CONTRIVANCE AND COLLUSION: THE CORPORATE ORIGINS OF SHAREHOLDER DERIVATIVE LITIGATION IN THE UNITED STATES

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Since at least the 1930s, corporate managers and their attorneys have denounced shareholder derivative suits.[1] They have painted such actions as dangerous vehicles for unscrupulous plaintiffs' attorneys to manufacture frivolous claims that permit stockholders to harass faithful, hard-working corporate officers and directors.[2] In particular, critics have charged that derivative suits have allowed aggressive plaintiffs' lawyers to manipulate unsophisticated, impressionable small investors (or, worse yet, to collude with repeat or "professional plaintiffs") to pursue groundless litigation against corporate management for the purpose of extracting unreasonable settlements.[3]

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1. An early, highly influential expression of the hostility of corporate leaders to shareholder derivative actions appeared in a 1944 report commissioned by the New York Chamber of Commerce, an association of business and financial executives in New York. FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS, AUTHORED ON BEHALF OF THE SPECIAL COMMITTEE ON CORPORATE LITIGATION OF THE CHAMBER OF COMMERCE OF THE STATE OF NEW YORK (1944) [hereinafter WOOD REPORT]. A contemporary commentator described the New York Chamber of Commerce as an "organization composed very largely of extremely conservative corporation and financial interests." Sergei S. Zlinkoff, *The American Investor and the Constitutionality of Section 61-B of the New York General Corporation Law*, 54 YALE L.J. 352, 360 n.34 (1945). For a history of the WOOD REPORT and the legislative restrictions on stockholder litigation that it inspired, see *id.* at 359-72 and *infra* notes 266-280 and accompanying text. For a later critique of the derivative suit by business executives, see THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE (1983).

2. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1748 (2004) ("[D]erivative suits are today regularly portrayed as nuisance suits whose 'principle beneficiaries . . . are attorneys.'") (alteration in original); Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis,* 51 WM. & MARY L. REV. 1749, 1792 (2010) (noting "widespread belief among corporate officers and directors that these [derivative] suits are nothing more than strike suits").

3. For charges that attorneys who specialize in derivative litigation manipulate unsophisticated investors with a negligible stake in the corporation and in the recovery

These settlements, which typically include hefty payments of attorneys' fees, are said to operate almost entirely for the personal gain of the plaintiffs' bar rather than for the shareholders as a whole or the corporation itself.[4]

But the history of the shareholder derivative action in the United States teaches us that corporate counsel and corporate executives did not always regard such suits with hostility. On the contrary, an exploration of the origins of derivative litigation shows that, beginning around the middle of the nineteenth century, sophisticated corporate officers and their lawyers developed imaginative ways to mobilize stockholder suits to protect firms in situations where they calculated that a direct action by a corporation would be unlikely to succeed. In particular, corporations frequently engineered derivative actions to secure a federal forum for test cases that challenged the validity of governmental restraints on corporate power. Indeed, it was the elite representatives of well-financed corporations, not plaintiffs' attorneys for small shareholders, who first devised the façade that stockholders genuinely initiated and propelled derivative litigation.[5]

Part I of this Article surveys the rise of the derivative action in the nineteenth-century United States. It emphasizes the early use of such suits by minority shareholders seeking to hold directors or officers of a corporation accountable for acts of misconduct such as fraud, self-dealing, waste of assets, *ultra vire*s transactions, and gross negligence.[6] Part II explores how, around the middle of the nineteenth

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of damages to serve as plaintiffs in nuisance suits, see WOOD REPORT, *supra* note 1, at 11, 16, 28-29. Asserting that plaintiffs' lawyers preferred to recruit the "smallest of small investors," preferably women, as named plaintiffs, Wood opined: "This shoddy burlesque of a professional relationship to clients makes the ambulance-chaser by comparison a paragon of propriety." *Id.* at 47. On the problematic presence of professional plaintiffs in recent shareholder derivative litigation, see Jessica Erickson, *The New Professional Plaintiffs in Shareholder Litigation*, 65 FLA. L. REV. 1089, 1104-24 (2013).

4. For a prominent scholarly iteration of some of these themes, see Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 60-65 (1991). For a description of the incentives for plaintiffs' lawyers in derivative suits to collude with corporate defendants and their counsel to obtain "non-zero sum" settlements that contain large fee awards for plaintiffs' attorneys but little or no relief for the corporation and its shareholders, along with proposals for reform, see John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and A Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 318-20 (1981). Professor Coffee has produced a series of valuable articles on plaintiffs' attorneys and the agency problems that occur in the context of shareholder litigation. *See generally* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action,* 54 U. CHI. L. REV. 877 (1987); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions,* 86 COLUM. L. REV. 669 (1986); John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation,* 48 LAW & CONTEMP. PROBS. 5 (1985).

5. *See infra* notes 143-54 and accompanying text.

6. *See infra* notes 9-36 and accompanying text.

century, corporate advisors recognized the benefits of derivative litigation for corporations, especially in federal court, and began to employ such actions against third parties (*i.e.*, individuals or entities that were unaffiliated with the corporation). Throughout the second half of the nineteenth century and into the early decades of the twentieth, corporations often orchestrated litigation by shareholders as a vehicle for asserting corporate claims against outsiders, especially governmental bodies seeking to regulate business.[7] Part III offers a brief account of the waning of corporate enthusiasm for the strategic deployment of derivative proceedings in the 1930s. By the early 1940s, this change of heart had hardened into high-profile attacks on derivative suits and the lawyers who pursued them.[8]

I. THE GENESIS OF SHAREHOLDER DERIVATIVE LITIGATION IN THE UNITED STATES

The legal theory underlying the stockholder derivative suit in American law emerged more than 180 years ago. In essence, the derivative action arose as an equitable remedy that permitted a shareholder of a corporate body to commence litigation to protect the corporation in situations where it was threatened with harm or had suffered an injury. But the stockholder could avail herself of this equitable device only if she could show that the corporation's directors had improperly refused or failed to take legal action against the wrongdoers or that they could not be trusted to do so because the alleged malefactors were in control of the corporation.[9]

Commentators have generally identified *Robinson v. Smith*, decided by the Chancery Court of New York in 1832, as the first case to clearly recognize a right by minority shareholders to pursue a derivative suit against miscreant corporate officers and directors.[10] In

7. *See infra* notes 38-262 and accompanying text.

8. *See infra* notes 263-80 and accompanying text. The antagonism of corporate management toward derivative litigation continues to this day. Recently (though ultimately unsuccessfully), corporate representatives lobbied the Delaware legislature to allow boards of directors to adopt fee-shifting, "loser-pays" bylaws and charter provisions designed to curtail derivative suits or suppress them altogether. *See infra* note 281 and accompanying text.

9. On the theoretical foundations of early shareholder derivative actions, see generally HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS HAVING CAPITAL STOCK §§ 138-41; §§ 683-91 (1884); DEBORAH A. DEMOTT, SHAREHOLDER DERIV. ACTIONS L. & PRAC. § 1:3 (2014-2015); George D. Hornstein, *Problems of Procedure in Stockholder's Derivative Suits*, 42 COLUM. L. REV. 574 (1942); Bert S. Prunty, Jr., *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980 (1957); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 306-09 (1998); Ann M. Scarlett, *Shareholder Derivative Litigation's Historical and Normative Foundations*, 61 BUFF. L. REV. 837 (2013).

10. Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832). Prunty, however, cites *Taylor v. Miami Exporting Co*., 5 Ohio 162 (1831), decided the year before *Robinson*, as the first derivative case. Prunty, *supra* note 9, at 988.

Robinson, three shareholders of the New York Coal Company, who together owned 160 of the company's 4,000 outstanding shares of stock, asserted that its directors had engaged in a series of blatantly fraudulent and illegal acts by misappropriating corporate funds to speculate in financial stocks, despite the company being incorporated by the New York legislature only for the purpose of "exploring for, digging and vending coal."[11] According to the plaintiffs, the actions of the directors had caused losses of at least $150,000 and rendered the value of their stock virtually worthless.[12]

The defendant directors filed a demurrer challenging the shareholders' suit on four separate grounds. In responding to each of these objections in kind, Chancellor Walworth took the opportunity to address a series of fundamental procedural questions raised by the emerging shareholder derivative action in Anglo-American law.

First, the directors argued that the court should reject the suit because the necessary parties rule required that all the investors in the coal company had to be joined as plaintiffs.[13] The necessary or proper parties rule, developed by English chancery courts in the eighteenth century, "required the presence of all parties interested in the matter in suit, in order that a final end might be made of the controversy."[14] But English law soon recognized multiple exceptions to the rule, such as situations in which numerous persons, including investors in business enterprises, had common interests in a particular matter and where the joinder of all interested parties was impractical and would create injustice. In 1828, for instance, in *Hichens v. Congreve*, the directors of a joint stock company attempted to dismiss a shareholder's suit to recover funds misappropriated by the directors on the ground that the complaint failed to name all 200 shareholders as parties.[15] In *Hichens*, the English Court of Chancery did not hesitate to apply an exception to the necessary parties rule for the sake of convenience and to prevent injustice.[16]

American chancery courts followed their English counterparts by applying the necessary parties rule as well as liberal exceptions to the rule. As Supreme Court Justice Joseph Story made clear in the first

11. 3 Paige Ch. at 222, 230.

12. *Id.* at 224.

13. *Id.* at 229.

14. Duke of Bedford v. Ellis, [1901] A.C. 1 (H.L.) 8 (reviewing early formulation of the necessary parties rule in the English Court of Chancery).

15. Hitchens v. Congreve, (1828) 38 Eng. Rep. 917 (Ch.) 920.

16. *Id.* at 922. On the history of the necessary parties rule and its exceptions, as well as its application to stockholder litigation in England, see generally Scarlett, *supra* note 9, at 848-56. According to Prunty, the first English derivative suit involving a corporation (as opposed to a joint stock company) was recorded in 1840 in Preston v. Grand Collier Dock Co., (1840) 59 Eng. Rep. 900. Prunty, *supra* note 9, at 982.

edition of his *Commentaries on Equity Pleadings* (1838), equity courts should not adhere to the necessary parties standard when doing so would "defeat the very purposes of justice, if they can dispose of the merits of the case before them without prejudice to the rights or interests of other persons, who are not parties, or if the circumstances of the case render the application of the rule impracticable."[17] Story explained that in such situations courts instead should allow the bill of complaint to be filed

> not only in behalf of the plaintiff, but also in behalf of all other persons interested, who are not directly made parties (although in a sense they are thus made so), so that they may come in under the decree, and take the benefit of it, or show it to be erroneous, or entitle themselves to a rehearing.[18]

In *Robinson v. Smith*, the Chancery Court of New York avoided the need for an exception to the necessary parties rule by concluding that the named defendants (*i.e.*, the directors) likely held the remaining 3,840 shares of the New York Coal Company and therefore all shareholders were already joined as either plaintiffs or defendants.[19] Even if additional shareholders did exist, Chancellor Walworth confirmed the availability of an exception for shareholders filing a derivative suit: "[I]f the stockholders were so numerous as to render it impossible, or very inconvenient to bring them all before the court, a part[y] might file a bill, in behalf of themselves and all others standing in the same situation."[20] From this point on, shareholders filing derivative suits in American courts routinely included an allegation that they were suing "in behalf of themselves and all others standing in the same situation," or nearly identical language.

Second, the directors in *Robinson* asserted an "objection for multifariousness," in which they argued that the three named plaintiffs should have filed three separate bills rather than joining together in one suit. Chancellor Walworth disagreed, finding that the stockholders "are seeking precisely the same redress against their trustees [*i.e.*, the directors], and for the same acts; by which they allege they have received a similar and common injury."[21] Accordingly, it was entirely appropriate for the three plaintiffs to join together to file a single suit.[22]

Third, the directors of the New York Coal Company urged

17. JOSEPH STORY, COMMENTARIES ON EQUITY PLEADINGS AND THE INCIDENTS THERETO § 77 (1838).

18. *Id.* at § 96. Story's explication of the necessary parties rule and its exceptions were substantially codified in 1842 in Federal Equity Rules 47 and 48. Scarlett, *supra* note 9, at 867-68.

19. Robinson v. Smith, 3 Paige Ch. 222, 230 (N.Y. Ch. 1832).

20. *Id.* at 233 (citing Hichens v. Congreve, (1828) 38 Eng. Rep. 917 (Ch.)).

21. *Id.* at 230-31.

22. *Id.* at 231.

dismissal of the shareholder suit because the discovery process might subject the corporation to forfeiture of its franchise in a subsequent *quo warranto* action by the New York attorney general for engaging in activities contrary to the corporate charter.[23] Under nineteenth-century law, the scope of corporate action was strictly limited to the terms of the corporation's grant of incorporation.[24] Deviations from the specified scope of that grant could be challenged either through an action by a single shareholder to restrain the unauthorized conduct or through a *quo warranto* suit by the state attorney general to revoke a corporation's right to do business.[25] Given the allegations that the directors had used the company's capital for "gambling speculation in stocks" rather than selling coal, the possibility that New York public authorities might seek to dissolve the company's charter was not far-fetched.[26] Nonetheless, Chancellor Walworth found the potential for a state forfeiture action provided no basis for denying shareholders the right to hold the directors accountable and to recover losses from them on behalf of the corporation in advance of any forfeiture proceeding.[27]

Finally, the directors argued that the New York Coal Company itself had to be named as a party to the suit.[28] On this last point, the court sided with the defendants.[29] Normally, the court indicated, the corporation would be the proper party to initiate a proceeding against malfeasant directors and officers and therefore should appear as the plaintiff.[30] However, in situations where "the corporation refused to prosecute" or "was still under the control"[31] of the defendants, courts

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23. *Id.*

24. TAYLOR, *supra* note 9, at §§ 458-59, 556 (1884); Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1304 (2001).

25. On the right of any objecting shareholder to challenge *ultra vires* acts by a corporation, see JOSEPH K. ANGELL & SAMUEL AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE § 393 (7th ed. 1861) ("[T]he powers of a Court of Equity may be put in motion, at the instance of a single shareholder, if he can show that the corporation are employing their statutory powers for the accomplishment of purposes not within the scope of their institution."). On the authority of state attorneys general to revoke charters of "errant corporations" for *ultra vires* conduct through *quo warranto* proceedings, see Peter Karsten, *Supervising the "Spoiled Children of Legislation": Judicial Judgments Involving Quasi-Public Corporations in the Nineteenth Century U.S.,* 41 AM. J. LEGAL HIST. 315, 364-67 (1997).

