1945

THE AMERICAN INVESTOR AND THE CONSTITUTIONALITY OF SECTION 61-B OF THE NEW YORK GENERAL CORPORATION LAW

SERGEI S. ZLINKOFF

Follow this and additional works at: https://digitalcommons.law.yale.edu/ylj

Recommended Citation

This Article is brought to you for free and open access by Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in Yale Law Journal by an authorized editor of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.
THE AMERICAN INVESTOR AND THE CONSTITUTIONALITY OF SECTION 61-B OF THE NEW YORK GENERAL CORPORATION LAW

SÉRGEI S. ZLINKOFF†

"The divorce between corporate ownership and corporate control, now almost complete in many large business units, requires that courts of equity be alert to protect the interests of scattered ownership against personal profit-seeking on the part of those exercising centralized control and that minority owners be encouraged to be active in asserting their rights, as the only alternative of some administrative control by government of the internal affairs of large corporations."

PROFESSOR SIDNEY P. SIMPSON.¹

"It is clear that the stockholder's derivative suit is an absolutely necessary arm of equity jurisdiction and that, when used with justice and restraint, it has both public and private value."

RALPH M. CARSON, ESQ.²

"It must be remembered that [the stockholder's derivative suit] is, at present, the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations."

JUDGE BERNARD L. SHIENTAG.³

These considered judgments of distinguished scholar, counsel and jurist, respectively, serve to emphasize the importance of the stockholder's derivative suit as the means evolved in the Anglo-American legal system to provide legal protection for the interests of all who invest in corporate shares.⁴ Similarly, the increasingly dominant position that publicly held stock corporations have come to occupy in every phase of modern economic life⁵ underscores the "public and private

† Member of the New York Bar.
4. The form of action is a little over a century old, stemming from Hichens v. Congreve, 4 Russ. 562, 38 Eng. Rep. R. 917 (Ch. 1828); the next case appears to be Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. R. 189 (Ch. 1843).
5. In 1909 the 200 largest non-financial corporations held 33½% of the assets of all non-financial corporations. By 1933 the physical assets of these "200" corporations comprised one-half of the total industrial wealth of this country and represented one-fifth of the entire wealth. NAT. RESOURCES COU., THE STRUCTURE OF THE AMERICAN ECONOMY (1939) pt. I, pp. 106–7.

The classic study of the "200" corporations is BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). The dissent of Mr. Justice Brandeis, concurred in by Mr., now Chief, Justice Stone, in Liggett v. Lee, 288 U. S. 517, 541 (1933), contains an
value" of the stockholder's derivative suit. Obviously, therefore, legislation or decisions which affect the conditions under which this protective device may be utilized are matters of great significance not only to corporate managements and their cestuis que trustent, the stockholders of whose funds and assets they are fiduciary guardians, but to the community at large. The law of New York is of particular importance because of the position of that state as a financial and commercial center from which the affairs of innumerable corporations are directed and because the maintenance of derivative suits requires jurisdiction over the corporations on whose behalf the suits are brought as well as over the individual defendants.  

It is for these reasons that a New York statute, Section 61-b of the General Corporation Law, enacted early in 1944 under the innocuous title of "Security for Expenses" but also providing in a circuitous

important collection of material on this subject. See also Twentieth Century Fund, Big Business, Its Growth and Its Place (1937).

6. For a discussion of these jurisdictional problems and the proposals of the New York Law Revision Commission with respect to them, see Note (1941) 41 Col. L. Rev. 548.

7. N. Y. Laws 1944, c. 668, effective April 9, 1944, adding a new subdivision to Section 61 of the New York General Corporation Law. The statute reads:

"Sec. 61-b. Security for expenses. In any action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five per centum of the outstanding shares of any class of such corporation's stock or voting trust certificates, unless the shares or voting trust certificates held by such holder or holders have a market 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 it may become subject to which it may become subject pursuant to section sixty-one-a of this chapter, to which the corporation shall have recourse in such amount as the court having jurisdiction 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 is excessive."

A companion statute passed at the same time changed the New York common law rule of Pollitz v. Gould, 202 N. Y. 11, 94 N. E. 1038 (1911), that a stockholder need not have owned his shares at the time the wrong complained of occurred, and imposed such a requirement. N. Y. Laws 1944, c. 667, adding the following paragraph to Section 61 of the General Corporation Law:

"In any action brought by a shareholder in the right of a foreign or domestic corporation it must be made to appear that he was a stockholder at the time the transaction of which he complains or that his stock thereafter devolved upon him by operation of law."

Although this statute is of obvious importance in relation to the matters discussed herein, limitations of space prevent discussion of the constitutional questions presented by it. Several lower New York courts have, however, already sustained the constitutionality of this statute and have even applied it retroactively. Coane v. American Distilling Co., 182 Misc. 926, 49 N. Y. S. (2d) 538 (Sup. Ct. 1944); Klum v. Clinton Trust Co., 183 Misc. 340, 48 N. Y. S. (2d) 267 (Sup. Ct. 1944). Contra: Noel Associates, Inc. v. Merrill, 53 N. Y. S. (2d) 143 (Sup. Ct. 1944).
fashion for the imposition of unprecedented liabilities, merits careful consideration on the part of the general public and especially the average, usually small, stockholding American investor.\footnote{See infra, pp. 367–70.} Several years before, without the benefit of any hearings or study by the New York Legislature, by the Law Revision Commission, or by any other public body, a related statute, Section 61-a of the General Corporation Law, had been enacted.\footnote{N. Y. Laws 1941, c. 350, effective April 14, 1941, adding a new subdivision “a” to Section 61 of the General Corporation Law: “In any action, suit or proceeding against one or more officers or directors, or former officers or directors, of a corporation, domestic or foreign, brought by the corporation, or brought in its behalf by a receiver or trustee or by one or more stockholders or creditors or officers or directors of such corporation, and whether brought under the provisions of this article or otherwise, the reasonable expenses, including attorneys fees, of any party plaintiff or party defendant incurred in connection with the successful prosecution or defense of such action, suit or proceeding shall be assessed upon the corporation; or, if any such party or parties shall be successful in part only, or if such action, suit or proceeding shall be settled with the approval of the court having jurisdiction thereof, the reasonable expenses, including attorneys fees, of any or all such parties shall be assessed upon the corporation in such amount as such court shall determine and find to be reasonable in the circumstances; and the amount of all such expenses so assessed shall be awarded as special costs of the action, suit or proceeding and recoverable in the same manner as statutory taxable costs.”} It imposed upon corporations on whose behalf derivative suits are brought a liability for the defendants’ “reasonable expenses, including attorneys fees” in the event that the defendants are successful in whole or in part. No corresponding liability, however, was imposed on the defendants for the reasonable counsel fees of the corporation or its plaintiff-protectors in the event that the latter achieve a measure of success in their prosecution of claims on behalf of all the stockholders.

Although writers of all shades of opinion have leveled severe criticism
at Section 61-a on grounds both of its poor draftsmanship and of public policy, and though its constitutionality has not been authoritatively passed upon, no legislative steps have been taken to meet these criticisms. To the contrary, the New York Legislature has enacted Section 61-b to impose the same liabilities upon the plaintiff-stockholder if he happens to own either less than 5% of any outstanding class of stock or voting certificate or stockholdings with a market value of less than $50,000. The mechanics of the statute are as follows: first, it requires the small stockholder to furnish, whenever the nominal defendant corporation so requests of the court, sufficient security to cover any liability for the defendants' reasonable expenses, including attorneys' fees, that might be assessed against the corporation under the provisions of Section 61-a; secondly, the court upon the termination of the action may resort to the security required to be posted by the small stockholder to pay the defendants' expenses, including reasonable attorneys' fees. The obvious effect of these provisions is succinctly summarized by these words of one New York judge: "It would be denying the obvious to deny that the dire effect of the statute—if not the deliberate purpose of it—is to bar many stockholders' actions by making them excessively costly and difficult."

The extreme importance of Section 61-b to all American investors is emphasized by two of its additional aspects. First, it is not limited in its application to suits involving New York corporations, but by its express terms affects the rights of the small stockholders of foreign corporations in the event that they should seek to invoke the protection of the derivative suit in New York State. Indeed, all the cases to date


Legislation designed to cure the poor draftsmanship of Sections 61-a and 27-a has been recommended by the Law Revision Commission after a comprehensive study of the subject. See Recommendation of the Law Revision Commission Relating to Reimbursement of Litigation Expenses of Corporate Officials, submitted in conjunction with S. I. 122 and A. I. 183, Jan. 13, 1945. The complete study of the Law Revision Commission, Legis. Doc. No. 65E, has not yet been printed. In its recommendations, however, the Commission states that it did not seek to deal with questions of policy, but that the proposed legislation was merely "designed to make the two statutes consistent so far as possible."


14. Thus, the opening sentence of the statute commences: "In any action instituted or maintained in the right of any foreign or domestic corporation . . . . " N. Y. Gen. Corp. Law § 61-b. For the entire text of the statute see note 7 supra.
wherein the statute has been invoked have involved foreign corporations and the rights of their small stockholders.\(^1\) Secondly, in all likelihood the statute will be deemed applicable not only to state court actions but, under \textit{Erie Railroad v. Tompkins},\(^2\) to those derivative suits brought in the federal courts located in New York in which federal jurisdiction is predicated upon diversity of citizenship.\(^3\) Its sponsor, the New York Chamber of Commerce,\(^4\) specifically intended it to apply to federal court actions on the ground that it affected “substantive rights,”\(^5\) and that it does can hardly be denied. Particularly is this true in view of the realistic interpretation which the Supreme Court of the United States has given the words “substantive rights” in its rigorous application of the \textit{Erie} doctrine.\(^6\) Indeed, even a decade before the \textit{Erie} decision, the Supreme Court recognized that a state statute imposing liability for reasonable attorneys’ fees was not a matter affecting merely procedure, although the liability was denominated in the statute as “costs,” but one dealing with substance and therefore applicable to a federal court suit.\(^7\)

\(^{15}\) See cases cited infra note 23.

\(^{16}\) 304 U. S. 64 (1938). For two valuable discussions on the background and significance of this far-reaching decision see McCormick and Hewins, \textit{The Collapse of “General” Law in the Federal Courts} (1938) 33 ILL. L. REV. 126; Note (1938) 47 YALE L. J. 1336.


\(^{18}\) It is the author’s view that the doctrine of \textit{Erie v. Tompkins} is applicable only where the basis of federal jurisdiction is mere diversity of citizenship and that it has no application to actions where the federal court’s jurisdiction is predicated upon other grounds. If this view is correct, Section 61-b would not be applicable to cases like Goldstein v. Groesbeck, 142 F. (2d) 422 (C. C. A. 2d, 1944), cert. denied, 65 S. Ct. 36 (U. S. 1944) (double derivative stockholder’s suit based upon violation of Public Utility Holding Company Act).

\(^{19}\) See infra, pp. 359–60.

\(^{20}\) For discussion of the cases involving the distinction between “substance” and “procedure” under the \textit{Erie} case, see Notes (1941) 41 COL. L. REV. 104, (1943) 43 COL. L. REV. 836, 856, 867, 906–7.

\(^{21}\) In \textit{Sioux County v. National Surety Co.}, 276 U. S. 238, 243–4 (1928), involving a Nebraska statute imposing liability on insurance companies for reasonable attorneys’ fees in the event of a successful suit on a policy by the beneficiary thereof, Mr., now Chief, Justice Stone declared that “whether this liability for an attorney’s fee . . . may be enforced in the federal courts does not depend on any nice distinctions which may be taken between the right created and the remedy given. \textit{Disregarding mere matters of form, it is the policy of the state to allow plaintiffs to recover an attorney’s fee in certain cases, and it has made that policy effective by making the allowance of the fee mandatory on its courts in those cases. It would be at least anomalous if this policy could be thwarted and the right so plainly given destroyed by removal of the case to the federal courts.}
Obviously, therefore, Section 61-b because of its nature and broad application raises fundamental social, economic and political questions. Surprisingly enough, however, there has been little discussion of the vital issues of constitutional law involved although a number of lower New York courts have already ruled upon its constitutionality and one of these cases is now pending for decision before the New York Court of Appeals. Whether or not the Court of Appeals chooses to pass upon the constitutional questions in that particular action, it seems far more than probable that owing to the importance of the statute, the issue of constitutionality will be presented repeatedly to

"That the statute directs the allowance, which is made to plaintiff, to be added to the judgment as costs are added does not make it costs in the ordinary sense of the traditional, arbitrary and small fees of court officers, attorneys' docket fees and the like, allowed to counsel by R. S. §§ 823, 824.

