Corporation Law (A. Int. 885, Pr. 885, § 6.26(d) (1961)), which would have expressly overruled Richman v. Felmus (see 1961 N.Y. Leg. Doc. No. 12, at 43-44 Supp.), was omitted from the law as finally enacted.}

In reaching its result the Kaufman court relied on Cohen v. Beneficial Industrial Loan Corp.,\footnote{337 U.S. 541 (1949).} which the court interpreted as stating "in effect that, despite substantive state law that the claim could be maintained by plaintiffs who purchased their stock subsequent to the alleged injury. Rule 23(b) F.R.C.P. had the effect of prohibiting the maintenance of the claim in the federal court. . . ."\footnote{Id. at 556. The Kaufman case concedes that the New Jersey statute involved in Cohen contained a "time of ownership" provision substantially similar to the Federal Rule. 136 F. Supp. at 940.}

It is submitted that this represents a serious overstatement of the Cohen case. That famous case, decided in the heyday of the "outcome determinative" interpretation of Erie Railroad Co. v. Tompkins,\footnote{304 U.S. 64 (1938). The phrase "outcome determinative" originated with Guaranty Trust Co. v. York, 326 U.S. 99 (1945).} "whereby in diversity cases the federal court administers the state system of law in all matters except details related to its own conduct of business," merely held that the New Jersey security-for-expenses statute had to be applied by a federal court sitting in New Jersey.

The reference in Cohen to Rule 23(b) was simply a response to the plaintiff's argument that the New Jersey statute was only procedural, and that, because the Federal Rule set forth the procedure to be followed in a derivative suit in federal courts, the state rule should not apply. The Court avoided having to choose between the two rules, by holding that there was no conflict between them,\footnote{Id. at 556.} and, accordingly, that both could be applied. The Court in Cohen did not pass judgment on a situation where state law would have allowed suit by a noncontemporaneous shareholder, \textit{i.e.}, where there was a conflict between state law and the Federal Rule. What Mr. Justice Jackson actually stated was:

\begin{itemize}
\item \textit{Ironically, a later New York State court decision, Richman v. Felmus, 8 App. Div. 2d 985, 190 N.Y.S.2d 920 (2d Dep't 1959), interpreted the New York statute to impose the same requirement of contemporaneous ownership on all intervenors. The present state of the law in New York is uncertain. In the Second Department contemporaneous ownership is required, while in the First Department it is not. Sorin v. Shahmoon Indus., Inc., 30 Misc. 2d 408, 220 N.Y.S.2d 760 (Sup. Ct. 1961); Noel Associates, Inc. v. Merrill, 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944). A provision in an earlier version of the Business Corporation Law (A. Int. 885, Pr. 885, § 6.26(d) (1961)), which would have expressly overruled Richman v. Felmus (see 1961 N.Y. Leg. Doc. No. 12, at 43-44 Supp.), was omitted from the law as finally enacted.}
\item \textit{337 U.S. 541 (1949).}
\item \textit{136 F. Supp. at 941.}
\item \textit{304 U.S. 64 (1938). The phrase "outcome determinative" originated with Guaranty Trust Co. v. York, 326 U.S. 99 (1945).}
\item \textit{Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 555 (1949).}
\end{itemize}
It is urged, however, that Federal Rule of Civil Procedure No. 23 deals with plaintiff’s right to maintain such an action in federal court and that therefore the subject is recognized as procedural and the federal rule alone prevails.

Rule 23 requires the stockholder’s complaint to be verified by oath and to show that the plaintiff was a stockholder at the time of the transaction of which he complains or that his share thereafter devolved upon him by operation of law. In other words, the federal court will not permit itself to be used to litigate a purchased grievance or become a party to speculation in wrongs done to corporations. It also requires a showing that an action is not a collusive one to confer jurisdiction and to set forth the facts showing that the plaintiff has endeavored to obtain his remedy through the corporation itself. It further provides that the class action shall not be dismissed or compromised without approval of the court, with notice to the members of the class. These provisions neither create nor exempt from liabilities, but require complete disclosure to the court and notice to the parties in interest. None conflict with the statute in question and all may be observed by a federal court, even if not applicable in state court.

We see no reason why the policy stated in Guaranty Trust Co. of New York v. York, 326 U.S. 99, 65 S.Ct.1464, 89 L.Ed. 2079,160 A.L.R. 1231, should not apply.\textsuperscript{37}

The Supreme Court has supplied no more definitive statement on the subject than that provided in the Cohen case, it has never answered the question of whether intervenors under state security-for-expenses statutes must be contemporaneous owners, or, for that matter, whether this is required of intervenors in shareholder derivative suits generally.

As a result of the Supreme Court’s silence, the effect of state law on the rights of both noncontemporaneous plaintiffs and intervenors has been left to formulation by lower federal courts.

\textit{D. Present Status of the Rule - The Results of Lower Court Formulation}

Most federal courts require the plaintiff in a shareholder’s derivative suit to have been a shareholder at the time of the alleged wrong, or to have received his shares by operation of law from one who was a contemporaneous shareholder, even though the

\textsuperscript{37} 337 U.S. at 556 (emphasis added).
state court would not impose the requirement.\textsuperscript{38} It can be argued that the matter is not of too great importance, since so many states have similar court rules or statutes,\textsuperscript{39} and others have adopted the requirement by judicial decision as a “sound and wholesome principle of equity,” in that it prevents a person from buying a lawsuit.\textsuperscript{40}

It may be conceded that it is undesirable to allow a person to buy shares in a corporation solely for the purpose of bringing a derivative action.\textsuperscript{41} Similarly it would be unfair to allow a purchaser of a business to use such an action as a method for obtaining a rebate on the purchase price.\textsuperscript{42} Since, however, a shareholder’s derivative action is an equitable one, there are other techniques for preventing such abuses that are as satisfactory as a


\textsuperscript{39} A. FREY. C. MORRIS, JR., & J. CHOPER, CASES AND MATERIALS ON CORPORATIONS 491 (1966). See also Moore, supra note 9, ¶ 23.1.15[2], at 23.1-58 n.6. Developments (through legislation and court rules) are proceeding so rapidly in this area that it is not inconceivable that by the time of publication of this article virtually every state will have some provision requiring at least the original plaintiff to be a contemporaneous owner. On the other hand. Pennsylvania, by statute, apparently allows a noncontemporaneous owner to sue, in the discretion of court, where it appears that the plaintiff has a good claim. Pa. STAT. ANN. tit. 15, § 1516(a) (1967).

\textsuperscript{40} See, e.g., Home Fire Ins. Co. v. Barber. 67 Neb. 644. 93 N.W. 1024 (1903). See also Venner v. Great Northern Ry. 209 U.S. 24 (1908); Jepsen v. Peterson. 69 S.D. 388. 10 N.W.2d 749 (1943); Moore, supra note 9, ¶ 23.1.15[2]. at 23.1-58 n.6; Wright, supra note 38. at 318-19.

\textsuperscript{41} Compare, however, the prevailing view that contemporaneity is not required in suits to compel insiders to account for “short-swing” profits under § 16b of the Securities Exchange Act of 1934. 15 U.S.C. § 78p (1970). See Henn. supra note 1. at 767-68.

\textsuperscript{42} See United Elec. Sec. Co. v. Louisiana Elec. Light Co., 68 F. 673, 675 (C.C.E.D. La. 1895) (dictum); Capitol Wine & Spirit Corp. v. Pokrass. 277 App. Div. 184. 98 N.Y.S.2d 291 (1st Dep’t 1950). aff’d. 302 N.Y. 734. 98 N.E.2d 704 (1951) (corporation cannot prosecute an action in which recovery would be for sole benefit of stockholders all of whom would be precluded from instituting a derivative action by the contemporaneous ownership requirement). See also Perlman v. Feldmann. 219 F.2d 173 (2d Cir. 1955) (individual rather than corporate recovery allowed, in order to prevent this rebate problem).
rigid rule of disqualification of all noncontemporaneous owners.\textsuperscript{43} Thus in \textit{Capitol Wine & Spirit Corp. v. Pokrass},\textsuperscript{44} which held that not even the corporation could bring suit where no shareholder would be qualified to do so, Justice Schientag, in dissent, said "it may still be held on a full disclosure of the facts that, considering the nature of the stock ownership and the manner and circumstances under which it was acquired, there is such gross inequity in the plaintiff's claim as would preclude recovery."\textsuperscript{45} Participation in the wrongdoing, laches, and acquiescence have all been held to bar suit by a subsequent shareholder, even in jurisdictions lacking the absolute disqualification rule,\textsuperscript{46} and should be sufficient to deter "strike" suits.\textsuperscript{47} Furthermore, even an acceptance of the wisdom of the disqualification rule does not solve the fundamental problem of the desirability of state and federal court congruity in those states which have not chosen to adopt the Federal Rule.

Finally, lower court formulation of the contemporaneous ownership requirement has had its most unfortunate effects in the security-for-expenses area. Here, state law does differ, and the problems will increase as enactment of these statutes accelerates. With varied and largely uninterpreted statutes waiting, the incongruity in treatment of \textit{intervening} plaintiffs cannot be passed off as inconsequential, and the results of divergence will be more disastrous as time goes on.

The Advisory Committee on Civil Rules recommended that the Supreme Court take no action with regard to Rule 23.1 until the problem arose in a case litigated before it. This is a counsel of despair. If, as a shareholder has every incentive to do in order to get a timely adjudication on the merits, one contemplating a derivative suit procures the necessary contemporaneous owners in order to comply with the Rule's requirement, the question of


\textsuperscript{45}277 App. Div. at 190. 98 N.Y.S.2d at 297.

\textsuperscript{46}See \textit{Russell v. Louis Melind Co.}, 331 Ill. App. 182, 72 N.E.2d 869 (1947) (barring even a bona fide transferee from bringing a derivative action where his transferor was subject to such equitable defenses); \textit{Babcock v. Farwell}, 245 Ill. 14, 91 N.E. 683 (1910). \textit{See also} \textit{Bank of Mill Creek v. Elk Horn Coal Corp.}, 133 W. Va. 639, 57 S.E.2d 736 (1950). \textit{See generally} \textit{Ballantine}, \textit{supra} note 2, at 353-54; \textit{R. Stevens, Corporations 810-11} (2d ed. 1949); \textit{Annot.}, 16 A.L.R.2d 467 (1951).

