RECENT CASES

CORPORATIONS

PROPRIETY OF AWARD OF STOCKHOLDER'S COUNSEL FEES UNDER SECTION 16B OF SECURITIES EXCHANGE ACT

Dottenheim, one of the stockholders of Emerson Electric Mfg. Co., engaged an attorney to investigate the security transactions of the president of the corporation to determine if his activities were in violation of Section 16b of the Securities Exchange Act of 1934. The attorney discovered that the president had realized a short-term profit which, by the statute, should inure to the benefit of the corporation.[1] In a letter to the corporation, he demanded that it enforce this right to recover the profit. The directors of the corporation had known of the profit of the president and of the corporation's right to recover, but had decided not to press the claim for the time being. However, because of the demand by Dottenheim's attorney the corporation enforced its claim immediately, and the president paid the profit of $57,872 without the necessity of suit. Dottenheim brought this action against the corporation to recover compensation for the services of his counsel. The corporation contended that attorney's fees could not be allowed because the profit had not been recovered as a result of a stockholder's suit, and that there could be no recovery for simply serving a demand and furnishing information already fully known to the directors. The court held that the investigation and subsequent demand by Dottenheim's attorney had benefited the corporation and allowed Dottenheim compensation for reasonable attorney's fees in relation to the benefit. *Dottenheim v. Emerson Electric Mfg. Co.*, 77 F. Supp. 306 (E. D. N. Y. 1948).

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1. Any profit realized by a person from transactions within a period of six months in securities issued by a corporation in which he is an officer, director or major stockholder "shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months." 48 STAT. 896 (1934), 15 U. S. C. A. § 78p (b) (1940). The profit may be recovered in an action by the corporation, or by a security holder by a suit in behalf of the corporation.

The underlying purpose of Section 16b of the Securities Exchange Act is to protect the securities markets; the statute applies only to transactions in securities listed on the stock exchanges.[2] But in attaining the primary objective, an alternate purpose is accomplished; that of eliminating all possible profits from insiders' stock transactions.[3] Although the section provides for suit by a stockholder as a means of enforcing the corporate right, it is silent concerning reimbursement of the enforcing stockholder for expenses incurred by him. While it might thus be argued that a court is not permitted to allow expenses to a stockholder who acts to enforce the section,[4] that question has been set at rest for the district court in this case. For the Circuit Court of Appeals for the Second Circuit has held that a stockholder who has unsuccessfully demanded that his corporation sue and who then himself sues and recovers in the corporation's behalf is entitled to reasonable compensation for attorney's fees.[5] Unless such compensation is allowed, reasoned the circuit court, no stockholder would be willing to take action, and the enforcement provision would be ineffective.[6] Clearly then Section 16b does not prevent the district court from allowing Dottenheim his expenses. The problem is simply

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2. See Smolowe v. Delendo Corporation, 136 F.2d 231, (C. C. A. 2d 1943); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939).

3. See *Hearings before Committee on Interstate and Foreign Commerce on H. R. 7852 and H. R. 8720*, 73d Cong., 2d Sess. 85 (1934); *Hearings before Committee on Banking and Currency on S. 84*, 72d Cong., 2d Sess., and on *S. 56* and *S. 97*, 73d Cong., 1st and 2d Sess. (1934).

4. Section 9e of the Securities Exchange Act grants an action to persons injured as a result of unlawful manipulation of security prices, and provides for discretionary allowance of attorney's fees to the injured party. 48 STAT. 889 (1934), 15 U. S. C. A. § 78i (e) (1940). Section 18a provides for discretionary allowance of attorney's fees to a person who sues to redress an injury sustained as a result of reliance upon the misleading statements of another party. 48 STAT. 897 (1934), 15 U. S .C. A. § 78r (a) (1940).

5. Park & Tilford v. Schulte, 160 F.2d 984 (C. C. A. 2d 1947); Smolowe v. Delendo Corporation, 136 F.2d 231 (C. C. A. 2d 1943). It is controversial whether attorney's fees should have been read into § 16b in view of the principle that all parts of a statute should be construed together. The advisability of this interpretation is not discussed here.

