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Shareholder Derivative Litigation’s Historical and Normative Foundations

ANN M. SCARLETT†

INTRODUCTION

Justice Marshall described a corporation as “an artificial being, invisible, intangible, and existing only in [a] contemplation of law.” 1 While it is easy to imagine the purposes for which an individual may act, the artificial nature of a corporation makes it difficult to know the purposes for which a corporation acts or should act. Scholars, judges, and politicians have long debated the proper purpose of a corporation. Does a corporation exist for the benefit of its shareholders, its managers, its employees, its customers, the public at large, or some combination of these groups? That question directly impacts the allocation of power within a corporation. Should directors and officers have complete authority to control the corporation? Should shareholders, employees, or the public have the ability to challenge the decisions made by the corporation’s directors and officers? If so, how and when can they bring such challenges?

These questions have been intensely debated as the United States experienced a series of corporate scandals during the first decade of the 21st century. The scandals began with Enron and WorldCom in 2001, followed by the backdating of stock options scandals at numerous corporations during the middle of the decade, and concluded with the numerous scandals related to subprime mortgages at the end of the decade. In response to these events, new

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statutes and regulations were imposed on corporations. In addition, various methods for increasing shareholder power relative to the board of directors have been proposed by shareholder primacy advocates, who believe that the corporation is owned by its shareholders and also that the board of directors must act for the purpose of maximizing shareholder wealth. Shareholder primacy advocates’ proposals have gained traction. For instance, when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, it specifically included a provision giving the Securities and Exchange Commission (SEC) the authority to grant shareholders proxy access to nominate directors. The SEC did adopt a rule to give shareholders the power to nominate directors for election, but the rule was later struck down on judicial review. Dodd-Frank also included provisions giving shareholders a say on pay with the right to non-binding votes on executive pay and golden parachutes and a provision requiring a corporation to disclose in its proxy statement the


3. See, e.g., A.A. Berle, Jr., Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049, 1049 (1931); Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. TIMES MAG., Sept. 13, 1970, at 32 (arguing that, because shareholders own the corporation, the corporation’s responsibility is to increase profits); see also LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION 3-5 (2011) (describing shareholders’ efforts to increase their power over corporate affairs and the resulting alteration of the corporate governance landscape); William T. Allen, Our Schizophrenic Conception of the Business Corporation, 14 CARDOZO L. REV. 261, 264-66 (1992) (describing theories of corporate purpose); Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 833, 840 (2005) (arguing “shareholders should have the power to adopt charter provisions that would permit them subsequently to intervene in specific business decisions”).

4. Dodd-Frank Wall Street Reform and Consumer Protection Act § 971.

5. SEC Rule 14a-11 required a corporation to include certain shareholder nominated directors in its proxy statement, but it was struck down in Bus. Roundtable v. SEC, 647 F.3d 1144, 1146 (D.C. Cir. 2011).

relationship between executive compensation and company performance.\(^7\)

Other scholars have intensely argued against such proposals and the shareholder primacy theory of the corporation. Good arguments have also been made that at least some of the recent corporate scandals were caused by directors and officers seeking to maximize shareholder wealth, by raising stock prices to the detriment of all else.\(^8\)

A competing corporate model is the director primacy theory, which argues that the power to make corporate decisions is vested solely in the board of directors and the board serves “as the nexus of the various contracts making up the corporation.”\(^9\) While rejecting the shareholder primacy theory, the director primacy theory embraces the same shareholder wealth maximization purpose of the board of directors.\(^10\)

The team production theory also views the board as having the power to make the corporation’s decisions, but argues that directors and officers must “mediat[e] the various and often conflicting interests of shareholders” and the interests of “customers, suppliers, employees, and other stakeholders whose specific investments contribute to the firm’s success.”\(^11\)

The stakeholder or managerialist model views the corporation as a social institution in which the

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8. LYNN STOUT, THE SHAREHOLDER VALUE MYTH 22 (2012) (stating that Enron’s “managers and employees were famous for their fixation on raising stock price”); E. Norman Veasey, State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors, 28 J. Corp. L. 441, 441-42 (2003) (stating the Enron and WorldCom scandals revealed that “(1) officers ran amok, wallowing in greed-driven schemes and other abuses; and (2) directors allowed it to happen, tolerating officers who were managing to the market while they contented the directors with ever-rising stock prices”).


10. Id. at 551.

board's duties extend beyond assuring investors a fair return and includes some duty to all those affected by the corporation, such as employees, suppliers, customers, and the public.\footnote{12} This debate over corporate purpose is not new. It raged in the first half of the 20th century with the proliferation of public corporations, in which many investors could purchase shares in corporations on a public stock exchange but play no active role in the management of those corporations.\footnote{13} Before the early 1900s, most corporations were privately owned by a small group of shareholders who typically participated in managing the corporation.\footnote{14} But even then, courts struggled with the question of corporate purpose within these private companies as shareholders sought to challenge the actions of directors through litigation. The shareholder derivative lawsuit is an important part of the debate about corporate purpose because, through such lawsuits, shareholders seek to hold directors accountable for their decisions. Yet scholars in the modern debate over corporate purpose have ignored its historical origins as reflected in shareholder litigation prior to the 20th century. Almost all scholarship that even briefly mentions early shareholder derivative lawsuits in the United States relies solely upon a 15-page paper by Professor Bert Prunty published in 1957.\footnote{15} This Article seeks to remedy this gap in the literature by more fully examining English and U.S. law

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\item \textit{E.g.}, Allen, \textit{supra} note 3, at 264-66; E. Merrick Dodd, Jr., \textit{For Whom Are Corporate Managers Trustees?}, 45 Harv. L. Rev. 1145, 1145-46 (1932).
\item Professors Berle and Means famously described the dangers inherent in the structural separation of passive ownership from the active management of the corporation. Adolf A. Berle & Gardiner C. Means, \textit{The Modern Corporation and Private Property} xxx-xxxv (rev. ed. 1967) (1932).
\item Bert S. Prunty, Jr., \textit{The Shareholders' Derivative Suit: Notes on Its Derivation}, 32 N.Y.U. L. Rev. 980 (1957); \textit{see e.g.}, David A. Skeel, Jr., \textit{Shareholder Litigation: The Accidental Elegance of Aronson v. Lewis}, in \textit{The Iconic Cases in Corporate Law} 165, 167 n.4 (Jonathan R. Macey ed., 2008) (noting the article draws from Professor Prunty's work); \textit{see also} Ross v. Bernhard, 396 U.S. 531, 534 n.3 (1970) (citing Professor Prunty's work).
\end{enumerate}
on the shareholder derivative action to understand its true historical and normative foundations.

The shareholder derivative action is a form of representative litigation long recognized by courts in the United States, as is the class action. These are representative actions because one or a few persons stand for another or group of persons.\(^\text{16}\) Today it is commonly said that the plaintiff in a class action represents the other class members,\(^\text{17}\) while the plaintiff in a shareholder derivative action brings suit on behalf of the corporation.\(^\text{18}\) A modern shareholder can potentially pursue litigation of either type depending on the nature of the claim asserted. A shareholder’s action is derivative when it is based on an injury to the corporation, such as a claim for monetary damages based on corporate mismanagement.\(^\text{19}\) A shareholder may also pursue a direct action in his own name, or as a class action on behalf of himself and other shareholders, when the claim is based upon a personal right.

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16. \textit{Black's Law Dictionary} 1417 (9th ed. 2009). Representative actions also include those in which a person is designated to represent another, such as a guardian appointed to represent a child or an executor appointed to represent the estate of a deceased person. \textit{See id.}

17. \textit{E.g.}, \textsc{Robert H. Klonoff, Class Actions and Other Multi-Party Litigation in a Nutshell} 17 (4th ed. 2012). A defendant class is also possible, \textit{Fed. R. Civ. P. 23(a)}, but is extremely rare in modern litigation. CIGNA Healthcare of St. Louis v. Kaiser, 294 F.3d 849, 853 (7th Cir. 2002) (calling defendant classes “rare birds”); \textsc{John C. Coffee, Jr., Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation, 100 Colum. L. Rev. 370, 388 (2000) (stating “[d]efendant class actions are as rare as unicorns”).


19. \textsc{Stephen M. Bainbridge, Corporation Law and Economics, § 8.2, at 363 (2002); Black's Law Dictionary, supra note 16, at 509 (defining a derivative action as “[a] suit by a beneficiary of a fiduciary to enforce a right belonging to the fiduciary; esp., a suit asserted by a shareholder on the corporation’s behalf against a third party (usu. a corporate officer) because of the corporation’s failure to take some action against the third party”).}
belonging to the shareholders, such as a claim regarding shareholder voting rights.\textsuperscript{20}

Commentators have frequently stated that the United States imported the shareholder derivative action from England.\textsuperscript{21} However, that is not entirely accurate. What the United States imported from the English Court of Chancery was the necessary parties rule and exceptions to that rule. Part I of this Article will examine the historical and normative foundations of both class actions and shareholder derivative actions in the English Court of Chancery during the 1700s and early 1800s. Early representative litigation in the English Court of Chancery reveals examples of group litigation that are comparable to today's class actions. It also reveals that similar actions involving shareholders were recognized by the English Chancery Court, but such actions were greatly limited.

Part II will then compare the English precedents to the first instances and the evolution of class actions and shareholder derivative actions in the United States during the 1800s. Before the American Revolution, corporate law and shareholder litigation in the colonies followed English precedents.\textsuperscript{22} However, U.S. law began to diverge soon after the United States won its independence from England. During the 1800s, U.S. courts recognized an exception to the necessary parties rule that permitted representative

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\item BAINBRIDGE, \textit{supra} note 19, § 8.2, at 362-64 (contrasting direct shareholder suits from derivative shareholder litigation); BLACK'S LAW DICTIONARY, \textit{supra} note 16, at 509.
\item See, e.g., Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341, 347 (1855) (noting that the equity jurisdiction of U.S. courts is the same as in England from which it was derived and holding that courts of equity have jurisdiction over corporations in claims brought by their shareholders); Nicholas Calcina Howson, \textit{When “Good” Corporate Governance Makes “Bad” (Financial) Firms: The Global Crisis and the Limits of Private Law}, 108 MICH. L. REV. FIRST IMPRESSIONS 44, 47 (2009), http://www.michiganlawreview.org/assets/fi/108/howson.pdf (describing derivative actions as "imported into U.S. state corporate law from England").
\item See Bank of the U. S. v. Deveaux, 9 U.S. (5 Cranch) 61, 88 (1809) ("[O]ur ideas of a corporation, its privileges and its disabilities, are derived entirely from the English books, we resort to them for aid, in ascertaining its character."); see also Howson, \textit{supra} note 21, at 47 (noting the shareholder derivative action was imported into U.S. state law from England).
\end{enumerate}
\end{footnotesize}
lawsuits, but the contours of these actions differed significantly from such actions in England. Today, these lawsuits would be classified as class actions and shareholder derivative actions in the United States. The Part will demonstrate that the historical and normative foundations of the U.S. shareholder derivative action differed significantly from that of England, and that the shareholder derivative action is more closely related to the class action than is commonly recognized.

The shared history of these two forms of representative litigation has long been overlooked, but it reveals the early normative justifications for shareholder litigation. For the United States’ first 150 years, shareholders were permitted to bring lawsuits on behalf of themselves and all other shareholders in certain circumstances, similar to class actions. That formulation did not change until the late 1940s, when courts began to regularly describe such lawsuits as being brought on behalf of the corporation. Part III will examine this shift in the normative foundations of U.S. shareholder derivative litigation and explore the possible explanations for the variances. It will also examine the changes in the limitations on when shareholders can bring derivative actions. The historical and normative foundations of shareholder derivative litigation offer potential insights for the current debate on shareholder power and corporate purpose.

I. REPRESENTATIVE LITIGATION IN THE ENGLISH COURT OF CHANCERY

Examples of representative litigation are found in the “earliest days of English law.” The history of group litigation developed gradually from communal harms within English feudal society during the 12th to 15th centuries.


The earliest published examples of group litigation date from the 16th century and fall into two main categories: manorial conflicts between landlords and tenants, and parochial conflicts between villagers and parsons.\(^\text{25}\)

The 1681 case of *How v. Tenants of Bromsgrove*\(^\text{26}\) is an example of group litigation involving manorial conflicts. The lord of a manor sued his tenants claiming a grant of “free warren,” which is the right to kill small game.\(^\text{27}\) The English Court of Chancery held that the case was proper in equity because it was essentially a bill of peace and its maintenance would avoid multiplicity of suits.\(^\text{28}\)

An example of a parochial conflict, as well as an example of the binding nature of group litigation, is *Brown v. Vermuden*\(^\text{29}\) from 1676, in which a vicar sued the miners of his parish to enforce his customary right to purchase a tenth of their ore.\(^\text{30}\) In an earlier case brought by the vicar’s predecessor, the miners chose four persons to defend the suit for them, and the case was decided in favor of the vicar’s predecessor.\(^\text{31}\) In the current case, a miner named Vermuden insisted that he was not bound by the previous decree, because he was not a party to it.\(^\text{32}\) The Chancery Court dismissed this argument stating that “[i]f the Defendant should not be bound, Suits of this Nature . . . would be infinite, and impossible to be ended.”\(^\text{33}\)

Every group litigation case decided during the 16th and 17th centuries involved these two types of conflicts, manorial or parochial, between members of agricultural


\(^\text{26}\) How v. Tenants of Bromsgrove, (1681) 23 Eng. Rep. 277 (Ch.); 1 Vern. 22.

\(^\text{27}\) Id. at 277, 1 Vern. at 22.

\(^\text{28}\) Id.


\(^\text{30}\) Id. at 796, 1 Chan. Cas. at 272.

\(^\text{31}\) Id. at 796-97, 1 Chan. Cas. at 272.

\(^\text{32}\) Id.

\(^\text{33}\) Id. at 797, 1 Chan. Cas. at 272.
communities. These litigation groups, which could involve either plaintiffs or defendants, represented shared identical interests, and their members consented to representation by the named parties.

A. Transition to Class Litigation in the English Court of Chancery

Group litigation began to transition to class litigation during the 18th century. Group litigation relied on the representative authority conferred by preexisting groups of villagers or parishioners, whereas more commercially-connected groups such as proprietors and shareholders began to seek recognition as litigative entities in the 18th century. During this century, the English Chancery Court created the necessary parties rule or proper parties rule, which required the joinder of all parties interested in the matter so that a final resolution could be made. As with any rule, the Chancery Court soon recognized exceptions to the necessary parties rule. In its creation of exceptions, the Chancery Court increasingly set aside the idea of consent and instead relied on shared interest of the group as the key for representation, although the precise degree of consent was not clearly defined.

34. Yeazell, supra note 25, at 872.

35. Id. at 880.

36. Yeazell, supra note 24, at 175-76; see also Cutting v. Gilbert, 6 F. Cas. 1079, 1080 (S.D.N.Y. 1865) (stating the medieval manorial cases involved “a community of interest growing out of the nature and condition of the right in dispute”). In terms of jurisdiction, the Chancery Court heard most of these cases from the 16th century and almost all such cases during the 17th century. Yeazell, supra note 24, at 125.

