Derivative Actions by Policyholders

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this is that although the plaintiff utilized Section 235 for service in an action seeking divorce and alimony, the court held that the defendant had, by interposing an answer, made a general appearance. However, a dissent recognized that the application of Section 235 is not yet settled. The position taken was that the defendant had not subjected himself personally to the jurisdiction of the court and in stating that the case should be remanded, added, “the effect of that section (235) could be tested in that event.”


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During the past century there has been considerable expansion and growth in the business of insurance, until today a large portion of the wealth of this nation is in the hands of insurance companies. Whenever there are large holdings and concentrations of wealth, there will also be attempts at control by those who have, in any way, an interest in such holdings. Such attempts are illustrated by those actions brought by policyholders under theories analogous to those which lie behind a stockholders’ derivative action. The existence of the right of a policyholder to bring such a derivative action has received scant clear-cut judicial or legislative recognition, therefore if the right exists, it requires clarification as to its nature and extent.

Fundamentally, derivative actions were evolved for the purpose of exercising an additional check on the management of a corporation and as a further protection of those who had a beneficial interest in its assets and affairs. There is no doubt that the stockholders’ derivative action has proved a wholesome means of protecting the stockholder’s interest, not only because it has afforded a means of obtaining redress for injuries and wrongs actually inflicted but also because it has prevented many acts of mismanagement. Since a corporation is a separate entity, the ownership of all the property is in its name and any cause of action that accrues belongs to the corporation and not to the stockholders individually or collectively.¹ The corporation must act through its duly authorized agents, namely its officers and Board of Directors, but they may not always act in the best interest of the corporation or they may neglect to pursue the corporation’s rights. In theory, the stockholder has control over the management

¹ Brainard v. Brainard, supra note 100.
through voting rights in the corporate elections, but often these rights are of little practical value. This is especially so where there is a large body of stockholders whose individual interests are small, since in any conflict between a stockholder and the management, the stockholder must rely on his individual means to obtain support, whereas the management is financed by the corporation. When direct action within the corporation has proved insufficient, the stockholder has sought judicial aid through the derivative form of action. He is to be considered merely as the instigator of the action, and he assumes this role because he knows that his interest will suffer whenever any injury or wrong to the corporation goes without redress.²

Primarily, it is the policyholders in mutual companies who seek to bring derivative actions. When a policy is issued by a stock company, the relation is clearly one of contract and the policyholder paying a fixed premium, does not expect a voice in the management. He is interested only in protection at reasonable rates. However, a mutual company generally has no stockholders, and the policyholders share in the profits that accrue. The paid-in premiums constitute a fund out of which the individual policyholder or his beneficiary will be paid on the happening of the contingency upon which the insurance is based. The premiums which are charged by the company are always more than enough to cover the cost of the insurance. A margin of safety must be maintained to offset any unavoidable increase in death and disability over the actuaries' calculations. This fund is, of course, invested by the company in order to further reduce the cost of insurance. Any excess, surplus or profit is returned to the policyholder in the form of dividends.³ It is for this reason that policies in a mutual company are termed participating.

It is easily understood why these policyholders, who share in the surplus of the company, feel that they have the right to protect their interest. Since there are no stockholders, and there is a considerable amount of property and wealth controlled by the company, they contend that they are the beneficial owners of these vast assets. The fund is for their protection and the profits for their benefit. The officers and directors are their agents entrusted with management but not with ownership. The title ownership is in the company as an entity but since the ultimate ownership must exist in someone, the policyholders argue that it is in them. Therefore, in addition to any governmental controls, they believe that they have an absolute right to bring an action in behalf of the company as a safeguard of their interest or to prevent a breach of the fiduciary duty owed to them by the directors.