6. "In many cases the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of § 16b." Smolowe v. Delendo Corporation, 136 F.2d 231, 241 (C. C. A. 2d 1943).

one of the propriety of allowing attorney's fees to a stockholder whose attorney's investigation and demand were effective to move the corporation to act in its own behalf to enforce its right.

Two lines of reasoning may be advanced to support the action of the district court. The first proceeds upon the ground that the award of counsel fees to Dottenheim will encourage stockholders to investigate the activities of management. That this effectuates the statutory purposes of protecting the securities markets from manipulation and of preventing fiduciaries from siphoning profits from their beneficiaries is self-evident. The fact that it may sometimes, as in this case, be unnecessary for the stockholder to sue to redress a violation of the statute is not determinative. The vital question is simply whether the activity for which compensation is claimed is directly effective to promote the purposes sought to be achieved by the statute. It was competent for the court to find that Dottenheim's activity was so effective.

The second argument in support of the court's decision is based upon analogy. In those cases where suit has been brought by a stockholder under the statute, the courts have considered the statutory method of enforcement to be in the nature of an equitable derivative suit.[7] Courts award counsel fees to stockholders who have prevailed in equitable derivative suits[8] on either of two rationales. One theory is that the stockholder is acting for a class, and that the fund recovered should be charged with the expense incurred by

7. Park & Tilford v. Schulte, 160 F.2d 984 (C. C. A. 2d 1947); Smolowe v. Delendo Corporation, 136 F.2d 231 (C. C. A. 2d 1943); Pottish v. Divak, 71 F. Supp. 737 (S. D. N. Y. 1947); Note, 148 A. L. R. 313 (1943); 46 MICH. L. REV. 99 (1947). The stockholder's derivative suit is available in equity to pursue a right of action to which the corporation is entitled but wrongfully refuses to enforce. *Cf.* Hawes v. Oakland, 104 U. S. 450 (1881); Dodge v. Woolsey, 18 How. 331 (U. S. 1856); Johnson v. Ingersoll, 63 F.2d 86 (C. C. A. 7th 1933); Whittaker v. Brictson Mfg. Co., 43 F.2d 485 (C. C. A. 8th 1930); Wayne Pike Co. v. Hammons, 129 Ind. 368, 27 N. E. 487 (1891); Marcovich v. O'Brien, 63 Ind. App. 101, 114 N. E. 100 (1916); Tevis v. Hammersmith, 31 Ind. App. 281, 66 N. E. 79 (1903); Hichens v. Congreve, 4 Russ. 562, 38 Eng. Rep. 917 (1828); BALLANTINE, CORPORATIONS § 145 (rev. ed. 1946).

8. Wolfes v. Paragon Refining Co., 74 F.2d 193 (C. C. A. 6th 1935); Watus v. Disbrow & Co., 70 F.2d 572 (C .C. A. 8th 1934); Beaudette v. Graham, 267 Mass. 7, 165 N. E. 671 (1929); Note, 152 A. L. R. 909 (1944).

the representative before it is distributed to the class.[9] The other theory is quasi-contractual; the corporation which has received the benefit of the attorney's services should pay the reasonable value thereof.[10] Dottenheim's conduct taken as a preliminary step to enforcing the statute is comparable to similar conduct by a stockholder who intends to bring an ordinary derivative suit. If a court might properly award counsel fees under similar circumstances in a derivative suit, that is persuasive argument for the propriety of the award in the *Dottenheim* case.

The purpose of the stockholder's derivative suit is to control intra-corporate abuse and to assure that those benefits to which the corporation is entitled are obtained.[11] Since such suits are expensive, and often the defendants will apply corporate funds to place every conceivable obstacle and procedural delay before the stockholder,[12] it is essential that a stockholder be certain before suit that he will not incur a large uncompensated expense. In order to discourage abuse of the derivative suit,[13] courts have refused to allow a stockholder attorney's fees when he is unsuccessful in obtaining a benefit for the corporation.[14]

The court in the *Dottenheim* case required a benefit. This benefit is found in the fact that the demand of Dottenheim's attorney impelled the directors to enforce a right which they had decided not to press for a time. Thus the demand had made a fund available to the corporation earlier

9. *See* Lamar v. Hall, 129 Fed. 79, 82 (C. C. A. 5th 1904); Hand v. Savannah & Charleston R. R., 21 S. C. 162, 178-179 (1884).