26. *Robinson*, 3 Paige Ch. at 231.

27. *Id.* at 231-32.

28. *Id.* at 232-33.

29. *Id.* at 233.

30. *Id.* ("Generally, where there has been a waste or misapplication of the corporate funds, by the officers or agents of the company, a suit to compel them to account for such waste or misapplication, should be in the name of the corporation.").

31. *Id.* Going forward, nineteenth-century courts continued to excuse shareholders from making a demand on the board where their bill showed that the alleged wrongdoers controlled the corporation. As the New York Court of Appeals explained in 1882:

would not rule out relief for the stockholders.[32] Instead, shareholders "would be permitted to file a bill in their own names, making the corporation a party defendant."[33] Given that the New York Coal Company was under the control of the delinquent directors named as defendants, the Chancellor affirmed the eligibility of the stockholders in *Robinson* to proceed derivatively and granted them leave to amend their complaint to add the company as a defendant.[34]

In addition to deciding the procedural issues discussed above, the Chancery Court of New York delivered a powerful statement on the duties of trust owed by corporate directors and their personal liability for damages caused by breaches of that duty. As Chancellor Walworth pronounced:

> I have no hesitation in declaring it as the law of this state, that the directors of a . . . corporation, who willfully abuse their trust, or misapply the funds of the company, by which a loss is sustained, are personally liable as trustees to make good their loss. And they are equally liable, if they suffer the corporate funds or property to be lost or wasted by gross negligence and inattention to the duties of their trust.[35]

In the years following *Robinson v. Smith*, minority shareholders seized on the derivative device in an effort to hold corporate managers accountable for wrongdoing and mismanagement, whether in the form of fraud, *ultra vires* transactions, self-dealing, waste of assets, or gross negligence.[36]

> [I]f it appears that the corporation is still under the control of those who must be made the defendants in the suit (See *Butts v. Wood*, 37 N. Y. 317; *Robinson v. Smith*, 3 Paige, 222.) . . . a demand upon the corporation to bring the suit would be manifestly futile and unnecessary. A suit prosecuted under the direction and control of the very parties against whom the misconduct is alleged, and a recovery is sought, would scarcely afford to the shareholders the remedy to which they are entitled, and the fact that the delinquent parties are still in control of the corporation is of itself sufficient to entitle the shareholders to sue in their own names.

Brinckerhoff v. Bostwick, 43 Sickels 52, 88 N.Y. 52, 59-60 (1882); *see also* Barr v. New York, Lake Erie & W. R.R. Co., 51 Sickels 444, 96 N.Y. 444, 450 (1884) ("It was not necessary . . . to show an active effort on the part of the plaintiffs with the body of the corporation affected to induce remedial action on its part, as it is apparent, from the facts stated, that such effort would have been of no avail.").

32. Robinson v. Smith, 3 Paige Ch. at 233 (noting that an equity court "never permits a wrong to go unredressed merely for the sake of form").

33. *Id.*

34. *Id.*

35. *Id.* at 231.

36. For examples of antebellum derivative suits alleging improper conduct by corporate directors, see Scarlett, *supra* note 9, at 871-82; *see also* Abbot v. Am. Hard Rubber Co., 33 Barb. 578, 579 (N.Y. Gen. Term 1861) (granting injunction to shareholder suing derivatively to set aside self-dealing transactions and *ultra vires* transfers of corporate property by directors).

II. TURNING SHAREHOLDER DERIVATIVE SUITS TO THE CORPORATION'S ADVANTAGE

The earliest derivative suits, such as the one in *Robinson v. Smith*,[37] typically involved challenges by stockholders to alleged misconduct by directors and officers. This type of litigation generally placed corporate officials in an adversarial, and sometimes deeply antagonistic, relationship with minority shareholders. Within two decades, however, corporate agents began to devise innovative strategies for exploiting stockholder suits for corporate advantage, especially in the context of federal derivative actions against third parties.[38]

A. Creating Federal Jurisdiction: The Case of Dodge v. Woolsey

The first shareholder derivative suit to reach the U.S. Supreme Court—the landmark 1856 case, *Dodge v. Woolsey*—arose from circumstances in which corporate managers and their counsel appear to have orchestrated a shareholder action to secure a result that the corporate entity was unlikely to achieve in its own right.[39] In a lengthy opinion that reflected "extended investigation and its most careful judgment," the *Dodge* Court strongly endorsed the legitimacy of the derivative suit in American corporate law and recognized the equitable right of shareholders to redress wrongs to the corporation through such litigation.[40] More important for our purposes, the Court also implicitly condoned the calculated resort of corporate counsel to federal stockholder actions to gain more favorable outcomes than they anticipated obtaining in a direct suit by their clients in state court.

In *Dodge*, John M. Woolsey, a resident of New Haven, Connecticut and a holder of thirty shares of the Commercial Branch Bank of Cleveland (the "Bank" or "Bank of Cleveland"), brought suit in the U.S. Circuit Court for the District of Ohio on behalf of himself and all other similarly situated shareholders.[41] His bill of complaint named the directors of the Bank, the Bank itself, and George C. Dodge, the tax

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37. 3 Paige Ch. 222.

38. For early federal rulings that permitted shareholders to pursue derivative suits that included third-party defendants, see Foote v. Linck, 9 F. Cas. 366, 366 (C.C.D. Ohio 1853) (No. 4913) (entertaining derivative suit based on diversity jurisdiction against a state auditor and directors of a trust company to restrain collection and payment of allegedly unconstitutional tax); Paine v. Wright, 18 F. Cas. 1010, 1010-11 (C.C.D. Ind. 1855) (No. 10,676) (entertaining derivative suit by shareholders of railroad corporation against Indiana tax collector and corporate directors to enjoin collection and payment of allegedly unconstitutional tax).

39. Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1856).

40. *Id.* at 336, 341.

41. *Id.* Woolsey is identified as a resident of New Haven, Connecticut in Transcript of Record at 15, Dodge v. Woolsey, 59 U.S. (1 How.) 331 (1856) (No. 126) (injunction bond of John M. Woolsey).

collector for the State of Ohio, as defendants.[42] Woolsey also alleged that he was a citizen of Connecticut and that all the defendants were citizens of Ohio, thereby satisfying the requirements for federal diversity jurisdiction.[43]

The sole substantive claim asserted by Woolsey was a challenge to the constitutionality of an Ohio statute, passed in accordance with an amended state constitution, that levied higher taxes on the Bank of Cleveland than the rate specified in the Bank's charter.[44] That charter, granted by the Ohio Assembly in 1845, provided that the Bank, in satisfaction of all taxes, should set aside and pay, on a semi-annual basis, six percent of its net profits for that period to the state.[45] In 1851, however, Ohio adopted a new constitution requiring that the property of all corporations, including all banking corporations, be taxed in the same manner as the property of individuals.[46] One year later, in 1852, the Ohio legislature enacted a law imposing taxes in the manner prescribed in the amended constitution.[47] As a result of the 1852 law, the Bank of Cleveland was assessed $7,526 more in taxes for 1852 and $11,665 more in taxes for 1853 than it would have owed under its 1845 charter.[48] Allegedly "fearing the penalty imposed by the act for a refusal or neglect to make a return," the president and cashier of the Bank agreed to pay the additional tax for each year, though they did so under protest as to the constitutionality of the tax.[49]

As a stockholder of the Bank of Cleveland, Woolsey claimed to object to the tepid opposition of the directors of the Bank to the new tax law and their failure to protect the corporation's financial wellbeing though litigation.[50] Specifically, Woolsey averred that his attorney delivered a letter to the directors asking them "to take measures, by suit or otherwise, to assert the franchises of the bank against the collection of what he believes to be an unconstitutional tax."[51] The board refused Woolsey's application for resistance to the tax in the following resolution:

> Resolved, that *we fully concur in the views expressed in said letter as to the illegality of the tax therein named*, and believe it to be in no way binding upon the bank; but, *in consideration of the many obstacles in the way of testing the law in the courts of the State*, we cannot consent to take the action which we are called upon to take,

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42. *Dodge*, 59 U.S. at 336.
43. *Id.*
44. *Id.* at 338-39.
45. *Id.* at 336-37.
46. *Id.* at 337-38.
47. *Id.* at 338.
48. *Id.* at 338-39.
49. *Id.* at 338.
50. *Id.* at 339.
51. *Id.*

> but must leave the [shareholder] to pursue such measures as he may deem best in the premises.[52]

Woolsey's attorney then commenced a derivative suit in Ohio federal court seeking an injunction against further collection of the tax. Specifically, Woolsey's complaint asserted that the Ohio constitutional amendment of 1851 and Ohio law of 1852, which resulted in a higher tax for the Bank of Cleveland than the one specified in its charter, impaired an obligation of contract in violation of the Contracts Clause of the U.S. Constitution.[53] Woolsey also alleged that the challenged assessments, if continued, would decrease the value of his stock in the Bank, reduce his dividends, and even "compel a suspension and final cessation" of the Bank's business.[54]

None of the directors of the Bank bothered to answer Woolsey's complaint, even though it charged them with a breach of trust owed to the Bank and its stockholders by refusing his demand and failing to attack the legitimacy of the tax.[55] Only Dodge, the tax collector, filed an answer.[56] In essence, Dodge's response disputed Woolsey's standing to sue in equity on behalf of the Bank and denied the unconstitutionality of the Ohio tax.[57]

At the circuit court level, Woolsey's shareholder action produced a decisive victory for the Bank of Cleveland, as well as numerous other banking corporations in Ohio that faced higher taxes as a result of the 1852 law.[58] Recognizing Woolsey's ability to proceed derivatively, the lower court granted all the relief requested in his suit.[59] It pronounced Ohio's property tax unconstitutional to the extent it conflicted with rates guaranteed in earlier corporate charters and permanently enjoined enforcement of the tax.[60]

Dodge appealed the circuit court's ruling to the U.S. Supreme Court on three grounds.[61] First, he insisted that Woolsey, as a

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52. *Id.* at 340 (emphasis added). One sign that Woolsey's suit was in fact coordinated by a coalition of Ohio banks was that a stockholder of another Ohio bank adversely affected by the 1852 law, also acting through his attorney, sent a demand to the directors of his bank that was virtually identical to the one Woolsey sent to the Bank of Cleveland. He received the same board resolution that Woolsey did in response. *Id.* The dissenters in *Dodge v. Woolsey* noted that a "confederacy of some fifty banking corporations" in Ohio faced higher taxes as a result of the 1852 law and were determined to contest its constitutionality. *Id.* at 370 (Campbell, J., dissenting).

53. The Contracts Clause provides that no state shall pass any "law impairing the obligation of contracts." U.S. CONST. art I., § 10, cl. 1.

54. *Dodge*, 59 U.S. at 339.

55. *Id.* at 339.

56. *Id.*

57. *Id.* at 339-40.

58. *Id.* at 340.

59. *Id.*

60. *Id.*

61. *Id.* at 340-41.

shareholder, lacked standing to sue on behalf of the corporation.[62] Dodge maintained that the charter of the Bank provided "that its affairs shall be managed by a board of directors" rather than by stockholders and that the Bank's directors had already considered and declined Woolsey's demand that they resist the law.[63] This decision of the directors to comply with the tax law, even if erroneous or misguided, was exempt from stockholder challenge because directors were not answerable to stockholders for "an error of judgment merely."[64] Second, Dodge asserted that Woolsey failed to establish federal diversity jurisdiction because his suit came about through collusion with officials of the Bank of Cleveland, who deliberately recruited Woolsey, an out-of-state (*i.e.*, non-Ohio) shareholder, to sue.[65] Specifically, the filing of a federal diversity action in Woolsey's name amounted to a "contrivance" by the Bank "to create a jurisdiction, where none fairly exists, by substituting an individual stockholder in place of the Commercial Bank as complainant, and making the directors defendants."[66] This ruse was designed to avoid having the Bank file suit in state court, where it expected an unsympathetic reception for its attempt to invalidate Ohio's efforts to tax bank property at the same rate as personal property.[67] Finally, Dodge argued on the merits that he was acting in his official capacity in collecting a tax that had been properly assessed in conformity with the Ohio constitution of 1851.[68]

On the first issue, the Court, speaking through Justice Wayne, strongly affirmed the standing of a stockholder to sue in equity to protect a corporation from harm.[69] "It is now no longer doubted, either in England or the United States," Wayne declared, that courts could exercise equity jurisdiction over corporations, at the request of one or

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62. *Id.* at 340. As John Coffee and Donald Schwartz have noted: "'Standing' in the context of derivative actions is not to be confused with its more traditional function in limiting an individual's right to challenge governmental action. As used in the context of derivative suits, the word ['standing'] has become a term of art, and denotes a requirement that minority shareholders must satisfy in order to sue despite the opposition of the board of directors." Coffee & Schwartz, *supra* note 4, at 262-63 n.8.

63. *Dodge*, 59 U.S. at 340.

64. *Id.*

65. *Id.* at 340-41. At the time *Dodge v. Woolsey* was decided, federal question jurisdiction had not yet been established. Congress expanded the jurisdiction of the federal courts to include federal questions in 1875, as part of a general increase in the power of the national government during the Reconstruction Era. Act of Mar. 3, 1875, ch. 137, § 1, 18 Stat. 470, 470 (codified as amended at 28 U.S.C. § 1331 (2015) [hereinafter 1875 Judiciary Act] (giving federal trial courts jurisdiction over "all suits . . . arising under the Constitution or laws of the United States").

