Washington and Lee Law Review

Volume 27 | Issue 2 Article 10

Fall 9-1-1970

Derivative Actions And The Seventh Amendment

teen exclusions in subsection (b). Furthermore, neither a broad nor a narrow interpretation of the language in question relieves a foreign employer of the possibility of duplicate taxation on wages paid pursuant to its foreign employees' performing services within the United States. The solution to the problems raised cannot adequately be solved by judicial pronouncements. Congress created the ambiguity in section 3121, and, absent a treaty provision covering the situation, the burden of its clarification must rest with that body. The specific exclusion from employment of services performed within the United States by foreign citizen employees for foreign international highway carriers is one possible method of clarifying the situation. This suggestion does not appear unrealistic since the indicia of this type of service do not differ significantly from services performed in connection with foreign vessels or aircraft which are specifically excluded under FICA.[56] A broader remedy for the situation could best be accomplished by clearly stating in section 3121(c) that its provisions contemplate in "excluded service" only the specific exclusions listed in section 3121(b). Adoption of the latter suggestion could save the courts from having to render further judicial interpretations to determine the scope of "Included and excluded service" with respect to the definition of employment in section 3121(b).

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DERIVATIVE ACTIONS AND THE SEVENTH AMENDMENT

Following the view that a corporation is a trust,[1] the equity courts of the early nineteenth century created the shareholder's derivative action to enable the *cestui que trust* to sue his trustee.[2] Thereafter,

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[56]Note 11 and accompanying text *supra*.

[1]*See* Robinson v. Smith, 3 Paige Ch. 222 (N.Y. 1832); Taylor v. Miami Exporting Co., 5 Ohio 162 (1831).

[2]Apparently the earliest American case in which the subject was considered was Attorney Gen'l v. Utica Ins. Co., 2 Johns. Ch. 371 (N.Y. 1817), where the court noted that persons who exercise the powers of a corporation may be liable as trustees. In Taylor v. Miami Exporting Co., 5 Ohio 162 (1831), the court discussed the duties of directors in terms of both trust and agency and held that a shareholder may maintain a bill in equity for an accounting. The court in Robinson v. Smith, 3 Paige Ch. 222 (N.Y. 1832), reiterated the view expressed in *Utica* in allowing a derivative action against directors for "improper conduct in the management of the trust." 3 Paige Ch. at 222. *See* 4 J. POMEROY, EQUITY JURISPRUDENCE § 1088 (5th ed. S. Symons 1941).

such cases continued to be brought only in equity,[3] with the resulting absence of a jury.[4] To maintain a derivative suit, the shareholder must show to the satisfaction of the court that all possible remedies within the corporation have been exhausted, and that he has made an earnest effort to induce remedial action by the directors.[5] The derivative action is brought on behalf of the corporation and the claim being sued on is the corporation's claim.[6] The damages recovered go to the corporation, rather than to the individual shareholder.[7] When the claim asserted by the shareholder is legal in nature, within the context of the seventh amendment,[8] a problem arises as to whether or not there is a right to a jury trial.

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[3]Koster v. Lumbermens Mut. Cas. Co., 330 U.S. 518 (1947); Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855); Liken v. Shaffer, 64 F. Supp. 432 (N.D. Iowa 1946). The Court in *Dodge* stated the rule that courts of equity have jurisdiction to prevent actions by corporate directors "...if the acts intended to be done create what is in the law denominated a breach of trust." 59 U.S. (18 How.) at 341. It is to be noted that in this early case the Court talked in terms of "restraining" acts for which there was no "adequate remedy at law." *Id.* In *Koster,* the Court noted that the shareholder's derivative action"...is an invention of equity to supply the want of an adequate remedy at law to redress breaches of fiduciary duty by corporate managers." 330 U.S. at 522. *See generally* 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 730 (1959); N. LATTIN, THE LAW OF CORPORATIONS 349 (1959); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 8.04 (1969).

[4]This is the general rule as stated in most of the treatises. *E.g.,* 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 730 (1959). *Contra,* DePinto v. Provident Security Life Ins. Co., 323 F.2d 826 (9th Cir. 1963), *cert. denied,* 376 U.S. 950 (1964). *Cf.* Fleitmann v. Welsbach Street Lighting Co., 240 U.S. 27 (1916).

[5]Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949) (dictum); Hawes v. Oakland, 104 U.S. 450 (1881); FED. R. CIV. P. 23.1. If these elements are not shown, the shareholder must give an adequate explanation. The reason for this rule, as stated in *Hawes,* is to prevent fraud and collusion on the part of the directors in admitting the action to federal court. 104 U.S. at 460-61.