37. Id. at 165-66.


40. For simplicity, this Article will refer to the rule as the necessary parties rule although it may also properly be referred to as the proper parties rule.

organization required for a finding of shared interest varied. An English court in 1901 summarized the Court of Chancery’s necessary parties rule as follows:

The old rule in the Court of Chancery was very simple and perfectly well understood. Under the old practice the Court required the presence of all parties interested in the matter in suit, in order that a final end might be made of the controversy. But when the parties were so numerous that you could never “come at justice”, to use an expression in one of the older cases, if everybody interested was made a party, the rule was not allowed to stand in the way. It was originally a rule of convenience: for the sake of convenience it was relaxed. Given a common interest and a common grievance, a representative suit was in order if the relief sought was in its nature beneficial to all whom the plaintiff proposed to represent.

As more simply stated later by the English Supreme Court’s procedural rules: “Where there are numerous persons having the same interest in one cause or matter, one or more of such persons may sue . . . on behalf of or for the benefit of all persons so interested.”

As examples of the application of the necessary parties rule and its exceptions to class actions, consider the following two cases involving similar factual scenarios. In the 1751 case of _Leigh v. Thomas_, the Chancery Court sustained a demurrer (similar to a modern motion to dismiss) for want of parties when part of a ship’s crew appointed two members as their agents. The plaintiffs sued for prize money for which they claimed entitlement under the general articles of the ship, which stated the crew had

42. Yeazell, supra note 24, at 277.
43. Bedford v. Ellis, [1901] A.C. 1 (H.L.) 8 (appeal taken from Eng.) (holding that the necessary parties rule was not limited to persons having a beneficial proprietary interest) (U.K).
44. Smith v. Cardiff Corp., [1954] 1 Q.B. 210 at 214-15 (Eng.) (quoting Rules of the Supreme Court Ord 16, r 9 (Eng.)). In this case, four tenants sued “on behalf of themselves and all other tenants” to challenge their landlords’ decision to increase rests on a differential basis according to the tenants’ incomes; the court held it was not a proper representative action because there was no class of persons “having the same interest” but rather two classes with conflicting interests since affluent tenants subsidize the others. Id. at 212, 220-22.
liberty to appoint two agents. 46 The two agents filing this lawsuit were appointed by an agreement signed by 64 members of the 80-person crew. 47 “They brought this bill therefore, not on behalf of the whole crew,” but on behalf of themselves and those 64 members. 48 Against the demurrer, the plaintiffs cited several cases where all persons interested were not made parties “from necessity.” 49 The court allowed the demurrer but suggested that the result might be different if the two agents had brought a bill on behalf of the whole crew. 50

In 1807, the captain of a privateer sued its owners for an account of prize money in Good v. Blewitt. 51 After the defendants objected that all interested persons must be parties, the Chancery Court gave leave for the captain to amend his bill to state that he represented all other members of the crew. 52 The court then expressly rejected the defendant’s objection with regards to joinder, declaring that this situation “calls peculiarly” for an exception to the necessary parties rule, because it would be impossible to locate and join all these sailors individually. 53 The court also emphasized that the representation was occurring on the plaintiff’s end, and there was no greater inconvenience to the defendant if all the plaintiffs were joined than otherwise. 54

46. Id. at 201, 2 Ves. Sen. at 312.
47. Id.
48. Id.
49. Id.
50. Id. at 201-02, 2 Ves. Sen. at 312-13.
52. Id. at 343-45, 13 Ves. Jun. at 398-99.
53. Id. at 345, 13 Ves. Jun. at 401.
B. Shareholder Actions in the English Court of Chancery

During the 18th and 19th centuries, the English Court of Chancery also recognized a similar exception to the necessary parties rule for lawsuits involving the owners of businesses, and these actions can be seen as precursors to the modern shareholder derivative action. The cases involved a variety of business enterprises such as partnerships and joint-stock companies, as well as corporations. Joint-stock companies were far more prevalent than corporations during this time period and in some ways were more similar to partnerships, but the capital of joint-stock companies were divided into transferable shares similar to corporations and thus had a larger number of investors than partnerships generally.\(^{55}\) In applying the necessary parties rule and its exceptions, however, the English decisions treated these business entities the same and recognized an exception to the necessary parties rule for actions by or against their owners. The exception recognized by these cases was similar to that for class actions.\(^{56}\) However, a few cases demonstrate that the development of an exception to the necessary parties rule for shareholder-type actions was a bumpy path, as is often the case with common law.

In the 1722 case of *Chancey v. May*,\(^{57}\) the English Chancery Court held that part of the proprietors of an enterprise may bring suit without making all the proprietors actual parties, if they sue on behalf of themselves and all the proprietors.\(^{58}\) The treasurer and manager of the Temple Mills Brass-works brought suit on behalf of themselves and all other proprietors against the late treasurers and managers alleging mismanagement and


\(^{58}\) *Id.* at 265, Prec. Ch. at 592.
embezzlement. The defendants demurred because all the proprietors were not made parties and they might be “harassed and perplexed with multiplicity of suits.” The court denied the demurrer finding that the proprietors were suing “on behalf of themselves and all the others,” and so all the rest “were in effect parties.” Furthermore, the court stated that it would be impracticable if all were made parties by name and there would be “no coming of justice.”

By contrast, the Chancery Court did not permit an exception to the necessary parties rule in a similar situation in Moffat v. Farquharson in 1788. The bill was filed by the plaintiff, “on behalf of himself and the other part-owners of a ship,” for an account of the ship’s profits and particularly the money paid to the defendants for the appointment of a captain. The defendants demurred, arguing that all part-owners should have been parties. Finding this case distinguishable from earlier cases “of part of the parishioners filing a bill for themselves and the other parishioners,” the court held that all the part-owners must be made actual parties. However, the reporter recognized that the case conflicted with later cases by noting after the case: “The decision here is clearly wrong.”

In Lloyd v. Loaring, three officers of the Caledonian Lodge of Free Masons filed a bill on behalf of all the other lodge members seeking the return of a chest of the chapter’s ceremonial items that they alleged the two defendants had

59. Id.
60. Id.
61. Id.
62. Id.
64. Id. at 129, 2 Bro. C.C. at 338.
65. Id.
66. Id.
67. Id. (emphasis omitted); cf. Williams v. Farrington, (1789) 29 Eng. Rep. 395 (Ch.) 395-96; 3 Bro. C.C. 39, 39-40 (permitting one owner to sue the captain of a ship on behalf of all the other part-owners).
stolen. The defendants demurred for want of parties arguing that the three plaintiffs could not file on behalf of themselves and all the others because the interest stated by the bill was joint among all the lodge members, and therefore the others must be joined. Lord Eldon allowed the demurrer because the plaintiffs had sued in effect as a corporation, which the Lodge was not. However, Lord Eldon noted that if the plaintiffs had sued as individuals jointly interested, on behalf of the others, alleging that it was “manifestly inconvenient to justice to make them all parties,” then the bill “might be very proper.” Seizing the hint, the plaintiffs sought leave to amend to sue as individuals on behalf of the other members, and Lord Eldon allowed the amendment.

In the 1805 case of Adair v. New River Company, Lord Eldon similarly recognized an exception to the necessary parties rule in a case involving a true corporation. The New River Company was a corporation originally created by King James I in return for a share of its profits; the Crown’s original share had subsequently been divided into many shares purchased by at least one hundred individuals. One of these shareholders argued that he was being mis-taxed (as individual shareholders were accountable for such tax), and that he was contributing disproportionately to the

69. Id. at 1302-03, 6 Ves. Jun. at 773-75.
70. Id. at 1303, 6 Ves. Jun. at 775.
71. Id. at 1305, 6 Ves. Jun. at 779 (Lord Eldon’s concern was the affectation of a “corporate character” in the bill).
72. Id. at 1304, 6 Ves. Jun. at 777; cf. Douglas v. Horsfall, (1825) 57 Eng. Rep. 315 (Ch.); 2 Sim. & St. 184 (allowing demur because the trustees for a company seeking specific performance of a company lease did not join all members nor file the bill on behalf of the other members).
75. Id. at 1159, 11 Ves. Jun. at 444.
76. Id. at 1153, 11 Ves. Jun. at 429.
company’s total tax payments. The shareholder sued the company as a corporation and joined eight individual shareholders, seeking the money owed him. The defendants objected for the lack of necessary parties, stating that all the shareholders must be joined to avoid multiplicity of suits and to account for differing circumstances among the shareholders regarding taxes already paid. The plaintiff argued, citing Lloyd v. Loaring, that while the necessary parties requirement is theoretically the rule, it does not prevail where it is impossible for justice to be served otherwise, such as here where joining all the parties was impossible. Although Lord Eldon dismissed the bill on the merits, he rejected at length the objection for lack of necessary parties stating that, while the application of the rule depends on the circumstances of each case, it should not be applied where joining all the parties is impracticable.

In Cockburn v. Thompson, the plaintiffs were proprietors of The Philanthropic Annuity Institution, whose purpose became impossible when Parliament denied the Institution permission to accept and grant annuities in the name of trustees. The plaintiffs, on behalf of themselves and all other proprietors, sued the Institution’s solicitor and bankers for an account of the sums received by them on behalf of the Institution and to have all of the plaintiffs’ money returned to them. Defendants objected that other proprietors existed who were not named in the bill, and that they must be made parties. Citing Chancey v. May and

77. Id. at 1153, 11 Ves. Jun. at 429-30.
78. Id. at 1153-54, 11 Ves. Jun. at 429-30.
79. Id. at 1154, 11 Ves. Jun. at 430.
81. Id. at 1159, 11 Ves. Jun. at 444; see also Yeazell, supra note 24, at 277 (noting Lord Eldon permitted the representation of a group “entirely lack[ing] social cohesion,” as the members could not be identified much less contacted for their consent).
83. Id. at 1005, 16 Ves. Jun. at 321-22.
84. Id. at 1005-06, 16 Ves. Jun. at 321-22.
85. Id. at 1006, 16 Ves. Jun. at 322-23.
Adair v. New River Company, the plaintiffs argued that the necessary parties rule may be dispensed with when joinder of all parties is impracticable. Lord Eldon held that though the plaintiffs could not bring forward all the persons who may be liable “that is not an obstacle, that should prevent the institution of this suit, if necessary to justice.” Lord Eldon stated the strict rule that all persons materially interested ought to be parties, but acknowledged that there were “several well known cases of exception” and cited Chancey v. May and Adair v. New River Company, among others. His view of the necessary parties rule and its exceptions can be summarized by a quote from the end of his analysis.

The principle being founded in convenience, a departure from it has been said to be justifiable, where necessary; and in all these cases the Court has not hesitated to depart from it, with the view by original and subsequent arrangement to do all, that can be done for the purposes of justice; rather than hold, that no justice shall subsist among persons, who may have entered into these contracts.

The justifications for an exception to the necessary parties rule in shareholder-type cases were further developed in Meux v. Maltby, which involved a lawsuit against the directors of the East Country Dock Company, a joint-stock company established by an act of Parliament. In 1804, Richard Frost had made a contract with Moses Agar to lease a house and contributed to its construction costs, but later Agar claimed he could not give Frost his

87. Id. at 1008, 16 Ves. Jun. at 330.
89. Id. at 1008, 16 Ves. Jun. at 329 (emphasis added).
91. Id. at 621-22, 2 Swans. at 277-79 (noting the establishing act decreed that all current or future property belonging to the company was vested in the company, and that it would be lawful for the company, in the name of its treasurer, to sue any person who might damage this property).
92. Id. at 621, 2 Swans. at 277.
lease because the property had been sold to the East Country Dock Company.\textsuperscript{93} The assignees of Richard Frost sued the treasurer and six directors of East Country Dock, seeking specific performance of the lease.\textsuperscript{94} These defendants protested that they could not grant the lease because they did not have the whole interest and the other proprietors of the company were not made parties.\textsuperscript{95} The opinion began with the general rule that the plaintiff must bring before the court all necessary parties, but noted the rule had exceptions.\textsuperscript{96} It quoted from Lord Eldon in \textit{Lloyd v. Loaring} that requiring the impracticable joinder of parties would result in a “failure of justice.”\textsuperscript{97} It also quoted Lord Eldon in \textit{Adair v. New River Company} that if the plaintiff brings enough of those who represent the King’s share “as can be taken duly and honestly” to litigate the issue “that ought, in equity, to bind those who are present, representing those who are absent.”\textsuperscript{98} The judge declared that this “current of authority” adopts a “general principal of exception,” in which the general rule “yields when justice requires” on either the plaintiff or defendant side.\textsuperscript{99} Applying the rule to this case, the judge noted the only novelty was that the plaintiff’s bill “requires an act to be done by the absentees.”\textsuperscript{100} Acknowledging that a lease cannot be executed by a few on behalf of the rest, the judge declared that the rights of the absent parties may still be

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\item \textit{Id.} at 621-22, 2 Swans. at 277-78 (noting the property was sold by Agar to a man named Matthews, and Matthews then sold the property to Sir Charles Price and William Browning, in trust for the East Country Dock Company).
\item \textit{Id.} at 622, 2 Swans. at 279.
\item \textit{Id.} at 623, 2 Swans. at 281.
\item \textit{Id.}
\item \textit{Id.} at 624, 2 Swans. at 284 (quoting \textit{Adair v. New River Co.}, (1805) 32 Eng. Rep. 1153 (Ch.) 1159; 11 Ves. Jun. 429, 445) (internal quotation marks omitted).
\item \textit{Id.}
\item \textit{Id.}, 2 Swans. at 284-85.
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The judge then wrote rather dramatically on the necessity of not letting the company avoid responsibility for want of parties: “Are the company aware . . . that, in every case, it is impracticable to compel them to perform a contract? That, unless all the proprietors are made parties, which is impossible, no suit can be maintained against them . . . ?” The judge asserted that he would “do what [he] can to assist the Plaintiffs,” by declaring them entitled to the lease and restraining the East Country Dock treasurer from disturbing their possession.

Similarly, in *Hichens v. Congreve*, the court permitted shareholders in a mining company, on behalf of themselves and all other shareholders, to file a bill seeking to recover money misappropriated by the directors. The defendants demurred that all 200 shareholders had to be made parties, but the exception to the necessary parties rule was so well established by this point in time that the court rejected the defendants’ objection in a mere five paragraphs. The court similarly approved a representative suit by shareholders on behalf of all shareholders against the corporation’s directors in *Preston v. Grand Collier Dock Co.*, in which the plaintiff’s bill sought to force the directors to pay calls on stock subscribed by them.

Not all shareholders were successful in their efforts to pursue lawsuits on behalf of themselves and all other shareholders. In *Long v. Yonge*, the plaintiffs were forty-seven members of the Norwich Equitable Insurance

101. Id., 2 Swans. at 285 (“If the Court cannot proceed to compel the Defendants to do the act required, it must go as far as it can.”).
102. Id., 2 Swans. at 286.
103. Id.
105. Id. at 917, 923, 4 Russ. at 562, 577.
106. Id. at 922, 4 Russ. at 575-77.
108. Id. at 900, 11 Sim. at 327-28.
Company, a joint-stock company. On behalf of themselves and all other members, they sued the survivors of the original directors and trustees of the company, those appointed to replace the original directors and trustees, and the executor of the late company secretary for mismanagement of the company and sought to have the company dissolved. They noted in their bill that it would be impracticable to join all the shareholders, who numbered around 4,000. The defendants demurred for want of equity because all 4,000 shareholders had not been made parties and because several of the directors had not been made parties (presumably as defendants). The court allowed demurrer. After noting both the general rule that all interested parties must be joined and the exception stated in both Cockburn v. Thompson and Adair v. New River Company, the court stated that the demurrer would have been denied if the bill had been filed by several members on behalf of the rest against someone whom all the members had a grievance. However, the court concluded that to dissolve the company would deprive all the members of a right they currently enjoyed, and this could not be done without making them parties.