² For an excellent treatment of stockholders' derivative actions generally see Horstein, Legal Controls for Incorporate Abuse—Present and Future, 41 Col. L. Rev. 405 (1941).
In most instances, the courts have neglected to make any definite statement affirming or denying this contention. Often the actions were disallowed on other grounds and where the cause is sustained, no specific treatment of the fact that the plaintiff is a policyholder is given. It is unfortunate that *Young v. Equitable Life Assurance Society*, which fully discusses the issue, must be considered as *dicta* because of the peculiar fact situation involved. It warrants attention here, nonetheless, since the language used so clearly summarizes the theory which lies behind these actions. Henry T. Kellogg, J., who wrote the opinion at Special Term, said, "It seems to me entirely clear that, in a purely mutual company, the whole body of policyholders at any given time, whose policies are not yet mature, have a *quasi* ownership in all the assets of the corporation, and are, like stockholders of an ordinary corporation, in effect its *cestuis que trustent* . . . unless all the policyholders at a given moment in equity own the corporate property, then we have the extraordinary spectacle of a corporation, without members, without stockholders, a legal fiction, an abstract idea, owning absolutely all corporate property, in trust for no one, with responsibility to no one except creditors and then only to pay debts. . . . Whatever the nature of a stockholder's interest technically may be, he does, in effect, enjoy rights of ownership in the corporate property; and, upon this broad ground, a remedy is given him to compel his corporation to collect from its delinquent directors. The nature of a policyholder's interest in a mutual company is very similar to that of an ordinary stockholder." However, since the plaintiff was a stockholder as well as a policyholder and the company was not purely a mutual company, the Appellate Division based its affirmance on the ground that the plaintiff could sue as a stockholder and her status as a policyholder need not have been considered.

Frequently this reference is made to fiduciary duties and trust relationships in the cases involving derivative actions. The relation of the directors of a corporation to the stockholders is said to be essentially that of trustee and *cestui que trust*. But contrary to this, many cases state that an insurance company does not hold any funds in trust for a policyholder.

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*See People ex rel. Manice v. Powell*, 201 N. Y. 194, 201, 94 N. E. 634, 637 (1911).

Uhlman v. New York Life Ins. Co. was an action for an accounting by a policyholder who held what was termed a “ten year dividend system policy” which entitled him to an equitable share in the surplus of the company. It was held that in no sense was the defendant a trustee of any fund for the plaintiff. The relation of the company to the policyholder was one of debtor and creditor which was measured by the terms of the policy. The defendant had agreed to distribute or apportion the surplus fund equitably but that did not give the policyholder the right to an accounting since the management of the fund was confined to the judgment, discretion and skill of the officers and directors of the company. This case is often cited as an authority for the proposition that a policyholder has not the capacity to sue in a derivative action; but its weight is considerably weakened by the fact that this was not a derivative action. The plaintiff sued in his own name and for his own benefit; the action was against and not for the company and would have only incidentally benefited the other policyholders had the plaintiff been successful. The case is important, however, since it does show a very decided attitude on the part of the Court of Appeals with respect to an action based on a trust relationship.

A stronger authority is Russell v. Pittsburg Life and Trust Co. which refused to allow an action by the plaintiff-policyholder, wherein he sought to enjoin a merger with another insurance company, on the ground that he had no capacity to sue. The court, referring to Equitable Life Assurance Society v. Brown in which the Supreme Court of the United States reviewed the law in the State of New York, said, “... it would seem that the doctrine that a policyholder has a standing in court in an equitable action against the company upon the ground that he is a cestui que trust has finally been set at rest in accordance with the long line of decisions in the State of New York by the final determination of the Supreme Court of the United States.” The holding in Young v. Equitable Life Assurance Society was also expressly limited as an action by a stockholder. As the court indicated, the doctrine did seem to be set at rest since no policyholder’s action of this nature reached the Court of Appeals until 1941 when that court affirmed without opinion, a holding that


a policyholder was a mere creditor of the insurance company and as such cannot invoke the jurisdiction of a court of equity against the officers and directors for acts of mismanagement or to enjoin waste by reason of alleged ultra vires acts.

Therefore, it may be stated as a matter of law, that there is no trust or fiduciary relationship between a policyholder and the insurance company, the relation being merely that of debtor and creditor.

However, the absence of a trust relationship does not completely resolve the issue since there are many other rights possessed by a policyholder which are analogous to those of a stockholder, upon which the right to sue in a derivative action may be based. A policyholder often may vote for directors,\(^{15}\) inspect the records as to names and addresses of other policyholders,\(^ {16}\) and participate in the annual surplus of the company.\(^ {17}\) An indication that the right of a policyholder to sue does exist when all the proper requisites have been met is found in several recent decisions,\(^ {18}\) where the courts declined to state that such right does not exist, even though the question was squarely presented, but instead dismissed the complaints on other grounds.