"The present allowance, since it is not costs in the ordinary sense, is not within the field of costs legislation covered by R. S. §§ 823, 824." (Emphasis supplied.) See also Sacramento Municipal Util. Dist. v. Pacific Gas & Elect. Co., 20 Cal. (2d) 684, 128 P. (2d) 529 (1942), cert. denied, 318 U. S. 759, discussed infra, note 126.


Shielcrawt v. Moffett, 51 N. Y. S. (2d) 188 (App. Div., 1st Dep't, 1944), affirmed 3-2 the decision of Judge Collins, 49 N. Y. S. (2d) 64 (Sup. Ct. 1944), sustaining the constitutionality of the statute. Although the majority wrote no opinion, two judges dissenting on the ground that since the statute as a matter of construction and constitutional law was not retroactive, it did not apply to pending actions like the Shielcrawt case, and therefore there was no need to decide the constitutionality per se of Section 61-b. Wolf v. Atlantic, 182 Misc. 675, 49 N. Y. S. (2d) 703 (Sup. Ct. 1944); Mann v. Luke, N. Y. L. J., Nov. 10, 1944, p. 1244, col. 4 (N. Y. Sup. Ct.), sustained the constitutionality of the statute on the authority of Shielcrawt v. Moffett, supra. Contra: Citron v. Mangel Stores Corp., 50 N. Y. S. (2d) 416 (Sup. Ct. 1944), holding the statute unconstitutional as a violation of the due process and equal protection clauses of the Fourteenth Amendment of the United States Constitution. This decision has an interesting background. At the time the corporation made its motion for security under Section 61-b, the defendant-directors and officers moved to dismiss the complaint; the latter motion was granted by Judge Schreiher on the grounds (a) that the complaint failed to show damage to the corporation as a result of the complained-of acts, and (b) that the complaint related to matters concerning the internal management of a foreign corporation which was deemed to be a subject over which the New York courts would not take jurisdiction. Citron v. Mangel Stores Corp., N. Y. L. J., Aug. 8, 1944, p. 245, col. 2 (N. Y. Sup. Ct.). Subsequently, Judge Koch handed down his decision in the Citron case, 50 N. Y. S. (2d) 416 (Sup. Ct. 1944), denying the corporation's motion for security because of Section 61-b's unconstitutionality. In view of the prior decision dismissing the complaint, no order was entered upon Judge Koch's decision, and it has become a moot question in the case because, after its rendition, the Appellate Division sustained without opinion the dismissal of the complaint, 268 App. Div. 905, 51 N. Y. S. (2d) 754 (1st Dep't, 1944), and later denied leave to appeal the question to the Court of Appeals. 52 N. Y. S. (2d) 579 (App. Div., 1st Dep't, 1944). Finally, that court declined to grant leave to bring the dismissal of the complaint before it. N. Y. L. J., Jan. 13, 1945, p. 168, col. 3 (N. Y. Ct. App.).

the New York courts, or to the federal courts sitting in New York, until there is a conclusive decision by the Supreme Court of the United States.

This article is devoted to a consideration of the fundamental questions of constitutional law raised by Section 61-b. The resolution of constitutional law problems, however, does not turn upon a mere mechanistic matching of the language of the enactment in question with that of the constitutional provisions invoked, but, as the late Mr. Justice Brandeis repeatedly emphasized:

"The determination of these questions involves an enquiry into facts. Unless we know the facts on which the legislators may have acted, we cannot properly decide whether they were (or whether their measures are) unreasonable, arbitrary or capricious. Knowledge is essential to understanding; and understanding should precede judging." 26

In keeping with these premises, the Supreme Court has reiterated the undesirability of deciding the constitutionality of statutes in vacuo without having before it, either by way of judicial notice or factual findings, "adequate findings of fact in relation to controlling economic conditions." Indeed, the Court, when it has felt it could not take judicial notice of the social and economic conditions involved, has reversed lower court decisions ruling upon the constitutionality of statutes because of an absence of social and economic data with which the statutes in question were interrelated, and has directed the lower courts to make their constitutional rulings only after they have made such factual findings. 28

25. Chief Justice Marshall is the father of the theory that constitutional questions should be decided by a comparison of the words of the statute with the specific constitutional provision involved. See Marbury v. Madison, 1 Cranch 137, 177-9 (U. S. 1803). The Supreme Court, however, has long since departed from such a mechanistic method of deciding these issues. For discussion of recent trends in the decisions of the United States Supreme Court and the approach of that tribunal see Pekelis, The Case for a Jurisprudence of Welfare (1944) 11 Social Research 312.


27. Chief Justice Hughes in Borden's Farm Products Co. v. Baldwin, 293 U. S. 194, 211 (1934). Similarly, the concurring opinion of Justices Stone and Cardozo reflects what is undoubtedly the Court's position today on the importance of the relevant social and economic facts in the resolution of constitutional law questions: "We are in accord with the view that it is inexpedient to determine grave constitutional questions upon a demurrer to a complaint, or upon an equivalent motion, if there is a reasonable likelihood that the production of evidence will make the answer to the question clearer." Id. at 213.

28. See, e.g., Borden's Farm Products Co. v. Baldwin, 293 U. S. 194 (1934). Subsequently, after the lower court had made appropriate factual findings, the Supreme Court affirmed its decision. Borden's Farm Products Co. v. Ten Eyck, 297 U. S. 251 (1936); see also Polk Co. v. Glover, 305 U. S. 5, 10 (1938). In Gibbs v. Buck, 307 U. S. 66, 77 (1939),
It is therefore essential to a consideration of the constitutional law problems raised by Section 61-b to consider the economic and social patterns of which it must be viewed as an integral part, including "the genesis of the statute, the evils it seeks to rectify, the conditions which inspired it, and its effect." 29 Such an analysis is especially requisite because it is the presumption of factual support for the legislation involved that underlies the often-invoked doctrine of presumptive constitutionality 30 upon which the leading case, Shielcrawtv. Moffett, 31 sustaining Section 61-b's constitutionality, has so heavily relied.

THE FACTUAL BACKGROUND OF SECTION 61-B. 32

Origin and Legislative History of Section 61-b. Section 61-b did not originate with the Law Revision Commission or the Judicial Council of the State of New York, and, indeed, their opinion was not even requested. Nor was the statute one proposed by any bar association. Admittedly it is identical, except in one respect, 33 with one recom-
mended by the New York Chamber of Commerce, and it was introduced in the state legislature simultaneously with the public release of the Chamber's proposed act and Report of its Special Committee on Corporate Litigation, dealing with stockholder suits and issued after a privately conducted study of more than a year.

No hearings of any character were conducted by the legislature, and it was hurriedly passed in the closing days of the legislative session with the scantiest of debate. Every bar group that had an opportunity to express an opinion about the Act before its signature by the Governor, including the Committee on State Legislation of the New York County Lawyers Association, the Federal Bar Association of New York, New Jersey and Connecticut, and the Law Reform Committee of the New York City Chapter of the National Lawyers Guild, condemned the statute as undesirable. Strong objection to the legislation was made by the non-partisan Citizens Union of New York City and by the American Investors Union, a non-profit organization devoted to the protection of the interests of the American investor, and both the AFL and CIO issued statements expressing disapproval. Many of these groups joined numerous individuals in requesting the legislature and the governor of New York to hold hearings before enacting the measure into law, but none was held.

Thus Section 61-b was enacted without the legislative or gubernatorial investigation into the facts that has so often led the Supreme Court of the United States to sustain statutes as a presumptively reasonable exercise of legislative power.

34. "The New York State Chamber of Commerce ... is not in fact a state chamber at all and is indeed entirely different from most chambers of commerce. It is strictly a New York organization composed very largely of extremely conservative corporation and financial interests of that City." Communication from the Springfield, Illinois, Chamber of Commerce to the editor of FORBES MAGAZINE and printed in its issue of May 15, 1944, at 10; quoted by Jackson, supra note 22, at 337, n. 76.

35. REPORT, op. cit. supra note 19.

36. "The chief document in the winter drive for the new law was a detailed study of stockholders' derivative actions by the New York State Chamber of Commerce... Political strings apparently had been pulled in Albany, for the publication of the Report was followed almost immediately by the introduction of a bill, and it became law before important opposition could develop." Crane, N. Y. Times, Sept. 10, 1944, § 5, p. 5, col. 8.


38. PM, March 12, 1944, p. 12, col. 1; PM, April 4, 1944, p. 11, col. 1; N. Y. Evening Post, April 12, 1944, p. 29, col. 1; YOUR INVESTMENTS (Am. Investors Union) April 1944, pp. 29-30, 32-3.

39. See, e.g., Nebbia v. New York, 291 U. S. 502, 515 (1934), where Mr. Justice Roberts, in speaking for a majority of the Court, stated that "we first inquire as to the occasion for the legislation and its history." After a review in great detail of the factual conditions, he continued with a painstaking analysis of the legislative history, pointing out the extensive public hearings conducted by a joint legislative committee and the character of the evidence there adduced. He then referred to the joint legislative committee's report based upon these hearings, stating "that the conscientious efforts and thoroughness exhibited by the report
Abuses of the Stockholder's Suit Assertedly Justifying Section 61-b.

The Report of the New York Chamber of Commerce drew as its fundamental conclusion that stockholders' derivative suits do not justify their cost in time and money to the stockholders of corporations or to the state. The following statistics on derivative actions brought during the decade 1932–1942 in the Supreme Court of New York and Kings Counties and in the Federal Court for the Southern District of New York are the main evidence upon which the recommendations of the Report of the Chamber of Commerce are predicated:

"Analysis of the 1400 minority stockholders' actions . . . , which total with duplicating actions eliminated is reduced to 1266, shows that of this number, 693 involved so-called privately or closely held corporations and that 573 involved publicly held corporations. Out of the 693 actions involving closely held corporations, recoveries were had in 32 cases, or 5%, settlements were made in 194 cases, or 28%, 122 cases or 18% were dismissed, and the remainder were discontinued or show no record disposition. Out of the 573 actions involving publicly held corporations, recoveries were had in 13 cases or 2%, settlements were made in 33 cases with court approval, or 6%, and 215 cases or 37% were dismissed. Of the remainder, 60 cases or 10% were settled privately, 155 or 27% were discontinued (15 of these known to have been discontinued with no payment), 54 are pending and 43 show no record disposition." 40

Taking these very figures, as well as others presented in the Report, it may be shown that on their own grounds they afford no justification for the conclusions of the Report. First, since the Report discloses that in New York County during the ten-year period involved there were some 421,417 suits of all types filed, only 1,128, or .27%, were suits brought by stockholders; in Kings County, 41 out of 86,840 suits, only 142, or .16%, were litigations of this character; and in the United States District Court for the Southern District of New York only 130 suits of this type were instituted, no figures being given for the total number of actions filed. 42 Certainly these figures fail to support any thesis that minority stockholder suits have constituted an undue burden upon the courts.

Secondly, "if we include in recoveries not only judgments after trial, or on court-approved settlements, but also all other settlements, the

Jend weight to the committee's conclusions." Id. at 516. Only after thus reviewing the factual material which the legislature considered in passing the legislation did he conclude that where the legislation has a "reasonable relation to a proper legislative purpose, the requirements of the Constitution are satisfied." Id. at 537.

40. REPORT, op. cit. supra note 19, at 6.
41. This covers only 1938–1942, which are the only years for which figures are given in the Report.
42. REPORT, op. cit. supra note 19, at 3–4.
figures for recoveries in suits involving publicly held corporations would go up to 31½ per cent. This figure is reached by adding to the 8 per cent previously noted, a figure of 10 per cent for 'settlements' without court approval, and half of the 27 per cent total of 'discontinued' cases, [since] the Report, at 33, indicates that as many as 50 per cent of the discontinuances may represent private settlements."

