Right to Jury Trial in a Stockholders' Derivative Action

J. Douglas Hand

The Government's costly[67] predicament in *Seckinger* could have been easily avoided. It could have written a common indemnity clause, as in *Maloof*,[68] or it could have appealed the FTCA judgment. The United States is supposed to be treated as a private party under the FTCA, and the congressional intent to do so should not be thwarted by misinterpreting a contract clause to avoid a denial of recovery under state tort law.[69] It is apparent that the United States was given an unfair advantage in the Court's interpretation, for the Court virtually ignored the most important principles of contract interpretation in allowing the Government to recover. In his dissent, Justice Stewart was correct when he wrote that "the meaning attributed to that clause today is as unconscionable as it is inaccurate."[70]

Dennis L. Lutes

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Stockholders of a closed-end investment company brought a derivative action in federal district court against the corporate directors and the corporation's brokers. The stockholders alleged that: (1) the brokers maintained excessive control over the board of directors through illegally large representation, in violation of federal law,[1] and thus were extracting excessive brokerage fees; (2) both the directors and the brokers had breached fiduciary duties;[2] and (3) the contract between the corporation and the brokers had been breached. In addition to demanding that the defendants "account for and pay to the corporation for their profits and gains and [the corporation's] losses,"[3] the plaintiffs demanded a jury trial on the claims of the corporation. On a motion to strike the demand, the district court held that the question of jury trial of right was to be decided as if the corporation itself were the plaintiff, and that only the question of the shareholders' standing to sue for the corporation had to be tried to the court.[4] On interlocutory appeal,[5] the Court of Appeals for the Second Circuit reversed, holding that a stockholders' derivative action was a single, equitable cause of action, and that no right to jury trial existed.[6] *Held*,

[67] *See* note 6 *supra*.

[68] Maloof v. United States, 242 F. Supp. 175 (D. Md. 1965); *see* notes 49-51 *supra*, and accompanying text.

[69] *See* note 38 *supra*, and accompanying text.

[70] 397 U.S. at 219-20.

[1] The law allegedly violated was the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80b-21 (1964).

[2] Alleged breaches of fiduciary duty consisted of (1) conversion of the corporate assets by the directors; (2) "gross abuse of trust, gross misconduct, wilful misfeasance, bad faith, [and] gross negligence" by the directors; and (3) other breaches of fiduciary duty by both the directors and the brokers. Ross v. Bernhard, 396 U.S. 531-32 (1970).

[3] *Id.* at 532.

[4] Ross v. Bernhard, 275 F. Supp. 569, 570-71 (S.D.N.Y. 1969).

[5] 28 U.S.C. § 1292(b) (1964).

[6] Ross v. Bernhard, 403 F.2d 909 (2d Cir. 1969).

reversed: The seventh amendment right to jury trial attaches in a stockholders' derivative action to all issues on which the corporation would have been entitled to jury trial had it been the plaintiff. *Ross v. Bernhard*, 396 U.S. 531 (1970).

I. The Seventh Amendment Right to Jury Trial

The seventh amendment to the Constitution delineates those actions in which the right to jury trial exists: "In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved . . . ."[7] Originally, the basic test whether the right to jury trial existed in a given action was an historical one.[8] If in 1791, the date the seventh amendment was adopted, an action was one which would have been brought in a court of common law in England, the right to a trial by jury existed. If, on the other hand, the action was one which in 1791 would have been brought in a court of equity, no right to jury trial existed.

Such an historical test was completely workable as long as the actions to which it was applied were those existent in 1791. As new types of actions were created, however, the simple historical test became insufficient. The rule used to decide the question of jury right in such cases became one of analogy—as new causes of action evolved, they were to be compared to the historical forms, and those to which they were the closest by analogy would be used as bases for deciding the right to jury trial in their newer counterparts.[9]

Such a situation persisted past the time of the adoption of the Federal Rules of Civil Procedure, which abolished all procedural distinctions between law and equity,[10] until 1959. In that year, the Supreme Court of the United States, in *Beacon Theatres, Inc. v. Westover*,[11] began a process of attrition which has cast doubt on the continued vitality of the historical test and indeed suggests its ultimate replacement by tests more adaptable to post-Federal Rules procedure.[12] A line of cases beginning with *Beacon Theatres*, followed by *Dairy Queen, Inc. v. Wood*[13] and *Simler v. Conner*,[14] has substantially changed the criteria for allowing jury trial of right in the federal courts.

