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CORPORATIONS-CLASS ACTIONS UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934-FEDERAL RULE 23

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CORPORATIONS—CLASS ACTIONS UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934—FEDERAL RULE 23—Pursuant to section 16 (b) of the Securities Exchange Act of 1934 [1] an action was commenced by a shareholder to recover for the corporation profits realized by another shareholder through "short swing" transactions in securities of the corporation, the esti-

[1] 15 U.S.C. (1940) § 78p (b), providing for an action by the issuer or the owners of any security of the issuer against directors, officers, or owners of more than 10 per cent of any equity security to recover for the issuer any profits realized from a purchase and sale of the issuer's security within any period less than six months.

mated profits being $50,770. Plaintiff's attorney filed an affidavit stating the reasons why recovery of the full amount was doubtful and made application for leave to settle and compromise for $5,000. The corporation's attorney agreed to this proposal. *Held*, the merits of the compromise cannot be considered until in conformance with Rule 23 (c),[2] actual notice of the compromise and its terms is given to the Securities and Exchange Commission and each of the directors, and notice by publication is given to all the shareholders. *Pottish v. Divak*, (D.C. N.Y. 1947) 71 F. Supp. 737.

The court pointed out that section 16 (b) created a new cause of action [3] which is essentially a derivative or secondary suit for the benefit of the corporation [4] and a "true class action" under Rule 23 (a) (1).[5] However, most class actions by shareholders must comply with Rule 23 (b) [6] which requires that the plaintiff aver (1) that he held stock at the time of the transaction or that his

[2] Rule 23 (c) provides for compulsory notice to members of the class if the right is "joint, common, or secondary." Federal Rules of Civil Procedure, Rule 23; 28 U.S.C. (1940) following § 723c.

[3] At common law the only similar action was by a shareholder against an officer or director for failure to disclose the full and true basis for his purchase of shares from the stockholder. See Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Yourd, "Trading in Securities by Directors, Officers, and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 at 140 (1939). However, this was the minority view, the majority allowing an action only in case of fraud. 84 A.L.R. 615 (1933); Walker, "The Duty of Disclosure by a Director Purchasing Stock from his Stockholders," 32 YALE L. J. 637 (1923). The federal courts allowed recovery by the shareholder in "special circumstances," Strong v. Repide, 213 U. S. 419, 29 S. Ct. 521 (1909). Section 28 of the Securities Exchange Act of 1934, 15 U. S. C. (1940) 78bb (a), provides that this remedy is in addition to common law remedies. See Grossman v. Young, (D.C. N.Y. 1947) 70 F. Supp. 970, 4 FED. SECURITIES LAW SERV., ¶90, 389 at p. 91,038.

[4] Dottenheim v. Emerson Electric Manufacturing Co., (D.C. N.Y. 1947) 4 FED. SECURITIES LAW SERV., ¶ 90,367 at p. 90,952; Smolowe v. Delendo Corporation, (C.C.A. 2d, 1943) 136 F. (2d) 231 at 241. As to the Nature of the stockholder's suit generally see, STEVENS, CORPORATION 655 (1936); Glenn, "The Stockholder's Suit—Corporate and Individual Grievances," 33 YALE L. J. 580 (1934).

[5] Rule 23 (a) (1) provides for a representative suit when the "right sought to be enforced for or against the class is joint, or common, or secondary in the sense that the owner of a primary right refuses to enforce it." A shareholder's derivative suit is in this category, 2 MOORE, FEDERAL PRACTICE 2237 (1938); FEDERAL RULES OF CIVIL PROCEDURE ANNOTATED 50 (1938).

[6] 2 MOORE, FEDERAL PRACTICE 2237, 2246 (1938); The H.F.G. Co. v. Pioneer Publishing Co., (C.C.A. 7th, 1947) 162 F. (2d) 536, 10 FED. RULES SERV. 23b.11, Case 2; in Grossman v. Young, (D.C. N.Y. 1947) 70 F. Supp. 970, 4 FED. SECURITIES LAW SERV., ¶ 90,389 it was considered that section 16 (b) actions were governed by Rule 23 (b). Rule 23 (b) is the counterpart of former Equity Rules 94 and 97 which derive from the decision in Hawes v. Oakland, 104 U.S. 450 at 460, 461 (1882); see FEDERAL RULES OF CIVIL PROCEDURE ANNOTATED 51 (1938). The purpose of the rule is to prevent collusion to obtain federal jurisdiction. 15 MINN. L. REV. 453 at 456, note 17 (1931).

stock thereafter devolved on him by operation of law,[7] (2) that the action is not collusive to confer jurisdiction on a court of the United States,[8] and (3) either that a demand has been made on the corporation and if necessary the other shareholders to obtain the desired action [9] or that such would have been futile.[10] In order to obviate requirements (1) and (2) the court pointed out that Rule 23 (b) applied to actions by "shareholders" while under section 16 (b) the owner of any "security" [11] can maintain the action. In as much as this particular action was commenced by a shareholder, the court's opinion may be open to criticism; but the holding is supported by reason. If the purpose of requirements (1) and (2) is to prevent collusive resort to the federal courts in diversity cases or collusive suits generally,[12] there is little reason to apply the rule to cases which do not depend on diversity for federal jurisdiction,[13] and which obviously would not be collusive. While some cases hold that contemporaneous share ownership relates to the substance of the shareholder's claim and not to the means of invoking the jurisdiction of the court,[14] section 16 (b) creates a new cause of action

[7] See, Ilsen, "Recent Cases and New Developments in Federal Practice and Procedure," 16 ST. JOHN'S L. REV. 1 at 40 (1941), abridged in 6 FED. RULES SERV. L. R. 56 (1941).