66. *Dodge*, 59 U.S. at 340-41.

67. *Id.* at 337.

68. *Id.* at 341.

69. *Id.* at 344.

more shareholders, to restrain managers of corporations from misconduct.[70] This equitable power extended to the circumstances of *Dodge v. Woolsey*, where Woolsey charged that the payment of an unconstitutional tax violated the Bank's charter and constituted an illegal allocation of profits.[71] As the Court explained, shareholders could sue to prevent corporate officers "from doing acts which would amount to a violation of charters, or to prevent any misapplication of their capitals or profits, which might result in lessening the dividends of stockholders, or the value of their shares."[72]

At the same time, Justice Wayne made clear, courts should only entertain derivative suits if a shareholder could show a "breach of trust" by the directors, such as facts demonstrating that the board acted beyond the scope of the company's charter.[73] Where "there is no breach of trust, but only error and misapprehension, or simple negligence on the part of the directors," a shareholder should not have standing to proceed on behalf of the corporation.[74] In this respect, the *Dodge* court laid the groundwork for what would later become the business judgment rule, a powerful shield for directors against derivative suits seeking to challenge negligent management of corporations.[75]

According to *Dodge*, Woolsey satisfied the "breach of trust" requirement by demonstrating that the allocation of profits to unconstitutional taxes and the failure to resist the tax law were *ultra vires* acts by the board of the Bank of Cleveland rather than an "error of judgment merely."[76] The Court began by noting that it was "illegal for a corporation to apply" its profits "to objects not contemplated by its charter."[77] It then classified the refusal of the Bank's directors to pursue a test case against the tax law as "a non-performance of a confessed official obligation, amounting to what the law considers a breach of trust, though it may not involve intentional moral delinquency."[78] In other words, the directors' "refusal was an [*ultra vires*] act outside of the obligation which the charter imposed upon them to protect what they conscientiously believed to be the franchises of the bank."[79] In situations of this kind, a shareholder was entitled to

70. *Id.* at 341-42.

71. *Id.* at 344-45.

72. *Id.* at 341.

73. *Id.* at 341-42.

74. *Id.* at 344 (quoting JOSEPH K. ANGELL & SAMUEL AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE § 393 (4th ed. 1852)).

75. RALPH C. FERRARA et al., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 1.03[1] (2014).

76. *Dodge*, 59 U.S. at 344.

77. *Id.* at 342.

78. *Id.* at 345.

79. *Id.*

sue for injunctive relief and to "maintain a bill in equity against the directors and compel the company to refund any of the profits thus improperly applied."[80]

The Court gave short shrift to Dodge's second point on appeal, which argued that diversity jurisdiction did not properly exist because the shareholder suit represented a procedural "contrivance" rather than an actual dispute between Woolsey and the board of the Bank.[81] It rejected this objection on the ostensibly unremarkable basis that Dodge made no effort to prove the existence of collusion between corporate management and Woolsey in the circuit court proceedings.[82] In actuality, however, the Court's acceptance of diversity jurisdiction in *Dodge* involved a somewhat more controversial move than its cursory dismissal of the imputation of collusion revealed.

At the outset, in order to determine whether diversity existed, the Court needed to identify what state it would recognize as Woolsey's residence. In a case decided a mere two years before, the Court announced that in suits involving corporations it would consider shareholders as citizens of the state of incorporation for the purpose of analyzing diversity, a standard that would have defeated diversity if applied in *Dodge*.[83] By accepting the state where Woolsey resided (Connecticut) rather than the state where the Bank was incorporated (Ohio) as the basis for Woolsey's citizenship, the Court seemed to go out of its way to hear the federal constitutional claim raised in *Dodge*. At the same time, it swept aside—without discussion—the conclusive presumption previously employed by the Taney Court in diversity cases that all shareholders resided in the state of incorporation, regardless of their actual domicile.[84]

Finally, the Court squarely rejected Dodge's third ground for appeal—that the tax he sought to collect was justified by the amended Ohio constitution of 1851, which allegedly superseded the Bank's 1845 charter. A "change of constitution," the Court proclaimed, "cannot release a State from contracts made under a constitution which permits them to be made."[85] As the Court chided the defendant: "The moral obligations" created by a contract (here, the Bank's original

80. *Id.* at 342.

81. *Id.* at 340.

82. *Id.* at 346.

83. Marshall v. Baltimore & Oh. R.R., 57 U.S. (16 How.) 314 (1854) (applying a presumption that all shareholders resided in the chartering state when analyzing diversity in cases involving corporations). On this point, see Ann Woolhander, *The Common Law Origins of Constitutionally Compelled Remedies*, 107 YALE L. J. 77, 88-89, 91 (1997).

84. Woolhandler, *supra* note 83, at 91 (noting that, in *Dodge* and later federal derivative suits, the "Supreme Court permitted end runs around its own diversity decisions, which had presumed that shareholders resided in the state of incorporation.").

85. *Dodge*, 59 U.S. at 360.

charter) "never die."[86]

Justice John Archibald Campbell, joined by Justices Catron and Daniel, filed an impassioned, hard-hitting dissent that contested both the jurisdictional and constitutional reasoning of the majority.[87] Campbell had practiced law in Alabama before joining the Supreme Court in 1853 and enjoyed a "hard-earned reputation based on dedication, talent, and unswerving integrity."[88] When the Civil War broke out he resigned from the Court and later served as Confederate Assistant Secretary of War from 1862 to 1865.[89] At the close of the war he was imprisoned for nearly five months along with other high-ranking former Confederates.[90] Despite these obstacles, he quickly resumed a thriving law practice in Louisiana after his release.[91] In one of his most famous (though unsuccessful) representations, Campbell argued the *Slaughter-House Cases* before the Supreme Court, which resulted in the Court's first construction of the meaning of the newly enacted Fourteenth Amendment in 1873.[92]

In his *Dodge* dissent, Campbell opened with the second point raised on appeal, namely, the absence of federal diversity jurisdiction. He first zeroed in on the issue the majority had glossed over when it recognized Connecticut, rather than Ohio, as the state of citizenship of shareholder Woolsey for the purpose of establishing diversity. Campbell pointed out that the Court had recently adopted a presumption that the shareholders of a corporation and the corporation itself shared the same domicile, namely, the state of incorporation.[93] Based on that precedent, decided a mere two years earlier, Campbell argued that Woolsey failed to satisfy the test for diversity.[94] Specifically, in a case where a shareholder of an Ohio

86. *Id.*

87. *See id.* at 361-80 (Campbell, J., dissenting).

88. THE OXFORD COMPANION TO THE SUPREME COURT OF THE UNITED STATES 116 (Kermit L. Hall, ed., 1992). For biographical information on Campbell see *id.*; ROBERT SAUNDERS, JOHN ARCHIBALD CAMPBELL: SOUTHERN MODERATE, 1811-1889 (1997); James P. McPherson, *The Career of John Archibald Campbell: A Study of Politics and the Law*, 19 ALA. REV. 53 (1966).

89. SAUNDERS, *supra* note 88, at 154.

90. *Id.* at 189.

91. McPherson, *supra* note 88, at 60.

92. *In re* Slaughter-House Cases, 83 U.S. (16 Wall.) 36 (1873). In that proceeding, Campbell represented a collection of New Orleans butchers challenging a grant of monopoly privileges to a slaughterhouse corporation by the Louisiana legislature. *Id.* On behalf of the butchers' association, Campbell argued, *inter alia*, that the state-created monopoly deprived individual butchers of their right to pursue a livelihood in violation of the Privileges and Immunities Clause of the Fourteenth Amendment. *See id.* at 55.

93. *Dodge*, 59 U.S. at 364-65 (Campbell, J., dissenting) (citing Marshall v. Baltimore & Oh. R.R. Co., 57 U.S. 314 (1854)).

94. *Id.* at 365.

corporation sued that corporation (along with corporate directors and a state officer who resided in Ohio), all the parties either actually or presumptively qualified as citizens of the same state.[95]

Wary of extending national power and eager to protect state sovereignty, Campbell predicted that the majority's ruling would incite and gratify a "most morbid appetite for jurisdiction" in the federal courts.[96] In particular, he warned that allowing a shareholder residing outside the chartering state to pursue a federal diversity action against a corporation and its directors "upon the real or affected indifference" of the board would introduce a dangerous device for "bringing into the courts of the United States all questions in which these artificial beings are concerned."[97]

Campbell then attacked Woolsey's standing to pursue a derivative suit. He insisted that Woolsey had failed to demonstrate a breach of trust by the Bank's directors, a prerequisite for a stockholder to proceed derivatively on behalf of the corporation.[98] The decision of the Bank's directors not to apply for an injunction against the collection of the allegedly unconstitutional tax in state court (the only jurisdiction available to the Bank as a litigant), Campbell argued, amounted to "merely a question of discretion in the performance of an official duty" rather than a breach of trust.[99] As he pointed out, there was no evidence that the directors could not be relied on to decide whether to commence litigation. They collectively owned only ten percent of the Bank's shares and consequently did not control the corporation through their stock ownership.[100] Moreover, there was "no charge of fraud, collusion, neglect of duty, or of indifference by the directors" in the management of the Bank's affairs, save their failure to apply for an injunction against the collection of the new tax.[101]

In addition, the dissent insisted that the alleged refusal of the defendant directors and the Bank itself to resist the tax was illusory and contrived.[102] Far from taking an adversarial position with respect to Woolsey's claims, management of the Bank had collaborated with Woolsey for the purpose of fabricating federal jurisdiction. According to Campbell, the alleged breach of duty by the board was in reality a transparent attempt to gain a more sympathetic hearing for the Bank's constitutional attacks on Ohio's efforts to raise taxes on the

95. *Id.* The Supreme Court had already decided that a corporation could be treated as a citizen of the state of incorporation for the purpose of the diversity test. Louisville, C. & C.R.R. v. Letson, 43 U.S. (2 How.) 497 (1844).

96. *Dodge*, 59 U.S. at 365 (Campbell, J., dissenting).

97. *Id.*

98. *Id.* at 365-69.

99. *Id.* at 366.

100. *Id.* at 367.

101. *Id.*

102. *Id.* at 369.

state's banking industry:

> This suit is evidently maintained with [the directors'] consent; there has been no appearance either by the directors or the corporation, but they abide the case of the stockholder. The decree is for the benefit of the corporation. The question then is, can a corporation belonging to a State, and whose officers are citizens, upon some hope or assurance that the opinions of the courts of the United States are more favorable to their pretensions, by any combination, contrivance, or agreement with a non-resident shareholder, devolve upon him the right to seek for the redress of corporate grievances, which are the subjects of equitable cognizance in the courts of the United States, by a suit in his own name.[103]

Campbell urged the Court to refuse to legitimize the corporation's tactic of circumventing state tribunals by employing an out-of-state shareholder to create the appearance of diversity jurisdiction.[104]

Only after this extensive discussion of the folly of permitting the shareholder in *Dodge* to proceed derivatively in federal court did the dissent address the merits of Woolsey's suit. In a sweeping opinion, Campbell vigorously attacked the growing power of business corporations in mid-nineteenth-century America and aggressively defended the use of state police power to restrain them.[105] As he framed the plaintiff's claim, it required the Court to decide what effect to give a state constitutional amendment "to adopt equality as the rule of assessment of taxes upon corporate property."[106] In his view, "[c]ertainly no greater question—none involving a more elemental or important principle—has ever been submitted to a judicial tribunal."[107] According to a "confederacy of some fifty banking corporations, having one fortieth of the property of the State" that had evidently masterminded the constitutional challenge, the people and government of Ohio were utterly without power to change any provisions of the charters of Ohio banks, "particularly that determining the amount of their contribution to the public revenue."[108] Campbell declared that business corporations posed an ongoing threat to public welfare because of their continual quest for power and desire to shield themselves from responsibility to the public.[109] He referred to the disturbing possibility that the Contracts Clause would permit a "careless or a corrupt" legislature to grant a corporation a perpetual

103. *Id.*

104. *Id.* ("In my opinion, there should be but one answer to the question.").

105. *See id.* at 369-80. On the exercise of state police power in nineteenth-century America, see generally WILLIAM J. NOVAK, THE PEOPLE'S WELFARE: LAW AND REGULATION IN NINETEENTH-CENTURY AMERICA (1996).

106. *Dodge*, 59 U.S. at 369 (Campbell, J., dissenting).

107. *Id.* at 369-70.

108. *Id.* at 370.