By contrast, consider the 1841 case of Wallworth v. Holt, in which some of the shareholders of an insolvent joint-stock bank sued on behalf of themselves and all other shareholders, seeking dissolution and their debts from the directors. The defendants demurred, arguing that all shareholders must be joined. Plaintiffs argued that there were too many shareholders to make them all individually

110. Id. at 827, 2 Sim. at 269-70.
111. Id. at 827-29, 2 Sim. at 269-75.
112. Id. at 829, 2 Sim. at 374.
113. Id., 2 Sim. at 375.
114. Id. at 834, 2 Sim. at 387.
115. Id. at 833, 2 Sim. at 386.
116. Id.
118. Id. at 243, 4 My. & Cr. at 631-32.
119. Id. at 243, 4 My. & Cr. at 632.
parties to the suit and that all shareholders had a common interest.\textsuperscript{120} The court denied the demurrer.\textsuperscript{121} Although the court recognized that there were strong authorities holding that when a bill seeks dissolution all shareholders must be parties, it concluded that here they were too numerous and the court should “adapt its practice . . . to the existing state of society.”\textsuperscript{122} Citing Cockburn \textit{v. Thompson} and Chancey \textit{v. May}, the court stated that it is “scarcely necessary to say anything as to the objection for want of parties.”\textsuperscript{123}

C. \textit{Foss v. Harbottle} and Subsequent Developments in English Law

The 1843 case of \textit{Foss v. Harbottle}\textsuperscript{124} is the seminal case cited regarding the shareholder derivative action in English law.\textsuperscript{125} Two shareholders in The Victoria Park Company, which was incorporated by an Act of Parliament, sued on behalf of themselves and all the other shareholders except the defendants, who included five directors and the solicitor of the company.\textsuperscript{126} Plaintiffs alleged that the defendants engaged in fraudulent and illegal transactions, using their positions to cause the corporation to purchase their own lands at a price exceeding the value of such lands and to cause the corporation to mortgage the lands to fund those purchases.\textsuperscript{127} They sought, among other things, to have the

\begin{itemize}
  \item \textsuperscript{120} \textit{Id.} at 241, 4 My. & Cr. at 627-28.
  \item \textsuperscript{121} \textit{Id.} at 246, 4 My. & Cr. at 633.
  \item \textsuperscript{122} \textit{Id.} at 244, 4 My. & Cr. at 635. \textit{But see Deeks v. Stanhope}, (1844) 60 Eng. Rep. 278 (Ch.) 282-85; 14 Sim. 57, 66-75 (holding all the shareholders must be joined for dissolution to occur, but giving plaintiffs leave to amend their bill to seek only return of the controverted funds because the court recognized the lawsuit would be impossible to maintain if all shareholders were made parties).
  \item \textsuperscript{124} \textit{Foss v. Harbottle}, (1843) 67 Eng. Rep. 189 (Ch.); 2 Hare 461.
  \item \textsuperscript{125} Skeel, \textit{supra} note 15, at 167 (stating \textit{Foss v. Harbottle} “looms large in the history of Anglo-American derivative litigation” and “courts on both sides of the Atlantic treated the case as a watershed throughout the nineteenth century”).
  \item \textsuperscript{126} \textit{Foss}, 67 Eng. Rep. at 189-90, 2 Hare at 461.
  \item \textsuperscript{127} \textit{Id.} at 190-96, 201, 2 Hare at 461-75, 488.
\end{itemize}
defendants “make good to the company” the losses and expenses occasioned by the acts complained of. Defendants demurred for “want of equity, want of parties and multifariousness; and suggesting that all the proprietors of shares in the company . . . were necessary parties.” Defendants contended that the corporation itself was a necessary party and further that only the corporation was entitled to bring this action.

The court had to consider whether it should depart from the rule requiring “that the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative.” The court, however, recognized that “[c]orporations like this, of a private nature, are in truth little more than private partnerships.” Relying on Wallsworth v. Holt, the court stated that:

If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, ... the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.

Although Foss involved a true corporation, it recognized a right for shareholders to bring a lawsuit on behalf of all the shareholders in certain situations, just as the court in Wallsworth v. Holt did with respect to a joint-stock company.

128. Id. at 199, 2 Hare at 482-83.
129. Id. at 200, 2 Hare at 484.
130. Id., 2 Hare at 485.
131. Id. at 202, 2 Hare at 490-91.
132. Id. at 202-03, 2 Hare at 491-92.
133. Id. at 203, 2 Hare at 492.
On the facts of *Foss*, however, the court concluded that the individual shareholders could not bring a lawsuit because, pursuant to The Victoria Park Company’s charter, the shareholders retained the power to call a special general meeting and a majority of the shareholders could confirm the transactions.\(^{135}\) In other words, a majority of shareholders assembled at a special general meeting could confirm the transaction and defeat any decree sought from the court in this lawsuit. However, the court stated that if a transaction is void, such as when a transaction is beyond the powers of the corporation or when managers engaged in fraudulent misrepresentation, the corporation cannot confirm it “whilst any one dissenting voice is raised against it.”\(^{136}\)

Later courts interpreted *Foss*’s holding to mean that nothing connected with internal corporate disputes could be made the subject of a bill by one shareholder on behalf of himself and all other shareholders, unless the acts were not ratifiable by a simple majority of shareholders, such as ultra vires or oppressive acts.\(^{137}\) In other words, shareholder suits were allowed only if an illegal or fraudulent act was alleged, or the wrong was committed by the majority shareholders against the minority shareholders.\(^{138}\) Although the corporation was the proper party to bring a lawsuit for injuries to the corporation, English law recognized that,

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135. See *Foss*, 67 Eng. Rep. at 203, 2 Hare at 492-94 (stating “that the directors are made the governing body, subject to the superior control of the proprietors assembled in general meetings . . . [which has power] to originate proceedings for any purpose within the scope of the company’s powers, as well as to control the directors in any acts which they may have originated”).


137. See, e.g., Russell v. Wakefield Waterworks Co., [1875] 20 L.R. Eq. 474 (construing *Foss* to permit shareholders to sue only when the alleged acts were ultra vires, or the acts were committed by the majority shareholders against the minority shareholders.); Atwool v. Merryweather, [1867] 5 L.R. Eq. 464 (construing *Foss* to permit shareholders to sue the majority shareholders for managerial fraud); see also Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1404 (2006) (stating the exceptions included fraud on minority shareholders and ultra vires conduct).

because the board of directors decided when a company would sue, the directors were not likely to bring a lawsuit against themselves.139 English law thus created an exception to the necessary parties rule that permitted a shareholder to bring a suit on behalf of the company for ultra vires or oppressive acts, but otherwise the English courts would not supervise companies.140

In the middle of the 19th century, the English Parliament passed a series of legislation addressing both substantive and procedural problems of corporations, joint-stock companies, and friendly societies, which altered the laws originally created through common law development by the courts of England.141 Thereafter, the cases concerning such entities did not involve questions of group litigation, and group litigation “fell into desuetude.”142 Though the derivative action was a procedure still available in English courts, such lawsuits were extremely uncommon and did not play a “significant role” in British law after 1850.143 The

139. Cheffins & Black, supra note 137, at 1404. Occasionally new directors would bring proceedings when the former directors departed. Id.

140. Lord v. Copper Miners’ Co., (1848) 47 Eng. Rep. 1337 (Ch.) 1342; 1 H. & Tw. 85, 99 (“If a Court of Equity were to assume jurisdiction in such a case, could it do so without opening its doors to all parties interested in corporations, or joint stock companies, or private partnerships, who, although a small minority of the body to which they belong, may wish to interfere with the conduct of the majority? This cannot be done; and the attempt to introduce such a remedy ought to be checked, for the benefit of the community.”); see also Equitable Life Assurance Soc’y v. Bowley, [2003] EWHC (Comm) 2263, (2004) 1 B.C.L.C. 180, 188-89.


142. YEAZELL, supra note 24, at 194-95; see also id. at 197 (noting that group litigation had vanished by the middle of the twentieth century).

143. Id. at 211-12; see also Skeel, supra note 15, at 168 (“Derivative litigation has always been extremely uncommon in England, and it remains so today.”); Bernard Black et al., Legal Liability of Directors and Company Officials Part Two: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability (Report to the Russian Securities Agency), 2008 Colum. Bus. L. Rev. 1, 26 (2008) (“The circumstances in which this [derivative suit] can be done . . . are so obscure and difficult to establish that the derivative action is virtually non-existent in England.”).
shareholder derivative action essentially disappeared until the adoption of the Companies Act of 2006, which statutorily permitted shareholder derivative lawsuits for the first time.

II. HISTORICAL ROOTS OF THE SHAREHOLDER DERIVATIVE LITIGATION IN COURTS WITHIN THE UNITED STATES

After achieving independence from England, courts in the United States continued to follow the English necessary parties rule and its exceptions. The earliest examples involved class action type lawsuits, but the same principles were soon applied to lawsuits brought by shareholders in corporations created under state law.

A. The Necessary Parties Rule and Class Actions in the United States

In the 1820 case of West v. Randall, Justice Joseph Story famously summarized the necessary parties rule and its exceptions as recognized by courts in England and in the United States, providing extensive citations to opinions of both countries. The plaintiff was an heir of William West, suing the survivors of four trustees for an account of property which was allegedly conveyed to them by William West in trust for payment of his debts. The plaintiff


145. Companies Act, 2006, c. 46, Part 11, § 260(1)-(3) (U.K.) (defining a derivative claim as a proceeding by a shareholder “in respect of a cause of action vested in the company, and [seeking relief on behalf of the company”; stating a derivative claim “may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company”). For more information on the new Companies Act of 2006 and comparisons to current U.S. shareholder derivative law, see Ann M. Scarlett, Imitation or Improvement? The Evolution of Shareholder Derivative Litigation in the United States, United Kingdom, Canada, and Australia, 28 ARIZ. J. INT'L & COMP. L. 569, 590-604 (2011).


147. Id. at 721-24.

148. Id. at 721.
claimed an eleventh of the resulting surplus, but he did not join the other heirs of William West or the personal representative as parties.\footnote{149} The defendant’s answer insisted the other heirs were necessary parties.\footnote{150} Justice Story stated that “it is a general rule in equity that all those materially interested . . . in the subject of a bill . . . ought to be made parties,” and then he proceeded to examine the exceptions to the rule.\footnote{151} After a lengthy consideration of “the doctrine as to making parties,” Justice Story held the defendants’ objection was well-founded.\footnote{152}

Five years later, in \textit{Elmendorf v. Taylor},\footnote{153} the U.S. Supreme Court elaborated on the nature of the necessary parties rule in response to the defendant’s objection that a tenant may not sue without joining his co-tenants in a lawsuit concerning the law of land surveys.\footnote{154} The Court held that it was not a jurisdiction question, but rather a question of Court policy.

Courts of equity require, that all the parties concerned in interest shall be brought before them, that the matter in controversy may be finally settled. This equitable rule, however, is framed by the Court itself, and is subject to its discretion. It is not, like the description of parties, an inflexible rule, a failure to observe which turns the party out of Court, because it has no jurisdiction over his cause; but, being introduced by the Court itself, for the purposes of justice, is susceptible of modification for the promotion of those purposes.\footnote{155}

The court required “the plaintiff to do all in his power to bring every person concerned in interest before the Court,” but in its discretion permitted the case to proceed even if such persons could not be joined because the process of the court could not reach them.\footnote{156}

\begin{footnotes}
\item 149. \textit{Id.}
\item 150. \textit{Id.}
\item 151. \textit{Id.} at 721.
\item 152. \textit{Id.} at 723-24.
\item 154. \textit{Id.} at 166-67.
\item 155. \textit{Id.}
\item 156. See \textit{id.} at 167.
\end{footnotes}
The U.S. Supreme Court, in another opinion written by Justice Story, addressed the necessary parties rule in the context of an unincorporated association in Mandeville v. Riggs157 in 1829. The defendants were stockholders in the Merchant’s Bank of Alexandria, which failed a year after its inception.158 The plaintiff had not joined all of the stockholders, and some deceased stockholders were not replaced by representatives in the lawsuit.159 The Supreme Court reversed the verdict for the plaintiff on grounds of defect of parties and remanded the case so that all shareholders, and representatives of deceased shareholders, could be brought before the court.160 The Court stated that it was not necessary in all cases to bring all stockholders before the court: “It is well known, that there are cases in which a court of equity dispenses with such a proceeding when the parties are very numerous, or unknown, and the adoption of the rule would essentially impede, if not defeat the purposes of justice.”161 Here, however, the Court held that the exception did not apply because, if the decree against the defendants was valid, they would be entitled to contribution from the other shareholders, who would be entitled to “controvert every material fact upon which the decree was founded” in a later contribution suit.162 Thus, the other shareholders should have been joined to prevent “multiplicity of suits.”163

The 1829 case of Beatty v. Kurtz164 was another U.S. Supreme Court opinion written by Justice Story.165 The

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159. Id. at 482-83, 486.
160. Id. at 486-87, 490-91.
161. Id. at 487.
162. Id. at 487-88.
163. Id.
165. Id. at 578.
original plaintiffs were trustees of the German Lutheran church of Georgetown and sued “in behalf of themselves and the members of the said church.” They sued two defendants to quiet title to their church and cemetery. Among other objections, the defendants denied the authority of plaintiffs to sue, “declaring them to be mere volunteers, and demanding proof of their authority.” On appeal, the Supreme Court held that the plaintiffs could maintain the bill. The court stated that it was not necessary to consider whether the plaintiffs had authority, because this was “one of those cases, in which certain persons, belonging to a voluntary society; and having a common interest, may sue in behalf of themselves and others having the like interest.” The Court thus applied an exception to the necessary parties rule in an action that today would be classified as a class action.