[8] See the concurring opinion of Justice Brandeis in Ashwander v. Tennessee Valley Authority, 297 U.S. 288 at 341, 56 S. Ct. 466 (1937).

[9] Lucking v. Delano, (C.C.A. 6th, 1942) 129 F. (2d) 283 at 286; Wachsman v. Tobacco Products Corp. of New Jersey, (C.C.A. 3d, 1942) 129 F. (2d) 815 at 817; as to the necessity of this requirement generally see annotation in 72 A.L.R. 628 (1931), and comment in 37 MICH. L. REV. 773 (1939).

[10] Craftsman Finance & Mortgage Co., Inc. v. Brown, (D.C. N.Y. 1945) 64 F. Supp. 168 at 174, 175; Berg v. Cincinnati, Newport & Covington Ry. Co., (D.C. N.Y. 1944) 56 F. Supp. 842 at 845; Delaware and Hudson Company v. Albany and Susquehanna Railroad Company, 213 U.S. 435, 29 S. Ct. 540 (1909). Although the necessity for demand is more strict under Section 16 (b), Yourd, "Trading in Securities by Directors, Officers, and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 at 155, note 72 (1939), it too can be obviated; Kogan v. Schulte, (D.C. N.Y. 1945) 61 F. Supp. 604.

[11] "Security" is used in the broadest possible sense, Securities Exchange Act of 1934, § 3 (a) (10); 15 U.S.C. (1940) 78c (a) (10).

[12] Note 8, supra. The opinion in Norman v. Consolidated Edison Co., (C.C.A. 2d, 1937) 89 F. (2d) 619, portrays the general aversion of federal courts to collusive stockholder's suits.

[13] In re Western Tool & Mfg. Co., (C.C.A. 6th, 1944) 142 F. (2d) 404 at 408; Jablow v. Agnew, (D.C. N.Y. 1940) 30 F. Supp. 718; Hand v. Kansas City Ry. Co., (D.C. N.Y. 1931) 55 F. (2d) 712.

[14] Venner v. Great Northern Railway Co., 209 U.S. 24, 28 S. Ct. 328 (1908); discussed in Jacobson v. General Motors Corp., (D.C. N.Y. 1938) 22 F. Supp. 255 at 257, 258. This view is given support by the fact that many state courts also make this requirement; see Home Fire Insurance Co. v. Barber, 67 Neb. 664, 93 N.W. 1024 (1903), and cases cited in 2 MOORE, FEDERAL PRACTICE 2251, note 13 (1938). However, the majority of the states probably do not so hold; see Pollitz v. Gould, 202 N.Y. 11 at 14, 94 N.E. 1088 (1911); 38 COL. L. REV. 1462 at 1480, note 53 (1938). The basis of this requirement has received considerable analysis in

which apparently does not require ownership at the time of the transaction.[15] The requirement that proper steps must have been taken to make the corporation enforce the right is a reasonable prerequisite to any secondary suit,[16] and is specifically required by section 16 (b) [17] so that there is no problem as to fulfilling this requirement as set out in Rule 23 (b).[18] Consequently, section 16 (b) actions are governed by Rule 23 (a) (1) but need not be within Rule 23 (b) [19] although notice of dismissal or compromise must be given in accordance with Rule 23 (c).[20]

Richard J. Archer

the application of the doctrine of Erie R. R. v. Tompkins, 304 U.S. 64, 58 S. Ct. 817 (1938); see 38 COL. L. REV. 1472 at 1482 (1938) and 41 COL. L. REV. 104 at 115 (1941); Gallup v. Caldwell, (C.C.A. 3d, 1941) 120 F. (2d) 90.

[15] Kogan v. Schulte, (D.C. N.Y. 1945) 61 F. Supp. 604 at 610; Yourd, "Trading in Securities by Directors, Officers, and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 at 156, note 17 (1939).

[16] Jacobson v. General Motors Corp., (D.C. N.Y. 1938) 22 F. Supp. 255 at 257.

[17] The issuer must have failed to bring the suit within sixty days after request by the security holder or must have failed to prosecute the suit diligently, Securities Exchange Act of 1934, § 16 (b), 15 U.S.C. (1940) § 78p (b).

[18] As pointed out in note 10, supra, the requirement for demand under section 16 (b) is probably more strict.

[19] Due to the highly penal nature of the statute some federal courts might adopt a "strict construction" necessitating a fulfillment of all the prerequisites of Rule 23 (b). It should also be pointed out that actions under Rule 23 (b) may not have to comply with the requirement of Rule 23 (a), that the "persons constituting the class are so numerous as to make it impracticable to bring them all before the court." Galdi v. Jones, (C.C.A. 2d, 1941) 141 F. (2d) 984 at 992.

[20] Brendle v. Davis, (D.C. N.Y. 1946) 9 FED. RULES SERV. 23c.1, Case 3; Lucking v. First National Bank, (C.C.A. 6th, 1944) 142 F. (2d) 528, cert. den., 323 U.S. 740, 65 S. Ct. 61 (1944). As to this problem generally see, McLaughlin, "Capacity of a Plaintiff-Stockholder to Terminate a Stockholder's Suit," 46 YALE L. J. 421 (1937).