Thirdly, since only a small percentage of any type of litigation reaches the stage of actual trial,44 and since it is not possible to tell with complete accuracy whether or not "settlements" were made or the exact reasons for discontinuances, it would seem more proper in evaluating the results of derivative suits to consider the figures for the number of suits in which issue was joined and thereafter either the plaintiff or defendant was successful, eliminating all actions that were discontinued. Applying this method of analysis to the Report's figures, "we find 171 cases in which issues were joined. Out of this number there were 13 recoveries and 93 settlements, while only 65 suits were won by the defendants. In other words, 106 out of 171 suits were won by stockholders, or 62 per cent of the cases involved." 46 Furthermore, it is difficult to express any views about the number of cases in which the defendants secured dismissal of the actions because the Report fails to give any clue as to the bases upon which the suits were adversely terminated to the plaintiff, i.e., whether on the merits or on technical grounds.

Nor do the figures of the assertedly low number of judgments and settlements that were recovered by stockholders for their corporations give an accurate basis of conclusion. Attention must be called to the fact that almost all the judgments and settlements involved recoveries of hundreds of thousands of dollars and, in many instances, of millions.40

44. The eminent former New York Supreme Court Judge Philip McCook has stated that a study of all litigation instituted in the Supreme Court, New York County, disclosed that of all such suits, including commercial and tort actions of all kinds, less than 5% over reached trial. Cited in Hornstein, supra note 22, at 127, n. 12.
45. YOUR INVESTMENTS (Am. Investors Union) March 1944, p. 27.
46. Among these may be mentioned: Bysheim v. Miranda, 44 N. Y. S. (2d) 15 (Sup. Ct. 1943) (settlement resulting in estimated benefits of $1,800,000 upon trial of action instituted by new board of directors, approved by the Government, on charges originally made by plaintiff-stockholders); Winkelman v. General Motors Corp., 44 F. Supp. 960 (S. D. N. Y. 1942) (settlement of $4,000,000 after judgment); Heller v. Boylan, 29 N. Y. S. (2d) 653 (Sup. Ct. 1941), aff'd mem., 263 App. Div. 815, 32 N. Y. S. (2d) 131 (1st Dep't 1941) (settlement of $1,809,935 after decision on merits by trial court); Chelrob, Inc. v. Barrett, 57 N. E. (2d) 825 (1944) (reversing an Appellate Division decision, 265 App. Div. 455, 39 N. Y. S. (2d) 625 (2d Dept' 1943), which dismissed the complaint in an action in which the Supreme Court had awarded a recovery of more than $350,000); Litwin v. Allen, 25 N. Y. S. (2d) 667 (Sup. Ct. 1940) (settlement of $750,000 after decision on the merits by trial court); Cwerdinski v. Bent, 256 App. Div. 612, 11 N. Y. S. (2d) 208 (1st Dept' 1939) (settlement of $1,105,821 in repayment of corporate funds and by defendants in securing private settle-
The Report seeks to minimize the importance of these recoveries by emphasizing that the consequent increase in the value of each share of stock in question was often no more than a few cents. This, however, rather than indicating the baselessness of the actions involved, merely reflects the large number of shares which most important corporations have outstanding in the hands of the public. Obviously, if there are millions of shares outstanding, even a recovery of millions of dollars will yield but a small increase in the value of each share; but this fact should not be permitted to obscure the large sums that have been recovered on behalf of all the shareholders. The failure of the stockholder's suit to provide complaining stockholders with sufficient personal incentive to make use of it as a remedy is one of its great weak-

ements during period prior to institution of action, after court ruled main action barred by statute of limitations); Gallin v. National City Bank, 155 Misc. 880, 281 N. Y. Supp. 795 (Sup. Ct. 1935) (judgment of $1,844,642.21 after special master had taken testimony). For a more complete tabulation of settlements, see Hornstein, The Counsel Fee in Stockholder's Derivative Suits (1939) 39 Col. L. Rev. 784, 814; Hornstein, Problems of Procedure in Stockholder's Derivative Suits (1942) 42 Col. L. Rev. 574, 587 (bringing the earlier list up to date). Among the more important of these recoveries in minority stockholders' derivative actions outside of New York are Fleishhacker v. Blum, 109 F. (2d) 543 (C. C. A. 9th, 1940), cert. denied, 311 U. S. 665 (1940) (judgment after trial of $736,485.57); Overfield v. Panroad Corp. (proposed settlement of $15,000,000 after Third Circuit Court of Appeals by a 2-1 vote had reversed, solely on the grounds of the statute of limitations, a judgment, after trial, of approximately $23,000,000), N. Y. Times, March 2, 1945, p. 25, col. 5; Mann v. Hearst (unreported decision of Cal. Super. Ct., 1941) (judgment of $5,022,258.89).

This article represents solely the work, judgment and views of the author as an individual. The firm of which the author is a member, has acted as counsel for the plaintiff in a number of the above mentioned cases. It has likewise acted to a lesser extent as counsel for corporate and individual defendants in derivative suits.

Even the record of actions instituted does not afford an adequate picture of the extent to which corporate fiduciaries have in fact failed to fulfill their responsibilities to their stockholders. An SEC study, dealing only with investment trusts, reveals that of seven billion dollars invested by the public between 1 and 1 1/2 billion dollars were lost within a period of ten years "due to a management acting for its own interests either in bad faith or with wanton disregard of the rights of investors." Testimony of L. M. C. Smith, Associate Counsel, Hearings before a Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong., 3rd Sess. (1940) 788. See also id. at 796, 799, 803. The study was printed as H. R. Doc. No. 279, 76th Cong., 1st Sess. (1939).

See also the earlier Congressional investigations, such as the Pecora Investigation (1932–1934), Hearings before Committee on Banking and Currency on S. 34, 72nd Cong. Sess. (1932–1933) and Hearings on S. 56 and S. 97, 73rd Cong. (1933–1934); and the Wheeler Investigation of Railroads, Holding Companies and Affiliated Companies, Hearings before the Committee on Interstate Commerce on S. R. 71, 74th Cong., 1st Sess. (1935). 47. REPORT, op. cit. supra note 19, at 49–54.

48. GOLDSMITH AND FARMALEE, TNEC REP., DISTRIBUTION OF OWNERSHIP IN THE 200 LARGEST NONFINANCIAL CORPORATIONS, Monograph 29 (1940), show that these corporations rarely have less than half a million outstanding shares, and often many millions of such shares. "Basic Statistical Data on Each of 408 Equity Security Issues in 200 Largest Nonfinancial Corporations" is given in id. at 206.

49. See infra, pp. 367–8.
nesses, but it is anomalous that a weakness should be used as a justification for practical abolition of this means of relief without substituting another more efficient in its place.

Not only does the Report fail to call proper attention to these aspects of its cited figures, but it wholly misstates the nature of the actions wherein judgments and settlements were obtained by saying that "in none of them has bad faith or actual fraud on the part of the management been found or suggested." The complete falsity of this general characterization of the actions involved has been indicated by Hornstein, and it would serve no purpose to rediscuss here the issues in these litigations.

Apart from the substantial recoveries secured by small stockholders for the benefit of their corporations, the availability of the minority stockholder's suit has undoubtedly been in many instances a deterrent to the abuse of fiduciary powers by officers and directors, who themselves often have no substantial financial interest in the corporations under their administration. This specific point was recently made by a federal judge with wide experience in corporate matters:

"The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to management and outsiders. Corporate attorneys now have an arsenal of authorities to support their cautioning advice to clients who may be disposed to risk evasion of the high standard the courts have imposed upon directors." 54

Similar views were expressed by the Citizens Union of the City of New York in disapproving Section 61-b: "In spite of abuses, minority stockholders' suits have been an effective means of holding large corporations

50. Jackson, supra note 22, at 340, suggests remedying this defect by giving to shareholders instrumental in procuring a recovery for all stockholders some personal interest in the amount obtained.

51. REPORT, op. cit. supra note 19, at 10.


53. A TNEC study of the distribution of stockholders in the 200 largest non-financial corporations of this country reveals that "The financial stake of officers and directors in their own corporation is relatively small. Officers and directors own 6% of the common stock and slightly over 2% of the preferred stock of the 200 corporations. One-half of the individual officers and directors own securities having a market value (as of September 30, 1939) of less than $20,000 each." GOLDSMITH AND PARMALEE, op. cit. supra note 48, at xvi.

in restraint and preventing them from wasting large sums of the stockholders' money for the benefit of a favorite few." 55

While there is a complete lack of any factual foundation for the Report's wholesale charges of groundless "strike" suits, it is far more significant that the statute proposed and enacted, Section 61-b, does not provide an effective means for their elimination—the principal justification urged for the enactment of the statute in both the Report and the Governor's message accompanying his signing of the bill. The provisions of the act dealing with the posting of security for the defendants' expenses, including reasonable attorneys' fees, apply regardless of whether the small stockholder has a reasonable or even meritorious claim. The large stockholder is not only wholly exempt from the requirement of posting security, but he is also exempt from liability for these expenses, imposed upon the small stockholder indirectly through the security device. Significantly, this exoneration from the requirement of security, and consequently from ultimate liability as well, is wholly unrelated to whether or not the large stockholder's claim is in fact shown to be baseless, groundless or prosecuted in bad faith. There is not the slightest evidence of any kind that the greater the value or extent of a plaintiff's stockholdings, the more justified his claim. As the court in Shielcrawt v. MoffsIt, 55 although sustaining the constitutionality of Section 61-b, has candidly stated:

"It has been thought that the holder of a few shares of stock might be more disastrously affected by waste and wrongdoing than would be the owner of many shares. Too, the grievance of one small stockholder may be as justifiable as the grievance of a hundred. Yet this assailed statute presupposes that an action initiated by a stockholder whose holdings have a market value in excess of $50,000, or who represents at least 5% of the outstanding shares, is more meritorious than an action brought by the holder of a few shares or shares of lesser value. The stockholder's access to the courts is thus made dependent on the magnitude of his till." 57

Apart from the general charge of the baselessness of derivative actions, three specific "evils" are commented upon in the Report. The

55. Quoted by Judge Collins in Shielcrawt v. Moffett, 49 N. Y. S. (2d) 64, 72 (Sup. Ct. 1944). The New York County Lawyers Association, in expressing its criticism of Section 61-b, stated: "New York State has long held leadership in matters financial and, conscious of their responsibilities, its courts long set a high standard in enforcement of fiduciary responsibility. Any reduction in these standards may have unpredictable long-range effects not pleasant to contemplate. We regard this bill as tending to prevent enforcement of these standards, and accordingly contrary to the public interests. It is accordingly, and for all the other reasons mentioned, disapproved." Quoted in Shielcrawt v. Moffett, Record on Appeal before N. Y. Court of Appeals, fols. 479-80.


57. Id. at 72.
first is the duplication of actions once a suit of this character is instituted. This abuse can
and should be eliminated, but Section 61-b has nothing whatever to do with its cure. In fact, the Report makes no recommendation of a method to deal with this problem. The second 
"evil" is the allowance of "extravagant" fees to attorneys and counsel for small stockholders. It is significant that although these charges are made, the Report again makes no recommendation with respect to the matter; certainly the statute does not obviate this alleged abuse. Moreover, it would seem that there is no true foundation in fact for the claim that excessive fees are awarded, since fees are predicated upon the amount of recovery inuring to the benefit of all the stockholders as the result of the attorney's efforts, as well as upon the amount of work done and the difficulties encountered in prosecuting the claim. In each instance it is the court which fixes the fair amount of the attorney's compensation.