\textsuperscript{47}In contrast to the more flexible equitable doctrine, under the arbitrary contemporaneous ownership rule the plaintiff's motive has been held to be immaterial, so long as he can show wrongful acts after his purchase. \textit{Mardel Sec. Inc. v. Alexandria Gazette Corp.}, 320 F.2d 890 (4th Cir. 1963).
the rights of noncontemporaneous owners to bring suit becomes moot, and, accordingly, the Supreme Court will refuse to pass on it.\textsuperscript{48} If the shareholder is unable to comply, no sensible litigant—assuming appealability of the order\textsuperscript{49}—would have the temerity to risk all the money involved in taking the matter all the way to the Supreme Court. Thus the Advisory Committee's case that is ripe for decision will probably never arise.

II. RETAINING THE STATUS QUO—ARGUMENTS ADVANCED BY TWO AUTHORITIES

Before continuing the argument in favor of the proposed change, the opinions of two authorities who favor the status quo should be mentioned. Hopefully, in meeting these authors' objections, some of the reasons for adoption of the proposed change will also become clear.

Professor Charles Alan Wright, a leading authority on federal procedure, argues that there is nothing objectionable about Rule 23.1 even though its effect may be to close the doors of the federal courts to prospective litigants. He states:

The requirement that the plaintiff allege that he was a shareholder at the time of the transaction complained of is applicable in federal question cases, except where a specific provision in a federal statute makes an exception to it. It has led to difficulty in diversity cases, since such a requirement is not yet universal in the states, and poses questions under the \textit{Erie} doctrine. Some courts and commentators take the view that an allegation of this kind is unnecessary, and that plaintiff need not have been a shareholder at the time of the transaction, if the law of the state in which suit is brought or the state of incorporation would permit him to sue without meeting this requirement. Most courts and writers have thought, however, that the rule must be met regardless of state law. Though the arguments both ways are strong, there seems especial force to the position that the \textit{Erie} doctrine does not require the federal


courts to entertain a suit, merely because such a suit might be brought in the state court.\textsuperscript{50}

This is part of the increasingly popular philosophy that would completely abolish the federal diversity jurisdiction.\textsuperscript{51} The expansion of state jurisdiction through "long-arm" statutes, which allow in personam jurisdiction over nonresidents once thought beyond the sweep of territorially limited state power, has now made state courts much more effective forums than in the past. However, there are a number of situations, especially in the shareholder derivative action area, where, unless the federal courts with their even wider jurisdictional sweep\textsuperscript{52} are available, the shareholder-plaintiff and his corporation will have no court with jurisdiction to handle the suit.\textsuperscript{53} To take even the simplest case, state court jurisdiction will ordinarily be impossible where a defendant-director has committed a tort for which his liability is sought in a state in which the corporation does no business. Jurisdiction over the corporation cannot be obtained through the state's long-arm statute, hence the action must fail because the corporation for whose benefit the derivative action is brought is an indispensable party.\textsuperscript{54}

\textsuperscript{50} WRIGHT, supra note 38, at 319 (citations omitted).


\textsuperscript{53} Cf. WRIGHT, supra note 38, at 74.

\textsuperscript{54} See Goer v. Mathieson Alkali Works, 190 U.S. 428 (1903); Jordan v. Hartness, 230 N.C. 718, 55 S.E.2d 484 (1949); Dean v. Kellogg, 294 Mich. 200, 292 N.W. 704 (1940); HENN, supra note 1, at 776. In personam jurisdiction over the corporation is ordinarily necessary. Dean v. Kellogg, supra; HENN, supra note 1, at 743. Such jurisdiction is not obtainable unless the corporation has sufficient contacts with the state attempting to exercise that jurisdiction. International Shoe Co. v. Washington, 326 U.S. 310 (1945). The typical long-arm statute (see, e.g., ILL. REV. STAT. tit. 110 § 17(1) (1968); MICH. STAT. ANN. § 27A.701 et seq. (1962); N.Y. CIV. PRAC. LAW & RULES § 302 (McKinney 1972); N.Y. BUS. CORP. LAW § 307 (McKinney 1963), as amended, (Supp 1973)), which allows in personam jurisdiction over foreign corporations based on causes of action arising out of the corporation's activities within the state, or on the causing of injury within the state, is therefore unavailable in a derivative action against the beneficiary corporation, where it does not carry on business within the state and is not licensed to do so, since, by hypothesis, it is not a wrongdoer.

Accordingly, the state which has jurisdiction over the real defendants (the wrongdoers) may be unable to secure the necessary jurisdiction over the corporation. Dean v. Kellogg, supra, while the state which has jurisdiction over the corporation may be unable to secure jurisdiction over the real defendants. Platt Corp. v. Platt, 17 N.Y.2d 234, 217 N.E.2d 134, 270 N.Y.S.2d 408 (1966).

These obstacles are removed in the federal courts by 28 U.S.C. § 1401, which allows suit to be brought in any judicial district where the real defendants could have been sued by the corporation, and by 28 U.S.C. § 1695, which allows service to be made on the corporation in any district where it is organized or licensed to do business or is doing business.
Accordingly, whatever may be the wisdom of limiting the diversity jurisdiction in other areas, it seems unwise to limit access to the federal courts in the cases governed by Rule 23.1, since such a limitation may result in an effective denial of justice. In short, "door-closing" is an unpersuasive argument in favor of the present Rule and its prevailing interpretation. With regard to noncontemporaneous intervenors, Professor Harry Henn, a leading authority on corporate law, apparently approves of the predominant view that disqualifies such potential litigants. He states:

There is conflicting authority as to whether those shareholders who desire to intervene as plaintiffs in order to avoid a security-for-expenses requirement need to qualify under any prevailing contemporaneous share-ownership requirement so long as the original plaintiff is a contemporaneous share-owner. The better view would seem to be that if the original plaintiff must be a contemporaneous share-owner in order to bring a derivative action, persons desiring to intervene as plaintiffs should be subject to the same contemporaneous share-ownership requirement.

None of the cases cited by Henn as agreeing with what he characterizes as the "better view" gives any policy reasons for debarring noncontemporaneous intervenors, so we are left to speculate as to why these cases represent the "better view."

A possible policy argument against allowing the intervention of noncontemporaneous shareholders is that such a shareholder, anxious to bring an action even for harassment, can solicit at least one contemporaneous owner to bring the action. By then intervening, the noncontemporaneous shareholder can avoid the security-for-expenses statute and circumvent the policy of that

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55 The limitation of federal diversity jurisdiction is ordinarily based upon the continued presence of another forum. Cf. Wright, supra note 38, at 74. The illustration in the text points out that such an alternative may not exist in shareholder derivative actions.

56 Henn, supra note 1, at 785 (footnote omitted).

57 Id. at 785 n.20. The note reads: Richman v. Felmus, 8 A.D.2d 985, 190 N.Y.S.2d 920 (2d Dept. 1959); Breswick & Co. v. Harrison Rye Realty Corp., 280 App. Div. 820, 114 N.Y.S.2d 25 (2d Dept. 1952). In Sorin v. Shahmoon Industries, Inc., 30 Misc. 2d 429, 220 N.Y.S.2d 760, 783 (Sup. Ct. 1961), the court ruled that, under the New York contemporaneous-share-ownership statute, one suing in a derivative action was required to be a contemporaneous owner. But that, under the New York security-for-expenses statute, it was not necessary for him—alone or in association with others—to have owned the required shares in number or value to avoid posting security for expenses at the time of the alleged wrongs. A provision in the proposed New York Business Corporation Law expressly allowing the intervention of noncontemporaneous owners was eliminated.
statute, which is the prevention of strike suits. The complete answer is that there would be no bar to this sequence of events under Rule 23.1 were it not for the state security-for-expenses statutes, and accordingly, state policy, from which these statutes arose, should be looked to for their proper interpretation. Just as New York, which came close to adopting the rule which Henn criticizes, could have enacted a provision expressly allowing intervention by noncontemporaneous owners, which presumably would have been applied in the federal courts, any state could bar noncontemporaneous intervenors by enacting a similar statutory provision.

As already pointed out, the basis for the typical security-for-expenses statutory exception, which dispenses with the necessity for posting security when the plaintiff or plaintiffs own a specified minimum percentage or dollar value of the stock, is the assumption that where the stockholdings of the litigants are significant the danger of strike suits is small. If this philosophy is correct, it should make no difference when the statutorily significant holdings were acquired. Accordingly, state decisions allowing noncontemporaneous shareholders to intervene for the pur-


Shareholders or holders of voting trust certificates of the corporation or of beneficial interests in such shares may be permitted to intervene as plaintiffs in such action, whether or not they were holders thereof at the time of the transaction complained of, and the number and value of such share or shares represented by such interests may be counted for the purposes of section 6.27 (Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor.)

59 E.g., N.Y. Bus. Corp. Law § 627 (McKinney Supp. 1973) provides:

§ 627. Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor.—In any action specified in section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), unless the plaintiff or plaintiffs hold five percent or more of any class of the outstanding shares or hold voting trust certificates or a beneficial interest in shares representing five per cent or more of any class of such shares, or the shares, voting trust certificates and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable under this chapter. under any contract or otherwise under law, to which the corporation shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.
pose of avoiding the security-posting requirements appear correct.\textsuperscript{60}

In fairness to Professor Henn, it must be conceded that his statement was apparently addressed to intervention under state security statutes as an original proposition, rather than to any federal court resolution of the problem. Thus, he is really criticizing the rule in force in New York's First Department,\textsuperscript{61} and not explicitly a federal decision to apply that state rule. The important thing to note, therefore, is that one can still agree with Henn, and at the same time accept the argument that state practice, right or wrong, as an abstract principle, should nevertheless govern in the federal courts.