109. *Id.* at 375.

exemption from taxation:

> A concession of the kind contained in this act, by a careless or a corrupt legislature, for a term or in perpetuity, would impair in many States their resources to an alarming extent . . . . And were this to happen, should it be that a State of this Union had become the victim of vicious legislation, its property alienated, its powers of taxation renounced in favor of chartered associations, and the resources of the body politic cut off, what remedy has the people against the misgovernment?[110]

Campbell further asserted that "[a] material distinction has always been acknowledged to exist" between the powers that governments could properly exercise over the rights of individuals and the powers they could exercise over the rights of corporations.[111] He attributed this distinction to the state's authority to bring corporate entities to life:

> Individuals are not the creatures of the State, but constitute it. They come into society with rights, which cannot be invaded without injustice. But corporations derive their existence from the society, [and] are the offspring of transitory conditions of the State . . . .[112]

Unfortunately, corporations often returned this gift from the state by displaying "durable dispositions for evil," "a love of power," and a "preference for corporate interests to moral or political principles or public duties."[113] As a result, Campbell concluded, all "civilized States" had taken steps "to limit their privileges" or even "to suppress their existence" altogether.[114]

Campbell's emotional plea to buttress the authority of states to restrain corporate power failed to sway the Court's majority. Buoyed by their decisive victory in *Dodge*, corporations became even more aggressive in their use of shareholder derivative actions to challenge third-party conduct, especially by governmental entities, in the coming decades.[115]

B. The Aftermath of Dodge and the Development of the Federal Demand Standard

When the highest court next considered the validity of a derivative suit thirteen years after *Dodge*, it began to signal some ambivalence about the use of shareholder litigation to secure a federal forum for disputes between a corporation and third parties.[116] In *Memphis City*

110. *Id.* at 370-71.
111. *Id.* at 375.
112. *Id.*
113. *Id.*
114. *Id.*
115. *See infra* notes 143-262 and accompanying text.
116. Memphis City v. Dean, 75 U.S. 64 (1869).

v. Dean (1869), the Court took a step toward curbing such suits by highlighting a requirement that stockholders make a sincere demand on a board of directors and receive a clear refusal of that demand prior to bringing a federal derivative action.[117]

The plaintiff-shareholder in *Memphis City*, Thompson Dean, filed a derivative suit in federal court challenging the alleged refusal of the board of directors of Memphis Gaslight Company ("Memphis Gaslight") to protect rights contained in an 1852 contract between the company and the city of Memphis. According to Dean, the 1852 contract granted Memphis Gaslight an exclusive right to supply gas to the city for public use and to residents for private use for twenty years.[118] He claimed that the city breached its agreement with Memphis Gaslight by proposing a voter referendum as to whether the municipality should invest in the stock of a competing gas business, Memphis Gayoso (Gayoso), which the state had incorporated in 1866.[119] Aside from Memphis Gaslight as the nominal corporate defendant, the only other defendants named in the action—the city of Memphis and Gayoso—were third parties, entirely unaffiliated with Memphis Gaslight.[120] Alleging breach of contract, the derivative suit sought an injunction restraining city officials from holding the proposed referendum or subscribing to the stock of Gayoso and barring Gayoso from laying down pipes in Memphis or selling gas to the city's inhabitants.[121]

In their defense, the city of Memphis and Gayoso asserted that Dean lacked standing to sue as a stockholder because he failed to show that the board of Memphis Gaslight had refused his request to take legal action.[122] On the contrary, the record showed that Memphis Gaslight, in reliance on an alleged grant of monopoly rights contained in its 1849 charter from the state of Tennessee, had already commenced a proceeding against Gayoso in state court seeking to enjoin that company from doing business in Memphis.[123] At a preliminary hearing in the state action, however, the Tennessee

117. *See id.* at 73. Though an 1882 case, *Hawes v. Oakland*, 104 U.S. 450 (1882), is often cited as the origin of the demand requirement in federal courts, the Supreme Court first articulated the demand prerequisite in *Memphis City* in 1869. As noted above, however, nineteenth-century courts generally excused shareholders from making a demand on the board where the complaint showed that the corporation was under the control of the alleged wrongdoers. *See supra* note 9 and accompanying text.

118. *Memphis City*, 75 U.S. at 65-67.

119. *Id.* at 66-67.

120. For identities of parties, see Brief for Appellant at 1, City of Memphis v. Dean, 75 U.S. 64 (1869) (No. 155) (listing plaintiff as Thompson Dean and defendants as the Board of mayor and aldermen of the City of Memphis, the Memphis Gayoso Gas Light Company, and the Memphis Gas Light [stet] Company).

121. *Memphis City*, 75 U.S. at 67-68.

122. *Id.* at 69-70. Memphis Gaslight did not file an answer. *See id.* at 69.

123. *Id.* at 66-67, 69-70.

chancery court rejected Memphis Gaslight's claim to an exclusive privilege to supply gas.[124]

In support of Dean's standing to proceed derivatively, his lawyers insisted that the federal suit presented a new and distinct grievance from the state action because it introduced the city of Memphis as an additional defendant.[125] They also contended that the Memphis Gaslight directors had refused Dean's request to name the municipality as a defendant in the pending state court action.[126] Attorneys for Gayoso and the city unsuccessfully countered that the derivative suit represented an obvious effort to end run the state court's preliminary ruling denying Memphis City's claim to exclusive rights: "[I]t is evident that [Dean] went into the Federal court, in order to evade the jurisdiction of the local one; to appeal, in fact, from the decision of the State chancellor, who had refused to recognize the monopoly claimed by the old company."[127]

When the city of Memphis and Gayoso appealed the grant of an injunction in Dean's federal derivative action, the U.S. Supreme Court took the occasion to reiterate its support for the general principles of *Dodge v. Woolsey* and the legitimacy of the derivative suit in American law. In the Court's unanimous view, *Dodge* "authorize[d] the stockholder of a company to institute a suit in equity in his own name against a wrong-doer, whose acts operate to the prejudice of the interests of the stockholders, such as diminishing their dividends and lessening the value of their stock."[128]

However, the *Memphis City* decision also spelled out two prerequisites for recognizing the authority of shareholders to pursue such actions. First, the stockholder had to demonstrate a prior demand on the board and denial of that demand. In the Court's words, the stockholder had to show that an "application has first been made to the directors of the company to institute the suit in its own name, and they have refused."[129] As the Court explained, shareholder demand on the board and subsequent refusal of that demand were necessary to confer standing on the stockholder to sue in place of the corporate entity:

> This refusal of the board of directors is essential in order to give to the stockholder any standing in court, as the charter confers upon the directors representing the body of stockholders, the general

124. *Id.* at 67.

125. *Id.* at 68, 70-71, 74.

126. *Id* at 74.

127. *Id.* at 70. Lawyers for Gayoso and the city of Memphis also pointed out that Dean used the same attorneys to prosecute his federal derivative suit as Memphis Gaslight used to prosecute its claim in state court. Transcript of Record at 18, City of Memphis v. Dean, 75 U.S. 64 (1869) (No. 306).

128. *Memphis City*, 75 U.S. at 73.

129. *Id.*

> management of the business of the company.[130]

Second, the stockholder had to show that the board's rejection of demand was wrongful. As the Court made plain, to "authorize a stockholder to institute the suit in his own behalf," the derivative complaint had to show "a clear default . . . involving a breach of duty" by directors in denying the demand.[131]

Relying in part on the new federal demand standard, the Supreme Court overturned the circuit court's issuance of a permanent injunction against the third-party defendants in *Memphis City* and directed dismissal of Dean's derivative action.[132] Among other things, the Court concluded that the derivative suit was improper because the Memphis City board, far from rejecting Dean's demand, had approved the filing of a prior case against Gayoso, still pending in state court, to protect its allegedly exclusive rights to supply gas in Memphis.[133]

Despite the pushback from the Court in *Memphis City*, corporations continued to mobilize derivative suits to obtain federal hearings for disputes involving third parties throughout the 1870s. On some occasions, corporations turned to derivative actions to pursue cases against rival businesses. In *Morgan v. Railroad Co.*, for instance, a New York shareholder of the Pontchartrain Railroad, a Louisiana corporation, commenced a derivative suit against the New Orleans, Mobile and Chattanooga Railroad in the federal circuit court for the district of Louisiana.[134] Former Supreme Court Justice John Archibald Campbell, who served as counsel for the New Orleans line, must have taken satisfaction from the court's finding that the shareholder action represented an improper effort to avoid the state court system.[135] As the circuit court observed: "The only apparent reason for the suit being brought in the name of the complainant is that he is a citizen of New York, and can maintain a suit against the defendants in the federal court; whereas the Pontchartrain Railroad Company, being a corporation of Louisiana, would be obliged to sue in the state court."[136]

On other occasions, corporate counsel resorted to derivative actions to bypass state courts in cases involving politically sensitive challenges to state or local regulation and taxation of corporations. In *Davenport v. Dows*, for instance, a railroad chartered in Iowa,

130. *Id.*

131. *Id.*

132. *Id.* at 73-76.

133. *Id.* at 76. In addition, the Court ordered dismissal of Dean's breach of contract claim against the city on the ground that, even if Memphis voters did authorize the city to subscribe to the stock of another gas company, such an investment would not violate the terms of the 1852 contract between the city and Memphis Gaslight. *Id.* at 66, 75-76.

134. 1 Woods, 15, 17 F. Cas. 759 (U.S. C.C. D. La. 1870).

135. *Id*. at 759-60.

136. *Id.*

following the roadmap provided by *Dodge v. Woolsey*,[137] deployed a derivative suit by a non-resident shareholder to contest the legality of an Iowa tax on the railroad in federal court.[138]

The railway in question, the Chicago, Rock Island, and Pacific Railroad Company ("Rock Island"), was chartered under the laws of Iowa.[139] David Dows, a citizen of New York and an owner of 500 shares of Rock Island, filed a suit in federal court in Iowa "in behalf of himself and all other non-resident citizens of Iowa, who were stockholders" in Rock Island against the city of Davenport, Iowa, and a city official.[140] Given that Rock Island was chartered under Iowa law, the corporation could not have satisfied the diversity requirement for federal jurisdiction in a suit against a municipality in Iowa.

Finding a New York stockholder conveniently enabled the railroad to pursue a test case in federal court that otherwise would have been precluded for lack of jurisdiction. The lawyer for the city of Davenport characterized Dows' shareholder action in this way: "This suit is an ingenious attempt to withdraw from the state courts the interpretation of state statutes, affecting state corporations, by the device of making a non-resident stockholder plaintiff on the record."[141] The city's assertion of collusion between corporate management and the New York shareholder was supported by the fact that Dows' counsel in the derivative action was Thomas F. Witherow, an Illinois attorney who frequently represented Rock Island in litigation and later became general counsel for the line.[142]

C. Contrivance and Collusion: The Gilded Age and Beyond

By the early 1880s, the corporate practice of manufacturing derivative litigation to gain access to federal courts had grown so

137. Dodge v. Woolsey, 59 U.S. 331 (1855).

138. Davenport v. Dows, 85 U.S. 626, 626-27 (1873).

139. Abstract and Argument for Appellants at 3, Davenport v. Dows, 85 U.S. 626 (1873) (No. 190).

140. *Davenport*, 85 U.S. at 626.

141. Abstract and Argument for Appellants at 24, Davenport v. Dows, 85 U.S. 626 (1873) (No. 190).

142. For Witherow's representation of the Chicago, Rock Island, and Pacific line, see, e.g., Chi., Rock Island & Pac. R.R. Co. v. Bell, 70 Ill. 102 (Ill. 1873) (identifying Witherow as counsel for the Chicago, Rock Island and Pacific Railroad); Chi., Rock Island & Pac. R.R. Co. v. McKittrick, 78 Ill. 619 (Ill. 1875) (same); Chi., Rock Island & Pac. R.R. Co. v. Payzant, 87 Ill. 125 (Ill. 1877) (same); RICHARD C. CORTNER, THE IRON HORSE AND THE CONSTITUTION: RAILROADS AND THE TRANSFORMATION OF THE FOURTEENTH AMENDMENT 68 (1993) (describing Thomas F. Witherow as "general counsel of the Chicago, Rock Island & Pacific road" in 1889). While Witherow's strategic resort to a federal derivative suit succeeded at the circuit court level, the U.S. Supreme Court overturned the lower court's injunction against collection of the disputed tax on the technical ground that the derivative suit failed to name the Chicago, Rock Island, and Pacific Railroad as a nominal defendant. *Davenport,* 85 U.S. at 626-28.

rampant that it compelled the Supreme Court to address the phenomenon in a series of 1882 decisions. In a trio of unanimous opinions, each written by Justice Samuel Miller, the Court weighed the continued validity of the derivative action, sharpened the contours of the demand requirement, and pointedly rebuked corporate management for colluding with shareholders to create federal jurisdiction on sham pretenses.[143]

In the first and most elaborately reasoned decision, *Hawes v. Oakland*,[144] the Court began by distinguishing between derivative suits involving a "real contest[]" between the "stockholder and the corporation of which he is a member" and what it described as a "simulated . . . arrangement."[145] The former category of disputes, in which shareholders sought to hold officers and directors liable for wrongdoing, properly invoked the "beneficent powers and flexible methods" of equity courts:

> The exercise of this power in protecting the stockholder against the frauds of the governing body of directors or trustees, and in preventing their exercise, in the name of the corporation, of powers which are outside of their charters or articles of association, has been frequent, and is most beneficial, and is undisputed.[146]

But the Court was considerably less positive about the explosion of federal shareholder litigation that had occurred in the quarter century since it first approved the derivative suit in *Dodge v. Woolsey* (1856).[147] Justice Miller took a dim view of the "frequency with which the most ordinary and usual chancery remedies are sought in the Federal courts by a single stockholder of a corporation who possesses the requisite citizenship, in cases where the corporation whose rights are to be enforced cannot sue in those courts."[148] The Court was particularly troubled by the tendency of corporations to employ shareholder suits to gain entry to the federal court system on specious grounds:

> This practice has grown until the corporations created by the laws of the States bring a large part of their controversies with their neighbors and fellow-citizens into the courts of the United States for

143. Although the Court did not identify specific cases, it had decided at least two shareholder derivative suits, in addition to *Davenport v. Dows*, 85 U.S. 626 (1873), that likely involved collusion between corporate management and the plaintiff- stockholders in the prior decade. *See* Humphrey v. Pegues, 83 U.S. (16 Wall.) 244 (1873); Tomlinson v. Branch, 82 U.S (15 Wall.) 460 (1873) (both involving non-resident shareholder suits challenging state taxes that allegedly violated the Contracts Clause by failing to honor exemptions from taxation prescribed in corporate charters).

144. 104 U.S. 450 (1882).

145. *Id.* at 453.

146. *Id.*

147. *Id.* at 452.