In *Beacon Theatres* the plaintiff sought a declaratory judgment and an injunction, and the defendant counterclaimed for treble damages under the antitrust laws. The decisions of the trial court and the court of appeals denied jury trial of the defendant's legal counterclaim by deciding the is-

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[7] U.S. Const. amend. VII.

[8] 2B W. Barron & A. Holtzoff, Federal Practice and Procedure § 872 (1961); 5 J. Moore, Federal Practice § 38.08(5) (2d ed. 1969) [hereinafter cited as Moore]. On the various tests for determining jury right, see James, *Right to a Jury Trial in Civil Actions*, 72 Yale L.J. 655 (1963).

[9] 5 Moore § 38.11(7) at 125; James, *supra* note 8, at 656.

[10] Fed. R. Civ. P. 2 states that "there shall be one form of action to be known as 'civil action.'"

[11] 359 U.S. 500 (1959).

[12] *See* C. Wright, Federal Courts § 92 (2d ed. 1970).

[13] 369 U.S. 469 (1962).

[14] 372 U.S. 221 (1963).

sue common to claim and counterclaim without the aid of a jury. The Supreme Court, however, held that the trial court was required to allow the defendant a jury trial on the issue common to the legal and equitable claims. In *Dairy Queen* the plaintiff asked for an injunction and an "accounting," which was in fact a demand for a money judgment. The defendant's demand for jury trial was denied by the trial court on the ground that any legal issues were incidental to equitable ones. The Supreme Court held that it was improper to refuse the jury trial demand by such characterization of legal issues as "incidental." The complaint in *Simler* involved an attorney's contingent fee, was framed as a declaratory judgment action, and was thus viewed by the lower courts as "equitable." The Supreme Court held that the complaint presented a common law claim for a money judgment, and ordered the jury trial demand reinstated.

In general, then, the Court held in each of these three cases that the nature of the issues presented, not the overall characterization of the action, decides the right to jury trial. Under the *Beacon Theatres-Dairy Queen-Simler* development, a party cannot be denied the right to jury trial by trying equitable claims before legal claims involving the same facts,[15] nor by the court's classification of legal issues as "incidental" to equitable ones.[16] The nature of the issue is controlling.[17]

II. Jury Trial and the Stockholders' Derivative Action

At common law there was no procedure by which stockholders could bring suit against the corporation's managers for activities injurious to the corporation.[18] The nineteenth century saw the beginnings of the stockholders' derivative action in equitable proceedings which initially allowed only suits to redress wrongful activities by corporate managers.[19] But equity soon expanded its protection of stockholders by allowing them to pursue claims of the corporation against third parties,[20] creating a new remedy to fit an obvious need.

The theory of the stockholders' derivative action soon came to be that of one action with a "dual nature." The two questions involved in such suits were: (1) that of the shareholders' right to bring suit for the corpoation, which was purely an equitable question, and (2) that of the corporation's claims against the managers or third parties, which was either a legal or equitable question, depending on the nature of the claim.[21] Up to

[15] Beacon Theatres, Inc. v. Westover, 359 U.S. 500 (1959).

[16] Dairy Queen, Inc. v. Wood, 369 U.S. 469 (1962).

[17] Simler v. Conner, 372 U.S. 221 (1963).

[18] Prunty, *The Shareholders' Derivative Suit: Notes on its Derivation*, 32 N.Y.U.L. Rev. 980, 981 (1957).

[19] The first such suit in the United States was apparently Robinson v. Smith, 3 Paige Ch. R. 222 (N.Y. 1832), which proceeded on the theory that the managers were trustees for the shareholders.

[20] Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855), was the first suit of this type in the United States. For a general description of the stockholders' derivative action at the present time, see Haudek, *The Settlement and Dismissal of Stockholders' Actions* (pts. I & II), 22 Sw. L.J. 767 (1968), 23 Sw. L.J. 765 (1969).

[21] Koster v. Lumbermen's Mut. Cas. Co., 330 U.S. 518, 522 (1947); 2 G. Hornstein, Corporation Law and Practice § 711 (1959) [hereinafter cited as Hornstein].

and through the adoption of the Federal Rules of Civil Procedure, however, the derivative suit's unitary equity origin left no doubt in the minds of courts or commentators that the entire derivative action was triable to the court only, and that no right of jury trial attached to any part of it.[22]