Neither Wright's view as to contemporaneity in general, nor Henn's view as to intervenors specifically, has gone unchallenged. Lattin, speaking on the contemporaneous ownership issue generally (\textit{i.e.}, not specifically addressing himself to the application of a state rule by the federal courts), considers the minority rule allowing a noncontemporaneous owner to sue to be the "sounder" view.\textsuperscript{62} Quoting from \textit{Pollitz v. Gould},\textsuperscript{63} an early New York decision, since overruled by statute,\textsuperscript{64} he states:

A contrary rule prevails in many states, thereby permitting a shareholder who acquired his shares other than by operation of law subsequent to the events upon which suit is based to bring the action even in a case where he had knowledge of the transaction at the time he purchased the shares. Thus, in the absence of special circumstances about to be discussed, a shareholder is not barred simply by looking at the time when he acquired his shares. This rule is thought to be the sounder of the two and the reasons for so considering it have been explained as follows: "A stockholder has an indivisible interest in the property and assets of a corporation subject to the discharge of its obligations. This indivisible

\textsuperscript{60}The impetus for enactment of the first security-for-expenses statute was Wood's survey of stockholders' derivative suits prepared for the Special Committee on Corporate Litigation, Chamber of Commerce of the State of New York. F. Wood, \textit{Survey and Report Regarding Stockholders' Derivative Suits}, (1944). The study, which analyzed 693 New York shareholders' derivative suits, adverted to the fact that in most of the cases involving public issue corporations, the plaintiffs' interest in the corporation was so small as to suggest that many of the actions were brought in the interest of the attorney rather than the ostensible client. \textit{Id.} at 48. Therefore, an interpretation of the statute only to require substantial holdings, whenever acquired, seems consistent with the purpose of the statute.

\textsuperscript{61}See note 31 supra.

\textsuperscript{62}\textit{Lattin, supra} note 2, at 422-23.

\textsuperscript{63}202 N.Y. 11, 94 N.E. 1088 (1911).

\textsuperscript{64}The present statute embodying the principle that overruled the case is \textit{N.Y. Bus. Corp. Law} § 626(b) (McKinney 1963).
interest generally speaking is represented by certificates of stock and is transferred by their transfer. . . . As an original proposition it would seem to be clear that a right of action by or in behalf of the corporation for fraud to set aside a conveyance of its assets or to avoid obligations imposed upon it is part of its rights, property and assets in which a stockholder has this indivisible interest transferable by the transfer of his certificates. I am unable to see any real or substantial distinction by virtue of which a stockholder transferring his certificates would transfer all of his indivisible interest in bonds or real estate on hand, but would not transfer his interest in a right of action to recover bonds or real estate which had been fraudulently withdrawn from the possession of the corporation, and which it was entitled to recover. And if the subsequent holder by acquiring the certificates does acquire such latter interest, it seems to follow that he may if necessary, in behalf of the corporation, assert and prosecute an action to protect and enforce the same." Arguments of the practical inconvenience of determining whether the transferor had participated in or ratified the transaction sued upon, or that a shareholder buys shares subject to transactions preceding his purchase, or that the price of the share has been adjusted to take into consideration prior transactions which are the foundation of suits were rejected by the court.

The special circumstances mentioned above are that a shareholder who has participated in or ratified the acts which are the subject of the suit, or who has been guilty of laches in failing to take action after discovery of them, is barred from being a plaintiff in a derivative action. Some of the cases hold that a transferee of such a shareholder, even though he has no notice of what the previous owner has done, is barred from suit because the shares carry with them the taint which would have barred the former owner. This is contrary to the negotiability concept. Another line of cases believed to be preferable permits the transferee, who has no notice at the time of acquiring his shares of the events upon which successful suit depends, to bring the action. The innocent transferee ought not to be barred from bringing what, after all, is a corporate cause of action; and, if the shares are negotiable which is now the case, one who purchases them without notice of what the previous owner has done should have all the advantages that negotiability gives in other negotiable instrument legal controversies.65

As to intervenors, Lattin also argues (understandably) that the

65 LATTIN, supra note 2, at 422–23 (footnotes omitted).
contemporaneous ownership requirement should not be superimposed on security-for-expenses statutes. He states:

As far as the security-for-expenses statutes are concerned, their language and the reasons for their enactment would appear to be inapplicable to intervening shareholders whether intervention be to defend or prosecute on behalf of the corporate defendant. These statutes were aimed at discouraging plaintiffs from bringing "strike" suits, not at intervention which normally works toward frustrating such motives.66

In this latter position he is joined by Professor Dykstra, who says:

[J]f the plaintiff is able to marshall intervenors possessing collectively $50,000 worth of security or five percent of any class of stock outstanding, it seems unlikely that the policy against "purchased grievances" would be seriously compromised. At least, the danger does not seem sufficient to warrant the serious interference which a contemporaneous ownership requirement would impose on "the more fundamental policy of allowing derivative suits as a check on the transgressions of corporate management."67

The most forceful argument in support of the proposed amendment to the Rule is found, however, in Moore's treatise. Ignoring the question of the wisdom of allowing suit or intervention by noncontemporaneous owners, Moore addresses himself solely to the question of the validity of Rule 23.1 in the face of conflicting state law. He decides that, in such circumstances, the Rule must be regarded as substantive, and accordingly yield to a contrary state rule. Explaining his conclusion, he says:

In reaching the above conclusion we have not overlooked Hanna v. Plumer and the very strong presumption which it creates in favor of the validity of a rule or a provision of a rule because of the prima facie judgment of the Advisory Committee, the Supreme Court, and Congress that the questioned rule is proper. But, as noted above, original Rule 23(b) was formulated by the original Advisory Committee and promulgated by the Supreme Court prior to Erie; and while the original Rules were before Congress, both prior to and after the Erie decision, the Congress would have had to be clair-

66 Id. at 438 (citation omitted).
67 Dykstra, The Revival of the Derivative Suit, 116 U. PA. L. REV. 74, 93(1967) (citation omitted). Criticism of state security-for-expenses statutes themselves has been widespread. See BALLANTINE, supra note 2, at 374 and LATTIN, supra note 2, at 457 and authorities cited therein. Attitudes toward intervention may, of course, be affected by opinions on the overall wisdom of such statutes.
voyant to ferret out at that time a possible conflict between the clause in question and *Erie*. When, for the first time, in 1946 the Advisory Committee seriously considered the matter, the Committee concluded that it should not decide the issue but that the matter had best be left to a litigated case; and apparently the Supreme Court then acquiesced in that recommendation. It is true that in the revision of 1966, original Rule 23(b) was amended in some formal respects and carried forward as Rule 23.1, but neither then nor since has the Committee, the Court, or Congress considered the matter. And hence we conclude that where there is a collision between clause (1) and state law that the validity of clause (1) is subject to challenge; and, of course, for reasons stated above, in that event clause (1) should yield to state law. This will not seriously maim Rule 23.1 for (a) a contra state rule can be applied without emasculating the balance of the rule, (b) the issue will not frequently arise for the law in most states is in accord with clause (1), and (c) those who specialize in stockholder's suits can live with clause (1) and usually need not challenge its validity.\(^{68}\)

Thus the conclusion from "counting noses" of authorities pro and con must at least be that the proposal for change should stand on its own merits, rather than having to rely on the number of people for or against the change.

### III. THE PROPOSED AMENDMENT: RATIONALE

Adoption of the simple amendment proposed, which will make the contemporaneous ownership requirement of Rule 23.1 subject to state law, can be justified on three grounds: (a) to avoid the constitutional infirmity of the present Rule as foreseen by the Advisory Committee that proposed the Rule;\(^{69}\) (b) to produce consistency in treatment not only with that given under other Federal Rules but, more importantly, between that given in state and federal courts in the important matter of suits to redress intracorporate wrongdoing; and (c) ultimately, therefore—the best reason for any change—to do justice.

#### A. Validity

1. *The Erie Doctrine*—There is a strong argument that Rule


\(^{69}\) See note 12 and accompanying text *supra*. 
23.1 by ignoring state law governing the right of a shareholder to sue, is unconstitutional under the *Erie* doctrine. The requirement of contemporaneity in federal shareholder derivative actions was first imposed long ago in the "untrammeled" pre-*Erie* period. Except for incorporating the notice of settlement provision, and making express the requirement of adequate representation, present Rule 23.1 merely sets out in a "separate count" the provisions contained in old Rule 23(b), *i.e.*, makes no change in the substance of that Rule. Accordingly, any infirmities in the old Rule are carried over. *Erie* and the Rules Enabling Act, of course, made it imperative to differentiate between matters of substance, which had to be controlled by state law in diversity cases, and those of procedure, which were the only proper province of the Federal Rules of Civil Procedure. It is noteworthy that the 1946 revisers of Rule 23(b) conceded that the category into which the Rule fitted was debatable, *i.e.*, whether it was constitutional or not!

The Supreme Court has never directly confronted this "debatable" question. Under the "outcome determinative" test of *Guaranty Trust Co. v. York*, the matter would seem to be clearly substantive, since a noncontemporaneous plaintiff will lose in the federal court, even though he might be victorious in the state court.

Although *Guaranty Trust* answered negatively

the narrow question whether, when no recovery could be had in a State court because the action is barred by the statute of limitations, a federal court in equity can [nonetheless] take cognizance of the suit because there is diversity of citizenship between the parties,

it laid down a test, later widely applied, under which "procedural" state rules were held sufficiently "substantive" to mandate their application by federal courts in diversity of citizenship actions under the *Erie* doctrine.

In *Guaranty Trust*, after pointing out the impossibility of a rigid "substance"-"procedure" dichotomy and conceding that the

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71 The 1946 Advisory Committee carried over the 1937 text of the Rule. See note 11 supra.
72 Moore, *supra* note 9, ¶23.1.01[4], at 23.1-16.
74 326 U.S. 99 (1945). Compare, however, Justice Harlan's concurring opinion in Hanna v. Plumer, 380 U.S. 460, 474 (1965) (security-for-expenses statutes not outcome determinative, but should be upheld as representing a strong state policy).
75 326 U.S. 107.
"forms and mode of enforcing the right" may properly vary between federal and state courts, Justice Frankfurter continued:

Here we are dealing with a right to recover derived not from the United States but from one of the States. When, because the plaintiff happens to be a non-resident, such a right is enforceable in a federal as well as in a State court, the forms and mode of enforcing the right may at times, naturally enough, vary because the two judicial systems are not identical. But since a federal court adjudicating a State-created right solely because of the diversity of citizenship of the parties is for that purpose, in effect, only another court of the State, it cannot afford recovery if the right to recover is made unavailable by the State nor can it substantially affect the enforcement of the right as given by the State.