In 1838, Justice Story published his Commentaries on Equity Pleadings in which he expanded his analysis of the necessary parties rule and its exceptions. In a later edition of Commentaries on Equity Pleadings, Justice Story described the “proper and necessary parties rule” as “a general rule in Equity (subject to certain exceptions, which will hereafter be noticed), that all persons materially interested, either legally, or beneficially, in the subject-matter of a suit, are to be made parties to it, either as plaintiffs, or as defendants, however numerous they may be, so that there may be a complete decree, which shall bind them all.” By a complete decree between the parties, Justice Story noted the court may prevent a multiplicity of

166. Id. at 579.
167. Id. at 580.
168. Id. at 582, 585.
169. Id. at 585.
172. Id. § 72, at 86; see also West v. Randall, 29 F. Cas. 718, 721 (C.C.D.R.I. 1820) (citing GILBERT'S FORUM ROMANUM 157).
lawsuits and ensure that no injustice is done by taking a partial view of the merits of the case.\textsuperscript{173} This was contrary to the rule observed in courts of law that only “the persons directly and immediately interested in the subject-matter of the suit, and whose interests are of a strictly legal nature, should be parties to it.”\textsuperscript{174} Story stated that the purpose of the necessary parties rule was to achieve justice and was based on public convenience, but that the “Courts of Equity will not suffer [the rule] to be so applied as to 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 wholly impracticable.”\textsuperscript{175}

Justice Story then explained the exceptions to the necessary parties rule including the representative exception, among others.\textsuperscript{176} In discussing these exceptions, Story noted that both the general rule and the exceptions were motivated by equitable principles: rules being established for the convenient administration of justice should not be followed when they are incapable of being applied.\textsuperscript{177} In these situations, granting relief to the plaintiff without making the other persons parties was a lesser evil than to “wholly deny the plaintiff the equitable relief, to

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\item \textsuperscript{173} Story, supra note 171, § 72, at 87; see also West, 29 F. Cas. at 721 (citing, among others, Cockburn v. Thompson, (1809) 33 Eng. Rep. 1005 (Ch.); 16 Ves. Jun. 321).
\item \textsuperscript{174} Story, supra note 171, § 76, at 91.
\item \textsuperscript{175} Id. § 77, at 101 (stating “the object of the general rule is to accomplish the purposes of justice between all the parties in interest, and it is a rule founded, in some sort, upon public convenience and policy”); see also West, 29 F. Cas. at 722-23 (citing Adair v. New River Co., (1805) 32 Eng. Rep. 1153 (Ch.); 11 Ves. Jun. 429, and Cockburn, 33 Eng. Rep. 1005; 16 Ves. Jun. 321, for the proposition that the necessary parties rule is adopted merely for convenience and may be dispensed with when compliance is impracticable).
\item \textsuperscript{176} Other exceptions include cases where one party is out of the jurisdiction, or where joinder of certain parties destroys diversity jurisdiction. Story, supra note 171, §§ 78-79, at 102-04; see also Milligan v. Milledge, 7 U.S. (3 Cranch) 220, 228 (1805) (holding that a want of proper parties was not a good plea when the parties are out of the jurisdiction of the court).
\item \textsuperscript{177} Story, supra note 171, § 96, at 121.
\end{itemize}
which he is entitled.”

To achieve justice in these cases, the court “will generally require the Bill 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.” Story also mentioned that in these situations, courts will entertain bills bringing “the rights and interests of the absent parties” before the court if there is any danger “of injury or injustice to them.”

Story listed three sets of cases falling within the representation exception. First, “where the question is one of a common or general interest, and one or more sue, or defend for the benefit of the whole,” such as a lawsuit brought by a few ship crew members on behalf of the whole crew. This class of cases would also include suits brought on behalf of many persons including some who cannot be easily found. For instance, creditors may bring a suit on behalf of themselves and all the other creditors seeking an account of the estate of a deceased debtor to obtain payment from his representative, and then the other creditors may “come in under the decree” and prove their debts to the judge.

The second set of cases within the representation exception included “where the parties form a voluntary association for public or private purposes, and those, who sue, or defend, may fairly be presumed to represent the rights and interests of the whole.” Thus, a few members of

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178. *Id.*
179. *Id.* § 96, at 122 (emphasis added).
180. *Id.* § 96, at 122-23.
181. *Id.* §§ 97-98, at 123-25.
182. *Id.* § 99, at 125; *see also id.* §§ 99-103, at 125-34.
183. *Id.* § 99, at 125-27. Another example is suits by legatees seeking relief against executors may sue on behalf of themselves and other legatees. *Id.* §§ 104-106, at 134-39.
184. *Id.* § 97, at 123; *see also* West v. Randall, 29 F. Cas. 718, 722 (C.C.D.R.I. 1820).
a voluntary society or unincorporated body of proprietors were allowed to sue on behalf of the rest, seeking relief against their own agents.\textsuperscript{185} Because such associations commonly involved numerous persons with privity of interest and joinder of all them would be exceedingly inconvenient, courts allowed representation by some of the parties on behalf of themselves and all the others, “taking care, that there shall be a due representation of all substantial interests before the Court.”\textsuperscript{186} “[S]uch a Bill must be brought on behalf of all the parties in interest; for if it be brought for the plaintiffs alone, it will not be sustained by the Court for the want of proper parties.”\textsuperscript{187} This exception applied when the members of an association or proprietors were sued as defendants or plaintiffs.\textsuperscript{188}

For the third set of cases within the representation exception, Justice Story included those “where the parties are very numerous, and although they have, or may have, separate distinct interests; yet it is impracticable to bring them all before the Court.”\textsuperscript{189} This exception applied where the parties were “exceedingly numerous, and it would be impracticable to join them without almost interminable delays, and other inconveniences, which would obstruct, and probably defeat the purposes of justice.”\textsuperscript{190} In such cases where the parties were too numerous to make it practicable to prosecute the suit if they were all made parties, the court dispensed with them if a decree could be rendered without injury to the absent persons (generally when their interests were only “incidentally and indirectly affected” by the

\textsuperscript{185} Story, supra note 171, § 108, at 141-42.

\textsuperscript{186} Id. § 107, at 141; see also id. § 108, at 141-42 (discussing Chancey v. May, (1722) 24 Eng. Rep. 265; Prec. Ch. 592); id. § 109, at 142 (discussing Hichens v. Congreve, (1828) 38 Eng. Rep. 917 (Ch.) 922; 4 Russ. 562, 576); id. § 115, at 146 (discussing Small v. Atwood, (1832) 159 Eng. Rep. 1051 (Ch.) 1052; You. 407, 408).

\textsuperscript{187} Story, supra note 171, § 107, at 141.

\textsuperscript{188} Id. §§ 116-119, at 149-52.

\textsuperscript{189} Id. § 97, at 123-24; see also id. § 120, at 152.

In this class of cases, there is usually a privity of interest between the parties, or at least “a common interest, or a common right, which the Bill seeks to establish and enforce.” In most of these cases, the resulting decree “will ordinarily be held binding upon all other persons standing in the same predicament,” and thus the court must ensure that adequate representatives exist to “honestly, fairly, and fully” try the right. In these circumstances, when a few were permitted to represent themselves and all others and “the decree must directly affect the interests” of the absent persons, they had a right “to be heard before the decree is made.”

It has often been said that Justice Story “in a clear but indirect way, virtually created the American law of class suits.” His analysis of the necessary parties rule and the exceptions to the rule in Commentaries on Equity Pleading were essentially codified when the Supreme Court promulgated the Federal Equity Rules 47 and 48 in 1842.

[Rule 47:] In all cases where it shall appear to the court, that persons, who might otherwise be deemed necessary or proper parties to the suit, cannot be made parties by reason of their being out of the jurisdiction of the court, or incapable otherwise of being made parties, or because their joinder would oust the jurisdiction of the court as to the parties before the court, the court may in their discretion proceed in the case without making such persons parties; and in such cases the decree shall be without prejudice to the rights of the absent parties.

[Rule 48:] Where the parties on either side are very numerous, and cannot, without manifest inconvenience and oppressive delays in the suit, be all brought before it, the court in its discretion may

192. Id. § 120, at 152; see also id. § 126, at 158-59.
193. Id. § 120, at 152-53.
194. Id. § 130, at 162.
195. Hazard et al., supra note 38, at 1878; see also Yeazell, supra note 24, at 216 (describing Joseph Story’s role in the promotion of group litigation in America).
196. See Diane Wood Hutchinson, Class Actions: Joinder or Representational Device?, 1983 SUPREME CT. REV. 459, 460-61 (1983); Yeazell, supra note 24, at 221.
dispense with making all of them parties, and may proceed in the
suit, having sufficient parties before it to represent all the adverse
interests of the plaintiffs and the defendants in the suit properly
before it. But in such cases the decree shall be without prejudice
to the rights and claims of all the absent parties.\(^{197}\)

The Supreme Court, however, continued to rely on the
common law interpretations of the necessary parties rule
and its exceptions in interpreting Federal Equity Rules 47
and 48.

Relying on the common law of the necessary parties
rule, the Supreme Court in \textit{Smith v. Swormstedt}\(^{198}\) in 1853
ignored the last line of Rule 48, regarding the res judicata
effect of a class decree. In \textit{Swormstedt}, the bill to recover a
share of a fund was filed by a number of preachers, on
behalf of themselves and the rest of the traveling 1,500
preachers of the Methodist Episcopal Church South.\(^{199}\)  The
case also involved a group of defendants as the bill was filed
against several preachers of the newly-split Methodist
Episcopal Church North on behalf of its 3,800 preachers.\(^{200}\)
The defendants objected for want of parties, and the
plaintiffs argued that each of these numerous preachers had
“an interest in the fund in the same right, so that it is
impossible . . . to make them all parties to the bill.”\(^{201}\) The
Court held the objection was improper.\(^{202}\)  Citing Story’s
\textit{Commentaries on Equity Pleadings}, the Court declared it a
well-established rule that “where the parties interested are
numerous, and the suit is for an object common to them all,
some of the body may maintain a bill on behalf of
themselves and of the others; and a bill may also be
maintained against a portion of a numerous body of
defendants, representing a common interest.”\(^{203}\) Again citing

\begin{footnotes}

197. 42 U.S. (1 How.), at lv-lvi (1843).
198. Smith v. Swormstedt, 57 U.S. (16 How.) 288, 302-03 (1853); see also
Hazard et al., \textit{supra} note 38, at 1901.
200. \textit{Id.}
201. \textit{Id.} at 300, 302.
203. \textit{Id.} (citing \textit{Story, supra} note 171). \textit{But see} Hazard et al., \textit{supra} note 38, at
1899 (noting that, while the opinion draws heavily on Story’s \textit{Commentaries on}}
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Story, the Court noted that the rights of the several parties may be distinct, but there must be “a common interest or a common right” for the court to enforce.204 It cautioned that “care must be taken that persons are brought on the record fairly representing the interest or right involved, so that it may be fully and honestly tried.”205 Directly contradicting the last sentence of Federal Equity Rule 48, the Court also stated that “the decree binds all of them the same as if all were before the court.”206 The Court declared that the representation exception to the necessary parties rule applied, because to require that all the parties must be joined would essentially amount to “a denial of justice.”207

The general trend in state and federal cases in the late 1800s was to allow representation when there was a common interest between the party and the absent person, but holding that “common question” representation was not sufficient.208 For example, in Mason v. York & Cumberland Railroad Company,209 the Maine Supreme Court allowed one bondholder on behalf of all bondholders to pursue a bill to recover the mortgage securing the bonds because, while bondholders are numerous and constantly changing, their interest is homogenous.210 The court also noted that if no representation were allowed the plaintiff would be without remedy, but recognized that it must “carefully guard” the

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204. Swormstedt, 57 U.S. (16 How.) at 302 (citing STORY, supra note 171); see also Hazard et al., supra note 38, at 1899 (noting this phrase, from Story's Commentaries on Equity Pleadings, became a formula for courts to identify a representative suit with binding effect).


206. Id.

207. Id.

208. See, e.g., In re Engelhard & Sons Co., 231 U.S. 646, 649-52 (1914); Hutchinson, supra note 196, at 467-69.


210. Id. at 108-09 (citing STORY, supra note 171 and Swormstedt, 57 U.S. (16 How.) 288).
interests of the absent parties.\textsuperscript{211} By contrast, the court in \textit{Cutting v. Gilbert}\textsuperscript{212} did not allow representation because the only matter in common was an interest in the question involved.\textsuperscript{213} Six brokerage firms, on behalf of themselves and all others doing business as brokers, had filed a lawsuit against a tax assessor seeking to enjoin the collection of a certain tax.\textsuperscript{214} The defendants objected that there was not a joint interest that would allow the plaintiffs to represent the rest.\textsuperscript{215} The court agreed, stating that the interest required was an interest in the subject matter of the suit, not merely an interest in the answering of a legal question.\textsuperscript{216}

In 1912, the Supreme Court promulgated revisions to the Federal Equity Rules. The revisions made the decree in a class suit binding on absent parties, as had been held in \textit{Swormstedt}, and also permitted common question representation.\textsuperscript{217} Then in 1938, the Supreme Court

\begin{footnotesize}
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\item[211.] Id. at 107-09.
\item[212.] Cutting v. Gilbert, 6 F. Cas. 1079 (S.D.N.Y. 1865).
\item[213.] Id. at 1080.
\item[214.] Id. at 1079-80.
\item[215.] Id.
\item[216.] Id. at 1080; see also Scott v. Donald, 165 U.S. 107, 116-17 (1897) (plaintiff sought an injunction in a bill filed on behalf of himself and all others in South Carolina who import alcohol from other states for their own use; court held that merely a common interest in the question is not enough to support representation).
\item[217.] The text of the revised Federal Equity Rules 38 and 39 reads as follows:
\begin{itemize}
\item Rule 38. Representatives of Class: When the question is one of common or general interest to many persons constituting a class so numerous as to make it impracticable to bring them all before the court, one or more may sue or defend for the whole.
\item Rule 39. Absence of Persons who would be Proper Parties: In all cases where it shall appear to the court that persons, who might otherwise be deemed proper parties to the suit, can not be made parties by reason of their being out of the jurisdiction of the court, or incapable otherwise of being made parties, or because their joinder would oust the jurisdiction of the court as to the parties before the court, the court may, in its discretion, proceed in the cause without making such persons parties; and in such cases the decree shall be without prejudice to the rights of the absent parties.
\end{itemize}
\end{itemize}
\end{footnotesize}

226 U.S. 659.
promulgated the Federal Rules of Civil Procedure, which merged law and equity for the first time. Federal Rule of Civil Procedure 23 specifically codified class actions and Rule 23, as revised in 1966, is substantially the same as today’s rule. Justice Story’s classification of class actions arguably endures to modern times through Federal Rule of Civil Procedure 23.

B. Recognition of Shareholder Actions in the United States

Commentators have often said that U.S. courts imported the shareholder derivative device from England, but that is not entirely accurate. Unlike in England, American courts have “never limited shareholder litigation to cases involving ultra vires acts” or oppressive acts by a controlling majority. However, unlike English courts, American courts restricted shareholders to filing lawsuits only in situations in which the corporation was incapable of seeking redress or improperly refused to seek redress. Even with that restriction, shareholders have been able to pursue derivative actions far more easily in the United States than in England.

1. Shareholder Litigation in the State Courts. The Louisiana Supreme Court appears to have decided the first shareholder action in the United States in 1829. In Percy v. Millaudon, the plaintiffs were stockholders in Planters’

218. FED. R. CIV. P. 2.

219. FED. R. CIV. P. 23 Advisory Notes.


221. See, e.g., Howson, supra note 21, at 47.


225. Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829).
Bank, which was incorporated by act of the Louisiana Territory Legislature, and they sued three of the directors for fraudulent and unfaithful conduct. This case demonstrates that U.S. courts, similar to the English courts, were applying the necessary parties rule and its exceptions to class actions as well as shareholder lawsuits. Several stockholders had refused to join the plaintiffs’ petition, so the trial court stated that they “were necessarily made parties to the suit in order that a final settlement should be made between all, having an interest in the institution.” The Louisiana Supreme Court summarized the case as being brought by the owners of 413 shares and that the other stockholders who had declined to become plaintiffs were joined as defendants “for no other purpose, than that of having all the stockholders in court.” This case is typically cited by scholars as the earliest example of a court stating that directors’ decisions are entitled to deference. However, the Louisiana Supreme Court found that the directors were “much influenced by a view to promote the interest of a few individuals” in voting to allow the president to discount notes in contravention of the corporate charter and ultimately held the defendants liable for their acts.