[6]*See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949); Koster v. Lumbermens Mut. Cas. Co., 330 U.S. 518 (1947); DePinto v. Provident Security Life Ins. Co., 323 F.2d 826 (9th Cir. 1963); *cert. denied,* 376 U.S. 950 (1964); Richland v. Crandall, 259 F. Supp. 274 (S.D.N.Y. 1966); Liken v. Schaffer, 64 F. Supp. 432 (N.D. Iowa 1946) ("When a stockholder institutes a derivative suit, it is the same in legal effect as if the corporation itself had sued." *Id.* at 441); Miller v. Weiant, 42 F. Supp. 760 (S.D. Ohio 1942); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 8.04 (1969). Knepper states, "If the corporation does not have a cause of action, there can be no recovery in a stockholder's derivative suit." *Id.*

[7]Smith v. Sperling, 354 U.S. 91, 99 (1957) (dissenting opinion); Dewing v. Perdicaries, 96 U.S. 193 (1877) (dictum). *See generally* W. CARY, CORPORATIONS 868-79 (4th ed. 1969).

[8]U.S. CONST. amend. VII provides:

> In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.

The problem of the right to a jury trial in a derivative action was presented to the United States Supreme Court in the recent case of *Ross v. Bernhard.*[9] The plaintiff in *Ross* charged the directors of his corporation with "gross abuse of trust, gross misconduct, willful misfeasance, bad faith, [and] gross negligence,"[10] and sought an accounting.[11] The district court refused to strike the plaintiff's demand for a jury trial[12] and on an interlocutory appeal the circuit court reversed.[13] The Supreme Court reversed the decision of the circuit court.

The Court held that the seventh amendment right to trial by jury is applicable to any "individual issue" in a derivative action which is legal in nature. In reaching its decision, the Court noted that a derivative suit has two phases, "... first the plaintiff's right to sue on behalf of the corporation and second the merits of the corporation claim itself."[14] Where the "corporation claim" is in part legal the right to a jury trial attaches. The Court found that at least one of the "individual issues" to be tried was legal in nature.[15] If the corporation itself had brought the action it would have been entitled to a jury trial. Therefore, since the shareholder in a derivative action is asserting the rights of the corporation, he also should be entitled to a jury.

While the seventh amendment right to a jury trial in actions at common law has been held inapplicable to the states,[16] it is of great importance in proceedings in the federal courts.[17] The question as to

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[9]90 S. Ct. 733 (1970).

[10]*Id.* at 734. The action was brought under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1964).

[11]90 S. Ct. at 734.

[12]Ross v. Bernhard, 275 F. Supp. 569 (S.D.N.Y. 1967). The district court reasoned that the plaintiff's demand for an "acounting" was essentially a demand for a money judgment, a legal demand, and thus held that a jury trial was appropriate. *Id.* at 570-71.

[13]Ross v. Bernhard, 403 F.2d 909 (2d Cir. 1968). In reaching its decision the court merely reiterated the traditional view that since derivative actions were created by equity, the seventh amendment guarantee has no application. *Id.* at 914.

[14]90 S. Ct. at 736 (footnote omitted).

[15]*Id.* at 740. Mr. Justice Stewart dissented on the ground that historically neither party in a derivative action could be granted a jury trial, such actions being equitable in nature. The Chief Justice and Mr. Justice Harlan joined in this dissent. *Id.* at 740-45.

[16]Pearson v. Yewdall, 95 U.S. 294 (1877); Walker v. Sauvinet, 92 U.S. 90 (1875); Edwards v. Elliott, 88 U.S. (21 Wall.) 532 (1874). The clause pertaining to appellate review of facts found by a jury has been held to apply to the states. The Justices v. Murray, 76 U.S. (9 Wall.) 274 (1869).

[17]Dairy Queen, Inc. v. Wood, 369 U.S. 469 (1962); Beacon Theatres, Inc. v. Westover, 359 U.S. 500 (1959); Baltimore & Carolina Line, Inc. v. Redman, 295 U.S. 654 (1935); Scott v. Neely, 140 U.S. 106 (1891). *Cf.* Simler v. Conner, 372 U.S. 221 (1963); Dimick v. Schiedt, 293 U.S. 474 (1935).