Such a situation persisted until 1963, when the Court of Appeals for the Ninth Circuit, in *DePinto v. Provident Security Life Insurance Co.*,[23] held that the seventh amendment right to jury trial attached to all legal issues in a stockholders' derivative action. The court in *DePinto* asked itself two questions: first, whether the equitable origin of the derivative action foreclosed the question of jury trial; and second, whether the corporate claims involved were cognizable in a "suit at common law." It answered the first in the negative and the second in the affirmative. From these answers it followed that the plaintiffs in *DePinto* were entitled to jury trial on all the legal claims of the corporation. The Supreme Court denied certiorari, and *DePinto* was allowed to stand alone amidst a smattering of criticism by commentators and rejection by the other circuits.[24]

III. Ross v. Bernhard

The Supreme Court in *Ross v. Bernhard* chose to follow the policy and reasoning of *DePinto*. It prefaced its approbation, however, with a description of the procedural difficulties in a pre-Federal Rules derivative suit, *Fleitmann v. Welsbach Street Lighting Corp.*,[25] which involved a claim of treble damages under the antitrust laws. The Court stated that *Fleitmann* contained "seventh amendment overtones,"[26] and implied that these "overtones" prefigured a time when all stockholders' derivative suits would enjoy the right of jury trial on all "legal" claims of the corporation on whose behalf the suit was brought. In fact, though, *Fleitmann* neither implied nor prefigured any such idea. Rather, it stood for the principle that derivative suits were not properly brought under statutory schemes that called specifically for jury trial.[27] While perhaps highlighting the difficulties inherent in any bifurcated procedural system, *Fleitmann* is really irrelevant to the question of the right to jury trial in properly-brought derivative actions.[28]

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[22] Koster v. Lumbermen's Mut. Cas. Co., 330 U.S. 518 (1947); 13 W. Fletcher, Private Corporations §§ 5931, 5944 (1970); Hornstein § 730; N. Lattin, Corporations ch. 8, § 3 (1959); 5 Moore § 38.38, at 307. Professor Lattin is the most explicit on the point:

> A derivative action is an invention of courts of equity and may be brought only in equity whether the corporate cause of action be in law or not. As far as corporate rights and defenses available against it are in issue, these issues are decided exactly as if the corporation were the plaintiff except the matter of jury trial, for the case being in equity there is no right to jury trial.

N. Lattin, *supra*, § 3, at 350. Hornstein is more laconic: "The judge, without a jury, tries the case on the merits." Hornstein § 730, at 245.

[23] 323 F.2d 826 (9th Cir. 1963), *cert. denied*, 376 U.S. 950 (1964).

[24] *See, e.g.*, Note, *The Right to a Jury Trial in a Stockholder's Derivative Action*, 74 Yale L.J. 725 (1965). The Second Circuit specifically disagreed with *DePinto* in Ross v. Bernhard, 403 F.2d 909 (2d Cir. 1969).

[25] 240 U.S. 27 (1916).

[26] 396 U.S. at 536.

[27] 240 U.S. at 28.

[28] The specific problem of cases such as *Fleitmann* has been solved by the Second Circuit in Fanchon & Marco, Inc. v. Paramount Pictures, Inc., 202 F.2d 731 (2d Cir. 1953), in which the

The balance of the opinion was an affirmation of *DePinto*. Taking as its starting point the *Beacon Theatres* and *Dairy Queen* cases, the Court reviewed the *DePinto* rationale and found it correct in every aspect. The crux of the theory of *Ross* is found in a single sentence: "Purely procedural impediments to the presentation of any issue by any party, based on the difference between law and equity, were destroyed [by the adoption of the Federal Rules]."[29] The Court reasoned that the pre-Federal Rules refusal to split derivative suits in to equitable and legal parts, with consequent court and jury trials respectively, was based on a system of remedies in which courts of law would simply not allow derivative suits, and courts of equity, after obtaining jurisdiction, would try all the corporate issues after determining the plaintiff's right to sue on the corporate claim. According to the Court, the only stumbling blocks to allowing jury trial in such cases were "purely procedural impediments" caused by the law-equity split.[30] The Court pointed out that if the law courts had taken from equity, as they had so many other things, the idea that stockholders' derivative suits were a proper remedy under their system, the corporate claims would doubtless have been tried to a jury. It then reasoned that despite the absence of such borrowing, the adoption of the Federal Rules had had precisely the same effect. The nature of the issue presented, whether legal or equitable, was to be the sole criterion for deciding the right to jury trial. The manner in which the parties were granted access to the court was to be no bar to the presentation of legal issues to a jury.[31]