148. *Id.*

> adjudication, instead of resorting to the State courts, which are their natural, their lawful, and their appropriate forum.[149]

To ward off any possible confusion about the improper practices he referred to, Miller's opinion described how wily corporate advisors went about drumming up out-of-state shareholders to assert claims in federal court that their clients could not raise there directly:

> A corporation having . . . a controversy, which it is foreseen must end in litigation, and preferring for any reason whatever that this litigation shall take place in a Federal court, in which it can neither sue its real antagonist nor be sued by it, has recourse to a holder of one of its shares, who is a citizen of another State. This stockholder is called into consultation, and is told that his corporation has rights which the directors refuse to enforce or to protect.[150]

The shareholder then cooperates by "instantly" demanding that the board "do their duty in this regard, which of course they fail or refuse to do."[151] The board's refusal conveniently opens the door to a federal derivative action by the stockholder based on diversity jurisdiction:

> [H]e discovers that he has two causes of action entitling him to equitable relief in a court of chancery; namely, one against his own company, of which he is a corporator [*i.e.*, stockholder], for refusing to do what he has requested them to do; and the other against the party which contests the matter in controversy with that corporation. These two causes of action he combines in an equity suit in the Circuit Court of the United States, because he is a citizen of a different State, though the real parties to the controversy could have no standing in that court.[152]

Even the absence of an out-of-state shareholder eligible to bring suit evidently had not deterred determined corporate counsel. "If no non-resident stockholder exists," the Court observed, "a transfer of a few shares is made to some citizen of another State, who then brings the suit."[153] As a result of such dubious maneuvers, "the overburdened courts of the United States have this additional important litigation imposed upon them by a simulated and conventional arrangement, unauthorized by the facts of the case or by the sound principles of equity jurisdiction."[154]

Underlying the Court's concern lay a distinction between those derivative suits that involved genuine intra-corporate conflict between shareholders and corporate managers and those in which corporate officers were named as defendants but the real dispute pitted the

149. *Id.*
150. *Id.*
151. *Id.*
152. *Id.* at 452-53.
153. *Id.* at 453.
154. *Id.*

corporation against one or more third parties.[155] What made the shareholder claim in *Hawes*—as well as the prior shareholder action in *Dodge*—potentially problematic to the Court was that neither seemed to present "real contests"[156] between shareholders and management.

In *Hawes,* a shareholder named Loring P. Hawes, a citizen of New York, challenged a decision by the board of directors of the Contra Costa Water-Works Company ("Contra Costa"), a corporation chartered by the state of California, to provide free water to the city of Oakland for public use.[157] The derivative complaint named the five members of the board of directors of Contra Costa, the water company itself, and the city of Oakland as defendants.[158] Hawes asserted that Contra Costa directors improperly complied with Oakland's demand to supply it with free water for all municipal purposes, including watering the streets and flushing sewers, contrary to the corporation's charter.[159] According to Hawes, the charter only required Contra Costa to furnish water to the city at no charge in cases of great emergency, such as fires.[160]

As was typically the case in suits involving collusion between the corporation's attorneys and counsel for shareholders suing derivatively, Contra Costa and its directors failed to answer the stockholder's bill of complaint or to defend the charges in any way.[161] Instead, the sole defendant not affiliated with the company—the city of Oakland—asserted a demurrer seeking dismissal of the action.[162]

The federal circuit court sustained the city of Oakland's demurrer on two separate points. The first turned on the standing of Hawes as a shareholder to pursue the claim.[163] As the city maintained and the circuit court agreed, Hawes "has shown no capacity in himself to maintain this suit," because the "injury, if any exists," is "to the interests of the corporation," and therefore the "right to sue belong[s] solely to that body."[164] Second, on the merits, the lower court found that the charter under which Contra Costa was organized by the state entitled the city of Oakland to receive water for public works on a gratuitous basis.[165]

155. *See id.*
156. *See id.*
157. *Id.* at 450-51.
158. *Id.*
159. *Id.* at 451.
160. *Id.* at 451, 461.
161. *Id.* at 451.
162. *Id.*
163. *Id.* at 452.
164. *Id.*
165. *Id.* Indeed, the California Supreme Court, in an earlier case involving the City of San Francisco and the Spring Valley Water Works, had construed an identical

In considering the stockholder's appeal, Justice Miller opined that the first ground for dismissal—lack of shareholder standing—presented a "matter of very great interest, and of growing importance in the courts of the United States."[166] The Court then embarked on a lengthy reconsideration of *Dodge v. Woolsey*. At the outset, Miller remarked that derivative cases in state courts were relatively rare in comparison to those brought in federal courts: "In this country the case[s] outside of the Federal courts are not numerous."[167] While acknowledging that *Dodge* had spawned a worrisome proliferation of derivative suits in federal tribunals, Justice Miller made clear that the Court did not intend to overrule *Dodge* or hold it responsible for the suspect practices that had arisen in its wake. Indeed, the Court described the opinion as "manifestly well considered."[168] Moreover, Miller clearly sympathized with the *Dodge* Court's desire to provide a federal hearing on a federal constitutional question that "peculiarly belonged to the Federal judiciary." Because the corporation that faced the allegedly unconstitutional tax in *Dodge* was chartered in Ohio and all the defendants resided in Ohio, it could not avail itself of diversity jurisdiction. Therefore, unless the Supreme Court allowed the Connecticut shareholder in *Dodge* to sue derivatively, the bank would have had no access to federal court on the constitutional question "except by writ of error to a State court from the Supreme Court of the United States."[169]

But the institutional considerations that weighed in favor of granting stockholder standing in *Dodge*—to provide a federal forum for the resolution of a federal constitutional question—no longer existed in 1882. The creation of federal question jurisdiction by Congress in 1875, which granted federal courts jurisdiction over "all suits . . . arising under the Constitution or laws of the United States," was linked to a general enlargement of federal power during the Civil War and Reconstruction era.[170] It also solved the specific tactical problem faced by the corporation in *Dodge*. As Justice Miller pointed out, if federal question jurisdiction had been available at the time the events in *Dodge* unfolded, the bank "could undoubtedly have brought suit to restrain the collection of the tax in its own name, without resort

provision in the Spring Valley charter entitling the city to free water "in cases of fire or other great necessity" to require the provision of free water to the city of San Francisco for flushing sewers and for schools, hospitals, and prisons. *See* Brief for Appellee at 17, Hawes v. Oakland, 104 U.S. 450 (1882) (No. 148) (citing Spring Valley Water Works v. S.F., 52 Cal. 111 (1877)).

166. *Hawes*, 104 U.S. at 452.

167. *Id.* at 457.

168. *Id.* at 459.

169. *Id.*

170. 1875 Judiciary Act, *supra* note 65.

to one of its shareholders for that purpose."[171]

While the 1875 Judiciary Act substantially expanded the jurisdiction of the federal courts, it also attempted to crack down on collusive attempts to gain improper access to such courts. Section five of the statute provided that if a circuit court determined at any time in a case that a "suit does not really and substantially involve a dispute or controversy properly within the jurisdiction of said circuit court, or that the parties to said suit have been improperly or collusively made or joined, either as plaintiffs or defendants, for the purpose of creating a case cognizable or removable under this act, the said circuit court shall proceed no further."[172]

Rather than overturn the Supreme Court's decision in *Dodge*, Justice Miller delivered a stern admonishment to the lower federal judiciary to enforce section five of the 1875 Judiciary Act more rigorously. "It is believed that a rigid enforcement of this statute by the Circuit Courts," he reproached, "would relieve them of many cases which have no proper place on their dockets."[173] Only with these qualifications did the *Hawes* Court reaffirm *Dodge v. Woolsey* and the continued soundness of the derivative suit in American law.[174]

In a further effort to contain what it viewed as an improper deluge of federal stockholder suits, the Court also demarcated four limited sets of circumstances that would entitle a shareholder to pursue a claim on behalf of the corporation:

> Some action or threatened action of the managing board of directors or trustees of the corporation which is beyond the authority conferred on them by their charter or other source of organization;
>
> Or . . . a fraudulent transaction completed or contemplated by the acting managers, in connection with some other party, or among

171. *Hawes*, 104 U.S. at 459.

172. 1875 Judiciary Act, *supra* note 65, at §5.

173. *Hawes*, 104 U.S. at 459.

174. Immediately after its decision in *Hawes v. Oakland*, the Supreme Court issued new Equity Rule 94. Additional Rule of Practice in Equity No. 94, 104 U.S. at ix-x (1882). This rule stated:

> Every bill brought by one or more stockholders in a corporation, against the corporation and other parties, founded on rights which may properly be asserted by the corporation, must be verified by oath, and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law; and that the suit is not a collusive one to confer on a court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action.

Id. Equity Rule 94 was later recodified as Equity Rule 27 and ultimately incorporated, with minor changes, in Federal Rule of Civil Procedure 23.1.

> themselves, or with other shareholders as will result in serious injury to the corporation, or to the interests of other shareholders;
>
> Or where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the corporation itself, or of the rights of the other shareholders;
>
> Or where the majority of shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation, which is in violation of the rights of other shareholders, and which can only be restrained by the aid of a court of equity.[175]

According to the Court, the New York shareholder in *Hawes* failed both to satisfy the procedural requirements for making a demand on the Contra Costa board prior to instituting suit and to set forth one of the four substantive grievances that would entitle the company to relief. On the first point, Justice Miller indicated that Hawes "merely avers that he requested the president and directors to desist from furnishing water free of expense to the city, except in case of fire or other great necessity, and that they declined to do as he requested."[176] In the Court's view, such allegations were deficient in a number of respects: "No correspondence on the subject is given. No reason for declining. We have here no allegation of a meeting of the directors, in which the matter was formally laid before them for action."[177] In contrast, the shareholder's attorney in *Dodge* had provided a written request to the board of the Bank of Cleveland, which then issued a formal resolution indicating that it had considered the application and stating the reason for refusing it.[178]

On the second point, the Court concluded that Hawes failed to allege a sufficient substantive foundation for a suit against the directors, such as fraud, *ultra vires* acts, "or of destruction of property, or of irremediable injury of any kind."[179] Even assuming Hawes' construction of Contra Costa's charter was correct and that the language entitling the city to water free of charge "in cases of fire or other great necessity" applied only to emergency situations, the Court found that the charter did not explicitly *forbid* the gratuitous provision of water by the corporation to the city.[180] Justice Miller noted that the city had "conferred on the company valuable rights by special ordinance; namely, the use of the streets for laying its pipes, and the

175. *Hawes*, 104 U.S. at 460. In addition to the four specified categories of grievances, the Court recognized that "[p]ossibly other cases may arise in which, to prevent irremediable injury, or a total failure of justice, the court would be justified in exercising its [equitable] powers." *Id.*

176. *Id.* at 461.

177. Id.

178. Dodge v. Woolsey, 59 U.S. 331, 340 (1856).

179. Hawes, 104 U.S. at 461.

180. Id.

privilege of furnishing water to the whole population."[181] In light of these grants, "[i]t may be the exercise of the highest wisdom to let the city use the water in the manner complained of," even if not required by the charter. In an early variation on the business judgment rule, Miller concluded that "directors are better able to act understandingly on this subject than a stockholder residing in New York."[182]

Huntington v. Palmer,[183] handed down the same day as *Hawes v. Oakland*, indicated the willingness of the Court to enforce both the demand and non-collusion requirements even in cases presenting federal constitutional challenges to state regulation. In *Huntington*, Collis P. Huntington, a founder, vice president, and chief lobbyist of the Central Pacific Railroad Company ("Central Pacific"), as well as a holder of $100,000 worth of its stock, filed a derivative suit "on behalf of himself and such other stockholders as will come in and contribute to its prosecution."[184] The suit named two defendants—the Central Pacific itself and Charles Palmer, the tax collector of the County of Alameda, California—and sought to enjoin the Central Pacific board from wasting corporate assets by paying allegedly unconstitutional taxes levied by the state of California.[185]

Again writing for a unanimous Court, Justice Miller affirmed the circuit court's dismissal of Huntington's suit on the combined basis of failure to make sufficient demand and collusion to create jurisdiction. As the Court initially noted:

> Although the company is the party injured by the taxation complained of, which must be paid out of its treasury, if paid at all, the suit is not brought in its name, but in that of one of its stockholders. Of course . . . this cannot be done without . . . an *honest and earnest effort* by the complainant to induce the corporation to take the necessary steps to obtain relief.[186]

In this case, Collis Huntington's complaint alleged that he requested the Central Pacific board to institute legal proceedings to test the constitutionality of the assessed taxes.[187] But the board "absolutely and wilfully [sic] refused to do so," with the result "that it will pay

181. Id. at 462.

182. Id.

183. Huntington v. Palmer, 104 U.S. 482 (1882).

184. Id. at 482, 484. For the identity of the plaintiff and background on Huntington's role in the Central Pacific, see Transcript of Record at 2, Huntington v. Palmer, 104 U.S. 482 (1882) (No. 1127); RICHARD WHITE, RAILROADED: THE TRANSCONTINENTALS AND THE MAKING OF MODERN AMERICA 93-133 (2011); DAVID LAVENDER, THE GREAT PERSUADER: THE BIOGRAPHY OF COLLIS P. HUNTINGTON, 94-123 (1999).

185. *Huntington*, 104 U.S. at 482. Huntington's suit challenged the tax under both the constitution of California and the Equal Protection Clause of the Fourteenth Amendment of the federal constitution. *See* Brief for Appellant at 25, Huntington v. Palmer, 104 U.S. 482 (1882) (No. 1127).

186. *Huntington*, 104 U.S. at 483 (emphasis added).