Similarly, in Taylor v. Miami Exporting Company, the Ohio Supreme Court allowed a stockholder of a bank to pursue a bill in equity against the corporation and its directors, with other stockholders not joining the suit aligned as defendants. The plaintiff alleged mismanagement and fraud by the president and directors of the Miami Exporting Company, which had been

227. Percy, 8 Mart. (n.s.) at 68.
228. Id. at 71.
229. Percy, 3 La. at 568, 570.
231. Percy, 3 La. at 580.
233. Id. at 168-69.
incorporated in 1803. \(^{234}\) After noting that the bill did not put into issue the life of the corporation nor interrupt the exercise of its corporate functions, the court stated that the corporation was not exempt from legal responsibility. \(^{235}\) “We cannot believe the powers of this court to be so feeble as not to reach a case of such palpable fraud . . . .” \(^{236}\) Therefore, the court held that the stockholder could sustain a bill in equity against the corporation and its directors, with the other stockholders named as defendants. \(^{237}\)

The first U.S. lawsuit in which shareholders were permitted to bring a representative action on behalf of themselves and the other shareholders against the corporation’s directors was the 1832 case of Robinson v. Smith. \(^{238}\) Stockholders in the New York Coal Company, a company incorporated in 1824, filed an equitable action against the directors for fraud and mismanagement. \(^{239}\) Although the company had received its corporate charter for the purpose of exploring for, digging, and vending coal and was restricted from carrying on any banking business, the stockholders claimed that the directors had used their funds almost exclusively to buy and sell stocks in other corporations. \(^{240}\) Noting that the plaintiffs owned only 160 of the company’s 4,000 shares of stock, the defendants demurred, arguing that all the shareholders needed to be joined. \(^{241}\) The court held that the objection could not be sustained. \(^{242}\) All the complainants were cestui que trusts, having the same interest in every respect: “They are seeking precisely the same redress against their trustees, and for the same acts; by which they allege they have received a

\(^{234}\) Id. at 162-63.
\(^{235}\) Id. at 166-68.
\(^{236}\) Id. at 167.
\(^{237}\) Id. at 168-69.
\(^{238}\) Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832).
\(^{239}\) Id. at 222-23.
\(^{240}\) Id. at 222, 228 (Chancellor described this conduct as stock jobbing at its wildest).
\(^{241}\) Id. at 224.
\(^{242}\) Id. at 230-31.
similar and common injury.” 243  Thus, the court held that there was no reason to file separate bills. 244  The court recognized that generally a suit to compel corporate officers to account for their actions should be in the name of the corporation, but stated that it should not permit a wrong to go unredressed merely for the sake of form. 245  The court stated that if the “corporation refused to prosecute” or “was still under the control of” the defendants, the stockholders “would be permitted to file a bill in their own names” and on behalf of all the shareholders, with the corporation being made a defendant. 246  “[I]f the stockholders are so numerous as to render it impossible, or very inconvenient to bring them all before the court, a part[ys] might file a bill in behalf of themselves and all others standing in the same situation.” 247  The court then declared it the law of the state that directors of corporations “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 that loss.” 248

The New York Chancery Court again summarized when stockholders could pursue an action in their own names in Forbes v. Whitlock 249 in 1840.

Cases have occurred in which stockholders have been at liberty to exhibit a bill in their own names. This can be done when the directors, officers or managers, having the control of the corporation and its affairs, are guilty of misconduct that amounts to a breach of their duty as trustees. 250

However, the court held that if the complaint was not against the board of directors but simply a single member,

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243.  Id. at 230-31.
244.  Id. (citing Brinkerhoff v. Brown, 7 Johns. Ch. 217 (N.Y. Ch. 1822)).
245.  Id. at 233.
246.  Id.
247.  Id.
248.  Id. at 231.
249.  Forbes v. Whitlock, 3 Edw. Ch. 446, 448 (N.Y. Ch. 1840).
250.  Id. at 448.
then “the corporation itself has the exclusive right to sue.”\textsuperscript{251} Thus, the stockholders’ lawsuit alleging fraudulent acts against a single director could not be brought by the stockholders independently.\textsuperscript{252}

Shareholders’ right to file suit when the corporation is incapable of doing so or improperly refuses to do so was also recognized in Maine in 1844. In \textit{Hersey v. Veazie},\textsuperscript{253} a shareholder sued an agent of the corporation for fraud in causing the franchise of the corporation to be sold.\textsuperscript{254} The court held that the wrongs alleged were wrongs committed against the corporation and, until it has been shown that the corporation is incapable of doing so, no shareholder can assume the right of the corporation to obtain redress for such wrongs.\textsuperscript{255} The court noted that, if after attempting to get the corporation to make redress, it was found incapable of doing it or improperly refused to do so, the shareholders may bring suit by making the corporation a party defendant.\textsuperscript{256} In this case, however, there was no allegation that the corporation had refused to call upon the defendant to account for the harm done.\textsuperscript{257}

In 1855, the Maine Supreme Court again addressed the issue. In \textit{Smith v. Poor},\textsuperscript{258} the court stated that a shareholder could not bring bill in equity “against the officers for misfeasance, until proper measures have been taken to induce the corporation to obtain redress, and they improperly refuse.”\textsuperscript{259} However, if the corporation was under

\textsuperscript{251} Id. at 447-48.
\textsuperscript{252} Id. at 448.
\textsuperscript{253} Hersey v. Veazie, 24 Me. 9 (1844).
\textsuperscript{254} Id. at 11.
\textsuperscript{255} Id. at 12.
\textsuperscript{256} Id.
\textsuperscript{257} Id. at 13.
\textsuperscript{258} Smith v. Poor, 40 Me. 415 (1855) (holding shareholder’s claim that directors fraudulently prevented the execution of his contract could be asserted only against the company, not the directors).
\textsuperscript{259} Id. at 418 (citing \textit{Hersey}, 24 Me.); \textit{id.} at 421 (stating that if an injury resulted to the plaintiff in common with other stockholders, the remedy would be by the corporation because directors are responsible to the corporation for misconduct in the discharge of their duties).
the control of guilty parties, the court stated that the remedy would be by “some of the injured stockholders for the benefit of all.” 260 In all cases, the court noted that “the corporation is a necessary party either as complainants or defendants.” 261

In 1866, the Maine Supreme Court elaborated on when shareholders could bring suit in *Kennebec & Portland R.R. Co. v. Portland & Kennebec R.R. Co.* 262 The complainants alleged that the directors carelessly, negligently, and unskillfully managed the company, and that the net earnings were $50,000 less annually than had the company been managed faithfully. 263

The corporation itself is regarded as a distinct person; and its property is legally vested in itself, and not in its stockholders. As individuals, they cannot, even by joining together unanimously, convey a title to it, or maintain an action at law for its possession, or for damages done to it. The . . . corporation must manage its affairs in its own name, as exclusively as a natural person manages his property and business. The officers, though chosen by a vote of the stockholders, are not their agents, but the agents of the corporation, and they are accountable to it alone.”

Stockholders undoubtedly have an interest in the property and business of the corporation, which will be protected in equity when invaded. They have equitable rights which, when violated, may be enforced by equitable remedies. “The corporation itself holds its property as trustee for the stockholders, who have a joint interest in all its property and effects, and each of whom is related to it as *cestui que trust.*” So long as the corporation is faithful to its trust, the stockholders, as individuals, have no occasion and no right to resort to or enforce any remedies, legal or equitable, to vindicate any injury to the corporate property. When it is guilty of a breach of trust, then, and only then, the relationship of the stockholders, arising from that trust, gives them a right to pursue the proper remedy to vindicate their rights. But, in such a case, it necessarily follows that the corporation must, or at least may be, a party defendant; for it is only the violation of the trust existing

260. *Id.* at 420.
261. *Id.* at 422.
263. *Id.* at 176.
between the corporation and its stockholders, that gives the latter any occasion for a remedy.\textsuperscript{264}

The court found the bill defective for misjoinder of plaintiffs because there was no allegation the corporation had breached its trust with stockholders.\textsuperscript{265}

Massachusetts subsequently followed Maine’s formulation of when to permit shareholder litigation. Although the Massachusetts Supreme Court did not allow a stockholder of a bank to pursue an action against the directors for negligence in conducting the bank’s affairs in \textit{Smith v. Hurd}\textsuperscript{266} in 1847, it stated that shareholders could pursue litigation when the corporation failed to do so or was incapable of doing so.\textsuperscript{267} The stockholder had alleged nonfeasance and misfeasance led the bank to fail.\textsuperscript{268} The court held that no legal privity existed between the shareholder and the directors,\textsuperscript{269} because the directors’ duties arose from a promise to the corporation, not to the stockholders.\textsuperscript{270} The court stated that the directors were agents and the corporation was the principal, and therefore a stockholder could not call the corporation’s “agents to account, by a bill in equity, without the consent of the corporation legally obtained.”\textsuperscript{271} However, the court recognized an exception: a stockholder could bring a bill in

\textsuperscript{264}. \textit{Id.} at 181 (citation omitted) (quoting Peabody v. Flint, 88 Mass. (6 Allen) 52, 55-56 (1863)).

\textsuperscript{265}. \textit{Id.} at 1882.


\textsuperscript{267}. \textit{Id.} at 377-78.

\textsuperscript{268}. \textit{Id.} at 375.

\textsuperscript{269}. \textit{Id.} at 384.

\textsuperscript{270}. \textit{Id.} at 373.

\textsuperscript{271}. \textit{Id.} at 377-78 (“As the corporation may have a single action for the whole injury alleged to have been done by the defendants, there is no reason why each stockholder should have an action; and as no stockholder can have suffered any special damage, that is, any damage not also suffered by the others, the analogies of the law would seem to confine the remedy to a single action by a party that can recover for the whole injury.”).
equity when “the corporation is incapable of obtaining redress, or collusively refuses to seek it.”

The Massachusetts Supreme Court reiterated this principle in *Peabody v. Flint* in 1863 and in *Brewer v. Boston Theatre* in 1870. In *Peabody*, two stockholders filed a bill in equity on behalf of themselves and the other stockholders of the Lowell and Salem Railroad Company alleging conspiracy and fraud against certain directors and agents of the company. Although acknowledging stockholders’ interest was merely an equitable interest, the court stated that an equitable interest possessed equitable rights that may be enforced by equitable remedies.

The corporation may call its officers to account if they willfully abuse their trust, or misapply the funds of the company; and if it refuses to sue, or is still under the control of those who must be made defendants in the suit, the stockholders who are the real parties in interest may file a bill in their own names, making the corporation a party defendant; or a part of them may file a bill in behalf of themselves and all others standing in the same relation.

This bill, however, was ultimately dismissed for unreasonable delay.

The shareholders in *Brewer v. Boston Theatre* alleged that several directors of the corporation leased its property to parties whom they secretly had agreed to share in the advantages of such leases. To pursue their lawsuit, the Massachusetts Supreme Court held that the plaintiffs had to show that redress cannot be obtained through action of the corporation and plaintiff must have applied to the board

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272. *Id.* at 378.
276. *Id.* at 56.
277. *Id.*
278. *Id.* at 57-58.
to bring an action and the board must have refused. 280 “It is only from the necessity of the case, and to prevent a failure of justice, that suits in equity in the form of these bills are allowed.” 281 The court recognized that there was “some diversity” as to what satisfied the requirement that suitable redress was not attainable through the action of the corporation. 282 It held that where stockholders retain no control of the corporate business, except by annual elections of officers, a simple refusal by the officers to take proper action to protect the corporation’s interests should be sufficient to allow a lawsuit on behalf of the stockholders.” 283 In what could be an early statement of the demand excusal test, the court stated, “[a] formal application and refusal need not be alleged, if enough appears to show that such an application would be unavailing.” 284 The court found that because the majority of the corporation was under the control of the defendants being accused and the alleged breaches of trusts by the defendants could not be ratified by the corporation, there was no capacity for the plaintiffs to move the corporation to take action for their redress. 285

The Wisconsin Supreme Court in 1849 permitted shareholders to bring an action on behalf of themselves and the other shareholders in Putnam v. Sweet. 286 The plaintiffs (about twenty in number) filed a bill on behalf of themselves and subscribers to the stock of Milwaukee and Janesville Plank Road Company, chartered on March 6, 1848. 287 The complainants alleged the directors permitted the fraudulent subscription of thousands of shares. 288 The court held that it was not necessary for all the shareholders to be made

280. Id. at 386.
281. Id.
282. Id. at 387.
283. Id.
284. Id.
285. Id. at 396.
287. Id. at 302-09.
288. Id. at 325.
A few of a large number could maintain a bill in equity on behalf of themselves and their fellow shareholders, even when a majority was opposed to the suit. As the court stated, “[a] more appropriate case ‘for some of a large number having a common right to maintain a suit in behalf of themselves and fellows, in aid of that common right,’ cannot well occur.”

The Rhode Island Supreme Court in *Hodges v. New England Screw Company* permitted stockholders to sue directors for mismanagement. The court noted that the corporation was the party injured by breaches of trust by its managers and thus was the primary party to sue for such acts, but held that the stockholders in their individuals names could bring suit when the corporation refused to sue. On the merits, the court held that the directors had acted in good faith for the benefit of the company and under the belief that their actions were lawful.

The Connecticut Supreme Court recognized an exception to the necessary parties rule for shareholders in *Allen v. Curtis* in 1857. Stockholders of a bank brought an action at law against the corporation’s directors alleging that the directors willfully managed the corporation’s affairs in an “unskillful, careless, and reckless manner.” The court recognized the principle that directors are agents of the corporation and only liable to it, and that the corporation is the sole representative of the stockholder. However, the court noted that an individual stockholder, on

289. *Id.* at 345.
290. *Id.*
291. *Id.*
293. *Id.* at 340-41.
294. *Id.*
295. *Id.* at 344.
297. *Id.* at 457. The alleged actions included “making false entries in the books of the bank [and] loaning money without security.” *Id.*
298. *Id.* at 461.
behalf of himself and all the stockholders, may bring suit in equity if “the corporation is unable to bring suit, or if, through fraud and collusion, the directors refuse or neglect to bring suit in the corporate name.” Because there was no allegation that through fraud or collusion the corporation refused to sue, the suit was not allowed.

In *March v. Eastern Railroad Company*, the New Hampshire Supreme Court held that stockholders, on behalf of themselves and all the stockholders, had a remedy in equity against the directors and the corporation to prevent any misapplication of the corporation’s assets. Railroad A had leased part of the railroad track owned by Railroad B but then refused to pay rent. When the board of Railroad B refused to take measures to collect the rent payments, stockholders in Railroad B brought suit against their own corporation, its directors, and the corporation of Railroad A. The defendants argued that the plaintiffs were not proper parties to bring suit because all the stockholders were not made parties. However, the court held that it was a “well settled” principle that when the parties are numerous, and “the suit is for an object common to them all, some of the body may maintain a bill in behalf of themselves and others having a like interest.” Furthermore, the court noted that it was no longer doubted that courts of equity have “jurisdiction over corporations, at the instance of one or more of their members, to apply preventative remedies by injunction.” Citing *Robinson v. Smith*, the court stated that, “[i]f the directors of a corporation refuse to prosecute, . . . the stockholders, who

299. *Id.* at 461-62.
300. *Id.* at 462.
302. *Id.* at 548.
303. *Id.*
304. *Id.*
305. *Id.* at 566.
306. *Id.*
307. *Id.* at 567.
are the real parties in interest, would be permitted to file a bill in their own names.”