And so the question is not whether a statute of limitations is deemed a matter of "procedure" in some sense. The question is whether such a statute concerns merely the manner and the means by which a right to recover, as recognized by the State, is enforced, or whether such statutory limitation is a matter of substance in the aspect that alone is relevant to our problem, namely does it significantly affect the result of a litigation for a federal court to disregard a law of a State that would be controlling in an action upon the same claim by the same parties in a State court?

It is therefore immaterial whether statutes of limitation are characterized either as "substantive" or "procedural" in State court opinions in any use of those terms unrelated to the specific issue before us. *Erie R. Co. v. Tompkins* was not an endeavor to formulate scientific legal terminology. It expressed a policy that touches vitally the proper distribution of judicial power between State and federal courts. In essence, the intent of that decision was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the *outcome of the litigation in the federal court should be substantially the same*, so far as legal rules determine the outcome of a litigation, as it would be if tried in a State court. The nub of the policy that underlies *Erie R. Co. v. Tompkins* is that for the same transaction the accident of a suit by a non-resident litigant in a federal court instead of in a State court a block away should not lead to a substantially different result. And so, putting to one side abstractions regarding "substance" and "procedure," we have held that in diversity cases the federal courts must follow the law of the State as to burden of proof. *Cities Service Co. v. Dunlap*, 308 U.S. 208, as to conflict of laws. *Klaxon Co. v. Stentor Co.*, 313 U.S. 487, as to contributory negligence. *Palmer v. Hoffman*, 318 U.S. 109, 117.
And see Sampson v. Channell, 110 F.2d 754. *Erie R. Co. v. Tompkins* has been applied with an eye alert to essentials in avoiding disregard of State law in diversity cases in the federal courts. A policy so important to our federalism must be kept free from entanglements with analytical or terminological niceties.\(^7\)

**He concluded:**

Plainly enough, a statute that would completely bar recovery in a suit if brought in a State court bears on a State-created right vitally and not merely formally or negligibly. As to consequences that so intimately affect recovery or non-recovery a federal court in a diversity case should follow State law.\(^7\)

Four years after the *Guaranty Trust* case was decided, the Supreme Court extended its holding to make three other state procedural rules binding in federal courts. In *Ragan v. Merchants Transfer & Warehouse Co.*,\(^7\) the Court held a diversity action barred by the Kansas statute of limitations, where the state statute required service of process to commence the action, and this had not been done within the time limit. The action was barred despite the provision of Federal Rule 3 that an action is commenced on the filing of the complaint, which in this case was done within the time limit. *Woods v. Interstate Realty Co.*\(^7\) applied a Mississippi statute barring suit on a contract by a foreign corporation which had not appointed a process agent, even though the state statute did not purport to invalidate the contract, but merely closed the state courts to suit on it. The third case was *Cohen v. Beneficial Industrial Loan Corp.*,\(^8\) in which the New Jersey security-for-expenses statute (law of the forum state, not of the state of incorporation) was applied to bar a stockholder's suit, although the plaintiff had met the qualifications of Rule 23.1 for a derivative action.

Thus, even if one accepts the argument that the contemporaneity requirement is procedural, state rules even more clearly procedural than a subsequent shareholder's qualification to sue have been held sufficiently substantive to demand their application under the *Erie* doctrine. The guiding principle has always

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\(^7\) *Id.* at 108–10 (emphasis added).

\(^7\) *Id.* at 110.

\(^7\) 337 U.S. 530 (1949).

\(^7\) 337 U.S. 535 (1949).

\(^8\) 337 U.S. 541 (1949). *See* notes 32–37 and accompanying text *supra*. 
been that the outcome must be the same in federal court as in state court.\footnote{Although all of these decisions had the effect of federal door-closing, as opposed to a rule allowing noncontemporaneous owners to sue, this would not seem a proper ground for constitutional distinctions, and, in any event, is not one propounded by the decisions.}

Under the more recent test evolved in \textit{Hanna v. Plumer},\footnote{380 U.S. 460 (1965) (upholding service of process under Federal Rule 4(d)(1), in a diversity action, against an assertion that the service was void because it was not made in accordance with the Massachusetts’ statute on the subject). The Court said that where the question is governed by the Rules of Civil Procedure, if the rule is valid when measured against the standards of the Rules Enabling Act and the Constitution, it is to be applied regardless of state law. Just as \textit{Guaranty Trust}’s holding was correct, so also the \textit{Hanna} decision is clearly correct if the Federal Rules are to have any meaning, since a contrary holding would have rendered those Rules nugatory, \textit{i.e.}, would have made federal practice completely subservient to state procedural rules in any diversity action. The only problem arises, as is usual with significant decisions of the Supreme Court, in applying the tests, which were laid down to justify a particular result, to different factual situations.} phrased by the dissent as holding that a Federal Rule “arguably procedural” equals “constitutional,” the holding that Rule 23.1 is constitutional might appear to be guaranteed. This does not necessarily follow, however, since \textit{Hanna} reasserts the constitutional status of the \textit{Erie} doctrine, as opposed to the theory, which had grown up in the interim, that \textit{Erie} merely represented a rule of desirable federal policy. Therefore, it would follow that a federal intrusion into a subject genuinely substantive would be unconstitutional.\footnote{380 U.S. 460 (1965) (upholding service of process under Federal Rule 4(d)(1)) in a diversity action, against an assertion that the service was void because it was not made in accordance with the Massachusetts’ statute on the subject). The Court said that where the question is governed by the Rules of Civil Procedure, if the rule is valid when measured against the standards of the Rules Enabling Act and the Constitution, it is to be applied regardless of state law. Just as \textit{Guaranty Trust}’s holding was correct, so also the \textit{Hanna} decision is clearly correct if the Federal Rules are to have any meaning, since a contrary holding would have rendered those Rules nugatory, \textit{i.e.}, would have made federal practice completely subservient to state procedural rules in any diversity action. The only problem arises, as is usual with significant decisions of the Supreme Court, in applying the tests, which were laid down to justify a particular result, to different factual situations.}

Furthermore, \textit{Hanna} re-affirms the \textit{Erie} criterion of prevention of forum-shopping, relying, in upholding the service under the federal as opposed to the Massachusetts rule, on the fact that a plaintiff would not choose between the federal and state court on

\begin{itemize}
\item When a situation is covered by one of the Federal Rules, the question facing the court is a far cry from the typical, relatively unguided \textit{Erie} choice: The court has been instructed to apply the Federal Rule, and can refuse to do so only if the Advisory Committee, this Court, and Congress erred in their prima facie judgment that the Rule in question transgresses neither the terms of the Enabling Act nor constitutional restrictions.
\end{itemize}

\textit{Id.} at 473 (emphasis added) (citation omitted). The Court concluded:

\begin{itemize}
\item \textit{Erie} and its offspring cast no doubt on the long-recognized power of Congress to prescribe \textit{housekeeping rules} for federal courts even though some of those rules will inevitably differ from comparable state rules.
\end{itemize}

\textit{Id.} at 473 (emphasis added) (citation omitted).

The requirement of contemporaneous ownership in Rule 23.1 can well be regarded as more than a mere “housekeeping rule.” Further, the Court expressly qualifies its holding as to the validity of the Federal Rules by reiterating the constitutional limitation. The Advisory Committee’s doubts about the constitutionality of the Rule are especially apposite because of the importance the Supreme Court attaches to the Committee’s judgment on the issue of validity. \textit{See} \textit{Moore}, supra note 9, ¶23.1.15[3], at 23.1-67 to -68.
the basis of the particular rules as to service of process.\textsuperscript{84} Obviously, however, the plaintiff's choice of forum in a state allowing noncontemporaneous owners to sue will be dictated by the difference between the federal and state rules.\textsuperscript{85} Likewise, where the real defendants, \textit{i.e.}, the directors, can do so, they will attempt to remove a state court action to federal court where they can secure dismissal under Rule 23.1.\textsuperscript{86}

Forum-shopping is, therefore, mandated by the present Federal Rule. If the Rule is not raised to the level of unconstitutionality, it is still clearly inconsistent with the policy of \textit{Erie}. Conversely, the proposed change will foster the policy of \textit{Erie} by guaranteeing the same treatment to subsequent shareholders whether the action is brought in the state or federal court.\textsuperscript{87}

2. Rule-Making Power—As Justice Reed pointed out in \textit{Erie}, it was not necessary to decide that case on constitutional grounds.\textsuperscript{88} \textit{Swift v. Tyson},\textsuperscript{89} with its federal common law theory, could simply have been overruled as an incorrect interpretation of the word “laws” in the Rules of Decision Act.\textsuperscript{90}

Similarly, Rule 23.1, as interpreted, need not be castigated as “unconstitutional” to be rendered invalid. As \textit{Hanna} points out, the Rule is still void if it exceeds the rule-making authority given to the Court by Congress in the Rules Enabling Act.\textsuperscript{91} That Act

\textsuperscript{84} The restoration of \textit{Erie} to constitutional status destroys any argument (See, e.g., Developments in the Law—Multi-party Litigation in the Federal Courts, 71 Harv. L. Rev. 874, 965 (1958)) that the Rule may be valid under the Enabling Act even though in conflict with \textit{Erie} principles. See \textit{Wright}, supra note 38, at 228-32. Justice Harlan, concurring in the \textit{Hanna} case, although (strangely) regarding security-for-expenses statutes as not outcome determinative, would uphold them on the ground that they represent a strong state policy. 380 U.S. at 477-78 (Harlan, J. concurring). This rationale would seem equally applicable to state rules allowing noncontemporaneous owners to sue.

\textsuperscript{85} The difference would exist except, of course, where the federal court disregards the Federal Rule. See \textit{Wright}, supra note 28, at 319, for cases holding that the allegation of contemporaneity need not be made where the state law would not require contemporaneity. Most courts, however, require compliance with the Federal Rule.