which actions are encompassed by the guarantee presents itself. The Supreme Court at an early time determined the test to be whether the action was tried by a jury when the seventh amendment was adopted in 1791.[18] In using this "historical" test a court merely decides whether in 1791 the action was at common law, in equity, or in the admiralty court.[19] The jury trial right attached only when the action was at common law. The Court has reasoned that the framers of the seventh amendment meant to preserve the distinction between law and equity actions by inserting the "suits at common law" provision.[20] In other words, if the framers had intended that equitable actions were to be tried by a jury, they would not have limited the jury trial right to common law actions. Thus, the amendment was interpreted so as not to infringe upon the jurisdiction of the equity courts.[21]
jury trial in an equitable action did not arise as frequently as it does today. In 1891, the Supreme Court held that legal and equitable relief could not be sought in the same action, since to do so would jeopardize the jury trial right on the legal issues.[23] By 1922 the Court's position had changed; legal and equitable issues could be blended in the same action, but the equitable issue had to be tried first. Any remaining legal issues could then be tried by a jury.[24]

After adoption of the Federal Rules and the resulting merger of law and equity into one form of action,[25] the problem of a right to jury trial in traditionally equitable actions became more severe. The "character of the overall action" approach was formulated to deter-

[18]Parsons v. Bedford, 28 U.S. (3 Pet.) 433 (1830) (dictum).

[19]Though innocuous in appearance, the "historical" test has led to many problems, particularly where new actions have been developed which did not exist in 1791. Obvious examples may be found in the new actions developed in the commercial law field, and actions created by statute. In such a situation, a court may attempt to draw an analogy between the action in controversy and a "similar" action in 1791. This would amount to speculation as to how the courts would have viewed the action in the eighteenth century, a highly unsatisfactory mode of determining the applicability of a constitutional right.

[20]Parsons v. Bedford, 28 U.S. (3 Pet.) 433, 446-47 (1830).

[21]Shields v. Thomas, 59 U.S. (18 How.) 253, 262 (1856).

Prior to the merger of law and equity in 1938,[22] the question of a

[22]FED. R. CIV. P. 1 provides that there shall be one form of action, designated a civil action.

[23]Scott v. Neely, 140 U.S. 106, 112 (1891).

[24]Liberty Oil Co. v. Condon Nat'l Bank, 260 U.S. 235, 242 (1922). In this case, the Court merely reiterated the view that the practice in the English and American courts in 1791 determines the construction of the seventh amendment. *Id.* at 243.

[25]FED. R. CIV. P. 1.

mine whether or not the right to a jury trial existed.[26] This test involves deciding whether the basic character of the overall issue presented in the action is legal or equitable.[27] The problem, according to Professor Fleming James, is that there are no adequate guidelines for determining what constitutes the character of the action.[28] He suggests that in determining the character, a court could ascertain the suitability of trial by jury; or that the character could be defined by custom—whether the action is usually tried by a jury. A third possibility suggested by James is to examine the action using the "historical" test.[29]

Since the same factual situation often gave rise to both legal and equitable claims, the prior determination of the facts on the equitable claim acted to estop litigation of the facts on the legal claim.[30] The Supreme Court's solution to this dilemma was announced in *Beacon Theatres, Inc. v. Westover*,[31] where a claim determined by the district court to be equitable was met by a legal counterclaim. To alleviate the problem of estoppel, the Court held that where both legal and equitable claims are presented, legal issues must be tried by the jury.[32] The

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[26]*E.g.*, Bruckman v. Hollzer, 152 F.2d 730 (9th Cir. 1946) (basic nature of action legal, hence triable by a jury prior to adjudication of equitable issues); General Motors Corp. v. California Research Corp., 9 F.R.D. 565 (D. Del. 1949) (basic nature of issue determines right to jury trial). *See generally* 5 J. MOORE, FEDERAL PRACTICE ¶ 38.16 (2d ed. 1969) [hereinafter cited as MOORE]. Traditionally, the "character of the overall action" test has been referred to as the "basic nature of the issue" test.

[27]5 MOORE ¶ 38.16.

[28]F. JAMES, CIVIL PROCEDURE § 8.11 (1965).

[29]The "character of the overall action" test, though strongly advocated by Professor Moore and adopted by a number of courts, note 27 *supra*, was rejected by the Supreme Court in Beacon Theatres, Inc. v. Westover, 359 U.S. 500 (1959). It is apparent that the test was a semantical device to enable a court to do no more than examine the overall character of the action, rather than look at whether legal issues existed. For a further discussion see text accompanying notes 31-33 *infra*.

[30]*See* Dairy Queen, Inc. v. Wood, 369 U.S. 469, 472 (1962); Thermo-Stitch, Inc. v. Chemi-Cord Processing Corp., 294 F.2d 486, 488 (5th Cir. 1961). In Prudential Insurance Co. v. Bonney, 299 F. Supp. 794 (W.D. Okla. 1969), an equitable action to foreclose a mortgage was met by a legal counterclaim with a demand for a jury trial. The court held to try the equitable claim first would estop a trial of the facts on the legal counterclaim. Holding this to be a blending of legal and equitable claims, the court ordered the entire case tried by the jury.