A discussion of these cases is held in abeyance since other elements of derivative actions must first be introduced. As was stated earlier, the cause of action belongs to the corporation and before a stockholder can bring a derivative action for any alleged wrongs, he must show that the corporation itself has failed to seek a remedy. He must make a demand through the Board of Directors or show that such demand would be fruitless.\(^ {19}\) The stockholder-plaintiff must exhaust all the means within his reach to obtain redress before he can come into equity for relief since he is not the real party in interest.\(^ {20}\) When the Superintendent of Banks has the power to regulate and interfere in the affairs of a banking corporation, a stockholder of a banking company has not exhausted all his means until

\(^{15}\) N. Y. INSURANCE LAW § 198(1) (2).

\(^{16}\) N. Y. INSURANCE LAW § 198(3) (4) (5) (6).

\(^{17}\) N. Y. INSURANCE LAW § 216(1).

\(^{18}\) Koster v. Lumbermens Mutual Casualty Co., — U. S. —, 91 L. ed. 764 (1947) (action dismissed on grounds of forum non conveniens but court said a policyholder’s action is analogous to a stockholder’s). In Clifford v. Metropolitan Life Ins. Co., 264 App. Div. 168, 169, 34 N. Y. S. 2d 693, 695 (2d Dep’t 1942) the court said, “There remains, nevertheless, some doubt as to the correctness of the contention of the directors that it must be held, as a broad and arbitrary rule of law, that a policyholder has no standing to bring a derivative action in behalf of his insurance company.” In Shay v. Metropolitan Life Insurance Co., 172 Misc. 202, 14 N. Y. S. 2d 347 (Sup. Ct. 1939), aff’d, 260 App. Div. 958, 24 N. Y. S. 2d 870 (2d Dep’t 1940) “... even though it be assumed that the plaintiff has a standing in equity by reason of the ownership of two policies ...”


he has made a demand and received a refusal from the Superintendent to intervene.\(^{21}\)

If the analogy be closely drawn it might be presented with great force that before a policyholder may bring a derivative suit he should first seek intervention by the Superintendent of Insurance. The complaints in both *Clifford v. Metropolitan Life Insurance Co.*\(^{22}\) and *Shay v. Metropolitan Life Insurance Co.*\(^{23}\) were dismissed on this ground, reference being made to the section of the Insurance Law pertaining to examinations by the Superintendent. To fully understand the effect of our present statute, tracing its historical development is indispensable. This brings us back to the *Uhlman* case which in its closing statement struck the keynote argument against allowing these suits without check. "Of course it is not to be supposed that each individual policyholder would avail himself of this right, but the fact that each one might, would place the company in the power of unscrupulous parties to take advantage of it for the purpose of endeavoring to levy contribution from it which it might pay in order to secure freedom to itself from troublesome, expensive, unnecessary and wholly disingenuous investigations (and made in numerous suits) into the affairs of the company and its accounts running through many years."\(^{24}\) As a direct result of this statement a section \(^{25}\) was added to the Insurance Law in 1892 which provided that any interference with the internal affairs of an insurance company must be made by the Attorney General. This section apparently was framed to prevent the intolerable nuisance to which an insurance company would be subjected if any one of its many policyholders was allowed to maintain a derivative action. As a matter of public policy it must be deemed much more desirable that the control over a business so invested with public interest, be exercised by a public officer rather than by any individual policyholder whose knowledge of the intricacies of the business of insurance may be very limited. Although poorly worded, since it did not state that a policyholder could not sue but provided that no order, judgment or decree be made except on petition of the Attorney General, this section was effectively pleaded as a bar to several actions.\(^{26}\) It was held to be constitutional since

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\(^{22}\) 264 App. Div. 168, 34 N. Y. S. 2d 693 (2d Dep't 1942).


\(^{25}\) N. Y. Laws of 1892, c. 690, § 56.

"No order, judgment or decree providing for an accounting or enjoining, restraining or interfering with the prosecution of the business of any domestic insurance corporation or appointing a temporary or permanent receiver thereof shall be made or granted otherwise than upon the application of the attorney-general, on his own motion or after his approval of a request in writing therefor of the superintendent of insurance, except in an action by a judgment-creditor or in proceedings supplementary to execution."

it did not deprive a policyholder of any right but merely changed his form of remedy.\textsuperscript{27}

The Insurance Law was revised in 1909 and the entire Chapter 690, Laws of 1892, was repealed.\textsuperscript{28} However, the revised statute contained a section which required the Superintendent of Insurance to make an examination into the affairs of any insurance corporation upon the request of a policyholder.\textsuperscript{29} This section may be considered as the equivalent of Section 56 of the repealed code. It is therefore clear that the State continued to frown on any suit which interfered with the management of an insurance company when brought by anyone other than a proper public official.