\textsuperscript{87} See generally \textit{Moore}, supra note 9, ¶ 23.1.15[2], at 23.1-57 to -68.

\textsuperscript{88} 304 U.S. at 90-92.

\textsuperscript{89} 41 U.S. (16 Pet.) 1 (1842).

\textsuperscript{90} 28 U.S.C. § 1652 (1970) provides:

State laws as rules of decision. The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply.

\textsuperscript{91} 380 U.S. at 471. See also note 83 supra.
provides that "[s]uch rules shall not abridge, enlarge or modify any substantive right. . . ."92

As the *Erie* progeny demonstrate,93 "substance" and "procedure" do not form a neat dichotomy. It is for this reason that the decisions discussed above have found it necessary to attempt standards of definition apart from the terms themselves. The whole project may be futile, perhaps because the division is an artificial one. It savors of isolating an Aristotelian "substance" from its "accidents," a later conceptualism imposed on a system which was, in the days of the original writs, completely "procedural."

If, however, the term "substance" is to have any meaning apart from its pragmatic, operational one for *Erie* purposes, it must in some sense partake of the idea of importance, emphasized by Justice Frankfurter in his dissent in *Sibbach v. Wilson & Co.*94 Indeed, this emphasis on the importance of the matter is even more clearly suggested by the term "substantive rights," used by the Rules Enabling Act. It fairly evokes as its opposite, "mere procedure."

If federal jurisdiction provides the only forum for enforcement of a cause of action, only the most hair-splitting of distinctions could conclude that a rule which closes that court's doors to a plaintiff is not an abridgment of his "substantive rights." To paraphrase the common law's maxim, if there is no remedy, there is no right. In this sense, then, the Federal Rule must be regarded, because of its drastic effect, as beyond the rule-making power granted by Congress.

The proposed change will return the Rule to its proper scope

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Rules of civil procedure for district courts. The Supreme Court shall have the power to prescribe, by general rules, the forms of process, writs, pleadings, and motions, and the practice and procedure of the district courts of the United States in civil actions.

Such rules shall not abridge, enlarge or modify any substantive right and shall preserve the right of trial by jury as at common law and as declared by the Seventh Amendment to the Constitution.

Such rules shall not take effect until they have been reported to Congress by the Chief Justice at or after the beginning of a regular session thereof but not later than the first day of May, and until the expiration of ninety days after they have been thus reported.

All laws in conflict with such rules shall be of no further force or effect. Nothing in this title anything therein to the contrary notwithstanding, shall in any way limit, supersede, or repeal any such rules heretofore prescribed by the Supreme Court.

93 See, e.g., the discussion in Sampson v. Channell. 110 F.2d 754 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940); Hanna v. Plumer. 380 U.S. 460 (1965).

94 312 U.S. 1, 16–19 (1941) (upholding the validity of the physical examination rule. Federal Rule 35).
under the Rules Enabling Act. Furthermore, since the amendment proposed here is only ameliorative and does not require a decision on the true nature of the Rule, i.e., substantive or procedural, there is no obstacle to utilization of the normal ex parte rule amendment procedure.\footnote{28 U.S.C. § 2072 (1970). See note 92 supra.}

**B. Consistency**

Although consistency is no longer a highly-prized virtue, it is at least worth mentioning that the proposed change will not only produce a consistent interpretation of the contemporaneity requirement, by overruling those decisions which impose the requirement despite contrary state law,\footnote{Elkins v. Bricker, 147 F. Supp. 609 (S.D.N.Y. 1956); Kaufman v. Wolfson 136 F. Supp. 939 (S.D.N.Y. 1955); Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942); Perrott v. United States Banking Corp., 53 F. Supp. 953 (D. Del. 1944); Piccard v. Sperry Corp., 36 F. Supp. 1006 (S.D.N.Y.). aff'd 120 F.2d 328 (2d Cir. 1941); Lissauer v. Berles, 37 F. Supp. 881 (S.D.N.Y. 1940); Robbins v. Sperry Corp., 1 F.R.D. 220 (S.D.N.Y. 1940). See WRIGHT, supra note 38, at 319; Developments in the Law—Multiparty Litigation in the Federal Courts, 71 Harv. L. Rev. 874, 964-66 (1958).} but will also make the first portion of Rule 23.1 consistent with its second sentence and with the general trend of federal law on capacity to sue in corporate litigation.

The second sentence of Rule 23.1—again a carryover from previous law—requires the complainant in a shareholder's derivative action to allege his efforts to secure redress from the directors or the reasons for his failure to have done so. Since this allegation is a universal requirement of state law,\footnote{N. LATTIN, R. JENNINGS & R. BUXTBAUM, CORPORATIONS—CASES AND MATERIALS (4th ed. 1968) states:}

In all American jurisdictions, either by statute, court rule or judicial decision, a stockholder must first exhaust his remedies within the corporation by requesting the board of directors to take action to redress the wrong unless such demand would be futile. . . .

\textit{Id.} at 803.

\textit{See also} 13 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 5963 (perm. ed., rev. vol. 1970) (citing cases from thirty-nine states): W. CARY, CASES AND MATERIALS ON CORPORATIONS 905 (4th ed. 1969); HENN, supra note 1, at 771; 19 AM. JUR. 2d Corporations § 540 (1965); 18 C.J.S. Corporations § 564 (1939); Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746 (1960).

\footnote{See Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), cert. denied, 379 U.S. 841 (1964).}

whether a demand must be made on the body of shareholders as a condition precedent to suit, it is certainly anomalous to treat the contemporaneous ownership requirement as a question of federal law.

Furthermore, Rule 17(b), defining capacity to sue, expressly incorporates state law. It is certainly incongruous to apply a federal requirement to a shareholder bringing a suit for the benefit of his corporation, when, if the corporation itself were suing, its capacity to sue would be determined by state law.

Some other Federal Rules expressly incorporate state law, while an even greater number, which are clearly more procedural than Rule 23.1, have been made subject to state law by judicial construction, at least as regards certain aspects of their interpretation. An especially significant example, so clearly procedural and, at the same time, so apposite to shareholder derivative actions, is the prevailing judicial rule that a corporation's amenability to federal process is to be determined by state criteria. Even more crucial, the question of who constitutes a "shareholder" under Rule 23.1 is to be determined by state law. Clearly, consistency demands the application of state law


Moore suggests that it will be the law of the state of incorporation, rather than that of the forum, which will be applied. MOORE, supra note 9, ¶ 23.1-19, at 23.1-258. Under their choice of law rules, state courts might well look to the law of the state of incorporation in this matter. But quare if the federal court should not be expressly required to apply whichever rule the state court of the forum state would. See Palmer v. Hoffman, 318 U.S. 109 (1943). This possibility might suggest that clarifying language might be added to the Rule here as well.

See, e.g., FED. R. CIV. P. 17(b). See WRIGHT, supra note 38, at 296.

Rule 17(b) states in part: "The capacity of a corporation to sue or be sued shall be determined by the law under which it was organized."

See as to state statutes of limitations. Guaranty Trust Co. v. York, 326 U.S. 99 (1945); as to state law closing courtroom doors to particular litigants or claims. WRIGHT, supra note 38, at 176; as to capacity to sue and substantive rights of members in class actions. id. at 306; as to burden of proof. id. at 280; as to pleading substantive elements of a cause of action. id. at 281; as to the availability of declaratory judgment where state law prohibits it in a particular situation. id. at 451; as to privilege. id. at 414 (the law here is confused); as to certain aspects of the interpretation of Rule 14 (third-party practice). id. at 335; Rule 18 (joinder of claims). id. at 343; Rule 20(a) (permissive joinder of parties). id. at 305 n. 24; Rule 25 (substitution of parties). id. at 338.

Most of the reported decisions even apply state law in determining the indispensability of a party. See, e.g., Kuchenig v. California Co., 350 F.2d 551 (5th Cir. 1965), cert. denied, 382 U.S. 985 (1966); United States v. Elfer, 246 F.2d 941 (9th Cir. 1957). The analogy to the capacity of a shareholder to sue is obvious.

Arrowsmith v. United Press Int'l, 320 F.2d 219 (2d Cir. 1963); WRIGHT, supra note 38, at 268-69.

Although many of the earlier cases used their own standards to determine who
in the determination of a shareholder's capacity to sue under Rule 23.1.


It is not completely clear, however, which state's law will apply. Henn suggests that the law of the forum should govern in determining who qualifies as a shareholder. HENN, supra note 1, at 762. Moore suggests that although this is technically true, the forum state's conflicts rule will normally require basing the decision on the law of the state of incorporation. MOORE, supra note 9, at 23.1-17. Wright apparently agrees. WRIGHT, supra note 19, at 319. Compare Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949) (applying the forum state’s (New Jersey’s) security-for-expenses statute although the corporation was a Delaware corporation), with Klaxon Co. v. Stentor Mfg. Co., 313 U.S. 487 (1941), and Griffin v. McCoach, 313 U.S. 498 (1941) (holding that the forum state's conflicts rules must be applied).

The matter is important, since the rules differ from state to state as to the right of an equitable owner, as opposed to only the record owner, to sue. Compare, e.g., N.Y. BUS. CORP. LAW § 626(a) (McKinney 1962), and PA. STAT. ANN. tit. 15. § 1516(a) (1954) allowing equitable owners to sue, with ABA-ALI MODEL BUS. CORP. ACT § 49 (enacted, e.g., in WASH. REV. CODE § 23A.08.460 (1965)), allowing only record owners the right to sue.

To avoid these and any interpretive difficulties with regard to the proposed change, the words “if necessary” could, throughout the Rule, be modified by adding “under the law which the forum state would apply.” See note 1 supra. Compare the somewhat ambiguous conflicts rule as to interpleader in proposed 28 U.S.C. § 2363(c). S. 1876, 93d Cong., 1st Sess. (1973).