10. *See* Trustees v. Greenough, 105 U. S. 527, 532 (1881); Buell v. Kanawha Lumber Corp., 201 Fed. 762, 767-769 (E. D. S. C. 1912); Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COL. L. REV. 784, 789 (1939).

11. For a realistic evaluation of the stockholder's suit as a restraint on intracorporate abuse see Hornstein, *Legal Controls for Intracorporate Abuse—Present and Future*, 41 COL. L. REV. 404, 425 (1941).

12. See Berlack, *Stockholder's Suits—A Possible Substitute*, 35 MICH. L. REV. 597 (1937).

13. *See* Dresdner v. Goldman Sachs Trading Corp., 269 N. Y. Supp. 360, 367 (1934). For a discussion of the strike suit as an abuse of the stockholder's derivative action see Washington, *Stockholder's Derivative Suits: The Company's Role, and a Suggestion*, 25 CORN. L. Q. 361, 369 (1940). See also Note, 34 COL. L. REV. 1308 (1934).

14. "Fair and reasonable fees for results actually achieved, with due consideration for time and effort required, will neither encourage strike suits nor discourage real ones." Winkelman v. General Motors Corp., 48 F. Supp. 504, 506 (S. D. N. Y. 1942).

than it would otherwise have been.[15] Assuming that the directors would have acted to enforce the corporation's claim before the statute of limitations had run, there is an element of conjecture in arriving at the exact sum by which Dottenheim's activity benefited the corporation. This fact should not limit a court's conception of a benefit to an exactly identifiable sum the recovery of which was solely attributable to the services of the stockholder's attorney. It should be enough that there is an unmistakable contribution of some type upon which counsel fees can be based.[16] It seems proper that the objection that no suit was filed should not be a bar to allowance of counsel fees when the reasons for such an award are present.[17] Initiation of a suit is simply evidence of benefit, the essential factor; to require suit to have been brought by Dottenheim would be to give undue importance to technicality.[18]

Several objections to the decision may be advanced, but examination reveals that they lack substance. A prerequisite to allowance of counsel fees for stockholder's derivative ac-

15. The recovery was made ten months before the expiration of the statute of limitations. The court assumed that the directors would have enforced the claim at some time prior to the running of the statute of limitations; thus, the entire $57,872 recovered could not be considered as resulting from the demand. The money benefit was then computed by placing $57,872 at 4% interest for ten months which gave a figure of $1929.05. On this basis attorney's fees of $1000 were awarded. Dottenheim v. Emerson Electric Co., 77 F. Supp. 306, 308 (E. D. N. Y. 1948).

16. The form of benefit from stockholder's derivative suits does not seem to be of great importance. "The principle on which allowances in derivative actions are made is that those who share in the benefit produced by one of their number should justly share in the expense of producing the benefit. Under that principle it is manifest that the award depends on the production of the benefit and not upon the form that the benefit may take." Berustein, J. in Byshein v. Miranda, 45 N. Y. S.2d 473, 475 (1943). *See* Allen v. Chase Nat'l. Bank, 40 N. Y. S.2d 245, 252 (1943).

17. It is true that in every case where counsel fees have been awarded the stockholder had filed suit. See cases cited note 7 *supra*. But counsel fees have been awarded where satisfactory settlement had been made subsequent to the filing of the action by the stockholder but before trial. Meighan v. American Grass Twine Co., 154 Fed. 346 (C. C. A. 2d 1907); Greenough v. Coeur D'Alenes Lead Co., 52 Idaho 599, 18 P.2d 288 (1932); Baker v. Seattle-Tacoma Power Co., 61 Wash. 578, 112 Pac. 647 (1911). The fact that suit need not be pressed to a judgment is evidence that the requirement is simply to give conclusive evidence of benefit; if benefit can be found without suit filed, it would then seem proper to award attorney's fees.