[31]359 U.S. 500 (1959).

[32]The Court elaborated on this point by saying that

> ...only under the most imperative circumstances, circumstances which in view of the flexible procedures of the Federal Rules we cannot now anticipate, [footnote omitted] can the right to a jury trial of legal issues be lost through prior determination of equitable claims.

Id. at 510-11.

Court rejected the "character of the overall action" approach and adopted instead an approach which considers all the individual issues to determine whether or not the right to jury trial is applicable. If a legal issue is present, it will be tried by a jury and the problem of estoppel will be eliminated.[33]

Three years after *Beacon,* the Court further ensured this seventh amendment right. In *Dairy Queen, Inc. v. Wood,*[34] the Court was faced with a demand for a jury trial in an action for an injunction and an accounting. The Court reasoned that the constitutional right to a jury trial cannot be made dependent upon the label given to the relief sought.[35] Instead, where the relief sought is essentially a money judgment the action must be tried by a jury unless the plaintiff can show that the relief demanded would be too complicated for a jury to understand.[36]

The court considered the "nature of the relief" sought instead of the cause of action alleged, and then applied the "historical" test. Where the relief sought would have been obtainable at common law in 1791—damages, for example—the right to a jury trial attaches.[37] The Court determined that the relief sought was essentially legal. It naturally followed that the parties were entitled to a jury.[38] By con-

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[33]*See, e.g.,* Allstate Ins. Co. v. Winnemore, 413 F.2d 858 (5th Cir. 1969); AMF Tuboscope, Inc. v. Cunningham, 352 F.2d 150 (10th Cir. 1965); Thermo-Stitch Inc. v. Chemi-Cord Processing Corp., 294 F.2d 486 (5th Cir. 1961); Prudential Ins. Co. v. Bonney, 299 F. Supp. 794 (W.D. Okla. 1969). In *Thermo-Stitch,* the court reasoned that it is immaterial that the basic issue of the action is equitable, or that the equitable cause clearly outweighs the legal cause. Where a legal issue is present, the right to jury trial attaches. 294 F.2d at 491.

[34]369 U.S. 469 (1962).

[35]*Id.* at 477. In the district court the defendant demanded a jury trial which denied on the ground that the action was purely equitable; any possible legal issues were merely incidential to the action. McCullough v. Dairy Queen, Inc., 194 F. Supp. 686 (E.D. Pa. 1961).

[36]369 U.S. at 478. The Court held that to avoid a trial by jury, the plaintiff must show that the " 'accounts between the parties' are of such a 'complicated nature' that only a court of equity can satisfactorily unravel them." *Id. quoting* Kirby v. Lake Shore & M.S.R.R., 120 U.S. 130, 134 (1887).

[37]Wirtz v. National Maritime Union, 399 F.2d 544 (2d Cir. 1968) (no part of relief sought could be construed as legal, hence no jury trial); Simmons v. Avisco, Local 713, Textile Workers Union, 350 F.2d 1012 (4th Cir. 1965) (relief sought was legal in nature, hence case triable by a jury). *Contra,* Klein v. Shell Oil Co., 386 F.2d 659 (8th Cir. 1967) (form of relief sought is *not* determinative, but is a factor in deciding whether action is legal or equitable). *Cf.* McGraw v. United Ass'n of Plumbing, 341 F.2d 705 (6th Cir. 1965) (recovery of money damages only incidental to equitable relief sought).

[38]369 U.S. at 479. A similar result has been reached in the circuits. Kennedy v. Lakso Co., 414 F.2d 1249 (3d Cir. 1969) (accounting sought for patent infringement held not too complicated for a jury); Halladay v. Verschoor, 381 F.2d 100

sidering whether or not a jury would be confused by the proceedings, the Court indicated its willingness to take a more functional approach to the jury problem. Subsequently this approach has been followed in the lower federal courts.[39]

Shortly after *Dairy Queen,* the Ninth Circuit decided the case of *DePinto v. Provident Security Life Insurance Co.*[40] The court held that while a shareholder's action is brought in equity, if the claims asserted present a legal issue the right to a jury trial attaches. In reaching this conclusion, the court observed that the derivative action asserts claims belonging to the corporation.[41] Had the corporation itself brought the action it would have been entitled to a jury trial on any legal issues presented. The court then reasoned that the right to a jury trial on legal issues should attach regardless of which party-plaintiff brings the action.[42]