2. Shareholder Litigation in the Federal Court. Early shareholder lawsuits in the United States were all decided by state courts. The U.S. Supreme Court did not address shareholder actions until *Dodge v. Woolsey* in 1855. In *Dodge*, a stockholder filed suit against a third party tax collector seeking an injunction to prevent the county treasurer from collecting an allegedly unconstitutional tax on the corporation, Commercial Branch Bank of Cleveland. The Court allowed the stockholder to step in between the corporation and a third party to institute and control a suit concerning the rights of the corporation because the directors of the bank had refused to take any steps to prevent the collection of the tax upon demand of the stockholder. The Court viewed the directors’ action to be a breach of duty and held the stockholder had a right to bring suit in equity to restrain the collection of the tax, but it did not directly address the representative nature of the case.

The underlying story of this case, and many other early shareholder cases in the Supreme Court, was that by the out-of-state shareholder bringing the action, the case could be filed in federal court on diversity grounds. Diversity jurisdiction in the federal court was preferable to having a court of the local government deciding the constitutionality of the local tax.

In *Bronson v. La Cross & Milwaukie Railroad Company*, the U.S. Supreme Court again permitted a stockholder to defend a suit against the company where the directors refused to do so. A plaintiff had filed a bill against the La Crosse and Milwaukie Railroad Company,

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308. *Id.* at 567-68 (citing Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832)).
310. *Id.* at 335-36.
311. *Id.* at 341.
312. *Id.* at 344-45.
313. *Id.* at 345.
315. *Id.* at 303.
seeking to foreclose a mortgage of the corporation.\(^{316}\)

According to the shareholder who sought to defend the case, the directors had refused to defend the bill for the “fraudulent purpose of sacrificing the interests of the stockholders.”\(^{317}\) The court found that “it would be a reproach to the law . . . if stockholders were remediless” and thus used its discretion to “permit a stockholder to become a party defendant, for the purpose of protecting his own interest against unfounded or illegal claims against the company.”\(^{318}\)

In *Memphis City v. Dean*,\(^{319}\) the corporation, Memphis Gaslight Company, entered into a charter in 1852 that allegedly gave the company exclusive rights to provide gas to the city for twenty years.\(^{320}\) However, “[i]n 1866, the State passed an act incorporating another gaslight company.”\(^{321}\) Memphis Gaslight Company therefore filed a bill in a state court of chancery against the new corporation, but a permanent injunction was not granted.\(^{322}\) Following initiation of the corporation’s lawsuit, a stockholder filed a bill “against the new company[] and also against the city of Memphis.”\(^{323}\) Citing *Dodge v. Woolsey*, the Supreme Court stated that for the stockholder to have standing, the stockholder must have demanded that the corporation bring the lawsuit itself, and the corporation refused.\(^{324}\) The refusal of the board of directors to institute a suit in the corporation’s name was essential and there had to be a clear default involving a breach of duty before a stockholder is

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316. *Id.* at 283.
317. *Id.* at 302 (“It is thus apparent, that while the name of the corporation is thus used as a real party in the litigation, so far as the rights and interests of the complainants are concerned, it is an unreal and fictitious party . . . .”).
318. *Id.*
320. *Id.* at 66.
321. *Id.*
322. *Id.* at 66-67.
323. *Id.* at 67.
324. *Id.* at 73 (citing *Dodge v. Woolsey*, 59 U.S. (18 How.) 331 (1855)).
authorized to institute the suit in his own behalf.\textsuperscript{325} Although the corporation refused to bring the lawsuit that Dean intended, the corporation argued that its previously filled complaint was substantially the same.\textsuperscript{326} The court dismissed the shareholder’s complaint, holding that the two actions were substantially similar and the corporation had not broken its trust to the stockholders.\textsuperscript{327}

In \textit{Davenport v. Dows},\textsuperscript{328} stockholders in the Chicago, Rock Island, and Pacific Railroad filed a bill to arrest the collection of a tax on the corporation by the city of Davenport.\textsuperscript{329} The Court held that a stockholder may bring a suit based on the rights of the corporation when the corporation refused to do so, as was the case here.\textsuperscript{330} However, the shareholder had failed to make the corporation a defendant in the action.\textsuperscript{331} The court noted that “proceedings for this purpose should be so conducted that any decree which shall be made on the merits shall conclude the corporation. This can only be done by making the corporation a party defendant.”\textsuperscript{332} If the corporation were not made a party, the corporation might be able to bring a later lawsuit if the stockholder was unsuccessful.\textsuperscript{333} To avoid this result, the court stated that it would not “settle a question in which the corporation is the essential party in interest, unless [the corporation] is made a party to the litigation” as a defendant.\textsuperscript{334}

\begin{footnotes}
\item[325] Id. (citing \textit{Dodge}, 59 U.S. (18 How.) at 331); \textit{cf.} City of Detroit v. Dean, 106 U.S. 537, 541-42 (1883) (holding a stockholder seeking to protect the property of the corporation against a third party must show a clear breach of duty by the directors in neglecting or refusing to bring suit).
\item[326] \textit{Memphis City}, 75 U.S. (8 Wall.) at 74.
\item[327] Id. at 75-76.
\item[328] \textit{Davenport v. Dows}, 85 U.S. (18 Wall.) 626 (1873).
\item[329] Id. at 626.
\item[330] Id. at 627.
\item[331] Id.
\item[332] Id.
\item[333] Id.
\item[334] Id.
\end{footnotes}
In *Hawes v. Oakland*, \(^{335}\) the United States Supreme Court sought to establish limitations on a shareholder’s ability to bring derivative actions similar to the limitations the English court in *Foss v. Harbottle* had established. \(^{336}\) A stockholder in the Contra Costa Water-works Company filed suit on behalf of his interest in the corporation against the corporation and the city of Oakland for the corporation’s supply of free water to the city beyond the purposes prescribed in the charter. \(^{337}\) The plaintiff had urged the directors of the corporation to take immediate proceedings to prevent the city from taking water from the works of said company without compensation for any purpose other than those listed in the charter, but the directors had refused. \(^{338}\) The court stated that the frequency of such suits by stockholders after *Dodge v. Woolsey* had “overburdened courts of the United States” by a “simulated and conventional arrangement.” \(^{339}\) The court explained that through this “arrangement,” shareholders essentially were colluding with their corporations to bring these suits in federal court, because the shareholder had the requisite citizenship for federal diversity jurisdiction that the corporation whose rights were to be enforced lacked. \(^{340}\) The court stated that *Dodge v. Woolsey* had not established a doctrine different than cases in English courts or other American courts, and the doctrine enabled a stockholder to bring an action only if one of the following exists:

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 such a fraudulent transaction completed or contemplated by the acting managers, in connection with some other party, or

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337. *Id.* at 451.
338. *Id.*
339. *Id.* at 453.
340. *Id.* at 452-53.
among themselves, or with other shareholders as will result in serious injury to the corporation, or to the interests of the 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. 341

However, “before the shareholder is permitted in his own name to institute . . . litigation”, he had to show that “he exhausted all means within his [control] to obtain the redress of his grievances.” 342 The court held that the facts of Hawes presented “no such case,” because the plaintiff had merely requested “the directors to desist from furnishing water free of expense to the city” and had not exhausted all efforts to obtain the corporation’s action against the city. 343

III. UNDERSTANDING THE HISTORICAL AND NORMATIVE DISTINCTIONS BETWEEN HISTORICAL AND MODERN SHAREHOLDER DERIVATIVE ACTIONS IN THE UNITED STATES

The English Court of Chancery in the early 1800s applied the necessary parties rule and its exceptions to lawsuits that today would be called class actions and shareholder derivative actions, as Part I demonstrated. During that same time period, the courts of the newly established United States also followed the necessary parties rule and recognized an exception that permitted representative lawsuits for similar actions. However, as Part II explained, the U.S. courts limited when shareholders could bring actions, and the U.S. limitations always differed from the limitations imposed on similar actions in England. Now, Sections A and B below will

341. Id. at 460.
342. Id. at 460-61.
343. Id. at 461.
explain that the normative foundation of shareholder derivative litigation in the first 150 years of the United States varies dramatically from the modern version. Section C will then examine the likely explanations for the variance between early and modern shareholder derivative litigation, and it will suggest the implications that the normative foundation of early shareholder derivative actions may have on modern corporate law debates.

A. Shareholders May File an Action “On Behalf of All Shareholders”

The shared history of class actions and shareholder derivative actions has long been overlooked, but that history reveals the early normative justifications for shareholder litigation. Both class actions and shareholder derivative actions are forms of representative litigation, meaning that one or a few persons stand for another or group of persons. Prior to Foss v. Harbottle in 1843, shareholders in English corporations and joint-stock companies were allowed to bring actions on behalf of all the shareholders with almost no limitations. Similar to class actions, these actions were permitted as an exception to the necessary parties rule. In Foss and subsequent cases, English courts limited shareholders to bringing suit only when an illegal or fraudulent act was alleged, or the wrong was committed by the majority shareholders against the minority shareholders.

During the 1800s and early 1900s, shareholders in U.S. companies were also permitted to bring lawsuits on behalf

344. See supra nn. 16-18 and accompanying text.
of all the shareholders in certain circumstances. Thus, just like the plaintiff in a class action represented the other class members, the shareholder represented the other shareholders. Like class actions, these shareholder actions were also originally permitted as an exception to the necessary parties rule. Subsequent cases allowed shareholders in these lawsuits to bring them on behalf of themselves and the other shareholders when the shareholders were so numerous as to make it inconvenient to bring them all before the court. That formulation did not change until the late 1940s, when U.S. courts


348. See Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829); Taylor v. Miami Exporting Co., 5 Ohio 162 (1831).

349. See, e.g., Peabody v. Flint, 88 Mass. (6 Allen) 52, 56 (1863); Robinson v. Smith, 3 Paige Ch. 222, 232-33 (N.Y. Ch. 1832). Even today, U.S. courts use the language of the exceptions to the necessary parties rule in describing shareholder derivative actions.

The procedural requirements for derivative suits further protect the corporation and its stockholders by preventing a “multiplicity of lawsuits,” by limiting “who should properly speak for the corporation” and by precluding “self-selected advocate[s] pursuing individual gain rather than the interests of the corporation or the shareholders as a group, [from] bringing costly and potentially meritless strike suits.” A derivative lawsuit is thus the vehicle for a shareholder to litigate injuries that result in the diminution in value of the corporation’s stock. Rivers v. Wachovia Corp., 665 F.3d 610, 615 (4th Cir. 2011) (alteration in original) (quoting Norman v. Nash Johnson & Sons’ Farms, Inc., 537 S.E.2d 248, 253 (N.C. App. 2000)).

routinely began to describe shareholder derivative lawsuits as being brought on behalf of the corporation but without any explanation for the change. Prior to the 1940s, courts typically referred to these lawsuits as brought by shareholders on behalf of all the shareholders.351 Courts had previously referred to these lawsuits as derivative,352 but often continued to state that the lawsuits were brought by shareholders on behalf of all the shareholders.353 In these

351. See, e.g., Davenport v. Dows, 85 U.S. 626, 627 (1873) (“[T]he individual shareholder is allowed to assert in behalf of himself and associates, because the directors of the corporation decline to take the proper steps to assert them.”); Nussbaum v. Nussbaum, 199 S.E. 169, 172 (Ga. 1938) (“The petition is what is sometimes called a stockholders’ derivative or representative suit, brought on behalf of the plaintiffs and other stockholders similarly situated . . . .”); McIlvaine v. City Nat’l Bank & Trust Co., 19 N.E.2d 584, 584 (Ill. 1939) (“This is a representative suit in equity, instituted by the named plaintiffs on behalf of themselves and all other stockholders . . . to enforce a derivative cause of action in favor of the [company] . . . .”); Brady v. Meenan, 198 N.Y.S. 177, 177 (N.Y. App. Div. 1923) (“This is a derivative action, brought by a stockholder of a corporation, on behalf of himself and other stockholders . . . .”); Pollitz v. Wabash R.R. Co., 100 N.E. 721, 722 (N.Y. 1912) (“The action is in behalf of the plaintiff and all other stockholders of the defendant company similarly situated against the company and five of its directors.”).

352. See, e.g., Pepper v. Litton, 308 U.S. 295, 307 (1939) (describing case as “stockholder’s derivative action”); Wales v. Jacobs, 104 F.2d 264, 267 (6th Cir. 1939) (explaining that the case may not “be entertained as a stockholder’s derivative suit”); Wile v. Burns Bros., 2 F. Supp. 950, 950 (S.D.N.Y. 1932) (describing case as “stockholders’ derivative suit”); Nussbaum, 199 S.E. at 172 (describing case as “stockholders’ derivative or representative suit”); Alexander v. Donohoe, 38 N.E. 263, 265 (N.Y. 1894) (“Suing as a stockholder, the plaintiff’s right of action is a derivative one. He sues, not primarily in his own rights, but in right of the corporation.”).

353. See, e.g., J.R.A. Corp. v. Boylan, 30 F. Supp. 393, 393 (S.D.N.Y. 1939) (stating plaintiff “alleged a derivative stockholder’s suit in behalf of itself, and all other stockholders similarly situated, against” current and former directors of American Tobacco Company); Flynn v. Brooklyn City R.R. Co., 41 N.Y.S. 566, 567 (N.Y. App. Div. 1896) (describing the shareholder’s right of action as “derivative from the corporation, and existing only by the failure of the corporation to assert its own right” and stating the lawsuit “is on behalf, not only of the particular plaintiff, but all the stockholders”); cf. In re Swofford Bros. Dry Goods Co., 180 F. 549, 552 (W.D. Mo. 1910) (describing the action as “prosecuted by the plaintiff on behalf of himself and the other stockholders of said corporation and on behalf of said corporation”); Wright v. Floyd, 86 N.E. 971, 972 (Ind. App. 1909) (“It is well settled that shareholders . . . may bring suit on behalf of the corporation to protect the interest of the corporation and incidentally the interest of the members . . . .”); Hingston v. Montgomery, 97
cases, the corporation was named as a defendant to prevent it from later bringing a duplicative action. By contrast, modern shareholder derivative actions are filed by shareholders on behalf of the corporation in both the United States and England.

This historical account of U.S. shareholder derivative lawsuits being brought on behalf of all the shareholders reveals a normative judgment that the shareholders had the right to seek remedy when the managers engaged in fraud or mismanagement. While acknowledging that a corporation was a separate legal entity and that normally the corporation was the proper party to bring suit against its managers for mismanagement or fraud, courts also recognized that corporate managers were not likely to sue themselves and permitted shareholders to bring suits in those circumstances. Therefore, courts recognized that it

S.W. 202, 204 (Mo. Ct. App. 1906) (stating “stockholder may maintain an action against the corporation and the offending officers in his own name, though in reality on behalf of the corporation, and through it of all of its stockholders”).

354. See, e.g., Davenport, 85 U.S. at 627 (“[A] court of equity will not take cognizance of a bill brought to settle a question in which the corporation is the essential party in interest, unless it is made a party to the litigation.”); Smith v. Poor, 40 Me. 415, 422 (1855) (stating that “the corporation is a necessary party, either as complainants or defendants”); Alexander v. Quality Leather Goods Corp., 269 N.Y.S. 499, 503 (N.Y. Sup. Ct. 1934) (stating when a shareholder brings an action “on behalf of other stockholders similarly situated, he exercises a derivative right and judgment must ordinarily be rendered in favor of the corporation, though the corporation be a defendant in the action.”).