18. See opinion of Judge Inch denying motion to dismiss the principal case. Dottenheim v. Emerson Co., 7 F. R. D. 195, 197 (E. D. N. Y. 1947).

tions is that the corporation must have refused to enforce its right of action satisfactorily.[19] The fact that the corporation did not refuse to enforce its claim in the instant case might be considered as interposing an objection to allowance of attorney's fees. However, that objection must fall when it is considered that the requirement of refusal by the corporation is to insure against unnecessary litigation or undesirable interference by the stockholder.[20] The requirement is applicable only where a stockholder actually initiates suit; since Dottenheim did not sue, it is unnecessary that he prove a refusal by the corporation to sue. It should be enough that the stockholder make it appear that his acts were not undesirable, inconsequential, or unnecessary. Dottenheim's activities were none of these; they were indispensable to an early recovery of the profit, and there was the danger that the claim would be allowed to lapse.[21] The necessity of the investigation and demand must be a question of fact to be decided in each case. A sine qua non test would probably suffice; that is, if the benefit would not have been recovered without the attorney's services, those services were necessary and may be the subject of reasonable compensation.

It may be contended that the allowance of counsel fees for this type of activity by the stockholder will operate to encourage a substitution of the business judgment of the

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19. Carter v. Carter Coal Co., 298 U. S. 238 (1935); Ashwander v. Tennessee Valley Authority, 297 U. S. 288 (1935); Sias v. Johnson, 86 F.2d 766 (C. C. A. 6th 1936); Wright v. Floyd, 43 Ind. App. 546, 86 N. E. 971 (1908). A demand on the corporation to enforce its claim is not necessary if it can be shown that under the circumstances it would have been futile. Zeleznik v. Grand Riviera Theater Co., 128 F.2d 533 (C. C. A. 6th 1942); Nisonoff v. Irving Trust Co., 68 F.2d 32 (C. C. A. 2d 1933); Greer Inv. Co. v. Booth, 62 F.2d 231 (C. C. A. 10th 1932); Tevis v. Hammersmith, 31 Ind. App. 281, 66 N. E. 79 (1903).

20. Counsel fees will be denied when the stockholder's suit was unnecessary. Evans v. Diamond Alkali Co., 315 Pa. 335, 172 Atl. 678 (1934). *See* Lucking v. Delano, 129 F.2d 283, 286 (C. C. A. 6th 1942); Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COL. L. REV. 784, 802 (1939).

21. It is probable that the directors could have been held liable for mismanagement in a stockholder's derivative suit if they had allowed the statute of limitations to expire, in view of the clarity of § 16b of the Securities Exchange Act. *See* Greenwood v. Greenblatt, 173 Ga. 551, 161 S. E. 135 (1931); Shaw v. Harding, 306 Mass. 441, 28 N. E.2d 469 (1940); Caldwell v. Eubanks, 326 Mo. 185, 30 S. W.2d 976 (1930); Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV. 1125 (1942).

stockholder for that of the officials of the corporation.[22] Such a consequence is not necessary, because an official may still employ his business judgment to refuse to enforce the corporate right.[23] If the stockholder then initiates a derivative suit and there is no recovery for the corporation, the stockholder will not be allowed counsel fees.[24] If the corporation receives a benefit as a result of the stockholder's activity, either in the form of an earlier recovery of a claim or recovery by a stockholder's suit, this would indicate that the officials of the corporation had probably abused their privilege of business judgment. In the cases under Section 16b of the Securities Exchange Act the element of business judgment is of little importance; the directors are given no discretion as to whether they will sue promptly to enforce the statute.[25]

It may be objected that a probable consequence of awarding counsel fees in the present case will be to encourage indiscriminate investigations of corporate activities by numerous stockholders, resulting in costly interference in the efficient operation of the business.[26] There can be no valid contention of burdensome investigation when the stockholder seeks to enforce Section 16b of the Securities Exchange Act. The stockholder may obtain his information from the reports that the corporate officials are required to file with the Securities and Exchange Commission, and he need not inspect

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22. The law will not hold directors liable for honest errors of business judgment when they act in good faith. Briggs v. Spaulding, 141 U. S. 132 (1891); Toebelman v. Missouri-Kansas Pipe Line Co., 41 F. Supp. 334 (D. C. Del. 1941); Helfman v. American Light & Traction Co., 121 N. J. Eq. 1, 187 Atl. 540 (Ch. 1936); Gamble v. Queens County Water Co., 123 N. Y. 91, 25 N. E. 201 (1890).