187. *Id.*

these illegal taxes out of the funds of the company, to the detriment of himself and other stockholders."[188] As in *Hawes v. Oakland*, Miller treated the allegations of demand as perfunctory and inadequate: "There is here no formal written appeal to the board, nor any formal resolution of that body, as in *Dodge v. Woolsey*."[189]

Determined to bolster enforcement of section five of the 1875 Judiciary Act and likely affronted by the transparent attempt to pass off Huntington, one of the organizers and leading executives of the Central Pacific, as an aggrieved minority shareholder, the Court also took a hard line on the issue of collusion.[190] While the Supreme Court in *Dodge* declined to examine charges of improper collaboration between shareholders and corporate management in the absence of hard proof, the *Huntington* Court was unwilling to look the other way.[191] Indeed, it indicated that when a derivative suit displayed signs of concerted action between management and the shareholder pursuing the suit—as was evidently the case in *Huntington v. Palmer*—the burden of overcoming the presumption of collusion should rest with the plaintiff. As the Court put the matter, dismissal of Huntington's suit was warranted because "there [was] nothing to repel the reasonable presumption that parties were improperly and collusively made in order to invoke the jurisdiction of the Federal court."[192]

In the last of its 1882 rulings on derivative actions, *Greenwood v. Freight Co.*, the Supreme Court upheld the standing of the stockholder in question, James Greenwood, to sue derivatively.[193] According to the Court, Greenwood, a citizen of New York, satisfied the requirements for demonstrating non-collusion and making an adequate demand on the Marginal Freight Railroad Company ("Marginal Company"), a Massachusetts corporation.[194] The Court reached this result even though the only reason the directors stated for denying Greenwood's

188. *Id.* at 484.

189. *Id.*

190. *See id.*

191. *See id.*

192. *Id.*

193. 105 U.S. 13, 16 (1882).

194. Greenwood's bill of complaint shows that the board of the Marginal Company, in rejecting his demand, relied on the template developed by the board in *Dodge v. Woolsey*. The Marginal Company board resolved: "That we fully concur in the views expressed in the communication of Mr. James Greenwood, of September 3, 1872, as to the illegality and unconstitutionality of the act of the legislature therein referred to, and believe it to be in no way binding upon this company; but in consideration of the many obstacles in the way of testing the law in the courts of the State, we cannot consent to take the action which we are called upon to take, but must leave said Greenwood to pursue such measures as he may deem best in the premises." Transcript of Record at 4-5, Greenwood v. Union Freight Railroad Co., 105 U.S. 13 (1882) (No. 169); *cf.* Dodge v. Woolsey, 59 U.S. (18 How.) 331, 340 (1856).

request that they challenge the constitutionality of a state legislative repeal of the charter and rights of the Marginal Company and grant of a new franchise to a second street railway (also a defendant in the action) was that the "assertion of the rights of the corporation in the State courts is accompanied with so many embarrassments that they decline to attempt it."[195] Miller's opinion for the Court seemed to give special weight to the stockholder's allegation that the state's action would completely destroy the value of the Marginal Company and render plaintiff's investment worthless: "It is sufficient to say that this bill presents so strong a case of the total destruction of the corporate existence, and of the annihilation of all corporate powers . . . . . .that we think complainant as a stockholder comes within the rule [of *Hawes v. Oakland*,] . . . which authorizes a shareholder to maintain a suit to prevent such a disaster, where the corporation peremptorily refuses to move in the matter."[196]

A year after *Huntington v. Palmer* and *Hawes v. Oakland*, the Supreme Court again reprimanded corporate management for collusion with shareholders to obtain federal jurisdiction. In *City of Detroit v. Dean*,[197] Justice Stephen Field, writing for a unanimous court, applied the standards of *Hawes* to reject a stockholder suit that he regarded as simulated for the purpose of gaining access to federal court.[198] In this case, a shareholder and director of the Mutual Gas-light Company of Detroit ("Mutual Gas-light"), Thompson Dean—the same plaintiff whose suit the Court dismissed in *City of Memphis v. Dean* (1869)[199]—filed a derivative action to enjoin the city of Detroit from seizing the assets of Mutual Gas-light as a penalty for failing to honor its obligation to supply gas under the terms of an agreement with the city.[200]

Mutual Gas-light had three directors, two of whom were residents of Michigan. Dean, the Company's largest shareholder (with more than $200,000 worth of stock) as well as a director, was a citizen of New York.[201] According to the complaint, Dean urged the Mutual Gas-

195. *Greenwood*, 105 U.S. at 15. Despite recognizing Greenwood's standing to seek an injunction through a derivative suit, the Court rejected the merits of his Contracts Clause claim that the state had impaired the contractual charter rights of the Marginal Company. Specifically, the Court held that the corporate laws of Massachusetts contained an expansive reservation clause that broadly authorized the state to alter, and even repeal, the terms of corporate charters. *Id.* at 17-18.

196. *Id.* at 16.

197. 106 U.S. 537 (1883).

198. *Id.* at 542.

199. *See* Brief for Complainant at 1, City of Detroit v. Dean, 106 U.S. 537 (1883) (No. 73) (listing Thompson Dean as "Complainant and appellee"). For discussion of Dean's earlier derivative suit involving the city of Memphis, see *supra* notes 116-33 and accompanying text.

200. 106 U.S. at 539.

201. Appellant's Brief at 4, City of Detroit v. Dean, 106 U.S. 537 (1883) (No. 73).

light board to bring a state court suit to prevent the city from executing its threat to seize the company's property. But he allegedly could not convince the other directors to go along. The president and second director, an old friend of Dean named William Fitch, disavowed any resort to the law, purportedly preferring to "settle the matter by force" and to shoot "any man who meddled with him . . . 'as quick as he would have shot a burglar in his house at midnight.'"[202] The third director, an attorney for the company named E.W. Meddaugh, agreed with Dean that legal proceedings should be instituted, but "expressed a want of confidence in the local tribunals of the state by reason of the then excited condition of the public mind."[203] As a result, in response to Dean's request that the board authorize suit in state court against the city of Detroit, the board resolved, by a vote of two to one: "That the company, convinced of the improbability of obtaining redress or justice in the local courts . . . cannot prudently enter into a litigation with the city."[204] The next day, Dean commenced a federal derivative suit against the city of Detroit and Mutual Gas-light based on the board's refusal to institute state proceedings.[205] Meddaugh, one of the company's three directors, represented Dean in the shareholder suit.[206]

Justice Field, normally a staunch advocate of corporate contract and property rights,[207] did not mince words in condemning the derivative action as a charade by corporate management to evade the proper jurisdiction of the Michigan courts. He declared:

> It is impossible to read the testimony of the president . . . with his hesitating and evasive answers to the interrogatories of counsel, and not be convinced that the refusal, which constituted the basis of the present suit, was made for the express purpose of enabling a suit to be brought in a federal court . . . .[208]

Despite Dean's assertion that Mutual Gas-light's contractual and property rights were in dire jeopardy and despite a board resolution denying his demand for legal action—the formality that was supposedly missing from the shareholder complaint in *Hawes v.*

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202. *City of Detroit*, 106 U.S. at 540; Brief for Complainant at 8, City of Detroit v. Dean, 106 U.S. 537 (1883) (No. 73) (identifying Fitch and noting that together Fitch and Dean owned a majority of the stock of the Mutual Gas-light Company). William H. Fitch, Jr. is also identified as president of the Mutual Gas-light Company in City of Detroit v. Dean, 5-6 NORTHWESTERN REPORTER 1039, 1044 (C.C. E.D. Mich. 1880).

203. *City of Detroit*, 106 U.S. at 540. Meddaugh's roles are specified in Brief for Complainant at 8-9, City of Detroit v. Dean, 106 U.S. 537 (1883) (No. 73).

204. 106 U.S. at 540.

205. *Id.*

206. *Id.* at 541; Brief for Complainant at 28, City of Detroit v. Dean, 106 U.S. 537 (1883) (No. 73) (listing E.W. Meddaugh as "Solicitor for Complainant and Appellee").

207. *See* PAUL KENS, JUSTICE STEPHEN FIELD: SHAPING LIBERTY FROM THE GOLD RUSH TO THE GILDED AGE 236-65 (1997).

208. *City of Detroit*, 106 U.S. at 541.

Oakland—Field dismissed the company's alleged "refusal to take legal proceedings in the local courts" as a "mere contrivance, a pretense, the result of collusive arrangement to create for one of the directors a fictitious ground for federal jurisdiction."[209]

For the Court, the facts of *Dean* presented a clear-cut case for the application of section five of the 1875 Judiciary Act, requiring the dismissal of "collusively made" suits.[210] The federal circuit court, unfortunately, had failed to recognize Dean's demand on the board and the board's purported refusal of that demand as a "mere contrivance" and "pretense" by the management of Mutual Gas-light to evade the jurisdiction of the state court system. As a result, the Supreme Court reversed the circuit court's judgment, without prejudice to Mutual Gas-light's ability to pursue its own claim in the state courts of Michigan.[211]

In 1887, in *City of Quincy v. Steel*, the Supreme Court considered another shareholder derivative suit involving a dispute between a gaslight corporation and a municipality.[212] James W. Steel, a resident of Alabama and the holder of 75 shares of the Quincy Gaslight & Coke Company ("Quincy Gaslight"), brought an action against the city of Quincy, Illinois for breach of contract in failing to pay the full amount owed to the corporation under a contract for furnishing gas.[213] Steel alleged that he wrote a letter to the Quincy Gaslight board "directing and requiring said board to resolve to at once institute suit against said city of Quincy, in the name of said company, in such court or courts as were proper, for the recovery of said claim."[214] He further stated that the board of directors "laid said communication upon the table," prompting him to file his derivative complaint sixteen days later.[215] The city of Quincy asserted a demurrer to the suit, citing, among other grounds, Steel's lack of standing as a shareholder to proceed in place of Quincy Gaslight.[216]

Again, the Court did not shy away from charging corporate managers with concocting the federal shareholder action to obtain a more congenial reception than they believed the company would receive in state court.[217] It denounced the shareholder demand on the board of Quincy Gaslight as a "perfunctory" sham that failed to satisfy the requirements of Equity Rule 94.[218] Writing for a unanimous Court,

209. *Id.*
210. *Id.*
211. *Id.* at 541-42.
212. 120 U.S. 241, 242 (1887).
213. *City of Quincy v. Steel*, 120 U.S. at 242.
214. *Id.* at 243.
215. *Id.* at 243, 247.
216. *Id.* at 244.
217. *Id.* at 247.
218. *Id.* ("The most meager description possible of a bare demand in writing, made

Justice Miller concluded: "The inference that the whole of this proceeding was a preconcerted and simulated arrangement to foist upon the Circuit Court of the United States jurisdiction in a case which did not fairly belong to it, is very strong."[219] Miller even suggested that Quincy Gaslight's collusive scheme to create federal jurisdiction extended to having "stock placed in the hands of Mr. Steel" solely to satisfy the diversity-of-citizenship test:

> [I]t is not an unreasonable supposition that the gas company, foreseeing litigation which it might be desirable for that company to have carried on in a Federal court, immediately after receiving notice of that resolution had this stock placed in the hands of Mr. Steel for the purpose of securing that object . . . .[220]

Accordingly, the Court reversed the circuit court order awarding damages to Quincy Gaslight and directed dismissal of the derivative suit.[221]

By the mid-1890s, however, the Supreme Court seemed to retreat from its commitment to policing the authenticity of stockholder litigation in federal courts. This reluctance was particularly pronounced when the derivative suit in question attacked the constitutionality of governmental regulation or taxation of corporations. Between 1895 and 1901, the Court upheld shareholder standing to contest the validity of governmental action via the derivative mechanism in a series of landmark decisions in the arena of constitutional law. In *Pollock* v. *Farmers' Loan & Trust Co.* (1895), the Court allowed a shareholder to pursue a derivative action on behalf of a New York trust company that successfully challenged the constitutionality of a federal income tax.[222] In *Smyth v. Ames* (1898), the Court agreed to hear a series of shareholder suits by residents of Massachusetts that led to the invalidation of Populist-inspired regulation of intrastate railroad rates by the state of Nebraska under the Due Process Clause of the Fourteenth Amendment.[223] And in *Cotting v Godard* (1901), the Court permitted stockholders to sue derivatively to overturn an 1897 Kansas statute that set maximum rates for stockyards of a certain size on the ground that it violated the Equal Protection Clause.[224]

In *Pollock*, the Farmers' Loan and Trust Company was able to circumvent the federal Tax Anti-Injunction Act of 1867 by having a stockholder attack the propriety of the income tax indirectly via a

16 days before the institution of this suit, is all we have of the efforts which he should have made to induce this corporation to assert its rights.").

219. *Id.*

220. *Id.* at 246.

221. *Id.* at 249.

222. 157 U.S. 429, 530, 553-54 (1895).

223. 169 U.S. 466, 469, 522 (1898).

224. 183 U.S. 79, 79, 87 (1901).

derivative suit alleging that the directors of the trust corporation breached their fiduciary duty in failing to resist the tax. The 1867 Anti-Injunction Act prohibited claims for injunctive relief from federal taxation, recognized only after-the-fact requests for reimbursement, and therefore would have barred a direct suit for an injunction by the Farmers' Loan & Trust Company.[225]

In *Smyth v. Ames*, the Court entertained three consolidated derivative suits brought by shareholders of the Union Pacific Railway Company, the Chicago & Northwestern Railroad Company, and the Chicago, Burlington & Quincy Railroad Company.[226] *Smyth* represented the culmination of a long-term legal strategy that railroad counsel had been intensely focused on in the aftermath of a series of 1876 decisions known as the *Granger Cases*, in which the Supreme Court upheld state regulation of intrastate railroads and other common carriers, including the power to set rates.[227] Following the *Granger Cases*, railroad attorneys were constantly on the lookout for ways to overturn state regulation of railroad charges, such as the Nebraska law at issue in *Smyth*, on constitutional grounds.[228] Their central goal was to persuade the federal judiciary to strike down such regulation as an impairment of property rights under the Due Process Clause of the Fourteenth Amendment.[229]

Each stockholder suit in *Smyth* questioned the constitutionality of an 1893 law passed by the Nebraska legislature "to regulate railroads, to classify freights, [and] to fix reasonable maximum rates

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225. Revenue Act of 1867, Pub. L. No. 39-169, 14 Stat. 475 (codified as amended at 26 U.S.C. § 7421(a) (2015)). For discussions of the advantages of the shareholder derivative device to corporations seeking to challenge federal tax laws in *Pollock* and later in *Brushaber v. Union Pacific Co*., 240 U.S. 1, 9-10 (1916), see Larry Yackle, *Young Again*, 35 U. HAW. L. REV. 51, 63 (2013) [hereinafter *Young Again*] ("[Corporations] also used shareholder suits to get around equitable and statutory prohibitions on injunctions against the collection of taxes. Corporations were limited to suits for reimbursement, but shareholders could sue up front to keep corporations from paying taxes in the first place."); Larry Yackle, *Federal Banks and Federal Jurisdiction in the Progressive Era: A Case Study of* Smith v. K.C. Title & Trust Co., 62 U. KAN. L. REV. 255, 288-89 (2013) [hereinafter *Federal Banks*]; DEMOTT, *supra* note 9, at § 1:4. *See also* Pollock, 157 U.S. at 609-10 (White & Harlan, JJ., dissenting) (emphasizing that corporations should not be permitted to use derivative suits to accomplish indirectly what federal law prohibited them from doing directly).