See, e.g., the problems caused in the area of shareholders' derivative actions by 28 U.S.C. § 1332(c):

(c) For the purposes of this section and section 1441 of this title [removal], a corporation shall be deemed a citizen of any State by which it has been incorporated and of the State where it has its principal place of business: Provided further, That in any direct action against the insurer of a policy or contract of liability insurance, whether incorporated or unincorporated, to which action the insured is not joined as a party-defendant, such insurer shall be deemed a citizen of the State of which the insured is a citizen, as well as of any State by which the insurer has been incorporated and of the State where it has its principal place of business.

See also Anniston Soil Pipe Co. v. Central Foundry Co., 329 F.2d 313 (5th Cir. 1964); Kelly v. United States Steel Corp., 284 F.2d 850 (3d Cir. 1960); WRIGHT, supra note 38, at 90-91; Note, Location of Corporation’s Principal Place of Business, 47 IOWA L. REV. 1151 (1962); Comment, New Federal Jurisdictional Statute Achieves Early Success in
undesirable consequences of the current interpretation of clause (1) of the present Rule are considered.

It must be remembered that consistency between state and federal treatment is the heart of the *Erie* doctrine. Both the "outcome determinative" and "prevention of forum-shopping" slogans have as their bases the similar treatment of litigants in both forums, which *Erie* holds is essential to the constitutional guarantee of equal protection of the laws.

Further, the obvious effect of the present inconsistency between federal and state practice as to derivative actions is federal door-closing. Since the federal court may provide the only forum that can acquire jurisdiction over all of the essential parties, such door-closing may well mean that wrongdoing directors will escape from liability, and consequently, that their corporation will be denied justice. When the practical consequences of inconsistent treatment are considered in the context of related state


If the corporation's principal place of business is held to be in the same state as that of which the plaintiff is a citizen, the action will of course fail to meet the diversity requirement. (28 U.S.C. § 1332(a)(1)). This is only one of many hurdles the plaintiff must overcome to bring his action in what may be the only forum able to adjudicate his corporate claim, the federal court. See, as to the others, Kessler, *Corporations and the New Federal Diversity Statute: A Denial of Justice*, 1960 Wash. U.L.Q. 239.

The new state statutes and rules on shareholder derivative actions are much more explicit than was true in the past (see notes 123, 161 infra), and accordingly, collision between the Federal Rule and these new provisions is more likely than before. The consequence will undoubtedly be an increase in inconsistent interpretations not only between state and federal court decisions, but even within Rule 23.1 itself, unless the Rule is expressly amended to apply state law, as proposed.

107 See Hanna v. Plumer, 380 U.S. 460, 467 (1965). The oft-cited Sampson v. Channell, 110 F.2d 754 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940), gives excellent advice to federal judges, encouraging them to pretend that they are state court judges for *Erie* purposes: "The theory is that the federal court in Massachusetts sits as a court coordinate with the Massachusetts state courts to apply the Massachusetts law in diversity of citizenship cases." 110 F.2d at 761.


The problem is especially difficult in the case of an action brought in a state court having no contemporaneous-ownership requirement and which is then removed to a federal court by a defendant, the citizen of another state, on the basis of diversity. If the rule is regarded as procedural and a federal court is compelled to dismiss the action rather than remand to the state court, both doors are closed and plaintiff may be deprived of a state-created right. See Venner v. Great Northern Ry., 209 U.S. 24 (1908). It seems artificial to say that there is a case which may be removed, but that the complaint should be dismissed for want of equity and not for want of jurisdiction. The case should either be remanded to the state court or the state rule should be applied by the federal court as a substantive equitable principle.

*See also* Ilsen, *Recent Cases and New Developments in Federal Practice and Procedure*, 16 St. John's L. Rev. 1, 41-44 (1941).
and federal statutes, the arguments for the proposed change become even stronger.

1. Security-for-Expenses Statutes—The greatest anomaly under the present Rule and the most cogent practical reason for the proposed change is found in the rulings involving the contemporaneous ownership requirement as it relates to state security-for-expenses statutes.

As pointed out previously, the security-for-expenses statutes, which a number of states have enacted, have as their purpose the discouragement of "strike" suits.\(^{110}\) Most are rationalized on the basis that plaintiffs with holdings sufficient to satisfy the statutory criteria are less likely to bring spurious suits. Assuming the validity of this theory, the time at which the plaintiffs acquired their shares should be irrelevant.\(^{111}\) Some courts have held this way, but the federal courts have generally imposed the requirement of contemporaneity on all intervenors.\(^{112}\) Thus, even though a particular state will allow noncontemporaneous shareholders to intervene for the purpose of avoiding the statutory requirements, the corresponding federal court will nonetheless require security to be posted. This inconsistency in treatment is not mandated by Rule 23.1.\(^{113}\)

Further, such a result is inconsistent with the treatment of intervenors generally, under which intervenors of right\(^{114}\) are not even required to meet jurisdictional requirements,\(^{115}\) e.g., diversity of citizenship. It has also been expressly held that an intervening shareholder in a derivative action is not required to meet this jurisdictional requirement.\(^{116}\) It is certainly inexplicable for courts to require contemporaneity when the fundamental requirement of diversity can be ignored.

The federal court's requiring the posting of security where the state court would not, is especially incongruous since the state

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\(^{110}\) See notes 19-21 and accompanying text supra.

\(^{111}\) See notes 25-26 and accompanying text supra.

\(^{112}\) See notes 26-28 and accompanying text supra.

\(^{113}\) See note 29 and accompanying text supra.

\(^{114}\) Such status, under present Fed. R. Civ. P. 24(a), only requires an "interest" in the transaction, and a practical impairment of one's ability to protect that interest, unless it is already adequately represented by existing parties. See WRIGHT, supra note 38, at 328.

\(^{115}\) See, e.g., Gaines v. Dixie Carriers, Inc., 434 F.2d 52 (5th Cir. 1970); Babcock & Wilcox Co. v. Parsons Corp., 430 F.2d 531 (10th Cir. 1970); Smith Petroleum Serv. Inc. v. Monsanto Chem. Co., 420 F.2d 1103 (5th Cir. 1970); Hardy-Latham v. Wellsens 415 F.2d 674 (4th Cir. 1968); Black v. Texas Empire Ins. Ass'n, 326 F.2d 603 (10th Cir. 1964); Formulabs, Inc. v. Hartley Pen Co., 318 F.2d 485 (9th Cir.), cert. denied, 375 U.S. 945 (1963); East v. Crowdis, 302 F.2d 645 (8th Cir. 1962); Kozak v. Wells, 278 F.2d 104 (8th Cir. 1960); WRIGHT, supra note 38, at 331.

security-for-expenses statutes would not apply at all in federal courts were they not held to be *substantive* by the Supreme Court.\(^\text{117}\) Consistency would seem to dictate that the interpretation given these statutes by the courts of the very states which enacted them should also be held substantive. This was the rule even before *Erie*.\(^\text{118}\) Worse yet, the present judicial interpretation conflicts with the *Erie* rule, even as reinterpreted in *Hanna*, since by allowing different results to be obtained in state and federal courts, forum-shopping is provoked.

Frequently, state statutes setting forth security-for-expenses requirements impose the contemporaneous ownership requirement in the same statute section.\(^\text{119}\) It is particularly inappropriate for the federal courts to take one portion of such a statute as binding, while ignoring the balance, especially where these statutes, albeit not without ambiguity, indicate that intervenors are not required to meet the contemporaneous ownership test, and may be so interpreted by the courts of the state enacting them.

Unfortunately, the above interpretation can be even more disastrous when a choice of forum is not possible. Although recent "long-arm" statutes\(^\text{120}\) have made state jurisdiction more available, there are still situations where it will be impossible to get jurisdiction over all necessary parties\(^\text{121}\) in any state court, with the result that a state court suit is precluded. With a minor lapse in 1958,\(^\text{122}\) the general federal policy has been to facilitate the bringing of derivative suits in the federal courts.\(^\text{123}\) The predominant interpretation of Rule 23.1 runs counter to that permissive policy by restricting access to the federal courts in situations where even state law would not bar suit by the plaintiff.

Furthermore, this imposition of the contemporaneity requirement on top of the state security-for-expenses statutes clearly seems to conflict with the very purpose of most such statutes, which is to prevent "strike" suits simply by making sure that the plaintiffs have an adequate stake in corporation. And, it must be


\(^{118}\) See *Erie* R.R. *v.* Tompkins, 304 U.S. 64 (1938); WRIGHT, *supra* note 38, at 223.

\(^{119}\) See, e.g., statutes discussed in note 161 *infra*, except that of New York.

\(^{120}\) See, e.g., ILL. REV. STAT. tit. 110, § 17 (1968), the pioneer.

\(^{121}\) See note 54 and accompanying text *supra*.


\(^{123}\) See 28 U.S.C. §§ 1401 (special venue provision) and 1695 (special service provisions). See also the post-1958 amendments to 28 U.S.C. § 1391(a) and FED. R. CIV. P. 4(e), allowing use of state long-arm statutes in federal courts.
remembered, the Supreme Court has, by its Cohen decision, in effect, held that state policy should control in this area.\textsuperscript{124}

The addition of the language suggested here will result in uniform treatment of plaintiffs in state and federal courts in this vital area. The inconsistencies and, more importantly, the injurious consequences of the present construction of the Rule will thus be overcome, at least in those states which give a sensible interpretation to their security statutes.\textsuperscript{125}

2. Discrimination Against State-Created Claims—The exigency of amending Rule 23.1 appears most clearly when suit under the Rule is contrasted with an action grounded on SEC rule 10b-5. It has become fashionable to refer to rule 10b-5 as creating a “federal corporation law,”\textsuperscript{126} and not without reason, since it is fast becoming a substitute for the derivative action as a means of redressing corporate mismanagement. The Supreme Court has now given the stamp of approval to the growing number of lower court cases which allow recovery for corporate waste under the rule, by requiring only that the wrongdoing “touch” a securities transaction in order to be actionable.\textsuperscript{127}

Inasmuch as every derivative action in a sense “touches” a securities transaction, since the plaintiff must be a shareholder, \textit{i.e.}, must have acquired some stock, greater displacement of de-

\textsuperscript{124} See the Cohen case supra note 117 and note 84 supra.