The dismissal of the complaint in \textit{Shay v. Metropolitan Life Ins. Co.} was based on the ground that the plaintiff had failed to show that he had exhausted all the remedies afforded him by this section. However, in 1939, while this case was being prepared for appeal, the legislature again revised the Insurance Law repealing the entire Insurance Chapter of the Laws of 1909.\textsuperscript{30} The dismissal was affirmed by the Appellate Division,\textsuperscript{31} and the case was annotated under Section 28 of the present law,\textsuperscript{32} which is the counterpart of Section 40. Although the wording has been completely altered,\textsuperscript{33} the powers of

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\textsuperscript{27} Swan v. Mutual Reserve Fund Life Ass'n, 155 N. Y. 9, 49 N. E. 258 (1898).

\textsuperscript{28} N. Y. Laws of 1909, c. 35, §§ 360, 361.

\textsuperscript{29} N. Y. Laws of 1909, c. 33, § 40. Examination by superintendent upon request of stockholder, policyholder or creditor. "The superintendent shall make an examination into the affairs of any insurance corporation doing business in this state, whenever any stockholder, policyholder or judgment creditor of any such corporation shall, by a declaration subscribed and sworn to by him, notify the superintendent of facts within the knowledge of the person making the declaration, and stated therein, or within the knowledge of persons whose affidavits stating the same are presented therewith, which in the judgment of the superintendent make such an examination advisable."

\textsuperscript{30} N. Y. INSURANCE LAW §§ 600, 601.


\textsuperscript{32} 27 MCKINNEY'S CONSOL. LAWS § 28, n. 1.

\textsuperscript{33} N. Y. INSURANCE LAW § 28.

"Examination of insurers; when authorized or required.

1. The superintendent may make an examination into the affairs of any insurance corporation or other insurer doing any insurance business in this state or authorized to do an insurance business in this state or, of any pension fund, retirement system or other organization which is required by law to make reports to, or is subject to examination by, the insurance department as often as he deems it expedient for the protection of the interests of the people of this state, in addition to examinations authorized by the other provisions of this chapter.

2. The superintendent shall make an examination into the affairs of every domestic life insurance company, every cooperative life and
the Superintendent have not been changed.34

The intention of the legislature is evidenced by the language which was used in the section. The first paragraph reads that the Superintendent may make an examination as often as he deems it expedient. Although there is no longer any reference to a demand by a policyholder for such examination, it is apparent that the Superintendent has the power to act in any case which may be brought to his attention. When this paragraph is read in connection with paragraph (2) which provides that the Superintendent shall make an examination of certain insurance companies every three years, there is no doubt that the legislature did not intend to make any change in the policy indicated by the earlier statutes or to limit the inquisitorial powers of the Superintendent.

The primary purpose of a policyholder in an insurance company is not the same as that of a stockholder in a corporation. The stockholder’s purpose is to derive pecuniary profit from his investment whereas a policyholder seeks security and protection at reasonable rates. The need for control over the insurance companies is apparent but the interest of the policyholder will be more properly safeguarded by governmental regulations than by derivative suits. Therefore, the Superintendent of Insurance with his broad powers should be regarded as the representative of the public and the policyholders. This view was affirmed in Clifford v. Metropolitan Life Insurance Co., which held that a request on the Superintendent of Insurance to exercise his powers under Section 28 of the Insurance Law was a condition precedent to the bringing of a derivative action.