The third "evil" mentioned is that of "private settlements to the detriment of the stockholders and the corporations involved." It is interesting to note the care with which the Report skims over this topic, making no recommendation for elimination of this genuine evil. Indeed, the Report itself points out that although the Law Revision Commission of New York in 1942 proposed a statute which would largely destroy the possibility of these private deals, "substantial opposition developed against this on the part of corporations and defendants' attorneys, and the legislature failed to pass the above section, which was modeled after Section 23(c) of the Federal Rules of Practice." Nor has Section 61-b the slightest relation to the obviation of these "private settlements," which have often enabled faithless fiduciaries to escape detection or accountability for illegal actions (by, for example, the lapse of the statute of limitations) except, of course, in so far as it effectually eliminates all stockholder suits. Although the Governor in signing the bill apparently acted under the

58. See, e.g., the recommendation of Hornstein, supra note 22, at 134.
59. For an analysis of the subject of counsel fees in derivative suits see Hornstein, The Counsel Fee in Stockholder's Derivative Suits (1939) 39 Col. L. Rev. 784.
60. REPORT, op. cit. supra note 19, at 89-90.

The SEC has revealed in part the extent of the practice of private settlements being paid for out of the corporate treasury and has vigorously denounced such settlements. See SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937) pt. I, 694-7.
misapprehension that it did outlaw such settlements. Section 61-b contains not a word that forbids or in any way deals with the specific problem of "secret settlements." As the financial editor of the New York Times has pointedly remarked: "The most significant criticism came from persons friendly to the purposes of the bill. These declared that the same end would be achieved without any doubt of constitutionality if the bill merely required that all stockholders' derivative suits be settled in court." 

Operation and Effect of Section 61-b. Does Section 61-b concern only the "strike suit" plaintiff or will any substantial number of stockholders in American corporations be affected by its terms? The simple answer to this fundamental question appears to be that the act will unquestionably affect the rights of an overwhelming majority of stockholders who seek to maintain derivative suits in New York.

A monographic study prepared for the Temporary National Economic Committee by the SEC, reveals the following data on the distribution of shareholdings in 1710 corporations having securities listed upon any national exchange, which were chosen for study because "compared to all domestic corporations, these 1,710 companies—only 2% per cent of the total number—accounted for more than half of the total shareholdings and somewhat over 40 per cent of the estimated value of all outstanding stocks." The stocks of these 1710 key corporations were found to be held in fourteen million record shareholdings, and, analyzing their distribution from the point of view of their value, the SEC found that 7,500,000 of these shareholdings, or 54%, had a value of $500 or less, that about 2,000,000 shareholdings, or 14.2%, had a value of between $501 to $1,000, and that about 3,000,000, or 22%, were valued at from $1,001 to $5,000, while less than 9% of the total shareholdings were valued in excess of $5,000. Furthermore, of this last and smallest group, only 4.5% had a value of from $5,001 to $10,000, and only 4% of the total number of shareholdings had a value in excess of...

62. "In recent years a veritable racket of baseless lawsuits accompanied by many unethical practices, has grown up in this field. Worse yet, many suits that were well based, have been brought not in the interest of the corporation or of its stockholders, but in order to obtain money for particular individuals who had no interest in the corporation or its stockholders. Secret settlements—really payoffs for silence—have been the subjects of common suspicion." Memorandum of Governor Thomas E. Dewey, quoted in Shielcratt v. Moffett, Record on Appeal before N. Y. Court of Appeals, fols. 126-7.


64. GRAMBY, TNEC REP., SURVEY OF SHAREHOLDINGS IN 1,710 CORPORATIONS WITH SECURITIES LISTED ON A NATIONAL SECURITIES EXCHANGE, Monograph 30 (1941).

65. Id. at 7 (emphasis supplied).
$10,000.66 The average value of all shareholdings was placed by the survey at $3,000.7 Thus, 90% of all shareholdings analyzed had a value of less than $5,000, and 96% had a value of less than $10,000.

These facts, therefore, seem to establish that Section 61-b, in so far as it requires the plaintiff-stockholder’s shares to have a market value of $50,000 or more before he can maintain a derivative action, will operate as a practical matter to deprive an estimated 96% of all shareholders in American corporations of their right to maintain derivative actions in New York. It may even take this right from as many as 98% of the shareholders since it seems likely that of the 4% of shareholdings valued in excess of $10,000, not more than half have a value in excess of $50,000. It should be evident from these figures that only the smallest minority of shareholders will be able to meet the requirement of Section 61-b that the plaintiff’s shareholdings have a value of $50,000 or more.

In an analysis of the distribution of shareholdings from the point of view of their size, the TNEC study shows that about 86% of the total shareholdings of common stocks and 93% of the total shareholdings of preferred stocks were distributed in lots of 100 shares or less.6 Since the number of shares outstanding ranges from several hundred thousand to many millions, it seems clear that the alternative requirement of Section 61-b, namely, that the plaintiff-stockholder’s shares constitute 5% of the outstanding stock, is one which the overwhelming majority of individual shareholders will be unable to meet.

Thus, Section 61-b sets up conditions that will affect the rights of most shareholders to maintain derivative actions. Furthermore, the generally wide distribution of shareholdings, the inertia of stockholders, and the expense involved in securing concerted action by an appreciable number of them make apparent the difficulties that would be encountered in securing joint action by a sufficient percentage of shareholders to make Section 61-b inapplicable. It would seem therefore that Governor Dewey’s statement in signing the bill, that a complaining stockholder should find it “easy enough to interest others, who do hold at least 5%, or stock valued at $50,000,” is basically
unsound. These practical obstacles are emphasized by a recent decision holding that the intervention by additional stockholders so as to make the aggregate value of the complaining shares $50,000 or more does not constitute compliance with the requirements of Section 61-b so that a stockholder must secure the joinder of other shareholders "before the action is brought, and not thereafter." 70

Upon consideration of the actual operation of the statute, it is found that, when required, the security must be sufficient to enable a court to meet any award that may be made to the defendants in reimbursement for their reasonable expenses including attorneys' fees. "It is not unusual nor would it be unreasonable for defendants in such actions to retain distinguished counsel. Stockholders' actions are ordinarily directed against several defendants, each of them entitled to counsel of his own choice. The anticipated aggregate charges of several prominent law firms for services in a protracted and intricate litigation are bound to be formidable." 71 Indeed, the amounts of security which the lower New York courts sustaining Section 61-b have required the stockholder to post have ranged from $5,000 to $50,000, and these amounts under the express terms of the statute may at any time be further increased by the court if it should deem them insufficient to provide a fund for the payment of such of the defendants' expenses as might be assessed pursuant to the provisions of Section 61-a. In other words, before a stockholder can secure a hearing on his claims, he may be confronted with the necessity of putting up many thousands of dollars, all or part of which he may forfeit in the event that the defendants are even partially successful, although their victory may be predicated upon, for example, the statute of limitations rather than upon the merits of the action. Furthermore, Section 61-b imposes not merely a requirement for security, but also, although its misleading title does not reveal it, 72 authorizes the court to resort to this security for the payment of the defendants' and corporation's expenses including reasonable attorneys' fees. Nor is this indirect manner of imposing liability


72. See note 23 supra.

73. See supra, p. 353.
upon the complaining stockholders one which is applicable only if the court finds bad faith or lack of reasonable basis for the prosecution of the claim. Although the courts may by interpretation place such a restriction upon the conditions under which resort to the security may be made, the statute contains no such express limitation.

More adequate comprehension of the oppressive character of Section 61-b may be obtained by demonstration of the burdens imposed by the statute in relation to the individual interest which stockholders have in derivative actions. Attention has already been called to the fact that the most important publicly held corporations generally have thousands of shares outstanding in the hands of the public, distributed so widely that the average shareholdings are small in both size and value, and that therefore the personal interest of any shareholder in a recovery is likely to be small. Obviously, therefore, the burdens which Section 61-b places upon the average shareholder will make it totally impractical for the average shareholder to maintain a derivative suit. The leading decision sustaining the constitutionality of Section 61-b,74 as well as the well reasoned dissenting opinion, are in accord that Section 61-b as a practical matter means the elimination of the right of small stockholders to maintain derivative suits. Although sustaining the act's constitutionality for reasons to be considered later, Judge Collins realistically declared in the Shielcrawt case:

"The defendant plausibly retorts that the statute does not impose a lethal sentence on stockholders' actions. All the plaintiffs have to do, defendant says, is to comply with the statute, whereupon they proceed. True. But there are many devious stratagems for denying a litigant his day in court. One circuitous but no less effective way to destroy a right is to make its enforcement burdensome. It would be denying the obvious to deny that the dire effect of the statute—if not the deliberate purpose of it—is to bar many stockholders' actions by making them excessively costly and difficult."75

Similarly, in declaring Section 61-b unconstitutional in Citron v. Mangel Stores Corporation,76 Judge Koch emphasized that "the remedy remaining if application is made under the statute and granted is or could be practically prohibitive and, therefore, no remedy."77

74. Shielcrawt v. Moffett, 49 N. Y. S. (2d) 64 (Sup. Ct. 1944).
75. Id. at 73. Similarly, the opinion of the dissenting justices in the Appellate Division, although predicated upon the view that the statute could not be retroactively applied to the situation in the Shielcrawt case, contains further substantiation of the views expressed by Mr. Justice Collins as to the effect of the statute. Thus, the dissent of Judge Callahan comments: "Common sense tells us that to require the posting of $25,000 as security for such expenses is, in effect, to deprive the owner of a small number of shares of his day in court."
76. 50 N. Y. S. (2d) 416 (Sup. Ct. 1944).
77. Id. at 419.
CONSTITUTIONALITY OF SECTION 61-B

The full and complete significance of the effect and operation of Section 61-b upon the rights of a large majority of American investors may be seen, however, only by viewing its effects in relation to the fact that "the stockholder's suit is, at present, the only practical way of permitting the small stockholders to question controlling stockholders and directors." In the case of large publicly held corporations with their widely dispersed ownership, it has long been recognized that "the privilege of voting is purely theoretical" as far as affording a means whereby the stockholders can secure the accountability of the management or dominating stockholders to the stockholders as a body. Berle and Means in their pioneer study of the modern corporation have succinctly summarized the position of the mass of stockholders:

"As his personal vote will count for little or nothing . . . , the stockholder is practically reduced to the alternative of not voting at all or else handing over his vote to individuals over whom he has no control and in whose selection he did not participate. In neither case will he be able to exercise any measure of control. Rather, control will tend to be in the hands of those who select the proxy committee by whom, in turn, the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own successors. Where ownership is sufficiently subdivided, the management can thus become a self-perpetuating body even though its share in the ownership is negligible." 89

The factual considerations here discussed should demonstrate the necessary "public and private" function which the derivative suit fulfills as a means of affording the average stockholder at least a slight measure of control over the acts of corporate managements and controlling

---

79. DEWING, THE FINANCIAL POLICY OF CORPORATIONS (2d ed. 1926) 628.
80. BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 86-8 (emphasis supplied). Similar views have been repeatedly expressed even in conservative financial circles. See, e.g., a recent article by Ralph Hendershot, Financial Editor of the New York World Telegram:

"Another basic weakness in the manner in which the free enterprise system has been interpreted by business leaders is the infringement on the rights of owners of our big industrial enterprises. . . . As most people realize, corporations are owned by common or capital stockholders. And, as most people also know, these stockholders have little or no voice in management, even though technically they have the right to vote. This is both undemocratic and unsound. To all intents and purposes, it places many corporate managements in the position of imposters. . . . The argument may be advanced that stockholders are interested only in dividends and, for the most part, are either too dumb or too uninterested to bother replying to requests for their views. Many people also have felt, and some still feel, that the general public should not be given the right to vote on political questions for the same reason. This is a democracy; remember?" N.Y. World Telegram, Dec. 7, 1944, p. 24, col. 2.
stockholders; its value as a potential sanction insures in some measure at least their personal honesty, their reasonable attention to the affairs of the corporation, and the fairness of their conduct with respect to all stockholders. That the remedy is cumbersome, inefficient, costly, and utterly inadequate to perform its functions,\textsuperscript{81} as well as one that has been abused by "strike-suitors," are facts that may not be questioned. Yet, until other methods of control and protection are substituted,\textsuperscript{82} drastic curtailment of the remedy's availability in the manner provided by Section 61-b means the complete disappearance of any equitable judicial check on fiduciaries to whom the public at large has entrusted tens of billions of dollars in assets.\textsuperscript{83} The inherent vice in Section 61-b is that it destroys the only means available to the overwhelming majority of stockholders in corporations with publicly distributed stock without giving them an alternative means of redress or control and leaving them as a practical matter without access to any judicial remedy for protection of their rights.