\textsuperscript{125} Another beneficial consequence of the addition of the suggested language will be the resolution of a conflict as to whether the right of an equitable owner of shares to bring a derivative action is to be determined by state or federal law. See Moore, supra note 9, § 23.1.17, at 23.1-152 to -153; Wright, supra note 38, at 319. While the preferable rule would be to allow an equitable owner to sue, this again is a matter on which state law should control, if the desirability of the Erie rule is accepted. See 2 Model Bus. Corp. Act § 49 (1971), which limits the right to sue to holders of record in the same section that imposes the security-for-expenses requirement. By pointing to state law as to a shareholder's status, the suggested change should guarantee congruity between state and federal court treatment of equitable owners.

Federal Rule 23.1 refers only to suits by “shareholders or members.” Recent statutes (\textit{e.g.}, N.Y. Bus. Corp. Law § 626 (McKinney Supp. 1973), 2 Model Bus. Corp. Corp. Act Ann. § 49 (1971)) also expressly allow suit by holders of voting trust certificates, persons who technically fall into neither category of shareholders, record or equitable. Again, by pointing to state law, interpretive problems, otherwise bound to arise, will be obviated.

A number of other interpretive problems which come up under state security-for-expenses statutes, and which cannot be resolved by the inconsistent Cohen-contemporaneous rubric, would also be resolved by the proposed amendment adopting state law. See, \textit{e.g.}, Amdur v. Meyer, 36 Misc. 2d 433, 233 N.Y.S.2d 15, aff'd, 17 App. Div. 2d 571, 237 N.Y.S.2d 352, aff'd, 13 N.Y.2d 1089, 196 N.E.2d 63, 246 N.Y.S.2d 408 (1963) (effect of sale of some of plaintiff's shares bringing him below statutory minimum); Sorin v. Shahmoon Indus., Inc., 30 Misc. 2d 408, 220 N.Y.S.2d 760 (Sup. Ct. 1961) (effect of fall in value of plaintiff's shares below statutory minimum); Tyler v. Gas Consumers Ass'n, 34 Misc. 2d 947, 229 N.Y.S.2d 169 (Sup. Ct. 1962) (whether plaintiff who meets contemporaneous ownership requirement but does not hold sufficient shares can avoid posting security by purchase of additional shares).


Shareholder Derivative Actions

by "the federal corporation law" is inevitable. It should be noted in this connection that the new Federal Securities Code, at least as presently proposed, will do nothing to prevent this expansion of rule 10b-5 into the derivative area. Although Professor Loss, the draftsman of the Code, disclaims any express intent to give a mere holder a private right of action solely from his being a shareholder,128 he adds, in referring to the application of the Code to corporate mismanagement in general, that "the pattern of this draft is to codify a good deal of the implied liability that has developed but not to foreclose further evolution on a case-by-case basis."129

Today, skilled practitioners in this area usually try to frame their complaints in terms of a violation of rule 10b-5 in order to secure the many advantages of section 27 of the Securities Exchange Act of 1934,130 adding the common law derivative claim merely as backup insurance in case the rule 10b-5 claim fails for some reason. The contrast between the procedural advantages of a rule 10b-5 action, and the burdens of an ordinary derivative suit is striking: in the rule 10b-5 action, diversity of citizenship is not required;131 venue may be laid in the district where "any act or transaction constituting the violation occurred," or in which the defendant is "found or is an inhabitant or transacts business;"132 process may be served in any other district where the defendant "is an inhabitant or wherever the defendant may be found;"133 state security-for-expenses statutes do not apply;134 and apparently no demand on shareholders is necessary even though state law would require one.135 It is not inconceivable that much of the impetus for judicial expansion of the scope of rule 10b-5 has come from the courts' realization that unless suit is allowed under that rule, the plaintiff will be effectively denied justice because of his inability to hurdle the numerous obstacles in an ordinary derivative action.136

129 Id. § 225. Comment 3(a) at 11; § 1423. Comments 5(d). 6 at 187.
130 See notes 131-135 and accompanying text infra.
132 Id.
133 Id.
Academic commentators, until recently, have applauded the macro-evolution of rule 10b-5. Now, however, some are beginning to have second thoughts, which, if officially adopted, would severely curtail the utility of the rule as a substitute for the derivative suit. Undoubtedly there is even stronger opposition to expansion of the rule among corporation lawyers. If the opponents of the federal corporation law are to succeed in stopping its spread, it would seem essential to provide a viable substitute based on state law. Access to federal court as a forum for enforcement of such state law claims is also essential because of the jurisdictional limitations of state courts.

Perhaps more sweeping changes, e.g., abolition of state security-for-expenses statutes, will be necessary if the states are to regain control over the substantive law to be applied to their corporations. At the very least, artificial federal impediments to state law actions must be removed if the derivative action is to offer a palatable alternative to an expanding federal securities law. Accordingly, the changes proposed, which will require the federal courts to apply plaintiff-oriented state rules, are fundamental to any campaign to revitalize state corporation law.

But, whatever the outcome of the battle between state and federal corporation laws, the anomaly between the treatment in a single case of the federal claim under rule 10b-5, and the state-created shareholder derivative claim (which, in order to be "pendent," i.e., to avoid the diversity requirements, must arise from a "common nucleus of operative facts" with the federal one) is unjustifiable. In the absence of overriding federal policy, subjecting what is basically the same claim to more onerous requirements than the state itself would impose, merely because it is state-created, smacks of a denial of due process.

3. Prevention of Collusive Suits—It should be noted that the proposed change does no violence to the generally accepted purpose of Federal Rule 23.1. The genealogy of the Rule has been traced:

140 Cf. Shapiro v. Thompson, 394 U.S. 618, 642 (1969), and cases cited therein.
141 See generally Moore, supra note 9, § 23.1.10[1], at 23.1-11, 23.1.10[4], at 23.1-12 to -16, 23.1.15[1], at 23.1-51 to -55, 23.1.15[2], at 23.1-57 to -68. A comprehensive discussion of Rule 23.1 is also found in C. Wright & A. Miller, Federal Practice and Procedure: Civil §§ 1821-41 (1972). See also Ballantine, supra note 2, at 357-58.
Rule 23(b) was basically the same as Equity Rule 27,\textsuperscript{142} which, in turn, was sired by Equity Rule 94,\textsuperscript{143} a codification (at the same term of court) of the rule laid down in \textit{Hawes v. Oakland}\.\textsuperscript{144}

\textit{Hawes} makes it clear that the basic purpose of the Rule was to prevent collusive suits, which were designed to confer federal jurisdiction where it would not otherwise be available.\textsuperscript{145} But this purpose is adequately served by the second clause of the Rule, which requires the plaintiff to swear “that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have,” and even more so by the parallel statute, which withholds federal jurisdiction from collusive suits.\textsuperscript{146} In fact, the anti-collusion law can, with some justification, be said to make both the first and second clauses of Rule 23.1 unnecessary, insofar as their object is to prevent collusively conferred federal jurisdiction.\textsuperscript{147} This is especially true because of the vigorous interpretation which has recently been given to the anti-collusion statute.\textsuperscript{148}

\textsuperscript{142} Equity Rule 27 was promulgated at 226 U.S. 656 (1912).
\textsuperscript{143} MOORE, supra note 9, \S\ 23.1.01[4], at 23.1-13.
\textsuperscript{144} 104 U.S. 450 (1882). See HENN, supra note 1, at 752.
\textsuperscript{145} According to Ballantine, before the decision in \textit{Hawes v. Oakland}, [i]t became a practice, in order to get such cases [where diversity would not exist if the corporation brought the suit itself] into the federal courts, to arrange either to have a non-resident shareholder sue the corporation, or if there was no non-resident shareholder, to have a few shares transferred to a non-resident who would, upon formal refusal of the board of directors to act, bring a derivative suit in the federal courts.

\textit{Ballantine, supra} note 2, at 357. See N. LATTIN, R. JENNINGS & R. BUXBAUM, \textit{Corporations—Cases and Materials} 786–88 (4th ed. 1968); WRIGHT, supra note 38, at 319; HENN, supra note 1, at 766. Oddly enough, state rules requiring contemporaneous ownership were patterned after the federal rule.

It has been argued that the anti-collusion purpose of the Rule had behind it the further purpose of preventing forum-shopping. \textit{See} Note. 45 \textit{CALIF. L. REV.} 80, 82 (1957). If so, as the author of the Note points out, its rationale disappeared with the \textit{Erie} decision. It must, however, be conceded that today, prohibitions against collusively conferring federal jurisdiction have an additional basis: cutting down, generally, the caseload in the federal courts.

\textit{Compare} MOORE, supra note 9, \S\ 23.1.15[2], at 23.1-57. Moore states that the reasons underlying the requirement are not clear, and although he concedes that there is support for the noncollusion argument, he seems to regard the basis of the rules to be “substantive equitable principles which would estop a shareholder to question transactions which occurred prior to his becoming a shareholder.” \textit{Id.} at 23.1-60. This interpretation seems to rely on later case justifications for the rule, rather than the original impetus for its promulgation. Of course, if the Rule is, for whatever reason, “substantive,” it becomes unconstitutional under the \textit{Erie} doctrine, and, it should be noted, Moore so argues. \textit{Id.}


If the first clause of Rule 23.1 is taken, as some cases have suggested, as reflecting not merely an attitude against collusively conferred federal jurisdiction, but also as an additional federal equity policy barring litigation of "purchased claims," this policy, which seems clearly substantive, should yield in the federal courts in favor of state-federal uniformity, in that minority of states which have not chosen to adopt the policy, or at least do not choose to apply it in the security-for-expenses area.

C. Justice

The results of the failure to follow the policy of Erie and inconsistency are the same: possible unavailability of any court to adjudicate the plaintiff's claim. It is the purpose of the proposed change to rectify this denial of justice.


150 See Wright, supra note 38, at 242.

151 See Moore, supra note 9, ¶ 23.1.15[2], at 23.1-68.

Obviously, any such policy of the Rule is satisfied when the original plaintiff meets the contemporaneous ownership requirement, and, thus, the judicial gloss imposing the requirement on intervenors as well seems clearly unwarranted. However, since the language of the proposed amendment would have a broader application, i.e., not restricted to intervention, any such federal equity policy would conflict with the Rule as amended, unless the state had a similar policy.