Many of these suits present situations where a policyholder seeks to force his own legal theory or economic point of view on the company. A comparison of the Clifford and Shay cases clearly illustrates this point. During the years of 1938 to 1942 there were several self-titled “Insurance Advisors” who advertised over the radio to the effect that they could procure policies at reduced costs, that the large companies charged exorbitant rates and that insurance agents generally made false representations to prospective policyholders in order to secure commissions for themselves. They offered advice and services to those who would call at their offices. Shay, a policyholder in the Metropolitan Company, brought a derivative suit to enjoin waste of the company’s assets by the directors when they expended certain sums for radio broadcasts advising the public not to consult

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34 See Pink, Tentative Draft of Revised Insurance Law (1937), Introductory comment by Professor Edwin W. Patterson, Chairman, Committee on Insurance Law Revision (p. x), “The inquisitorial powers of the Department remain substantially unchanged.”
these Insurance Advisors. Clifford, on the other hand, sought to compel the same company to take action against these Insurance Advisors whom he termed as "conspirators." Both of these suits were dismissed for failure to first consult the Superintendent of Insurance. Neither need have been brought and considerable expense to the company and therefore to the policyholders could have been avoided.

In New York, stockholders' derivative suits are generally brought under Article 6 of the General Corporation Law. The attitude of the legislature as evidenced by recent additions and revisions of this article, has been to limit the stockholder's derivative suit. A prominent authority called this legislation "the death knell of stockholders' derivative suits in New York." Security for expenses is required where a stockholder does not own more than five per cent of the outstanding stock unless his interest exceeds fifty thousand dollars. Provisions in the by-laws may provide that officers and directors be indemnified for reasonable expenses, including attorneys' fees which are incurred in the successful defense of any action brought against them under this article. There is no longer any provision for attorneys' fees for the stockholder-plaintiff since it was said that repealed Section 61a which formerly so provided was unnecessary because it merely affirmed the common law right of a successful plaintiff to costs. How severe a blow to the stockholder's derivative suit this legislation will prove remains to be answered in the future. But it surely can be seen that any present attempt by a policyholder to bring a derivative suit based on the analogy of a stockholder's suit will be met at the outset with the obstacles furnished by this legislation.

Conclusion

While it cannot be stated as an established rule of law that a policyholder has no standing in equity to bring a derivative action in behalf of his company, it is at least certain that any attempt to bring such action is beset with many difficulties and conditions. That he has an equitable interest cannot be denied but the courts consistently hold that the company does not hold any funds in trust for him. He must first try to compel the company to take action, through a

37 N. Y. Laws of 1945, c. 869, §§ 1, 2, 3, 4, which repealed section sixty-one-a and added sections sixty-one-b, and sections sixty-three to sixty-eight.
38 Hornstein, New Aspects of Stockholders' Derivative Suits, 47 Col. L. Rev. 1, 2 (1947).
39 N. Y. GEN. CORP. LAW § 61-b.
40 N. Y. GEN. CORP. LAW §§ 63, 64.
request to the Board of Directors, and failing this, he must request the Superintendent of Insurance to intervene. Then if the provisions of Article 6 of the General Corporation Law apply to him, he must supply security for expenses, if he does not hold five per cent of the outstanding policies or if his interest does not exceed fifty thousand dollars. Therefore, if the right of a policyholder to bring a derivative action exists, it is so limited that it is of little practical value under the present state of our law.

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THE EMPLOYER AND THE FIRST AMENDMENT

Equality of opportunity and freedom of action are inherent rights of individuals under any socio-economic system such as our own democracy. Unlimited freedom of action permitted to one group, however, will inevitably infringe upon the goal of equality of opportunity, toward which all strive. The reason for this is apparent: just as the law of physics states, as a fundamental precept, that every action has an equal and opposite reaction, so we find in economics that in any given field where two or more persons have their individual interests, the actions of one taken in his own behalf, will prove correspondingly detrimental to the others. The struggle between labor and management gives perhaps the greatest example of the conflict.

The relationship of employer and employee necessarily results in the economic dominance of the employer over the employee, and this in turn leads to the imposition, to at least some extent, of the will of the employer upon that of the employee. In the words of the National Labor Relations Board: "In the normal relationship between employer and employee, almost any expression of opinion by the employer indicating to those who depend upon his continued good will for their livelihood an unequivocal disapproval of their forming or joining a labor organization characteristically carries home to employees an implied threat of unlawful discrimination for non-compliance with the employer's desires."¹ We find here, therefore, an instance wherein we are compelled in the interest of society to restrict the freedom of activity of one group, the employers, so that another group, the employees, may achieve the desired goal of equality of opportunity. But what is the nature of this restriction, and what limitation is placed upon it by the Constitutional guaranty of freedom of speech?²

² U. S. CONST. AMEND. I. Congress shall make no law respecting an es-