355. See, e.g., Burks v. Lasker, 441 U.S. 471, 477 (1979) (“A derivative suit is brought by shareholders to enforce a claim on behalf of the corporation.”); Ross v. Bernhard, 396 U.S. 531, 538 (1970); Rivers v. Wachovia Corp., 665 F.3d 610, 614 (4th Cir. 2011) (stating a derivative action is “brought by a shareholder in the name or right of a corporation to redress an injury sustained by, or to enforce a duty owed to, the corporation”) (quoting 1 William Meade Fletcher, Fletcher Cyclopedia of the Law of Corporations §§ 5939-5940 (rev. ed. 2011)).

356. Companies Act, 2006, c. 46 § 260(1) (U.K.) (defining a derivative claim as a proceeding by a member of a company “(a) in respect of a cause of action vested in the company, (b) and seeking relief on behalf of the company”).

357. See, e.g., Fleer v. Frank H. Fleer Corp., 125 A. 411, 414 (Del. Ch. 1924) (“Where the demand if made would be directed to the particular individuals who themselves are the alleged wrongdoers and who therefore would be invited to sue themselves, the rule is settled that a demand and refusal is not requisite.”);
was the shareholders who were harmed in these circumstances and allowed the shareholders to pursue a lawsuit.

Equity, at least, recognizes the truth that the stockholders are the proprietors of the corporate interests, and are ultimately the only beneficiaries thereof, and the remedies given the corporation are really, though indirectly, for the protection of their rights. They may at each authorized election entirely change the directorate and may at any time keep the directors within the line of faithful administration by an appeal to a court of equity or repudiate their acts which are intra vires of them, but voidable.358

For this reason, early shareholder derivative litigation struck a balance of power between the board and the shareholders. The board of directors could be held accountable by shareholders other than through elections, and the board was not the sole power controlling the corporation. Importantly, other stakeholders (such as employees or customers) were not given this right to pursue litigation, only the shareholders. The historical and normative foundation of early shareholder derivative litigation in the United States bolsters the shareholder primacy theory and may prove valuable to its advocates.

The shift to shareholder derivative actions brought on behalf of the corporation that took hold in the late 1940s through today reveals a different normative judgment. That a different normative foundation underlies the modern shareholder derivative action can also be seen in the increasingly narrow circumstances in which shareholders are permitted to pursue such litigation.

Orlando Orange Groves Co. v. Hale, 144 So. 674, 678 (Fla. 1932) (“Under the showing made by the bill in the instant case, a request that the directors sue themselves would have been fruitless.”); Estel v. Midgard Inv. Co., 46 S.W.2d 193, 195 (Mo. Ct. App. 1932) (“The wrongs complained of are charged against the directors themselves, who are in control of the assets and business of the corporation. The wrongdoers could hardly be expected to sue themselves.”).

B. Shareholders May File an Action in Limited Circumstances

To prevent abuse, courts in the United States imposed limits on when shareholders could seek redress through litigation. Although some early U.S. lawsuits by shareholders claiming mismanagement or fraudulent conduct by directors and officers did not appear to limit when such suits could be pursued, the first decisions of the New York Chancery Court did impose limitations. The New York Chancery Court held that if the corporation refused to prosecute or was still under the control of the defendants, then shareholders were permitted to file a bill in their own names and on behalf of all the shareholders, with the corporation being made a defendant. Subsequent court decisions in other states similarly limited shareholder lawsuits to instances where the corporation was incapable of seeking redress or improperly refused to seek redress.

This historical limitation on shareholder derivative actions reveals a normative judgment, as did its procedural nature of being brought on behalf of all the shareholders. Limiting derivative actions to instances in which the corporation refused or was unable to seek redress itself allowed shareholder lawsuits essentially on one topic: misconduct by the corporation’s directors or officers. Shareholders had the right to seek remedy when these managers engaged in fraud or mismanagement. “Devised as a suit in equity, the purpose of the derivative action was

359. See, e.g., Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829); Taylor v. Miami Exporting Co., 5 Ohio 162 (1831); Putnam v. Sweet, 2 Pin. 302 (Wis. 1849).
360. See, e.g., Forbes v. Witlock, 3 Edw. Ch. 446, 448 (N.Y. Ch. 1840); Robinson v. Smith, 3 Paige Ch. 222, 233 (N.Y. Ch. 1832).
363. See id.
to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of ‘faithless directors and managers.’” 364 Even though a corporation was a separate legal entity that should bring suit against its managers for mismanagement or fraud, courts recognized that corporate managers were the ones making the corporation’s decisions, and they were not likely to sue themselves. 365 For this reason, courts in equity permitted shareholders to bring suits in those circumstances and gave shareholders the power to hold directors accountable through litigation. Again, recognizing that it was the shareholders who were harmed, courts’ decisions to allow such litigation reflected a balance of power between the board and the shareholders. This normative foundation of early shareholder derivative litigation in the United States further bolsters the shareholder primacy theory.

Modern courts also limit when shareholders can pursue litigation for misconduct by corporate officers and directors, but the limitation started becoming much stricter with the shift to derivative actions being recognized as on behalf of the corporation. The U.S. Supreme Court in 1946 described shareholder derivative suits as a remedy “for those situations where the management through fraud, neglect of duty or other cause declines to take the proper and necessary steps to assert the rights which the corporation has.” 366 Today the limitation is typically a precondition “for the suit,” requiring the shareholder to demonstrate “that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions.” 367 Because the board of directors possesses the statutory authority to manage the corporation and its assets, including a cause of action, 368 federal courts and most state

364. Id. at 95 (quoting Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949)).
365. See supra n. 357 and accompanying text.
367. Ross, 396 U.S. at 534.
368. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2011); MODEL BUS. CORP. ACT § 8.01(b) (2010).
courts today permit a shareholder to file a derivative action only after making demand on the board to rectify the challenged transaction. The board could choose to prosecute the litigation itself in response to the demand, but typically the board rejects the demand.

To pursue a derivative action after a demand has been rejected, the shareholder must demonstrate to the court that the demand was wrongfully rejected. In some states, the shareholder can forego making a demand and argue that demand should be excused. To establish either that a demand was wrongfully rejected by the board or that demand should be excused, the plaintiff essentially must show that the business judgment rule does not apply to the board’s decision. The business judgment rule is a defense that presumes directors acted in a manner consistent with

369. See, e.g., Fed. R. Civ. P. 23.1(b)(3) (“The complaint must be verified and must . . . state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.”); Del. Ch. R. 23.1(a) (“The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”); Model Bus. Corp. Act § 7.42 (“No shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action; and (2) 90 days have expired from the date delivery of the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.”).

370. Bainbridge, supra note 19, § 8.5, at 395; see also Lisa M. Fairfax, Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability, 42 Hous. L. Rev. 393, 408 (2005) (noting “most boards” decide “not to bring any action” and “most courts defer to boards on this matter”).


372. See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (stating that demand is excused when officers and directors are under influences that impede their discretion to act on behalf of the corporation). The MBCA, however, states a universal demand requirement. Model Bus. Corp. Act § 7.42.

373. Aronson, 473 A.2d at 813-14; see also Bainbridge, supra note 19, § 8.5, at 395.
their fiduciary duties of care, loyalty, and good faith.\textsuperscript{374} Therefore, to show that the directors wrongfully rejected demand, the plaintiff must establish that a majority of the directors breached one of their fiduciary duties.\textsuperscript{375} The application is similar for cases in which the plaintiff seeks demand excusal: the plaintiff must establish that a majority of directors were financially interested or not independent in making the challenged decision.\textsuperscript{376} In other words, a trial court will excuse demand when the board is disabled by a conflict of interest, because the judge may presume the directors will not sue themselves. For example, Delaware excuses demand if the plaintiff can allege particularized facts creating reasonable doubt that (1) a majority of the board has a material interest in the challenged transaction; (2) a majority of the board lacks independence; or (3) the challenged transition is not the product of a valid exercise of business judgment.\textsuperscript{377} New York will excuse demand if the plaintiff can allege with particularity that (1) a majority of directors are interested in the transaction; (2) the directors failed to inform themselves; or (3) the challenged transaction is so egregious that it could not have been the product of sound judgment.\textsuperscript{378}

\textsuperscript{374} Aronson, 473 A.2d at 812. The United Kingdom has never recognized a judicially-created business judgment rule defense similar to that in U.S. law, although English judges are reluctant to second-guess directors’ decisions. Companies Act, 2006, c. 46, § 232(1) (U.K.) (“Any provision that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company is void.”); Cheffins & Black, \textit{supra} note 137, at 1401.

\textsuperscript{375} See Aronson, 473 A.2d at 813 (“Moreover, where demand on a board has been made and refused, we apply the business judgment rule in reviewing the board’s refusal to act pursuant to a stockholder’s demand.”); \textit{see also} Beneville v. York, 769 A.2d 80, 85 n.9 (Del. Ch. 2000) (noting that in the case of a board with only two directors, business judgment rule protection is unavailable because the interested director can block the action of the impartial director).

\textsuperscript{376} See Aronson, 473 A.2d at 814-15.

\textsuperscript{377} \textit{Id.} at 812-14; \textit{Beneville}, 769 A.2d at 85 n.9.

However, a majority of states have adopted the Model Business Corporation Act (MBCA),\textsuperscript{379} which was originally drafted in 1950.\textsuperscript{380} It requires demand to be made in all cases, so no excusal of demand is possible.\textsuperscript{381} The MBCA therefore limits shareholder derivative litigation more than the common law standards of states such as Delaware and New York, which permit demand excusal.\textsuperscript{382} After the board rejects a shareholder’s demand, the MBCA requires the shareholder to allege with particularity facts establishing that a majority of the board of directors did not consist of qualified directors at the time the determination to reject the demand was made.\textsuperscript{383} The MBCA defines a qualified director for this purpose as one who does not have “(i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest.”\textsuperscript{384} Compared to the discretion provided to judges through the third elements of the demand excusal standards of Delaware and New York, the MBCA imposes a much stricter limitation for shareholders wanting to pursue derivative litigation.

Both the common law and the MBCA formulations of the modern limitations on shareholder derivative actions are far tougher than the limitation expressed in cases in the 1800s. The courts in those cases phrased the limitation in terms of whether a corporation had been found incapable of seeking redress or improperly refused to do so.\textsuperscript{385} Later cases expanded on the former scenario by focusing on whether the corporation was still under the control of those who would


\textsuperscript{380} Model Bus. Corp. Act, at v, ix.

\textsuperscript{381} Id. § 7.42.

\textsuperscript{382} See supra nn. 376-77 and accompanying text.

\textsuperscript{383} Id. § 7.44(c).

\textsuperscript{384} Id. § 1.43(a)(1).

\textsuperscript{385} See, e.g., Bronson v. La Crosse & Milwaukie R.R. Co., 69 U.S. 283, 302 (1864); Dodge v. Woolsey, 59 U.S. 331, 335 (1855); Smith v. Hurd, 53 Mass. (12 Met.) 371, 377-78 (1847); Smith v. Poor, 40 Me. 415, 422 (1855); Hersey v. Veazie, 24 Me. 9, 12-13 (1844).
be defendants in the lawsuit.\textsuperscript{386} For instance, consider \textit{Robinson v. Smith}'s 1832 formulation:

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. But as this court never permits a wrong to go unredressed merely for the sake of form, if it appeared that the directors of the corporation \textit{refused to prosecute by collusion with those who had made themselves answerable by their negligence or fraud, or if the corporation was still under the control of those who must be made the defendants} in the suit, the stockholders, who are the real parties in interest, would be permitted to file a bill in their own names, making the corporation a party defendant. And if the stockholders were so numerous as to render it impossible, or very inconvenient to bring them all before the court, a part might file a bill, in behalf of themselves and all others standing in the same situation.\textsuperscript{387}

These broader statements of when shareholder derivative lawsuits could be pursued continued through the early 1900s.\textsuperscript{388} The modern formulations are more limiting for shareholders wanting to pursue shareholder derivative litigation and thereby reflect a decrease in shareholder power.

To some extent, the modern limitations on when a shareholder derivative lawsuit may be brought, particularly the business judgment rule defense as applied to demand

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\item \textsuperscript{386} Brewer v. Boston Theatre, 104 Mass. 378, 387 (1870); Peabody v. Flint, 88 Mass. (6 Allen) 52, 56 (1863).
\item \textsuperscript{387} Robinson v. Smith, 3 Paige Ch. 222, 233 (N.Y. Ch. 1832) (emphasis added).
\item \textsuperscript{388} See, \textit{e.g.}, McKee v. Rogers, 156 A. 191, 193 (Del. Ch. 1931) (holding that where a defendant controlled the board of directors, “[i]t is manifest then that there can be no expectation that the corporation would sue him, and, if it did, it can hardly be said that the prosecution of the suit would be entrusted to proper hands”); Miller v. Loft, Inc., 153 A. 861, 862 (Del. Ch. 1931) (stating “if by reason of hostile interest or guilty participation in the wrongs complained of, the directors cannot be expected to institute suit. . . no demand upon them to institute suit is requisite”); Fleer v. Frank H. Fleer Corp., 125 A. 411, 414 (Del. Ch. 1924) (“Where the demand if made would be directed to the particular individuals who themselves are the alleged wrongdoers and who therefore would be invited to sue themselves, the rule is settled that a demand and refusal is not requisite.”).
\end{itemize}
excusal and wrongful rejection of demand determinations, reflect judges’ reluctance to second-guess directors’ decisions. In many early shareholder cases, courts expressed concern about adopting a standard of liability that would render corporate managers liable whenever loss resulted from their actions. For instance, the opinion in \textit{Percy v. Millaudon} may have stated a precursor to the modern business judgment rule when it expressed concern about imposing liability whenever loss ensues from directors’ decisions.\footnote{Percy v. Millaudon, 8 Mart. (n.s.) 68, 77-78 (La. 1829) (“[T]he adoption of a course from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions.”).}

It stated that “[t]he test of responsibility, therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the agent is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.”\footnote{Id. at 78.} In 1847, in \textit{Godbold v. Branch Bank at Mobile}, the Alabama Supreme Court espoused a similar concern about holding directors to “extreme accuracy of knowledge,” particularly when a large degree of discretion is necessarily entrusted to them.\footnote{Godbold v. Branch Bank at Mobile, 11 Ala. 191, 199 (1847).} “The inevitable tendency of such a rule, would be hostile to the end proposed by it, as no man of ordinary prudence would [accept] a trust surrounded by such perils.”\footnote{Id.} In \textit{Hodges v. New England Screw Co.}, the Rhode Island Supreme Court in 1853 also stated a version of deference to the directors: “We think a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake.”\footnote{Hodges v. New England Screw Co., 3 R.I. 9, 18 (1853).} In \textit{Spering’s Appeal},\footnote{71 Pa. 11 (1872).} the Pennsylvania Supreme Court in 1872 stated that directors

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\item 389. Percy v. Millaudon, 8 Mart. (n.s.) 68, 77-78 (La. 1829) (“[T]he adoption of a course from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions.”). 
\item 390. \textit{Id.} at 78. 
\item 391. Godbold v. Branch Bank at Mobile, 11 Ala. 191, 199 (1847). 
\item 392. \textit{Id.} 
\item 394. 71 Pa. 11 (1872). 
\end{itemize} \end{footnotesize}
are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confided to the managing body.  