As noted earlier, the derivative action was created by the old equity courts as a device to enable the beneficiaries (shareholders) of a trust (the corporation) to sue their trustees (directors) for breach of duty.[43] The courts which have considered this problem since *DePinto,* and thus after *Beacon* and *Dairy Queen,* have followed the more traditional approach.[44] For example, in *Local 92, International Association of Iron Workers v. Norris,*[45] a derivative action seeking an accounting was brought against the leaders of a labor union. The Fifth Circuit denied the defendant's demand for a jury trial, reasoning that the derivative action was traditionally equitable in nature.[46] In *Richland v. Crandall,*[47] another court struck the plaintiff's demand for a jury trial in a derivative action, reasoning that such an action could

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(8th Cir. 1967) (legal claim presented in proceeding to enforce a trust held triable by a jury); Swofford v. B & W, Inc., 336 F.2d 406 (5th Cir. 1964) (accounting for profits held to be a rule of administration and not of jurisdiction and thus triable by a jury). *Cf.* Thermo-Stitch, Inc. v. Chemi-Cord Processing Corp., 294 F.2d 486 (5th Cir. 1961) (where a legal cause is present, the right to a jury trial attaches). *Contra,* Senchal v. Carrol, 394 F.2d 797 (10th Cir.), *cert. denied,* 393 U.S. 979 (1968).

[39]*E.g.,* Kennedy v. Lakso Co., 414 F.2d 1249 (3d Cir. 1969); Burgess v. General Elec. Co., 285 F. Supp. 788 (D.N.J. 1968).

[40]323 F.2d 826 (9th Cir. 1963), *cert. denied,* 376 U.S. 950 (1964).

[41]323 F.2d at 836.

[42]*Id.*

[43]Text accompanying notes 1-2 *supra.*

[44]*E.g.,* Ross v. Bernhard, 403 F.2d 909 (2d Cir. 1968), *rev'g* 275 F. Supp. 569 (S.D.N.Y. 1967); Local 92, Int'l Ass'n of Iron Wkrs. v. Norris, 383 F.2d 735 (5th Cir. 1967); Richland v. Crondall, 259 F. Supp. 274 (S.D.N.Y. 1966) (dictum).

[45]383 F.2d 735 (5th Cir. 1967).

[46]The court noted that "... the relief sought is, not only in name but in substance, traditionally equitable." *Id.* at 740.

[47]259 F. Supp. 274 (S.D.N.Y. 1966).

never be a suit at common law for seventh amendment purposes.[48] The circuit court in *Ross v. Bernhard*[49] relied on the ". . . teaching of history that the stockholder's derivative action has always been regarded exclusively as a creature of equity to which the right to a jury trial does not apply."[50] That court distinguished *Beacon* by noting that in *Beacon* a jury trial right had been lost, while in this case no right to a jury trial had ever existed. The court further noted that law courts have never recognized derivative suits, and thus any legal claim involved therein had traditionally been decided by the equity courts.[51] All of these cases holding contrary to *DePinto* were decided using the "historical" test.[52]

In *Ross,* the Supreme Court's reasoning was essentially the same as that used by the Ninth Circuit in *DePinto.* The plaintiffs in *Ross* sought an accounting but the Court had announced in *Dairy Queen* that it will look behind the label of the action to see if the "nature of the relief" is legal and if the action is suitable for jury trial.[53] The corporate legal claim was for negligence. By splitting the concept of the derivative action into two phases the corporate claims were segregated. Under *Beacon,* once a legal issue is found, the seventh amendment jury trial right comes into being.[54] The Court also announced the proper method for determining whether the nature of each individual issue to be tried is legal.[55] The Court first considers the pre-1938 custom, thereby employing the "historical" test, and then the remedy sought, thus using the "nature of the relief" test. Then the Court will assess the practical abilities and limitations of juries,[56] under the doctrine announced in *Dairy Queen.* Consequently, the Court has adopted a modified version of James' guidelines for the "character of the overall action" approach which will now be used to determine the nature of each individual issue to be tried.[57]

Mr. Justice Stewart's dissenting opinion[58] in *Ross* relies heavily on the "historical" test. In his application of the "historical" test,

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[48]*Id.* at 279. On the basis that the action was also brought as a class suit the case was remanded for a jury trial. *Id.* at 280.

[49]403 F.2d 909 (2d Cir. 1968).

[50]*Id.* at 911.

[51]*Id.* at 914.

[52]Text accompanying notes 18-20 *supra.*

[53]Text accompanying notes 34-38 *supra.*

[54]Text accompanying note 31-33 *supra.*

[55]90 S. Ct. at 738 n.10.

[56]*Id.*

[57]*Id.* at 738.

[58]*Id.* at 740-45.