\textbf{CONSTITUTIONAL LAW AND SECTION 61-B}

The statute has been challenged as violative of both the due process and equal protection clauses of the Federal\textsuperscript{84} and New York State\textsuperscript{85} Constitutions. The lower New York courts' decisions are divided upon the fundamental question of whether Section 61-b violates either or

\begin{enumerate}
\item \textsuperscript{81} "Whether from this larger point of view the stockholder's derivative suit is still socially an uneconomical device for policing corporate management, it is difficult to estimate. That it is slow, cumbersome and expensive to all concerned, if the calculation is limited to the actual cases which reach the courts, cannot be doubted." Rifkind, J., in Brendle v. Smith, 46 F. Supp. 522, 526 (S. D. N. Y. 1942).

\item \textsuperscript{82} The difficulties confronting a stockholder seeking to maintain a derivative action are manifold; as one trial counsel in this field has remarked, there cannot be "the slightest hesitation in declaring that by far the most difficult and burdensome path in the field of corporate law is that which must be followed by the stockholder who seeks to invoke the only civil remedy available, the derivative suit." Podell, \textit{A Non-Bureaucratic Alternative to Minority Stockholders' Suits: A Third Viewpoint} (1943) 43 Col. L. Rev. 1045, 1047.

\item \textsuperscript{83} It is for these reasons that former New York Supreme Court Judge Rosenman recommended that the stockholders derivative suit "should be favorably evaluated by the courts: (a) as a protection to stockholders and investors; (b) as a deterrent to negligent or unscrupulous directors; (c) as a promotion of confidence for future investment in corporate securities; (d) as a means to make directors direct." Rosenman, \textit{supra} note 78, at p. 1 of mimeographed outline of remarks.

\item \textsuperscript{84} U. S. Const. Amend. XIV, § 1.

\item \textsuperscript{85} N. Y. Const. Art. I, § 6.
\end{enumerate}
both of these constitutional guaranties. One case, *Shielcrawl v. Moffett, 53* has sustained the statute's constitutionality. The same result was also reached in *Wolf v. Atkinson 57* and *Mann v. Luke 58* primarily upon the authority of the *Shielcrawl* decision. A contrary ruling declaring the statute unconstitutional under both the due process and equal protection provisions has been rendered in the case of *Citron v. Mangel Stores Corporation.* 59

Before a detailed analysis can be made of the constitutional questions considered in these various cases and the judicial techniques employed in their resolution, it is essential first to differentiate between the due process and equal protection objections to Section 61-b. The necessity for making this distinction has been well stated by former Chief Justice Taft:

"It is customary to consider them together. It may be that they overlap, that a violation of one may involve at times the violation of the other, but the spheres of the protection they offer are not co-terminous." 90

An analysis of whether the statute violates the due process guaranty must be concerned with the manner in which the act in question operates and its effect in relation to the scope of legislative power; consideration must also be given the various subject matters over which a legislative body has power and the extent of its authority with respect to each of these subjects. On the other hand, resolution of the equal protection question necessarily involves the validity of the classification and differentiation embodied in the statute.

*The Due Process Clause Objection.* It has been a fundamental American tradition "that every man has an inalienable right to go to law." 91 It was in keeping with this fundamental principle that the Supreme Court of the United States, when giving basic substantive content to the due process clause of the Fourteenth Amendment, declared that one of the positive rights assured by that constitutional guaranty was "access to the courts of the country for the protection of . . . persons and property, the prevention and redress of wrongs. . . ." 92 The Court has been rigorous in its insistence that there be no direct or indirect denial of the right of access to legal processes for the protection

---

86. 49 N. Y. S. (2d) 64 (Sup. Ct. 1944).
87. 182 Misc. 675, 49 N. Y. S. (2d) 703 (Sup. Ct. 1944).
89. 50 N. Y. S. (2d) 416 (Sup. Ct. 1944), aff'd mem., 268 App. Div. 905, 51 N. Y. S. (2d) 754 (1st Dep't 1944).
91. Note (1940) 49 Yale L. J. 699, 703. This Note contains material from a comparative law point of view upon the question of the imposition of attorneys' fees upon litigants.
of rights and the adjudication of disputes with respect to them. Neither the presumption of the constitutionality of legislation nor judicial reluctance to interfere with legislative judgment on the reasonableness of enactments has deterred the Supreme Court from declaring unconstitutional legislation which it has deemed violative of these basic tenets of the due process clause. An opinion by the late Mr. Justice Brandeis in a case in which judicial interpretation of a statute was deemed to have deprived a party of all legal remedy for the protection of his property illustrates the basic constitutional principles which are germane:

"While it is for the state courts to determine the adjective as well as the substantive law of the State, they must, in so doing, accord the parties due process of law. Whether acting through its judiciary or through its legislature, a State may not deprive a person of all existing remedies for the enforcement of a right, which the State has no power to destroy, unless there is, or was, afforded to him some real opportunity to protect it." 

When these premises are applied to the facts which the courts have already found with respect to the effect of Section 61-b—that it will deprive a great majority of stockholders of the only available judicial remedy for the protection of their rights,—the unconstitutionality of the statute under the due process clause would appear patent. It may not seriously be contended that the New York legislature has the power completely to destroy the right of a majority of all stockholders to question the honesty or fairness of the conduct of a corporate management in handling the assets entrusted to them, unless an adequate alternative remedy is provided to perform the protective and remedial

93. See cases cited infra notes 94, 109, 114, 121.
94. Brinkerhoff-Faris Trust & Savings Co. v. Hill, 281 U. S. 673, 682 (1930). "We do not think it is competent for the legislature to deny, for any cause, to a party who has been illegally deprived of his property, access to the constitutional courts of the State for relief." Gilman v. Tucker, 128 N. Y. 190, 202, 28 N. E. 1040 (1891). See also Gibbs v. Zimmerman, 290 U. S. 326, 332 (1933); New York Central R. R. v. White, 243 U. S. 188, 201 (1917). Nor do cases like Fearon v. Treanor, 272 N. Y. 268, 5 N. E. (2d) 815 (1936) or Hanfgarn v. Mark, 274 N. Y. 22, 8 N. E. (2d) 47 (1937) (sustaining the constitutionality of certain aspects of the New York statute abolishing actions for breach of promise) constitute authority in favor of the constitutionality of Section 61-b. Those cases, as the Court of Appeals was very careful to point out, turned expressly "upon the broad ground that the Legislature, in dealing with the subject of marriage, has plenary power, as marriage differs from ordinary common law contracts and is subject to control and regulation by the state." Hanfgarn v. Mark, 274 N. Y. 22, 24, 8 N. E. (2d) 47 (1937). Indeed, Hubbs, J., writing for the court, concluded his opinion with these remarks: "It is suggested that if the Legislature has authority to abolish the action for alienation of affections, it may also lawfully abolish actions for libel, slander, and other actions, and that a decision holding the statute in question valid will be so construed. . . . The decision now made should not be so construed." Id. at 26, 8 N. E. (2d) at 48.
functions now performed by the derivative suit. If Section 61-b simply read, "The stockholder's derivative suit may no longer be brought in
New York," (which is often the only place where such actions can be
properly and effectively maintained), no one would entertain the
slightest doubt as to its unconstitutionality. In effect such an act
would free fiduciary managements from all legal responsibility or
liability to account for their conduct to the stockholders, and no pre-
sumption of the reasonableness of legislative enactments could serve to
sustain it because its obvious objective and effect are not within legisla-
tive power. Moreover, since the interest which stockholders have in the
assets entrusted to the management of their corporations must cer-
tainly be deemed "property rights" within the Fourteenth Amend-
ment, the affirmative constitutional guaranty of an adequate judicial
remedy for the protection of such rights would be clearly violated.

Does the fact that Section 61-b is not framed in such crude terms but
instead imposes requirements of security for "costs," including at-
torneys' fees, and authorizes the use of the fund posted for their pay-
ment make the statute constitutional although factually the burden of
these provisions renders prohibitive resort to the derivative suit by a
large majority of stockholders? Granted, of course, that the elimina-
tion of baseless suits is a matter within the legislative power, it has been
demonstrated that the requirements of security, and particularly the
imposition of ultimate liability for the defendants' attorneys' fees, are
not actually related under Section 61-b to whether the action is prose-
cuted in good or bad faith or with reasonable cause. May a legislature
thus accomplish indirectly through a great increase in the burden of
costs upon small stockholders what it might not directly?

An affirmative answer to these questions would be indicated by one
of the New York cases sustaining the constitutionality of Section 61-b.
It is reasoned in Wolf v. Atkinson that the legislature has control over
the matter of "costs," that it may impose a requirement of security
thereof, and that, accordingly, the legislature may define "costs" to
include an amount sufficient to cover liability for attorneys' fees and
expenses and require security for the same in stockholders' derivative
actions. But the opinion overlooks completely the effect of imposing
these additional burdens upon stockholders and gives no consideration
whatever to the manner in which they will operate in practice to deny
the great majority of stockholders in American corporations their right

---

95. See supra, p. 353.
96. In speaking of a plaintiff-stockholder's right to maintain a derivative action for mis-
management or dishonest conduct, Judge Koch said, "his cause of action is a property right.
Goldstein v. Groesbeck, (142 F. (2d) 422 (CCA 2d, 1944))." Citron v. Mangel Stores Corp.,
50 N. Y. S. (2d) 416, 419 (Sup. Ct. 1944).
97. See supra, pp. 361-7.
98. 182 Misc. 675, 49 N. Y. S. (2d) 703 (Sup. Ct. 1944).
to protect their interests through the maintenance of derivative suits. No pertinent authority for the court's views on constitutionality is cited other than the decision in the Shielcrawt case.

The court in the Shielcrawt case was fully aware that Section 61-b operates to deny to the small stockholder his right of access to the courts for protection of his interests from a faithless management or an oppressive majority. Yet, Judge Collins held that Section 61-b did not violate either the due process or equal protection clause of the Constitution. The heart of his decision is to be found in these lines, which follow a review of the facts concerning Section 61-b and its effect:

"Presumably, all these considerations, as well as others, were addressed to the Legislature and to the Governor. Their rejection of the objections is expressed in the passage and approval of the bill. The debate concerning the sapience of the law has been resolved. Respect for the divisional character of our government directs that each department remain inviolate and independent—that there be no encroachment by one on the prerogatives of another. People ex' rel. Bryant v. Zimmerman, 241 N. Y. 405, 412, 150 N. E. 497, 499. . . ."

That respect for legislative judgment should result in judicial reluctance to declare legislation unconstitutional is commendable, but for this reluctance to be carried to the limits of the Shielcrawt case is tantamount to abdication of the power of judicial review. If the courts are to continue to exercise that function, and if that function is to be justified on the ground that it operates to safeguard against legislative encroachment those rights and privileges guaranteed by the Constitution, the courts should not hesitate—in view of the incontrovertible facts concerning the operation and effect of the statute—to declare Section 61-b unconstitutional.

The judicial technique employed by Judge Collins is to be contrasted with that embodied in the opinion rendered in Citron v. Mangel Stores Corporation, in which the court declared Section 61-b unconstitutional under both the due process and equal protection clauses. Judge Koch in that case did not review in great detail the facts concerning Section 61-b, but, having the opinions of the courts in the Shielcrawt and

101. 50 N. Y. S. (2d) 416 (Sup. Ct. 1944).
Wolf cases before him, proceeded to set forth his conception of the judicial function in dealing with such statutes:

“The Constitution is the bedrock of American democracy. Unless vigorously upheld by a judiciary eternally vigilant to preserve the letter and spirit of that immortal document and blind to the temporary passing needs of the moment, such rights might easily be whittled away by the disintegrating erosion of successive apparently harmless invasions. The very fact that conceded evils existed requiring the reforms sought to be accomplished by the statute here attacked is all the more reason why the courts must be zealous to inquire whether fundamental rights have been invaded.”