Since the present Rule has its more undesirable effects in cases involving intervention in the security-for-expenses area, an amendment, more limited in scope but more cumbersome in language, might suggest itself. A new sentence, before the final one of the present Rule might read: "In the application of any security-for-expenses statute or Rule of the forum state, intervention shall be permitted under the circumstances in which it would be permitted by the courts of said state in the district in which the federal court sits..."

The later language is necessary in order to accommodate such states as New York, where the permissibility of intervention by noncontemporaneous owners to avoid the security-for-expenses statute differs from department to department. Compare, e.g., Perry v. Shahmoon Indus., Inc., 11 Misc. 2d 137, 172 N.Y.S.2d 245 (Sup. Ct.), aff'd mem. 6 App. Div. 2d 1010, 178 N.Y.S.2d 612 (1st Dep't), appeal denied, 7 App. Div. 2d 634, 179 N.Y.S.2d 846 (1st Dep't 1958), and Noel Associates v. Merrill, 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944), representing the First Department view that noncontemporaneous owners may intervene, with Breswick & Co. v. Harrison-Rye Realty Corp., 280 App. Div. 821, 114 N.Y.S.2d 25 (2d Dep't 1952) and Richman v. Felmus, 8 App. Div. 2d 985, 190 N.Y.S.2d 920 (2d Dep't 1959), exemplifying the contrary Second Department practice. The bill which became the New York Business Corporation Law, as originally introduced (A. Int. 885. Pr. 885. § 6.26(d) (1961)), would have expressly enacted the Noel (First Dep't) rule, but unfortunately the provision was deleted in the law as finally enacted, leaving the matter in the realm of case law determination. New York's highest court has not yet resolved the conflict.

152 See Henn, supra note 1, at 766.
IV. Practical Problems of the Proposed Amendment

It has been assumed here that the addition of the words "if necessary" would result in incorporation of state law into Rule 23.1. As already pointed out, most of the few cases interpreting the expression in terms of the shareholder demand requirement of the Rule have so held. At least one case, however, has apparently held that federal law would control on the issue of the necessity for making such a demand.

Abstractly, it would be desirable to abolish the requirement of a demand on the shareholders completely. Federal courts, applying their own standard, might be more apt to excuse the demand than their counterpart state courts. Obviously, however, the proposed change in the contemporaneous ownership provision will be of no value if the phrase "if necessary" is not referred to state law. Since the added words will almost surely be given the same interpretation as they have been given in the old context, it is necessary to overrule any anti-state law interpretation given to the expression in the shareholder demand sentence, in order to guarantee the proper construction of clause (1). Fortunately, a reviser's comment will probably be sufficient to accomplish the desired interpretation, in the event that the proposed change is made.

The principal problem, should the proposal to incorporate state law into the contemporaneity requirement be adopted, will come in trying to determine the state law which must be applied. The right vel non of a subsequent shareholder to sue will not pose much of a problem because of the significant amount of state statutory and case law on the subject. The same cannot be said, however, for the determination of whether subsequent shareholders will qualify as intervening plaintiffs. Under a security-for-expenses statute like California's, which allows the court to compel the plaintiff or plaintiffs to post security regardless of the amount of their holdings, the problem is of little signifi-

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153 See note 99 supra.
156 See also Hirshfeld v. Briskin, 447 F.2d 694, 698 (7th Cir. 1971). liberally interpreting Rule 23.1 to allow suit by a shareholder, under the devolution by operation of law provision, despite elements of a sale (which would have debarred plaintiff as a noncontemporaneous shareholder). HENN, supra note 1, at 766; See Moore, supra note 9.
cance. Similarly, under a statute like Pennsylvania's, where a plaintiff can be excused from posting security where the posting of such security "would impose undue hardship on plaintiffs and serious injustice would result."¹⁵⁸ the permissibility of intervention also becomes less important.

The typical security-for-expenses statute, however, sets an arbitrary financial interest which the plaintiff or plaintiffs must possess in order to avoid the necessity for posting such security,¹⁵⁹ and in effect makes the posting of security mandatory upon demand of the corporate defendant.¹⁶⁰ Unfortunately, also, such statutes typically do not indicate whether subsequent shareholders qualify to meet the requisite share ownership amount and thus to excuse imposition of the security liability.¹⁶¹

¹⁵⁸ PA. STAT. ANN. tit. 15, § 1516 (1967).
¹⁵⁹ See note 19 supra.
¹⁶⁰ See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 49: "[T]he corporation ... shall be entitled ... to require the plaintiff or plaintiffs to give security...." See also N.Y. Bus. CORP. LAW § 627, and other statutes cited in note 19 supra.
¹⁶¹ The New York Business Corporation Law, as introduced in 1961, would have been explicit, but the provision was excised on final enactment. See note 58 supra. Unfortunately, even the Model Business Corporation Act is not without ambiguity. Section 49 of the Model Act provides:

Provisions Relating to Actions by Shareholders—No action shall be brought in this State by a shareholder in the right of a domestic or foreign corporation unless the plaintiff was a holder of record of shares or of voting trust certificates therefor at the time of the transaction of which he complains, or his shares or voting trust certificates thereafter devolved upon him by operation of law from a person who was a holder of record at such time.

In any action hereafter instituted in the right of any domestic or foreign corporation by the holder or holders of record of shares of such corporation or of voting trust certificates therefor, the court having jurisdiction, upon final judgment and a finding that the action was brought without reasonable cause, may require the plaintiff or plaintiffs to pay to the parties named as defendant the reasonable expenses, including fees of attorneys, incurred by them in the defense of such action.

In any action now pending or hereafter instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of record of less than five percent of the outstanding shares of any class of such corporation or of voting trust certificates therefor, unless the shares or voting trust certificates so held have a market value in excess of twenty-five thousand dollars, the corporation in whose right such action is brought shall be entitled at any time before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including fees of attorneys, that may be incurred by it in connection with such action or may be incurred by other parties named as defendant for which it may become legally liable. Market value shall be determined as of the date that the plaintiff institutes the action or, in the case of an intervenor, as of the date that he becomes a party to the action. The amount of such security may from time to time be increased or decreased, in the discretion of the court, upon showing that the security provided has or may become inadequate or is excessive. The corporation shall have recourse to such security in such amount as the court having jurisdiction shall determine upon the termination of such action, whether or not the court finds the action was brought without reasonable cause.

It should be noted that the first paragraph requires contemporaneous record ownership by "the plaintiff" (or his predecessor if the plaintiff received his shares by operation of
The few state cases which have passed on the subject have not reached consistent results. Most states apparently have not decided the question. The problem for federal courts applying state law is difficult enough where they have only lower court decisions on which to rely; the difficulties are compounded where there are no relevant decisions whatsoever.

The problem is, however, not infrequently faced by federal courts. The task of the federal judge is really the same as that of his state court counterpart, i.e., to predict how the highest state court will decide the case, and, accordingly, unless the Erie doctrine itself is to be condemned, such task constitutes no real objection to the proposed additional incorporation of state law under the Rule.

V. Conclusion

The proposed change in Rule 23.1 is designed to make its contemporaneous share ownership requirement yield to contrary state rules in the few jurisdictions where noncontemporaneous owners are allowed to commence derivative actions, and, more importantly, to allow intervention by noncontemporaneous owners, where state law allows, to permit the plaintiffs to escape the requirement of posting security for expenses.

The enacted statutes which excuse security posting where certain percentage or value requirements are met are almost all equally ambiguous. See, e.g., FLA. STAT. § 608.131 (1956) (subsection 1 requires "plaintiff" to be a contemporaneous owner, subsection 3 allows corporation to demand security where "plaintiff or plaintiffs" own less than 5 percent, or their shares are not in excess of $50,000 (no reference to intervenors)); N.J. STAT. ANN. § 14A:3-6 (1969) (subsection 1 requires contemporaneous ownership by "plaintiff," subsection 3, concerning security-for-expenses, refers to "plaintiff or plaintiffs" (no reference to intervenors); N.Y. BUS. CORP. LAW § 626(a) (1963) (requires "plaintiff" to be contemporaneous, while § 627(a) refers to "plaintiff or plaintiffs" not holding 5 percent or over $50,000 value (silent as to intervenors)); WASH. REV. CODE § 23A.08-460 (1965) (similar to Model Act).

Although PA. STAT. ANN. § 1516 a (1954) provides that "the plaintiff or plaintiffs must aver and it must be made to appear, that the plaintiff or each plaintiff was a shareholder . . . ." it allows the court to waive the requirement completely.

162 See 2 MODEL BUS. CORP. ACT ANN. § 4.25 (1971).

163 See Fidelity Union Trust Co. v. Field, 311 U.S. 169 (1940), in which the federal court in New Jersey was ordered to follow two New Jersey Chancery Court decisions, which, after the federal court decision, New Jersey's highest court repudiated. Hickey v. Hahl, 129 N.J. Eq. 233, 19 A.2d 33 (Ct. Err. & App. 1941).

164 See Wright, supra note 38, at 240. The most satisfactory solution, if the state courts cooperate, is for the federal court to ask the highest court of the state what the state law is. See Clay v. Sun Ins. Office Ltd., 363 U.S. 207 (1960), questions answered, 133 So. 2d 735 (Fla. 1961); F. JAMES, JR., CIVIL PROCEDURE 42 (1965); Vestal, The Certified Question of Law, 36 IOWA L. REV. 629, 643 (1951).
Although there is respectable authority supporting the present Rule and its interpretation, it is submitted that this subjection of the Federal Rule to state law, even if not mandated by the Constitution, is nevertheless advisable for several reasons. Not only will the change produce internal consistency within Rule 23.1, consistency of interpretation with other Rules and with the substantive characterization given to state security-for-expenses statutes, but it will also better serve the policy of *Erie* by ensuring the same treatment to plaintiffs in federal as in state courts. More importantly, the change is warranted in order that the plaintiff not be denied, on a technicality, what is frequently the only available forum in which justice can be secured for his corporation.