226. 169 U.S. at 469-70.

227. *See* Munn v. Illinois, 94 U.S. 113 (1876); Chi., Burlington, & Quincy R.R. Co. v. Iowa, 94 U.S. 155 (1876); Peik v. Chi. & Nw. Ry. Co., 94 US. 164 (1876); Chi., Milwaukee, & St. Paul R.R. Co. v. Ackley, 94 U.S. 179 (1876); Winona & St. Peter R.R. Co. v. Blake, 94 U.S. 180 (1876); Stone v. Wisconsin, 94 U.S. 181 (1876).

228. CORTNER, *supra* note 142, at 125-130; JAMES W. ELY, JR., RAILROADS & AMERICAN LAW 96-98 (2001); WILLIAM G. THOMAS, LAWYERING FOR THE RAILROAD: BUSINESS, LAW, AND POWER IN THE NEW SOUTH 170-71 (1999); BENJAMIN R. TWISS, LAWYERS AND THE CONSTITUTION: HOW LAISSEZ-FAIRE CAME TO THE SUPREME COURT 63-92 (1942).

229. *See supra* note 228 and accompanying text.

to be charged for the transportation of freights upon each of the railroads in the state of Nebraska."[230] Among other things, the 1893 statute lowered the maximum prices that railroads had been charging for intrastate transportation of freight.[231] However, the law specifically provided that *only a railroad corporation*, *suing directly*, could assert challenges to rates, and only in a *state court proceeding*.[232] Despite this provision, railroad counsel proceeded to engineer test cases via derivative suits in federal court, where they calculated their clients would receive a more receptive response, and obtain a more far-reaching ruling, than they would in a Nebraska state court.[233] When the Court issued its decision on the shareholder suits in *Smyth*, railroad corporations and their attorneys enjoyed a resounding victory. In a sweeping opinion, the Court declared that the Nebraska rate schedule deprived the railways of the right to a "fair return" and amounted to a confiscation of property in violation of the Due Process Clause.[234]

By the time *Cotting* was decided in 1901, the Supreme Court felt comfortable brushing aside any suggestion that a strategic alliance between a corporate board and a stockholder in the pursuit of a federal derivative suit was improper in any way. In *Cotting*, the Court was untroubled by the appearance of concerted action between the officers of the Kansas City Stock-Yards Company, who plainly believed the 1897 Kansas stock-yard law was unconstitutional and favored its invalidation, and the Massachusetts shareholders who filed derivative actions naming those corporate officers, along with the attorney general of Kansas, as defendants:

> There is no force in the suggestion that the officers of the corporation agreed with the stockholders as to the unconstitutionality of the statute, and that therefore the suit is a collusive one. That was the condition in *Dodge* v. *Woolsey*, . . . and it only emphasizes the fact that the officers were refusing to protect the interests of the stockholders, not wantonly, it is true, but from prudential reasons.[235]

In the coming years, corporate lawyers continued to exploit the shareholder derivative suit as an instrument to voice corporate opposition to economic regulation, and the federal judiciary continued to countenance the practice. Even forceful, extensive objections by

230. *Smyth*, 169 U.S. at 470 (quoting COMP. ST. NEB. 1893, c. 72, art. 12).

231. *Id.* at 528-29.

232. *Id.* at 474 (quoting COMP. ST. NEB. 1893, c. 72, art. 12).

233. CORTNER, *supra* note 142, at 129-30; Yackle, *Young Again*, *supra* note 225, at 63.

234. *Smyth*, 169 U.S. at 547. Railroad counsel again successfully employed the stockholder derivative device to challenge state regulation of railroads in *Prout v. Starr*, 188 U.S. 537 (1903).

235. Cotting v. Goddard, 183 U.S. 79, 112-13 (1901) (citation omitted).

third-party defendants to apparent collusion between counsel for corporations and shareholder-plaintiffs generally failed to persuade courts to block the strategic use of the derivative device to gain a federal forum.

Consider the 1907 case of *Chicago v. Mills*.[236] There, the city of Chicago, in defending a municipal ordinance regulating gas rates against a derivative suit by Darius Mills, a large stockholder of the People's Gas, Light, & Coke Company ("People's Gas"), placed the issue of collusion front and center.[237] In the circuit court, the city formally demurred to Mills' suit on the ground that it failed to satisfy the requirement of non-collusion stated in Equity Rule 94.[238] In essence, the defense team for the city of Chicago contended that the lead attorney for Mills, William D. Guthrie, then the presiding partner of the New York firm, Guthrie, Cravath & Henderson, had colluded with James F. Meagher, an Illinois lawyer who was the regular outside counsel for People's Gas, to manufacture a hearing in federal court.[239] By this point, Guthrie was highly skilled at employing federal derivative suits to strike down unwanted governmental regulation, having orchestrated the successful stockholder proceedings in *Pollock* and *Cotting*.[240] As the biographer of the Cravath firm, Robert T. Swaine, reported, Guthrie advocated a derivative action when Meagher first consulted with him on the matter of overturning the objectionable gas rate ordinance: "In the early stages of the People's Gas litigation Guthrie preferred a stockholders' suit 'such as we had in the Income Tax Cases and in the Kansas City Stock Yards Case' over a direct attack by the affected corporation."[241]

In a blow to the lawyers for the city of Chicago, the circuit court dismissed their charges of collusion and granted a permanent injunction against enforcement of the municipal rate regulation.[242] Unbowed, the city continued to press the issue on appeal to the Supreme Court. It insisted that the Mills suit had been instituted "for

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236. Chicago v. Mills, 204 U.S. 321 (1907).

237. *Id.* at 325.

238. *Id.*; Equity Rule 94, *supra* note 174.

239. For an account of the charges of collusion leveled by the city of Chicago as Guthrie experienced them, see ROBERT T. SWAINE, THE CRAVATH FIRM AND ITS PREDECESSORS, 1819-1947 747-49 (1946-[1948]). Guthrie, Cravath & Henderson was a predecessor of today's Cravath, Swaine & Moore. *Id.* at xviii. On the allegations of collusion, see also Brief and Argument In Behalf of Appellant at 31, Chicago v. Mills, 204 U.S. 321 (1907) (No. 286) (The "evidence clearly and conclusively established that the Mills suit was fraudulent and collusive and instituted by Mr. Mills as a mere stool-pigeon for the purpose of protecting the corporate interests and with the co-operation and connivance of the directors and attorneys of the Peoples Company."); *id.* at 43-44; 58-59.

240. SWAINE, *supra* note 239, at 745.

241. *Id.*

242. Mills v. Chicago, 143 Fed. 430 (C.C.N.D. Ill. 1906).

the fraudulent purpose of invoking the jurisdiction of the Federal court concerning a controversy which was really between the company and the city of Chicago,—parties lacking the requisite diversity of citizenship to maintain the suit in the Federal courts."[243] In its brief to the Supreme Court, the city argued that the corporation's rejection of Mills' demand amounted to a sham:

> [T]he bill of complaint in this cause was filed because both the Peoples Company and the complainant Mills desired to keep this litigation out of the state court and to improperly and collusively confer jurisdiction upon a federal court. Further . . . the refusal of the board of directors to commence a suit, if they have so refused, is not *bona fide*, but is collusive, and . . . the demand of the complainant and the refusal of the directors is part of the scheme to secure a hearing of this cause of action in the United States courts."[244]

When the Supreme Court ruled in *Chicago v. Mills* in 1907, however, it followed the circuit court in sweeping aside the municipality's allegations of collusion and vindicating the integrity of the corporate lawyers in the case.[245] Although it acknowledged the close collaboration between counsel for People's Gas and counsel for Mills, the Court found that "the record establishes that complainant and his counsel honestly believed" a derivative proceeding "was necessary to protect the stockholders' interests."[246]

While sanctioning the strategic use of shareholder suits to secure a federal forum for corporate challenges to economic regulation in cases like *Mills*, the Supreme Court dismissed such actions only where the evidence of collusion between the corporation and the shareholder was especially flagrant or the failure of the stockholder to make a demand on the board of directors was incontrovertible. In *Corbus v. Alaska Treadwell Gold Mining Co*. (1903), for instance, a shareholder who held 100 shares of Alaska Treadwell stock filed a derivative complaint seeking to enjoin an allegedly unconstitutional territorial license tax levied against the company.[247] The shareholder further alleged that the managing agents of the corporation had breached a duty by agreeing to submit to the tax rather than risk the penalties of nonpayment.[248]

Alaska Treadmill, the sole defendant, did not answer the complaint, except to assert a demurrer when the case was called for a hearing four months later.[249] The corporation made no effort to file a

243. *Chicago*, 204 U.S. at 325.

244. Brief and Argument in Behalf of Appellant, Chicago v. Mills at 10-11, 204 U.S. 321 (1907) (No. 286).

245. Chicago v. Mills, 204 U.S. at 330.

246. *Id.*

247. Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903).

248. *Id.* at 456-57.

249. *Id.* at 457.

brief or argue in favor of its demurrer in the circuit court.[250] But a U.S. district attorney appeared *amicus curiae* to defend the constitutionality of the license tax, contest the propriety of jurisdiction, and dispute the shareholder's standing to sue.[251] As the circuit court summarized the district attorney's argument on the jurisdictional issue: "[He] insisted that the suits were of a friendly nature, collusive in character, and brought for the sole purpose of conferring jurisdiction upon the court, to the end that the defendants might escape paying the license fee imposed by the law."[252] In dismissing the suit, the lower court plainly sympathized with the district attorney's charge that Alaska Treadwell had stage-managed the shareholder suit in *Corbus*—a case in which "the interests of the plaintiff and defendant are identical"—in order to circumvent the anti-injunction ban in tax cases.[253]

On appeal, the Supreme Court seconded the circuit court's suspicion that the derivative suit had been collusively brought, especially in light of the failure of Alaska Treadwell, once again, to file a brief or appear at oral argument.[254] The Court also found the shareholder's claim defective because he admitted that he had neglected to make a demand on the Alaska Treadwell board. Allegedly deterred by the "distance of such directors from the place where he resides," he had only contacted the managing agents of the company in Alaska.[255] Under these circumstances, the Court affirmed the dismissal of the stockholder's suit for failure to make a demand and consequent lack of standing to sue in place of the corporation. The Court nonetheless noted that, had the shareholder made any effort to contact the board of directors (headquartered in California), it might well have permitted the derivative suit to proceed.[256]

Corporations and their shareholders continued to mobilize derivative suits to challenge governmental action throughout the

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250. *Id.*

251. *Id.* at 455-56.

252. *Id.* at 458.

253. *Id.* In addition to impugning the dubious ethics such a maneuver entailed, the circuit court questioned the wisdom of allowing corporations to exploit the derivative device to gain more favorable treatment than individuals who protested their taxes: Assuming "the object and purpose of the suit is solely to test the constitutionality of the law without first paying into the United States Treasury the amount of the license tax (and there can be no other object)," should the court agree to "sustain the plaintiff and enjoin the defendant as prayed, how is the private citizen to avail himself of a similar remedy?" *Id.*

254. *Id.* at 455.

255. *Id.*

256. *Id.* (The shareholder "should at least have shown some effort. If he had made an effort, and obtained no satisfactory result, either by reason of the distance of the directors, or by their dilatoriness or unwillingness to act, a different case would have been presented, but to do nothing is not sufficient.").

Progressive and New Deal eras.[257] The derivative device was employed to oppose state laws limiting the rates of railroads,[258] the federal income tax,[259] the Federal Farm Loan Act,[260] taxation and regulation of coal companies under the National Bituminous Coal Conservation Act,[261] and the Social Security Act,[262] among other measures.

III. THE RISE OF CORPORATE ATTACKS ON DERIVATIVE SUITS AND THE ETHICS OF ATTORNEYS WHO PURSUED THEM

During the 1930s, elite corporate lawyers and business leaders began to regard the shareholder derivative suit less as a useful tool for litigating corporate grievances against governmental entities and other third parties than as a threat to corporate welfare. The reasons for this transition were complex and multi-faceted. In part, fundamental developments in Supreme Court constitutional jurisprudence made corporate challenges to economic regulation far

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257. For valuable discussions of shareholder derivative suits by corporations seeking to overturn governmental regulation and taxation in the Progressive era, see Yackle, *Young Again*, *supra* note 225 (analyzing *Ex parte Young* as shareholder action); Yackle, *Federal Banks*, *supra* note 225 (analyzing *Smith v. K.C. Title & Trust Co*. as shareholder action); DEMOTT, *supra* note 9, at § 1:4; CORTNER, *supra* note 142, at 153-62. Cortner points out that railroads not only selected the lead counsel for shareholder actions challenging state rate regulation, but also financed the litigations. *Id.* at 202. On the use of shareholder derivative suits to challenge governmental regulation and taxation of corporations in the New Deal era, see Comment, *The Case-Concept and Some Recent Indirect Procedures for Attacking the Constitutionality of Federal Regulatory Statutes*, 45 YALE L. J. 649, 649 (1936) ("Stockholders' suits . . . have been conspicuous weapons in recent phases of the constitutional battle between business and the New Deal."); Felix Frankfurter and Adrian S. Fisher, *The Business of the Supreme Court at the October Terms, 1935 and 1936*, 51 HARV. L. REV. 577, 624-25 (1938) ("The ordinary stockholder's suit invented for the adjustment of internal corporate difficulties," now functions as "a friendly procedure to have legislation declared unconstitutional."); DEMOTT, *supra* note 9, at § 1:4.