Judge Koch goes on to consider the nature and effect of the burdens imposed by Section 61-b, concluding:

“... The prohibitive demands already made in applications under this statute in previous cases (§113,000 in Shielcrawt v. Moffett ...) indicate clearly one of the inherent evils. To require security in amounts such as have already been applied for would, in practical effect, be to deprive a plaintiff of his cause of action. His cause of action is a property right. Goldstein v. Groesbeck, 2 Cir., 142 F. 2d 422. The remedy remaining if application is made under the statute and granted is or could be practically prohibitive and, therefore, no remedy. Ex parte Young, 209 U. S. 123; Brinkerhoff, Faris Trust & Savings Co. v. Hill, 281 U. S. 673. . . .

“The mere increase in liability for costs is not the vice of the statute. . . . But the increase in liability for costs and expenses in an unlimited amount that might well be prohibitive and the denial of the right to be heard unless security therefor is furnished in advance is a deprivation of property without due process which the fundamental law of the land forbids. Chicago & N.W. R. Co. v. Nye Schneider Fowler Co., 260 U. S. 35. . . .”

If constitutional guaranties are to be protected by the judiciary, the approach and technique employed in the Citron case appear sounder and more in harmony with repeated decisions of the Supreme Court of the United States than the point of view expressed in Shielcrawt v. Moffett. On several occasions the question of the constitutionality of state legislation imposing liability for attorneys' fees has been presented to the Supreme Court. The decisions of the Court have been marked

102. Id. at 418.
103. Id. at 419-20.
by a disregard for labels\textsuperscript{105} (such as whether the liabilities were denominated “costs,” “liquidated damages,” or simply “penalties”) and have focused upon the \textit{factual} character and \textit{practical} effect of the burdens imposed. That a liability for attorneys’ fees constitutes a burden upon free access to the courts has long been recognized\textsuperscript{106} and is undoubtedly the reason why, apart from statute, such fees are not recoverable in this country,\textsuperscript{107} although the law is otherwise in England.\textsuperscript{108}

The classic opinion of the Supreme Court upon the subject, and one which illustrates the basic approach of the Court to the constitutionality of such legislation, is that of Mr. Chief Justice Taft in \textit{Chicago & Northwestern Railway v. Nye Schneider Fowler Company},\textsuperscript{109} the facts of which are typical of the situations presented to the Court. A statute relating to freight claims against carriers provided that upon failure of a carrier to pay claims within ninety days after their presentation, the plaintiff, if obliged to resort to the courts, could recover 7\% interest, a reasonable attorney’s fee, and an additional fee on appeal. The provisions did not apply, however, if the recovery by the plaintiff was not in excess of a tender made by the defendant. In the \textit{Chicago & North-

\begin{thebibliography}{99}
\footnotesize
\item 106. Thus, the Circuit Court of Appeals in the leading case of \textit{Straus v. Victor Talking Machine Co.}, 297 Fed. 791 (C. C. A. 2nd, 1924), refused to allow as an element of damage in an anti-trust action (in which reasonable attorneys’ fees are allowed a successful plaintiff) attorneys’ fees incurred by the successful plaintiff in a previous suit between the parties. The court voiced a theme recurrent in many judicial opinions: “’The courts are open and free to all who have grievances and seek remedies therefor, and there should be no restraint upon a suitor, through fear of liability resulting from failure in his action, which would keep him from the courts.’ Never was it more necessary than now to preserve unimpaired this right so vital to the public welfare and so thoroughly a part of our theory of government. . . . It would be a negation of the principle and right of free access to the courts to hold that the submission of rights to judicial determination involved a dangerous gamble which might subject the loser to heavy damage.” \textit{Id.} at 799.
\item 107. See McCormick, \textit{Counsel Fees and Other Expenses of Litigation as an Element of Damages} (1931) 15 MINN. L. REV. 619; \textit{Comment} (1940) 49 \textit{YALE L. J.} 699.
\item 108. For a discussion of the English system see Goodhart, \textit{Costs} (1929) 38 \textit{YALE L. J.} 849.
\item 109. 260 U. S. 35 (1922).
\end{thebibliography}
western Railway case no tender had been made. The plaintiff was successful upon the trial, but the defendant had procured on appeal a reduction of the damages allowed by the lower court. The state supreme court had held that under the statute plaintiff was entitled to a fee on the appeal because no tender had ever been made by the defendant, and it awarded an attorney's fee of $100 for the appeal and $200 for the trial. Mr. Chief Justice Taft, writing for a unanimous Court, reviewed the facts of many of the Supreme Court decisions concerning the constitutionality of state legislation allowing attorneys' fees and set forth the basic approach and criteria utilized in determining the constitutionality of such legislation involved.

"In this scrutiny of the particular operation of a statute of this kind, we have sustained it in its application to one set of facts by the state court and held it invalid when applied to another. . . .

"It is obvious that it is not practical to draw a line of distinction between these cases based on a difference of particular limitations in the statute and the different facts in particular cases. The Court has not intended to establish one, but only to follow the general rule that when, in their actual operation in the cases before it, such statutes work an arbitrary, unequal and oppressive result . . . which shocks the sense of fairness the Fourteenth Amendment was intended to satisfy in respect of state legislation, they will not be sustained." 110

Applying these basic principles, the Court held that in so far as the statute was construed to allow an attorney's fee of $200 in connection with the judgment secured in the trial court by the plaintiff, the act was valid, but that in so far as it was deemed to allow the recovery of an attorney's fee, even though only $100 in amount, to the plaintiff upon the appeal although the defendant had secured some reduction in the damages the act was unconstitutional because the burden so imposed acted as a deterrent upon the railroad's right of access to the courts.

Recognizing that the legislature in the exercise of its powers could impose penalties upon carriers in order to discourage delays by them in the payment of claims, the opinion of the Court emphasizes:

"This penalty or stimulus may be in the form of attorney's fees. But it is also apparent from these cases that such penalties or fees must be moderate and reasonably sufficient to accomplish their legitimate object and that the imposition of penalties or conditions that are plainly arbitrary and oppressive and 'violate the rudiments of fair play' insisted on in the Fourteenth Amendment, will be held to infringe it." 111

110. Id. at 44-5.
111. Id. at 44.
After reviewing the facts of the case in connection with the allowance of the attorney's fee upon the appeal, the opinion concludes with this passage, which appears equally applicable to Section 61-b:

"Penalties imposed on one party for the privilege of appeal to the courts, deterring him from vindication of his rights, have been held invalid under the Fourteenth Amendment. Missouri Pacific Ry. Co. v. Tucker, 230 U. S. 340. While the present case does not involve any such penalties as were there imposed, we think the principle applies to the facts of this case." 112

The unconstitutionality of Section 61-b as a violation of the due process clause of the Constitution would seem established by the Supreme Court's decision in Chicago & Northwestern Railway v. Nye Schneider Fowler Company and the principles there enunciated. Furthermore, the Court's citation of its decision in Missouri Pacific Railway v. Tucker 113 emphasizes the Court's fundamental concern with protecting, unimpaired and unhindered, the right of free access to the courts for the protection of asserted violations of property or personal rights. The Missouri Pacific Railway case is but one of a long series of Supreme Court decisions 114 wherein the Court, in order to protect the constitutional privilege of asking for judicial protection against the destruction of one's rights, has repeatedly declared unconstitutional legislation imposing burdens upon access to the courts far less stringent and onerous than those embodied in Section 61-b. The essence of these Supreme Court decisions is epitomized by this sentence from the

112. Id. at 47.
114. Ex parte Young, 209 U. S. 123 (1908) ($5,000 fine for violation of statutory rate); Missouri Pac. Ry. v. Tucker, 230 U. S. 340 (1913) ($500 liquidated damages provision imposed on common carriers charging rates in excess of those fixed by the statute, Wadley Southern Ry. v. Georgia, 235 U. S. 651 (1915) (fine of $1,000 under a statute authorizing $5,000 penalty for each violation of the statute); Southwestern Tel. Co. v. Danaher, 238 U. S. 482 (1915) (action to recover $6,300 in penalties at rate of $100 per day for alleged violation of statutory prohibition against rate discrimination); Oklahoma Operating Co. v. Love, 252 U. S. 331 (1920) (penalty of $500 a day for violation of a statutory rate); see also Cotting v. Kansas City Stockyards Co., 183 U. S. 79, 100 (1901); F. C. Henderson, Inc. v. Railroad Comm. of Texas, 56 F. (2d) 218, 223 (W. D. Tex. 1932).

For discussion of some aspects of these cases, see Note (1935) 44 YALE L. J. 1216, reprinted in 2 ASS'N AM. LAW SCHOOLS, op. cit. supra note 100, at 1526.

An analogous line of cases is that represented by Terral v. Burke Construction Co., 257 U. S. 529 (1922), in which the Court held unconstitutional a state statute withdrawing the licenses of foreign corporations to do business in the state if they resorted to the federal courts located in the state. The basis of the Court's decision was stated by Chief Justice Taft: "The principle ... rests on the ground that the Federal Constitution confers upon the citizens of one state the right to resort to federal courts in another, that state action whether legislative or executive, necessarily calculated to curtail the free exercise of the right thus secured is void, because the sovereign power of a State ... is subject to the limitations of the supreme fundamental law." Id. at 532-3.
opinion of Mr. Justice Brandeis in *Oklahoma Operating Company v. Love*: “Obviously a judicial review beset by such deterrents does not satisfy the constitutional requirements. . . .” 115 Similarly, in a leading case on this question, 116 Mr. Justice Lamar, writing for a unanimous Court, used language which appears particularly appropriate to Section 61-b:

“But in whatever method enforced, the right to a judicial review must be substantial, adequate and safely available—but that right is merely nominal and illusory if the party to be affected can appeal to the courts only at the risk of having to pay penalties so great that it is better to yield to orders of uncertain illegality rather than to ask for the protection of the law.” 117

It is these considerations, as Mr. Chief Justice Taft expressly pointed out in the *Chicago & Northwestern Railway* case, which have guided the courts in their resolution of the constitutional validity of legislation imposing liability for a reasonable attorney’s fee. Such statutes have been sustained only where the burden was deemed one which would not “through fear of liability resulting in his action . . . keep [the suitor] from the courts.” 118 Even in sustaining the validity of particular applications of such statutes, however, the courts have taken pains to point out, as did the late Mr. Justice Cardozo in the much cited case of *Life & Casualty Insurance Company v. McCray*, 119 that “it is all ‘a question of more or less.’ . . . The price of error may be so heavy as to erect an unfair barrier against the endeavor of an honest litigant to obtain the judgment of a court. In that event the Constitution intervenes and keeps the courtroom open.” 120 Indeed, as exemplified by the *Chicago & Northwestern Railway* case, the Supreme Court has not hesitated to declare unconstitutional such statutes when they were construed to impose burdens which would deter a person from securing judicial protection or vindication of his rights. 121

It should be evident, therefore, that one may not deduce from the decisions allowing the imposition of liability for a *reasonable* attorney’s fee that a legislature may impose an *unlimited* liability for such fees

---

115. 252 U.S. 331, 337 (1920).
117. Id. at 661.
119. 291 U.S. 566 (1934) (state statute imposing liability for reasonable attorney’s fee and 12% damage penalty in event beneficiary required to resort to litigation sustained when the attorney’s fee involved was $200 and the penalty an additional $62.50).
120. Id. at 574-5.
121. Two additional cases in which the Supreme Court has held legislation unconstitutional for imposing liability for attorney’s fees are St. Louis, I. M. & S. Ry. v. Wynne, 224 U.S. 354 (1912); Chicago, M. & St. P. Ry. v. Polt, 233 U.S. 334 (1914).
without violating the due process clause. Furthermore, the circumstances under which the courts have sustained the imposition of liability for reasonable attorneys' fees indicate the inapplicability of such cases to the situation presented by Section 61-b. Practically all the legislation involved in these cases has been concerned with securing from common carriers, insurance companies, and employers, the prompt payment of reasonable claims by the companies and the prevention of their resorting to delay, thereby compelling claimants to engage in litigation to secure payment. Under such factual circumstances, the rationale supporting judicial sanction of "moderate penalties," whether in the form of damages or liability for reasonable attorneys' fees or both, has always been that "the seasonable payment of just claims against them for faulty performance of their function is a part of their duty, and that reasonable penalties may be imposed upon them for failure to consider and pay such claims, in order to discourage delays by them."  