23. Corbus v. Alaska Treadwell Gold Mining Co., 187 U. S. 455 (1903); Post v. Buck's Stove & Range Co., 200 Fed. 918 (C. C. A. 8th 1912); Groel v. United Electric Co. of New Jersey, 70 N. J. Eq. 616, 61 Atl. 1061 (Ch. 1905).

24. Evans v. Diamond Alkali Co., 315 Pa. 335, 172 Atl. 678 (1934).

25. If the corporation fails to sue to recover the profit within sixty days after demand by the stockholder, the stockholder may sue to enforce the claim in behalf of the corporation. 48 STAT. 896 (1934), 15 U. S. C. A. § 78p (b) (1940).

26. Every stockholder of a private corporation has the right at common law to inspect and examine the books and papers of the corportation at reasonable times and places, and for proper purposes. Guthrie v. Harkness, 199 U. S. 148 (1905); Stone v. Kellogg, 165 Ill. 192, 46 N. E. 222 (1896); Varney v. Baker, 194 Mass. 239, 80 N. E. 524 (1907); White v. Manter, 109 Me. 408, 84 Atl. 890 (1912); Eldred v. Elliott, 161 Mich. 262, 126 N. W. 219 (1910); Latimer v. Herzog Teleseme Co., 78 N. Y. Supp. 314 (1902).

the books of the corporation.[27] Further it is settled that a corporation may refuse to allow investigation of its books by a stockholder at times when such investigation would unreasonably interfere with the management of the business.[28] The very fact that no expenses of investigation will be allowed unless it is shown to have produced a benefit to the corporation will discourage unreasonable investigations.

It must be recognized that the present holding will encourage investigations. The requirement that there be benefit to the corporation will be a factor in limiting any abuse to which the decision may be conducive, even though the determination of whether or not there was a benefit will be a difficult question in some cases. In view of the practices in which numerous corporate officials have engaged in the past,[29] the desirability of closer supervision of their activities more than offsets the slight possibility that it will lead to burdensome investigations. Traditional concepts of corporate entity with management by officials rather than stockholders will not be substantially impaired. Instead, ownership interests will exert a legitimate influence upon those in control to assure a faithful performance of fiduciary duties.

JURIES

PEREMPTORY CHALLENGING OF NEGRO VENIREMEN AS DISCRIMINATION AGAINST NEGRO CRIMINAL DEFENDANT

Three Negroes were indicted in the Federal District Court for the District of Columbia on a charge of murder in the first degree. Nineteen members of the Negro race

27. 48 STAT. 896 (1934), 15 U. S. C. A. § 78p (a) (1940). This section makes it mandatory for corporate officials to file monthly reports with the Securities and Exchange Commission in regard to their transactions in the securities of the corporation. These reports are public records available for inspection.

28. Breslauer v. S. Franklin & Co., 205 Ill. App. 372 (1917); Weihenmayer v. Bitner, 88 Md. 325, 42 Atl. 245 (1898); Watkins v. Donnell Mfg. Co., 129 Mo. App. 206, 107 S. W. 1112 (1908); Conerty v. Butler County Oil Ref. Co., 301 Pa. 417, 152 Atl. 672 (1930); Kuhback v. Irving Cut Glass Co., 220 Pa. 427, 69 Atl. 981 (1908); 5 FLETCHER, CYCLOPEDIA CORPORATIONS § 2242 (perm. ed. 1943).

29. See *Hearings before the Committee on Banking and Currency on S. 84*, 72d Cong., 2d Sess., and on *S. 56* and *S. 87*, 73d Cong., 1st and 2d Sess., (1934); Tracy and MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1032 (1934).