There are difficulties inherent in each step of this reasoning, several of which were noted by the dissent. First, the Court's postulating the "dual nature" of the derivative suit, distinguishing the stockholder's right to sue from the merits of the corporate claims, is arguably of little probative force. For the dual nature concept is essentially an attempt to point out that the plaintiff and his corporation are separate legal persons, and that the derivative plaintiff is bringing what would have been a claim of the corporation. The concept thus describes the nature of the derivative action —one brought to sustain a right contained in the more "direct" right of another. It does *not* describe two actual substantive phases of the derivative action.[32] This is where the Court's reliance on the dual nature concept fails. All the substantive rights brought in the derivative action are

court approved the bringing of a derivative suit under the antitrust laws, the same type of action unsuccessfully brought by the plaintiff in *Fleitmann*. The resolution of this problem is only incidentally related to the question in *Ross*, however, since the action approved in *Fanchon* is a new post-Federal Rules breed of derivative action, and not the historical derivative action represented by *Ross*. *Fanchon* involves a new remedy, one not envisioned before the adoption of the Federal Rules, and only post-Federal Rules developments apply to it.

[29] 396 U.S. at 539-40.

[30] The Court did note that jury trial by right of the corporate claims would have been possible, prior to the adoption of the Federal Rules, under Equity Rule 23, Act of Mar. 3, 1887, ch. 359, § 4, 24 Stat. 506, and the Law and Equity Act of 1915, ch. 90, §§ 274a-74c, 38 Stat. 956. This admission does substantial damage to the rationale of *Ross*, for if the right of jury trial could have been exercised under the earlier procedural system, clearly it was not "purely procedural impediments" which caused the conspicuous absence of jury trial by right in pre-*DePinto* derivative actions. This was pointed out by the dissenting opinion in *Ross*.

[31] The Court concluded that at least some of the corporate claims in *Ross* were legal, requiring jury trial. 396 U.S. at 542.

[32] *See* note 22 *supra*, and authorities cited therein.

those of the plaintiff-shareholder: first, the right to bring the action on behalf of his recalcitrant corporation, and second, the right to obtain a judgment on what the dual nature concept describes as the corporate claims, in order to protect his own right as part owner of the corporation. "Dual nature" is thus a misnomer when used to describe the substantive makeup of a derivative action. The concept describes the several components of the action—the plaintiff's shareholding and the wrongs done the corporation. But, in ignoring the translation of these components into a substantive claim, the concept overlooks the substantive basis for describing the entire derivative action as unitary and equitable—the fact that all the components of the action are sustained by one plaintiff holding a derivative right to the total redress demand. The *Ross* Court's dual nature analysis succeeds in combating the theory that the derivative action is a *single* equitable action by arguing in terms of something other than the derivative action. The Court instead envisions some sort of action in which the "corporate claims" are viewed in theoretical isolation, removed from their context of enforcement by a separate legal entity, the plaintiff-stockholder. The Court's analysis thus says that for purposes of determining the right to a jury trial, the derivative action will be deemed to be not what it really is, a suit brought by the stockholder, but rather a suit brought by the corporation. The game is declared won by momentarily suspending the rules.

Second, the Enabling Act expressly precludes the Federal Rules from abridging, modifying, or enlarging the substantive rights of any party.[33] It should follow that if the right to jury trial did not exist in derivative actions prior to the Federal Rules, the adoption of the Rules should have had no effect on the right to jury trial in such actions. The reply to this contention is that the right to jury trial always existed in the "legal" phases of derivative actions, but was blocked by procedural impediments until the passage of the Federal Rules. No matter how it is rationalized, however, the fact remains that whereas the right to jury trial was not allowed in pre-Federal Rules derivative actions, now, after *Ross*, it is. This fact would seem to indicate an enlarging of the substantive rights of parties by the Federal Rules—a clear violation of the Enabling Act.

The ultimate source of the *Ross* rationale was the Court's interpretation of *Beacon Theatres* and *Dairy Queen*, and the supposed attrition worked by these cases on the scope of equity jurisdiction. The Court was correct in observing that this line of cases had affected the scope of equity. But in failing to supersede *Beacon Theatres* and *Dairy Queen* by declaring equity's existence a thing of the past, the Court lost an excellent chance to clarify the entire question of the seventh amendment's post-Federal Rules scope. The dissent's view of these cases is the proper one as long as equity exists at all: the decisions in *Beacon Theatres* and *Dairy Queen* mean that where legal and equitable causes of action, historically brought as separate actions in separate courts, are mixed under the merged system of procedure, the

[33] 28 U.S.C. § 2072 (1964). The *Ross* dissent found this prohibition, in combination with history, conclusive of the issue in *Ross*. 396 U.S. at 544.