122. A student comment on the Citron case in the Harvard Law Review appears to be guilty of just such an error of logic: "Nor, apart from the problem of discrimination, is the imposition of liability for the successful party's attorney's fees, a denial of due process." (1944) 58 Harv. L. Rev. 135, 136. Life & Cas. Ins. Co. v. McCray, 291 U. S. 566 (1934), and Missouri, K. & T. Ry. v. Cade, 233 U. S. 642 (1914), are cited in support. Such a statement seemingly reflects faulty analysis of the cases cited and a disregard for the Supreme Court's concern with the factual character of the particular burdens imposed.


124. Fidelity Mutual Life Ass'n v. Mettler, 185 U. S. 308 (1902) (attorney's fee of $2,500 on $15,000 recovery plus 12% penalty damages of $5,175, of which plaintiff had remitted $3,375, leaving only $1,800 as the penalty to be passed on by the Court); Farmers' & Merchants' Ins. Co. v. Dobney, 189 U. S. 301 (1903) (attorney's fee of $150); Hartford Fire Ins. Co. v. Wilson & Toomer Fertilizer Co., 4 F. (2d) 835 (C. C. A. 5th; 1925), cert. denied, 268 U. S. 704 (1925) (in action on insurance policy in which there was recovery by plaintiff of $21,000, award of $2,100 attorney's fee sustained).


These cases, as well as those cited supra notes 94, 123, 124, are typical of the factual situations in which statutes imposing liability for attorneys' fees has been involved. For collections of additional authorities see Notes (1921) 11 A. L. R. 884, (1934) 90 A. L. R. 530.

126. Chicago & N. W. Ry. v. Nye Schneider Fowler Co., 260 U. S. 35, 43-4 (1922). Moreover, many of the statutes imposing liability for attorney's fees have used that device to secure compliance with a statutory duty. See, e.g., Atchison, T. & S. F. R. R. v. Matthews, 174 U. S. 96 (1899) (statute allowed action for damages resulting from fires caused by operation of railroad, and if recovery under statute, plaintiff allowed reasonable attorney's fee); Liberty Warehouse Co. v. Burley Tobacco Growers' Ass'n, 276 U. S. 71 (1928) (statute legalized cooperative market associations and allowed liquidated damages of $800 and a reasonable attorney's fee in actions against one inducing a cooperative member's breach of contract with the association); Hindman v. Oregon Short Line R. R., 32 Idaho 133, 178
Through analysis of the particular cases which have sustained such penalties it is demonstrable that the burdens thus far allowed to be imposed upon an insurance company, carrier, or employer can in no sense be deemed factually to have operated as a deterrent to their securing a legal determination of their rights. Indeed, as already pointed out, when the statutes as construed have been found to have any such effect, the courts have declared them unconstitutional. 127 Legislation of this character, therefore, seeks the avoidance of litigation when the disparity of power and resources between the parties is such that one of them by resorting to it can render valueless, for practical purposes, the "just" claims of the other. 125 In contrast, Section 61-b imposes its burdens not upon those whose power and resources enable them to engage in endlessly protracted litigation, but solely upon the stockholder asserting a claim of mismanagement, dishonesty, or inequitable treatment against fiduciaries who occupy such a position of domination or control over the corporation to whom the claim belongs that it declines to sue. 129 To find an analogy to Section 61-b

Pac. 837 (1918) (statute required railroads to maintain fences along their right of way and provided for damage action where railroad failed to maintain such fences); Cleveland, C., C. & St. L. Ry. v. Hamilton, 200 Ill. 633, 66 N. E. 389 (1903) (statute required railroads to keep right of way free of combustible material and in actions for damages resulting from breach, reasonable attorney's fee allowed); United States Elect. Power & Light Co. v. State, 79 Md. 63, 28 Atl. 768 (1894) (in action to recover taxes where not paid promptly, reasonable attorney's fee allowed).

A recent case falling into this category is Sacramento Municipal Util. Dist. v. Pacific Gas & Elect. Co., 20 Cal. (2d) 684, 128 P. (2d) 529 (1942), cert. denied, 318 U.S. 759 (1943), upholding a California statute which provided that if the residents of a locality authorized the acquisition by a municipality of its own utilities and a private utility company instituted unsuccessful action to enjoin such acquisition, the municipality could recover reasonable attorneys' fees incurred in such proceeding:

"... the Legislature in order to protect the public agency in engaging in a pursuit which it had deemed necessary to the public welfare, might reasonably have required, as it did, that a private utility with such a probable motive [i.e., to engage in litigation as a means of delay and harassment], should reimburse the public treasuries for expenses incurred in unjustifiable litigation prosecuted by the utility." Id. at 694, 128 P. (2d) at 535. The California Supreme Court was quite emphatic in its characterization of the provisions for the recovery of attorneys' fees as creating "substantive rights," and it therefore allowed the recovery of such fees, although the litigation in question had been brought by the utility in the federal court located in California.

127. See cases cited supra notes 114-7, 121.

128. "Dependents left without a breadwinner will be exposed to core distress if life insurance payments are extracted slowly and painfully, after costly contests in the courts. Health and accident insurance will often be the sources from which the sick and the disabled are to meet their weekly bills. Fire insurance moneys, if withheld, may leave the businessman or the householder without an office or a home." Life & Cas. Ins. Co. v. McCray, 291 U. S. 566, 569 (1934).

129. "Courts of equity will, at the suit of a stockholder, interpose their powers to remedy or prevent a wrong to a corporation by its officers or directors when the corporation, because it is controlled by the wrongdoers or for other reason, fails and refuses to take appropriate
among the statutes imposing liability for reasonable attorneys' fees that have been sustained by the courts one would have to find an act (a) that imposed upon a claimant virtually unlimited liability for the common carrier's or insurance company's attorneys' fees, (b) that governed a claimant who, like the stockholder, does not secure any personal recovery but acts merely in a representative capacity, and (c) that imposed upon defendants no obligation equivalent to that imposed upon the claimant. Furthermore, the type of statute so far sustained has been one which serves the socially desirable objective of securing the fulfillment of duties by the person upon whom the burden is imposed; Section 61-b will obviously have exactly the opposite effect since its burdens are placed not upon the fiduciary with duties to stockholders but upon the latter in the event that they should resort to the only available judicial remedy for the non-performance of those duties. Moreover, a factual analysis of the burdens imposed by Section 61-b shows that it violates those elementary premises of due process which the courts have required even though they may sustain in a particular case the liability or penalty involved. Judged from the standpoint of "the rudiments of fair play" insisted on in the Fourteenth Amendment," the provisions of Section 61-b would appear clearly to violate that constitutional guaranty.

The Equal Protection Clause Objection. Section 61-b imposes its requirements of security and the right to resort thereto for defendants' expenses, including reasonable attorneys' fees, only upon shareholders owning less than either $50,000 worth of stock or 5% of the outstanding shares; it has no application to those owning more than either of these alternative amounts of stock, and it imposes no burdens of any character upon the defendants in the event that they are unsuccessful in whole or in part. Such a statute raises under the equal protection clause the fundamental issue of the validity of its classification and differentiation between (a) large and small stockholders of the same corporation and (b) plaintiffs and defendants in stockholders' suits.

It is of course well settled that a legislature has broad discretion in its power to classify and differentiate, and it is only when the classification employed has no reasonable relationship to an end within legislative power that the statute violates the constitutional guaranty of action for its own protection." Isaac v. Marcus, 258 N. Y. 257, 264, 179 N. E. 487, 489 (1932).

Moreover, a derivative action will not lie when the corporation itself institutes action, General Investment Corp. v. Addinsell, 255 App. Div. 319, 7 N. Y. S. (2d) 377 (1st Dep't 1938), and "individual stockholders had the right to institute suit only after demand therefor had been made to the directors and they refused to proceed, or upon alleging such facts as would show that a demand would be futile. Guttmann v. Conda Co., 249 App. Div. 421, 290 N. Y. S. 874; Continental Securities v. Belmont, 206 N. Y. 7, 99 N. E. 138. . . ." Noel Associates, Inc. v. Merrill, 53 N. Y. S. (2d) 143, 148 (Sup. Ct. 1944).

equal protection. Although there has been much disagreement over whether the facts in a given case afforded a basis for the classification employed in the particular statute, the courts have been unanimous in their statement of the basic test to be applied. Former Chief Justice Hughes said that "the principle that the State has a broad discretion in classification, in the exercise of its power of regulation, is constantly recognized by this Court. Still, the statute may show on its face that the classification is arbitrary . . . or that may appear by facts admitted or proved." Mr. Justice Brandeis, in one of his classic dissents, stated the applicable principles in these words:

"In passing upon legislation assailed under the equality clause we have declared that the classification must rest upon a difference which is real, as distinguished from one which is seeming, specious, or fanciful, so that all actually situated similarly will be treated alike; that the object of the classification must be the accomplishment of a purpose or the promotion of a policy, which is within the permissible functions of the State; and that the difference must bear a relation to the object of the legislation which is substantial, as distinguished from one which is speculative, remote or negligible." 132

Assuming that the end which Section 61-b is designed to serve is the elimination of "baseless" derivative suits, an objective clearly within legislative power, does the differentiation made by it between those holding $50,000 or 5% of the stock and those who hold a lesser amount bear a reasonable relation to this objective? Further, is this relationship one "which is substantial, as distinguished from one which is speculative, remote or negligible"?

It is to be noted that the differentiation which the statute makes between the right of stockholders to bring derivative suits based upon the amount of shares owned violates the basic principles of the stockholder's derivative suit. It has been a cardinal rule that the action may be brought by any shareholder without regard to the amount of his holdings because he is acting not to obtain a personal recovery, but on behalf of all of the stockholders.


132. Quaker City Cab Co. v. Pennsylvania, 277 U. S. 389, 403, 406 (1928). Substantially the same language was used in the opinion of Mr. Justice Sutherland for the majority of the Court in finding the statute in question violative of the equal protection clause. See also Frost v. Corporation Comm., 278 U. S. 515, 522-3 (1929); Louisville Gas & Elec. Co. v. Coleman, 277 U. S. 32, 37 (1928).

133. See, e.g., Everett v. Phillips, 288 N. Y. 227, 233, 43 N. E. (2d) 18, 20 (1942), in which the Court of Appeals declared that "the plaintiff here is asserting a cause of action for wrong done to the corporation of which he is a minority stockholder. In such an action it is
The only possible argument that may be used to sustain the statutory classification is that those holding $50,000 or 5% of stock will have a greater personal interest in a recovery obtained in such actions, that this will serve as an indication of the good faith underlying institution of the action, and that since the personal interest in a recovery of the stockholder owning a lesser amount of shares is smaller there is an indication that the action is without reasonable basis or brought in bad faith. There is, however, no evidentiary support for an assumption that derivative suits brought by those holding $50,000 worth of stock or 5% thereof are more meritorious or brought in better faith than those brought by stockholders owning lesser amounts of shares or that more suits of this character are brought in bad faith by small stockholders than by larger stockholders. Moreover, this argument for the classification is realistically untenable, certainly in so far as the most important American corporations are concerned. In the previous discussion of the factual background of this statute it was pointed out that many of the corporations in this country have thousands of shares outstanding, and that therefore the personal interest in a recovery of any shareholder, or group of shareholders, is necessarily quite small although the total amount obtained for all shareholders may reach millions of dollars.