However, all such statements during this period were made by courts as they decided whether the directors were liable for their actions. The courts were not deciding whether the shareholder’s lawsuit may proceed, as that decision had already been made. Thus, the modern standard for determining when a shareholder derivative lawsuit may be pursued differs significantly from the historical inquiry. This shift also significantly diminishes shareholders’ power and reflects an alteration in the normative judgment underlying shareholder derivative litigation.

C. Possible Explanations for the Shift in Shareholder Derivative Litigation’s Normative Foundation

The shift in the normative foundation of shareholder derivative litigation occurred in the late 1940s with courts regularly recognizing shareholder derivative lawsuits as being brought on behalf of the corporation. It can also be seen through modern courts’ adoption of ever stricter limitations on when shareholders can pursue derivative litigation. The obvious question is: why did this shift occur? Did something in the nature of the corporation change, such as new state legislation that altered the terms by which corporations were created and governed? Or was it something else?

1. The Evolution of Corporations in the United States. In colonial times, corporations were created by royal charters
just as they were in England, and only local public service corporations were well represented. After winning independence from England in the American Revolution, the United States attained the sovereign power to incorporate its own corporations, which allowed for business enterprises to obtain the privileges of limited liability and conditions of a more stable organization. Although Congress has the power to charter corporations, it has rarely done so. Instead, most U.S. corporations are created under state law.

In early U.S. history, very few business corporations were chartered compared to the staggering numbers that exist today because “small-scale enterprise was still the order of the day.” However, by 1800 no less than 310 business corporations of various types had been created.

396. Chisholm v. Georgia, 2 U.S. 419, 448 (1793) (“A corporation is a mere creature of the King, or of Parliament; very rarely of the latter; most usually of the former only. It owes its existence, its name, and its laws, (except such laws as are necessarily incident to all corporations merely as such) to the authority which create[s] it.”).

397. Joseph Stancliffe Davis, Essays in the Earlier History of American Corporations 5 (1917); see also Edwin Merrick Dodd, American Business Corporations Until 1860 6 (1954); Berle & Means, supra note 13, at 11 (noting that of the 335 corporations existing in 1800, 219 were turnpike, bridge, and canal companies; another thirty-six were water, fire protection, and wharfage companies; while sixty-seven were banks and insurance companies; and six were engaged in manufacturing).

398. Davis, supra note 397, at 6-7; see also E. Merrick Dodd, Jr., Statutory Developments in Business Corporation Law, 1886-1936, 50 Harv. L. Rev. 27, 28 (1936). For the survival of the legal status of corporate charters created under English law, see Trs. of Dartmouth College v. Woodward, 17 U.S. 518, 551-56, 621-23 (1819) and Fletcher v. Peck, 10 U.S. 87, 97-104 (1810).


400. Dodd, supra note 397, at 2.

401. Davis, supra note 397.

402. Dodd, supra note 397, at 11; see also Berle & Means, supra note 13, at 11 (stating that only 335 profit-seeking corporations were organized in the United States until 1800, and nearly all of them were organized in the 1890s); Davis,
This number increased in the early 1800s, and “by 1830 the New England states alone had created nearly 1900 business corporations.” For many decades in American history, “the almost universal practice was [for the state legislature] to embody the charter of each corporation in a special act.” A special legislative act created a single particular corporation, whereas a general corporate statute allowed incorporation by complying with prescribed conditions. Despite the fact that for many years the privilege of incorporation was available only by obtaining a special act of incorporation from the state legislature, it was typically granted. However, as the 19th century progressed, incorporation through special act came under fire because it produced opportunities for corruption.

General corporate statutes eliminated the need to specially legislate upon applications of incorporation and


\[\text{404. DODD, supra note 397, at 197. Before 1811, general acts had been present but were only applied to certain categories of corporations, such as those for religious purposes. See DAVIS, supra note 397, at 16-18.}\]

\[\text{405. 1 JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 2:3 (3d ed. 2012).}\]

\[\text{406. Dodd, supra note 397, at 28.}\]

\[\text{407. See id.; see also Louis K. Liggett Co. v. Lee, 288 U.S. 517, 549 (1933) (Brandeis, J., dissenting in part) (“The desire for business expansion [in the early 1800s] created an irresistible demand for more charters; and it was believed that under general laws embodying safeguards of universal application the scandals and favoritism incident to special incorporation could be avoided.”); ARTHUR M. SCHLESINGER, JR., THE AGE OF JACKSON 336-37 (1953) (noting that state legislators were often hesitant to move to a general incorporation statute, because they would no longer be able to receive bribes for special incorporation acts); Deborah A. Ballam, The Evolution of the Government-Business Relationship in the United States: Colonial Times to Present, 31 AM. BUS. L.J. 553, 589 (1994) (noting general incorporation statutes were meant to change the monopolistic nature of special acts and return to the concept of equality of opportunity).}\]
produced equality of opportunity that led to the establishment of a larger variety of corporations.\footnote{Dodd, supra note 397, at 316; see also Louis K. Liggett, 288 U.S. at 548-49 (Brandeis, J., dissenting in part) (noting that general incorporation laws "were, in part, an expression of the desire for equality of opportunity"). However, some criticized general laws as a departure from the “true principle upon which an act of incorporation should ever be granted,” that of public utility. Dodd, supra note 397, at 316.} The first general incorporation act was established in New York’s Act of 1811.\footnote{Cox & Hazen, supra note 405, § 2:4.} However, it was limited to manufacturing businesses, and the incorporation was limited to 20 years with capital not to exceed $100,000.\footnote{Id.} Connecticut in 1837 adopted a general corporation statute that allowed for the incorporation of any corporation engaged in “lawful business.”\footnote{Smiddy & Cunningham, supra note 379, at 229.} “[By] the outbreak of the Civil War, general acts for the incorporation of manufacturing and . . . some other common types of business corporations had been adopted by most . . . states.”\footnote{Dodd, supra note 397, at 28.}

Although general incorporation acts were customary after the Civil War,\footnote{Schlesinger, supra note 407, at 337.} restrictions on corporations, such as limits on size and scope of corporate activity, remained common until approximately 1890 due to an attitude of suspicion and fear toward the corporate mechanism.\footnote{Fletcher, supra note 387, § 2; Louis K. Liggett Co. v. Lee, 288 U.S. 517, 548-49 (1933) (Brandeis, J., dissenting in part) (explaining that incorporation for business purposes was commonly denied because of fear: “Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations.”).} Given the restrictive nature of the general incorporation laws, many companies still preferred to seek special legislative acts for incorporation to attain greater privileges, and legislators liked the ability to directly influence
business activity. However, by the end of the 19th century, most states had added a prohibition against special charters to their constitutions and eliminated restrictions on corporate formation and operation. In 1855, Massachusetts enacted the first general law to authorize the carrying on of business outside of the state that incorporated the company. In 1896, New Jersey enacted what may be regarded as the first permissive modern incorporation act that conferred broad powers on corporations, by removing restrictions on capital and duration and allowing three or more persons to become a corporation for “any lawful purpose or purposes whatever, other than a savings bank, a building and loan association, [and] an insurance company.” Although New Jersey was the first to enact such a permissive incorporation statute, Delaware later enacted a nearly identical statute. When New Jersey revised its statute in 1913 to make it more restrictive, Delaware became the leader in incorporation and remains the preeminent state for incorporation today.

So the shift in the normative foundation of shareholder derivative litigation that occurred in the late 1940s cannot be explained by the transition to general incorporation

415. Robert M. Ireland, The Problem of Local, Private, and Special Legislation in the Nineteenth-Century United States, 46 AM. J. LEGAL HIST. 271, 281 (2004) (“Although a number of states enacted general laws of incorporation by the mid-nineteenth century, often these laws were not mandatory, and the influential usually avoided them and continued to secure special acts of incorporation that granted them powers and privileges not available through the general incorporation statute.”); Walter Werner, Corporation Law in Search of Its Future, 81 COLUM. L. REV. 1611, 1618 (1981) (stating that “charters often continued to be granted by special act even when available under general incorporation statutes” and that special acts “allowed legislatures to relieve entrepreneurs from the uniform standards of the general statutes”).

416. Louis K. Liggett Co., 288 U.S. at 549 n.4; see also id. at 549 n.3 (stating that New York in 1822, Delaware in 1831, Illinois in 1848, and Wisconsin in 1848 passed constitutional amendments requiring a legislative supermajority vote or ratification by popular vote of any bill creating or renewing a corporate charter); COX & HAZEN, supra note 405, § 2:4.

417. DODD, supra note 397, at 324.

418. JOHN J. TREACY & JOHN MILTON, THE GENERAL CORPORATION ACT OF NEW JERSEY 5, 8 (1921).

419. COX & HAZEN, supra note 405, § 2:4.
statutes nor the removal of restrictions on corporations, because those occurred in the late 1800s to early 1900s. Furthermore, the growth of the modern public corporation alone also cannot explain this shift. Public corporations did not reach full maturity, as known today, until the early 1900s. The spread of general corporate laws and the removal of restrictions on corporations were crucial to the growth of public corporations. In combination, these changes allowed public corporations to assemble the capital necessary to expand and the permanence demanded by long-term investors. However, public corporations existed long before the late 1940s, as evidenced by the stock market crash of 1929 and the passage of new federal securities laws to govern public corporations in 1933 and 1934.

2. Perceptions of Corporations and Derivative Litigation. The rise of public corporations alone may not explain the normative shift in shareholder derivative litigation, but public corporations did cause changes in the perception of corporations and subsequently shareholder derivative litigation. Scholarly writing on the issue of corporate purpose grew during the 1930s and 1940s. In 1932, Professor Adolf Berle advanced the shareholder primacy theory, arguing that “all powers granted to a corporation or

420. See Berle & Means, supra note 13, at 14; Skeel, supra note 15, at 169-70 (noting that shareholders in the United States have been widely dispersed since the beginning of the twentieth century). Some companies had wider ownership such as early New England textile companies and the New York Central Railroad (NYCR). The NYCR, created in 1853 from consolidation of shortline rail companies, was a public company of nearly 2,500 investors without a controlling person. Berle & Means, supra note 13, at 11-13 & n.3. Similar corporate ownership patterns can be seen in other entities in the last half of the 1800s in areas such as public utilities and general manufacturing. See id. at 14.

421. See Ballam, supra note 407, at 589.

422. See Martin C. McWilliams, Jr., Who Bears the Costs of Lawyers’ Mistakes?—Against Limited Liability, 36 Ariz. St. L.J. 885, 901 (2004) (noting the benefits of general incorporation statutes for shareholders included “limited liability, free transferability of shares, passive equity ownership, agency efficiencies, and perpetual jural existence of corporations”).

to the management of a corporation . . . [are] at all times exercisable only for the ratable benefit of all the shareholders.” In the same year, Professor Merrick Dodd advanced the stakeholder theory, arguing that the proper purpose of a public corporation included not only making money for shareholders, but also included providing secure jobs to its employees, quality products for its customers, and other benefits for society as a whole. This debate about corporate purpose has been well chronicled, and the stakeholder or managerialist theory won the argument for several decades, until the shareholder primacy theory gained the upper hand in the 1970s. Given the timing of this debate about corporate purpose, it appears to have influenced both courts and legislatures to change their perspective of shareholder derivative litigation.

A 1944 study of shareholder derivative litigation commissioned by business leaders in New York may also have influenced that change of perspective. The Wood Report examined 1,266 lawsuits filed by shareholders in two New York counties and one federal district court in New York from 1932 to 1942. Although 693 of the cases involved closely held corporations, the study focused on the 573 public corporation cases. The report criticized the frequency of shareholder suits filed by small investors and concluded that these investors were essentially pawns for the plaintiff’s attorneys, who were the true beneficiaries of such derivative lawsuits. The report also noted that the corporation ultimately bears the costs of both sides in such litigation, because it must pay the plaintiff’s attorneys their fees if the suit provided a benefit to the corporation and it

428. Id. at 6-7.
429. Id.
430. Id. at 16-21.
usually must indemnify the fees of the directors.\textsuperscript{431} The report’s proposed solution was to limit standing to shareholders owning stock at the time of the alleged wrong and to require plaintiffs owning small amounts of stock to post a bond to secure the defendants’ expenses if the suit was found to be without merit.\textsuperscript{432} The New York legislature enacted the first security for expenses statute a month later, requiring the plaintiff to post a bond unless he owned “at least 5% or $50,000 of [the corporation’s] stock.”\textsuperscript{433} However, over time, this restriction was eased by allowing shareholders to band together to meet the ownership requirement.

It is not surprising that corporate directors and officers dislike the shareholder derivative device; it permits shareholders to challenge their decisions. The Wood Report gave directors and officers a basis for arguing to legislatures and courts that shareholder derivative litigation needed to be restrained. When the 1944 Wood Report is combined with the academic debate over corporate purpose in which the stakeholder or managerialist view had prevailed by the 1940s, the changed perception of the corporation is the most likely explanation for the normative shift in shareholder derivative litigation.

CONCLUSION

For the first 150 years of the United States, courts permitted shareholders to bring a lawsuit \textit{on behalf of all the shareholders}, but limited when shareholders could bring such actions to instances where the corporation was incapable of seeking redress or improperly refused to seek redress. This historical account reveals a normative judgment that shareholders, as a group, had the right to

\textsuperscript{431} Id.
\textsuperscript{432} Id. at 21-25.
\textsuperscript{433} Skeel, \textit{supra} note 15, at 172 (internal quotation marks omitted) (citing Ch. 668, §61-b, 1944 N.Y. Laws 1455); see also 7C CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, \textit{FEDERAL PRACTICE AND PROCEDURE} § 1835, at 164 n.1 (3d ed. 2007) (listing Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, and Wisconsin as states adopting security for expenses statutes).
seek remedy when the managers engaged in fraud or mismanagement. While acknowledging a corporation was a separate legal entity that normally was the proper party to bring suit against its managers for mismanagement or fraud, courts recognized that corporate managers controlled the corporation’s decision to sue and were not likely to sue themselves. For this reason, courts of equity permitted shareholders to bring suits in those circumstances on behalf of all shareholders. Thus, recognizing that it was the shareholders who were harmed, courts’ choice to allow litigation reflected a balance of power between the board and the shareholders. The board of directors could be held accountable by shareholders other than through elections, and the board was not the sole power controlling the corporation. Notably, other stakeholders such as employees were not given this right to pursue litigation, only shareholders. The historical and normative foundation of shareholder derivative litigation in the United States bolsters the shareholder primacy theory and may prove valuable to its advocates.

At the same time, other scholars could focus on the reasons for the normative shift and suggest corresponding changes to the structure of shareholder derivative litigation. Today shareholders may bring a derivative lawsuit on behalf of the corporation and only within much narrower circumstances. This modern shareholder derivative action reflects the theory that the corporation is an entity unto itself. Shareholders’ role in the corporation through modern shareholder derivative litigation has been markedly diminished. This shift was driven by a change in the perception of public corporations, but nothing in the fundamental nature of the corporation changed because the state laws creating corporations did not change. State statutes always gave the board of directors the power to make the corporation’s decisions. Yet courts, and later those legislatures adopting the MBCA, altered the balance of power between boards of directors and shareholders that had existed for 150 years through shareholder derivative litigation. While these changes were driven by the perception of public corporations, the shareholder derivative action was altered for all corporations, both public and private. Perhaps it is time to rethink shareholder derivative
litigation in relation to the nature of corporations and their purposes.