258. *See Ex parte* Young, 209 U.S. 123, 126-27, 168 (1908) (upholding contempt order against Minnesota Attorney General Edward Young for defying federal court decision, issued in response to nine coordinated stockholder derivative suits, enjoining enforcement of Minnesota law limiting maximum railroad rates as a violation of the Fourteenth Amendment). For a detailed discussion of the strategic use of derivative suits in the litigation underling *Ex parte Young*, see Yackle, *Young Again*, *supra* note 225.

259. *See* Brushaber v. Union Pac. Co., 240 U.S. 1 (1916) (derivative suit challenging constitutionality of federal income tax).

260. *See* Smith v. Kan. City Title & Trust Co., 255 U.S. 180 (1921) (derivative suit challenging constitutionality of Federal Farm Loan Act). For a detailed discussion of the strategic use of a stockholder derivative suit in *Smith*, see Yackle, *Federal Banks*, *supra* note 225.

261. *See* Carter v. Carter Coal Co., 298 U.S. 238 (1936) (derivative suit challenging constitutionality of National Bituminous Coal Conservation Act).

262. *See* Helvering v. Davis, 301 U.S. 619 (1937) (derivative suit challenging constitutionality of Social Security Act).

less promising by the late 1930s than in earlier decades,[263] with the result that derivative suits embodying such challenges became less inviting as well. In addition, changes in standing doctrine relaxed the requirements for corporations seeking access to federal courts on the basis of economic injury after 1940, obviating the need for corporations to rely on shareholder standing.[264] Most important for our purposes, by the 1930s, corporate counsel and their clients had become alarmed by a rising tide of derivative litigation asserting claims of fraud and self-dealing by officers and directors of large public companies. These suits not only had become increasingly numerous and burdensome; they also had begun to expose high-profile public corporations and their managers to the risk of huge judgments, settlement payments, and attorneys' fee awards.[265]

Emblematic of the corporate change of heart toward derivative proceedings was the decision of the Special Committee on Corporate Litigation of the New York Chamber of Commerce, a collection of leading corporate and financial interests in New York, to commission an investigation of the harms and abuses of derivative actions in 1942.[266] The resulting study, generally known as the Wood Report after its lead author, Franklin S. Wood, a prominent New York attorney, assailed shareholder derivative suits and the lawyers who brought them. In this 1944 study, Wood took special aim at what he described as a sudden, disturbing increase in derivative actions in which the named plaintiffs were small investors and the individual defendants were corporate officers or directors of public companies accused of various forms of wrongdoing.[267] According to the Wood Report, this phenomenon appeared after 1930, in the aftermath of the stock market crash of 1929 and the ensuing Great Depression.[268]

Wood charged that, during the 1930s and after, the plaintiffs' bar systematically exploited unwitting shareholders to concoct frivolous

263. *See, e.g.*, W. Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937) (upholding constitutionality of state minimum wage legislation).

264. *See* Yackle, *Federal Banks*, *supra* note 225, at 282-84; Yackle, *Young Again*, *supra* note 225, at 63-64 ("Corporations equally employed shareholder suits to achieve standing to litigate in federal court. Prior to 1940, companies could not sue on the basis of economic injury alone, but shareholders could secure standing on the strength of their legal relations with their corporations.").

265. WOOD REPORT, *supra* note 1, at 26-29 (sharply contrasting the characteristics of derivative litigation before 1930 and derivative litigation after 1930); *see also* George D. Hornstein, *Rights of Stockholders in the New York Courts*, 56 YALE L. J. 942, 949 (1947) (observing that stockholder suits "rapidly increased in number after 1933, when Congressional disclosures made known to stockholders how some directors and officers were looting their corporations").

266. WOOD REPORT, *supra* note 1, at 1.

267. *See id.* at 16, 26-29, 54.

268. *Id.* at 26-29.

"strike suits" against faithful managers.[269] Plaintiffs' lawyers were especially adept at finding impressionable women and other unsophisticated investors, who had little or no understanding of the substance of their suits and were "merely a catspaw for counsel."[270] Derivative lawyers then filed groundless nuisance suits that were designed to extort settlements with generous payments of attorneys' fees but little or no relief for the corporation or its stockholders.[271]

To reduce the dangers of derivative litigation, the Wood Report recommended the adoption of a new provision of New York General Corporation Law, section 61-b, which was effectively designed to stamp out derivative suits by small shareholders in New York, the leading jurisdiction for such actions.[272] The proposed statute entitled a defendant corporation to compel the plaintiff in a derivative suit to post security for all expenses incurred by the defendants, including counsel fees, unless the plaintiff held a certain percentage of the corporation's shares.[273]

The New York legislature rewarded the labors of the creators of the Wood Report as well as the New York Chamber of Commerce when it swiftly passed new section 61-b (now section 627) in 1944.[274] The law generally required stockholders, upon application by the corporate defendant, to provide security for payment of the defendants' expenses as a condition of pursuing a derivative action. Only large holders of a corporation's stock were exempted from its provisions. Specifically, section 61-b did not apply if the derivative plaintiff owned more than five percent or $50,000 (equivalent to more than $670,000 today[275]) of the corporation's outstanding shares.[276]

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269. *Id.* at 56-57.

270. *Id.* at 56; *see also id*. at 46. For sarcastic effect, Wood added: "Presumably, these [female] stockholders flock to examine S.E.C. reports and studies, minutes of the Public Service Commission and the like for these have been the main source of information upon which stockholders' suits are based." *Id.* at 47.

271. *Id.* at 49.

272. *Id.* at 21. For contemporaneous discussions of the intent and likely impact of section 61-b, as enacted, see George Hornstein, *The Death Knell of the Stockholders Derivative Suits in New York*, 32 CAL. L. REV. 123, 125 (1947) [hereinafter *Death Knell*] (noting that "the new law effectually bars stockholders who own less than $50,000 worth of stock in a large corporation from suing their fiduciaries for misconduct, however flagrant"); Zlinkoff, *supra* note 1, at 367-72. On New York's role as the leading forum for shareholder suits in this era, see Eric A. Chiappinelli, *The Underappreciated Importance of Personal Jurisdiction in Delaware's Success,* 63 DEPAUL L. REV. 911, 926-27 (2014).

273. WOOD REPORT, *supra* note 1, at 21.

274. Act of April 9, 1944, ch. 668, 1944 N.Y. LAWS 1455.

275. CPI Inflation Calculator, Bureau of Lab. Stat., http://www.bls.gov/data/inflation_calculator.htm/ (last visited May 31, 2015) ($50,000 in 1944 equivalent to $672,156.25 in 2015).

276. Act of April 9, 1944, ch. 668, 1944 N.Y. LAWS 1455. The alternative of owning more than $50,000 worth of stock was added by the legislature. *Death Knell*, *supra* note 272, at 126 n.10, 140 n.41.

Passage of the New York statute inspired a burst of heated attacks on the derivative suit as an abusive and corrupt device from supporters of business interests throughout the country.[277] At the instigation of corporate leaders and lobbyists, four other states—New Jersey,[278] Maryland, Pennsylvania, and Wisconsin—followed New York's lead by adopting virtually identical security-for-expense statutes between 1944 and 1945.[279] The New Jersey legislature, for instance, in justifying its version of the law, broadly condemned derivative litigation as a "subject of great abuse and malodorous scandal."[280] As denunciations of this kind became pervasive in business quarters in the 1940s, the long era of corporate endorsement

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277. The New York legislature's hasty adoption of section 61-b also gave rise to incisive critiques of the conclusions and methodology of the WOOD REPORT by defenders of derivative litigation. *See* Zlinkoff, *supra* note 1, at 359-67; *Death Knell*, *supra* note 272, at 138 (noting that the New York security statute "was rushed through the Legislature at the behest of corporate management—without a public hearing."); *id.* at 128 (characterizing the WOOD REPORT as "[e]mploying obvious propaganda devices" against derivative suits). For a forceful recent critique of the WOOD REPORT, *see* Lawrence E. Mitchell, *Gentleman's Agreement: The Antisemitic Origins of Restrictions on Stockholder Litigation* 36 QUEEN'S L. J. 71 (2010) (challenging methodology of WOOD REPORT and drawing connections between opposition of corporate leaders and the corporate bar to stockholder litigation in the 1940s and widespread antisemitism in the legal and business professions of the era).

278. 1945 N.J. LAWS 487, 487-88. The New Jersey statute provided in relevant part:

> In any action instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of shares, or of voting trust certificates representing shares, of such corporation having a total par value or stated capital value of less than five per centum (5%) of the aggregate par value or stated capital value of all the outstanding shares of such corporation's stock of every class . . . unless the shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars ($50,000.00), the corporation in whose right such action is brought shall be entitled, at any stage of the proceeding before final judgment, to require the complainant or complainants to give security for the reasonable expenses, including counsel 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 pursuant to law, its certificate of incorporation, its by-laws or under equitable principles, 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 . . . . 3. This act shall take effect immediately and shall apply to all such actions, suits or proceedings now pending in which no final judgment has been entered, and to all future actions, suits and proceedings.

279. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541, 549 n.2 (1949) (listing statutes). In *Cohen*, the U.S. Supreme Court rejected a derivative plaintiff's challenge to the constitutionality of the New Jersey security-for-expenses statute under the Due Process and the Equal Protection Clauses of the Fourteenth Amendment. *Id.* at 551-55.

280. Brief for Beneficial Industrial Loan Corporation at 42, Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949) (No. 442) (emphasis omitted).

and deployment of derivative litigation, a period stretching back nearly a century, came to a decisive close.

CONCLUSION

The ability of corporations to restrict derivative litigation continues to be a topic of controversy. Most recently, corporate representatives have campaigned for the power of boards of directors to adopt fee-shifting, "loser-pays" bylaws and charter provisions designed to deter shareholder litigation, including derivative suits that seek to hold directors and officers accountable for breaches of fiduciary duty.[281]

In the midst of ongoing debates about corporate efforts to suppress stockholder suits, it is worth remembering the now largely forgotten origins of derivative litigation in the United States. This early history demonstrates that corporate managers did not always disdain the derivative device. On the contrary, beginning around the middle of the nineteenth century and extending into the New Deal era, corporate managers and their lawyers often embraced such suits in broad and

281. In general, fee-shifting bylaws and charter provisions automatically require a shareholder who does not prevail in intra-corporate litigation, such as a derivative suit, to bear the defendants' expenses, including attorneys' fees, in connection with the litigation. In a controversial 2014 decision, the Delaware Supreme Court declared that fee-shifting bylaws were facially valid under Delaware law in connection with non-stock corporations. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 558 (Del. 2014). Following the *ATP Tour* decision, at least 70 public corporations adopted fee-shifting bylaws. *See* Laura D. Richman & Andrew J. Noreuil, *DGCL Amendments Authorize Exclusive Forum Provisions and Prohibit Fee-Shifting Provisions*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 6, 2015), http://corpgov.law.harvard.edu/2015/07/06/dgcl-amendments-authorize-exclusive-forum-provisions-and-prohibit-fee-shifting-provisions/. In addition, corporate lobbyists and leading business associations, such as the U.S. Chamber of Commerce, pressed Delaware legislators to preserve the ability of corporate boards to enact sweeping, "loser-pays" bylaws and charter provisions that would curtail stockholder suits, including but not limited to derivative litigation. *See* Lisa A. Rickard, *Delaware Flirts With Encouraging Shareholder Lawsuits*, WALL ST. J., May 18, 2014, at A-11 (emphasizing threat of "predatory [shareholder] lawsuits" and expressing strong support of U.S. Chamber of Commerce for ability of directors to implement fee-shifting measures); *see also* Francis Pileggi, *Delaware Proposes New Fee-Shifting and Forum Selection Legislation*, DEL. CORP. & COMMERCIAL LITIG. BLOG (Mar. 6, 2015), http://www.delawarelitigation.com/2015/03/articles/commentary/delaware-proposes-new-fee-shifting-and-forum-selection-legislation/ (noting arguments by "[t]he DuPont Company and other large companies as well as the U.S. Chamber of Commerce" for capacity of corporate boards to enact fee-shifting bylaws and charter provisions); Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation By Shifting the Doctrine on Fees*, 56 B.C.L. REV. 1, 4 (2015) (describing "significant corporate lobbying" in Delaware in favor of ability of corporations to adopt "loser-pays" provisions). In June 2015, however, the Delaware General Assembly amended Delaware General Corporation Law to prohibit fee-shifting bylaws and charter provisions in connection with "internal corporate claims." *See* Richman and Noreuil, *supra* (providing link to amendments).

imaginative ways. In particular, they freely deployed derivative litigation against third parties in circumstances where they calculated that a direct claim by a corporation would be unlikely to succeed. Over the course of many decades, sophisticated corporate counsel became especially adept at orchestrating stockholder actions to secure a federal forum for challenges to the validity of governmental restraints on corporate power.[282]

In the aftermath of the Great Depression, however, corporations came to view the derivative mechanism in a different light. Faced with increasingly hefty damage awards and settlements in derivative cases against corporate insiders and the declining utility of management-contrived derivative claims against third parties, corporate managers and their counsel began to broadcast the dangers of derivative suits. They took pains to emphasize the presumptively abusive and frivolous nature of such proceedings and the purported manipulation of stockholder claims by an allegedly unscrupulous plaintiffs' bar. As the 1944 Wood Report and the rapid enactment of security-for-expense statutes to deter derivative litigation illustrate, by the 1940s corporate agents had turned to condemnations of derivative actions and the lawyers who pursued them, expressing an antipathy that survives to this day.[283]

282. *See* discussion *supra* Part II.

283. *See supra* notes 266-81 and accompanying text.