Concretely, with respect to these corporations, since the amount of personal interest in the recovery by shareholders having more than $50,000 worth of stock will be relatively as slight as those possessing a lesser amount of stock, the differentiation between them is without any rational basis. For example, in the case of *Winkelman v. General Motors Company*, there was a recovery of some $4,000,000, and the Report of the New York Chamber of Commerce in citing the case emphasizes that the personal interest of the plaintiff-stockholders was only a few dollars, apparently suggesting that in spite of the large absolute amount of the recovery the action was without reasonable basis or not brought in good faith. Yet, if the action had been maintained by a stockholder having $50,000 worth of stock, his personal interest in the recovery would have been relatively no greater than the actual plaintiff's, and the amount of his personal interest would have afforded no greater assurance of reasonable grounds for the action or of good faith in its prosecution. There are approximately 44,000,000 shares of General Motors Company outstanding, and, assuming a market value of $50 per share, a stockholder who had 1,000 shares would be exempt under Section 61-b. His personal interest in a recovery of $4,000,000 would

---

134. See *supra*, pp. 359–72.
be 1,000 times $110. This analysis might be repeated with respect to any number of the corporations in which so many Americans have an investment. Thus, in so far as publicly held corporations are concerned, the differentiation between stockholders owning more or less than $50,000 worth of stock seemingly lacks a reasonable relationship to any permissible objective.

Two hypothetical examples may demonstrate further this absence of reasonable relation to a permissible objective, such as the elimination of groundless suits. Assume, first, that a stockholder owns 4% of the stock of a corporation, which shares have a market value of $40,000. He asserts a claim that faithless fiduciaries have wrongfully depleted the assets of the corporation to the extent of $4,000,000. Under the provisions of Section 61-b he must post security which in amount may well exceed the total value of his shareholdings. Even though owning only 4% of the stock, he has a personal interest in the recovery of approximately $40,000. Inability to raise the large amount required by Section 61-b means that he will be unable to prosecute his action, regardless of the merit of his claims.

Contrast that case with one in which a stockholder owns 5% of the stock of a corporation whose assets total $100,000, the market value of his stock being $5,000. He seeks to assert a claim of wrongdoing in the amount of $50,000. His personal interest in any recovery would be only $2,500, yet such a stockholder, unlike the one in the first case presented, is wholly exempt from any requirement of security or the possibility of having any ultimate liability assessed against that security.

These examples should demonstrate the complete lack of reasonable relationship between the means employed by the statute—the differentiation between the stockholders required to post security and the possibility of its subjection to the assessment of liability—and any permissible objective. Such lack of reasonable relationship between means and end has often been a ground upon which the Supreme Court of the United States has declared a statute unconstitutional. 137

It may be argued, as has been pointed out, that the ownership of $50,000 worth of stock may be regarded, at least _prima facie_, as some evidence of good faith and that, therefore, security from those owning

137. See, _e.g._, Liggett Co. v. Baldridge, 278 U. S. 105 (1928) (Pennsylvania statute which required every drugstore to be operated by a pharmacist and prohibited the ownership of drugstores by corporations, associations or partnerships, unless all partners or members were licensed pharmacists); Nectow v. Cambridge, 277 U. S. 183 (1928) (city zoning regulation found to have no substantial relation to subject matter within legislative power, namely, public health, safety, morals, or general welfare); Burns Baking Co. v. Bryan, 264 U. S. 504 (1924) (Nebraska statute requiring loaves of bread to be not more nor less than a specific weight); Smith v. Texas, 233 U. S. 630 (1914) (Texas statute prohibiting any person from being a railroad train conductor unless for two years immediately preceding his employment as such he had been employed as a brakeman or conductor on a freight train).
less than this amount may reasonably be required merely as a means of
insuring the good faith of those prosecuting the action. Section 61-b
goes much further, however, and provides that the court may resort to
this security to pay any allowance for the defendants’ expenses, includ-
ing reasonable attorneys’ fees. This imposition of liability for the
defendants’ expenses is not limited to situations in which, after trial, the
action is found to have been brought in bad faith or without reasonable
grounds. No liability is imposed by the statute upon stockholders who
are found to have brought an action without reasonable grounds or even
in bad faith, provided only that they own more than a certain amount
of stock. Instead, such liability is imposed upon small stockholders
regardless of the reasonable ground for their conduct in bringing the
action if they are so unfortunate as to lose the suit in whole or in part.
When a court has before it all the plaintiff’s grounds for bringing suit,
from which a determination may be made whether the suit is baseless,
and a distinction is made between plaintiffs solely upon the amount of
stock owned by them, such discrimination between rich and poor
would seem an odious one clearly repugnant to the equal protection
clause of the Constitution.

Although Judge Collins in the Shielcrawt case failed to analyze clearly
the operation of the classification of Section 61-b, merely citing nu-
umerous cases to the effect that the legislature has broad powers of
differentiation, Judge Koch in the Citron case went directly to the
heart of the equal protection objection:

“The classification set up in the statute is not predicated upon a
showing of any lack of merit or probable lack of merit in the action,
or the existence or probable existence of any of the other attendant
evils sought to be corrected, but upon an arbitrary classification of
the ownership, of a certain proportion or value of stock. The real
vice insofar as a determination of the validity of the statute under
the equal protection clause is concerned is the imposition of liability
for the additional expenses only upon a certain class without any
reasonable relation between the object of the legislation to prevent
the institution and maintenance of baseless litigation and attendant
evils and the class upon which the new liability is imposed with the
requirement of security in advance.”

half a century ago, Mr. Justice Brewer in a United States Supreme Court decision involving
the equal protection clause wrote: “The State may not say that all white men shall be sub-
jected to the payment of the attorney’s fees of parties successfully suing them and all black
men not. It may not say that all men beyond a certain age shall be alone thus subjected, or
all men possessed of a certain wealth. These are distinctions which do not furnish any proper
basis for the attempted classification. That must always rest upon some difference which
bears a reasonable and just relation to the act in respect to which the classification is pro-
posed, and can never be made arbitrarily and without any such basis.” Gulf C. & S. F. Ry. v.
Ellis, 165 U. S. 150, 155 (1897).
One New York court, however, has used the following assailable chain of reasoning in finding that Section 61-b does not violate the equal protection clause: the legislature may require security for costs for non-residents as distinguished from residents; therefore it may distinguish between those owning more than $50,000 worth of stock and those owning a lesser amount, not only for the purpose of imposing a security requirement but also in assessing liability for defendants' expenses, including attorneys' fees. Such an argument appears to overlook the fact that while a distinction between residents and non-residents may be justified as to the requirement of security for costs, it affords no basis for authorizing the imposition of liability for defendants' expenses. Similarly, the initial premises of the court's argument offer no basis for the conclusion that not only security but the imposition of liability may be predicated upon the amount of stock that a plaintiff owns, which is, in effect, the criterion employed.

Section 61-b contains an even more pervasive inequality than the imposition of liabilities on and the requirement of security from small stockholders only. Following the pattern of Section 61-a, it allows assessment of ultimate liability for the defendants' expenses against the security posted by the plaintiff, but it imposes upon the defendants in the event that they are unsuccessful no liability of any character for the plaintiff's or corporation's similar expenses. Consequently it has no security requirements with respect to the defendants. The statute


140. Cardozo, writing as Chief Justice for a unanimous New York Court of Appeals in the leading case of Smith v. Loughman, 245 N. Y. 486, 157 N. E. 753 (1927), cert. denied, 275 U. S. 560 (1927), held a New York statute which imposed a greater tax liability upon non-residents as distinguished from residents violative of the equal protection clause, pointing out that even with respect to such an obvious basis of differentiation statutes may be unconstitutional unless there is a reasonable ground for classification apart from the mere fact that there are two separate categories. The essence of his opinion is equally apposite to Section 61-b:

"At times, the character of the act may be so affected by the residence of the actor as to call for varying regulation with a view to the attainment in the end of a truer level of equality. Thus, non-residents resorting to our courts may be compelled to give security for costs. . . . In these and like cases, the effect of the apparent discrimination is not to cast upon the non-resident a burden heavier in its ultimate operation than the one falling upon residents, but to restore the equilibrium by withdrawing an unfair advantage. . . . In these and like cases, the difference in treatment, whatever it may have been, was made necessary by conditions inseparably interwoven with difference of residence, and was proportioned to the necessity. Only for this was it upheld.

"The statute now before us does not use its discriminations to establish measure and proportion, its discords as a means to harmony. . . . What is here is an inequality that is purported and pervasive." Id. at 493–4, 157 N. E. at 755–6.

See also Kentucky Finance Corp. v. Paramount Auto Exchange Corp., 262 U. S. 544 (1923) (statute imposing greater procedural burdens upon foreign than upon domestic corporations held violative of the equal protection clause).
therefore serves to increase an existing great disparity in wealth and power in these actions between the stockholders on the one hand and the defendant fiduciaries on the other. "The statute . . . does not use its discriminations to establish measure and proportion, its discords as a means to harmony," 141 but, on the contrary, instead of operating to create a fairer measure of equality between the parties—as do statutes imposing liability for attorneys’ fees upon common carriers and insurance companies, for example 142—operates only to increase the existing lack of equality. This aspect of Section 61-b’s arbitrary classifications would appear to be the very one which Mr. Justice Brewer, writing on behalf of the United States Supreme Court in the famous case of Cotting v. Kansas City Stock Yards Company, 143 condemned in declaring a Kansas statute unconstitutional for violation of the equal protection clause:

"Suppose a law were passed that if any laboring man should bring or defend an action and fail in his claim or defence, either in whole or in part, he should in the one instance forfeit to the defendant half of the amount of his claim, and in the other be punished by a fine equal to half of the recovery against him, and that such law by its terms applied only to laboring men, would there be the slightest hesitation in holding that the laborer was denied the equal protection of the laws?" 144

CONCLUSION

It seems clear that Section 61-b violates both the due process and equal protection clauses of the State and Federal Constitutions. For this reason the additional issues of statutory construction and constitutional law raised by application of the act to litigations already pending at the time it became effective have not been treated. To date all the New York lower courts that have administered the statute, including those which have held it unconstitutional, have applied it retroactively to pending actions. The doubtful validity of such retroactive construction is demonstrated, however, by the forceful dissenting opinion rendered by two judges of the New York Appellate Division in the Shielcrawt case.145

142. See supra, pp. 381–2.
143. 183 U. S. 79 (1901).
144. Id. at 100–1.
145. "Forgetting for the moment any attempt at nomenclature in order to classify the new law as one affecting 'substantive' rights or one affecting merely the remedy and thus being 'procedural' in nature, it is plain that the law in question imposes new and drastic restrictions on the rights of stockholders of a certain class to sue on behalf of their corporation. . . . The new law, if applied here, would have the practical effect of nullifying things already done by plaintiffs as of right when this action was brought. . . . So applied Sec-
Section 61-b, it is submitted, places in jeopardy the rights and interests of the vast majority of investors in American public corporations, as well as those of an incalculable number of shareholders in closed corporations. It is of the utmost importance that the question of its constitutionality be authoritatively determined as quickly as possible. It would be unfortunate if the issue of its application to pending suits—a matter of no inconsiderable practical importance since a most conservative estimate would place the number of actions of this character at not less than one hundred—were permitted to obscure or delay the immediate consideration by the New York Court of Appeals of its constitutionality.

Finally, one may express the hope that no other legislature will copy the unfortunate example that has been set in New York by the enactment of Section 61-b. The precipitous procedure by which its passage into law was secured should warn the legislators of other states that the statute does not reflect the mature and considered judgment which might otherwise be expected from the legislature of one of the most important financial and commercial states in the Union.

After the foregoing article was written and printed, the Court of Appeals handed down its decision in the Shielcrawt case. The Court chose to avoid passing upon any aspect of the constitutionality of Section 61-b and limited its ruling to the narrow issue of the retroactive
application of the Act to suits pending at the time of its enactment. The Court recognized that the statute differed from "purely procedural statutes, both in purpose and effect," but following the pattern of reasoning and authorities embodied in the Appellate Division dissenting opinion, it ruled that the statute could not be construed to be applicable to pending actions. It is regrettable, indeed, for the reasons outlined above, that the Court should have disregarded the interests in corporate management of the American investor by failing to pass upon the constitutionality of Section 61-b.

147. See note 145 supra.